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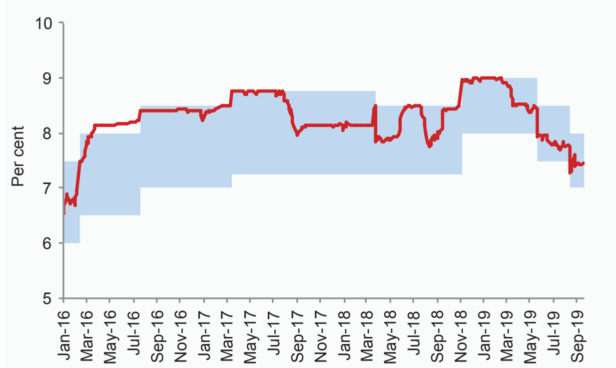
MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

Muted inflation and inflation outlook, below potential economic growth, decelerating private sector credit growth, subdued monetary aggregates, high nominal and real interest rates and global monetary policy easing prompted the Central Bank to adopt an increasingly accommodative monetary policy stance in 2019. Earlier, in November 2018 and March 2019, the Central Bank reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 2.50 percentage points, in total, while signaling the maintenance of a neutral monetary policy stance. Although these measures helped the domestic money market to record surplus liquidity, market interest rates, both in nominal and real terms, remained elevated. Following the notable expansion in 2018, credit extended to the private sector by commercial banks as well as other monetary aggregates decelerated sharply during the first eight months of 2019, largely on account of high market lending rates, subdued economic activity and negative investor sentiments following the Easter Sunday attacks along with monetary, fiscal and regulatory actions taken to contain macroeconomic imbalances observed in 2018. Supported by these factors, inflation as well as inflation expectations broadly remained in check reflecting muted demand pressures, although transitory upticks in inflation were observed during the period under review largely due to supply developments. With the view of reducing high market interest rates on deposit and lending products and the necessity to strengthen and expedite monetary policy transmission through the financial market by limiting unhealthy competition in deposit mobilisation, interest rate caps on deposit products of financial institutions were imposed by the Central Bank in April 2019. Subsequently, deposit interest rates and yields on Government securities displayed a notable reduction. Meanwhile, the Central Bank provided forward guidance to the market on possible reduction of policy interest rates in April 2019. Capitalising on muted inflationary pressures, decelerating monetary growth and the global move towards increasingly accommodative monetary policy supported by a relatively stable external sector, the Central Bank relaxed monetary policy by reducing policy interest rates, namely the Standing Deposit Facility rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50 basis points to 7.50 per cent and 8.50 per cent, respectively, in May 2019. Considering the available monetary policy space to support productive economic activity, the Central Bank further reduced the SDFR and the SLFR by 50 basis points to 7.00 per cent and 8.00 per cent in August 2019. However, most market lending rates remained downward rigid, requiring further policy action to enhance the transmission of monetary policy stance to market interest rates. Accordingly, as a temporary measure, the Central Bank imposed caps on lending rates of licensed banks in September aimed at inducing a sizable reduction in market lending rates, thereby promoting lending and reviving economic growth. Simultaneously, the Central Bank removed caps on deposit rates of licensed banks imposed in April 2019.

Monetary Policy Stance of the Central Bank

- **Amidst subpar economic growth that was further affected by the Easter Sunday attacks, rapidly decelerating private sector credit and muted inflation expectations, the Central Bank moved to an accommodative monetary policy stance in 2019 in line with the increasingly accommodative global monetary policy stance, after maintaining a neutral monetary policy stance since April 2018.** Due to the pressure on the external sector led by capital outflows in response to monetary policy normalisation in advanced economies and a widened trade deficit, the Central Bank maintained a neutral monetary policy stance since April 2018, before providing forward guidance of relaxing its stance in April 2019. Whilst maintaining a neutral monetary policy stance, the Central Bank reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by a total of 2.50 percentage points in November 2018 and March 2019 with a view to addressing large and persistent deficit levels in the domestic money market observed since mid-September 2018. This resulted in an improvement in domestic money market liquidity, and market liquidity turned to surplus levels from mid-April 2019. Considering subdued economic growth, muted inflationary pressures and continued deceleration in private sector credit amidst high nominal and real market interest rates, the Central Bank provided forward guidance to the market in April 2019 on future reduction of policy interest rates. Subsequently, the Central Bank moved to an accommodative monetary policy cycle by reducing policy interest rates, namely the Standing Deposit Facility rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50 basis points to 7.50 per cent and 8.50 per cent, respectively, by end May 2019, with a view to reducing market lending rates and thereby boosting credit flows to the private sector. In addition, in view of the need to expedite monetary policy transmission through the financial system, interest rate caps on deposit products of banks and non-bank financial institutions were imposed with effect from 26 April 2019. Resulting from these measures along with eased monetary conditions, market interest rates, particularly, market deposit rates, gradually started to adjust downwards, while market lending rates remained downward rigid. In this environment, the Central Bank further reduced the SDFR and the SLFR by 50 basis points to 7.00 per cent and 8.00 per cent, respectively, effective 23 August 2019, with a view to inducing a sizable reduction in lending rates. In spite of the continued accommodative monetary policy stance as well as reduced cost of funds with the imposition of caps on deposit rates, market lending rates did not adjust downwards commensurate to the decline observed in deposit interest rates. In the context of an unduly persistent lag in the transmission of policy measures, the Central Bank imposed lending rate caps on 24 September 2019 to enhance the efficiency of the transmission of recent policy decisions to market lending rates, while removing deposit rate caps on licensed banks. Accordingly, the Central Bank issued an order to licensed banks to reduce lending rates of rupee denominated loans and advances by 200 basis points by 15 October 2019 from rates applicable at end April 2019. Further, licensed commercial banks were ordered to reduce the weekly

Figure 7.1
Standing Rate Corridor and Average Weighted Call Money Rate (AWCMR)



Source: Central Bank of Sri Lanka

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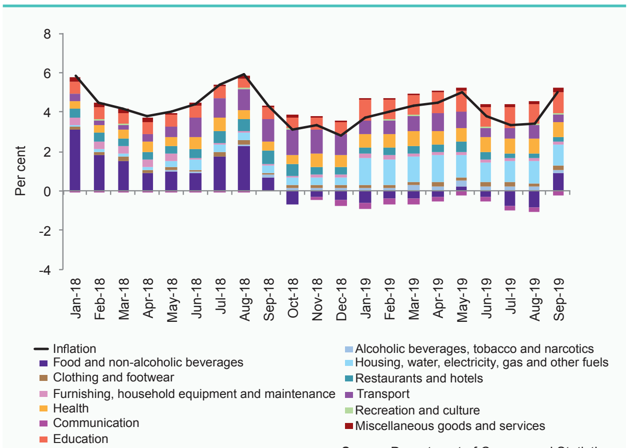
Average Weighted Prime Lending Rate (AWPR) by 150 basis points by 01 November 2019 and 250 basis points by 27 December 2019 from levels reported as at 26 April 2019. In addition, caps on interest charged on credit card advances and pre-arranged temporary overdrafts were imposed at the maximum rates of 28 per cent per annum and 24 per cent per annum, respectively, with effect from 01 November 2019. Consequent to these monetary and regulatory measures of the Central Bank, a sizable reduction in lending rates is expected, which will gradually enhance the demand for credit, thereby contributing to promote economic activity. The Central Bank will review the lending rate caps by March 2020.

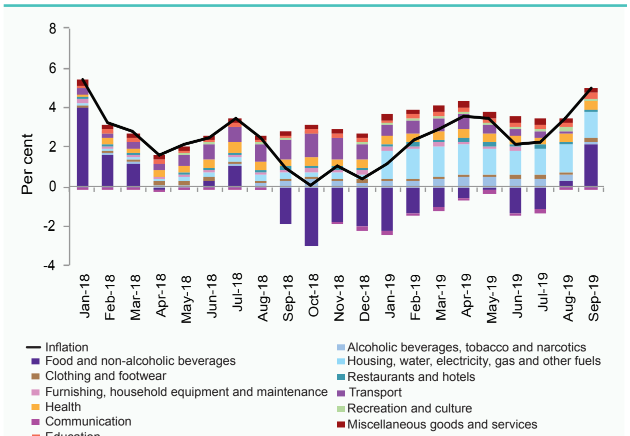
- **In line with the favourable developments in the supply side and subdued demand conditions, inflation broadly remained in the desired range during the first nine months of 2019.** Headline inflation, as measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2013=100), was recorded at 2.8 per cent in December 2018, before picking up during 2019 to reach mid-single digit levels by May 2019. This acceleration in inflation was mainly driven by the upward adjustments to administratively determined prices, including domestic petroleum prices, increase in house rentals and upward tax revisions to the prices of some food and non-food items. Further, the lagged effect of the sharp depreciation of the rupee in late 2018 also contributed to the acceleration in inflation during this period of 2019. Subsequently, due to declining food prices, inflation decelerated to 3.4 per cent by August 2019, before accelerating again to 5.0 per cent in September 2019 driven by higher food prices. The annual average headline inflation stood at 3.9 per cent in September 2019 compared to 4.3 per cent at end 2018. Following a similar trend, year-on-year headline inflation based on the National Consumer Price Index (NCPI, 2013=100) also increased to 3.6 per cent in April 2019 from 0.4 per cent at end December 2018. Although the year-on-year headline inflation based on NCPI decelerated during the months of June and July due to the decrease in both food and non-food inflation as well as the base effect, NCPI based headline inflation picked up again in August to 3.4 per cent and September to 5.0 per cent driven by food inflation. On an annual average basis, NCPI based headline inflation was at 2.3 per cent in September 2019 compared to 2.1 per cent at end 2018. Food price hikes could exert some price pressures in the near term, while hikes of wages and salaries of public servants could also pose inflationary risks in the medium term. Accordingly, inflation is likely to remain around the upper bound of the desired inflation target range of 4-6 per cent during the remainder

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



Source: Department of Census and Statistics

Figure 7.3
Contribution to Year-on-Year Headline Inflation (NCPI)



Source: Department of Census and Statistics of 2019. Inflation is expected to be maintained within this desired range over the medium term supported by appropriate timely policy measures and well anchored inflation expectations.

- **Core inflation, which is a key indicator of the demand driven component of inflation, witnessed an elevation in January 2019, mainly due to a one-off adjustment in the Housing and Education categories and remained broadly in mid-single digits levels thereafter.** In addition, increases in prices across the health category and administratively determined commodity prices alongside the lagged effect of the depreciation of rupee in late 2018 caused year-on-year core inflation to rise gradually during the period up to May 2019. However, core inflation experienced a slight slowdown thereafter with the moderation in non-volatile food prices in the ensuing months. Accordingly, year-on-year core inflation based on CCPI stood at 5.6 per cent in September 2019, compared to 3.1 per cent at end 2018, while annual average core inflation was 5.1 per cent in September 2019, compared to 3.5 per cent at end 2018. Following a similar trend, year-on-year core inflation based on NCPI, which was at 3.1 per cent at end 2018, rose to 6.3 per cent by April 2019, and gradually moderated to 5.6 per cent at end September 2019. On an annual average basis, NCPI based core inflation rose to 5.2 per cent in September 2019 from 2.4 per cent at end 2018. The impact of one-off adjustments observed in the Housing and Education categories is expected to continue throughout 2019 before wearing off in January 2020.

- **Inflation expectations of the corporate sector broadly remained around the lower bound of the 4-6 per cent range, while expectations of the household sector remained around the upper bound of this range thus far in 2019.** Respondents of the corporate sector cited the increases in commodity prices, concerns of peace and stability in the country following the Easter Sunday attacks and the depreciation of the rupee as key reasons for their inflation expectations. Meanwhile, concerns of peace and stability in the country following Easter Sunday attacks, increases in commodity prices, and the increase in salary and wages were highlighted by respondents of the household sector as factors affecting their expectations on future inflation.

- **On the verge of transitioning towards explicit Flexible Inflation Targeting (FIT), the Central Bank continued to conduct monetary policy within an enhanced framework with the aim of stabilising inflation around mid-single digit levels over the medium term and thereby paving way for a sustainable growth trajectory.** Having conducted monetary policy under a monetary aggregate based framework since early 1980s, the Central Bank transitioned to an enhanced monetary policy framework in 2015, thereby making an important step in the move towards FIT. In the current framework, the average weighted call money rate (AWCMR) serves as the operating target, while broad money (M_{2b}) remains an indicative intermediate variable in the conduct of monetary policy. The AWCMR continues to be guided by market based monetary policy instruments, particularly policy interest rates and open market operations. Meanwhile, the Central Bank made substantial progress in the process of institutionalisation of key reforms, including necessary legislative enactments which are essential for a smooth transition to an explicit FIT framework by 2020.

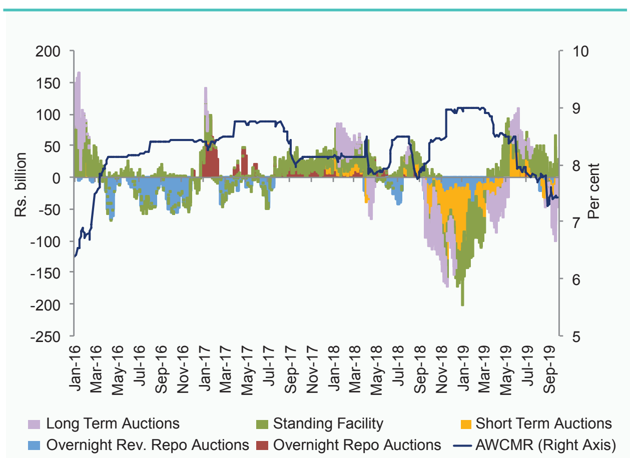
- **The Central Bank continued to enhance its communications strategy with a view to educating stakeholders of the economy, particularly on its transition towards FIT.** Several initiatives have been taken to improve both internal and external communication with a view to enhancing transparency of monetary policy as well as managing and anchoring inflation expectations effectively. The Central Bank continued to conduct awareness programmes and publish information series notes to educate stakeholders, journalists and the general public. Apart from the improved forward looking press release on the monetary policy review, press statements on external sector developments and on various other developments were also released. In addition, the Central Bank improved the content and the format of its key publication, the Annual Report, with infographics to provide the general public with a better understanding of macroeconomic developments. The Central Bank disseminated economic and financial statistics through daily, weekly and monthly indicators and bulletins published on its website as well as through its data library. Further, the Central Bank published updates on key macroeconomic developments and policy measures via press conferences, seminars, lectures and speeches by the Governor and other key officials of the Central Bank, on a regular basis, in all three languages.

Movements in Interest Rates

Market Liquidity, Market Operations and Short Term Interest Rates

- **Liquidity in the domestic money market, which was persistently in deficit levels since September 2018, improved gradually as a result of monetary policy and operational measures and turned into surplus levels by mid April 2019.** Despite the permanent liquidity injections through the reduction in SRR applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points to 6.00 per cent effective mid November 2018, money market liquidity remained in deficit at the beginning of 2019. The Central Bank continued to conduct overnight, short term and term reverse repurchase transactions as well as outright purchases of Treasury bills to inject liquidity to the market thereby easing pressures on short term money market rates. However, as the deficit liquidity conditions displayed signs of persistence, the Central Bank reduced the SRR further by 1.00 percentage point to 5.00 per cent with effect from 01 March 2019. With the two SRR cuts in November 2018 and March 2019, around Rs. 150.0 billion of permanent liquidity was added to the domestic money market. Consequently, liquidity conditions in the domestic money market continued to improve, subsequently turning into surplus levels by mid-April 2019. Liquidity remained in surplus levels until September 2019. Meanwhile, purchases from the primary Treasury bill market by the Central Bank during January 2019 as a result of the government borrowing programme being disrupted by the political crisis in the fourth quarter in 2018 and the conversion of proceeds from the International Sovereign Bonds (ISBs) also caused an increase in rupee liquidity in the market. During the period from May to end July 2019, the Central Bank mopped up excess liquidity through Open Market Operations (OMOs) by way of overnight, short term and long term repurchase transactions. However, in spite of the surplus overall liquidity in the market, the Central Bank was compelled to carry out reverse repurchase transactions on overnight and short term basis as well as several outright purchases of Treasury bills since the second week of August 2019 to negate the impact of asymmetric liquidity distribution among banks in early August 2019. Money market liquidity turned into deficit levels by end August 2019 mainly due to maturities of

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



Source: Central Bank of Sri Lanka

Treasury bill holdings of the Central bank, early retirement of Treasury bills, swap maturities and scheduled foreign loan repayments as well as sales of foreign exchange to prevent disorderly adjustments in the exchange rate. Meanwhile, with effect from 06 September 2019, the Central Bank extended its outright transactions to include Treasury bonds, considering the projected sustained liquidity deficits in the money market. At the same time, a Liquidity Support Facility (LSF) for standalone primary dealers, who have been prevented from participating in overnight OMO auctions, was introduced on 06 September 2019. Accordingly, the average overnight liquidity surplus during mid April to end September 2019 in the domestic market was around Rs. 27.7 billion.

- **The overnight interbank call money rate, which remained around the upper bound of the policy rate corridor since September 2018 due to deficit liquidity, gradually started to decline from March 2019 with improved liquidity conditions and policy measures of the Central Bank.** Reflecting deficit liquidity conditions in the money market, the Average Weighted Call Money Rate (AWCMR) was allowed to remain mostly at the upper bound of the policy rate corridor during the period from September 2018 to February 2019. With the reduction in the SRR at the beginning of March 2019, the AWCMR adjusted towards the middle of the policy rate corridor. Following the reduction in policy rate by 50 basis points by end May 2019, the AWCMR started to adjust downwards reaching 7.70 per cent by end July 2019. With the decision to further reduce policy rates by 50 basis points in August 2019, the AWCMR declined further and thereafter, was guided to hover around the middle of the policy rate corridor. During the first nine months of 2019, the AWCMR declined by around 153 basis points. Moreover, the weighted average yields at the daily OMO auctions and Sri Lanka Interbank Offered Rate (SLIBOR) also moved in line with the movements in the AWCMR during the first nine months of 2019. By end September 2019, overnight and 12-month SLIBOR were at 7.45 per cent and 10.58 per cent, respectively, compared to 9.00 per cent and 11.80 per cent at end 2018.

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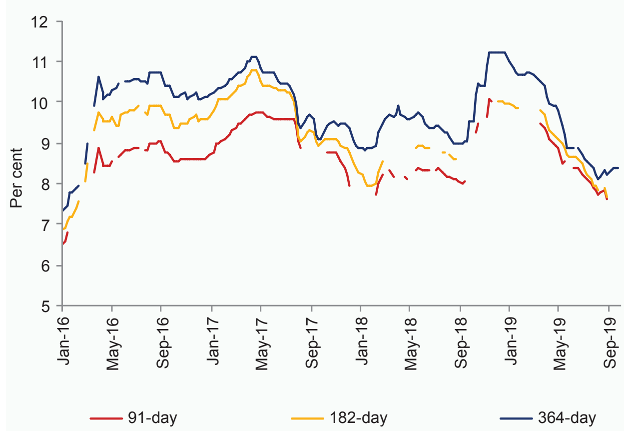
Yields on Government Securities

- **Yields in the Government securities market showed a notable decline thus far during 2019.** With surplus market liquidity conditions, accommodative monetary policy stance, availability of foreign financing with ISB receipts, streamlined Treasury bond primary auction system and well anchored inflation expectations, yields on government securities showed a declining trend during the year. The imposition of deposit caps by the Central Bank in April 2019, would also have contributed to reduce yield rates as some savers shifted from regular bank deposits to Government securities. Further, reduction in the SRR by 2.50 percentage points in two steps allowed the banks to invest more in Government securities in the context of slow growth of credit to the private sector. Accordingly, during the year up to end September 2019, primary market yields on 91-day, 182-day and 364-day Treasury bills decreased by 239, 224 and 279 basis points to 7.62 per cent, 7.75 per cent and 8.41 per cent, respectively, despite a temporary upward pressure observed during September. In the Treasury bond market, yields on short to medium

Figure 7.5
Primary Market Treasury Bill Yields (a)

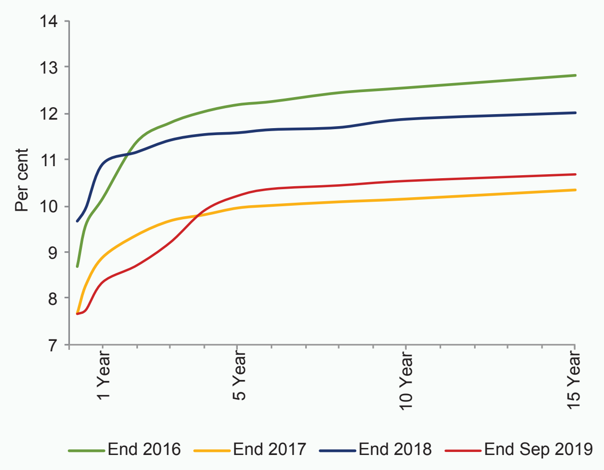


Source: Central Bank of Sri Lanka

(a) Yields for some weeks are not available due to non-acceptance of bids or not offering relevant tenures term maturities declined by around 99-216 basis points during the first nine months of 2019, while yields on long term maturities of 10-years, 15-years and 20-years were recorded at 11.35 per cent, 10.59 per cent and 10.29 per cent, respectively, by end September 2019, reflecting a decline in yields by around 91-245 basis points. Meanwhile, the government issued short and medium-term US dollar denominated Sri Lanka Development Bonds (SLDBs) at various fixed and floating rates. During the auctions conducted in January 2019 and May 2019, US dollars 179.7 million and US dollars 165.5 million, respectively, were raised through SLDBs. During the latest auction conducted in May 2019, SLDBs of 1-year 8 months and 2-year 2 months tenures were issued at floating rates of 3.53 per cent and 3.20 per cent above the 6-month US dollar LIBOR rate, respectively, as well as at fixed rates of 5.93 per cent and 5.87 per cent, respectively. In addition, under the same auction, SLDBs of 2-year 11 months and 3-year 11 months tenures were issued at floating rates of 3.48 per cent and 3.93 per cent above the 6-month US dollar LIBOR rate, respectively. Further, two ISB offerings were conducted in March 2019 and June 2019, through which US dollars 2.4 billion and US dollars 2.0 billion were raised, respectively. During the March ISB offering, 5-year and 10-year tenures were issued at rates of 6.85 per cent and 7.85 per cent, respectively, which were 441-521 basis points above the corresponding US Treasury yields that prevailed at the time. During the June 2019 ISB offering, 5-year and long 10-year tenures were issued at rates of 6.35 per cent and 7.55 per cent, respectively, which were 460-553 basis points above the corresponding US Treasury yields that prevailed at the time. The issuance of these foreign currency denominated debt securities helped ease the pressure on yields on domestic debt instruments to some extent.

- **In line with the primary market yield movements, the secondary market yield curve for Government securities shifted downwards by end September 2019, with a steeper downward shift in the shorter end of the yield curve.** Accordingly, yields on 91-day, 182-day and 364-day Treasury bills in the secondary market decreased by 201 basis points, 221 basis points and 255 basis points, respectively to 7.66 per cent, 7.76 per cent and 8.36 per cent by end September 2019, in comparison to the yields that prevailed at end 2018. The secondary market yields on 2-year bonds decreased by 245 basis points to 8.71 per cent, while 5-year and 10-year Treasury bonds decreased by 136 basis points and 133 basis points to 10.22 per cent and 10.54 per cent by end September 2019, in comparison to the yields at end 2018.

Figure 7.6
Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka

Deposit and Lending Interest Rates

- **Deposit rates of licensed commercial banks declined notably from May 2019 in response to measures taken by the Central Bank.** In view of high nominal and real interest rates on deposit and lending products in the economy and the need to strengthen monetary policy transmission through the financial system, maximum interest rate caps on deposit products of banks and non-bank financial institutions were imposed with effect from 26 April 2019 to help financial institutions to reduce their cost of funds. The imposition of caps on deposit interest rates, supported by eased liquidity conditions and the accommodative monetary policy stance, resulted in a notable decline in deposit rates. Accordingly, the average weighted new deposit rate (AWNDR)

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Table 7.1
Movements of Interest Rates

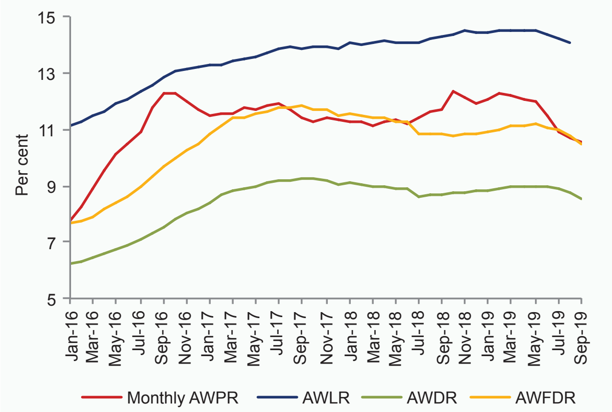
Per cent per annum

Interest Rate	End 2018	End Sep 2019
Policy Interest Rates		
Standing Deposit Facility Rate	8.00	7.00
Standing Lending Facility Rate	9.00	8.00
Average Weighted Call Money Rate (AWCMR)	8.95	7.45
Yield Rates on Government Securities		
Primary Market (a)		
Treasury bills		
91-day	10.01	7.62
182-day	9.99	7.75
364-day	11.20	8.41
Treasury bonds		
2-year	-	9.79
3-year	11.88	10.72
4-year	-	-
5-year	11.69	10.27
10-year	10.20	11.35
Secondary Market		
Treasury bills		
91-day	9.67	7.66
182-day	9.96	7.76
364-day	10.91	8.36
Treasury bonds		
2-year	11.16	8.71
3-year	11.42	9.21
4-year	11.54	9.90
5-year	11.58	10.22
10-year	11.87	10.54
Licensed Commercial Banks (b)		
Interest Rates on Deposits		
Savings Deposits	0.50-8.50	0.20-7.00 (e)
1-year Fixed Deposits (c)	4.53-15.00	1.00-15.00 (e)
Average Weighted Deposit Rate (AWDR) (d)	8.81	8.51
Average Weighted Fixed Deposit Rate (AWFDR) (d)	10.85	10.46
Average Weighted New Deposit Rate (AWNDR) (d)	10.94	8.40 (e)
Average Weighted New Fixed Deposit Rate (AWNFDR) (d)	11.27	8.67 (e)
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	11.94	10.57
Average Weighted Lending Rate (AWLR)	14.40	14.04 (e)
Average Weighted New Lending Rate (AWNLR)	14.54 (f)	13.84 (e)
Other Financial Institutions (g)		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	4.00	4.00
1-year Fixed Deposits	10.50	9.83
Licensed Finance Companies (h)		
Savings Deposits	5.21-7.77	5.28-7.16 (e)
1-year Fixed Deposits	11.63-13.21	10.75-11.57 (e)
Interest Rates on Lending		
National Savings Bank	6.75-16.25	3.46-16.50
State Mortgage and Investment Bank (i)	10.50-20.00	10.25-19.50 (e)
Licensed Finance Companies (h)		
Finance Leasing	16.17-28.80 (f)	16.19-27.88 (e)
Hire Purchase	15.16-18.65	13.28-20.79 (e)
Loans against Real Estate	18.94-19.21 (f)	16.50-20.29 (e)
Corporate Debt Market		
Debentures	12.00-14.75	12.88-15.50
Commercial Paper	13.10-15.00	13.50-16.25

(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 are 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. The same method is applied to calculate AWNDR and AWNFDR since June 2018.
(e) As at end August 2019
(f) Revised
(g) Based on the rates quoted by other selected Financial Institutions
(h) 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 2019 are provisional.
(i) Lending for housing purposes only

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

Figure 7.7
Selected Market Interest Rates

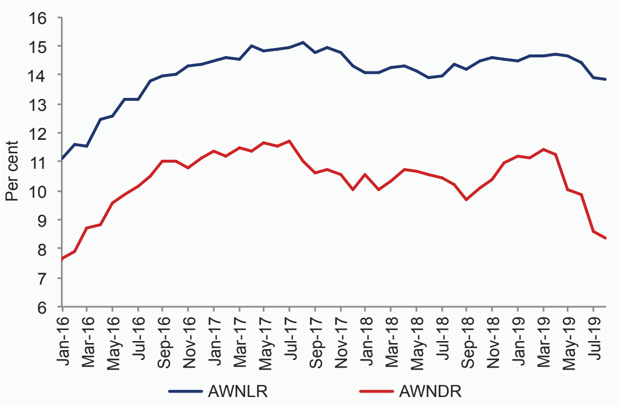


Source: Central Bank of Sri Lanka

of licensed commercial banks (LCBs), which is based on interest rates pertaining to all new interest bearing deposits, moderated notably by 284 basis points to 8.40 per cent in August 2019 from 11.24 per cent at end April 2019. Meanwhile, the average weighted deposit rate (AWDR), which reflects the movements in interest rates pertaining to all outstanding interest bearing deposits held with LCBs, declined by 46 basis points to 8.51 per cent by September 2019 from end April 2019. In spite of the decline in deposit interest rates, depositors continued to benefit from positive real rates of return during this period, with inflation continuing to remain substantially low relative to the deposit rates offered by most financial institutions. With the imposition of lending rate caps, the Central Bank removed caps applicable on deposit products of licensed banks with effect from 24 September 2019.

- **The Central Bank imposed lending rate caps on licensed banks on 24 September 2019, considering the downward rigidity observed in lending rates in spite of the measures taken to reduce market interest rates during the year.** With the gradual decline in cost of funds of commercial banks supported by the imposition of deposit caps and the injection of large volumes of liquidity, the 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, declined by 160

Figure 7.8
New Deposit and New Lending Rates



Source: Central Bank of Sri Lanka

basis points to 10.49 per cent by end September 2019 compared to 12.09 per cent reported at end 2018. Moreover, monthly AWPR, which is the simple average of weekly AWPR, declined by 137 basis points to 10.57 per cent during first nine months of 2019. 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, declined by 70 basis points to 13.84 per cent by end August 2019 from end 2018. The average weighted lending rate (AWLR), which is based on interest rates of all outstanding loans and advances extended by LCBs, declined by 36 basis points to 14.04 per cent during the first eight months of 2019. Meanwhile, bankwise average weighted lending rates were in the range of 9.99-17.14 per cent at end August 2019 compared to the range of 10.96-17.25 per cent recorded at end 2018. Further, the security-wise breakdown of advances displayed a reduction in average weighted interest rates of most type of advances by end August 2019. In particular, interest rates on loans secured by documentary bills; Gold and other precious metals under pawning; Fixed, savings and other deposits and CDs; Stock in trade; Government securities; Foreign currency deposits, and Immovable property, plant and machinery declined by August 2019 compared to the levels recorded at end 2018. Most of the real lending rates had also adjusted downward to some extent by end August 2019. Amidst the sluggish decline in market lending rates, the Central Bank imposed maximum interest rates on rupee denominated market lending products of licensed banks on 24 September 2019 to enhance efficiency of the transmission of monetary policy decisions to market lending rates.

Interest Rates on Debt Instruments

- **Interest rates applicable on corporate debt instruments remained high during the first nine months of 2019.** Interest rates on commercial paper, which is a short term debt instrument, increased to a range of 13.50-16.25 per cent during the first nine months of 2019 compared to a range of 13.10-15.00 per cent at end 2018. Meanwhile, 17 new listings of corporate debentures were reported by 9 corporates during the first nine months of 2019 with multiple maturities from 5 to 10 years, in comparison to the 21 new listings reported in 2018. Fixed interest rates offered on these issues were in the range of 12.88-15.50 per cent by end September 2019 compared to the range of 12.00-14.75 per cent at end 2018.

Interest Rates on Foreign Currency Deposits

- **Interest rates applicable on foreign currency deposits maintained with LCBs remain almost unchanged during the first nine months of 2019.** Interest rates pertaining to US dollar denominated time deposits remained unchanged in the range of 0.25 – 6.00 per cent by end September 2019 compared to end 2018. However, interest rates on US dollar denominated savings deposits were in the range of 0.20-4.50 per cent by end September 2019 compared to the range of 0.02 – 4.12 per cent at end 2018. Interest rates applicable on pound sterling denominated time deposits remain unchanged at the range of 0.10-3.50 per cent by end September 2019 from end 2018. Interest rates on savings deposits denominated in pound sterling remained almost unchanged in the range of 0.10 – 2.46 per cent by end September 2019.

Movements in Monetary and Credit Aggregates

Reserve Money

- **Reserve money, which is the monetary base of the economy, recorded a sharp decline during the first eight months of 2019, mainly due to the reduction of SRR.** SRR was reduced by 2.50 percentage points in two steps in November 2018 and March 2019. Currency in circulation also declined during the first six months of the year as a result of subdued economic activity, which was further affected by the Easter Sunday attacks, although some pickup was observed since then. Increased opportunity cost due to high interest rates that prevailed in the market, particularly during the first four months of the year, as well as the growing importance of digital payment systems, also contributed to the decline. Accordingly, reserve money contracted by 9.1 per cent, year-on-year, at end August 2019 compared to the growth of 2.3 per cent recorded at end 2018. In absolute terms, reserve money decreased by Rs. 47.7 billion during the first eight months of 2019 to Rs. 913.4 billion by end August 2019, compared to an expansion of Rs. 64.9 billion in the corresponding period of 2018. Commercial banks' deposits with the Central Bank decreased by Rs. 52.9 billion during the first eight months of 2019 to Rs. 267.2 billion by end August 2019, which was a negative growth of 30.6 per cent, year-on-year. Currency in circulation increased marginally by Rs. 5.2 billion during the first eight months of the year to Rs. 646.1 billion by end August 2019. Accordingly, currency in circulation, on a year-on-year basis, recorded a moderate growth of 4.3 per cent by end August 2019 in comparison to an increase of 7.2 per cent at end 2018.

Figure 7.9
Daily Reserve Money (a)

Source: Central Bank of Sri Lanka

(a) Steep reductions in Reserve money in November 2018 and March 2019 were due to the reduction of SRR. Sharp increases during April are due to seasonal demand for currency.

- **Viewed from the assets side, a notable decline in net domestic assets (NDA) of the Central Bank, which outweighed the expansion in net foreign assets (NFA) of the Central Bank, contributed to the negative growth of reserve money during the first eight months of 2019.** The reduction in NDA of the Central Bank, mainly on account of the decline in net credit to the government (NCG), partially offset the expansion of NFA during the period under review. NDA of the Central Bank contracted by Rs. 145.6 billion to Rs. 65.0 billion during the first eight months of 2019 in comparison to a marginal increase of Rs. 9.6 billion in the corresponding period of 2018. NCG by the Central Bank declined due to the reduction of Treasury bill holdings of the Central Bank (net of repurchase transactions), which were mainly acquired in late 2018 under reverse repurchase agreements with a view to inject liquidity to the domestic money market. Treasury bill holdings of the Central Bank (net of repurchase transactions) decreased by Rs. 160.9 billion during the first eight months of the year to Rs. 112.1 billion. However, provisional advances to the government increased by Rs. 39.2 billion to Rs. 237.8 billion by end August 2019 with the full utilisation of the entitled amount for 2019 by the government at the beginning of the year following the repayment of a portion of provisional advances to the Central Bank at end 2018. As a combined effect of these, NCG by the Central Bank declined by Rs. 121.9 billion during the first eight months of the year. In contrast, NFA of the Central Bank increased by Rs. 97.9 billion in the first eight months of 2019 mainly due to the conversion of ISB proceeds and the Central Bank's purchases of foreign exchange from the domestic market. Meanwhile, foreign currency liabilities of the Central Bank also expanded during the first eight months of 2019, albeit at a slower pace than the increase in foreign currency assets, mainly with receipts of ISBs to government accounts, receipts under the Extended Fund Facility Programme with the International Monetary Fund (IMF) as well as increased liabilities to other international agencies, including the Asian Development Bank (ADB) and the International Bank for Reconstruction & Development (IBRD), during the period under review.

Narrow Money (M_1)

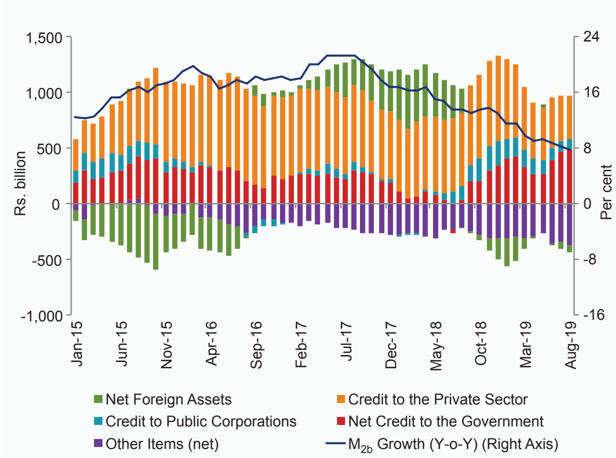
- **With relatively high deposit interest rates, particularly during the first four months of the year, along with subdued economic activities amidst the Easter Sunday attacks, narrow money (M_1), which comprises currency and demand deposits held by the public, grew moderately, recording a growth of 3.4 per cent, year-on-year, by end August 2019 following the year-on-year growth of 4.7 per cent at end 2018.** Accordingly, narrow money decreased during the first eight months of 2019 as a result of the decrease in both currency and demand deposits held by the public. Currency held by the public recorded a moderate growth of 1.8 per cent, year-on-year, by end August 2019 compared to 7.7 per cent by end 2018. In absolute terms, during first eight months of 2019, currency held by the public contracted by Rs. 2.9 billion. Meanwhile, demand deposits held by the public with commercial banks recorded a growth of 5.5 per cent, year-on-year, by end August 2019, compared to 1.1 per cent growth recorded by end 2018. In absolute terms, during the first eight months of 2019, demand deposits held by the public with commercial banks contracted by Rs. 9.7 billion, reflecting the declining demand for non-interest bearing deposits.

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

- **Broad money growth (M_{2b}) continued to moderate during the first eight months of 2019 mainly driven by the deceleration in private sector credit growth amidst subdued economic activity.** Accordingly, the year-on-year growth of M_{2b} was 7.7 per cent at end August 2019 compared to 13.0 per cent at end 2018. The moderate expansion in NDA of the banking system contributed positively to monetary growth in the first eight months of 2019 while NFA of the banking system recorded a negative year-on-year growth during the period under consideration.

- **On the liabilities front, the growth of broad money during the first eight months of 2019 was mainly driven by the increase in time and savings deposits held by the public with LCBs, amidst high interest rates offered on time deposits, particularly during the first four months of 2019.** Accordingly, time and savings deposits grew by 8.3 per cent (year-on-year) during the first eight months of 2019, compared to a growth of 14.2 per cent at end 2018, contributing entirely to the growth of broad money supply during the first eight months of 2019. In absolute terms, time and savings deposits of LCBs increased by Rs. 281.2 billion during the first eight months of 2019 compared to the increase of Rs. 560.1 billion recorded during the corresponding period of 2018.

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

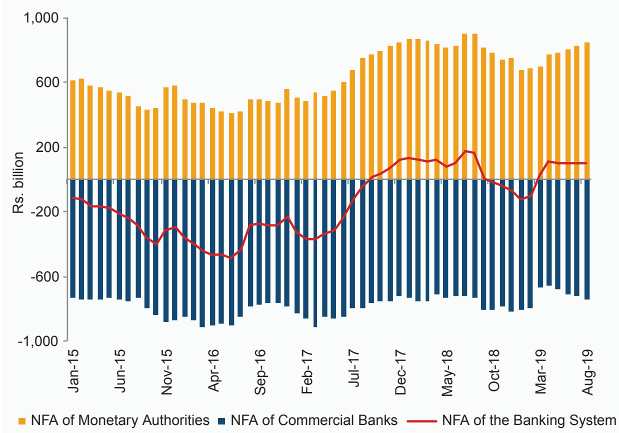


Source: Central Bank of Sri Lanka

- **An expansion in NFA of the banking system was observed during the first eight months of 2019 with the increase in NFA of both the Central Bank and LCBs.** Compared to end 2018, in absolute terms, NFA of the banking sector increased by Rs. 168.8 billion by end August 2019. NFA of the Central Bank recorded an increase of Rs. 97.9 billion during the first eight months of 2019 on account of the conversion of ISB proceeds and foreign exchange purchases by the Central Bank from the domestic market. Meanwhile, NFA of commercial banks increased by Rs. 70.9 billion in the first eight months of 2019 entirely due to the increase in NFA of Offshore Banking Units (OBUs). Accordingly, NFA of OBUs increased by Rs. 72.9 billion during the first eight months of 2019 with a larger decline in foreign liabilities compared to the increase in foreign assets. Foreign assets of OBUs increased due to the expansion in placements with banks abroad while foreign liabilities declined as a result of lower borrowings from banks abroad, amidst an increase in deposits from non-residents. In contrast, NFA of Domestic Banking Units (DBUs) declined by Rs. 2.0 billion during the first eight months of 2019, due to the increase in foreign currency liabilities, in terms of borrowings from banks abroad, while foreign currency assets in terms of placements with banks abroad by DBUs recorded a moderate increase.

- **NDA of the banking sector expanded at a slower pace, mainly driven by the moderate expansion in credit to the private sector during the first eight months of 2019.** In absolute terms, NDA of the banking system increased by Rs. 99.8 billion during the first eight months of 2019 compared to a significant increase of Rs. 513.0 billion observed during the corresponding period of 2018. The marginal expansion in NDA thus far in 2019 was mainly driven by credit provided to the government.

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



Source: Central Bank of Sri Lanka

- **Within NDA, NCG by the banking system continued to increase during the first eight months of 2019, entirely due to the increase in NCG by the LCBs through increased investment in the Government securities.** Accordingly, NCG by the banking system increased by Rs. 235.7 billion during the first eight months of 2019 compared to an increase of Rs. 103.4 billion in the corresponding period of 2018 and a total of Rs. 346.7 billion for 2018. NCG by LCBs increased by Rs. 357.5 billion during the first eight months of 2019 compared to the increase of Rs. 82.7 billion during the

Table 7.2
Domestic Credit Expansion (M_{2b}) and Contributory Factors

Period	Absolute Change (Rs. billion)				Share of Domestic Credit (%)		
	Domestic Credit	Credit to Private Sector	Net Credit to the Government	Credit to Public Corporations	Credit to Private Sector	Net Credit to the Government	Credit to Public Corporations
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
2018	1,327.3	762.1	346.7	218.4	57.4	26.1	16.5
Jan - Aug 2018	655.1	449.1	103.4	102.5	68.6	15.8	15.6
Jan - Aug 2019	**291.8**	**64.7**	**235.7**	**-8.5**	**22.2**	**80.8**	**-2.9**

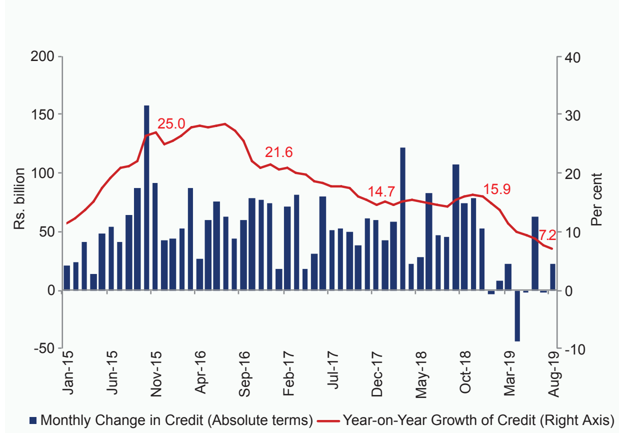
Source: Central Bank of Sri Lanka

corresponding period of 2018. NCG by DBUs increased significantly by Rs. 345.2 billion in the first eight months of 2019 following the increase of Rs. 92.1 billion in the corresponding period of 2018 with the increase in investment in Government securities. Reduction of SRR by 2.50 percentage points in two occasions in November 2018 and March 2019 provided additional liquidity to LCBs in an environment of a low demand for private sector credit. This resulted in a notable increase in investment in Government securities by LCBs. However, the government's overdraft balances with state banks contracted by Rs. 37.6 billion during the period under review. Following a contraction of Rs. 9.4 billion during the corresponding period of 2018, NCG by OBUs recorded an increase of Rs. 12.3 billion during the first eight months of 2019. Meanwhile, NCG from the Central Bank showed a notable decline by Rs. 121.9 billion during the first eight months of 2019 in contrast to an increase of Rs. 20.7 billion during the corresponding period of 2018, due to the decline in Treasury bill holdings (net of repurchase transactions) of the Central Bank.

- **Credit extended by the banking system to public corporations declined during the first eight months of 2019, mainly due to repayments made by some key state owned business enterprises (SOBEs).** Credit obtained by SOBEs from the banking system declined by Rs. 8.5 billion during the first eight months of 2019 compared to an increase of Rs. 102.5 billion in the corresponding period of 2018 and the increase of Rs. 218.4 billion in 2018. Contributing to this decline, the Ceylon Petroleum Corporation (CPC) settled around Rs. 32.3 billion of its outstanding liabilities to LCBs during the first eight months of 2019, while SriLankan Airlines also repaid their liabilities to LCBs amounting to Rs. 4.2 billion during this period. However, credit obtained by the Road Development Authority (RDA) from the banking sector increased by Rs. 19.9 billion during the first eight months of 2019, while borrowings by several other SOBEs, including the Ceylon Electricity Board (CEB) and National Water Supply & Drainage Board (NWS&DB) also increased during the period under review.

- **Following a higher than projected expansion of credit extended to the private sector by commercial banks in the past few years, credit to the private sector moderated during the first eight months of 2019, mainly due to high market lending rates, subdued economic activity and monetary, fiscal and regulatory action taken by the Central Bank and the government to contain macroeconomic imbalances observed in 2018.** Accordingly, in comparison to a growth of 15.9 per cent at end 2018, the year-on-year growth of credit to the private sector decelerated to 7.2 per cent by end August 2019. Meanwhile, the average growth of credit to the private sector was 10.3 per cent during the first eight months of 2019, compared to the growth of 15.3 per cent during 2018. In absolute terms, credit to the private sector increased only by Rs. 64.7 billion during the first eight months of 2019 compared to the substantial increase of Rs. 449.1 billion in the corresponding period of 2018. Settlement of arrears owed to private contractors by the government on account of various projects which enabled repayments to the banking sector, and uncertainty amongst economic agents following the Easter Sunday attacks also affected the demand for credit. Further, banks also adopted a cautious approach in granting credit due to rising non performing loans (NPLs) of the banking system. As per the security wise analysis of advances, increases

Figure 7.12
Credit Granted by Commercial Banks to the Private Sector

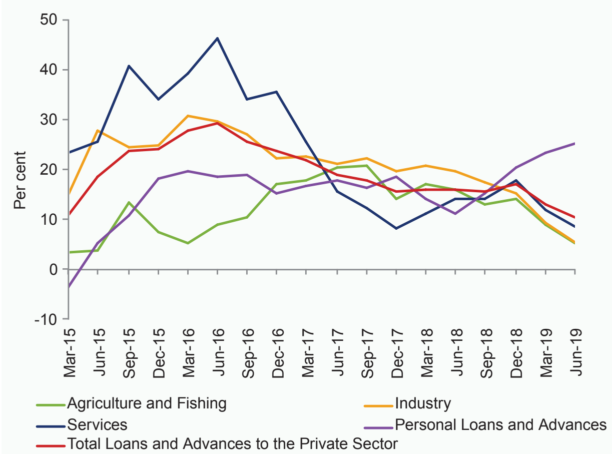


Source: Central Bank of Sri Lanka

in unsecured credit, and credit against Gold and Other Precious Metals under Pawning and Immovable Property contributed to the overall expansion in advances during the first eight months of 2019 while credit granted against Personal Guarantees and Promissory Notes, and Other Securities contracted during the year.

- **Growth of credit to all sectors except credit under Personal Loans and Advances decelerated in the first half of 2019, as per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector.** Accordingly, credit to the Agriculture sector grew by 5.3 per cent, on a year-on-year basis, by end June 2019, in comparison to a growth of 16.0 per cent during the same period of 2018. Within the Agriculture sector, credit to all sub sectors expanded, with credit to Vegetable and Fruit Cultivation and Minor Food Crops growing by 17.2

Figure 7.13
Year-on-Year Growth of Credit Granted by Commercial Banks to Key Sectors



Source: Central Bank of Sri Lanka

per cent, on a year-on-year basis, by end June 2019. With subdued industry related economic activity, credit to the Industry sector grew at a slow pace of 5.5 per cent, year-on-year, by end June 2019, although credit flows towards most of

Table 7.3
Classification of Outstanding Credit to the Private Sector Granted by Commercial Banks (a)(b)(c)

Rs. billion

Sector	End Jun 2018	End Dec 2018	End Jun 2019 (d)	Year-on-Year Change (June 18/June 19)	
				Amount	%
Agriculture and Fishing	**443.3**	**470.0**	**466.9**	**23.6**	**5.3**
of which, Tea	102.3	100.0	106.1	3.8	3.7
Rubber	27.5	34.4	28.0	0.6	2.1
Coconut	23.1	24.5	23.6	0.6	2.4
Paddy	33.8	35.7	37.3	3.5	10.3
Vegetables, Fruit and Minor Food Crops	28.1	37.9	33.0	4.8	17.2
Fisheries	17.1	20.1	20.1	3.0	17.7
Industry	**2,231.5**	**2,354.4**	**2,353.3**	**121.8**	**5.5**
of which, Construction	1,069.7	1,133.8	1,137.3	67.6	6.3
Food and Beverages	115.8	124.6	125.9	10.1	8.7
Textiles and Apparel	180.6	201.6	219.0	38.5	21.3
Fabricated Metal Products, Machinery and Transport Equipment	196.7	202.7	194.9	-1.8	-0.9
Services	**1,520.6**	**1,641.4**	**1,653.4**	**132.8**	**8.7**
of which, Wholesale and Retail Trade	455.9	486.7	492.7	36.7	8.1
Tourism	190.1	198.3	207.5	17.4	9.1
Financial and Business Services	356.3	396.3	361.0	4.7	1.3
Shipping, Aviation and Freight Forwarding	20.4	25.4	26.7	6.2	30.5
Personal Loans and Advances (e)	**1,081.2**	**1,267.4**	**1,351.8**	**270.6**	**25.0**
of which, Consumer Durables	215.2	228.4	232.6	17.4	8.1
Pawning	156.2	171.7	188.0	31.8	20.4
Credit Card	92.8	106.6	119.1	26.3	28.4
Total	**5,276.6**	**5,733.1**	**5,825.5**	**548.9**	**10.4**

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

Source: Central Bank of Sri Lanka

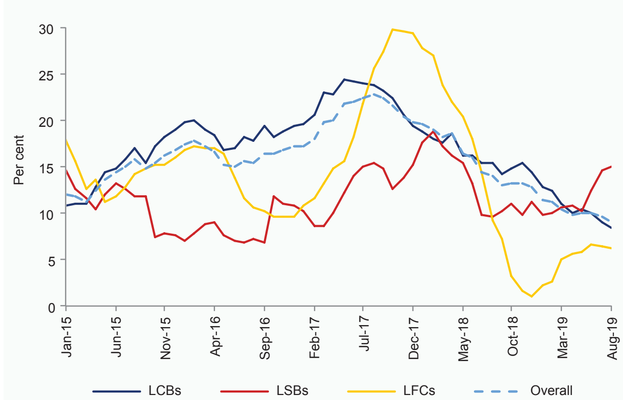
the sub sectors of the Industry sector recorded positive growth rates. Within Industry, credit to the Construction sector grew at a slower pace of 6.3 per cent, year-on-year, by end June 2019 compared to 18.5 per cent recorded at end June 2018. Meanwhile, growth in credit to the Services sector was 8.7 per cent, year-on-year, by end June 2019, compared to the growth of 14.2 per cent recorded during the corresponding period of 2018. Although credit flows to the Shipping, Aviation and Freight Forwarding sub sector recorded a high growth rate of 30.5 per cent, year-on-year, Financial and Business Services sector recorded a marginal growth of 1.3 per cent due to the contraction of 12.5 per cent of the sub sector of Leasing companies primarily due to the effect of policy measures that slowed motor vehicle imports. In contrast, credit under the Personal Loans and Advances category grew at a higher rate of 25.0 per cent, year-on-year, during the first half of 2019 compared to 11.2 per cent recorded in the corresponding period of 2018. Within this sector, Credit Cards and Pawning grew significantly by 28.4 per cent and 20.4 per cent, year-on-year, respectively, during the first half of 2019 in comparison to 13.2 per cent and 13.6 per cent recorded in the corresponding period of 2018.

Broad Money (M_4)

- **The growth of broad money supply (M_4), as measured by the Financial Survey[1], moderated during the first eight months of 2019 driven by the notable deceleration of credit to the private sector.** The year-on-year growth of M_4, which followed the same trend as M_{2b}, decelerated to 8.7 per cent, year-on-year, at the end of August 2019 compared to the growth of 12.0 per cent recorded at end 2018. Viewed from the liabilities side of M_4, total time and savings deposits held by the public at LCBs, Licensed Specialised Banks (LSBs) and Licensed Finance Companies (LFCs) grew by 9.0 per cent, year-on-year, by end August 2019, compared to 12.7 per cent at end 2018. During the period under review, time and savings deposits held at LSBs and LFCs grew by 15.0 per cent and 6.3 per cent, year-on-year, respectively, by end August 2019, compared to 11.3 per cent and 1.0 per cent, respectively, recorded at end 2018. On the assets side, the expansion in M_4 was due to the expansion in both NDA and NFA of licensed banks and LFCs, during the first eight months of 2019. Supporting to this expansion, NDA of LSBs and LFCs increased by Rs. 140.6 billion, while NFA of LSBs increased by Rs. 6.8 billion during the period under review.

- **Growth of credit to the private sector in M_4 also decelerated to 6.5 per cent, year-on-year, by August 2019 compared to 14.9 per cent at end 2018.** Growth of credit granted to the private sector by LSBs and LFCs decelerated notably to 9.8 per cent and 1.3 per cent, year-on-year, respectively, by the end of August 2019, compared to 11.4 per cent and 13.0 per cent, respectively, recorded at end 2018. In absolute terms, compared to the expansion of Rs. 610.6 billion in the corresponding period of 2018, the expansion in credit extended to the private sector amounted to Rs. 98.2 billion during the first eight months of 2019, contributing 25.5 per cent to the cumulative expansion in domestic credit. Further,

Figure 7.14
Year-on-Year Growth in Savings and Time Deposits (As per M_4)



Source: Central Bank of Sri Lanka

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

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

Rs. billion

Sector	End Aug-18	End 2018	End Aug-19 (a)	Year-on-Year Change			
				End 2018		Aug-19	
				Amount	%	Amount	%
Financial Survey (M_4)	8,403.3	8,729.6	9,132.8	933.7	12.0	729.5	8.7
Underlying Factors							
Net Foreign Assets	3.0	-133.7	41.9	-99.5	-291.2	38.9	1,281.6
Monetary Authorities	901.5	750.5	848.4	-95.6	-11.3	-53.1	-5.9
LCBs	-734.6	-817.5	-746.6	-92.9	-12.8	-12.0	-1.6
LSBs & LFCs	-163.8	-66.7	-59.9	89.1	57.2	103.9	63.4
Net Domestic Assets	8,400.3	8,863.3	9,090.9	1,033.2	13.2	690.6	8.2
Domestic Credit	10,679.4	11,355.1	11,740.7	1,513.3	15.4	1,061.3	9.9
Net Credit to the Government	2,903.5	3,098.6	3,394.5	319.6	11.5	491.0	16.9
Monetary Authorities	245.8	471.3	349.5	246.3	109.4	103.7	42.2
LCBs	2,026.1	2,043.9	2,401.4	100.5	5.2	375.3	18.5
LSBs	565.5	518.6	563.2	-27.1	-5.0	-2.3	-0.4
LFCs	66.1	64.8	80.4	0.0	-0.1	14.3	21.7
Credit to Public Corporations (LCBs)	639.5	755.4	746.9	218.4	40.7	107.4	16.8
Credit to the Private Sector	7,136.4	7,501.1	7,599.3	975.3	14.9	462.9	6.5
LCBs	5,248.4	5,561.4	5,626.0	762.1	15.9	377.7	7.2
LSBs	721.5	753.8	792.1	77.0	11.4	70.5	9.8
LFCs	1,166.5	1,185.9	1,181.2	136.1	13.0	14.7	1.3
Other Items (net) (b)	-2,279.1	-2,491.8	-2,649.8	-480.1	-23.9	-370.7	-16.3

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

Source: Central Bank of Sri Lanka

NCG under M_4 aggregates increased by Rs. 295.9 billion, during the first eight months of 2019 in absolute terms, with LSBs and LFCs contributing positively to the expansion by Rs. 44.6 billion and Rs. 15.7 billion, respectively.

Expected Developments

- **As the Central Bank has already made notable progress in institutionalising the pre-requisites for the transition towards flexible inflation targeting (FIT) over the past few years, sustaining this achievement would be a key priority in the coming years.** In this endeavour, continued commitment of the government towards fiscal consolidation as well as sound monetary and fiscal policy coordination would remain necessary conditions. During 2019, notable progress has been made in terms of drafting amendments to the central banking law. Strengthening of Central Bank independence, the establishment of a strong mandate for price stability with improved accountability and transparency and building effective fiscal-monetary coordination are the primary focus of the proposed amendments. In line with this, a key aspect of the proposed central banking law will be the restriction of monetary financing by the Central Bank. As it is imperative that the fiscal consolidation path of the government continues as envisaged, fiscal rules for Sri Lanka are expected to be strengthened. These binding fiscal rules, which are to be incorporated as an amendment to the Fiscal Management (Responsibility) Act No. 3 of 2003, would ensure greater fiscal discipline and support the Central Bank to successfully transition to a FIT framework which would yield low and stable inflation on a sustained basis to create a growth conducive economic environment.

- **While monetary policy will focus on sustaining inflation at mid-single digit levels, thereby facilitating growth, proactive efforts by the government to address short term supply side volatilities in inflation are essential.** The Central Bank would facilitate sufficient growth in credit flows to revive economic activities in the economy with the continuation of the accommodative monetary policy stance. Although the Central Bank has been successful in managing demand driven inflation and inflation expectations, weather driven increases in food prices, which are beyond the control of the Central Bank, could pose a threat to anchoring inflation expectations at desired levels. As such, timely and appropriate policy measures from the government are also essential to ensure price stability.

- **The introduction of new financial products with a reasonable return for savers, in particular senior citizens, has become an urgent requirement as deposit interest rates recede to single digit levels, affecting the living standards of citizens who depend on the interest income accruing from their savings.** Under FIT, inflation is expected to be maintained at mid-single digit levels on a sustained basis, which implies single digit market interest rates beyond the near term. This highlights the need to introduce new financial products with reasonable rates of return, particularly in the context of a rapidly ageing population. In a low interest rate environment, the general public should avoid approaching unauthorised establishments, which claim to offer unusually high returns. Such investments could eventually result in a loss of hard earned savings of the public.

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