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MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

The Central Bank followed a cautious approach in the conduct of monetary policy during the first nine months of 2018 in view of the current and expected developments in the domestic and global economy. In April 2018, the Central Bank signalled the end of monetary policy tightening that commenced at end 2015 in consideration of the favourable developments in inflation and inflation outlook as well as the subdued performance in the real economy. Accordingly, the Central Bank reduced the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50 per cent, while maintaining the Standing Deposit Facility Rate (SDFR) unchanged at 7.25 per cent, thereby narrowing the width of the policy interest rate corridor from 150 basis points to 125 basis points. Nevertheless, considering the impact of global developments that affected the external sector stability of the economy, the Central Bank maintained a neutral monetary policy stance during the ensuing period. Despite the transitory uptick in inflation due to upward revisions to prices of domestic petroleum products and other administered prices, during the first nine months of 2018, headline inflation as measured by the Colombo Consumer Price Index (CCPI) remained mostly within the targeted band of 4-6 per cent, while the National Consumer Price Index (NCPI) based headline inflation remained subdued. Meanwhile, demand driven inflation as measured by core inflation based on both CCPI and NCPI also remained low. Although liquidity in the domestic money market remained largely in surplus during most of the period under review, liquidity turned into deficit levels, particularly in June, July and September 2018. Short term interest rates responded to the policy rate reduction in April 2018 along with improved market liquidity conditions, but some upward movement was allowed towards the upper bound of the policy rate corridor at times of foreign exchange market pressure. Yields in the government securities market showed mixed movements, while most other market interest rates remained at relatively high levels, both in nominal and real terms. Responding to the tight monetary policy stance maintained in the past, the growth of broad money supply continued to moderate, mainly driven by the gradual deceleration in the growth of private sector credit. Credit obtained by the government from the banking sector increased at a slower pace, while credit extended to public corporations by commercial banks expanded notably. Looking ahead, the inflation outlook over the medium term remains benign in spite of possible short term price pressures. During the year, the Central Bank made substantial progress in transitioning to a Flexible Inflation Targeting (FIT) regime by 2020.

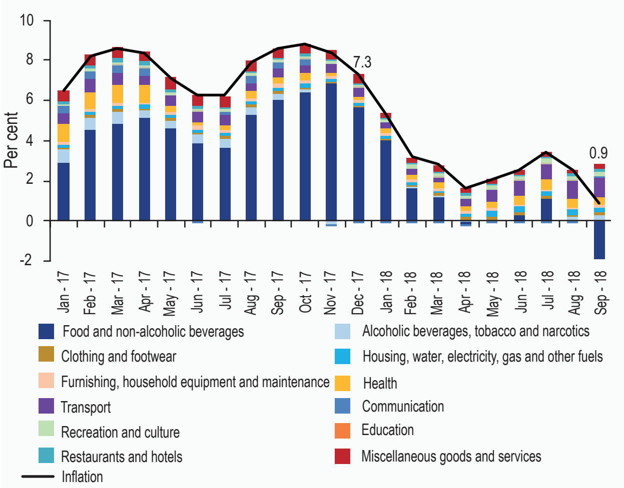
Monetary Policy Stance of the Central Bank

- **In line with the move towards a Flexible Inflation Targeting (FIT) framework, the Central Bank conducted monetary policy within an enhanced monetary policy framework, with the aim of stabilising inflation at mid-single digit levels over the medium term, thereby facilitating a sustainable growth trajectory for the Sri Lankan economy**. As an important step towards moving to FIT, the Central Bank gradually moved away from the monetary aggregates based monetary policy framework with the adoption of an enhanced monetary policy framework in 2015. Under this interim arrangement, the average weighted call money rate (AWCMR) serves as the operating target to steer market interest rates and influence inflation, while broad money (M_{2b}) is used as a key indicative intermediate variable in the conduct of monetary policy. Furthermore, market based monetary policy instruments, particularly policy interest rates and open market operations (OMOs), remain key monetary policy instruments to guide AWCMR. During the year, the Central Bank continued to take several measures to further improve monetary policy conduct, while institutionalising key reforms to ensure a smooth transition to FIT by 2020. As highlighted in the *"Monetary and Financial Sector Policies for 2018 and beyond" (Road Map 2018),* recognising the need to have a strong mandate for a central bank to ensure autonomy, governance, transparency, accountability and credibility, all of which are vital aspects of an effective FIT framework, the Central Bank embarked on an initiative to propose amendments to the Monetary Law Act (MLA), which is the key legislation related to central banking in Sri Lanka. The Central Bank also continued to improve its in-house modelling and forecasting capacity and infrastructure with technical assistance from the International Monetary Fund (IMF) with a view to streamlining the monetary policy decision making and policy formulation process.

- **Consumer price inflation remained in the desired range during the first nine months of 2018 in spite of a temporary uptick in prices due to upward adjustments to domestic petroleum products and other administered prices**. Year-on-year headline inflation based on the National Consumer Price Index (NCPI, 2013=100) declined notably to 1.6 per cent by April 2018 from 7.3 per cent at end December 2017. Although headline inflation based on NCPI increased to 3.4 per cent, year-on-year in July 2018, mainly due to the impact of upward adjustments to administered prices, it decelerated to 0.9 per cent, year-on-year in September 2018, as a result of the decline in volatile food prices. On an annual average basis, NCPI headline inflation declined to 4.0 per cent in September 2018 from 7.7 per cent recorded at end 2017. Headline inflation, as measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2013=100), which was 7.1 per cent at end December 2017, also declined to 3.8 per cent by April 2018, mainly driven by the decelerating food inflation as a result of favourable supply side developments due to the dissipation of weather related disturbances. Nevertheless, upward adjustments to domestic petroleum products and the pressure on domestic food supplies during the off-season contributed to the acceleration of year-on-year headline inflation, which reached 5.9 per cent in August 2018. Inflation decelerated thereafter to 4.3 per cent, year-on-year, by September 2018, as a result of easing of food inflation. CCPI based annual average headline inflation stood at 5.4 per cent in September 2018, compared to 6.6 per cent at end 2017. With appropriate policy adjustments, inflation is expected to remain within the 4 - 6 per cent target range over the medium term.

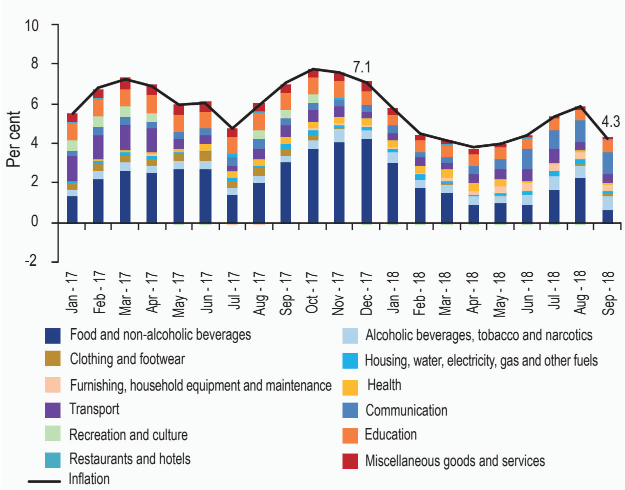
- **Core inflation, which reflects the demand driven component of inflation, remained subdued thus far in 2018, indicating that underlying demand pressures in the economy are well contained**. Relatively tight monetary conditions together with anchored inflation expectations caused a moderation in core inflation during the first nine months of 2018. Accordingly, year-on-year core inflation based on NCPI remained low at 3.1 per cent by September 2018, while on an annual average basis, NCPI

Figure 7.1
Contribution to Year-on-Year Headline Inflation (NCPI)



Source: Department of Census and Statistics

Figure 7.2
Contribution to Year-on-Year Headline Inflation (CCPI)



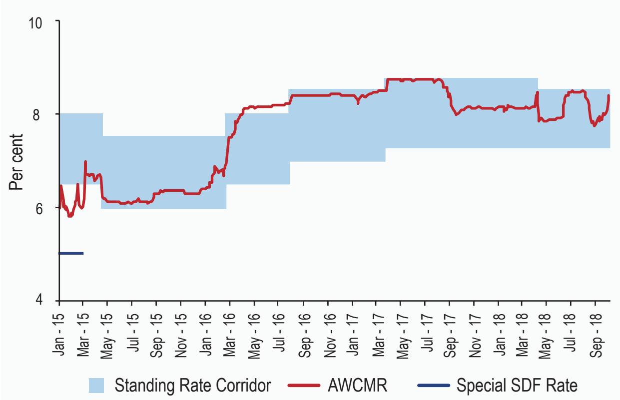
Source: Department of Census and Statistics

based core inflation moderated to 2.4 per cent in September 2018 from 4.9 per cent at end 2017. Year-on-year core inflation based on CCPI also decelerated to 3.8 per cent by September 2018 from 4.3 per cent at end 2017, while annual average core inflation also declined to 3.9 per cent in September 2018 compared to 5.9 per cent at end 2017.

- **Inflation expectations continued to remain anchored, reflecting the favourable outlook of stakeholders on inflation in an environment of increasingly forward looking conduct of monetary policy by the Central Bank.** Inflation expectations of the corporate sector, as measured by the Inflation Expectations Survey of the Central Bank, declined noticeably during the first half of the year, although some increase was observed during the third quarter of 2018 induced by the movements in actual inflation along with the revisions to administered prices, particularly domestic petroleum prices, and the depreciation of the rupee. Inflation expectations of the household sector indicated mixed movements during 2018.

- **The Central Bank followed a cautious approach in conducting monetary policy during the first nine months of 2018, in view of current and expected developments in the domestic and global economy.** The tight monetary policy stance pursued by the Central Bank since end 2015 by way of raising the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks by 1.50 percentage points to 7.50 per cent and policy interest rates by a total of 125 basis points yielded the desired outcomes, especially on demand driven inflation and trends in money and credit aggregates. Such developments, in particular, the favourable developments in inflation, inflation outlook and the trends in the monetary sector, in an environment of lackluster

Figure 7.3
Standing Rate Corridor and Average Weighted Call Money Rate (AWCMR)



Source: Central Bank of Sri Lanka

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performance in economic growth, induced the Central Bank to relax the monetary policy stance. Accordingly, in April 2018, the Central Bank reduced the Standing Lending Facility Rate (SLFR) by 25 basis points to 8.50 per cent, while the Standing Deposit Facility Rate (SDFR) was kept unchanged at 7.25 per cent, thereby narrowing the policy rate corridor from 150 basis points to 125 basis points. Nevertheless, global economic conditions and the pressure on the exchange rate compelled the Central Bank to follow a neutral monetary policy stance since April 2018, and allow an upward adjustment in AWCMR within the policy rate corridor.

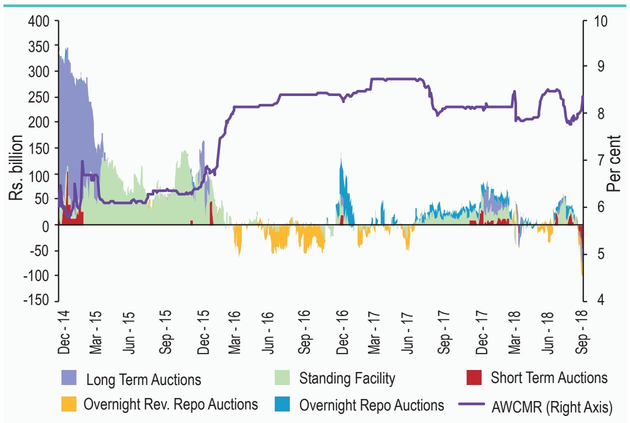
- **The Central Bank pursued several initiatives to enhance communication with its key stakeholders with a view to providing a clear understanding on the Central Bank's stance on monetary policy and the macroeconomic direction over the medium term to support effective decision making by economic agents**. The *Road Map*, which serves as a key communication device of the Central Bank by providing broader guidance on the economic outlook and policies to be adopted, was released at the beginning of the year. An advance release calendar for monetary policy announcements was also made public with the *Road Map*. Monetary policy announcements highlighting the macroeconomic background and the rationale for such policy decisions were made via an improved and forward-looking monetary policy review press release, followed by a press conference chaired by the Governor and other senior officials of the Central Bank. In addition, the Central Bank published updates on key macroeconomic developments and policy measures via press releases, information notes, publications, bulletins and other communiqués, on a regular basis in all three languages, while macroeconomic data releases were made available in its website. The Central Bank also conducted special sessions for journalists to educate them on the Central Bank's proposed adoption of FIT by the year 2020.

Movements in Interest Rates

Market Liquidity, Market Operations and Short Term Interest Rates

- **The Central Bank conducted open market operations (OMO) appropriately to ensure the availability of adequate liquidity in the domestic money market to steer the overnight interest rates in line with the monetary policy stance**. During the first five months of the year, market liquidity remained in surplus, averaging Rs. 20 billion, mainly due to purchases of foreign exchange from the domestic foreign exchange market and the subscription to Treasury bills by the Central Bank. To manage liquidity appropriately, the Central Bank conducted overnight, short term, as well as long term repurchase transactions during this period. Rupee liquidity in the domestic money market recorded a deficit from June to mid-July mainly as a result of the early retirement of Treasury bills as well as foreign exchange sales in the domestic foreign exchange market by the Central Bank. In spite of the temporary increase in liquidity in the domestic money market by mid July 2018, market liquidity turned back to negative levels by late September 2018. This was mainly due to the reversal of the forward transactions with government, foreign exchange swap maturities and maturities in respect of Treasury bills held by the Central Bank. By end

Figure 7.4
Rupee Liquidity in the Domestic Money Market and Liquidity Management



Source: Central Bank of Sri Lanka

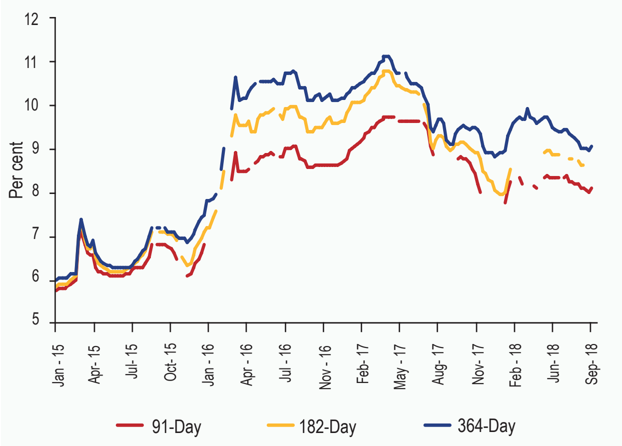
September 2018 overnight market liquidity was at a deficit of Rs. 57.7 billion. The Central Bank allowed the AWCMR to hover close to the upper bound of the policy rate corridor, while supplying liquidity to fulfill the needs of market participants through overnight, short term and long term reverse repurchase transactions as well as outright purchases of government securities.

- **Overnight interest rates showed mix movements in line with the changes in market liquidity conditions**. AWCMR continued to remain mostly around the middle of the policy rate corridor during the first three months of 2018 although some transitory increase was observed towards end March due to the misinterpretation of the effect of the withholding tax adjustments by commercial banks. However, with the reduction in SLFR in early April 2018, AWCMR declined and remained around the middle of the policy rate corridor up to end May 2018. With deficit liquidity condition in the domestic money market since early June 2018, AWCMR increased and hovered around the upper bound of the policy rate corridor. However, as liquidity conditions improved to a surplus since mid-July 2018, AWCMR again adjusted downwards towards the middle of the policy rate corridor during August to mid-September 2018. Nevertheless, responding to deficit liquidity conditions since the third week of September 2018, AWCMR adjusted upwards and reached 8.40 per cent by end September 2018. Moreover, the weighted average yields at the daily OMO auctions and overnight Sri Lanka Inter Bank Offered Rate (SLIBOR) also moved in line with the movements in AWCMR during the first nine months of 2018. By end September 2018, overnight and 12-months SLIBOR were at 8.35 per cent and 11.50 per cent, respectively, compared to 8.15 per cent and 12.18 per cent, respectively, at end 2017.

Yields on Government Securities

- **Yields in the government securities market showed mix movements during the first nine months of 2018, reflecting the changes in market sentiments as well as the funding requirement of the government and availability of foreign financing**. Yields on Treasury bills in the primary market showed a notable upward movement during the first quarter of 2018, reflecting the increased funding requirement of the government, with the delay in securing foreign funds. Some stabilisation in the yields was observed since then. However, an upward pressure on the yields of government securities was observed in May 2018, partly due to the withdrawal of investments in government securities by foreign investors amidst tightening global financial market conditions. Although, the upward pressure in the yields eased mostly in July-August 2018 as seen by a reduction in interest rates at primary auctions, an uptick in Treasury bill yields was observed during September 2018 due to unfavourable market sentiments amidst capital outflows and prevailing tight liquidity conditions. During the year up to end September 2018, yields of 91-day, 182-day and 364-day Treasury bills increased by 87, 30 and 61 basis points, to 8.56 per cent, 8.60 per cent, and 9.51 per cent, respectively, compared to end 2017.

Figure 7.5
Primary Market Treasury Bill Yields (a)



Source: Central Bank of Sri Lanka

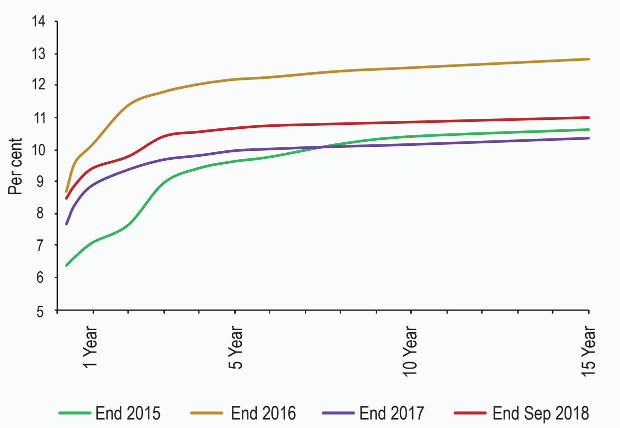
(a) Yield rates for some weeks are not available due to non-acceptance of bids or not offering relevant tenors

- **Yields on Treasury bonds in the primary market also showed mixed movements during the first nine months of 2018**. Following a similar trend observed in the yields on Treasury bills, yields on Treasury bonds displayed an increasing trend during the first quarter of 2018. However, a mixed movement in yields on Treasury bonds was observed thereafter, in line with market sentiments. The government relied more on short to medium-term Treasury bond issuances during the first nine months of 2018, while Treasury bonds with longer-term maturities of 10-years and 15-years were also issued during the period. Meanwhile, the government issued short and medium-term US dollar denominated Sri Lanka Development Bonds (SLDBs) at various fixed and floating rates. During the latest auction conducted in September 2018, SLDBs of 1-year and 8-months, and 3-years and 8-months tenures were issued at a fixed rate of 5.00 per cent and 5.75 per cent, respectively. Further, 5-year and 10-year International Sovereign Bonds (ISBs) were issued in April 2018 at rates of 5.75 per cent and 6.75 per cent, respectively.

- **By end September 2018, the secondary market yield curve for government securities shifted upwards compared to end 2017**. This upward shift could be attributed to market sentiments amidst tight monetary conditions. The yields on 91-day, 182-day and 364-day Treasury bills in the secondary market increased by 77 basis points, 58 basis points and 51 basis points, respectively, to 8.45 per cent, 8.88 per cent and 9.41 per cent

Figure 7.6

Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka

Table 7.1

Movements of Interest Rates

Per cent per annum

Interest Rate	End 2017	End Sep 2018
Policy Interest Rates		
Standing Deposit Facility Rate	7.25	7.25
Standing Lending Facility Rate	8.75	8.50
Average Weighted Call Money Rate (AWCMR)	8.15	8.40
Yield Rates on Government Securities		
Primary Market (a)		
Treasury bills		
91-day	7.69	8.56
182-day	8.30	8.60
364-day	8.90	9.51
Treasury bonds		
2-year	9.83	-
3-year	9.55	10.03
4-year	11.14	-
5-year	10.20	9.91
10-year	10.36	10.20
Secondary Market		
Treasury bills		
91-day	7.68	8.45
182-day	8.30	8.88
364-day	8.89	9.41
Treasury bonds		
2-year	9.37	9.77
3-year	9.68	10.41
4-year	9.81	10.55
5-year	9.96	10.67
10-year	10.15	10.86
Licensed Commercial Banks (b)		
Interest Rates on Deposits		
Savings Deposits	0.50-9.50	0.50-8.50
1 Year Fixed Deposits (c)	4.89-15.00	4.53-15.00
Average Weighted Deposit Rate (AWDR) (d)	9.07	8.69
Average Weighted Fixed Deposit Rate (AWFDR) (d)	11.48	10.84
Average Weighted New Deposit Rate (AWNDR) (d)	10.06	10.24 (e)
Average Weighted New Fixed Deposit Rate (AWNFDR) (d)	10.65	10.69 (e)
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	11.33	11.72
Average Weighted Lending Rate (AWLR)	13.88	14.18 (e)
Average Weighted New Lending Rate (AWNLR)	14.31	14.35 (e)
Other Financial Institutions (f)		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	4.00	4.00
1 Year Fixed Deposits	11.00	10.50
Licensed Finance Companies (g)		
Savings Deposits	5.43-7.99	5.26-7.95 (e)
1 Year Fixed Deposits	12.15-13.71	11.50-13.09 (e)
Interest Rates on Lending		
National Savings Bank	13.00-16.00	12.75-16.00
State Mortgage and Investment Bank (h)	10.50-20.00	10.50-20.00
Licensed Finance Companies (g)		
Finance Leasing	17.40-28.03	16.89-29.96 (e)
Hire Purchase	15.00-20.84	13.80-22.43 (e)
Loans against Real Estate	17.95-20.18	18.82-21.27 (e)
Corporate Debt Market		
Debentures	12.50-15.00	12.00-14.20 (e)
Commercial Paper	13.75-16.50	13.10-15.00

(a) Weighted average yield rates at the latest available auction
(b) Based on the rates quoted by commercial banks
(c) Maximum rate is a special rate offered by certain commercial banks
(d) Since July 2018, AWDR and AWFDR were calculated by replacing senior citizens' special deposit rate of 15 per cent with relevant market interest rates to exclude the impact of special rates which are subsidised by the government. Same method was applied to calculate AWNDR and AWNFDR since June 2018
(e) As at end August 2018
(f) Based on the rates quoted by other selected Financial Institutions
(g) Interest rate ranges are based on the average maximum and average minimum rates quoted by LFCs which are applicable for deposits mobilised and loans granted during the respective months. Data for 2018 are provisional
(h) Lending for housing purposes only

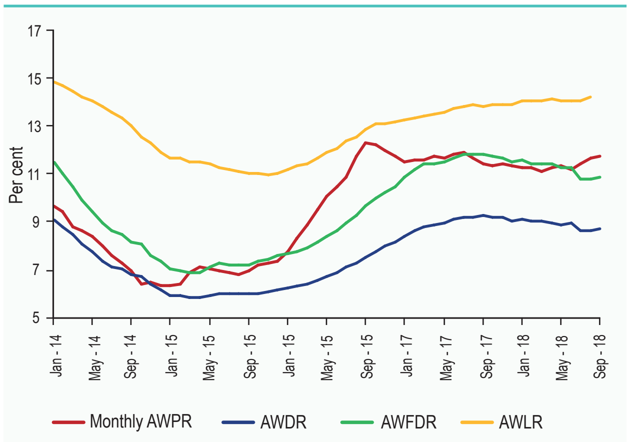
Sources: Colombo Stock Exchange
Respective Financial Institutions
Central Bank of Sri Lanka

by end September 2018, in comparison to the yields that prevailed at end 2017. Treasury bond yields across all maturities also increased within a range of 29 to 74 basis points by end September 2018, from the levels observed at end 2017.

Deposit and Lending Interest Rate

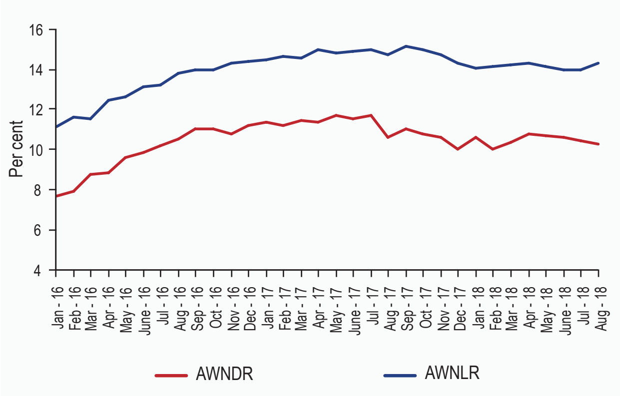
- **Most deposit interest rates of commercial banks remained at high levels during the first nine months of the year**. Following the reduction in policy interest rates by the Central Bank in April 2018, deposit interest rates started to decline gradually, although there was an increase in September. The Average Weighted Deposit Rate (AWDR), which reflects the movements in interest rates pertaining to all outstanding interest bearing rupee deposits held with commercial banks, decreased by 38 basis points to 8.69 per cent by end September 2018 from 9.07 per cent at end 2017. Meanwhile, the Average Weighted Fixed Deposit Rate (AWFDR), which is based on interest rates pertaining to all outstanding time deposits held with commercial banks, also decreased by 64 basis points to 10.84 per cent by end September 2018 compared to 11.48 per cent at end 2017. However, reflecting the commercial banks' attempts to mobilise deposits, particularly when the market is experiencing deficit liquidity conditions, the Average Weighted New Deposit Rate (AWNDR), which is based on interest rates

Figure 7.7
Selected Market Interest Rates



Source: Central Bank of Sri Lanka

Figure 7.8
New Deposit and New Lending Rates



Source: Central Bank of Sri Lanka

pertaining to all new interest bearing deposits, increased by 18 basis points to 10.24 per cent by end August 2018 from 10.06 per cent at end 2017. Meanwhile, depositors continued to benefit from positive real rates of return as inflation remained well below the deposit interest rates offered by many banks during this period.

- **Lending rates of commercial banks continued to increase during the first nine months of 2018**. Reflecting the movements in short term lending rates, the weekly Average Weighted Prime Lending Rate (AWPR), which is based on interest rates applicable on short term loans and advances granted by commercial banks to their prime customers during a week, increased by 19 basis points to 11.74 per cent by end September 2018 compared to 11.55 per cent at end 2017 although some downward adjustments were recorded in certain weeks. The monthly AWPR, which is the average rate of weekly AWPR, was 11.72 per cent by end September 2018 in comparison to 11.33 per cent recorded at end 2017. Moreover, the Average Weighted Lending Rate (AWLR), which is based on interest rates of all outstanding loans and advances extended by commercial banks, increased by 30 basis points to 14.18 per cent by end August 2018 from 13.88 per cent at end 2017. Meanwhile, the Average Weighted New Lending Rate (AWNLR), which captures interest rates of all new loans and advances extended by commercial banks during a particular month, increased by 4 basis points to

14.35 per cent by end August 2018 from 14.31 per cent at end December 2017. As inflation remained low compared to nominal interest rates, an upward adjustment was observed in most real lending rates.

Interest Rates on Debt Instruments

- **Interest rates applicable on corporate debt securities declined during the first eight months of 2018**. Interest rates on commercial paper, which is a short term debt instrument, decreased to a range of 13.10-15.00 per cent during the first eight months of 2018 compared to a range of 13.75-16.50 per cent that prevailed in 2017. During this period, about 20 listings of debentures by seven corporates with maturities of 4-10 years at various fixed and floating rates were recorded. Fixed interest rates applicable on debentures were in the range of 12.00-14.20 per cent by end August 2018 compared to the range of 12.50-15.00 per cent recorded in 2017.

Interest rates on Foreign Currency Deposits

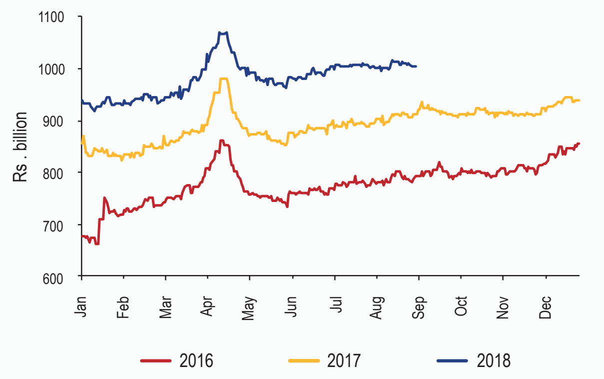
- **Interest rates applicable on foreign currency deposits maintained with commercial banks showed mixed movements during the first nine months of 2018**. Interest rates on US dollar denominated savings deposits were in the range of 0.02-4.00 per cent by end September 2018 compared to the range of 0.02-4.38 per cent at end 2017. Interest rates pertaining to US dollar denominated time deposits were in the range of 0.15-6.00 per cent by end September 2018 compared to the range of 0.15-5.03 per cent at end 2017. Meanwhile, interest rates on savings deposits denominated in pound sterling were in the range of 0.10-2.47 per cent by end September 2018 in comparison to the range of 0.10-2.25 per cent recorded at end of 2017. Interest rates applicable on pound sterling denominated time deposits were in the range of 0.10-3.25 per cent by end September 2018 whereas the comparable rates were 0.20-4.57 per cent at end 2017.

Movements in Monetary and Credit Aggregates

Reserve Money

- **Reserve money expanded at a moderate pace during the first eight months of 2018**. The year-on-year growth of reserve money was 10.2 per cent by end August 2018 in comparison to a growth of 9.8 per cent by end 2017. In absolute terms, reserve money increased by Rs. 64.9 billion to Rs. 1,004.7 billion during the first eight months of 2018, compared to an expansion of Rs. 55.2 billion in the corresponding period of 2017. From the liability side of reserve money, the expansion was due to both the increase in commercial banks' deposits with the Central Bank and the increase in currency in circulation during the period under consideration. Accordingly, commercial banks' deposits with the Central Bank increased by Rs. 43.3 billion to Rs. 385.0 billion. The year-on-year growth of commercial banks' deposits was 16.8 per cent by end August 2018 in comparison to the growth of 12.7 per cent at end 2017. Reflecting the high opportunity cost of holding currency due to prevailing high interest rates, year-on-year growth of currency in circulation grew moderately by 6.5 per cent by end August 2018 in comparison to 8.2 per cent at end 2017. Accordingly, currency in circulation increased by Rs. 21.5 billion to Rs. 619.6 billion by end August 2018.

Figure 7.9
Daily Reserve Money (a)



Source: Central Bank of Sri Lanka

(a) Sudden change in Reserve money in January 2016 was due to revisions to SRR and sharp increases during April and December periods are due to seasonal demand

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- **Viewed from the assets side of the balance sheet of the Central Bank, the increase in reserve money during the first eight months of 2018 was due to the expansion in both Net Domestic Assets (NDA) and Net Foreign Assets (NFA) of the Central Bank**. NDA of the Central Bank increased by Rs. 9.6 billion to Rs. 103.2 billion during the first eight months of 2018 in comparison to the substantial decline of Rs. 203.9 billion observed during the year 2017. The expansion in NDA of the Central Bank was mainly due to the increase in net credit to the government (NCG) by the Central Bank. NCG by the Central Bank increased by Rs. 20.7 billion to Rs. 245.8 billion during the first eight months of 2018 compared to the decline of Rs. 187.9 billion during 2017. This was entirely a result of the increase in provisional advances to the government by the Central Bank amounting to Rs. 24.9 billion during the first eight months of 2018, while Treasury bill holdings (net of repurchase transactions) of the Central Bank declined by Rs. 4.2 billion. Moreover, other items (net) of the Central Bank, which is the difference between other assets and other liabilities of the Central Bank, declined by Rs. 5.5 billion during the first eight months of 2018 mainly on account of international reserve revaluation. Contributing to the expansion in reserve money, NFA of the Central Bank also increased by Rs. 55.3 billion during the first eight months of 2018 in comparison to the significant increase of Rs. 287.5 billion recorded during 2017. The expansion in NFA of the Central Bank is attributable to the increase in investment in foreign securities although foreign financial liabilities also increased, particularly with international organizations. However, the buildup of foreign financial assets of the Central Bank outpaced the expansion in foreign financial liabilities during the period under consideration.

Narrow Money (M_1)

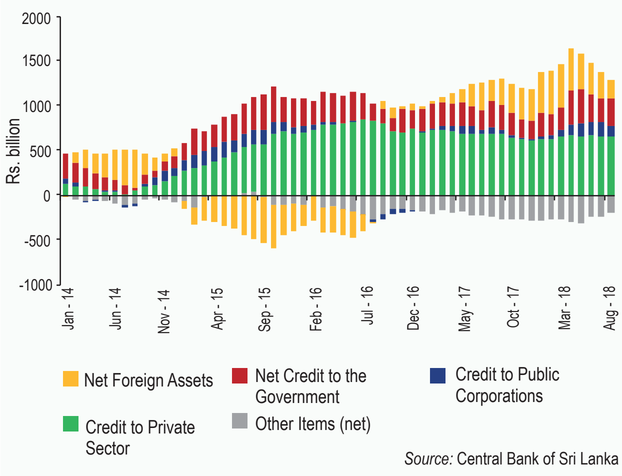
- **With the high interest rate environment, narrow money (M_1), which comprises currency and demand deposits held by the public, continued to grow moderately, recording a growth of 4.3 per cent by end August 2018 following the year-on-year growth of 2.1 per cent at end 2017.** The increase in narrow money during the first eight months of 2018 was a result of the increase in currency held by the public. Accordingly, currency held by the public grew by 4.6 per cent, year-on-year, during the first eight months of 2018 when compared to 2.3 per cent in 2017, accounting for around 62 per cent of the expansion. Meanwhile, demand deposits held by the public with commercial banks recorded a moderate growth of 3.8 per cent, year-on-year, by end August 2018 reflecting the low demand for non-interest bearing deposits in an environment of high market interest rates. In absolute terms, demand deposits contracted by Rs. 24.1 billion to Rs. 329.8 billion by end August 2018 from Rs. 353.9 billion at end 2017.

Broad Money (M_{2b}) and Domestic Credit

- **In response to the tight monetary policy stance pursued by the Central Bank in the past, the growth of broad money supply (M_{2b}) continued to decelerate in 2018**. The year-on-year growth of M_{2b} was 13.5 per cent by end August 2018 compared to 16.7 per cent by end 2017, while the average growth stood at 15.4 per cent during the first eight months of 2018 compared to a growth of 20.1 per cent in the corresponding period of 2017. Continued deceleration of the growth in private sector credit was the key contributory factor for the decline in broad money growth. The expansion in both NDA and NFA of the banking sector contributed to the monetary growth during the first eight months of 2018. NDA contributed 73 per cent to the year-on-year expansion in broad money aggregates, while NFA accounted for the remainder during the first eight months of 2018.

- **On the liability side, the increase in time and saving deposits held by the public with commercial banks contributed mainly to the expansion in M_{2b}**. High market interest rates attracted considerable amounts of time and savings deposits to commercial banks during

Figure 7.10
Contribution to Year-on-Year Change in Broad Money - M_{2b} (Assets Side)

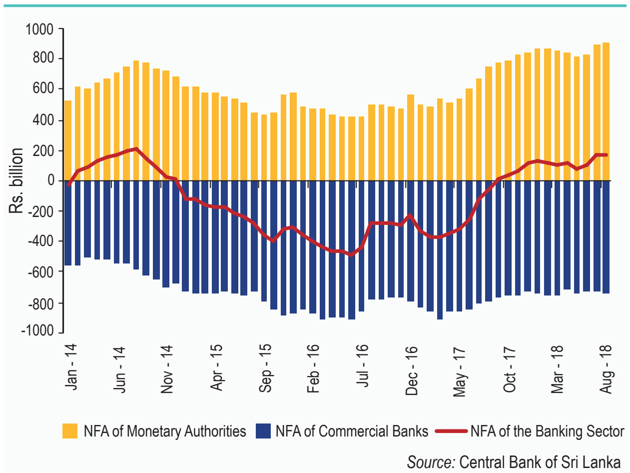


Source: Central Bank of Sri Lanka

the period under review contributing around 96 per cent to the overall expansion in M_{2b}. Time and savings deposits grew by 14.8 per cent, year-on-year, by end August 2018 in comparison to 19.1 per cent at end 2017. As a result, in absolute terms, time and savings deposits of the commercial banking sector increased by Rs. 560.1 billion during the first eight months of 2018 compared to the increase of Rs. 662.5 billion during the corresponding period of 2017.

- **On the asset side, NFA of the banking sector increased during the first eight months of 2018, entirely on account of the increase in NFA of the Central Bank**. In absolute terms, NFA of the banking sector increased by Rs. 45.3 billion by end August 2018, driven by NFA of the Central Bank, which expanded by Rs. 55.4 billion during the first eight months of 2018. Meanwhile, NFA of commercial banks decreased by Rs. 10.0 billion during this period, reflecting the impact of the decline in NFA of Domestic Banking Units (DBUs) by Rs. 23.1 billion. The decline in NFA of DBUs was mainly due to the increase in foreign currency deposit liabilities of non-residents held with commercial banks despite the increase in foreign financial assets on account of increased foreign currency placements with banks abroad. Meanwhile, NFA of Offshore Banking Units (OBUs) increased by Rs. 13.1 billion during the period under review, owing to the decline in foreign liabilities over foreign assets. Foreign assets of OBUs declined marginally due to the contraction in placements with banks abroad amidst an increase in credit to non-residents. Foreign liabilities declined mainly due to lower borrowings from banks abroad, amidst the increase in deposits from non-residents.

Figure 7.11
Net Foreign Assets (NFA) of the Banking Sector



Source: Central Bank of Sri Lanka

- **NDA of the banking sector expanded during the first eight months of 2018, underpinned by the expansion in credit disbursments to both the private and public sectors**. In absolute terms, NDA of the banking system increased by Rs. 513.0 billion during the first eight months of 2018 when compared to an increase of Rs. 463.8 billion observed during the same period of 2017.

- **Reflecting some improvements in the borrowing pattern of the government, the expansion in credit to the government on net basis (NCG) by the banking sector moderated during the first eight months of 2018**. NCG from the banking system increased by Rs. 103.4 billion during the first eight months of 2018 in comparison to the increase of Rs. 265.4 billion during the corresponding period of 2017. Contributing to the overall expansion, NCG of the Central Bank increased by Rs. 20.7 billion during the first eight months of 2018 as against the contraction of Rs. 119.5 billion witnessed during the corresponding period of 2017. NCG from commercial banks increased by Rs. 82.7 billion in the first eight months of 2018 in comparison to

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Table 7.2
Domestic Credit Expansion and Contributory Factors

Period	Absolute Change (Rs. billion)				Share of Domestic Credit (%)		
	Domestic Credit (a)	Credit to Private Sector (b)	Net Credit to the Government	Credit to Public Corporations (b)	Credit to Private Sector (b)	Net Credit to the Government	Credit to Public Corporations (b)
2014	439.4	219.0	134.6	85.8	49.8	30.6	19.5
2015	1,091.9	688.6	323.6	79.7	63.1	29.6	7.3
2016	939.6	743.9	212.6	-16.9	79.2	22.6	-1.8
2017	833.0	613.4	196.4	23.2	73.6	23.6	2.8
Jan - Aug 2017	677.8	404.7	265.4	7.7	59.7	39.2	1.1
Jan - Aug 2018	**655.1**	**449.1**	**103.4**	**102.5**	**68.6**	**15.8**	**15.6**

(a) Domestic credit includes credit to the private sector, net credit to the government and credit to public corporations
(b) Revised

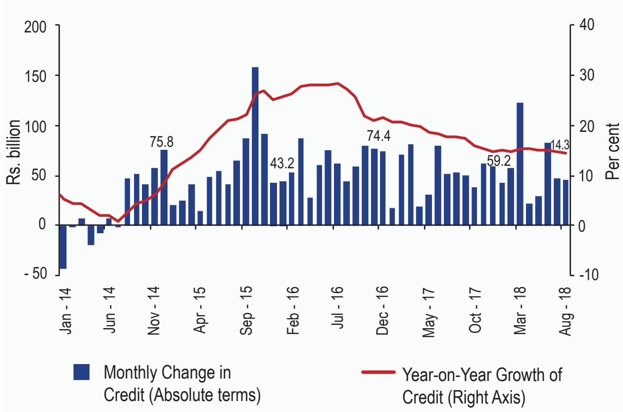
Source: Central Bank of Sri Lanka

the significant increase of Rs. 384.9 billion recorded in the corresponding period of 2017. The increase in NCG by commercial banks during the first eight months of 2018 was entirely due to the expansion in credit to the government by DBUs, while NCG by OBUs of commercial banks declined during the period. NCG by DBUs increased by Rs. 92.1 billion during the period January - August 2018 in comparison to the increase of Rs. 322.1 billion in 2017 mainly due to higher investments in Treasury bills, Treasury bonds and SLDBs. Meanwhile, overdraft balances of the government with commercial banks and domestic currency loans to the government increased by Rs. 19.6 billion and Rs. 3.4 billion, respectively, during the period under review. NCG by OBUs declined by Rs. 9.4 billion during the first eight months of 2018, in contrast to an increase of Rs. 62.2 billion in 2017. The reduction in NCG by OBUs was mainly due to the decline in OBU investments in SLDBs.

- **Credit to public corporations increased at a faster pace during the first eight months of 2018 due to the increased reliance of key public corporations on banks as a result of their poor financial performance**. Credit obtained by public corporations rose by Rs. 102.5 billion during the first eight months of 2018 in comparison to the increase of Rs. 7.7 billion recorded in the corresponding period of 2017. The cumulative increase in credit to public corporations during the first eight months of 2018 was mainly driven by the borrowings of key State-Owned Business Enterprises (SOBEs) such as Ceylon Electricity Board (CEB) amounting to Rs. 42.3 billion and Ceylon Petroleum Corporation (CPC) amounting to Rs. 39.4 billion. The National Water Supply and Drainage Board (NWS&DB), the SriLankan Airlines, the Co-operative Wholesale Establishment (CWE) and the Road Development Authority (RDA) also recorded increases in their borrowings during this period. Meanwhile, Ceylon Fertilizer Corporation and Colombo Commercial Fertilizers Limited repaid their loan liabilities to commercial banks amounting to Rs. 5.0 billion and Rs. 2.4 billion, respectively, during the first eight months of 2018.

- **Responding to high interest rates, the growth of credit to the private sector decelerated to envisaged levels during the first eight months of 2018**. Accordingly, the growth of credit to the private sector decelerated to 14.3 per cent by end August 2018 when compared to the growth of 17.8 per cent by end August 2017 and 14.7

Figure 7.12
Credit Granted by Commercial Banks to the Private Sector

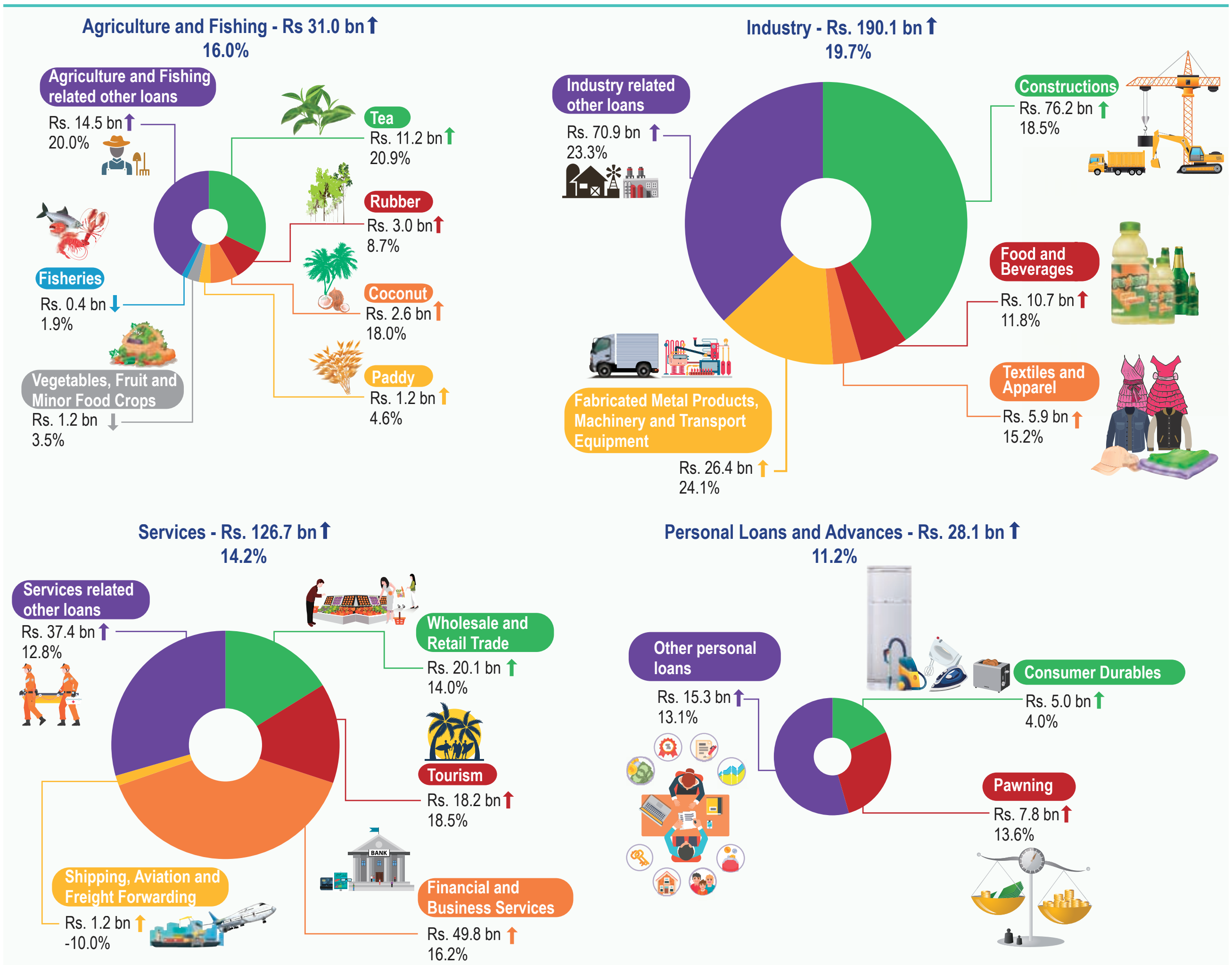


Source: Central Bank of Sri Lanka

per cent by end 2017. In addition to monetary policy measures, the continuation of macroprudential measures to curtail excessive credit for certain sectors such as motor vehicles may also have contributed to the deceleration in private sector credit growth. However, in absolute terms, credit to the private sector increased by Rs. 449.1 billion during the first eight months of 2018 in comparison to the increase of Rs. 404.7 billion during the corresponding period of 2017.

- **Credit to all major sectors of the economy expanded during the first half of 2018, indicating the availability of adequate financial resources to support economic activity.** As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit to the Agriculture sector grew by 16.0 per cent, year-on-year, by end June 2018, partly reflecting increased borrowings to support the recovery from weather related disruptions in certain regions. Meanwhile, credit to the Industry sector also grew by 19.7 per cent, year-on-year, by end June 2018. Credit flows to all sub sectors of the Industry sector recorded positive growth rates, while the credit to Construction sub-sector, which accounts for around 48 per cent of the total credit flows to the Industry sector and 20 per cent of total private sector credit, recorded a growth of 18.5 per cent, year-on-year, during the first half of 2018 compared to 21.8 per cent recorded in the corresponding period of 2017. Credit to the Services sector grew by 14.2 per cent during the first half of 2018 in comparison to the

Figure 7.13
Credit Granted by Commercial Banks to Key Sectors - 2018 (a)



Source: Central Bank of Sri Lanka

(a) Absolute numbers indicate the change of credit granted by commercial banks during the first half of 2018, while percentages indicate the year-on-year growth as at end June 2018

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Table 7.3

Classification of Outstanding Credit to the Private Sector Granted by Commercial Banks (a) (b) (c)

Rs. billion

Sector	End Jun 2017	End Dec 2017	End Jun 2018 (d)	Year-on-Year Change (June 17/June 18)	
				Amount	%
Agriculture and Fishing	**382.0**	**412.4**	**443.3**	**61.3**	**16.0**
of which, Tea	84.6	91.0	102.3	17.6	20.9
Rubber	25.3	24.4	27.5	2.2	8.7
Coconut	19.6	20.4	23.1	3.5	18.0
Paddy	32.3	32.6	33.8	1.5	4.6
Vegetables, Fruit and Minor Food Crops	27.2	29.3	28.1	0.9	3.5
Fisheries	16.8	17.5	17.1	0.3	1.9
Industry	**1,864.0**	**2,041.4**	**2,231.5**	**367.5**	**19.7**
of which, Construction	902.8	993.5	1,069.7	166.9	18.5
Food and Beverages	103.6	105.1	115.8	12.2	11.8
Textiles and Apparel	156.8	174.7	180.6	23.8	15.2
Fabricated Metal Products, Machinery and Transport Equipment	158.5	170.3	196.7	38.2	24.1
Services	**1,331.0**	**1,393.9**	**1,520.6**	**189.5**	**14.2**
of which, Wholesale and Retail Trade	400.0	435.8	455.9	56.0	14.0
Tourism	160.4	172.0	190.1	29.7	18.5
Financial and Business Services	306.6	306.5	356.3	49.7	16.2
Shipping, Aviation and Freight Forwarding	22.7	19.2	20.4	-2.3	-10.0
Personal Loans and Advances (e)	**972.1**	**1,053.2**	**1,081.2**	**109.2**	**11.2**
of which, Consumer Durables	207.0	210.2	215.2	8.2	4.0
Pawning	137.5	148.4	156.2	18.7	13.6
Credit Card	82.0	91.5	92.8	10.8	13.2
Total	**4,549.1**	**4,900.9**	**5,276.6**	**727.5**	**16.0**

(a) Based on the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector

Source: Central Bank of Sri Lanka

(b) Includes loans, overdrafts and bills discounted and excludes cash items in the process of collection

(c) Total values in this Table differ from credit to the private sector values in Table 7.2 due to differences in the compilation methodologies

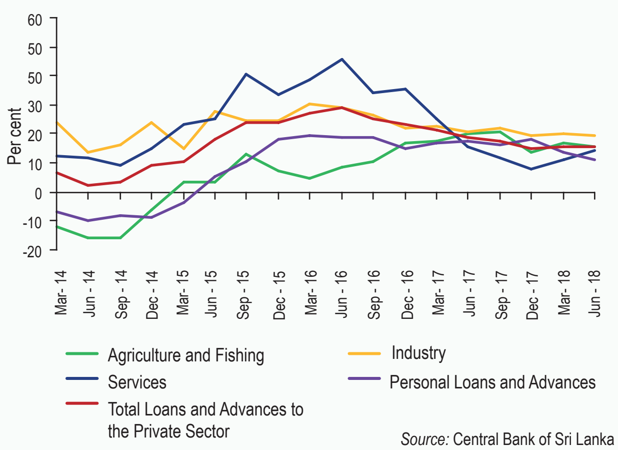
(d) Provisional

(e) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry' and includes Safety Net Scheme related Loans

year-on-year growth of 15.8 per cent recorded during the corresponding period of 2017, underpinned by borrowings of Wholesale and Retail Trade, Tourism and Financial and Business Services sub-sectors. Meanwhile, credit towards the Personal Loans and Advances category grew by 11.2 per cent, year-on-year, during the first half of 2018 in comparison to 17.9 per cent in the corresponding period of 2017. While the growth of pawning advances accelerated to 13.6 per cent by end June 2018 from 12.4 per cent during the corresponding period of 2017, credit disbursed to purchase consumer durables declined to 4.0 per cent by end June 2018 from the significant growth of 20.4 per cent recorded in the corresponding period of the previous year.

Figure 7.14

Year-on-Year Growth of Credit Granted by Commercial Banks to Key Sectors



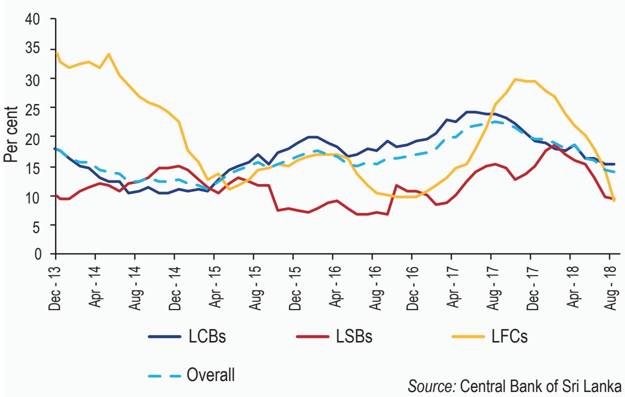
Source: Central Bank of Sri Lanka

Broad Money (M_4)

- **Reflecting the slowdown in monetary liabilities created across financial institutions, the growth of broad money supply (M_4),[1] as measured by the Financial Survey further moderated during the first eight months of 2018**. The year-on-year growth of M_4, which followed the same trend as M_{2b}, moderated to

1 The Financial Survey provides a broader measure of liquidity, covering LSBs and LFCs, in addition to LCBs and the Central Bank.

Figure 7.15
Year-on-Year Growth in Savings and Time Deposits (As per M_4)



Source: Central Bank of Sri Lanka

12.7 per cent at the end of the first eight months of 2018 compared to 17.6 per cent at end 2017. On the liabilities side, time and savings deposits held by the public at Licensed Commercial Banks (LCBs), Licensed Specialised Banks (LSBs) and Licensed Finance Companies (LFCs) grew by 14.0 per cent, year-on-year, by end August 2018 in comparison to a growth of 19.7 per cent by end 2017. By end August 2018, time and savings deposits held at LSBs and LFCs grew by 9.6 per cent and 9.2 per cent, year-on-year, respectively, compared to 15.2 per cent and 29.4 per cent, respectively, reported at end 2017. Based on the asset side of M_4, the expansion was due to the growth in both NDA and NFA of licensed banks and LFCs during the first eight months of 2018. Accordingly, NDA of licensed banks and LFCs increased by Rs. 570.2 billion and NFA of licensed banks and LFCs increased by Rs. 37.2 billion during the period under review.

- **The growth of credit to the private sector in M_4 slowed down to 14.5 per cent by end August 2018 compared to 17.3 per cent at end August 2017.** Credit to the private sector provided by LFCs increased to 15.7 per cent by end August 2018 from 11.0 per cent by end 2017, while growth of credit to the private sector by LSBs moderated to 14.2 per cent, year-on-year, compared to 20.4 per cent recorded at end 2017. In absolute terms, the

Table 7.4
Assets Side of Broad Money (M_4)
(Computed as per the Financial Survey)

Rs. billion

Sector	End Aug-17	End 2017	End Aug-18 (a)	Year-on-Year Change			
				End 2017		Aug-18	
				Amount	%	Amount	%
Financial Survey (M_4)	**7,457.0**	**7,795.9**	**8,403.3**	**1,165.7**	**17.6**	**946.3**	**12.7**
Underlying Factors							
Net Foreign Assets	**-205.2**	**-34.2**	**3.0**	**349.0**	**91.1**	**208.3**	**101.5**
Monetary Authorities	745.8	846.1	901.5	287.5	51.5	155.7	20.9
LCBs	-795.9	-724.6	-734.6	65.2	8.3	61.2	7.7
LSBs & LFCs	-155.1	-155.7	-163.8	-3.8	-2.5	-8.7	-5.6
Net Domestic Assets	**7,662.3**	**7,830.1**	**8,400.3**	**816.6**	**11.6**	**738.0**	**9.6**
Domestic Credit	**9,595.6**	**9,841.8**	**10,679.4**	**1,078.5**	**12.3**	**1,083.8**	**11.3**
Net Credit to the Government	**2,843.2**	**2,778.9**	**2,903.5**	**223.1**	**8.7**	**60.3**	**2.1**
Monetary Authorities	293.5	225.1	245.8	-187.9	-45.5	-47.8	-16.3
LCBs	1,944.0	1,943.4	2,026.1	384.3	24.6	82.2	4.2
LSBs	541.4	545.6	565.5	30.0	5.8	24.0	4.4
LFCs	64.2	64.8	66.1	-3.3	-4.9	1.9	2.9
Credit to Public Corporations (LCBs) (b)	**521.5**	**537.0**	**639.5**	**23.2**	**4.5**	**118.0**	**22.6**
Credit to the Private Sector (b)	**6,230.9**	**6,525.8**	**7,136.4**	**832.2**	**14.6**	**905.5**	**14.5**
LCBs (b)	4,590.5	4,799.2	5,248.4	613.4	14.7	657.9	14.3
LSBs	631.9	676.8	721.5	114.6	20.4	89.6	14.2
LFCs	1,008.6	1,049.8	1,166.5	104.2	11.0	158.0	15.7
Other Items (net) (c)	**-1,933.3**	**-2,011.7**	**-2,279.1**	**-261.8**	**-15.0**	**-345.7**	**-17.9**

(a) Provisional
(b) Revised
(c) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

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expansion in credit extended to the private sector amounted to Rs. 610.6 billion during the first eight months of 2018 contributing around 73 per cent to the cumulative expansion in domestic credit in M_4, compared to the expansion of Rs.537.3 billion in the corresponding period of 2017. Moreover, NCG in M_4 aggregates increased by Rs. 124.5 billion, in absolute terms, with LSBs and LFCs contributing positively to the expansion by Rs. 19.9 billion and Rs. 1.3 billion, respectively, during the period under review.

Expected Developments

- **In order to facilitate a smooth transition to FIT by 2020, institutionalising the FIT framework and enacting the required legislative amendments are expected to be completed, while the fiscal consolidation programme of the government is expected to continue**. While maintaining flexibility in the determination of the exchange rate as a key prerequisite for successfully adopting a FIT framework, the Central Bank has already taken several steps, including the initiation of amendments to the existing MLA, enhancing technical capacity in modelling and forecasting of key macroeconomic variables, improving the quality of data compilation and strengthening internal and external communication. It is also expected that the government would extend its commitment towards the ongoing revenue-based fiscal consolidation process, which would enable the Central Bank to successfully transition to a FIT framework to secure low and stable inflation on a sustainable basis to create a growth-conducive economic environment.