Chapter 7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

The Central Bank of Sri Lanka (CBSL) eased its monetary policy stance in 2009 in the context of a sharp reduction in inflation. This reduction was achieved through stringent monetary policy measures that were implemented during the last few years, supported by a decline in global commodity prices. This policy stance was directed at supporting economic activity, which had been affected by the global economic slowdown and by the relatively high interest rates that had prevailed in the domestic market. Accordingly, the Penal rate of interest applicable on reverse repurchase (reverse repo) transactions, when participating institutions exceeded their monthly quota at the Reverse repo rate was gradually reduced from January 2009 and harmonised with the Reverse Repo rate in May 2009, while all restrictions on access to repurchase (repo) and reverse repo facilities were removed, thus re-establishing the interest rate corridor. These measures together with the significant reduction in both the Repo and Reverse repo rates to 7.50 per cent and 9.75 per cent, respectively, in 2009, provided a strong signal for a substantial reduction in market interest rates. The sharp reduction in inflation made it possible for CBSL to revert to the interest rate corridor approach and place a greater emphasis on interest rate stability, from the strategy of directly restraining the reserve money released by CBSL, which was found to be very effective in restraining monetary expansion within a short period, in a high inflation environment. This enabled CBSL to signal its monetary policy stance more effectively by changing the policy interest rates.

CBSL took timely measures to manage rupee liquidity and maintain greater stability in financial markets in an exceptionally challenging external and domestic environment in 2009. The continued capital outflows during the first quarter of the year amidst the turbulent external economic conditions necessitated CBSL to provide foreign currency to the market to contain the high volatility in the foreign exchange market, which in turn drained rupee liquidity from the market. CBSL responded swiftly by injecting the required rupee liquidity through its open market operations (OMO) and a further reduction of the Statutory Reserve Ratio (SRR) applicable on all rupee deposits of licensed commercial banks (LCBs). However, the significant increase in foreign exchange inflows subsequent to the post-conflict developments, and the purchase of such inflows by

CBSL resulted in surplus rupee liquidity in the money market since June 2009. CBSL conducted OMO to absorb this excess liquidity and introduced several alternative instruments, such as Central Bank Securities and foreign exchange swaps (FX swaps)[1], in the absence of a sufficient stock of government securities in its portfolio, to conduct OMO.

CBSL, which continued to conduct monetary policy within a monetary targeting framework, stipulating the targets for monetary aggregates in the 'Road Map: Monetary and Financial Sector Policies for 2009 and beyond' (Road Map), revised downward its targets taking into account the subsequent developments in the economy. The reduction in the SRR in February 2009, the sharp decline in inflation and the slowdown in domestic economic activity were the key factors that warranted the revision in the targets for monetary aggregates. Although reserve money contracted during the first three quarters of the year largely due to the base effect caused by the lowering of the SRR in 2008, it began to increase in the last quarter. In addition, an increase in credit to the government by CBSL also contributed to the increase in reserve money. CBSL was able to maintain the annual average growth in reserve money within the target stipulated in the revised monetary programme for 2009, while the annual average growth in broad money was marginally above the revised target.

Market interest rates declined following the downward adjustment of policy interest rates, albeit with a lag. Despite the low interest rate environment, the growth in credit to the private sector declined significantly in 2009 due to a lack of demand for loans as a result of the slowdown in economic activity and the cautious approach to lending adopted by banks in view of the rising non-performing loans (NPL), amidst the uncertainty that arose on account of the global financial and economic crises. However, a reversal in the decline in credit to the private sector in absolute terms has been observed since the latter part of the year. This is expected to gather momentum in 2010 given the low interest rate environment that prevails and the favourable outlook for economic activity, which is underpinned by improved business confidence and the recovery in the global economic environment. Credit to the public sector, on the other hand, expanded by a large volume due to the increase in government borrowing.

[1] FX swaps involve the purchase of one currency against another at an initial date with an agreement to reverse that transaction at a future date at a specified rate. This is similar to a Repo transaction, where the collateral used is foreign exchange instead of Treasury bills.

7.2 Monetary Policy

The positive developments in inflation together with a favourable outlook for inflation going forward enabled CBSL to ease its monetary policy stance in 2009. The Penal rate charged on reverse repo transactions with CBSL when a participating institution exceeded the maximum number of times it could access the reverse repo window in a given month, which was introduced in November 2007 and served as the effective ceiling on interbank interest rates, was gradually reduced in several steps from 19 per cent to 13 per cent by April 2009 and removed in May 2009. Further, the Reverse repo rate was reduced in several steps by a total of 225 basis points to 9.75 per cent in 2009. Meanwhile, the floor, the Repo rate was also reduced in several steps by a total of 300 basis points in 2009 to 7.50 per cent. Further, to ease credit conditions in the domestic market, several prudential measures that had been imposed were gradually removed.

Table 7.1 Monetary Policy Measures (2007-2009)

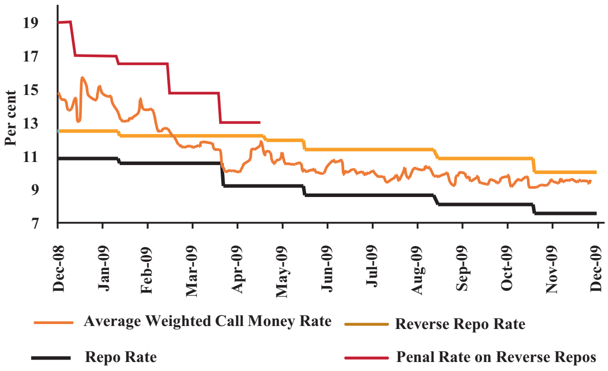
Per cent per annum

Date	Repo Rate	Reverse Repo Rate	SRR	Penal Rate on Reverse Repo
23 February 2007	10.50	12.00	10.00	
21 November 2007	10.50	12.00	10.00	19.00 (a)
13 October 2008	10.50	12.00	9.25 (b)	19.00
25 November 2008	10.50	12.00	7.75 (c)	19.00
12 January 2009	10.50	12.00	7.75	17.00
11 February 2009	10.25	11.75	7.75	16.50
24 February 2009	10.25	11.75	7.00 (d)	16.50
18 March 2009	10.25	11.75	7.00	14.75
22 April 2009	9.00	11.75	7.00	13.00
21 May 2009	9.00	11.50	7.00	Removed
16 June 2009	8.50	11.00	7.00	
11 September 2009	8.00 (e)	10.50 (e)	7.00	
18 November 2009	7.50	9.75	7.00	

Source: Central Bank of Sri Lanka

(a) Effective from 03 December 2007.
(b) Effective from the reserve week commencing 17 October 2008.
(c) Effective from the reserve week commencing 28 November 2008.
(d) Effective from the reserve week commencing 27 February 2009.
(e) Effective from the close of business.

Chart 7.1 Average Weighted Call Money Rate and Policy Rates of the Central Bank



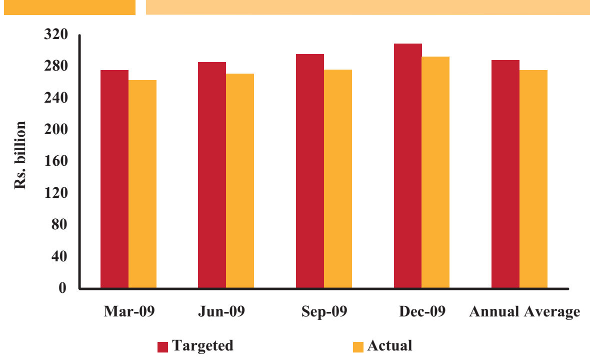
A 100 per cent margin deposit requirement against the opening of letters of credit (LC) for the importation of motor vehicles, which was imposed in 2004, was increased to 200 per cent in October 2008. This was reduced to 100 per cent in March 2009 and removed altogether in April 2009. In addition, the margin requirement of 100 per cent imposed in October 2008 against the opening of LC for certain non-essential items as well as in respect of imports of the same items on Documents against Acceptance (DA) terms was removed, in March 2009.

CBSL took measures to augment rupee liquidity to mitigate the adverse impact of the global economic and financial crisis on domestic financial markets. The fallout of the global financial crisis was a large outflow of foreign investment in government securities, which required CBSL to ease the pressure on the exchange rate by providing foreign exchange to the market. The resulting drain of rupee liquidity from the domestic money market required CBSL to take several measures to off-set the shortage of rupee liquidity. Following a 225 basis point reduction in SRR during the last quarter of 2008, CBSL lowered the SRR by a further 75 basis points in February 2009 to 7 per cent, releasing about Rs. 9 billion to the market, thus easing the liquidity deficit in the money market. CBSL also purchased government securities in the primary market and engaged in reverse repo transactions, both on an overnight basis and on a term basis, to augment rupee liquidity in the market. In May 2009, CBSL also removed restrictions on access to its reverse repo standing facility at the Reverse Repo rate, while at the same time removing restrictions on the maximum amount that a participating institution can place with CBSL under the repo standing facility. Since June 2009, there has been a turnaround, posing a challenge to managing the surplus liquidity. Renewed investor confidence with the end to the conflict and the approval of the IMF's Stand-by Arrangement (SBA) facility saw a turnaround of foreign investments in government securities from May 2009 onwards. The proceeds of these inflows were absorbed by CBSL, thus leading to a surplus of rupee liquidity in the domestic market during the second half of 2009.

The sharp reduction in inflation enabled CBSL to reduce its policy interest rates to support domestic economic activity, thereby re-establishing the policy interest rate corridor. A notable development with respect to interest rates during the first half of the year was that the average weighted call money rate (AWCMR) was brought within the policy interest rate corridor formed by the Repo rate and the Reverse Repo rate, by around mid-March. Since then, the AWCMR has hovered around the middle of the policy interest rate corridor.

CBSL revised downward the targets for monetary aggregates in April 2009. The targets for broad money (the intermediate target) and reserve money (the operating target) expansion, which were published in the Road Map were set at 14 per cent and 5 per cent, respectively. The low targeted growth in reserve money was on account of the reductions in SRR in 2008, as a result of which the money multiplier was expected to rise to around

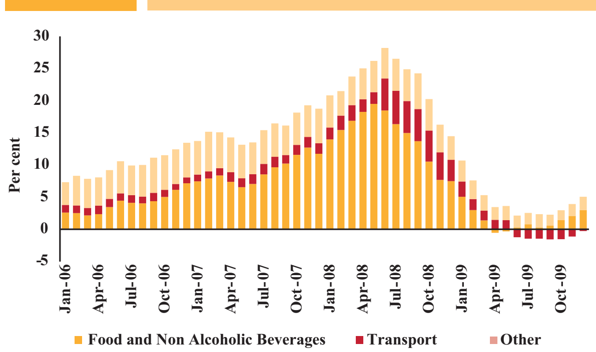
Chart 7.2 Reserve Money - Quarterly Targets vs Actual



6 in 2009. However, the reduction of the SRR to 7 per cent in February 2009, the sharp decline in inflation, and the apparent slowing down of economic activity, which moderated growth prospects, warranted a downward revision to the targets for monetary aggregates in April 2009. Accordingly, the targets for the growth of reserve money and broad money were revised downward to 2.8 per cent and 13 per cent, respectively. Annual average growth in reserve money was maintained within the target set in the revised monetary programme, while the annual average growth in broad money was marginally above the revised target.

The tight monetary policy stance adopted by CBSL during the preceding years as well as the moderation of global commodity prices, from the very high levels that prevailed in mid-2008, significantly eased inflationary pressures in 2009. Inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI), which was 14.4 per cent at end 2008, continued to decline during much of the first three quarters of the year, to reach a five-year low of 0.7 per cent by September 2009. Year-on-year inflation picked up gradually thereafter, to reach a moderate level of 4.8 per cent by end 2009, as the base effect of the rapid decline in prices in 2008 gradually diminished. Annual average inflation, which was 22.6 per cent at end 2008, also declined continuously, to reach 3.4 per cent by end 2009. Reflecting the moderation in demand pressures in the economy, year-on-year change in core inflation also declined significantly to 5.9 per cent in 2009 from 15.7 per cent in 2008, while annual average core inflation declined to 9.2 per cent in 2009 from 13.6 per cent in 2008.

Chart 7.3 Contribution to Inflation from Key Categories



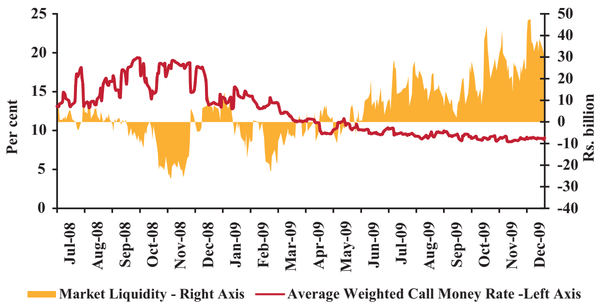
CBSL continued to give high priority to the communication of its policy actions with a view to aligning the expectations of market participants with the policy stance of CBSL and improving the efficiency of the monetary policy transmission mechanism. In the Road Map presented at the beginning of each year, the Bank announces its monetary policy strategy for the forthcoming year as well as for the medium term. Such communication helps align market expectations with those of policymakers. In addition, the Bank continues to communicate its monetary policy decisions in its monthly monetary policy press releases, explaining the reasons for the policy actions taken by the Monetary Board. Further, in accordance with the Bank's policy of engaging in continuous dialogue with the public, the views of the Monetary Policy Consultative Committee (MPCC), which comprises representatives from academia and the private sector, were also taken into consideration in the monetary policy deliberations of CBSL.

7.3 Developments in Money and Credit Aggregates

Money Market Liquidity

The money market, which was in deficit in rupee liquidity during the first five months of 2009, turned to a surplus in the second half. Intervention by CBSL to ease pressure on the foreign exchange market, drained rupee liquidity from the domestic money market.This was promptly addressed, to prevent pressure on money market interest rates, through providing liquidity by lowering the SRR, purchasing Treasury bills from the primary market and conducting reverse repo auctions on both overnight basis and term basis. However, the improvement in foreign currency inflows to the country and the purchase of the same by CBSL to build up reserves and to ease the pressure on the exchange rate created surplus rupee liquidity in the money market in the second half of 2009. As the surplus continued to rise and CBSL ran out of its traditional instrument for absorbing excess liquidity, i.e., Treasury bills, managing liquidity became challenging.

Chart 7.4 Market Liquidity and Average Weighted Call Money Rate



In this environment CBSL took measures to expand the instruments available at its disposal to conduct OMO. Accordingly, CBSL commenced issuing its own securities and introduced FX swaps, in order to absorb the excess during the latter part of 2009. There was a substantial reduction in CBSL's holdings of Treasury bills to around Rs. 4 billion by end September 2009 from around Rs. 200 billion in March 2009, due to the government retiring Treasury bills held by CBSL with the proceeds from foreign investments in government securities and the sale of Treasury bills by CBSL to absorb excess liquidity. Hence, from October 2009, CBSL resorted to issuing Central Bank Securities to absorb liquidity. Although Central Bank Securities are comparable with Treasury bills, there was relatively low demand for such securities, except on overnight basis, as they could not be offered as collateral for reverse repo facilities with CBSL and for obtaining intra-day liquidity facilities (ILF), as CBSL is not permitted to hold its own liabilities as collateral. As a remedy to this situation, CBSL permitted participating institutions to sell back their holdings of Central Bank Securities, in the event they required liquidity, which would then be retired immediately. However, this facility was not used and an introduction of an alternative instrument became imperative as by this time, due to the continuing sales of Treasury bills and Central Bank Securities to absorb liquidity, portfolio limits of participating institutions on government securities had well exceeded their own prudential limits. Consequently, in November 2009, CBSL commenced FX swap transactions under its OMO as an additional instrument for absorbing liquidity. At end 2009, the outstanding value of FX swap transactions conducted with LCBs in order to absorb rupee liquidity from the domestic money market amounted to around US dollars 245 million (Rs.28 billion).

Reserve Money

The growth in reserve money, the operating target for monetary policy, was maintained within the revised targets set for 2009. The contraction of reserve money during the first quarter of 2009 at a higher rate than anticipated, due to the slowdown in economic activity and the lower demand for money arising from a decline in inflation, as well as the

Table 7.2 Developments in Monetary Aggregates

Rs. billion

Item	End 2008	End 2009(a)	Change 2008 Amount	Change 2008 %	Change 2009 Amount	Change 2009 %
1. Currency Outstanding	186.1	217.4	12.7	7.3	31.3	16.8
1.1 Currency held by the Public	155.0	181.8	7.8	5.3	26.8	17.3
1.2 Currency with Commercial Banks	31.1	35.6	4.9	18.7	4.5	14.5
2. Commercial Banks' Deposits with the Central Bank	82.3	86.1	-8.7	-9.6	3.8	4.6
3. Government Agencies' Deposits with the Central Bank	…	…	…	…	…	…
4. Reserve Money (1+2+3)	**268.4**	**303.5**	**4.0**	**1.5**	**35.1**	**13.1**
5. Demand Deposits held by the Public with Commercial Banks	122.3	154.9	2.9	2.4	32.6	26.6
6. Narrow Money Supply, M_1 (1.1+5)	**277.3**	**336.7**	**10.7**	**4.0**	**59.4**	**21.4**
7. Time and Savings Deposits held by the Public with Commercial Banks	1,004.9	1,200.0	123.7	14.0	195.2	19.4
8. Broad Money Supply, M_2 (6+7)	**1,282.2**	**1,536.8**	**134.5**	**11.7**	**254.6**	**19.9**
9. Foreign Currency Deposits (b)	240.6	269.4	-15.7	-6.1	28.8	12.0
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**1,522.8**	**1,806.2**	**118.8**	**8.5**	**283.4**	**18.6**
Money Multiplier, M_{2b}	**5.67**	**5.95**				
Velocity, M_{2b} (c)	**3.01**	**2.90**				

(a) Provisional.
(b) Includes deposits of Resident Category of Offshore Banking Units and a part of foreign currency deposits with Domestic Banking Units.
(c) During the year.

Source: Central Bank of Sri Lanka

Box 12

Broadening the Range of Instruments in Open Market Operations

Open Market Operations (OMO) is an instrument of monetary policy commonly used by central banks to influence the volume and the cost of money. Central banks use particular instruments, often government securities in their holdings, to purchase or sell these securities to either infuse or drain money from the banking system in order to maintain the interbank interest rates consistent with a level considered appropriate with their broader monetary policy targets.

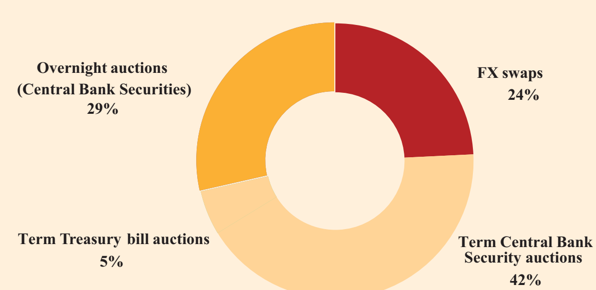
The Central Bank of Sri Lanka (CBSL) moved into a system of active OMO in 2003 from a passive OMO approach so as to conduct its monetary policy operations more effectively and in a market based manner.[1] Under this system of active OMO currently practiced by CBSL, the policy interest rates, i.e., the Repurchase (Repo) and Reverse Repurchase (Reverse Repo) rates, form a corridor setting the lower and upper bound for the interbank interest rate (call money rate). Given these parameters, OMO are then conducted to maintain the interbank interest rate at an appropriate level, usually around the middle of the corridor. Any shortage of liquidity would exert pressure on the interest rate to move towards the upper bound and CBSL would then take measures to inject money into the system by conducting auctions to offer the reverse repo facility on an overnight basis. The reverse would be applicable in the case of a surplus. While these auctions influence liquidity on an overnight basis, CBSL also carries out auctions to sell or buy securities on outright basis and/ or offer reverse repo or repo facilities on term basis as and when necessary to address longer term structural shortages/surpluses of liquidity.

Since the inception of OMO, Treasury bills have been the predominant instrument used in the repo/ reverse repo transactions conducted by CBSL. However, there could be occasions when the stock of Treasury bills held by CBSL depletes to a level which is not sufficient to absorb excess liquidity. The most recent situation experienced was during the second half of 2009. The large inflows of foreign exchange to the country, which were absorbed by CBSL resulted in a build up of excess liquidity in the market. A significant portion of these inflows were from foreign investments in government securities, which enabled the government to retire a large portion of Treasury bills held by CBSL. Thus the holdings of government securities with CBSL declined, requiring the Bank to explore alternative instruments to conduct its monetary operations in an unhindered manner.

As permitted in Section 91 Sub section(1)(b) of the Monetary Law Act, CBSL commenced issuing its own securities, i.e.,Central Bank Securities, which could be used in place of Treasury bills to carry out OMO. The Bank has resorted to this course of action on several occasions in the past and more recently, during March-August 2008 and from September 2009 onwards. Central Bank Securities are similar to government securities in most aspects, but the market's appetite for Central Bank Securities was comparatively lower, primarily on account of the restraints faced by CBSL in accepting its own liabilities as collateral in reverse repo agreements and when providing intra-day liquidity facilities to participating institutions. This issue however was subsequently resolved with CBSL allowing participating institutions facing temporary liquidity needs to sell back their Central Bank Securities to CBSL. Central Bank Securities have thus overcome the poor response initially observed, to some extent, and have gradually become the key instrument in CBSL's OMO.

More recently, the Bank initiated foreign exchange swap (FX swap) agreements in a bid to diversify its use of instruments and to supplement the efforts of conducting OMO using Treasury bills and Central Bank Securities. FX swaps involve the purchase of one currency against another at an initial date with an agreement to reverse the transaction at a future date, and at a specified rate. An FX swap transaction is similar to a repo transaction where the collateral of a security is replaced by foreign currency. CBSL may enter into sell-buy swaps in order to absorb excess liquidity, while buy-sell swaps may

Chart B 12.1 **Liquidity Absorption by Instrument- as at end 2009**



[1] Refer Box Article on 'More Active Open Market Operations', Central Bank of Sri Lanka Annual Report 2002.

be used to infuse liquidity. In the environment of continuously high liquidity experienced in the second half of 2009, CBSL has extensively engaged in sell-buy swaps with commercial banks to absorb liquidity.

In addition to using a wide range of instruments, CBSL has also entered into longer tenure agreements. Term repo transactions were introduced in May 2008, while term reverse repo transactions were introduced in March 2009. Engaging in longer term maturities enables CBSL to address more persistent shortages/surpluses in liquidity for a specific period in contrast to auctions on an overnight basis. The introduction of term repo and reverse repo transactions also enabled the Bank to conduct OMO more freely without being constrained by the maturity profile. At present, term transactions, using both Treasury bills and Central Bank Securities, account for the highest share of liquidity absorbed from the interbank market.

CBSL also proposes to implement a bond borrowing programme to build up its portfolio of government securities to conduct OMO in the future as enunciated in the Road Map: Monetary and Financial Sector Policies for 2010 and beyond. Under this programme, the Bank would borrow government securities from institutional investors at a fee on a term basis and use these securities to conduct repo transactions with participating institutions to drain excess liquidity from the market.

Introducing new instruments for the conduct of OMO has increased its flexibility by presenting new options to participating institutions, while strengthening CBSL's efforts of managing market liquidity.

The eligible currencies for FX swaps were given as the US dollar, euro or the pound sterling but presently, FX swaps carried out by CBSL are limited to US dollar /rupee transactions in line with market preference. CBSL has the option to conduct either fixed rate (volume) or variable rate (price) tenders. In a fixed rate tender, the Bank specifies the interest rate by way of swap points and the potential counterparties may bid the amount they are willing to transact at the said interest rate. In case of the latter, i.e., variable rate tenders, the counterparties bid the volume as well as the interest rates (by way of swap points) under which they are willing to enter into the agreement with CBSL.

The interest rate of the swap, specified in terms of swap points, would be computed on the basis of the interest rate differential between the respective foreign currency and the rupee. Swap points are quoted as the difference between forward and spot exchange rates (F-S) and are calculated as follows:

$F-S=S\,[((1+R_d*D/365)/(1+R_f*D/C))-1]$

where: F= forward rate, S= spot rate – i.e., number of rupees per foreign currency, R_d= rupee interest rate, R_f= foreign currency interest rate, D= term of the deal in number of calendar days, C= day count basis (for Sri Lanka rupee this is 365 days)

reduction in SRR in February 2009, warranted CBSL to revise downward its target for reserve money in April 2009. Reserve money continued to record negative growth as expected during the first three quarters due to the lowering of the SRR. However, reserve money began to expand in the last quarter as the impact of the changes in SRR in the last quarter of 2008 on reserve money dissipated and as credit to the government by CBSL increased. Given these developments during the course of the year, on average, reserve money contracted by 0.7 per cent in 2009, compared to the growth of 8.5 per cent recorded in 2008, which was within the target set in the revised monetary programme for 2009.

On the source side, the expansion of reserve money during the year was entirely due to an increase in net foreign assets (NFA) of CBSL as its net domestic assets (NDA) declined during this period. During the first quarter of 2009, there was a reduction in NFA of CBSL of Rs. 52.6 billion. The significant outflow of foreign investments in government securities required the Bank to intervene in the foreign exchange market as funds were not available in the domestic market to meet the outflow. This decline in NFA was however, largely off-set by an increase in NDA of Rs. 50.5 billion due to an increase in provisional advances from CBSL to the government and an increase in CBSL's holdings of Treasury bills. However, this situation reversed from April 2009, with the NFA of CBSL increasing by around Rs. 316.6 billion during the rest of the year. Significant foreign exchange inflows, which were purchased by CBSL to build up its foreign reserves, were the main reasons for the improvement in NFA. However, the overall impact of the considerable increase in NFA of CBSL on reserve money was largely off-set by a substantial reduction in NDA by Rs. 279.5 billion. The reduction in NDA was due to several factors: foreign investments in government securities enabled the government to retire a large portion of CBSL's holdings of Treasury bills (Rs.96.8 billion); the sterilised intervention by CBSL to stabilise the foreign exchange market resulted in sales of government securities out of the Bank's holdings and the issue of Central Bank Securities (Rs.78 billion).

Table 7.3 **Underlying Factors of Reserve Money and Broad Money**

Rs. billion

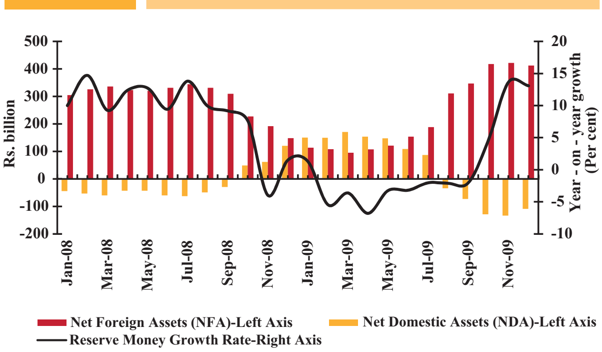
Item	End 2008 (a)	End 2009(b)	Change 2008 Amount	Change 2008 %	Change 2009 Amount	Change 2009 %
Reserve Money	**268.4**	**303.5**	**4.0**	**1.5**	**35.1**	**13.1**
Net Foreign Assets of the Central Bank	148.2	412.2	-144.8	-49.4	264.0	178.2
Net Domestic Assets of the Central Bank	120.3	-108.7	148.8	521.9	-228.9	-190.4
Broad Money (M_{2b})	**1,522.8**	**1,806.2**	**118.8**	**8.5**	**283.4**	**18.6**
Net Foreign Assets	77.7	401.9	-150.3	-65.9	324.2	417.2
Monetary Authorities	148.2	412.2	-144.8	-49.4	264.0	178.2
Commercial Banks	-70.5	-10.3	-5.5	-8.5	60.1	85.3
Net Domestic Assets	1,445.1	1,404.3	269.0	22.9	-40.8	-2.8
Domestic Credit	1,897.5	1,907.7	289.7	18.0	10.2	0.5
Net Credit to the Government	582.9	639.4	208.8	55.8	56.5	9.7
Monetary Authorities	217.4	109.0	116.3	115.0	-108.3	-49.8
Commercial Banks	365.6	530.4	92.5	33.9	164.8	45.1
Credit to Public Corporations	47.0	73.2	-2.2	-4.4	26.2	55.8
Credit to the Private Sector	1,267.6	1,195.1	83.1	7.0	-72.5	-5.7
Other Items (net)	-452.4	-503.5	-20.7	-4.8	-51.0	-11.3

(a) Revised.
(b) Provisional.

Source: Central Bank of Sri Lanka

On the use side, the growth in reserve money was mainly driven by an increase in currency in circulation, although deposits of LCBs with CBSL also increased during the year. Currency in circulation increased by around Rs. 31 billion in 2009, although a marginal decline was recorded during the first half of the year. The gradual pick-up in economic activity, especially in the Northern and the Eastern provinces after the end to the conflict and the low interest rate environment, increased currency in circulation significantly during the second half of the year. Although deposits of LCBs with CBSL declined during the first half of 2009 due to the reduction of the SRR in February, there was an overall increase in deposits by Rs. 3.7 billion in 2009.

Chart 7.5 **Growth and Sources of Reserve Money**



Narrow Money

Narrow money supply (M_1), which comprises currency and demand deposits held by the public, increased significantly during the second half of the year. On a year-on-year basis, narrow money, which had contracted by 1.7 per cent by June 2009, increased by 21.4 per cent by end 2009. The increase in narrow money during the second half of 2009 was due to a significant increase in both demand deposits and currency held by the public. Demand deposits began to increase in the second half of 2009, growing by 26.6 per cent at end year compared to the marginal growth of 2.4 per cent recorded in 2008, reflecting the overall expansion in credit from the banking sector. The other component in narrow money, which is currency held by the public, also recorded a higher growth of 17.3 per cent in 2009, compared to the growth of 5.3 per cent recorded in 2008.

Broad Money

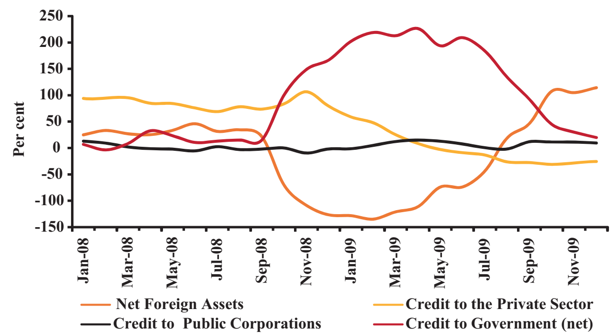
The growth in the broad money supply (M_{2b}), which remained subdued during the first half of the year, gathered pace during the second half of 2009. Broad money growth increased to 18.6 per cent at end 2009 from 8.5 per cent a year ago, while the annual average growth in broad money was

13.6 per cent. The growth in broad money during the year was due to an expansion in both narrow money and quasi money. The contribution of narrow money to the growth in broad money increased to 21 per cent in 2009 from 9 per cent in 2008, while the contribution of quasi money to the growth in broad money declined from 91 per cent in 2008 to 79 per cent in 2009. However, quasi money also recorded a higher growth of 18 per cent in 2009 compared to a growth of 9.5 per cent recorded in 2008. Within quasi money, time and savings deposits registered a growth of 19.4 per cent, compared with a growth of 14 per cent a year ago. This has been due to several factors, such as a shift of deposits from Registered Finance Companies (RFCs) to LCBs, as depositor confidence in RFCs deteriorated due to the severe liquidity problems experienced by some RFCs, particularly at the beginning of the year and special rates offered by LCBs to mobilise deposits.

On the source side, the growth in M_{2b} during the year was entirely due to the expansion in NFA, as NDA declined during the year. NFA of the banking system, which contracted during the first quarter of the year due to the supply of foreign exchange to the market, recorded a significant increase during the remaining months of the year. Absorption of foreign exchange inflows by CBSL largely contributed to the expansion of its NFA. The NFA of LCBs steadily increased over the year by around Rs. 60 billion. The significant build-up of net foreign assets in LCBs during the year was partly due to the repayment of borrowings from off-shore banking units (OBUs) by the Ceylon Petroleum Corporation (CPC), the settlement of some outstanding foreign currency liabilities of the government with the state banks using a part of the proceeds from the international sovereign bond issue in October 2009, and the lack of domestic credit demand, leading LCBs to invest these funds abroad.

NDA of the banking system declined during 2009. The contraction in credit to the private sector, the major component of domestic credit, was primarily responsible for the decline in NDA of the banking system. However, credit to the government and public corporations, the other components of domestic credit, increased during the year.

Chart 7.6 Contribution to Year-on-year Growth in M_{2b}



Credit flows to the private sector contracted considerably in 2009. The year-on-year change in credit to the private sector, which grew at a slower pace of 7.0 per cent at end 2008, contracted by 5.7 per cent by end 2009. This sharp decline was partly due to the negative spin-off effects of the global financial crisis on domestic economic activity, following the contraction of both world trade and output. Moreover, with the decline in economic activity, and reflecting higher NPL, LCBs were conservative in their lending activities. The lagged effect of the tight monetary policy stance adopted in the last few years, which kept market interest rates high at the beginning of the year, also partly contributed to the lower credit growth in 2009. Although the expansion in credit by LCBs to the private sector contracted during the year as a whole, there was some increase in absolute terms towards the latter part of the year. The rebound in credit flows reflects the response to lower lending rates as well as the improved prospects for economic activity in the period ahead, as the world economy gradually recovers and the Sri Lankan economy is in a better position to realise its full potential given the end to the three decade long conflict.

Credit to several key sectors declined during the year. As per the purpose-wise distribution of credit to the private sector, lending for trading activities, which accounts for the largest share of the total credit extended by LCBs, contracted by over 22 per cent during the year, in line with the sluggish growth in import and export trade, as well as domestic trading activities. Lending to the financial sector also faced a set-back, declining by 29.3 per

Table 7.4 **Sectoral Distribution of Advances by Commercial Banks (a) (b)**

Rs. billion

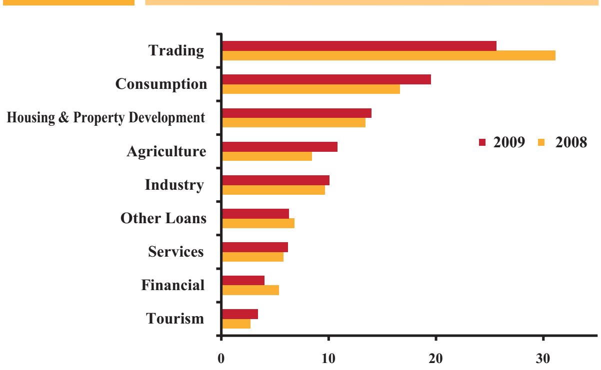
Sector	End 2008(c)	End 2009	As a % of Total End 2009	Change % 2009
Trading	396.1	307.7	25.7	-22.3
o/w Exports	128.1	113.4	9.5	-11.4
Imports	121.6	79.1	6.6	-35.0
Financial	68.3	48.3	4.0	-29.3
Agricultural	116.5	129.9	10.8	11.5
Industrial (d)	122.7	120.6	10.1	-1.7
Tourism	34.3	40.9	3.4	19.3
Housing	170.4	167.8	14.0	-1.5
Consumption	202.6	234.1	19.5	15.5
Services	73.8	74.8	6.2	1.4
Other	86.8	75.3	6.3	-13.2
Total	**1,271.4**	**1,199.3**	**100.0**	**-5.7**

(a) Includes advances of domestic banking units and off-shore banking units.
(b) Advances include loans, overdrafts and bills discounted and exclude cash items in the process of collection.
(c) Revised.
(d) Includes advances granted for engineering and building trade, mining and fishing.

Source: Central Bank of Sri Lanka

cent, largely due to the contraction in credit extended for lease financing. Lending to industry and housing sectors also marginally contracted during the year. On the other hand, credit for consumption activity, which ranks second highest in terms of the share of credit and accounts for 19.5 per cent of total credit extended, increased by 15.5 per cent during the year. This sector includes loans obtained for personal requirements and purchase of consumer durables, as well as a part of pawning activities and outstanding credit card balances. Increases were also observed in lending to agriculture, tourism and services sectors, reflecting the pick-up in activity observed in these sectors, particularly during the second half of the year.

Chart 7.7 **Share of Credit Extended by LCBs to Selected Sectors**



Net credit to the government (NCG), which increased until July 2009, declined significantly during the second half of 2009, mainly due to the retirement of a significant portion of CBSL's holdings of government securities. NCG from the banking sector increased by Rs. 56.5 billion during the year compared to Rs. 208.8 billion during 2008. NCG from the LCBs increased by Rs.164.8 billion in 2009. This was mainly on account of an increase in the LCBs' holdings of Treasury bills and Treasury bonds by Rs. 152.3 billion. However, the increase in borrowing from LCBs was partly off-set by a significant reduction in NCG from CBSL by Rs. 108.3 billion.

Credit to public corporations increased significantly in 2009. The credit absorbed by public corporations increased from Rs. 47 billion at end 2008 to Rs. 73 billion at end December 2009. Domestic banking units (DBUs) contributed Rs. 58 billion to the overall increase in credit to public corporations, while credit granted by OBUs contracted by Rs. 32 billion, mainly due to the repayment of its debt obligations to OBUs by CPC. However, during the second half of the year, CPC increased its borrowings from DBUs by Rs. 25 billion. Meanwhile, the credit utilised by the Ceylon Electricity Board (CEB) from the banking sector increased by Rs. 9 billion, while borrowings by Ceylon Fertilizer Corporation and Colombo Commercial Fertilizer Ltd. increased by Rs. 27 billion during the year.

Financial Survey

Growth in broad money as measured by the financial survey[2] (M_4) has been accelerating gradually throughout 2009, in line with the trend observed in broad money supply (M_{2b}). Year-on-year growth in M_4 increased to 18.8 per cent by end 2009, compared to a lower growth of 9.5 per cent recorded at end 2008. This growth was largely driven by a substantial increase in NFA, which accounted for about 89 per cent of the overall increase in the money supply. With respect to NDA, both NCG and credit to public corporations

[2] The financial survey provides a broader measure of liquidity, covering licensed specialised banks and registered finance companies, in addition to licensed commercial banks and the Central Bank.

Table 7.5 **Financial Survey and Underlying Factors**

Rs. billion

Item	End 2008 (a)	End 2009(b)	Change 2008 Amount	Change 2008 %	Change 2009 Amount	Change 2009 %
Financial Survey (M_4)	**1,918.7**	**2,280.0**	**166.4**	**9.5**	**361.3**	**18.8**
Underlying Factors						
Net Foreign Assets	56.2	378.1	-148.5	-72.6	322.0	573.0
Net Domestic Assets	1,862.5	1,901.8	314.9	20.4	39.4	2.1
Domestic Credit	2,429.4	2,513.9	334.8	16.0	84.5	3.5
Net Credit to the Government	794.6	910.6	229.2	40.5	116.0	14.6
Credit to Public Corporations	47.0	73.2	-2.2	- 4.4	26.2	55.8
Credit to the Private Sector	1,587.8	1,530.1	107.7	7.3	-57.7	-3.6
Other Items (net)	-566.9	-612.1	-19.8	-3.6	-45.1	-8.0

(a) Revised.
(b) Provisional.

Source: Central Bank of Sri Lanka

increased, while credit to the private sector continued to decline in 2009. Credit to the private sector contracted by 3.6 per cent at end 2009, compared to a growth of 7.3 per cent recorded at end 2008. However, this decline in credit is lower than the contraction in credit to the private sector as per the monetary survey, because of an increase in credit extended by licensed specialised banks (LSBs) and RFCs to the private sector in 2009. The time and savings deposits of LCBs and LSBs grew in 2009 partly due to a shift of deposits from RFCs and partly due to the campaigns carried out by these institutions to mobilise deposits. Time and savings deposits of RFCs fell during the first few months of 2009, reflecting the large withdrawals from RFCs due to the liquidity problems faced by a few RFCs at the beginning of the year. However, the situation improved in the second half of 2009 with public confidence in RFCs improving as a consequence of several measures taken by CBSL. Consequently, although during the year, time and savings deposits of RFCs grew by 15 per cent, it was a significant reduction from the high growth of above 30 per cent recorded in 2008.

7.4 Interest Rates

The entire market interest rate structure gradually shifted downwards following the reduction in the policy rates of CBSL. Enabled by the decline in inflation as well as a favourable outlook for inflation, CBSL began to lower its policy rates signalling to the market the need to lower the overall interest rate structure. In response to the relaxed monetary policy stance, interest rates across various market segments declined, albeit with a time lag.

Money Market Rates

Short-term money market interest rates remained at a low level with much of the volatility smoothened out during 2009. The AWCMR was brought within CBSL's policy interest rate corridor by end March 2009, thus improving the effectiveness of the monetary policy operations of CBSL through the interest rate channel. During the period January to May 2009, when there was a shortage of rupee liquidity in the money market, the AWCMR moved in a wider range of 9.58 –15.54 per cent. However, a surplus rupee liquidity position in the money market since June 2009 stemmed the upward pressure on interest rates. Thus the AWCMR remained broadly at single digit levels, around the middle of the policy rate corridor, during the second half of 2009. The Sri Lanka Interbank Offered Rates (SLIBOR),

Table 7.6 **Money Market Rates**

Per cent per annum

	Central Bank Repo Rate	Weighted Average Repo Auction Rate	Average Weighted Call Money Rate: End Period	Average Weighted Call Money Rate: Average for the Month	SLIBOR-Overnight: End Period	SLIBOR-Overnight: Average for the Month
Dec-07	10.50	11.98	24.99	15.40	21.75	15.69
Dec-08	10.50	10.96	14.66	15.13	13.74	15.57
Mar-09	10.25	-	11.21	12.18	11.29	12.24
Jun-09	8.50	9.25	9.52	9.92	9.60	10.04
Sep-09	8.00	8.48	9.30	9.48	9.40	9.62
Dec-09	7.50	8.24	9.07	9.00	9.03	9.10

Source: Central Bank of Sri Lanka

the average of offered rates for interbank rupee transactions, also declined to single digit levels by the second half of the year, in line with the easing of liquidity conditions in the interbank market.

Yield rates at the OMO auctions declined during the year with the improvement in liquidity conditions in the domestic market. Although reverse repo auctions were conducted during the first half of the year, with the improvement in rupee liquidity, measures were taken to drain the excess liquidity from the market during the second half of 2009. With the re-commencement of repo auctions in the second half of the year, the weighted average yield rate at the daily OMO repo auctions, which was 10.96 per cent at end 2008 declined to 8.24 per cent by end 2009 in line with the decline in CBSL's Repo rate. With the re-commencement of the issue of Central Bank Securities in October 2009, term auctions of Central Bank Securities with maturities spanning from 14-30 days were conducted with the intent of mopping up rupee liquidity on a longer term basis. The weighted average yield rate at the term auctions were in the range of 8.10-9.62 per cent during the period of issue. In November 2009, FX swaps were introduced to address the excess rupee liquidity condition in the market.The swap points on sell-buy FX swaps, with US dollars as the counterparty foreign exchange, were in the range of 0.36-0.53 on transactions carried out in 2009.

Deposit and Lending Rates

Interest rates of banks shifted downwards, although with a time lag, in response to the changes in CBSL's monetary policy stance. The average weighted deposit rate (AWDR) of LCBs declined by a total of 362 basis points during the year to 8.01 per cent at end 2009, while the average weighted fixed deposit rate (AWFDR) declined by a greater margin of nearly 600 basis points during the year to 10.91 per cent at end 2009. In line with the reduction in policy interest rates and given the decline in the cost of funds, lending rates also declined, although the rise in non-performing credit volumes has dampened the pace of reduction in lending rates. A further decline in market rates was observed following a request made by the government in October 2009 to the state owned banks to bring down their lending rates. The average weighted prime lending rate (AWPR), the rate at which LCBs lend to their prime customers, showed a marked decline of over 800 basis points to 11.12 per cent at end December 2009. The average weighted lending rate (AWLR), which is the rate applicable to the entire loan portfolio of LCBs, except for lending to the government, has gradually declined during the year by a total of 272 basis points to 17.41 per cent, with a marked decline observed in the final quarter of 2009. Interest rates charged by long-term lending institutions also declined considerably during the year reflecting the efforts of CBSL to bring down

Chart 7.8 Movements in Market Interest Rates

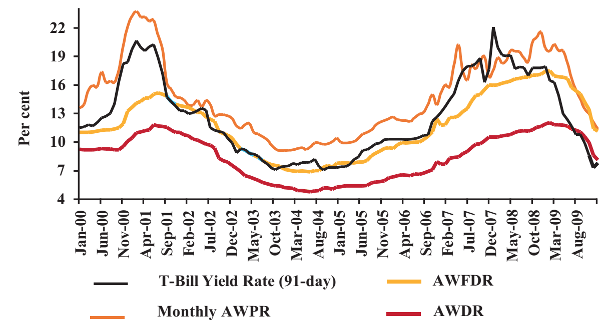


Table 7.7 Interest Rates on Deposits and Lending (a)

Per cent per annum

Institution	End 2008	End 2009
Commercial Banks		
Interest Rates on Deposits		
One year fixed deposits	8.50-20.25	7.25-19.00
Savings deposits	3.0-16.50	1.50-10.50
Average Weighted Deposit Rate (AWDR)	11.63	8.01
Average Weighted Fixed Deposit Rate (AWFDR)	16.89	10.91
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	19.17	11.12
Average Weighted Lending Rate (AWLR)	20.13(b)	17.41
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings deposits	5.00	5.00
One year fixed deposits	15.00	9.50
State Mortgage and Investment Bank		
One year fixed deposits	20.00	10.00
DFCC Bank		
One year fixed deposits	18.00	9.50
Interest Rates on Lending		
National Savings Bank (c)	19.00-20.00	12.00-15.00
State Mortgage and Investment Bank (c)	23.00-24.00	16.50-20.00
DFCC Bank	22.50-23.00	14.00-16.00
National Housing Development Authority (c)	11.00	11.00

(a) Based on the rates quoted by commercial banks and other selected financial institutions.
(b) Revised.
(c) Lending for housing purposes only.

Source: Central Bank of Sri Lanka

the cost of borrowing and encourage credit flows to the private sector. Penal rates of interest charged by LCBs on outstanding payments on credit cards remained in the range of 33.6 - 48 per cent in 2009, although they were adjusted downward from January 2010. Meanwhile, the Legal rate and the Market rate for the year 2010, which are compiled based on the average weighted deposit rates of all LCBs in 2009, remained at almost the same level as the rate for the year 2009 at 11.33 per cent, reflecting the higher interest rates prevailing at the beginning of the year.

Interest rates paid on foreign currency denominated deposits at LCBs remained at low levels reflecting the low interest rate environment in advanced economies. Interest rates on savings deposits denominated in US dollars were in a range of 0.1 per cent to 2.3 per cent compared to 0.2 per cent to 3.9 per cent in 2008, while interest rates on term deposits were in a range of 0.2 per cent to 5.6 per cent compared to 1.1 per cent to 6.0 per cent in 2008.

Yield Rates on Government Securities

The government securities market responded more swiftly to the changes in the policy rates of CBSL. Yield rates on Treasury bills in the primary market declined sharply in 2009. Yield rates on Treasury bills of all three maturities declined by around 10 percentage points until November 2009, although they increased marginally in December. However, this reversal in the trend was seen as a correction to the market rates as the yield rate on Treasury bills with a maturity of 91 days declined below the Repo rate in November 2009.

Yield rates on government securities with longer maturities also reflected the declining trend, buoyed by the marked improvement in the investment climate. During the year, yield rates on Treasury bonds declined significantly, while facilitating the issue of bonds with longer tenure. The yield rate on two year Treasury bonds declined from 20.53 per cent at end 2008 to a single digit level of 9.55 per cent by end 2009, while yield rates on Treasury bonds of other maturities also followed a similar trend.

Table 7.8 Yield Rates on Government Securities

Per cent per annum

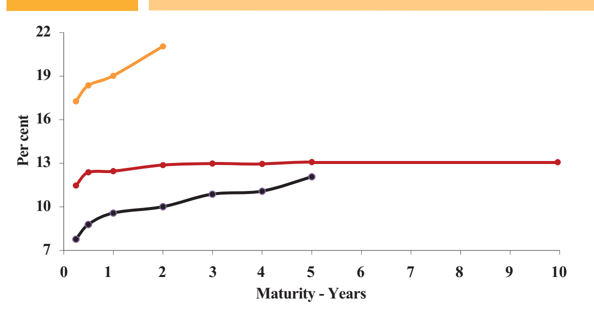
	End 2008	End 2009
Primary Market		
Treasury bills		
91 days	17.33	7.73
182 days	18.57	8.73
364 days	19.12	9.33
Treasury bonds		
2 years	20.53	9.55
3 years	20.34	12.83 (a)
4 years	19.60	9.78
Rupee Securities	18.40	14.00
Secondary Market		
Treasury bills		
91 days	-	7.78
182 days	18.36	8.78
364 days	19.03	9.58
Treasury bonds		
2 years	21.06	10.00
3 years	-	10.88
4 years	-	11.08

(a) The last auction for 3-year Treasury bonds was held in July 2009.

Source: Central Bank of Sri Lanka

During the year, the yield curve for government securities in the secondary market shifted downward and was extended to longer maturities. Improved market confidence arising from a healthy outlook for inflation as well as better macroeconomic conditions were reflected in the sharp downward shift in the yield curve during the year. The issue of Treasury bonds in the primary market, which was limited to bonds with maturities of 2-3 years at end 2008, was extended to bonds with maturities up to 10 years during the year, extending the yield curve. Lower yield rates and a yield curve that extended up to 5 years were observed at end 2009, in contrast to maturities of around 2 years at end 2008.

Chart 7.9 Government Securities - Secondary Market Yield Curve



7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

Yield Rates on Corporate Debt Securities

Interest rates pertaining to corporate debt securities also declined during the second half of 2009. Interest rates pertaining to commercial paper with maturity periods of three months and less, which were issued throughout the year declined in line with the trend observed in overall market interest rates. Interest rates on commercial paper were in a wider range of 9.52 – 28.00 per cent on account of the lower interest rates prevailing towards the latter part of the year compared to 18.25 – 27.00 per cent in 2008.

7.5 Future Developments, Challenges and Outlook

Inflationary pressures are building with the gradual recovery of the global economy and the upward pressure from commodity prices. Inflation in some countries has already exerted pressure on monetary authorities to begin unwinding the monetary stimulus measures undertaken at the height of the global financial and economic crises and to shift towards a tighter monetary policy stance. On the domestic front, some price pressures are expected to emerge in 2010, particularly with the recovery of the domestic economy, rapid reconstruction activity in the Northern and the Eastern provinces and increases in global commodity prices, especially crude oil prices. However, improvements on the supply side, particularly due to higher agricultural production in the Northern and the Eastern provinces, as well as appropriate demand management policies, are expected to contain inflationary pressures in the domestic market.

The monetary programme for 2010 has been designed under a medium-term macroeconomic policy framework in order to place the economy on a higher growth trajectory, while maintaining inflation at a desirable level. Monetary aggregates are projected to increase at a rate commensurate with the expected growth in nominal GDP, which would be sufficient to facilitate the smooth functioning of economic activity. The monetary programme for 2010 expects a pick up in private sector credit in 2010, thus facilitating the recovery of the domestic economy. Higher foreign inflows are expected to result in a BOP surplus, while borrowing by the public sector is expected to be contained in 2010. However, any additional increase in credit to either the government or public corporations poses a significant challenge to the conduct of monetary policy particularly in relation to maintaining monetary and credit aggregates at targeted levels and containing inflation at the desired level.

The prevailing low interest rate environment is expected to facilitate the growth momentum in the economy mainly through the expansion of private sector activity. Credit flows to the private sector remain subdued despite the low interest rate environment mainly due to the lower demand for credit and the cautious approach adopted by financial institutions towards extending credit. In this regard, benefiting from the prevailing low interest rate environment, private sector agents are encouraged to utilise the available financial resources in the economy to engage in innovative and productive economic activity. At the same time, it is hoped that financial institutions would facilitate the recovery of the private sector by providing access to financial resources at reasonable rates of interest, while preserving the quality of credit. Improving the infrastructure needed to facilitate the delivery of credit would be vital to expanding credit to the private sector. At present a major proportion of lending is against collateral of immovable property. However, in cases where such collateral is not available, the creation of a moveable assets registry would enable movables to be considered as an acceptable form of collateral. Further, establishing mechanisms to deal with distressed companies and the development of efficient resolution methods would be vital to improving the private sector's access to credit from financial institutions.

CBSL will continue to strengthen its monetary policy framework in 2010. A new core inflation measure is expected to be introduced in 2010 with a view to better tracking underlying inflationary pressures in the economy. This measure is derived by excluding ‘fresh food, rice, coconut, energy and transport’ categories from the headline inflation index. This new index will be compiled by the Department of Census and Statistics (DCS) and published in 2010 along with the proposed revision to the CCPI. In addition, considering the importance of measuring and assessing expected inflation for the conduct of monetary policy, CBSL would continue to conduct its inflation expectations survey on a regular basis in 2010, while seeking to improve the methodology and expand the coverage of the survey. Since regular communication plays an important role in aligning public expectations with those of the policymaker, CBSL is committed to strengthening its monetary policy communication strategy further.

CBSL will continue to implement policies to strengthen the financial system, which is essential for the effective transmission of monetary policy. Experience from the global financial crisis indicates that monetary policy cannot be implemented in isolation of the developments in financial and capital markets. Monetary policy will need to be concerned not only with price and economic stability but also with financial system stability. Consequently, the conduct of monetary policy in the future will require paying attention not only to macroeconomic indicators but also to a broader range of macro prudential indicators, which measure the health and stability of financial systems.