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MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

Amidst the significant slowdown of economic activity with the spread of the COVID-19 pandemic, the Central Bank relaxed the accommodative monetary policy stance it adopted in early 2019 to unprecedented levels in 2020. The Central Bank reduced its policy rates by 50 basis points in January 2020 with a view to supporting the flow of credit to the private sector, while also foreseeing the likely impact of the global pandemic on the Sri Lankan economy. In March 2020, the Central Bank, in an emergency move, reduced both the policy interest rates and the Statutory Reserve Ratio (SRR) aimed at easing distress on the domestic financial market and economic activity. Further, several operational measures were taken by the Central Bank to ensure the provision of ample liquidity to the market, thereby enabling the banks to extend support to businesses and individuals hit by COVID-19. As a part of this endeavour, required financing to the Government was also provided by the Central Bank by way of profit transfers and purchases of Treasury bills from the primary market. In the absence of demand driven inflationary pressures and amidst the lockdown measures, the Central Bank eased its policy rates again during April and May 2020 to alleviate the impact of COVID-19 on businesses and individuals. Moreover, the Bank Rate was also reduced in April 2020 paving way for banks to approach the Central Bank for their emergency funding needs if necessary. Despite the multitude of measures adopted to ease credit conditions, the growth of credit to the private sector remained tepid, prompting the Central Bank to reduce the SRR further in June 2020 with the aim of increasing liquidity and reducing the cost of funds of banks further, thereby lowering lending rates for private sector borrowing. Simultaneously, the Central Bank introduced new credit schemes under the Section 83 of the Monetary Law Act (MLA) No.58 of 1949, to enable licensed banks to lend to the COVID-19 hit sectors of the economy at highly concessional rates for working capital purposes. However, as disbursement of credit to the private sector did not accelerate and market lending rates remained downward rigid, the Central Bank reduced the policy rates further by 100 basis points in July 2020 with a view to inducing a further reduction in market lending rates and prompting the financial system to aggressively channel lending to the productive sectors of the economy. Furthermore, the Central Bank took several regulatory measures in August 2020 to reduce excessive rates of interest charged on certain financial products, to support marginal borrowers and increase the appetite for borrowing. The gamut of measures adopted by the Central Bank has led to a faster passthrough of monetary policy resulting in a notable decline in market interest rates so far during the year. Reduced lending rates are expected to enhance the flow of credit to the private sector, reinforcing support to sectors affected by the pandemic as well as the broader economy. The expansion of private sector credit, together with the increase in credit to the public sector, is expected to result in a rapid expansion in broad money during the year, although an immediate threat to price stability is not envisaged. With the economy operating well below its estimated potential, inflation remained relatively subdued, although transitory increases in food prices caused headline inflation to accelerate during some months of the year. Going forward, over the medium term, inflation is expected to be maintained within the 4-6 per cent range with appropriate policy measures.

The Monetary Policy Stance of the Central Bank

- **In order to minimise the economic impact of the COVID-19 outbreak and the resultant containment measures, the Central Bank promptly eased monetary conditions by adopting an extremely accommodative monetary policy stance, which was supported by muted inflation and well anchored inflation expectations**. The Central Bank commenced monetary easing in 2019 by reducing its policy rates, namely, the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), by 100 basis points in two occasions and the SRR by 1.00 percentage point, and signaled to the market of the continuation of eased policy stance amidst prolonged subdued economic growth. The Central Bank further reduced its policy rates by 50 basis points in January 2020, being the first central bank to reduce policy interest rates following the outbreak of COVID-19 globally. In order to support the businesses and individuals affected by the pandemic and to ensure a speedy revival in economic activity, urgent policy interventions were required. Accordingly, the Central Bank, in emergency moves, reduced policy rates further by a cumulative 100 basis points, consecutively on three occasions in March, April and May 2020 with a view to lowering market lending rates and easing market conditions, thereby enabling the domestic financial market to provide further relief to businesses and individuals. Furthermore, the Central Bank reduced the SRR applicable on all rupee deposit liabilities of commercial banks by 3.00 percentage points in two steps, in March and June 2020, thereby providing additional liquidity of around Rs. 180 billion to the domestic money market that helped increase money market liquidity substantially. Meanwhile, as the pandemic resulted in a nationwide lockdown from mid March through early May 2020, and affected the Government's revenue mobilisation and expenditure rationalisation, the Central Bank accommodated the Government's request for required emergency financing by way of purchasing Treasury bills from the primary market. Moreover, in early July, with a lower than expected reduction in lending interest rates, the

Table 7.1
Recent Monetary Policy Measures

Date	Measure
02 Mar 2015	Withdrawal of the 5.00% special SDF rate, which was applied on OMO participants who deposit at the SDF more than three times per calendar month.
15 Apr 2015	SDFR and SLFR reduced by 50 basis points to 6.00% and 7.50%, respectively.
03 Sep 2015	The exchange rate allowed to be determined based on demand and supply conditions in the foreign exchange market.
30 Dec 2015	SRR increased by 1.50 percentage points to 7.50% to be effective from the reserve period commencing 16 Jan 2016.
19 Feb 2016	SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.
28 Jul 2016	SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.
24 Mar 2017	SDFR and SLFR increased by 25 basis points to 7.25% and 8.75%, respectively.
04 Apr 2018	SLFR reduced by 25 basis points to 8.50%. Accordingly, the width of the SRC narrowed to 125 basis points from 150 basis points.
14 Nov 2018	SRR reduced by 1.50 percentage points to 6.00% to be effective from the reserve period commencing 16 Nov 2018. SDFR increased by 75 basis points to 8.00% and SLFR increased by 50 basis points to 9.00%. Accordingly, the width of the SRC narrowed to 100 basis points from 125 basis points.
22 Feb 2019	SRR reduced by 1.00 percentage point to 5.00% to be effective from the reserve period commencing 01 Mar 2019.
31 May 2019	SDFR and SLFR reduced by 50 basis points to 7.50% and 8.50%, respectively.
23 Aug 2019	SDFR and SLFR reduced by 50 basis points to 7.00% and 8.00%, respectively.
30 Jan 2020	SDFR and SLFR reduced by 50 basis points to 6.50% and 7.50%, respectively.
17 Mar 2020	SDFR and SLFR reduced by 25 basis points to 6.25% and 7.25%, respectively.
17 Mar 2020	SRR reduced by 1.00 percentage point to 4.00% to be effective from the reserve period commencing 16 Mar 2020.
27 Mar 2020	Introduced a concessional loan scheme, the Saubagya COVID-19 Renaissance Facility (Phase I - Refinance Scheme), up to a cumulative value of Rs. 50 billion at an interest rate of 4.00% to support the COVID-19 hit businesses.
03 Apr 2020	SDFR and SLFR reduced by 25 basis points to 6.00% and 7.00%, respectively, to be effective from the close of business on 03 Apr 2020.
16 Apr 2020	Bank rate reduced by 500 basis points to 10.00% and allowed to automatically adjust in line with the SLFR, with a margin of +300 basis points.
06 May 2020	SDFR and SLFR reduced by 50 basis points to 5.50% and 6.50%, respectively, to be effective from the close of business on 06 May 2020. Bank Rate automatically reduced to 9.50%.
16 Jun 2020	SRR reduced by 2.00 percentage points to 2.00% to be effective from the reserve period commencing 16 June 2020.
16 Jun 2020	Extended the concessional loan scheme introduced on 27 Mar 2020 up to Rs. 150 billion at an interest rate of 4.00% to support the COVID-19 hit businesses (the Saubagya COVID-19 Renaissance Facility - Phase II)
09 Jul 2020	SDFR and SLFR reduced by 100 basis points to 4.50% and 5.50%, respectively. Bank Rate automatically reduced to 8.50%.

Note:
The Central Bank imposed caps on interest rates as follows:
- 26.04.2019: Imposed interest rate caps on deposit products of licensed banks and non-bank financial institutions
- 24.09.2019: Imposed caps on lending rates while withdrawing caps on deposit rates of licensed banks
- 27.04.2020: Imposed interest rate caps on pawning advances of licensed banks
- 24.08.2020: Tightened interest rate caps on selected lending products

Source: Central Bank of Sri Lanka

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Figure 7.1
Monetary Sector Developments

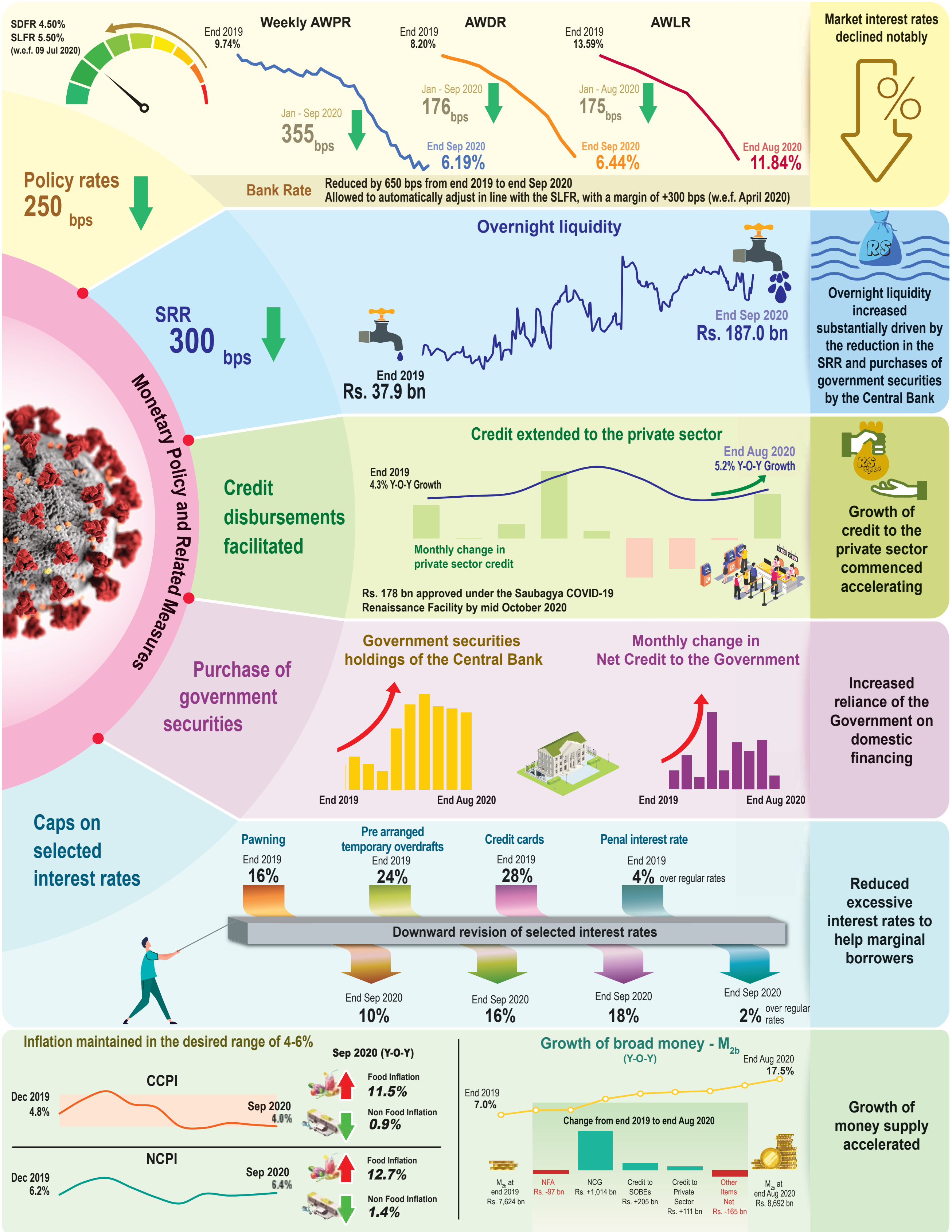
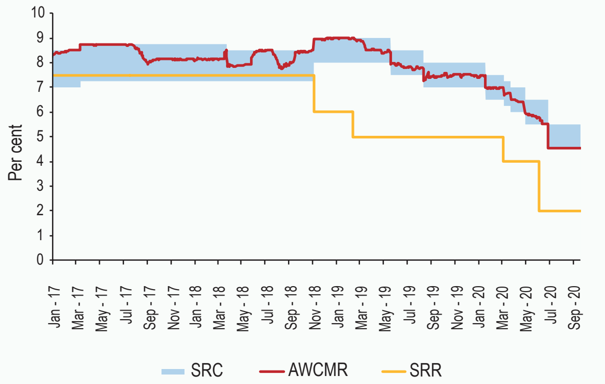


Figure 7.2
The Standing Rate Corridor (SRC), the Average Weighted Call Money Rate (AWCMR) and the Statutory Reserve Ratio (SRR)



Source: Central Bank of Sri Lanka

Central Bank reduced its policy rates, the SDFR and the SLFR, by 100 basis points each, to their lowest levels of 4.50 per cent and 5.50 per cent, respectively. Further, the Central Bank, with a view to indicating the availability of emergency funding at reduced rates of interest, lowered the Bank Rate by 500 basis points in April 2020, while allowing it to be determined automatically with a margin of 300 basis points above the SLFR. Accordingly, the Bank Rate declined by a total of 650 basis points to 8.50 per cent during the year by end September 2020. Reflecting these monetary easing measures, market lending rates declined notably by end July 2020. However, to expedite the monetary policy transmission process and help marginal borrowers, the Central Bank adopted further regulatory measures in August 2020 to reduce excessive interest rates charged on credit cards, pawning, pre-arranged temporary overdrafts as well as penal interest rates. In spite of the reduction in market lending rates and the availability of large domestic rupee liquidity, credit disbursements to the private sector remained tepid, reflecting the risk averse behaviour of financial institutions amidst the pandemic and subdued economic activity. In view of the above, the Central Bank implemented concessional credit schemes to provide finance to needy sectors of the economy and support the revival of economic activity.

- **The implementation of monetary policy focused on reviving the economy in the near term, given subdued inflationary pressures.** The medium term objective of monetary policy continued to be maintaining inflation in mid-single digit levels, while supporting the economy to reach its potential growth path. The monetary policy framework continued to conform to the premise of flexible inflation targeting, where the Average Weighted Call Money Rate (AWCMR) serves as the operating target, and is maintained at desired levels in accordance with the Central Bank's objective of maintaining inflation within the target of 4-6 per cent. Given the low inflation environment and well anchored inflation expectations, the Central Bank adopted several policy easing measures aimed at supporting businesses and individuals and reviving subdued growth in the near term. Eased monetary conditions along with fiscal stimulus measures are expected to boost aggregate demand gradually, facilitating a recovery in economic activity hampered by the COVID-19 pandemic. Although the lagged impact of monetary and fiscal stimulus measures could fuel demand driven inflationary pressures in the period ahead, once economic activity improves, inflation is expected to be maintained within the range of 4-6 per cent over the medium term with appropriate policy responses, while supporting a sustained growth in the economy.

- **The Central Bank continued to improve its communication strategy, with a view to raising awareness among stakeholders on the Central Bank's monetary policy stance and intended outcomes of macroeconomic policy measures.** The Central Bank published the *Road Map 2020: Monetary and Financial Sector Policies for 2020 and Beyond* at the beginning of the year, delivering broadbased plans on the macroeconomic policies forthcoming in the period ahead. The publication of the advance release calendar in the Road Map to announce the monetary policy stance of the Central Bank and the release of the Monetary Policy Review highlighting the economic rationale underlying

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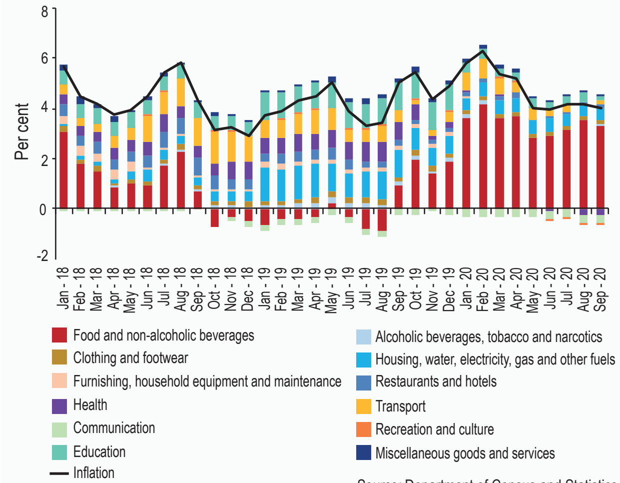
the monetary policy decisions, helped anchor inflation expectations, while facilitating forward looking monetary policy. However, unprecedented circumstances brought about by COVID-19 necessitated the Central Bank to implement an array of measures outside the advance release calendar. On such occasions, explanations for the decisions taken were provided, informing the public and the financial market of the underlying circumstances which warranted such measures. Further, press conferences on the regular review of the monetary policy stance and live webcasting of the same on social media continued, providing real time access to information to a broader spectrum of viewers. As the first step towards publishing a Monetary Policy Report, the Central Bank commenced publishing medium term projections on inflation in the monetary policy review press releases. Publishing of medium term inflation projections is considered key to enhancing the confidence of stakeholders on the Central Bank's continued commitment towards maintaining inflation at the desired level, while such information is expected to assist stakeholders in making informed savings and investment decisions. Meanwhile, the flagship publication of the Central Bank, the Annual Report, was published within the stipulated time, amidst challenges encountered due to COVID-19. Information dissemination to the general public continued via several means including media releases, public notices, other publications, information briefs in all three languages and through awareness programmes, seminars, lectures, meetings, and speeches conducted by the Central Bank officials including the Governor. In addition, key macroeconomic statistics were published through the Central Bank website in daily, weekly, monthly and quarterly frequencies.

- **Headline inflation based on the Colombo Consumer Price Index (CCPI, 2013=100) remained within the targeted range of 4-6 per cent so far during 2020, except in February**. Apart from an uptick observed in the early months of the year owing to the rise in food inflation,

Figure 7.3

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

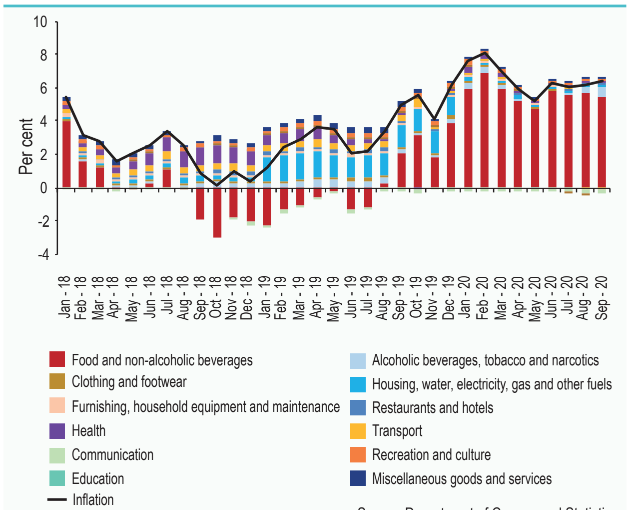


Source: Department of Census and Statistics

inflation remained within the desired levels thus far during the year. Inflation based on the National Consumer Price Index (NCPI, 2013=100) also showed a similar trend, although remaining relatively high due to its larger weight on the food category. Headline inflation as measured by the year-on-year change in CCPI, peaked at 6.2 per cent in February 2020 compared to 4.8 per cent in December 2019, driven by an acceleration in food inflation due to adverse weather conditions and the low base that prevailed in the corresponding period of the previous year. However, with the gradual moderation of food

Figure 7.4

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



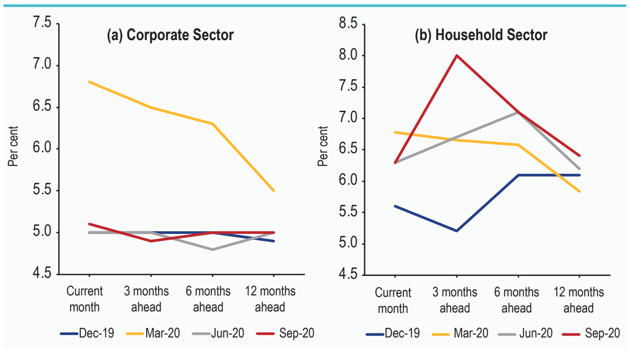
Source: Department of Census and Statistics inflation, headline inflation remained subdued thereafter. Accordingly, CCPI based headline inflation moderated to 4.0 per cent, year-on-year, by September 2020. On an annual average basis, headline inflation stood at 4.7 per cent in September 2020, compared to 4.3 per cent at end 2019. Following a similar trend, year-on-year headline inflation based on NCPI also peaked at 8.1 per cent in February 2020, before moderating to 6.4 per cent by September 2020. Accordingly, the annual average NCPI based headline inflation accelerated to 6.2 per cent in September 2020, compared to 3.5 per cent at end 2019. The near term projections indicate that headline inflation is likely to remain within the targeted range during the remainder of 2020. However, the lagged impact of fiscal and monetary measures aimed at stimulating the economy and the gradual normalisation of global oil prices could exert upward pressures on inflation over the medium term once economic conditions normalise. Nevertheless, with appropriate monetary policy measures, inflation is expected to be maintained within the targeted levels over the medium term.

- **Core inflation, which is an indicator of the demand driven component of inflation, reflected subdued demand conditions thus far during the year**. Low core inflation also reflected the impact of a reduction in prices of telecommunication and data services with the reduction of the telecommunication levy, while the reduction in Value Added Tax on the supply of services and imports of goods, effective from December 2019 also supported subdued core inflation. However, a slight acceleration in core inflation was observed in July 2020, mainly due to by the increase in the prices of certain non volatile food items. In addition, an upward revision to the Housing and Education subcategories in January 2020 led to a one-time adjustment in year-on-year core inflation. Nevertheless, year-on-year core inflation based on CCPI decelerated to 2.9 per cent in September 2020, compared to 4.8 per cent at end 2019, while annual average core inflation decelerated to 3.6 per cent in September 2020, compared to 5.5 per cent at end 2019. Following a similar trend, year-on-year core inflation based on NCPI, which stood at 5.2 per cent at end 2019, decelerated to 4.8 per cent by September 2020, while annual average core inflation decelerated to 4.3 per cent in September 2020, from 5.7 per cent at end 2019.

- **Inflation expectations of the corporate sector remained contained in mid single digit levels, while those of the household sector remained relatively high**. As reflected in the Inflation Expectations Survey of the Central Bank, inflation expectations of the corporate sector increased during the period of the nationwide lockdown, before decelerating and settling around the levels observed at the beginning of the year, by the third quarter of 2020. Factors that drove inflation expectations downward included the expected developments in the domestic supply side and subdued demand amidst the outbreak of COVID-19, while factors driving inflation expectations upward included the expected recovery in aggregate demand supported by stimulus measures, relaxed monetary policy and the expected pickup in credit growth. In contrast, inflation expectations of the household sector remained somewhat elevated during the first three quarters of the year. The expected decline in domestic production along with the impact of COVID-19, increase in pre-election government expenditure, import restrictions, higher demand during the festive seasons and the depreciation of the rupee were highlighted by the respondents

Figure 7.5

Median Inflation Perceptions/Expectations (Y-o-Y)



Source: Central Bank of Sri Lanka

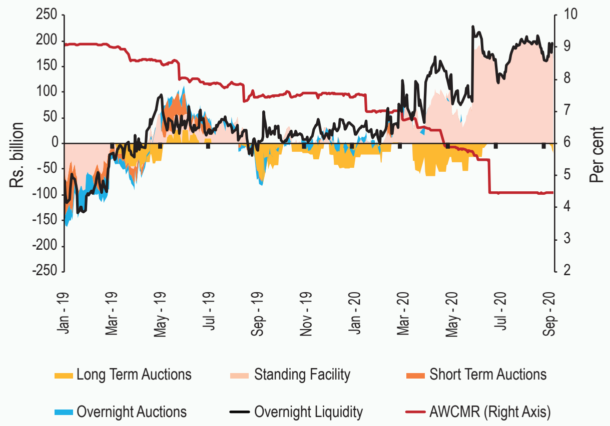
of the household sector as factors affecting expectations on higher future inflation. Expectations on import relaxation, gradual improvements in domestic production and the reduction in indirect taxes and government expenditure were among the reasons cited for lowering inflation expectations.

Movements in Interest Rates

Market Liquidity, Market Operations and Short Term Interest Rates

- **Surplus rupee liquidity in the domestic money market was maintained at high levels since the outbreak of the COVID-19 pandemic**. Domestic money market liquidity, which remained broadly in surplus levels since mid April 2019, averaged around Rs. 30 billion during the year 2020 up to mid March. However, the occasional asymmetric distribution of liquidity drove the Central Bank to conduct reverse repurchase auctions in order to maintain the AWCMR at desired levels. The outbreak of COVID-19 and the urgent need to support domestic economic activity by enhancing credit flows to COVID-19 hit businesses led the Central Bank to reduce the SRR applicable on all rupee deposit liabilities of commercial banks by a total of 3.00 percentage points to 2.00 per cent[1] on two occasions so far during the year, thereby releasing additional liquidity of around Rs. 180 billion to the domestic money market on a permanent basis. Such injection of liquidity assured the availability of sufficient funds for the financial market to counter any adverse impact arising from uncertainties, while also reducing the cost of funds of licensed commercial banks (LCBs). The Central Bank's profit transfers to the Government as well as the purchase of government securities from the primary market to fulfill urgent cash requirements of the Government, under exceptional circumstances, caused domestic money market liquidity to increase further. Moreover, the Central

Figure 7.6
Rupee Liquidity in the Domestic Money Market and Liquidity Management



Source: Central Bank of Sri Lanka

Bank signaled its readiness to provide liquidity to domestic financial markets, as necessary, to mitigate any adverse impact stemming from the COVID-19 outbreak. Accordingly, in spite of the surplus liquidity conditions in the market, the Central Bank conducted overnight, short term and long term reverse repurchase auctions for LCBs, while also providing additional liquidity through the liquidity support facility (LSF) for standalone primary dealers. As a result of these measures, overnight market liquidity increased to around Rs. 220 billion by mid June 2020 with the AWCMR adjusting downwards towards the lower bound of the policy rate corridor. However, due to scheduled foreign loan repayments, reverse repurchase maturities as well as Treasury bill maturities, market liquidity declined gradually to around Rs. 120 billion by the last week of July 2020. Domestic money market liquidity increased thereafter with the Central Bank purchasing foreign currency from the domestic foreign exchange market, foreign currency swaps and disbursements of credit through the Saubagya COVID-19 Renaissance credit facility scheme. Meanwhile, the Central Bank purchased government securities from the primary market towards end September and early October 2020 to assist the Government in its scheduled foreign loan repayments. However, to partially counter liquidity absorptions resulting from scheduled foreign loan repayments falling due in early October, the Central Bank proactively

1 With the reduction of the SRR to 2 per cent, the Central Bank also reduced the till cash adjustment for the SRR compilation from 2 per cent (based on currency notes and coins maintained between 2-4 per cent of average rupee deposit liabilities) to 1 per cent (based on currency notes and coins maintained between 2-3 per cent of average rupee deposit liabilities).

recommenced conducting term reverse repo auctions and liquidity support facility in late September 2020. Accordingly, overnight market liquidity remained around Rs. 180 billion by mid October 2020.

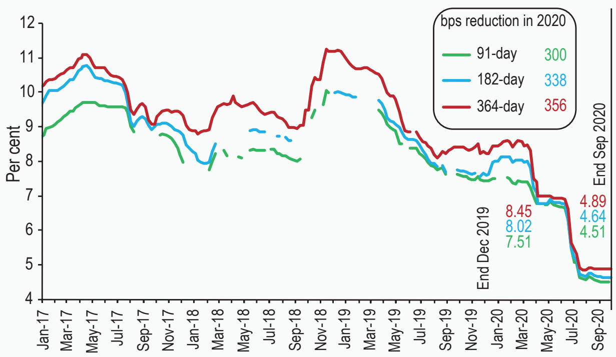
- **In response to the surplus liquidity conditions in the domestic money market, the AWCMR gradually adjusted downwards to the lower bound of the policy rate corridor**. The reduction in policy interest rates by a total of 250 basis points since January 2020 together with the slashing of the SRR by a total of 3.00 percentage points thus far in 2020, led the AWCMR to decline by 292 basis points to 4.53 per cent by end September 2020. Further, weighted average yields of transactions in the repo market also followed a similar trend. However, an uptick was observed in the average weighted repo rate mid September 2020 onwards due to the asymmetric distribution of liquidity, particularly among standalone primary dealers. Accordingly, the weighted average yield of transactions in the repo market was recorded at 4.58 per cent by end September 2020. Meanwhile, the Central Bank discontinued the compilation and publication of the Sri Lanka Interbank Offered Rate (SLIBOR) with effect from 01 July 2020. This decision was taken considering the lack of usage of SLIBOR in benchmarking loan products in the domestic financial market, the global trend of phasing out the compilation and publication of offered rates including the London Interbank Offered Rate (LIBOR), requests from several LCBs to discontinue the reporting of offered rates in the context of thin interbank market volumes for longer tenures, and the availability of alternative benchmark interest rates in the domestic financial market.

Yields on Government Securities

- **Yields on Treasury bills declined substantially so far during 2020 in response to the reduction in policy interest rates, increased purchases of government securities by the banking sector and the imposition of maximum yield rates for acceptance at Treasury bill auctions**.

Figure 7.7

Primary Market Treasury Bill Yields (a)



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

Source: Central Bank of Sri Lanka

Although yields on Treasury bills recorded an increase towards the end of 2019 until end January 2020 due to the increased funding requirements of the Government and uncertainty about the direction of fiscal policy, yields began to decline substantially since then. While this reduction was partly due to the administrative rate ceilings that were imposed by the Government from April 2020 onwards at Treasury bill auctions, the overall reduction in market interest rates following the reduction in policy interest rates, the market preference towards investing in risk free assets during the pandemic, and the availability of Central Bank financing to the Government given the exceptional circumstances created by the pandemic, also contributed to the significant reduction in Treasury bill yields. The availability of surplus liquidity in the domestic money market amidst sluggish growth of credit to the private sector, resulted in a rise in investment in Treasury bills by the banking sector. Nevertheless, some pressure on yields of Treasury bills was observed in early August and since mid September 2020 owing to increased borrowings by the Government and adverse market speculation triggered by the downgrade of the sovereign rating by Moody's Investors Service. However, the market stabilised soon afterwards.

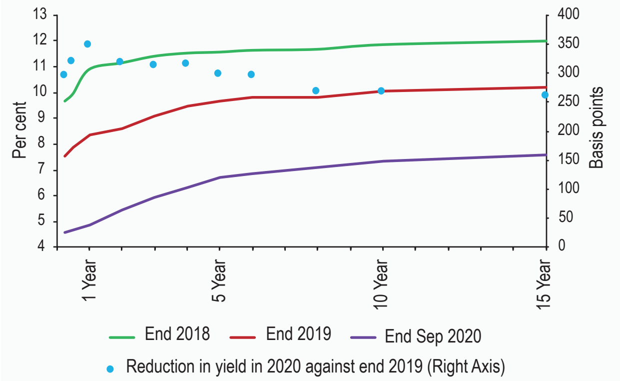
- **Yields on Treasury bonds in the primary market also showed a declining trend during the January to August period of 2020 in line**

with Treasury bill yields. As the market appetite for investments in longer term bonds was low amidst uncertainties triggered by the COVID-19 outbreak, the Government issued short to medium term Treasury bonds with maturities of less than 10 years so far during the year up to September 2020, with the only exception being the issuance of a 10 year bond in mid January 2020. However, as Government borrowing continued unabated, an uptick was observed in yields of certain tenors since late July 2020. In addition to rupee denominated Treasury bills and bonds, the Government has also issued US dollar denominated Sri Lanka Development Bonds (SLDBs) at various fixed and floating rates, over six auctions so far during 2020. The Government raised US dollars 420 million in total at fixed interest rates in the range 5.70-6.87 per cent, and floating rate agreements with margins in the range of 388-609 basis points, over 6-month LIBOR. The bleak global economic outlook due to the COVID-19 pandemic led to increased levels of perceived risk of International Sovereign Bonds (ISBs), resulting in an unprecedented rise in secondary market yields during the period from April to June 2020, although some normalisation was observed since then until early September 2020. Sovereign yields rose again towards the end of September 2020 as investor sentiment was impacted by the downgrade of Sri Lanka's sovereign rating by Moody's Investors Service. However, with the successful repayment of the ISB matured in early October, a turnaround is expected in sovereign yields in the period ahead.

- **Emulating the reduction in yields across all maturities in the primary market, the secondary market yield curve on government securities also adjusted downwards by end September 2020 compared to end 2019.** The reduction in yields on short term maturities was higher than that on longer term yields, reflecting the increased appetite for investment in short term risk free assets due to uncertainties associated with the pandemic.

Figure 7.8

Movements in the Secondary Market Yield Curve



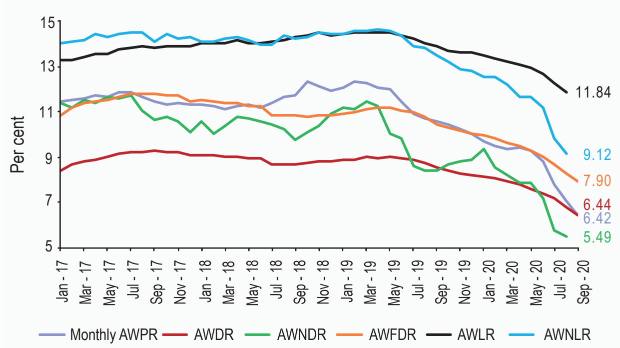
Source: Central Bank of Sri Lanka

Deposit and Lending Rates

- **Market deposit rates declined markedly responding to monetary easing measures taken during 2020.** Accordingly, significant reductions were observed in all four average weighted deposit rates compiled by the Central Bank. The Average Weighted Deposit Rate (AWDR)[2] and the Average Weighted Fixed Deposit Rate (AWFDR)[3] declined by 176 basis points and 215 basis points, respectively, during the nine months ending in September 2020, while the Average Weighted New Deposit Rate (AWNDR)[4] and the Average Weighted New Fixed

Figure 7.9

Movement of Selected Market Interest Rates



Source: Central Bank of Sri Lanka

2 AWDR reflects the movements in interest rates pertaining to all outstanding interest bearing rupee deposits held with commercial banks.

3 AWFDR is based on interest rates pertaining to all outstanding interest bearing rupee time deposits held with commercial banks.

4 AWNDR is based on interest rates pertaining to all new interest bearing rupee deposits mobilised by commercial banks during a particular month.

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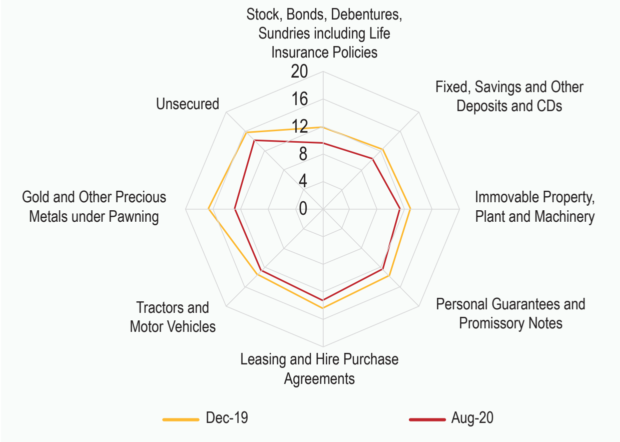
Deposit Rate (AWNFDR)[5] declined by 340 basis points and 351 basis points, respectively, during the eight months ending in August 2020. As per the data reported for August 2020 under AWNDR, new fixed deposit rates of several maturities offered by major commercial banks, particularly at the shorter end, and the rates on savings deposits were in the range of 2.50-7.00 per cent. Although inflation is low, substantially low deposit rates carry the risk of yielding negative real returns for some depositors.

- **Lending rates of commercial banks, which initially remained downward rigid in spite of the series of monetary easing measures, declined recently showing an accelerated adjustment**. The weekly Average Weighted Prime Lending Rate (AWPR)[6] declined notably by 355 basis points during the period from end 2019 to end September 2020, recording at 6.19 per cent, the lowest recorded in history so far. Meanwhile, the monthly AWPR, which is the average rate of weekly AWPR, declined by 358 basis points to 6.42 per cent by end September 2020. The interest rate spread between weekly AWPR and AWCMR, which remained relatively unchanged during the early phase of the current policy easing cycle, began to narrow July 2020 onwards, implying a reduction of interest margins charged on loans by commercial banks.

Figure 7.11

Average Weighted Lending Rates by Type of Security (%)

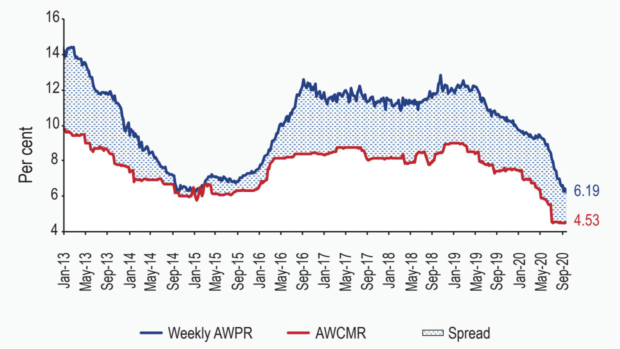


Source: Central Bank of Sri Lanka

Meanwhile, the Average Weighted Lending Rate (AWLR)[7] declined by 175 basis points to 11.84 per cent by end August 2020 from 13.59 per cent at end 2019. A reduction of average weighted lending rates was observed on loans granted against all types of securities from end 2019 to August 2020. Meanwhile, the Average Weighted New Lending Rate (AWNLR)[8] declined by 368 basis points thus far during the year to 9.12 per cent up to end August 2020. Following a similar trend, real lending rates also adjusted downwards by end August 2020 amidst the low inflation environment. Despite the downward adjustment of most lending rates of LCBs,

Figure 7.10

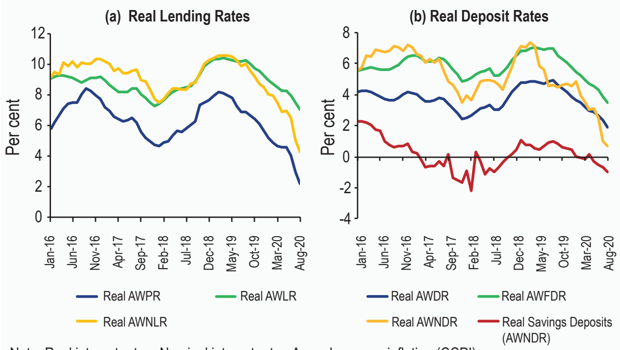
Spread between AWPR and AWCMR



Source: Central Bank of Sri Lanka

Figure 7.12

Movement of Real Interest Rates



Note: Real interest rate = Nominal interest rate - Annual average inflation (CCPI)

Source: Central Bank of Sri Lanka

5 AWNFDR is based on interest rates pertaining to all new interest bearing rupee time deposits mobilised by commercial banks during a particular month.

6 AWPR is based on interest rates applicable to short term rupee loans and advances granted by commercial banks to their prime customers during a particular week.

7 AWLR is based on interest rates pertaining to all outstanding rupee loans and advances extended by commercial banks.

8 AWNLR is based on interest rates pertaining to all new rupee loans and advances extended by commercial banks during a particular month.

certain lending products continued to charge considerably high interest rates. Therefore, with a view to streamlining the reduction in interest rates across the overall lending rate structure, thereby easing the burden on marginal borrowers, the Central Bank tightened the interest rate ceilings applicable on credit cards, pre-arranged temporary overdrafts, pawning facilities and penal interest rates in August 2020.

Interest Rates on Debt Instruments

- **Interest rates applicable on corporate debt instruments, which remained broadly unchanged during the first half of 2020, showed signs of downward adjustment thereafter**. Interest rates on commercial paper, which is a short term debt instrument, remained in the range of 9.00-15.50 per cent by August 2020, compared to the range of 13.00-16.25 per cent at end 2019. Meanwhile, six corporates reported 12 new listings of debentures during the period from January to September 2020 with maturities of 3 and 5 years, in comparison to the 30 new listings reported in 2019. Fixed interest rates offered on these issuances were in the range of 9.50-13.25 per cent by end September 2020, compared to the range of 12.30-15.50 per cent at end 2019, showing signs of downward adjustment of rates on corporate debt, thus far in 2020.

Interest Rates on Foreign Currency Deposits

- **Interest rates applicable on foreign currency deposits maintained with commercial banks showed mixed movements during the nine months ending in September 2020**. Interest rates on US dollar denominated savings deposits were reported in the range of 0.03-4.75 per cent by end September 2020, compared to the range of 0.02-4.50 per cent at end 2019. Interest rates pertaining to savings deposits denominated in pound sterling remained in the range of 0.03-2.00 per cent by end September 2020, compared to 0.10-2.46 per cent at end 2019. Meanwhile,

Table 7.2
Movements of Interest Rates

Per cent per annum

Interest Rate	End 2019	End Sep 2020	Change in bps
Policy Interest Rates			
Standing Deposit Facility Rate (SDFR)	7.00	4.50	-250
Standing Lending Facility Rate (SLFR)	8.00	5.50	-250
Average Weighted Call Money Rate (AWCMR)	7.45	4.53	-292
Yield Rates on Government Securities			
Primary Market (a)			
Treasury bills			
91-day	7.51	4.51	-300
182-day	8.02	4.64	-338
364-day	8.45	4.89	-356
Treasury bonds			
2-year	9.79	5.65	-414
3-year	9.65	5.72	-393
4-year	-	8.70	-
5-year	9.87	6.59	-328
10-year	10.23	9.99	-24
Secondary Market			
Treasury bills			
91-day	7.52	4.56	-296
182-day	7.88	4.67	-321
364-day	8.36	4.88	-348
Treasury bonds			
2-year	8.60	5.43	-317
3-year	9.08	5.94	-314
4-year	9.46	6.31	-315
5-year	9.67	6.69	-298
10-year	10.05	7.36	-269
Licensed Commercial Banks (b)			
Interest Rates on Deposits			
Savings Deposits	0.20-7.50	0.10-7.00	-
1-year Fixed Deposits (c)	3.55-15.00	0.25-15.00	-
Average Weighted Deposit Rate (AWDR) (d)	8.20	6.44	-176
Average Weighted Fixed Deposit Rate (AWFDR) (d)	10.05	7.90	-215
Average Weighted New Deposit Rate (AWNDR) (d)	8.89	5.49 (e)	-340
Average Weighted New Fixed Deposit Rate (AWNFDR) (d)	9.17	5.66 (e)	-351
Interest Rates on Lending			
Average Weighted Prime Lending Rate (AWPR)-Monthly	10.00	6.42	-358
Average Weighted Lending Rate (AWLR)	13.59	11.84 (e)	-175
Average Weighted New Lending Rate (AWNLR)	12.80	9.12 (e)	-368
Other Financial Institutions (f)			
Interest Rates on Deposits			
National Savings Bank			
Savings Deposits	4.00	3.50	-50
1-year Fixed Deposits	9.83	5.50	-433
Licensed Finance Companies (g)			
Savings Deposits	5.14-7.10	4.23-5.90 (e)	-
1-year Fixed Deposits	10.98-11.97 (h)	8.19-9.03 (e)	-
Interest Rates on Lending			
National Savings Bank	12.00-14.50	7.00-10.00	-
State Mortgage and Investment Bank (i)	10.25-18.00	8.50-12.50	-
Licensed Finance Companies (g)			
Finance Leasing	14.75-27.40 (h)	15.15-26.60 (e)	-
Hire Purchase	13.40-24.82	13.00-24.31 (e)	-
Loans against Real Estate	15.53-16.71	23.08-25.80 (e)	-
Corporate Debt Market			
Debentures	12.30-15.50	9.50-13.25	-
Commercial Paper	13.00-16.25	9.00-15.50 (e)	-

(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. Same method was applied to calculate AWNDR and AWNFDR since June 2018.
(e) As at end August 2020
(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 2020 are provisional.
(h) Revised
(i) Lending for housing purposes only.

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

interest rates on time deposits denominated in US dollars were in the range of 0.10-6.00 per cent by end September 2020, in comparison to the range of 0.20-5.50 per cent recorded at the end of 2019. Further, interest rates applicable on pound sterling denominated time deposits were in the range of 0.05-4.25 per cent by end September 2020, compared to the range of 0.10-3.52 per cent at end 2019. The Government, in consultation with the Central Bank, introduced Special Deposit Accounts (SDA) in April 2020 to attract foreign currency deposits to the country amidst the COVID-19 outbreak. These SDAs are offered interest rates of 1.00 percentage point above the normal rate for six month deposits and 2.00 percentage points above the normal rate for twelve month deposits.

Movements in Money and Credit Aggregates

Reserve Money

- **Reserve money expansion peaked in mid April, before contracting markedly thereafter as a result of the second round of reduction in the SRR during the year in mid June 2020**. The year began with reserve money remaining lower than the levels in the previous year. But reserve money gradually commenced expanding as it approached the festive season. However, considering the impact of the outbreak of COVID-19 on the domestic economy and financial markets, the Central Bank took steps to reduce the SRR in March 2020 with a view to easing policy and credit conditions, which resulted in a drop in reserve money driven by the decline in commercial banks' deposits with the Central Bank. With uncertainty mounting with the spread of COVID-19 and associated lockdowns, precautionary demand for money increased, resulting in a surge in currency in circulation from the latter half of March through mid April 2020 by around Rs. 138 billion. Although the spread of COVID-19 was contained to a great extent towards late May 2020, the return of currency was noticeably slower than expected, partly due to the reduced opportunity cost of holding currency with the decline in market deposit rates. As a result, the level of reserve money continued to remain elevated till around mid June 2020. However, the Central Bank reduced the SRR for the second time during the year in mid June 2020 with the aim of injecting liquidity, reducing the cost of funds further and supporting the ailing economy. With such reduction in the SRR, commercial banks' deposits with the Central Bank declined immediately by around Rs. 131 billion causing reserve money to reduce to levels lower than that recorded in the corresponding period of the previous year. Accordingly, reserve money, which increased to Rs. 1.05 trillion in mid April 2020, reduced to Rs. 879.8 billion by end August, a decline of

Figure 7.13
Movements in Daily Reserve Money (a)

(a) Sudden changes in reserve money in November 2018, March 2019, March 2020 and June 2020 were due to revisions to the SRR.

Source: Central Bank of Sri Lanka

Figure 7.14
Daily Currency in Circulation

Source: Central Bank of Sri Lanka

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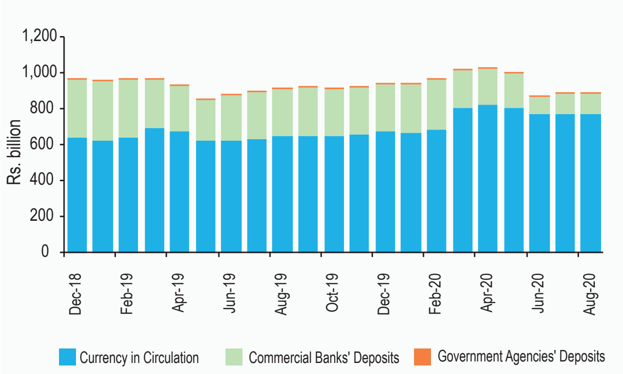
Figure 7.15
Components of Reserve Money



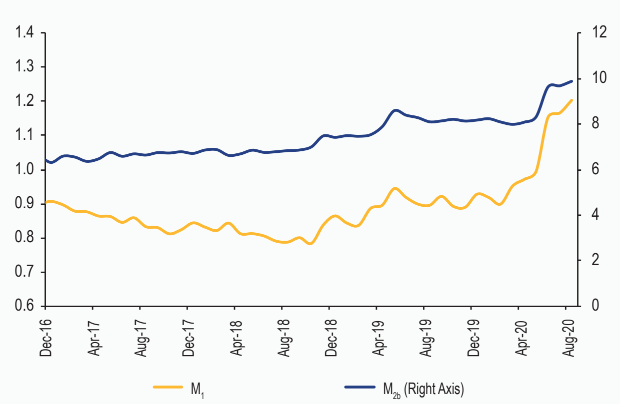
Source: Central Bank of Sri Lanka

Rs. 52.8 billion since end 2019, thereby recording a year-on-year contraction of 3.7 per cent over August 2019. Contributing to this contraction was commercial banks' deposits with the Central Bank, which declined by Rs. 142.9 billion to Rs. 111.7 billion during the eight months ending in August 2020. In contrast, currency in circulation increased substantially by Rs. 90.0 billion to Rs. 768.0 billion by end August 2020 compared to end 2019.

- **Viewed from the assets side, the contraction of reserve money during the eight months ending in August 2020 was entirely due to the decline in net foreign assets (NFA) of the Central Bank, which outweighed the expansion in net domestic assets (NDA)**. NFA of the Central Bank decreased by Rs. 73.6 billion during the eight months ending in August 2020 due to the increase in foreign currency liabilities, which outweighed the increase in foreign currency assets of the Central Bank. Increase in payables to the International Monetary Fund (IMF) and entering into a bilateral currency swap agreement with the Reserve Bank of India (RBI) for US dollars 400 million in July 2020 were the key drivers that led to the increase in foreign currency liabilities of the Central Bank by Rs. 215.7 billion during the period under review. On the other hand, foreign assets of the Central Bank also increased by Rs. 142.1 billion during the eight months ending in August 2020 driven by increased investments in foreign currency deposits and fixed income securities, the effect of which, however, was dampened by the disposal of a portion of the gold reserves of the Central Bank. In addition, the net absorption of foreign exchange from the domestic market also contributed to the increase in foreign assets of the Central Bank during this period. Meanwhile, NDA of the Central Bank expanded during the period from January through August 2020, largely driven by the increase in net credit to the government (NCG) resulting from the purchase of government securities from the primary market, while claims on commercial banks also increased with the implementation of concessional credit schemes amidst the COVID-19 pandemic. Government securities holdings of the Central Bank (net of repurchase transactions) increased substantially by Rs. 170.7 billion during the period under review to Rs. 297.6 billion by end August 2020 as a result of the extraordinary measures taken by the Central Bank in line with the MLA to support the efforts of the Government in dealing with the pandemic. In the meantime, balances under the Standing Deposit Facility (SDF) expanded by Rs. 147.9 billion during the eight months ending in August 2020, as market participants continued to use the SDF window of the Central Bank to park surplus liquidity, primarily on an overnight basis. Accordingly, NDA of the Central Bank increased by Rs. 20.8 billion during the period under review to Rs. 57.4 billion by end August 2020, in comparison to the decline of Rs. 145.6 billion in the corresponding period of 2019.

- **The money multiplier, compiled as the ratio between broad money supply (M_{2b}) and reserve money, increased notably in 2020, reflecting the effect of the reduction in the SRR and the notable growth of M_{2b}**. The downward adjustments to the SRR in March and June 2020 caused a notable increase in the ability of the banking system to create money. The currency to deposit ratio, which is negatively related to the M_{2b} money multiplier, increased to 7.4 per cent by end August 2020 from 6.9 per cent recorded at end 2019, due to the increase in currency

Figure 7.16
Movements in the Money Multiplier



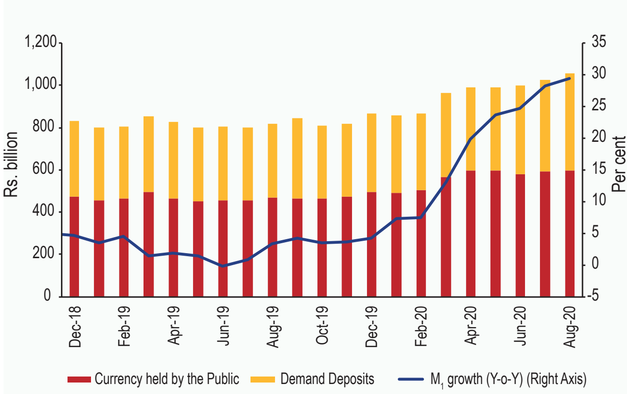
Source: Central Bank of Sri Lanka

held by the public outweighing the increase in deposits considered under M_{2b}, highlighting the precautionary behaviour amidst the pandemic and the low return earned on deposit investments. However, the effect of the decline in reserves of LCBs, which was driven by the reduction in the SRR, outweighed the increase in currency to deposit ratio, leading to a notable increase in the M_{2b} money multiplier. Accordingly, the M_{2b} money multiplier increased to 9.88 by end August 2020, compared to 8.18 recorded at end 2019. On average, it stood at 8.74 during the period from January to August 2020, compared to an average of 7.97 during the corresponding period of 2019.

Narrow Money (M_1)

- **Narrow money, which comprises currency and demand deposits held by the public, grew notably during the period from January to August 2020 amidst the pandemic and declining interest rates**. Accordingly, narrow money recorded a growth of 29.4 per cent, year-on-year, by end August 2020 following the tepid growth of 4.2 per cent at end 2019. Currency held by the public recorded a notable growth of 26.8 per cent, year-on-year, by end August 2020, compared to 4.5 per cent by end 2019. In absolute terms, during the period from January to August 2020, currency held by the public increased by Rs. 101.8 billion. Demand deposits held by the public with commercial banks recorded a growth of

Figure 7.17
Growth of Narrow Money (M_1)



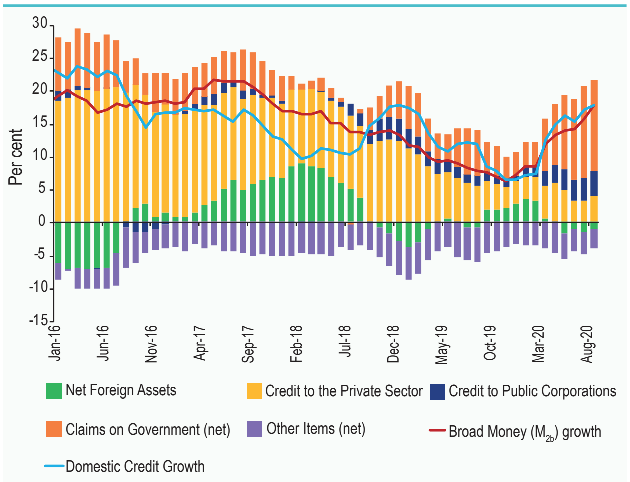
Source: Central Bank of Sri Lanka

32.9 per cent, year-on-year, by end August 2020, compared to the moderate growth of 3.8 per cent recorded at end 2019. In absolute terms, during January to August 2020, demand deposits held by the public with commercial banks increased by Rs. 91.2 billion.

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

- **Growth of broad money (M_{2b}) continued to accelerate during the eight months ending in August 2020 with the acceleration in the growth of NDA of the banking system due to the notable expansion in credit to the public sector**. Accordingly, the year-on-year growth of

Figure 7.18
Contribution to Year-on-Year Growth of Broad Money - M_{2b} (Assets Side)



Source: Central Bank of Sri Lanka

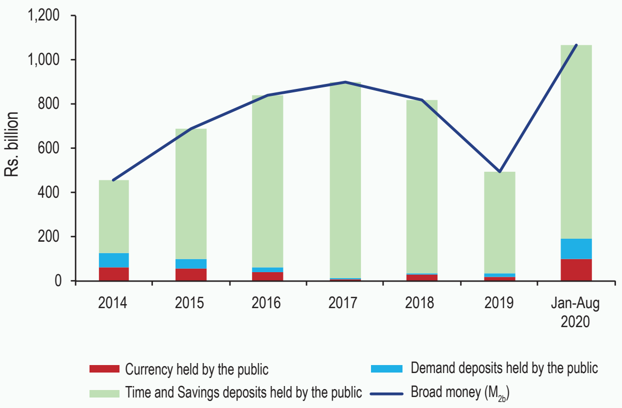
M_{2b} accelerated to 17.5 per cent by end August 2020, compared to the growth of 7.0 per cent at end 2019. The increase in NDA of the banking system contributed entirely to the overall monetary expansion during the period of eight months from January to August 2020, while NFA of the banking system contracted during the period under review.

- **With regard to the liabilities side of broad money, the increase in time and savings deposits held by the public with LCBs largely contributed to the growth of broad money during the eight months ending in August 2020**. The year-on-year growth of time and savings deposits accelerated to 16.0 per cent by end August 2020 from 7.3 per cent at end 2019. In absolute terms, reflecting the limited spending opportunities due to the pandemic effect as well as the increased appetite of depositors to save in the banking sector rather than with non-bank financial institutions, time and savings deposits of LCBs increased by Rs. 874.9 billion during the period from January to August 2020, compared to the increase of Rs. 281.2 billion recorded in the corresponding period of 2019. Meanwhile, precautionary motives due to mounting uncertainty with the spread of COVID-19 and the gradual decline in interest rates prompted the public to increasingly hold money in the form of currency and demand deposits during the pandemic, thus increasing the contribution of currency and demand deposits to the overall expansion of M_{2b} during the period under review, compared to 2019.

- **NFA of the banking system contracted during the eight months ending in August 2020 reflecting the decline in NFA of both the Central Bank and LCBs**. In absolute terms, NFA of the banking sector decreased by Rs. 96.6 billion during January to August 2020 in contrast to the notable increase of Rs. 178.4 billion in the corresponding period of 2019. NFA of the Central Bank contracted by Rs. 73.6 billion during the eight months ending in August 2020 as the increase in foreign currency liabilities, mainly to international organisations, outpaced the increase in foreign currency assets. NFA of commercial banks also contracted by Rs. 23.0 billion during the period under review, entirely due to the decline in NFA of Domestic Banking Units (DBUs) by Rs. 65.9 billion. The decline in NFA of DBUs was mainly due to the increase in foreign currency liabilities by way of deposit liabilities of non residents and borrowings from banks abroad, and the contraction in foreign assets in the form of placements with banks abroad. In contrast, NFA of Offshore Banking Units (OBUs) increased by Rs. 42.9 billion during the period with the increase in foreign assets outweighing that of foreign liabilities. Foreign assets of OBUs increased due to the increase in placements with

Figure 7.19

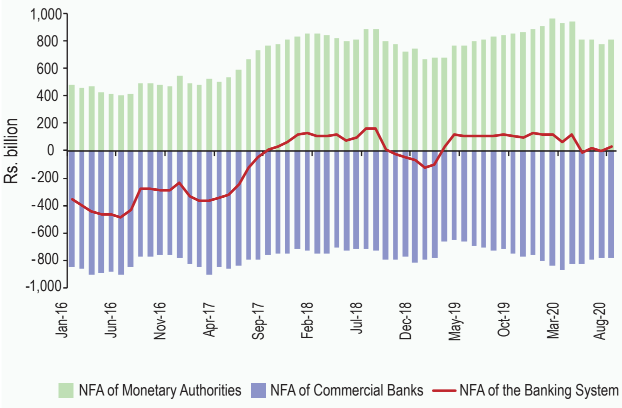
Contribution to the Expansion of Broad Money - M_{2b} (Liabilities Side)



Source: Central Bank of Sri Lanka

Figure 7.20

Movements in Net Foreign Assets (NFA) of the Banking System



Source: Central Bank of Sri Lanka

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Table 7.3
Developments in Monetary Aggregates and Underlying Factors

Rs. billion

Item	2016 Dec	2017 Dec	2018 Dec	2019 Dec	2020 Aug (a)
1. Reserve Money	**856.1**	**939.8**	**961.1**	**932.6**	**879.8**
(year-on-year change in per cent)	27.1	9.8	2.3	-3.0	-3.7
Net Foreign Assets of the Central Bank	558.6	846.1	750.5	896.0	822.4
Net Domestic Assets of the Central Bank	297.6	93.7	210.6	36.6	57.4
2. Narrow Money (M_1)	**776.6**	**793.3**	**830.8**	**865.5**	**1,058.5**
(year-on-year change in per cent)	8.6	2.1	4.7	4.2	29.4
3. Broad Money (M_{2b})	**5,405.6**	**6,308.1**	**7,128.3**	**7,624.1**	**8,692.0**
(year-on-year change in per cent)	18.4	16.7	13.0	7.0	17.5
3.1 Net Foreign Assets	-231.2	121.5	-67.0	128.3	31.7
Monetary Authorities (b)	558.6	846.1	750.5	896.0	822.4
Commercial Banks	-789.8	-724.6	-817.5	-767.7	-790.8
3.2 Net Domestic Assets	5,636.8	6,186.5	7,195.3	7,495.9	8,660.3
Domestic credit	6,671.7	7,504.7	8,833.4	9,383.2	10,712.8
Net Credit to the Government	1,972.1	2,168.5	2,516.7	2,767.1	3,781.2
Central Bank	413.0	225.1	472.8	363.0	534.6
Commercial Banks	1,559.1	1,943.4	2,043.9	2,404.1	3,246.6
Credit to Public Corporations	513.8	537.0	755.4	818.0	1,022.9
Credit to the Private Sector	4,185.8	4,799.2	5,561.4	5,798.1	5,908.7
(year-on-year change in per cent)	21.6	14.7	15.9	4.3	5.2
Other Items (net)	-1,034.8	-1,318.2	-1,638.1	-1,887.3	-2,052.5
Memorandum Items:					
Money Multiplier (M_{2b})	6.31	6.71	7.42	8.18	9.88
Velocity (M_{2b} average) (c)	2.43	2.26 (d)	2.12 (d)	2.04 (a)	-

(a) Provisional
(b) This includes NFA of the Central Bank as well as the Government's Crown Agent's balance reported by the Department of State Accounts
(c) Based on GDP estimates by the Department of Census and Statistics
(d) Revised

Source: Central Bank of Sri Lanka

banks abroad and lending to non residents, while foreign liabilities of OBUs increased with higher borrowings from banks abroad, amidst a decline in deposits of non residents.

- **NDA of the banking system expanded notably during the eight months ending in August 2020, mainly driven by the increase in domestic credit.** Accordingly, in absolute terms, NDA of the

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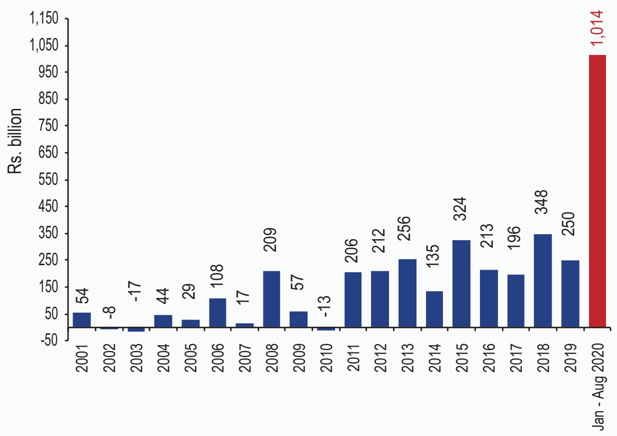
Table 7.4
Changes in Domestic Credit Flows

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
2017	833.0	613.4	196.4	23.2	73.6	23.6	2.8
2018	1,328.7	762.1	348.2	218.4	57.4	26.2	16.4
2019	549.7	236.8	250.4	62.6	43.1	45.5	11.4
Jan - Aug 2019	281.9	55.1	235.3	-8.5	19.6	83.5	-3.0
Jan - Aug 2020 (a)	**1,329.6**	**110.6**	**1,014.1**	**205.0**	**8.3**	**76.3**	**15.4**

(a) Provisional

Source: Central Bank of Sri Lanka

Figure 7.21
Annual Change in Net Credit to the Government from the Banking System



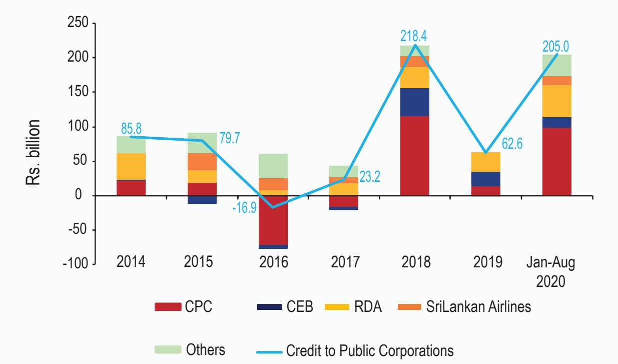
Source: Central Bank of Sri Lanka

banking system increased by Rs. 1,164.5 billion during the period under review, compared to the increase of Rs. 90.2 billion recorded during the corresponding period of 2019.

- **Within NDA, NCG by the banking system increased substantially during the period of eight months from January to August 2020, recording the highest cumulative increase within a year**. This was mainly due to the increased reliance of the Government on domestic financing amidst limited foreign financial flows and the shortfall in government revenue collection. Accordingly, NCG by the banking system increased by Rs. 1,014.1 billion during the period from January to August 2020, compared to the increase of Rs. 235.3 billion in the corresponding period of 2019. The expansion of NCG by LCBs amounted to Rs. 842.6 billion during the period from January to August 2020, compared to the increase of Rs. 357.5 billion during the corresponding period of 2019. The availability of surplus funds with LCBs following the series of monetary easing measures by the Central Bank and the preference of LCBs for risk free assets amidst heightened uncertainties resulted in the substantial increase in investment in government securities by LCBs during the period. Accordingly, NCG by DBUs increased notably by Rs. 825.3 billion during the period from January to August 2020, compared to the increase of Rs. 345.2 billion in the corresponding period of 2019. This was largely driven by the increase in investment in government securities as well as the increase in government overdraft balances with DBUs of LCBs during the period under review. NCG by OBUs also recorded an increase of Rs. 17.2 billion during the period from January to August 2020 mainly on account of direct loans to the Government, which increased by about Rs. 67.4 billion. However, this increase was largely offset by the decline of Rs. 50.2 billion in investment in SLDBs. Meanwhile, NCG from the Central Bank increased by Rs. 171.5 billion during the period from January to August 2020, mainly due to the net purchases of government securities amounting to Rs. 170.7 billion by the Central Bank during the period under consideration in view of the urgent financing needs of the Government given the exceptional circumstances caused by the pandemic. The provisional advances of the Central Bank of Sri Lanka remained broadly unchanged during the period from January to August 2020.

- **Credit extended to State Owned Business Enterprises (SOBEs) by the banking system also recorded a notable expansion during the period of eight months from January to August 2020, reflecting the weak financial**

Figure 7.22
Annual Change in Credit to SOBEs from the Banking System



Source: Central Bank of Sri Lanka

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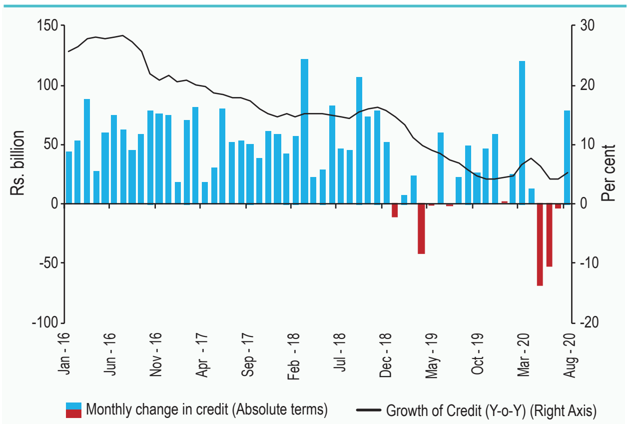
position of most SOBEs aggravated by the pandemic. Accordingly, credit obtained by SOBEs from the banking system increased by Rs. 205.0 billion during the period from January to August 2020, compared to a contraction of Rs. 8.5 billion in the corresponding period of 2019 and an annual increase of Rs. 62.6 billion during 2019.

- **Despite the series of monetary easing measures, the growth of credit extended to the private sector remained moderate during the seven months ending in July 2020, before recording a notable expansion in August 2020**. Although some recovery was observed in the growth of credit extended to the private sector by commercial banks during the first quarter of 2020 supported by monetary easing measures, the momentum changed thereafter, due to the spread of COVID-19 and related lockdown measures. The low credit expansion since April 2020 in spite of large liquidity levels in the market and relatively low market interest rates was also driven by the restrained supply of credit. Credit supply was low reflecting the risk averse behaviour of banks towards lending during the pandemic in fear of the likely heightened risk of default. However, a notable expansion of credit was observed during August 2020 after recording contractions of credit to the private sector during the period from May to July 2020, supported by credit extended to pandemic hit businesses through the concessional loan schemes. As a result, credit extended to the private sector, in absolute terms, increased by Rs. 110.6 billion during the period from January to August 2020, compared to the increase of Rs. 55.1 billion in the corresponding period of 2019 and the annual increase of Rs. 236.8 billion during 2019. The year-on-year growth of credit extended to the private sector accelerated to 5.2 per cent by end August 2020, compared to the growth of 4.3 per cent at end 2019. As per the security-wise analysis of loans and advances, in addition to Unsecured loans, credit granted against Fixed, Savings and Other Deposits, and Documentary bills recorded contractions during the eight months ending in August 2020, while credit granted against Personal Guarantees and Promissory Notes, Immovable Property, Gold and Other Precious Metals under Pawning, Leasing and Hire Purchase Agreements, Stock, Bonds, Debentures, Sundries including Life insurance policies, and Other Securities expanded during the period under review.

Figure 7.23
Credit Granted by Commercial Banks to the Private Sector

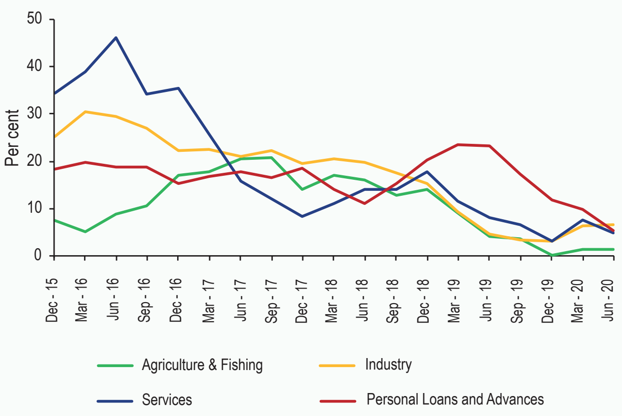


Source: Central Bank of Sri Lanka

- **As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, the growth of credit to the Industry and Services sectors accelerated, while credit to the Agriculture and Fishing Sector as well as credit granted in the form of Personal Loans and Advances decelerated during the first half of 2020, compared to the corresponding period in 2019**. The substantial easing of monetary policy, which resulted in a notable reduction in market lending rates, as well as companies shoring up liquidity by tapping into their credit lines amidst the increased domestic spread of COVID-19 led to the expansion of credit obtained by the private sector during the first quarter of 2020. However, with the imposition of strict lockdown measures, a contraction in credit extended to the private sector was observed in the second quarter of the year. In spite of such contraction, an acceleration in the growth of aggregate credit to some economic sectors, as

Figure 7.24

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



Source: Central Bank of Sri Lanka

measured by the Quarterly Survey, was observed during the first half of 2020, compared to the growth observed in the corresponding period of the previous year. Accordingly, credit to the Industry sector grew by 2.5 per cent, year-on-year, during the first half of the year, compared to 0.9 per cent contraction in the first half of 2019. Meanwhile, growth of credit extended to the Services sector accelerated to 1.8 per cent, year-on-year, during the first half of 2020, compared to the marginal growth of 0.1 per cent in the same period of 2019. However, growth of credit to the Agriculture and Fishing sector contracted by 0.5 per cent, year-on-year, during the first half of 2020, in comparison to a contraction of 1.7 per cent recorded in the corresponding period of the previous year. Growth of credit in the form of Personal Loans and Advances contracted by 0.9 per cent, year-on-year, during the first half of 2020, compared to the growth of 5.2 per cent recorded in the corresponding period of the previous year. Further, in terms of the maturity of outstanding credit to the private sector by commercial banks,

Table 7.5

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

Rs. billion

Sector	End Jun 2019	End Dec 2019	End Jun 2020 (c)	Year-to-Date Change			
				(Jun 19/Dec 18)		(Jun 20/Dec 19)	
				Amount	%	Amount	%
Agriculture and Fishing	**462.0**	**471.1**	**468.7**	**-8.0**	**-1.7**	**-2.5**	**-0.5**
of which, Tea	103.3	95.8	94.4	3.3	3.3	-1.4	-1.5
Rubber	27.8	25.9	24.3	-6.5	-19.0	-1.6	-6.4
Coconut	23.4	24.7	26.5	-1.1	-4.6	1.8	7.3
Paddy	35.8	38.0	40.6	0.0	0.1	2.6	6.9
Vegetables, Fruit and Minor Food Crops	32.0	30.8	26.3	-5.9	-15.5	-4.5	-14.5
Fisheries	20.1	21.5	20.7	-0.1	-0.3	-0.9	-4.0
Industry	**2,332.3**	**2,427.0**	**2,487.2**	**-22.0**	**-0.9**	**60.2**	**2.5**
of which, Construction	1,133.5	1,197.6	1,231.2	-0.2	-0.0	33.6	2.8
Food and Beverages	124.8	130.8	147.6	0.1	0.1	16.8	12.9
Textiles and Apparel	214.5	214.6	252.1	12.9	6.4	37.5	17.5
Fabricated Metal Products, Machinery and Transport Equipment	190.9	192.3	166.9	-11.8	-5.8	-25.3	-13.2
Services	**1,642.2**	**1,692.8**	**1,723.9**	**0.8**	**0.1**	**31.1**	**1.8**
of which, Wholesale and Retail Trade	491.9	502.4	478.1	5.2	1.1	-24.3	-4.8
Tourism	207.2	235.1	252.3	8.9	4.5	17.2	7.3
Financial and Business Services	359.0	370.6	370.4	-37.3	-9.4	-0.3	-0.1
Shipping, Aviation and Freight Forwarding	26.6	27.2	22.4	1.3	4.9	-4.8	-17.6
Personal Loans and Advances (d)	**1,333.7**	**1,418.5**	**1,405.2**	**66.2**	**5.2**	**-13.2**	**-0.9**
of which, Consumer Durables	232.5	239.1	223.7	4.0	1.8	-15.4	-6.4
Pawning	187.6	211.0	220.9	15.8	9.2	10.0	4.7
Credit Card	118.4	131.0	126.2	11.8	11.1	-4.9	-3.7
Total (e)	**5,770.2**	**6,009.4**	**6,085.0**	**37.1**	**0.6**	**75.6**	**1.3**

(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) Provisional

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

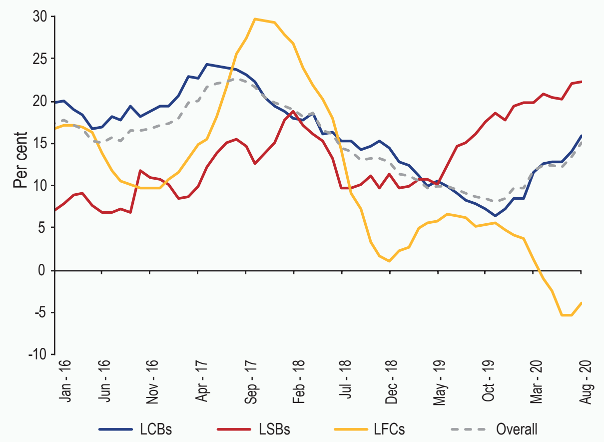
(e) Total credit to the private sector as per the Quarterly Survey differ from that in the Monetary Survey due to differences in the compilation methodologies a slowdown was observed in short and medium term credit facilities, while an expansion was observed in long term credit, possibly indicating increased private sector appetite to restructure debt by obtaining long term loans at low rates of interest to settle short to medium term loans, priced at relatively high rates. Accordingly, on a year-on-year basis, the growth of short term credit facilities decelerated to 0.6 per cent by end June 2020, compared to the growth of 3.0 per cent at end 2019, while growth of medium term credit facilities contracted by 6.9 per cent by end June 2020, compared to the growth of 2.6 per cent at end 2019. However, growth of long term credit facilities to the private sector accelerated at a faster pace of 20.7 per cent, year-on-year, by end June 2020, in comparison to the growth of 8.0 per cent at end 2019.

Broad Money (M_4)

- **Growth of broad money supply (M_4), as measured by the Financial Survey,[9] accelerated during the eight months ending August 2020, in line with the growth of M_{2b}, due to the notable acceleration in growth of NDA of licensed banks**. Accordingly, the year-on-year growth of M_4 accelerated to 16.5 per cent by end August 2020, compared to the growth of 8.2 per cent recorded at end 2019. On the assets side, the absolute increase in M_4 was entirely due to the expansion of NDA of the Central Bank and licensed banks, while NFA of the overall banking sector contracted during the period. Contributing to the increase in NDA of M_4, domestic credit of Licensed Specialised Banks (LSBs) increased by Rs. 104.5 billion, while domestic credit of Licensed Finance Companies (LFCs) contracted by Rs. 10.5 billion during the eight months ending in August 2020. Although overall NFA contracted during the period from January to August 2020, NFA of LSBs increased by Rs. 1.2 billion during the period under review due to the decline in its foreign liabilities. Viewed from the liabilities side of M_4, total time and savings deposits held by the public with LCBs, LSBs and LFCs grew by 15.0 per cent, year-on-year, by end August 2020, compared to 8.5 per cent at end 2019. Time and savings deposits held with LSBs grew by 22.2 per cent, year-on-year, by end August 2020, compared to 17.8 per cent at end 2019. However, time and savings deposits held with LFCs contracted by 3.9 per cent, year-on-year, by end August 2020, compared to the growth of 4.9 per cent at end 2019, reflecting the impact of the termination of license and business activity of a large finance company in June 2020 as well as the gradual shift of deposits from LFCs to banking sector institutions due to pandemic driven uncertainties.

9 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.

Figure 7.25
Year-on-Year Growth in Savings and Time Deposits (As per M_4)



Source: Central Bank of Sri Lanka

- **As per the Financial Survey, growth of credit extended to the private sector accelerated to 4.8 per cent, year-on-year, by end August 2020, compared to 3.9 per cent at end 2019**. In absolute terms, the expansion of credit extended to the private sector as per the Financial Survey amounted to Rs. 156.9 billion during the period from January to August 2020, compared to the expansion of Rs. 88.7 billion in the corresponding period of 2019. Credit extended to the private sector by LSBs increased by Rs. 39.2 billion during the eight months ending in August 2020,

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Table 7.6
Assets Side of Broad Money (M_4)
(Computed as per the Financial Survey)

Rs. billion

Sector	End Aug-19	End 2019	End Aug-20 (a)	Year-on-Year Change			
				End 2019		Aug-20	
				Amount	%	Amount	%
Financial Survey (M_4)	**9,132.8**	**9,444.5**	**10,637.6**	**714.9**	**8.2**	**1,504.8**	**16.5**
Underlying Factors							
Net Foreign Assets	**51.5**	**116.3**	**21.0**	**250.0**	**187.0**	**-30.5**	**-59.2**
Monetary Authorities (b)	848.4	896.0	822.4	145.5	19.4	-26.0	-3.1
LCBs	-737.1	-767.7	-790.8	49.8	6.1	-53.7	-7.3
LSBs	-59.9	-11.9	-10.7	54.7	82.1	49.2	82.1
Net Domestic Assets	**9,081.4**	**9,328.2**	**10,616.6**	**465.0**	**5.2**	**1,535.3**	**16.9**
Domestic Credit	**11,732.2**	**12,066.6**	**13,490.3**	**710.1**	**6.3**	**1,758.0**	**15.0**
Net Credit to the Government	**3,395.6**	**3,454.1**	**4,515.9**	**354.1**	**11.4**	**1,120.3**	**33.0**
Central Bank	350.6	363.0	534.6	-109.8	-23.2	184.0	52.5
LCBs	2,401.4	2,404.1	3,246.6	360.2	17.6	845.2	35.2
LSBs	563.2	613.9	679.2	95.3	18.4	116.0	20.6
LFCs	80.4	73.2	55.5	8.4	13.0	-24.9	-30.9
Credit to Public Corporations (LCBs)	**746.9**	**818.0**	**1,022.9**	**62.6**	**8.3**	**276.1**	**37.0**
Credit to the Private Sector	**7,589.8**	**7,794.5**	**7,951.4**	**293.4**	**3.9**	**361.6**	**4.8**
LCBs	5,616.5	5,798.1	5,908.7	236.8	4.3	292.2	5.2
LSBs	792.1	814.2	853.4	60.3	8.0	61.3	7.7
LFCs	1,181.2	1,182.2	1,189.3	-3.7	-0.3	8.1	0.7
Other Items (net) (c)	**-2,650.9**	**-2,738.4**	**-2,873.6**	**-245.1**	**-9.8**	**-222.7**	**-8.4**

(a) Provisional
(b) This includes NFA of the Central Bank as well as the Government's Crown Agent's balance reported by the Department of State Accounts
(c) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

recording a year-on-year growth of 7.7 per cent, while credit extended to the private sector by LFCs increased by only Rs. 7.1 billion during the same period, resulting in a year-on-year growth of 0.7 per cent by end August 2020 possibly due to the slowdown in the granting of vehicle related loans due to restrictions on vehicle imports. Further, NCG under M_4 increased notably by Rs. 1,061.8 billion, during the period from January to August 2020, in absolute terms, compared to the increase of Rs. 295.6 billion during the corresponding period of 2019, mainly due to the increase in NCG by the Central Bank and licensed banks. NCG by LSBs increased by Rs. 65.3 billion during the period from January to August 2020, compared to the increase of Rs. 44.6 billion during the corresponding period of 2019, while NCG by LFCs contracted by Rs. 17.6 billion during the period from January to August 2020, compared to the increase of Rs. 15.7 billion during the corresponding period of 2019.

Expected Developments

- **Reflecting the passthrough of highly accommodative monetary policy measures amidst the pandemic, market lending rates, which showed an accelerated decline in recent months, are expected to decline further supporting a sustained pickup in credit extended to the private sector**. Most market lending rates have adjusted downwards in response to monetary easing measures, while some excessive interest rates of specific loan products were brought down via regulatory measures. However, given the level of monetary accommodation, further space is available for some market lending rates to adjust downwards. Supported by the declining market lending rates along with positive market sentiments and improved domestic economic activity, an acceleration in the growth momentum of credit to the private sector is expected during the remainder of 2020 and 2021.

- **In spite of the occasional uptick in headline inflation driven by increases in food prices, medium term projections indicate that inflation will remain within the targeted 4-6 per cent levels with appropriate policy measures**. The recent acceleration in headline inflation, particularly at the national level, was driven by high food prices due to supply side factors. However, demand driven inflation remained subdued as displayed by low levels of core inflation. With improvements expected in domestic supply conditions and the likely intervention by the Government to lower cost of living, food inflation is expected to subside gradually. Amidst well anchored inflation expectations, and the subdued global outlook on commodity prices, inflation is expected to remain in the desired range in the medium term, with appropriate policy actions to contain any lagged impact of the ongoing monetary and fiscal stimulation measures.