7

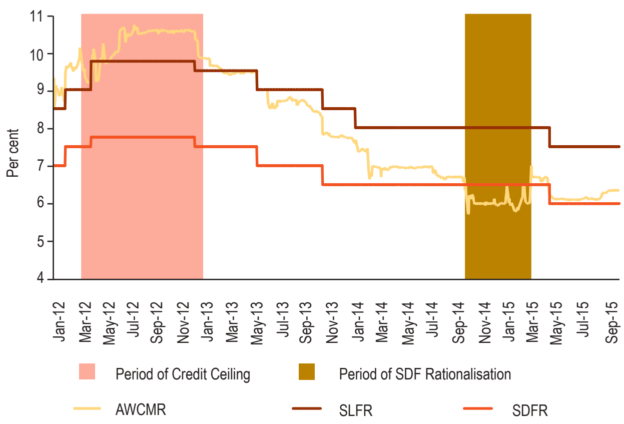
MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

In the first nine months of 2015, the Central Bank continued to pursue a relatively relaxed monetary policy stance in an environment of continued low inflation and subdued inflation expectations, with a view to support the growth momentum of the economy. As private sector credit growth revived gradually, in March 2015, the Central Bank removed the restrictions placed on access to its Standing Deposit Facility (SDF) under open market operations that have been in effect since September 2014. To dampen the impact of this adjustment on short term interest rates, the Central Bank lowered its policy interest rates by 50 basis points in April 2015. In the domestic money market, the excess rupee liquidity, which was significantly high throughout 2014, declined gradually during the year. Even though some upward pressure on interest rates was observed in certain periods of the year, particularly on short term interest rates due to changing liquidity levels as well as on the yield rates of the government securities, market interest rates broadly continued to remain low. Benefiting from the low interest rate environment, credit flows to the private sector increased substantially during the first eight months of 2015. The sustained increase in credit provided by commercial banks to key sectors of the economy such as Industry and Services, together with high borrowings by the public sector caused broad money supply to expand at a higher than projected rate during the first eight months of the year. Meanwhile, headline inflation declined further into the negative territory during 2015 mainly due to the favourable supply side developments and the impact of significant downward adjustments of domestic administered prices, although trends in core inflation reflected the gradual firming up of aggregate demand in the economy.

Monetary Policy

- **During the first nine months of 2015, the Central Bank continued to maintain a relatively relaxed monetary policy stance with the view of supporting economic activity in the backdrop of persistently low levels of inflation.** During the early part of 2015, the Central Bank actively engaged in managing high levels of excess liquidity in the domestic money market. Accordingly, with the view of maintaining interest rate stability, the Central Bank conducted auctions for outright sale of Treasury bills to absorb excess market liquidity on a permanent basis, while overnight repurchase auctions were also conducted. The low interest rate environment driven by the continuously relaxed monetary policy stance encouraged the demand for bank credit by the private sector reflecting the effective pass-through of monetary policy actions into the broader economy. The sustained increase in credit flows to the private sector enabled the Central Bank to remove the temporary restriction placed in September 2014 on access to its Standing Deposit Facility (SDF) under open market operations (OMO) with effect from 02 March 2015. Following this move, the overnight interest rates moved upwards and settled within the policy rate corridor close to the lower bound. However, considering the intermittent increase in interest rates in certain market segments in the aftermath of the removal of restrictions on the SDF and also the sharp decline in inflation, in April 2015 the Central Bank reduced its Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) by 50 basis points to 6.00 per cent and 7.50 per cent, respectively. This downward adjustment was expected to provide greater stability to market interest rates, thereby supporting the continued flow of funds to the economy. As expected, the undue increase observed in certain short term interest rates reversed following the downward adjustment in policy interest rates. Meanwhile, with the decline in market liquidity levels, the Central Bank allowed a gradual upward adjustment in overnight interest rates towards end August 2015. Nevertheless, despite such increases in short term interest rates, including the yield rates on government securities, retail interest rates have continued to remain low so far during the year. In the meantime, the Central Bank conducted reverse repurchase auctions occasionally to provide liquidity to market participants under OMO who experienced a shortage of funds, and accordingly to maintain interest rate stability. The Central Bank continued to monitor developments in inflation and output of the economy vis-à-vis the monetary developments for the early identification of possible threats to economic and price stability. Meanwhile, as a macro-prudential measure, the Central Bank imposed a maximum Loan to Value (LTV) ratio of 70 per cent in September 2015 with effect from 01 December 2015 in respect of loans and advances granted for the purpose of purchase or utilisation of motor vehicles by banks and financial institutions supervised by the Central Bank. This measure, along with the other demand management policies, was expected to facilitate the maintenance of monetary and credit expansion at a tolerable level.

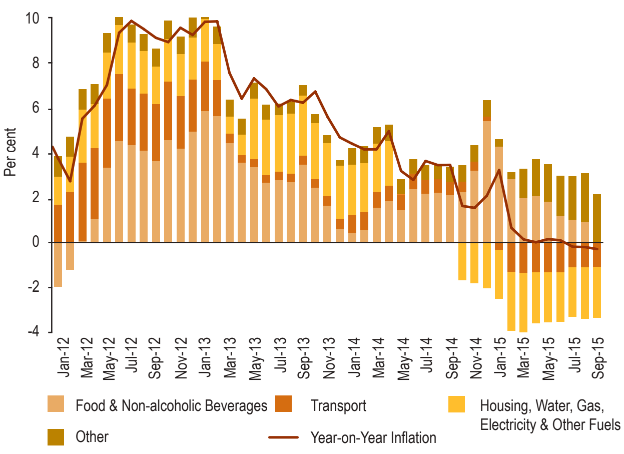
Chart 7.1 Policy Rate Corridor and Average Weighted Call Money Rate (AWCMR)



- **During 2015, the Central Bank conducted monetary policy in an enhanced framework aligning increasingly towards a flexible inflation targeting (FIT) framework, while monetary aggregates continued to remain as key indicative variables.** Under this enhanced policy framework of the Central Bank, inflation is expected to be stabilised in a range of 3-5 per cent in the medium term, while supporting the growth momentum in the economy. Considering the importance of money supply as a key indicative variable to guide monetary policy, the Central Bank continued preparing its monetary programme, which originally envisaged an annual growth of 12 per cent in broad money (M_{2b}). Nevertheless, the actual broad money growth, on a year-on-year basis, was 16.8 per cent by end August 2015. Higher than expected growth in broad money on account of increased domestic credit provided to both public and private sectors necessitated a revision to monetary projections of the Central Bank. Accordingly, as per the revised projections, broad money is expected to increase by around 16 per cent by end 2015.

- **Inflation continued to remain at single digit levels for the seventh consecutive year, reflecting prudent demand management policies of the Central Bank, while it declined to the negative territory mainly due to the favourable supply side developments and the impact of significant downward adjustments to domestic administered prices.** Headline inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI), declined sharply from 2.1 per cent recorded at end December 2014 to negative levels by July 2015 and continued to be in the negative territory during the months of August and September as well. Accordingly, by September 2015, headline inflation, on a year-on-year basis, remained at -0.3 per cent, and consequently annual average inflation also moderated to 0.7 per cent in September 2015 compared to 3.3 per cent recorded in December 2014. While sustained low inflation is a reflection of the effectiveness of the monetary policy conduct of the Central Bank, the significant decline in inflation in 2015, even towards negative levels, was mainly caused by the downward revisions to domestic energy prices as well as the impact of the reduction in the prices of certain food items by the Government's Interim Budget for 2015. Meanwhile, core inflation, which directly measures the demand driven component of inflation, also continued to remain in low-single digit levels. Nevertheless, some upward movement in core inflation was observed during the last seven months due to price pressures in the non-food items of the CCPI basket such as expenses related to health care, clothing and footwear, indicating the gradual firming up of underlying inflation in the economy. Year-on-year core inflation remained at 4.2 per cent in September 2015 compared to 3.2 per cent recorded at end 2014, while annual average core inflation was at 2.8 per cent compared to 3.5 per cent recorded in 2014.

Chart 7.2 Contribution to Year-on-Year Headline Inflation

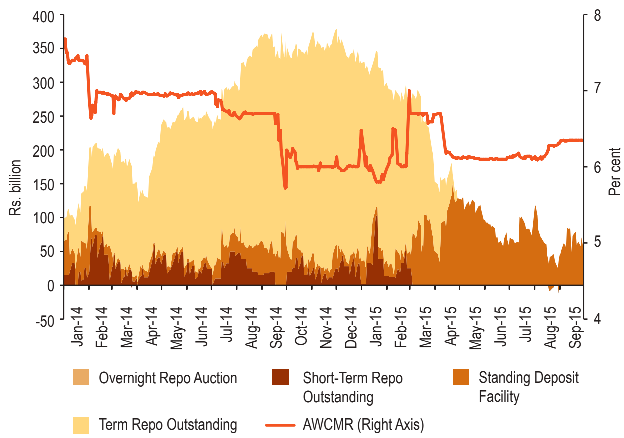


- **The Central Bank pursued its communication strategy with an aim of providing greater clarity about policy decisions among market participants and the general public.** The policies and the decisions of the Central Bank were communicated to the market participants and the general public on a regular basis and in a timely manner by way of issuing regular and occasional communiqués, conducting press conferences, seminars and lectures as well as speeches by the Governor and the senior officials of the Central Bank. The Central Bank held a continuous dialogue with market participants in order to provide a high degree of predictability with regard to policy actions of the Bank, while implementing several measures to improve the data dissemination. The Central Bank subscribed to the Special Data Dissemination Standard (SDDS) of the International Monetary Fund (IMF) for disseminating economic and financial data to the public, while continuing to publish useful economic information in weekly and monthly economic indicators, monthly bulletins as well as the macroeconomic chart pack. The effectiveness of the Central Bank's communication strategy along with its move towards greater transparency was evident by well aligned perceptions and expectations of the public as reflected in favourable inflation expectations.

Money Market Liquidity

- **High excess liquidity that prevailed throughout 2014 in the domestic money market, gradually declined during the year up to end September 2015.** During the first nine months of 2015, overnight excess liquidity ranged from Rs. 3.3 billion to Rs. 149.4 billion, and averaged to Rs. 70.8 billion. At the same time, total excess liquidity remained at Rs. 62.4 billion by end September 2015 compared to Rs. 325.6 billion at end 2014. The substantial decline in excess liquidity during 2015 was a combined outcome of net sales of foreign exchange by the Central Bank in the domestic foreign exchange market, retirements and outright sales of Treasury bills held by the Central Bank, foreign loan repayments and currency withdrawals from the Central Bank during the year as well as the pickup in domestic credit expansion. Nevertheless, a substantial amount of rupee liquidity was injected to the market through the purchases of Treasury bills by the Central Bank as well as through the purchase of part of the proceeds of the Sri Lanka Development Bonds (SLDBs) by the Central Bank. During the early part of 2015, the Central Bank actively engaged in managing excess liquidity in the domestic money market on overnight, short term and long term bases, while encouraging commercial banks to utilise high excess liquidity to increase credit flows to the private sector. In the meantime, all outstanding term repurchase (repo) agreements were allowed to mature by end April 2015. Hence, the remaining excess liquidity in the money market was largely absorbed on an overnight basis through the SDF to maintain the stability of short term interest rates. During 2015, the Central Bank also conducted auctions for outright sales of Treasury bills to absorb liquidity, while conducting overnight reverse repurchase auctions occasionally to inject liquidity to the market considering the uneven distribution of excess liquidity among market participants and thereby preventing excessive volatility in short term interest rates.

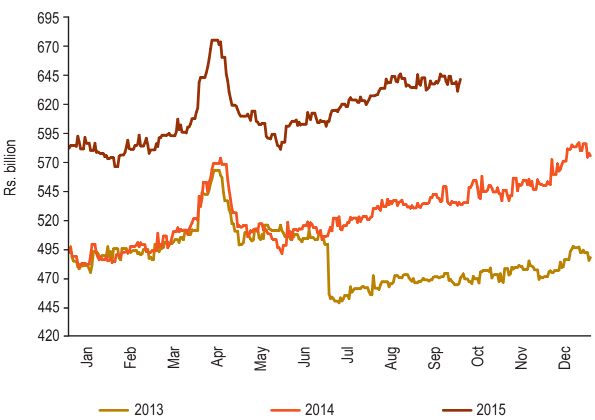
Chart 7.3 Absorption of Market Liquidity by Instruments



Reserve Money

- **Reserve money grew at a high pace in the first eight months of 2015.** On a year-on-year basis, reserve money increased by 19.8 per cent by end August 2015 compared to the growth of 18.3 per cent recorded at end 2014. The average growth of reserve money during the first eight months of 2015 was 19.0 per cent. On the liabilities side, the expansion in reserve money was mainly due to the increase in currency in circulation and the commercial banks' deposits with the Central Bank. In addition to the substantial increase in currency in circulation observed in 2015 as a result of the high demand for currency in view of the national elections and the sluggish return of currency to the banking system due to low interest rates on deposits, currency in circulation displayed similar historical patterns indicating a significant increase due to the higher demand for currency during festive seasons. Accordingly, currency in circulation increased by Rs. 47.1 billion during the first eight months of the year, in comparison to the increase of Rs. 34.3 billion in the corresponding period of 2014. The outstanding currency in circulation amounted to Rs. 464.0 billion by end August 2015.

Chart 7.4 Movements in Daily Reserve Money*



*Sudden changes in the movements of reserve money in particular months are due to revisions to statutory reserve ratio and seasonal factors.

- **On the assets side, the expansion in reserve money during the first eight months of 2015 was entirely due to the increase in net domestic assets (NDA) of the Central Bank.** NDA of the Central Bank, which contracted during 2014, increased considerably by Rs. 296.4 billion during the first eight months of 2015. Within NDA, net credit to the government (NCG) by the Central Bank increased by Rs. 94.9 billion due to the surge in holdings of government securities, which increased by Rs. 86.0 billion to Rs. 92.1 billion and an increase in provisional advances extended to the government by Rs. 9.1 billion to Rs. 153.0 billion. Further, the contraction in net other liabilities of the Central Bank, which is included in NDA, declined significantly by Rs. 207.3 billion by end August 2015 mainly due to non-reliance of borrowed bonds by the Central Bank in view of increased Treasury bill holdings. Meanwhile, net foreign assets (NFA) of the Central Bank declined significantly by Rs. 237.1 billion during the first eight months of the year. The significant decline in NFA was mainly due to foreign currency sales by the Central Bank in the domestic foreign exchange market along with the decline in holdings of foreign securities and increased foreign liabilities of the Central Bank due to international swap arrangements.

Narrow Money (M_1)

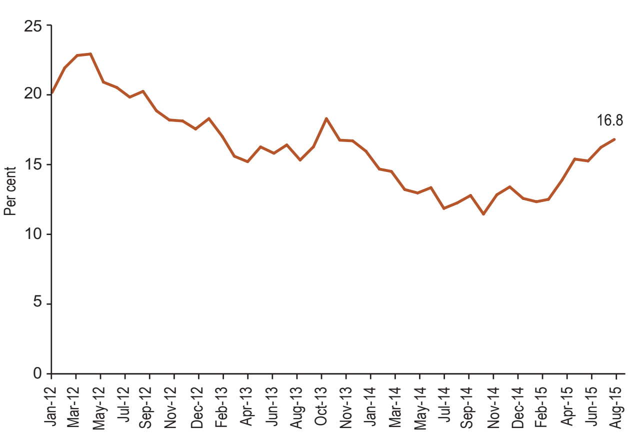
- **Following the increasing trend observed in 2014, narrow money supply (M_1) continued to expand considerably during the first eight months of 2015, albeit at a lower rate compared to end 2014.** Narrow money, which comprises currency and demand deposits held by the public, expanded by 20.2 per cent on a year-on-year basis by end August 2015, compared to 26.3 per cent recorded at end 2014. Currency held by the public grew by

22.9 per cent, year-on-year, in August 2015, compared to 24.5 per cent recorded at end 2014. The increase in currency held by the public during the period under consideration is mainly attributed to the high currency demand related to two national elections held in 2015, while the increase in currency in circulation during the festive season did not fully return to the Central Bank. In addition, the continuation of the low interest rate environment has led to lower opportunity cost of holding currency, thereby raising the demand for currency. Meanwhile, the year-on-year growth of demand deposits held by the public at commercial banks was 17.0 per cent in August 2015, compared to the growth of 28.5 per cent recorded at end 2014. The low interest rate environment along with the seasonal effects led to the relatively high increase in demand deposits held by the public during the period under review although the expansion was slower compared to end 2014.

Broad Money (M_{2b})

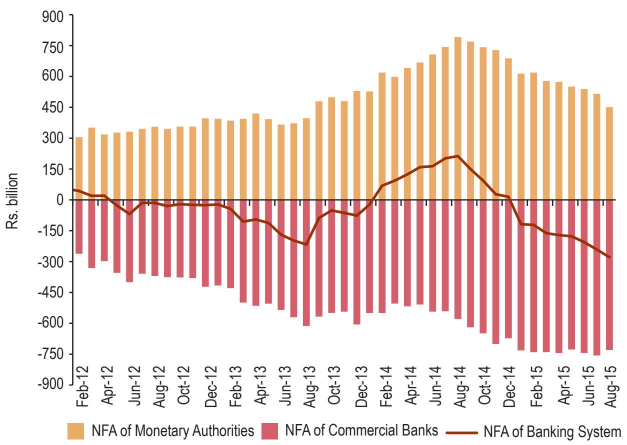
- **Reflecting the relaxed monetary conditions in the economy, the growth of broad money supply (M_{2b}) accelerated further during the first eight months of 2015**. Broad money recorded a year-on-year growth of 16.8 per cent by end August 2015 compared to 13.4 per cent recorded at end 2014, while the average broad money growth during the first eight months of 2015 was 14.4 per cent compared to 13.6 per cent in the corresponding period of 2014. The significant increase in domestic credit, which includes credit flows to the private sector, the government as well as public corporations from the banking system, entirely contributed to the monetary expansion during this period, as the NFA of the banking system recorded a contraction. From the liabilities side, the increase in time and savings deposits held by the public accounted for around 82 per cent of the year-on-year growth of broad money in August 2015, while the remainder could be attributed to the growth of narrow money. The growth of time and savings deposits held by the public, which decelerated to 11.3 per cent on a year-on-year basis by end 2014, increased to 16.2 per cent by end August 2015 led by time and savings deposits held in the domestic banking units (DBUs) of commercial banks.

Chart 7.5 Year-on-Year Growth of Broad Money (M_{2b})



- **On the source side of broad money expansion, NFA of the banking system contracted substantially during the first eight months of 2015 on account of the diminution in NFA of both the Central Bank and commercial banks.** The decline in NFA of the Central Bank amounting to Rs. 237.1 billion was a combined outcome of increased foreign currency sales in the domestic foreign exchange market, declined investments in foreign securities and increased foreign liabilities of the Central Bank as well as repayments in domestic currency swap arrangements. NFA of commercial banks also declined by Rs. 56.9 billion by August 2015, of which NFA from DBUs declined by Rs. 18.6 billion. The contraction in NFA of commercial banks was mainly due to a reduction in foreign currency placements with foreign banks and an increase in both non-resident foreign currency account (NRFC) and resident non-national

Chart 7.6 Net Foreign Assets (NFA) of the Banking System



foreign currency account (RNNFC) balances of commercial banks. At the same time, NFA of offshore banking units (OBUs) also declined by Rs. 38.2 billion during the period under review, reflecting a significant reduction in foreign currency placements by OBUs with foreign banks. Accordingly, during the first eight months of the year, NFA of the banking system contracted by Rs. 294.0 billion, contributing negatively to the expansion in broad money.

- **Reflecting the sustained growth in domestic credit, NDA of the banking system, which increased towards the latter part of 2014, continued to expand in the first eight months of 2015 as well.** During the year up to August 2015, domestic credit provided by the banking sector, which is the main component of NDA, increased due to the expansion in credit to the private sector as well as to the government and public corporations. As a result, NDA of the banking system increased significantly by Rs. 670.6 billion, contributing entirely to the expansion in broad money.

- **NCG from both the Central Bank and commercial banks increased significantly during the first eight months of 2015.** During this period, NCG increased by Rs. 299.7 billion compared to the Rs. 60.9 billion increase in the corresponding period of the previous year and also compared to the annual budgetary estimate for bank borrowing of Rs. 70 billion for 2015. The delay in foreign financing flows to the government during the period under review led the government to resort to increased domestic financing, thereby raising the level of NCG from the banking sector. The increase in NCG during the reference period was mainly due to the significant increase in credit granted to the government by commercial banks amounting to Rs. 204.9 billion. Contributing to the increase in NCG by commercial banks, investments in SLDBs by commercial banks increased significantly by around Rs. 151.3 billion. Also, reflecting a shift in the appetite to short term government securities, Treasury bill holdings of commercial banks (net of repurchase transactions) increased by around Rs. 23 billion by end August 2015, whereas Treasury bond holdings (net of repurchase transactions) declined by around Rs. 19 billion. In addition, the outstanding government overdraft balance with the two state commercial banks increased by around Rs. 28 billion to Rs. 142.2 billion during the first eight months of 2015.

- **Credit obtained by public corporations increased by Rs. 36.5 billion during the first eight months of 2015 compared to the contraction of Rs. 27.2 billion observed during the corresponding period of 2014.** This was mainly due to increased bank borrowings by SriLankan Airlines (SLA), the Road Development Authority (RDA) and the Ceylon Petroleum Corporation (CPC). Credit obtained by SLA amounted to Rs. 14.7 billion during the first eight months of the year. In addition, RDA obtained credit amounting to Rs. 10.2 billion during this period. In spite of the substantial reduction in domestic petroleum prices, the benefit of low international oil prices was reflected in reduced borrowings by CPC. During the

Chart 7.7 Credit Granted by Commercial Banks to the Private Sector

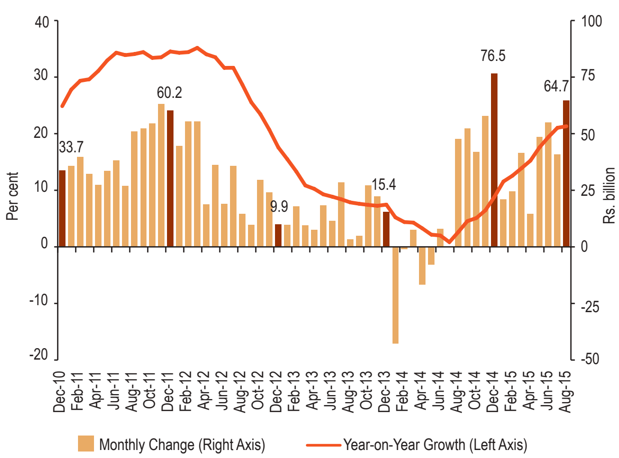
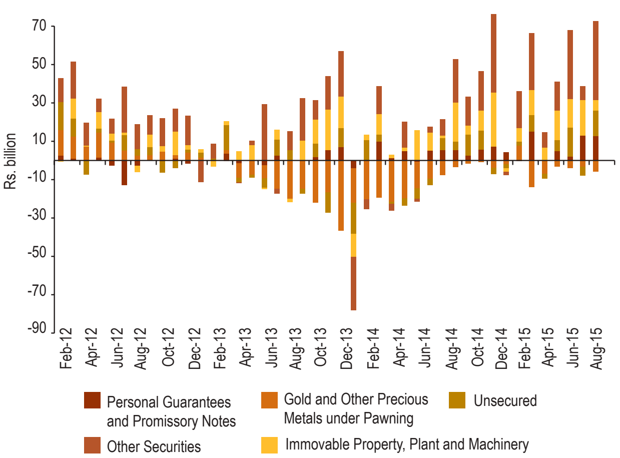


Chart 7.8 Monthly Change in Security-wise Advances of DBUs of Licensed Commercial Banks



first eight months of the year, liabilities of CPC to the banking system increased only by Rs. 9.7 billion. Meanwhile, the Ceylon Electricity Board (CEB) repaid Rs. 8.3 billion from its dues to the banking sector during the first eight months of 2015.

- **The growth of credit extended to the private sector by commercial banks, which rebounded towards end 2014, sustained its momentum in the first eight months of 2015.** The declining impact of the contraction in pawning advances on overall credit, continued low market lending rates as well as high import demand underpinned by increased real wages led to an expansion in credit extended to the private sector by commercial banks. Accordingly, credit to the private sector increased by 21.3 per cent on a year-on-year basis in August 2015 compared to 8.8 per cent recorded at end 2014. The existence of a lower base due to the contraction in credit extended to the private sector during the first eight months of 2014 caused a higher year-on-year growth rates in 2015. Nevertheless, on average, credit to the private sector increased by around Rs. 39 billion per month, thereby recording a cumulative increase of Rs. 310.5 billion during the first eight months of 2015.

- **As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit flows to all major sectors recorded an expansion during the first half of the year.** According to the latest available information at end June 2015, credit to the Industry and Services sectors increased by 27.8 per cent and 25.6 per cent, respectively, on a year-on-year basis. In the Industry sector, major sub sectors of Construction, and Textiles and Apparel reported a healthy expansion in credit. Similarly, key sub sectors in the Services sector, such as Wholesale and Retail Trade, Financial and Business Services, and Tourism, received high credit flows, whereas the substantial increase in credit flows to the Financial and Business Services sub sector was mainly underpinned by increased lending to leasing companies in view of high demand for finance facilities related to motor vehicles. Meanwhile, by end June 2015, credit to the Agriculture and Fishing sectors increased by 3.9 per cent, on a year-on year basis, compared to the decline of 5.8 per cent reported in December 2014. Even though the growth in Personal Loans and Advances declined by 11.1 per cent by end 2014, credit flows for such purposes increased by 3.1 per cent by end June 2015. The marginal increase in credit to the Agriculture and Fishing sectors as well as Personal Loans and Advances indicates that the impact of pawning related

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

Rs. billion

Sector	End June 2014	End June 2015 (c)	Year-on-Year Change	
			Amount	%
Agriculture and Fishing	**280.2**	**291.2**	**11.0**	**3.9**
of which, Tea	62.6	69.0	6.4	10.2
Rubber	20.0	20.3	0.4	1.8
Coconut	6.8	9.8	3.1	45.1
Paddy	16.2	16.6	0.4	2.3
Vegetable, Fruit and Minor Food Crops	13.9	16.2	2.3	16.5
Fisheries	9.9	10.3	0.3	3.3
Industry	**929.9**	**1,188.0**	**258.1**	**27.8**
of which, Construction	406.8	528.5	121.8	29.9
Food and Beverages	64.8	73.5	8.7	13.5
Textiles and Apparel	101.1	131.8	30.7	30.4
Fabricated Metal Products, Machinery and Transport Equipment	86.7	105.2	18.5	21.3
Services	**626.6**	**787.0**	**160.4**	**25.6**
of which, Wholesale and Retail Trade	207.6	232.0	24.4	11.8
Tourism	70.9	88.8	17.9	25.2
Financial and Business Services	102.7	165.3	62.6	60.9
Shipping, Aviation and Supply, and Freight Forwarding	11.0	12.7	1.7	15.5
Personal Loans and Advances (d)	**624.9**	**644.1**	**19.2**	**3.1**
of which, Consumer Durables	84.0	108.2	24.2	28.8
Pawning	200.9	153.3	-47.7	-23.7
Safety Net Scheme Related Advances	**34.1**	**50.2**	**16.1**	**47.2**
Total	**2,495.7**	**2,960.5**	**464.7**	**18.6**

(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

credit contraction has now ended. The gradual decline in the contraction in pawning related credit is also reflected in the Monthly Survey on Security-wise Advances.

Broad Money (M_4)

- **As per the Financial Survey, the year-on-year growth of broad money (M_4)[1] was 16.4 per cent in August 2015 compared to 14.3 per cent at end 2014.** Among monetary liabilities of broad money as measured by M_4, the growth of quasi money, comprising time and savings deposits in all licensed banks and licensed finance companies (LFCs) increased by 15.8 per cent in August 2015 compared to 12.7 per cent recorded in December 2014. However, the year-on-year growth of quasi money held with licensed specialised banks (LSBs) and LFCs declined to 11.9 per cent and 14.3 per cent by August 2015 compared to 15.0 per cent and 22.5 per cent, respectively, recorded at end 2014 reflecting the impact of low interest rates of these financial institutions and the offer of higher interest rates by commercial banks for deposits held by the senior citizens. On the assets side, the growth in M_4 was solely driven by the expansion in NDA, which increased by Rs. 792 billion, while NFA declined by Rs. 299 billion during the first eight months of 2015. Increased credit disbursements to both the private and public sectors contributed to the significant expansion in NDA during this period.

- **Credit disbursed to the private sector in M_4 followed a similar trend that was observed for credit growth in M_{2b}.** According to M_4,

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 2014	End 2014	End August 2015 (a)	Year-on-Year Change			
				Dec - 2014		Aug - 2015	
				Amount	%	Amount	%
Financial Survey (M_4)	**4,630.6**	**4,897.7**	**5,390.7**	**614.4**	**14.3**	**760.1**	**16.4**
Underlying Factors							
Net Foreign Assets	**94.5**	**-136.7**	**-435.7**	**63.3**	**31.6**	**-530.2**	**-561.2**
Monetary Authorities	791.4	688.0	450.9	158.9	30.0	-340.5	-43.0
LCBs	-578.7	-672.9	-729.7	-67.4	-11.1	-151.0	-26.1
LSBs and LFCs	-118.2	-151.9	-156.9	-28.2	-22.8	-38.7	-32.7
Net Domestic Assets	**4,536.1**	**5,034.4**	**5,826.5**	**551.2**	**12.3**	**1,290.3**	**28.4**
Domestic Credit	**5,723.4**	**6,291.9**	**7,161.8**	**723.1**	**13.0**	**1,438.4**	**25.1**
Net Credit to the Government	**1,888.2**	**2,010.4**	**2,349.3**	**223.2**	**12.5**	**461.1**	**24.4**
Monetary Authorities	145.7	149.7	244.5	35.7	31.3	98.9	67.9
LCBs	1,216.6	1,286.2	1,491.1	98.9	8.3	274.5	22.6
LSBs	479.2	514.8	552.1	56.8	12.4	72.9	15.2
LFCs	46.8	59.7	61.5	31.8	114.3	14.7	31.5
Credit to Public Corporations (LCBs)	**337.9**	**446.0**	**482.5**	**80.9**	**22.2**	**144.7**	**42.8**
Credit to the Private Sector	**3,497.3**	**3,835.5**	**4,330.0**	**419.0**	**12.3**	**832.7**	**23.8**
LCBs	2,529.6	2,758.2	3,068.7	223.9	8.8	539.1	21.3
LSBs	410.0	474.4	534.2	94.3	24.8	124.2	30.3
LFCs	557.7	602.9	727.0	100.9	20.1	169.4	30.4
Other Items (net)	**-1,187.2**	**-1,257.5**	**-1,335.3**	**-172.0**	**-15.8**	**-148.1**	**-12.5**

(a) Provisional

Source: Central Bank of Sri Lanka

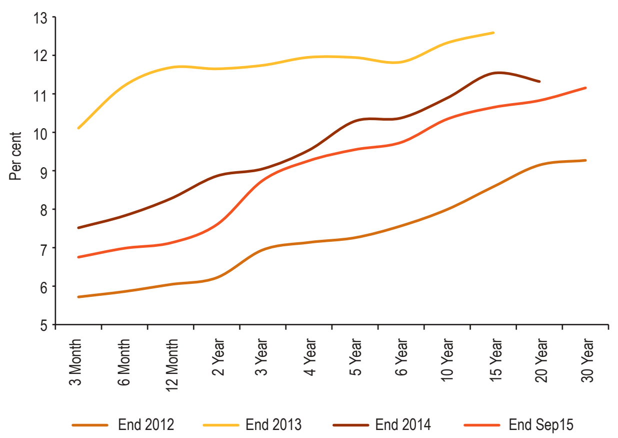
the growth of credit disbursed to the private sector accelerated to 23.8 per cent, on a year-on-year basis, during the first eight months of 2015 from 12.3 per cent recorded at end 2014. Accordingly, during the first eight months of 2015, credit to the private sector increased by Rs. 494.5 billion compared to the increase of Rs. 80.8 billion recorded during the same period of 2014. In addition to the increase in credit to the private sector by commercial banks as observed in M_{2b}, both LSBs and LFCs also contributed to the significant expansion in credit flows. Credit disbursed to the private sector by LSBs grew by 30.3 per cent by end August 2015 compared to the growth of 24.8 per cent recorded at end 2014. In absolute terms, credit extended to the private sector by LSBs increased by Rs. 59.8 billion during the first eight months of 2015 contributing 12 per cent to the overall expansion in private sector credit. At the same time, the year-on-year growth of credit to the private sector by LFCs also increased to 30.4 per cent in August 2015 from 20.1 per cent growth at end 2014. In absolute terms, credit extended to the private sector by LFCs increased by Rs. 124.2 billion during the first eight months of 2015 contributing 25.1 per cent to the overall increase in private sector credit. The significant increase in credit flows provided by LFCs was mainly driven by credit facilities on account of leasing of motor vehicles, which increased by around 53 per cent, on a year-on-year basis, contributing around 76 per cent to the credit growth in LFCs during the first eight months of 2015. Meanwhile, NCG by LSBs and LFCs reported an expansion of Rs. 39.2 billion mainly due to increased investments in government securities.

Interest Rates

- **As a result of persistently relaxed monetary conditions, market interest rates continued to remain at low levels in the first nine months of 2015.** With the recovery of the growth in credit to the private sector by commercial banks since the latter part of 2014 and in view of the signs of sustained credit growth in 2015, the restrictions placed on the SDF of the Central Bank were removed in March 2015. As a result, overnight interest rates, which had declined below the SDFR, stabilised within the policy rate corridor despite some volatility observed immediately after the removal of restrictions on SDF. Benefitting from the policy rate reduction in April 2015, average lending rates for loans continued their declining trend. At the same time, deposit interest rates also continued their declining trend up to April 2015, although some marginal increase was witnessed in average interest rates indicating the impact of the special interest rates offered on deposits maintained at banks by the senior citizens.

- **The Average Weighted Call Money Rate (AWCMR) displayed somewhat mixed movements in the first nine months of 2015.** Following the rationalisation of access to the SDF in September 2014, the AWCMR declined below the SDFR stabilising at around 6.00 per cent throughout the remaining period of 2014 as well as in the first two months of 2015. However, with the removal of the rationalised access to SDF, the AWCMR peaked at 7.00 per cent by 02 March 2015 and then hovered around 6.70 per cent level until mid-April 2015. With the reduction in policy interest rates in April 2015, the AWCMR declined immediately by 42 basis points to 6.23 per cent and continued its declining trend thereafter towards the lower bound of the policy rate corridor reaching 6.10 per cent by end July 2015. However, by mid-August 2015, with the decline in excess liquidity in the domestic money market, AWCMR witnessed some upward movement and stabilised at around 6.35 per cent thereafter. Meanwhile, the Sri Lanka Inter Bank Offered Rates (SLIBOR) also moved in line with the movements in the AWCMR. Accordingly, by end September 2015, overnight and 12-months SLIBOR remained at 6.35 per cent and 7.65 per cent, respectively, compared to 6.10 per cent and 7.15 per cent, respectively, recorded at end 2014.

Chart 7.9 Secondary Market Yield Curve for Government Securities

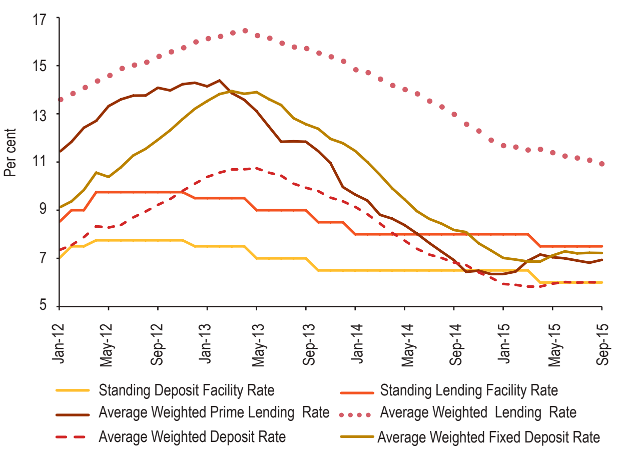


- **Yield rates on government securities indicated an upward trend during the first nine months of 2015.** With the removal of restrictions placed on the SDF by the Central Bank and reflecting the market anticipation of the government's high domestic funding requirement, the yields on Treasury bills, which remained below the SDFR in the preceding seven months, increased significantly from March 2015. Accordingly, compared to the yields observed at end 2014, the 91-day, 182-day and 364-day Treasury bill yields increased by 104 basis points, 123 basis points and 117 basis points, to 6.78 per cent, 7.07 per cent and 7.18 per cent, respectively, by end September 2015. The yields pertaining to Treasury bonds also exhibited an upward trend during the first nine months of 2015. The government continued to issue Treasury bonds with longer maturities during this period with the view of maintaining an extended yield curve. Accordingly, Treasury bonds with maturity periods of 20 years and 30 years were issued in the primary market during February-March period at average yields of 11.20 per cent and 11.73 per cent, respectively. The government also issued US dollar denominated SLDBs at various floating rates, where these issuances helped to maintain an orderly adjustment in the government securities market and to ease the pressure on yields of domestic debt instruments to some extent.

- **The secondary market yield curve for government securities shifted upwards during the first nine months of 2015 in comparison to end 2014.** Reflecting the low interest rate environment, the secondary market yield curve for government securities displayed a gradual downward adjustment during the past two years, and this trend has reversed somewhat in 2015. Accordingly, the yields on Treasury bills of all maturities in the secondary market increased by 103 to 112 basis points, while the yields on Treasury bonds of all maturities increased by 138 to 235 basis points by end September 2015 in comparison to the yields observed at end 2014.

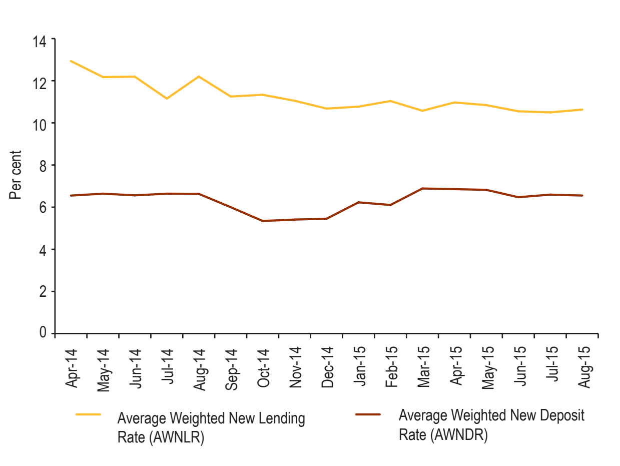
- **Reflecting the low interest rate environment, interest rates offered on deposits by commercial banks also remained low during the first nine months of 2015.** The Average Weighted Deposit Rate (AWDR), which reflects the movements in interest rates pertaining to all outstanding interest bearing deposits held with commercial banks, declined by 20 basis points to 6.00 per cent by end September 2015, compared to end 2014. The Average Weighted Fixed Deposit Rate (AWFDR), which is computed in respect of outstanding term deposits held with commercial banks, also declined by 11 basis points to 7.22 per cent by end September 2015 compared to end 2014. However, both AWDR and AWFDR increased marginally since April 2015 due to the impact of the special interest rate provided for the deposits of senior citizens maintained at licensed banks.

Chart 7.10 **Movements in Selected Market Interest Rates**



- **Low levels of lending rates of commercial banks continued despite irregular movements observed for some lending rates.** The Average Weighted Lending Rate (AWLR), which reflects interest rates pertaining to the stock of all loans and advances extended by commercial banks to the private sector,

Chart 7.11 **New Deposit and Lending Rates of Licensed Commercial Banks**



declined by 88 basis points to 11.03 per cent by end September 2015 from 11.91 per cent recorded at end 2014. Security-wise average weighted lending rates were in the range of 8.17-13.73 per cent by end September 2015 compared to the range of 8.24-15.39 per cent at end 2014. Bank-wise average weighted lending rates remained in the range of 6.80-12.98 per cent by end September 2015, compared to 5.66-16.57 per cent by end 2014. Meanwhile, the weekly Average Weighted Prime Lending rate (AWPR), which reflects interest rates applicable to loans and advances granted by commercial banks to their prime customers, increased by 78 basis points to 7.04 per cent by end September 2015 compared to 6.26 per cent recorded at end 2014 reflecting the upward pressure in short term interest rates. The monthly AWPR also increased by 59 basis points to 6.94 per cent by end September 2015 compared to end 2014.

- **Interest rates pertaining to new loans declined, while interest rates on new deposits displayed some upward adjustment thus indicating gradually narrowing interest spreads.**[2] The Average Weighted New Lending Rate (AWNLR), which is based on all new loans and advances extended by commercial banks to the private sector, declined by 5 basis points to 10.63 per cent by August 2015 compared to 10.68 per cent in December 2014. AWNLR remained lower than the AWLR indicating that commercial banks continued to reduce lending rates charged for new loans in an environment of eased monetary conditions. Meanwhile, the Average Weighted New Deposit Rate (AWNDR), which reflects the movement of interest rates pertaining to all new interest bearing deposits held with commercial banks during a month, increased by 110 basis points to 6.55 per cent in August 2015 compared to 5.45 per cent in December 2014.

2 The Central Bank commenced the compilation of average interest rates on new deposits and new loans in April 2014.

Table 7.3 Movements in Interest Rates

Per cent per annum

Interest Rate	End 2014	End September 2015 (a)
Policy Interest Rates (b)		
Standing Deposit Facility Rate	6.50	6.00
Standing Lending Facility Rate	8.00	7.50
Average Weighted Call Money Rate (AWCMR)	6.21	6.35
Yield Rates on Government Securities		
Primary Market (c)		
Treasury bills		
91-day	5.74	6.78
182-day	5.84	7.07
364-day	6.01	7.18
Treasury bonds		
2-year	-	6.70
3-year	-	8.18
4-year	-	9.50
5-year	8.93	9.58
10-year	7.88	10.38
Secondary Market		
Treasury bills		
91-day	5.72	6.75
182-day	5.86	6.98
364-day	6.04	7.12
Treasury bonds		
2-year	6.22	7.60
3-year	6.94	8.75
4-year	7.14	9.26
5-year	7.26	9.55
10-year	7.99	10.34
Licensed Commercial Banks (d)		
Interest Rates on Deposits		
Savings Deposits	0.50-8.00	0.50-8.50
1 - year Fixed Deposits (e)	3.95-12.00	3.50-15.00
Average Weighted Deposit Rate (AWDR)	6.20	6.00
Average Weighted Fixed Deposit Rate (AWFDR)	7.33	7.22
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	6.35	6.94
Average Weighted Lending Rate (AWLR)	11.91	11.03
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
1 - year Fixed Deposits	6.50	6.50
Licensed Finance Companies (f)		
Savings Deposits	5.17-6.81	4.83-6.81
1 - year Fixed Deposits	8.56-10.27	8.69-10.47
Interest Rates on Lending		
National Savings Bank (g)	8.00-13.00	8.00-13.00
State Mortgage and Investment Bank (g)	7.59-14.25	7.07-13.50
Licensed Finance Companies (f)		
Finance Leasing	15.45-23.26	14.81-24.23
Hire Purchase	16.36-20.42	14.75-21.21
Loans against Real Estate	17.00-24.33	17.31-19.52
Corporate Debt Market		
Debentures	6.88-15.50	7.60-10.50
Commercial Paper	6.44-12.50	7.00-12.00

(a) Provisional
(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) Weighted average yield rates at the latest available auction
(d) Based on the rates quoted by commercial banks and other selected financial institutions.
(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

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

- **Interest rates on foreign currency deposits held with commercial banks declined marginally by September 2015 compared to the rates prevailed at end 2014.** Interest rates on US dollar denominated savings deposits were in the range of 0.02-3.00 per cent by end September 2015 compared to the range of 0.01-3.25 per cent recorded at end 2014. Meanwhile, interest rates pertaining to US dollar denominated time deposits were in the range of 0.10-5.25 per cent by end September 2015 compared to the range of 0.06-4.25 per cent recorded at end 2014. Interest rates on savings deposits in pound sterling denomination were in the range of 0.10-2.26 per cent by end September 2015, whereas the rates for the same product was in the range of 0.05-2.25 per cent by end 2014. Interest rates applicable on pound sterling denominated time deposits were in the range of 0.09-4.00 per cent by end September 2015 compared to the range of 0.20-4.25 per cent by end 2014. The low interest rates applicable on foreign currency deposits reflect the continued low interest rate environment prevalent in advanced economies.

- **Interest rates applicable on debt instruments issued by the corporate sector showed some downward adjustment.** Amongst debt instruments, interest rates pertaining to commercial papers were in the range of 7.00-12.00 per cent during the first nine months of 2015 compared to the range of 6.44-12.50 per cent that was observed at end 2014. Meanwhile, during the first nine months of the year, there were 29 listings of debentures by 16 corporates with maturities ranging from 3 to 5 years. Interest rates offered on these issues, payable quarterly, semi-annually and annually, were in the range of 7.60-10.50 per cent by end September 2015, compared to 6.88-15.50 per cent reported at end 2014.

Monetary Policy in Other Countries

- **Central Banks of many advanced economies continued their accommodative monetary policies with the view of supporting economic activity while lifting inflation back to target levels.** In the United States, the target for the Federal funds rate has remained within the 0-0.25 per cent interval since December 2008. Nevertheless, the Federal Reserve of the United States is expected to continue to normalise its monetary policy stance gradually in the period ahead since inflation is expected to rise over the medium term with the ongoing recovery of the economy. The Bank rate of the Bank of England (BOE) continued to remain at 0.5 per cent in order to meet the 2 per cent inflation target, indicating the continuation of relaxed monetary conditions into 2015 as well. In addition, the BOE continued to maintain the stock of purchased assets financed by the issuance of central bank reserves. However, with the recovery of the economy, an interest rate hike is also expected in the United Kingdom in the months ahead. In September 2015, inflation in the Euro area was negative 0.1 per cent, where a deflationary situation was also experienced in the first quarter of the year. The European Central Bank (ECB) maintained its relaxed

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

Per cent

Country	Policy Rate	End 2012	End 2013	End 2014	Sep 2015
Emerging Economies					
India	Repo rate	8.00	7.75	8.00	6.75
Malaysia	Overnight policy rate	3.00	3.00	3.25	3.25
Thailand	1-day bilateral repo rate	2.75	2.25	2.00	1.50
China	1-year yuan lending	6.00	6.00	5.60	4.60
Advanced Economies					
USA	Federal funds rate	0-0.25	0-0.25	0-0.25	0-0.25
UK	Bank rate	0.50	0.50	0.50	0.50
ECB	Refinance rate	0.75	0.25	0.05	0.05
Japan	Overnight call rate	0-0.10	0-0.10	0-0.10	0-0.10
Canada	Overnight funding rate	1.00	1.00	1.00	0.50
Australia	Cash rate	3.00	2.50	2.50	2.00
Sweden	Repo rate	1.00	0.75	0.00	-0.35
South Korea	Base rate	2.75	2.50	2.00	1.50

Source: Websites of respective central banks monetary policy stance for an extended period to support credit provision to the Eurozone and hence to revive the weaker economic conditions amidst the continued crisis in Greece. Further, the ECB is likely to continue with its ongoing programme of providing short-term liquidity through its main refinancing operations until 2016 with the view of reducing volatility in financial markets, while maintaining its deposit rate at negative levels. Moreover, the monthly asset purchase programme of the ECB is expected to continue until next year or until inflation in the Euro area increases up to its target level of 2 per cent. Following a contraction in the economy in the second quarter of 2015, it is expected that Bank of Japan will continue its qualitative and quantitative easing programme until mid-2016. In the meantime, the Reserve Bank of New Zealand lowered its policy interest rates by 75 basis points and the Reserve Bank of Australia and the Bank of Canada also reduced their policy rates by 50 basis points so far during the year to support the economy amidst falling commodity prices. In Sweden, the Riksbank reduced its repo rate to negative 0.35 per cent in July 2015, while extending its programme to purchase government bonds.

- **The growth outlook in emerging market and developing economies is generally weakening, requiring them to maintain relaxed monetary conditions to support economic activity**. Among major emerging market economies, the Reserve Bank of India (RBI) and the People's Bank of China (PBC) have adopted several measures to ease monetary policy since late 2014 to spur economic activity. In particular, the RBI has reduced its policy interest rates by 125 basis points so far during 2015 and the PBC has lowered its policy interest rate by 100 basis points during the first nine months of 2015. Moreover, the reserve ratio for commercial banks was also reduced by 50 basis points in August 2015 by the PBC amidst a sharp decline in the Chinese stock market indices. In August 2015, China devalued its currency with the view of supporting the export sector. Meanwhile, Russia reduced the policy rate by 600 basis points during 2015 as the economy contracted by 2.2 per cent in the first quarter of 2015 followed by a further contraction of 4.6 per cent in the second quarter.

Expected Developments

- **The current relaxed monetary conditions along with continued low interest rates are expected to further induce private sector credit growth during the period ahead**. Indicating the lagged effect of monetary policy actions, market lending rates, particularly medium to long term interest rates, have adjusted downwards since end 2014. Benefiting from such low interest rates, it is expected that private sector credit would continue to flow into the economy during the remainder of the year as well as in 2016, facilitating investment activity and the growth momentum in the economy. Nevertheless, past episodes indicate that credit flows to the private sector could pick up sharply subsequent to a period of credit contraction. Therefore, the Central Bank is vigilant of the current trends in private sector credit and will adopt timely monetary policy measures in the event of continued excessive credit growth beyond the expected levels. Further, given the expected expansion in private sector credit during the ensuing period, there is a strong need for the public sector to restrict its borrowings to budgeted levels in order to avoid undue expansion in money and credit aggregates, while enabling the private sector to obtain adequate financial resources for investment activity.

- **Prevailing low inflation is expected to continue in the medium term with appropriate policies, thereby enabling a conducive**

environment for investment and economic activity while preserving the purchasing power of the general public. Reflecting the impact of significant downward adjustments in fuel and energy prices and the reduction in the prices of certain essential food items announced in the Interim Budget 2015, the year-on-year headline inflation continued to remain at low levels thus far in 2015 and even recorded negative levels. Sustaining its trend seen in last several years, it is projected that headline inflation is likely to remain at low single digit levels by end 2015. In the medium term, in an event of a rise in trend inflation due to demand side pressures, the Central Bank would pursue preemptive policy actions in a forward looking framework to ensure continued price stability.

- **The Central Bank would continue its efforts to strengthen the monetary policy framework in the period ahead**. As the country moves towards the upper middle income levels gradually, the Central Bank is of the view that the envisaged flexible inflation targeting (FIT) framework would be more effective in the context of enhanced fiscal consolidation of the government, improved monetary-fiscal coordination and better institutional arrangements to ensure central bank independence. Also, in order to strengthen the efficacy of the monetary policy framework, the Central Bank expects to further improve its communication policy through various initiatives to enhance policy transparency and predictability. The Central Bank would also continue its efforts to upgrade the technical capabilities, particularly with regard to macroeconomic modelling and forecasting in order to devise sound economic analysis and forecasts for the purpose of formulating effective policies, which would ensure macroeconomic stability on a sustainable basis.