7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

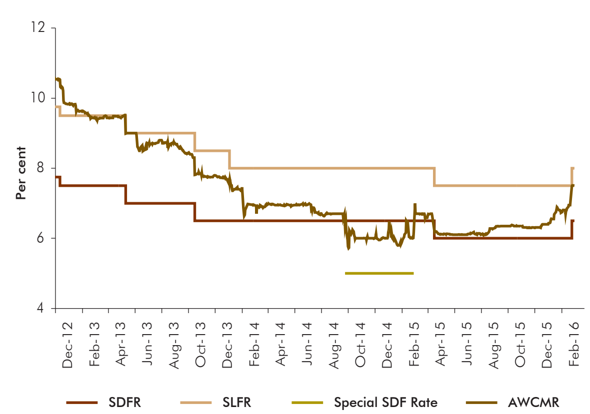
In an environment of continued low inflation, the Central Bank maintained a relaxed monetary policy stance during the year, but initiated a gradual tightening of monetary policy towards end 2015 to preempt the emergence of excessive demand pressures on inflation emanating from high credit and money expansion. As private sector credit growth revived gradually, in March 2015, the Central Bank removed the restrictions placed on the access to the Standing Deposit Facility (SDF) under its open market operations (OMO) that was in effect since September 2014. To dampen the impact of this adjustment on short term interest rates, the Central Bank lowered its policy rates by 50 basis points in April 2015. Monetary aggregates grew at a higher than projected rate in 2015 as a result of the expansion in net domestic assets (NDA) of the banking system driven by enhanced credit flows to both private and public sectors amidst a contraction in net foreign assets (NFA) of the banking sector. The year-on-year growth of credit granted by commercial banks to the private sector accelerated to reach 25.1 per cent by end 2015 from 8.8 per cent at end 2014. Increased domestic demand, a part of which was transformed into high demand for imports, amidst continued low interest rates drove the demand for credit by the private sector. This expansion was reflected in credit flows to all major sectors of the economy. Given the higher than expected domestic credit growth, several policy measures were introduced towards the end of 2015 to contain credit flows to selected sectors. Accordingly, a minimum cash margin requirement was imposed on Letters of Credit (LCs) opened for the importation of motor vehicles, which was replaced later by a maximum Loan to Value (LTV) ratio on loans and advances granted for the purpose of purchase or utilisation of motor vehicles. These measures, along with greater flexibility allowed in the determination of the exchange rate and the changes to the tax structure introduced by the government, were expected to support containing excessive growth of personal loans and advances, and strengthen macroeconomic and financial system stability. Meanwhile, credit obtained by the public sector also increased as a result of the heavy reliance of the government on domestic sources to finance the budget deficit in the midst of slow foreign financial flows as well as the weak financial position of certain public corporations. Excess rupee liquidity in the domestic money market, although declined from the levels observed in the previous year, remained high reflecting accommodative monetary conditions in the economy. The Central Bank conducted open market operations appropriately to guide short term interest rates in the money market. Both deposit and lending rates remained relatively low during 2015 although yield rates in the government securities market increased responding mainly due to the high domestic borrowing requirement of the government, amidst the Central Bank's decision to issue government securities only through public auctions. In the meantime, headline inflation declined further during the year mainly as a result of downward revisions to administered prices of key commodities, favourable domestic supply side developments and declining prices in international commodity markets. Nevertheless, core inflation displayed an upward trend since February 2015 reflecting the firming up of demand conditions.

Although an immediate threat to price stability is not expected, the Central Bank commenced tightening its monetary policy stance gradually from end 2015 in order to forestall excessive demand pressures on inflation arising from high credit and monetary expansion and the continued high excess rupee liquidity in the domestic money market. Accordingly, the Central Bank raised the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks (LCBs) by 1.50 percentage points in December 2015, to be effective from 16 January 2016. This measure was expected to permanently absorb a part of excess liquidity from the market. Furthermore, the Central Bank increased its main policy interest rates, namely the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50 basis points effective from the close of business on 19 February 2016. Reflecting these policy changes as well as continued demand for credit, overnight interest rates, which remained close to the lower bound of the policy rate corridor since March 2015, increased to the upper half of the corridor, while yields on government securities increased substantially and other market interest rates also commenced moving upwards. Going forward, amidst volatile global economic conditions and domestic vulnerabilities, the conduct of monetary policy in 2016 will be focused on maintaining inflation in mid-single digits, while facilitating the economy to realise its potential in the medium term.

7.2 Monetary Policy

The monetary policy stance of the Central Bank continued to be accommodative throughout the year 2015 with a view to supporting economic activity in an environment of continued low inflation and favourable inflation expectations. Considering the sustained increase in credit flows to the private sector that was encouraged by the low interest rate environment maintained during the past few years, with effect from 2 March 2015, the Central Bank removed the temporary restrictions that were placed in September 2014 on the access to its Standing Deposit Facility (SDF) by market participants under the open market operations (OMO). Following this move, the overnight interest rates in the money market increased and displayed some volatility before settling closer to the lower

Chart 7.1 Policy Interest Rates and Average Weighted Call Money Rate



bound of the policy rate corridor. Considering the space created by the sharp decline in inflation as well as the favourable outlook for inflation, the Central Bank reduced its main policy interest rates, namely, the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), by 50 basis points to 6.00 per cent and 7.50 per cent, respectively, in April 2015. This downward adjustment was also expected to provide greater stability to market interest rates by signalling the continuation of the accommodative monetary policy stance, thereby supporting continued flow of credit to the economy. At the same time, the Central Bank continued to monitor developments in key sectors of the economy vis-à-vis monetary developments for the early identification of possible threats to economic and price stability.

Liquidity in the domestic money market continued to be in excess throughout 2015, and the Central Bank conducted its OMO to maintain the average weighted call money rate (AWCMR), which is the operating target under the current enhanced monetary policy framework of the Central Bank, at the desired level with minimal fluctuations. Although excess liquidity declined from the levels observed in 2014, it continued to remain high during the year. Accordingly, the Central Bank conducted auctions occasionally for outright sales of Treasury bills to absorb excess liquidity on a permanent basis, while overnight repurchase auctions and term repurchase auctions were also conducted. In the meantime, during August/September, the Central Bank conducted reverse repurchase auctions infrequently to provide liquidity to OMO participants who experienced a shortage of funds mainly due to the asymmetric distribution of liquidity in the market. In the context of accelerating growth of domestic credit, the high level of excess liquidity in the domestic money market remained a concern, given its potential to fuel further credit expansion leading to inflationary pressures eventually.

As credit and monetary aggregates continued to grow at a higher pace than projected, while excess liquidity in the domestic money market remained persistently high, the Central Bank commenced tightening monetary policy towards end 2015. Accordingly, the Central Bank raised the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points to 7.50 per cent to be effective from the reserve period commencing 16 January 2016. This

Table 7.1 Recent Monetary Policy Measures

Date	Measure
3-Feb-2012	Repurchase rate and Reverse Repurchase rate increased by 50 basis points to 7.50% and 9.00%, respectively.
9-Feb-2012	Greater flexibility in the determination of the exchange rate allowed.
12-Mar-2012	Direction issued to licensed banks to limit rupee denominated credit growth to 18% or Rs. 800 mn. Additional 5% (23% or Rs. 1 bn) allowed to banks that bridge the gap with funds raised abroad.
5-Apr-2012	Repurchase rate increased by 25 basis points to 7.75% and Reverse Repurchase rate increased by 75 basis points to 9.75%, respectively.
12-Dec-2012	Repurchase rate and Reverse Repurchase rate reduced by 25 basis points to 7.50% and 9.50%, respectively.
31-Dec-2012	Ceiling on rupee denominated credit growth allowed to expire.
10-May-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 7.00% and 9.00%, respectively.
26-Jun-2013	Statutory Reserve Requirement (SRR) reduced by 2 percentage points to 6% with effect from 1-Jul-2013.
15-Oct-2013	Repurchase rate and Reverse Repurchase rate reduced by 50 basis points to 6.50% and 8.50%, respectively.
2-Jan-2014	The Policy Rate Corridor was renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and Reverse Repurchase rate of the Central Bank were renamed as the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), respectively. SLFR reduced by 50 basis points to 8.00%. The Standing Deposit Facility (SDF) was uncollateralised with effect from 1-Feb-2014.
23-Sep-2014	Access to the SDF of the Central Bank by OMO participants at 6.50% was rationalised to a maximum of three times per calendar month. Any deposits at the SDF window exceeding three times by an OMO participant was accepted at a special interest rate of 5.00%.
2-Mar-2015	The 5.00% special SDF rate was withdrawn.
15-Apr-2015	The SDFR and SLFR reduced by 50 basis points to 6.00% and 7.50%, respectively.
3-Sep-2015	The exchange rate was allowed to be determined based on demand and supply conditions in the foreign exchange market (a).
30-Dec-2015	SRR was increased by 1.50 percentage points to 7.50% to be effective from the reserve period commencing 16 January 2016.
19-Feb-2016	The SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.

Source: Central Bank of Sri Lanka

(a) In addition, the Central Bank imposed:
i. a minimum cash margin requirement of 100% on 30 October 2015 against Letters of Credit (LC) opened with commercial banks for the importation of motor vehicles to be effective until 1 December 2015, and
ii a maximum Loan to Value (LTV) ratio of 70% 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 with effect from 1 December 2015, as a macro-prudential measure.

measure signalled the end of the relaxation cycle of monetary policy, and absorbed around Rs. 52 billion of excess liquidity on a permanent basis from the money market. Short term money market rates responded to tightened market liquidity conditions, and AWCMR, which had settled close to the lower bound of the policy rate corridor by end 2015, gradually increased towards the middle of the policy rate corridor. In spite of the policy measures taken by the Central Bank and some upward adjustments observed in market interest rates, the Central Bank observed that certain risks to macroeconomic stability persisted due to excessive growth of broad money fuelled by domestic credit expansion amidst the continued upward trend in underlying inflation, and in the context of rising global interest rates. Accordingly, as a preemptive policy measure to contain further buildup of demand driven inflationary pressures, the Central Bank increased its SDFR and the SLFR by 50 basis points each, to 6.50 per cent and 8.00 per cent, respectively, effective from the close of business on 19 February 2016. Meanwhile, following Central Bank's decision to allow greater flexibility in the determination of exchange rate through market forces, the Sri Lanka rupee depreciated against the US dollar by around 9.0 per cent during 2015. This complemented other policy actions and helped curtail increased import demand in the economy.

Several measures were taken by the Central Bank to contain credit flows to selected sectors in order to ensure macroeconomic and financial system stability. As a significant surge in motor vehicle imports was observed in 2015, a minimum cash margin requirement of 100 per cent was imposed on Letters of Credit (LCs) opened with commercial banks for the importation of motor vehicles with effect from 30 October 2015 for a period of one month. Subsequently, as a macro-prudential measure, a maximum Loan to Value (LTV) ratio of 70 per cent was imposed with effect from 1 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. These measures, supplemented by exchange rate policy and fiscal policy adjustments, were expected to contain credit expansion to some extent and ease excessive pressure in the domestic foreign exchange market while mitigating possible threats to financial system stability arising from excessive credit growth.

Inflation declined further in 2015 mainly reflecting the downward adjustments to administratively determined domestic prices, including fuel and key consumer items. Inflation, which remained in single digits continuously for over a period of seven years due to favourable domestic supply conditions, subdued global commodity prices and the effect of demand management policies of the Central Bank, moved to negative territory for a brief period during July - September 2015. Headline inflation, as measured by the year-on-year change in the Colombo Consumers' Price Index (CCPI), increased from 2.1 per cent recorded at end December 2014 to 2.8 per cent by end December 2015. However, annual average inflation moderated to 0.9 per cent in 2015 compared to 3.3 per cent recorded in 2014. Meanwhile, along with some upward movement observed due to price pressures in the non-food items of the CCPI basket, core inflation, which measures the demand driven component of inflation, indicated an upward trend in 2015. Accordingly, year-on-year core inflation was 4.5 per cent at end December 2015 compared to 3.2 per cent recorded at end December 2014, while annual average core inflation was at 3.1 per cent compared to 3.5 per cent recorded in 2014. In the meantime, as per the newly introduced National Consumer Price Index (NCPI), which covers all provinces in the country, year-on-year headline inflation was 4.2 per cent in December 2015 and annual average inflation was recorded at 3.8 per cent.

BOX 10 Modifications to the Monetary Policy Framework in Sri Lanka

Evolution of the Monetary Policy Framework in Sri Lanka

The conduct of monetary policy by the Central Bank of Sri Lanka to regulate monetary conditions and price developments has evolved gradually over the past sixty six years. Under the fixed exchange rate regime that was in place until 1977 as well as during the period of the managed floating exchange rate regime that existed until the adoption of a floating exchange rate in 2001, the exchange rate played a key role in anchoring inflation expectations. During the early 1980's, the Central Bank adopted monetary targeting (MT) as its monetary policy framework, and monetary aggregates became the key nominal anchor in the conduct of monetary policy in Sri Lanka. Accordingly, the final objective of price stability is to be achieved by influencing an intermediate target defined based on broad money aggregates, which is linked to reserve money through the money multiplier. Reserve money was considered the operating target of monetary policy under this framework. For each year, the MT framework required targets for reserve money and broad money growth to be announced and monitored, based on the annual monetary programme prepared by the Central Bank considering various factors, such as the expected fiscal and balance of payments developments, expected economic growth, desired levels of growth in credit and inflation.

Recent Global Developments in Monetary Policy Framework

Monetary policy conduct under the MT framework assumes that there is a strong and reliable relationship between the goal variable and the nominal anchor. If the relationship is weak, monetary aggregate targeting will not work and hence, may not deliver the expected results of monetary policy. This seems to have been a serious problem in many countries all over the world and given the breakdown of the relationship between monetary aggregates and goal variables such as inflation, as well as the changes in money demand function, many countries have adopted inflation targeting (IT) as their monetary policy framework.

IT framework is characterised by (1) an announced numerical inflation target; (2) an inflation forecast, which facilitates forward looking monetary policy decision making; and (3) a high degree of transparency and accountability. IT framework is generally associated with an institutional framework by the trinity of a mandate for price stability, independence, and accountability for the central bank (Svensson, 2010), which enables anchoring of inflation expectations more effectively. Accordingly, a country needs to fulfill several prerequisites prior or parallel to adopting an IT framework in terms of institutional setup, legal framework and the efficacy of policy transmission mechanism. Since the adoption of IT by New Zealand in 1989, many countries have moved towards IT frameworks as shown in Table B.10.1.

Table B.10.1 Inflation Targeting Countries

Year adopted Inflation Targeting	Countries
1989-1994	New Zealand, Canada, United Kingdom, Sweden, Australia,
1995-1999	Czech Republic, Israel, Poland, South Korea, Brazil, Chile, Colombia
2000-2004	South Africa, Thailand, Mexico, Iceland, Norway, Hungary, Peru, Philippines
2005 onwards	Romania, Guatemala, Indonesia, Armenia, Turkey, Ghana, Serbia

* Three other countries Finland, the Slovak Republic and Spain adopted inflation targeting, but abandoned it when they began to use the euro as their currency.

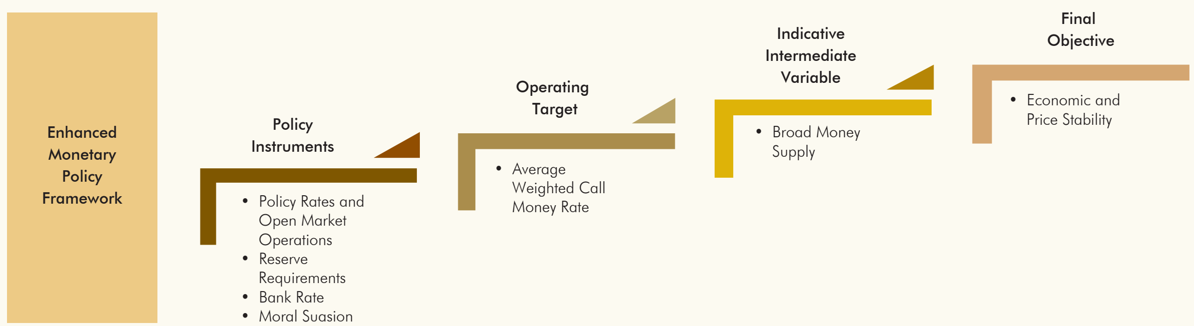
In practice, IT is flexible rather than strict, and most of the central banks do not only aim at stabilising inflation around an inflation target, but also put efforts in to stabilising other macroeconomic variables in the economy. As such, it appears that all IT central banks conduct flexible inflation targeting (FIT) rather than strict IT. FIT means that monetary policy aims at stabilising both inflation around the inflation target, and the real economy, whereas strict IT aims at stabilising only inflation, with little regard to the stability of the real economy (Svensson, 2009).

In addition to the central banks shown in Table B.10.1, in February 2015, the Reserve Bank of India (RBI) and the Ministry of Finance in India have agreed to put in place a monetary policy to focus on a FIT framework. Under this framework, the Consumer Price Index (CPI) based inflation is targeted to be below 6 per cent by January 2016 and 4 per cent for 2016-2017 with a band of +/- 2 per cent. Further, subject to the establishment and achievement of the nominal anchor in terms of an inflation target, monetary policy conduct is expected to be consistent with a sustainable growth trajectory and financial stability.

Enhanced Monetary Policy Framework in Sri Lanka

In line with the global tendency for central banks to move away from MT frameworks, the Central Bank of Sri Lanka has also been improving its monetary policy framework and increasingly aligning it with a FIT framework. A number of prerequisites for the new framework has been fulfilled by the Central Bank of Sri Lanka and the government during the past few years with the view of moving towards FIT in the medium term. This move has also been prompted by several weaknesses that have been observed with regard to the MT framework in Sri Lanka, including the weakening relationship between money supply and inflation. Given the rising volatility in money multiplier and velocity, the role of monetary targets as a nominal anchor has become uncertain and also complicated the Central Bank's communication strategy.

Figure B.10.1 Modifications to Monetary Policy Framework in Sri Lanka



At present, as an interim arrangement, the Central Bank of Sri Lanka conducts its monetary policy within an enhanced monetary policy framework with features of both MT and FIT frameworks. Under this enhanced monetary policy framework, the Central Bank focuses on stabilising inflation in mid-single digits over the medium term, while supporting the growth objectives and flexibility in exchange rate management. Although the Central Bank does not announce any monetary targets explicitly, broad money aggregates would continue to remain as the indicative intermediate variable to guide the conduct of monetary policy. Moreover, instead of reserve money, Central Bank currently uses average weighted call money rate (AWCMR) as its operating target and increasingly relies on its market based policy instruments, namely policy interest rates and open market operations (OMO). Macroeconomic projections of the Central Bank, including inflation projections, are currently being strengthened using short term forecasting tools and medium term dynamic stochastic general equilibrium (DSGE) techniques. Going forward, the Central Bank would continue its efforts to further modify and develop the monetary policy framework in line with the growing needs of the economy as well as the dynamic global environment in order to ensure both price and real sector stability on a sustainable basis. However, the commitment of the government towards fiscal consolidation is essential, if the Central Bank is to formally adopt FIT as its monetary policy framework.

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The Central Bank conducted monetary policy within an enhanced monetary policy framework with features of both monetary targeting and flexible inflation targeting (FIT). Under this enhanced monetary policy framework, which is essentially an interim arrangement until a more formal FIT framework is adopted, the Central Bank focuses on stabilising inflation in mid-single digits over the medium term, while supporting the growth momentum of the economy. Greater emphasis is placed on market based instruments, particularly policy interest rates and OMO, to guide AWCMR, the operating target of the framework, along the desired path. Although reserve money is no longer the operating target, broad money supply remains the indicative intermediate variable to guide monetary policy, and plays a key role in the annual monetary programme of the Central Bank, which is prepared considering the envisaged inflation target and the growth of real GDP. The monetary programme for

2015 originally envisaged an annual growth of 13.5 per cent in broad money (M_{2b}), consistent with the projected real GDP growth of 8.0 per cent and the expected implicit GDP deflator of 5.0 per cent, while the average growth was set at 12.0 per cent. In comparison to this envisaged monetary expansion, the actual broad money growth in 2015 averaged 15.2 per cent, although an immediate threat to inflation was not observed due to favourable supply conditions.

The monetary policy decision making process of the Central Bank continued to be based on a comprehensive analysis of the economy, covering monetary sector developments as well as the developments in other sectors of the economy. In making policy decisions by the Central Bank, the developments in monetary and credit aggregates as well as the direction of future inflation compared to the desired levels were assessed vis-à-vis the rest of the developments in the economy. The Monetary Policy Committee (MPC) continued to assist the Monetary Board of the Central Bank in making monetary policy decisions.

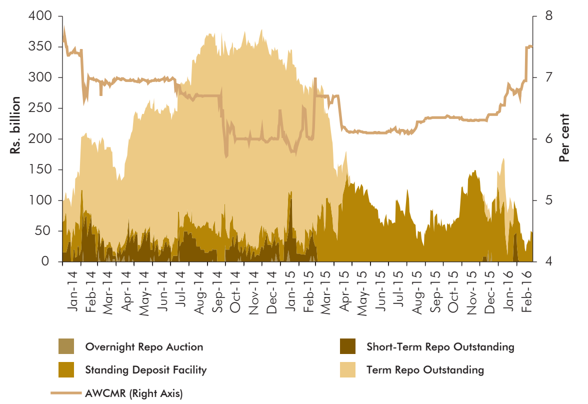
Communication of monetary policy focused on disseminating monetary policy decisions to market participants and the general public with greater clarity while continuing efforts to improve the data dissemination process of the Central Bank. With a view to managing expectations, particularly on inflation, policies and decisions of the Central Bank were communicated to market participants and the general public on a regular basis and in a timely manner with the rationale for such measures through regular and occasional communiqués, press conferences, seminars and lectures as well as speeches by the Governor and the senior officials of the Central Bank. Meanwhile, the Central Bank formally adopted the Special Data Dissemination Standard (SDDS) of the International Monetary Fund (IMF) for disseminating economic, monetary and financial data to the public, while continuing to publish useful economic information on a daily, weekly and monthly basis in the form of economic indicators, bulletins as well as a macroeconomic chart pack in all three languages on the Central Bank website.

7.3 Developments in Money and Credit

Money Market Liquidity

Excess liquidity in the domestic money market declined gradually in 2015 despite some variations observed throughout the year. During 2015, overnight excess liquidity ranged from Rs. 3.3 billion to Rs. 149.6 billion, and averaged Rs. 76.6 billion, while total excess liquidity stood at Rs. 105.3 billion by end 2015 compared to Rs. 325.6 billion at end 2014. Excess liquidity remained high during January 2015 due to Treasury bill purchases and the provisional advances to the government by the Central Bank. However, excess liquidity started to decline gradually until August 2015, mainly due to the continued supply of foreign exchange to the domestic foreign exchange market, foreign loan repayments, early retirements and outright sales of Treasury bills held by the Central Bank as well as high currency withdrawals from the Central Bank, particularly during the general election period. The decline in liquidity was also a reflection of the utilisation of liquidity by commercial banks to provide credit to the economy. During the early part of 2015, the Central Bank managed excess liquidity in the domestic money market using overnight, short term and long term OMO auctions. The Central Bank also allowed all outstanding term repurchase (repo) agreements to mature by end April 2015 and the remaining excess liquidity in the money market was largely absorbed on an overnight basis through the SDF of the Central Bank. At the same time, considering the needs of market participants

Chart 7.2 Rupee Liquidity in the Domestic Money Market and Liquidity Absorption



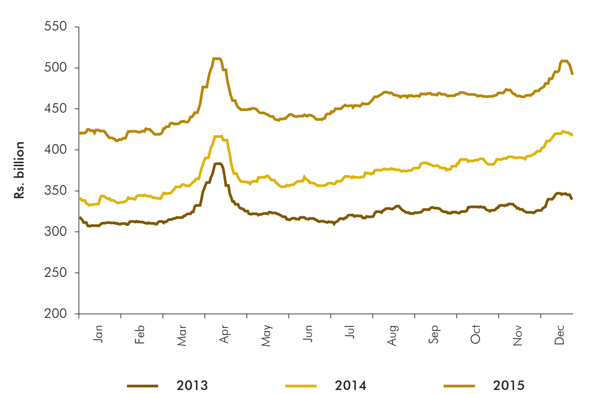
arising from asymmetric distribution of excess liquidity among banks, the Central Bank also conducted overnight reverse repurchase auctions from time to time to maintain the stability of short term interest rates. From September 2015, excess liquidity in the money market started to increase gradually as substantial amounts of rupee liquidity was injected through purchasing the proceeds of the Sri Lanka Development Bonds (SLDBs) as well as the purchasing of Treasury bills by the Central Bank in the primary market. In November 2015, further liquidity injections were observed on account of the purchase of a part of the proceeds of the International Sovereign Bond (ISB) of US dollars 1.5 billion by the Central Bank. In view of continuously high excess liquidity in the market for an extended period and its possible implications, the Central Bank raised the SRR applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points with effect from the reserve period commencing 16 January 2016, which absorbed around Rs. 52 billion from the domestic money market.

Reserve Money

The monetary base of the economy, which is measured by reserve money, continued to expand at a relatively high pace during 2015, although some declining trend was observed towards the end of the year. In absolute terms, reserve money increased by Rs. 95.5 billion from Rs. 577.9 billion at end 2014 to Rs. 673.4 billion at end 2015. On a year-on-year basis, reserve money grew by 16.5 per cent by end 2015 compared to a growth of 18.3 per cent recorded at end 2014. The continued expansion of reserve money was mainly due to the significant increase in currency in circulation, which contributed about 80 per cent of total expansion of the monetary base. During 2015, currency in circulation increased by Rs. 74.8 billion to Rs. 491.7 billion compared to Rs. 416.9 billion recorded at end 2014. On a year-on-year basis, currency in circulation increased by 17.9 per cent by end 2015. A similar historical pattern of high demand for currency was observed during the periods of national elections and key festivals, and the low opportunity cost of holding currency caused a sluggish return of currency to the banking system. Meanwhile, commercial bank deposits with the Central Bank increased by 12.9 per cent, on a year on year basis, to Rs. 181.7 billion at end 2015, mainly reflecting the impact of sustained credit expansion, particularly during the second half of the year.

With regard to the assets side, the growth of reserve money in 2015 was entirely driven by the expansion in net domestic assets (NDA) of the Central Bank. NDA of the Central Bank, which contracted to negative

Chart 7.3 Movements of Currency in Circulation



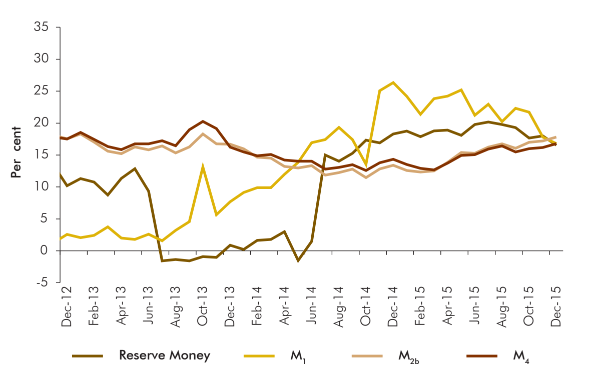
levels in 2014, increased substantially by Rs. 207.3 billion to Rs. 97.2 billion in 2015 reflecting higher credit flows to the government through increased placements of Treasury bills with the Central Bank. During the year, net credit to the government (NCG) by the Central Bank increased by Rs. 80.3 billion compared to an increase of Rs. 35.7 billion reported at end 2014. The Central Bank holding of government securities (net of repurchase transactions) increased by Rs. 73.1 billion to Rs. 79.2 billion at end 2015, while provisional advances extended to the government, the other major component of NCG, also increased by Rs. 7.2 billion to Rs. 151.1 billion. Further, other liabilities of the Central Bank, which is included in NDA, declined significantly by Rs. 147.5 billion in 2015 mainly due to the non-reliance on the bond borrowing programme by the Central Bank for monetary operations in the backdrop of increased Treasury bill holdings during the year. Meanwhile, with the depreciation of the rupee in 2015, the international reserve revaluation gain, which is recorded as an increase in other liabilities of the Central Bank, prompted other items (net) within NDA of the Central Bank to decline by Rs. 10.6 billion during the year. In contrast to the expansion in NDA, net foreign assets (NFA) of the Central Bank contracted by Rs. 111.8 billion during 2015. In spite of the purchase of a part of the proceeds of the ISB by the Central Bank towards the end of the year, the supply of foreign currency to 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 and liabilities to international organisations resulted in a significant decline in NFA of the Central Bank.

The money multiplier, which is a measure of the extent to which reserve money causes the growth in the broad money supply (M_{2b}), increased marginally to 6.78 compared to 6.71 recorded at end 2014. This increase reflected the impact of the gradual decrease in the currency to deposits ratio towards the end of the year amidst increasing market interest rates. However, on average, the broad money multiplier decreased to 6.73 in 2015 from 6.93 in 2014. The increase in SRR with effect from 16 January 2016 would lower the money multiplier by limiting the ability of the banking system to create money.

Narrow Money (M_1)

The expansion of narrow money (M_1) moderated gradually in 2015. Narrow money, which is the sum of currency and demand deposits held by the public, expanded by 16.8 per cent, on a year-on-year basis, by end 2015 compared to a growth of 26.3 per cent recorded at end 2014. Growth of narrow money, which averaged 22.7 per cent during the first ten months of the year, slowed down thereafter, reflecting the high base effect as well as the impact of gradually rising interest rates. Contributing around 57 per cent of the total expansion in the narrow money supply during 2015, currency held by the public increased by 17.8 per cent, year-on-year, to Rs. 388.1 billion by end 2015 compared to a growth of 24.5 per cent recorded at end 2014. The expansion in currency held by the public during 2015 can be attributed to the increased demand for currency during the periods of national elections in

Chart 7.4 Year-on-Year Growth of Monetary Aggregates



January and August 2015, and the sluggish return of currency to the banking system owing to the low interest rate environment, particularly in the early part of the year. Meanwhile, demand deposits held by the public with commercial banks increased by 15.6 per cent by end 2015 on a year-on-year basis compared to the significant growth of 28.5 per cent recorded at end 2014. The high credit expansion underpinned by a low interest rate environment led to the expansion in demand deposits during the year, although the growth decelerated towards end 2015 reflecting the impact of rising interest rates and the base effect. In absolute terms, demand deposits held by the public increased from Rs. 282.7 billion at end 2014 to Rs. 326.9 billion at end 2015.

Broad Money (M_{2b})

Broad money (M_{2b}) growth accelerated during 2015 beyond the projected levels reflecting increased demand for domestic credit from the private sector as well as the public sector. Broad money increased by 17.8 per cent, year-on-year, by end 2015 compared to a growth of 13.4 per cent recorded at end 2014. The average broad money growth in 2015 was at 15.2 per cent compared to 13.3 per cent recorded in the previous year. The expansion in broad money aggregates during 2015 was entirely due to the increase in domestic credit, since NFA of the banking system recorded a contraction during the year.

With regard to the liability side of broad money, the increased savings and time deposits held by the public with commercial banks largely contributed to the monetary expansion. Compared to the contribution of currency and demand deposits, the increase in time and savings deposits accounted for about 85 per cent of the year-on-year growth of broad money compared to 72 per cent observed for the previous year. Along with special interest rate schemes for senior citizens and the general increase in deposit interest rates towards the

Table 7.2 Developments in Monetary Aggregates

Rs. billion

Item	End 2014 (a)	End 2015 (b)	Change 2014 Amount	Change 2014 %	Change 2015 Amount	Change 2015 %
1. Currency Outstanding	416.9	491.7	77.1	22.7	74.8	17.9
1.1 Currency held by the Public	329.4	388.1	64.8	24.5	58.6	17.8
1.2 Currency with Commercial Banks	87.5	103.6	12.3	16.4	16.2	18.5
2. Commercial Banks' Deposits with the Central Bank	161.0	181.7	12.2	8.2	20.7	12.9
3. Government Agencies' Deposits with the Central Bank (c)	...	...	...		...	
4. Reserve Money (1+2+3)	**577.9**	**673.4**	**89.3**	**18.3**	**95.5**	**16.5**
5. Demand Deposits held by the Public with Commercial Banks	282.7	326.9	62.8	28.5	44.2	15.6
6. Narrow Money Supply, M_1 (1.1+5)	**612.2**	**715.0**	**127.6**	**26.3**	**102.8**	**16.8**
7. Time and Savings Deposits held by the Public with Commercial Banks	2,848.4	3,342.2	274.2	10.7	493.8	17.3
8. Broad Money Supply, M_2 (6+7)	**3,460.6**	**4,057.2**	**401.8**	**13.1**	**596.6**	**17.2**
9. Adjusted Foreign Currency Deposits (d)	415.3	508.7	56.2	15.7	93.4	22.5
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**3,875.9**	**4,565.9**	**458.0**	**13.4**	**690.0**	**17.8**
Money Multiplier, M_{2b}	**6.71**	**6.78**				
Velocity, M_{2b} (e)	**2.88**	**2.67**				

(a) Revised
(b) Provisional
(c) Government Agencies' Deposits with the Central Bank amounted to Rs. 7.3 million at end 2014 and Rs. 5.1 million at end 2015
(d) Includes deposits of the Resident Category of Offshore Banking Units (OBUs) and a part of foreign currency deposits with Domestic Banking Units (DBUs)
(e) During the year

Source: Central Bank of Sri Lanka

end of the year, positive real interest rates due to low inflation caused time and savings deposits held by the public to increase by 18.0 per cent, year-on-year, by end 2015 compared to a growth of 11.3 per cent at end 2014. In absolute terms, savings and time deposits with the commercial banking system increased by Rs. 587.2 billion during 2015 compared to Rs. 330.4 billion in the previous year. Savings and time deposits of domestic banking units (DBUs) and offshore banking units (OBUs) increased by 17.7 per cent and 23.8 per cent, respectively, during the period under consideration.

Contributing negatively to the expansion in monetary aggregates, NFA of both the Central Bank and commercial banks contracted during 2015. NFA of the banking system contracted substantially by Rs. 413.6 billion in the first ten months of 2015. However, some improvement in NFA was observed during the last two months of the year, with the receipt of proceeds from the ISB by the Central Bank. Accordingly, NFA of the banking system improved by Rs. 100.3 billion during the last two months of 2015, moderating the overall contraction of NFA to Rs. 313.3 billion during 2015. NFA of the Central Bank declined by Rs. 111.8 billion during the year, in comparison to the increase of Rs.158.9 billion observed in 2014. The overall contraction in NFA of the Central Bank in 2015 was mainly due to the increase in foreign liabilities, particularly to international organisations, including the Asian Clearing Union (ACU), along with increased foreign currency supply by the Central Bank in the domestic foreign exchange market and the decline in foreign securities held by the Central Bank. With regard to commercial banks, NFA declined by Rs. 201.5 billion in 2015 mainly due to the increased short term foreign borrowings as well as the increased balances of non resident foreign currency accounts (NRFC) and resident non national foreign currency accounts (RNNFC).

The growth of NDA of the banking system accelerated further during the year, contributing entirely to the broad money expansion in 2015. Accordingly, NDA of the banking system, which is mainly driven by domestic credit, expanded at 26.0 per cent, year-on-year, by end 2015 compared to the growth of 10.5 per cent recorded at end 2014. During the year under review, domestic credit extended by the banking system expanded significantly

Table 7.3 Sources of Reserve Money and Broad Money (M_{2b})
(Computed as per the Monetary Survey)

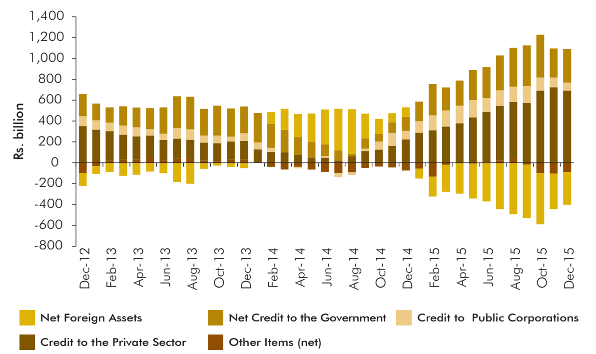
Rs. billion

Item	End 2014 (a)	End 2015 (b)	Change 2014 Amount	Change 2014 %	Change 2015 Amount	Change 2015 %
Reserve Money	**577.9**	**673.4**	**89.3**	**18.3**	**95.5**	**16.5**
Net Foreign Assets of the Central Bank	688.0	576.2	158.9	30.0	-111.8	-16.3
Net Domestic Assets of the Central Bank	-110.1	97.2	-69.6	171.6	207.3	-188.3
Broad Money (M_{2b})	**3,875.9**	**4,565.9**	**458.0**	**13.4**	**690.0**	**17.8**
Net Foreign Assets	15.1	-298.2	91.5	-119.8	-313.3	-2,071.2
Monetary Authorities	688.0	576.2	158.9	30.0	-111.8	-16.3
Commercial Banks	-672.9	-874.3	-67.4	11.1	-201.5	29.9
Net Domestic Assets	3,860.7	4,864.1	366.5	10.5	1,003.3	26.0
Domestic Credit	4,640.1	5,732.0	439.4	10.5	1,091.9	23.5
Net Credit to the Government	1,435.9	1,759.5	134.6	10.3	323.6	22.5
Central Bank	149.7	229.9	35.7	31.3	80.3	53.6
Commercial Banks	1,286.2	1,529.5	98.9	8.3	243.3	18.9
Credit to Public Corporations	446.0	523.0	80.9	22.2	76.9	17.2
Credit to the Private Sector	2,758.2	3,449.6	223.9	8.8	691.4	25.1
Other Items (net)	-779.4	-868.0	-72.8	10.3	-88.5	11.4

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 7.5 Contribution to Year-on-Year Change in Broad Money - M_{2b} (Assets Side)

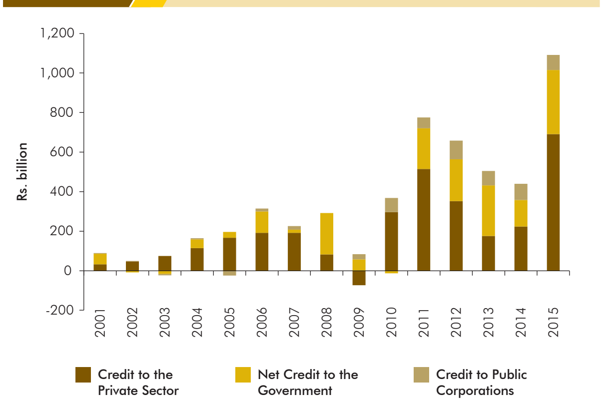


driven by the surge in credit to the private sector as well as to the public sector. In absolute terms, NDA of the banking system increased by Rs. 1,003.3 billion in 2015 compared to the increase of Rs. 366.5 billion in the previous year.

Within NDA of the banking system, the increase in NCG exceeded the levels stipulated in the government budget for 2015. During the year, NCG extended by the banking system increased substantially by Rs. 323.6 billion compared to the increase of Rs. 134.6 billion recorded in 2014. The increased reliance of the government on domestic financing amidst delays in the receipt of foreign financial flows, the continued shortfall in revenue collection, and expenditure overruns led to an increase in NCG during the year, although the issuance of the ISBs supported a moderation of this expansion to some extent. In terms of contributing institutions, NCG by the Central Bank increased by Rs. 80.3 billion during 2015 with increased purchases of Treasury bills by the Central Bank in the primary market. Treasury bill holdings of the Central Bank (net of repurchase transactions) increased from Rs. 6.1 billion at end 2014 to a peak of Rs. 186.3 billion by end October 2015, but early retirement of Treasury bills using the proceeds of the ISB limited the the Treasury bill holdings to Rs. 79.2 billion by end 2015. Meanwhile, with a considerably high contribution of around 75 per cent to the overall expansion, NCG by commercial banks increased by Rs. 243.3 billion in 2015 compared to the increase of Rs. 98.9 billion recorded at end 2014. Contributing to this expansion, NCG by DBUs increased by Rs. 79.7 billion due to investments in Treasury bills (Rs. 63 billion, net of repurchase agreements) and SLDBs (Rs. 74.7 billion), while investments in Treasury bonds declined by Rs. 52.2 billion (net of repurchase tranactions) reflecting lesser appetite of commercial banks towards long maturities. The outstanding overdraft balance of the government with state banks also increased by Rs. 10.5 billion to Rs. 125.1 billion at end 2015 from Rs. 114.6 billion recorded at end 2014. NCG by OBUs also increased by Rs. 163.6 billion during 2015, with increased investments in SLDBs.

The expansion of bank credit obtained by public corporations moderated to some extent in 2015. Credit to public corporations increased by Rs. 76.9 billion in 2015 in comparison to the increase of Rs. 80.9 billion observed in 2014. The increase in credit granted to Sri Lankan Airlines (SLA), Ceylon Petroleum Corporation (CPC), Road Development Authority (RDA) and Paddy Marketing Board (PMB) mainly contributed to the expansion in credit to public corporations. Credit obtained by SLA from the banking sector increased by Rs. 24.0 billion during the year, which was mainly utilised to settle past dues to

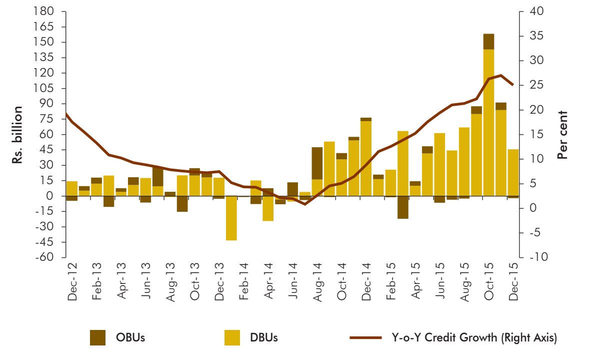
Chart 7.6 Annual Increase in Domestic Credit



the CPC. Compared to the significant increase of Rs. 35.0 billion in 2014, credit obtained by RDA was contained at Rs. 16.6 billion in 2015. Reflecting increased paddy purchases during the year, credit obtained by PMB also increased by Rs. 8.2 billion during 2015. Meanwhile, credit obtained by CPC was limited to Rs. 3.4 billion during the first seven months of the year reflecting the improving financial position of CPC. However, credit to CPC from the banking system increased by Rs. 18.9 billion by end 2015 driven by the elevated rupee value of fuel imports and foreign currency denominated liabilities stemming from the impact of exchange rate depreciation. Meanwhile, during the year, Ceylon Electricity Board (CEB) repaid Rs. 11.6 billion of its outstanding loan liabilities to the banking sector, while Ceylon Fertiliser Corporation and Colombo Commercial Fertiliser also settled Rs. 6.8 billion and Rs. 3.1 billion, respectively.

In response to continued relaxed monetary conditions, credit extended to the private sector by commercial banks expanded substantially in 2015. Credit extended to the private sector, which bottomed out in July 2014 recording a year-on-year growth of 0.8 per cent, steadily expanded thereafter to reach a growth of 27.0 per cent in November 2015. In December 2015, private sector credit growth moderated somewhat to 25.1 per cent as against the growth of 8.8 per cent recorded at end 2014. The expansion in credit to the private sector in absolute terms during 2015 was Rs. 691.4 billion compared to the increase of Rs. 223.9 billion recorded in the previous year. The sharp increase in credit to the private sector was fuelled by persistently low market lending rates and aggressive marketing campaigns by lending institutions. As per the Security-wise Analysis of Advances, the contraction in pawning advances was limited to Rs. 38.2 billion in 2015 compared to the significant decline of Rs. 140.0 billion recorded in 2014. Moreover,

Chart 7.7 Credit to the Private Sector by Commercial Banks



indicating high import demand for motor vehicles, credit in terms of leasing and hire purchase agreements increased considerably by Rs. 65.6 billion in 2015 compared to the increase of Rs. 16.4 billion in the previous year. The total expansion in credit to the private sector during the year also included around Rs. 83 billion of additional loans and advances portfolio that was added to the stock of private sector credit in M_{2b} with the merger of DFCC Vardhana Bank and DFCC PLC in October 2015 to formulate one licensed commercial bank (LCB).

Credit disbursed to all major sectors of the economy expanded during the year. As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, during 2015, credit flows to the Services sector and the Industry sector expanded significantly by 34.1 per cent and 25.0 per cent, respectively. In the Services sector,

Chart 7.8 Year-on-Year Growth of Private Sector Credit to Key Sectors (%)

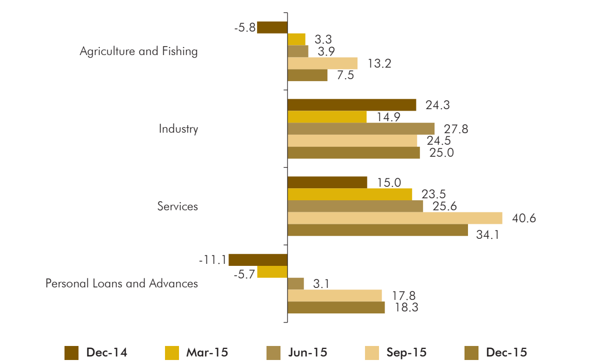


Table 7.4 Classification of Outstanding Credit to the Private Sector Granted by Commercial Banks (a)(b)

Rs. billion

Sector		End 2014	End 2015 (c)	% Share 2015	% Change 2015
Agriculture and Fishing		**287.3**	**309.0**	**9.0**	**7.5**
of which,	Tea	68.5	72.7	2.1	6.1
	Rubber	20.8	18.5	0.5	-11.1
	Coconut	7.8	12.2	0.4	56.4
	Paddy	16.9	19.0	0.6	12.8
	Vegetable, Fruit and Minor Food Crops	16.4	20.0	0.6	21.8
	Fisheries	11.7	11.0	0.3	-5.9
Industry		**1,118.0**	**1,397.5**	**40.8**	**25.0**
of which,	Construction	469.8	639.2	18.6	36.1
	Food and Beverages	71.1	85.4	2.5	20.1
	Textiles and Apparel	148.5	129.9	3.8	-12.6
	Fabricated Metal Products, Machinery and Transport Equipment	101.0	124.9	3.6	23.7
Services		**709.3**	**950.9**	**27.7**	**34.1**
of which,	Wholesale and Retail Trade	230.8	273.0	8.0	18.3
	Tourism	76.8	102.9	3.0	34.1
	Financial and Business Services	147.5	217.6	6.3	47.5
	Shipping, Aviation and Supply, and Freight Forwarding	13.9	13.2	0.4	-4.9
Personal Loans and Advances (d)		**651.6**	**771.1**	**22.5**	**18.3**
of which,	Consumer Durables	92.0	143.5	4.2	56.0
	Pawning	172.7	133.4	3.9	-22.7
Total		**2,766.2**	**3,428.5**	**100.0**	**23.9**

(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' and includes outstanding balances of credit card advances which is a part of 'credit to the private sector' in the monetary survey

Source: Central Bank of Sri Lanka

credit to major sub sectors, such as Tourism, Financial Business Services, Transport and Health grew at considerably high rates, while credit to the Shipping and Aviation sub sector recorded a contraction in 2015. Meanwhile, credit directed towards all sub sectors of the Industry sector, except for Textiles and Apparel industry, expanded with higher contributions from Construction, Food and Beverages, Chemical, Petroleum, Pharmaceutical and Healthcare, and Rubber and Plastic Products, and Fabricated Metal Products, Machinery and Transport Equipment sub categories. During the year, credit to the Textiles and Apparel industry declined by 12.6 per cent partly reflecting the impact of slowdown in apparel exports. Compared to the contraction of 5.8 per cent recorded in 2014, a growth of 7.5 per cent was observed in credit flows to the Agriculture and Fishing sector. However, the performance of sub sectors was mixed. Accordingly, credit flows to the Rubber and Fisheries sub sectors contracted in 2015 while credit to other sub sectors in the Agriculture sector showed some expansion. Moreover, Personal Loans and Advances, which include accommodations granted for the purpose of purchasing consumer durables, and health and education services, as well as pawning and credit card balances, increased by 18.3 per cent in 2015. Within the Personal Loans and Advances category, credit on Consumer Durables increased substantially by 56.0 per cent, whereas pawning advances recorded a negative growth of 22.7 per cent compared to the significant contraction of 41.0 per cent recorded at end 2014.

Table 7.5 Maturity Analysis of Outstanding Credit to the Private Sector by Commercial Banks (a)(b)

Sector	Maturity	December 2014		December 2015	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	7.1	-14.5	5.9	2.1
	Medium Term	2.3	17.4	1.9	5.8
	Long Term	1.0	30.5	1.2	50.3
Industry	Short Term	14.7	16.9	13.3	12.1
	Medium Term	11.2	32.7	10.9	21.5
	Long Term	14.5	26.2	16.5	40.8
Services	Short Term	11.7	8.9	11.2	18.0
	Medium Term	8.1	18.4	9.2	40.8
	Long Term	5.8	24.2	7.3	57.3
Personal Loans and Advances	Short Term	12.7	-12.7	10.5	2.6
	Medium Term	6.1	-14.8	6.3	27.1
	Long Term	4.7	16.4	5.7	49.4

(a) Based on the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector
(b) Classification of credit is based on original maturity and is as follows: up to one year - short term, between one and five years - medium term, over five years - long term

Source: Central Bank of Sri Lanka

Broad Money (M_4)

Reflecting a significant expansion of monetary liabilities across various deposit taking institutions, the year-on-year growth of broad money, based on the Financial Survey (M_4)[1] increased to 16.8 per cent by end December 2015 compared to 14.3 per cent at end 2014. In absolute terms, M_4 increased by Rs 822.5 billion in 2015 entirely due to the expansion in NDA. Increased credit disbursements to both the private and public sectors contributed to the expansion in NDA, while NFA recorded a contraction during the year.

On the liabilities side of M_4, the growth of savings and time deposits of licensed banks and licensed finance companies (LFCs) increased to 16.8 per cent in 2015 compared to 12.7 per cent recorded at end 2014. In spite of a significant increase in savings and time deposits held with LCBs, by end 2015, the year-on-year growth of savings and time deposits held with licensed specialised banks (LSBs) and LFCs decelerated to 7.7 per cent and 16.0 per cent, respectively, compared to 15.0 per cent and 22.5 per cent, respectively, recorded at end 2014. Lower growth of savings and time deposits held with LSBs partly reflected the merger of DFCC Vardhana Bank and DFCC Bank PLC in October 2015 to formulate one LCB.

In terms of the Financial Survey (M_4), the growth in credit extended to the private sector accelerated to 23.5 per cent, on a year-on-year basis, by end 2015 from 12.3 per cent recorded at end 2014. Credit to the private sector increased significantly by Rs. 900.9 billion in 2015 compared to the increase of Rs. 419.0 billion recorded in 2014. In addition to the increase in credit to the private sector by commercial banks as observed in M_{2b}, credit disbursements by LFCs contributed largely to the overall expansion in private sector

1 The Financial Survey provides a broader measure of liquidity, covering licensed specialised banks and licensed finance companies, in addition to licensed commercial banks and the Central Bank.

Table 7.6 Sources of Broad Money (M_4) (Computed as per the Financial Survey)

Rs. billion

Item	End 2014 (a)	End 2015 (b)	Change 2014 Amount	Change 2014 %	Change 2015 Amount	Change 2015 %
Financial Survey (M_4)	4,897.7	5,720.2	614.4	14.3	822.5	16.8
Underlying Factors						
Net Foreign Assets	-136.7	-444.1	63.3	31.6	-307.4	-224.8
Monetary Authorities	688.0	576.2	158.9	30.0	-111.8	-16.3
LCBs	-672.9	-874.3	-67.4	-11.1	-201.5	-29.9
LSBs and LFCs	-151.9	-146.0	-28.2	-22.8	5.9	3.9
Net Domestic Assets	5,034.4	6,164.4	551.2	12.3	1,130.0	22.4
Domestic Credit	6,291.9	7,603.7	723.1	13.0	1,311.8	20.8
Net Credit to the Government	2,010.4	2,344.3	223.2	12.5	333.9	16.6
Monetary Authorities	149.7	229.9	35.7	31.3	80.3	53.6
LCBs	1,286.2	1,529.5	98.9	8.3	243.3	18.9
LSBs	514.8	529.2	56.8	12.4	14.4	2.8
LFCs	59.7	55.6	31.8	114.3	-4.1	-6.8
Credit to Public Corporations (LCBs)	446.0	523.0	80.9	22.2	76.9	17.2
Credit to the Private Sector	3,835.5	4,736.4	419.0	12.3	900.9	23.5
LCBs	2,758.2	3,449.6	223.9	8.8	691.4	25.1
LSBs	474.4	481.7	94.3	24.8	7.2	1.5
LFCs	602.9	805.2	100.9	20.1	202.3	33.6
Other Items (net)	-1,257.5	-1,439.3	-172.0	-15.8	-181.8	-14.5

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

credit under M_4. By end 2015, credit disbursed to the private sector by LFCs grew at a high rate of 33.6 per cent compared to the growth of 20.1 per cent recorded at end 2014. In absolute terms, credit extended to the private sector by LFCs increased by Rs. 202.3 billion during 2015. The significant increase in credit flows provided by LFCs was mainly driven by credit facilities amounting to Rs. 140 billion granted on account of leasing of motor vehicles, which recorded a phenomenal increase of 61.2 per cent, on a year-on-year basis. Nonetheless, the year-on-year growth of credit disbursed to the private sector by LSBs declined to 1.5 per cent by end 2015 compared to 24.8 per cent recorded at end 2014 reflecting the impact of the merger of DFCC in October 2015. Meanwhile, NCG by LSBs expanded by Rs. 14.4 billion due to increased investments by LSBs in government securities. In contrast, NCG by LFCs declined by 6.8 per cent during the year driven by a decline in their holding of government securities.

7.4 Interest Rates

Benefitting from relatively relaxed monetary conditions, market interest rates remained low during 2015 although some upward movements were witnessed intermittently. With the removal of restrictions placed on the access to SDF in March 2015, overnight interest rates, which had remained below the SDFR, moved upwards and settled within the policy rate corridor close to the lower bound. At the same time, excessive increase in some interest rates, including yields on government securities, was observed in the aftermath of the removal of restrictions placed on the SDF. This trend was dampened by the reduction in policy rates of the Central Bank in April 2015. However, with the decline in market liquidity levels, a gradual upward adjustment in overnight interest rates was observed since August 2015. Meanwhile, retail interest rates remained low during 2015, although some increase was witnessed toward the end of the year. With the Central Bank's decision to raise SRR with effect from January 2016 and the increase in policy interest rates in February 2016, market interest rates increased further in the first quarter of 2016.

Money Market Rates

Interbank call money market rates responded to policy adjustments and changing liquidity conditions in the domestic money market. Following the removal of restrictions placed on accessing the SDF on 2 March 2015, AWCMR, which had remained below the SDFR since September 2014, jumped by 82 basis points to 7.00 per cent before settling around 6.70 per cent. With the reduction in policy interest rates on 15 April 2015, AWCMR declined immediately by 42 basis points to 6.23 per cent and continued its declining trend thereafter reaching 6.10 per cent by end July 2015. Following the decline in excess liquidity in the domestic money market, AWCMR increased by mid-August 2015 and stabilised at around 6.35 per cent thereafter. AWCMR hovered in a range of 6.30 – 6.40 per cent thereafter, but with the Central Bank's decision to raise SRR in December 2015, AWCMR started increasing towards the middle of the policy rate corridor in early 2016. At the end of 2015 and end January 2016, the

Table 7.7 Selected Money Market Rates

Per cent per annum

	AWCMR		SLIBOR- Overnight		SLIBOR-12 Month	
	End Period	Average for the Month	End Period	Average for the Month	End Period	Average for the Month
Dec-12	9.83	10.22	9.92	10.30	14.34	14.41
Dec-13	7.66	7.73	7.76	7.80	11.09	11.39
Dec-14	6.21	6.01	6.10	6.02	7.15	7.12
Mar-15	6.64	6.69	6.62	6.69	7.94	8.00
Jun-15	6.12	6.10	6.13	6.11	7.31	7.31
Sep-15	6.35	6.34	6.35	6.35	7.65	7.67
Dec-15	6.40	6.35	6.40	6.36	7.66	7.68

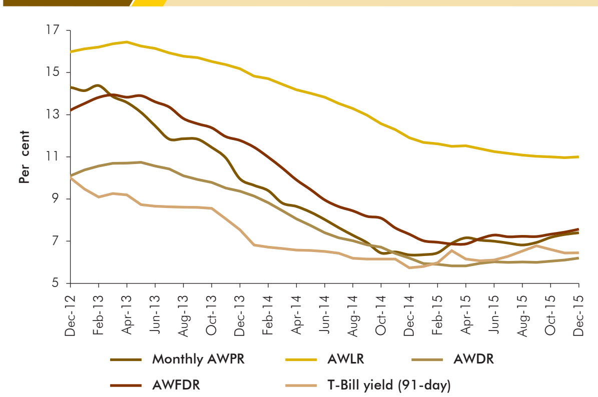
Source: Central Bank of Sri Lanka

AWCMR stood at 6.40 per cent and 6.73 per cent, respectively compared to 6.21 per cent that was observed at end 2014. With the increase in policy interest rates in February 2016, AWCMR increased immediately by 54 basis points. Meanwhile, the Central Bank conducted OMO auctions during 2015 as required, and at such auctions, the weighted average interest rates reflected the market liquidity conditions prevailing at the time. The Sri Lanka Inter Bank Offered Rate (SLIBOR) also moved in line with the movements in AWCMR. Accordingly, by end 2015, overnight and 12-months SLIBOR were recorded at 6.40 per cent and 7.66 per cent, respectively, compared to 6.10 per cent and 7.15 per cent, respectively at end 2014.

Deposit and Lending Rates

Interest rates offered on deposits by commercial banks remained relatively low during 2015, although a gradual increase was observed from the middle of the year. The average weighted deposit rate (AWDR), which reflects movements in interest rates pertaining to all interest bearing deposits held with commercial banks, continued its declining trend to reach 5.83 per cent by April 2015. However, AWDR increased gradually since then, mainly reflecting the impact of special interest rates offered for the deposits of senior citizens.

Chart 7.9 Movements of Selected Market Interest Rates



Further upward movements in AWDR were observed in the fourth quarter of 2015, reflecting the impact of monetary policy measures, market expectations of tighter monetary conditions as well as the increased efforts of financial institutions to mobilise deposits from the general public. Accordingly, by end 2015, AWDR stood at 6.20 per cent returning to the same level that prevailed at end 2014. Meanwhile, the average weighted fixed deposit rate (AWFDR), which is based on interest rates pertaining to all time deposits held with commercial banks, increased by 24 basis points to 7.57 per cent by end 2015 from 7.33 per cent at end 2014. Furthermore, the average weighted new deposit rate (AWNDR), which is calculated based on interest rates pertaining to all new interest bearing deposits placed with commercial banks during the month, also increased by 151 basis points to 6.96 per cent by end December 2015 compared to 5.45 per cent at December 2014.

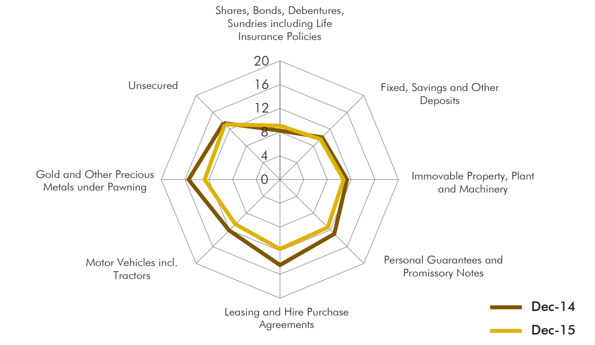
The Legal rate and the Market rate of interest[2] as determined by the Monetary Board and published in the Government Gazette at the end of each year, were 5.98 per cent per annum for 2016 compared to 7.76 per cent per annum for 2015. These rates are computed based on simple averages of monthly AWDR of commercial banks during the preceding 12 months.

Lending rates continued their declining trend during 2015, before commencing an upward movement towards the end of the year. The average weighted lending rate (AWLR), which is based on interest rates of all outstanding loans and advances extended by commercial banks to the private sector, declined by 91 basis points to 11.00 per cent by end 2015 from

2 The Legal rate is defined under the Civil Procedure Code (Amendment) Act No. 6 of 1990 and is applicable to any action for the recovery of a sum of money. The Market rate is defined under the Debt Recovery (Special Provisions) Act No. 2 of 1990 and applies only in relation to actions instituted by lending institutions for the recovery of debt exceeding Rs. 150,000 arising out of commercial transactions, where there is no agreed rate of interest.

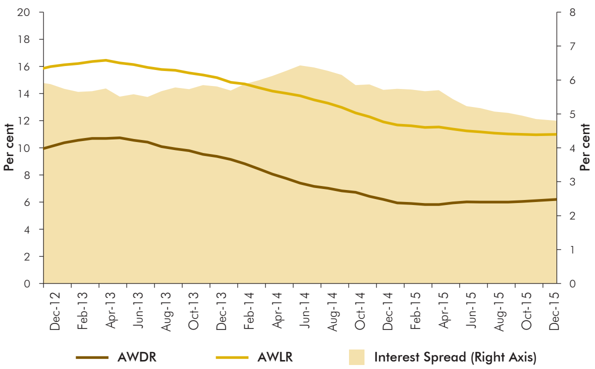
11.91 per cent recorded at end 2014. Meanwhile, bank-wise average weighted lending rates were in the range of 7.82-13.35 per cent by end 2015 compared to the range of 5.66-16.57 per cent observed at end 2014. Lending rates against most types of securities also decreased during 2015. In particular, interest rates on loans and advances, secured by leasing and hire purchase agreements, gold and other precious metals under pawning, personal guarantees and promissory notes as well as motor vehicles including tractors, decreased considerably. However, a marginal increase in lending rates on stock, bonds, debentures, sundries, including life insurance policies, and stocks in trade was observed during 2015. Meanwhile, reflecting the gradual rise in upward pressure on short term lending rates during the year, the weekly average weighted prime lending rate (AWPR), which is computed based on interest rates applicable on loans and advances granted by commercial banks to their prime customers, increased by 127 basis points to 7.53 per cent by end 2015 from 6.26 per cent at end 2014. In line with the movements in weekly rates, the monthly AWPR also increased by 105 basis points to 7.40 per cent by end 2015 from 6.35 per cent reported at end 2014. Furthermore, the average weighted new lending rate (AWNLR), which captures interest rates of all new loans and advances extended by commercial banks to the private sector during a particular month, also increased by 11 basis points to 10.79 per cent by end December 2015 from 10.68 per cent reported at end December 2014. During the year, the AWNLR remained lower than the AWLR indicating an environment of relatively relaxed monetary conditions. Meanwhile, although interest rate spread in the banking sector, as measured by the difference between AWDR and AWLR, indicated a gradual decline during the year, some marginal reversal in the trend was observed towards early 2016.

Chart 7.10 Average Weighted Lending Rates by Type of Security (%)



Reflecting the prevalence of relatively low global interest rates, interest rates on foreign currency deposits held with commercial banks remained low in 2015. Interest rates offered by commercial banks on US dollar denominated savings deposits were in the range of 0.02-3.00 per cent by end 2015 compared to the range of 0.01-3.25 per cent that prevailed at end 2014. Meanwhile, interest rates pertaining to US dollar denominated time deposits were in the range of 0.14-4.25 per cent by end 2015 compared to 0.06-4.25 per cent recorded at end 2014. Interest rates on pound sterling denominated savings deposits were in the range of 0.05-2.25 per cent by end 2015 remaining at the same levels observed at the end of the previous year. Meanwhile, interest rates applicable on pound sterling denominated time deposits were

Chart 7.11 Interest Rate Spread between Average Lending and Deposit Rates



MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7

Table 7.8 Movements of Interest Rates

Per cent per annum

Interest Rate	End 2014	End 2015
Policy Interest Rates (a)		
Standing Deposit Facility Rate	6.50	6.00
Standing Lending Facility Rate	8.00	7.50
Average Weighted Call Money Rate (AWCMR)	6.21	6.40
Yield Rates on Government Securities		
Primary Market (b)		
Treasury bills		
91-day	5.74	6.45
182-day	5.84	6.83
364-day	6.01	7.30
Treasury bonds		
2-year	-	6.70
3-year	-	8.18
4-year	-	8.91
5-year	8.93	9.79
10-year	7.88	10.94
Secondary Market		
Treasury bills		
91-day	5.72	6.39
182-day	5.86	6.66
364-day	6.04	7.11
Treasury bonds		
2-year	6.22	7.65
3-year	6.94	8.96
4-year	7.14	9.42
5-year	7.26	9.63
10-year	7.99	10.41
Licensed Commercial Banks (c)		
Interest Rates on Deposits		
Savings deposits	0.50-8.00	0.50-8.00
One year fixed deposits (d)	3.95-12.00	3.95-15.00
Average Weighted Deposit Rate (AWDR)	6.20	6.20
Average Weighted Fixed Deposit Rate (AWFDR)	7.33	7.57
Average Weighted New Deposit Rate (AWNDR)	5.45	6.96
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	6.35	7.40
Average Weighted Lending Rate (AWLR)	11.91	11.00
Average Weighted New Lending Rate (AWNLR)	10.68	10.79
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings deposits	5.00	5.00
One year fixed deposits	6.50	7.25
Licensed Finance Companies (e)		
Savings deposits	5.17-6.81	4.98-6.77
One year fixed deposits	8.89-10.27	9.34-10.68
Interest Rates on Lending		
National Savings Bank (f)	8.00-13.00	8.00-13.00
State Mortgage and Investment Bank (f)	7.07-14.00	7.07-13.50
Licensed Finance Companies (e)		
Finance Leasing	15.45-23.18	15.28-24.12
Hire Purchase	16.36-20.49	18.20-20.38
Loans against Real Estate	17.00-24.33	20.00-21.33
Corporate Debt Market		
Debentures	6.88-15.50	8.00-12.00
Commercial Paper	6.44-12.50	7.00-12.00

(a) 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. 2 January 2014.
(b) Weighted average yield rates at the latest available auction.
(c) Based on the rates quoted by commercial banks and other selected financial institutions.
(d) Maximum rate is a special rate offered by certain commercial banks.
(e) Average rates, based on the maximum and minimum rates quoted by Licensed Finance Companies and therefore data for 2014 is revised and 2015 is provisional.
(f) Lending for housing purposes only.

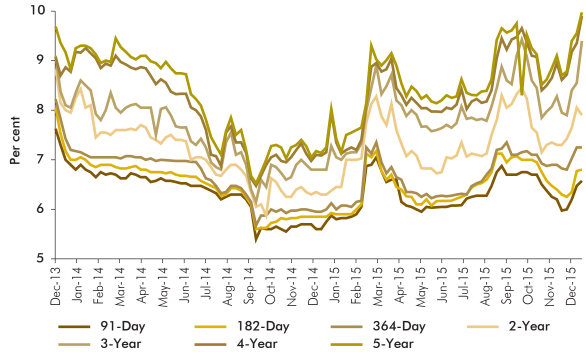
Sources: Colombo Stock Exchange
Respective financial institutions
Central Bank of Sri Lanka

in the range of 0.09-4.00 per cent by end 2015, whereas the rates for the same product were in the range of 0.20-4.25 per cent by end 2014.

Yield Rates on Government Securities

Yield rates on government securities in the primary market increased during 2015. Yield rates pertaining to Treasury bills in the primary market, which had remained below the SDFR in the preceding seven months, increased significantly by March 2015 with the removal of restrictions placed on the SDF by the Central Bank and due to market anticipation of the high domestic funding requirement of the government amidst delays in foreign financial inflows and Central Bank's decision to issue government securities only through public auctions. Yields declined to some extent during April – June 2015 responding to the reduction of policy rates, but moved upwards thereafter. Accordingly, by end 2015, the 91-day, 182-day and 364-day Treasury bill yields increased by 71 basis points, 99 basis points and 129 basis points to 6.45 per cent, 6.83 per cent and 7.30 per cent, respectively compared to the yields that prevailed at end 2014. With the view of maintaining an extended yield curve in a low interest rate environment, the government issued a significant amount of Treasury bonds with longer term maturities. Accordingly, Treasury bonds with maturity periods of 30 years and 20 years were issued in the primary market during February and March 2015 at yield rates of 11.73 per cent and 11.20 per cent, respectively, followed by issuances of Treasury bonds of various tenors throughout 2015. Overall, the yield rates on Treasury bonds in the primary market were in the range of 6.70 per cent on 2-year Treasury bonds to 11.73 per cent on 30-year Treasury bonds. The government also issued US dollar denominated SLDBs at various floating

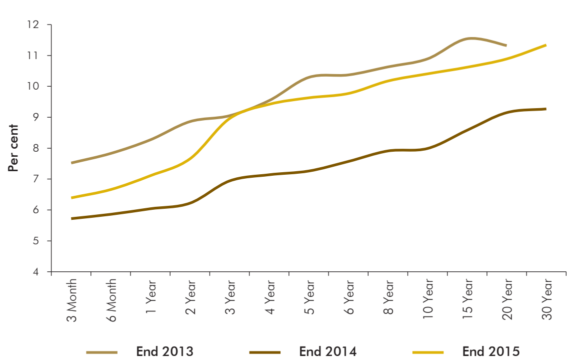
Chart 7.12 Movements of Secondary Market Yields for Government Securities



rates and two ISBs in May and October 2015, at yield rates of 6.125 per cent and 6.850 per cent, respectively. These issuances were instrumental in easing the pressure on interest rates of domestic debt instruments to some extent.

The secondary market yield curve for government securities shifted upward in 2015. Compared to the short end of the yield curve, steeper increases were observed in yields in the long end. Yield rates on Treasury bills pertaining to all three maturities in the secondary market increased by 67 to 107 basis points to a range of 6.39-7.11 per cent by end 2015 compared to the yields at end 2014. Meanwhile, yield rates on Treasury bonds of all maturities in the secondary market were recorded in a range of 7.65-11.34 per cent by end 2015.

Chart 7.13 Secondary Market Yield Curve for Government Securities



Yield Rates on Corporate Debt Securities

During 2015, interest rates applicable on private debt instruments issued by the corporate sector moved in line with other market interest rates. Interest rates pertaining to commercial paper, which is a short term private debt instrument, were in the range of 7.00-12.00 per cent during 2015 compared to the range of 6.44-12.50 per cent that was observed in 2014. Meanwhile, there were 55 listings of debentures by 25 corporations during 2015 with multiple maturities ranging from 3 to 10 years at various interest rates payable quarterly, semi-annually and annually on the basis of fixed and floating rates. Fixed interest rates applicable on debentures were in the range of 7.60-12.00 per cent in 2015 compared to 6.88-15.50 per cent reported in 2014.

7.5 Future Developments, Challenges and Outlook

Monetary policy in 2016 will continue to focus on managing aggregate demand to ensure price stability on a sustainable basis in terms of maintaining inflation at low and stable levels and containing inflation expectations, while facilitating the economy to move towards a high growth trajectory. Following the continued expansion in private sector credit as well as the increase in public sector credit over the envisaged levels, during 2015 monetary aggregates increased at a rate inconsistent with economic growth thus fuelling fears of escalating demand driven inflation in the economy. As a result, although inflation remained contained at moderate levels mainly due to supply side factors, the Central Bank commenced a process of gradual tightening of monetary policy towards end 2015. This is expected to be instrumental in containing monetary expansion at desired levels consistent with economic activity. Nevertheless, in the event of a rising trend in inflation above the projected levels, the Central Bank is expected to pursue further preemptive policy measures to ensure price stability on a sustainable basis, creating a conducive environment for economic activity to move along a high growth path as envisaged in the medium term macroeconomic policy framework.

Timely policy intervention by the government to supplement Central Bank policies is also essential to maintain the low inflation environment as a permanent feature of the economy. Low inflation observed during the past few years is partly a reflection of favourable supply side developments as well as subdued international commodity prices. In the event of inflationary pressures arising from adverse supply disturbances in future, demand management policies of the Central Bank may not be sufficient to dampen second round effects on inflation and inflation expectations. This requires policy intervention by fiscal authorities, particularly by encouraging continued improvements to supply conditions with the adoption of appropriate policies to enhance domestic agriculture production mainly through productivity enhancements, introducing high yielding crops and providing relevant support services, providing greater access to markets and improved connectivity across regions through proper transportation, creating buffer stocks and increasing storage facilities with the support of the private sector as well as minimising post harvest losses. It is also necessary to ensure that the domestic demand for essential items is fulfilled through timely importation of essential food items, particularly during festive seasons and during off-seasons for certain agricultural produce. As the economic policy advisor to the government, the Central Bank would continue to support government efforts through providing appropriate policy advice while adopting relevant measures on the monetary front.

While monetary policy measures adopted by the Central Bank are expected to directly impact private sector credit expansion, it is vital that the government also implements relevant measures to contain borrowings from the banking sector in the pursuit of curbing demand driven inflationary pressures in the economy. Excessive credit demand from the public sector poses a significant challenge to liquidity management in the domestic money market, interest rate stability, and aggregate demand management in order to contain inflationary pressures. If high levels of government borrowing from the banking sector continue, the resultant unwarranted monetary expansion would also threaten the realisation of the projected low inflation path, while exerting upward pressures on market interest rates due to competing efforts of the private sector and the government to obtain scarce financial resources. In this context, it is essential for the government to adopt necessary measures and structural reforms to adhere to its fiscal targets with a strong commitment and strengthen efforts towards fiscal consolidation. At the same time, it is imperative for public corporations to take appropriate measures to implement market based cost reflective pricing, to enhance operational efficiency and to strengthen the institutional setup, which would help reducing their heavy exposure to the domestic banking sector.

Diverse monetary policy responses observed in advanced and emerging market economies in the recent period are expected to continue during 2016 impacting the global economy and financial markets. It is expected that policy divergence among countries would have serious implications on global economic conditions, particularly on emerging markets, through cross currency movements, widening interest rate spreads, reversal of capital flows as well as portfolio rebalancing. Some emerging market economies have used the conducive financial conditions in the post financial crisis period to reduce their external vulnerabilities along a number of dimensions, including reducing current account deficits and adopting more flexible exchange rates. In the Sri Lankan context, further monetary policy normalisation in the United States may create additional pressures on the external sector through increased capital outflows and increased cost of external borrowing. It would also add pressure on the domestic foreign exchange market posing significant challenges to monetary management, thus requiring the Central Bank to follow a prudent exchange rate policy to supplement the conduct of monetary policy.

In the medium term, with a view to maintaining inflation comfortably in the range of 3-5 per cent, the Central Bank will continue its efforts to align the current enhanced monetary policy framework more towards FIT. A FIT framework would be more effective in the context of deeper and more liquid financial markets, stronger financial institutions, greater exchange rate flexibility and greater fiscal consolidation. In addition, continued efforts are necessary to improve the communication policy of the Central Bank, enhance transparency of Central Bank policies, upgrade technical capabilities of the Central Bank staff, particularly with regard to macroeconomic and macroeconometric modelling and forecasting, enhancing central bank independence, credibility as well as policy predictability in order to maintain economic and price stability in a more efficient and effective manner.