7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

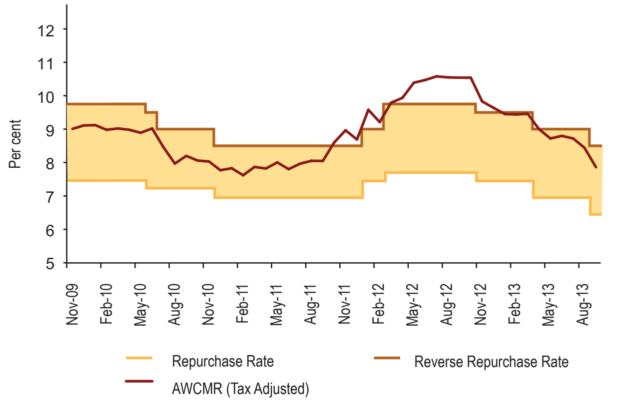
The monetary policy stance in the first ten months of 2013 was aimed at guiding the economy back to the high growth trajectory in the midst of a low inflation environment. The growth of money supply gradually moved towards the desired path during this period. Credit expansion in the first eight months of the year was mainly due to high level of credit obtained by the public sector while credit extended to the private sector by commercial banks was lower than anticipated. A decline in net foreign assets of the banking sector with increased utilisation of foreign assets to lend domestically by banks also contributed to the moderation of broad money growth. The market interest rate structure, which shifted upwards in 2012 in response to tight monetary conditions, remained downward rigid in the first few months of the year despite the relaxation of monetary policy by the Central Bank in December 2012 by reducing the Repurchase rate and the Reverse Repurchase rate of the Central Bank by 25 basis points each and the removal of the credit ceiling in December 2012. Well anchored inflation and inflationary expectations allowed the Central Bank to reduce policy interest rates further by 100 basis points in two steps, once in May and again in October 2013 and reduce the Statutory Reserve Ratio (SRR) by 2 percentage points with effect from July 2013, while continuing an active dialogue with financial institutions on the progress of monetary transmission. Responding to these policy changes many market interest rates adjusted downwards. With declining market interest rates, it is expected that the growth of credit extended to the private sector would pick up in the period ahead. Meanwhile, a containment of credit obtained by public sector, in particular public corporations, has been observed with improved financial position of the key corporations. Tight monetary policy that was in effect in 2012 and the disciplined monetary expansion in 2013 have well contained demand driven inflation as evidenced by the current behaviour of headline and core inflation and inflation expectations of the public.

Monetary Policy

- **The Central Bank eased its monetary policy stance further during the first ten months of 2013 to regain the high growth momentum in the context of well contained demand driven inflationary pressures and subdued inflation expectations.** Subsequent to reducing its policy interest rates by 25 basis points in December 2012, the Central Bank lowered policy interest rates again by another 50 basis points in May 2013. In line with such policy, short term money market rates adjusted downwards, but the adjustment of deposit rates and general lending rates was downward rigid in the first few months of the year. Hence, to address the downward rigidity in lending rates and the high spread between lending and deposit rates, the Central Bank reduced the Statutory Reserve Ratio (SRR) on all rupee deposit liabilities of commercial banks by 2 percentage points to 6 per cent in July 2013. Taking into account the prevailing favourable inflation outlook, the Central Bank was able to relax its monetary policy stance further by reducing policy interest rates by another 50 basis points in October 2013. Consequently, the Repurchase rate and the Reverse Repurchase rate are currently at 6.50 per cent and 8.50 per cent, respectively. The current favourable macroeconomic environment, underpinned by well anchored inflation expectations, therefore provides the required monetary space for sustained economic growth, without fuelling undue inflationary pressures in the period ahead.

- **The Central Bank continued to conduct monetary policy within the monetary targeting policy framework.** As presented in the 'Annual Report 2012' the average growth rate for broad money in 2013 was targeted at 15 per cent while reserve money was targeted to grow at a higher rate of 16.5 per cent due to low base effect.

Chart 7.1 Policy Rate Corridor and the Average Weighted Call Money Rate (AWCMR)



The money multiplier was expected to remain broadly stable. The monetary programme was based on the projected real GDP growth of 7.5 per cent and inflation, as measured by the implicit GDP deflator, of 7 per cent. However, a combination of factors such as the reduction in the SRR, which resulted in a higher money multiplier and the lower than anticipated credit growth to the private sector in the first half of the year necessitated a revision to the monetary programme for 2013. As per the revised programme, the targeted average broad money growth for the year was maintained at 15 per cent, while the targeted growth of reserve money was revised downwards to 3.1 per cent as the money multiplier increased to around 6.7 in response to the reduction in SRR. A notable change to the framework for monetary operations was the extension of the period of reserve maintenance by Licensed Commercial Banks (LCBs) from 01 July 2013 in order to grant greater flexibility in liquidity management to banks. Accordingly, the 7 day reserve maintenance period was extended to a system of two periods per month where period A was defined as the first 15 days of each month and period B, as day 16 to the end of the month. To facilitate the new extended reserve management framework, the Central Bank introduced short-term auctions (Repo and Reverse Repo) upto 7 days on the same day settlement (T+0) basis in addition to the removal of restrictions on access to standing facilities imposed in 2012. These measures are expected to offer commercial banks greater flexibility to invest their surplus funds.

- **The lagged effect of tight monetary policy, moderation of global commodity prices and the absence of significant supply-side shocks domestically, contributed to inflation remaining within single digits during the first nine months of 2013, a trend that was observed since February 2009**. Year-on-year inflation, which remained at 9.8 per cent during the first two months of 2013, decreased to 6.4 per cent by April 2013. Thereafter, inflation rose to 7.3 per cent during the month of May, mainly on account of the upward revision of electricity prices. However, inflation moderated subsequently as anticipated, and declined to 6.2 per cent by September 2013. Core inflation also continued to remain low reflecting well contained demand pressures and reached its lowest level of 3.0 per cent, on a year-on-year basis in September 2013. Continued single digit inflation, which has already prevailed for over 4 ½ years, and subdued inflation expectations provide space for the continuation of the current relaxed monetary policy stance to support the growth agenda of the country.

- **Rupee liquidity in the domestic money market, which was broadly in a balanced position by the beginning of the year, increased thereafter while remaining volatile during the first nine months of the year**. Daily excess rupee liquidity during the first nine months of 2013 averaged around Rs. 22.5 billion reflecting the easing of monetary conditions, compared to a deficit of Rs. 7.5 billion at end 2012. The excess market liquidity increased during the first two months of 2013 largely due to purchases of Treasury bills and the absorption of foreign currency by the Central Bank from the domestic foreign exchange market. Excess liquidity in the money market subsided from a peak of Rs. 52 billion in February to about Rs. 13 billion by end June on account of outright sales of Treasury bills and the reversal of forex swap arrangements, while the remaining excess liquidity was absorbed on a daily basis by way of repurchase agreements. Commencing 01 July 2013, the Central Bank reduced the SRR applicable to rupee deposit liabilities of commercial banks by 2 percentage points, thus releasing additional liquidity of around Rs. 44 billion to the market. Excess liquidity rose further to Rs. 88 billion by 23 September following the utilization of the proceeds of the international bond issued by the National Savings Bank (NSB), while the Central Bank conducted repo auctions and retired part of its holdings of Treasury bills to maintain

Chart 7.2 Contribution to year-on-year Inflation

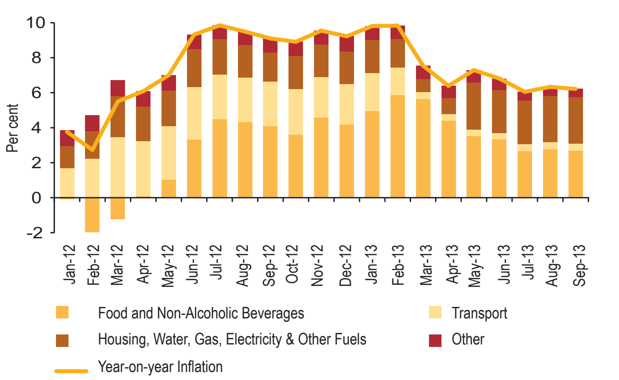
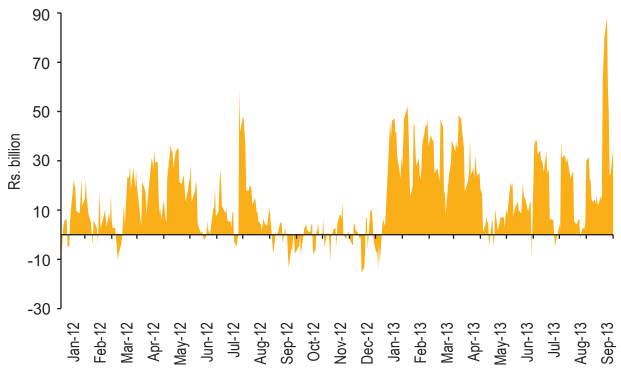


Chart 7.3 Overnight Rupee Liquidity in the Domestic Money Market



liquidity at a desirable level. The Central Bank recommenced using borrowed securities for liquidity mopping up operations since September 2013 as its holdings of government securities had declined to a very low level.

Reserve Money

- **On a quarterly average basis, reserve money was maintained within the targets stipulated under the monetary programme during the first and third quarters while it remained marginally above the targeted levels in the second quarter of 2013**. The average daily reserve money grew by 9.8 per cent to Rs. 495 billion in the first quarter of 2013. Thereafter, the growth of reserve money increased to about Rs. 518.5 billion, a growth of 9.7 per cent by end June 2013. The decelerating trend in the growth of reserve money was attributed to lower growth in currency in circulation. Subsequent to the reduction in the SRR with effect from July 2013, reserve money contracted by around Rs. 44 billion, thus resulting in a negative growth of 3.8 per cent by end July 2013. The Central Bank revised its targets for reserve money taking into account the increase in money multiplier due to the reduction in the SRR in July 2013. Accordingly, year-on-year reserve money growth is expected to be around 3.1 per cent in 2013. Average reserve money, in the third quarter stood at Rs. 464.9 billion, compared to the revised quarterly target of Rs. 466.0 billion.

- **Following the reduction in SRR with effect from July 2013, reserve money declined by Rs. 17.8 billion in the first eight months of the year.** NFA of the Central Bank declined by around Rs. 24 billion during the first seven months of the year mainly due to settlement of foreign loans, incurrence of valuation losses following declines in the price of gold and effects of cross currency movements, but increased afterwards in August to record a marginal increase of around Rs. 0.3 billion during January-August 2013 on account of foreign currency swaps by the Central Bank from commercial banks. NDA of the Central Bank, on the contrary, contracted by around Rs. 18.0 billion during the first eight months of 2013 due to the substantial reduction in the Treasury bill holdings of the Central Bank by Rs. 105.9 billion although provisional advances extended to the government increased by Rs. 13.8 billion during this period. Also, a decline in other liabilities of the Central Bank by Rs. 73.4 billion on account of reductions in retained earnings and international reserves revaluation balances subdued the contraction in NDA of the Central Bank somewhat during this period.

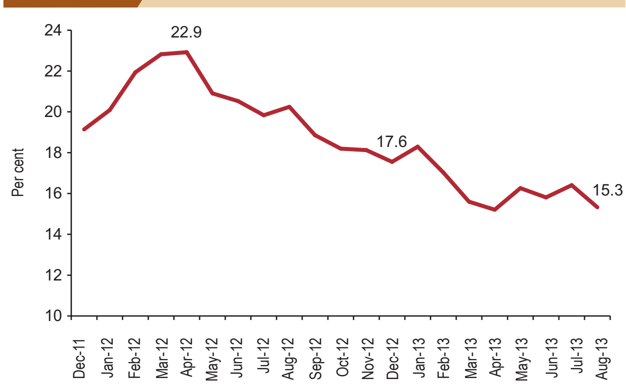
Narrow Money (M_1)

- **Narrow money supply (M_1), which consists of currency and demand deposits held by the public, continued its slow year-on-year growth during the first eight months in 2013, as the opportunity cost of holding these non-interest bearing assets remained relatively high.** The year-on-year growth of narrow money was 3.2 per cent by end August 2013, compared to 2.6 per cent growth recorded at end December 2012. The year-on-year growth of currency held by the public decelerated from 3.6 per cent at end 2012 to 3.3 per cent at end July 2013. However, during the month of August 2013, currency held by the public increased by Rs. 8 billion due to the currency withdrawals during the provisional council elections and for the harvesting season. The year-on-year growth of demand deposits, which was negative during the period from May-November 2012 and grew by 1.4 per cent at end 2012, recorded a growth of 1.9 per cent by end August 2013. In absolute terms, M_1 increased by Rs. 3 billion in the first eight months of the year.

Broad Money (M_{2b})

- **Due to the lag effect of tight monetary policy measures adopted in early 2012, monetary expansion slowed during the first eight months of 2013 towards the desired levels, with the year-on-year growth of broad money (M_{2b}) decelerating to 15.3 per cent in August 2013 from 17.6 per cent at end 2012.** The tepid growth of credit to the private sector caused by high market lending rates, slower growth in domestic economic activities and the sluggish recovery in the global economy, had a lower contribution to the growth in broad money supply thus far in 2013. Furthermore, credit obtained by public corporations (in absolute terms) during the first eight months of 2013 remained relatively low compared to that of the corresponding period of the previous year. However, the significant increase in NCG during this period contributed to the expansion of money supply. Meanwhile, NFA of the banking sector declined as NFA of commercial banks reduced in the first eight months of the year, while that of the Central Bank increased marginally. On the source side, the increase in time and savings deposits held by the public contributed almost entirely (by around 97 per cent) to the year-on-year growth of broad money supply.

Chart 7.4 Year-on-Year Growth of Broad Money (M_{2b})

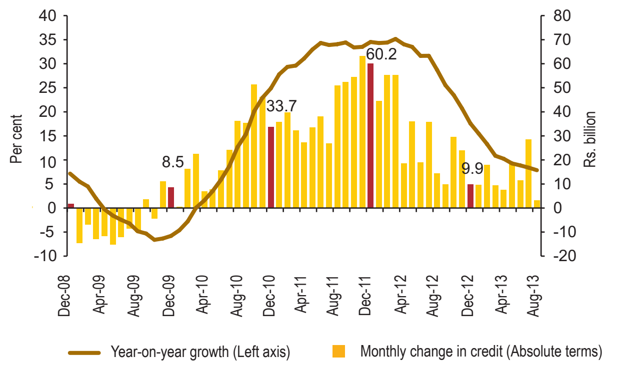


- **NFA of the banking system contracted during the first eight months of 2013 entirely due to the diminution in NFA of commercial banks.** NFA of commercial banks declined year-to-date by around Rs. 191 billion by August 2013. This was mainly as a result of the state banks utilising their assets abroad to settle oil import bills of the Ceylon Petroleum Corporation (CPC), the increased channeling of funds obtained from abroad to swap with the Central Bank, and increased investments in SLDBs. NFA of the Central Bank, which deteriorated by around Rs. 24 billion during the first seven months of the year largely on account of valuation losses due to the decline in the price of gold, and cross currency movements, improved in August to record a marginal increase of Rs. 0.3 billion during the period January-August 2013. Commercial banks' forex swaps with the Central Bank (on a net basis) and net absorption of forex by the Central Bank from the domestic foreign exchange market during this period contributed to the improvement in NFA of the Central Bank. NFA of overall banking system declined by Rs. 190.7 billion during the period.

- **NDA of the banking system increased significantly by around Rs. 506 billion during the first eight months of 2013 owing to the substantial increase in credit obtained by the government alongside the moderate increase in credit obtained by the private sector and public corporations.** NDA contributed 147 per cent to the year-on-year expansion in broad money, while the decline in NFA of the banking system during this period dampened the impact of expansion in NDA on the overall increase of money supply.

- **The growth of credit extended to the private sector, which decelerated since April 2012 following tight monetary policy measures taken in early 2012, continued to slow down**

Chart 7.5 Credit Granted by Commercial Banks to the Private Sector



further in 2013 partly due to the high base effect. In addition, the slow recovery in the growth of credit to the private sector was due to the stickiness of market lending rates to adjust downwards, a sharp reduction in the growth of pawning activity due to low gold prices, and the sluggish global growth. The private sector also resorted to alternative forms of direct finance in the form of issuing debentures in the domestic market and borrowing funds from abroad. As a result, the year-on-year growth of credit extended to the private sector slowed to 7.9 per cent in August 2013, from 17.6 per cent at end 2012. Considering the slow growth in credit to the private sector thus far during the year, projections for private sector credit growth in 2013 was revised downwards from 18.5 per cent to 11.0 per cent, year-on-year, which is expected to be met with the downward adjustment of market lending rates.

- **As per the Quarterly Survey of Commercial Banks, Loans and Advances to private sector, growth of credit to all major categories except the services sector decelerated on year-on-year basis by end June 2013.** On a quarter-on-quarter basis, the Quarterly Survey of Loans and Advances displayed some recovery in the growth of credit to the Agriculture and Fishing, and

Table 7.1 Classification of Loans and Advances Granted by Commercial Banks (a) (b)

Rs. billion

Sector	End Dec 2012	End Mar 2013	% Change (Dec 12 - Mar 13)	End Jun 2013 (c)	% Change (Mar 13 - Jun 13)
Agriculture and Fishing	**321.8**	**323.6**	**0.6**	**332.2**	**2.7**
of which, Tea	43.1	45.1	4.8	50.7	12.4
Rubber	14.6	14.7	0.3	19.2	31.3
Coconut	5.1	5.3	3.9	6.3	19.0
Paddy	12.6	13.0	3.1	13.3	1.9
Vegetable, Fruit and Minor Food Crops	14.0	13.6	(2.9)	12.4	(9.3)
Fisheries	10.4	10.0	(3.3)	9.9	(1.7)
Industry	**789.7**	**786.6**	**(0.4)**	**814.6**	**3.5**
of which, Construction	329.6	344.0	4.4	353.1	2.6
Food and Beverages	53.5	54.6	2.0	58.8	7.8
Textiles and Apparel	96.3	92.9	(3.5)	94.6	1.9
Fabricated Metal Products, Machinery and Transport Equipment	72.4	72.6	0.3	73.4	1.1
Services	**525.5**	**543.6**	**3.5**	**559.3**	**2.9**
of which, Wholesale and Retail Trade	183.2	194.8	6.4	201.9	3.6
Tourism	54.2	52.6	(3.0)	56.0	6.5
Financial and Business Services	121.1	120.6	(0.4)	116.5	(3.4)
Shipping, Aviation and Supply, and Freight Forwarding	6.2	5.5	(11.3)	10.4	89.1
Personal Loans and Advances (d)	**702.7**	**713.6**	**1.6**	**705.5**	**(1.1)**
of which, Consumer Durables	60.5	61.2	1.2	70.5	15.1
Pawning	339.4	345.3	1.7	334.8	(3.0)
Safety Net Scheme Related (e.g., Samurdhi)	**24.3**	**25.5**	**4.8**	**24.1**	**(5.6)**
Total	**2,364.0**	**2,393.0**	**1.2**	**2,435.6**	**1.8**

Source: Central Bank of Sri Lanka

(a) Based on the Quarterly Survey of commercial banks' loans and advances to the private sector
(b) Includes loans, overdrafts and bills discounted and excludes cash items in the process of collection
(c) Provisional
(d) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry'

the Industry sector in the second quarter of the year, reflecting market responses to monetary policy relaxation. The growth of credit to the Agriculture and Fishing sector, which decelerated to 0.6 per cent in March 2013 from 3.8 per cent at end 2012, improved by the end of the second quarter of 2013 to 2.7 per cent largely on account of credit obtained by the Tea and Rubber sectors. The growth of credit to the Industry sector, which declined by 0.4 per cent in the first quarter of 2013, improved by 3.5 per cent by end June 2013 mainly due to the continued growth of credit obtained by the Construction sector and the increase in outstanding credit obtained by the Food and Beverages, and the Textiles and Apparel sectors in the second quarter of 2013. Nevertheless, the growth of credit to the Services sector decelerated marginally to 2.9 per cent in June 2013 from 3.5 per cent in the previous quarter. This was mainly due to the decline in credit obtained by the Financial and Business Services, Transport, and Communication and Information Technology sectors during the second quarter of 2013. Furthermore, Pawning, which constitutes close to 48 per cent of the total outstanding credit in the form of Personal Loans and Advances, declined in the second quarter of 2013 mainly as a result of the drop in gold prices in the international market. As a result, credit in the form of Personal Loans and Advances declined by 1.1 per cent in June 2013 from the low growth of 1.6 per cent seen at end March 2013.

- **NCG from the banking system increased substantially by around Rs. 297 billion during the first eight months of 2013.** This increase was entirely on account of credit extended to the government by commercial banks as credit extended by the Central Bank declined. Treasury bill holdings (net of repos) of domestic banking units (DBUs) of commercial banks increased by around Rs. 169 billion, while Treasury bond holdings (net of repos) increased by around Rs. 112 billion during the first eight months of 2013. Moreover, investments in SLDBs by DBUs of commercial banks increased by around Rs. 43 billion, whilst that of offshore banking units (OBUs) of commercial banks increased by around Rs. 56 billion during the first eight months of 2013. Further, loans and advances to the government increased by around Rs. 7 billion during this period. However, the outstanding government overdraft balance declined by around Rs. 5 billion by end August 2013. Despite the increase in provisional advances thus far during the year, NCG from the Central Bank declined by around Rs. 92 billion mainly on account of the decline in Treasury bill holdings (net of repos) of the Central Bank by around Rs.106 billion.

- **Credit obtained by public corporations increased by around Rs. 72 billion during the first eight months of 2013, compared to the increase of Rs. 65 billion in the corresponding period of the previous year.** The increase was mainly on account of credit obtained by the Ceylon Petroleum Corporation (CPC) from OBUs of commercial banks (by around Rs. 27 billion) to finance its oil import bills. However, credit obtained by the CPC has reduced compared to that of the previous year due to the general fuel price revision in February 2013 and also due to the revision in the prices of furnace oil supplied by CPC to the Ceylon Electricity Board (CEB) in April 2013. Credit obtained by CEB declined by around Rs. 3 billion during the first half of the year reflecting increased revenue from electricity tariff revisions in mid-April 2013 and the lower usage of furnace oil for power generation due to favourable weather conditions. SriLankan Airlines obtained credit amounting to around Rs. 4 billion from OBUs of commercial banks during this period. Furthermore, credit obtained by the two fertilizer corporations increased by around Rs. 17 billion during the first eight months of 2013.

Broad Money (M_4)[1]

- **The year-on-year (y-o-y) growth of broad money as measured by the financial survey (M_4), was 16.4 per cent in August 2013 compared to 17.5 per cent at the end 2012.** In absolute terms, M_4 increased by Rs.410.6 billion during the first eight months of 2013, and this increase was solely driven by an increase in NDA by Rs. 606.1 billion while NFA declined by Rs.195.5 billion during the first eight months of 2013.

- **The growth of credit to the private sector as per the financial survey (M_4) on a year-on-year basis increased by 12.4 per cent in August 2013 compared to the lower growth of 7.9 per cent as per the monetary survey (M_{2b}) during the corresponding period.** The growth of credit extended to the private sector in M_4 decelerated by end August 2013 in comparison to the growth of 21.6 per cent in December 2012. However, the growth of credit to the private sector by Licensed Finance Companies (LFCs) remained high with the year-on-year growth of 46.9 per cent in August 2013 compared to 57.6 per cent at end 2012. Credit extended to the private sector by LFCs increased in absolute terms by Rs. 48.4 billion during the first eight months of 2013, contributing 29.5 per cent of the overall increase in private sector credit. However, compared to the growth of 15.7 per cent recorded at end 2012, credit granted to the private sector by Licensed Specialised Banks (LSBs) decelerated to 9.3 per cent in August 2013. In absolute terms, credit extended by LSBs to the private sector increased by Rs. 9.6 billion, contributing 5.9 per cent of the overall increase in private sector credit during the first eight months of 2013.

1 Financial survey provides a broader measure of liquidity, covering licensed specialised banks and licensed finance companies, in addition to licensed commercial banks and the Central Bank. However, M_{2b} is used for monetary policy purposes by the Central Bank.

Table 7.2 Sources of Broad Money (M_4) (Computed as per the Financial Survey)

Rs. billion

Item	End August 2012	End 2012	End August 2013 (a)	Year-on-year change Dec-12 Amount	Dec-12 %	Aug-13 Amount	Aug-13 %
Broad Money (M_4)	**3,517.3**	**3,685.0**	**4,095.6**	**549.2**	**17.5**	**578.3**	**16.4**
Underlying Factors							
Net Foreign Assets	**-24.8**	**-35.1**	**-230.5**	**-127.5**	**-138.0**	**-205.8**	**-830.1**
Monetary Authorities	355.3	396.5	396.8	56.4	16.6	41.4	11.7
LCBs	-370.2	-422.3	-613.4	-180.3	74.5	-243.1	-65.7
LSBs & LFCs	-9.9	-9.2	-14.0	-3.6	63.8	-4.1	-41.2
Net Domestic Assets	**3,542.1**	**3,720.1**	**4,326.2**	**676.7**	**22.2**	**784.1**	**22.1**
Domestic Credit	**4,569.0**	**4,829.1**	**5,396.2**	**888.4**	**22.5**	**827.2**	**18.1**
Net Credit to the Government	**1,358.6**	**1,389.9**	**1,721.0**	**235.3**	**20.4**	**362.4**	**26.7**
Monetary Authorities	316.5	278.8	186.9	16.1	6.1	-129.6	-40.9
LCBs	714.9	766.4	1,155.7	195.5	34.2	440.7	61.6
LSBs	310.4	327.6	353.2	17.7	5.7	42.8	13.8
LFCs	16.8	17.0	25.2	6.0	54.0	8.4	50.3
Credit to Public Corporations	**263.8**	**292.5**	**364.3**	**94.0**	**47.3**	**100.4**	**38.1**
LCBs	263.8	292.5	364.3	94.0	47.3	100.4	38.1
Credit to the Private Sector	**2,946.5**	**3,146.7**	**3,310.9**	**559.1**	**21.6**	**364.4**	**12.4**
LCBs	2,285.1	2,358.4	2,464.6	352.6	17.6	179.5	7.9
LSBs	331.0	354.5	364.1	48.0	15.7	31.0	9.3
LFCs	328.3	433.8	482.2	158.5	57.6	153.9	46.9
Other Items (net)	**-1,026.9**	**-1,109.0**	**-1,070.0**	**-211.7**	**23.6**	**-43.2**	**-4.2**

Source: Central Bank of Sri Lanka

(a) Provisional

- **As per the financial survey, the growth of time and savings deposits stood at 18.4 per cent (year-on-year) by August 2013 compared to 19.9 per cent at end 2012 due to high deposit rates offered by financial institutions.** In absolute terms, overall time and savings deposits increased by Rs. 408.6 billion during the first eight months of 2013. The year-on-year growth of time and savings deposits with LFCs increased marginally to 39.0 per cent in August 2013 compared to 38.0 per cent in end 2012. Meanwhile, the year-on-year growth of time and savings deposits with LSBs increased to 13.9 per cent by end August 2013 compared to 10.9 per cent growth recorded in end 2012. In absolute terms, this was an increase of Rs. 41.6 billion, and the contribution of LSBs to the overall increase in time and savings deposits in the first eight months of 2013 was 10.2 per cent.

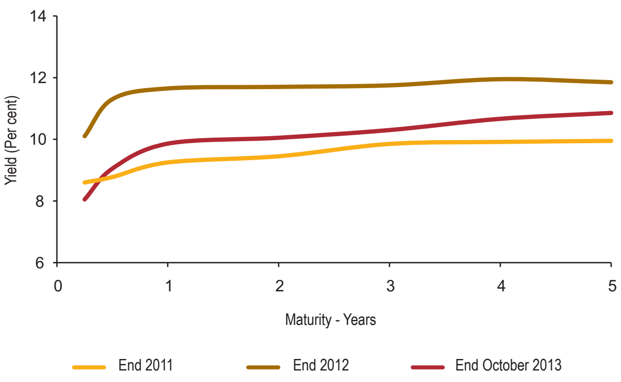
Interest Rates

- **The relaxed monetary policy stance adopted in December 2012 continued during the first ten months of 2013 as benign inflation and inflation expectations enabled the Central Bank to reduce policy interest rates further.** The perceived slow adjustment in market interest rates after the initial policy rate reduction in December 2012 prompted the Central Bank to further reduce policy interest rates each by 50 basis points once in May and again in October 2013. Accordingly, the Repurchase rate and the Reverse Repurchase rate currently stand at 6.50 per cent and 8.50 per cent, respectively.

- **The average weighted call money rate (AWCMR) declined during the first ten months of the year reflecting the impact of overall monetary policy easing on the interbank call money market, and remained broadly within the policy rate corridor.** The tax adjusted AWCMR, which remained close to the upper bound of the policy interest rate corridor before policy rates were reduced in December 2012, declined further responding to increased excess liquidity in the domestic money market since mid-January 2013. With the policy rate reduction on 10 May, the tax adjusted AWCMR eased to 7.65 per cent by mid-June and thereafter increased due to lower levels of liquidity, before settling at around 7.80-7.90 per cent since 1 July till mid–September 2013. With increased market liquidity since mid-September resulting from the proceeds of the NSB bond issue entering the market, the tax adjusted AWCMR eased further to 7.07 per cent by end October 2013.

- **The reduction of policy interest rates in December 2012, May and October 2013, increased levels of liquidity and improved foreign investor appetite reflecting positively on the yield rates on government securities.** In the primary market, the Treasury bill yields of all three maturities decreased until end February and thereafter increased marginally until mid-April due to higher borrowing requirement of the government. Yield rates declined thereafter contributed by the policy rate reduction in May 2013 and remained broadly stable during the third quarter of 2013, reflecting the absence of adverse market pressures, and contained government borrowing needs. Overall, during the year by end October, the yield rates on 91-day, 182-day and 364–day bills decreased by 144, 232 and 186 basis points, respectively. In a bid to increase the depth of Sri Lanka's bond market, the Central Bank of Sri Lanka issued 20-years and 30-years government bonds in the primary market starting from end May 2013. The primary market yields on 20-years and 30-years Treasury bonds were at 12.15 per cent and 12.50 per cent, respectively, while maturities

Chart 7.6 **Secondary Market Yield Curve**



that ranged between the 20-years and 30-years tenors carried yields within the aforesaid range. Overall, the primary market bond yield curve ranged from 10.87 per cent for the short end (for 3 years and 5 months) to 12.50 per cent for the longer end (30 years) thus far in 2013. Treasury bond issues to the primary market during the first ten months of 2013 amounted to Rs. 923.4 billion (face value) whereas Treasury bills amounting to Rs. 1,063.2 billion (face value) were issued for the same period. The shift from short end of the yield curve to the longer end was supported by the increased foreign investor appetite for Treasury bonds. Foreign holdings in Treasury bonds increased to Rs. 397.3 billion by end September 2013, compared to holdings of Rs. 313.8 billion by end September in the previous year.

- **A significant downward shift at the short end of the secondary market yield curve was observed during the first ten months of the year while longer term yields also declined reflecting favourable market expectations.** Accordingly, the secondary market yield curve at end October 2013 remained below the yield curve at end 2012.

Table 7.3 **Movements in Interest Rates: 2011-2013**

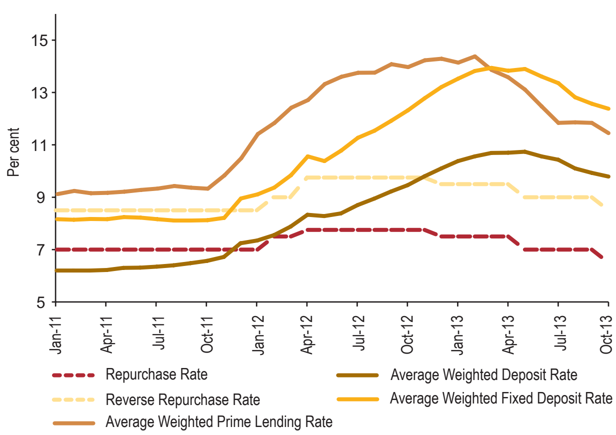
Per cent per annum

Interest Rate	End Dec 11	End Dec 12	Change (Dec 11 - Dec 12) in bps	End Mar 13	End June 13	End Sept 13	End Oct 13	Change (End Oct.13 - end Dec 12) in bps
Policy Rates of the Central Bank								
Repurchase Rate	7.00	7.50	50	7.50	7.00	7.00	6.50	-100
Reverse Repurchase Rate	8.50	9.50	100	9.50	9.00	9.00	8.50	-100
Average Weighted Call Money Rate (AWCMR) (with tax)	8.97	9.83	86	9.44	8.72	8.44	7.86	-197
Average Weighted Call Money Rate (AWCMR) (Tax adjusted)	8.07	8.85	77	8.50	7.85	7.60	7.07	-177
Average Weighted OMO Auction Rate (Repo)	7.58 [a]	8.86	128	8.36	7.80	7.10 [b]	7.10 [b]	-176
Average Weighted OMO Auction Rate (Reverse Repo)	8.07	9.31 [c]	124	9.30 [d]	8.57	8.28 [e]	8.28 [e]	-103
Treasury Bill Yield Rates								
91-day	8.68	10.00	132	9.26	8.66	8.60	8.56	-144
182-day	8.71	11.32	261	10.25	9.70	9.63	9.00	-232
364-day	9.31	11.69	238	11.35	10.66	10.57	9.83	-186
Lending Rates of Commercial Banks								
Average Weighted Prime Lending Rate (AWPR) - Weekly	10.77	14.40	363	13.77	12.09	11.94	11.25	-315
Average Weighted Prime Lending Rate (AWPR) - Monthly	10.49	14.29	380	13.86	12.47	11.84	11.45	-284
Average Weighted Lending Rate (AWLR) [f]	13.44	15.98	254	16.36	16.14	15.71	-	-
Deposit Rates								
Average Weighted Deposit Rate (AWDR)	7.24	10.10	286	10.69	10.56	9.93	9.79	-31
Average Weighted Fixed Deposit Rate (AWFDR)	8.95	13.21	426	13.94	13.61	12.57	12.38	-83

(a) Auction held on 25th November 2011
(b) Auction held on 20th September 2013
(c) Auction held on 18th December 2012
(d) Auction held on 04th January 2013
(e) Auction held on 26th July 2013
(f) AWLR is compiled on a monthly basis from January 2011 onwards

- **Market interest rates on deposits during the early part of the year, displayed a weak response to monetary policy easing, although gradually adjusting downwards by end October 2013.** The deposit rates continued to increase until May as a result of increased competition in the banking sector and aggressive deposit mobilisation efforts to meet targets. With the reduction in policy rates in May 2013, deposit rates commenced declining. The average weighted deposit rate (AWDR), which reflects interest rates pertaining to the stock of all interest bearing deposits held by the public with commercial banks, increased by 64 basis points from end December 2012 to 10.74 per cent by end May 2013. AWDR adjusted downwards to 9.79 per cent by end October 2013, 31 basis points lower than the end 2012 level. The average weighted fixed deposit rate (AWFDR), which reflects the movements of interest rates pertaining to all interest bearing time deposits held by the public with commercial banks, continued its increasing trend until May 2013, and decreased thereafter. The AWFDR, declined to 12.38 per cent by October 2013, falling by 83 basis points from end 2012. The increase in the time deposit interest rates up to May was directly attributable to the aggressive deposit mobilisation efforts by the commercial banks.

Chart 7.7 Movement of Selected Market Interest Rates



- **Commercial bank lending rates, particularly those pertaining to longer term credit, remained downward rigid although prime lending rates were quick to adjust downwards in response to monetary policy easing.** The monthly average weighted prime lending rate (AWPR), which reflects rates applicable on loans and advances granted by commercial banks to their prime customers, decreased from 14.29 per cent by end December 2012 to 11.45 per cent by end October 2013, recording a significant decrease of 284 basis points for the ten month period. Coupled with the 50 basis point reduction in policy rates in May 2013, other lending rates also commenced reducing gradually. The average weighted lending rate (AWLR) pertaining to the stock of all loans and advances extended by commercial banks to the private sector, increased during the first four months of the year and thereafter declined gradually. The AWLR gained 47 basis points since end 2012 to reach a peak of 16.45 per cent in April, and thereafter decreased by 74 basis points to 15.71 per cent by September 2013.

- **Interest rates applicable on foreign currency deposits held with commercial banks recorded a marginal drop compared to the rates prevailed at end 2012, except for those on US dollar time deposits.** Interest rates applicable on US Dollar denominated savings deposits were in a range of 0.015 per cent to 2.682 per cent by end September 2013 compared to a range of 0.015 per cent to 2.737 per cent in 2012. By end September 2013, depositors holding US dollar denominated time deposits were paid interest rates ranging from 0.15 per cent to 5 per cent by commercial banks compared to a range of 0.15 per cent to 3.82 per cent in 2012. Interest rates on pound sterling denominated savings deposits remained unchanged in the range of 0.10 per cent to 3.5 per cent in September 2013, compared to those at end December 2012 while rates on time deposits were in the range of 0.4 per cent to 4.5 per cent in September 2013, compared to a range of 0.375 per cent to 5.354 per cent in 2012. The low interest rates reflected the accommodative monetary policy stance adopted by the Central Banks of advanced economies.

- **Interest rates on debt instruments issued by the corporate sector increased during the first nine months of 2013**. Interest rates relating to commercial paper, a short term debt instrument issued by the commercial banks, increased to a range of 12.15 per cent to 22.00 per cent in the first eight months of 2013 from a range of 11.25 per cent to 22.00 per cent in 2012. Meanwhile, there were twelve listings in the corporate debenture market up to September 2013, of which, three listings were by LCBs. Maturity periods of said debentures were ranging from 3 to 5 years. Interest rates on these issues were in both fixed and floating form, whereas the fixed rates were in the range of 13.5 per cent to 20.00 per cent in comparison to the range of 10.50 per cent to 16.00 per cent recorded in 2012. The interest rates of the debentures issued by the non-financial sector during the first nine months of 2013 ranged from 13.50 per cent to 14.50 per cent.

Monetary Policy in Other Countries

- **Signs of global economic recovery have begun to emerge while inflation worldwide remained broadly contained allowing monetary policy in a majority of economies to stand mostly accommodative.** Within this overall scenario, country performances have been mixed, with key emerging market economies slowing down and while monetary space has been narrowing in some other economies. Communication strategies of central banks continued to play a vital role as an important monetary policy tool as a result of lower maneuverability in interest rates. Central Banks of major economies such as the Federal Reserve, Bank of Japan, European Central Bank and the Bank of England continued experimenting with forward guidance more explicitly, signalling the future path of interest rate policy in order to stabilise medium-to-longer term expectations and strengthen growth performance.

- **Policy interest rates in advanced economies continued to remain close to the zero lower bound and assurances of the continuation of low interest rates were given amidst speculation of early tapering of quantitative easing.** So far in 2013, the Federal Reserve has continued its accommodative monetary policy stance with a near zero Fed funds target rate since 2008 and with quantitative easing. The tapering off of the US asset purchase programme, which was expected to begin in September 2013 depending upon the economic and financial developments of the country, was postponed thereby easing the pressure on global financial markets. It is expected that a high degree of policy accommodation would continue until economic recovery strengthens and unemployment declines towards more desirable levels. In the Euro area, economic conditions have shown some signs of improvement and inflation pressures are expected to remain subdued. In

Table 7.4 Changes in the Policy Interest Rates of Selected Central Banks

	Key Policy Rate	End 2010	End 2011	End 2012	Oct-13
Emerging Economies					
India	Repo rate	6.25	8.50	8.00	7.75
Malaysia	Overnight policy rate	2.75	3.00	3.00	3.00
Thailand	1-day bilateral repo rate	2.00	3.25	2.75	2.50
China	1-year yuan lending	5.56	6.56	6.00	6.00
Advanced Economies					
USA	Federal funds rate	0-0.25	0-0.25	0-0.25	0-0.25
Canada	Overnight funding rate	1.00	1.00	1.00	1.00
UK	Bank rate	0.50	0.50	0.50	0.50
ECB	Refinance Rate	1.00	1.00	0.75	0.50
Sweden	Repo rate	1.25	1.75	1.00	1.00
Japan	Overnight Call rate	0-0.10	0-0.10	0-0.10	0-0.10
South Korea	Base rate	2.50	3.25	2.75	2.50
Australia	Cash rate	4.75	4.25	3.00	2.50

Source: Websites of respective Central Banks

May 2013, the European Central Bank (ECB) reduced its key policy rates i.e., refinancing rate and marginal lending facility by 25 basis points and 50 basis points, respectively, while maintaining the interest rate on the deposit facility unchanged at 0.00 per cent to encourage banks to extend credit. The ECB also announced that its monetary policy stance will remain accommodative as long as the economy needed. The Bank of Japan (BoJ) strengthened further its expansionary monetary policy regime, characterised as quantitative and qualitative monetary easing, and moved to a new operational target of monetary base from a short term interest rate. Accordingly, monetary operations were aimed at increasing the money base at an annual pace of US dollars 600-700 billion for the next two years. The BoJ indicated that monetary easing would continue for as long as necessary to raise inflation to a target of 2 per cent. The monetary policy stance of the Bank of England (BoE) was maintained unchanged with record low levels of policy interest rates that have remained unchanged since March 2009. Furthermore, in August 2013, the BoE also provided explicit forward guidance to the market on the future path of policy interest rates and announced its intent not to raise policy interest rates at least until unemployment declines below 7 per cent. The Reserve Bank of Australia too continued with monetary policy easing and lowered its benchmark cash rate by 25 basis points to a historically low value of 2.50 per cent in August 2013 with the aim of supporting economic growth.

- **Weaker growth prospects in emerging market economies heightened the need for accommodative monetary policy stance to foster economic recovery, but fears of inflation and depreciation caused some emerging market economies to adopt more strict policy measures in the conduct of monetary policy.** Amongst Asian emerging market economies, Bangladesh and Thailand continued to ease their monetary policy during the first nine months of 2013 in response to the below potential economic growth rates and declining inflation. Malaysia, in the meantime, continued to hold its key policy rates unchanged during the first half of 2013. In contrast, Bank Indonesia, the first Asian central bank to raise policy interest rates in June 2013, continued with tighten monetary policy stance and raised its key policy interest rate three consecutive months in a row (July, August and September) in order to combat currency depreciation as well as to ensure that inflation remains within the targeted path. To address the possible re-emergence of inflationary pressures and depreciation of Indian Rupee, Reserve Bank of India raised its key policy rate by 25 basis points in September 2013. In similar vein, the State Bank of Pakistan also raised its policy rate by 50 basis points to 9.00 per cent in September 2013 to contain inflationary expectations in the economy.

Expected Developments

- **The relaxation of the monetary policy stance since end 2012 is expected to encourage private sector credit growth to support the economy to move towards a higher growth trajectory**. The slow adjustment of market lending rates, particularly pertaining to medium to long term credit remains a cause for concern, as economic agents cannot reap the full benefit of the low inflation environment and the low interest rate regime to enhance productive activity. Strengthening the interest rate pass through mechanism through continued dialogue with lending institutions, promoting competition among lending institutions and encouraging flexible interest rate options for both deposit and lending facilities are required in the period ahead.

- **A gradual reversal of continued high borrowing by the public sector from the banks that was observed since 2010 will be required for the private sector to reap the benefits of mega scale physical infrastructure facilities put in place during the past few years.** Increased access to bank funds by the public sector could either induce broad money growth or crowd out banking sector credit to the private sector rendering monetary policy to be less effective in the medium term. Therefore, stringent measures are necessary to curtail bank borrowings from the public sector in order to maintain monetary and credit aggregates on paths consistent with the medium term macroeconomic framework. The continuation of fiscal consolidation efforts should also aim at reducing the reliance of the public sector on bank credit.

- **The low inflation environment achieved and maintained by authorities is expected to continue in the period ahead, although prompt policy action would be needed should a threat of inflation arises in future.** Well contained demand pressures and continuous favourable developments in domestic and global supply conditions would help to keep inflation within the targeted level during the year. However, the revisions to bus fares together with the effect of Rupee depreciation on imports could impact on inflation adversely. Appropriate and timely action to mitigate such adverse developments would help consolidate the benefits of sustained price stability.