Chapter 7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

- **The thrust of monetary policy throughout 2005 was on curbing burgeoning inflationary pressures in the economy, while supporting economic growth and mitigating the negative impacts of several adverse shocks.** After the low inflation period that ended in 2003, monetary policy accommodation was gradually withdrawn in 2004 and 2005. This was accomplished in 2005 in the face of several challenges and uncertainties impinging on macroeconomic management. These included the escalating oil prices, the impact of the phasing out of the Multi Fibre Arrangement on Sri Lanka's largest export industry, and the financing of tsunami related relief, rehabilitation and reconstruction. While these uncertainties dissipated gradually as the year progressed, foreign inflows continued strengthening the balance of payments position and exchange rate stability while at the same time raising domestic liquidity and posing problems for monetary management.
- **Monetary policy responded proactively to the manifestation of adverse inflation expectations and the relatively high expansion in money and credit aggregates throughout 2005.** Money and credit aggregates began to rise at a faster rate leading to adverse inflation expectations as witnessed in the upward pressure on market interest rates, especially yields on government securities. The Central Bank raised its policy interest rates gradually by 125 basis points in four steps, and mopped up excess liquidity through aggressive open market operations (OMOs) on an overnight and permanent bases to curb the excessive growth in monetary aggregates and to dampen inflation expectations.
- **The economy responded well to the tightening of monetary policy as evidenced in the increase in market interest rates, which slowed down monetary expansion and moderated inflation and inflation expectations.** In response to monetary policy measures, market interest rates increased gradually enabling the deceleration in growth in money and credit aggregates, resulting in a slow down in inflation. The expansion in reserve money decelerated to the targeted growth path by end December 2005 while broad money growth also slowed down but remained above the desired path. A decline in inflationary expectations was evident from the decline in the forward premia in the foreign exchange market and the stability in secondary market yields on government securities towards the latter part of the year. These developments led to the moderation in inflation, which was supported by favourable supply side developments.

7.2 Monetary Policy

- **The Central Bank conducted monetary policy operations within the monetary targeting framework, under an independently floating exchange rate system.** Reserve money (high powered money) and broad money (M_{2b}), continued to be the operating and intermediate targets, respectively. Monetary operations were conducted to achieve the pre-determined path of reserve money targets using active open market operations (OMOs) within an interest rate corridor bounded by the Repurchase (Repo) rate and the Reverse Repurchase (Reverse Repo) rate of the Central Bank. The Statutory Reserve Requirement (SRR) was maintained at 10 per cent, while the Bank Rate (the rate at which the Central Bank grants advances to commercial banks) remained at 15 per cent per annum.
- **Monetary policy was tightened during 2005 with the objective of containing the rapid growth of monetary and credit aggregates and the burgeoning inflationary pressures.** The Central Bank's policy interest rates, viz. Repo and Reverse repo rates, were raised by 125 basis points in four steps in 2005: 25 basis points in May, 50 basis points in June, 25 basis points in September and another 25 basis points in December. Simultaneously, OMOs were conducted aggressively to absorb excess liquidity on a daily basis. These measures were buttressed by outright sales of Treasury bills held by the Central Bank, which sterilized the market liquidity arising from the purchases of foreign currency inflows to the government by the Central Bank. However, to ensure the availability of sufficient liquidity in the market, for urgent expenditure in the aftermath of the tsunami disaster, the absorption of excess liquidity through daily auctions under OMOs was suspended temporarily from early January 2005. OMOs were subsequently resumed in late February 2005 as the threat of the tsunami on the financial sector and economic activities gradually receded.
- **Monetary policy measures were instrumental in reducing the excessive growth in money and credit aggregates and arresting inflationary pressures in 2005.** With the revision of the Repo and Reverse Repo rates of the Central Bank to 8.75 per cent and 10.25 per cent, respectively, the interest rate structure moved to a higher plateau resulting in an increase in the cost of funds. At daily OMO auctions conducted by the

Central Bank, the weighted average Repo auction rate (i.e. the effective policy rate) rose by 145 basis points in 2005. Call money rates increased by 125 basis points, while the average weighted deposit rate (AWDR) and the average weighted prime lending rate (AWPR) increased by 93 basis points and 201 basis points, respectively. Reserve money growth, which accelerated in 2004, began to decelerate gradually throughout 2005 and by the end of the year, reached a rate of 15.8 per cent, marginally higher than the target of 15 per cent. Broad money expansion also decelerated towards the end of the year responding positively to the tightening of monetary policy. Inflation, as measured by the point to point increase in the Colombo Consumers' Price Index (CCPI) peaked in February, at 15.9 per cent, and declined thereafter due to the contractionary monetary policy as well as improved supply conditions, and was 8.0 per cent in December 2005. The point-to-point inflation as measured by the Sri Lanka Consumers' Price Index (SLCPI) declined at a faster rate from 16.8 per cent at end 2004 to 3.6 per cent at end 2005.

- **The Central Bank continued to lay emphasis on the transparency of monetary policy decision making and communication, which is key to improving the effectiveness of monetary policy.** Accordingly, the Central Bank makes public the monetary policy targets, with explanatory notes, at the beginning of the year. The public was informed of the decisions and factors considered at the regular monetary policy reviews through press releases issued as per the advance release calendar. The Central Bank also continued to make available information on developments in relation to key macroeconomic variables through media including its website, to enable market participants as well as the general public to arrive at informed decisions.
- **Efforts were also taken to strengthen monetary policy transmission by improving the efficiency of the financial system.** The Payment and Settlement Systems Act was brought in to improve the security, safety and efficiency of the payment system and facilitate the smooth functioning of financial markets. A number of regulatory measures were taken to improve risk management, resilience, competition and the efficiency of financial institutions. The amendments to the Finance Leasing Act allowing leasing companies to securitise leasing portfolios and measures taken to expand the government securities trading and settlement mechanisms would help promote the long term debt securities market.

7.3 Developments in Money and Credit Aggregates

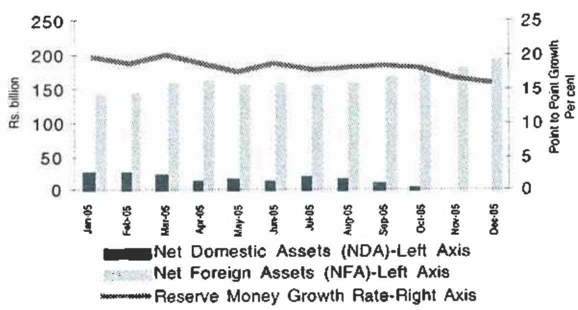
Money Market Liquidity

- As high excess liquidity in the market could lead to an excessive monetary expansion that could raise future inflationary pressures, money market liquidity was maintained throughout 2005 at a desirable level to foster the ongoing economic development, while containing demand pressures in the economy.
- However, in the immediate aftermath of the tsunami disaster, the Central Bank implemented a relief package to ensure the availability of adequate liquidity to facilitate the smooth functioning of money and financial markets. The absorption of excess liquidity through daily OMO auctions was discontinued temporarily from 5 January 2005 till 21 February 2005. As tsunami related financial inflows raised the level of liquidity in the economy, OMOs were conducted aggressively, both on an overnight basis and permanently, to mop up the entirety of excess liquidity.

Reserve Money

- **In 2005, the quarterly targets of reserve money were achieved except in March.** Reserve money continued to rise above the targeted level till end March as a result of the high

Chart 7.1
Growth and Sources of Reserve Money



demand for currency to finance tsunami related relief operations. Compared with the growth rate of 20.9 per cent in December 2004, reserve money rose by 15.8 per cent in December 2005. This was only a marginal increase above the target of 15 per cent set for December 2005.

- **The expansion in reserve money in 2005 was entirely reflected in the increase in net foreign assets (NFA) of the Central Bank.** The build up of NFA was a result of the Central Bank purchasing foreign currency proceeds received by the government. These consisted of tsunami related inflows, other grants, loans from foreign donor agencies and domestic foreign currency borrowings from Foreign Currency Banking Units (FCBUs).
- **The net domestic assets (NDA) of the Central Bank were brought down through OMO to offset the increase in NFA and contain the growth in reserve money.** The decline in

NDA by Rs. 18 billion helped contain the increase in reserve money to Rs. 26 billion in 2005. With the sterilisation of the additional liquidity created by increased NFA, the Treasury bill holdings of the Central Bank fell from Rs. 74 billion as at end 2004 to Rs.35.6 billion as at end 2005. However, the provisional advances to the government from the Central Bank rose by Rs. 5 billion in 2005.[1] In addition to the reduction in Treasury bill holdings, the increase in the liabilities of the Central Bank by about Rs.15 billion consequent to the appreciation of the rupee in 2005, also contributed to the decline in NDA of the Central Bank.

- **From the point of view of uses of money, the expansion in reserve money was reflected in the increase in currency in circulation and commercial bank deposits.** The deposits of commercial banks with the Central Bank increased by Rs. 10.5 billion while currency in circulation increased by Rs.16.5 billion. However, the growth in currency declined reflecting public preference to move to interest bearing assets with the increase in interest rates.

Narrow Money (M_1)

- **The narrow money supply (M_1) consisting of currency and demand deposits held by the public, increased by 22.4 per cent in 2005, in comparison with the 16.6 per cent growth in 2004.** Currency held by the public increased by 14.4 per cent (Rs. 14.4 billion) and demand deposits held by the public grew by 31.4 per cent (Rs.27.8 billion).

1 The government is eligible to borrow up to 10 per cent of the estimated annual revenue in the budget from the Central Bank by way of provisional advances.

Broad Money (M_{2b})

- **The higher expansion in broad money (M_{2b}) in 2004 continued into most of 2005 but had begun to slow down by December 2005. This deceleration was in response to the tightening of monetary policy.** During most of 2005, broad money continued to grow by around 20-21 per cent, before it declined to around 19 per cent by end December 2005. The expansion in broad money was mainly reflected in a higher increase in credit to the private and public sectors.
- **All components of M_{2b}, *viz.* currency, demand deposits, and time and savings deposits increased during 2005.** Currency held by the public increased by 14.4 per cent compared to the 16.4 per cent growth in 2004. This was due to the high transaction demand for money arising from expanding economic activities. Savings deposits grew by 13.0 per cent and

Chart 7.2

Growth in M_{2b} and its Sources

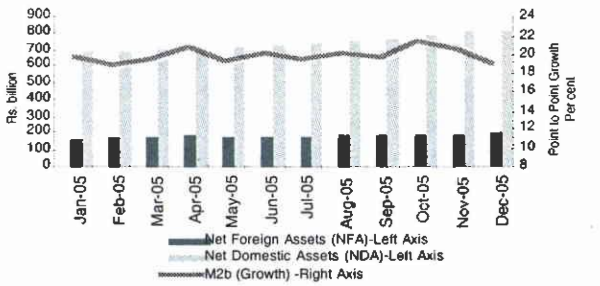


Table 7.1

Developments in Monetary Aggregates

Rs. billion

Item	End 2004	End 2005	Change 2004 Amount	2004 %	Change 2005 Amount	2005 %
1. Currency Outstanding	115.9	132.4	17.1	17.3	16.5	14.3
1.1 Currency held by the Public	99.7	114.1	14.1	16.4	14.4	14.4
1.2 Currency with Commercial Banks	16.2	18.3	3.0	22.7	2.1	13.0
2. Commercial Banks' Deposits with the Central Bank	55.1	65.5	12.5	29.3	10.4	18.9
3. Government Agencies Deposits with the Central Bank	...	...	...	...	...	...
4. Reserve Money (1+2+3)	**171.0**	**197.9**	**29.6**	**20.9**	**26.9**	**15.8**
5. Demand Deposits held by the Public with Commercial Banks	88.8	116.6	12.8	16.8	27.8	31.4
6. Narrow Money Supply, M_1 (1.1+5)	**188.5**	**230.7**	**26.9**	**16.6**	42.2	22.4
7. Time and Savings Deposits held by the Public with Commercial Banks	499.5	592.2	80.4	19.2	92.7	18.6
8. Broad Money Supply, M_2 (6+7)	**688.0**	**822.9**	**107.3**	**18.5**	**134.9**	**19.6**
9. Foreign Currency Deposits *(a)*	170.7	199.4	33.6	24.5	28.7	16.8
10. Consolidated Broad Money Supply, (M_{2b}) (8+9)	**858.6**	**1,022.3**	**140.9**	**19.6**	**163.6**	**19.1**
Money Multiplier M_{2b}	5.02	5.16				
Velocity, M_{2b}(b)	2.61	2.53				

Source: Central Bank of Sri Lanka

(a) Includes deposits of the Resident Category of Foreign Currency Banking Units and a part of foreign currency deposits with Domestic Banking Units.
(b) During the year.

Box 14

Need for High Denomination Currency

At the time of establishing the Central Bank of Sri Lanka in 1950, the country had been using currency notes in denominations of Re. 1 and rupees 2, 5, 10, 50, 100, 500 and 1,000 and coins in denominations of cents 1, 2, 5, 10, 25, 50 and Re. 1 issued by the Board of Commissioners of Currency. The Central Bank started to print its own currency notes in denominations of Re. 1 and rupees 2, 5, 10, 50, and 100 in 1951/52. Subsequently, a note of rupees 20 denomination was introduced in 1979, followed by notes of rupees 500 and 1,000, issued in 1981. Since then a note of a higher denomination has not been issued.[1]

In a modern economy, in addition to currency notes and coins, a variety of instruments is available for payments and settlements. The most common instruments are cheques, credit cards, debit cards, and electronic means. Although the use of currency has been declining slowly in relative terms in modern economies, it remains by far the most popular payment instrument throughout the world. The demand for currency increases due to increased volumes of transactions and increases in prices.

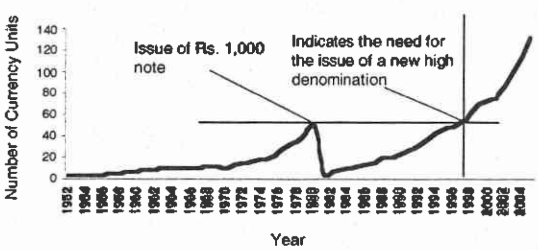
When the value of transactions is increasing, the general public seek more convenient modes of payments, in particular high value currency notes, to effect large value transactions. At the time when the high denomination rupees 1,000 note was first issued in 1981, the demand for currency had increased substantially to Rs.380 per person from Rs.49 per person in 1952. Moreover, with the increased transactions, the share of the rupees 1,000 note in currency in circulation has also increased, in terms of value, to 77 per cent by 2005. The Chart B14.1 indicates the demand for currency units in terms of the highest denomination note available. The currency in circulation in terms of the highest denomination note, increased from 3.9 million notes in 1952 to 56.4 million notes in 1981. After the introduction of the Rs.1000 note, the currency in circulation in terms of the highest denomination fell to 5.6 million notes. By 2005, this has again increased to 132.4 million notes, indicating the need for a note of an even higher denomination. Although the demand has increased sharply, there has not been a note of a higher denomination to match the demand.

Table B 14.1: Changes in Demand for Currency

Year of New Currency Issue	Denomination of New Currency	Population (million)	Currency Outstanding (Rs. million)	Per Capita Currency Holdings (Rs)	Currency Outstanding / Highest Denomination (No. of notes in millions)
1951/52	Re.1, Rs. 2, Rs. 5, Rs.10, Rs.50, Rs.100	7.9	389	49	3.9
1981	Rs.500, Rs.1000	14.8	5,644	380	56.4
2005		19.6	132,436	6,757	132.4

Source : Central Bank of Sri Lanka

Chart B14.1
Number of Currency Units in Terms of Highest Denomination Notes



There are several benefits as well as costs associated with the introduction of new higher denomination currency notes. The currency denominations required for automated teller machines (ATMs) are often found to be large value notes since it may not be economical to stock the machines with small denominations. With the increase in the use of ATMs, there is an increased demand for high value notes as small denominations increase the operating costs of banks. The non-availability of non-cash payment facilities in remote areas further increases the need for higher denomination currency notes. For example, high denomination notes increase the convenience provided to tourists who wish to purchase high value goods at rural or remote locations.

Printing of higher denomination notes is more economical, since the printing cost does not significantly vary with the denomination of the note. The cost savings arise not only through the reduction in printing a large number of lower denomination notes, but also through the increase in the life span of higher value denomination notes, because of lower circulation. In addition, the weighted average lifetime of the Rs.1,000 and the Rs. 500 currency notes is about 6-7 years. In comparison, lower denomination notes such as Rs.10 have

1 In 1998, a note in the denomination of Rs. 200 was issued as a commemorative note.

Box 14 (Contd.)

a very short average lifespan of less than a year. Further, high value denominations help save time, particularly, in large value transactions, thus improving the efficiency of transactions.

The risk of counterfeiting is more prominent in higher denomination currency notes. It could provide a convenient means for money laundering and underground economic activities. However, these drawbacks can be addressed effectively to a large extent by taking precautionary measures. The risk of counterfeiting could be reduced by the use of advanced security features built into higher value notes and increasing alertness of the public when accepting such notes. This would require enhancement of public awareness through appropriate measures. The cost of improved security features of high denominations would be marginal due to savings on printing cost.

time deposits grew by 23.6 per cent. This was in response to the gradual increases in interest rates and the continued efforts of banks to attract more deposits through attractive schemes. Foreign currency deposits also increased, by 17 per cent, which could be attributed to the attractive interest rates offered by banks on such deposits following the increase in interest rates in major international markets.

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

- **The increase in both NDA and NFA of the banking system contributed to the expansion in broad money in 2005.** The higher contribution of 79 per cent was from NDA as a result of the higher expansion in domestic credit.
- **Credit to both the private and government sectors contributed to the rise in NDA.** However, the growth of 21.5 per cent in credit to the private sector accounted for 84 per cent of the overall growth in broad money. Net credit to the government grew by 11.9 per cent contributing 16 per cent to the growth in broad money. The decline in credit to public corporations by 59.5 per cent and the increase in other liabilities of the banking system with the improvement in capital funds helped contain the high expansion in broad money.
- **Credit to the private sector grew due to the fast recovery in economic activities, which was aided by low real lending rates and attractive credit schemes, specially consumer credit schemes promoted by banks.** The dominant share of 91 per cent of the credit expansion was accounted for by domestic banking units, while the balance 9 per cent was from FCBUs. A major share of the increase in credit (21 per cent) was absorbed by the commercial sector consisting of external and domestic trade. This was followed by credit for consumption (20 per cent) and housing (17 per cent). The expansion in credit to the private sector showed signs of deceleration towards the end of the year. Since monetary policy works with a lag, a further deceleration is expected .
- **Net credit to the government (NCG) from the banking system increased, but at a lower pace than in 2004.** NCG from the banking sector increased by Rs. 26 billion in 2005 compared with the Rs. 43 billion increase in 2004. The increase in NCG in 2005 was a net result of the increase in NCG from commercial banks by Rs.60 billion and a decline in NCG from the Central Bank by Rs. 33.7 billion. The government made use of foreign currency loans from commercial banks to ease the pressure on interest rates in the domestic market and to manage its deficit financing. The increase in NCG from commercial banks consisted of a net increase in FCBU loans by Rs. 43 billion, an increase in commercial bank holdings of government securities by Rs. 19.6 billion, and an increase in overdraft facilities granted to the government by commercial banks by Rs. 6.3 billion. Provisional advances to the government by the Central Bank increased by Rs.5 billion. However, the increase in credit from the banking system moderated due to the decline in the Central Bank's holdings of Treasury bills by Rs. 38 billion following the sterilization of high rupee liquidity in the market created by the increased foreign currency inflows.
- **Credit to public corporations declined substantially, by Rs.24.5 billion, in 2005, mainly due to the arrangement of two credit facilities by the government to import oil .** About 91 per cent of the decline in credit was due to the repayments

Chart 7.3
Composition of Domestic Credit and Private Sector Credit Growth

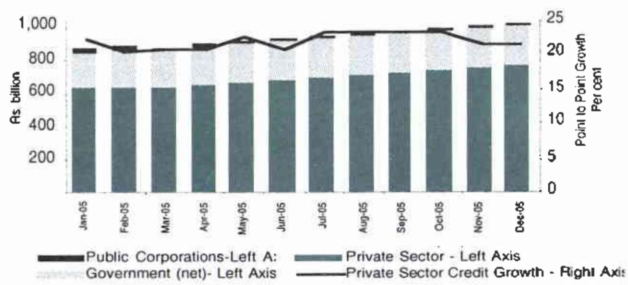


Table 7.2

Underlying Factors of Reserve Money and Broad Money

Rs. billion

Item	End 2004	End 2005	Change 2004 Amount	Change 2004 %	Change 2005 Amount	Change 2005 %
Reserve Money	171.0	197.9	29.5	20.9	27.0	15.8
Net Foreign Assets of the Central Bank	151.7	196.9	-12.9	-7.8	45.2	29.8
Net Domestic Assets of the Central Bank	19.3	1.0	42.4	183.3	-18.3	-94.8
Broad Money (M_{2b})	858.6	1,022.3	140.8	19.6	163.7	19.1
Net Foreign Assets	170.2	204.8	3.1	1.9	34.6	20.3
Monetary Authorities	151.7	196.9	-12.9	-7.8	45.2	29.8
Commercial Banks	18.5	7.9	16.0	641.7	-10.6	-57.3
Net Domestic Assets	688.4	817.5	137.7	25.0	129.1	18.7
Domestic Credit	895.9	1,034.4	164.1	22.4	138.5	15.5
Net Credit to the Government	220.5	246.8	44.2	25.1	26.3	11.9
Monetary Authorities	108.1	74.4	66.0	156.6	-33.7	-31.2
Commercial Banks	112.3	172.3	-21.8	-16.2	60.0	53.4
Credit to Public Corporations	41.2	16.7	5.0	13.8	-24.5	-59.5
Credit to the Private Sector	634.3	771.0	114.9	22.1	136.7	21.5
Other Items (net)	-207.5	-217.0	-26.4	-14.6	-9.4	-4.5

Source: Central Bank of Sri Lanka

by the Ceylon Petroleum Corporation (CPC) to commercial banks while the balance was due to the decline in credit to the Ceylon Electricity Board (CEB). Despite the surge in oil prices in the international market, the CPC was able to settle about 95 per cent of its short-term liabilities to commercial banks amounting to Rs.22 billion. This was made possible by the long-term credit facility from India arranged by the government, amounting to US dollars 150 million, to import oil from India in 2005, domestic price revisions and the government subsidy to cover the losses of the CPC. In addition, Iran also provided a short-term credit facility of US dollars 150 million for oil imports, which was settled during the year.

Table 7.3

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

Rs. billion

Sector	End 2004	End 2005	As a % of Total End 2005	Change % 2004	Change % 2005
Commercial	186.1	213.4	32.6	18.3	14.7
Exports	50.5	48.5	7.4	31.4	-4.0
Imports	63.7	65.8	10.0	11.1	3.3
Financial	25.0	34.0	5.2	39.9	36.1
Agricultural	19.8	28.1	4.3	3.7	41.7
Industrial (b)	52.3	63.4	9.7	12.0	21.2
Tourism	7.0	9.9	1.5	20.7	40.6
Housing	74.4	94.5	14.4	24.1	27.0
Consumption	85.0	113.4	17.3	40.7	33.5
Services	38.1	43.3	6.6	4.6	13.6
Other	33.1	55.3	8.4	40.8	67.3
Total	520.8	655.3	100.0	21.9	25.8

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.

Liabilities of the CEB to commercial banks also declined by about Rs.2.7 billion, though its liabilities to other parties such as the CPC and private power producers increased.

- **NFA of the banking system increased due to higher foreign currency inflows to the government and the private sector.** These included tsunami related inflows and higher private remittances. This increase was reflected in the build up of NFA of the Central Bank, which increased by US dollars 501 million. NFA of commercial banks however, declined as the government raised foreign currency loans from commercial banks and sold the proceeds to the Central Bank, resulting in a compositional shift of these assets.

Financial Survey

- **The financial survey (M_4) is a broader measure of liquidity, which includes the assets and liabilities of licensed specialised banks and finance companies in addition to the Central Bank and licensed commercial banks, which are covered in computing consolidated broad money (M_{2b}).**[2] The growth in broad money as measured by the financial survey (M_4) was in a range of 17.7 – 19.8 per cent in 2005 compared to the growth of 19.4 – 21.5 per cent in M_{2b} during 2005.

- **The growth in NCG based on the financial survey was 15.6 per cent compared to the 13.2 per cent growth in the monetary survey.** Investments in government securities by LSBs increased by Rs. 25 billion while investments by Finance Companies also increased marginally. Meanwhile, credit to the private sector as per the financial survey increased by 21.7 per

2 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.

Table 7.4
Finacial Survey and Underlying Factors

Rs. billion

Item	End 2004	End 2005(a)	Change 2004 Amount	Change 2004 %	Change 2005 Amount	Change 2005 %
Financial Survey	1,094.1	1,293.9	165.8	17.9	199.9	18.3
Underlying factors						
Net Foreign Assets	161.5	195.7	3.8	2.4	34.3	21.2
Net Domestic Assets	932.6	1098.2	162.0	21.0	165.6	17.8
Domestic Credit	1,205.2	1,411.4	196.4	19.5	206.2	17.1
Net Credit to the government	354.1	409.4	46.6	15.2	55.2	15.6
Credit to public corporations	41.6	16.7	4.8	13.1	-25.0	-59.9
Credit to the private sector	809.5	985.4	145.0	21.8	175.9	21.7
Other items (net)	-272.6	-313.2	-34.4	-14.4	-40.6	14.9

(a) Provisional

Source: Central Bank of Sri Lanka

cent in 2005 compared to the growth of 21.5 per cent in M_{2b}. The contribution from LSBs, finance companies and RDBs to the total credit expansion in M_4 were Rs.17 billion, Rs.16 billion and Rs.3 billion, respectively. Credit extended by finance companies in 2005 indicated a substantial increase when compared with the Rs.8 billion expansion recorded in 2004. This was largely due to the increase in credit facilities provided for leasing and hire purchase.

7.4 Interest Rates

- **Market interest rates moved up in 2005 reflecting the increase in the Central Bank's policy interest rates, the higher demand for credit and inflation expectations.** With the moderation in inflation towards the second half of the year, real interest rates that were low in many market segments in 2004 gradually increased. Interest rates applicable to foreign currency deposits and lending also increased following the upward revision of interest rates in several major foreign economies.

Central Bank Policy Interest Rates

- **The Central Bank's policy interest rates, i.e., the Repurchase (Repo) and Reverse Repurchase (Reverse Repo) rates, were gradually raised in 2005 reversing the low interest rate regime that prevailed from 2003 to November 2004.** The upward adjustment of interest rates was warranted as a measure to contain the higher than anticipated increase in credit and other monetary aggregates as well as to arrest rising inflation and inflation expectations. The upward adjustment in policy interest rates commenced in November 2004 with an increase in both the repo and reverse repo rates by 50 basis points to 7.50 per cent and 9.00 per cent, respectively. During 2005, the Central Bank gradually tightened its monetary policy stance by raising policy interest rates further by 125 basis points

Table 7.5
Changes in Policy Interest Rates of the Central Bank

Per cent

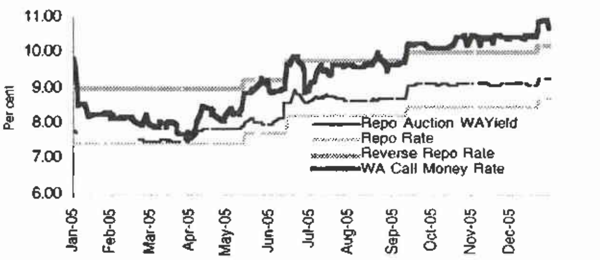
Date	Repo Rate	Reverse Repo Rate	Bank Rate
2002.11.22	9.75	11.75	18.00
2003.01.07	9.00	11.00	18.00
2003.05.09	8.25	10.25	18.00
2003.08.15	7.50	9.50	15.00
2003.10.16	7.00	8.50	15.00
2004.11.10(Close of Business)	7.50	9.00	15.00
2005.05.13	7.75	9.25	15.00
2005.06.15	8.25	9.75	15.00
2005.09.13	8.50	10.00	15.00
2005.12.22	8.75	10.25	15.00

Source: Central Bank of Sri Lanka

in four steps: by 25 basis points in May, 50 basis points in June, 25 basis points in September and a further 25 basis points in December.

- **The Bank rate remained unchanged.** The bank rate, the rate at which the Central Bank grants advances to commercial banks to meet urgent liquidity requirements against collateral such as government securities, gold and commercial bills, remained at

Chart 7.4
Money Market Rates



15 per cent in 2005. This is, however, an indicative rate since banks do not make use of this facility, generally.

Money Market Rates

- **Interest rates in the money market increased with the tightening of the monetary policy stance in 2005.** The weighted average yield rate at the daily Repo auctions, which was 7.84 per cent at end 2004, declined to 7.55 per cent at end February, following the resumption of liquidity absorption through daily OMO on 21 February. Aggressive OMOs by way of permanent absorption reduced excess liquidity after March, and the average yield rate at the daily OMO auction moved up. The continuation of these measures and the adjustment of policy rates led to the Repo auction rate moving gradually closer to the middle of the interest rate corridor. It remained around 9.29 per cent by end December 2005.
- **The movements in the OMO auction rate were reflected in other short-term rates as well.** The Sri Lanka Inter Bank Offered Rate (SLIBOR)[3], declined in February and March following the discontinuation of the OMO auctions. However, the SLIBOR increased with the recommencement of daily absorption through OMO auctions. A similar trend was reflected in the average weighted call money market rate as well. It declined from 9.73 per cent at end December 2004 to 7.61 per cent at end March 2005, its lowest level in 2005. Thereafter, it increased gradually and reached 10.73 per cent by end December 2005.

Deposit and Lending Rates

- **Both deposit and lending rates in the banking system increased during 2005.** With the larger adjustment in deposit rates, particularly fixed deposit rates, the interest spread of commercial banks, which is measured by the difference between average interest income and average interest cost, narrowed marginally in 2005, but still remains high.
- **The average weighted deposit rate (AWDR)[4], increased from 5.31 per cent at end December 2004 to 6.24 per cent by end December 2005.** The average weighted fixed deposit rate (AWFDR) increased from 7.67 per cent at end December 2004 to 9.25 per cent by end December 2005.

3 SLIBOR is the average of the offered rates for inter-bank rupee transactions by 12 commercial banks.

4 AWDR is the weighted average of the interest rates on all outstanding interest bearing deposits of commercial banks.

Table 7.6

Money Market Rates (a)

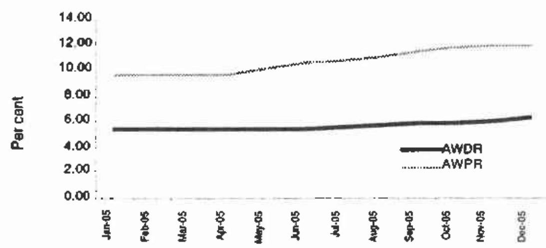
Per cent

	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
Dec-04	7.50	7.84	9.73	9.66
Mar-05	7.50	7.56	7.77	8.23
Jun-05	8.25	8.58	8.97	9.22
Sep-05	8.50	9.15	10.14	10.31
Dec-05	8.75	9.29	10.73	10.93

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

Chart 7.5

Average Weighted Prime Lending Rate and Average Weighted Deposit Rate of Commercial Banks



- **The Average Weighted Prime Lending Rate (AWPR)[5] of commercial banks declined at the beginning of the year but increased thereafter.** It declined from 10.23 per cent at end 2004 to 9.76 per cent in February 2005, with the decline in OMO auction rates and call market rates. Thereafter, it increased gradually and reached 12.24 per cent in December 2005. Meanwhile, the average weighted lending rate (AWLR), which is the average lending rate applicable to the entire loan portfolio of domestic banking units of commercial banks, increased from 14.8 per cent in December 2004 to 15.4 per cent in December 2005. The interest rates on outstanding balances in relation to credit cards, which are penal rates, increased from a range of 21 - 33 per cent in December 2004 to a range of 29 – 34 per cent by end December 2005.
- **Both deposit and lending rates of long term lending institutions also moved up. However, lending rates applicable to housing loans of key long-term lending institutions remained unchanged in 2005.** The rates of interest offered by National Savings Bank (NSB) for savings deposits remained unchanged at 5 per cent, while its rate for one year fixed deposits increased from 8 to 9 per cent. The NSB continued to offer high rates of interest for special deposit schemes targeted at senior citizens. The State Mortgage and Investment Bank (SMIB) and the DFCC Bank also raised their deposit rates during the year. Interest rates pertaining to housing loans granted by NSB, SMIB and HDFC Bank remained unchanged.
- **The Legal Rate and the Market Rate, which are identical in value terms also increased.** The Legal Rate and the Market Rate, are computed based on the AWDR and published in the government gazette by the Central Bank at the end of each

5 AWPR is the average weighted lending rate charged by commercial banks from their most creditworthy (prime) customers.

Table 7.7
Interest Rates on Deposits and Lending (a)

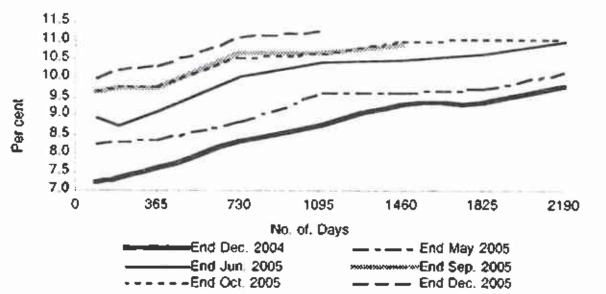
Per cent

Institution	End 2004	End 2005
Commercial Banks		
Interest Rates on Deposits		
Savings Deposits	3.00-7.75	3.00-10.25
Average Weighted Deposit Rate (AWDR)	5.31	6.24
Average Weighted Fixed Deposit Rate (AWFDR)	7.67	9.25
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	10.23	12.24
Average Weighted Lending Rate (AWLR)	14.80	15.10
Non-Commercial Bank Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
One Year Fixed Deposits	8.00	9.00
State Mortgage and Investment Bank		
One Year Fixed Deposits	8.00	9.20
DFCC Bank		
One Year Fixed Deposits	8.25	10.00
Interest Rates on Lending		
National Savings Bank (b)	10.00-12.00	10.00-12.00
State Mortgage and Investments Bank(b)	12.00-13.25	12.00-13.25
DFCC Bank	9.25-16.00	5.00-17.00 (c)
National Development Bank	9.60-16.00	12.25-15.00
National Housing Development Authority	11.00	11.00

Source: Central Bank of Sri Lanka

(a) Based on the rates quoted by commercial banks and non-commercial bank financial institutions.
(b) Lending for housing purposes only.
(c) Including special concessional loan schemes for tsunami and other purposes.

Chart 7.6
Government Securities-Secondary Market Yield Curve



year.[6] The rate was 5.16 per cent in 2005. The rate applicable for 2006 is 5.70 per cent.

- **Interest rates on foreign currency deposits and lending increased with the increase in international interest rates in respect of major international currencies.**

Yields on Government Securities

- **Yields on government securities, which increased at a relatively high rate in the middle of the year, showed some stability towards the end of the year with the moderation of inflation.** With regard to the term structure of yields on government securities, greater market preference was seen for short-term government securities, which could be a reflection of market uncertainty in relation to future interest rate behaviour. However, the yield curve, which was still upward sloping, showed a gradual flattening towards end year.

- **In the primary Treasury bill market, the increase in the yield on 364-day bills was lower than the increase in the yield on 91-day Treasury bills.** During 2005, yields on 91-day Treasury bills increased by 285 basis points while the yields on 364-day Treasury bills rose by 272 basis points. A similar movement was seen in the yield rates pertaining to Treasury bonds as well. The yield on 3-year Treasury bonds increased by 262 basis points compared to an increase of 225 basis points in the yield on 4-year Treasury bonds.

- **In the secondary market for government securities, the yield curve flattened towards the end of 2005 and the spread between the primary market and the secondary market narrowed.**

- **With the upward adjustment of the yields on Treasury bills and Treasury bonds, interest rates on rupee securities were increased.** Rupee loans with call options that carried high yield rates were recalled. The interest rate applicable to rupee securities was raised from 9.15 per cent at the beginning of the year to 11 per cent.

- **The government issued index-linked bonds amounting to Rs. 21 billion with a maturity period of 3 years.** These bonds carry a coupon rate of 11.2 per cent in the first year. During the second and third years, the coupon rate will be fixed at one percentage point above the annual average change in the CCPI.

Yields on Corporate Debt Securities

- **Yields on corporate debt securities also increased in 2005.** Interest rates on commercial paper, which is a source of short-term borrowings for large corporates, were in a range of 9.00-14.25 per cent by end 2005, in comparison to a range of 9.50 -13.75 per cent by end 2004. Seylan Merchant Leasing Limited issued unsecured subordinated redeemable debentures at interest rates ranging from 10.25 per cent to 12.50 per cent. Senkadagala Finance Company Limited also made two issues of unsecured subordinated redeemable debentures; one at fixed rates and the other at floating rates. The fixed rate debentures carried an interest rate of 14 per cent, while the floating interest rate debentures carried an interest rate of the three-month Treasury bill rate plus 275 basis points.

6 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.

Box 15

Recent International Monetary Policy Measures

Many central banks around the world began to provide monetary policy stimulus in 2001 with the onset of a downturn in the global economy, exacerbated by the geopolitical uncertainty, specially the terrorist attack on the USA in 2001. The historically low inflation environment that prevailed in many industrial as well as emerging market economies further rationalised the provision of monetary policy stimulus. As the economic growth momentum in the domestic economies and abroad became firmed, and concerns over price stability with the emerging signs of inflationary pressures and rising asset prices, a number of central banks began to remove the policy stimulus gradually from 2004.

Among the advanced economies, the USA reduced its monetary policy accommodation gradually by raising the federal funds rate by 375 basis points in 15 consecutive steps during the period from June 2004 to March 2006. The Bank of England, Reserve Bank of Australia and Bank of Canada also raised their policy rates considering the demand pressures reflected specially by rising asset prices. The European Central Bank also raised its key policy interest rate (main refinancing rate) in December 2005 after maintaining it at historically low levels for two and a half years. Among Asian economies, tightening monetary policies was adopted by the Bank of Korea, Bank Negara Malaysia, Bank of Thailand, Reserve Bank of India and State Bank of Pakistan.

Table B 15.1

Policy Interest Rates and Inflation in Major Economies and Emerging Market Economies

Per cent

Period End	USA	UK	ECB	Canada	Australia	Malaysia	Thailand	Korea	India	Pakistan
	Policy Interest Rates									
	Federal Funds Rate	Repo Rate	Main Re-financingRate	Target Over-night Rate	Cash Rate	Over-night Policy Rate	14-day RepoRate	Bench-mark Call Rate	Reverse Repo Rate	Repo Rate (Discount Rate)
Dec-01	1.75	4.00	3.25	2.25	4.25	2.75	2.25	4.00	6.50	13.00
Dec-02	1.25	4.00	2.75	2.75	4.75	2.70	1.75	4.25	5.50	10.00
Dec-03	1.00	3.75	2.00	2.75	5.25	2.75	1.25	3.75	4.50	7.50
Dec-04	2.25	4.75	2.00	2.50	5.25	2.70	2.00	3.25	4.75	7.50
Jun-05	3.25	4.75	2.00	2.50	5.50	2.70	2.50	3.25	5.00	9.00
Dec-05	4.25	4.50	2.25	3.25	5.50	3.00	4.00	3.75	5.25	9.00
Mar-06	4.75	4.50	2.50	3.75	5.50	3.00	4.50	4.00	5.50	8.75
	Inflation									
2001	1.60	1.10	2.00	0.70	6.00	3.20	0.70	4.10	3.80	5.40
2005	3.40	1.90	2.20	2.20	2.40	3.30	5.80	2.60	3.90	8.50

7.5 Further Developments and Monetary Policy Issues

- **The Central Bank has taken several measures to improve monetary management in the recent past.** The market orientation of monetary operations was further increased, competition among market participants was further facilitated and transparency in policy conduct was continued through regular communications to the general public.
- **Monetary policy needs to be guided by more representative price indices and indicators of inflation expectations.** Adopting a more representative inflation measure to identify and quantify sources of inflationary pressures, developing a core inflation measure that captures demand pressure in the economy, conducting inflation expectation surveys and developing forward looking indicators are vital for the further improvement of monetary policy decision making and monetary operations. In this context, preparation of the SLCPI without a time lag and the acceptance of it as the official price index by the government without further delay are imperative.

Table 7.8
Yield Rates of Government Securities

Per cent

	End December 2004	End June 2005	End December 2005
Primary Market			
Treasury bills			
91 days	7.25	9.01	10.10
182 days	7.40	9.16	10.32
364 days	7.65	9.25	10.37
Treasury bonds			
2 years	8.25	10.32	10.39 (a)
3 years	8.60	9.82	11.22
4 years	8.75	-	11.10
Rupee Securities	8.90	9.15	11.00
Secondary Market			
Treasury bills			
91 days	7.21	8.94	10.04
182 days	7.33	8.76	10.22
364 days	7.59	9.16	10.31
Treasury bonds			
2 years	8.30	10.07	10.72
3 years	8.74	10.42	11.15
4 years	9.34	10.50	11.28

Source: Central Bank of Sri Lanka

(a) The last auction for 2 year Treasury bonds was held in July 2005

- **Monetary policy transmission depends heavily on the efficiency and stability of the financial system.** Therefore, the further strengthening of measures to improve efficiency and resilience of the financial system, such as reducing the intermediation cost of banks, increasing capital funds and further improvement of risk management, is needed.
- **The continuation of the fiscal consolidation process is vital for success in monetary management.** In the absence of fiscal consolidation, an excessive demand for resources would increase the demand pressure in the economy, with ensuing corresponding inflationary pressures. Counter-measures by way of monetary policy are expected, to reduce demand pressures by raising the cost of borrowing for both the government sector and the private sector. The objective of the government is to continue fiscal adjustments gradually. However, any delays and/or reversal in fiscal consolidation would affect moving toward an inflation targeting monetary policy framework. Thus, the current efforts in fiscal consolidation need to be accelerated to enhance the efficacy of monetary policy.