

12. MONEY, CREDIT AND INTEREST RATES

Financial Sector

Performance in the financial sector reflected the gradual recovery in the economy after the setback in 2001. The Central Bank reduced its policy interest rates cautiously considering the decline in inflation and developments in the money and foreign exchange markets. The money market has been liquid in 2002 mainly due to the purchase of foreign exchange by the Central Bank. Improved liquidity conditions and changes in the Central Bank's interest rates led to a reduction in all market interest rates. Deposit mobilisation of banks increased, while net interest income grew moderately. Broad money supply grew at a rate somewhat higher than projected, though the growth in base money was as projected. The higher monetary expansion was mainly a result of the higher than expected growth in the net foreign assets of the banking system and increased demand for money related to liquidity demand coming from the North and East following the cease-fire. During the period, overall public sector credit expansion was low; private sector credit grew moderately.



Monetary Policy

The focus of monetary policy was to contain inflation and ensure the maintenance of financial market stability, while facilitating a recovery in the economy after the external and internal shocks experienced in the economy in 2001.

- ◆ Based on the declining trend in the rate of inflation from the beginning of the year, and expectations for a declining trend in international interest rates during the coming months, the Central Bank reduced its policy rates, i.e., Repurchase (Repo) rate and Reverse Repurchase (Reverse Repo) rate, cautiously.
- ◆ The money market has been liquid during much of the period in 2002, facilitating a decline in money market rates, especially short-term. The purchase of foreign currency by the Central Bank from the market, increase in provisional advances to the government, transfer of Central Bank profits to the Treasury and the sale of proceeds of the issue of US dollar denominated Sri Lanka Development Bonds to the Central Bank, by the government, contributed to the increase in money market liquidity.
- ◆ The Bank continued careful management of base money to avoid inflationary pressure emanating from an excessive growth in money supply. In spite of an increase in net foreign assets (NFA) of the Central Bank, the expansionary impact on base money was offset by the significant reduction in the holdings of government paper by the Central Bank, which contained the rise in base money to the projected level.

- ◆ To increase transparency and credibility in the conduct of monetary policy, reports on the monetary policy framework and monetary projections were posted on the Central Bank website in September 2002.
- ◆ In order to manage market liquidity better, the Central Bank proposes to have more active Open Market Operations. More information on monetary developments would be released on a regular basis on the stance of monetary policy to increase transparency.
- ◆ As broad money expansion so far in 2002 is somewhat higher than projected, monetary policy needs to be conducted prudently to avoid adding demand pressure from an excessive growth in money supply.
- ◆ In view of the current recovery in the economy, improvement in the balance of payments and decline in inflation, a growth of about 15 per cent in money supply is expected for the end of 2002.

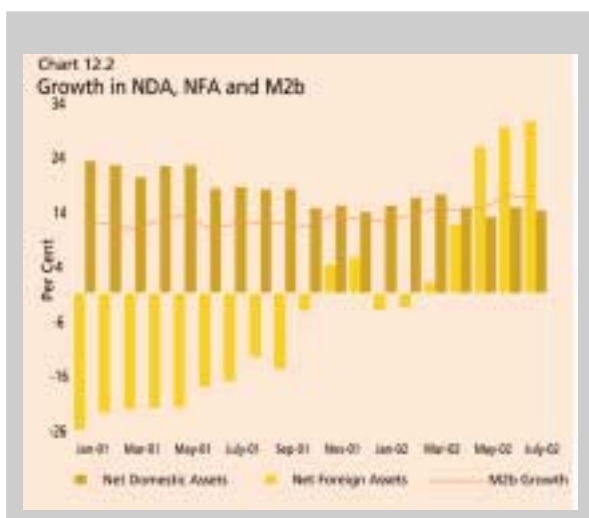


Table 12.1

Changes in Central Bank Rates

	Repurchase Rate %	Reverse Repo Rate (%)	Bank Rate %
Rates on 12/31/2001	12.00	14.00	18.00
Changes			
20 Mar.-02	11.50	13.50	
21 Mar.-02	11.50	13.60	
22 Mar.-02	11.50	13.65	
4 Apr.-02	11.50	13.85	
4-Jun-02	11.50	13.75	
26-Jul-02	10.50	12.75	

Source: Central Bank of Sri Lanka

Money Supply

The rate of monetary expansion (M2b) was somewhat higher than expected in the first half of 2002, though the rise in base money was as projected in the monetary programme.

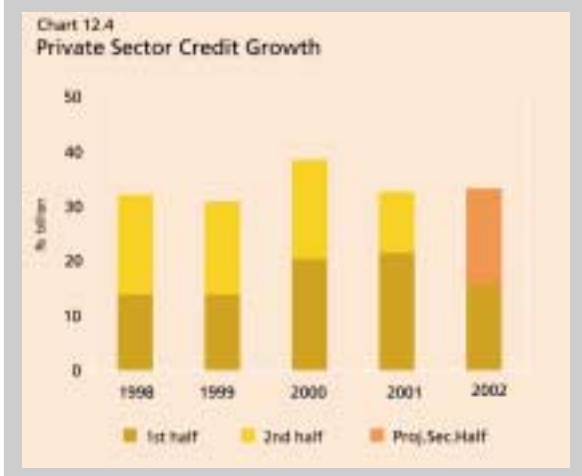
- ◆ The higher than projected growth in money supply is attributed to a greater than expected increase in net foreign assets and increased demand for money arising from the additional liquidity demand emanating from the North and East following the ceasefire. The monthly growth in broad money on a point to point basis during the first six months of the year was in the range of 13.3 - 17.9 per cent as compared to the expected growth of 12.9-14.7 per cent in the monetary projections.

- ◆ Increases in both NFA and net domestic assets (NDA) contributed more or less equally to the growth in money supply during the first half of 2002. NFA of the banking system increased by Rs.19.9 billion. This reflected the improvement in the balance of payments and the increased inflows to the commercial banks due to the refund of the deposit on war risk insurance, increase in NRFC deposits and inflows to the stock market.
- ◆ Credit to the government grew only moderately, by Rs.2.2 billion, as the profit transfers from the Central Bank (Rs.10 billion) in February, and the return of the war risk insurance deposit (US dollars 50 million) enabled the government to reduce its liabilities to commercial banks.

- ◆ Consolidated broad money is expected to grow by around 15 per cent in 2002 in comparison to an original estimate of 13.5 per cent.

Credit to private sector from commercial banks

- ◆ Credit to the private sector grew by about Rs.16 billion (6.9 per cent) during the period, less than originally expected, and was a reflection of the slow recovery in the economy. In comparison, credit to the private sector had grown by Rs.21.8 billion during the first half of 2001, and Rs.10.6 billion in the second half of 2001. A moderate credit expansion is expected during the second half of 2002, with annual credit growing at 9 per cent.



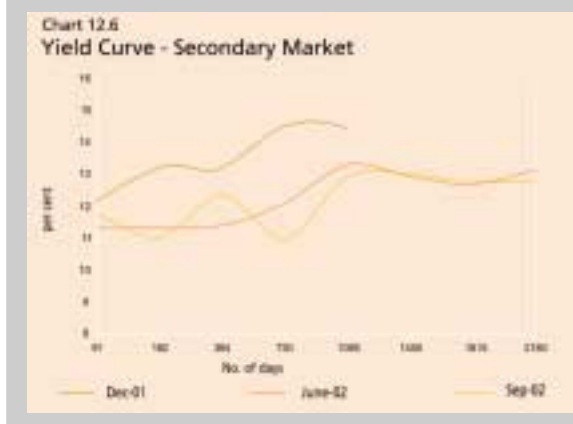
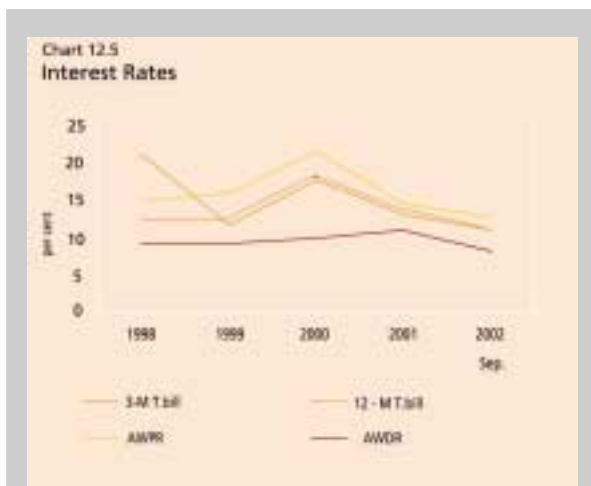
- ◆ Credit to public corporations declined by Rs.1.5 billion. The CPC was able to repay Rs.4 billion of its liabilities to the banking system as a result of an improved cash flow. However, there was an increase in borrowings by the CEB (Rs.3 billion) due to higher expenditure on emergency power purchases from the private sector.
- ◆ For the year as a whole, credit to public corporations is expected to decline by about Rs.3.5 billion, primarily due to the repayments by the CPC. However, this is less than the originally expected repayment of Rs.7 billion as the debt recovery component was removed from the petroleum pricing formula, without alternative measures to reduce the debt.

Financial Survey

- ◆ The financial survey, which yields a broader concept of money (M_4) than the consolidated broad money (M_{2b}), includes consolidated broad

money supply (M_{2b}) and activities of other financial institutions (OFIs), (i.e., Licensed Specialised Banks and finance companies). In absolute terms, the stock of M_4 was Rs.746 billion in comparison to the stock of M_{2b} of Rs.581 billion at end June 2002.

- Monetary growth derived from the financial survey indicated an expansion of 17.9 per cent (a growth similar to the M_{2b}) at end June 2002, as compared to the growth of 13.6 per cent recorded at end December 2001, mainly reflecting the improvement in NFA in the banking system.



Credit from Long-term Lending Institutions

- In addition to the commercial banks, long-term lending institutions (National Development Bank and DFCC Bank), finance companies and Regional Development Banks (RDBs) also provided credit facilities to the private sector.
- Credit facilities provided by these other financial institutions increased by 2.3 per cent during the first half of the year.

Table 12.2

Credit to the Private Sector from NDB and DFCC Banks

	(Rs. million) *		
	NDB	DFCC	Total
2000	35,667	22,567	58,234
2001	35,202	22,793	57,995
2002 June	33,335	23,693	57,028

Source: Central Bank of Sri Lanka

* Outstanding amount at end of period.

Interest Rates

The Central Bank has cautiously reduced its main policy rates in the first half of the year. With the reduction in the Central Bank policy rates and the increase in market liquidity, all market rates, particularly short-term rates, declined.

- The Repo rate and the Reverse Repo rate, which were 12.00 per cent and 14.00 per cent, respectively, at end December 2001, were reduced by 125-150 basis points. At end August 2002, the Repo rate was 10.50 per cent and the Reverse Repo rate was 12.75 per cent.

- ◆ In response to changes in policy rates, the average call market rate decreased from 12.7 per cent at the end of 2001 to 12.2 per cent at end June and 10.63 per cent at end September.
- ◆ Deposit and lending rates of commercial banks declined by 100-150 basis points from December 2001 to August 2002.
- ◆ The prime lending rate, which was 14.31 per cent at the end of 2001, declined to 14.04 per cent at end June 2002, and 12.57 per cent at end September.
- ◆ General lending rates of commercial banks, also declined but still remain high, partly due to the high spreads caused by inefficiencies, high non performing loans, and litigation delays in the loan recovery process.
- ◆ Non-performing advances as a per cent of total advances of domestic banking units of commercial banks increased marginally to 18.0 per cent (8.4 percent when adjusted for provisions) at the end of the second quarter of 2002 from 16.9 per cent (8.0 per cent when adjusted for provisions) at end 2001, while the liquid assets ratio of commercial banks increased from 29.8 per cent to 31.8 per cent in the same period.

Foreign Currency Deposits

- ◆ The total foreign currency deposits of commercial banks increased by 6 per cent (US dollars 65 million) during the first half of the year to US dollars 1,196 million.

With increasing market stability and the decline in market rates, the issue of longer-term Treasury bonds was re-commenced, which would help extend the benchmark yield curve.

Banking and Finance

The operations of the commercial banking sector increased moderately during the first half of 2002, reflecting the slow recovery in economic activities.

- ◆ The operating profits of commercial banks during the first half of 2002 amounted to Rs.3,921 million in comparison to Rs.6,178 million for the year 2001 as a whole. This reflected mainly the increase in net interest income as the cost of funds declined along with the decline in deposit rates. Meanwhile, deposits mobilised by commercial banks grew by 3.1 per cent during the first half of 2002 in comparison to 4.9 per cent during the first half of 2001.

Table 12.3

Foreign Currency Deposit Rates (%)

Month/ Year	Savings Deposits for US \$	Fixed Deposits-1Yr For US \$	US Fed Funds Rate	LIBOR (12 month) for US \$
2000 Dec.	2.50-5.90	6.00-6.90	6.50	6.20
2001 Jan.	2.25-6.25	5.00-6.75	5.50	5.36
Mar.	2.25-5.50	4.50-6.25	5.00	4.71
Jun	2.00-4.45	3.50-5.30	3.75	3.83
Sep	1.50-4.20	3.00-4.80	3.00	2.53
Dec	0.50-3.50	1.50-4.00	1.75	2.44
2002 Mar.	0.50-2.60	1.20-3.00	1.75	3.08
Jun	0.50-2.60	1.00-2.27	1.75	2.24

Sources: Bank of Ceylon, People's Bank, HSBC, Sampath Bank, Seylan Bank

- ◆ An increase in the number of people employed abroad, increased political stability, improved stability in the exchange rate and a decline in interest rates in international markets contributed to the increase in foreign currency deposits.

Banking Facilities

Commercial banks continued to expand facilities and services provided to customers, while increasing the application of modern technology.

- ◆ The total number of commercial bank branches increased by 17 to 1,147 at end June 2002. Banking density, which is the number of bank branches per 10,000 people, was 0.60.
- ◆ The ATM network of the commercial banks expanded to 76 by end June 2002, increasing the total number of ATMs to 548.
- ◆ The use of credit cards increased. Currently, eight commercial banks issue credit cards, which could be used both domestically and internationally. The total number of credit cards (net of cancellations) issued during the first half of the year was around 24,000, increasing the total number of cards issued so far to around 280,000.
- ◆ Two domestic private banks raised medium-term funds through the issue of debentures. The decline in interest rates was beneficial in encouraging these issues, which were heavily over-subscribed.

Table 12.4
Banking Facilities

Year	Banking Density(a)	Total ATM Machines	Credit cards Issued Excluding Cancellations
1999	0.58	316	161,079
2000	0.59	379	205,297
2001	0.60	472	255,584
2002 June	0.60	548	279,765

(a) Number of commercial bank branches per 10,000 people.

Source: Central Bank of Sri Lanka

- ◆ There is increased momentum in financial sector reforms designed to improve the efficiency of the financial system. Key areas that have been identified are the restructuring of the two state banks, and legislative changes, including amendments to the Banking Act, Monetary Law Act and Exchange Control Act.
- ◆ In order to create a sound and solvent banking system, the minimum capital adequacy requirement for banks is to be increased by 2003. This will strengthen their ability to withstand shocks. In addition, it is proposed to change the capital requirement of finance companies to a risk weighted asset basis, as in the case of commercial banks.
- ◆ It is also expected to improve management information and risk management systems, while enhancing corporate governance of financial institutions.

Commercial Paper

- ◆ Commercial paper has become a popular short term borrowing instrument in the corporate sector. Total funds raised through commercial paper (including re-issues) by the end of June amounted to Rs. 10 billion in comparison to Rs. 11 billion in the first half of 2001. However, with the decline in interest rates and the removal of tax advantages in Budget 2002, the volume of issues declined in 2002.

Table 12.5**Funds Raised through Commercial paper**

	Rs.mn	
	Total Issues	Outstanding
1999	16,203	5,056
2000	14,150	3,968
2001	23,300	6,521
2002*	10,110	5,611

* As at end June

Source: Central Bank of Sri Lanka

Upliftment of Rural Sector

Several policy measures have been taken in the past few years to increase income generating activities in the rural sector and alleviate poverty.

- ◆ Promotion of people-based micro finance organisations: Samurdhi Bank Societies and Isuru Development Societies.
- ◆ Extension of the poverty alleviation project implemented in the Galle, Matara, Kandy and Puttalam districts to 6 more districts namely, Hambantota, Kalutara, Nuwara Eliya, Badulla Matale and Kurunagela under the Poverty Alleviation Micro Finance Project (PAMP).
- ◆ Establishment of 6 Regional Development Banks to facilitate overall development at regional level.
- ◆ Introduction and Promotion of a 'Forward Sales Contract System' to stabilise the prices of agricultural produce of small farmers.

- ◆ Further encouragement to improve the credit facilities to the rural sector by providing interest subsidies and refinance facilities against the loans granted to rural borrowers under donor funded credit schemes.
- ◆ Introduction of a fee based agricultural extension system under certain credit programmes.

Credit Facilities**New Comprehensive Rural Credit Scheme**

- ◆ This is an islandwide scheme, which provides short-term cultivation loans on concessional terms for paddy and subsidiary food crops. An interest subsidy is given by the government. A sum of Rs. 307 million was granted under this scheme in 2001. This facility was extended to cover commercial scale seed and planting material production and purchase of agricultural produce under the forward sales contract system.

The Second Perennial Crops Development Project

- ◆ The Second Perennial Crops Development Project operates with a facility from the ADB and is designed to support the development and commercialisation of the perennial crop sector by providing credit facilities and support services. Loans disbursed by the end of first half of 2002 stood at Rs. 788 million under this credit scheme.

Surathura Scheme

- ◆ The Self-employment Promotion through Micro-Enterprise Credit (Surathura Scheme) operates with the participation of three lending institutions to increase income and improve living standards

of unemployed persons. Under Phase II of this project, which commenced in 1998, the banks grant loans out of their own funds at 10 per cent per annum with an interest subsidy of 10 per cent

from the government. The amount of loans granted stood at Rs. 969 million as at end March 2002. Interest subsidy paid stood at Rs. 98.2 million.

Other Credit Schemes in Operation

Credit Scheme	Mission
Small Farmers and Landless Credit Project	Establish a cost effective and sustainable micro-credit delivery system to generate employment and improve savings habits.
Kegalle District IRDP (Revolving Fund) Project	Uplift the standard of living of the people in the Sabaragamuwa Province (both the Kegalle and Ratnapura districts) by promoting income generating activities.
Tea Development Project	Increase tea smallholders' income on a sustainable basis and improve the natural environment in the project area.
Southern Province Rural Development Project	Improve the quality of life of the peoples in the Southern province.
North-Central Province Participatory Rural Development Project	Poverty alleviation, improve food security nutrition and increase employment opportunities for low-income families .
Skills Development Project	Improve the quality and relevant skill training programmes to build a quality work force.
Poverty Alleviation and Micro -Finance Project (PAMP)	Establish a cost-effective and sustainable micro - credit delivery system to generate employment and improve savings habits.
Urban Environmental infrastructure Development Project	Improve environmental facilities, health and sanitary conditions of the people living in urban areas.
Matale Rural Economic Advancement Project	Permanent increase and sustaining of income of small enterprises of rural and farmer families in the Matale District.
Urban Development & Low Income Sector Project (UDCIHSP)	Increase the accessibility of low income households, whose monthly income is below the 55 th income percentile, to housing finance through the banking sector.

Employees' Provident Fund

- ◆ The country's main superannuation fund, the Employees' Provident Fund (EPF) continued to grow in 2002.
- ◆ Total contributions received by EPF amounted to Rs.12.5 billion during the first eight months of 2002 in comparison to Rs. 11.8 billion in the same period of 2001.

- ◆ The outstanding value of investments of the EPF increased to Rs.281 billion at end August 2002 from Rs.246 billion at end 2001.
- ◆ Total refunds by the EPF during the first eight months period amounted to Rs.8 billion.

Employees' Trust Fund

- ◆ The Employees' Trust Fund (ETF) is an employers' contributory fund. The total contribution to the fund during the first eight months was Rs.2.3 billion.
- ◆ ETF can invest in private sector investments such as equities. Total investments of ETF at end August 2002 were Rs. 3.7 billion. The total number of employers contributing to ETF was around 40,000.



Capital Market

The Colombo stock market has shown increased activity since mid-October 2001 reflecting improved business confidence.

- ◆ With both domestic and foreign investors participating actively, key market indicators, including price indices, turnover volumes, net foreign inflows, and the market price earnings ratio increased significantly.

Table 12.6**Share Market Indicators**

	End 2001	End September 2002
ASPI - end period	621	857
MPI - end period	1,031	1,464
Turnover (Rs. mn)*	13,955	24,784
Net Foreign Purchases(Rs.mn)*	(1024)	2,710
Market Capitalisation (Rs.bn)	124.0	174.3

*Cumulative

Source: Colombo Stock Exchange

- ◆ Budget 2002 had positive implications for stock market activity. Dividend income is now taxed separately at the rate of 10 per cent, which is of benefit to those in higher income brackets whose income is taxed at a rate higher than 10 per cent. Further, the 20 per cent surcharge on corporate taxes, which was imposed in April 2001, was removed with effect from 31 March 2002.
- ◆ A better economic outlook for the latter half of the year and the gradual decline in interest rates on fixed income securities are also likely to have helped boost the market.

Expected Developments in 2003

A further improvement in money, foreign exchange and capital markets, with continued financial stability, is expected in 2003.

- ◆ On the basis of an economic growth of about 5-6 per cent and inflation of about 7-8 per cent, and after allowing sufficient credit growth to private sector, the desirable level of monetary expansion in 2003 is 13-14 per cent. Accordingly, the emphasis of monetary policy in 2003 would be to ensure that monetary targets are consistent with the overall macro-economic programme and to facilitate the declining trend in inflation, while encouraging economic growth.
- ◆ The achievement of these monetary targets will depend largely on the containment of public sector credit expansion (i.e., credit to the government and public corporations). Further reduction of credit to the public sector would enable the release of additional resources to the more efficient private sector.
- ◆ Interest rates are likely to ease further in 2003, as the fiscal outlook and balance of payments surplus are expected to improve, adding liquidity to the market, while inflationary pressure is expected to be lower.
- ◆ The buoyancy in share market activity is likely to continue through 2003 as the progress on the political and economic fronts would lead to further increase in investor and business confidence. The privatisation programme of the government will also help boost the market. The planned divestiture of state owned enterprises such as Sri Lanka Telecom, a part of which would

be through listing on the stock exchange, would add much needed depth to the market and help lure foreign investors.

- ◆ Debt market activity is expected to expand further with the reduction in interest rates, improved market liquidity and improvements to market infrastructure. The issue of longer-term government bonds will extend the benchmark

yield curve, which is essential for the private sector to price its longer-term debt issues.

- ◆ Another development expected in the government debt securities market is the introduction of a Scripless Trading System. The shift from paper based trading to scripless or electronic book entry trading, together with the implementation of a Real Time Gross Settlements System (RTGS) would also assist the private sector.