

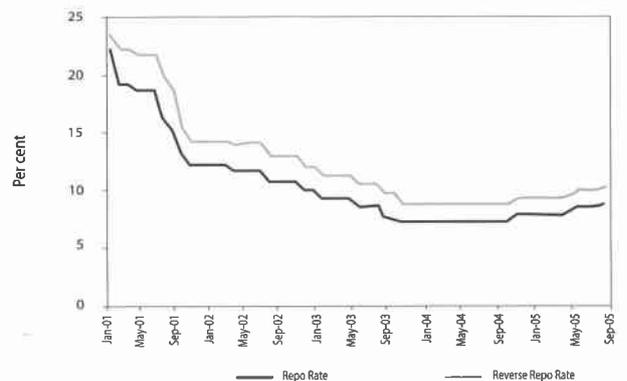
7. MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

Monetary policy in 2005 continued to focus on minimising inflationary pressures while facilitating the continuing growth momentum of the economy. Since money and credit aggregates were rising faster than anticipated, the monetary policy stance was tightened by raising policy interest rates on three occasions and conducting open market operations aggressively. Following these policy measures, market interest rates have gradually moved up and the Central Bank was able to contain the growth in reserve money and decelerate the growth in other monetary and credit aggregates.

Monetary Policy

- Monetary policy was tightened in 2005.** However, the year 2005 began with the adversity of the tsunami devastation, which prompted a temporary change in monetary operations. The gradual tightening of the policy stance since the emergence of the first signs of inflationary pressures in mid 2004 was discontinued temporarily by suspending the daily open market operations (OMOs) commencing in early January 2005, to ensure the smooth functioning of the financial markets immediately after the tsunami devastation. OMOs were subsequently recommenced during the latter part of February 2005 as the threat of the tsunami on the financial sector and economic activities began to dissipate gradually.
- Monetary policy was implemented through a series of measures.** These measures included the aggressive conduct of OMOs and raising the Central Bank's policy interest rates, viz. Repurchase and Reverse repurchase rates, in three steps; 25 basis points in May, 50 basis points in June and 25 basis points in September 2005.
- The policy actions have resulted in higher interest rates and a deceleration of monetary aggregates.** The weighted average Repo auction rate increased from 7.84 per cent at end 2004 to 9.15 per cent at end September 2005. The monetary policy measures helped meeting the reserve money targets for June and September 2005. However, the continuation of the high growth in broad money and credit aggregates remains a concern.
- The Central Bank continued its efforts to strengthen monetary policy transmission, by improving the efficiency of the financial system and by disseminating information on economic developments, monetary policy decisions and monetary policy operations.**

Chart 7.1
 Changes in Policy Interest Rates



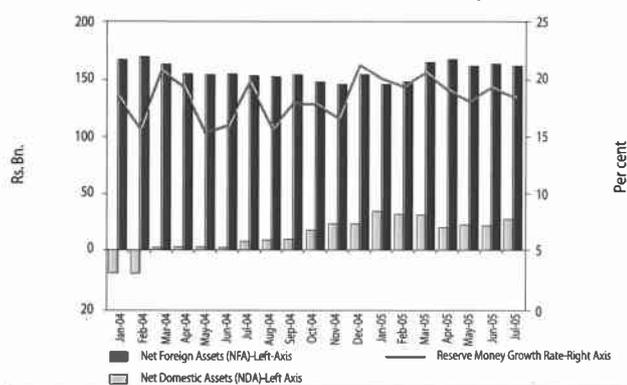
Several measures have been taken to improve financial sector competitiveness, soundness of institutions and markets, and financial infrastructure. The public was informed of the regular monetary policy reviews as per the advance release calendar through monthly press statements. The Central Bank also continued to publish information on developments relating to key macroeconomic variables on the Central Bank's website, to enable the market participants as well as the general public to make informed decisions.

Money, Credit and Interest Rates

Reserve Money

- **The excessive growth in reserve money was contained through the tight monetary policy stance.** Reserve money rose and was above the target level by end March as a result of the high demand for currency due to tsunami related disturbances and the festive season. It was brought down to reach the targeted levels in June and September 2005, using monetary policy measures.

Chart 7.2
 Growth and Sources of Reserve Money

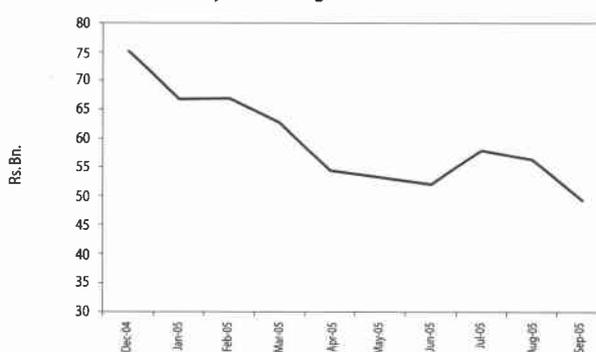


- **Reserve money increased during the first eight months, largely reflecting the increase in net foreign assets (NFA).** The contribution from NFA was 85 per cent while the contribution from net domestic assets (NDA) was 15 per cent. The build-up of NFA was a result of the Central Bank purchasing the foreign currency proceeds received by the government by way of grants and loans from foreign donor agencies, tsunami related programme loans and domestic foreign currency borrowings from foreign currency banking units (FCBUs). The NDA of the Central Bank also increased due to the increase in provisional advances to the government. The holdings of Treasury bills of the Central Bank declined by about Rs 19 billion during this period.

Narrow Money

- **The narrow money supply (M_1), consisting of currency and demand deposits held by the public, grew by above 20 per cent on a point-to-point basis during the first eight months of the year.** This was due to the higher demand for money arising from the increase in economic activity.

Chart 7.3
 Treasury bill Holdings of the Central Bank



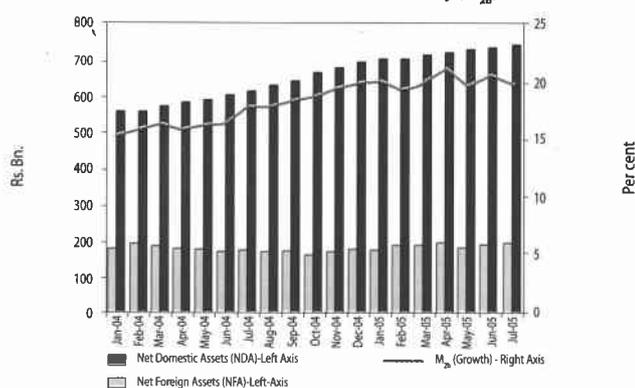
Broad Money

- **The growth in consolidated broad money (M_{2b}), on a point-to-point basis, was in the range of 19 – 20 per cent during the first eight months of the year, which was somewhat higher than the projected growth.** The increase in M_{2b} was a result of deposits of commercial banks increasing by 21 per cent and currency increasing by 16 per cent. The contribution of NDA and NFA of the banking system to this increase were 82 per cent and 18 per cent, respectively.
- **The expansion in the NFA of the overall banking sector was a result of the increase in the NFA of both the Central Bank and commercial banks.** The NFA of commercial banks increased mainly due to the receipt of tsunami related private inflows and increased private remittances.
- **The increase in the NDA reflects the increased credit provided by commercial banks to both the private sector and the government.** During the twelve months ending August 2005, credit extended by

commercial banks to the private sector has increased by around 23 per cent, while credit to the government from the banking system has increased by 16 per cent. Meanwhile, credit to public corporations has declined by 57 per cent.

- **Net credit to the government (NCG) from the banking sector increased by Rs. 15 billion to Rs. 235 billion during the first eight months of 2005.** NCG from commercial banks increased by Rs.30 billion due to increased holdings of government securities and foreign currency loans given by FCBUs to the government. NCG from the Central Bank declined by Rs. 15 billion.
- **Credit to public corporations declined during the first eight months by around Rs. 23 billion.** This was largely due to the decrease in credit to the Ceylon Petroleum Corporation (CPC) with the receipt of suppliers' credit from India and Iran for oil imports, enabling the CPC to settle a part of its accumulated loan liabilities from its revenue.
- **Credit to the private sector continued to increase during the first eight months of the year,** given the relatively low interest rates that prevailed and the high demand for credit with the expansion in economic activities. Credit to the private sector contributed to about 91 per cent of the domestic credit expansion. A major share of the credit was for commercial, housing and consumption purposes.

Chart 7.4
Growth and Sources of Broad Money (M_{2b})



Financial Survey

- **The growth in money supply as measured by the financial survey increased by 18-19 per cent.**

The financial survey provides a broader measure of liquidity, covering licensed specialised banks and finance companies, in addition to licensed commercial banks and the Central Bank. Amongst the factors contributing to the growth in money supply as measured by the financial survey were the increase in investments in government securities by licensed specialised banks and credit extended to the private sector by licensed specialised banks and finance companies.

Interest Rates

- **During the first nine months of the year, market interest rates moved up** as a result of monetary policy actions and increased demand for credit. The policy interest rates of the Central Bank; Repurchase and Reverse Repurchase rates, were revised upward by 100 basis points in three steps during the first nine months of 2005. The first revision was made in May, raising policy rates by 25 basis points, followed by two more increases of 50 basis points and 25 basis points in June and September 2005, respectively. Accordingly, the Repo and the Reverse Repo

rates, which were 7.50 per cent and 9.00 per cent, respectively, at end 2004, rose to 8.50 per cent and 10.00 per cent, respectively, by end September 2005. The overnight interest rates have also been rising since April 2005. The Repo auction rate, which was 7.84 per cent at end 2004, declined to around 7.55 per cent in early March, with the temporary suspension of OMOs. However, following the commencement of aggressive OMOs in February and the increases in the policy interest rates of the Central Bank, it increased gradually to 9.15 per cent by end September 2005. The weighted average call money rate declined from 9.73 per cent at end 2004 to its lowest level in 2005 of 7.60 per cent at end March 2005. Since then it has increased gradually, to 10.28 per cent by end September, responding to the monetary policy actions.

- **Yields on government securities also increased in line with the inflation and following the monetary policy actions.** Yield rates pertaining to Treasury bills increased by about 215-237 basis points during the first nine months of 2005. Yield rates pertaining to Treasury bonds also increased, by about 214-242 basis points.

Chart 7.5
 Composition of Domestic Credit and Private Sector Credit Growth

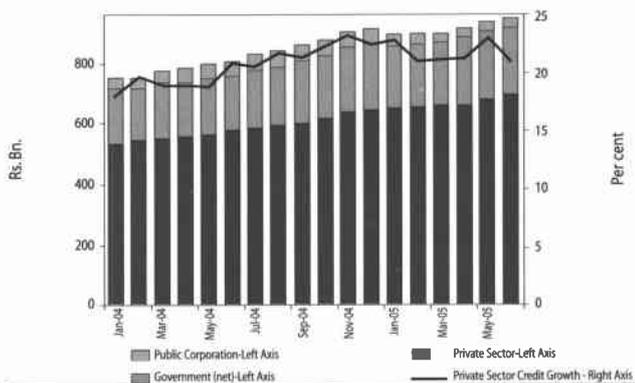
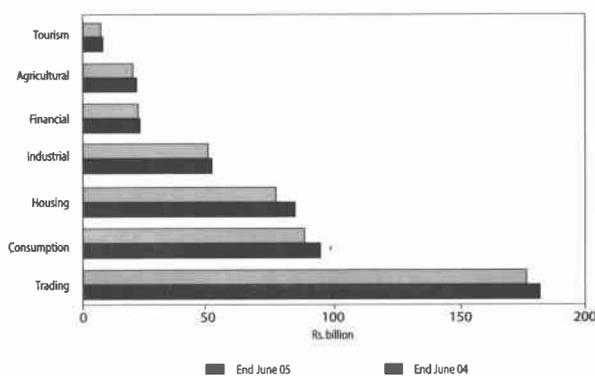


Chart 7.6
 Distribution of Private Sector Credit



- **Lending and deposit rates of commercial banks increased during the first nine months of the year.** The average weighted prime lending rate (AWPR), which declined from 10.23 per cent at end 2004 to 9.76 per cent by February 2005, increased thereafter, and was 11.76 per cent by end September 2005. The average weighted deposit rate (AWDR), which was 5.31 per cent in December 2004 increased to 5.84 per cent in September 2005. Meanwhile, the average weighted fixed deposit rate (AWFDR) increased from 7.67 per cent at end 2004 to 8.70 per cent by September 2005.
- **The interest spread remains high in the banking system in Sri Lanka in comparison to the interest spread in many other countries in the region.** The Central Bank continued its efforts to reduce it by publishing lending and deposit rates of commercial banks to create greater public awareness, and also by way of discussions with the officials of commercial banks.
- **Interest rates offered for foreign currency deposits maintained at commercial banks also increased,**

following the increase in international interest rates. Interest rates for US dollar denominated savings deposits increased from a range of 0.65 – 1.80 per cent at end 2004 to a range of 0.88 – 2.25 per cent as at end August 2005.

Prospects for 2006

- **The desirable rate of growth in the broad money supply is projected at around 14 - 15 per cent for 2006, which would facilitate the smooth functioning of economic activity while preventing the build-up of inflationary pressures and expectations.** The growth in money supply has been estimated based on the expected real economic growth of around 6 per cent and an increase in the GDP deflator of around 8 per cent. The Central Bank will continue to review macroeconomic developments on a regular basis and the monetary policy stance will be adjusted accordingly.

