Chapter 10
FINANCIAL SECTOR

10.1 Monetary Policy

In the context of declining inflation and greater stability in money and foreign exchange markets, monetary policy in 2002 was focused on providing adequate liquidity to support economic recovery, while giving due consideration to achieving a sustainable path of low inflation. As warranted by economic developments, the Central Bank cautiously reduced further its key policy rates, namely, the Repurchase (Repo) rate and Reverse Repurchase (Reverse Repo) rate, during the year. In contrast to the two previous years, the money market continued to remain liquid in view of the significant foreign inflows and greater fiscal discipline. The Bank absorbed excess liquidity through open market operations, dampening the potential expansionary impact of the build up of foreign assets on monetary aggregates. Reserve money, which is the principal operating target of monetary policy, was maintained within the targets set under the macroeconomic programme. Monetary growth was slightly higher than projected, in the middle of the year, largely due to the low base effect, *i.e.*, the contraction in money supply in the middle of 2001. However, the rate of growth declined towards the end of the year, as projected. During the year, the Bank continued to undertake further measures aimed at enhancing the efficiency and transparency of monetary management. The amendments to the Monetary Law Act (MLA) by Parliament in December 2002 gives greater flexibility to the Central Bank in the conduct of monetary policy.

As announced at the beginning of the year, policy rates of the Bank were gradually reduced. The Central Bank reduced its Repo rate and Reverse Repo rate in several steps, a larger part of the reduction being made in the second half of the year. Taking into account the decline in the rate of inflation from the beginning of the year, expectations for the coming months and the decline in international interest rates, both rates were reduced by 50 basis points in March 2002. The Reverse Repo rate was increased by 25 basis points in three steps in March and April, in view of market conditions. As both international interest rates and domestic inflation continued to decline, and there was a need to support the economic recovery and encourage investment, the Repo and Reverse Repo rates were reduced again by 100 basis points in July. A further downward adjustment was effected in November, as inflation further moderated in line with expectations, and market rates declined. A total reduction of 225 basis points was made in 2002 in each rate. An increase in real terms is likely to have occurred in some interest rates, as a consequence of the decrease in these rates being less than the decrease in the inflation rate. The Central Bank also adjusted its discount margin, *i.e.*, the difference between the discounting (outright sales) rates for Treasury bills at the secondary window of the Central Bank and the primary market yield rates, to prevent potential arbitrage benefits from market distortions. The margin was raised in June and July, to 125 basis points, from 5 basis points.

The Bank continued the careful management of base money to avoid inflationary pressure emanating from excessive growth in the money supply. The money market continued to remain liquid throughout 2002. Central Bank's purchases of foreign exchange from the market, receipts of loan proceeds from both programme and project loans, the sale of US dollar denominated government loan proceeds to the Bank, and the transfer of Central Bank's profits to the government, mainly contributed to enhancing market liquidity. The Bank mopped up excess liquidity through its repurchase and secondary market operations to mitigate the expansionary impact of net foreign inflows of funds on the domestic economy. As a result, Central Bank's holdings of government paper declined during the year, helping the Bank to maintain reserve money within the desired targets.

The independent floating of the exchange rate in 2001 provided the Bank with greater flexibility to use monetary policy actions, focusing on domestic market conditions. Under the new regime, the Central Bank's intervention in the foreign exchange market is limited to minimising excessive fluctuations and to building up official external reserves. In 2002, the Central Bank's interventions were mainly for the purchase of foreign exchange from the market. This contributed to improving rupee liquidity in the market. With greater stability in the forex market, the Bank was able to permit an increase in the net open position of commercial banks, allowing greater flexibility for their operations.

Another important effort of the Bank last year was to improve the transparency of monetary policy. The overall monetary policy framework and monetary policy projections were posted on the Central Bank's website early in 2002 (www.centralbanklanka.org). In addition, changes to monetary policy measures were notified to market players simultaneously, with explanatory notes. Action was also taken to provide more information to the market on monetary developments to enable market participants and the public to have a better understanding of monetary policy objectives.

The internal discussions and policy dialogues within the Bank too were broadened with the setting up of the Monetary Policy Committee (MPC). The MPC met regularly at least once a month to evaluate the monetary developments and make recommendations to the Monetary Board.

Measures were also taken to improve the efficiency of formulating monetary policy and to promote the market orientation of monetary policy. Amendments to the Monetary Law Act passed in December 2002 give more flexibility to the Bank in conducting monetary policy. These changes removed the lower limits on statutory reserve requirements (SRR) and permit greater flexibility in defining eligible financial institutions and instruments for purposes of SRR. The Central Bank announced that it would move to active open market operations (OMO) in early 2003 in order to enable it to manage market liquidity more effectively to ensure the realisation of monetary targets. This system would also encourage market participants to manage their liquidity more efficiently. Initial action, such as mock operations, commenced in the latter part of 2002, in consultation with market participants.

10.2 Money and Credit Aggregates

Reserve Money

Reserve money, which comprises notes and coins issued by the Central Bank and deposits of commercial banks with the Central Bank, recorded a higher growth in 2002 than in 2001. The increase was within the targets set under the monetary programme for the year. Reserve money increased by Rs.14 billion as against an increase of Rs.7.4 billion in 2001, entirely due to an increase in net foreign assets (NFA) of the Central Bank, reflecting the build up of external reserves. In fact, net domestic assets (NDA) of the Central Bank declined. A major share of the increase in reserve money (Rs.12 billion) was in the form of currency in circulation, which partly satisfied higher demand for currency from increased economic activity, especially in the North and East following the peace process. The imposition of a debit tax on deposit withdrawals may also have contributed to enhanced use of currency. Deposits of commercial banks with the Central Bank increased (Rs.2 billion) due to the growth in commercial bank deposits against which reserves are maintained.

Although NFA of the Central Bank increased sharply, this increase was partly offset by the decline in NDA of the Bank, limiting the expansion of high powered money. NFA of the Bank increased by Rs.33 billion. Open market operations conducted by the Central Bank during the year to mop up excess liquidity resulted in a decline of NDA of the Bank by Rs.19 billion. A significant reduction occurred in the Treasury bill holdings of the Bank and consequently, net credit to the government from the Central Bank declined (by Rs.13.6 billion) for the second consecutive year.

Money Supply

The growth in money supply for the year was as projected, although the growth in the middle of the year was slightly higher than anticipated. Money supply growth reached its peak in June 2002, and was about 2 percentage points higher than anticipated. However, the rate of expansion gradually declined in the second half of the year, eventually recording a money growth of 13.4 per cent by the end of 2002. This rate of growth was consistent with the real growth in the economy and underlying inflation.

TABLE 10.1
Summary Monetary Statistics

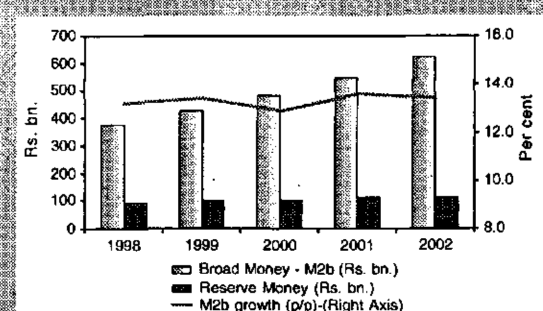
Item	End 2001 Rs. bn.	End 2002 Rs. bn.	Change 2001 Amount Rs. bn.	Change 2001 %	Change 2002 Amount Rs. bn.	Change 2002 %
Monetary Aggregates:						
Narrow Money Supply (M_1)	122.2	139.4	3.7	3.2	17.2	14.0
Broad Money Supply (M_2)	450.7	510.4	46.1	11.4	59.7	13.2
Consolidated Broad Money Supply (M_{2b})	549.1	622.5	65.7	13.6	73.4	13.4
Underlying Factors (a)						
Domestic Credit to :	638.9	682.0	88.9	16.2	43.1	6.7
Government (net)	201.3	194.6	54.0	36.7	(6.7)	(3.3)
Public Corporations	40.8	43.0	2.6	6.7	2.2	5.4
Private Sector	396.8	444.4	32.4	8.9	47.6	12.0
External Assets (net)	74.1	107.9	4.6	6.6	33.8	45.5
Other Items (net)	(163.9)	(167.4)	(27.8)	(20.5)	(3.5)	(2.1)
Reserve Money	112.5	126.4	7.4	7.0	13.9	12.3
Money Multiplier (M_{2b})	4.88	4.92				
Velocity (M_{2b}) (b)	2.77	2.70				

(a) In relation to M_{2b}
(b) During the year

Source: Central Bank of Sri Lanka

Monetary growth (M_{2b}), which peaked in June, reaching 17.9 per cent, gradually declined thereafter, reaching 13.4 per cent in December 2002. The main contributory factor for the expansion of money supply was the higher increase in NFA of the banking system. Meanwhile, narrow money (M_1), which includes currency and demand deposits held by the

Chart 10.1
Monetary Aggregates - Growth and Levels



public increased by 14 per cent, due to a higher increase in currency. A broader monetary aggregate (M_4), based on the financial survey, covering the transactions of other deposits taking financial institutions *i.e.*, licensed specialised banks (LSBs) and finance companies (FCs), in addition to the monetary authorities and licensed commercial banks, showed a trend similar to M_{2b}. M_4 grew by 14.0 per cent at end 2002 in comparison to 13.6 per cent in 2001.

Among the components from the demand side, currency held by the public increased significantly during the year. The growth in deposits was moderate. Currency held by the public increased by Rs.10 billion in 2002 as against Rs.3 billion in 2001, reflecting the recovery in economic activity, especially higher demand following the peace process. The impact of the debit tax and the declining deposit rates may have also contributed to increased currency holdings. Within deposits, the growth in foreign currency deposits increased significantly from US dollars 56 million in 2001 to US dollars 117 million in 2002. The total foreign currency deposit base at end 2002 was US dollars 1,248 million. This growth is attributed to improved confidence in the domestic economy and comparatively lower interest rates available in international markets. In the case of rupee deposits, the share of savings deposits increased, while the share of time deposits decreased. This may be due partly to the relative attractiveness in savings deposits as a result of the larger decline in interest rates on time deposits compared to savings deposits and promotional campaigns by banks for savings deposits.

A substantial portion of the growth in M_{2b} in 2002 (6.7 per cent) has been due to an increase in NFA of the banking system, in comparison to 2001, when NFA contributed only around 1 per cent. Within the NFA, the net foreign assets of the monetary authorities increased by Rs.33 billion, reflecting improvements in the overall balance of the BOP, while the NFA of commercial banks improved by about Rs.3 billion.

The government's fiscal performance improved and, hence, its borrowings decreased in 2002, even though it was not able to repay as much to the banking system as originally expected. Net credit to government (NCG) from the banking system during 2002 declined by Rs.8 billion. A change was also seen in the composition of NCG from commercial banks. As indicated in Budget 2002, the government reduced its overdrafts on state banks sharply from Rs.38.1 billion to Rs.3.6 billion, by issuing market oriented government paper. NCG from the Central Bank declined though NCG from commercial banks increased, partly due to increased holdings of government paper by banks in the context of moderate private sector credit demand.

Credit to public corporations increased by Rs.2.2 billion. Public corporations, which were expected to repay about Rs.7 billion to the banking sector, were unable to do so, as the debt recovery component in the CPC pricing formula was removed in July 2002. Credit utilised by CPC declined by Rs.2.4 billion. However, credit to CEB increased sharply by Rs.4.8 billion as it was compelled to spend more on emergency power purchases to ensure an uninterrupted power supply.

Along with the recovery in the economy, growth in credit to the private sector showed a recovery in 2002, especially in the second half. Growth in bank lending to the private sector increased from 8.9 per cent at end 2001 to 12 per cent at end 2002. In absolute terms, credit grew by Rs.48 billion in 2002, when compared with Rs.32 billion in 2001. However, the growth in private sector credit was less

TABLE 10.2
Monetary Aggregates : 2001 – 2002 (a)

Amount in Rs. billion

End of Period	Narrow Money Supply (M_1)						Broad Money Supply (M_2)						Consolidated Broad Money Supply (M_{2b})					
	2001	2002	Percentage Change				2001	2002	Percentage Change				2001	2002	Percentage Change			
			Point to Point		Moving Average				Point to Point		Moving Average				Point to Point		Moving Average	
			2001	2002	2001	2002			2001	2002	2001	2002			2001	2002	2001	2002
January	112	120	3.8	7.5	7.7	2.9	399	452	10.9	13.2	12.7	10.7	487	550	12.6	13.1	12.0	13.0
February	112	121	4.6	8.6	7.3	3.2	401	457	11.0	14.0	12.5	11.0	489	559	12.8	14.2	12.0	13.1
March	114	126	3.8	10.3	7.0	3.8	404	466	10.3	15.4	12.3	11.4	494	570	11.7	15.5	11.9	13.5
April	114	124	3.9	8.7	6.7	4.2	407	469	10.2	15.1	12.0	11.8	499	575	13.4	15.2	12.0	13.6
May	110	126	3.5	14.4	6.7	5.1	406	471	11.2	15.9	12.0	12.2	498	577	14.4	15.8	12.3	13.8
June	109	126	-0.2	15.6	5.9	6.4	406	476	9.4	17.5	11.7	12.9	496	584	11.9	17.9	12.4	14.3
July	109	128	1.1	17.3	5.4	7.7	410	482	9.8	17.5	11.4	13.5	502	590	12.7	17.4	12.5	14.7
August	110	129	0.7	17.6	4.6	9.1	413	485	9.8	17.4	11.1	14.2	510	596	13.0	17.0	12.6	15.0
September	112	129	0.4	15.5	3.9	10.3	421	489	9.9	16.0	10.8	14.7	516	601	12.8	16.6	12.6	15.3
October	111	129	-1.1	16.0	2.9	11.8	426	494	9.7	15.8	10.5	15.2	520	605	12.3	16.3	12.6	15.6
November	117	132	7.5	12.5	3.1	12.2	436	500	12.5	14.7	10.6	15.3	533	614	14.4	15.3	12.9	15.7
December	122	139	3.2	14.0	2.6	13.1	451	510	11.4	13.2	10.5	15.5	549	622	13.6	13.4	13.0	15.6
Monthly Average	113	127	2.6	13.2			415	479	10.5	15.5			508	587	13.0	15.6		

(a) Monetary data from 1990 have been classified to be consistent with standard international practice. Please refer notes to Appendix Tables 106, 107 and 111.

Source: Central Bank of Sri Lanka

TABLE 10.3

Monetary Aggregates and Underlying Factors : 2000 – 2002 (a)

Rs. million

Item	Dec. 2000	Dec. 2001	Dec. 2002	Change 2001 Amount	Change 2001 Percentage	Change 2002 Amount	Change 2002 Percentage
Monetary Aggregates							
Currency held by the Public	62,647	65,536	75,292	2,889	4.6	9,756	14.9
Demand Deposits held by the Public	55,830	56,674	64,069	844	1.5	7,395	13.0
Narrow Money Supply (M_1)	118,477	122,210	139,361	3,733	3.2	17,151	14.0
Time & Savings Deposits of the Private Sector held with Com. Banks	364,944	426,927	483,134	61,983	17.0	56,207	13.2
DBUs	341,776	395,071	445,741	53,295	15.6	50,670	12.8
FCBUs	23,168	31,856	37,393	8,688	37.5	5,537	17.4
Consolidated Broad Money Supply (M_{2b})	483,421	549,137	622,495	65,716	13.6	73,358	13.4
Underlying Factors							
Net Foreign Assets	69,529	74,130	110,642	4,601	6.6	36,512	49.3
Monetary Authorities	57,947	84,346	117,376	26,399	45.6	33,030	39.2
Commercial Banks	11,582	-10,216	-6,734	-21,798	-188.2	3,482	34.1
DBUs	11,629	-1,117	-6,658	-12,746	-109.6	-5,541	-496.1
FCBUs	-47	-9,099	-76	-9,052	-19,259.6	9,023	99.2
Net Domestic Assets	413,892	475,009	511,852	61,117	14.8	36,843	7.8
Domestic Credit	549,927	638,876	680,396	88,949	16.2	41,520	6.5
Claims on Government (net)	147,304	201,311	192,994	54,007	36.7	-8,317	-4.1
Monetary Authorities	91,556	84,535	70,934	-7,021	-7.7	-13,601	-16.1
Commercial banks	55,748	116,776	122,060	61,028	109.5	5,284	4.5
DBUs	42,928	77,067	82,237	34,139	79.5	5,170	6.7
FCBUs	12,820	39,709	39,823	26,889	209.7	114	0.3
Credit to Public Corporations	38,254	40,811	43,031	2,557	6.7	2,220	5.4
DBUs	26,986	22,934	28,010	-4,052	-15.0	5,076	22.1
FCBUs	11,268	17,877	15,021	6,609	58.7	-2,856	-16.0
Credit to the Private Sector	364,369	396,754	444,371	32,385	8.9	47,617	12.0
DBUs	307,613	328,788	367,397	21,175	6.9	38,609	11.7
FCBUs	56,756	67,966	76,974	11,210	19.8	9,008	13.3
Other Items (net)	-136,035	-163,867	-168,544	-27,832	-20.5	-4,677	-2.9
DBUs	-78,406	-79,270	-74,194	-864	-1.1	5,076	6.4
FCBUs	-57,629	-84,597	-94,350	-26,968	-46.8	-9,753	-11.5

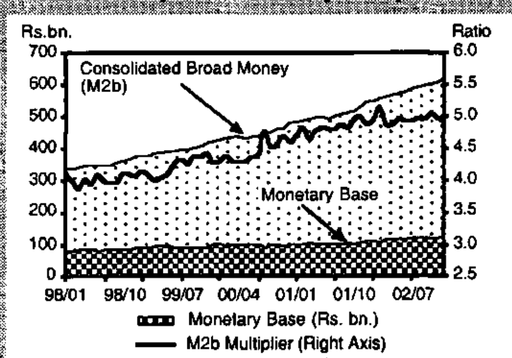
(a) Signs indicate the effect on M_{2b}.

Source: Central Bank of Sri Lanka.

than initially anticipated (13.4 per cent), mainly due to a weaker than expected recovery in international trade, arising mainly from sluggish external demand for exports. A major share of private sector credit was utilised for commerce, trading and private consumption.

The money multiplier increased from 4.88 to 4.92 by end December, as money supply growth continued the trend of being above reserve money growth. The major contributory factors were the decline in the currency to deposit ratio (deposits inclusive of both rupee and foreign currency deposits) brought about by financial innovations in payment systems and a decline in the effective statutory reserve ratio (SRR) due to an increase in the proportion of foreign currency deposits (for which the statutory reserve requirement is not applicable) in commercial bank deposits. Both these developments raised the amount of deposits available to banks for creating multiple deposits and credit. The income velocity of money declined further to 2.70 in 2002. The expansion in the financial sector, reflecting a greater degree of financial deepening, and a decline in inflationary expectations, contributed to the decline in the velocity of money.

Chart 10.2
Monetary Base and Money Multiplier



10.3 Financial Survey

The financial survey generates a broader measure of monetary aggregates (M_4), than the consolidated monetary survey (M_{2b}). It covers the transactions of other deposit taking financial institutions *i.e.*, licensed specialised banks (LSBs) and finance companies (FCs), in addition to the monetary authority and licensed commercial banks. Further, the NFA of the financial survey conveys a more accurate assessment of the exposure of Sri Lanka's financial sector to the rest of the world, while the components of domestic credit provide information on credit made available to both the public sector and the private sector by major financial organisations other than commercial banks.

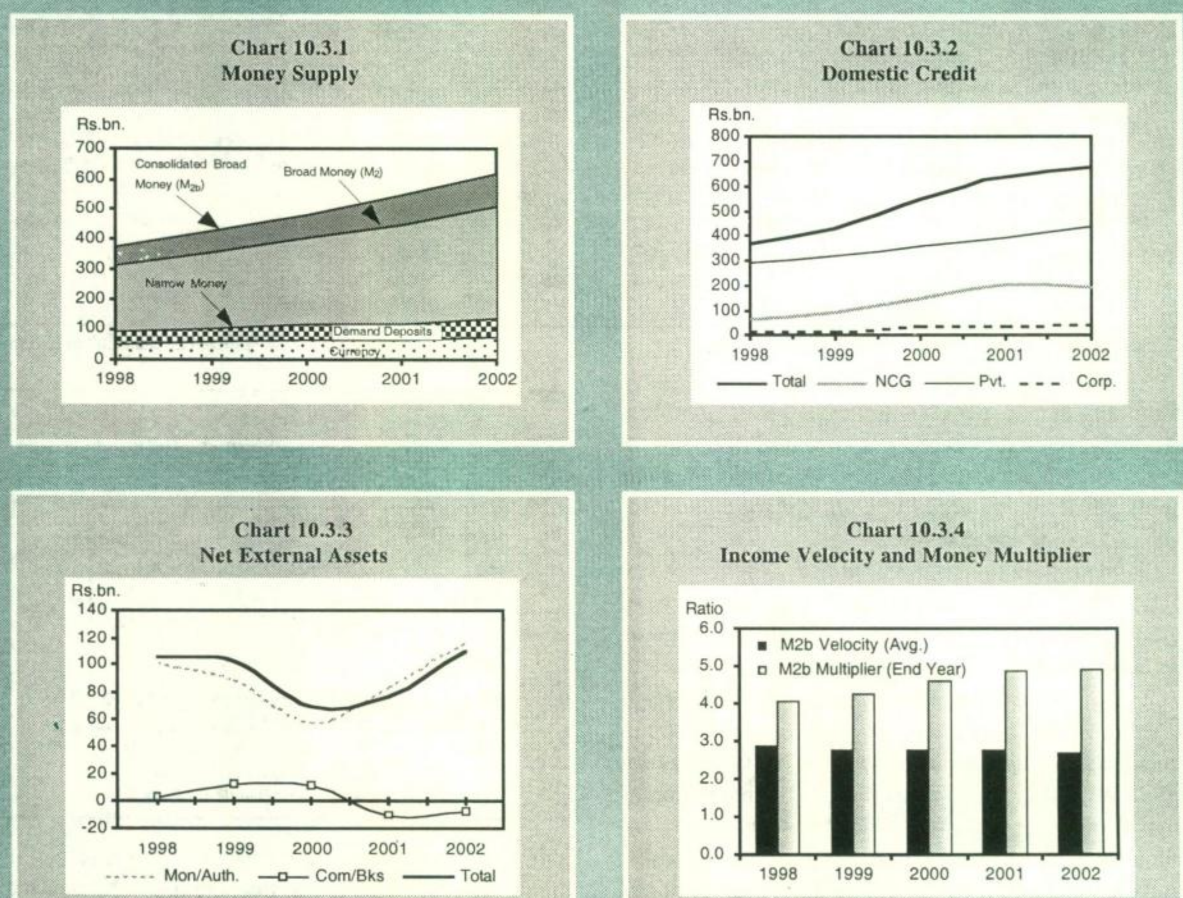
In 2002, the movements in M_4 closely followed the movements in M_{2b}. On a point to point basis, the growth in M_4 was 14 per cent at end December 2002, in comparison to 13.6 per cent at end December 2001. Growth in M_4 as well as M_{2b} has been generally in the range of 12 to 18 per cent during the year, in comparison to a range of 12 to 14 per cent during 2001. Money supply which grew faster in the mid-part of the year, decelerated gradually during the second half of the year towards the originally anticipated level. The major contributory factor to the growth in both the M_{2b} and M_4 has been the increase in NFA, in contrast to a larger contribution of NDA to monetary growth in 2001.

In absolute terms, broad money supply (M_4) increased by about Rs.97 billion in 2002 and stood at Rs.798 billion at end December 2002. Broad money supply (M_4) was higher than M_{2b} mainly due to the substantial amount of public deposits with the National Savings Bank (NSB).

NFA in the broad money supply (M_4) increased by around Rs.37 billion in 2002 in comparison to Rs.8 billion in 2001. The increase in NFA in 2002 was mainly due to the improvement in NFA of the Central Bank with the improvement in BOP, inflows to the stock market, growth in NRFC deposits and the return of war risk deposits placed abroad by the government.

NCG increased by around Rs.16 billion during the 12 month period ending December 2002 in the financial

Chart 10.3
Monetary Aggregates, Velocity and Money Multiplier



survey in contrast to a decrease of Rs.8 billion in the computation of M_{2b} during the same period. A substantial increase in NCG in the financial survey was mainly due to the increase in holdings of government paper by NSB, which holds government paper as its primary asset.

On a point to point basis, credit to the private sector grew by 10.4 per cent in M_4 as at end 2002, in comparison to a 12 per cent growth recorded in M_{2b}. In absolute terms, the growth in private sector credit was Rs.53 billion in M_4 in comparison to an increase of Rs.48 billion in M_{2b} during the year.

The money multiplier in the broad monetary survey (M_4) was 6.31 at end December 2002, compared to 6.22 at end December 2001. As mentioned earlier, a similar increase was seen in money multiplier for M_{2b}.

TABLE 10.4
Summary Statistics of Financial Survey (M_4)

Item	End 2001 Rs. bn.	End 2002 Rs. bn.	Change 2001 Amount Rs. bn.	Change 2001 %	Change 2002 Amount Rs. bn.	Change 2002 %
Monetary Aggregates:						
Broad Money Supply (M_2)	450.7	510.4	46.1	11.4	59.7	13.2
Consolidated Broad Money Supply (M_{2b})	549.1	622.5	65.7	13.6	73.4	13.4
Broad Money Supply (M_4)	699.6	797.6	83.5	13.6	97.9	14.0
Underlying Factors (a)						
Net Foreign Assets	63.2	100.5	8.3	9.2	37.3	58.9
Domestic Credit	840.0	911.5	104.2	14.2	71.2	8.5
Claims on Government (net)	283.0	299.0	62.0	28.2	15.7	5.6
Credit to Public Corporations	41.7	43.8	2.5	6.2	2.1	5.0
Credit to the Private Sector	515.3	568.7	39.5	8.4	53.4	10.4
Other Items (net)	(203.8)	(214.3)	(28.7)	(14.8)	(10.5)	(5.2)
Money Multiplier (M_4)	6.22	6.31				

Source: Central Bank of Sri Lanka

10.4 Interest Rates

The decline in interest rates observed since February 2001 continued during 2002. Taking into account economic developments and prospects, the Central Bank reduced its key policy rates, *i.e.*, the Repo rate and the Reverse Repo rate three times, particularly in the second half of the year. These reductions, assisted by increased market liquidity, resulted in a fall in market interest rates. Short-term rates, in particular, call market rates and the average weighted prime lending rate, decreased almost commensurately with Central Bank rates. The downward trend in other market rates and reduced borrowing by the government also caused yield rates on market oriented government securities to decrease. The yield curve for government securities, which shifted downward and flattened in 2001, shifted further down in 2002, and in fact, had a downward slope, indicating market perceptions of a decline in medium-term inflation. However, some increase in real interest rates was seen in 2002, as the decline in inflation was about 2 to 5 percentage points (depending on the index chosen). Following the decline in international market rates, interest rates on foreign currency deposits and lending also decreased during the year. A feature in the market rates during 2002 was the low volatility in rates, reflecting improved stability in the money market. Even though both the deposit and lending rates of the banking sector declined during the year, the reduction in lending rates was at a slower pace, resulting in increased interest spreads, and hence banking sector profits. These high interest rate spreads are a symptom of inadequate competition in the financial sector, relatively high non-performing loans of some commercial banks and legal hindrances to fast track recovery of defaulted loans.

Meanwhile, some fiscal measures in the 2002 budget, *i.e.*, removal of stamp duty and the National Security Levy (NSL) from financial transactions, had an impact on reducing effective lending rates. Demand for credit, which was lower than expected during the first half of the year, picked up during the second half of the year. This pick up is partly on account of the reduction in interest rates and partly due to the recovery in economic activity.

Central Bank Policy Rates

The Central Bank's key monetary policy rates are the Repo rate and Reverse Repo rate, which are closely linked to market rates, and the Bank rate, which is more an indicative rate. The Repo rate is the rate at which commercial banks and primary dealers can invest their surplus funds in Treasury bonds and Treasury bills held by the Central Bank, while the Reverse Repo rate is the rate at which commercial banks and primary dealers can obtain funds from the Central Bank against the collateral of Treasury bills and Treasury bonds.

Changes in Repo and Reverse Repo rates are the Central Bank's signalling mechanism to indicate the expected direction of interest rates in the market. Stability in the foreign exchange market since the free flotation of the rupee in January 2001, and other favourable macro-economic indicators such as the gradual decline in inflation, enabled the Central Bank to gradually reduce its Repo and the Reverse Repo rates by 800 and 900 basis points, respectively, to 12.00 per cent and 14.00 per cent, respectively, in 2001. Favourable economic developments in 2002 permitted a further reduction of the rates by 225 basis points, in three steps, to 9.75 per cent and 11.75 per cent, by end 2002. The larger portion of the reduction came in the second half of the year. The first reduction of these rates was in March, when the Repo and the Reverse Repo rates were reduced by 50 basis points each to 11.50 per cent and 13.50 per cent, respectively. With this reduction, the Central Bank announced to the market that there would be more frequent changes of these rates based on developments in the market conditions. Accordingly, the Reverse Repo rate was increased slightly on three occasions by 10, 5 and 20 basis points during March to April 2002, taking into account developments in the market. This trend was reversed in June 2002, with a reduction in the Reverse Repo rate by 10 basis points.

Thereafter, there were reductions in both the Repo and the Reverse Repo rate on two occasions. A symmetric reduction of both rates by 100 basis points was made in July 2002 to 10.50 per cent and 12.75 per cent, respectively. This reduction was warranted by the reduction in international rates, and further moderation in inflation and excess rupee liquidity in the market. Even though Sri Lanka's capital account is not open fully and thus its domestic rates are not directly linked to international rates, since the current account is open and Sri Lanka has an independently floating exchange rate, changes in major international rates need to be considered in deciding domestic policy rates. Another reduction of the Repo and the Reverse Repo rates by 75 basis points and 100 basis points, respectively, to 9.75 per cent and 11.75 per cent, were made in November 2002. This reduction was required especially to eliminate an anomaly in the money market rates (which were increased by about 65 basis points on 06 November) caused by a fiscal measure when the government granted a withholding tax credit in respect of secondary market transactions in government paper.

TABLE 10.5

Changes in Policy Interest Rates of the Central Bank

per cent per annum

Date	Repo Rate	Reverse Repo Rate	Bank Rate
30 Dec. 2000	17.00	20.00	25.00
18 Jan. 2001	20.00	23.00	25.00
26 Feb. 2001	19.00	22.00	25.00
03 April 2001	18.50	21.50	25.00
02 July 2001	16.00	19.50	23.00
02 Aug. 2001	15.00	18.50	23.00
03 Sep. 2001	13.00	15.00	23.00
17 Oct. 2001	12.00	14.00	23.00
27 Dec. 2001	12.00	14.00	18.00
20 Mar. 2002	11.50	13.50	18.00
21 Mar. 2002	11.50	13.60	18.00
22 Mar. 2002	11.50	13.65	18.00
04 April 2002	11.50	13.85	18.00
04 June 2002	11.50	13.75	18.00
26 July 2002	10.50	12.75	18.00
22 Nov. 2002	9.75	11.75	18.00

Source: Central Bank of Sri Lanka

Meanwhile, the Bank Rate at which the Central Bank grants advances to commercial banks to satisfy temporary liquidity needs as the lender of last resort and which is not an effective rate, has remained unchanged at 18 per cent since December 2001.

Short-Term Rates

The money market was liquid throughout the year. The main reasons were the injection of rupee liquidity by the Central Bank through purchases of foreign exchange from the market, sale of some foreign exchange receipts of the government to the Central Bank and the decline in the government's recourse to bank financing during the year. This excess liquidity was invested in the Central Bank's Repo facility. Accordingly, call market rates closely followed the Bank's Repo rate throughout much of the year. In comparison to 2001, the volatility in the call market rates declined substantially in 2002. The variation of call market rates, as measured by the standard deviation of the average call money rate was 4.2 per cent in 2001 and declined to 0.8 per cent in 2002. Call market rates, which were in the range of 12.50-13.00 per cent at end 2001, declined during the first quarter in 2002, and increased in April with seasonal demand and remained relatively high until June. The peak in these rates was observed in May when the maximum rate went up to 13.87 per cent. With the reduction in the Central Bank's policy rates in July and increase in market liquidity, rates declined gradually, thereafter. From end July to end October, call market rates were very stable and moved in the range of 10.50-11.13 per cent and the average call market rate remained close to the Repo rate. However, a sudden increase in the average call market rates by about 65 basis points to 11.44 per cent (maximum rate of 11.75 per cent on 07 November) was observed on 06 November as a consequence of the withholding tax credit granted by the government in respect of secondary market transactions in government paper. The market perception was that the call market rates needed to be raised to equate returns. To offset this increase, the Central Bank reduced its policy rates on 22 November and, subsequently, call market rates declined to a range of 10.00-11.00 per cent. As market liquidity further improved towards the end of the year, call market rates continued to decline gradually. The average rate was 10.39 per cent by end December, while the minimum and maximum rates were in the range of 10.25-10.87 per cent.

The Sri Lanka Inter Bank Offered Rates (SLIBOR), which are based on the rates offered for rupee inter bank transactions by 12 commercial banks, showed a downward trend similar to call market rates. The overnight SLIBOR, which was 12.88 per cent at end December 2001, reached the peak of 13.35 per cent in mid April and declined to 10.67 per

TABLE 10.6

Sri Lanka Inter-bank Offered Rates (SLIBOR) (Month-end values, %)

	2001 Dec.	2002 Mar.	2002 Jun.	2002 Sep.	2002 Dec.
Overnight	12.88	12.35	12.40	10.71	10.67
7 Days	13.11	12.34	12.54	10.88	10.78
1 Month	13.26	12.56	12.79	11.12	10.84
3 Month	13.38	12.75	12.94	11.32	10.92
6 Month	13.63	13.17	13.10	11.58	11.05
12 Month	14.10	13.56	13.63	11.85	11.33

Source: Central Bank of Sri Lanka

cent by end December 2002. The one year SLIBOR declined from 14.10 per cent at end December 2001 to 11.33 per cent at end December 2002.

The yields on Treasury bills showed the same declining trend as other short-term market rates. The Treasury imposed a 10 per cent withholding tax on interest on government securities from 22 May 2002. This was charged up front at the primary auctions. Auction yields rose to maintain the after tax yield at around the level prevailing before the imposition of the tax. Hence, the yield rate excluding the tax rate, was considered as the effective rate for market participants. The yield on 91-day and 364-day Treasury Bills moved down from 12.92 per cent and 13.74 per cent at end December 2001 to 9.92 per cent and 9.91 per cent (without tax), respectively, at end December 2002. The reductions in policy rates, a reduced budget deficit, increased liquidity in the market, and the reduction in other market rates were factors that contributed to these decrease.

The Weighted Average Prime Lending Rate (AWPR), which is the weighted average of commercial banks' lending rates to their prime customers, was 14.31 per cent at end 2001 and came down to 12.24 per cent at end 2002. The volatility in the AWPR was lower in 2002 than in 2001.

The Central Bank's discount and rediscount rates, which are the rates applicable to outright purchases and sales of Treasury Bills by commercial banks and primary dealers through the Central Bank's secondary market window, moved with market interest rates. The margin between the discount and rediscount rates at the secondary market, which was 130 basis points at end 2001, was increased to 250 basis points in 2002 by raising the discount margin to 125 basis points on three occasions. This margin was increased to 15 basis points at end June, 50 basis points in mid July and 125 basis points at the beginning of August with the intention of making primary market auctions more attractive.

Deposit and Lending Rates

Following the decline in the Central Bank's policy rates and other market interest rates, deposit and lending rates of commercial banks too declined, though the decline in lending

Chart 10.4
Interest Rates

Chart 10.4.1
Treasury Bills – Yield Rates

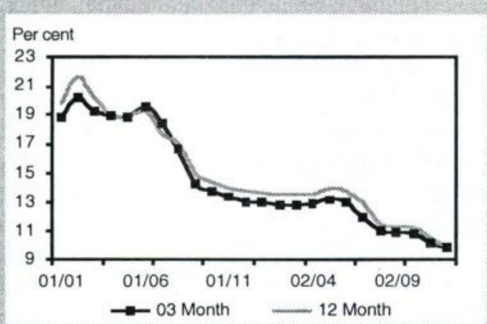


Chart 10.4.2
Deposit Rates

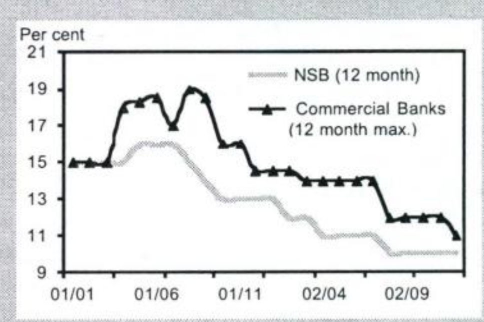


Chart 10.4.3
Lending Rates

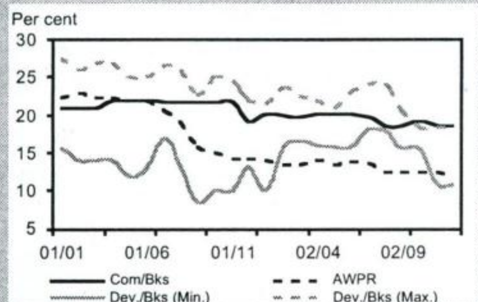


Chart 10.4.4
Call Market Rates and SLIBOR

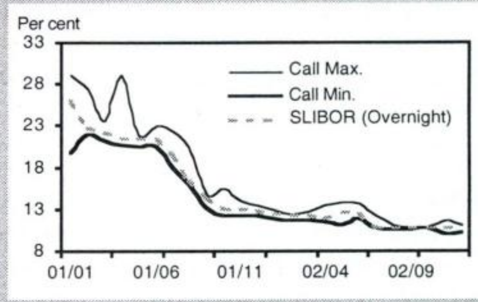
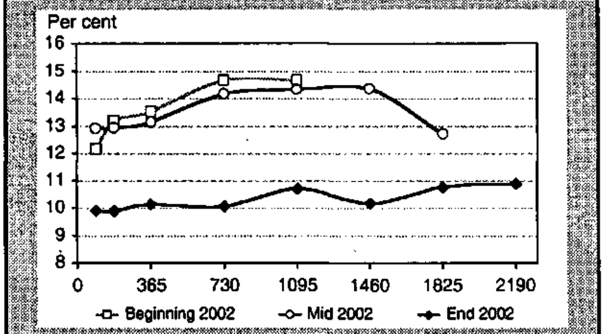


Chart 10.5
Government Securities – Secondary Market Yield Curve



rates was at a slower pace. Interest rates on savings deposits, which were, on average, around 8 per cent during the first half of 2002 gradually came down to around 6.25 per cent during the latter part of 2002. One year fixed deposit rates, on average came down from 12.6 per cent at the beginning of the year to 9.3 per cent at the end of the year. In general, lending rates of commercial banks came down by 125-175 basis points. Lending rates on export financing facilities came down from 17.5 per cent at the beginning of the year to 16.2 per cent towards the end of the year. Rates on import financing facilities, on average, declined from 19.6 per cent to 17.95 per cent during the same period. The Average Weighted Deposit Rate (AWDR), which is based on the weighted average of outstanding interest bearing deposits of commercial banks, declined commensurately from 10.78 per cent in December 2001 to 7.47 per cent in December 2002. Indicating a similar trend, the Average Weighted Fixed Deposit Rate (AWFDR), which was 13.47 per cent in December 2001 declined to 10.17 per cent in December 2002.

Following the trend in market rates, the NSB reduced its deposit rates during the year. The savings deposit rate, which was 8.4 per cent at the end of 2001, was reduced gradually in three steps to 6 per cent by end 2002. Following a similar pattern, the one year fixed deposit rate, which was 13 per cent at end 2001, was reduced in several steps to 10 per cent by end 2002.

Interest rates charged by commercial banks on outstanding payments through credit cards, was in a range of 21-33 per cent at the end of 2002, and did not move down in line with other market rates.

Lending rates of long-term credit institutions, *i.e.*, DFCC Bank, National Development Bank (NDB), State Mortgage and Investment Bank (SMIB) and NSB also came down during the year. Lending rates of NDB changed from 13.25-22.00 per cent in December 2001 to 10.81-18.35 per cent in December 2002. Lending rates of DFCC Bank were in the range of 11.5-19.0 per cent, while NSB rates were in the range of 14.0-16.5 per cent at the end of the year.

Most international interest rates decreased substantially in 2002 responding to the world recession in 2001. As the economic recovery was weak in 2002, the major economies further reduced their interest rates to support growth. For example, the most widely followed rate, the US Fed Funds Rate, which was 1.75 per cent in December 2001, was reduced by 50 basis points, to 1.25 per cent in November 2002. Following the trend in international market rates, commercial banks in Sri Lanka reduced their interest rates on foreign currency deposits and foreign currency lending, particularly during the second half of the year.

In general, though the interest rates showed a declining trend from the beginning of 2001, the interest rate spread in commercial banks was still high, in the range of 4-8 per cent, due to slow adjustment of lending rates, high administrative costs and generally high non-performing loans and less competition in the banking sector. Increasing efficiency, reducing non-performing loans, rationalising costs in banking business and increasing competition are necessary for a further reduction in interest rate spreads. The Central Bank started to publish bank-wise interest rates and charges/ commissions to encourage competition in the financial system by making available more information to the public.

Rates on Medium and Long-Term Government Paper

The Central Bank recommenced issuing longer-term Treasury bonds, *viz*., 4, 5 and 6-year bonds, while continuing with 2 and 3-year Treasury bond issues during the year, with the intention of building up a long-term risk free yield curve and reducing the bunching of debt repayments of the government. Following other market rates, yield rates on all maturities of Treasury bonds declined, particularly in the second half of the year. Yield rates on 2 and 3-year bonds were 14.94 per cent and 14.50 per cent, respectively, at the beginning of the year, and came down to 11.86 per cent and 11.13 per cent (without tax) at end 2002. Meanwhile, yield rates on 4, 5 and 6-year Treasury bonds, which were 13.79 per cent, 14.18 per cent and 12.95 per cent respectively in the second quarter of the year when those issues recommenced, declined to 10.85 per cent 11.02 per cent and 11.08 per cent (without tax), respectively, at the end of the year. In 2002, the government floated the balance amount of US dollars 91.5 million of dollar denominated Sri Lanka Development Bonds (SLDBs). US dollars 158.5 million of SLDBs were floated in 2001. The SLDBs were for 2 years, while the rate applicable was 6-month LIBOR plus 194 basis points per annum.

Rupee loans with maturity periods ranging from 2 - 5 years were issued during 2002. Interest rates on Rupee loans, which are administratively determined, was 13 per cent per annum for all maturities, paid semi-annually.

Rates on Corporate Debt Securities

Rates on commercial paper, a short-term debt instrument, varied in the range of 14.00-24.75 per cent during 2001 and came down to a range of 10.50-16.50 per cent towards the end of 2002. The decline in other market rates and improved liquidity reduced both the rate and the variation in rates. Four listed corporates, Ace Power Generation Matara Ltd., Eagle Insurance Co. Ltd., Aitken Spence & Co. Ltd. and Hatton National Bank Ltd. issued listed debentures during the year. Interest rates on these debentures varied from 12-16 per cent, depending on the type of debentures, maturity period and frequency of interest payments.

The Legal Rate and the Market Rate

The Legal Rate and the Market Rate are published by the Central Bank annually as required by law. The Legal Rate is defined under the Civil Procedure Code (Amendment) Act, No.6 of 1990 and is applicable to any action for the recovery of a sum of money. The Market Rate is defined under the Debt Recovery (Special Provisions) Act, No.2 of 1990. The Market Rate applies only in relation to actions instituted by lending institutions for the recovery of debts exceeding Rs.150,000 arising out of commercial transactions, where there is no agreed rate of interest. Both the Legal Rate and the Market Rate are computed based on the weighted average deposit rates of commercial banks. In 2002, the Legal Rate and the Market Rate were 9.11 per cent per annum, as compared to 9.21 per cent per annum in 2001.

10.5 Commercial Banking

Activities of the commercial banking sector grew, particularly in the second half of the year, with the gradual recovery in the economy after the setback experienced in 2001. The improvement was reflected entirely in domestic banking units (DBUs) of commercial banks, while the activities of the foreign currency banking units (FCBUs) declined due to a decline in their exposure to the non resident sector. The decline in interest rates during the year and improvement in economic activities resulted in an increase in credit demand from the private sector towards the end of the year. Meanwhile, net credit to government by commercial banks increased by Rs.5 billion, while credit to public corporations increased by Rs.2 billion during the year. A substantial improvement in rupee liquidity in the commercial banks was seen in 2002 partly due to the selling of foreign exchange to the Central Bank by commercial banks and partly due to the better fiscal performance of the government.

The total number of commercial banks operating in Sri Lanka declined from 25 at end December 2001 to 23 at end December 2002 with the operations of two foreign banks being taken over by two domestic banks. Accordingly, the number of foreign banks declined to 12, while the number of domestic banks remained at 11 at end 2002.

Interest income and the profits of commercial banks increased in 2002, as the interest margin increased with deposit rates of commercial banks declining faster than lending rates, following the reduction of the Central Bank policy rates.

Total assets/liabilities of the domestic banking units (DBUs) of commercial banks grew by 6.3 per cent in 2002 in comparison to 9.4 per cent in 2001. However, total assets/ liabilities of the FCBUs declined by 7 per cent in US dollar terms, in comparison to 20 per cent growth in 2001.

Credit outstanding to the government from DBUs increased only by Rs.5 billion in 2002 in comparison to Rs.34 billion increase in 2001. This was due to an improvement in the government cash flow and settlement of some of its liabilities to the banks, though the settlement was less than anticipated originally. Also, a compositional change in government liabilities to DBUs was seen, as the government reduced its overdraft liabilities by issuing market oriented government paper.

Meanwhile, credit to public corporations by DBUs increased, mainly due to an increase in credit to the CEB, which had to purchase emergency power from the private sector at high cost, to ensure an uninterrupted supply of electricity in 2002. Due to increased cash inflows and improved treasury management, CPC reduced its liabilities to commercial banks.

The credit to deposits ratio of the DBUs of commercial banks declined as deposits grew by 10.5 per cent in contrast to a marginal decline of 0.8 per cent in total advances (mainly due to a conversion of government overdrafts to Treasury bonds and Treasury bills).

Credit extended by FCBUs to the government increased following investments in the dollar denominated SLDBs (US dollars 91.5 million) and a net increase of US dollars 50 million in term loans to the government. Credit to public corporations by FCBUs declined by about Rs.2.5 billion due to the repayment of part of its loans by CPC. Meanwhile, credit to the private sector by FCBUs improved marginally during the year.

Deposit mobilisation of commercial banks grew at a lower rate (10.5 per cent) in 2002, in comparison with the previous year (16.2 per cent). This could be attributed to the decline in interest rates and budgetary measures such as the imposition of the debit tax on demand deposits, and a withholding tax on interest income on deposits. In addition, investments may have shifted from banks to government paper. Further, investments in the share market increased with improved political stability and investor confidence. Credit extended by commercial banks to the private sector grew moderately during the first half of the year, but accelerated towards the end of the year, reflecting the gradual recovery in the economy, and the continuing decline in lending rates. Meanwhile, the ratio of non performing loans (gross) to total loans and advances of commercial banks (DBUs and FCBUs), which was 15.3 per cent at end 2001, increased during 2002 but, declined back to 15.3 per cent at end 2002.

Structure of Assets and Liabilities of Commercial Banks

Domestic Banking Units

The growth in total resources of commercial banks was lower than in the previous year. Total resources increased by Rs.46.9 billion (6.3 per cent) in 2002, in comparison to Rs.63.5 billion (9.4 per cent) increase in 2001. On the assets side, this was reflected in the slower growth of total loans and advances, dues from the Central Bank and the acquisition of foreign assets. Total loans and advances, which include loans, overdrafts and purchases of commercial bills, increased by 1.5 per cent in 2002 in comparison to 6 per cent increase in 2001. As a result, the contribution of the growth in total loans and advances to the growth of total assets fell from 34 per cent in 2001 to 12 per cent in 2002. The low growth in loans and advances in 2002 was entirely a result of a decline in overdrafts, as the government reduced its overdraft liabilities to the state banks replacing those with market based instruments *i.e.*, Treasury bonds and Treasury bills. The government's overdraft position declined from Rs.38.1 billion at end 2001 to Rs.3.6 billion at end 2002. In commercial bills, holdings of import bills increased marginally while export bills declined by about 7.5 per cent in 2002 in comparison to a 12 per cent decline in 2001, a result of the improvement in international trade in 2002 over 2001.

Investments of commercial banks, including holdings of government securities, increased substantially (70 per cent) in 2002, following the 98 per cent growth in investments in 2001. The growth in investments in 2002 was a reflection of replacing government overdrafts with Treasury bonds and Treasury bills, investment in government debt instruments and in the Central Bank's overnight repurchase facility.

Commercial banks further improved their liquidity position during the year. Total liquid assets increased by

TABLE 10.7
Selected Assets and Liabilities of Commercial Banks (a)

Item	Change			
	2001 Dec / 2000 Dec		2002 Dec / 2001 Dec	
	Amount (Rs. Mn.)	Percentage	Amount (Rs. Mn.)	Percentage
Assets Category				
1. Liquid Assets	30,789	17.8	36,336	17.8
Cash on Hand	356	3.3	1,991	18.1
Due from Central Bank	9,862	34.2	1,483	3.8
Foreign Currency on Hand	10,926	12.3	3,455	3.5
Treasury Bills	2,292	31.0	16,226	167.4
Treasury Bonds (b)	11,876	164.0	13,805	72.2
Commercial Bills	(4,522)	(15.1)	(624)	(2.4)
2. Investment	29,749	97.9	41,792	69.5
Treasury Bills	2,292	31.0	16,226	167.4
Other Government Securities	16,161	220.4	23,069	98.2
Other Investment	11,295	72.2	2,497	9.3
3. Total Loans and Advances	21,573	6.0	5,690	1.5
Loans	6,048	2.9	34,281	16.1
Overdrafts	20,047	16.8	(27,968)	(20.0)
Commercial Bills	(4,522)	(15.1)	(624)	(2.4)
4. Fixed and other Assets	(2,720)	(2.3)	1,901	1.7
Liabilities Category				
1. Capital Account	(7,288)	(14.1)	7,250	16.3
2. Total Deposits	73,155	16.4	54,407	10.5
Demand Deposits	13,931	19.8	(3,997)	(4.7)
Time & Savings Deposits	59,224	15.8	58,404	13.4
3. Borrowings	(9,864)	(13.6)	(18,986)	(30.3)
Local Borrowings	(8,828)	(13.2)	(16,896)	(29.2)
Foreign Borrowings	(1,036)	(17.4)	(2,090)	(42.5)
4. Other Liabilities	7,470	6.9	4,199	3.6
Total Assets / Liabilities	**63,474**	**9.4**	**46,870**	**6.3**

(a) Includes only the operations of domestic banking units.
(b) With effect from 18 May 1998 Treasury bonds are considered as part of liquid assets of commercial banks.

Source: Central Bank of Sri Lanka

18 per cent in 2002 as in 2001. They increased their holdings of Treasury bills and bonds and cash on hand, which grew faster than the balances due from the Central Bank and foreign currency holdings of commercial banks. The ratio of total liquid assets to total assets increased from 27 per cent in 2001 to 31 per cent in 2002. The excess liquidity in the market at end 2002 was around Rs.11 billion in comparison with about Rs.1 billion at end 2001.

Within liabilities, deposit liabilities grew by 10.5 per cent in 2002 in comparison to a 16.4 per cent growth in 2001. The slower growth could be partly due to investors reaction to lower interest rates and slow growth in credit extended by banks. The growth in total liabilities (6 per cent) was less than the growth in deposit liabilities as borrowing by commercial banks from both local and foreign sources declined during the year. In the deposits, a compositional shift from demand deposits to time and savings deposits was seen, which could be partly attributed to the debit tax imposed on demand deposits by the government in 2002. Demand deposits declined by 4.7 per cent in 2002 in contrast to a 19.8 per cent growth in 2001. Time and savings deposits grew by 13.4 per cent in comparison to a 15.8 per cent growth in 2001. Deposit liabilities as a ratio of total liabilities increased to 73 per cent at end 2002 from 70 per cent at end 2001.

Reflecting a further improvement in the liquidity of banks and the relatively low demand for credit, inter-bank borrowings declined by 29 per cent in 2002 in comparison to the decline of 13.2 per cent recorded in 2001. Similarly, the exposure of commercial banks to external financing declined in 2002 by 43 per cent in comparison to 17 per cent decline in 2001.

In contrast to the previous year, balances in capital accounts improved by 16 per cent (Rs.7,250 million) in 2002 as profits of banks increased in 2002 and also some banks raised funds through debenture issues. Banks were acting in preparation for the increase in the risk weighted capital adequacy ratio from 9 per cent to 10 per cent scheduled to come into force in 2003.

NFA of the banking system rose during the year, partly reflecting an increase in foreign remittances and inflows to the stock market under improved political stability in the country. In addition, the return of the war risk deposits placed abroad by the government (US dollar 50 million) helped to increase the foreign assets of commercial banks. Some shift in foreign assets from commercial banks to the Central Bank occurred during the year, as the Central Bank bought US dollars 177 million, augmenting net official reserves. Commercial banks (particularly FCBUs), invested in dollar denominated bonds issued by the government in June 2002 (US dollars 91.5 million). Both foreign assets and foreign liabilities of DBUs of commercial banks increased, with the growth in liabilities faster than the growth in assets. Foreign assets grew by 3 per cent in 2002 in comparison to a 10 per cent growth in 2001. The growth in 2002 consisted of increases in foreign currency loans (140 per cent), foreign currency holdings (19 per cent), placements with FCBUs (4 per cent) and deposits with foreign banks (2 per cent). In contrast, export bills discounted declined by 7 per cent compared with the 10 per cent decline in 2001.

Over 95 per cent of the foreign liabilities of the DBUs arose from foreign currency deposits in the NRFC, RNNFC, RFC accounts and Foreign Currency Accounts of exporters. Balances in foreign currency accounts grew by 15 per cent in 2002 compared to 19 per cent in 2001.

Foreign Currency Banking Units

The number of FCBUs operating in 2002 declined to 23 from 25 in 2001 as operations of two foreign banks were taken over by two domestic banks. Total assets/liabilities of FCBUs decreased by US dollars 129 million (7 per cent) to US dollars 1,775 million in 2002. In comparison, total resources increased by US dollars 314 million (20 per cent) in 2001. The decline in total resources of FCBUs in 2002 was due to reduced foreign exposure of FCBUs during the year. About 54 per cent of the resources of FCBUs came from DBU placements of foreign currency deposits (US dollars 623 million) and deposits by BOI enterprises (US dollars 343 million). Resources from non-national sources accounted for around 19 per cent of total resources (US dollars 330 million) in 2002, in comparison to 27 per cent of total resources (US dollars 519 million) in 2001.

Loans and advances to BOI enterprises, credit to the government and public corporations and investment in non-resident enterprises were the main areas where FCBU funds were utilised. Credit extended to BOI enterprises increased from US dollars 702 million to US dollars 770 million. FCBUs lent a net amount of US dollars 50 million to the government in 2002. The government obtained a new loan of US dollars 100 million in November 2002 and at the same time repaid a loan of US dollars 50 million, obtained in November 2001. Two other loans of US dollars 100 million each, which were to be settled in July and October 2002, were rolled over for another 3 year period at lower interest rates. FCBUs invested US dollars 41 million in SLDBs issued by the government in June 2002 and the total outstanding amount of SLDB holdings of the FCBUs at end of 2002 was US dollars 106 million. Meanwhile, credit extended to public corporations declined by US dollars 37 million as the CPC settled a part of its loans outstanding during the year.

Sources and Uses of Funds of Domestic Units of Commercial Banks

Reflecting the growth in assets and liabilities of commercial banks, resources available to commercial banks increased during the year though to a less extent in comparison to 2001. The total net availability of resources to commercial banks grew by 63 per cent (Rs.28,778 million) in comparison to the

TABLE 10.8
Sources and Uses of Resources of Commercial Banks : 2001 – 2002 (a)

Rs. million

Category	Change (b) 2001 Sources	Change (b) 2001 Uses	Change (b) 2002 Sources	Change (b) 2002 Uses
1. Government Sector		**34,139**		**5,169**
Holdings of Govt. Securities		18,453		39,296
Deposits	13,150			11,796
Import Bills & Textile Loans	2,479			173
Short-term Credit		12,393	11,623	
Overdrafts		18,920	34,472	
2. Central Bank		**11,293**		**3,426**
Borrowings		1,075	48	
Reserves		9,862		1,483
Investment in Central Bank Securities				
Till Cash		356		1,991
3. Government Corporations	**1,603**			**2,815**
Deposits		2,449	2,261	
Advances	4,052			5,076
4. Co-operatives	**378**		**675**	
Deposits	287		447	
Advances	91		228	
5. Other Domestic Private Sector	**25,726**		**7,234**	
Deposits (c)	45,342		47,195	
Local Bills	290			79
Import Bills	922		521	
Overdrafts		1,314		4,393
Loans		16,868		34,390
Investments in Securities & Bonds		4,295		497
Debentures	1,650			1,123
6. Inter-Bank Transactions	**8,985**			**17,367**
Balance with Domestic Banks	18,508			1,576
Deposits & Borrowings with Domestic Banks		9,523		15,791
7. Foreign Sector	**5,829**		**11,333**	
Borrowings		1,036		2,090
Deposits	16,939		16,284	
Foreign Balances including Export Bills		10,075		2,860
8. Other Assets & Other Liabilities	**2,911**		**9,535**	
Capital & Reserves		7,288	7,250	
Fixed Assets		1,709		1,192
Other Assets	4,429			709
Other Liabilities	7,478		4,187	
Total Net Sources / Users	**45,432**	**45,432**	**28,778**	**28,778**

Source: Central Bank of Sri Lanka

(a) Includes only the operations of domestic banking units.

(b) The bold figures indicate whether each sector is a net source or a net user of resources.

(c) Includes long- term deposits mobilised by the two state banks under special savings schemes.

growth of 70 per cent (Rs.45,432 million) in 2001. On a net basis, the foreign sector, the domestic private sector, and capital and reserves were the major sources of funds for DBUs (approximately 98 per cent of the total), while other banks, loans to the government and loans to the public corporations and deposits with the Central Bank were the major items with regard to the use of funds.

In 2002, the largest source of funds of DBUs, on a net basis, was the foreign sector reflecting an expansion in foreign currency deposits. The contribution of the foreign currency resources to the total resources of banks was about 39 per cent. In comparison, 13 per cent of total resources were provided from this source in 2001. Secondly, other assets and other liabilities of the commercial banks became the second largest source of funds by contributing about 33 per cent to the total resources. This was reflected particularly in increased capital and reserves of the banks.

Meanwhile, the private sector contributed about 25 per cent of the resources in the domestic banking units reflecting the expansion in the deposit base during the year.

On a net basis, inter-bank lending of commercial banks absorbed about 60 per cent of the resources in commercial banks, reflecting the improved liquidity surplus in commercial banks. Meanwhile, the government absorbed about 18 per cent of the growth in resources of DBUs in 2002 mainly through government securities, in comparison to an absorption of 75 per cent of the growth in resources in 2001.

Commercial Banks' Loans and Advances [1]

The quarterly survey of loans and advances of DBUs of commercial banks for the 12 month ending September 2002 revealed a moderate growth (8.1 per cent) in credit provided to the non government sector (public corporations and private sector). This growth rate was higher than the 12 months ending June 2002 (4.4 per cent) but lower than the growth rate for the 12-months ending September (9.9 per cent) 2001. Credit to the private sector has accelerated after June 2002, with the gradual recovery in domestic economic activity. The picking up of credit growth reflects the developments in the economy, as GDP expanded by 2.5 per cent and 5.3 per cent, in the second and the third quarters of 2002, respectively.

Among sectors, credit to the industrial and agricultural sectors grew faster during the 12 months ending September 2002 in comparison with the 12 months ending September 2001. Credit to the industrial sector grew at a faster rate due to the recovery in the textiles, wearing apparel and leather products in the manufacturing sector. Credit to the agricultural sector also grew at a somewhat faster rate than the growth at end September 2001, along with the increase in domestic production due to improved weather conditions.

The services sector, which absorbed 10 per cent of total credit, grew at 30 per cent during the year ending September

1 Based on the Quarterly Survey of Commercial Banks' Loans and Advances as at end September 2002.

2002. The growth in credit to the services sector was from the improvements in transport, telecommunications, tourism, shipping and aviation. The growth in the services sector was also seen in GDP, where the sector recorded 3.9 per cent and 8.0 per cent growth in the second and third quarters, respectively, in 2002.

Housing and property development and the consumption categories, which absorbed 14 per cent and 12 per cent of credit each, grew by 14 and 16 per cent, respectively. Growth in credit to the housing and property development is attributed to increased activities in personal housing and real estate development. Credit to the tourism sector grew by 6 per cent as at end September 2002, reflecting the gradual recovery in tourist arrivals following the improved political environment. Growth in credit to the financial sector dropped by 9 per cent at end September 2002 mainly due to the drop in credit to other financial services.

In terms of the maturity pattern, short-term credit (less than one year) accounted for 61 per cent of total credit from commercial banks, while medium-term (2-5 years) and long-term (over 5 years) credit accounted for 22 per cent and 17 per cent, respectively.

TABLE 10.9

Sectoral Distribution of Commercial Banks' Loans and Advances (a)

Category	End Sep 2001 Rs. bn.	End Sep 2002 Rs. bn.	As a % of Total Sep 2002	Growth (%) Sep 2001	Growth (%) Sep 2002
Commercial	135.3	140.1	39.1	6.1	3.6
Exports	33.1	35.8	10.0	8.2	8.2
Imports	42.2	46.3	12.9	-9.6	9.8
Financial	11.5	10.5	2.9	-11.5	-9.0
Agricultural	15.5	16.5	4.6	1.1	6.7
Industrial (b)	33.3	37.0	10.3	-3.0	11.1
Tourism	4.4	4.7	1.3	7.3	6.2
Housing	45.2	51.3	14.3	12.7	13.6
Consumption	37.9	43.8	12.2	18.6	15.7
Services	26.3	34.2	9.5	43.7	29.7
Other	21.8	20.1	5.6	30.5	-7.8
Total	**331.2**	**358.1**	**100.0**	**9.9**	**8.1**

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 for engineering and building, trade, mining and fishing.

Out of the total credit outstanding, the share of credit given at interest rates ranging between 10-20 per cent increased from 44 per cent at end September 2001 to 54 per cent at end September 2002. The share of credit given at interest rates ranging between 21-25 per cent decreased to 18 per cent at end September 2002 from 26 per cent at end September 2001. Meanwhile, the proportion of credit at interest rates above 25 per cent decreased to 16 per cent at end September 2002 in comparison to 19 per cent at end September 2001. The difference in the interest rate structure of credit outstanding is in keeping with the decline in interest rates since the second quarter of 2002. Accordingly, the Average Weighted Lending Rate (AWLR) declined from 19.8 per cent at end September 2001 to 18.3 per cent at end September 2002.

10.6 Central Banking

The operations of the Central Bank in 2002 were mainly focused on further strengthening the stability in money and foreign exchange markets by providing adequate liquidity to the market, avoiding demand fuelled inflationary pressure, and building up of official reserves. As the foreign exchange market was stable throughout the year, the Central Bank was able to purchase foreign currency from the market. Also, the government sold its foreign exchange receipts from foreign loans and from the issue of US dollar denominated SLDBs to the Bank. These purchases of foreign exchange helped to build up official reserves while increasing rupee liquidity in the market. The Central Bank's open market operations mopped up excess rupee liquidity and consequently, holdings of government paper shifted from the Central Bank to commercial banks. Gross official reserves of the Bank were further strengthened as the balance amount under the Stand By Arrangement (SBA) Facility was received during the year.

The Central Bank adopted International Accounting Standards (IAS) in preparing its financial statements starting from 2001. Changes in reporting formats and valuation methods, were affected the overall value of assets and liabilities of the Bank. Under IAS reporting format, the Central Bank moved away from "cash" based accounting to "accrual" based accounting. Thus, in addition to changes in total assets and liabilities due to normal transactions, some changes in total asset/liabilities were seen due to the adoption of a "marked to market" valuation method instead of a "historical cost" valuation system. However, these changes resulted in only a compositional change in NFA and NDA and therefore did not affect the reserve money (base money) of the Central Bank.

Structure of Assets and Liabilities of the Central Bank

The value of total assets and liabilities (based on International Accounting Standards) of the Central Bank increased by around 3 per cent during 2002. On the assets side, the increase was entirely in foreign assets, which more than offset the decline in domestic assets. The increase in foreign assets was supported by receipts of the balance amount of SBA Facility of the IMF (SDR 97 million), receipts from the World Bank for compensation under the Voluntary Retirement Scheme (VRS) of the Central Bank, purchase of foreign exchange by the Central Bank from commercial banks and sales of foreign exchange receipts of the government to the Central Bank. Total net foreign assets of the Central Bank increased by 39 per cent (Rs.33 billion), as reflected in the surplus of the balance of payments in 2002.

In contrast, net domestic assets of the Central Bank declined by 68 per cent (Rs.19 billion) particularly due to the decline in holdings of government securities by Rs.19.0 billion to Rs.40.1 billion at end December 2002. Meanwhile, loans and advances to government declined by Rs.8 billion as a combined outcome of an increase of Rs.1.6 billion in provisional advances to the government through the revolving credit facility and the omission of special advances to the government amounting to Rs.9.6 billion from the balance sheet (which was decided upon in October 2002).

On the liabilities side, the total currency issue of the Bank increased by Rs.12.0 billion (15.3 per cent); the issue of currency notes increased by 15.7 per cent and coins by 6 per cent. Deposit liabilities of the Central Bank increased (11.0 per cent), consequent upon the deposit of drawings from the IMF's SBA facility in 2002. Deposits of commercial banks increased (6 per cent), which was due to an increase in statutory reserve requirements (SRR) on increased commercial banks deposit liabilities. However, deposits of the government with the Central Bank declined by Rs.4 billion from Rs.4.3 billion at end 2001 to a mere Rs.201 million at end 2002.

Development of Payment and Settlement Systems

With a view to enhancing the efficiency of the payment system, upgrading financial system infrastructure and reducing risks, particularly systemic risk to promote financial sector stability, the Central Bank initiated several measures in 2002. Amendments were made to the MLA (see Box 6) to deal with payment oversight, establishing and operating systems for the settlement of payment obligations through securities in scripless form and granting legal validity and enforceability to transactions effected electronically. The Central Bank divested the cheque clearing function to LankaClear (Pvt.) Ltd., which became the successor to the Sri Lanka Automated Clearing House. LankaClear is jointly owned by commercial banks and the Central Bank, which exercises oversight over its activities. Preparatory work in connection with the setting up of the Real Time Gross Settlement (RTGS) System, which will process large value and other critical fund transfers, was finalised. This system is expected to be in operation from last quarter of 2003. A new Department, named the Payments and Settlement Department, was created in the Central Bank to undertake these functions.

The volumes and values of payments made through the major payment systems in operation are in Table 10.10. Cheque clearing operations, which facilitate the transfer of funds from one bank to another through the Central Bank, constitute, by far, the major operator of the payment system. The next largest in terms of volume is the Sri Lanka Inter-bank Payment System (SLIPS), which was introduced mainly to carry out low value but high volume transactions through an off-line payment system. Electronic payments, credit cards, and pay orders are the other major forms of payment modes. Though the volumes and values of funds transferred by these means have increased, a large share of transactions, especially low value transactions, are still settled by cash.

TABLE 10.10

Major Payment Systems

	2001		2002 (a)	
	No. of Transactions '000s	Value Rs. bn.	No. of Transactions '000s	Value Rs. bn.
Cheque Clearing	20,160	1,378	20,782	1,410
SLIPS	777	1,075	980	823
ATMs/EFTPOS	15	51	31	97
Credit Cards	5,444	15	6,256	18
Electronic Means (b)	321	169	157	90
Money/Postal Orders	n.a.	9	n.a.	9

Sources : SLACH, NSB, Commercial banks, CBSL

(a) Provisional
(b) Telebanking, Phone banking, Mobile banking, Internet banking

The effective functioning of the payment systems, which facilitate transfer of funds between users; is essential to the efficient functioning of financial markets and make a significant contribution to overall economic performance. Efficient payment systems help integrate financial markets and therefore help in the conduct of monetary policy. However, payment systems may transmit problems in one sector or one user to other sectors or other users. Therefore, the Central Bank is constantly taking measures to ensure that risk control mechanisms are in place in the design and management of payment systems.

10.7 Banking Development

The total number of Licensed Commercial Banks (LCBs) operating in the country decreased to 23 at end 2002 from 25 at end 2001, as a result of the operations of two foreign banks being acquired by two domestic private banks. The Sri Lankan operations of Habib Bank AG Zurich were acquired by Hatton National Bank (HNB), while the local operations of American Express Bank were taken over by Nations Trust Bank (NTB). Both these acquisitions took place in October 2002. Hence, at end 2002, there were 12 domestic banks and 11 branches of foreign banks in operation. The total number of Licensed Specialised banks (LSBs) dropped to 13 with the revocation of the licence of Pramuka Savings and Development Bank Ltd. by the Central Bank in December 2002, as its financial condition deteriorated to insolvency.

TABLE 10.11

New Commercial Banking Facilities – 2002

Bank	Deposit Scheme	Lending Schemes	Other Services
Bank of Ceylon		1. Kantha Ran Diriya – A loan scheme for women in Small and Micro Industries and Enterprises Development. 2. Estate Sector Self Employment Revolving Fund Credit Scheme. A credit scheme aimed at unemployed estate youth to start self- employment projects in the plantation sector 3. Credit Scheme for purchase of motor cycles. A loan scheme for permanent employees in the public sector to purchase motor cycles. 4. Credit Scheme for purchase of bicycles. A credit scheme for farmers, fishermen, and government and private sector employees to purchase bicycles.	21 ATMs installed.
Commercial Bank of Ceylon Ltd.	DotComSpin. A deposit scheme for children.	1. SMESDP. An ADB funded credit line for all industrial, manufacturing and service oriented small & medium enterprises. 2. Diribala Sahanaya- A loan scheme for Small & Medium Enterprises.	1. 35 ATMs installed 2. ComBank Online- Internet Banking services 3. Priority Banking: Provides premier services such as portfolio manage-ment, higher credit card limits etc for high net worth customers.
Deutsche Bank Ltd.	Dual Currency Deposit – A foreign currency deposit scheme under which a customer deposits funds for a fixed period and is paid back in either of original currency or a second foreign currency at an exchange rate agreed at the initial stage.		Launch of internet banking facility
Hatton National Bank Ltd.	Long term CD with bearer interest coupons.	1. HNB Group Consumer Leasing. A loan scheme to purchase consumer durable items for groups of over 25. 2. HNB Graduateship. A package loan covering college education, professional education and career development 3. Waasi Leasing. A leasing facility to purchase vehicles. 4. Foreign Currency Housing Loan. A credit scheme for Sri Lankans employed abroad to purchase of land and for construction and upgrading of residential houses. 5. Gold Investment Loan. A loan scheme for the purchase of gold sovereigns or gold jewellery.	1. 29 ATMs installed 2. Hatna-Net which enables customers to do their transaction from any branch of the bank. 3. Senior Citizens Scheme. A scheme to provide benefits to account holders who are 55 years and above.
Hong Kong and Shanghai Bank Ltd.	Minor Savings Account for children under 18 years.	Personal Exclusive Revolving Credit. An overdraft facility which can be used repeatedly without having to re-apply each time.	
NDB Bank	Minors Savings Account.		5 ATMs installed
Pan Asia Bank Ltd.	Money Builder. A savings plus loan scheme under which a customer agrees to saves a targeted sum, within a specific period and becomes eligible for a loan.		
People's Bank			17 ATMs installed.
Sampath Bank Ltd.	Sampath Professional – A savings and loan package for current and savings deposits holders who are permanent employees of approved companies, having a minimum monthly income of Rs. 20,000.		1. 8 ATMs installed. 2. Issue of Platinum Visa card 3. Issue of Abimani loyalty card
Seylan Bank Ltd.		Seylan SMILE. A small and medium scale credit scheme.	28 ATMs installled
Union Bank Ltd.		Dynamic Overdraft Facility.	

Sources : Commercial Banks

TABLE 10.12
Distribution of Bank Branches

Category	2000	2001	2002(a)
1. Licensed Commercial Banks			
i. Total No. of commercial banks	**26**	**25**	**23**
Domestic banks	10	11	11
Foreign banks	16	14	12
ii. Total No. of commercial bank branches (b)	**1,096**	**1,130**	**1,163**
Domestic bank branches	1,051	1,084	1,128
Main branches	931	951	974
ASC branches	11	11	11
Kachcheri branches	23	23	23
Extension/Pay offices	82	95	116
Overseas branches	4	4	4
Foreign bank branches (c)	45	46	35
Pawning centres	188	188	188
Students savings units	165	194	204
2. Licensed Specialised Banks (d)			
i. Total No. of licensed specialised banks	**12**	**14**	**13**
Regional development banks	6	6	6
National savings bank	1	1	1
Long-term lending institutions	2	2	2
Housing finance institutions	1	2	2
Private savings and development banks	2	3	2
ii. Total No. of licensed specialised bank branches	**315**	**328**	**329**
Regional development banks	181	188	188
National savings bank	100	101	102
Long-term lending institutions	20	22	23
Housing finance institutions	3	5	5
Private savings and development banks	11	12	11

Source: Central Bank of Sri Lanka

(a) Provisional.
(b) Includes head offices. Excludes pawning centres and students savings units.
(c) Includes extension offices and sub branches.
(d) Includes financial institutions which have been issued with a licence under the Banking Act to operate as a Licensed Specialised Bank (LSB).

TABLE 10.13
Credit Cards Issued by Commercial Banks

Category	2001(a)	2002(b)	% Change
Total number of credit cards issued	255,584	321,145	25.7
Local	57,154	69,437	21.5
Global	198,430	251,708	26.8
Outstanding credit at end year (Rs.mn.)	5,129	6,390	24.6
Local	483	618	28.0
Global	4,646	5,771	24.2
Overdues (as a % of outstanding credit)	12	10	-
Past dues (as a % of outstanding Credit)	10	9	-
Commission from Dealers (%)	0.25-4.5	0.25-3.5	-

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Branch Expansion

The branch network of commercial banks increased from 1,130 at end 2001 to 1,163 at end 2002. The increase was entirely in domestic banks, whose branch network increased by 44 during the year. Foreign bank branches decreased by 11 as a result of the transfer of operations of two foreign banks to domestic banks. Continuing the trend seen in 2001, the banking density, *i.e.*, the number of commercial bank branches per 10,000 people, increased marginally from 0.60 in 2001 to 0.61 in 2002. The branch network of LSBs dropped by one, consequent on the cancellation of the licence of Pramuka Savings and Development Bank Ltd., and stood at 329 at end 2002. A major share of LSBs branch network was accounted for by National Savings Bank (NSB) (102 branches) and Regional Development Banks (RDBs) (188 branches).

Banking Facilities

In the face of competition, commercial banks continued to innovate and improve their existing banking products and delivery channels as a strategy to attract and retain customers. A number of banks introduced new deposit and lending schemes, in addition to improving their service delivery channels through Internet banking, personal banking and Automated Teller Machines (ATMs). Many deposit products targeted minors, as the associated funds would be available to banks for long periods of time. The total number of ATMs operated by commercial banks in the country increased significantly to 635 at end 2002 from 477 at end 2001. The total number of credit cards issued (net of cancellations) increased from 255,584 at end 2001 to 321,145 at end 2002. Of the total cards issued, the majority (78 per cent) were global cards, which are accepted for both local and foreign transactions.

10.8 Credit Information Bureau of Sri Lanka

The Credit Information Bureau of Sri Lanka (CRIB), established under the Credit Information Bureau of Sri Lanka Act, No. 18 of 1990 (as amended by Act, No.8 of 1995) completed its twelfth year in operation in May 2002. The main function of CRIB is to collect credit information on borrowers from lending institutions, and provide credit information to shareholding lending institutions of the CRIB. Presently, all licensed commercial banks, licensed specialised banks, registered finance companies, registered leasing establishments and the Central Bank are shareholders of CRIB. CRIB currently collects information on regular advances of Rs.500,000 and over, and irregular advances of Rs.100,000 and over.

The number of credit reports issued increased to 285,200 during the year from 186,200 credit reports in 2001, reflecting higher demand for credit with recovery in economic activities, as well as strict credit evaluation by

Box 19

Should Banks that Fail be Bailed-out with Public Funds?

In many market economies, banks hold a dominant position in the financial sector and are important for the efficient functioning of these economies. Banks provide a number of services to individuals and businesses which closely link them with the every day life and activities of people. The most traditional function of banks is mobilising savings in the form of various types of deposits from the public and channelling these resources into productive uses. A large percentage of the public, institutions and markets are dependent on banking services in their day-to-day activities. An efficient and stable financial sector is also important for the smooth functioning of the payment system and is the key to the efficient conduct of monetary policy. Further, banks provide other services such as financing of foreign trade, issuing guarantees for the payment of foreign bills and handling foreign inward/outward remittances, which extend banking services in a country beyond its national boundaries. Because of these links, unlike other business failures, any large disruption of banking operations affects the general public as a whole and hence, bank failures are treated differently from failures of other enterprises.

A bank failure is a situation where a bank cannot meet its obligations to depositors and creditors and ceases to carry on the business of banking (Mishkin[1] –1997). If a bank becomes insolvent, *i.e.*, when its equity capital is exhausted and its net worth becomes negative, and the authority decides to revoke the banking license, that bank has failed[2]. A related problem faced by an individual bank is illiquidity, *i.e.*, the inability to meet liabilities on demand in a timely manner. Although illiquidity may be one of the first signs of insolvency, illiquidity does not always cause insolvency. Illiquidity could result from a banking system failure or from a run on banks. It is important to differentiate between an individual bank failure, and a banking system failure. The failure of one bank may lead to a loss of public confidence in the other banks, leading to premature withdrawals of deposits at one time[3] due to fear that the banks may not be able to repay; this is the case of a bank run. The failure of one bank could lead to the fall of other banks, which could even be financially sound banks; this is the case of bank panics. Further, a problem at one bank could lead to the failure of other banks if they operate on similar fundamental characteristics. That is, a group of banks could be affected by the same shock, leading to a systemic failure of banks.

Banks could fail due to a number of reasons, which could either be internal or external. Although an exact distinction cannot be made, individual bank failures could occur largely due to internal factors such as bad banking practices, taking excessive risks, lack of internal control systems, connected lending[4] and moral hazard[5]. In fact, banks, in their normal banking operations, are exposed to a number of risks. For example, when a loan is granted, a bank is exposed to several risks such as credit risk, liquidity risk, interest rate risk and operational risks. If a bank has not taken adequate risk control measures, it would be exposed to these risks. External factors include economic booms and downturns, currency crises, inflation and financial liberalisation, which affect the entire banking system. For instance, in an economic boom, asset prices may rise and the value of collateral increases, especially commercial and residential property values, further expanding the ability to lend. In an economic downturn, the reverse will occur with a decline in collateral value and a rise in credit risks. Financial liberalisation has increased competition among banks and non-banks and has added new instruments which could pose threats to traditional banking activity. Banks that do not have proper risk control systems face a higher risk of becoming insolvent, a situation where capital is eroded.

Bailing out banks can take different forms, of which the provision of public funds is one method. Funding could come from the central bank or from the government as a loan. It could also take the form of a government guarantee. Public funds may be utilised to make pay-outs to depositors of closed banks, compensate banks that

1 Mishkin, Frederic S. (1977), "The Economics of Money, Banking and Financial Markets", Addison-Wesley.

2 As different techniques have been adopted in banking crisis resolution by different countries, the specific definitions used in studies on bank failure vary depending on the country specific situations.

3 Typically banks carry other liabilities such as inter-bank borrowing, CDs and commercial paper which could also be sources of liquidity problems for banks.

4 The BCCI crash is an example of connected lending and Barings PLC can be cited as an example of non-availability of proper risk control measures.

5 Moral hazard is a problem of skewed incentives. As highlighted in Beim, David O. and Charles W. Calomiris (2001). "Emerging Financial Markets." Boston: McGraw-Hill Irwin., when the government guarantees deposits and other bank liabilities, bank depositors and other debt holders need not concern themselves with how well the bank is run. Instead, government agents must perform the monitoring. Banking risk becomes socialised and can grow very large because government discipline is much more permissive than market discipline.

Box 19 (contd.)

agree to accept deposit transfers, facilitate an acquisition, merger or purchase or help recapitalise banks. It is, however, important to distinguish this from the lender of last resort facility (LOLR) provided to banks by central banks to overcome liquidity problems. A solvent bank may face problems of abnormal demand for liquidity as a result of an adverse shock. If the bank cannot obtain funding from other sources, such as the inter-bank market and failure of the bank has potential effects on the financial system as a whole, there is justification for central bank funding under the LOLR[6]. This is so when the bank is fundamentally sound but faces a temporary problems of illiquidity.

There are costs[7] and benefits of bailing out failed banks. Where public funds are used for bailing out banks, a section of the public benefits while others pay for it. If the central bank bails it out, it would lead to monetary expansion. If government funds are used, then taxes need to be raised to fund the bailout or other public expenditure may have to be curtailed, resulting in an inferior quality of public services. If monetary expansion is used to finance the bailout, there will be economic costs in addition to higher inflationary pressure on the economy. An important part of economic costs arise due to moral hazard, *i.e.*, once the decision is made to bail out insolvent banks, there are increased incentives for banks to take higher risks in the future. Another problem is that higher inflationary pressure created by bailouts could increase the risks of further banking crises. The benefits of official intervention in a banking crisis, on the other hand, can be categorised into broad classes that reflect the benefits of intervention to stabilise the banking system and avert a panic and to restore the banking system to a healthy state. These benefits can therefore be characterised as maintaining the integrity of the payments system, and maintaining financial and general economic stability.

Considering the high social costs of using public funds to bail out failed banks, a question arises as to what other alternative approaches can be found to address bank failures. First, the authorities could promote bank mergers. In order to strengthen the soundness of financially distressed banks, they may seek mergers with other banks in the system. There are many instances when banks have voluntarily opted to merge with other banks, though in some countries the authorities have attempted forced mergers as well. There may, however, be requests to inject funds to facilitate mergers. Second, the authorities could promote market discipline by not allowing automatic financing for troubled banks. Market discipline can also be promoted by having forced exit criteria for insolvent banks. Third, a safety net such as a deposit insurance scheme with risk based premia could be set up. Deposit insurance helps in safeguarding the depositors by minimising the losses and also contributes to reduce the systemic effect of a failure of one bank. Further, the need for public funds for bailouts does not usually arise if there is a deposit insurance scheme. However, one concern in setting up a deposit insurance scheme is the problem of moral hazard as the deposit insurance schemes could tempt banks to take on more risks and depositors too may not be vigilant about banks. Finally, further strengthening regulatory and prudential measures and enhancing the screening process in entry to the banking sector are other areas that could be used to reduce future bank failures.

As discussed above, a crisis in the entire or part of the banking sector could impose a significant cost on the economy. In addition to stakeholders of banks, there are fiscal costs arising out of crisis resolution as well as output losses. As pointed out by Charles Goodhart[8], a central bank neither could or should stop all individual failures; it has to be prepared to stop an individual failure causing concern and panic about the stability of the system as a whole. Bailing out could be considered to maintain systemic stability instead of maintaining the existence of a particular financial institution. Although it is not required to bail out each individual institution, there is justification for providing financing to avoid systemic consequences. However, it is necessary to analyse the costs and benefits of bailing out banks even if it is required for systemic reasons.

6 At an early stage, central banks may not be able to distinguish solvency of banks when providing LOLR.

7 Fiscal costs of resolving banking crisis during 1997-2000 are given in Glenn Hoggarth. These costs would have been much higher if banking crises were associated with currency crises. It has been estimated that the fiscal costs were 4-5 per cent of GDP in the case of banking crises and about 25 per cent of GDP when currency crises were associated. Glenn Hoggarth (2001) - 'Costs of Banking System Instability' - Some Empirial Evidence - FSR (BoE).

8 A former member of MPC at the Bank of England and the Deputy Director of the Financial Markets Group, London School of Economics.

lending institutions. The increased demand for credit information, contributed to increase profit sharply to Rs.24 million in 2002 from Rs.14 million in 2001.

The number of advances in the data base amounts to 139,500 of which 88,000 was regular advances and 51,500 was irregular advances (advances which are more than six months in default). The value of irregular (defaulted) advances in the data base was about Rs.99 billion, about 7 per cent of GDP. Of the total defaulted advances, 74 per cent was accounted for by the corporate sector, while the balance was by individual borrowers. Almost 90 per cent of these irregular advances were advances over one million rupees.

10.9 Rural Banking and Credit

Overall Trends and Developments

There were several major policy decisions taken during 2002 in respect of the development of rural sector finance. With the peaceful environment that prevailed in the North and the East, banks and other financial institutions took an initiative to expand their credit programmes into the rural areas of these regions.

Further expanding the scope of the New Comprehensive Rural Credit Scheme (NCRCS), the upper limit of credit for the purchase of paddy under the Forward Sales Contract System (FSCS) was increased from Rs.2.7 million to Rs.5 million. However, with the increase of the upper limit, the guarantee cover for such loans was withdrawn in consultation with the lending banks, because the risk of recovery, according to the banks, was not high.

The implementation of the FSCS, introduced in 1999 to ensure stable and reasonable prices for agricultural commodities for both farmers and buyers, gained momentum in 2002 with funds made available by the World Bank under its Development Market Place Project for expanding the scheme. Under the Memorandum of Understanding (MOU) signed between the Central Bank of Sri Lanka and the World Bank in 2002, the promotion of the scheme through awareness programmes, media presentations, provision of motor cycles and computer equipment for the participating

TABLE 10.14
Cultivation Loans Granted under the New Comprehensive Rural Credit Scheme (Position as at 31 December, 2002)

Rs. million

Season	State Banks			Domestic Private Banks (a)			Regional Development Banks			Total Loans (Amount)		
	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total	Paddy	Subsidiary Food Crops	Total Loans Granted under NCRCS
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
1997/98 Maha	177	24	201	21	20	41	32	13	45	230	57	287
1998 Yala	74	24	98	12	30	42	24	17	41	110	71	181
Cultivation Year 1998	251	48	299	33	50	83	56	30	86	340	128	468
1998/99 Maha	149	24	173	30	22	52	29	27	56	208	73	281
1999 Yala	75	23	98	10	29	39	25	20	45	110	72	182
Cultivation Year 1999	224	47	271	40	51	91	54	47	101	318	145	463
1999/2000 Maha	176	34	210	44	21	65	58	46	104	278	101	379
2000 Yala	83	39	122	45	31	76	53	43	96	181	113	294
Cultivation Year 2000	259	73	332	89	52	141	111	89	200	459	214	673
2000/2001 Maha	123	39	162	67	25	92	61	51	112	251	115	366
2001 Yala	68	32	100	34	25	59	68	45	113	170	102	272
Cultivation Year 2001	191	71	262	101	50	151	129	96	225	421	217	638
2001/2002 Maha (b)	128	27	155	48	12	60	58	35	93	234	74	308
2002 Yala (b)	166	32	198	86	15	101	63	44	107	315	91	406
Cultivation Year 2002 (b)	294	59	353	134	27	161	121	79	200	549	165	714

(a) Hatton National Bank, Seylan Bank and Sampath Bank only.
(b) Provisional.

Source: Central Bank of Sri Lanka

institutions and training, both local and foreign, for persons involved with the scheme has been envisaged.

During 2002, technical assistance was received by way of consultancy under an agreement signed between the ADB and the government on a proposed Rural Finance Sector Development Project. The consultants submitted their report to the government in late 2002 and, according to the proposed programme, the proposed Rural Finance Sector Development Project will enable the government to address policy and structural problems in the rural finance sector, introduce best practices in rural finance through restructuring of rural finance institutions, assist micro-finance providers to move towards international best practices in the field, facilitate access to micro-finance in the North and the East, and stimulate the rural economy by assisting micro-entrepreneurs to gain access to finance for investment purposes. The scope of reforms suggested by consultants includes policy, legal, accounting and an information framework for rural finance.

Two micro-finance programmes, *i.e.*, Small Farmers' and the Landless Credit Project (SFLCP – ISURU) and the Poverty Alleviation Micro-finance Project (PAMP), aimed at alleviating poverty through building social capital and using self-help groups, continued to be implemented by the Central Bank during 2002. The self-help groups approach is useful for minimising the cost relating to grassroots level outreach by the banks. The SFLCP has been in operation in four districts, *viz*., Matara, Galle, Kandy and Puttalam. The 'Isuru' Development Societies organised under the Project and the members of the self help groups under the SFLC Project were strengthened by extensive training of Isuru leaders and office bearers of the societies in accounting and general management of the societies. The project was jointly implemented and monitored by the Central Bank and the respective Regional Development Banks (RDBs). Action was initiated to hand over the district level management of the Project to the respective RDBs by mid 2003. The PAMP, funded by the Japan Bank for International Co-operation (JBIC), is a replication of the SFLC approach in six other districts, *viz*., Badulla, Hambantota, Kalutara, Kurunegala, Matale and Nuwara Eliya. The programme made progress during the year by increasing credit facilities from Rs.1.2 million for 130 beneficiaries in 2001 to Rs.83 million for 5,137 beneficiaries as at end 2002.

The practice of charging fees for the services provided by private sector support service providers, which was a breakthrough in the policy in agricultural credit, continued in 2002 under the Second Perennial Crop Development Project (SPCDP) funded by ADB. This system would contribute to the long-term sustainability of projects financed under SPCDP by making would be borrowers cost-conscious and weaning them away from the 'free good' culture to which the country's farmers are accustomed.

A new insurance scheme to cover post harvest losses introduced by the Ceylinco Insurance Company Ltd. (CICL) commenced operations in 2002. The need for post harvest insurance came from the farmers who had signed forward sales contracts, indicating the increased commitment of farmers to supplying quality agricultural products to the market. The Agricultural and Agrarian Insurance Board (AAIB) introduced a new insurance policy during 2002 for farmers who cultivated on a commercial scale with forward sales contracts. Under this policy, farmers were entitled to recover the loss of income upto a maximum of 80 per cent, based on the value of the premia paid by them.

TABLE 10.15

Savings Mobilised and Advances – Selected Rural Sector Institutions

Rs. million

	Co-operative Rural Banks (CRBs)		Regional Development Banks		Thrift and Credit Co-operative Societies (SANASA)		Sarvodaya (SEEDS)		Janashakthi Bank Hambantota		SANASA Development Bank	
	2001	2002(a)	2001	2002(a)	2001	2002(a)	2001	2002(a)	2001	2002(a)	2001	2002(a)
Total Savings (b)	**16,576**	**18,687**	**4,746**	**6,344**	**4,539**	**4,902**	**n.a.**	**n.a.**	**67**	**65**	**1,361**	**1,490**
Savings	12,186	13,477	3,200	4,102	1,276	1,385	n.a.	n.a.	26	28	262	380
Special Savings	–	–	–	–	1,754	1,899	n.a.	n.a.	23	17	9	6
Fixed Deposits	4,390	5,211	1,546	2,242	668	741	n.a.	n.a.	1	1	929	943
Shares	–	–	–	–	841	877	n.a.	n.a.	18	19	161	161
Total Loans Granted (c)	**5,663**	**3,326**	**4,695**	**6,345**	**2,996**	**3,176**	**620**	**1,020**	**356**	**381**	**615**	**646**
Agriculture	931	850	357	497	546	573	71	103	281	308	3	7
Animal Husbandry	169	101	46	64	150	165	22	29	–	–	–	–
Fisheries	18	33	36	47	–	–	14	15	–	–	–	–
Small Industries	302	280	237	340	59	62	62	157	37	29	8	12
Building Construction, Electrification and Water Supply	2,991	185	–	–	1,170	1,233	–	–	–	–	8	56
Projects/Commerce	183	226	387	499	270	288	269	564	–	–	231	209
Others	1,069	1,652	3,632	4,898	801	855	197	168	24	30	366	362

(a) All figures for 2002 are provisional.
(b) Total savings at the end of the years.
(c) Total loans granted during the years.

Sources : Co-operative Developemnt Department; Regional Development Banks; Women's Development Federation - Hambantota; SANASA Federation; Sarvodaya (SEEDS); SANASA Development Bank

As the lending rates of several donor funded credit programmes were linked to the Average Weighted Deposit Rate (AWDR), such lending rates continued to decline during the year under reference with the gradual decrease of AWDR. These schemes, funded by donors, provided refinance to lending banks in respect of loans granted to project beneficiaries. The low interest rates applicable to loans encouraged borrowers to borrow more funds under these projects.

Forward Sales Contract System (Govi Sahanaya)

The Central Bank continued with its promotion campaign of the Forward Sales Contract System (FSCS), introduced in 1999, among farmers, buyers, bankers, policy makers and the general public. Booklets, posters and videos were prepared by the Bank for this purpose. The scheme was most popular among farmers who produce paddy, maize, green gram and soya bean and the relevant traders. Steps were also taken to promote the scheme among finger millet farmers and livestock farmers.

During 2002, a sum of US dollar 240,900 was received from the World Bank under its Development Market Place Project for the development of the forward market system for agricultural commodities with the assistance of participating banks and other agencies. The funds are being utilised for capacity building of partner agencies (through the provision of motor cycles and computers) and awareness campaigns among target groups.

Accordingly, a project agreement was signed between the Central Bank as the leading co-ordinator and the World Bank in March 2002 to receive the above funds to implement a pilot project during a one year period commencing April 2002. Bank of Ceylon, People's Bank, Seylan Bank, Commercial Bank, six Regional Development Banks and Sarvodaya SEEDS signed agreements to implement the project as Partner Agencies (PAs).

During Yala 2002, the Central Bank and other PAs were able to promote the FSCS among the farmers and buyers, *i.e.*, large-scale buyers, agro industries, exporters, wholesale purchasers and rice millers. As a result, 12,957 new forward sales contracts were signed between the farmers and buyers in Yala 2002, affecting over 17,000 farmer families.

TABLE 10.16
Forward Sales Contracts – 2002

Crop	No. of Agreements Signed	No. of Farmers Benefited	Forward Price Determined (Rs. per kg.)
Maize	4,225	5,312	12 - 18
Paddy	6,384	8,520	12 - 16
Finger millet	1,504	2,120	20 - 22
Big onions	657	657	24
Soya	4,591	5,687	27 - 30
Green gram	3,774	4,825	40 - 42
Other crops	5,412	7,491	25 - 350
Total	**26,547**	**34,612**	–

Source: Central Bank of Sri Lanka

In Maha 2002/2003, 13,590 forward sales contracts were signed, mainly for paddy, maize, soya and green gram, with the active participation of large-scale buyers for such crops. A concerted effort made by both the Central Bank and PAs to promote the scheme among the farming community by substantially increasing the number of awareness creating programmes helped to increase activities in this area. Special projects were started in the North Central, Uva and Southern provinces, to cultivate the above crops on a large scale with forward sales arrangements with the help of PAs and the Agriculture Department, facilitating the signing of about 9,000 forward sales contracts.

It has been observed that farmers who entered into forward sales contracts were able to get an assured market for their produce with a reasonable price. With the assurance of a good price, farmers were motivated to increase the quality of their produce and buyers also benefited from an uninterrupted supply of good quality produce at an agreed price.

New Comprehensive Rural Credit Scheme (NCRCS)

The extension of credit on concessionary terms for cultivation of paddy and 27 other subsidiary food crops under NCRCS continued during the year under review. Out of the total cultivation loans granted under the scheme, a sum of Rs.308 million was granted in Maha 2001/2002 and Rs.406 million in Yala 2002. The value of Yala 2002 loans was substantially higher compared to the value of Rs.272 million granted in Yala 2001. The major cause for this increase was the granting of more cultivation loans for soya bean, greengram, chillies and gherkin under irrigation with the support of forward sales agreements made with the reputed buyers in the country. In addition to this, under the extended scope of NCRCS, Rs.208 million has been granted for purchase of agricultural produce directly from farmers under the forward sales contracts during the Yala season 2002. The government paid Rs.24 million to lending banks as interest subsidy in respect of cultivation loans granted in 2002 under NCRCS. A sum of Rs.68 million was paid under NCRCS to lending banks as credit guarantee indemnity against the loans granted in earlier years. The amount paid in 2002 by the Treasury for writing off defaulted loans below Rs.20,000 on paddy and banana during the cultivation seasons from Maha 1999/2000 to Yala 2001 amounted to Rs.104 million.

Crop Insurance Scheme

AAIB continued to provide insurance cover for 14 selected crops and livestock and post-harvest activities. The Ceylinco Insurance Company Ltd. (CICL) also covered the same crops and livestock under their scheme with additional benefits connected with life insurance to policy holders.

The total extent of paddy lands insured by AAIB and CICL in 2002 amounted 4,000 hectares and 19,692 hectares, respectively. The extent covered by AAIB increased by 1,320 hectares, while the extent insured by CICL increased by 1,045 hectares. The coverage by agriculture insurance by both institutions was marginal, accounting for only 2.8 per cent of the total extent cultivated during the year. AAIB and CICL paid Rs.2 million and Rs.4.2 million, respectively, as indemnity in 2002.

Microfinance Schemes

Microfinance, which was initially conceived as a non-conventional credit delivery mechanism, is now widely recognised as a form of total finance and an effective tool for economic empowerment of poor and low-income families. Microfinance refers to the provision of small-scale financial services, which include savings, credit and other financial services such as insurance. These services are not normally provided by commercial banks due to high administrative costs and lack of necessary human resources to handle microfinance. In addition to providing financial services, gender issues and marketing of the produce of small-scale entrepreneurs are also important considerations in the provision of micro finance. In providing microfinance services, it is necessary to adopt innovative policies and procedures in order to maximise the number of borrowers while keeping the cost low. Therefore, either specialised financial institutions have emerged as microfinance institutions or commercial banks have evolved special microfinance programmes to provide such services on a commercial basis. In these programmes, greater emphasis is paid to participatory approaches involving Community Based Organisations (CBOs) and Self Help Groups (SHGs) for minimising transaction costs and effective supervision and recovery of loans.

Microfinance schemes implemented by various institutions, NGOs, banks and community organisations in Sri Lanka continued to contribute to the overall development of the country in 2002 by way of mobilisation of savings and in meeting the demand for credit from people in low income categories.

A major issue relating to microfinance institutions and programmes is their sustainability. In ensuring sustainability, the major areas of concern are building the capacity of microfinance institutions, good governance, supervisory and regulatory systems, improvement of accounting practices, increased use of information and communication technology and commercial viability.

TABLE 10.17

Performance of Selected Microfinance Institutions / Schemes : 2002

Institute / Programme	Legal Status	Funding Source	Governance System	Total Membership / Borrowers	Loans granted in 2002 (Rs.mn.)	Total loans granted as at 31.12.2002 (Rs.mn.)
Samurdhi Programmes	Samurdhi Authority of Sri Lanka Act No. 30 of 1995	Government and Members' Savings	Samurdhi Authority of Sri Lanka	1,866,059(a)	3,078	10,118
Farmers' Banks	Agrarian Development Act No. 46 of 2000	Government and Members' Savings	Department of Agrarian Development	35,834(a)	293	587(c)
Gemi Pubuduwa Scheme	Banking Act No 30 of 1988	Hatton National Bank	Hatton National Bank	40,000(b)	233	1,800
Rural Banking Innovative Project (RBIP)	Banking Act No. 30 of 1988	People's Bank and GTZ	People's Bank and GTZ	3,600(b)	111	216
Sarvodaya SEEDS	Companies Act No. 17 of 1982.	Donor Funds, NDTF and Members' Savings	SEEDS Guarantee Ltd.	561,321(a)	1,020	5,507(d)
Kantha Ran Divi Maga	Banking Act No. 30 of 1988	Bank of Ceylon	Bank of Ceylon	1,220(b)	1	21
Janashakthi Banking Societies	Society Ordinance and Voluntary Social Services Organisation (Registration and Supervision) Act No. 31 of 1980	Donor Funds, NDTF and Members' Savings	Women Development Federation - Hambantota	30,014(a)	77	645
Co-operative Rural Banks (CRBs)	Co-operative Societies Law No. 5 of 1972	NDTF and Members Savings	Co-operative Dept. & Multi-purpose Co-operative Socities (MPCSs)	588,681(b)	1,050	4,827
Thrift and Credit Co-operative Societies (TCCSs)	Co-operative Societies Law No. 5 of 1972	NDTF and Members' Savings	SANASA Federation	854,583(a)	3,176	5,526

(a) Members
(b) Borrowers
(c) Cumulative from 1998 Maha
(d) Cumulative from 1998

Sources : Samurdhi Authority, Ministry of Agriculture, Women Development Federation (Hambantota), Dept. of Co-operative Development, People's Bank, Bank of Ceylon, HNB, TCCS, SEEDS

National Development Trust Fund

Sri Lanka adopted an open economy policy regime in 1977 in order to release the vast energy of the private sector supported by the government's infrastructure developments to achieve an accelerated economic growth in the country. Consequently, the country managed to accelerate the rate of growth from the previous 3.0 per cent to an average growth rate of 5.5 per cent between 1978 and 1985. However, by mid 1980s, it was revealed that a substantial segment of the population could not successfully integrate themselves with the free market economy policy and therefore, was left behind in the growth process, thereby generating a higher incidence of poverty throughout the country. It was necessary to adopt a targeted poverty alleviation approach to help such left-out groups of the population to facilitate them to cross the poverty line by adopting a holistic poverty alleviation methodology and integrating them to the free market economy system. To attain this objective, the Central Bank launched a pilot poverty alleviation project titled *'Small Farmers and the Landless Credit Project'* called the *'Isuru Project'* in Sinhala, in four selected districts, *viz*., Kandy, Puttalam, Galle and Matara, under the auspices of the International Fund for Agricultural Development (IFAD) and the Canadian International Development Agency (CIDA). The objective of this Project was to develop a method of new poverty alleviation based on a self-selection process of beneficiaries in partnership with banks, community based organisations and beneficiaries and set standards and procedures for others to replicate it for the same purpose. However, by early 1990s, it was felt that a nationwide poverty alleviation program should be started in order to address the immediate problem of vast unemployment and increase in poverty, which developed into an explosive situation as manifested by the youth insurrection during 1988 to 1990. The establishment of the Janasaviya Trust Fund (JTF), the predecessor of the National Development Trust Fund (NDTF), in 1991 was the first step taken by the government in this regard. To implement the NDTF programme, the World Bank and the Federal Republic of Germany provided a concessionary long-term loan of US dollars 52.8 million to the Government of Sri Lanka which was topped up by US dollars 5 million by the government. The administrative machinery for the implementation of the programme was created by establishing a Trust Fund under the Trust Ordinance. To help the Trust Fund to achieve its objectives, action was taken to enlist the services of lending institutions and community based organisations as partner organisations (POs) of the program.

NDTF formerly known as the JTF, was the first multi-pronged poverty alleviation strategy adopted by Sri Lanka on a nationwide basis. This approach requires poverty alleviation through a variety of strategies and instruments so that the targeted poor would be able to cross the poverty line within a given time period by being integrated into the market system. The NDTF strategy comprises four basic components: human resource development, women and child nutrition, rural community development projects and credit for micro enterprise to the identified beneficiaries. The strategy therefore adopted a holistic approach to the development of the poorest of the poor by empowering them through social mobilisation. It was implemented through a partnership of several stakeholders, *viz*., donors, government, banks, community based organisations and finally the beneficiaries. The aim of this partnership was to give ownership to the beneficiaries of the measures taken to cross the poverty line through a gradual empowerment process facilitated by other stakeholders.

This strategy was considered superior to the previous approaches to poverty alleviation in which only the government bureaucracy and the beneficiaries were involved and the delivery of benefits took the form of providing handouts to the poor to enable them to sustain their current consumption levels without regard to developing their future income earning capacity. Hence, the new approach, which sought to establish a demand driven system of poverty alleviation replacing the earlier supply driven policies, was expected to build a sustainable poverty alleviation programme in Sri Lanka on a national basis.

In any sustainable poverty alleviation programme, it is necessary that the target group should be identified through a self-selection process in order to prevent ineligible groups entering the scheme simply to derive benefits from the programme. In other countries, as well as in the previously mentioned Isuru Project, this was achieved by getting the poorest of the poor to identify themselves as eligible groups and organise themselves as self-help groups of people with similar social status, income level and locality. This practice is necessary to prevent moral hazard practices by selecting organisations and the resultant adverse selection issue that causes ineligible groups to join the programme. Hence, in the approach of NDTF in which the selection was made by community based organisations, it was necessary for NDTF, to devote resources and energy to closely monitor the work of community based organisations to prevent the abuse of the system by interested parties.

The operations of NDTF with all 4 components, was an integrated poverty alleviation strategy which continued till 1997, when a redesign in the methodology was effected by shedding all activities other than the microfinance component. At the same time, the administration of the Fund catering only to microfinance was entrusted to a special unit set-up for this purpose in People's Bank, but under a special Board of Trustees. The NDTF continued to rely on community based organisations for the identification and selection of target beneficiaries, delivery of microfinance, follow up action and loan recovery activities. The new design, concentrating only on microfinance without the other

TABLE 10.18

Performance of the National Development Trust Fund (NDTF) – Microfinance Component

Rs. million

Partner Organisation (PO)	No. of POs	Disbursement of Refinance		Recovery of Capital			
		2001	2002	2001	2002	Outstanding Loans as at 31.12.2002	Recovery Percentage
Non-governmental Organisations (NGOs)	131	153	163	116	103	239	69
Thrifit & Credit Co-operative Societies (TCCSs)	15	27	13	15	17	130	47
Regional Development Banks (RDBs)	6	81	76	41	69	114	100
SANASA Development Bank	1	59	34	8	25	60	100
Other Banks	4	8	1	18	5	2	100
Co-operative Societies	32	9	3	7	7	25	63
Total	**189**	**338**	**289**	**205**	**227**	**570**	**80**

Source : National Development Trust Fund

integral components, was a departure from the accepted methodology of developing microfinance recipients first as creditworthy individuals and then funding them with micro-credit. The provision of micro-credit alone normally does not lead to the establishment of a sustainable and viable poverty alleviation microcredit scheme in the long run, as the international best practices have revealed.

10.10 Other Financial Institutions

Savings Institutions

NSB, by far the largest savings bank in the country, took several steps during the year to expand and improve its services and products in order to meet the growing demand from its clientele for higher quality services. It introduced a new deposit product called 'Friends'. This deposit scheme, which was introduced to coincide with World Thrift Day, is a savings scheme which assures a depositor of a monthly income for life.

The bank also introduced three new credit schemes, *viz.*, 'Rata Ithuru', 'Sthree' and 'Express Service Housing Loans', during the year. The 'Rata Ithuru' scheme is to provide financial assistance to Sri Lankans travelling abroad for employment to meet expenses incurred for that purpose. A distinctive feature of the scheme is that part of the interest cost is borne by the Sri Lanka Bureau of Foreign Employment on behalf of the borrower. Under the 'Sthree' scheme, women who maintain a minimum balance of Rs.10,000 in their accounts are eligible to obtain a 'Ran Sahana' loan, which has an interest rate one percentage point lower than the normal rate. The 'Express Service Housing Loan' scheme is a housing loan scheme, under which funds are released within 24 hours, if required by the customer.

Other services introduced by the bank include acceptance of foreign currency notes and traveller's cheques into customer accounts, use of the 'Wall Street Instant Cash' system for faster inward remittances from any of the centres to any branch of the NSB and the introduction of a system of payment orders called 'Musandam Exchange' to transfer money among branches. The Bank also extended its ATM facilities to 16 branches and added two new branches to its branch network (102 branches) during the year.

NSB has now transformed all its branches into profit centres selling products and services to customers, from the original position of being mere collection centres for savings. The deposit base of the bank increased to Rs.135 billion in 2002 from Rs.119 billion in 2001, a growth of 13.4 per cent. The total loans outstanding too increased from Rs.20 billion at end 2001 to Rs.26 billion at end 2002, with loans over 5 years accounting for about 31 per cent of total outstanding loans. Loans disbursed during the year amounted to Rs.13 billion, of which the major share was accounted for by housing, personal and loans to financial institutions. The rate of interest charged by NSB on its loans ranged between 11 - 22.5 per cent. The bank's investments were mainly in government securities (88 per cent). Other significant areas of investment were debentures, promissory notes and shares.

Contractual Savings Institutions

Other than insurance companies, the major category of contractual savings institutions are the provident funds, which are designed to provide members with superannuation, benefits. There were three state controlled provident funds, *viz.*, the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF) and the Public Services Provident Fund (PSPF), and around 200 other approved private provident funds operating in Sri Lanka at end 2002. The total savings mobilised by the first three funds in the form of contributions amounted Rs.23 billion during the year.

EPF is the largest provident fund and the largest investment fund in the country. Total contributions to EPF increased to Rs.19.2 billion in 2002 as against Rs.17.7 billion in 2001, partly as result of an increase in membership by 70,799 during the year. Total investments grew by 15 per cent to Rs.283 billion at end 2002, from Rs.247 billion at end 2001. The bulk of EPF investments is concentrated in government securities. However, there has been a gradual portfolio diversification towards private securities. The share of government securities in the investment portfolio declined

Chart 10.6
Employees' Provident Fund

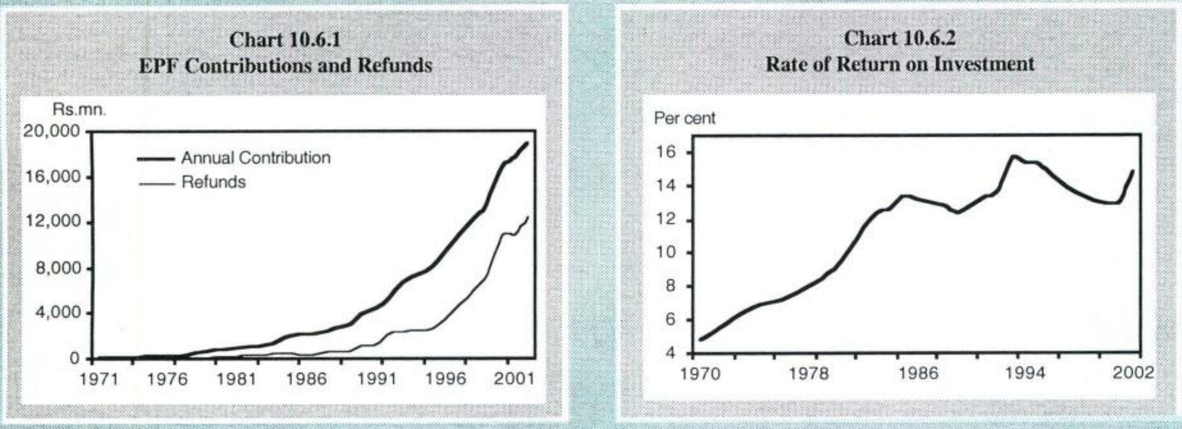


Chart 10.6.1 EPF Contributions and Refunds

Chart 10.6.2 Rate of Return on Investment

from 98.2 per cent in 2001 to 97.5 per cent in 2002, thus increasing the share of investments in private securities to 2.5 per cent in 2002 from 1.8 per cent in 2001. Although this diversification represents only a small fraction of the total portfolio, given the size of the Fund, in absolute magnitude it is significant (around Rs.7 billion). The boom in the share market and declining interest rates during the year resulted in capital gains from its investment portfolio, both equity and fixed income, increasing EPF's realised annual average return to 14.83 per cent in 2002 from 13.07 per cent in 2001.

Total contributions to ETF rose by 9 per cent, from Rs.3.2 billion in 2001 to Rs.3.5 billion in 2002, partly influenced by an increase in total employers contributing by 6,932. Total refunds made during the year amounted to Rs.2.5 billion as against Rs.1.6 billion in 2001. Outstanding member balances rose to Rs.40 billion at end 2002 from Rs.35 billion at end 2001. The investment portfolio, consisting of government securities (80 per cent), shares (4 per cent), debentures (9 per cent) and bank deposits (4 per cents), stood at Rs.38.9 billion at end 2002 from Rs.33.8 billion at end 2001. In terms of asset allocation, the share of government securities in the portfolio increased marginally from the previous year, partly due to investment in longer-term government paper, for asset - liability matching.

PSPF, operated by the state, is for the benefit of certain non-pensionable employees of the government. At end 2002, there were approximately 165,000 members with an active membership base of around 50,000, the majority of whom belong to the Reserve Police Service. Total assets of PSPF stood at Rs.8.5 billion at end 2002 from Rs.6.3 billion at end 2001. It received Rs.389 million by way of contributions, while paying Rs.92 million as refunds during the year.

The private sector provident funds, numbering about 200, had a membership base of 1.5 million as at year end. The total assets of the funds increased to Rs.79.7 billion at end 2002 from Rs.53.2 billion at end 2001.

Long-Term Lending Institutions

The number of reporting institutions for the year declined to nine consequent to the closure of Pramuka Savings and Investment Bank. These lending institutions, which include LSBs such as DFCC Bank, National Development Bank (NDB), State Mortgage and Investment Bank (SMIB), NSB and other private savings and development banks and two non bank housing finance institutions (HFIs), approved loans to the value of Rs.32.4 billion for different purposes

TABLE 10.19
Purposewise Classification of Loans Approved by Long-Term Credit Institutions

Rs. million

Purpose	LSBs(a)		HFIs (b)		Total	
	2001	2002(c)	2001	2002(c)	2001	2002(c)
Agriculture	1,191	1,048	0	0	1,191	1,048
Industry	9,518	6,939	0	0	9,518	6,939
Tourism	760	162	0	0	760	162
Commercial	3,340	2,580	0	0	3,340	2,580
Financial	1,846	4,370	0	0	1,846	4,370
Housing	3,209	4,476	1,320	1,720	4,529	6,196
Redemption of Debt	52	68	8	14	60	82
Other Loans	6,722	10,850	249	231	6,971	11,081
Total (Approved)	26,639	30,493	1,577	1,965	28,216	32,458
Loans Granted (d)	24,583	26,196	1,109	1,576	25,692	27,772
Loans Granted as a percentage of total loans approved	92	86	70	80	91	86

Source : Central Bank of Sri Lanka.

(a) Licensed Specialised Banks excluding Regional Development Banks

(b) Non-bank Housing Financial Institutions; National Housing Development Authority and Housing Development Finance Corporation of Sri Lanka

(c) Provisional

(d) Includes loans approved in previous years and disbursed during the period under review.

including agriculture, industry, tourism, housing and commerce. While the loans approved recorded a healthy 15 per cent growth, the loans disbursed, which stood at Rs.27.8 billion in 2002 as against Rs.25.7 billion in 2001, grew by 8 per cent. This was slightly below the 12 per cent growth in credit to the private sector from commercial banks. The loan growth was caused by higher credit demand in the housing (36 per cent) and financial (136 per cent) sectors. Negative loan growth was reported in the agriculture, industry, tourism and commercial sectors. Despite a 15 per cent increase in loans granted by DFCC Bank, the total loans granted by the two DFIs showed a 20 per cent decline over the previous year as a result of NDB recording a decline of 34 per cent in loans granted. An emphasis on recovery, adoption of a cautious approach in lending and non-use of competitive price cuts to avoid attracting risky borrowers are said to be factors that had an effect on NDB's loan growth. The two non-banks HFIs, Ceylinco Savings Bank, NDB Housing Bank and SMIB, together, approved loans amounting to Rs.4 billion to the housing sector, a 46 per cent growth. Tax concessions granted to housing finance institutions, purchasers and builders and the abolition of stamp duty, NSL and capital gains tax in Budget 2002 have contributed to the growth in credit demand for housing purposes.

In terms of maturity, approximately 72 per cent of outstanding loans of LSBs fell into the below 5 year category, whereas the equivalent share for HFIs was 20 per cent.

Finance Companies

The number of finance companies registered with the Central Bank increased to 26 in 2002 from 25 in 2001. One finance company was acquired by another financial group. A development seen towards the latter part of the year was the interest shown by existing financial institutions to register as finance companies with the Central Bank. One reason could be the publicity campaign the Central Bank has been carrying out regarding the risks of placing money with unregistered institutions. Another could be that finance companies are now able to attract more deposits due to the decline in interest rates offered by banks and on government paper.

The total assets of finance companies recorded a growth of 19 per cent (Rs.7 billion) over the previous year, in comparison to a growth of 10 percent in the case of commercial banks. The growth in assets was reflected in investments, loans and advances and fixed assets. Of loans and advances, leasing operations were the main contributor to growth, reflecting the recovery in economic activity during the year. As in the previous year, the increases in assets were almost entirely funded by deposit mobilisation, which accounted for about 88 per cent of sources of funds. Deposits increased by 19 per cent in 2002, in comparison to 17 in 2001. The fall in interest rates on commercial bank deposits and government securities is likely to have made deposits in

TABLE 10.20

Assets and Liabilities of Registered Finance Companies (a)

Rs. million

Item	As at 31 Dec 2001	As at 31 Mar 2002	As at 30 Jun 2002	As at 30 Sep 2002	As at 31 Dec 2002(b)
Assets					
1. Loans and Advances	24,049	25,428	26,541	28,303	30,479
1.1 Hire Purchase	1,612	1,667	1,701	1,832	2,129
1.2 Leasing	14,159	14,590	15,431	16,329	17,419
1.3 Real Estate	2,672	3,462	3,456	3,739	4,274
2. Equity and other investments	1,964	2,219	2,321	2,066	2,120
3. Treasury Bills	3,078	3,406	3,653	3,922	4,146
4. Cash and Bank Balances	1,248	1,165	933	1,038	1,015
5. Fixed Assets	3,113	3,182	3,347	3,497	3,580
6. Other Assets	3,492	3,508	3,587	3,735	3,571
Total	**36,944**	**38,907**	**40,382**	**42,561**	**44,910**
Libilities					
1. Capital Account	5,549	5,669	5,719	5,867	6,173
2. Fixed Deposits	23,329	24,607	25,194	26,226	27,153
3. Certificate of Deposits	1,092	1,192	1,258	1,326	1,474
4. Borrowings	1,258	1,388	1,485	2,323	2,780
5. Provisions	1,810	1,791	2,061	2,105	2,208
6. Other Liabilities	3,906	4,261	4,666	4,715	5,123
Total	**36,944**	**38,907**	**40,382**	**42,561**	**44,910**
No. of Finance Companies reporting to the Central Bank	25	25	25	25	26

Source : Finance Companies

(a) Unaudited
(b) Provisional

finance companies an attractive form of investment. Capital funds showed an increase of 8 per cent, although the share of capital in total liabilities decreased as a result of deposits increasing at a higher rate.

The investment portfolio, mainly consisting of Treasury bills, increased by 24 per cent during the year. Liquid assets, composed of cash and demand and savings deposits, dropped by 29 per cent as result of a running down of demand deposit balances held with banks. All the asset items included in the loans and advances portfolio, such as leasing, hire purchase and real estate loans, recorded increases. Interestingly, hire purchase activity has also picked up in 2002 in contrast to a drop in 2001, possibly due to the fact that after August 2002, hire purchase on goods over 12 month old was not subject to any form of tax, in contrast to the GST that was payable prior to that period.

10.11 Specialised Financial Institutions

Merchant Banking

The merchant banking industry showed some improvement in 2002 as reflected by performance indicators such as growth in income and profitability. The number of firms reporting has remained at 12 during the year under review. Total assets remained at the 2001 level of Rs.13.5 billion, in contrast to a

25 per cent drop in assets in 2001. However, total income for the year grew by 18 per cent from Rs.1.7 billion in 2001 to Rs.2.0 billion in 2002. The overall profits of the industry, though still negative, improved markedly, with total losses decreasing to Rs.391 million from Rs.935 million in 2001. Although many of the firms were able to record profits for the year, the profitability of the industry as a whole was affected mainly by the continuing losses in one company. The main sources of income for the industry continued to be leasing, share trading, investments in government securities and lending. Leasing accounted for 38 per cent of income in 2002.

TABLE 10.21
Progress of Activities of Merchant Banks

Rs. million

	2001 (a)	2002 (b)
1. Earned income on Leasing	705	767
2. Interest on Discounting Trade Bills	110	99
3. Financial and Marketing Consultancy Services	17	42
4. Underwritting Commissions	0	0
5. Insurance Commissions	5	7
6. Interest on Margin Trading	23	25
7. Profit /Loss on Investment in Shares	21	146
8. Interest on Treasury Bills	7	60
9. Interest on Loans	387	330
10. Dividends	153	89
11. Other Income	297	464
12. Total Income	1,723	2,027
13. Pre Tax Profits/Loss	-935	-392
14. Total Assets (end period)	13,529	13,424
No. of Merchant Banks Reporting	12	12

(a) Revised
(b) Provisional

Source : Merchant Banks

Leasing Companies

In terms of the provisions of the Finance Leasing Act, No. 56 of 2000, 50 institutions engaged in leasing operations have been registered with the Central Bank by end 2002. Included were commercial banks, specialised banks and finance companies other than specialised leasing firms. The number of reporting specialised leasing institutions increased to 10 in 2002 from 5 in 2001. Total assets grew by 15 per cent from Rs.14.2 billion in 2001 to Rs.16.4 billion in 2002, while the total lease portfolio recorded a substantial growth of 76 per cent over the pervious year. A distinctive feature of the total lease portfolio is its heavy concentration in passenger and commercial vehicles, which accounts for 84 per cent of the total value. One reason for the higher growth in passenger vehicle leasing has been identified as the exemption of rental payments from VAT with effect from last year. Sector-wise, trade, transportation and services accounted for 77 per cent of leases granted, with the trade sector receiving the highest share of 35 per cent.

TABLE 10.22
Specialised Leasing Companies
Sector Analyses of Leasing Facilities

Rs. million

Sector	2001 (a)	2002 (b)
Industry	698	862
Agriculture	320	518
Trade	2,071	3,525
Transportation	1,277	2,404
Construction	141	331
Services	839	1,741
Others	301	556
Total	**5,647**	**9,936**

(a) Revised
(b) Provisional

Sources : Specialised Leasing Companies

A recent development in the leasing industry is the use of new sources such as asset securitisation for generation of funds. For instance, Peoples Leasing Co. Ltd., alone has executed lease securitisation deals to the value of about Rs.1 billion during the year.

Venture Capital Companies

The total number of venture capital companies (VCC) remained at seven during the year. As in 2001, the industry did not show significant improvement in 2002, either in terms of the number of new projects financed or asset growth. The services sector was the only sector which recorded an increase in new projects. Other sectors, such as agriculture and manufacturing, declined in terms of new projects. This was reflected by the fall in total funds invested, which stood at Rs.1.2 billion at end 2002 in comparison to Rs.1.5 billion at end 2001.

VCC perform a vital role in the process of economic growth by providing long-term capital funds for innovative and high risk projects, particularly in knowledge based areas such as software development, which are generally based on human or intellectual capital and face difficulties in obtaining bank finance. In recognition of this role, Budget 2003 granted a 5-year tax holiday for new firms and partial exemption from income tax for investments in VCC.

Insurance Companies

The total number of insurance companies increased to 11 in 2002 with the commencement of operations by Amana Takaful Ltd., established in 2001 as a subsidiary of Amana Investments Ltd. The government divested its balance shareholding in National Insurance Corporation Ltd. (NIC) to Janashakthi Insurance Company Ltd., in 2002. Consequently, NIC is now fully owned by Janashakthi Life Insurance. The insurance industry grew in terms of assets and branch network. The branch network increased from 389 at end 2001 to 462 at end 2002, while the total assets grew by 14 per cent to Rs.42 billion from Rs.37 billion in 2001. Around 70 per cent of growth in total assets was accounted for by Sri Lanka Insurance Corporation Ltd. (SLIC). The revaluation of assets of SLIC in preparation for privatisation was the main reason for this substantial increase in assets. However, net profits for the year, in the industry, declined to Rs 1.4 billion in 2002 from Rs.2 billion in 2001. The industry-wide profit was negatively affected by a decline in profits of SLIC attributable to the settlement of a few large un-reinsured claims.

Life, general accident and motor insurance activities expanded, while marine and fire insurance activities contracted during the year. In terms of profitability, marine and fire insurance activities recorded negative profits, but motor and general accident insurance posted positive net profits during the year. The total value of life assurance funds stood at Rs.35.5 billion, an increase of 22 per cent over the previous year. The total premia collected and sums insured in respect of new life insurance business also followed the same trend. The total number of new policies amounted to 258,000. The total benefit payments on maturity, death and disability, surrender and other, increased by 8 per cent to Rs.2.4 billion in 2002. The net premia for policies in force in the general insurance category, consisting of fire, general accident, marine and motor insurance, rose by 17 per cent in 2002. The biggest contributor to the increase in net premia was the motor insurance sub sector, which increased by 23 per cent.

The insurance industry has a major role to play in the economy. It also has the potential for significant expansion in activity as the culture of insurance is not well developed in Sri Lanka. The larger role played by the domestic private sector, in collaboration with international insurers, is expected to increase the dynamism in the industry. The government plans to reduce its direct involvement in the industry further, by divesting its ownership of SLIC. Although this divestiture was to be completed in 2002, the subdued international investment environment delayed the process. The divestiture is expected to be completed in 2003.

10.12 Financial Markets

Money and Foreign Exchange Markets

The money market remained liquid in 2002 with increased trading volumes in several market segments. The Central Bank absorbed excess liquidity on a continuous basis through its repurchase transactions. Volatility in money market rates declined with a downward adjustment during the year. Call money rates declined and tended to mirror the movement of CBSL rates. The average weighted call money rate fluctuated within the Repo and Reverse Repo rates during the year and moved closer to the Repo rate towards the second half of year. In the government securities market, trading in government securities further expanded with primary auctions being heavily oversubscribed. The yield curve of government securities shifted down across maturities and flattened. The foreign exchange market remained stable particularly since May 2002 as a result of increased liquidity due to inflows under private transfers, services and capital inflows. Consequently, the Central Bank was able to purchase about US dollars 177 million, on a net basis, from the market to build-up official reserves. The foreign exchange forward market too expanded increasing the volume and duration of contracts, along with a reduction in forward premia.

During 2002, the Bank initiated action to further promote and upgrade the payment system infrastructure to keep abreast of technological developments and reduce systemic risks in payments and settlements, which is a key element in achieving financial stability. Among these are a Real Time Gross Settlement (RTGS) System and a Scripless Securities Settlement (SSS) System enabling banks and financial institutions to make secure, high value, inter-bank payments and to deal in real-time trading of and settlement for government securities. These measures will enhance the stability and reliability of the payment system and help expand and promote the efficiency of money market transactions.

Inter-Bank Call Money Market

Inter-bank transactions declined, particularly in the second half of the year, as improvements in the market liquidity condition reduced the need for inter-bank borrowing. Call money rates declined, with the average call money rate declining almost at the same pace as the change in CBSL rates. Call money rates, which remained within CBSL Reverse Repo and Repo rates, moved more towards the Repo rate in the second half of the year. With the announcement of the tax credit in the secondary market for government paper, call money rates moved up on 06 November. The rates declined somewhat towards the end of the year.

The volume of trading in the market declined in 2002 by 15 per cent. This decline occurred in the second half of 2002. The average call money rate declined from 12.65 per cent in 2001 to 10.39 per cent by end 2002.

Primary Treasury Bill Market

In response to excess liquidity and subdued credit expansion, market preference increased in favour of government securities, as was evident from heavy over subscription in all primary auctions. The yield curve gradually shifted down with a larger reduction in 364 day Treasury bills, reflecting moderation of inflationary expectations, and further reductions in interest rates. The yield on 91 day bills declined by a total of 300 basis points, while the yield on 182 day and 364 day bills declined by 338 basis points and 383 basis points, respectively. With these reductions, the gap between the yields on one year bills and the one year fixed deposit rates of commercial banks narrowed.

The Treasury bill limit was raised further to Rs.250 billion in 2002 from Rs.175 billion at end 2001, allowing greater flexibility to public debt management. Altogether, government sold Rs.343 billion worth of bills in 2002 as against Rs.248 billion in 2001. Of these issues in 2002, reissues amounted to Rs.303 billion and new issues amounted to Rs.40 billion, including Treasury bills issued for the securitisation of the government overdraft with the two state banks. A substantial portion of reissues were in the category of 364 day bills. Total outstanding Treasury bills at end year rose to Rs.211 billion as against Rs.171 billion in 2001. Although Treasury bills amounting to Rs.94 billion were purchased by the CBSL (reserved in the primary auctions and special issues), holdings of government paper by CBSL declined for the second successive year due to increased sales under repo and discount windows.

Central Bank Repo Market

In response to excess liquidity in the market, repo transactions with the Central Bank increased significantly during the year. The repurchase facility continued to remain mainly on an overnight basis. As the excess liquidity in the market improved, repo transactions increased significantly in the second half of 2002. Altogether, the repo transactions increased to Rs.1,076 billion against Rs.55 billion in 2001. The Repo rate fell from 12.00 per cent at end 2001 to 9.75 per cent at end 2002.

Central Bank Reverse Repo Market

The Reverse Repo market activities declined significantly when compared with the two previous years. Except for a brief period prior to the New Year season in April, the money market remained liquid, which reduced the demand for borrowing by banks through the reverse repo window in 2002. The total reverse repo volume declined from Rs.4,780 billion to Rs.154 billion in 2002. There were almost no reverse repo transactions in the forth quarter of 2002, as against Rs.333 billion in 2001. The reverse repo rate was reduced from 14.00 per cent at end 2001 to 11.75 per cent at end 2002.

Central Bank Discount and Rediscount Market for Treasury Bills

The value of total outright sales (discounts) of CBSL during the year amounted to Rs.46.5 billion, which was almost 115 per cent increase over the previous year. The arbitrage opportunity that existed due to the lower margin of 5 basis points difference between the discount rate for Treasury bills at the secondary window of the Central Bank and the Primary Market Weighted Average Yield Rates (PMYR), made the outright sales more attractive to the market participants, in the face of declining interest rates. The yield rates on Treasury bills were falling at a rate higher than 5 basis points, making it profitable for market participants to buy Treasury bills from the secondary market rather than from the primary market. The Bank took corrective steps to increase the said margin to 125 basis points in three steps by the middle of the year. This had the expected effect as reflected in the decline in outright sales in the second half of the year. The total value of discounted Treasury bills in the first two quarters amounted to Rs.35.5 billion, whereas for the second two quarters, the value was Rs.11 billion. In contrast, the total rediscount of Treasury bills amounted to about Rs.1 billion, due to excess liquidity in the market throughout the year, and the market rates for rediscounting Treasury bills being higher than the Bank rediscount rates.

Discount and rediscount rates moved with the primary market yields. The discount and rediscount rates fell from 12.87 per cent to 8.67 per cent and from 14.17 per cent to 11.17 per cent respectively from the beginning of the year to the end of the year.

TABLE 10.23

Money Market Operations : 2000 - 2002

Rs. million

	Call Money Market		Primary Treasury Bill Market						Secondary Market (Central Bank)							
	Total Lending/ Borrow-ings	Out-stand-ing at end period	Total Out-stand-ing	Amount Accepted (purchases)					Treasury Bill		Re-purchase (Repo)		Reverse Repo			
				Amount Issued	Central Bank	Comm-cial Banks	Others	Total	Dis-count (Sales)	Redis-count (Purch.)	Sales	Matu-rity	Treasury Bill		Treasury Bond	
													Purch.	Matu.	Purch.	Matur.
2000																
1st Qtr	336,470	6,045	124,996	49,269	7,440	32,052	9,777	49,269	6,268	333	73,907	75,863	27,413	26,547	9,304	9,278
2nd Qtr	281,150	10,465	124,996	43,799	16,089	18,209	9,501	43,799	3,536	200	7,070	7,141	116,284	117,241	178,652	169,753
3rd Qtr	409,243	11,743	131,996	48,548	23,176	14,381	10,991	48,548	1,409	103	20,129	19,957	20,897	20,985	201,930	202,307
4th Qtr	338,358	30,339	134,996	40,428	6,724	19,138	14,566	40,428	3,734	1,429	9,301	8,429	87,987	86,616	1,074,725	1,054,671
2001																
1st Qtr	294,051	5,638	134,995	46,207	1,180	26,800	18,227	46,207	2,808	596	8,427	9,010	144,251	142,406	1,714,557	1,711,451
2nd Qtr	263,931	4,760	150,420	64,221	38,643	15,457	10,121	64,221	4,009	–	10,228	9,969	101,449	104,271	1,492,124	1,502,694
3rd Qtr	427,901	7,802	160,420	61,289	35,470	15,882	9,937	61,289	7,924	126	13,408	13,648	15,552	15,721	993,363	1,000,058
4th Qtr	510,734	9,132	170,995	76,295	44,238	15,763	16,294	76,295	6,947	42	23,428	21,689	964	1,190	318,149	331,543
2002																
1st Qtr	417,684	3,409	174,245	70,831	6,998	36,614	27,219	70,831	19,151	938	252,649	253,545	300	106	28,291	25,601
2nd Qtr	319,288	4,262	201,995	102,299	21,900	50,648	29,751	102,299	16,484	87	80,418	78,287	3,844	4,038	121,367	125,557
3rd Qtr	275,764	5,130	206,295	90,845	29,050	37,702	24,094	90,846	7,997	104	310,310	307,984	170	170	680	680
4th Qtr	263,457	3,074	210,995	78,698	35,900	30,988	11,810	78,698	2,839	–	432,719	427,752	52	52	–	–

Source: Central Bank of Sri Lanka

Box 20

More Active Open Market Operations

The Central Bank conducts Open Market Operations (OMO) as an instrument of monetary policy to achieve the final objective of economic and price stability by influencing the volume of money (level of credit) and its cost (interest rate) in the economy. Central banks the world over have been moving away from non market oriented monetary policy measures such as credit ceilings, quantitative controls and statutory reserve requirements, which operate through regulations, to market based instruments which operate through market forces of the demand and the supply. In line with this general trend in conducting monetary policy, Central Bank of Sri Lanka began to place a greater reliance on OMO as its main instrument of monetary policy. As a major change in its policy thrust, on 03 March 2003, the Bank moved from a system of 'passive' OMO to a system of more active OMO in order to improve the effectiveness of monetary policy operations. This article outlines the rationale for introducing this system, its main features and benefits.

'Passive' OMO

Under this system of OMO, which prevailed up to the end of February 2003, the Central Bank offered unlimited repurchase (Repo) and reverse repurchase (Reverse Repo) facilities to manage short-term liquidity, and discounting and re-discounting facilities to manage market liquidity on a longer-term basis. 'Repo' transactions, *i.e.*, selling government securities to commercial banks and primary dealers (*i.e.*, participating institutions) with an agreement to purchase them back within an agreed period at an agreed price, were conducted to absorb liquidity, usually on an overnight basis. Similarly, 'Reverse Repo' transactions, *i.e.*, buying government securities from the participating institutions with an agreement to sell them back within an agreed period at an agreed price were conducted to inject liquidity on a short-term basis. Under the discounting facility, the Central Bank sold Treasury bills outright out of its holdings and thereby absorbed liquidity on a permanent basis, while under the re-discounting facility, government securities were purchased on an outright basis with a consequent injection of liquidity on a more permanent basis. These facilities were offered at rates of interest (prices) mainly determined by the Central Bank and were utilised by participating institutions, at their discretion.

This system of OMO enabled the Bank to maintain interest rates stable within a range defined by its Repo and Reverse Repo rates and achieve monetary policy targets by adjusting these policy rates. However, there was scope for further improving the system in view of its following limitations:

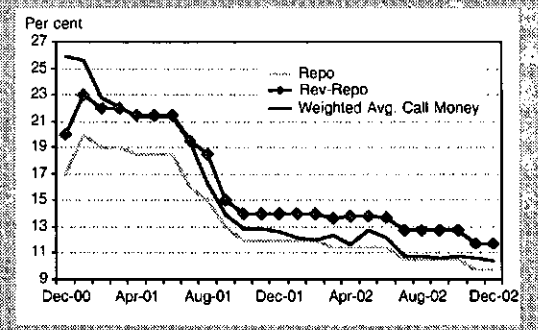
(*a*) As the facilities under OMO were used by the participating institutions at their discretion, the Central Bank did not have an instrument to regulate market liquidity directly and thereby ensure the achievement of monetary targets.

(*b*) Interest rates at which transactions under OMO were conducted were administratively determined by the Central Bank which were often influenced by non market decisions though they were usually related to prevailing market rates. It would therefore be more consistent with the move towards the use of market based instruments of monetary policy and the market orientation of economic policies of the country, if these facilities were offered at rates determined by market forces.

(*c*) There was potential for large fluctuations in interest rates within the range defined by the Repo and Reverse Repo rates. There was a tendency for inter bank rates to remain close to either the upper or the lower bound of the range and hence to vary by nearly 200 basis points under the present Repo and Reverse Repo Rates (see chart). A system which avoids the potential for such large fluctuations is more conducive to financial market stability.

(*d*) As the facilities under OMO were available to participating institutions to use at their discretion, there were no in-built incentives for them to improve liquidity management or to encourage competition in

Repo, Reverse Repo and Call Money Rates



Box 20 (contd.)

the market. Improved liquidity management and competition will lead to greater efficiency in the market, and reduce the cost of funds.

Active OMO

As a further step towards market orientation of monetary policy operations and to improve their effectiveness, the Central Bank introduced a system of active OMO, which has built-in incentives to encourage competition in the money market and for participating institutions to improve their liquidity management. The system operates within an explicit monetary targetting monetary policy framework. Monetary targetting has become more important with the floating of the rupee as the exchange rate no longer serves as a nominal anchor for monetary policy. In this framework, the final target of economic and price stability is to be achieved through an intermediate target on the broad money supply which, in turn, is linked to a time path of operating targets on the reserve money. OMO are conducted to ensure the achievement of reserve money targets while maintaining inter bank overnight interest rates, on which the impact of monetary policy decisions is reflected almost instantaneously, stable within a narrow range.

The main features of the system are:

(*i*) An interest rate corridor;

(*ii*) Daily auction of either repo or reverse repo to maintain the inter bank rate stable within the corridor;

(*iii*) Standing facilities;

(*iv*) Outright buying/selling of Treasury bills/bonds at the discretion of the Central Bank to either inject or absorb long-term liquidity.

(i) Interest Rate Corridor

The main instrument to achieve reserve money targets is the establishment of an interest rate corridor specified in terms of the Repo rate (lower bound) and the Reverse Repo rate (upper bound) at a level consistent with the targets. The corridor is reviewed regularly, usually at monthly intervals, against macro economic developments and prospects. At these reviews, a decision is made either to change or not to change the corridor. For example, if the actual level of reserve money is higher than the target, it is an indication that the present corridor is not compatible with the reserve money targets. Therefore, if warranted by other macro economic developments and prospects, the corridor will be revised upward. Similarly, if the actual level of reserve money is less than the target a downward revision of the corridor will be considered. Accordingly, a change in the monetary policy stance of the Central Bank is signalled by revising the interest rate corridor. The decision will be announced, together with an analysis of factors that were considered in arriving at the decision. This, in fact, is the practice adopted by many countries in their regular review of policy interest rates. This would make the Central Bank's monetary policy more transparent, enabling the market to have a better understanding of the thinking of the authorities, thereby reducing unwarranted speculation.

(ii) Daily Repo/Reverse Repo Auctions

Given the corridor, Open Market Operations are conducted to maintain inter bank rates stable at a level considered appropriate within the interest rate corridor. For example, when the market is broadly in balance, *i.e.*, when banks could cover their entire liquidity requirements in the inter bank market, the appropriate level for the inter bank rate would be around the middle of the corridor. If a shortage of liquidity emerges, the inter bank rate would tend to move towards the upper bound of the corridor. In such cases, the Central Bank will inject liquidity through reverse repo auctions to cover the deficit and maintain the rate around the middle of the corridor. Similarly, if a surplus emerges, it would be absorbed through repo auctions. The Central Bank makes an assessment of market liquidity daily and decides whether there is a need for either injecting liquidity or absorbing liquidity from the financial system. The decision is announced to the market and bids invited for a repo or reverse repo auction. The auctions are on multiple bid multiple price basis where each participating institution can make up to three bids per auction and allocations to successful bidders are at their bid rate of interest. This system of auctioning is preferred as it encourages competition among participating institutions.

(iii) Standing Facilities

There is a possibility that even after the daily injection or absorption of liquidity by the Central Bank, there could still be banks with a deficit or a surplus. Facilities known as 'standing facilities' are available at the bounds of the interest rate corridor for these banks to cover their liquidity needs. Deficit banks could borrow at the Reverse Repo rate, while surplus banks could invest their surpluses at the Repo rate. Compared with the average interest rate at which liquidity facilities are offered at the daily auction, standing facilities are at rates of interest which would encourage banks to manage their liquidity more cautiously and avoid resorting to standing facilities regularly.

Box 20 (contd.)

(iv) Outright Buying / Selling of Treasury bills / bonds

Under this system, outright buying and selling of government securities by the Central Bank at the secondary market would be only at the discretion of the Central Bank, either to absorb or inject long-term liquidity in order to address changes in long-term (structural) liquidity conditions. For example, a continuous injection of a large volume of liquidity on an overnight basis by the Central Bank for a long period is an indication that there is a need for an injection of long-term (permanent) liquidity. Then, the Central Bank will purchase government securities outright in the secondary market on auction basis or Treasury bills at the primary market to inject long-term liquidity.

Benefits of Active OMO

The active OMO system has benefits to both participating institutions and the Central Bank. Participating institutions are benefited as OMO facilities are available at market rates of interest, instead of administratively fixed rates. As the market rate is within the corridor, compared with the previous system, participating institutions now receive a higher rate of interest for their repurchases, while paying a lower rate for reverse repurchases. Furthermore, with the market gaining experience under this system, the potential volatility of interest rates would decline as participants will improve the accuracy of their liquidity needs estimates and management practices. Thus, the system has incentives for participating institutions to improve their liquidity management practices, which would enable them to reduce their excess reserves and hence, cost of funds.

The interest rate corridor, which signals the monetary policy stance, is reviewed at regular intervals and the decision of the Central Bank to change or not to change the corridor is announced with a statement analysing the underlying factors for the decision. Accordingly, market participants are well informed, which would eliminate excessive speculation on the timing of changes in the policy stance of monetary policy.

Under this system, the Central Bank would actively manage market liquidity and hence it would be more effective in realising its targets on monetary aggregates, which would lead to the achievement of the final target of economic and price stability in the country.

Domestic Foreign Exchange Market

Following the independent floating of the rupee in January 2001, the foreign exchange market gained greater stability and market activity improved. The inter-bank trading volumes expanded and the rupee depreciated against the US dollar by about 3.7 per cent in 2002 as against 6-7 per cent annual depreciation during the last decade. However, the rupee depreciated by about 10-18 per cent against other major international currencies as these currencies appreciated sharply against the US dollar. Trading volumes in the forward market also increased and forward premia declined. The Bank was able to purchase US dollars 177 million from the market on a net basis during the year to build up the official reserves of the country. In view of greater market stability, the net open position of commercial banks were raised from 10 per cent of capital funds to 15 per cent of capital funds in March 2002.

The trading volumes in the inter-bank market, which includes spot, tom, cash and forward transactions, increased by 37 per cent during the year. The forward volume increased significantly by 236 per cent in 2002. Another development in the forward market transactions was the extension of the duration of contracts, reflecting greater stability in the market. The total value of transactions increased from US dollars 281 million to US dollars 946 million in 2002. In the inter-bank market, foreign commercial banks were more active than local banks, holding by about 50 per cent of the transactions.

Commercial Paper

Commercial paper (CP) is a type of short-term money market instrument issued by companies to raise funds to meet working capital requirements. CP gives both borrower and lender a better rate of return than that offered by traditional banking products.

The total value of CP issues, including reissues during the year was Rs.24 billion, in comparison to Rs.23.3 billion in 2001. The slow growth in commercial paper issues could be attributed to the decline in their relative attractiveness with the reduction of lending rates of commercial banks, and the withholding tax on interest earnings from commercial paper imposed in 2002. The bulk of the issues (98 per cent) were supported by commercial banks. The commercial paper market is heavily concentrated (75 per cent) in the three month maturity, with CPs of six months duration accounting for almost all the balance. The outstanding value of CPs at year end was Rs.5.6 billion.

Sri Lanka Development Bonds

Issue of US dollar denominated SLDBs, first floated in 2001 to meet the shortfall in privatisation proceeds and other foreign financing, was completed in 2002. Of the approved limit of US dollars 250 million, the government raised US dollars 158.5 million in 2001, in two tranches. In June 2002, the balance US dollars 91.5 million was raised in the third and the final tranche, increasing the total liability under the SLDB issue to US dollar 250 million. Unlike the previous two issues, the participants were given more flexibility in determining the tenor and the yield, subject to certain limits. The SLDBs were offered with a minimum maturity period of two years, and the rate of interest payable was 6 month LIBOR per annum plus a margin up to 2 percentage points per annum. Targeted investors were foreign citizens and entities, non-resident Sri Lankans, authorised dealers who are commercial banks, and primary dealers. However, all successful applicants were commercial banks. All offers were for 2-year maturity and the weighted average yield was 1.94 per cent over 6 month LIBOR.

Treasury Bonds

In view of the declining inflation, excess liquidity and declining market rates, Treasury bonds with longer maturities were issued during the year and yield rates declined across all maturities. As the debt management strategy was to raise more market oriented debt, the total amount of debt raised through Treasury bonds increased substantially from Rs.47 billion in 2001 to Rs.207 billion in 2002. In order to reduce the bunching of repayments in the future and improve the liquidity in key benchmark issues, measures were taken to consolidate issues in key maturities. With a view to enabling institutional investors to plan their investments in government securities, a borrowing calendar was issued to market participants. In addition to market borrowing, a few private placements were made to key strategic investors when the maturing amounts were large and to match their existing maturing government paper. Steps were also taken during the year, to further promote the government securities market, Treasury bonds in particular. These included work on an SSS system, including a depository for government securities which would be operational towards end 2003, issue of guidelines on the maintenance of capital for Primary Dealers, provision of more information to market participants and the market on government securities trading.

Of the total issues, a major share of new issues was in five to six year maturities in 2002. A total of Rs.45.2 billion worth of Treasury bonds were issued to institutional investors *viz.*, NSB and EPF (22 per cent of the total issues). The total amount that matured during 2002 amounted to Rs.89 billion as against Rs.22 billion in 2001. Accordingly, total outstanding Treasury bonds amounted to Rs.347 billion as compared to Rs.229 billion by end 2001.

In line with the reduction in Central Bank policy rates, the yields on Treasury bonds gradually declined in 2002 across all maturities. The yields on two-year and three-year bonds have declined by 308 basis points and 337 basis points, respectively, in 2002. Treasury bonds of four, five and six year maturities, which were not issued in 2001, were issued in 2002, and their yields also declined by around 300 basis points in 2002.

The market yield of Treasury bonds as reflected in secondary market operations of Primary Dealers followed the primary market yields. The secondary market transaction volumes too increased during the year. The value of Treasury bonds sold and purchased increased to Rs.108 and 186 billions in 2002 as against Rs.28 and 51 billions in 2001.

TABLE 10.24

Treasury Bond Issues during 2002

Maturity Period	Coupon Rate (% per year) (a)	Weighted Average Yield to Maturity (a)	Issues (Rs. mn.)	Outstanding Amount at end year (Rs. mn.)
2 Year	12.50	14.94-11.86	21,422	49,488
3 Year	12.25	14.50-11.13	77,810	124,795
4 Year	12.00	13.79-10.85	19,221	48,125
5 Year	11.75	14.18-11.02	45,170	65,720
6 Year	11.50	14.18-11.08	43,500	59,000
Total			207,123	347,128

(a) Applicable to Treasury bond issues during 2002.

Source : Central Bank of Sri Lanka

Rupee Loans

The relative significance of Rupee loans declined from 19 per cent in 2001 to 13 per cent in 2002, when taken as a percentage of the total resources raised from rupee denominated instruments. This was due to the availability of alternative and tradable instruments with long-term maturities.

Sixteen Rupee loans amounting to Rs.38,419 million were floated in 2002. This was a notable decline compared to the total subscription in 2001, which was Rs.50,910 million. The major subscribers to Rupee loans, the EPF, the NSB, and the Employees' Trust Fund (ETF), contributed Rs.23,366 million (62 per cent), Rs.12,434 million (33 per cent), and Rs.1,239 million (3 per cent), respectively. Other subscribers accounted only for 800 million (2 per cent). All issues in 2002 had 2-5 year maturities while the interest rate was 13 per cent per annum.

TABLE 10.25

Rupee Loans Floated during 2002

Year	Maturities (Years)	Volume (Rs. mn.)	Interest Rate (% p.a.)
2001	2	19,500	15.00
	2-5	1,399	15.00
	2-5	13,100	13.00
	6-8	4,410	13.00
2002	2-5	38,419	13.00

Source : Central Bank of Sri Lanka

Rupee loans amounting to Rs.43,532 million were repaid at maturity, and the outstanding stock of Rupee loans declined to Rs.287,700 million by end 2002, from Rs.292,813 million at end 2001.

Unit Trusts

The total number of Unit Trusts increased to 13 from 12 in the previous year. At end 2002, there were three growth funds, four balanced funds, one index fund and five income funds in operation. Both total assets and net assets recorded increases of over 50 per cent, as a result of gains arising both from the continued bullish run experienced in the stock market and the decline in market interest rates, which helped appreciate the bond portfolio. Another feature discernible during the year was the shift in investment in government securities from short-term Treasury bills to longer-term Treasury bonds to lock in higher yields in a declining interest rate environment. This is further evident from the fact that investment in very short-term instruments like repos have dropped to zero level. The rise in the total value of investment has contributed to an increase in the net asset per unit from Rs.7.35 to Rs.9.62 in 2002.

One of the issues associated with a falling interest rate regime is the negative effect it has on the purchasing power of a section of the public such as pensioners who are dependent on interest income from bank deposits. One possible strategy would be to move away from bank deposits to other forms of investments such as government paper, shares and longer-term debt securities, depending on their risk-return appetite. However, it must be noted that higher returns are invariably linked with higher risks. Investment in Unit Trusts could be a good form of investment since they have almost diversified away the unsystematic part of the risks that a single investor might not be able to do due to resource constraints.

TABLE 10.26
Unit Trusts (a)

	1998	1999	2000	2001	2002(b)
1. Total Asset (Rs. mn.)	2,687	2,652	2,173	2,874	4,432
2. Net Assets Value (Rs. mn.)	2,675	2,639	2,162	2,794	4,415
3. Investments in Equities (Rs. mn.)	1,773	1,660	1,109	1,806	2,443
(3) as a ratio of (2)	66	63	51	65	55
4. Total No. of Unit Holders	27,709	27,536	26,863	25,936	25,291
5. No. of Units in Issue (mn.)	393	392	387	380	459
6. No. of Unit Trusts	10	12	12	12	13

(a) At end December
(b) Provisional
Source : Unit Trusts

10.13 Capital Market

In 2002 there was a significant improvement in stock market activity at the Colombo Stock Exchange and key market indicators recorded large gains, particularly in the first three

TABLE 10.27
Share Market Indicators

	2000	2001	2002
1. Market Capitalisation (Rs. bn.) (a)	89	124	163
2. Number of New Issues (No.)	2	–	5
3. Total Number of New Shares Issued (mn.)	6	–	244
4. Value of New Shares Issued (Rs. mn.)	60	–	3,637
5. Number of Shares Traded (mn.)	449	747	1,220
6. Value of Shares Traded (Rs. mn.)	10,624	13,905	30,183
7. Price Indices (a)			
CSE All Share Index	447.6	621.0	815.1
Milanka Index	698.5	1,031.0	1,374.6

(a) End of the year
Source : Colombo Stock Exchange

Chart 10.7
Share Market Indicators

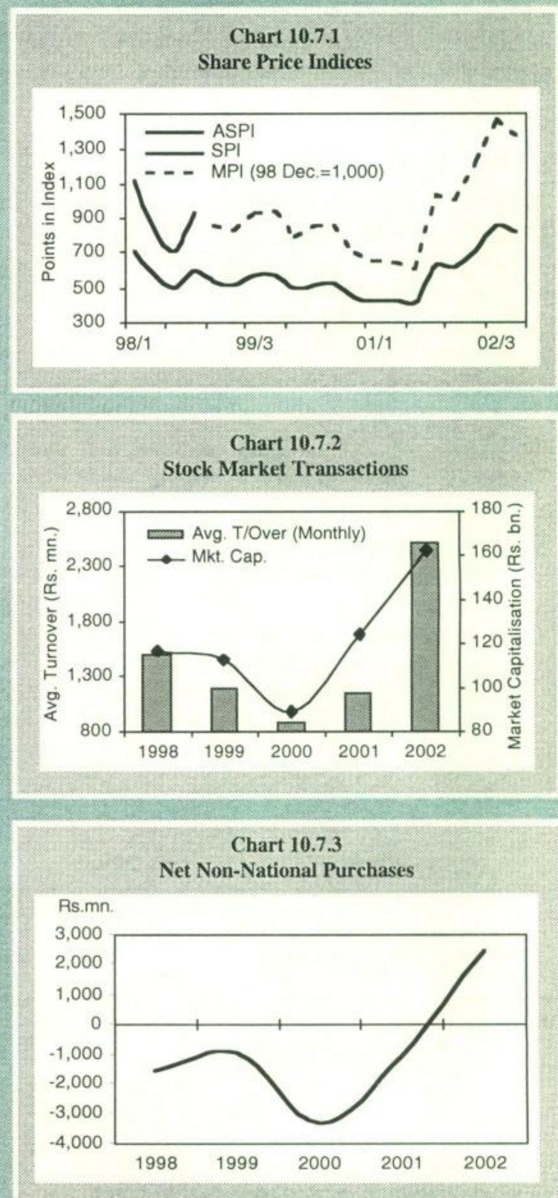


TABLE 10.28
Shares Offered by Companies during 2002 (a)

Name of Company	List opened for subs-cription	No. of Shares ('000)	Par Value (Rs.)	Premium (Rs.)	Value of Shares on offer (Rs. mn.)	No. of Shares Taken up by Underwriters ('000)	No. of Shares subscribed by Public ('000)
Touchwood Investments Ltd.	February	800	10	-	8	-	800
E-Channelling Ltd.	March	6,667	10	5	100	-	3,118
Tess Agro Ltd.	November	2,500	10	-	25	-	2,500
The Lanka Hospitals Corporation Ltd.	November	20,555	10	5	308	-	20,555
Sri Lanka Telecom Ltd.	November	216,583	10	5	3,249	-	216,583

(a) Based on the date of issue to the public

Source : Colombo Stock Exchange

quarters of the year. The Sri Lankan stock market was noted as one of the best performing markets in the world in 2002. There was a revival in primary market activity with several companies making initial public offers (IPOs) of shares, the government of Sri Lanka making an offer for sale of 12 per cent of the equity of Sri Lanka Telecom and some companies issuing debentures. Several companies obtained listings on the Colombo Stock Exchange (CSE) in 2002. Along with these new listings, the number of sectors used for classification of listed companies at the CSE was increased to 20 in 2002 from 17 at the end of the previous year; Power and Energy, Health Care and Information Technology sectors were introduced during the year. A key development in 2002 was the net inflow of foreign investment, following net outflows in four consecutive years since 1998.

Anticipation of better prospects with the progress in peace talks, strategic purchases by foreign investors and the expected improvement in corporate profits with the economy showing signs of recovery, were among the key factors that contributed to the bullishness at the Colombo Stock Exchange during the year. Easing of monetary policy and the consequent decrease in interest rates on fixed income securities, also contributed positively to the improvement in market activity. Further, with the implementation of Budget 2002, dividend income is now taxed separately at the rate of 10 per cent, which is of benefit to those in higher income brackets whose income is taxed at a rate higher than 10 per cent. The 20 per cent surcharge on corporate taxes, which was imposed in April 2001, was removed with effect from 01 April 2002, boosting after-tax corporate profitability.

During the last quarter of 2002, however, some proposals put forward in Budget 2003 presented in November 2002, had a dampening effect on share market activity. Amongst these was the proposed VAT on financial institutions including banks.

The bond market expanded further during the year. An important development in this respect, was the issue of ten-year debentures by Hatton National Bank Ltd. in September, whereas up to then, seven-year debentures issued by Suntel Ltd. had the longest tenor among listed debentures. Government borrowing through the issue of Treasury bonds also increased significantly in 2002, as interest rates gradually declined during the year. Whereas in 2001 only 2 and 3 year Treasury bonds were issued, Treasury bonds with maturities ranging from 2 to 6 years were issued during the year, with the bulk of the issues being made during the second half of the year. The third and final tranche of US dollar denominated Sri Lanka Development Bonds was issued by the government in June 2002. The first and second tranches had been issued in 2001.

Primary Market

The year 2002 has been one of the best so far in respect of primary market activity, with a total of Rs.7.3 billion being raised by way of issues of shares and debentures. Four IPOs of shares were made on the CSE in 2002 while 4 companies obtained listings by way of introductions. Meanwhile, in November 2002, the CSE's largest ever offer for sale was made by the Government of Sri Lanka with shares of Sri Lanka Telecom, the largest company to be listed on the CSE in terms of market capitalisation. With corporate profitability improving significantly during the year, particularly in the latter half of the year, both the number and the value of rights issues increased in 2002. The value of rights issues increased by 352 per cent when compared with the previous year, to Rs.964 million in 2002. However, the value of bonus issues was Rs.429 million in comparison to Rs.472 million in 2001. A total of nine companies made rights issues in 2002, while eighteen companies made bonus issues. Although nine companies obtained listings on the CSE during the year, the number of companies listed on the CSE as at end-2002 was 238, unchanged from the number as at end-2001, as there were nine de-listings during the year.

Secondary Market

Following the recovery during the last quarter of 2001, secondary market activity at the CSE picked up significantly during the year with key market indicators reached their peak in September with the conclusion of the first round of the peace talks in mid-September in Thailand. Profit taking was evident at the beginning of the year, following the rally in December 2001, and foreign investors were net sellers in the first two months of 2002. With both local and foreign investors active in the market, turnover increased significantly, particularly in June and September, when the monthly turnover exceeded Rs.5 billion. The Milanka Price Index (MPI), introduced in 1999, reached an all time high of 1,479.8 on 26 September. The All Share Price Index (ASPI) reached 860.3 on the same day, its highest during the year (it had peaked at 1,378 points on 1 March 1994). Subsequently, however, due to profit taking, and thereafter, in November, in response to proposals made in Budget 2003, both indices fell.

These developments were reflected in other market indicators too, and foreign investors who had been net buyers since March 2002 became net sellers in the last two months of the year. But, by end-2002, the ASPI was 815.1, 194.1 points (31 per cent) higher than at end-2001 and the MPI was 1,374.6, 343.6 points (33 per cent) higher than at end-2001. Further, the year 2002 has been noted as the year in which the second highest levels of turnover (Rs.30.5 billion), daily average turnover (Rs.128 million) and net foreign investment inflows were recorded. The highest turnover of Rs.34.5 billion and daily average turnover of Rs.147 million were recorded in 1994 while the highest net foreign inflow of Rs.3.2 billion was in 1993. The average daily turnover of equity in 2002 was Rs.126.5 million, while total turnover of equity amounted to Rs.30.2 billion. Net foreign investment amounted to Rs.2.4 billion (US dollars 25 million), with purchases and sales by foreigners during the year amounting to Rs.7.4 billion (US dollars 78 million) and Rs.5 billion (US dollars 53 million), respectively.

In line with the improvement in share prices, market capitalisation at the CSE rose by 31 per cent from Rs.124 billion at end 2001 to Rs.163 billion at end 2002, while the market price earnings ratio increased from 7.5 at end 2001 to 12.1 at end 2002. Meanwhile, the number of registered securities accounts at the Central Depository System held by local and foreign individuals increased to 260,260 and 1,593, respectively, at end-2002 from 252,742 and 1,482 at end 2001. The number held by local and foreign institutions increased to 2,950 and 2,817, respectively, from 2,769 and 2,671, during the same period.

With the business environment improving gradually and the accompanying improvement in corporate earnings, most sector indices grew significantly from the previous year. The highest increase was in Footwear and Textiles (92 per cent), while Investment Trusts, and Hotels and Travels increased by 75 per cent each. With respect to the four sectors with the highest market capitalisation (71 per cent of total market capitalisation at end-2002), Banks, Finance and Insurance increased by 37 per cent, Diversified Holdings increased by 31 per cent, Beverages, Food and Tobacco increased by 32 per cent, and Manufacturing increased by 26 per cent. Four sectors declined during the year; *viz*., Health Care, declined marginally by 1.9 per cent; Information Technology, which was introduced in May, declined by 10 per cent; Oil Palms and Plantations declined by 10.5 per cent and 15.5 per cent, respectively. Worldwide, technology stocks did not show any significant recovery, with the US economic recovery being slower than anticipated. With respect to plantations, rubber prices rose following the curtailment of production in the three major producer countries, namely, Malaysia, Indonesia and Thailand, while the outlook for tea prices was promising, with some major producer countries experiencing a drop in output. However, trade union action, which culminated in a wage hike for the estate workforce with effect from July 2002, is reported to have had a significant negative impact on sector profitability.

TABLE 10.29

Category-wise Distribution of Shares Traded in the Secondary Market in 2002

Category of Investment	No. of Transactions	No. of Shares ('000)	Value (Rs. Mn.)
Banks, Finance & Insurance	109,377	425,380	12,304
Beverage, Food & Tobacco	18,125	84,743	1,662
Chemicals & Pharmaceuticals	4,720	6,870	331
Construct & Engineering	4,847	15,507	347
Diversified	19,406	105,287	7,093
Footwear & Textiles	5,570	14,849	173
Hotels & Travels	31,453	201,489	2,062
Investment Trusts	2,493	2,684	63
Land & Property	12,465	89,927	542
Manufacturing	47,095	210,680	4,573
Motors	1,810	3,290	95
Oil Palms	219	195	75
Plantations	17,929	41,565	585
Services	400	340	14
Stores & Supplies	1,644	5,710	34
Trading	3,074	3,744	95
Power & Energy	6	–	–
Health Care	2,360	7,680	130
Information Technology	133	105	1
Telecom	–	–	–

Source : Colombo Stock Exchange

Developments in the Market

During the year, legislation to amend the SEC Act, No. 36 of 1987 was finalised and forwarded to the Ministry of Finance for submission to the Cabinet of Ministers by the Securities and Exchange Commission (SEC). The proposed amendments seek to grant wider powers of investigation to the SEC in all matters where the Act and the rules and regulations made thereunder are suspected to have been violated; widen the scope of the insider dealing provisions and the penalties thereon; widen the punitive jurisdiction of the SEC; widen the powers pertaining to listing and quotations; repeal provisions relating to the appellate powers granted to the Secretary to the Ministry of Finance; and register new intermediaries, namely, underwriters, margin providers, credit rating agencies, the Central Depository Systems, and investment mangers in so far as listed portfolios are concerned. Meanwhile, the SEC has requested the CSE to implement arrangements for the demutualisation of the Exchange within a period of three years from 2001. During the year, the SEC also signed Memoranda of Understanding in relation to assistance and mutual cooperation, with the Securities Commission of Malaysia, the Capital Market Supervisory Agency of Indonesia, the Australian Securities and Investments Commission and the Securities Commission of New Zealand.

Regional and Major International Stock Markets

In the South Asian region, improvements were seen in Karachi (112 per cent) and Bombay (3.5 per cent) markets in 2002. Karachi was the world's best performing market in 2002, reflecting better growth prospects, economic reforms, reduced interest rates, and the improvement in the foreign exchange reserves of Pakistan with significantly larger inflows of remittances by expatriates.

Amongst the major markets, in the USA, weaker than anticipated US economic recovery, uncertainty about profit expectations, and accounting scandals, were amongst the main factors that put downward pressure on share prices during the year. The New York Stock Exchange's Dow Jones Industrial Average, declined by 17 per cent in 2002. Further, fears of war against Iraq breaking out in the latter part of the year drove world oil prices up, and major international markets including European markets were affected by concerns about higher oil prices eating into corporate profits. The vulnerability of the recovery of the Japanese economy affected adversely the performance of the Japanese market.

TABLE 10.30

Share Price Indices of Regional and Major International Markets

	End - 2001	End - 2002
New York (DJIA)	10,022	8,342
London (FTSE100)	5,217	3,940
Tokyo (Nikkei 225)	10,543	8,579
Bombay (BSE Sensitive)	3,262	3,377
Karachi (BSE Sensitive)	1,273	2,701
Seoul (Kospi)	694	628
Taipei (Weighted Price)	5,551	4,452
Bangkok (SET)	304	356
Hong Kong (Hang Seng)	11,397	9,321
Singapore (Straits Times)	1,624	1,341
Manila (Composite)	1,168	1,018
Jakarta (Composite)	392	425
Kuala Lumpur (Composite)	696	646
Sydney (All Ordinaries)	3,360	2,976
Wellington (NZSE-40)	2,053	1,945

Source : The Asian Wall Street Journal

Credit Rating

It was announced in Budget 2003 that all deposit taking institutions should obtain a credit rating by January 2004 and publish such ratings. Further, credit rating was made mandatory for issues of all varieties of debt instruments except for those issued by the government, where the value of the issue exceeds Rs.100 million. Fitch Ratings Lanka Ltd. published ratings given by them to four finance sector institutions during the year. Commercial Bank of Ceylon Ltd. was rated SL AA+ in September, Bank of Ceylon was rated SL AA- in July, Hatton National Bank Ltd. was rated SL A in April, while Senkadagala Finance Co. Ltd. was rated SL BBB in December 2002. Meanwhile, in September 2002, John Keells Holdings Ltd. was rated SLAA+, while an issue rating was obtained by Singer (Sri Lanka) Ltd. for its 2002/2005 debentures.

Chart 10.8
Stock Prices

Chart 10.8.1
Comparison with Major International Markets
(2001 Dec = 100)

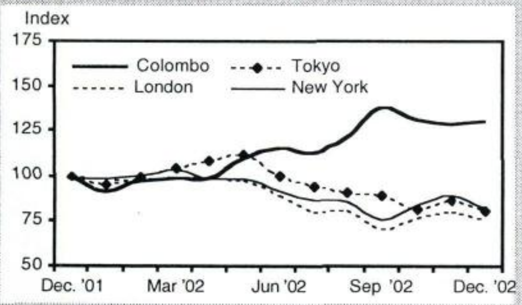


Chart 10.8.2
Comparison with South Asian Markets
(2001 Dec = 100)