10. FINANCIAL SECTOR

10.1 Monetary Policy

Monetary management in 1997 faced the challenge of supporting the economic recovery, without disturbing the declining trend in inflation in the early part of the year, and maintaining a proper balance between the money market and foreign exchange market. In the context of the East Asian currency turmoil, the domestic financial system had to be guarded against speculative attacks through close monitoring of market developments and appropriate policy responses. Accordingly, the highlights of monetary policy in 1997 were some relaxation of its tightness at the beginning of the year to support an orderly reduction in interest rates and a slight tightening towards the end of the year, to preserve stability in the domestic financial market amidst some uncertainty in the market following the East Asian currency crisis.

Towards the end of 1996, the economy was gradually recovering from the ill effects of the severe drought. Economic activity was picking up. The high levels of monetary expansion seen in the early part of the year had been controlled. Inflationary pressures were abating, as economic activities recovered. Government borrowing from the banking system was reduced as fiscal management improved and the deficit was narrowed. However, credit growth to the private sector was slow and some liquidity constraints were being observed in the market.

The monetary policy was relaxed somewhat in the first few months of 1997 after some years of continued tightness. The statutory reserve requirement (SRR) was reduced twice, the first reduction after 1992. On 17 January, the SRR on rupee deposit liabilities of commercial banks was reduced from 15 per cent to 14 per cent. The SRR on foreign currency deposits placed abroad, which stood at 5 per cent, was abolished. However, the SRR on foreign currency deposits lent domestically was maintained at 15 per cent. On 28 March, a second reduction was effected. The SRR on rupee deposits was reduced from 14 per cent to 12 per cent, while the SRR on foreign currency deposits lent domestically was reduced from 15 per cent to 12 per cent. The SRR on foreign currency deposits placed abroad was maintained at the zero level.

A further measure of relaxation of monetary policy was instituted in January, when, following the announcement made in the Budget 1997, commercial banks were permitted to provide foreign currency loans to direct and indirect non-BOI exporters either from their domestic units or from their Foreign Currency Banking Units (FCBUs). This measure also represented a further liberalisation of the capital account of the Balance of Payments. However, in providing this facility, due precaution was taken by placing specific limits and restrictions to contain the foreign currency exposure of the economy. Foreign borrowings by commercial banks were limited to 15 per cent of their capital. The conversion of domestic currency to repay these loans was not permitted, requiring borrowers to repay only in foreign currency.

Several reasons underlay these measures. In the first instance, the reductions in the SRR were designed to provide an immediate injection of liquidity into the system by releasing around Rs.8,000 million of reserve money held by the Central Bank, to the commercial banks. The consequent increase in the money multiplier would then create the potential for commercial banks to increase their credit levels ultimately by about Rs.20,000-Rs.25,000 million which would help boost credit to the private sector and support the recovery of the economy. Moreover, the reduction in the SRR would reduce the effective cost of funds of commercial banks, thus enabling them to reduce their lending rates. This measure also represented a further step in the Central Bank's move away from the use of direct controls to the use of more market oriented instruments in the implementation of monetary policy. The provision of foreign currency loans to non-BOI exporters was designed to increase liquidity in the market and to enable them to obtain credit at relatively low rates to improve their international competitiveness.

Following the reductions in the SRR, as expected, liquidity in the commercial banks increased significantly. This was initially invested in Treasury bills through purchases from the secondary window of the Central Bank. Gradually, however, the funds moved back into the credit operations of the commercial banks. Commercial banks also reduced their lending rates on many of their loan schemes, reflecting the impact of the reduction in the SRR on their cost of funds. However, as has been observed by many economists, while increases in SRR are effective in reducing credit if there is no excess liquidity, reductions in SRR do not necessarily lead to corresponding increases in credit unless there is additional demand for credit. Thus, due to caution on the part of both borrowers and lenders, the realised credit expansion consequent on the reduction in SRR was slower than expected. Together with additional liquidity arising from the inflow of foreign funds into the system, this led to a situation where commercial banks began increasing their portfolio of government securities and reducing the rates offered on deposits, resulting in lower interest rates at Treasury bill auctions. Overall, the reduction in deposit rates exceeded the reduction in lending rates, as evidenced by a fall in the average weighted deposit rate from 12.3 per cent in December 1996, to 10.0 per cent in December 1997, in comparison to a fall in the average weighted lending rate from 21.0 per cent to 20.1 per cent in the same period. However, the average prime lending rate declined faster from 18.4 per cent to 14.2 per cent during the same period.

A considerable inflow of foreign assets was experienced through the receipts from the Government's privatisation efforts, mobilisation of foreign funds by the development finance institutions and international compensation to victims of the war in Kuwait. These inflows added to the liquidity in the system and led to a further reduction in interest rates. Monetary policy during the second and third quarters of 1997 was therefore directed towards ensuring an orderly reduction in interest rates. Towards this end, open market operations (OMO) were engaged in to mop up excess liquidity. When the Central Bank's holdings of Treasury bills was exhausted, the Bank issued its own securities for OMO. This is the first occasion since 1994 when the Bank has issued its own securities. Short-term Central Bank securities, with maturities of 7 days and 28 days were issued to stabilise the lower end of short-term rates. The total gross value issued amounted to Rs.7,835 million. Implementation of monetary policy was assisted by improved fiscal management. The potential for monetary expansion due to the inflow of privatisation proceeds was dampened to a large extent by an immediate retirement of Rs.10,000 million worth of Treasury bills held by the Central Bank and the build up of government deposits with the Central Bank.

Towards the end of the year, with inflation being a little higher than expected, and some uncertainty being experienced in the foreign exchange market due to the East Asian Currency crisis, policies were implemented to increase short-term interest rates slightly. The repurchase rate, which had been gradually reduced to 7 per cent by April, and stood at 9 per cent during most of the fourth quarter in line with market trends, was increased to 11 per cent by end December. This was both to ensure a positive real rate of return in the short-end of the market as a slight increase in inflation was seen in November and December, and to discourage the use of relatively cheap call market funds for the speculative purchase of foreign exchange. The margin between the Central Bank's discount and rediscount rate for Treasury bills was also increased to influence the cost of liquidity provided by the Bank.

The policy of not granting refinance under the Medium and Long-Term Credit Fund (MLCF) or short-term refinance schemes, except to distressed finance companies, was maintained. However, the outstanding level of past refinance granted declined from Rs.2,259 million at end 1996 to Rs.1,691 million by end December 1997, due to larger repayments.

10.2 Money Supply

Despite a sharp increase in the net foreign assets of the banking system, the deceleration in monetary expansion experienced in the second half of 1996 continued into 1997, due to a repayment of government credit to the banking sector utilising privatisation proceeds, and a slower than expected pick up in bank credit to the private sector. The rate of monetary growth remained low throughout 1997, despite some relaxation of the monetary policy stance in the early part of the year. Although, in contrast to the developments in the previous two years, a large increase in the net foreign assets of the banking system was experienced in 1997, slower growth in domestic credit helped contain monetary expansion. In fact, net credit to government contracted in 1997. The growth of Board Money (M2) stood at 13.8 per cent on a point to point basis at end December 1997 (10.8 per cent at end December 1996), having fallen to a low of 8.0 per cent at end April. With the sharp decline in interest rates and inflation in 1997, the opportunity cost of holding cash or demand deposits declined and Narrow Money (M1), grew at a faster pace than in the past two years. At end December 1997, the point to point increase in M1 was 9.8 per cent, in comparison to 4.0 per cent at end December 1996.

TABLE 10.1
Summary Monetary Statistics

Item	End 1997	Change			
		1996		1997	
	Rs.Bn.	Amount Rs.Bn.	%	Amount Rs.Bn.	%
Monetary Aggregates :					
Narrow Money Supply (M_1)	85.9	3.0	4.0	7.7	9.8
Broad Money Supply (M_2)	288.3	24.7	10.8	35.1	13.8
Underlying Factors					
Domestic Credit to :	272.7	28.5	12.7	20.4	8.1(a)
Government (net)	46.4	13.1	37.0	-2.1	-4.5
Public Corporations	10.3	1.4	16.5	0.4	4.0(a)
Private Sector	216.0	14.0	7.8	22.2	11.4(a)
External Assets (net)	89.3	-4.6	-6.9	27.4	44.3
Other Items (net)	-73.8	0.8	1.3	-12.8	-21.0(a)
Reserve Money	83.7	6.9	8.8	-1.8	-2.1

Source: Central Bank of Sri Lanka

(a) When the effects of the bonds issued by the Treasury in lieu of some former directed credit are removed, the increases were 7.7, 3.6, 10.8 and 17.3 per cent, respectively.

The overall balance of payments showed a significant surplus, reversing the trend of the past two years. This led to a concomitant increase in the net foreign assets (NFA) of the banking system. The major causal factor for the

TABLE 10.2
Monetary Aggregates 1996 - 1997(a)

Rs Million

End of Period	Narrow Money Supply (M_1)						Broad Money Supply (M_2)					
	1996	1997	Percentage Change				1996	1997	Percentage Change			
			Point to Point		Moving Average				Point to Point		Moving Average	
			1996	1997	1996	1997			1996	1997	1996	1997
January	73,783	77,889	5.6	5.6	9.2	9.2	228,090	253,157	18.2	11.0	18.2	16.9
February	77,440	77,597	9.5	0.2	8.9	8.3	234,199	254,967	21.4	8.9	18.5	15.8
March	81,796	80,828	14.7	-1.2	9.0	6.9	239,178	260,657	22.4	9.0	18.9	14.6
April	79,478	80,583	15.7	1.4	9.4	5.7	241,893	261,357	23.4	8.0	19.4	13.4
May	76,620	80,241	12.1	4.7	9.4	5.1	242,072	262,189	22.3	8.3	19.7	12.3
June	75,956	79,670	10.5	4.9	9.4	4.7	240,407	265,104	19.5	10.3	19.8	11.5
July	76,200	79,535	11.7	4.4	9.7	4.1	240,083	267,601	18.4	11.5	19.9	11.0
August	76,185	81,068	9.9	6.4	9.8	3.9	240,097	271,989	16.9	13.3	19.7	10.8
September	76,634	82,287	9.0	7.4	10.0	3.8	241,700	276,994	14.5	14.6	19.4	10.8
October	74,004	83,300	3.5	12.6	9.7	4.5	242,845	279,577	12.8	15.1	18.9	11.1
November	75,276	82,708	4.8	9.9	9.4	4.9	245,227	281,697	12.0	14.9	18.3	11.3
December	78,203	85,851	4.0	9.8	9.2	5.4	253,201	288,258	10.8	13.8	17.5	11.6
Monthly Average	76,798	80,963	9.2	5.5			240,749	268,629	17.7	11.6		

Source: Central Bank of Sri Lanka

(a) Monetary data from 1990 have been reclassified to be consistant with the standard international practice.
Please refer notes to Appendix Tables 100,101 and 105.

TABLE 10.3
Monetary Aggregates and Underlying Factors 1995 - 1997 (a)

Rs. Million

Item	Dec. 1995	Dec. 1996	Dec. 1997	Change 1996 Amount	Change 1996 Percentage	Change 1997 Amount	Change 1997 Percentage
Monetary Aggregates :	42,198	42,565	45,680	367	0.9	3,115	7.3
1. Currency held by the Public	33,019	35,638	40,172	2,619	7.9	4,534	12.7
2 Demand Deposits held by the Public							
Narrow Money Supply (M_1)	75,217	78,203	85,851	2,986	4.0	7,649	9.8
3. Time and Savings Deposits of the Private							
Sector held with Commercial Banks	153,319	174,998	202,406	21,679	14.1	27,408	15.7
Co-operative Institutions	3,598	3,056	3,577	-542	-15.1	521	17.0
Government Corporations	15,888	17,864	16,690	1,976	12.4	-1,174	-6.6
Other Private Sector Constituents (b)	133,833	154,078	182,139	20,245	15.1	28,062	18.2
Broad Money Supply (M_2)	228,536	253,201	288,258	24,665	10.8	35,057	13.8
Underlying Factors							
1. Domestic Credit	223,799	252,317	272,733	28,518	12.7	20,416	8.1
Net Credit to Government	35,447	48,537	46,365	13,090	36.9	-2,172	-4.5
Gross Credit to Government	47,971	64,948	66,569	16,977	35.4	1,620	2.5
By Central Bank	27,458	37,801	26,776	10,343	37.7	-11,025	-29.2
By Commercial Banks	20,513	27,147	39,793	6,634	32.3	12,646	46.6
Govt. Deposits and Cash Balances	12,524	16,412	20,204	3,888	31.0	3,792	23.1
Gross Credit to the Private Sector	188,352	203,780	226,368	15,428	8.2	22,588	11.1
Co-operative Institutions	3,939	1,465	1,661	-2,474	-62.8	196	13.4
Government Corporations	8,527	9,938	10,338	1,411	16.5	400	4.0
Other Private Sector Constituents	175,886	192,377	214,369	16,491	9.4	21,992	11.4
2. External Banking Assets (net)	66,532	61,861	89,286	-4,671	-7.0	27,425	44.3
Central Bank (net)	74,301	73,786	89,930	-515	-0.7	16,144	21.9
Commercial Banks (net)	-7,769	-11,925	-644	-4,156	-53.5	11,281	94.6
3. Other Items (net)	-61,794	-60,978	-73,762	816	1.3	-12,783	-21.0
Other Liabilities (net) of Central Bank	-51,986	-58,476	-57,032	-6,490	-12.5	1,444	2.5
Other Liabilities (net) of Commercial Banks	-9,808	-2,502	-16,729	7,306	74.5	-14,227	-568.6

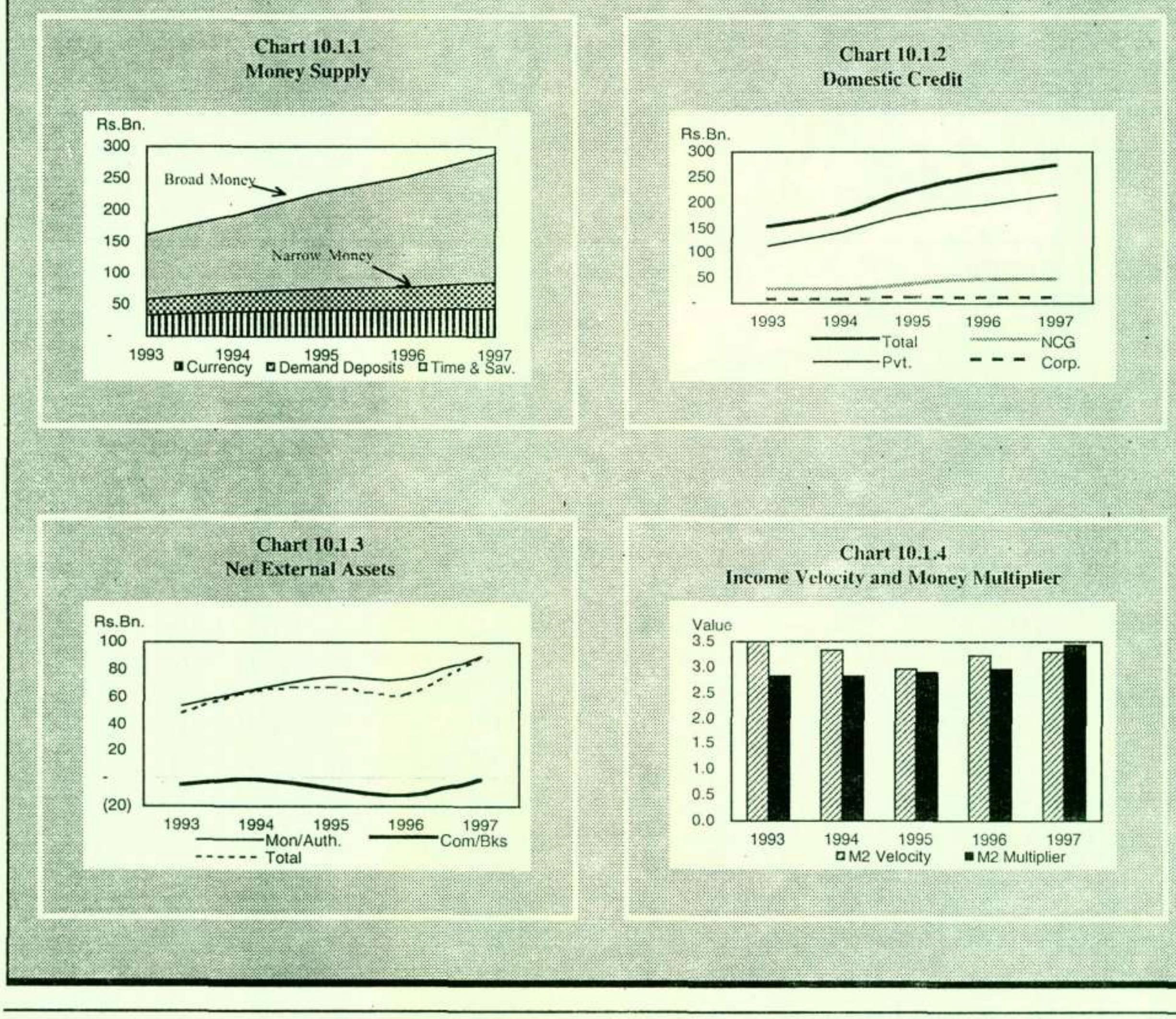
(a) Signs indicate the effect on M2 .
(b) Excludes non-resident foreign currency deposits.

Source: Central Bank of Sri Lanka

increase in money supply in 1997 was this increase in NFA. NFA of the banking system grew by Rs.27,425 million (44 per cent) in 1997, accounting for 78 per cent of the increase in M2, in contrast to a contraction of Rs.4,671 million (7 per cent) in 1996. Declining domestic interest rates and the East Asian currency crisis encouraged commercial banks to improve their net foreign assets position. NFA of the commercial banks increased by Rs.11,281 million, while their gross foreign assets increased by Rs.20,047 million.

Net domestic assets of the banking system increased by only 4 per cent in 1997 in comparison to a much higher increase of 18 per cent in 1996, and accounted for only 22 per cent of the increase in M2. A contraction in credit to the Government from the banking system and slower growth in private sector credit were primarily responsible for this dampened growth. A reduced deficit following improved fiscal management and assisted by receipts exceeding Rs.22,000 million from the privatisation programme enabled the Government to reduce its liabilities to the banking sector by Rs.2,172 million. This was the net result of a reduction of Rs.13,991 million of credit from the Central Bank and an increase in credit of Rs.11,819 million from commercial banks. This implies a significant reduction in the expansionary impact of government borrowing as credit from the Central Bank expands the stock of high powered money (reserve money), creating the potential for even greater expansion in money supply and consequent inflation. Furthermore, the increase in credit from commercial banks represented a discretionary change in the asset portfolio of commercial banks, rather than new credit obtained by the Government. Commercial banks exercised greater caution in their lending operations in 1997 and demonstrated a preference for investment in government securities, which are

Chart 10.1
Monetary Aggregates, Velocity and Money Multiplier



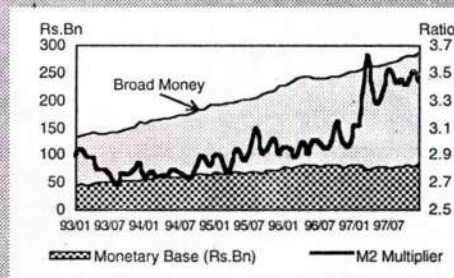
assets without default risk. Commercial bank holdings of government securities increased by Rs.6,736 million, in comparison to an increase of Rs.3,978 million in 1996, despite the lower yield on these instruments in 1997 than in 1996.

Private sector credit grew at a slow pace of 11.4 per cent or Rs.22,188 million in 1997, as against 7.8 per cent or Rs.25,736 million in 1996. Both supply and demand factors contributed to this moderate growth. Commercial banks displayed greater caution in extending credit from their domestic units. Demand too was constrained, with some borrowers adopting a wait and see approach towards large scale investments, while others resorted to credit from FCBUs or development finance institutions. Some corporate borrowers also obtained funds directly from investors through rights issues and the issue of commercial paper due to a downward rigidity in commercial bank lending rates, reducing the demand for bank credit. However, a somewhat different picture emerges when one considers total lending, inclusive of credit from FCBUs, as discussed below.

Credit expansion picked up in the last two months of the year. Of the total increase in credit to the private sector from the domestic units of commercial banks, 40 per cent (Rs.8,894 million) was granted in November and December. Credit to government corporations increased by 4 per cent in 1997, in comparison to an increase of 17 per cent in 1996, due to high credit utilisation by the Ceylon Petroleum Corporation and the C.W.E.

In view of the increasing impact of FCBU transactions on the domestic economy, a consolidated monetary survey including both the domestic units and the FCBUs of commercial banks was compiled for the first time in 1996. This was continued in 1997. The consolidated monetary survey indicated a 13.2 per cent point to point growth in broad money at end 1997, in comparison to a growth of 11.3 per cent at end 1996. An analysis of the causal factors of this growth indicted that 58 per cent of the growth was due to the growth in NFA and 42 per cent due to growth in net domestic assets, whereas in 1996, the change in NFA contributed to a 5 per cent decline in money supply. As in the case of the conventional monetary survey including the domestic units alone, net credit to the government from the banking system showed a contraction (of Rs.1,881 million). However, in contrast to the results in the domestic unit monetary survey, credit to the private sector has grown by 14.3 per cent in 1997, in comparison to 8.9 per cent in 1996. Total credit extended to the private sector amounted to Rs.32,878 million in 1997, as against Rs.30,789 million in 1996, indicating an increase in the credit from FCBUs. This credit from FCBUs is obtained mainly by BOI firms. With approximately 16 per cent of GDP coming from the manufacturing sector and 82 per cent of industrial exports being accounted for by BOI firms, it is clear that FCBUs have provided a significant amount of credit for the economic activity in the country. The consolidated monetary survey also indicates that the slower growth in credit from the domestic units of commercial banks is offset by the additional credit provided by the FCBUs.

Chart 10.2
Monetary Base and Money Multiplier



Reserve Money

Reserve money (high powered money or base money) decreased by Rs.1,773 million (2.1 per cent) in 1997 to Rs.83,736 million at the end of December, in contrast to an increase of Rs.6,922 million (8.8 per cent) in 1996. However, this decrease must be viewed in the context of the decreases in the statutory reserve requirement (SRR), which released around Rs.8,000 million of reserve money (RM) held with the Central Bank to the commercial banks for their usual operations. On the sources side, the decrease in reserve money was primarily due to a decrease in net credit to government of Rs.13,991 million, which was mainly a consequence of the retirement of Rs.10,000 million worth of Treasury bills held by the Central Bank and the build up of deposits with the Central Bank through the use of the proceeds from privatisation. This was offset by a significant increase in the net foreign asset holdings of the monetary authorities. From the perspective of uses, commercial bank deposits held with the Central Bank decreased by Rs.5,370 million as the effect of the reduction in SRR overrode the effect of the additional reserves required on increased deposits with commercial banks. Currency in circulation increased by Rs.3,655 million. Reflecting the impact of the reduction in the SRR, the money multiplier (M2/RM) increased and remained in the range of 3.12-3.63 in 1997, compared with 2.88-3.01 in 1996. The income velocity of money increased slightly to 3.3 in 1997, from 3.2 in 1996.

10.3 Interest Rates

The year 1997 was characterised by a fall in interest rates, mainly due to increased liquidity in the market, declining inflationary expectations, improved fiscal performance and a relatively low interest rate volatility due to active open market operations by the Central Bank. The introduction of market oriented medium-term Treasury bonds by the Government provided a medium-term risk free yield curve to the public. After a sharp decline in interest rates in the early part of the year, rates stabilised and interest rate volatility was very low.

Short-term Interest Rates

The main short-term interest rates are the overnight Repo rate, the secondary market Treasury bill rates, inter-bank call rates, the 3, 6, 12 months Treasury bill rates, and the deposit and lending rates for periods under one year. During 1997, almost all short-term rates declined sharply due to improved Treasury cash management, assisted by inflows from privatisation, a favourable balance of payments position, the reduction in SRR by the Central Bank and the permission granted to non-BOI exporters to obtain foreign currency loans. Many of these factors worked to reduce the yield on Treasury bills of all maturities. This led to a general downward movement in the interest rate structure of the country, demonstrating the importance of Treasury bill yields as a leading indicator in determining other interest rates in the market. The rates applicable to Central Bank Treasury bill transactions (i.e., repo and secondary markets) also moved in line with market rates.

Chart 10.3
Interest Rates

Chart 10.3.1
Treasury Bills

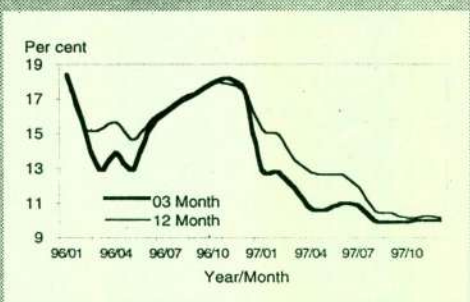


Chart 10.3.2
Deposit Rates

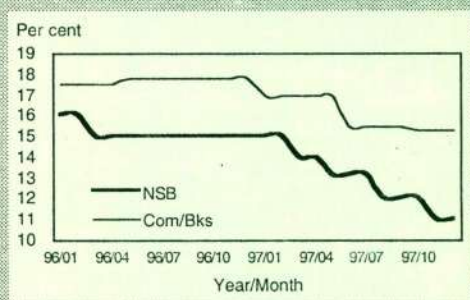


Chart 10.3.3
Lending Rates

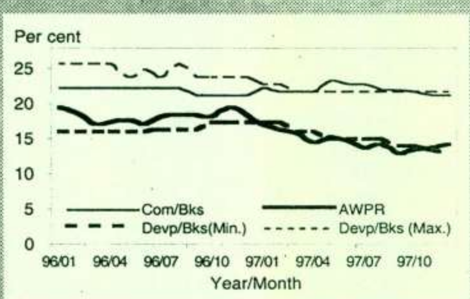
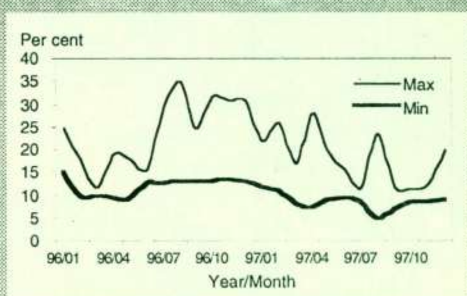


Chart 10.3.4
Call Market Rates



Primary Market Treasury Bill Rates

At the beginning of 1997, the 3-month Treasury bill rate was 17.14 per cent. It declined to 12.86 per cent at end January 1997. This rate gradually declined further thereafter as inflation fell rapidly and liquidity was released to the market through the reduction in the SRR and further improved due to foreign inflows. The 3-month yield fell to a low of 9.91 per cent at end October, following the retirement of Rs.10,000 million of Treasury bills held by the Central Bank in August and the inflow of proceeds from privatisation, before rising marginally to 9.97 at end December 1997. In line with the same trends, the 6-month and 12-month Treasury bill rates also declined from 17.03 per cent to 10.09 per cent and 17.11 per cent to 10.21 per cent, respectively, during the year 1997. Almost all the auctions were over-subscribed, despite the fall in yields, indicating the improvement in market liquidity.

Secondary Market and Repo Market Rates

The secondary market in Treasury bills plays an important role in the open market operations of the Central Bank. The yield rates offered by the Central Bank for its repo, discount and rediscount operations also directly affect the short-term interest rate structure in the money market. In line with the primary market rate trend, repo, discount and rediscount rates were reduced. During January 1997, the 3-month discount rate of the Central Bank varied between 12.61-16.89 per cent, while the 3-month rediscount rate varied between 14.36-18.64 per cent. However, after February, the 3-month discount rate declined gradually from 12.53 per cent to 9.62 per cent in October, before rising to 9.97 per cent at end December 1997. The 3-month rediscount rate varied in the range 18.64 - 14.36 per cent in January and then declined gradually from 13.99 per cent in the first week of February to 10.95 per cent in the first week of September and thereafter increased to 12.97 per cent at end December 1997. The stability in the discount and rediscount rates assisted in stabilising rates in the inter-bank call money market. The margin between the discount rate and the rediscount rate was maintained at 1.75 percentage points during the first five months of 1997.

The Central Bank was a net seller in the secondary market (the volume of bills discounted exceeded the volume of bills rediscounted) during this period, indicating that the economy was experiencing additional liquidity. From the last week of May 1997 to end August the margin between the discount rate and the rediscount rate was reduced to 1.25 percentage points to ease a temporary liquidity shortage in the market, evidenced by a rise in the call market rates towards the end of May. In June 1997, the Central Bank of Sri Lanka was a net purchaser of Treasury bills in the secondary market, thus injecting liquidity into the market. With the subsequent improvement in market liquidity, the Central Bank again became a net seller in the secondary market towards the end of the third quarter and the margin between the discount rate and the rediscount rate was raised to the earlier level of 1.75 percentage points in September.

The financial crisis in East Asia and the sharp depreciation of certain currencies in the region appeared to cause some concern that a similar depreciation would be experienced by the Sri Lankan rupee. This led exporters to delay repatriating their export proceeds and importers to obtain forward cover for the payment of their import bills. The fall in domestic interest rates also reduced the opportunity cost of using rupee funds. Commercial banks, who thus faced a shortage of foreign exchange for transactions, purchased exchange from the Central Bank. Banks obtained rupee funds for these purchases partly by selling Treasury bills to the Central Bank. Therefore, to discourage speculative activity, and because a slight increase in inflation was experienced towards the end of the year, the Central Bank raised its repo rate and the rediscount rate. The margin of 1.75 percentage points between the discount rate and the rediscount rate was increased to 2.25 per cent at end November and again by 1.00 percentage point during December to reach 3.25 per cent at end 1997, raising the overnight rediscount rate to 12.85 per cent.

The Central Bank's overnight repo rate, which was 12.75 per cent at the beginning of the year, was reduced to 11.00 per cent by the end of February 1997 and to 7.00 per cent in April in line with market trends and in view of the liquidity in the market. Thereafter, until the end of November, the repo rate was maintained in a narrow range of 8.00-9.00 per cent. In December, for the reasons indicated above, it was gradually increased to reach 11.00 per cent at the end of the year.

Deposit Rates

Deposit rates of commercial banks play a vital role in determining their cost of funds as well as the return to the deposit holders of the bank. In line with the reduction in Treasury bill rates, and because of the availability of liquid funds in the market, commercial bank deposit rates declined by 4.00-7.00 percentage points for many deposits during the year. Savings deposit rates of commercial banks, which were in the range of 4.50-13.00 per cent in 1996, declined to 3.00 to 11.00 per cent by end 1997. Fixed deposit rates of commercial banks declined from 9.00-17.75 per cent to 8.50 to 15.25 per cent in 1997. The Average Weighted Deposit Rate (AWDR), which is estimated by using all savings, time and other deposit rates of commercial banks, declined from 12.3 per cent at end December 1996 to 10.00

per cent at end December 1997. The Average Weighted Fixed Deposit Rate (AWFDR) declined from 14.3 to 11.5 per cent during this period.

The National Savings Bank (NSB), showing greater flexibility in its interest rates than in the past, revised its deposit rates on 12-month fixed deposits downward from 15.00 per cent at end February 1997 to 14.00 per cent in March and to 13.20 per cent in May, following market trends. In August 1997, this rate was further decreased to 12.00 per cent and in November to 11.00 per cent. Furthermore, in line with the declining trend in short-term rates, the interest on savings deposits was also decreased to 10.80 per cent in May 1997, from 12 per cent.

Lending Rates

Lending rates of banks declined on average by about 1-2 percentage points during the year. This reduction could be seen mainly in the priority sectors. The Average Weighted Lending Rate (AWLR), which is based on the Quarterly Survey of Bank Advances, declined from 21.1 per cent in September 1996 to 20.5 per cent in September 1997. This indicates that the benefit obtained from the SRR reduction by the banks has still not been fully transferred to their customers. Hence, the gross interest spread throughout much of 1997 has been higher than in the previous year.

The Average Prime Lending Rate (AWPR), the rate which commercial banks apply on loans to their prime customers, however, declined sharply from 20.2 per cent at end December 1996 to 14.5 per cent at end December 1997. The monthly average of the AWPR declined by 4.2 percentage points (18.4 per cent in December 1996 to 14.2 per cent in December 1997). This reveals that prime customers of commercial banks were the main beneficiaries of the interest rate reduction during the year.

The inter-bank call market, which provides short-term working capital for the commercial banks, provided cheaper funds for the banks in 1997 than in 1996. During the major part of 1997, call market rates were in the range 9.00-28.00 per cent, in comparison to a range of 9.00-35.00 per cent in 1996. On a few days in February, April and May, the rate rose above 20 per cent. An increasing trend was seen again in the last 3 weeks of the year following the uncertainty in the foreign exchange market and the reduction of market liquidity resulting from the purchase of foreign exchange by commercial banks from the Central Bank. Call rates reached 20 per cent at the end of the year due to a liquidity shortage, arising from seasonal factors as well as the behaviour of the exporters and importers reacting to the regional crisis.

Interest rates charged by FCBUs are based on the London Inter Bank Offered Rate (LIBOR). Most FCBUs lend money to their customers at LIBOR plus a mark-up of 1 to 4 percentage points. The deposit rates of FCBUs on US dollars were 5 to 6 per cent, sterling pounds 6 to 7 per cent and Deutsche marks around 5 per cent. In case of the foreign currency loan facility to non-BOI exporters, lending rates were slightly higher and were in the range 6.26 to 10.50 per cent.

In recent years, commercial paper, which are unsecured promissory notes, have become a popular financial instrument in the corporate sector and the commercial banking sector. The rate on commercial paper was in the range of 12-24 per cent during the year and many commercial banks were involved with this business during the year.

The Legal Rate and the Market Rate, which are published by the Central Bank under the Civil Procedure Code (Amendment) Act No.6 of 1990 and in terms of Section 23 of the Debt Recovery (Special Provision) Act No.2 of 1990, respectively, were 12.7 per cent in 1997 (18.0 per cent in 1996).

Long-Term Rates

Long-term rates include yields on Government securities and Treasury bonds, lending rates of specialised banks, and rates of other long-term credit institutions. The interest rate on Government securities (Rupee Loans), which are administratively determined, showed a declining trend in 1997. The rate on Rupee Loans with maturities of 2-4 years issued during the first five month period declined from 14.5 per cent to 12.50 per cent. Interest rates on Rupee Loans of 5-7 years and 6-7 year maturities, which were 14 per cent in 1996, declined to a 11.25 - 12.25 per cent range during 1997.

In 1997, the Government introduced a new market oriented medium-term financial instrument, namely Treasury bonds, to the market. The maturity of the Treasury bonds issued ranged from 2 to 4 years. The weighted average yield rate on this new instrument, which started at 14 per cent per annum for 2-year bonds in March, fell to 11.56 per cent by September. The yield on the last issue, a 4-year bond issued in October was 11.36 per cent per annum. These yields are market determined and provided some indication of the movement in long-term rates. The availability of these Treasury bond yields further helps to build up a longer-term yield curve in the financial market, and provides risk free benchmark rates for the private sector.

Interest rate, charged by specialised banks and the other long-term credit institutions also declined during the year.

The Development Finance Corporation of Ceylon Bank (DFCC), State Mortgage and Investment Bank (SMIB) and National Development Bank (NDB) reduced interest rates from 16.40 - 24.00 per cent in December 1996 to 13.00-22.00 per cent by December 1997. The lending rates of the National Housing Development Authority (NHDA) remained unchanged in the range of 10-15 per cent during the year. Long-term lending rates of the NSB declined from 17.00-20.00 per cent in December 1996 to 15.50-16.50 per cent in December 1997. The rate offered by the SMIB on one year deposits was reduced from 17 per cent per annum at the beginning of 1997 to 14 per cent in May and to 11 per cent in December 1997.

During the year, one listed public company issued long-term debt instruments (debentures) quoted on the Colombo Stock Exchange. The debenture interest rate declined from 18 per cent at the beginning of the year to 15 per cent at the end of 1997, in comparison to an interest rate range of 17.5 - 20.9 per cent for debentures issued in 1996.

10.4 Commercial Banking

With the recovery of the economy in 1997, commercial banks showed an improved performance. The reduction in the SRR increased the loanable funds in commercial banks while enabling them to reduce their lending rates. At the same time, the availability of liquid funds in the market and the decline in yield rates on government debt instruments led to a reduction in their deposit rates. Commercial banks preferred to invest in low risk government securities rather than lend aggressively to the private sector. Commercial bank holdings of Treasury bills and government securities showed an increase of 41 per cent in 1997 when compared to the increase of 33 per cent in 1996, in spite of the decline in yields. Private sector investors were also cautious about making large scale investments. Credit from the FCBUs to the private sector has expanded. Non-BOI exporters benefited from the new foreign currency loan facility which came into effect from January 1997. Gross lending under this facility amounted to approximately US dollars 254 million. Total

TABLE 10.4
Selected Items of Assets and Liabilities of Commercial Banks

Item	Change			
	96 Dec/95 Dec		97 Dec/96 Dec	
	Amount (Rs. Mn.)	%	Amount (Rs. Mn.)	%
Assets Category				
1. Liquid Assets	14,059	16.8	21,428	21.9
Cash on Hand	2,429	54.1	540	7.8
Due from Central Bank	3,310	10.7	-5,228	-15.3
Foreign Currency on Hand	411	1.9	19,385	87.1
Treasury Bills	3,978	34.4	4,960	31.9
Commercial Bills	3,931	26.6	1,771	9.5
Local Bills	-80	-36.6	-61	-44.4
Import Bills	3,416	38.1	1,072	8.7
Export Bills	594	10.6	760	12.2
2. Investments	7,686	39.9	8,454	31.4
Treasury Bills	3,978	34.4	4,960	31.9
Government Securities	88	11.7	1,776	211.3
Other Investment	3,620	52.0	1,718	16.2
3. Total Loans and Advances	15,430	8.3	27,766	13.7
Loans	10,075	9.4	19,968	17.0
Overdrafts	1,424	2.2	6,027	9.1
Commercial Bills	3,931	26.6	1,771	9.5
4. Fixed and Other Assets	24,459	42.5	2,937	3.6
Liability Category				
1. Capital Accounts	5,778	17.3	5,131	13.1
2. Total Deposits	33,675	14.8	40,340	15.4
Demand Deposits	6,291	14.8	3,837	7.9
Time & Savings Deposits	27,384	14.7	36,502	17.1
3. Borrowings	11,152	65.4	-786	-2.8
Local Borrowings	11,949	83.8	-2,037	-7.8
Foreign Borrowings	-797	-28.6	1,251	63.0
4. Other Liabilities	3,678	6.5	8,310	13.7
Total Assets/Liabilities	54,283	16.2	52,994	13.6

Source: Central Bank of Sri Lanka

assets of commercial banks grew by 14 per cent in 1997 compared to a rise of 16 per cent in 1996. Net external assets increased by Rs.11,281 million, in their attempt to restore foreign assets after a decline in the previous year. The decline in domestic interest rates, the inflow of foreign funds through the capital account and the uncertainty in exchange markets in East Asia have all contributed to commercial banks improving their net foreign asset position substantially.

Structure of Assets and Liabilities

The total resources of commercial banks increased by Rs.52,994 million or by 13.6 per cent in 1997, reflected mainly in the growth of loans and advances and foreign currency holdings. Reflecting the economic recovery in 1997, total loans and advances of commercial banks excluding advances to the Government expanded by 13.7 per cent and contributed 51 per cent of the growth of their assets. The increase in foreign assets contributed 38 per cent of the growth in total assets, while also helping to improve the liquidity of banks. The overall liquid asset to total assets ratio increased from 25 per cent in 1996 to 27 per cent in 1997.

Holdings of commercial bills, which consist of export bills, import bills and local bills grew at a slower rate of 9.5 per cent in 1997 compared to 26.6 per cent in 1996. Investments in export bills, however, increased by 12.2 per cent compared with an increase of 10.6 per cent in 1996. In line with the slower growth of imports, investments in import bills increased at a lower rate of 8.7 per cent.

On the liabilities side, a major development was a 7.8 per cent reduction in domestic interbank borrowings, as the liquidity of banks had improved significantly after the reduction in the SRR. In addition there was also a 15.4 per cent growth in deposits compared with a slightly lower rate of expansion of loans and advances. This phenomenon helped to stabilise interest rates.

Capital account balances increased by 13.1 per cent (Rs.5,131 million) in 1997, compared to the 17.3 per cent (Rs.5,778 million) increase in 1996. The banks continued to maintain the ratio of shareholders funds to total assets unchanged at 10 per cent in 1997.

Foreign assets during the year recorded a large increase of 70.2 per cent compared with only 4 per cent in 1996. Assets with banks abroad increased from Rs.8,736 million at end 1996 to Rs.18,260 million at end 1997. Foreign assets with FCBUs at Rs.12,935 million at end 1996, increased by 76.4 per cent to Rs.22,817 million at end 1997. The capital inflows that resulted from the privatisation process and the compensation paid to Kuwaiti workers, together with the uncertainty associated with the crisis in currency markets in East Asia encouraged commercial banks to maintain higher levels of foreign assets. Moreover, the decline in domestic interest rates made it much less profitable for commercial banks to shift their portfolio holdings from foreign currency to rupees. Foreign liabilities, which consist mainly of Non Resident Foreign Currency (NRFC), Resident-Non National Foreign Currency (RNNFC) and Resident Foreign Currency (RFC) deposits, increased by 21.7 per cent in 1997 compared to a 15 per cent increase in 1996. The reduction of the interest rate differential in favour of the domestic currency deposits caused by the decline in domestic interest rates, mainly the reduction in Treasury bill yields, together with the speculation of a large depreciation in the rupee, would have encouraged these deposit holders to retain their savings in foreign currency accounts, rather than converting them to rupees.

As the commercial banks changed the structure of their portfolios of investments by increasing their Treasury bills and Treasury bond holdings from Rs.15,530 million in 1996 to Rs.22,266 million (43.4 per cent increase) in 1997, net credit to government from commercial banks increased to Rs.11,819 million.

Sources and Users of Funds

Reflecting the strong recovery in the economy and the corresponding increase in economic activity, the total net availability of resources to the commercial banks rose by Rs.30,074 million in 1997, in comparison to an increase of Rs.20,945 million in 1996. As has been the case in the past, the domestic private sector was the major source of funds, contributing over half the increase in 1997. In addition, the Central Bank and other assets and liabilities were important sources of funds. The government sector and the foreign sector were the major users of funds.

The domestic private sector continued to be the biggest source of resources to the commercial banks, providing Rs.15,081 million of funds. These funds came primarily from the placement of deposits with the banks. A noteworthy feature in 1997 was that the Central Bank, which usually absorbs funds through the imposition of SRR, released funds to the banks with the reduction in the SRR from 15 per cent to 12 per cent. The co-operative sector was a net provider of resources to the banking system, as in the previous year. An increase in the capital and reserves held by the banks and an increase in other liabilities caused other assets and liabilities to become a net supplier of funds to the banks, in contrast to 1996, when this sector was a net user of funds.

The major users of funds were the government sector and the foreign sector. As commercial banks increased their

TABLE 10.5
Sources and Users of Resources of Commercial Banks

Rs. Million

Category	Change (a)			
	1996			
	Sources	Users		
1 . Government Sector		**2,471**		**12,797**
Holdings of Govt. Securities	4,066		6,736	
Deposits	3,419		827	
Import Bills		1,631		1,920
Short-Term Credit		619		406
Overdrafts	427			4,562
2 . Central Bank		**5,227**	**5,413**	
Borrowings	425		725	
Reserves		3,310	5,228	
Investments in Central Bank Securities	88			
Till Cash		2,429		540
3 . Government Corporations	**383**			**973**
Deposits	1,794			573
Advances		1,411		400
4 . Co- operatives	**1,639**		**425**	
Deposits		835	621	
Advances	2,474			196
5 . Other Domestic Private Sector	**12,598**		**15,081**	
Deposits (b)	23,721		32,455	
Local Bills		1,025	248	
Import Bills		693		490
Overdrafts		3,483		1,731
Loans		8,329		17,323
Investments in Securities & Bonds		3,708		1,718
Debentures	6,115		3,640	
6 . Inter-Bank Transactions	**2,169**			**5,023**
Balances with Domestic Banks	1,012		535	
Deposits & Borrowings with Domestic Banks	3,181			5,558
7. Foreign Sector	**4,157**			**11,281**
Borrowings		797	1,251	
Deposits	6,057		7,515	
Foreign Balances including Export Bills		1,103		20,047
8. Other Assets & Other Liabilities		**13,247**	**9,155**	
Capital & Reserves	5,778		5,131	
Fixed Assets		1,495		1,436
Long Term Govt. Bonds		19,883	1,000	
Restructuring Bonds	491			
Other Assets		3,571		2,501
Other Liabilities	5,433		6,962	
Total Net Sources/ Users	**20,945**	**20,945**	**30,074**	**30,074**

Source: Central Bank of Sri Lanka

(a) The bold figures indicate whether each sector is a net source or a net user of resources.
(b) Includes long- term deposits mobilised by the two state banks under the special savings schemes.

holdings of government securities and extended additional credit to the Government through the discounting of import bills and the provision of short-term credit, the government sector absorbed 43 per cent of the total increase in commercial bank resources in 1997. The large reduction in the differential between domestic interest rates and foreign interest rates and the uncertainty in foreign exchange markets due to the East Asian financial crisis in the latter part of the year encouraged banks to build up their foreign assets, while increasing their foreign liabilities by a much smaller amount. Reflecting this significant improvement in the net foreign asset position of commercial banks, the foreign sector became a net user of foreign resources. In contrast, this sector was a net supplier of funds in 1996. Government corporations too were net users of funds in 1997, whereas they had been net suppliers in the previous year.

Commercial Bank Loans and Advances[1]

The Quarterly Survey of commercial banks loans and advances showed little change in the composition of loans and advances. There has been a marginal increase in the share of consumption credit, from 7.5 per cent to 8.8 per cent of the total. Consumption loans increased by 20.2 per cent compared with 13.4 per cent in 1996. This increase in consumption credit could be attributed to both the reduction in interest rates in 1997 and the increase in income arising from a robust growth in the economy.

Confirming the importance of trading activity to commercial banking, this sector continued to absorb the largest amount of bank credit. The trading sector accounted for 42.4 per cent of the total credit outstanding as at end September 1997.

The industrial sector was the second largest recipient of credit. Its share in total credit accounted for 12.3 per cent of the total, compared to 13.7 per cent in 1996. It is noteworthy, that a major share of industrial sector credit is now obtained from FCBUs and the two development finance institutions.

Credit to housing and property development fell marginally by 0.6 per cent in the 12-month period ending September 1997, as compared to the 27 per cent growth during the previous period, reflecting reduced investment in this sector. Consequently, its share in total loans decreased slightly from 12.8 per cent at end September 1996 to 12.4 per cent at end September 1997.

In respect of collateral, 89 per cent of the loans were secured, while 25 per cent of the total loans were issued

1 The analysis is based on data for the first three quarters of 1997.

TABLE 10.6
Commercial Bank Advances by Purpose and Maturity (a)

Category	Short Term (1) Amount Rs. Mn.	Short Term (2) (1) as % of (7)	Medium Term (3) Amount Rs. Mn.	Medium Term (4) (3) as % of (7)	Long Term (5) Amount Rs. Mn.	Long Term (6) (5) as % of (7)	Total (7) Amount Rs. Mn.	Total (8) (7) as % of Grand Total
1. Trading								
September 1996	69,658	78.5	15,089	17.0	3,981	4.5	88,728	43.8
December 1996	68,762	77.6	15,836	17.9	4,006	4.5	88,603	45.1
September 1997	70,429	75.7	17,839	19.2	4,708	5.1	92,976	45.1
2. Financial								
September 1996	4,975	58.7	2,709	32.0	793	9.4	8,476	4.2
December 1996	4,895	58.8	2,248	27.0	1,179	14.2	8,322	4.2
September 1997	4,346	57.5	2,563	33.9	655	8.7	7,563	3.7
3. Agricultural								
September 1996	7,178	65.9	2,753	25.3	959	8.8	10,890	5.4
December 1996	7,127	66.7	2,666	24.9	898	8.4	10,691	5.4
September 1997	6,974	64.7	2,808	26.1	996	9.2	10,778	5.2
4. Industrial (b)								
September 1996	18,112	65.2	6,508	23.4	3,144	11.3	27,764	13.7
December 1996	18,633	72.4	4,883	19.0	2,212	8.6	25,727	13.1
September 1997	18,333	72.0	4,407	17.3	2,706	10.6	25,445	12.3
5. Tourism								
September 1996	1,753	54.7	625	19.5	824	25.7	3,202	1.6
December 1996	1,776	53.2	641	19.2	919	27.5	3,336	1.7
September 1997	1,470	45.0	663	20.3	1,131	34.7	3,264	1.6
6. Housing								
September 1996	5,525	21.4	9,507	36.8	10,800	41.8	25,832	12.8
December 1996	5,543	23.0	8,711	36.2	9,810	40.8	24,064	12.3
September 1997	6,498	25.3	10,014	39.0	9,159	35.7	25,671	12.4
7. Consumption								
September 1996	8,847	58.3	3,216	21.2	3,122	20.6	15,184	7.5
December 1996	9,870	60.5	3,439	21.1	3,004	18.4	16,314	8.3
September 1997	11,483	62.9	3,631	19.9	3,140	17.2	18,254	8.8
8. Other Loans								
September 1996	14,192	63.6	5,903	26.5	2,210	9.9	22,304	11.0
December 1996	12,933	67.4	4,001	20.8	2,263	11.8	19,196	9.8
September 1997	15,037	67.1	4,828	21.5	2,558	11.4	22,423	10.9
9. Total								
September 1996	130,239	64.4	46,307	22.9	25,833	12.8	202,379	100.0
December 1996	129,539	66.0	42,424	21.6	24,290	12.4	196,253	100.0
September 1997	134,570	65.2	46,753	22.7	25,052	12.1	206,375	100.0

Source: Central Bank of Sri Lanka

(a) Advances include loans,overdrafts and bills discounted and exclude cash items in process of collection.
(b) Includes advances granted to the Engineering and Building Trade, Mining and Fishing.

against immovable property, plant and machinery. About 16 per cent of the loans were covered by personal guarantees and promissory notes.

The maturity structure reflected a slight increase in short-term credit from 64.4 per cent to 65.2 per cent of the total.

Foreign Currency Banking Units

Foreign Currency Banking Units (FCBUs) expanded more vigorously in 1997 than in 1996. As in 1996, 26 FCBUs were in operation in 1997. However, the total assets/ liabilities increased by 26 per cent, in comparison to an increase of only 1.6 per cent in 1996. Both the international

TABLE 10.7

Advances by Type of Security (a)
September 1996 - September 1997

Security	30 Sep. 1996		31 Dec. 1996		30 Sep. 1997	
	Amount Rs. Mn.	% of Total	Amount Rs. Mn.	% of Total	Amount Rs. Mn.	% of Total
1. Documentary Bills	6,038	3.0	6,132	3.1	6,032	2.9
2. Government Securities	9,007	4.5	3,330	1.7	2,684	1.3
3. Shares of Joint Stock Companies, Bonds, Debentures and Sundries including Cash Value of Life Policies	2,906	1.4	2,793	1.4	2,139	1.0
4. Fixed, Savings & Other Cash Deposits and CDs	18,406	9.1	18,485	9.4	20,860	10.1
5. Stocks in Trade	16,493	8.1	16,107	8.2	16,597	8.0
6. Immoveable Property, Plant & Machinery	50,476	24.9	52,823	26.9	52,384	25.4
7. Personal Guarantees and Pro Notes	32,005	15.8	30,555	15.6	31,543	15.3
8. Trust Receipts	10,510	5.2	13,101	6.7	11,407	5.5
9. Purchase Agreements	1,991	1.0	2,076	1.1	1,301	0.6
10. Tractors & Motor Vehicles	2,935	1.5	2,988	1.5	2,791	1.4
11. Other Securities	28,731	14.2	28,144	14.3	32,046	15.5
12. Unsecured	22,880	11.3	19,719	10.0	26,591	12.9
TOTAL	202,379	100.0	196,253	100.0	206,375	100.0

Source: Central Bank of Sri Lanka

(a) Excludes cash items in the process of collection and advances granted for financing purposes under the guaranteed price scheme.

activities of FCBUs and their interaction with the domestic economy grew in 1997, in comparison to 1996 when activities had been at a comparatively low level. FCBUs obtained significant amounts of resources from resident sources, as well as non-resident sources. Foreign currency deposits with domestic banking units and deposits by BOI enterprises were the main avenues of obtaining funds from resident sources, both banks and non-banks were non-resident sources. These funds were deployed by FCBUs in two major areas, viz., investments with non-resident enterprises and loans and advances to BOI enterprises. The net foreign liabilities of FCBUs (i.e., net liabilities to non-residents) declined from US dollars 109.5 million at end 1996 to US dollars 20.4 million at end 1997, which is a considerable improvement. At end 1997, 41 per cent of the assets of FCBUs were placed with non-residents, while 42 per cent of the liabilities were to non-residents.

Total gross assets of FCBUs increased by US dollars 233.8 million to US dollars 1,663.4 million. Of this increase, 63 per cent was due to an increase in claims on non-residents. Placements with banks abroad represented 80 per cent of the increase in claims on non-residents while the balance 20 per cent were claims on non-banks. It is important to monitor carefully the changes in the net liabilities (or net exposure) of FCBUs, particularly with non-residents, as well as the asset quality. In addition, as the FCBUs are increasingly being integrated with the domestic economy as more and more enterprises are entitled to FCBU facilities, prudential norms will have to be set to help improve their performance.

FCBUs continued to be a significant source of funds to BOI enterprises, thus fulfilling one of the purposes for which these Units were permitted to be established. Credit provided to BOI enterprises increased by 28.4 per cent (US dollars 117.9 million) in 1997. Credit to other approved enterprises, however, decreased by 13.3 per cent (US dollars 31.4 million), primarily on account of reduced credit to public corporations. A sum of US dollars 4.2 million had been extended by FCBUs to non-BOI exporters under the special scheme which commenced in January 1997 with the implementation of the 1997 Budget proposal to extend foreign currency loans to non-BOI enterprises. Most of the loans under that facility, however, were extended through the domestic units, rather than through FCBUs.

On the liabilities side, 39 per cent of the increase was to non-residents and the balance increase was largely on account of placement of funds by domestic units. This increase was US dollars 141 million. Liabilities to BOI enterprises increased by US dollars 60.2 million, while the liabilities to other approved (non-BOI) organisations declined by US dollars 18 million.

10.5 Central Banking

The Central Bank of Sri Lanka, continued to perform its functions throughout 1997 to achieve its objectives of maintaining the internal and external stability of the rupee and promoting economic growth. In particular, the Bank worked to ensure the availability of money and credit and stabilise their cost in the economy throughout 1997 in line with national macro economic objectives. In this regard, a substantial reduction in the cost of money (interest rates), with minimising of volatility, could be regarded as important achievements of the Central Bank during the year.

The major changes in the Central Bank's balance sheet reflect these developments. Deposit liabilities of the Central Bank declined by 4.1 per cent during 1997. This is mainly due to some adjustment made to the SRR by the Central Bank in early 1997. Due to the above developments the base money decreased by 2.1 per cent in comparison to a rise of 8.8 per cent in 1996.

Structure of Assets and Liabilities

The total resources of the Central Bank at Rs.183,895 million at end December 1997 recorded a marginal increase of 1.3 per cent (Rs.2,332 million) during the year compared to a moderate increase of 4.6 per cent (Rs.8,053 million) in 1996.

Viewed from the assets side, the increase was entirely in foreign assets of the Central Bank. Reflecting a favourable improvement in the balance of payments, the foreign assets of the Bank reached Rs.118,999 million recording a Rs.15,755 million increase (15.3 per cent) during 1997. In 1996, foreign assets declined by Rs.2,652 million (2.5 per cent). The growth in foreign assets mainly reflected the proceeds from the Government's privatisation programme.

Domestic assets of the Central Bank recorded a decrease of Rs.1,423 million (77 per cent) in 1997 compared to an increase of Rs.10,710 million (15.8 per cent) in 1996. A decline in the fiscal deficit, better cash management of the Treasury and receipts from the Government privatisation programme reduced borrowings by the Government from the Central Bank during 1997, thus helping to reduce the inflationary pressure in the economy. Loans and advances to the Government increased by 2.2 per cent (Rs.614 million) in 1997. The Treasury bill holdings of the Central Bank declined by 58 per cent (Rs.9,878 million) compared to an increase of 37 per cent in 1996. The decline was mainly due to the retirement of Rs.10,000 million worth of bills by the Government using the proceeds received under privatisation.

On the liabilities side, total deposit liabilities of the Central Bank recorded a 4 per cent (Rs.3,277 million) decline during 1997 entirely reflecting a decline in commercial bank deposits by 15 per cent. Despite an increase in customer deposits with commercial banks in 1997, the statutory reserves held by these banks with the Central Bank declined as a consequence of the reduction in the SRR in the early part of 1997. As a part of the privatisation proceeds obtained by the Government was retained as deposits to avoid destabilising the money market, Government deposits with the Central Bank increased by Rs.2,910 million.

Total currency issues by the Bank during the year increased by 7.4 per cent (Rs.3,655 million) compared to a 6 per cent (Rs.2,796 million) increase in 1996. A greater usage of currency notes by the public was seen in 1997. The note issue increased by 7.5 per cent in 1997 compared to 6.0 per cent in 1996. Coin demand recorded an increase of 7.8 per cent (Rs.150 million) in 1997 in comparison to 6.4 per cent (Rs.115 million) in 1996.

10.6 Banking Development

A new foreign bank, Societe Generale, commenced its operations in Colombo while Indo-Suez Bank Ltd. ceased its operations and was taken over by Hatton National Bank Ltd. The total number of commercial banks operating in the country at end 1997 stood at 26, consisting of 2 state banks, 6 domestic private banks and 18 foreign banks. Another important development that took place in the banking field was the establishment of two Licensed Specialised Banks (LSBs), namely, Sanasa Development Bank and Pramuka Savings and Development Bank, to engage in savings and development banking.

Branch Expansion

An upsurge was seen in bank branch expansion in 1997. The steady growth of opportunities in the financial sector and the expansion of activities of non-commercial bank financial institutions had led to intensified competition among banks. The total number of commercial bank branches including main branches (excluding 171 pawning centres), Agrarian Services Centre (ASC) branches, Kachcheri branches, extension offices and overseas branches increased to 996 at end 1997, from 958 at end 1996. The increase in branch network mainly arose through the opening of 26 branches by domestic private banks. The opening of 12 branches by Hatton National Bank Ltd. (HNB) and 8 branches by Commercial Bank of Ceylon Ltd. increased their main branches to 84 and 28, respectively. Sampath Bank Ltd. opened 3 branches during the year thus raising its branch network to 30 including 2 extension offices. Union Bank Ltd. set up two branches, while Pan Asia Bank Ltd. established one branch during the year. However, the main branches of People's Bank (PB) and Bank of Ceylon (BoC) remained unchanged at 325 and 275, respectively. The total number of foreign bank branches including extension/sub offices increased from 39 to 42 with the opening of a branch by Hong Kong & Shanghai Banking Corporation the establishment of Societe Generale Bank, the opening of two extension offices by foreign banks and closing of the Indosuez Bank. In addition, PB opened 70 pawning centres during the year. With the expansion in the branch network, the number of persons served by a commercial bank branch (excluding pawning centres) declined from 19,182 in 1996 to 18,750 persons in 1997.

TABLE 10.8

Distribution of Bank Branches

Category	1996	1997(a)
1. No. of Institutions	44	44
Commercial Banks	26	26
Domestic Banks	8	8
Foreign Banks	18	18
Savings Banks	1	1
RRDBs (b)	17	17
2. No. of Branches (c)	1,230	1,271
Commercial Bank Branches	958	996
Domestic Bank Branches	919	954
Main Branches	828	857
ASC Branches	17	14
Kachcheri Branches	23	23
Extension/Pay offices	47	56
Overseas Branches	4	4
Foreign Bank Branches	39	42
Main Branches	37	38
Extension Offices/Sub Branches	2	4
Pawning Centres	101	171
NSB Branches	97	99
RRDB Branches	175	176

Source: Central Bank of Sri Lanka

(a) Provisional
(b) Regional Rural Development Banks established under the RRDB Act. No.15 of 1985.
(c) Includes Head Offices.

The total number of Regional Rural Development Banks (RRDBs) remained unchanged at 17, while the branches of RRDB increased to 176 with the opening of one new branch in 1997. The National Savings Bank established 2 new branches, thus raising the total number of branches to 99 in the year of its silver jubilee.

Banking Facilities

Automation and innovation increased in the banking sector, further enhancing the quality of facilities provided by commercial banks to customers. In addition to providing a wide range of innovative deposit products and lending facilities, commercial banks extended their services in areas such as endorsing, guaranteeing and underwriting commercial paper, leasing, pawn broking, tele-banking, Automated Teller Machines (ATMs), credit cards and debit cards facilities and electronic money transfers.

Most commercial banks have computerised their activities. Commercial Bank of Ceylon implemented a programme named 'ComServe' which offers on line cash management services. This helps customers to access their accounts at any time during the day via personal computers installed in their offices. Standard Chartered Bank offered tele-banking facilities which allows customers to communicate with banks to obtain a wide array of basic banking services.

The ATM network expanded while services provided through ATMs also increased during the year. Overseas Trust Bank expanded its services by installing an ATM. There were 38 new ATMs installed during the year, thus raising the total number of ATMs to 197, installed by ten commercial banks. Moving a step further towards a cashless society, Sampath Bank Ltd. launched the SET/CIRRUS/MAESTRO debit card which is an improved version of its existing SET card which was launched ten years ago. This is a convenient way to access deposit accounts. The new card can be used to pay for goods and services on line by directly debiting a card holder's bank account at Point of Sale (POS) machines installed in merchant outlets. The new card also provides access to the global ATM network of "CIRRUS" which would facilitate card holders to withdraw money from any ATM displaying the "CIRRUS" logo in any country in the currency of that country. With this linkage with the international debit card marketer "CIRRUS/MAESTRO", ATMs installed by the Sampath Bank Ltd. also joined their world wide network. In addition, foreigners having the "CIRRUS/MAESTRO" facility can use the facilities in Sri Lanka.

By end 1997, nine commercial banks were issuing credit cards. These banks were issuing well known brands of cards, i.e., Master Card, Visa Card and American Express, which can be used both locally and internationally. At end 1997, the total number of credit cards issued by 9 banks was approximately 53,000, of which approximately 30,000 could be used only for local transactions while the rest were meant for both local and international transactions. Total outstanding credit as at end 1997 was Rs.875 million and the rate of interest charged on credit cards was around 30 per cent. There are differences between a credit card and a debit card. Credit card is a form of short-term credit facility with a limit that can be enjoyed by card holders who are not necessarily account holders. A credit card holder can make purchases on credit as well as obtain cash advances from the bank and interest is charged by the bank for such facilities. Only an account holder is eligible to obtain a debit card, which allows card holders to pay for purchases at merchant outlets by debiting his account instantly while no credit is provided.

Deviating from traditional activities, commercial banks expanded their leasing and pawn broking facilities. HNB introduced foreign currency leasing facilities in 1997 to meet the needs of BOI enterprises. Leasing facilities were provided in US dollars, Sterling pounds, Deutsche marks and French francs. HNB also introduced a "Gold Certificate" against the value of gold jewellery deposited by customers. Holders of the Certificate are entitled to obtain 75 per cent of the value of the Certificate as a loan. Pan Asia Bank Ltd. entered the pawning business during the year. People's Bank expanded its pawning activities through the establishment of 70 new pawning centres.

Commercial banks also expanded their traditional forms of business. New deposit products which were linked to credit schemes or targetted to specific groups of people, were introduced. New loan schemes for various purposes such as housing, agriculture and self employment commenced. "Kantha Ran Divimaga", a special credit scheme which is linked to a "Kantha Ran Ginum" savings programme, was inaugurated by Seylan Bank Ltd. to set up, improve or expand micro enterprises in small scale industries, handicrafts, trade, animal husbandry, agriculture etc. Another special loan scheme for women who go to Brunei or the Seychelles for employment has been commenced by People's Bank. HNB introduced a new deposit scheme named "Saubhagya". The new scheme is designed to enable depositors to make regular deposits for a period of sixty months and is linked to a loan facility. Another loan scheme was launched by Seylan Bank, called the "Tikiri" Loan Scheme, under which credit facilities have been provided to "Tikiri" Savings Account holders, i.e. children, for higher education and self employment.

Seylan Bank Ltd. introduced a new deposit scheme named "Rewards Plus 3". Account holders who meet certain requirements specified by the bank are eligible to lucky draws and are entitled to receive rewards plus cards. The owners of reward plus cards would enjoy facilities such as concessions on commissions charged on travellers' cheques and bank drafts, interest rate rebates on loans, free cheque books etc. Hong Kong and Shanghai Banking Corporation Ltd. introduced a personal loan scheme for its customers employed by Hong Kong Bank approved employers for the purpose of financing expenses on overseas travel, family weddings, home improvement and other household expenses. Under this scheme, the borrower will be able to borrow up to six times the monthly salary, with a repayment period of 3 years. PB introduced two loan schemes, one for consumption purposes and the other a loan scheme for pensioners. Pan Asia Bank implemented a new savings scheme "Sovereign Accounts", while PB introduced a new deposit scheme named "Pranama" savings scheme, which is linked to a loan scheme. Meanwhile, Citibank N.A. introduced a loan scheme named Vendor Financing to finance the imports of garment exporters.

Commercial Bank introduced the "Nivahana" housing loan scheme. A loan scheme was implemented by Seylan Bank , named the "Piyasa" housing loan scheme, to provide credit facilities for housing purposes. The maximum amount granted under this scheme is Rs.10 million and it carries an interest rate in the range of 17-19 per cent. PB granted a loan facility for housing purposes to the people resettled in Jaffna, while another housing loan scheme was initiated by PB for rehabilitation of houses which were affected by the civil disturbances.

Short-term loan facilities have been granted by Seylan Bank Ltd. for maize cultivation in the Anuradhapura and Badulla districts and for cashew processing in selected areas of the country. "Ran Govi Thanpath Ginum", a special deposit scheme for farmers, was implemented by BoC in the North Central Province in order to encourage the savings and thrift habits of farmers. This has been extended in other provinces as well. A Credit scheme was launched by the BoC in the Anuradhapura and Moneragala districts to grant financial assistance to farmer organisations and community based organisations for on lending to their member farmers for the cultivation of soya beans. A special loan scheme for farmers in Jaffna was introduced by BoC to provide credit facilities for cultivation of paddy and other subsidiary crops. In addition, BoC implemented the Tea Shakthi savings mobilisation programme, while HNB introduced a credit scheme for sugar cane cultivation.

Self-employment project loans and the Singer sewing machine project loans were launched by Seylan Bank Ltd. in selected areas. These loans are granted against personal guarantees and carried an interest rate of 23 per cent. Further, Seylan Bank introduced the pottery producer loan scheme and the "Seylan Sarusara" loan scheme during the year.

10.7 Credit Information Bureau

Though the Credit Information Bureau incurred heavy financial expenses in 1996, 1997 was a successful year for the Bureau. The Bureau supplied 102,175 credit reports during 1997 to its shareholders. The report floors for loans remained unchanged at Rs.100,000 for irregular loan accounts and Rs.500,000 for regular loan accounts. The updating of irregular loans continued to be on a monthly basis. The updating of regular loans of non-Western Province state banks was on a quarterly basis, while for Western Province state banks, it was on a monthly basis.

In the latter part of 1997, the Bureau started collecting information on loans/facilities granted by Foreign Currency Banking Units of licensed commercial banks and information on finance leases granted by leasing units of the commercial banks and finance companies in order to improve the coverage of data and for better credit evaluation. The Bureau is considering the need to enrol leasing companies registered under the proposed leasing law as members of the Bureau.

In 1997, on the request of the Task Force for Security and Risk Management for Credit Card Centres, the Bureau commenced maintaining a database of delinquent credit card holders to which lending institutions have access when processing an application.

During the year another licensed commercial bank was admitted as a shareholder of the Bureau, bringing the total number of shareholders to 59.

10.8 Rural Banking and Credit

Overall Trends and Developments

The programme for generating self-employment opportunities among the rural poor came of age in 1997 with the successful completion of the Small Farmers and the Landless Credit Project (Isuru Project), a pilot credit scheme for the rural poor introduced in 1989. Under these arrangements, provision of credit is preceded by a social mobilisation programme, the main elements of which are the encouragement of beneficiaries to form themselves into self-help groups, a compulsory savings programme and the provision of opportunities to improve their trade and vocational skills. The completion of this process of social mobilisation makes the otherwise unbankable rural poor creditworthy and acceptable to formal lending institutions which normally have to strike a balance between the credit risk and their social responsibilities when extending credit to the rural sector. The Isuru Project, operated in partnership with the Regional Rural Development Banks (RRDBs) and a host of development oriented non-governmental organisations (NGOs), was successful in establishing a cost-effective credit delivery system for the poor in rural areas. The experiences of this Project can now be replicated and adopted by other institutions and agencies which are engaged in credit activities in the rural sector.

The strategy of the Government to gradually move away from state-funded rural credit schemes to a system of self-funding credit schemes in the rural sector was further reinforced during 1997. The agricultural credit scheme covering paddy and subsidiary food crops was continued by

TABLE 10.9

Cultivation Loans Granted Under the New Comprehensive Rural Credit Scheme (Position as at 31 December 1997)

Rs. Million

Season	State Banks			Domestic Private Banks (a)			Regional Rural Dev. Banks			Total Loans (b)		
	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total Loans Under NCRCS
1992/93 Maha	315	89	404	17	15	32	87	81	168	418	185	603
1993 Yala	140	76	216	2	6	8	43	51	94	185	132	317
Cultivation Year 1993	455	165	620	19	21	40	130	132	262	603	317	920
1993/94 Maha	308	85	393	23	22	45	122	73	195	453	180	633
1994 Yala (c)	136	64	200	8	35	43	62	38	100	207	136	343
Cultivation Year 1994	444	149	593	31	57	88	184	111	295	660	316	976
1994/95 Maha	516	182	698	18	18	36	37	22	59	571	222	793
1995 Yala	179	131	310	8	23	31	34	22	56	221	176	397
Cultivation Year 1995	695	313	1,008	26	41	67	71	44	115	792	398	1,190
1995/96 Maha	265	76	341	18	28	46	25	33	58	308	137	445
1996 Yala	71	33	104	3	12	15	14	8	22	88	53	141
Cultivation Year 1996	336	109	445	21	40	61	39	41	80	396	190	586
1996/97 Maha	233	59	292	18	28	46	24	36	60	275	123	398
1997 Yala	72	35	107	20	32	52	16	13	29	108	80	188
Cultivation Year 1997	305	94	399	38	60	98	40	49	89	383	203	586

Source: Central Bank of Sri Lanka

(a) Hatton National Bank, Commercial Bank and Seylan Bank only.
(b) The total for 1992 includes a small amount of credit granted by Multi Purpose Co-operative Societies.
(c) The Refinance Scheme was withdrawn in April 1994 and replaced by an Interest Subsidy Scheme.

lending banks using their own funds and with the support of an interest subsidy provided by the Government. Similarly, the Surathura Scheme - Phase I, a micro-finance scheme for generating self-employment among the unemployed, funded out of a budgetary allocation of Rs.350 million, was converted in Phase II to a bank funded scheme with an interest subsidy during the year.

Several institutional changes were effected in 1997. The Regional Development Bank (RDB) Act was enacted in Parliament amalgamating the district based Regional Rural Development Banks (RRDBs) into province-based Regional Development Banks (RDBs). This reform is expected to re-capitalise RRDBs, expand their resource and operational base, strengthen internal control systems, inject professionalism to management and broad-base ownership. In addition, two privately owned rural based specialised banks were also licensed by the Central Bank during 1997: the Sanasa Development and Savings Bank and the Pramuka Development and Savings Bank.

The informal self-help groups of the Isuru Project were formalised by establishing Isuru Development Societies which are limited liability corporate bodies registered with the Registrar of Companies under the Societies Ordinance. During 1997, 110 such development societies were set up, with an issued share capital of Rs.1.3 million and 3,500 shareholders. Similarly, the number of Samurdhi Bank Societies increased from 125 at end 1996 to 261 at end 1997. Hatton National Bank (HNB), a private commercial bank, continued to expand its Gami Pubuduwa Scheme in partnership with NGOs and self-help groups (SHGs). Janashakthi Banking Societies in Hambantota, another people-based organisation composed exclusively of women, expanded their activities considerably during the year. The expansion of these people-based organisations at the grass-roots level can be viewed as a salutary development, since they would fill the vacuum created by the withdrawal of direct Government participation in the rural credit system, on the one hand, and establish a viable institutional system at the grassroots level with which formal lending banks could collaborate when extending rural credit in the future, on the other.

TABLE 10.10

Deposits and Advances - Selected Rural Sector Institutions

Rs. Million

	Co-operative Rural Banks (CRBs)		Bank of Ceylon Sub-Offices at Agrarian Services Centres		Regional Rural Development Banks		Thrift and Credit Co-operative Societies		Sarvodaya		Janashakthi Bank Hambantota		Samurdhi Scheme	
	1996	1997	1996	1997	1996	1997(a)	1996	1997	1996	1997	1996	1997	1996	1997
1. Total Savings(b)	7,616	9,607	242	305	2,035	2,404	2,422	2,807	145	212	28	45	-	132
Savings	6,457	7,851	194	257	1,596	1,696	1,164	1,278	108	159	6	9	-	24
Special Savings	-	-	11	10	22	-	640	772	37	53	8	21	-	25
Fixed Deposits	1,159	1,756	37	37	417	708	271	364	-	-	1	1	-	-
Shares	-	-	-	-	-	-	347	393	-	-	13	14	-	83
2. Total Loans Granted(c)	1,066	1,271	177	223	2,295	1,781	1,913	2,181	214	261	50	269	-	28
Agriculture	94	139	81	95	267	167	261	314	49	49	23	157	-	6
Animal Husbandry	35	48	4	5	24	20	38	38	5	10	-	-	-	-
Fisheries	-	-	-	-	25	21	-	-	2	5	1	6	-	-
Small Industries	43	93	15	14	201	149	99	99	7	9	-	-	-	-
Housing, Electrification and Water Supply	584	599	13	23	-	-	182	208	-	-	2	11	-	-
Projects/ Commerce	158	193	48	62	1,064	1,424	542	645	11	21	5	68	-	21.4
Others	154	198	17	24	714	-	791	877	140	168	19	6	-	0.2

(a) Estimated data are given as at 30 September 1997.
(b) Savings - as at 31 December 1997
(c) Loans granted - during the years 1996 and 1997

Sources : People's Bank
Bank of Ceylon
Regional Rural Development Banks
Samurdhi Authority of Sri Lanka
SANASA
Sarvodaya
Women's Development Federation - Hambantota

New Comprehensive Rural Credit Scheme (NCRCS)

The value of credit disbursed by banks under the NCRCS in 1997 amounted to Rs.586 million, roughly the same level as in 1996. Of the total credit disbursed, Rs.398 million was for Maha 1996/97, while the balance Rs.188 million was in respect of Yala 1997. Although the value of loans granted in 1997 remained static compared to the previous year, the number of loans granted declined from 30,816 in 1996 to 28,643 in 1997. As usual, the major share of credit (70 per cent) was absorbed by paddy, leaving the balance for subsidiary food crops.

The Government continued to pay the interest subsidy of 7.5 percentage points per annum for cultivation loans under the NCRCS to enable the lending banks to lend their own funds to farmers at an interest rate of 16 per cent per annum. The interest subsidy so paid to banks in 1997 in respect of loans granted during Yala 1994 and Yala 1996 amounted to Rs.3 million.

The payment of compensation to banks under the Farmers' Relief Scheme introduced by the Government in 1994 was continued during the year under review. Under this scheme, defaulting farmers between Yala 1986 and Maha 1993/94 have been offered relief under the Government's relief package subject to the condition that the farmer agrees to make a down payment of 25 per cent of the amount in default to the respective lending bank. The Government's relief package required the Central Bank to relax its credit guarantee rules by waiving the requirement that a bank should institute legal action in order to be eligible for the full amount of the credit guarantee. In terms of this waiver, the Central Bank agreed to pay half of the principal amount of the loss remaining after the collection of the advance of 25 per cent from the farmers. During 1997, the Central Bank paid Rs.83.3 million to the RRDBs as the Central Bank's share under the Relief Scheme. The Government absorbed a sum of Rs.33.2 million as its share on account of the loans written-off by the RRDBs under the scheme.

Crop Insurance Schemes

During the year under review, the Agricultural Insurance Board (AIB) continued to offer its agricultural insurance schemes for paddy, other agricultural food crops and livestock. A special insurance scheme was implemented for paddy farmers in Farmers' Organisations in the Mahaweli areas. Another insurance scheme, titled 'Sarubima Scheme', was implemented in a selected village in each electorate with the assistance of governmental and non-governmental organisations. One of the objectives of this scheme is to enroll all the farmers in the age group of 18 - 59 years in selected villages in a Farmers' Pension Scheme, so that they could earn a permanent monthly income after 60 years of age and offer them a free insurance cover worth Rs.50,000. In addition, the other insurance schemes for paddy, livestock, coconut, fruits (pineapples) and flowers (anthuriums) will also be implemented in these villages. The Ceylinco Insurance Company Ltd. (CICL), the only private insurance company operating in this field, continued to offer insurance schemes for agriculture during the year under review.

The extent of paddy land insured by the AIB in 1997 was 21,000 hectares recording a 19 per cent decrease when compared with the previous year. At the same time, the area insured by CICL has increased by 34 per cent between the two years. The premia collected by the AIB in 1997 amounted to Rs.12.8 million while indemnities paid amounted to Rs. 5.6 million. The CICL collected premia for paddy amounting to Rs.0.46 million and paid compensation to the value of Rs.0.10 million. In the case of the other crops, the AIB collected premia amounting to Rs.0.79 million in 1997 and paid indemnities to a value of Rs.0.36 million. The comparable figures for CICL were Rs.1.5 million and Rs. 0.14 million, respectively. In the livestock insurance scheme of the AIB, the covered animals were cows, goats and calves. The total premia collected for livestock amounted to Rs. 1.8 million, while the indemnities paid were Rs.0.80 million. As a whole, the agricultural and livestock insurance schemes offered by both AIB and CICL have continued to expand in terms of coverage in the recent past.

Micro Finance and Savings Schemes

Self-Employment Promotion through Micro-Enterprises Credit (Surathura Scheme)

The Surathura Programme inaugurated in September 1996 by the Government, aimed at providing micro-finance to the educated unemployed to undertake self-employment income generating activities. A sum of Rs.350 million was allocated by the Government for refinancing the Surathura loans granted by the three Participating Credit Institutions (PCIs), viz., Bank of Ceylon, People's Bank and Hatton National Bank. The scheme was operated throughout the island.

The entirety of the allocation of Rs.350 million was fully utilised by the 3 PCIs during the year to extend 9,059 loans to the target group. These collateral-free loans, with an interest rate of 10 per cent per annum and a maturity of 3 years, enabled youths to commence new projects or expand their existing businesses mainly in trade and commerce, micro industrial activities, agriculture and livestock development. An islandwide sample survey conducted by the

Central Bank in April 1997 revealed that 88 per cent of the borrowers had utilised the loan proceeds for the intended project, while 12 per cent of borrowers had misused funds.

With the high demand for such micro loans continuing unabated, the Government introduced Phase II of the Surathura Scheme in September 1997 with a target of 10,000 further loans to a value of Rs.500 million. However, in line with the Government's policy to convert gradually such state funded credit schemes to self-funding schemes, Phase II was designed to be funded by the 3 PCIs out of their own resources. Taking into account the concessionary interest rate of 10 per cent per annum and the high transactions costs and credit risks involved in micro loans, the Government agreed to support PCIs with an interest subsidy of 10 per cent per annum on every performing loan. At end 1997, 4,542 loans to a value of Rs.171 million, had been granted by PCIs under Phase II of the Surathura Scheme.

Samurdhi Development Credit Scheme or SASANA Scheme

The Sasana Scheme, which was inaugurated in 1996, also aimed at promoting income generating self-employment opportunities among Samurdhi beneficiaries so as to raise their income levels, and thereby make them self-reliant and self-supporting. Under this Scheme, Samurdhi beneficiaries are eligible to obtain loans of up to Rs.10,000 for undertaking new income generating activities or expanding an existing business. During 1997, 4,990 sewing machines were distributed among selected Samurdhi families to enable them to commence small scale garment industries by using textile offcuts of large garment factories, in the initial stage.

As a part of the Samurdhi Movement, Samurdhi Bank Societies (SBSs) were setup throughout the country to promote savings and disburse credit. At end 1997, 261 such SBSs had been established, consisting of 68,577 Self Help Groups (SHGs) with a total membership of 404,738. Each SHG maintained its own savings fund that collected savings on a weekly basis. These savings, which were placed as deposits in SBSs, amounted to Rs.49.2 million at the end of 1997.

An issue that may arise with the placement of such savings with unregulated and unsupervised informal societies will be the consequential risk to which the savers are exposed. Hence, it is of utmost importance to take precautionary measures by linking these SBSs to a state bank and placing the funds in deposit with such a bank.

Gami Pubuduwa Scheme : An Experiment in Linkage Banking

Linkage banking is a novel method developed by banks for extending micro credit to a large number of retail borrowers by engaging the services of a community based voluntary organisation as an intermediary to link the borrowers to the bank. It helps the lending banks to lower transaction costs, reduce credit risks and reach a normally unbankable clientele in the rural sector. Lending banks have thus been able to tap the business potential in the rural sector and contribute to a balanced development in different sectors of the economy.

Hatton National Bank (HNB) experimented with a hybrid of linkage banking by inaugurating its Gami Pubuduwa Scheme (GPS) in 1989. In this scheme, HNB has successfully gone into partnership with a number of NGOs and SHGs, which introduce potential borrowers to the bank, monitor loans and take follow up action and help the bank to recover the loans on the due dates. The GPS is operated and directed by specially trained permanent officers attached to the relevant branch of the Bank. At the end of 1997, the GPS had covered 93 villages reaching 23,011 borrowers with a total loan portfolio of Rs.608.5 million. The overall recovery rate in GPS at 97 per cent has been well above the normal recovery performance of banks in rural lending in the country.

Thrift and Credit Co-operative Societies (TCCSs) Credit Scheme

TCCSs, popularly known as SANASA Societies, perform a useful function in the rural sector by mobilising funds from the rural population for developmental purposes, raising rural savings and extending micro and small loans to members. It also functions as a linkage agency in rural lending by going into partnership with a number of national and regional credit schemes. The culmination of SANASA activities was witnessed in 1997 when the SANASA Savings and Development Bank was set up as a specialised banking institution.

At the end of 1997, SANASA had disbursed loans amounting to Rs.2,181 million and mobilised savings amounting to Rs.2,807 million. Both these have recorded a progressive increase over the past few years. By making a concerted effort in loan monitoring and taking follow up action, SANASA has been successful in maintaining a very high loan recovery rate of 85 per cent.

Janashakthi Banking Societies in Hambantota

Janashakthi Banking Societies (JBSs), which are informal savings and loan associations, were set up in 1989 by the Women's Development Federation (WDF) in Hambantota with the objective of empowering the women in poor families in the area to become both socially and economically self-reliant. To achieve this objective, participating women are put through an awareness programme on health, nutrition, thrift and viable economic activities. Savings are mobilised as an integral part of the programme and re-lent to women members at above market rates (36 per cent per annum) to enable them to undertake micro-scale income generating activities. At the end of 1997, there were 67 JBSs with 26,000 members spread over 463 villages in 5 Divisional Secretariat Divisions in Hambantota.

During 1997, JBSs mobilised savings amounting to Rs. 10.6 million raising the total savings to Rs.44.6 million by the end of the year. Total loans disbursed during the year amounted to Rs. 268.8 million in respect of predominantly agricultural, trading, fisheries and livestock activities. With concerted supervisory and follow up action, JBSs managed to maintain a recovery rate of 100 per cent during the year.

Sarvodaya Economic Enterprises Development Services (SEEDS)

Sarvodaya Economic Enterprises Development Services (SEEDS), which is the economic arm of the Lanka Jathika Sarvodaya Shramadana Sangamaya (SSS), is a pioneer in rural economic development through peoples' participation. This was established as a separate division of SSS in 1986. The mission of SEEDS is to alleviate poverty among the rural poor in Sri Lanka by raising the economic conditions and income levels of the membership of the SSS, to strengthen each SSS to become a self reliant, self funding and self managing institution and ensure their sustainability as alternative development institutions. This programme, operated in 18 districts, covers 2,083 shramadana societies.

SEEDS also functions as a link institution in the credit schemes implemented by the Central Bank, National Development Trust Fund (NDTF) and the National Development Bank (NDB). At the end of 1997, SEEDS had disbursed 17,246 loans to a value of Rs.1,010 million, maintaining a recovery rate of 89 per cent.

Tea Shakthi Movement (TSM)

The Tea Shakthi Movement (TSM) is a scheme inaugurated by the Tea Small Holding Development Authority (TSHDA) in 1989 in collaboration with the Bank of Ceylon to raise the fund base of the Tea Small Holder Societies (TSHSs) and thereby make them self-reliant and sustainable. These societies were formed by TSHDA under the Small Holder Tea Development Project (SHTDA) funded by the ADB.

Under the scheme, every tea smallholder is encouraged to save the value of at least 1 kilogram of green leaves per week so that, in lean years they have accumulated savings to fall back on. These savings are, in turn, deposited by TSHSs with the BOC, which functions as the banker to the scheme. To enhance the range of benefits, the TSM has introduced a free life and accident insurance scheme and a pension scheme for tea smallholders. In addition, opportunity has been afforded to them to participate in equity in related projects involving green leaf transportation, private tea factories and tea packing plants. As at end 1997, 75,000 tea smallholders had joined the TSM with a total savings of Rs.75 million.

10.9 Other Financial Institutions

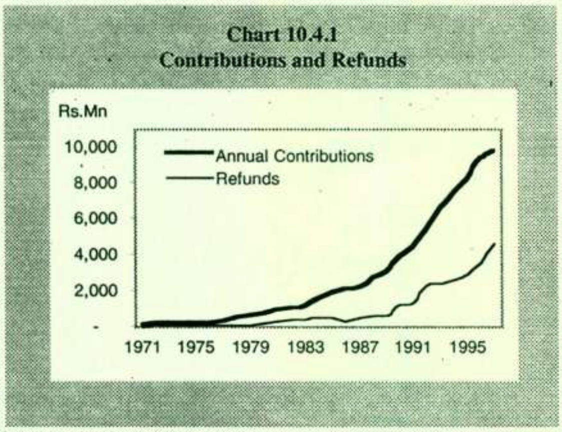
Savings Institutions

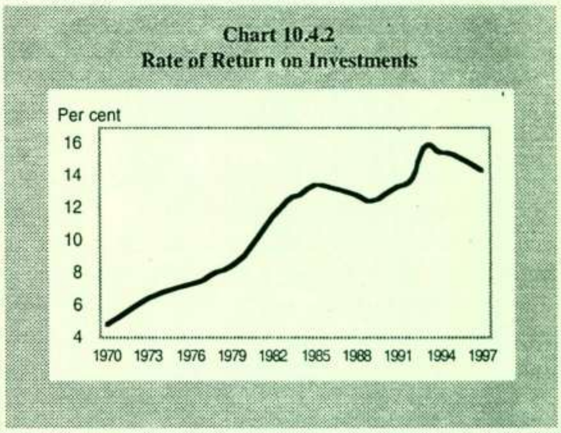
The National Savings Bank (NSB), the premier savings institution in Sri Lanka, celebrated its silver jubilee in 1997. It increased its deposit base by 17 per cent to Rs.77,865 million, while its total assets reached Rs.83,775 million at end 1997, displaying its financial stability and strength in a competitive banking environment. Attractive interest rates, together with large advertisement campaigns and the implementation of new deposit instruments/schemes contributed to the deposit growth of the bank. The NSB mobilised savings through already existing instruments such as pass book savings, fixed deposits, pension schemes, endowment schemes, premium savings bonds and also through new deposit schemes namely 'Ridee Reka' and 'National Savings Certificates'. Fixed deposits increased by Rs.6,545 million or 16 per cent, while savings deposits increased by Rs.3,788 million or 15 per cent during the year. This compares with a 9 per cent increase in fixed deposits and a 26 per cent increase in saving deposits of commercial banks. Other deposits of the NSB, which include National Savings Certificates, Savings Certificates, Premium Savings Bonds, and the NSB Pension Scheme, rose from Rs.98 million to Rs.794 million.

NSB interest rates were revised downward several times in line with trends in the market. Interest rates on savings deposits were reduced from 12 per cent at the beginning of 1997 to 10.8 per cent in May. Interest rates on one year fixed deposits paid at maturity decreased from 15 per cent to 14 per cent in March, to 13.2 per cent in May, to 12.0 per cent in August and to 11.0 pet cent in November 1997.

Amendments made to the NSB Act allowed diversification of the investment portfolio of the bank. Total investments of the bank increased to Rs. 73,771 million, which reflected an increase of Rs.10,241 million for the year. Investment in government and government guaranteed securities continued to dominate the investment portfolio and amounted to Rs.62,217 million, representing 84 per cent of

Chart 10.4
Employees' Provident Fund





the total investments. Within the government securities, the NSB has moved more towards market oriented securities (i.e.Treasury bills and Treasury bonds) in its new investments reducing its allocation for investment in Rupee Securities.

The Employees' Provident Fund (EPF), the country's main superannuation fund and the largest single investor in the market has undergone modernisation during the year through the establishment of electronic systems. The total members' balance of the EPF increased by approximately 20 per cent to Rs.104 billion. The total contributions received by the EPF amounted to Rs.9,763 million compared to Rs. 9,302 million in 1996. Refunds paid to members increased by 30 per cent to Rs.4,576 million. The total investments of the Fund increased by Rs.23,212 million and stood at Rs.137,584 million at end 1997. The EPF invested Rs.135,104 million in government paper which accounted for 98 per cent of total investments.

The Employees' Trust Fund (ETF) recorded a significant growth in 1997 with improved resources and activities. Total assets of the Fund reached Rs.19,676 million at end 1997, which reflected an increase of Rs.2,552 million for the year. Total contributions received by the ETF rose by Rs.263 million in 1997, while outstanding members' balances in the Fund increased by 6 per cent to Rs.17,853 million. Total superannuation benefits paid to members during 1997 amounted to Rs.936 million. The total number of ETF member accounts was approximately 2.2 million, of which 1.7 million were active accounts. There were 26,427 employers contributing to the Fund in 1997 compared with 27,280 in 1996. The total investments of the Fund increased by 18 per cent and stood at Rs.18,698 million by end 1997. As in the previous years, the major share of investments was in the category of government paper, which accounted for 66 per cent of total investments at end 1997. Investments in Rupee Securities increased significantly by Rs.2,254 million or 94 per cent, while investments in Treasury bills and Treasury bonds rose by 11 per cent in response to the decision taken by the Fund to invest in longer term instruments as a hedge against a downturn in interest rates. Investments in shares, which accounted for 16 per cent of the total investments in 1997, also rose substantially by Rs.1,092 million or 55 per cent over the previous year, while investments in Unit Trusts also increased by 12 per cent during the year. Investments in debentures rose by 10 per cent to Rs.1,539 million and amounted to 8 per cent of total investments at end 1996. Meanwhile, investments in asset backed notes and commercial paper were Rs. 99 million and Rs. 24 million, respectively, at end 1997.

Long-term Lending Institutions

The total number of long-term lending institutions increased to 8 with the establishment of two licensed specialised banks, namely, Sanasa Development Bank Ltd. and Pramuka Savings and Development Bank Ltd.

The DFCC Bank, one of the major development finance institutions, enhanced its development banking activities by providing medium and long-term credit for industrialists with a view to boosting medium and small enterprises. Total loans approved by the DFCC Bank increased from Rs.4,259 million in respect of 878 loans to Rs.6,631 million for 1,066 loans in 1997. Total loans granted by the DFCC Bank grew by 29 per cent to Rs.3,684 million. The bulk of loan facilities provided by the DFCC Bank was obtained by the industrial sector. During the year, Rs.3,806 million was

TABLE 10.11
Loans Approved and Granted by Long-Term Credit Institutions by Purpose

Rs. Million

Purpose	DFCC		NDB(a)		NSB		SMIB		HDFC		NHDA		PSDB (b)		Total		% of Total Loans Approved	
	1996	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996	1997	1996	1997
Agriculture	400	1122	1,057	815	-	-	26	13	-	-	-	-	-	2	1,483	1,950	8.7	7.2
Industry	2,223	3,806	3,979	6,679	-	-	-	-	-	-	-	-	-	19	6,202	10,485	36.4	38.5
Tourism	447	181	301	307	-	-	-	-	-	-	-	-	-	59	748	488	4.4	1.8
Commercial	-	888	-	-	-	-	-	-	-	-	-	-	-	353	0	888	0.0	3.3
Financial	569	320	35	569	999	-	-	-	-	-	-	-	-	16	1,603	889	9.4	3.3
Housing	-	-	199	-	1,328	1,812	1,081	1329	544	484	1,276	1,463	-	5	4,428	5,088	26.0	18.7
Redemption of Debt	-	-	-	-	-	-	-	17	-	-	-	-	-	2	0	17	0.0	0.1
Other Loans	620	314	1,831	3,276	78	3,808	57	-	-	-	-	-	-	161	2,586	7,396	15.2	27.2
Total (approved)	4,259	6,631	7,402	11,647	2,405	5,620	1,164	1359	544	484	1,276	1,463	-	615	17,050	27,205	100	100
Loans granted (c)	2,851	3,684	5,537	4,674	2,405	5,167	1,164	1359	468	362	519	386	-	449	9,848	20,805		
Loans granted as a percentage of total loans approved (%)	67	56	75	40	100	92	100	100	86	75	41	26	-	73	58	76		

(a) Including refinance loans and equity investments
(b) Private Savings and Development Banks.
(c) Includes loans approved in previous years and disbursed during the period under review.

Sources: Development Finance Corporation of Ceylon Bank Ltd. (DFCC)
National Development Bank Ltd. (NDB)
National Savings Bank (NSB)
State Mortgage and Investment Bank (SMIB)
SANASA Development Bank Ltd.
Pramuka Savings and Development Bank Ltd.
Housing Development Finance Corporation (HDFC)
National Housing Development Authority (NHDA)

approved to the industrial sector in respect of 382 loans. Of the total loans granted, 53 per cent were disbursed to the industrial sector which includes food, beverages and tobacco, engineering and building trade, wearing apparel and leather industries, paper and paper products, rubber and plastic products, chemical, petroleum and coal products etc. Loans to plantation agriculture sector, which accounted for 20 per cent of the total loans granted, increased from Rs.225 million to Rs.727 million at end 1997. Meanwhile, Rs.499 million was granted in respect of 204 loans for commercial purposes during the year. However, loans granted to the financial sector and tourism sector declined by Rs.341 million and Rs.150 million, respectively, during the year. Total loans outstanding at end 1997 stood at Rs.11,275 million, an increase of 8 per cent over the previous year. Rs.1,454 million was provided to eleven companies by way of equity financing, an increase of Rs.1,323 million. During the year, 74 per cent of total equity financing was for three companies in the financial sector, while Rs.260 million was provided for equity in five companies in the industrial sector. Of the total loans granted, 62 per cent were medium-term, 22 per cent were long-term and 16 per cent were short-term, while 89 per cent were loans above Rs.1 million. In terms of collateral, 53 per cent of total loans were provided against the security of property mortgages. Of the total loans granted, 78 per cent had interest rates in the range 15.00-20.00 per cent. As in the previous year, the main source of funds of the DFCC Bank were repayment of loans by customers (67per cent), lease amortisation (12 per cent), borrowings from the International Development Association (IDA) and the Asian Development Bank (ADB) (6 per cent).

The National Development Bank (NDB), the other major development bank, strengthened its activities in 1997, with an expanded resource base, enhanced lending activities and widened branch network. Convertible debentures of the NDB owned by the Government of Sri Lanka were converted into shares. A part of the conversion, i.e., 16.5 million shares, were sold through an international offering at Rs. 260 per share. A local issue of 0.917 million shares

Box 10

Non-Bank Financial Institutions

The definition of non-bank or 'other' financial institutions (OFIs) varies from country to country. Generally, they are defined in an indirect way as all those institutions which do not conduct 'banking business' or all those financial intermediaries which are not 'banking institutions'. However, as commercial banks also diversify their activities from traditional banking practices to activities such as leasing, direct project finance and equity funding, the major differences between commercial banks and OFIs have been gradually fading.

In the current Sri Lankan context, OFIs can broadly be identified as follows :

- deposit taking institutions (National Savings Bank, finance companies, RRDBs)
- long-term lending institutions (SMIB, DFCC, NDB, NHDA, private savings and development banks)
- insurance firms
- contractual savings institutions (EPF, ETF)
- leasing companies
- venture capital companies and
- money brokers

The history of OFIs dates back to the late 19th Century with the setting up of savings institutions, such as the Ceylon Savings Bank (1832), the Post Office Savings Bank (1885) and small Thrift and Credit Co-operative Societies (1906) in the early 20th Century. Although those OFIs were initially meant to enhance savings and inculcate thrift habits through the acceptance of interest bearing term deposits from the public for lending, with the sophistication in financial facilities and services, their horizons were broadened. Typically, OFIs flourish in open economies. Thus, with the increasing control of the economy by the State in the 1960s and 1970s, their activities declined. However, the Government itself and some public sector institutions did set up some public sector OFIs, such as Co-operative Rural Banks, the National Savings Bank and the Insurance Corporation of Sri Lanka, during this period. Following the economic policy reforms in 1977, the private sector took the initiative in establishing different types of OFIs to cater to varying needs of society. The expansion in finance companies and the emergence of merchant banks, venture capital companies, leasing companies and money brokers have been the result of this trend. This led to a more dynamic financial system and improved the quality and the efficiency of the financial intermediation process.

As economic development occurs in any economy, in particular, one that follows free market principles, the needs of its various sectors increase and become more complex and specialised. In order to meet these growing requirements, new facilities and institutions should spring up as the traditional banking system is inadequate to provide all these requirements. This is seen in Sri Lanka as well. The non-availability of credit from the traditional financial sector to certain categories of borrowers due to either the nature of the business of such borrowers or the non-acceptability of the collateral they could provide, contributed to the rapid growth of finance companies. The development of the money market, the secondary market in government securities and the stock market led to the emergence and expansion of merchant banks, venture capital companies, money brokers and share brokers. They play a significant role in the economy, performing functions such as deposit mobilisation, lending (short, medium and long-term), hire purchase, re-finance and leasing, granting rural credit, project financing, loan syndication, discounting of bills, property development financing, consultancy and advisory services, portfolio fund management, insurance services etc. Two major OFIs, i.e., NSB and the EPF, are important sources of funds for financing the fiscal deficit. The growth in importance of OFIs can be seen in the increase in their relative share of total assets of the financial system from 26.5 per cent in 1970 to 33.9 per cent in 1996.

The growth of OFIs, while bringing many benefits to the economy, also creates a number of challenges to the authorities engaged in formulating monetary policy. Monetary policy and the tools used in implementing monetary policy have, in the past, been focussed to operate in the framework of traditional commercial banking. However, as the OFIs grow, many financial activities take place outside the commercial banks. For instance, a significant amount of credit is now extended to enterprises by finance companies and long-term lending institutions such as the DFCC, NDB and the SMIB; private savings and development banks have been established, which take deposits and engage in medium and long-term lending, and even some short term trade financing, traditionally done by commercial banks; listed companies have begun to raise funds directly from the public through share issues, rather than obtain credit from commercial banks. Consequently, the monetary authorities need to focus on these OFIs too when determining monetary policies which are intended to influence economic activity.

In addition, the emergence of these institutions and their impact add to the responsibilities of the Central Bank in its function as the regulator and supervisor of the financial system of the country. The recent experience in many countries in both Asia and elsewhere clearly demonstrate the importance of the stability of the financial

Box 10 (contd.)

system. Thus, the major challenge in the years to come would be to ensure that while these OFIs expand providing much needed depth and efficiency to the financial market, they are adequately supervised and regulated to ensure the stability of the financial system.

Total Assets of Banking and Other Financial Institutions

Rs. Million

	1950	1960	1970	1977	1980	1990	1996
(A) Banking Sector	1,445	2,184	6,454	21,781	53,229	245,103	652,434
1. Central Bank	587	987	3,332	11,529	22,832	77,400	181,564
2. Commercial Banks	858	1,197	3,122	10,252	26,601	132,364	389,797
3. Foreign Currency Banking Units	—	—	—	—	3,796	35,339	81,073
(B) Deposit Taking Institutions	253	451	968	2,747	6,333	38,353	100,487
1. Finance Companies	n.a.	n.a.	171	n.a.	636	8,600	17,984
2. Rural Banks	—	—	17	—	368	3,379	10,610
3. RRDBs	—	—	0	—	0	980	3,965
4. Other Savings Institutions	253	451	780	2,747	5,329	25,394	67,928
4.1 National Savings Bank	253	451	780	2,747	5,329	25,145	67,700
4.2 Thrift & Credit Co-operative Societies	—	—	—	—	—	249	228
(C) Long-term Lending Institutions	26	24	62	265	405	19,310	52,128
1. Development Finance Institutions	—	24	62	129	278	8,543	36,117
1.1 DFCC	—	24	62	129	278	3,026	16,500
1.2 NDB	—	—	—	—	—	5,517	19,617
2. Housing Finance Institutions	26	n.a.	n.a.	136	127	10,767	16,011
2.1 SMIB	26	n.a.	n.a.	136	127	2,690	5,219
2.2 NHDA	—	—	—	—	—	7,886	8,957
2.3 HDFC	—	—	—	—	—	191	1,835
(D) Contractual Saving Institutions	0	187	1,188	3,555	7,711	60,382	159,129
1. Insurance Institutions	—	n.a.	n.a.	941	2,660	7,435	18,627
2. Employees Provident Fund	0	187	1,188	2,614	5,051	40,800	116,098
3. Employees Trust Fund	0	—	—	0	—	4,858	17,124
4. Private Provident Funds	—	n.a.	n.a.	n.a.	n.a.	7,289	6280
(E) Specialized Financial Institutions	—	—	—	—	—	2,149	24,040
1. Leasing Companies	—	—	—	—	—	1,249	6,084
2. Merchant Banks	—	—	—	—	—	900	13,008
3. Venture Capital Companies	—	—	—	—	—	—	2,296
4. Unit Trusts	—	—	—	—	—	—	2,652
Total	1,724	2,846	8,672	28,348	67,678	365,297	988,218

Source: Central Bank of Sri Lanka

Key:
- RRDBs - Regional Rural Development Banks
- DFCC - Development Finance Corporation of Ceylon Bank
- NDB - National Development Bank
- SMIB - State Mortgage and Investment Bank
- NHDA - National Housing Development Authority
- HDFC - Housing Development Finance Corporation of Sri Lanka Ltd.
- n.a. - not available

was made at Rs.250 per share, while the balance of 0.917 million shares was transferred to an Employees' Share Ownership Plan (ESOP) Trust. This share transaction resulted in increasing NDB's share capital from Rs.175 million to Rs.358 million. Further, the bank raised funds in the international market during the year through a syndicated loan of US dollars 55 million denominated in US dollars and Japanese yen. The enhanced resource base enabled the bank to increase its total assets from Rs.19,918 million at end 1996 to Rs.26,275 million at end 1997. Total loans approved by the NDB increased to Rs.11,647 million for 733 loans at end 1997, an increase of 57 per cent from the previous year's approvals. The increase in total loan approvals was 14 per cent in 1996. As in the previous year, the industrial sector received the largest portion of credit, accounting for 57 per cent of total credit approvals. Loan approvals to the industrial sector increased from Rs. 3,979 million to Rs. 6,679 million in 1997. Loan approvals to the tourism sector increased marginally, while credit approvals to the agriculture sector declined by 23 per cent and stood at Rs. 815 million at end 1997. The NDB also provided Rs.322 million for five projects during the year. The main sources of funds were foreign borrowings (40 per cent) and repayment of loans by customers (37 per cent). Of the total loans outstanding, 57 per cent were for medium-term financing, 29 per cent were for short-term financing and 14 per cent were for long-term financing. Meanwhile, the majority of loan approvals (74 per cent) were for loans above Rs.25 million.

The State Mortgage and Investment Bank (SMIB), which concentrates mainly on providing financing facilities for housing purposes, approved the vast majority of loans for the housing sector. Total loans approved by the SMIB in 1997 amounted to Rs.1,360 million. All the loans approved by the SMIB were less than Rs.5 million. Of the total approvals, 18 per cent were loans below Rs.100,000, while 82 per cent were in the range of Rs.100,000 - Rs.5 million. The majority of loans provided by the SMIB (93 per cent) were of a long-term nature, and were secured by property mortgages and EPF balances.

In line with market trends, the SMIB revised its deposit rates and lending rates several times during the year. At the beginning of the year, the rate on one year fixed deposits was 16.00 per cent per annum. This was gradually reduced to 12.00 per cent by end 1997. Interest rates on lending for housing were also reduced several times during the year. At the beginning of the year, rates on loans up to Rs. 500,000 were in the range of 19.00 - 20.00 per cent per annum. These rates were revised downwards in July and October. By end 1997, the rate charged on loans up to Rs.500,000 was 17.00 per cent per annum and on loans above Rs.500,000 it was 19.00 per cent per annum. Total loans granted by the SMIB amounted to Rs.1,211 million, while total deposits raised by the bank amounted to Rs.2,716 million at end 1997, an increase of 39 per cent over the previous year. The increase in total deposits partly resulted from the relatively high interest rates offered and the aggressive advertisement campaigns launched by the SMIB. Total assets of the SMIB stood at Rs.5,767 million at end 1997, an increase of 11 per cent over the previous year. In 1996, total assets grew by 16 per cent.

Two private licensed specialised banks, engaged in long-term funding activities, were established during the year. These were the Pramuka Savings and Development Bank Ltd. and the Sanasa Development Bank Ltd. The loans disbursed by these two banks amounted to Rs.599 million, of which Rs.40 million was long-term financing (over five years). The major sectors which obtained funds were, commerce (59 per cent), property development (13 per cent), housing (10 per cent) and industry (3 per cent). The majority of the loans had interest rates in excess of 20 per cent. The major sources of funds for both banks were fixed deposits and capital contributions.

The National Housing Development Authority (NHDA) and Housing Development Finance Corporation of Sri Lanka Ltd. (HDFC) enhanced their lending activities for housing purposes. The HDFC approved 3,478 loans to the value of Rs.484 million in 1997, of which Rs.362 million was disbursed during the year. This compares with Rs.544 million approved in 1996 in respect of 4,105 loans. The main sources of funds of the HDFC were international financial agencies (ADB and USAID) and the issue of investment bonds.

The NHDA approved loans to the value of Rs.1,463 million for housing purposes compared with Rs.1,276 million approved for the same purpose in the previous year. The total number of loans granted was 32,520 and these were below Rs.25,000 each. All these loans have been granted against personal guarantees and carried an interest rate of 14.00 - 15.00 per cent per annum. The sources of funds of the NHDA were government grants (42 per cent), sale of houses (30 per cent) and recovery of loans (28 per cent).

Finance Companies

Total assets of 25 finance companies operating in the country increased by 24 per cent, compared with a 19 per cent increase in 1996 and reached Rs.22,295 million at end 1997 reflecting a considerable improvement in their activities. In comparison, total assets of commercial banks increased by 14 per cent in 1997 and 16 per cent in 1996.

Total loans and advances including hire purchase and leasing increased by 20 per cent to Rs.14,544 million. The

TABLE 10.12
Assets and Liabilities of Licensed Finance Companies

Rs. Million

Item	As at 31 December 1996	As at 31 March 1997	As at 30 June 1997	As at 30 September 1997(a)	As at 31 December 1997(a)
Assts					
1. Loans & Advances	12,086	12,951	12,662	13,318	14,544
2. Equity Investments	1,036	1,145	1,179	1,427	1,697
3. Treasury Bills	1,125	1,285	1,241	1,348	1,534
4. Other Assets	3,737	3,862	4,964	5,327	4,520
Total	17,984	19,242	20,046	21,420	22,295
Liabilities					
1. Capital Accounts	2,605	2,648	2,844	2,932	3,124
2. Deposits	10,202	11,088	12,182	12,231	14,037
3. Borrowings	1,454	1,203	861	682	558
4. Other Liabilities	3,724	4,303	4,159	4,575	4,576
Total	17,984	19,242	20,046	21,420	22,295
Number of Finance Companies reporting to the Central Bank	24	25	25	25	25

(a) Provisional

Source: Central Bank of Sri Lanka

increase in total advances of commercial banks was 14 per cent in 1997. Investments of finance companies, consisting of investments in government securities, subsidiaries, associated companies and parent companies and other investments increased by 50 per cent to Rs.3,231 million. The bulk of these new investments was in Treasury bills and shares. Investments in Treasury bills, which accounted for 47 per cent of total investments, rose by 36 per cent bringing the investments in Treasury bills to Rs.1,534 million at end 1997. Meanwhile, other assets of finance companies increased by Rs.783 million (21 per cent) in 1997.

On the liabilities side, deposits with finance companies moved up by Rs.3,835 million (38 per cent) in 1997 compared to Rs.1,975 million (24 per cent) in 1996 reflecting an improvement in public confidence following the measures taken by the Central Bank to regulate their activities. Consequently, the dependence on borrowings by finance companies declined from Rs.1,454 million to Rs.558 million. Meanwhile, capital, reserves and retained earnings of finance companies increased by Rs.519 million during the year. Other liabilities of finance companies also increased by 23 per cent to Rs.4,576 million in 1997.

Following the declining trend observed in the deposit rates of commercial banks, deposit rates of finance companies have also been gradually reduced, particularly during the second half of the year. Interest rates on fixed deposits maturing in one year, which were in the range of 17.00-21.00 per cent per annum in the first part of year, were reduced to a range of 14.00-21.00 per cent per annum in the latter part of 1997. Interest rates on one year fixed deposits in 1996 were in the range of 18.00-21.00 per cent per annum. Interest rates on fixed deposits maturing in three months and six months were in the range of 8.00-19.00 per cent per annum and 12.00-20.00 per cent per annum, respectively, during the year. Meanwhile, interest rates on fixed deposits maturing in more than one year were in the range of 15.00-24.00 per cent per annum. Interest rates on one year and two year certificates of deposits were in the range of 13.00-22.00 per cent per annum during the period under review.

Lending rates on hire purchase financing were in the range 11.00-30.00 per cent per annum during the period under review, in comparison to a range of 16.00-30.00 per cent per annum in 1996, while the rate charged by most companies was 25.00 per cent per annum or above, reflecting the risks associated with such lending. Interest rates on leasing were in the range of 13.00-30.00 per cent per annum though the rates charged by most of the companies were less than 20.00 per cent per annum. Loans granted on hire purchase and leasing activities as a percentage of total loans and advances were 18 per cent and 53 per cent, respectively, at end December 1997, in comparison to 20 per cent and 54 per cent, respectively, at end 1996. The lending rates on secured loans and overdrafts of commercial banks were in the range of 11.00-29.00 per cent per annum while on unsecured loans and overdrafts they were in the range of 10-36 per cent during the period under review.

10.10 Specialised Financial Institutions

Merchant Banking

The total number of merchant banks in operation increased to ten in 1997. Two new merchant banks, including one run on Islamic banking principles, opened during the year, while another merchant bank, which had been established previously, commenced operations during the year. Merchant banks engaged in fund based and fee based activities. The performance of the merchant banking sector, as a whole, faced a setback in 1997, primarily due to the very large losses suffered by one merchant bank, which is currently implementing a major restructuring programme. The total income of merchant banks had decreased by 11 per cent in 1997 over the previous year. The major part of this income was derived from fund based activities such as leasing (25 per cent), discounting trade bills (18 per cent), and financial and marketing services (10 per cent). With the opening of the two new merchant banks, the total assets of merchant banks rose from Rs.13,002 million at the end of 1996 to Rs.18,647 million at end 1997.

TABLE 10.13
Progress of Activities of Merchant Banks 1996-1997

Rs. Million

	1996	1997*
1. Earned Income on Leasing	560	472
2. Interest on Discounting Trade Bills	375	335
3. Financial and Marketing Consultancy Services	40	181
4. Underwriting Commissions	12	1
5. Insurance Commissions	2	2
6. Interest on Margin Trading	71	25
7. Profit on Investment in Shares	144	96
8. Interest on Treasury Bills	126	123
9. Other Income	786	656
10. Total Income	2,115	1,891
11. Total Assets	13,008	18,647
No. of Merchant Banks reporting	6	10

* Provisional Source: Central Bank of Sri Lanka

Leasing Companies

There were five leasing companies, including three specialised leasing companies and two leasing companies which are subsidiaries of the two state banks, which were engaged primarily in leasing business in 1997. Activities of leasing companies were affected by competition from commercial banks, finance companies and development banks. Total assets of leasing companies increased from Rs.6,084 million in 1996 to Rs.7,028 million in 1997. The total new lease finance provided by these companies increased by 63 per cent and reached Rs.3,217 million. The bulk of lease finance was for commercial vehicles (38 per cent of the total finance), passenger vehicles (32 per cent), and plant and machinery (12 per cent).

In terms of sectors, trade and transport sectors each accounted for 30 per cent of the total lease financing, while the industrial sector and the services sector received 17 per cent and 15 per cent, respectively. Financing for the construction sector decreased by 31 per cent.

Venture Capital Companies

The total number of venture capital companies (VCCs) operating in the country increased to seven with the establishment of a new company in 1997. Total assets of VCCs grew by 2 per cent to Rs.2,348 million at end 1997. Total investments of VCCs rose from Rs.1,252 million in 1996 to Rs.1,588 million in 1997. As in the previous year, their investment portfolio continued to consist mainly of equity in new companies for commencement of operations. Of the total investments, 58 per cent were in equity for commencement of operations. The expansion of existing projects absorbed 21 per cent of total investments of VCCs in 1997, compared to 27 per cent in the previous year. VCCs invested funds mainly in ventures in the agriculture, manufacturing and services sectors. Investments in the manufacturing sector, which accounts for 55 per cent of the total, increased by 17 per cent to Rs. 799 million. Investment in the services sector rose by 12 per cent and absorbed 31 per cent of total finance provided. Equity financing for projects in the agriculture sector rose from Rs.163 million to Rs. 208 million and accounted for 14 per cent of total funds provided.

Insurance Companies

There were six insurance institutions operating in the country. Of the six, five companies engaged in life and general insurance activities, while one company conducted life insurance activities only. Life insurance activities, as well as general insurance activities, showed an increase during the year. Legislation is currently being prepared to improve the regulation of the insurance sector and its activities.

The total life premia collected by the six companies increased to Rs.2,209 million, an increase of 18 per cent over the previous year. This compared with a 22 per cent increase in 1996. The total value of the life funds of the insurance companies increased from Rs.10,892 million to Rs.13,400 million in 1997. Total benefit payments under life insurance rose by 25 per cent during the year. The total number of life policies in force increased by 17 per cent in 1997.

General insurance, which consists of fire, accident, marine and motor insurance activities also showed an increase during the year under review. Net premia for general insurance rose from Rs.3,398 million to Rs.3,782 million. Net premia in the motor insurance sector, which is the biggest non-life sector, rose by 10 per cent or to Rs.1,726 million. Meanwhile, net premia for fire insurance and general accident insurance rose by 15 per cent and 22 per cent, respectively. The net premia in marine insurance dropped by 17 per cent to Rs.329 million.

10.11 Money Market

Overall Trends

The Sri Lankan economy recovered strongly in 1997 after the setback in the middle of 1996. With this recovery and the injection of funds to the market that resulted from the reduction in the statutory reserve requirement (SRR), large inflows of foreign funds from privatisation proceeds to the Government, foreign loans obtained by development financial institutions, the Government's issue of Floating Rate Notes and compensation to workers in Kuwait, liquidity conditions improved and money market rates tended to stabilise at a lower range while activities of the money market grew. This trend was clearly reflected in the Treasury bill market which had a high degree of over-subscription at most primary Treasury bill auctions. The increased liquidity due to the above factors, in conjunction with a moderate demand for credit from both the private sector and the Government and a decline in inflationary expectations, also caused a decline in interest rates in the market. The yield on 12-month Treasury bills fell from 17.38 per cent at end 1996 to 10.21 per cent at end 1997. With a view to absorbing the excess liquidity experienced during the middle of the year, the Central Bank issued its own securities, thereby stabilising short-term interest rates. In the domestic foreign exchange market, the Central Bank's middle rate for the US dollar depreciated by 7.5 per cent in 1997, while the spot market rates depreciated by 8.0 per cent. Following the downward trends in domestic interest rates, the premium in the forward foreign exchange market declined from about 11.64 per cent per annum for 3 month forward sales at end 1996, to 6.35 per cent per annum at end 1997. The foreign exchange market was active and stable in 1997 though some speculative behaviour was seen towards the latter part of the year as a result of the financial crisis in some East Asian countries.

Inter-Bank Call Money Market

Following the liquidity developments in the money market, the activities in the inter-bank call money market expanded substantially while call market rates were generally stable within a lower range. This was mainly attributed to improved liquidity resulting from the reduction in the Statutory Reserve Requirement (SRR) twice during 1997, large foreign inflows from the receipts of privatisation proceeds, and the foreign loans obtained by development financial institutions. An improved fiscal performance which reduced government domestic borrowing pressure also contributed to commercial bank liquidity. Call market rates

TABLE 10.14
Money Market Operations 1995-1997

Rs. Million

Period	Call Money Market		Primary Treasury Bill Market						Secondary Treasury Bill Market	
					Amount Accepted (Purchases)					
	Total Lending/ Borrowings	Outstanding at end period	Total Outstanding	Amount Issued	Central Bank	Commercial Banks	Others	Total	Total Sales	Total Purchases
1995										
1st Quarter	121,858	3,308	98,546	57,166	1,028	36,946	19,192	57,166	5,867	2,977
2nd Quarter	145,655	2,301	100,396	56,577	4,770	35,085	16,723	56,577	3,534	6,542
3rd Quarter	166,686	2,942	107,671	55,445	5,882	33,507	16,057	55,445	2,696	12,358
4th Quarter	219,416	8,078	113,771	54,823	8,237	31,425	15,161	54,823	4,947	13,451
1996										
1st Quarter	217,697	2,390	120,021	52,025	3,560	27,170	21,295	52,025	9,384	795
2nd Quarter	191,406	4,792	122,821	50,009	8,586	27,285	14,138	50,009	1,710	3,871
3rd Quarter	233,790	3,977	124,521	58,819	9,502	33,021	16,296	58,819	1,975	5,854
4th Quarter	301,921	6,862	124,996	66,027	2,753	42,362	20,912	66,027	3,043	6,301
1997										
1st Quarter	303,208	4,811	124,996	56,629	9,304	30,179	17,146	56,629	7,222	4,027
2nd Quarter	275,508	5,830	124,996	38,609	7,863	22,452	8,294	38,609	4,373	4,433
3rd Quarter	224,566	1,853	114,996	46,676	3,886	25,776	17,014	46,676	5,936	1,563
4th Quarter	212,175	3,599	114,996	68,973	4,245	44,906	19,822	68,973	1,289	7,197

Source: Central Bank of Sri Lanka

which were in the range of 17.50-28.00 per cent per annum at end December 1996, declined to a narrow and lower range of 8.00-10.25 per cent at end March 1997. They narrowed further to a range of 9.50-10.00 per cent at end June and to 8.87-9.00 per cent at end September. Some increase in both volatility and the level of rates was seen in December, as a result of uncertainty in the foreign exchange market. Call market rates fluctuated within a range of 9.00-16.00 per cent during December 1997 except on three days when the rate was in the range 18.00-20.00 per cent. Reflecting the active participation by investors in the call market, the annual turnover amounted to Rs.1,015,457 million in 1997, an increase of 7.5 per cent when compared with Rs.944,814 million in 1996.

Treasury Bill Market

Primary Market for Treasury Bills

The major developments in the primary market for Treasury bills in 1997 was the significant decline in Treasury bill rates during the year and the retirement of Rs.10,000 million worth of bills by the Government. The improved liquidity condition in the market led to the low yield rates while open market operations of the Central Bank helped to stabilise interest rates. The increased liquidity in the system was reflected in the high degree of over-subscription at most Treasury bill auctions in 1997. The total value of Treasury bills offered in the primary market during 1997 stood at Rs.194,866 million as against Rs.219,254 million in 1996. The Central Bank purchased bills amounting to Rs.9,276 million at the auctions while Treasury bills reserved for the Central Bank totalled Rs.16,021 million and were mainly maturing bills in its portfolio. The Government retired Treasury bills amounting to Rs.10,000 million on 06 August with a part of the sales proceeds of Sri Lanka Telecom. In addition to reducing the Government's interest cost, this also increased the availability of financial resources to the private sector. The retirement of Treasury bills was effected by paying off bills held by the Central Bank, which not only curtailed the expansion of high powered money, thus reducing the inflationary pressure in the economy, but also avoided destabilising the money market. Accordingly, the total Treasury bills outstanding declined to Rs.114,996 million at end of 1997 from Rs.124,996 million at the end of 1996. The reduction in the portfolio of Treasury bills held by the Central Bank, however, affected its ability to use Treasury bills for its open market operations (OMO), compelling the Bank to issue its own securities for OMO. The Central Bank's holdings of Treasury bills stood at Rs.6,691 million at end 1997 as against Rs.17,114 million at end 1996. Treasury bills purchased by commercial banks in the primary market amounted to Rs.123,313 million in 1997 as against Rs.129,838 million in 1996. Primary market Treasury bill yields, which were in the range of 17.45-18.17 per cent per annum for 3-month bills in December 1996, fell significantly to a range of 9.96-9.98 per cent in December 1997, while the yields on 12-month bills decreased from a range of 17.38-17.93 per cent to a range of 10.17-10.21 per cent.

Central Bank Secondary Treasury Bill Market

The sales (discounting) of Treasury bills from the secondary window of the Central Bank rose to Rs.18,821 million in 1997 from Rs.16,111 million in 1996, while purchases (rediscounting) of Treasury bills increased to Rs.17,220 million in 1997 from Rs.16,822 million in 1996. In the context of declining money market rates, the Central Bank gradually reduced the discount and re-discount rates applicable in the secondary window of the Treasury bill market. Accordingly, discount and re-discount rates for 3-month bills declined sharply from 17.20 per cent per annum and 18.95 per cent per annum, respectively, at end 1996 to 9.72 per cent and 12.97 per cent at end 1997. The spread between the discount rate and the rediscount rate, which was 1.75 percentage points at the beginning of the year, was varied during the year to influence secondary market activity and market liquidity, and stood at 3.25 percentage points at the end of December 1997.

Central Bank Repurchase Market for Treasury Bills

Factors such as primary and secondary market rates, call market rates, market liquidity, foreign exchange market developments, general economic conditions and policy considerations were taken into account in setting the repo rate daily by the Central Bank. Following the declining trend in the interest rate structure in the country, the repo rate was adjusted during 1997. The overnight repo rate, which stood at 12.75 per cent at end 1996, was reduced to 7.00 per cent per annum by end March 1997, before being raised to 9.00 per cent by end June. Consequent to the improved liquidity conditions in the market, the repo rate was reduced again to 8.25 per cent at end August, and followed by an increase to 9.00 per cent at end September. The repo rate was gradually raised from 9.00 per cent at the beginning of December to 11.00 per cent by end 1997. The repo rate was adjusted upward in order to adjust the short-term interest rates to permit investors to obtain a positive real rate of return as inflation rose slightly in November and December, and to discourage domestic speculators from obtaining relatively low cost rupee funds for the speculative purchase of US dollars.

Reflecting increased liquidity in the market, high volumes were transacted in the repo market. This resulted in repo sales in 1997 of Rs.446,423 million, when compared with Rs.403,595 million in 1996. In view of the high liquidity conditions in the market, the reverse repurchase scheme of the Central Bank continued to be inactive in 1997.

Domestic Foreign Exchange Market

During 1997, the Central Bank continued to operate in the domestic foreign exchange market by trading US dollars against Sri Lanka Rupees. The Central Bank announced daily spot buying and selling rates for the US dollar for transactions with commercial banks. The spread between spot buying and selling rates, which was set at 2 per cent in 1995, remained unchanged during 1997. At the end of 1997, the Central Bank middle rate per US dollar was Rs.61.2850 as against Rs.56.7050 at end 1996, a depreciation of 7.5 per cent. Foreign exchange purchases of the Central Bank from commercial banks moved up from US dollars 96.2 million in 1996 to US dollars 136.6 million in 1997, while sales to commercial banks declined from US dollars 198 million to US dollars 154.6 million during the same period. Thus, for the year as a whole, the Central Bank had net sales of US dollars 18 million to commercial banks, in comparison to net sales of US dollars 101.8 million in 1996.

Commercial banks were permitted to grant foreign currency loans to non-BOI exporters, with effect from January 1997, either from their domestic units or from their FCBUs. This provided these exporters with relatively low cost funds, for improving their international competitiveness. Under this scheme, a gross sum of US dollars 254 million had been granted up to end December. At end December, the outstanding level of loans was US dollars 70.7 million.

The financial crisis in East Asia and the sharp depreciation of the exchange rates of these countries had some effect on the Sri Lankan market. Some volatility was seen in the domestic foreign exchange market towards the end of the year with speculation of a large depreciation. This led to the inter-bank spot rate for the US dollar depreciating more than the Central Bank's middle rate and to a purchase of foreign exchange by commercial banks from the Central Bank in December. Commercial banks purchased US dollars 58 million in December from the Central Bank. Market sources indicated that a part of this was to hedge against the forward sales of foreign currency by the banks.

Inter-bank foreign exchange activity also increased, partly due to the uncertainty caused by the East Asian financial crisis. Total inter-bank turnover amounted to US dollars 3,881 million in 1997, in comparison to US dollars 2,367 million in 1996. The uncertainty in the market was clearly reflected in the increase in the volume of forward transactions, which increased to US dollars 3,082 in 1997 from US dollars 1,473 in 1996. The uncertainty was most marked in November and December. Forward sales averaged US dollars 352 million per month in these two months compared with an average of US dollars 238 per month in the first ten months of 1997. The inter-bank spot rate for US dollars depreciated from Rs.56.6995 at end 1996 to Rs.61.6518 at end 1997, a depreciation of 8.0 per cent.

Central Bank Securities

Consequent on the excess liquidity which resulted from the receipt of an Asian Development Bank (ADB) loan by a development finance institution and the repayment of some of the Government's outstanding liabilities to commercial banks in August, the issue of Central Bank securities commenced on 1 September 1997, to sterilise the impact of this excess liquidity. Short-term Central Bank securities, with maturities of 7 and 28 days were issued, primarily with the intention of stabilising interest rates in the inter-bank call market. The issue was open ended with regard to the quantity. Total issues of 7 day and 28 day securities during the period 1 September- 29 December were Rs.7,825 million and Rs.10 million, respectively. The securities were sold at par, with interest rates based on the overnight repo rate. Accordingly, the interest rates for 7 days and 28 day issues were in the range of 8.35-10.91 per cent per annum and 9.21 per cent, respectively.

Commercial Papers (CP)

Commercial paper (CP), which are unsecured promissory notes issued by companies to raise short-term funds, have become a significant source of funds to the private sector and have gained in popularity in the recent past, due to the downward stickiness of the lending rates charged by commercial banks for traditional credit. CP are issued primarily by listed companies and financial institutions such as merchant banks. They are usually underwritten, endorsed or guaranteed by a commercial bank or a merchant bank. The maturity of CP is usually 3-6 months and they are almost always issued on a discount basis, rather than with a coupon.

The gross issues, including reissues, of CP in 1997 amounted to Rs.10,085 million. Merchant banks issued their own paper amounting to Rs.2,215 million and on behalf of clients totalling Rs.853 million. Commercial banks supported CP issues amounting Rs.7,016 million. The bulk of these issues were 3-month bills. The outstanding value of commercial papers supported by commercial banks stood at Rs.1,618 million at end 1997 compared with Rs.1,181 million at end 1996. The yield on commercial paper was in the range of 10.75 - 24.00 per cent per annum.

10.12 Capital Market

The activities in the Colombo stock market which remained at a depressed level in 1995 and 1996, showed an improvement in 1997. A recovery in the economy, improved foreign investor sentiment, favourable corporate performance, an increase in domestic demand for shares with a decline in interest rates on fixed income securities, the continuation of the privatisation programme and regional market developments, contributed largely to increased market activity and rising share prices, in the first half of 1997. During July 1997, the indices reached their highest levels since August 1995. However, terrorist activities in Colombo and foreign investor caution due to the financial crisis in South East Asian countries led to a slowing down in the stock market activities during the second half of the year. Net purchases of foreign investors increased significantly during April to June, before these investors became net sellers during the latter part of the year. Two plantation companies and three non-plantation companies had initial public offerings (IPOs) during the year. With high tea prices and resultant increased profits in the plantation companies, the IPOs of the plantation companies were heavily over-subscribed, whereas those of non-plantation companies (two hotel sector companies and a financial sector company) were under-subscribed. Under the privatisation programme of the Government, a 51 per cent stake of a plantation company was sold, on an all or nothing basis, through the Colombo Stock Exchange. In addition, a part of the Government held debentures in the NDB were converted into 916,700 shares and offered to the public through the Colombo Stock Exchange at Rs.250 per share (par value Rs.10) in September 1997. The Government also converted the balance of its holdings of debentures in the NDB into equity and offered these shares internationally at the dollar equivalent of Rs.260 per share. The offer was fully subscribed, demonstrating the confidence reposed in the Sri Lankan economy by international investors. A net sum of US dollars 73 million was realised by the Government through this sale. Meanwhile, the number of listed companies at end December 1997 increased to 239 with five new listings on the Colombo Stock Exchange (CSE).

A major development in the capital market in 1997 was the issue of Treasury bonds with maturities of 2, 3 and 4 years. These Treasury bonds carry a coupon rate and are sold by auction. Meanwhile, Vanik Incorporation Limited issued 1.5 million of unsecured 3-year redeemable debentures to the public in September 1997, which was over-subscribed by 15 per cent. These were sold at a par value of Rs.100 per debenture while it carried an interest of 18 per cent per annum payable half yearly. One of the salient features of these debentures was the tradability in the secondary market through the Colombo Stock Exchange.

TABLE 10.15
Share Market Indicators

	1994	1995	1996	1997
1. Market Capitalisation (Rs.Mn.)	143,210	106,869	104,197	129,428
2. Number of New Issues (No.)	21	17	8	5
3. Total Number of Shares Issued (Mn.)	190	100	64	50
4. Value of Shares Issued (Rs.Mn.)	4,589	2,120	2,178	456
5. Number of Shares Traded (Mn.)	506	315	227	515
6. Value of Shares Traded (Rs.Mn.)	34,522	11,249	7,403	18,315
7. Price Indices -				
CSE All Share (as at end Dec.)	986.7	663.7	603.0	702.2
CSE Sensitive (as at end Dec.)	1,438.8	990.5	897.7	1,068.0

Source : Colombo Stock Exchange

Primary Market

There was a total of five IPOs in 1997 in comparison to eight in 1996. Of these, three were non-plantation companies, viz, Marawila Resorts Ltd., Light House Hotel Ltd. and L.B. Finance Ltd., while two were plantation companies, viz., Maskeliya Plantations Ltd. and Watawala Plantations Ltd. The total market value of the five IPOs (inclusive of share premium) was Rs.583 million compared with the market value of Rs.2,178 million of eight IPOs made in 1996. Meanwhile, the total value of rights issues was Rs.1,078 million in 1997 compared with Rs.3,064 million in 1996.

Secondary Market

The All Share Price Index (ASPI) and Sensitive Price Index (SPI), which declined in 1995 and 1996, showed significant increases during the first seven months of 1997, reaching a peak in July. From July to November both indices declined continuously, while an upward movement was seen again in December. The ASPI and SPI improved by 44 per cent and 57 per cent from end December 1996 to end July 1997, rising from 603 to 870 and 898 to 1,411, respectively. Eventhough share prices recorded some decline during the second half of 1997, the year ended with an overall increase of 16 per cent in the ASPI and 19 per cent in the SPI, which were attractive increases when compared with the performance in other markets in the region.

Market capitalisation of the CSE increased by 47 per cent from Rs.104,200 million at the end of 1996 to

Chart 10.5
Share Market Indicators

Chart 10.5.1
Share Price Indices
(1985 = 100)

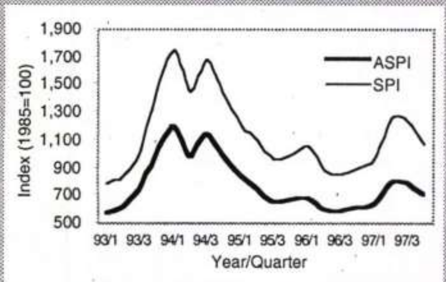


Chart 10.5.2
Stock Market Transactions

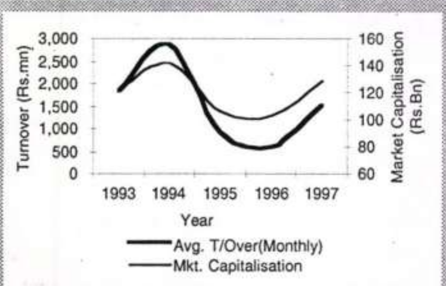
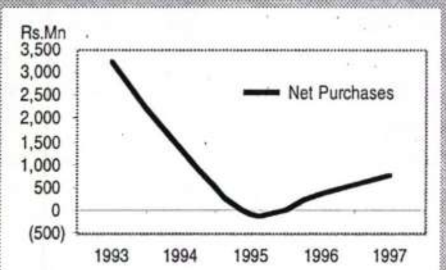


Chart 10.5.3
Non-National Participation



Rs.153,000 million at end July 1997. However, it declined to Rs.129,400 million by end December 1997, recording an increase of Rs.25,200 million (24 per cent) for the year as a whole. Forty per cent of the total value of the market capitalisation in Sri Lanka has been from 10 institutions. John Keels Holdings, NDB, DFCC Bank, Hayleys, HNB, Ceylon Tobacco, Commercial Bank, Sampath Bank, Lion Brewery and Distilleries are these top ten institutions. Five of these are financial institutions, including two development banks. The two development banks' share of market capitalisation was 20 per cent at end December 1997.

TABLE 10.16
Number of New Share Issues by Type of Investment

Type of Investments	1994	1995	1996	1997
Banks, Finance & Insurance	6	2	-	1
Beverages, Food & Tobacco	4	-	1	-
Chemicals & Pharmaceuticals	-	-	1	-
Constructions & Engineering	-	-	-	-
Diversified	-	-	-	-
Footwear & Textiles	1	-	-	-
Hotels & Travel	1	1	1	2
Investment Trusts	-	-	-	-
Land & Property	2	-	-	-
Manufacturing	6	5	-	-
Motors	-	-	-	-
Oil Palm	-	-	-	-
Plantations	-	9	5	2
Services	-	-	-	-
Stores & Supplies	-	-	-	-
Trading	1	-	-	-
Total	21	17	8	5
Number of Shares Offered (Mn.)	190	100	64	50
Value of Shares Offered (Rs.Mn.)	4,589	2,120	2,178	583

Source: Colombo Stock Exchange

The total turnover showed a substantial increase from Rs.7,403 million in 1996 to Rs.18,315 million in 1997 (an increase of 147 per cent). The average daily turnover increased from Rs.30.6 million in 1996 to Rs.75.9 million in 1997. The number of trades also showed a substantial increase to 206,312 in 1997 from 98,191 in 1996. The largest share (41 per cent) in the total turnover was from the banks, finance and insurance sector, while DFCC Bank, NDB, Sampath Bank and Commercial Bank accounted for 72 per cent of the share of this sector, with a contribution of 48 per cent from two development banks, i.e. DFCC Bank and NDB. Monthly turnover fluctuated, showing significant increases in the months of April, June and July. The highest turnover amounting to Rs.2,243 million was recorded in April, while the lowest (Rs.445 million) was recorded in February. However, turnover fell during the latter part of the year, reflecting the uncertainty that developed in the regional capital markets.

The market price earnings ratio (PER) improved during 1997 after a continuous decline during 1996. The highest

TABLE 10.17
New Share Issues of Companies during 1997

	Name of Company	Date of Opening List	No. of Shares (Thousands)	Par Value (Rs.)	Premium (Rs.)	Value of Shares on Offer (Rs. Mn.)	No. of Shares Applied for by Public (Thousands)	No. of Shares Taken up by Underwriters (Thousands)
1	Marawila Resorts Ltd.	26.03.97	15,666	10	-	157	250	2,750
2	Light House Hotel Ltd.	12.06.97	22,500	10	-	225	5,992	16,508
3	Maskeliya Plantations Ltd.	19.09.97	4,000	10	5	60	56,913	-
4	Watawala Plantations Ltd.	06.10.97	4,000	10	5	60	18,007	-
5	L. B. Finance Ltd.	10.11.97	4,050	10	10	81	525	3,525

Source: Colombo Stock Exchange

ratio of 15.2 per cent was recorded in July 1997, while at end December, it had declined to 12.5 per cent.

Improved political stability and recovery in economic activities had a favourable impact on foreign investor activities in the Colombo stock market, particularly in the first seven months of the year. The outcome of foreign investor activities during this period was a net purchase of Rs.1,658 million. However, the East Asian crisis had a dampening effect on foreign transactions in the stock market in Sri Lanka during the latter part of the year. Net sales of Rs.910 million were recorded during the period from August to December. However, overall, foreign transactions displayed a significant improvement from net purchases of Rs.352 million in 1996 to Rs.748 million in 1997. During the period under review, foreign participation accounted for 42.9 per cent of the total turnover compared to 54.7 per cent in the previous year. The decline of the percentage share of foreign participation was due to increased domestic activities in the share market, particularly in new share issues of plantation companies.

TABLE 10.18
Category-wise Distribution of Shares Traded in the Secondary Share Market in 1997

Category of Investment	No of Transactions	No. of Shares (Mn.)	Value (Rs. Mn.)
Banks, Finance & Insurance	53,470	138,122	7,514,497
Beverages, Food & Tobacco	20,966	58,245	1,654,541
Construction & Engineering	5,682	13,266	270,500
Chemicals & Pharmaceuticals	3,001	3,592	212,331
Diversified	12,788	61,965	3,092,328
Footwear & Textiles	4,383	6,859	89,969
Hotels & Travels	12,212	50,405	713,874
Investment Trusts	1,082	1,024	31,495
Land & Property	5,197	11,081	88,959
Manufacturing	53,107	108,045	2,421,608
Motors	1,903	4,574	187,305
Oil Palms	41	23	7,223
Plantations	28,193	53,515	1,789,835
Services	1,136	1,047	34,954
Stores & Supplies	210	350	22,267
Trading	2,941	3,110	109,418

Source : Colombo Stock Exchange

Sectoral Performance

The movements in the sectoral price indices showed that prices in 11 of the total of 16 sectors have moved favourably in 1997 compared with prices at end 1996. Plantations, diversified, trading, beverage, food and tobacco, services, motors, oil palm, manufacturing, hotels and travel, construction and banks, finance and insurance were the sectors in which price improvements were recorded. The price index of the plantations sector achieved the highest growth of 61 per cent, boosted by high tea prices, while the biggest loser was the footwear and textiles sector which recorded a decline in its prices by 25 per cent. Stores and supplies, chemical and pharmaceuticals, investment trusts and land and property were the other sectors in which price declines were recorded.

Regional Stock Markets

The problems in the financial sector in Thailand, experienced since mid 1997, had a spillover effect on other neighbouring countries particularly Malaysia, Indonesia, Korea, the Philippines, Japan, Hong Kong and Singapore. Together with comparatively strong growth in economies in North America and Western Europe, this resulted in stock markets in most countries in the Asia Pacific region being adversely affected as investors were cautious and reallocated their portfolios. The worst affected was the Bangkok stock market which had a 57 per cent decline in the price index by end December 1997, on a year on year basis. Declines were recorded in stock markets in Kuala Lumpur (54 per cent), Jakarta (42 per cent), Seoul (42 per cent), Tokyo (24 per cent), Singapore (30 per cent), Hong Kong (23 per cent) and Manila (42 per cent). However, Sydney, Taipei, Bombay, Karachi and Colombo markets recorded gains. Meanwhile, the share price indicator for the New York stock exchange, the Dow Jones Industrial Average, recorded a growth of 23 per cent, while in London, the Financial Times Stock Exchange Index grew by 25 per cent.

Developments in the Market

The CSE introduced a fully automated screen based trading system during the second half of the year, eliminating the old 'open outcry' system of trading that prevailed earlier. With the introduction of the new system, the CSE became one of the most technologically advanced stock exchanges in Asia. Under the new system, the buy or sell order placed through the broker will be transmitted electronically immediately to the Stock Exchange. When a matching order is received the trade would be executed electronically. About 20,000 transactions per trading day could be handled under this screen based trading system, which has 100 times the capacity of the old (manual) trading floor. This has introduced a new dimension in more competitive trading, enabling brokers to match orders better and more quickly which enhances the volume of transactions and gives better pricing.

With the intention of providing facilities to expand stock market activities in remote areas, the CSE is planning to set up branch offices in the provinces. The advanced technology of the current trading system has made it possible for the CSE to set up branches with full on line trading capability at a reasonable cost. Accordingly, stock brokers could be given a trading desk at the branch office to carry out transactions on behalf of their clients, eliminating the need to contact a Colombo broking office. The CSE is also hoping to introduce stock lending and borrowing to improve liquidity in the market.

Vanik Incorporation Ltd. (Vanik) was granted approval to start merchant banking and stock broking operations in Bangladesh, making it the first Sri Lankan institution to start stock broking operations in a foreign country. For this purpose Vanik has entered into a joint venture, named Vanik Bangladesh Ltd.

Several proposals were made in the Budget 1998 with a view to improving the activity and efficiency of the stock market. In the previous two Budgets, broker's fees and share transactions of investment companies and unit trusts had been exempted from turnover tax, while quoted share transactions had been exempted from stamp duty. In the 1998 Budget, the stamp duty on initial public offers was reduced to a nominal sum of 50 cents for every Rs.1,000. Companies seeking and obtaining a listing on the CSE were to be given a tax bonus of 5 percentage points over the prevailing tax rate. Existing listed companies were also to receive this concession, provided they maintained 25 per cent of their issued capital with the public. Capital gains arising from the sale of equity held in unquoted companies to enable a company to obtain a listing on the CSE within a prescribed period was to be exempt from income tax. In order to encourage individual participation in stock market activity, investments in new shares of listed companies were to be allowed as a deduction from assessable income, subject to certain limits, for a period of one year. The NSB, EPF and ETF were to be permitted to invest a portion of their funds in listed companies. The income of Unit Trusts was to be made tax exempt, though the income distributed by these would continue to be taxed in the hands of unit holders as usual. A Settlement Guarantee Fund and a Compensation Fund were to be established to facilitate market participation in trading transactions, with the Government's contribution to these being limited to a maximum of Rs.150 million.

Medium and Long-Term Government Securities

Treasury Bonds

A new development in the capital market was the issue of market oriented government securities. These Treasury bonds carry a coupon rate, with interest paid semi-annually, and are also sold by auction. Thus, the yield on these bonds is market determined. By varying the coupon rate, the monetary authorities are also able to provide indications to the market on the expected direction of medium- term interest rates. The issue of these bonds will provide the private sector with medium-term benchmark interest rates and provide a risk free yield curve for a period beyond the one year provided by Treasury bills. The Government is also thus able to make its medium-term debt instruments more market oriented.

The first issue of Treasury bonds, for Rs.500 million, was made on 1 March 1997. These bonds carried a coupon rate of 14.00 per cent per annum and had a maturity of 2 years. The offer was fully subscribed at par. Thereafter, auctions were held once a fortnight, with Rs.500 million being offered at each auction. A total of Rs.10 billion worth of Treasury bonds was issued in 1997. Of this total, Rs.7.5 billion of bonds had a maturity of 2 years, Rs.1 billion of bonds had a maturity of 3 years, and Rs.1.5 billion worth of bonds were for 4 years. All auctions were over-subscribed Following market trends and a reduction in inflationary expectations, the coupon rate was reduced gradually from 14.00 per cent per annum for 2 year bonds at the first auction, to 11.50 per cent per annum for 2 year bonds at the last auction on 12 November 1997. The market's growing acceptance of these Treasury bonds was discernible in the bidding patterns. The over-subscription, which was 128 per cent at the first auction, was 339 per cent at the last auction in November. Market perceptions of inflation and future interest rates were also displayed at these auctions. After October, many bids for Treasury bonds were received at a premium and the weighted average yield fell below the coupon rate. The weighted average yield on 2 year bonds declined from 14.00 per cent per annum in February to 11.56 per cent per annum at the last auction in September.

TABLE 10.19

Treasury Bond Issues during 1997

Maturity Period	Coupon Rate (% per year)	Weighted Average Yield to Maturity	Outstanding Amount at end Year (Rs. Million)
2 years	12.00 - 14.00	11.56 - 14.00	7,500
3 years	11.75 - 12.00	11.10 - 11.74	1,000
4 years	11.50 - 12.25	11.36 - 12.25	1,500
Total			10,000

Source: Central Bank of Sri Lanka

Rupee Loans

The major portion of medium and long-term Government borrowing continued to be obtained through Rupee Loans. A total of Rs.48,500 million was raised through Rupee Loans, in comparison to Rs.46,700 million in 1996. Rupee Loans are sold at par and carry a fixed rate of interest. The rate is administratively determined, taking market trends in interest rates also into consideration.

TABLE 10.20

Rupee Loans Floated during 1997

Maturities (Years)	Volume (Rs. Million)	Interest Rates
2	5,500	13.13-14.00
3	15,000	13.50-14.50
4	5,000	12.50-13.00
4-8	3,500	11.50-11.80
5-7	1,500	11.25
6-7	17,000	11.75-12.25
6-8	1,000	11.75

Unit Trusts

An upsurge of activities in Unit Trusts (UTs) took place in 1997. Not only did the number of UTs in operation increase, but a diversification in their investment focus also took place, with several of the new UTs, specialising in different types of investments, being established. The expansion in the industry was greatly assisted by an improved performance in the share market after two years of price decreases, and to some extent, by a fall in interest rates in the market. However, the value of their total assets is still lower than the peak level recorded in 1994.

TABLE 10.21

Unit Trusts (a)

	1994	1995	1996	1997(b)
1. Total Assets - Rs. Mn.	3,982	2,881	2,652	3,097
2. Net Assets Value - Rs. Mn.	3,947	2,855	2,637	3,072
3. Investment in Equities - Rs. Mn.	2,854	1,762	1,599	2,244
4. (3) as a percentage of (2)	72.4	61.7	60.6	73.0
5. Total Unit Holders	22,286	22,251	25,240	26,441
6. No. of Unit Trusts	4	4	5	10

(a) Values are as at 31 December
(b) Excluding Namal Income Fund which was launched on 27 November 1997.

Source : Unit Trusts

Five new Unit Trusts, viz. Namal Growth Fund, Namal Income Fund, Eagle Gilt Edged Fund, Eagle Income Fund and Eagle Growth Fund were established. This increased the total number of UTs operating in the country to 10 at the end of 1997. Of these, Eagle Income Fund and Namal Income Fund concentrate their investments in fixed income securities, while Eagle Gilt Edged Fund will be invested exclusively in Government securities. Namal Growth Fund and Eagle Growth Fund concentrate their investment particularly in equities which are expected to show a high growth in the medium to long-term. The combined Net Asset Value (NAV) of UTs rose by 16.5 per cent, compared to a drop of 7.6 per cent in 1996. The performance of the UTs was clearly related to the performance of the Colombo stock market which recorded an increase of 16.5 per cent in the All Share Price Index in 1997, compared to a drop of 9 per cent in 1996.

The structure of the asset portfolios of UTs has changed considerably in 1997 compared to that of 1996. Investment in equities, as a percentage of total net asset value, was 73 per cent in 1997 as against 61 per cent in 1996. The number of unit holders also increased by 5 per cent in 1997 compared to a marginal drop in 1996. Proposals in the 1998 Budget are also designed to encourage UTs. The tax exemption enjoyed by Unit Trusts was due to expire by 31 March 1998. The Budget proposed that the income of UTs would not be taxed in the hands of the Unit Trusts. Income distribution by UTs to unit holders would be taxed in the hands of unit holders as normal income.