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MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

7.1 Overview

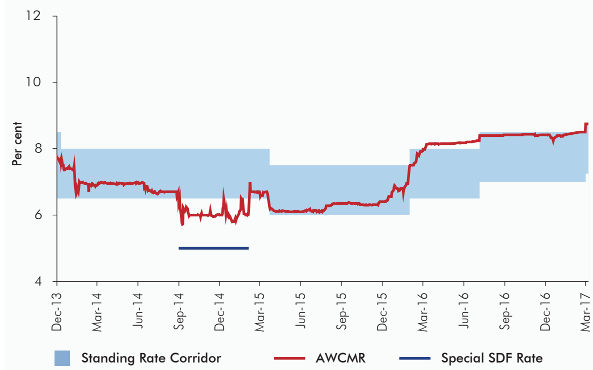
The conduct of monetary policy in 2016 was aimed at supporting the addressing of the existing and emerging imbalances in the Sri Lankan economy. The Central Bank tightened its monetary policy stance during 2016 to restrain excessive growth of monetary and credit aggregates to contain the possible buildup of demand driven inflationary pressures in the economy. 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 to 7.50 per cent effective January 2016, to permanently absorb a part of excess liquidity in the domestic money market. Furthermore, in view of rising inflationary pressures, the Central Bank increased its key policy interest rates, namely the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), by 50 basis points in February 2016. Despite policy measures taken preemptively, headline inflation indicated an upward movement, particularly in mid 2016 mainly due to supply side disturbances and changes to the government tax structure, while core inflation also increased. With credit to the private sector growing unabated amidst the rising trend in inflation, the Central Bank further tightened its monetary policy stance by increasing the SDFR and the SLFR by another 50 basis points in July 2016 to 7.00 per cent and 8.50 per cent, respectively. Alongside the restrictive monetary policy measures, open market operations (OMO) guided overnight interest rates towards the upper bound of the policy rate corridor. The continuation of the macroprudential measures adopted in late 2015 as well as the gradual adjustment in the exchange rate also complemented the monetary policy actions of the Central Bank. Although both headline and core inflation indicated some stabilisation during the second half of the year, the reimposition of revisions to the government tax structure along with further supply side disruptions, largely due to the drought caused inflation to increase somewhat towards the end of the year. Despite this upward movement, inflation remained broadly within the expected levels of the Central Bank and the target bands agreed with the International Monetary Fund (IMF) under the Extended Fund Facility (EFF) Programme. The upward adjustment of short term interest rates following monetary tightening measures permeated to market interest rates.

Reflecting the impact of monetary tightening amidst fiscal tightening measures and the base effect of the high growth in the previous year, the expansion of private sector credit decelerated to 21.9 per cent by end 2016 from its peak of 28.5 per cent in July 2016, although this deceleration was somewhat below expectations. Continued expansion in net credit to the government (NCG) and robust growth in private sector credit amidst a contraction in credit to public corporations, led broad money (M_{2b}) to grow by 18.1 per cent, on average, in 2016. With a view to containing the buildup of adverse inflation expectations and the possible acceleration of demand side inflationary pressures through continued monetary and credit expansion above the desired levels, the Central Bank further tightened the monetary policy stance by raising policy interest rates by 25 basis points in March 2017. The gradual transition from the current enhanced monetary policy framework towards flexible inflation targeting (FIT), which relies on managing inflation expectations through forward looking decision making as the key anchor of monetary policy in the context of increased flexibility of the exchange rate, is expected to enable maintaining price stability on a sustainable basis and the achievement of macroeconomic stability in the medium term.

7.2 Monetary Policy Stance of the Central Bank of Sri Lanka

Stabilising inflation at mid single digits over the medium term, without compromising growth prospects of the economy, remained the primary focus of the Central Bank of Sri Lanka in the conduct of monetary policy. Accordingly, the Central Bank conducted monetary policy within an enhanced monetary policy framework with features of both monetary targeting and inflation targeting. Market based policy instruments, particularly policy interest rates and OMO were used as the key policy tools to steer the Average Weighted Call Money Rate (AWCMR), the operating target of the current enhanced monetary policy framework along the desired path, while broad money (M_{2b}) continued to serve as the key indicative intermediate variable reflecting both liquidity and credit conditions in the economy. A comprehensive and systematic economic and monetary analyses, including short to medium term forecasts and expectations surveys, formed the basis of the monetary policy decision making process. Careful assessments of risks to future inflation were regularly conducted and the outcomes were informed through the Monetary Policy Committee (MPC) of the Central Bank to the Monetary Board to decide on appropriate policy measures to ensure the realisation of the envisaged monetary policy objectives.

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



Source: Central Bank of Sri Lanka

Headline inflation, which was on an upward trend during the first half of 2016, stabilised somewhat in the second half of the year. National Consumer Price Index (NCPI, 2013=100) based year-on-year headline inflation followed an increasing trend, but remained below mid single digits during the first four months of 2016. However, due to the combined impact of disruptions to domestic supplies on account of adverse weather conditions, increase in the rate of the Value Added Tax (VAT) and the removal of several exemptions pertinent to VAT and the Nation Building Tax (NBT), inflation accelerated in May-June 2016. The

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subsequent suspension of the implementation of changes to the government tax structure and the recovery in domestic supply conditions caused some deceleration in inflation during the third quarter of 2016. The reimposition of revisions to VAT and NBT in November 2016 exerted some upward pressure on prices, although year-on-year inflation remained broadly stable. Accordingly, year-on-year headline inflation based on the NCPI, which peaked at 6.4 per cent in June 2016, gradually receded to 4.2 per cent by end 2016, thus registering the same rate as at end 2015. On an annual average basis, however, NCPI based headline inflation accelerated to 4.0 per cent by end 2016 compared to 3.8 per cent at end 2015. Year-on-year headline inflation based on the Colombo Consumer Price Index (CCPI, 2013=100), peaked at 5.8 per cent in July 2016, before registering 4.5 per cent at end 2016. On an annual average basis, CCPI based headline inflation accelerated to 4.0 per cent by end 2016, compared to 2.2 per cent at end 2015. As per the Inflation Expectations Survey of the Central Bank, inflation expectations of the corporate sector remained subdued, although those of the household sector showed some increase.

Core inflation, which is typically considered a measure of the demand driven component of inflation, broadly followed an upward trend in 2016, albeit a decline was observed during some months. Although demand pressures underpinned by the expansion in monetary and credit aggregates would have been reflected in the movements of core inflation to a certain extent, upward revisions made to the tax structure by the government was the main contributory factor for the increase in core inflation by mid 2016. Foreseeing the upward pressure on inflation, the Central Bank tightened its stance on monetary policy in early January and mid February 2016, which helped contain inflation somewhat, although the upward revision of VAT with effect from May 2016 posed a direct threat on keeping inflation at mid single digits. However, further measures to tighten monetary policy in July 2016 alongside the suspension of revisions related to VAT and NBT, helped stabilise core inflation from August through October 2016. Nevertheless, the reimposition of revisions to VAT and NBT caused core inflation to increase somewhat during November and December 2016. Accordingly, NCPI based core inflation, which peaked at 7.5 per cent, on a year-on-year basis, in June 2016, slowed somewhat to 6.7 per cent by end 2016, but remained above the level of 5.8 per cent recorded at end 2015. On an annual average basis, NCPI based core inflation also accelerated to 5.9 per cent by end 2016 from 4.6 per cent at end 2015. However, year-on-year core inflation based on the CCPI decelerated from 6.7 per cent at end 2015 to 5.8 per cent by end 2016, while on an annual average basis, it slowed to 4.4 per cent by end 2016 from 4.9 per cent at end 2015.

In the meantime, M_{2b} expanded above the desired level during 2016 on account of the substantial expansion in credit to both the private sector and the government. Year-on-year growth of M_{2b} remained elevated at 18.4 per cent by end 2016, compared to the growth of 17.8 per cent observed at end 2015. The average growth of broad money also remained high at 18.1 per cent in 2016 in comparison to 15.2 per cent in 2015.

The Central Bank, with a view to curtailing the possible buildup of demand pressures on inflation arising from high monetary and credit expansion and high levels of liquidity in the domestic money market, adopted several policy measures. The notable expansion in domestic credit during 2015, which led to higher than expected expansion in money supply, warranted stern action by the Central Bank to preempt its likely impact on both price stability as well as financial system stability. Accordingly, the Central Bank

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introduced a number of prudential measures towards end 2015, such as the imposition of a minimum cash margin requirement on Letters of Credit (LCs) opened for the importation of motor vehicles, which was later replaced by the imposition of a maximum Loan-to-Value (LTV) ratio on motor vehicle purchases during the last quarter of 2015, while also allowing greater flexibility in the determination of the exchange rate. The monetary policy stance of the Central Bank was also tightened substantially. Accordingly, the SRR applicable on all rupee deposit liabilities of LCBs was raised by 1.50 percentage points to 7.50 per cent, to be effective from the reserve period commencing 16 January 2016. This measure permanently absorbed around Rs. 52 billion of excess liquidity from the domestic money market, while short term money market rates were allowed to adjust upwards in response. The Central Bank also raised its policy interest rates, namely the 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 with a view to reining in the growth of monetary and credit aggregates. Although market interest rates adjusted upwards reflecting the pass-through effect of monetary policy measures, credit flows to the private sector by commercial banks grew persistently at higher than projected levels due to increased ease of obtaining credit as well as increased demand for long term credit from all major sectors of the economy as reflected in the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector. Considering these developments, the Central Bank further tightened its monetary policy stance by raising the SDFR and the SLFR by 50 basis points each to 7.00 per cent and 8.50 per cent, respectively, effective from the close of business on 28 July 2016. With the view of bringing down monetary expansion to desired levels while curtailing the buildup of adverse inflation expectations, the Central Bank raised the policy interest rates again by 25 basis points effective 24 March 2017.

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 Ratio (SRR) reduced by 2 percentage points to 6% with effect from1-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 renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and Reverse Repurchase rate of the Central Bank 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) uncollateralised with effect from 1-Feb-2014.
23-Sep-2014	Access to the SDF of the Central Bank by OMO participants at 6.50% rationalised to a maximum of three times per calendar month. Any deposits at the SDF window exceeding three times by an OMO participant accepted at a special interest rate of 5.00%.
2-Mar-2015	The 5.00% special SDF rate 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 allowed to be determined based on demand and supply conditions in the foreign exchange market (a).
30-Dec-2015	SRR increased by 1.50 percentage points to 7.50% to be effective from the reserve period commencing 16-Jan-2016.
19-Feb-2016	The SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.
28-Jul-2016	The SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.
24-Mar-2017	The SDFR and SLFR increased by 25 basis points to 7.25% and 8.75%, 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 macroprudential measure.

OMO of the Central Bank was aimed at managing rupee liquidity in the domestic money market in order to maintain the overnight interest rates at desired levels. Rupee liquidity in the domestic money market, which declined with the increase in SRR in early 2016, declined further in the second quarter of the year. Regular reverse repurchase auctions were conducted by the Central Bank from the second quarter onwards to provide short term liquidity to market participants, while standing facilities were also made available. With rupee liquidity turning towards a surplus in certain times during the year, the Central Bank also conducted repurchase auctions appropriately to absorb liquidity on an overnight basis. Restrictive monetary policy measures, broadly tighter liquidity conditions and the resultant upward adjustment in short term market interest rates transmitted to deposit and lending rates of financial institutions, causing the economy's cost of funds to increase, which was crucial to restrict the excessive demand for credit from the private sector.

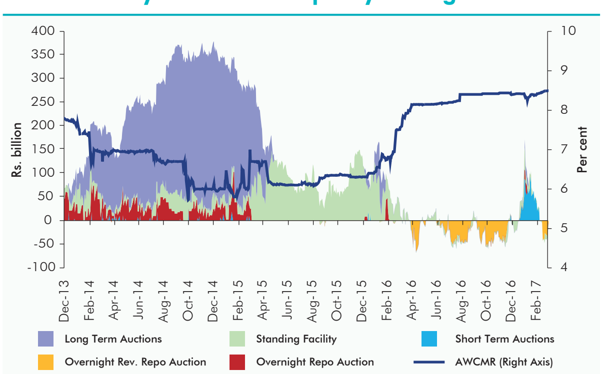
The Central Bank continued to enhance its communication policy effectively to keep all stakeholders of the economy informed of its monetary policy decisions with greater transparency and clarity. Policies and decisions of the Central Bank were communicated to the general public and market participants in a timely manner along with the rationale for such policy measures through regular communiqués, press conferences, meetings, seminars, lectures and speeches by the Governor and other key officials of the Central Bank, with the view of managing expectations. Moreover, key publications of the Central Bank, such as the Annual Report and the Recent Economic Developments, provided detailed analyses of macroeconomic data, while information on key macroeconomic indicators were disseminated and made available on daily, weekly and monthly bases through the Central Bank website in all three languages. The Macroeconomic Chart Pack continued to be featured on the Central Bank website, while the announcement of the Annual Road Map for Monetary and Financial Sector Policies to guide stakeholders of the economy with a medium term focus was recommenced in January 2017. In the "Road Map 2017", the Central Bank formally announced the intention to move to the FIT over the medium term. The number of MPC meetings were reduced to eight per annum to provide adequate time to conduct extensive analyses on the developments and projections of economic variables.

7.3 Movements of Interest Rates

Market Liquidity, Market Operations and Short Term Interest Rates

Rupee liquidity in the money market, which was in surplus during the first quarter of 2016, turned to a deficit thereafter, before increasing towards end 2016. The money market operated with a high level of excess liquidity of Rs. 105.3 billion at end 2015. Considering the ramifications of persistent and high liquidity levels in the market, the Central Bank increased SRR applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points to 7.50 per cent with effect from 16 January 2016. This absorbed liquidity from the domestic money market of around Rs. 52 billion permanently. Reflecting the decline in liquidity levels, short term interest rates commenced adjusting upwards. Nonetheless, rupee liquidity in the domestic money market remained notably high averaging around Rs. 84 billion during the first two months of 2016 due to maturing of term repurchase agreements, purchase of Treasury bills by the Central Bank and providing provisional advances to the government. However, excess liquidity in the domestic money market declined gradually to an average of around Rs. 9 billion in March 2016 as a result of new term repurchase agreements, foreign loan repayments and supply of foreign exchange to the domestic foreign exchange market by the Central Bank. Nevertheless, the impact of foreign exchange swap arrangements of commercial banks with the Central Bank moderated the decline in market liquidity levels to a certain extent. Consequently, the liquidity deficit in the domestic money market during April-June averaged at around Rs. 9 billion. However, occasional purchases of Treasury bills in the primary market by the Central Bank led to sporadic increases in liquidity levels. This was a result of the Central Bank intervening in the government securities market to dampen speculative increases in yield rates within the purely auction based system in issuing government securities, which may also have impacted the monetary policy transmission to some extent. Nevertheless, liquidity in the domestic money market continued to be in deficit levels during June-October 2016 averaging at around Rs. 27 billion due to the impact of maturing Treasury bills held by the Central Bank as well as foreign loan repayments. Due to the deficit in market liquidity that prevailed, auctions for outright purchases of Treasury bills were conducted to inject liquidity into the market on a permanent basis from the latter part of November 2016. Meanwhile, occasional purchases of Treasury bills by the Central Bank were observed in the primary market during the month of December, which also added liquidity to the money market. Accordingly, overnight liquidity in the domestic money market at end 2016 was a surplus of Rs. 39.2 billion.

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



Source: Central Bank of Sri Lanka

Table 7.2
Selected Money Market Rates

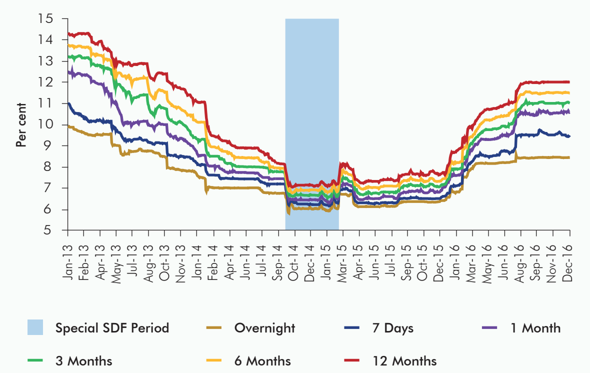
Per cent per annum

	AWCMR		Overnight OMO Auction		SLIBOR Overnight		SLIBOR 12 Month	
	End Period	Average for the Month	Repo	Reverse Repo	End Period	Average for the Month	End Period	Average for the Month
Dec-13	7.66	7.73	6.98	-	7.76	7.80	11.09	11.39
Dec-14	6.21	6.01	5.91	-	6.10	6.02	7.15	7.12
Dec-15	6.40	6.35	6.14	-	6.40	6.36	7.66	7.68
Mar-16	8.09	7.81	-	7.90	8.10	7.81	10.12	9.78
Jun-16	8.20	8.18	-	7.97	8.20	8.19	10.96	10.85
Sep-16	8.42	8.41	-	8.50	8.44	8.42	11.98	11.99
Dec-16	8.42	8.41	7.43	-	8.44	8.43	12.00	12.00

Source: Central Bank of Sri Lanka

Responding to monetary tightening measures of the Central Bank and deficit liquidity conditions in the domestic money market, interbank call money market rates adjusted upwards during 2016. With the Central Bank's decision to raise SRR with effect from January 2016 and to increase policy interest rates in February 2016, AWCMR increased to 7.50 per cent by end February 2016 compared to 6.40 per cent reported at end 2015. Responding to the decline in market liquidity levels by end March 2016, AWCMR increased further and moved beyond the upper bound of the policy rate corridor reaching 8.15 per cent by the first week of April 2016. With the support of OMO conducted by the Central Bank to stabilise interest rates, AWCMR hovered in a range of 8.15-8.24 per cent thereafter until July 2016. Following the increase in policy interest rates for the second time in July 2016, AWCMR increased and stabilised at around 8.40 per cent thereafter. By end 2016, AWCMR was at 8.42 per cent, recording an increase of 202 basis points during the year. With the increase in money market liquidity during January 2017, AWCMR adjusted downwards somewhat in January 2017, but increased towards end March 2017 with the upward adjustment in policy interest rates. Accordingly, by end March 2017, AWCMR was

Chart 7.3
Movements of Sri Lanka Interbank Offered Rates (SLIBOR)



Source: Central Bank of Sri Lanka

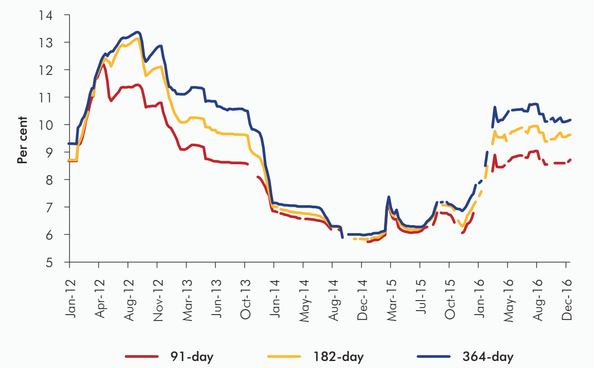
recorded at 8.75 per cent. Meanwhile, Sri Lanka Inter Bank Offered Rates (SLIBOR) also moved upwards during the year. Accordingly, by end 2016, overnight and 12-month SLIBOR stood at 8.44 per cent and 12.00 per cent, respectively, compared to 6.40 per cent and 7.66 per cent, respectively, at end 2015. Moreover, the weighted average yields at the daily OMO auctions adjusted upwards gradually during 2016 responding to the movements in policy interest rates and market liquidity levels. The Central Bank conducted overnight reverse repurchase auctions on most of the days in 2016, with the view of injecting liquidity into the domestic money market, and thereby stabilising money market rates. The weighted average yields at the OMO reverse repurchase auctions increased to 8.50 per cent by end November 2016 from 6.61 per cent recorded in mid January 2016.

Yields on Government Securities

Yields on government securities showed an upward trend during 2016 despite some moderation observed in the second half of the year. Reflecting the increased demand for funds by the government, delays in foreign financial inflows to the government as well as the impact of monetary tightening, yields in the primary Treasury bill market showed an increasing trend, especially during the first quarter of 2016. Accordingly, the weighted average yields on Treasury bills on 91-day, 182-day and 364-day increased by 245 basis points, 293 basis points and 334 basis points, respectively, to 8.90 per cent, 9.76 per cent and 10.64 per cent, respectively, by the end of March 2016 compared to end 2015. Meanwhile, the government's fiscal consolidation programme and the announcement of the EFF Programme of the IMF resulted in favourable market expectations in the government securities market. The upward pressure on yields of government securities began to moderate from April 2016 due to foreign inflows to the government securities market. Despite some upward movements of the yields of Treasury bills during April-July, yields in the primary market remained broadly stable during this period. Meanwhile, the receipt of long term financial flows from the successful issuance of Sri Lanka's tenth International Sovereign Bond (ISB) amounting to US dollars 1.5 billion in July 2016 as well as proceeds from the syndicated loans totalling US dollars 700 million helped minimise the pressure on yields of government securities. The policy rate hike in July 2016 led to an upward adjustment in yields again. Nevertheless, improvements in government finances and the availability of foreign inflows resulted in yields on Treasury bill rates declining from end August 2016, although a marginal increase in yields was observed during December. With these developments, the primary market yields on 91-day, 182-day and 364-day Treasury bills declined by 18 basis points, 13 basis points and 47 basis points, respectively, to 8.72 per cent, 9.63 per cent and 10.17 per cent, respectively, by the end of the year from the levels observed at end March 2016.

Yield rates pertaining to government securities with longer maturities displayed an increasing trend in 2016. Similar to the yields on Treasury bills in the primary market, yields on Treasury bonds also increased sharply during

Chart 7.4
Primary Market Treasury Bill Yields (a)

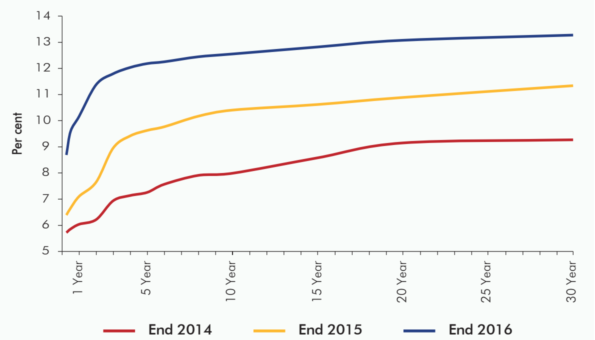


(a) Yield rates for same weeks are not available

Source: Central Bank of Sri Lanka

the first quarter of 2016 due to the high borrowing requirement of the government. The government relied more on short and medium term Treasury bonds and also issued short to medium term Sri Lanka Development Bonds (SLDBs) during the period. The primary market yield on 4-year Treasury bonds increased from 8.91 per cent at end 2015 to 11.94 per cent by end 2016. Similar movements were observed in yields pertaining to Treasury bonds of other maturities as well. Yields on 5-year Treasury bonds increased from 9.79 per cent at end 2015 to a peak of 13.00 per cent by early April, before moderating to 11.76 per cent at end 2016, showing an increase of 197 basis points during the year. The average weighted yield on 10-year Treasury bonds also increased by 117

Chart 7.5
Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka

basis points, from 10.94 per cent at end 2015 to 12.11 per cent by end 2016. Treasury bonds with longer maturities of 14 and 25 years were also issued during the first half of 2016.

In line with the movements in primary market yields, the secondary market yield curve on government securities shifted upwards during 2016. Secondary market yields on Treasury bills pertaining to all three maturities increased by 230-306 basis points in 2016. The secondary market yields on Treasury bonds with maturities of 2-30 years, which were in a range of 7.65 - 11.34 per cent by end 2015, also increased to a range of 11.38 - 13.27 per cent by end 2016. This upward shift in the rate structure can be partly attributed to the contractionary monetary policy stance and the continued high borrowing requirement of the government.

Deposit and Lending Interest Rates

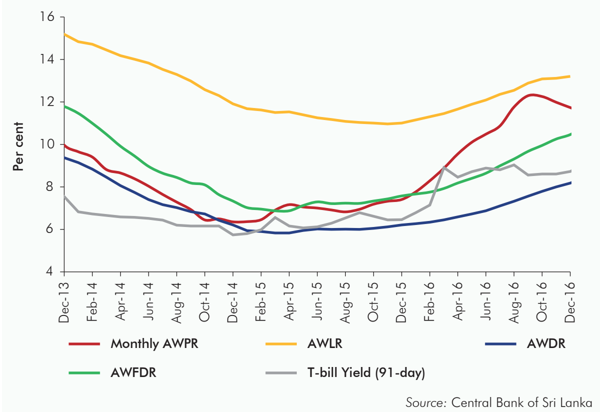
Interest rates offered on deposits of commercial banks continued to increase during 2016, reflecting the transmission of the effect of tight monetary conditions to retail interest rates. Upward movement in deposit rates during 2016 also reflected the increased funding costs of financial institutions. Accordingly, the Average Weighted Deposit Rate (AWDR), which reflects the movements in interest rates pertaining to all outstanding interest bearing deposits held with commercial banks, increased by 197 basis points to 8.17 per cent by end 2016 from 6.20 per cent at end 2015. Meanwhile, the Average Weighted Fixed Deposit Rate (AWFDR), which is based on interest rates pertaining to all outstanding time deposits held with commercial banks, also increased by 289 basis points to 10.46 per cent by end 2016 from 7.57 per cent at end 2015. A substantial increase in interest rates pertaining to short term time deposits, particularly for 3-months and 1-year, was observed during the year. The increase in deposit rates and increased efforts of banks to mobilise deposits from the general public aggressively also resulted in a substantial increase in the deposit base during 2016. Accordingly, the Average Weighted New Deposit Rate (AWNDR), which captures interest rates pertaining to all new interest bearing deposits placed with commercial banks during a month, increased by 421 basis points to 11.17 per cent by end December 2016 from 6.96 per cent at end December 2015. The Average Weighted New Fixed Deposit Rate (AWNFDR), which is based on interest rates pertaining to all new time deposits held with commercial banks during a month also increased by 431 basis points to 11.44 per cent by end December 2016 from 7.13 per cent recorded at end 2015. Despite some increase in inflation, depositors continued to benefit from positive real rates of return on their savings during 2016.

The Legal rate and the Market rate of interest,[1] as determined by the Monetary Board and published in the Government Gazette at the end of each year, were 7.06 per cent per annum for 2017 compared to 5.98 per cent per annum for 2016. These rates were computed in December 2016 based on simple averages of monthly AWDR of all commercial banks during the preceding twelve months.

Lending rates of commercial banks increased during 2016, reflecting the impact of the tight monetary stance, deficit liquidity conditions and increased cost of funds due to high deposit interest rates offered in view of aggressive deposit mobilisation. Reflecting the upward movement in short term lending rates during 2016, 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 every week, increased by 399 basis points to 11.52 per cent by end 2016 from 7.53 per cent at end 2015, while the monthly AWPR increased by 433 basis points to 11.73 per cent by end 2016 from 7.40 per cent reported at end 2015. 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, increased by 220 basis points to 13.20 per cent by end 2016 from 11.00 per cent at end 2015. The spread between AWDR and AWLR increased

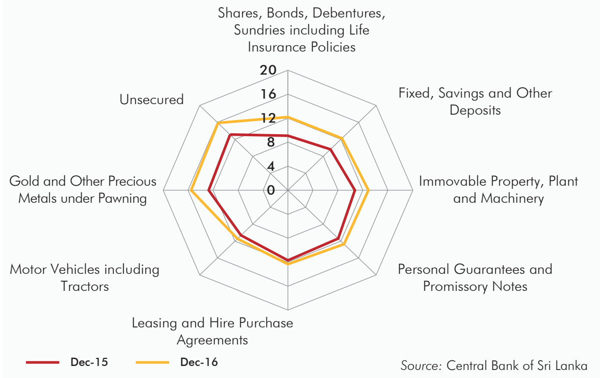
1 The Legal rate is defined under the Civil Procedure Code (Amendment) Act No. 6 of 1990 and is applicable to any action for the recovery of a sum of money. The Market rate is defined under the Debt Recovery (Special Provisions) Act No. 2 of 1990 and applies only in relation to actions instituted by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

Chart 7.6
Selected Market Interest Rates



Source: Central Bank of Sri Lanka

Chart 7.7
Average Weighted Lending Rates by Type of Security (%)



Source: Central Bank of Sri Lanka

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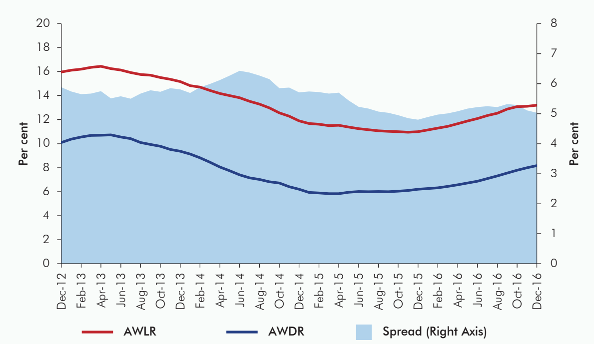
Chart 7.8
Spread Between Average Lending and Deposit Rates



Source: Central Bank of Sri Lanka

during 2016, although a marginal reversal in the increasing trend was observed during the last quarter of the year. Meanwhile, bankwise average weighted lending rates increased to a range of 10.12-15.66 per cent by end 2016 compared to the range of 7.82 - 13.35 per cent recorded at end 2015. The increase in lending rates was observed across all underlying securities during 2016. In particular, while interest rates based on different securities increased at different magnitudes, interest rates on loans and advances secured by shares, bonds, debentures, sundries, including life insurance policies; gold and other precious metals under pawning; fixed, savings and other deposits; and immovable property, plant and machinery increased considerably. Further, 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 month, increased substantially by 358 basis points to 14.37 per cent by end December 2016 from 10.79 per cent reported at end December 2015.

Interest Rates on Debt Instruments

Interest rates on corporate debt securities moved up in line with other market interest rates. Accordingly, interest rates pertaining to commercial paper, which is an avenue for short-term borrowing by large corporates, increased to a range of 8.70 - 14.80 per cent during 2016 compared to 7.00 - 12.00 per cent in 2015. There were 18 new listings of corporate debentures in 2016 with multiple maturities from 2 to 10 years. Most of these debentures were issued with fixed interest rates, while a few of them were issued on the basis of floating rates. Fixed interest rates applicable on debentures were in the range of 9.60 - 13.75 per cent in 2016 compared to 7.60 - 12.00 per cent reported in 2015.

Interest Rates on Foreign Currency Deposits

Interest rates applicable on foreign currency denominated deposits maintained at commercial banks increased marginally during 2016, responding to the movements in global interest rates. The increase in the Federal Funds target rate by the US Federal Reserve at end 2015 as well as at end 2016 drove the foreign currency deposit rates in Sri Lanka upwards. Further, relaxation of controls on withdrawals from foreign currency deposits and allowing retail investors to invest in SLDBs may have induced commercial banks to increase interest rates on foreign currency deposits to some extent during the year. Accordingly, interest rates on US dollar denominated savings deposits increased to a range of 0.02 - 3.62 per cent by end 2016 compared to the range of 0.02 - 3.00 per cent recorded at end 2015. Interest rates pertaining to US dollar denominated time deposits increased to a range of 0.15 - 5.00 per cent by end 2016 compared to the range of 0.14 - 4.25 per cent recorded at end 2015. Meanwhile, interest rates on savings deposits denominated in pound sterling were in the range

Table 7.3
Movements of Interest Rates

Per cent per annum

Interest Rate	End 2015	End 2016
Policy Interest Rates		
Standing Deposit Facility Rate	6.00	7.00
Standing Lending Facility Rate	7.50	8.50
Average Weighted Call Money Rate (AWCMR)	6.40	8.42
Yield Rates on Government Securities		
Primary Market (a)		
Treasury bills		
91-day	6.45	8.72
182-day	6.83	9.63
364-day	7.30	10.17
Treasury bonds		
2-year	6.70	11.04
3-year	8.18	11.62
4-year	8.91	11.94
5-year	9.79	11.76
10-year	10.94	12.11
Secondary Market		
Treasury bills		
91-day	6.39	8.69
182-day	6.66	9.60
364-day	7.11	10.17
Treasury bonds		
2-year	7.65	11.38
3-year	8.96	11.80
4-year	9.42	12.04
5-year	9.63	12.18
10-year	10.41	12.55
Licensed Commercial Banks (b)		
Interest Rates on Deposits		
Savings Deposits	0.50-8.00	0.50-9.00
1 Year Fixed Deposits (c)	3.95-15.00	4.50-15.00
Average Weighted Deposit Rate (AWDR)	6.20	8.17
Average Weighted Fixed Deposit Rate (AWFDR)	7.57	10.46
Average Weighted New Deposit Rate (AWNDR)	6.96	11.17
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	7.40	11.73
Average Weighted Lending Rate (AWLR)	11.00	13.20
Average Weighted New Lending Rate (AWNLR)	10.79	14.37
Other Financial Institutions (d)		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	4.25
1 Year Fixed Deposits	7.25	11.00
Licensed Finance Companies (e)		
Savings Deposits	4.98-6.77	5.38-7.74
1 Year Fixed Deposits	9.34-10.68	12.13-14.06
Interest Rates on Lending		
National Savings Bank (e)	9.00-14.00	9.75-15.00
State Mortgage and Investment Bank (f)	7.07-13.50	10.50-20.00
Licensed Finance Companies (e)		
Finance Leasing	15.28-24.05	17.48-25.97
Hire Purchase	18.20-20.38	17.51-22.65
Loans against Real Estate	20.00-22.00	19.12-20.80
Corporate Debt Market		
Debentures	7.60-12.00	9.60-13.75
Commercial Paper	7.00-12.00	8.70-14.80

(a) Weighted average yield rates at the latest available auction.
(b) Based on the rates quoted by commercial banks.
(c) Maximum rate is a special rate offered by certain commercial banks.
(d) Based on the rates quoted by other selected Financial Institutions.
(e) Interest rate ranges are based on the average maximum and average minimum rates quoted by LFCs for the month of December. Data for 2015 are revised and 2016 are provisional.
(f) Lending for housing purposes only.

Sources: Colombo Stock Exchange
Respective Financial Institutions
Central Bank of Sri Lanka

of 0.05-2.01 per cent by end 2016 in comparison to the range of 0.05 - 2.25 per cent at end 2015. Interest rates applicable on pound sterling denominated time deposits increased marginally to a range of 0.25 - 4.02 per cent by end 2016, whereas the comparable rates were in the range of 0.09 - 4.00 per cent at end 2015.

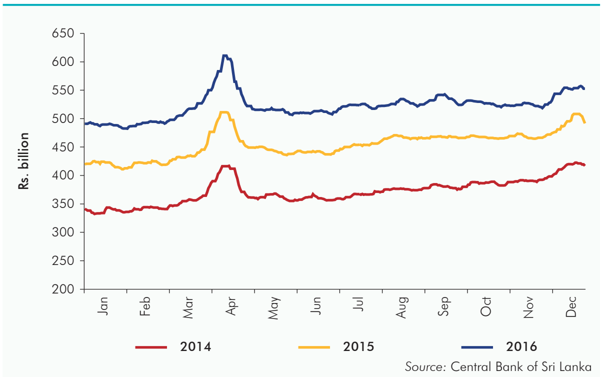
7.4 Movements of Monetary and Credit Aggregates

Reserve Money

Reserve money, also known as the monetary base of the economy, continued to expand at a high rate during 2016, and this was reflected in the significant expansion in commercial banks' deposits maintained at the Central Bank, while currency in circulation also increased in 2016. Accordingly, reserve money expansion, which was at 16.5 per cent, on a year-on-year basis, at end 2015, accelerated further to 27.1 per cent by end 2016. In absolute terms, reserve money increased noticeably by Rs. 182.7 billion to Rs. 856.1 billion by end 2016. Commercial banks' deposits increased significantly by Rs. 121.5 billion to Rs. 303.3 billion by end 2016, as a result of the upward adjustment in SRR applicable on all rupee deposit liabilities of LCBs from the beginning of 2016. Meanwhile, the expansion in currency in circulation was somewhat slow during the year as it increased by only Rs. 61.1 billion in 2016, compared to the increase of Rs. 74.8 billion in 2015, reflecting the increased opportunity cost of holding money with the upward adjustments in market interest rates.

Viewed from the assets side of the Central Bank balance sheet, the expansion in reserve money was entirely due to the increase in net domestic assets (NDA) of the Central Bank,

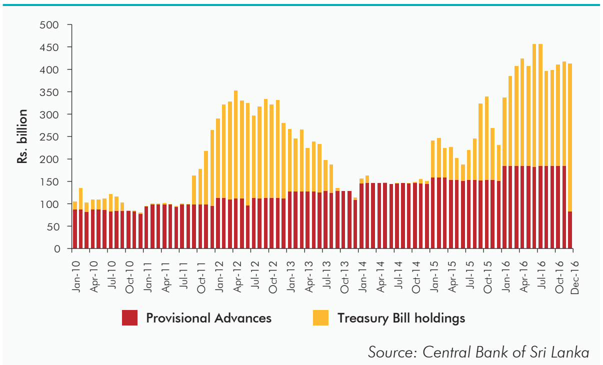
Chart 7.9
Currency in Circulation



Source: Central Bank of Sri Lanka

while net foreign assets (NFA) declined during 2016. NDA of the Central Bank increased by Rs. 200.3 billion in 2016 compared to the increase of Rs. 207.3 billion in 2015. Within NDA, NCG by the Central Bank increased by Rs. 183.1 billion to Rs. 413.0 billion by end 2016 as a result of the substantial increase in the Central Bank holdings of government securities (net of repurchase transactions) by Rs. 250.8 billion to Rs. 330.0 billion by end 2016 in comparison to Rs. 79.2 billion at end 2015. During the first eleven months of 2016, provisional advances extended to the government by the Central Bank averaged at around Rs. 184.6 billion in comparison to Rs. 151.1 billion at end 2015, but declined by Rs. 101.5 billion in the month of December 2016 to record Rs. 83.3 billion by end 2016. This was attributed to the settlement of a part of provisional advances using funds raised through the issuance of Treasury bills worth Rs. 100 billion to the Central Bank during the month of December 2016. Moreover, a decline in other liabilities of the Central Bank by Rs. 18.1 billion led to an increase in other items (net) within NDA of the Central Bank by Rs. 16.5 billion. This increase was mainly on account of the contraction observed in funds placed under the Standing Deposit Facility (SDF) during the year, resulting from declining levels of domestic money market liquidity, as well as international reserve revaluation losses incurred during the year. SDF placements by commercial banks, which remained at Rs. 47.7 billion by end February 2016 compared to Rs. 81.8 billion by end 2015, declined further to Rs. 24.8 billion on average during the period of March-November 2016, reflecting the changes in liquidity levels of the market. However, with the surplus liquidity observed in December 2016, SDF placements increased to Rs. 48.7 billion by end 2016. Moreover, increasing international reserve revaluation losses was largely as a result of the depreciation in the rupee during 2016, in the backdrop of a negative NFA position. Meanwhile, NFA of the Central Bank declined in 2016 by Rs. 17.6 billion to Rs. 558.6 billion compared to Rs. 576.2 billion at end 2015, as a result of the decline in foreign financial assets in terms of cash and bank balances abroad during the year. Total foreign liabilities also recorded a decline in 2016 due to a decrease in liabilities to foreign central banks/ international organisations including the Reserve Bank of India (RBI) and the Asian Development Bank (ADB) along with the reduction in liabilities under the Stand-By Arrangement Facility (SBA) of the IMF.

Chart 7.10
Central Bank Treasury Bill Holdings and Provisional Advances to the Government



Source: Central Bank of Sri Lanka

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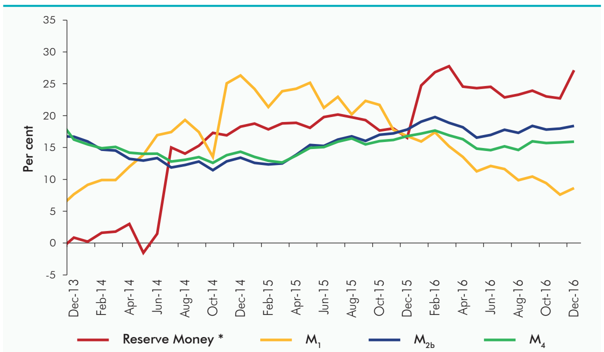
As a result of the significant expansion in reserve money during the year on account of the upward adjustment to SRR, the money

multiplier (in relation to M_{2b}) declined to 6.31 by end 2016 from 6.78 recorded at end 2015. Currency to deposits ratio also declined from 9.3 per cent at end 2015 to 8.6 per cent by end 2016. On average, the money multiplier decreased to 6.38 in 2016 compared to 6.73 in 2015.

Narrow Money (M_1)

Narrow money growth continued to decelerate during 2016, reflecting the response of the public to the increase in the opportunity cost of holding non-interest bearing monetary assets in the backdrop of rising market interest rates. The year-on-year growth of narrow money, which consists of currency and demand deposits held by the public with commercial banks, slowed to 8.6 per cent by end 2016 compared to 16.8 per cent recorded at end 2015. The rapid slowdown in narrow money growth was observed in the second half of the year, as it grew by only 9.6 per cent, on average, in comparison to the average growth of 14.2 per cent during the first half of 2016, partly reflecting the effect of the high base as well as the upward adjustment in market interest rates. Currency held by the public increased by 10.7 per cent, year-on-year, to Rs. 429.5 billion by end 2016 compared to 17.8 per cent in the previous year, contributing around 67 per cent to the total expansion in narrow money supply in 2016. The slowdown in the expansion of currency in circulation was a result of rising interest rates. Meanwhile, demand deposits held by the public with commercial banks at end 2016 increased by 6.2 per cent, on a year-on-year basis, compared to 15.6 per cent recorded at end 2015. In absolute terms, demand deposits amounted to Rs. 347.1 billion at end 2016 compared to Rs. 326.9 billion at end 2015. High interest rates offered on interest bearing deposits are likely to have impacted on the moderate expansion of demand deposits.

Chart 7.11
Year-on-Year Growth of Monetary Aggregates



Source: Central Bank of Sri Lanka

* The significant increase in Reserve Money since January 2016 is mainly attributable to the increase in SRR by 1.50 percentage points effective from the reserve week commencing 16 January 2016 by the Central Bank.

Broad Money (M_{2b}) and Domestic Credit

Broad money supply (M_{2b}) continued to grow at a high rate in 2016 mainly as a result of the expansion in credit to both the government and the private sector. The year-on-year growth of broad money, which peaked at 19.8 per cent in February 2016, decelerated to 18.4 per cent by end 2016, compared to 17.8 per cent at end 2015. On average, broad money growth was 18.1 per cent in 2016 in comparison to 15.2 per cent in 2015. The expansion in M_{2b} during 2016 was largely driven by the expansion in NDA of the banking system (which contributed 92 per cent to the expansion in broad money), while NFA of the banking system also increased during the year.

On the liability side of M_{2b}, the increase in time and savings deposits held by the public with commercial banks largely contributed to the monetary expansion during 2016. Reflecting the impact of the upward adjustment in interest rates offered on interest bearing deposits and competitive marketing campaigns by commercial banks to raise funds, the contribution of time and savings deposits to the overall year-on-year

Table 7.4
Developments in Monetary Aggregates

Rs. billion

Item	End 2015 (a)	End 2016 (b)	Change 2015 Amount	Change 2015 %	Change 2016 Amount	Change 2016 %
1. Currency Outstanding	491.7	552.8	74.8	17.9	61.1	12.4
1.1 Currency held by the Public	388.1	429.5	58.6	17.8	41.4	10.7
1.2 Currency with Commercial Banks	103.6	123.3	16.2	18.5	19.6	18.9
2. Commercial Banks' Deposits with the Central Bank (c)	181.7	303.3	20.7	12.9	121.5	66.9
3. Government Agencies' Deposits with the Central Bank (d)	...	...				
4. Reserve Money (1+2+3)	**673.4**	**856.1**	**95.5**	**16.5**	**182.7**	**27.1**
5. Demand Deposits held by the Public with Commercial Banks	326.9	347.1	44.2	15.6	20.2	6.2
6. Narrow Money Supply, M_1 (1.1+5)	**715.0**	**776.6**	**102.8**	**16.8**	**61.6**	**8.6**
7. Time and Savings Deposits held by the Public with Commercial Banks	3,342.2	4,046.9	493.8	17.3	704.7	21.1
8. Broad Money Supply, M_2 (6+7)	**4,057.2**	**4,823.6**	**596.7**	**17.2**	**766.3**	**18.9**
9. Adjusted Foreign Currency Deposits (e)	508.7	582.0	93.4	22.5	73.3	14.4
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**4,565.9**	**5,405.6**	**690.1**	**17.8**	**839.7**	**18.4**
Money Multiplier, M_{2b}	6.78	6.31				
Velocity, M_{2b} (f)	2.62	2.40				

(a) Revised
(b) Provisional
(c) Includes both Commercial Banks' Deposits with the Central Bank and balances of Primary Dealers with the Central Bank
(d) Government Agencies' Deposits with the Central Bank amounted to Rs. 5.1 million at end 2015 and Rs. 117.6 million at end 2016
(e) Includes deposits of Resident Category of offshore banking units (OBUs) and a part of foreign currency deposits with domestic banking units (DBUs)
(f) Average for the year

Source: Central Bank of Sri Lanka

expansion in broad money increased to about 93 per cent in 2016 compared to 85 per cent recorded in 2015. Accordingly, time and savings deposits held by the public with commercial banks increased by 20.2 per cent, year-on-year, to Rs. 778.0 billion in 2016, compared to the increase of Rs. 587.2 billion in 2015. Meanwhile, demand deposits held by the public with commercial banks expanded at a lower rate of 6.2 per cent, year-on-year, in 2016 in comparison to 15.6 per cent in 2015.

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With regard to the assets side of M_{2b}, NFA of the banking system recorded an increase during 2016, reversing the trend observed in the previous year, led entirely by the expansion in NFA of commercial banks. NFA of the banking system continued to contract during the first half of 2016 with a cumulative decline of Rs. 193.8 billion. However, this trend reversed during the second half of 2016, mainly on account of the improvement in NFA of commercial banks. Consequently, overall NFA of the banking system expanded by Rs. 66.9 billion in 2016 compared to the significant contraction of Rs. 313.3 billion recorded in 2015. Nevertheless, NFA of the Central Bank contracted by Rs. 17.6 billion in 2016 following the significant decline of Rs. 111.8 billion in 2015. This was mainly due to the supply of foreign exchange by the Central Bank to the domestic foreign exchange market in the backdrop of capital outflows in the economy leading to a deterioration in foreign reserves of the Central Bank. The decline in foreign assets of the Central Bank was reflected in the contraction of cash and bank balances abroad, while the Special Drawing Right (SDR) quota increased during the year with the increase of the country quota under the general quota review of the IMF with effect from 17 February 2016. Nevertheless, with the decline in liabilities to foreign central banks/international organisations including the RBI and the ADB along with the reduction in the liabilities under the SBA of

Table 7.5
Assets Side of Reserve Money and Broad Money (M_{2b})

Rs. billion

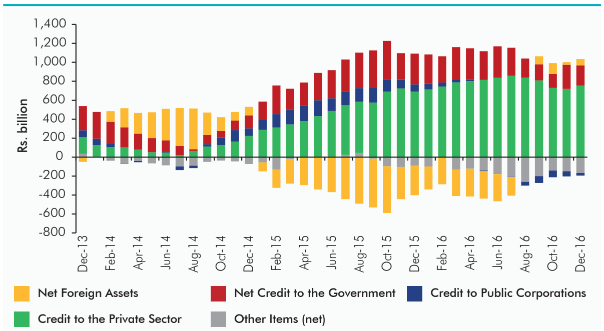
Item	End 2015 (a)	End 2016 (b)	Change 2015 Amount	Change 2015 %	Change 2016 Amount	Change 2016 %
Reserve Money	**673.4**	**856.1**	**95.5**	**16.5**	**182.7**	**27.1**
Net Foreign Assets of the Central Bank	576.2	558.6	-111.8	-16.3	-17.6	-3.1
Net Domestic Assets of the Central Bank	97.2	297.6	207.3	188.3	200.3	206.0
Broad Money (M_{2b})	**4,565.9**	**5,405.6**	**690.1**	**17.8**	**839.7**	**18.4**
Net Foreign Assets	-298.2	-231.2	-313.3	-2,071.2	66.9	22.4
Monetary Authorities	576.2	558.6	-111.8	-16.3	-17.6	-3.1
Commercial Banks	-874.3	-789.8	-201.5	-29.9	84.5	9.7
Net Domestic Assets	4,864.1	5,636.8	1,003.4	26.0	772.8	15.9
Domestic Credit	5,732.0	6,671.7	1,091.9	23.5	939.6	16.4
Net Credit to the Government	1,759.5	1,972.1	323.6	22.5	212.6	12.1
Central Bank	229.9	413.0	80.3	53.6	183.1	79.6
Commercial Banks	1,529.6	1,559.1	243.3	18.9	29.6	1.9
Credit to Public Corporations	523.0	495.1	76.9	17.2	-27.9	-5.3
Credit to the Private Sector	3,449.6	4,204.4	691.4	25.1	754.9	21.9
Other Items (net) (c)	-868.0	-1,034.8	-88.5	-11.4	-166.9	-19.2

(a) Revised
(b) Provisional
(c) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

the IMF, total foreign financial liabilities of the Central Bank also recorded a decline in 2016. However, the liabilities of the Central Bank to Asian Clearing Union (ACU) increased during the year. Meanwhile, NFA of commercial banks increased by Rs. 84.5 billion in 2016 compared to the significant contraction of Rs. 201.5 billion in 2015 partly attributing to the reversal of foreign currency swap arrangements with the Central Bank enabling more investments abroad successively. Within NFA of commercial banks, NFA of offshore banking units (OBUs) increased by Rs. 114.3 billion in 2016, with increased placements with banks and non-banks

Chart 7.12
Contribution to Year-on-Year Change in Broad Money - M_{2b} (Assets Side)



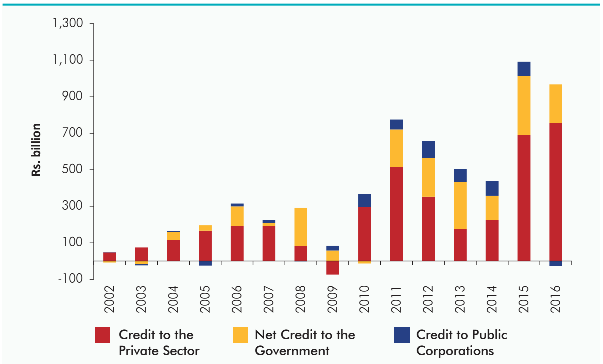
Source: Central Bank of Sri Lanka

abroad, while borrowings from abroad also declined considerably during the year. NFA of domestic banking units (DBUs) contracted by Rs. 29.8 billion in 2016 mainly due to the combined impact of the increase in commercial bank borrowings from abroad and the increase in balances of foreign currency accounts held with commercial banks by non-residents, while foreign currency placements with banks abroad increased during the period under review.

Driven by the expansion in credit flows to domestic sectors, NDA of the banking system expanded further in 2016, albeit at a slower pace in comparison to 2015. In absolute terms, NDA recorded an increase of Rs. 772.8 billion in 2016, but remained below the increase of Rs. 1,003.4 billion observed in the previous year. The expansion in NDA of the banking system was mainly driven by increases in credit extended to both the government and the private sector by the banking system, while there was a decline in credit obtained by public corporations in 2016.

Contributing to the increase in NDA, NCG from the banking system increased substantially in 2016. During the year, NCG increased by Rs. 212.6 billion compared to the increase of Rs. 323.6 billion recorded in 2015. The increase in NCG was mainly driven by the considerable increase in credit extended to the government by the Central Bank, while NCG from commercial banks also positively contributed to the overall increase. Accordingly, NCG from the Central Bank increased by Rs. 183.1 billion in 2016 compared to Rs. 80.3 billion in 2015, mainly due to the increased purchases of Treasury bills by the Central Bank in the primary market, amidst the temporary decline in provisional advances to the government observed at end 2016. The Treasury bill holdings (net of repurchase transactions) of the Central Bank increased significantly to a historically high level of Rs. 330.0 billion compared to Rs. 79.2 billion recorded at end 2015. Provisional advances to the government, which averaged around Rs. 184.6 billion during the first eleven months of 2016 compared to Rs. 151.1 billion at end 2015, declined by Rs. 101.5 billion to Rs. 83.3 billion by end 2016. This was mainly due to the partial settlement of provisional advances using funds raised through the issuance of Treasury bills worth Rs. 100.0 billion to the Central Bank during the month of December 2016. Meanwhile, NCG by commercial banks increased only by Rs. 29.6 billion during 2016 compared to the substantial increase of Rs. 243.3 billion in 2015. Contributing to the increase in NCG from commercial banks, NCG by DBUs increased by Rs. 96.6 billion in 2016 compared to the increase of Rs. 79.7 billion in 2015 mainly due to the higher investments in Treasury bonds (by Rs. 187.1 billion) and SLDBs (by Rs. 9.3 billion) indicating the commercial banks' preference towards securities with long term tenure, while short term loans to the government also increased by Rs. 10.4 billion during the period under review. Nevertheless, Treasury bill holdings (net of repurchase transactions) of DBUs declined by Rs. 97.5 billion during the year and outstanding overdraft balances of the government also declined by Rs. 27.8 billion. Meanwhile, NCG by OBUs of commercial banks declined by Rs. 67.1 billlion in 2016 compared to the notable increase of Rs. 163.6 billion recorded in 2015, largely due to maturities of SLDBs as well as the decline in new investments in SLDBs, despite the increase in direct loans to the government by around Rs. 8.3 billion during the year.

Chart 7.13
Annual Increase in Domestic Credit



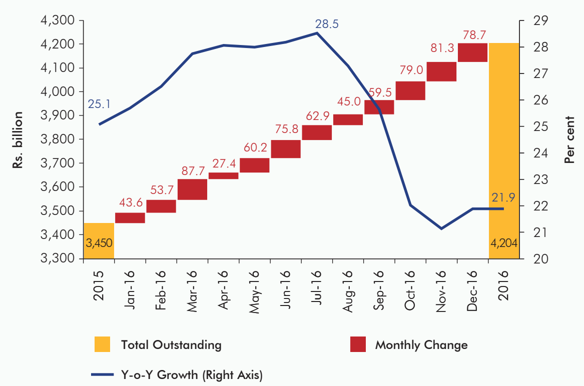
Source: Central Bank of Sri Lanka

Reflecting the improvements in a number of state owned business enterprises (SOBEs), credit extended by the banking system to public corporations declined during 2016. The declining trend in credit to public corporations that was observed since November 2015 continued during the first eight months of 2016 recording a cumulative contraction of outstanding credit to public corporations by around Rs. 81.5 billion by end August 2016. The improved financial position of key public corporations, particularly Ceylon Petroleum Corporation (CPC), contributed to this decline. However, this trend reversed since September 2016, thus limiting the overall contraction to Rs. 27.9 billion by end 2016 as against an increase of Rs. 76.9 billion recorded in 2015. With the improved financial position supported by relatively low oil prices, CPC settled around Rs. 71.9 billion of its outstanding liabilities to commercial banks in 2016. Ceylon Electricity Board (CEB) and Sri Lanka Ports Authority also repaid around Rs. 4.9 billion and Rs. 2.3 billion, respectively, during 2016. Meanwhile, credit obtained by SriLankan Airlines from the commercial banking sector increased by Rs. 16.7 billion in 2016, while borrowings of several other public corporations including Road Development Authority, Ceylon Fertiliser Corporation, Ceylon Shipping Corporation and Colombo Commercial Fertiliser also increased during the period under review.

Credit extended to the private sector by commercial banks continued to expand during 2016, although there was a deceleration in year-on-year growth amidst tight monetary policy measures and the effect of the high base.[2] With aggressive marketing campaigns by commercial banks and ample availability of funds as well as market expectations of upward adjustments in the government tax structure, credit to the private sector continued to accelerate during 2016 in spite of the upward adjustment in market interest rates in response to monetary tightening measures of the Central Bank. The acceleration observed in credit to the private sector in 2015 persisted in 2016 recording a peak growth of 28.5 per cent, on a year-on-year basis, by end July 2016. However, the year-on-year growth of credit to the private sector moderated towards the latter part of 2016, and recorded a growth of 21.9 per cent by end 2016, compared to 25.1 per cent at end 2015, reflecting the impact of tight monetary policy measures and the high base. In absolute terms, the increase in credit extended to the private sector was Rs. 754.9 billion during 2016 compared to the increase of Rs. 691.4 billion in the previous year. As per the Security wise Analysis of Advances, the cumulative increase in credit against Immovable Property, Plant and Machinery; Personal Guarantees and Promissory Notes; and Other Securities, which include corporate guarantees, indemnities and staff loans, etc. contributed around 68 per cent to the overall expansion in advances during the year. Meanwhile, reflecting the impact of the measures adopted by the government and the Central Bank to curb excessive demand for motor vehicles, the expansion in credit against leasing and hire purchase agreements was substantially lower during 2016 compared to the previous year.

As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit disbursed to all major sectors of the economy expanded considerably in 2016. On a year-on-year basis, credit flows to the Services and Industry sectors expanded by 35.4 per cent and 22.2 per cent, respectively, during 2016 compared to 34.1 per cent and 25.0 per cent, respectively, in 2015. Within the Services sector, credit flows to the subsectors of Shipping, Aviation and Freight Forwarding; Financial and Business Services; Wholesale and Retail Trade; Tourism; Education; Communication and Information Technology Services grew at high rates. Credit to major

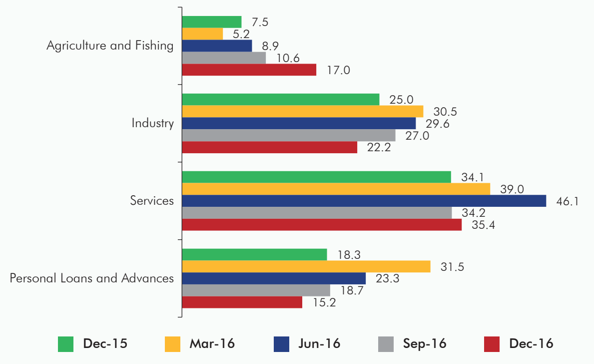
Chart 7.14
Credit to the Private Sector by Commercial Banks



Source: Central Bank of Sri Lanka

2 The outstanding credit volumes of commercial banks increased significantly in October 2015, with the amalgamation of DFCC Bank which operated as a LSB with the DFCC Vardhana Bank to operate as one LCB namely, DFCC Bank PLC, with effect from 1 October 2015.

Chart 7.15
Year-on-Year Growth of Private Sector Credit to Key Sectors (%)



Source: Central Bank of Sri Lanka

subsectors of the Industry sector also expanded with greater contributions from Construction; Textiles and Apparel; Fabricated Metal Products, Machinery and Transport Equipment; Food and Beverages; Chemical, Petroleum, Pharmaceutical and Healthcare, and Rubber and Plastic Products. Among these, credit to the Construction subsector increased by 26.9 per cent on a year-on-year basis by end 2016. Credit to the Textiles and Apparel subsector also increased by 22.7 per cent, year-on-year, by end 2016 as against a contraction of 12.6 per cent at end 2015. Meanwhile, by end 2016, credit to the Agriculture and Fishing sector grew by 17.0 per cent, year-on-year, compared to the growth of 7.5 per cent recorded in 2015. Within this sector, credit flows directed to the subsectors of Tea, Rubber, Coconut, Paddy, Vegetable and Fruit Cultivation and Minor Food Crops and Fisheries increased considerably during the year. Moreover, by end 2016, credit in terms of Personal Loans and Advances increased by 15.2 per cent, year-on-year, compared to 18.3 per cent recorded at end 2015. Within Personal Loans and Advances, credit to the subsectors of Consumer Durables, Personal Healthcare and Personal Education as well as Credit Card Balances increased during 2016 while Pawning Advances continued to record a contraction. During 2016, credit towards the purchase of Consumer Durables increased considerably by 38.1 per cent, although at a slower pace compared to the growth of 56.0 per cent in 2015. Pawning Advances recorded a slight contraction of 0.8 per cent, year-on-year, in 2016, compared to the notable contractions of 22.7 per cent in 2015 and 41.0 per cent in 2014. Moreover, as per the maturity analysis of outstanding credit to the private sector by commercial banks, short term credit grew substantially by 19.9 per cent, year-on-year, by end 2016 compared to 9.4 per cent recorded at end 2015, while some slowdown was observed in long term credit as it grew by 29.9 per cent, year-on-year, by end 2016 compared to 46.4 per cent at end 2015.

Table 7.6
Classification of Outstanding Credit to the Private Sector Granted by Commercial Banks (a)(b)(c)

Rs. billion

Sector	End 2015	End 2016 (d)	% Share 2016	% Change 2016
Agriculture and Fishing	**309.0**	**361.5**	**8.5**	**17.0**
of which, Tea	72.7	82.4	1.9	13.4
Rubber	18.5	23.8	0.6	29.0
Coconut	12.2	16.3	0.4	32.9
Paddy	19.0	28.9	0.7	52.3
Vegetable and Fruit Cultivation and Minor Food Crops	20.0	25.1	0.6	25.3
Fisheries	11.0	14.0	0.3	27.4
Industry	**1,397.5**	**1,707.5**	**40.2**	**22.2**
of which, Construction	639.2	811.2	19.1	26.9
Food and Beverages	85.4	95.3	2.2	11.7
Textiles and Apparel	129.9	159.4	3.8	22.7
Fabricated Metal Products, Machinery and Transport Equipment	124.9	148.8	3.5	19.1
Services	**950.9**	**1,287.6**	**30.3**	**35.4**
of which, Wholesale and Retail Trade	273.0	387.3	9.1	41.8
Tourism	102.9	138.7	3.3	34.8
Financial and Business Services	217.6	308.1	7.3	41.6
Shipping, Aviation and Freight Forwarding	13.2	28.1	0.7	112.1
Personal Loans and Advances (e)	**771.1**	**888.6**	**20.9**	**15.2**
of which, Consumer Durables	143.5	198.1	4.7	38.1
Pawning	133.4	132.4	3.1	-0.8
Total	**3,428.5**	**4,245.1**	**100.0**	**23.8**

(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) Total values in this Table differ from credit to the private sector values in Table 7.5 due to differences in the compilation methodologies
(d) Provisional
(e) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry' and includes credit card advances

Source: Central Bank of Sri Lanka

Table 7.7
Maturity Analysis of Outstanding Credit to the Private Sector by Commercial Banks (a)(b)

Sector	Maturity	December 2015		December 2016	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	5.9	2.1	5.5	16.5
	Medium Term	1.9	5.8	1.9	24.3
	Long Term	1.2	50.3	1.1	7.7
Industry	Short Term	13.3	12.1	13.3	23.7
	Medium Term	10.9	21.5	10.1	13.8
	Long Term	16.5	40.8	16.9	26.5
Services	Short Term	11.2	18.0	12.2	35.0
	Medium Term	9.2	40.8	10.6	41.3
	Long Term	7.3	57.3	7.6	28.5
Personal Loans and Advances	Short Term	10.5	2.6	8.6	1.0
	Medium Term	6.3	27.1	5.6	10.9
	Long Term	5.7	49.4	6.7	46.4
Total	Short Term	40.9	9.4	39.6	19.9
	Medium Term	28.4	27.1	28.2	22.8
	Long Term	30.7	46.4	32.2	29.9

(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)

As per the Financial Survey[3], the year-on-year growth of broad money supply (M_4), which is a broader measure of monetary liabilities, slowed to 15.9 per cent by end 2016, compared to 16.8 per cent at end 2015. The increase in NDA of the banking system and licensed finance companies (LFCs) accounted for 93.3 per cent of the expansion in M_4 as credit disbursements to both the private sector as well as to the government continued to increase during 2016.

As per M_4, the year-on-year growth of time and savings deposits, accelerated to 17.1 per cent by end 2016 from the growth of 16.8 per cent observed at end 2015. Time and savings deposits of LCBs grew by 19.3 per cent, on a year-on-year basis, by end 2016 in comparison to a growth of 19.0 per cent recorded at end 2015. Meanwhile, time and savings deposits of licensed specialised banks (LSBs) grew by 10.7 per cent, on a year-on-year basis, by end 2016 from 7.7 per cent at end 2015. The growth of time and savings deposits of LFCs decelerated, on a year-on-year basis, to 9.7 per cent by end 2016 from 16.0 per cent at end 2015, possibly as a result of a shift in deposits towards licensed banks in an environment of increased deposit rates.

The year-on-year growth of credit to the private sector in M_4 slowed to 20.6 per cent by end 2016 from 23.5 per cent at end 2015. In absolute terms, the increase in credit extended to the private sector amounted to Rs. 975.9 billion in 2016 in comparison to Rs. 900.9 billion in 2015, led mainly by the increase in credit granted by LCBs. Credit extended to the private sector by LSBs grew by 16.7 per cent by end 2016, compared to the tepid growth of 1.5 per cent at end 2015. In absolute terms, credit extended by LSBs to the private sector increased by Rs. 80.5 billion in 2016. The increase in credit extended by LFCs amounted to Rs. 140.5 billion in absolute terms, compared to Rs. 202.3 billion in 2015. The year-on-year growth of credit extended to the private sector by LFCs contracted sharply to 17.4 per cent by end 2016 from 33.6 per cent at end 2015 impacted by rising market interest rates and prudential measures introduced, particularly the imposition of a maximum Loan-to-Value ratio. As per M_4, NCG increased by a total of Rs. 211.6 billion, in absolute terms, with NCG by LFCs contributing positively to the expansion by Rs. 12.5 billion during 2016, while NCG by LSBs declined by Rs. 13.6 billion during the year.

3 The Financial Survey provides a broader measure of liquidity, covering LSBs and LFCs, in addition to LCBs and the Central Bank.

Table 7.8
Assets Side of Broad Money (M_4)
(Computed as per the Financial Survey)

Rs. billion

Item	End 2015 (a)	End 2016 (b)	Change 2015		Change 2016	
			Amount	%	Amount	%
Financial Survey (M_4)	5,720.3	6,630.3	822.6	16.8	910.0	15.9
Underlying Factors						
Net Foreign Assets	-444.1	-383.2	-307.4	-224.8	61.0	13.7
Monetary Authorities	576.2	558.6	-111.8	-16.3	-17.6	-3.1
LCBs	-874.3	-789.8	-201.5	-29.9	84.5	9.7
LSBs and LFCs	-146.0	-152.0	5.9	3.9	-6.0	-4.1
Net Domestic Assets	6,164.4	7,013.5	1,130.0	22.4	849.0	13.8
Domestic Credit	7,603.7	8,763.3	1,311.8	20.8	1,159.6	15.3
Net Credit to the Government	2,344.3	2,555.9	333.9	16.6	211.6	9.0
Monetary Authorities	229.9	413.0	80.3	53.6	183.1	79.6
LCBs	1,529.6	1,559.1	243.3	18.9	29.6	1.9
LSBs	529.2	515.7	14.4	2.8	-13.6	-2.6
LFCs	55.6	68.1	-4.1	-6.8	12.5	22.5
Credit to Public Corporations (LCBs)	523.0	495.1	76.9	17.2	-27.9	-5.3
Credit to the Private Sector	4,736.4	5,712.3	900.9	23.5	975.9	20.6
LCBs	3,449.6	4,204.4	691.4	25.1	754.9	21.9
LSBs	481.7	562.2	7.2	1.5	80.5	16.7
LFCs	805.2	945.7	202.3	33.6	140.5	17.4
Other Items (net) (c)	-1,439.3	-1,749.8	-181.8	-14.5	-310.6	-21.6

(a) Revised
(b) Provisional
(c) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

7.5 Future Developments, Challenges and Outlook

Similar to other countries, Sri Lanka has also experienced a gradual decline in the prominence assigned to the role of money in the monetary policy decision making process as a result of the deepening of and innovations in the financial system. The Central Bank, since the 1980s, has been pursuing monetary targeting as its monetary policy framework to achieve price stability. Accordingly, the final objective of price stability was to be achieved by influencing monetary aggregates, with reserve money being the operating target and broad money being the intermediate target of monetary policy. Nevertheless, issues such as the instability in the money demand function amidst financial developments and innovations, the rising gap between nominal GDP growth and broad money growth as well as the weakening relationship between money and inflation, have reduced the appeal of monetary targeting in the conduct of monetary policy. Given these developments, the Central Bank of Sri Lanka has been introducing gradual changes to its monetary policy framework, and currently conducts its monetary policy under an enhanced monetary policy framework with features of both inflation targeting and monetary targeting. Having announced in the "Road Map: Monetary and Financial Sector Policies" that the Central Bank will be adopting flexible inflation targeting (FIT) as its framework for monetary policy in the medium-term, the Central Bank has accelerated fulfilling technical requirements of such a framework. In this regard, the Central Bank is working with international agencies to improve its modelling and forecasting capabilities as well as to analyse the required legislative changes to facilitate inflation targeting. The government's ongoing fiscal consolidation programme is also expected to support a FIT framework, particularly through reduced reliance on the Central Bank for financing the fiscal deficit. The recognition of a medium term inflation target in the ongoing IMF-EFF Programme is also likely to support the adoption of FIT. It is expected that the FIT framework for the conduct of monetary policy would ensure price stability in the economy on a sustainable basis, thereby creating an enabling environment for businesses, by boosting business confidence, leading to high economic growth.

The Central Bank is in the process of further improving the quality of data and information used for monetary policy analysis. Accordingly, in 2016 with the assistance of the IMF, the Central Bank commenced reporting monetary and financial data based on standardised report forms (SRF) of the IMF. From 2018, the Central Bank is expected to release an improved set of monetary statistics along with relevant explanatory notes and analyses. This methodology assists in expanding the institutional coverage and the classification of financial instruments based on liquidity. In addition, the ongoing efforts to collect the sentiments of the private sector through various surveys as well as to disseminate information in a timely manner will also help the Central Bank in its analyses and managing expectations while helping the public to better understand the economic conditions of the country.

Recent domestic and global macroeconomic developments could pose challenges to the Central Bank in managing inflation expectations in the near term. Although, Sri Lanka has been maintaining single digit inflation continuously for a period of over eight years, some upward movement in inflation was observed in the recent past as a combined outcome of continued monetary and credit expansion, exchange rate movements, tax adjustments and supply side disruptions. While the Central Bank has responded to excessive monetary and credit expansion through the tightening of monetary policy, inflation could remain above the envisaged mid single digit levels due to other factors for some time in 2017. During this period of temporary increase in inflation, it is necessary to manage adverse inflationary expectations of the public, as any second round effect of these developments could result in a wage price spiral, which could derail the achievements so far on the inflation front.

The Central Bank's efforts to maintain inflation within the tolerable mid single digit levels, need to be supported by appropriate supply side policies with short, medium and long term focus. Short term disruptions to domestic supplies, particularly due to cycles of adverse weather, and thereby to inflation, cannot be mitigated through monetary policy measures. The government, as seen in many occasions, is better geared to address such disruptions through appropriate adjustments to tariffs and incentive structures. In the meantime, policies are required to increase domestic supply conditions on a sustainable basis. Continued economic and price stability would be possible only if both demand and supply policies are geared towards encouraging more productive usage of all factors of production.