7

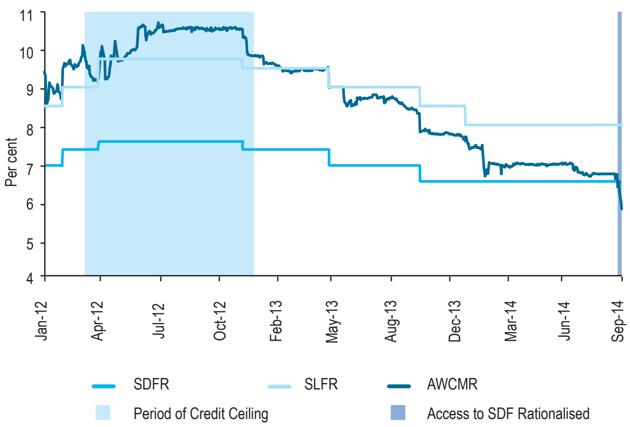
MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

The monetary policy stance remained relatively relaxed since end 2012 benefiting from the low inflation environment and well contained inflation expectations, providing the necessary stimulus to maintain the economy on a sustainable growth trajectory. Inflation remained benign at mid-single digit levels in the first nine months of 2014, and the recent reduction in administered prices for energy and fuel in September 2014 is likely to impact positively on price levels further in the near term. The growth of monetary aggregates was moderate during the first eight months of 2014 on account of the slow growth in credit disbursements to the private sector by commercial banks, although the impact was offset by the substantial buildup of net foreign assets of the banking system. In January 2014, in an effort to further smoothen open market operations (OMO), the policy interest rates were renamed as the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) while the Standing Rate Corridor (SRC) replaced the policy interest rate corridor. The corridor was compressed to 150 basis points by reducing the SLFR by 50 basis points effective 02 January 2014 while the Standing Deposit Facility was uncollateralised from February 2014. As a result of the relatively eased monetary policy stance, there has been a continued downward shift in the market interest rate structure including medium to long-term interest rates, which tightened the spread between lending and deposit rates to some extent. The rupee liquidity in the domestic money market remained high during the first nine months of 2014 mainly as a result of the Central Bank's net absorption of foreign exchange resulting from increased foreign inflows. In order to encourage commercial banks to pursue credit disbursements more actively, and hence, to use excess liquidity for productive economic activity, the Central Bank rationalised access to the Standing Deposit Facility with effect from 23 September 2014.

Monetary Policy

- **The Central Bank continued to maintain a relatively eased monetary policy stance amidst a persistently low inflation environment in the first nine months of 2014.** Several adjustments were introduced to streamline the policy rate corridor at the beginning of the year. On 02 January 2014, in line with the plans and policies unveiled in the *'Road Map: Monetary and Financial Sector Policies for 2014 and beyond',* several changes to the policy interest rate corridor were announced by the Central Bank. Accordingly, the Central Bank established a Standing Rate Corridor (SRC) in place of the policy rate corridor while introducing the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) that replaced, respectively, the Repurchase rate and the Reverse Repurchase rate of the Central Bank. Further, in consideration of the Central Bank's zero credit risk in rupee transactions, the Standing Deposit Facility (SDF) was uncollateralised from February 2014, while all other OMO transactions continued to remain collateral based. In January 2014, the SLFR was reduced by 50 basis points, thus compressing the SRC to 150 basis points from the previous 200 basis points. The SDFR and the SLFR has remained at 6.50 per cent and 8.00 per cent, respectively, since then. While the policy rate reduction was in line with continued monetary policy easing, the compression was expected to further reduce the banks' interest rate spread without unduly lowering deposit rates. A narrower corridor was also expected to facilitate a downward adjustment of lending rates by commercial banks. In addition to these measures, considering the improvement in the external sector, the Central Bank also decided to remove the minimum cash margin requirement of 100 per cent against letters of credit opened with commercial banks for the import of certain categories of motor vehicles, imposed on 30 August 2013, from 02 January 2014.

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

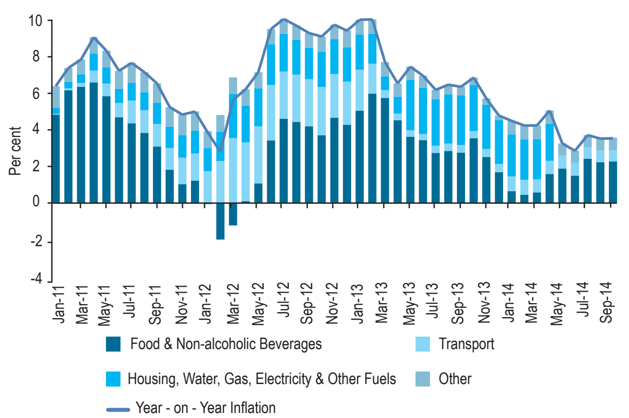


- **The Central Bank implemented further measures to rationalise access to its Standing Deposit Facility (SDF) in view of continued excess liquidity in the domestic money market.** The accumulation of a large amount of excess liquidity was a result of the absorption of foreign exchange from the domestic foreign exchange market by the Central Bank resulting from increased foreign inflows including sovereign bond inflows and swap arrangements with commercial banks. In order to limit OMO participants placing excess liquidity with the Central Bank on a continuous basis rather than temporarily, and allow liquidity to be utilised in productive economic activity, the Monetary Board on 23 September 2014 placed a limit on the use of the SDF by an OMO participant at the SDF rate of 6.50 per cent to three times per calendar month. Any deposit by an OMO participant at the SDF window in excess of three times is accepted at a reduced interest rate of 5.00 per cent per annum.

- **The Central Bank continued its monetary policy conduct based on its inflation and growth projections with necessary adjustments being made to reflect the developments and trends observed in the economy.** At the beginning of the year, both reserve money and broad money were expected to record an end year growth of 14 per cent while credit to the private sector was also expected to increase at a similar rate. Nevertheless, a lower than anticipated growth of credit to the private sector from commercial banks was observed during the first eight months of the year dampening broad money expansion to some extent. The slowdown in private sector credit growth was mainly due to the reduction in gold backed loans since last year in response to declined international gold prices and increased access to alternate financing sources including external sources of financing by the private sector. At the same time, a significant improvement in net foreign assets (NFA) of the banking sector was observed during the first eight months off setting the impact of lower private sector credit growth on broad money. Lower than anticipated credit growth to the private sector in the first half of the year necessitated a revision to the Monetary Programme for 2014, and accordingly, the projected average broad money growth for the year was lowered to 13.5 per cent from the previous projection of 14 per cent.

- **Inflation remained broadly subdued at mid single digit levels, with the outlook remaining benign for the remainder of 2014 as well as for 2015.** Headline inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI), has remained at single digit levels for the last 68 months. Year-on-year headline inflation in September was recorded at 3.5 per cent, while annual average inflation was 4.2 per cent. Low inflation was a combined result of timely policies adopted to manage supply constraints and demand conditions. Some impact on inflation was seen in certain months of the year due to supply disruptions stemming from adverse weather conditions. Nevertheless, these disruptions were counterbalanced by measures taken by the government such as encouraging rice imports and tariff adjustments for certain other imported food items. Further, the recent reduction in administered prices of energy and fuel would impact positively on inflation commencing October 2014, and accordingly, the outlook for inflation remains favourable at below 5 per cent levels by end 2014. Meanwhile, core inflation continued to remain low reflecting well contained demand pressures. As such, year-on-year core inflation was 3.7 per cent and annual average core inflation has also continued to trend downwards recording 3.2 per cent in September 2014.

Chart 7.2 Contribution to Year-on-Year Inflation



- **Considering the fact that communication is vital to anchor private sector expectations and in order to assist in achieving the overriding objectives of monetary policy, the Central Bank continued its efforts to improve awareness of the general public and market participants.** To this end, the Central Bank continued announcing its broad policies and strategies in advance through its *'Road Map: Monetary and Financial Sector Policies for 2014 and beyond'* and issuing regular and occasional communiqués, conducting press conferences, seminars and lectures as well as regular speeches and presentations by the Governor and senior officials of the Central Bank.

The views of the Monetary Policy Consultative Committee (MPCC), comprising eminent private sector representatives, were also taken into consideration in formulating monetary policy. The Central Bank initiated publishing a macroeconomic chart pack consisting of useful economic and financial information on the Central Bank website in July 2014 as a measure to further facilitate the information dissemination process. Through continuous communication with the public by way of several media including social media such as Twitter and Facebook, the Central Bank has been able to align perceptions and expectations of the public with its monetary policy stance, and this was reflected in favourable inflation expectations.

Liquidity

- **Rupee liquidity in the domestic money market remained in surplus in the first nine months of 2014.** Daily excess liquidity during the first nine months of 2014 averaged around Rs. 29 billion, and by end September, excess market liquidity, including that was absorbed on a term basis, amounted to Rs. 342 billion compared to Rs. 72 billion at end 2013. The buildup of large amounts of excess market liquidity has been mainly due to net purchases of foreign exchange by the Central Bank in the domestic foreign exchange market. In addition, liquidity was injected to the market by way of the Central Bank entering into swap arrangements with commercial banks and the purchase of part of the proceeds of the International Sovereign Bonds issued in January and April 2014. The buildup of large amounts of excess liquidity also reflects lower credit demand leaving banking sector resources largely underutilised. The Central Bank has been actively absorbing excess liquidity through term repurchase agreements, with borrowed bonds serving as the underlying security, as the Central Bank's holdings of Government securities remained at low levels.

Reserve Money

- **Reserve money, on a quarterly average basis, was broadly within projections during the first three quarters of the year.** The average quarterly reserve money grew marginally by 0.5 per cent and 1.0 per cent to Rs.497.6 billion and Rs. 523.8 billion in the first quarter and second quarter of 2014, respectively. This lower growth of reserve money during the first half of the year was mainly attributed to the base effect on account of the

Chart 7.3 Absorption of Market Liquidity by Instruments

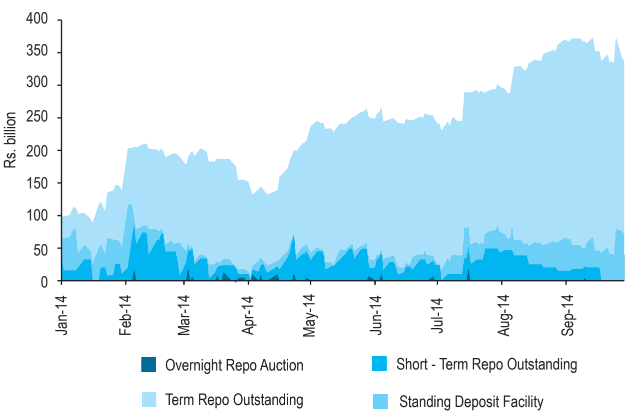
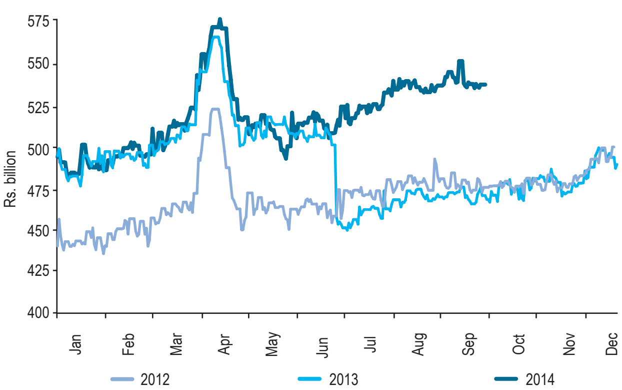


Chart 7.4 Movements of Daily Reserve Money*



*Sudden changes in the movements of reserve money in particular months are due to revisions to SRR and seasonal factors higher Statutory Reserve Requirement (SRR) in the first half of the previous year. This base effect has since dissipated, and average reserve money has grown by 14.3 per cent to Rs. 531.3 billion in the third quarter of the year. Along with the increase in currency in circulation by Rs. 37.0 billion during the first nine months of the year reflecting expanding economic activity, and lower opportunity cost of holding currency, the year-on-year growth of daily reserve money increased to 14.8 per cent by end September.

- **On the assets side, the growth of reserve money during the first eight months of 2014 was entirely due to the expansion in net foreign assets (NFA) of the Central Bank, as net domestic assets (NDA) of the Central Bank contracted during this period.** NFA increased by Rs. 262.2 billion during the period due to the net purchases of foreign exchange in the domestic foreign exchange market along with the Central Bank entering into SWAP arrangements with commercial banks and the purchase of the proceeds of the International Sovereign Bond issues. However, the overall impact of this increase on reserve money was dampened by the contraction in NDA by Rs. 218.8 billion. The reduction in NDA during this period in spite of the increase in net credit to the government (NCG) by Rs. 31.7 billion is mainly attributed to a significant increase in net other liabilities of the Central Bank by around Rs. 248.1 billion. The significant increase in net other liabilities is attributed to the mopping up of excess liquidity with borrowed bonds serving as the underlying security and deposits of commercial banks under the Standing Deposit Facility. Meanwhile, Treasury bill holdings of the Central Bank declined by Rs. 5.3 billion to zero levels, although provisional advances extended to the government increased by around Rs. 36.9 billion during this period.

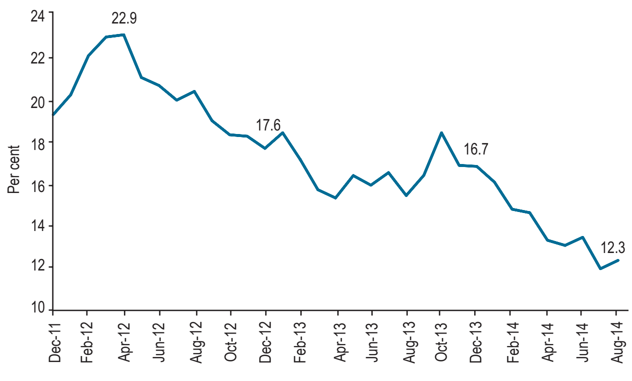
Narrow Money (M_1)

- **The prevailing low interest rate environment led to the public increasingly opting to hold non-interest bearing assets causing an expansion in narrow money supply (M_1) during the first eight months of 2014.** Narrow money, which comprises currency and demand deposits held by the public, grew by 19.3 per cent on a year-on-year basis in August 2014, compared to 7.7 per cent at end 2013. Currency held by the public recorded a year-on-year growth of 16.3 per cent in August 2014 from 5.2 per cent at end 2013, while the year-on-year growth of demand deposits held by the public increased markedly from 10.8 per cent at end 2013 to 23.1 per cent by August 2014. Low interest rates offered by financial institutions on time and savings deposits alongside increased corporate liquidity have caused the public to hold funds in more liquid assets as reflected in the increase in currency and demand deposits. In absolute terms, narrow money increased by Rs. 56.1 billion during the first eight months of 2014 compared to the increase of Rs. 3.0 billion in the corresponding period of the previous year.

Broad Money (M_{2b})

- **Broad money expansion was consistent with the continued growth momentum of the economy and moderating inflation.**

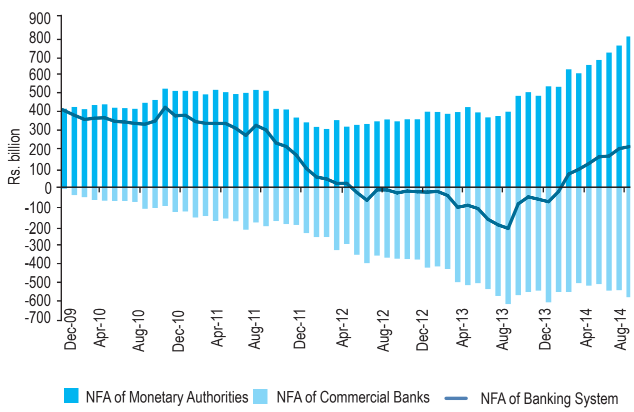
Chart 7.5 Year-on-Year Growth of Broad Money



Year-on-year growth of broad money (M_{2b}) decelerated to 12.3 per cent in August 2014 from 16.7 per cent at end 2013, while the a verage growth of broad money during the first eight months of 2014 was 13.6 per cent. Increase in net repayments along with a substantial drop in gold backed loans, and the availability of alternative sources of finance by the private sector led to the contraction in credit obtained by the private sector thereby dampening the growth of broad money during the first eight months of the year. Furthermore, cost reflective tariff revisions in 2013 led to a reduced reliance on bank funding by public corporations during this period. NCG also remained within the limits envisaged in the Budget 2014. The significant increase in NFA of the banking system during the first eight months of the year mainly contributed to the expansion of money supply. On the liabilities side, the increase in time and savings deposits contributed only around 78 per cent of the year-on-year growth of broad money supply in comparison to 96.7 per cent in the corresponding period of the previous year. Time and savings deposits held by the public increased by 11.1 per cent by August 2014 on a year-on-year basis compared to a growth of 18.3 per cent recorded at end 2013.

- **NFA of the banking system, which turned positive in February 2014, improved significantly thereafter.** Overall NFA increased by around Rs. 289 billion during the first eight months of 2014 due to the significant expansion in NFA of both the Central Bank and commercial banks. Central Bank intervention in the domestic forex market resulting in a net absorption of around US dollars 985 million (Rs. 130 billion) alongside the outright purchase of foreign exchange amounting to US dollars 541 million (Rs. 72 billion) from the proceeds of the sixth International Sovereign Bond led to the substantial increase in NFA of the Central Bank by around Rs. 262 billion during the first eight months of the year. Meanwhile, NFA of commercial banks improved by around Rs. 27 billion during this period following investments abroad from funds obtained through the reversal of forex swaps with the Central Bank and settlement of foreign currency loans obtained by certain public corporations from commercial banks.

Chart 7.6 Net Foreign Assets (NFA)



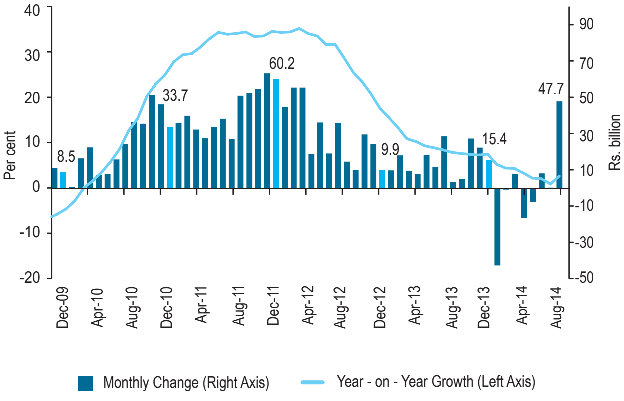
- **NDA of the banking system contracted by Rs. 64.7 billion during the first eight months of 2014 mainly due to the decline in credit obtained by the private sector as well as public corporations.** Nevertheless, within NDA, credit obtained by the government on a net basis (NCG) increased by Rs. 60.9 billion. The decline in NDA contributed negatively to the growth in broad money by about 28.8 per cent during the first eight months of 2014.

- **NCG from the banking system increased by around Rs. 60.9 billion during the first eight months of 2014.** This marks an improvement as NCG in the corresponding period of the previous year was at an elevated level of Rs. 297 billion, while NCG by end August 2014 remained well within the annual budget limit for bank borrowing of Rs. 100 billion for 2014. Credit granted by commercial banks to the government (net) amounted to around Rs. 29 billion during

January-August 2014, and this increase was largely a result of the growing appetite of commercial banks for investments in Treasury bonds owing to high and persistent levels of liquidity in the domestic money market. As a result, Treasury bond holdings of commercial banks (net of repurchase agreements) increased by around Rs. 110 billion, by end August 2014. Furthermore, the outstanding government overdraft balance increased by around Rs. 53 billion. The shift in appetite to long term Government securities resulted in Treasury bill holdings (net of repurchase agreements) by commercial banks to contract by around Rs. 128 billion.

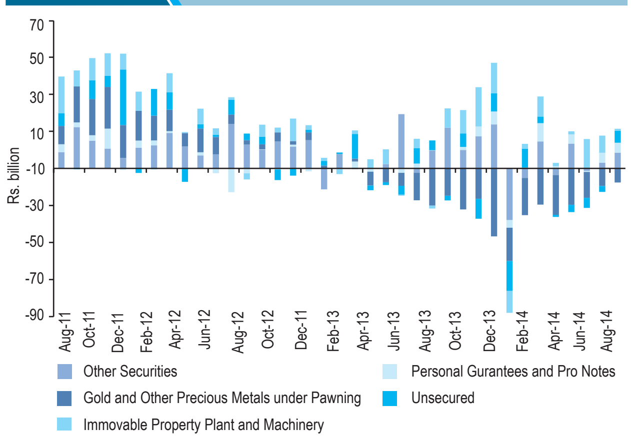
- **Credit obtained by public corporations contracted by around Rs. 27 billion during the first eight months of 2014 compared to an increase of Rs. 72 billion in the corresponding period of 2013.** Cost reflective tariff revisions and the resultant improvement in the financial performance were reflected in the decline in bank credit by Ceylon Petroleum Corporation (CPC) thus far during the year. Settlements of loans by the CPC amounted to around Rs. 57 billion by end August 2014 of which repayments to domestic banking units (DBUs) amounted to Rs. 31 billion. Furthermore, the State Pharmaceuticals Corporation (SPC) and the Paddy Marketing Board made net settlements of around Rs. 3 billion and Rs. 1 billion, respectively, during the first eight months of 2014. In addition, foreign currency loans obtained by SriLankan Airlines from offshore banking units (OBUs) of commercial banks were settled in part by around Rs. 4 billion during this period. However, the Road Development Authority (RDA) and the Ceylon Electricity Board (CEB) obtained credit amounting to around Rs. 22 billion and Rs. 3 billion, respectively, in the first eight months of the year, while Sri Lanka Ports Authority (SLPA) also obtained credit amounting to around Rs. 3 billion. Credit obtained by the two fertiliser corporations increased by Rs. 7 billion during the first eight months of 2014.

Chart 7.7 Credit granted by Commercial Banks to the Private Sector



- **Despite the downward adjustments in lending interest rates, eased access to foreign financial markets and improving domestic corporate debt and equity markets as well as the impact of the decline in pawning advances were reflected in the moderation of the growth of credit extended to the private sector by commercial banks during the first eight months of 2014.** The year-on-year growth of credit extended to the private sector slowed down to 2.6 per cent in August 2014 from 7.5 per cent at end 2013. Although credit obtained by the private sector during the first half of the year significantly contracted by around Rs. 53 billion in absolute terms from end 2013, there was a notable increase in credit by Rs. 47.7 billion during the month of August. Accordingly, the year to date

Chart 7.8 Monthly Change in Security-wise Advances of DBUs of LCBs



decline of credit extended to the private sector was limited to Rs. 4.7 billion by end August 2014. It is expected that credit demand will increase during the remaining months of the year responding to the downward adjustment in lending rates, particularly of medium to long term credit facilities.

- **The decline in gold backed loans remained a key contributory factor to the slowdown in private sector credit growth.** As per the Monthly Survey on Security-wise Advances, the gold backed advances (pawning) showed a significant decline. On a year-on-year basis, pawning advances reported a decline of Rs. 130 billion by August 2014 and this was mainly due to the significant decline in gold prices in international market since late 2012. In this background, in support of credit granted on gold backed advances, the Central Bank introduced a new credit guarantee scheme for pawning advances in June 2014 for licensed banks engaged in pawning activities, which is likely to facilitate the growth of gold backed advances to some extent.

- **As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, the growth of credit to the Industry and the Services sectors accelerated, while Agriculture and Fishing, and Personal Loans and Advances categories contracted, on a year-on-year basis, by end June 2014.** The growth of credit to the Industry sector increased to 14.2 per cent in June 2014 from 7.7 per cent in the corresponding period of last year. The growth of credit to the Services sector increased to 12 per cent in June 2014, compared to 6.9 per cent in the corresponding period of last year. The growth of credit to the Agriculture and Fishing category, which was negative since December 2013, continued to record a negative growth of 15.7 per cent (on a year-on-year basis) by June 2014. As there is a significant decline in credit in the form of pawning, the contraction in credit

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

Rs. billion

Sector	End Jun 2013	End Jun 2014 (c)	Year-on-Year Change	
			Amount	%
Agriculture and Fishing	**332.2**	**280.2**	**-52.0**	**-15.7**
of which, Tea	50.7	62.6	11.9	23.5
Rubber	19.2	20.0	0.7	3.8
Coconut	6.3	6.8	0.5	7.3
Paddy	13.3	16.2	2.9	22.1
Vegetable, Fruit and Minor Food Crops	12.4	13.9	1.6	12.7
Fisheries	9.9	9.9	0.1	0.6
Industry	**814.6**	**929.9**	**115.4**	**14.2**
of which, Construction	353.1	406.8	53.7	15.2
Food and Beverages	58.8	64.8	6.0	10.2
Textiles and Apparel	94.6	101.1	6.5	6.9
Fabricated Metal Products, Machinery and Transport Equipment	73.4	86.7	13.3	18.2
Services	**559.3**	**626.6**	**67.3**	**12.0**
of which, Wholesale and Retail Trade	201.9	207.6	5.7	2.8
Tourism	56.0	70.9	14.9	26.7
Financial and Business Services	116.5	102.7	-13.8	-11.9
Shipping, Aviation and Supply, and Freight Forwarding	10.4	11.0	0.6	6.0
Personal Loans and Advances (d)	**705.5**	**624.9**	**-80.6**	**-11.4**
of which, Consumer Durables	70.5	84.0	13.5	19.2
Pawning	334.8	200.9	-133.9	-40.0
Credit Cards	47.8	54.8	7.0	14.6
Safety Net Scheme Related Advances	**24.1**	**34.1**	**10.0**	**41.6**
Total	**2,435.6**	**2,495.7**	**60.1**	**2.5**

(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'

Source: Central Bank of Sri Lanka

obtained by the private sector through pawning for agriculture-related purposes was a major reason for this decline in credit to the Agriculture and Fishing category by end June 2014.

Broad Money (M_4)[1]

- **In line with the trend observed in broad money supply (M_{2b}), growth of broad money as measured by the financial survey (M_4), decelerated to 13.1 per cent (year-on-year) in August 2014 from 16.2 per cent at the end 2013.** In absolute terms, broad money (M_4) increased by Rs. 347.3 billion during the first eight months of 2014, mainly driven by the increase in NFA by around Rs. 294.5 billion, while NDA also increased by Rs. 52.9 billion during the first eight months of 2014. Meanwhile, the NFA of licensed specialised banks (LSBs) improved by Rs. 5.5 billion during the first eight months of 2014.

- **On a year-on-year basis, the growth of credit extended to the private sector as per the financial survey decelerated.** The growth of credit extended to the private sector in M_4 declined to 5.6 per cent by August 2014 from 8.6 per cent in end 2013. However, credit granted to the private sector by LSBs grew by 12.6 per cent by August 2014 compared to 7.2 per cent by end 2013. The growth of credit granted to the private sector by licensed finance companies (LFCs) remained at 15.7 per cent by August 2014. In absolute terms, credit extended to the private sector by LSBs and LFCs increased by Rs. 29.8 billion and Rs. 55.7 billion, respectively, during the first eight months of 2014.

1. M_4 provides a broader measure of liquidity, covering licensed specialised banks (LSBs) and licensed finance companies (LFCs), in addition to licensed commercial banks (LCBs) and the Central Bank.

Table 7.2

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

Rs. billion

Item	End August 2013	End 2013 (a)	End August 2014 (b)	Year-on-Year Change: Dec - 2013 Amount	Dec - 2013 %	Aug - 2014 Amount	Aug - 2014 %
Broad Money (M_4)	**4,095.6**	**4,283.3**	**4,630.6**	**598.2**	**16.2**	**535.0**	**13.1**
Underlying Factors							
Net Foreign Assets	**-230.5**	**-200.0**	**94.5**	**-164.9**	**-470.2**	**325.0**	**141.0**
Monetary Authorities	396.8	529.1	791.4	132.7	33.5	394.6	99.5
LCBs	-613.4	-605.5	-578.7	-183.2	-43.4	34.7	5.7
LSBs and LFCs	-14.0	-123.7	-118.2	-114.4	-1,238.2	-104.3	-747.1
Net Domestic Assets	**4,326.2**	**4,483.3**	**4,536.1**	**763.1**	**20.5**	**209.9**	**4.9**
Domestic Credit	**5,396.2**	**5,568.7**	**5,723.4**	**739.6**	**15.3**	**327.1**	**6.1**
Net Credit to the Government	**1,721.0**	**1,787.2**	**1,888.2**	**397.2**	**28.6**	**167.2**	**9.7**
Monetary Authorities	186.9	114.0	145.7	-164.8	-59.1	-41.2	-22.1
LCBs	1,155.7	1,187.3	1,216.6	420.9	54.9	60.9	5.3
LSBs	353.2	458.0	479.2	130.3	39.8	126.0	35.7
LFCs	25.2	27.8	46.8	10.8	63.4	21.5	85.2
Credit to Public Corporations	**364.3**	**365.1**	**337.9**	**72.6**	**24.8**	**-26.4**	**-7.2**
LCBs	364.3	365.1	337.9	72.6	24.8	-26.4	-7.2
Credit to the Private Sector	**3,310.9**	**3,416.5**	**3,497.3**	**269.8**	**8.6**	**186.4**	**5.6**
LCBs	2,464.6	2,534.3	2,529.6	175.9	7.5	65.0	2.6
LSBs	364.1	380.2	410.0	25.7	7.2	45.8	12.6
LFCs	482.2	502.0	557.7	68.2	15.7	75.5	15.7
Other Items (net)	**-1,070.0**	**-1,085.5**	**-1,187.2**	**23.5**	**2.1**	**-117.2**	**-11.0**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

- **As per the financial survey, the growth of time and savings deposits decelerated to 12.4 per cent (year-on-year) by August 2014 from 17.5 per cent at end December 2013.** In absolute terms, time and savings deposits increased by Rs. 290.2 billion during the first eight months of 2014. On a year-on-year basis, time and savings deposits with respect to LSBs increased by 12.4 per cent in August 2014 compared to 9.4 per cent by end 2013. In absolute terms, time and savings deposits of LSBs increased by Rs. 63.5 billion contributing 21.9 per cent to the overall increase in time and savings deposits during the first eight months of 2014. Meanwhile, the year-on-year growth of time and savings deposits with LFCs decelarated to 26.8 per cent in August 2014 from 32.7 per cent at end 2013. In absolute terms, this was an increase of Rs. 60.1 billion, and the contribution of LFCs to the overall increase in time and savings deposits in the first eight months of 2014 was 20.7 per cent.

Interest Rates

- **The easing of monetary policy since December 2012 continued to transmit to market interest rates during the first nine months of 2014.** Accordingly, the interest rate structure has declined to a historically low level. At the beginning of the year, the Central Bank reduced its Standing Lending Facility Rate (SLFR) by 50 basis points to 8.00 per cent, with a view to facilitate a reduction in the interest spread of commercial banks. Deposit and lending rates, which displayed some downward rigidity during 2013, showed a more notable decline during the first nine months of 2014. The yields on Government securities declined, reflecting the eased monetary conditions and greater demand for government securities by financial institutions in the context of low credit growth. The secondary market yield curve for Government securities shifted downwards indicating market perceptions of low inflation expectations. On 23 September 2014, the Central Bank limited access of OMO participants to the Standing Deposit Facility (SDF) of the Central Bank at the Standing Deposit Facility Rate (SDFR) of 6.50 per cent to a maximum of three times per calendar month, and any further deposits under the SDF were compensated at a reduced rate of 5.00 per cent, with a view to utilising the excess liquidity in the market more effectively to support productive economic activity.

- **The average weighted call money rate (AWCMR) declined by 189 basis points to 5.77 per cent during the first nine months of the year.** With the reduction in SLFR on 02 January 2014, the AWCMR declined to 7.46 per cent by end January from 7.66 per cent at end 2013. Reflecting the excess liquidity in the money market, the AWCMR eased further to 6.95 per cent by end February 2014 and thereafter settled between 6.63 to 6.99 per cent until end August 2014. Following the rationalisation of the access to the SDF facility in September, the AWCMR declined below the SDFR and accordingly, the AWCMR was 5.77 per cent by end September 2014 compared to 7.66 per cent at end 2013.

- **Yield rates on Government securities declined significantly during the first nine months of 2014.** Yield rates of 91-day and 182-day Treasury bills fell by 139 and 162 basis points to 6.15 per cent and 6.23 per cent, respectively, during the first nine months of the year while yields on 364-day Treasury bills decreased sharply by 240 basis points to 5.89 per cent, falling below 6 per cent for the first time in history. Excess liquidity in the domestic money market led to increased preference of market participants for Government securities thus driving down the yields, while the limited domestic borrowing requirement of the government also led to a lower supply of Government securities in the primary market. Yield rates pertaining to Treasury bonds also declined during the year up to September 2014. During the same period, the government continued to issue Treasury bonds with longer maturities with the view to extend the yield curve. Accordingly, Government securities with maturity of 20 years were issued in the primary market in March 2014 at a yield rate of 11.32 per cent while Treasury bonds with a maturity of 30 years were issued in the primary market during the months of March and May, both at a yield rate of 11.75 per cent.

- **The secondary market yield curve for Government securities shifted further downwards during 2014.** Compared to end 2013, the secondary market yields on Treasury bills of the three maturities decreased by 188 to 236 basis points by end September 2014. Reflecting the moderate inflation expectations and investors' preferences for longer maturities, the secondary market yields on Treasury bonds declined by 231 to 294 basis points by end September 2014 in comparison to end 2013.

- **Interest rates offered on deposits by commercial banks witnessed a more notable decline during the first nine months of 2014 in response to the easing of monetary policy since end 2012.** The average weighted deposit rate (AWDR), which reflects the movement of interest rates pertaining to all interest bearing deposits held with commercial banks, declined from 9.37 per cent at end 2013 to 6.83 per cent by end September 2014. The average weighted fixed deposit rate (AWFDR), which is computed in respect of term deposits maintained with commercial banks declined to 8.18 per cent by end September compared to 11.78 per cent at end 2013. Despite the notable decline in interest rates, depositors have benefitted from positive real rates of return as inflation continued to remain below the interest rates offered on most deposits by commercial banks.

- **In line with the downward adjustments in other market interest rates, commercial banks' lending rates also continued to decline during the period under review.** The average weighted prime lending rate (AWPR), which reflects the rates applicable on loans and advances granted by commercial banks to their prime customers, computed on a weekly basis, declined significantly by 381 basis points to historically low levels of 6.32 per cent by end September 2014 from 10.13 per cent recorded at end December 2013. The monthly AWPR too declined by 303 basis points to 6.93 per cent during the first nine months of 2014. Meanwhile, the monthly average weighted lending Rate (AWLR) relating to the stock of all loans and advances extended by commercial banks to the private sector decreased by 189 basis

Chart 7.9 Secondary Market Yield Curve

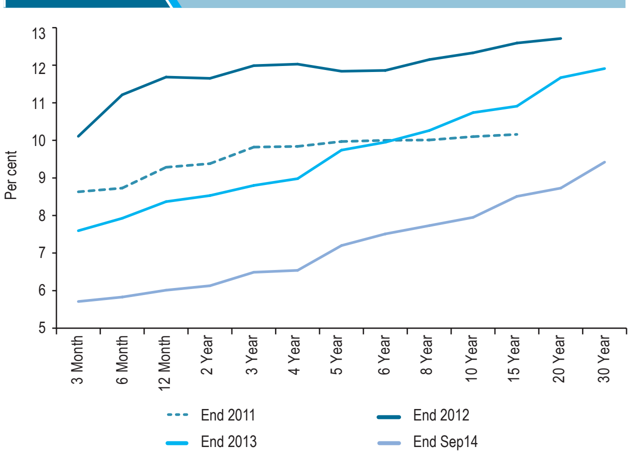


Chart 7.10 Movements of Selected Market Interest Rates

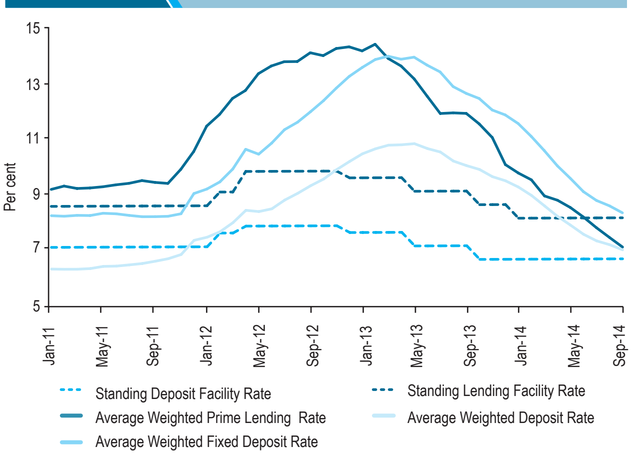


Table 7.3 Movements of Market Interest Rates (a)

Per cent per annum

Interest Rate	End Dec 11	End Dec 12	End Dec 13	End Sep 2014
Policy Interest Rates (b)				
Standing Deposit Facility Rate (SDFR)	7.00	7.50	6.50	6.50
Standing Lending Facility Rate (SLFR)	8.50	9.50	8.50	8.00
Average Weighted Call Money Rate (AWCMR)	8.97	9.83	7.66	5.77
Treasury Bill Rates				
91-Day	8.68	10.00	7.54	6.15(c)
182-Day	8.71	11.32	7.85	6.23(c)
364-Day	9.31	11.69	8.29	5.89
Commercial Banks				
Interest Rates on Deposits				
Savings deposits	1.00-8.50	0.75-10.50	0.75-9.14	0.75-8.00(d)
One year fixed deposits (e)	5.55-11.00	5.00-17.00	6.00-16.00	4.15-12.00(d)
Average Weighted Deposit Rate (AWDR)	7.24	10.10	9.37	6.83
Average Weighted Fixed Deposit Rate (AWFDR)	8.95	13.21	11.78	8.18
Interest Rates on Lending				
Average Weighted Prime Lending Rate (AWPR)	10.77	14.40	10.13	6.32
Average Weighted Lending Rate (AWLR)	13.44	15.98	15.18	13.29(d)
Other Financial Institutions				
Interest Rates on Deposits				
National Savings Bank				
Savings deposits	5.00	5.00	5.00	5.00
One year fixed deposits	8.50	12.50	9.50	6.50
Licensed Finance Companies (f)				
Savings deposits	6.16-7.50	7.79-9.69	6.67-8.86	5.81 - 7.41
One year fixed deposits	10.72-12.74	14.94-16.66	12.66-14.35	8.99 - 10.87
Interest Rates on Lending				
National Savings Bank (g)	10.00-12.50	14.00-15.50	14.00-15.50	12.00-13.50
State Mortgage and Investment Bank (g)	11.50-13.50	17.00-19.00	12.75-17.50	10.50-19.00
Licensed Finance Companies (f)				
Finance leasing	13.18-22.02	17.12-26.07	18.04-24.78	16.47 - 23.96
Hire purchase	13.18-19.74	16.60-23.83	19.47-22.89	16.15 - 21.56
Loans against real estate	15.87-19.47	20.87-24.75	20.00-23.60	16.30 - 22.04
Corporate Debt Market				
Debentures	11.50-13.00	10.50-17.00	8.00-20.00	10.75-15.50(d)
Commercial paper	8.26-14.00	11.25-22.00	8.50-22.00	7.70-12.50(d)

(a) Based on the rates quoted by commercial banks and other selected financial institutions.
(b) The Repurchase rate and the Reverse Repurchase rate of the Central Bank were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively, w.e.f. 02 January 2014.
(c) At the last auction for the quarter
(d) Data for the month of August 2014
(e) Maximum rate is a special rate offered by certain commercial banks
(f) Average rates, based on the maximum and minimum rates quoted by LFCs
(g) Lending for housing purposes only.

Sources: Colombo Stock Exchange
Respective financial institutions
Central Bank of Sri Lanka

points to 13.29 per cent by end August 2014 from 15.18 per cent in end 2013. Almost all security wise lending rates declined significantly by end August 2014, while bank wise average weighted lending rates shifted downwards to 8.90 to 17.95 per cent by end August 2014, from 10.14 to 19.52 per cent at end 2013.

- **Interest rates pertaining to foreign currency deposit liabilities with commercial banks declined marginally compared to rates that prevailed at end 2013.** Interest rates on US dollar denominated savings were in a range of 0.01 per cent to 3.25 per cent by end August 2014, compared to a range of 0.02 per cent to

3.82 per cent by end 2013. Meanwhile, interest rates offered by commercial banks on US dollar denominated time deposits were in the range of 0.01 per cent to 4.50 per cent during the first eight months of 2014 compared to a range of 0.20 per cent to 5.00 per cent by end 2013. Interest rates on savings deposits in pound sterling were in the range of 0.10 per cent to 3.50 per cent by August 2014, compared to a range of 0.10 per cent to 3.00 per cent reported at end 2013. Interest rates applicable on pound sterling denominated time deposits were in the range of 0.20 per cent to 4.25 per cent during the first eight months of 2014, compared to the range of 0.25 per cent to 4.55 per cent by end 2013. The low interest rates applicable to foreign currency deposits were mainly due to the continued low interest rate environment in advanced economies.

- **In line with the downward adjustments in interest rates observed so far in 2014, interest rates applicable on corporate debt instruments also showed signs of downward adjustments.** During the first eight months of 2014, there were fifteen listings in the corporate debenture market by six private corporations with a maturity of 3 years to 7 years. Rates offered on these issues payable quarterly, semi-annually and annually were in the range of 10.75 per cent to 15.50 per cent compared to 8.00 per cent to 20.00 per cent that prevailed at end 2013. Meanwhile, interest rates relating to commercial paper decreased to a range of 7.70 per cent to 12.50 per cent in the first eight months of 2014 compared to a range of 8.50 per cent to 22.00 per cent levels observed at end 2013. Investments in debentures and commercial papers by commercial banks increased by 20 per cent during the first eight months of 2014.

Monetary Policy in Other Countries

- **Low inflation environment in most advanced economies enabled their central banks to maintain a relaxed monetary policy stance amidst broadly strengthening economic activity.** Monetary conditions remained mostly supportive in advanced economies despite the increases in long term interest rates since May 2013 as the US Federal Reserve announced its intention to begin tapering its asset purchase programme. In December 2013, the Federal Reserve announced the tapering-off of US dollars 85 billion per month quantitative easing (QE) programme, limiting securities purchased under the programme to US dollars 75 billion each month, commencing January 2014. Accordingly, the monthly asset purchases by the Federal Reserve Bank reduced to US dollars 15 billion per month with effect from October 2014. The European Central Bank (ECB) reduced its key policy rates i.e., refinancing rate and marginal lending facility by 10 basis points and 35 basis points, respectively in June 2014. After several months of deliberation and speculation, the ECB also introduced negative interest rates on its deposit facility with effect from 11 June 2014. Accordingly, interest rate on the deposit facility decreased by 10 basis points to -0.10 per cent by July 2014. Meanwhile, further relaxing

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

Country	Key Policy Rate	End 2011	End 2012	End 2013	Sep - 2014
Emerging Economies					
India	Repo rate	8.50	8.00	7.75	8.00
Malaysia	Overnight policy rate	3.00	3.00	3.00	3.25
Thailand	1-day bilateral repo rate	3.25	2.75	2.25	2.00
China	1-year yuan lending	6.56	6.00	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	0.75	0.25	0.05
Sweden	Repo rate	1.75	1.00	0.75	0.25
Japan	Overnight Call rate	0-0.10	0-0.10	0-0.10	0-0.10
South Korea	Base rate	3.25	2.75	2.50	2.25
Australia	Cash rate	4.25	3.00	2.50	2.50

Source: Websites of respective central banks its monetary policy, ECB revised its key policy rates in September 2014. Accordingly, refinance rate, marginal lending facility rate and deposit facility rate were reduced by 10 basis points to 0.05 per cent, 0.30 per cent and -0.20 per cent, respectively, with effect from 10 September 2014. Further, to support provision of credit to the euro economy, ECB decided to launch its asset-backed securities purchase programme in October 2014. Furthermore, monetary policy stance of the Bank of England (BoE) was maintained unchanged since March 2009. It continued to maintain its quantitative easing, with the stock of assets purchases remaining at sterling pounds 375 billion at end August 2014. The Bank of Japan (BoJ) also used quantitative and qualitative monetary policy easing methods to achieve the inflation target of 2 per cent while continuing its assets buying programme at an annual space of about 60 to 70 trillion yen. Amongst other advanced countries, the Reserve Bank of New Zealand raised its policy interest rate by 25 basis points in March 2014 to 2.75 per cent and further to 3.50 per cent in July 2014 citing inflationary pressures.

- **Monetary policy in emerging economies showed somewhat mixed responses thus far in 2014 in view of the challenges arising due to quantitative easing of major central banks, such as fluctuation in exchange rates and volatility in capital flows as well as movements in inflation, unemployment and growth.** In response to the challenges faced by many emerging economies, their central banks were prompted to tighten the monetary policy stance while most other central banks eased their monetary policy stance. The Bank of Russia increased its key rate to 8.00 per cent to prevent excessive volatility in financial markets in July 2014. Further, Brazil, Indonesia and South Africa raised policy interest rates in order to dampen volatility in financial markets and currencies due to the US tapering programme. Meanwhile, India raised its policy interest rates in January 2014 to counter resurgence in inflation. In contrast to such tightening, the Bank of Thailand reduced its policy interest rates by 25 basis points to 2.00 per cent in March 2014 and Chile's Central Bank lowered its policy interest rates by 25 basis points to 3.25 per cent in September 2014. The policy interest rates in China remained unchanged at 6.00 per cent since July 2012. However, in order to encourage weakening economic growth in China, the Peoples' Bank of China announced a reduction in the reserve requirement for selected banks in April and June 2014.

Expected Developments

- **The current monetary conditions and low interest rate environment are expected to induce private sector credit growth in the remaining period of 2014 and in 2015.** Indicating the lagged effect of monetary policy, market lending rates, particularly rates pertaining to medium to long term credit have started to adjust downwards. The Central Bank also continued its dialogue with financial institutions in order to strengthen the interest rate pass through mechanism. Benefiting from such low interest rates and utilising the available large excess liquidity in the system, it is expected that private sector credit growth would pick up in the balance part of the year allowing the private sector to enjoy the benefits of the continued low interest rates and benign inflation environment.

- **Going forward, it is expected that the low inflation environment would continue into the medium term facilitated by prompt policy actions taken to address any demand side pressures and supply side disturbances.** It is projected that headline inflation is likely to remain at mid-single digit levels by the end of 2014 and in 2015, unless disturbed by severe supply shocks. To that end, given the subdued demand pressures in the economy, substantial pressures on prices are not expected in the medium term. Nevertheless, the Central Bank would closely observe macroeconomic conditions in order to address any future developments in demand building up excessively or to mitigate any impact from adverse supply shocks by providing timely policy advice to the government.

- **In moving towards the upper middle income levels, the monetary policy framework is expected to be further strengthened to place the Central Bank on par with current global best practices.** Under the existing monetary targeting framework, the Central Bank has been able to reduce and maintain inflation at single digit levels for a long period. In order to ensure the continuation of such achievement, the existing monetary targeting framework would be further strengthened by improvements to the communication policy, inflation forecasts and expectation surveys.