Chapter 7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

The focus of monetary policy in 2004 was on the need for minimizing inflationary pressures, while facilitating the continuing growth momentum in the economy. This was a challenging task given the difficult domestic and external environments brought about by the weather related domestic supply disturbances and the escalation of international oil prices, causing both balance of payments difficulties and upward pressure on prices. Monetary expansion has, however, been somewhat above the desired path, particularly after mid 2004, driven mainly by the higher expansion in credit to the private and public sectors. In response, the Central Bank further tightened the already somewhat tight monetary policy stance by implementing open market operations more aggressively and raising its policy rates. The higher demand for credit, some increase in inflationary expectations and the movement of policy rates led to a moderate increase in market interest rates during the year. Interest rates applicable to foreign currency deposits and lending also increased as major economies commenced withdrawing their monetary policy stimuli gradually to abate fears of rising inflation.

7.2 Monetary Policy

The Central Bank continued to conduct its monetary policy under an independently floating exchange rate regime within a framework of targeting monetary aggregates with reserve money (i.e., high powered money) as the operating target and broad money (M_{2b}) as the intermediate target. Monetary policy was implemented with a system consisting of active open market operations (OMO), which includes, as its main component, the interest rate corridor formed by the Repurchase rate and the Reverse Repurchase rate, and the continuation of the statutory reserve requirement.

The conduct of monetary management was challenging in 2004 given the need to support the growth momentum in a difficult macroeconomic environment created by several adverse external and domestic factors, while paying due attention to burgeoning inflationary pressures in the economy. Thus, the thrust of monetary policy was placed on containing growth rates of reserve money and broad money, which are operating and intermediate targets in monetary management, respectively, at desired levels, by making adjustments to policy rates and continuing active OMO. This effort was supplemented by maintaining the Statutory Reserve Ratio (SRR) unchanged at 10 per cent, and the Bank Rate at 15 per cent. In the context of sales of foreign reserves by the Central Bank to mitigate excessive volatility in the exchange rate, money market liquidity was maintained by injecting funds through Central Bank purchases of Treasury bills in the primary and secondary markets, in order to prevent a liquidity crunch and wider fluctuations in interest rates.

The gradual reduction in interest rates during the period 2001-2003 provided the necessary impetus to the recovery in economic activities from the economic contraction in 2001. As the economic recovery strengthened, the continuation of the low interest rate regime, despite rising inflation, induced a higher growth in private sector credit. The increased budget deficit raised the government's borrowing requirement. The delays in the receipts of official foreign inflows coupled with high oil prices, increased government deficit financing through domestic sources more than the increase in the fiscal deficit, while exerting pressure on the balance of payments. This, in turn, exerted pressure on the exchange rate and interest rates. The pressure on the exchange rate necessitated intervention by the Central Bank in the foreign exchange market, which led to a reduction in net foreign assets (NFA) of the Central Bank. The resulting liquidity contraction was offset by injecting rupee liquidity, raising net domestic assets (NDA) of the Central Bank. NDA of the banking system (i.e. the Central Bank and commercial banks) surged further with the increased government borrowings from the domestic market, as the available resources in the non-banking sector were limited. Consequently, monetary expansion continued to remain above the targeted path in 2004.

The difficult economic conditions that prevailed in 2004 required proper timing and sequencing of monetary policy tightening. Accordingly, as the first step, the Central Bank conducted OMO aggressively from June by absorbing almost the entire liquidity surplus in the money market through daily auctions, which induced an upward adjustment in the short term cost of funds, so as to contain the growth in monetary aggregates. Subsequently, it was supplemented by raising the Central Bank policy rates by 50 basis points in November 2004. Meanwhile, to contain the higher demand for import credit and to discourage vehicle imports in an already glutted market, a 100 per cent margin deposit requirement against letters of credit (LCs) opened with commercial banks for the importation of motor vehicles for private use was introduced, as a temporary measure.

The Central Bank implemented a relief package by granting loans through the banking system at concessionary rates to help the economy to recover from the impact of the tsunami disaster. This involved taking measures to keep the money market liquid and to ensure the smooth functioning of the financial markets and the payments and settlement system. In this regard, daily OMO auctions were temporarily suspended in early January 2005. The auctions were subsequently resumed in February 2005. The Central Bank continued to engage in a dialogue with financial institutions to meet the urgent financial needs of those affected and ensure an uninterrupted flow of financial services.

The Central Bank continued to enhance the dissemination of information on monetary policy to make monetary policy operations more transparent so that the public could make informed decisions. The monetary policy stance of the Central Bank was reviewed on a regular basis and the public was kept informed of the decisions as per an advance release calendar. In addition, the Central Bank continued to release information on developments in relation to key economic variables, including the monetary targets, on the Central Bank's website, to enable market participants to make better decisions.

In 2004, the financial environment became more conducive to monetary policy transmission, with the continued development of the payment and settlement systems. Improvements were made to the Real Time Gross Settlement (RTGS) system, the Scripless Securities Settlement (SSS) system was introduced and the Central Depository system (CDS) for government securities was established. There has been a consequential improvement in the efficiency of financial transactions and a reduction in risks and the cost of transactions.

Financial institutions and markets improved in terms of both soundness and increased use of technology, thereby further facilitating the smooth transmission of monetary policy. The Central Bank took several measures to improve the resilience and the stability of the banking sector, which included the computation of capital adequacy as well as liquid asset ratios on a consolidated basis and streamlining provisioning procedures in respect of NPLs. A series of further reforms have also been planned including amendments to major laws applicable to the financial system and enhancing access to finance.

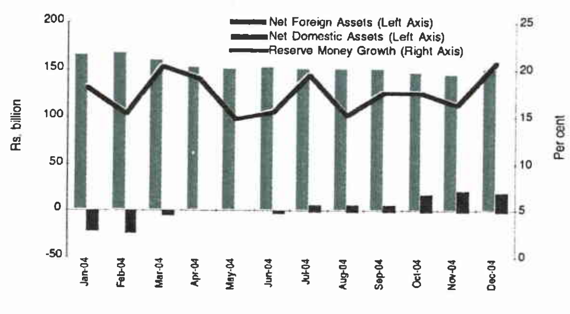
7.3 Developments in Money and Credit Aggregates

Reserve Money

Reserve money, which mainly consists of currency in circulation and the deposits of commercial banks with the Central Bank, rose by Rs.29.6 billion (21 per cent) to Rs.171 billion by end 2004, which is about Rs. 6 billion higher than the expected range in the monetary programme. This increase was entirely reflected in the expansion of NDA of the Central bank as its NFA recorded a decline, reflecting the deficit in the balance of payments. During 2004, the level of excess market liquidity remained at about Rs. 6 billion, on average, reducing

Chart 7.1

Reserve Money Growth and Sources of Reserve Money



the pressure on interest rates. To guide interest rates within the policy corridor, the Central Bank absorbed the excess liquidity on a daily basis through its active OMO.

The decline in net foreign assets was mainly a result of delays in receipts of foreign programme financing to the government and sales of foreign exchange by the Central Bank in the market to contain excessive volatility in the foreign exchange market. As the required level of foreign exchange sales was large and spread throughout the year, the Central Bank resorted to purchasing Treasury bills in order to prevent a potential liquidity crunch and ensure the smooth functioning of the financial system. Consequently, NDA of the Central Bank increased sharply, as the Central Bank's holdings of Treasury bills (net of Repos) increased from Rs.11.5 billion at end 2003 to Rs.74 billion by end 2004. However the total increase in the NDA was Rs. 42 billion, including the increase of Rs. 4 billion in the provisional advances to the government.[1]

From the perspective of how reserve money was used by the economy, the increase was reflected in an increase in the deposits of commercial banks with the Central Bank and, an increase in currency in circulation. The deposits of commercial banks with the Central Bank grew by Rs.12.5 billion as a result of the higher expansion in deposit liabilities of commercial banks. On the other hand, the currency component rose by Rs.17 billion in 2004 as against an increase of Rs. 11 billion in 2003.

Narrow Money (M_1)

Narrow money supply, which comprises currency held by the public and demand deposits held by the public, expanded by 16.6 per cent in 2004, in comparison to the 16 per cent growth in 2003. The increase in economic activity, the expansion in overall liquidity and the low interest rate regime contributed to raising the holdings of currency as well as demand deposits. Currency held by the public increased by Rs. 14 billion (16.5 per cent) and demand deposits held by the public grew by Rs. 13 billion (16.8 per cent).

1 The government is eligible to borrow up to 10 per cent of the estimated annual revenue in the budget from the Central Bank as a provisional advance.

Table 7.1

Developments in Monetary Aggregates

Rs. billion

Item	End 2003	End 2004	Change 2003 Amount	Change 2003 %	Change 2004 Amount	Change 2004 %
1. Currency Outstanding	98.8	115.9	10.5	11.9	17.1	17.3
1.1 Currency held by the Public	85.6	99.7	10.3	13.7	14.1	16.5
1.2 Currency with Commercial Banks	13.2	16.2	0.2	1.5	3.0	22.7
2. Commercial Banks' Deposits with the Central Bank	42.6	55.1	4.5	11.8	12.5	29.3
3. Government Agencies' Deposits with the Central Bank	...	...				
4. Reserve Money (1+2+3)	**141.4**	**171.0**	**15.0**	**11.9**	**29.6**	**20.9**
5. Demand Deposits held by the Public with Commercial Banks	76.0	88.8	11.9	18.6	12.8	16.8
6. Narrow Money Supply, M_1 (1.1+5)	**161.6**	**188.5**	**22.2**	**15.9**	**26.9**	**16.6**
7. Time and Savings Deposits held by the Public with Commercial Banks	419.1	499.5	48.1	13.0	80.4	19.2
8. Broad Money Supply, M_2 (6+7)	**580.7**	**688.0**	**70.3**	**13.8**	**107.3**	**18.5**
9. Foreign Currency Deposits (a)	137.1	170.7	25.0	22.3	33.6	24.5
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**717.8**	**858.7**	**95.3**	**15.3**	**140.9**	**19.6**
Money Multiplier, M_{2b}	**5.08**	**5.02**				
Velocity, M_{2b} (b)	**2.65**	**2.61**				

Source: Central Bank of Sri Lanka

(a) Includes the resident category of deposits with Foreign Currency Banking Units and a part of foreign currency deposits with Domestic Banking Units

(b) During the year

Broad Money (M_{2b})

The higher expansion in broad money (M_{2b}), since the latter part of 2003, continued in the first half of 2004 before accelerating further in the second half of 2004. During the first half of the year, broad money growth was in the range of 15 – 16 per cent, while it fluctuated in a range of around 17-19.6 per cent during the second half of 2004. This increase was mainly due to a high expansion of credit to both the private sector and the public sector.

Almost all the use side factors of M_{2b} *viz.* currency, demand deposits, and time and savings deposits, grew at a higher rate compared to 2003. Reflecting the higher transaction demand for money arising from improved economic activities currency increased by 16 per cent. Savings deposits grew by 20 per cent while time deposits grew by 25 per cent, reflecting the continued efforts of banks to attract savings through different deposit schemes as well as the higher levels of overall liquidity in the economy. Attracted by higher interest rates offered by domestic banks in Sri Lanka, foreign currency deposits also increased further by US dollars 316 million in 2004, following an increase of US dollars 168 million in 2003, increasing the total foreign currency deposit base to US dollars 1,731 million.

Factors Affecting Broad Money (M_{2b}) Growth

Almost the entire growth in M_{2b} was due to an increase in NDA of the banking system (98 per cent), in contrast to the original projections where the major contribution was expected from an increase in NFA of the banking system. NFA of the banking system improved only marginally in 2004 contributing about 2 per cent to the growth in money supply. This was wholly due to the improvement in NFA of commercial banks as NFA of the Central Bank declined, reflecting a deficit of about US dollars 205 million in the BOP. However, the decline in NFA of the Central Bank was partly offset by the proceeds of the Sri Lanka Development Bonds (SLDBs) as the government sold them to the Central Bank. NFA of commercial banks improved by about Rs.16 billion, benefiting from the increase in foreign remittances, higher earnings from tourism, foreign exchange received from the SLT bond issue and the receipt of the privatisation proceeds from Lanka Indian Oil Company (LIOC), enabling the Ceylon Petroleum Corporation (CPC) to settle a part of it's liabilities to commercial banks.

Credit to the private sector contributed largely to the monetary expansion (81 per cent). The acceleration of credit, from the end of 2003, continued in 2004 with an expansion of about Rs.115 billion in 2004. Accordingly, the point to point growth in credit to the private sector increased to 22 per cent as at end 2004 from 17 per cent as at end 2003.

Chart 7.2

Growth in M_{2b} and its Sources

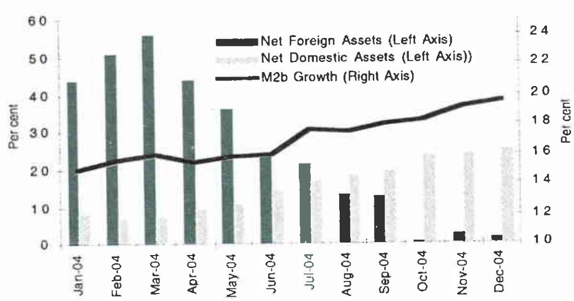


Table 7.2

Underlying Factors of Reserve Money and Broad Money

Rs. billion

Item	End 2003	End 2004	Change 2003 Amount	Change 2003 %	Change 2004 Amount	Change 2004 %
Reserve Money	**141.5**	**171.0**	**15.1**	**11.9**	**29.5**	**20.8**
Net Foreign Assets of the Central Bank	164.6	151.7	47.2	40.2	-12.9	-7.8
Net Domestic Assets of the Central Bank	-23.1	19.3	-32.1	-356.7	42.4	-183.5
Broad Money (M_{2b})	**717.8**	**858.6**	**95.2**	**15.3**	**140.8**	**19.6**
Net Foreign Assets	167.1	170.2	56.4	50.9	3.1	1.9
Monetary Authorities	164.6	151.7	47.2	40.2	-12.9	-7.8
Commercial Banks	2.5	18.5	9.2	-137.3	16.0	640.0
Net Domestic Assets	550.7	688.4	38.8	7.6	137.7	25.0
Domestic Credit	731.8	895.9	51.4	7.6	164.1	22.4
Net Credit to the Government	176.2	220.4	-16.8	-8.7	44.2	25.1
Monetary Authorities	42.1	108.1	-28.8	-40.6	66.0	156.8
Commercial Banks	134.1	112.3	12.0	9.8	-21.8	-16.3
Credit to Public Corporations	36.2	41.2	-6.8	-15.8	5.0	13.8
Credit to the Private Sector	519.4	634.3	75.0	16.9	114.9	22.1
Other Items (Net)	-181.1	-207.5	-12.6	-7.5	-26.4	-14.6

Source: Central Bank of Sri Lanka

About 84 per cent of the credit expansion came from domestic banking units (DBUs) of commercial banks while the balance 16 per cent came from the foreign currency banking units (FCBUs). The expansion in credit of a higher magnitude was a reflection of the continued recovery in economic activities, the expansion in foreign trade and the decline in lending rates in real terms. The decomposition of credit indicates that the high demand for credit in 2004 was mainly for commercial, consumption, housing, industrial, and services related puposes. The growth in credit granted for commercial, housing and consumption activities accounted for about 72 per cent of the credit growth with the consumption category recording the highest growth of around 41 per cent. The commercial sector, which generally absorbs about one third of the total credit and consists of export, import, wholesale and retail trade sub sectors, showed a growth of 18.2 per cent. Meanwhile, the industrial sector utilised about 10 per cent of the total credit expansion and grew by 12 per cent. Credit granted for housing and property development activities, which grew by 24 per cent, contributed to 14 per cent of the credit growth.

During 2004, net credit to the government (NCG) from the banking system increased by a higher rate than expected due to an increase in the budget deficit, and shortfalls in projected foreign financing and the realisation of privatisation proceeds. Limitations in the availability of non-bank sector resources for budgetary financing also caused an increase in bank credit to the government. Accordingly, NCG from the banking system increased by about Rs.44 billion in 2004. This was solely due to the increase in NCG from the Central Bank by Rs.66 billion as NCG from commercial banks declined by Rs.22 billion in 2004. The increase in NCG from the Central Bank reflected mainly the increased holdings of Treasury bills by the Central Bank, which increased by Rs.63 billion. A large part of the expansionary effect of this increase was offset by the decline in NFA of the Central Bank.

The decline in NCG from commercial banks was a net outcome of the decline in holdings of Treasury bills and Treasury bonds and an increase in their investments in SLDBs. In 2004, the government raised SLDBs amounting to US dollars 158.5 million, on a net basis, as the government issued SLDBs worth US dollars 250 million while SLDBs worth US dollars 91.5 million matured in 2004. Commercial banks were the main investors in SLDBs, subscribing to about 85 per cent of the issues.

An increase in credit to public corporations by Rs. 5 billion in 2004, in contrast to the repayments expected at the beginning of the year, was another contributory factor for the growth in money supply. This increase in credit was a result of borrowings by the CPC of about Rs.8 billion, while the other two major corporations, i.e., CEB and CWE, settled a part of their liabilities, amounting to Rs.3 billion during the year. The increase in credit to the CPC was a result of delays in adjusting domestic fuel prices in line with international prices, requiring additional borrowings from the banking system. Although liabilities of the CEB to commercial banks declined, the CEB has increased its liabilities to other parties such as the CPC and private power producers.

During 2004, the money multiplier declined only marginally from 5.08 as at end 2003 to 5.02 as at end 2004. However, the declining trend in the currency to deposit ratio further continued in 2004, which is attributed to the improvement in banking facilities and greater use of electronic payment methods.

Table 7.3

Finacial Survey and Underlying Factors

Rs. billion

Item	End 2003	End 2004	Change 2003 Amount	Change 2003 %	Change 2004 Amount	Change 2004 %
Financial Survey	**928.3**	**1,094.1**	**131.0**	**16.4**	**165.8**	**17.9**
Underlying factors						
Net Foreign Assets	157.7	161.5	57.1	56.8	3.8	2.4
Net Domestic Assets	770.6	928.8	73.5	10.5	158.1	20.5
Domestic Credit	1,008.8	1,205.2	97.4	10.2	196.4	19.5
Net Credit to the Government	307.5	354.1	8.5	2.8	46.6	15.2
Credit to Public Corporations	36.8	41.6	-7.0	-16.0	4.8	13.1
Credit to the Private Sector	664.5	809.5	95.8	16.8	145.0	21.8
Other Items (Net)	-238.2	-272.6	-23.5	-11.0	-34.4	-14.4

Source: Central Bank of Sri Lanka

Financial Survey

The financial survey, which includes the activities of licensed specialized banks and finance companies in addition to the Central Bank and licensed commercial banks, provides a broader measure of liquidity. However, some of the assets included in the financial survey are less liquid than the assets included in M_{2b}. Therefore, M_{2b} is considered to be a better measure as an intermediate target in the conduct of monetary policy than the measure of liquidity provided by the financial survey.

The overall liquidity measured by the financial survey recorded a lower growth than the growth of M_{2b}. On a point-to-point basis, this growth was in a range of 15.3 – 17.9 per cent in comparison to the growth of 15-19.6 per cent in M_{2b}. This was mainly due to the slower growth of investment in government paper by licensed specialised banks (LSBs).

In 2004, credit to the private sector in the financial survey increased by a higher magnitude in comparison to 2003. On a point-to-point basis, credit to the private sector based on the financial survey increased by 21.8 per cent compared with the 16.9 per cent growth recorded in 2003. In the total credit expansion of around Rs.145 billion, the contribution from LSBs, finance companies and RDBs was around Rs.30 billion. Of this, a larger contribution amounting to Rs.19 billion came from LSBs while the contribution from finance companies was Rs.8 billion. In comparison, the growth in credit extended by these institutions in 2003 was Rs.21 billion. A major share of the growth in loans granted by LSBs has been for agriculture, manufacturing and trading, while most of the lending by finance companies has been for leasing purposes.

7.4 Interest Rates

The declining trend in interest rates that prevailed throughout 2003 reversed with a marginal increase in 2004 with rising inflation, inflation expectations, increasing credit demand and the monetary policy measures taken. In 2004, real interest rates in many market segments became negative as inflation increased at a faster rate than the increase in interest rates. As many central banks around the world commenced tightening the monetary policy stance in their respective countries, international market rates also indicated a gradual upward movement.

Central Bank Policy Rates

The Repo and Reverse Repo rates, which were reduced continuously since February 2001, were left unchanged during the first ten months of the year until they were increased towards the end of the year. An increase in policy interest rates was necessitated in order to contain the higher than anticipated increase in credit and monetary aggregates as well as to address rising inflation and inflation expectations. Therefore, first, the yield rates at the Central Bank's OMO Repo auction were allowed to adjust upward by absorbing a large part of the excess liquidity from the market. Subsequently, the Repo and Reverse Repo rates, which were 7.00 per cent and 8.50 per cent, respectively, by end 2003, were increased to 7.50 per cent and 9.00 per cent, respectively, with effect from the close of business on 10 November 2004.

The Bank Rate, the rate at which the Central Bank grants advances to commercial banks to meet their temporary liquidity requirements, was left unchanged at 15.00 per cent during the year.

Table 7.4

Changes in Policy Interest Rates of the Central Bank

Per cent

Date	Repo Rate	Reverse Repo Rate	Bank Rate
2002.11.22	9.75	11.75	18.00
2003.01.07	9.00	11.00	18.00
2003.05.09	8.25	10.25	18.00
2003.08.15	7.50	9.50	15.00
2003.10.16	7.00	8.50	15.00
2004.11.10 (Close of Business)	7.50	9.00	15.00

Source: Central Bank of Sri Lanka

Money Market Rates

During the first five months of 2004, the average weighted yield rate at the daily Repo auctions remained close to the Central Bank's Repo rate. However, as the Central Bank started to absorb the entire amount of excess liquidity from the market, the Repo auction rate shifted upwards from the Repo rate and moved to the centre of the interest rate corridor. Accordingly, the weighted average OMO rate, which was 7.04 per cent on 31 December 2003, had increased to its highest level of 7.93 per cent by 29 November 2004. Market participants also continued to access the Repo standing facility, while there were some Reverse Repo transactions, reflecting structural rigidities in the financial system.

Unlike in the year 2003, call market rates became relatively more volatile in 2004, occasionally rising above the upper bound of the Central Bank policy corridor, despite maintaining overall liquidity adequately. Market uncertainty in the immediate aftermath of the general elections, concentration of surplus liquidity in some institutions that did not participate in the call money market, the tax structure affecting the call market rate and the existence of lending limits among institutions, were the causes of this behaviour in call market rates. The rates, which hovered in the range of 6.80 – 8.25 per cent during the first four months, increased with larger fluctuations thereafter. Commensurate with the increase in the Central Bank policy rates in November, call money market rates increased further, especially during the last week of the year.

Table 7.5

Money Market Interest Rates (a)

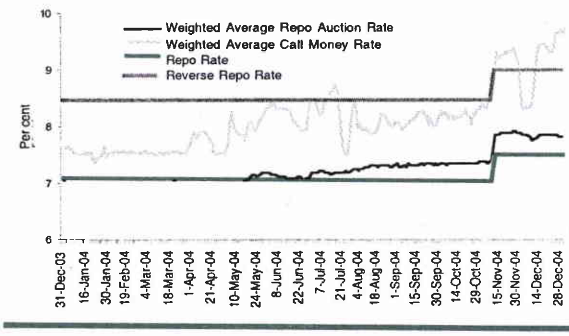
Per cent

	CBSL Repo Rate	Weighted Average Repo Auction Rate	Weighted Average Call Money Rate	SLIBOR-Overnight
Dec-03	7.00	7.04	7.59	7.73
Mar-04	7.00	7.01	7.50	7.66
Jun-04	7.00	7.11	7.89	8.28
Sep-04	7.00	7.37	7.97	8.24
Dec-04	7.50	7.84	9.73	9.66

(a) Month-end values Source: Central Bank of Sri Lanka

Chart 7.3

Money Market Interest Rates



The Sri Lanka Inter Bank Offered Rate (SLIBOR), which is computed based on the rates offered for rupee inter bank transactions by 12 commercial banks, showed movements similar to the call market rates.

Lending and Deposit Rates

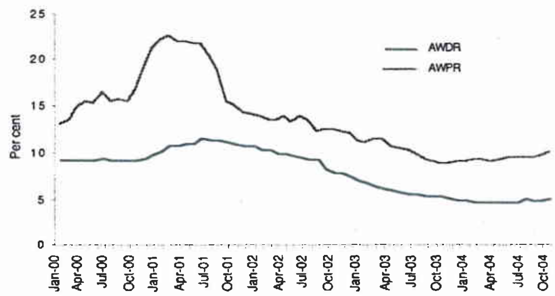
Both lending and deposit rates of commercial banks increased during the year. The weighted average prime lending rate (AWPR), declined from 9.26 per cent as at end 2003, to its lowest level of 8.89 per cent in January, but increased to 10.23 per cent by end 2004. Lending rates pertaining to overdrafts as well as export financing facilities and import financing facilities increased faster.

Interest rates on savings deposits continued to decline in the first half of the year but the rates on fixed deposits increased marginally with the increase in yield rates on government securities that was observed during the first seven months of the year. The average weighted deposit rate (AWDR), which is a weighted average of the rates on all outstanding interest bearing deposits of commercial banks, declined from 5.27 per cent in December 2003, to 4.84 per cent by June 2004, but had increased to 5.31 per cent by December 2004. The average weighted fixed deposit rate (AWFDR), increased gradually from 7.11 per cent in December 2003 to 7.67 per cent in December 2004. Meanwhile, the difference between the AWDR and the AWPR, which is an indicator of the interest spread, widened further in 2004.

The Legal Rate and the Market Rate, which are computed based on the AWDR and published in the Government Gazette by the Central Bank at the end of each year, also declined. Accordingly, the Legal Rate and the Market Rate applicable for the year 2005 are 5.16 per cent compared with 6.30 per cent in 2004, and 9.58 per cent in 2003.[2]

Chart 7.4

Commercial Bank Lending and Deposit Rates



2 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 and applies only in relation to actions instituted by lending institutions for the recovery of debt exceeding Rs.150,000 arising out of commercial transactions, where there is no agreed rate of interest.

Table 7.6
Average Interest Rates of Commercial Banks (a)

Per cent

	End December 2003	End June 2004	End December 2004
Lending Rates			
Overdrafts-Corporate	10.97	12.07	12.23
Overdrafts-Retail	12.26	14.07	14.36
Export Financing Facilities	10.27	12.01	12.56
Import Financing Facilities	12.20	13.63	14.11
Deposit Rates			
Savings Deposits	4.22	4.24	4.97
One-year Fixed Deposits	5.68	6.67	7.68

Source: Central Bank of Sri Lanka

(a) Based on the rates quoted by commercial banks

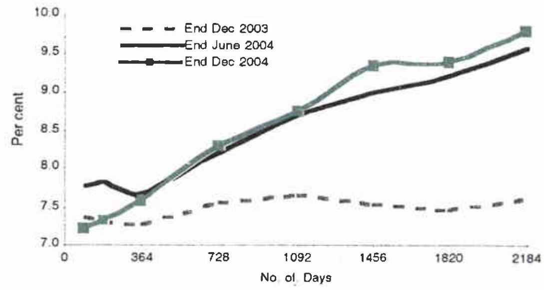
The savings deposit rate of the National Savings Bank (NSB) remained unchanged at 5.00 per cent throughout the year, although its one-year fixed deposit rate, which was 7.00 per cent in December 2003, increased to 8.00 per cent by end 2004. Considering the effect of low deposit rates on senior citizens and retirees, the NSB as well as the two state banks continued special deposit schemes with high interest rates, targeting them, while private commercial banks also introduced similar schemes.

Interest rates charged by commercial banks on outstanding payments through credit cards, which were in a range of 21-35 per cent at end 2003, remained broadly unchanged at end 2004. However, it should be noted that this is only a penal rate on those who do not settle their balances even after the interest free period provided to credit card holders and does not reflect the normal price of credit.

With respect to long-term credit institutions, lending rates of DFCC Bank and the State Mortgage and Investment Bank (SMIB) remained unchanged during the year, although lending rates of the National Development Bank (NDB) showed an increase. Accordingly, the lending rates of DFCC Bank remained in a range of 9.25-16.00 per cent at end 2004, while the lending rates of the SMIB were 12.00-13.25 per cent by end 2004. Lending rates of the NDB had increased from 7.75-15.20 per cent to 9.60-16.00 per cent during the year.

As international market rates started to increase towards the end of the year, commercial banks in Sri Lanka also increased their interest rates on foreign currency deposits and on foreign currency lending. At end 2004, interest rates on US dollar denominated savings accounts were in the range of 0.20 to 2.25 per cent, while on sterling pound denominated savings accounts they were 1.00 to 4.50 per cent. The interest rates applicable to lending in US dollars were in the range of LIBOR+0.75 per cent to 11.50 per cent, while on lending in sterling pounds, rates charged were between LIBOR+3.75 per cent and 11.50 per cent.

Chart 7.5
Government Securities-Secondary Market Yield Curve



Yields on Government Securities

Interest rates at the weekly Treasury bill auctions increased during the first seven months of the year, but declined thereafter. The decline in the yields on 91-day, 182-day and 364-day Treasury bills occurred with the shifting of government borrowings to foreign currency sources, with the issue of SLDBs, and as institutional investors increased their active role in the primary Treasury bill market.

In contrast to 2003, where longer-term Treasury bonds were issued continuously, Treasury bond issues in 2004 had shorter maturities. At the first primary auction for two-year Treasury bonds held in January 2004, the yield was 7.64 per cent, but it increased to 9.68 per cent by end July. However, the yield on two-year Treasury bonds had declined to 8.25 per cent by end December. Primary market yield rates on three-year Treasury bonds were around 8.40 – 8.88 per cent during the year, while there were a few four-year Treasury bond auctions as well.

The secondary market yields on government securities increased at the longer end, indicating higher inflation expectations in the medium term. In comparison to end 2003, the secondary market yield rates on Treasury bills increased by around 15-60 basis points, while yield rates on Treasury bonds had increased by 14-290 basis points at end 2004.

Rupee loans with call options, which carried high yield rates, were recalled as a cost reduction strategy o f the government, while a small amount of Rupee loans with maturity periods ranging from 2-6 years were issued during 2004. Interest rate on Rupee loans, which are administratively determined, was 8.00 per cent during the year. The dollar denominated SLDB issue amounting to US dollars 250 million was made in three tranches, with the weighted average yield of the entire issue being six months LIBOR+179.3 basis points.

Yields on Corporate Debt Securities

Interest rates pertaining to commercial paper, a short-term debt instrument, which were in the range of 7.25-13.00 per cent in 2003, had increased to a range of 9.50-13.75 per cent by end

2004. Merchant Bank of Sri Lanka and Sampath Bank made public issues of debentures during the year, which were later listed on the CSE, and the issues carried interest rates of 10.38 per cent and 10.00 per cent, respectively. The international bond issue of Sri Lanka Telecom carried a coupon rate of 6.875 per cent.

7.5 Issues in Conducting Monetary Policy

The conduct of monetary policy has improved over the years with greater market orientation and increased transparency, and further improvements are under consideration. The present monetary management strategy has been based on a monetary targeting framework, where the Central Bank uses its policy instruments to regulate the money supply. Under the monetary targeting framework, inflation is only an implicit target, whereas targeting inflation explicitly has several advantages. It helps anchor inflation expectations, through which it could also help reduce the size of inflationary shocks and their associated costs while strengthening business and public confidence in monetary policy.

Under the present monetary targeting framework, changes in policy interest rates are expected to impact on price levels, through various channels of monetary policy transmission.[3] Monetary policy transmission involves variable and long lags, and therefore monetary policy action may not show the expected impact on prices immediately. In Sri Lanka, it has been noticed that the interest rate pass through, the major policy transmission channel, has been sluggish and asymmetric due to structural rigidities in the financial markets. Further deepening of the financial system and increasing integration of financial markets would accelerate the monetary policy transmission process and raise the policy impact.

Therefore, in the medium term, moving to an inflation-targeting framework would increase the effectiveness of monetary policy aimed at price stability. However, several prerequisites need to be fulfilled before implementing a successful inflation-targeting framework.[4] In this regard, emphasis has to be given to (1) improving fiscal consolidation, (2) strengthening the monetary policy transmission process, (3) developing a widely accepted measure of inflation and (4) improving the technical abilities for modelling and forecasting.

3 Monetary policy transmission primarily works through five channels, *viz.*, interest rate channel, exchange rate channel, wealth channel, credit channel and expectations.

4 Debelle, G , *et al*, (1998), "Inflation Targeting as a Framework for Monetary Policy", IMF, cite four prerequisites for inflation targeting, *viz.*, (1) Central bank independence, i.e., no fiscal dominance, (2) willingness and ability of monetary authorities not to target other indicators, (3) establishing explicit quantitative targets, and (4) devise a forward looking operating procedure in which monetary policy instruments are adjusted in line with assessments of future inflation.