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MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

7.1 Overview

The Central Bank continued to maintain its tight monetary policy stance in 2017 to curtail the build up of adverse inflation expectations and the possible acceleration of demand driven inflationary pressures through excessive monetary and credit expansion. The policy interest rates of the Central Bank were increased by 25 basis points in March 2017, further to the 100 basis point increase in policy interest rates and the 1.50 percentage point increase in the Statutory Reserve Ratio (SRR) in 2016. Macroprudential measures, such as the imposition of loan to value ratios (LTV) on account of credit facilities for motor vehicles, also buttressed the tight monetary policy stance.

The Central Bank also pursued a more market based exchange rate policy to complement the conduct of monetary policy. Nevertheless, the Central Bank's efforts to maintain inflation in a range of 4.0-6.0 per cent, as announced, were undermined mainly by adverse domestic supply side shocks. Disturbances to domestic food supplies, caused by prolonged adverse weather conditions, along with the base effect associated with the implementation of changes to the tax structure caused inflation to trend upwards during most of 2017. Accordingly, during 2017, headline inflation remained mostly above the Central Bank's targeted range, compared to lower levels that prevailed over the past several years. However, the Central Bank was able to control demand driven inflation, as measured by the movements in core inflation, particularly towards the latter part of the year, with the gradual transmission of the tight monetary policy stance maintained over the past two years. Effective communication policies of the Central Bank helped manage inflation expectations of the public to reduce wage pressures and resultant second round inflationary pressures. High food inflation drove up headline inflation beyond the expected levels. Despite this, headline inflation was maintained within the inner band of the quarterly targets under the Extended Fund Facility (EFF) programme of the International Monetary Fund (IMF) during the first three quarters of 2017. Subsequently, inflation remained within the outer band of the target range in the last quarter of the year. Inflation reverted to mid-single digit levels in early 2018.

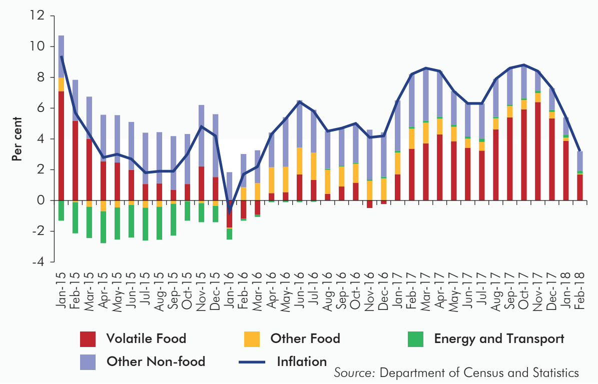
In response to the tight monetary policy stance of the Central Bank and the deficit liquidity position in the domestic money market, the

Average Weighted Call Money Rate (AWCMR) hovered around the upper bound of the policy rate corridor until mid July 2017. However, the AWCMR declined gradually thereafter in response to improved liquidity conditions, and the Central Bank conducted open market operations (OMO) actively to stabilise the rate around the middle of the corridor. The Central Bank was able to maintain short term interest rates at desired levels with the active and prudent management of liquidity in the domestic money market. Meanwhile, with the introduction of a new auction system for Treasury bonds and improved market sentiments, yields on government securities in the primary market recorded a substantial decline during the year from their peak rates registered in April 2017, correcting a significant gap that existed between the policy rates and the yields on government securities. Most other market interest rates were also on an upward trend at the beginning of the year and stabilised at higher levels thereafter, though deposit rates indicated some moderation towards end 2017. High real and nominal interest rates, which were the outcomes of tight monetary conditions, yielded desired effects in relation to monetary and credit aggregates. The growth of broad money that was at persistently high levels since 2016 began to decelerate gradually from September 2017 and reached the desired level by end 2017, reflecting the transmission of the tight monetary policy stance, albeit with a lag. Contributing mainly to the slowdown in monetary expansion, the deceleration that was observed in the growth of credit extended to the private sector by commercial banks, since July 2016, continued throughout 2017 and reached the desired level by end 2017, while the expansion in Net Foreign Assets (NFA) of the banking system also contributed positively to broad money growth. Considering the moderation in inflation during the first quarter of 2018 and the favourable inflation outlook, as well as the continued negative output gap, the Central Bank reduced the Standing Lending Facility Rate (SLFR), which is the upper bound of the policy interest rate corridor of the Central Bank, by 25 basis points on 4 April 2018. The Central Bank continued to progress towards moving to a Flexible Inflation Targeting (FIT) framework by 2020. Improvements to the monetary policy formulation processes are being institutionalised, while capacity building with technical assistance of the IMF continued throughout the year.

7.2 Monetary Policy Stance of the Central Bank of Sri Lanka

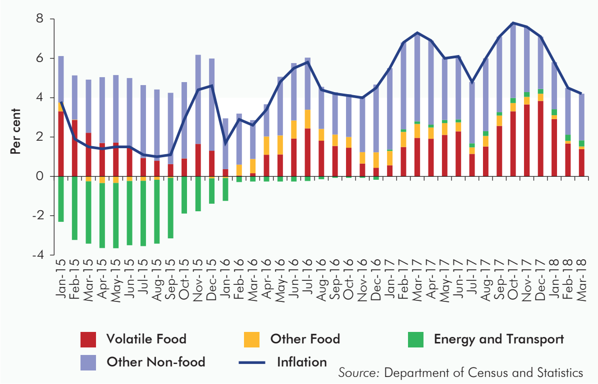
During 2017, the Central Bank continued to conduct its monetary policy within an enhanced monetary policy framework, which is the interim framework in the move towards FIT by 2020, wherein inflation is to be stabilised within a range of 4.0-6.0 per cent, thereby creating a growth conducive macroeconomic environment. Currently, the Central Bank primarily uses the policy interest rates and OMOs to guide the AWCMR, which is the operating target of the current monetary policy framework. Broad money continues to serve as a key indicative variable for the conduct of monetary policy. In the move towards FIT and to strengthen forward looking decision-making, underpinned by reliable medium term forecasts of key macroeconomic variables, the Central Bank was able to successfully integrate a Forecasting and Policy Analysis System (FPAS) during the year, developed with the assistance of the IMF, into the monetary policy formulation process. Accordingly, the policy formulation process followed an internal forecast calendar, which outlined timelines for projections and revisions of forecasts based on the latest domestic and international economic developments. Several rounds of discussions on projections and sectoral developments amongst technical staff

Chart 7.1
Contribution to Year-on-Year Headline Inflation (NCPI)



Source: Department of Census and Statistics

Chart 7.2
Contribution to Year-on-Year Headline Inflation (CCPI)



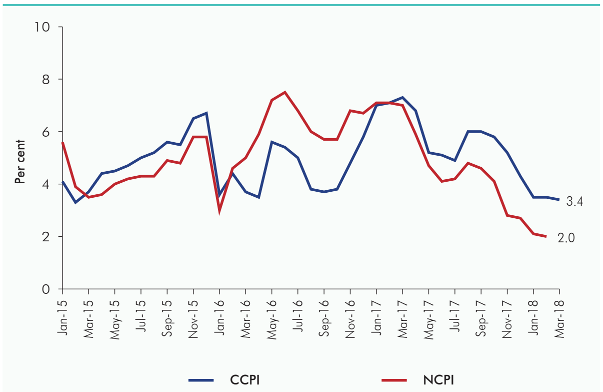
Source: Department of Census and Statistics

as well as with members of the Monetary Policy Committee (MPC) preceded the formal meetings of the MPC, which makes the recommendations on the appropriate monetary policy stance to the Monetary Board of the Central Bank. The number of MPC meetings was reduced from 12 to 8 in 2017 to provide sufficient time for technical staff to undertake increasingly sophisticated macroeconomic analyses in a forward-looking manner, considering current and future domestic and global economic conditions. Furthermore, with a view to obtaining the views of the private sector to be incorporated into the monetary policy decision making process, the Central Bank re-established the Monetary Policy Consultative Committee (MPCC) in 2017 as announced in the *Road Map 2017: Monetary and Financial Sector Policies for 2017 and Beyond.*

In spite of the tight monetary policy stance maintained during the past two years, inflation broadly remained higher than expected during 2017, driven by high food inflation caused by weather related supply disruptions as well as the effect of the tax adjustments made in 2016. Headline inflation, as measured by the year-on-year change in both the National Consumer Price Index (NCPI, 2013=100) and the Colombo Consumer Price Index (CCPI, 2013=100) increased during most of 2017 with twin peaks recorded in the first quarter and the fourth quarter. This was mainly due to an increase in food inflation caused by unanticipated supply side disruptions on account of adverse weather conditions as well as the increase in non-food inflation, led by the impact of tax revisions to Value Added Tax (VAT) and Nation Building Tax (NBT) and the upward movement in international commodity prices. However, some softening of headline inflation was observed in certain months, reflecting the favourable base effects and the moderation of food inflation, partly supported by the government's supply side initiatives to address price escalations. Accordingly, year-on-year headline inflation based on the NCPI, which was at 8.6 per cent in March 2017, gradually slowed thereafter, before reaching a peak of 8.8 per cent in October 2017. Nevertheless, the decline in volatile food prices caused inflation to moderate to 7.3 per cent by end 2017. Meanwhile, year-on-year headline inflation based on the CCPI also indicated a similar movement and peaked at 7.3 per cent in March 2017 and 7.8 per cent in October 2017, before moderating to 7.1 per cent by end 2017, indicating the gradual dissipation of price pressures stemming from supply side disruptions. The deceleration in food inflation continued at a faster pace in early 2018 as well, contributing favourably to the decline in headline inflation. Accordingly, year-on-year headline inflation based on the NCPI adjusted downwards to 3.2 per cent in February 2018, while headline inflation based on the CCPI receded to 4.2 per cent in March 2018. Reflecting upward movements in prices during 2017, on an annual average basis, NCPI based headline inflation accelerated to 7.7 per cent by end 2017, compared to 4.0 per cent recorded at end 2016, while CCPI based annual average inflation accelerated to 6.6 per cent by end 2017 from 4.0 per cent at end 2016. As per the Inflation Expectations Survey of the Central Bank, inflation expectations of the corporate sector as well as the household sector remained relatively high during the latter part of 2017, partly influenced by the actual increase in inflation during that period. However, inflation expectations over the period ahead appear to have moderated in line with the downward adjustment in recent headline inflation.

Core inflation, which is a measure of underlying inflation, was on an upward trend in the beginning of 2017, but declined thereafter, mainly responding to the tight monetary policy stance of the Central Bank. During the first quarter of 2017, core inflation remained relatively high mainly due to the impact of tax revisions and the increase in prices of the non-food category. However, core inflation declined and remained subdued in the remainder of 2017. Accordingly, NCPI based core inflation declined to 2.7 per cent, year-on-year, by end 2017 from 6.7 per cent at end 2016. On an annual average basis, NCPI based core inflation declined from 5.9 per cent at end 2016 to 4.9 per cent by end 2017. Following a similar trend, year-on-year core inflation based on CCPI declined to 4.3 per cent by end 2017, compared to 5.8 per cent at end 2016. However, on an annual average basis, CCPI based core inflation remained at 5.9 per cent by end 2017, compared to the 4.4 per cent recorded in 2016 due to the high inflation that prevailed in the early part of the year. Core inflation remained subdued in the first quarter of 2018. Accordingly, NCPI based year-on-year core inflation was at 2.0 per cent in February 2018, and CCPI based year-on-year core inflation was at 3.4 per cent in March 2018.

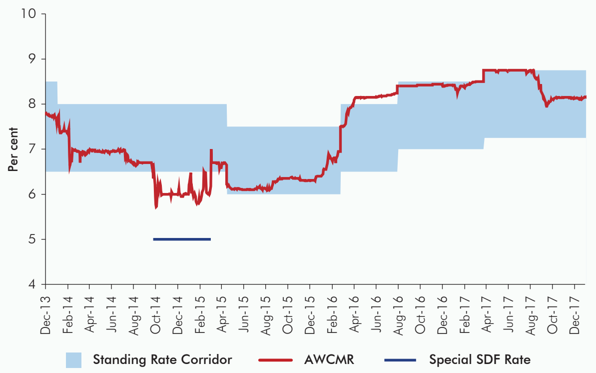
Chart 7.3
Movements in Year-on-Year Core Inflation



Source: Department of Census and Statistics

Reflecting the impact of the continued tight monetary policy stance, both the growth of broad money supply and the growth of credit extended to the private sector by commercial banks decelerated towards the desired levels by end 2017. Growth in credit extended to the private sector by commercial banks continued to decelerate gradually since July 2016 and reached the desired level by end 2017, responding to the high cost of borrowing as reflected by high nominal and real interest rates. The slowdown in the growth of credit disbursements helped contain the monetary expansion that remained at elevated levels during the last two years. The expansion in NFA of the banking system, particularly since April 2017, along with the reserve accumulation of the Central Bank as well as the reduction in foreign liabilities of commercial banks contributed to the monetary growth in 2017. Meanwhile, increase in credit obtained by the public sector from commercial banks also contributed to monetary expansion in 2017.

Chart 7.4
Standing Rate Corridor and Average Weighted Call Money Rate (AWCMR)



Source: Central Bank of Sri Lanka

The Central Bank actively conducted OMO to steer the AWCMR in line with the tight monetary policy stance. Rupee liquidity in the domestic money market remained tight until mid July 2017, as a result of the maturing of Treasury bills from the Central Bank holdings and foreign exchange sales by the Central Bank, in view of capital outflows, particularly in the first quarter of 2017. Accordingly, reflecting tight liquidity conditions, the AWCMR hovered closer to the upper bound of the standing rate corridor formed by policy interest rates of the Central Bank. However, liquidity conditions in the money market turned positive since mid July 2017, as a result of continued foreign exchange purchases by the Central Bank and part conversions of proceeds of the International Sovereign Bond (ISB) and foreign loans received by the government. Liquidity surplus resulted in a moderation of interest rates, and the AWCMR gradually adjusted downwards from the upper bound of the policy rate corridor. With a view to maintaining the overnight interest rates at the desired levels, the Central Bank actively conducted OMO by absorbing excess liquidity on an overnight, short term and long term basis and was able to stabilise the AWCMR around the middle of the corridor since August 2017.

Table 7.1
Recent Monetary Policy Measures

Date	Measure
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 renamed as the Standing Rate Corridor (SRC), and the Repurchase rate and the 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 deposit 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 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 allowed to be determined based on demand and supply conditions in the foreign exchange market.
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.
4-Apr-2018	The SLFR reduced by 25 basis points to 8.50%

Source: Central Bank of Sri Lanka

Note : Macroprudential measures introduced in this period are shown in Table 8.23

The Central Bank continued to improve communication with its key stakeholders to effectively convey the rationale and expected outcomes of monetary policy decisions and other regulatory measures abreast with its increased focus on transparency and accountability. Managing expectations, primarily of inflation, and building awareness among the general public and other key stakeholders have been at the forefront of the Central Bank's communication policy. At the beginning of the year, the Central Bank announced its strategies and

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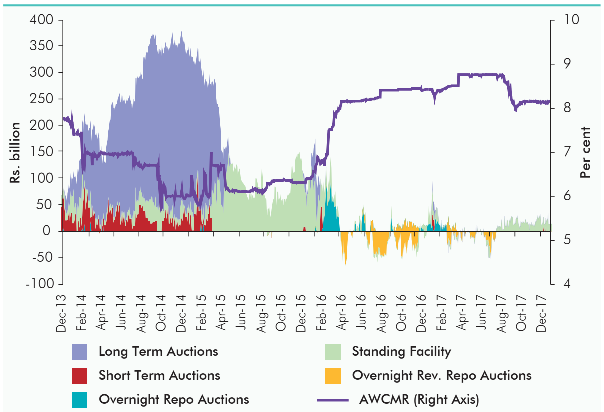
policies for 2017 and the medium term through its *Road Map 2017*, with a view to providing broad guidance on policies to all stakeholders of the economy. The Central Bank continued to pursue an active communication policy through press releases and press conferences, meetings and discussions, and public lectures and seminars, regularly and promptly. The periodic monetary policy review process was continued with a press conference, chaired by the Governor and attended by senior officers of the Central Bank. While updates on key macroeconomic developments and policy measures were publicised via regular press releases and other communiqués, the flagship publications of the Central Bank, namely the *Annual Report* and the *Recent Economic Developments*, presented detailed and comprehensive analyses of the same for public information in all three languages. In addition, the Central Bank continued to effectively disseminate macroeconomic data on a daily, weekly, monthly and quarterly basis through its website and other modes of communication.

7.3 Movements of Interest Rates

Market Liquidity, Market Operations and Short Term Interest Rates

Rupee liquidity in the domestic money market remained broadly in deficit during the first seven months of the year before improving to surplus levels, on average, during the latter part of the year. Money market liquidity was at surplus levels at the beginning of the year and remained in surplus until early February 2017, mainly due to the return of currency into the banking system after being utilised during the festive season, the release of provisional advances to the government as well as maturing term repurchase agreements of market participants with the Central Bank. However, excess liquidity declined thereafter

Chart 7.5
Rupee Liquidity in the Domestic Money Market and Liquidity Management



Source: Central Bank of Sri Lanka

and market liquidity remained negative until mid July 2017, due to the maturing of Treasury bills from the holdings of the Central Bank and net foreign exchange sales by the Central Bank, in view of capital outflows in the first quarter of 2017. Rupee liquidity recorded the highest deficit of Rs. 51.1 billion on 30 June 2017. Subsequently, the liquidity level increased to surplus levels until the end of 2017 mainly due to the continuous purchase of foreign exchange by the Central Bank and the conversion of part of the proceeds of the ISB obtained by the government. Hence, liquidity in the domestic money market was in excess of Rs. 24.4 billion, on average, during the second half of the year.

In response to the tight monetary policy stance and deficit levels of liquidity, overnight money market rates gradually adjusted upwards and hovered around the upper bound of the standing rate corridor till mid July 2017 and declined thereafter to stabilise in the middle of the corridor since September 2017, in line with improved liquidity conditions and effective OMO. The AWCMR reached the upper bound of the standing rate corridor in February 2017 and hovered at these levels until mid July 2017, as market liquidity levels remained in the negative territory.

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BOX 08

Management of Structural Liquidity: The Way Forward

Introduction

The term "liquidity" has several meanings and connotations, depending on the context within which it is being used. Accordingly, market liquidity[1] of any asset refers to the combination of the degree of ease with which it can be sold (or bought) in a timely manner and the level of costs associated with the transaction, either in terms of transactions costs or the acceptance of a lower price in order to find a buyer in a reasonable time. Funding liquidity denotes the ability to fund increases in assets and meet cash flow obligations as they fall due. Economic liquidity[2] refers to the volume of broad money supply available to fulfill the payment needs of the economy. Monetary liquidity[3] is defined as a subset of the domestic currency denominated non-interest bearing liabilities of a central bank that is held by the non-state sector, i.e., base money or reserve money. Liquidity in the interbank market is defined as the sum of the clearing balances of participatory banks held with the central bank.

There are several reasons underpinning a central bank's concern regarding interbank liquidity. One key reason is that it is the liquidity measure that is used by a central bank to steer the average interest rate in the interbank short term money market (in Sri Lanka, this is known as the Average Weighted Call Money Rate (AWCMR), which is the operating target in the current enhanced monetary policy framework), so that it remains at a desirable level. Hence, either the absorption or injection of liquidity to the market will provide the central bank the ability to control the cost of funds of commercial banks, and thereby enable the regulation of credit flows to the economy. For instance, in the event of a liquidity deficit, the central banks would supply liquidity to meet the requirements of the market and thereby strive to minimise undue fluctuations in market interest rates. This will also ensure the smooth operation of payment systems, which would otherwise be hindered by the insufficiency of funds. Hence, close surveillance and timely actions to ensure the presence of healthy levels of liquidity would play a key role in ensuring financial system stability. On the other hand, the immediate consequence of a liquidity surplus, that remains unabsorbed by the central bank, is a decline in short-term interest rates, possibly to levels within the proximity of zero per cent. Under such circumstances, commercial banks may resort to risky lending in search of higher yields or they may refuse to accept customer deposits. Further, such behaviour of commercial banks can create inflationary pressures through possible increases in consumption in the economy. Such developments in short term interest rates can also negatively impact the exchange rate and foreign exchange reserves. Some central banks have also observed that a large structural liquidity surplus in the market results in the weakening of the "interest rate channel" of the monetary policy transmission mechanism. In essence, therefore, liquidity management plays an important role in both monetary and financial stability policies.

Since neither a large deficit nor a surplus of liquidity is desirable, this gives rise to the policy question of the optimal level of liquidity for an economy. Policymakers recognise that while it is difficult to estimate an optimal liquidity level due to the dynamic nature of this measure, there is a general consensus that the prevalence of a liquidity deficit is preferred over its surplus counterpart as it provides a central bank with greater leeway for the management of short term interest rates and thereby supporting the effective conduct of monetary policy to ensure macroeconomic stability.

Interbank Liquidity

Interbank liquidity in the context of Sri Lanka is defined as the total deposits held by banks in the current accounts maintained by licensed commercial banks (LCBs) with the Central Bank. Under Section 83 of the Monetary Law Act of 1949, LCBs are required to maintain a portion of their rupee deposit liabilities as statutory reserve requirement in their current accounts with the Central Bank, based on the Statutory Reserve Ratio (SRR) determined by the Central Bank. As the current SRR is 7.5 per cent, this denotes that for every Rs. 100 worth of rupee deposits accepted, a LCB has to deposit Rs. 7.50 in a non-interest bearing account with the Central Bank. Therefore, any excess or deficit in the LCB's account with the Central Bank that is above or below the statutorily required level is termed as either excess liquidity or deficit liquidity, respectively. If the required reserve level on a given day is Rs. 100 million and the actual balance in the LCB's account with the Central Bank is Rs.110 million, then the amount over the required liquidity of Rs.10 million, is considered excess liquidity. A liquidity deficit of Rs. 5 million would be recorded with an account balance of Rs. 95 million.

There are two main factors that can induce changes in the level of liquidity in the interbank market, i.e., monetary policy actions and autonomous or

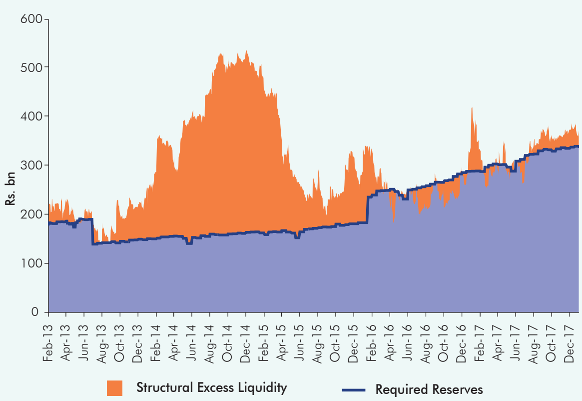
1. Elliott, Douglas J. (2015) "Market Liquidity: A Primer," The Brookings Institute.
2. Chung, Kyuil et al (2014): Global Liquidity through the Lens of Monetary Aggregates, IMF Working Paper WP/14/9.
3. Gray, Simon (2008): Liquidity forecasting, CCBS Handbook No. 27.

exogenous factors. Such monetary policy actions comprise Open Market Operations (OMO) such as repo/reverse repo auctions, outright auctions and the Standing Facilities of the Central Bank. Autonomous factors comprise variables such as demand for currency in circulation, foreign currency purchases by the Central Bank, and government borrowing from the Central Bank. Hence, such factors are exogenous to activities that are influenced to a great extent by parties other than the Central Bank, such as the public, banks and the government. Any decrease in demand for currency by the public or an increase in purchases of foreign currency by the Central Bank or an increase in credit from the Central Bank to the government would result in an increase in structural liquidity and vice versa. However, it should be noted that the impact of such developments may be fully or partially offset by an opposite change in any other factor, leaving the level of liquidity unchanged.

Structural Liquidity and Autonomous Factors

Structural liquidity is defined as the total amount of liquidity in the interbank market prior to a monetary policy action that entails the supply or drain of reserves from the banking system. In other words, structural liquidity comprises the level of reserves that are determined by autonomous factors[4]. Chart B 8.1 shows movements in total structural liquidity and the structural liquidity excess or deficit that was prevalent in the market in the recent past.

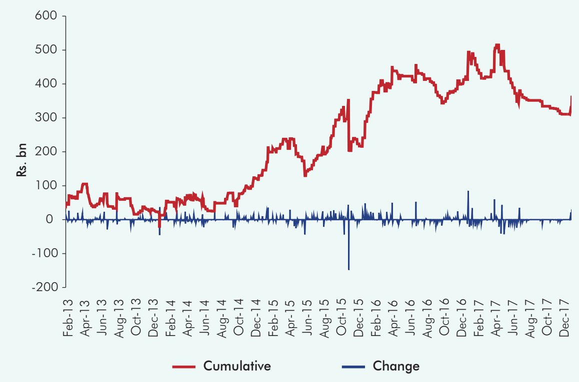
Chart B 8.1
Structural Liquidity



Source : Central Bank of Sri Lanka

One of the major factors contributing to changes in structural liquidity in Sri Lanka is credit granted to the government by the Central Bank, under the provisions of the MLA, as provisional advances and through subscription to Treasury bills at primary auctions. While credit provided under provisional advances has led to a permanent increase in structural liquidity, funds that are disbursed to the government through the Central Bank purchases of Treasury bills results in only a temporary increase in structural liquidity. These differences are illustrated in Chart B 8.2, where the increasing trend in credit to government over time is due to provisional advances while short terms variations are due to the changes in Treasury bill holdings of the Central Bank. Credit granted to the government as provisional advances by the Central Bank (10 per cent of the estimated government revenue in a financial year) leads to a permanent increase in structural liquidity as they have been accumulating over several years as it is essentially an 'overdraft facility,' which can be drawn down without being fully settled. However, credit granted by way of issuance of Treasury bills are of a temporary nature as they are settled fully upon maturity or when sold by the Central Bank in the secondary market.

Chart B 8.2
Changes and Cumulative Impact of Credit Granted to Government

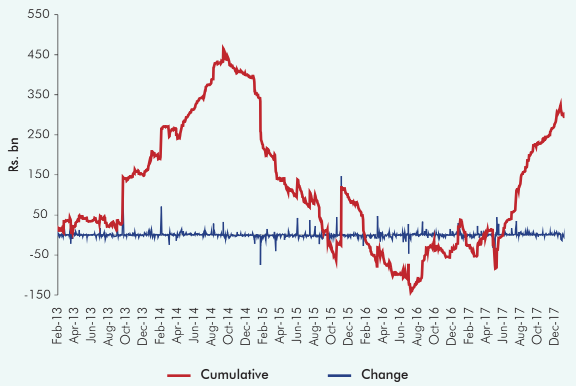


Source : Central Bank of Sri Lanka

An equally significant autonomous factor that causes sudden and sharp changes in structural liquidity is the net foreign currency purchases by the Central Bank. Net foreign currency purchases by the Central Bank are largely driven by two key factors, i.e., intervention by the Central Bank in the foreign exchange market to smooth volatilities in the exchange rate and the level of foreign exchange reserves that the Central Bank aims to maintain. Purchases by the Central Bank of proceeds of foreign inflows to the government, including International Sovereign Bond (ISB) issuances have also been a key driver of infrequent but substantial changes in structural liquidity during the past several years. For example, the main reason for the increase in excess liquidity in 2014 was the purchase of the proceeds by the Central Bank of such an ISB (See Chart B 8.3)

4. Aamodt, Ellen and Tafjord, Kristian (2013), "Structural Liquidity", Economic Commentaries, No. 9-2013, Norges Bank

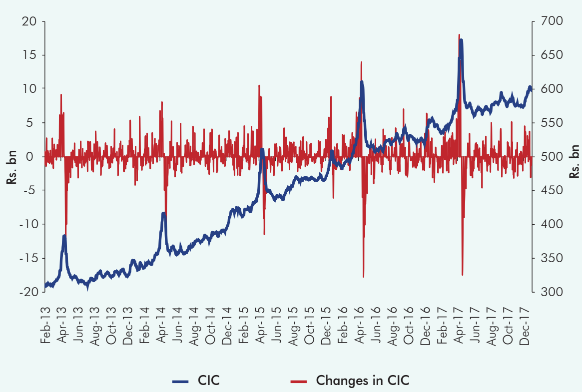
Chart B 8.3
Net Foreign Currency Purchases by the Central Bank



Source : Central Bank of Sri Lanka

Demand for notes and coins by the public is another autonomous factor related to structural liquidity. Changes in currency demand are seasonal and sharp, but are short lived with a substantial portion of the currency withdrawals experiencing a reversal within a month, as there is an opportunity cost of holding currency, which is the foregone interest earnings. Notably, these sharp fluctuations in currency in circulation are of a seasonal nature as these are around the Sinhala and Tamil New Year festival, and to a lesser extent during the Christmas season. Furthermore, over time, increases in per capita income increase the demand for currency by the public resulting in draining of liquidity (Chart B 8.4) on a permanent basis.

Chart B 8.4
Currency in Circulation (CIC) and Its Daily Changes



Source : Central Bank of Sri Lanka

Managing Structural liquidity

Globally, central banks use a variety of conventional and non-conventional tools for the management of structural liquidity. Some such temporary tools are repo/reverse repo auctions, the acceptance of deposits and foreign exchange swaps with different tenors and different collateral. Purchase and sale of different assets such as government securities, foreign exchange, corporate securities, equity and book loans are deployed to create permanent changes in structural liquidity, depending on the requirement at the time.

The Central Bank also employs OMO tools to either inject or absorb liquidity on a permanent or temporary basis. Permanent changes in liquidity can be brought about by changes to SRR, which is considered to be a non-market based monetary policy instrument. Instruments such as OMO repo or reverse repo auctions or the issuance of Central Bank securities are aimed at the absorption or injection of liquidity on a temporary basis while OMO outright auctions are carried out to permanently absorb or inject liquidity. It is only liquid asset such as Treasury bills or foreign exchange that can be deployed to induce permanent changes in structural liquidity at any given point of time. From a monetary policy perspective, there is no material difference in using Treasury bill holdings of the Central Bank, issuing Central Bank securities, or using borrowed securities for the absorption of liquidity on a temporary basis. What differs is the cost associated with such operations, as the cost of each instrument is primarily dependent on its liquidity and the tax treatment involved.

Way Forward

Current provisions in the MLA are rather restrictive in the conduct of OMO because OMO are confined to the purchase or sale of short term government securities (Treasury bills) in the open market and the issuance of Central Bank Securities. Furthermore, MLA provisions relating to the grant of credit to the government is another means of injecting structural liquidity to the system, wherein it could render significant difficulties to the effective conduct of monetary policy, especially under a flexible inflation targeting regime.

Modern central banks with inflation targeting monetary policy frameworks possess greater flexibility with regard to the conduct of OMO as they have at their disposal a comprehensive, expanded tool kit comprising several conventional or non-conventional instruments for the absorption or injection of liquidity for the effective conduct of monetary policy. The provision of credit to the government by these central banks is also reduced or restricted by statute due to the adverse impact of such arrangements on structural liquidity and on demand driven inflation. It is expected that envisaged modifications to monetary management under the proposed flexible inflation targeting framework would enable the Central Bank to manage market liquidity more effectively and actively, thereby steering the overnight interest rates consistent with the desired inflation path.

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-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
Dec-16	8.42	8.41	7.43	-	8.44	8.43	12.00	12.00
Mar-17	8.75	8.56	7.73	8.74	8.75	8.57	12.35	12.08
Jun-17	8.75	8.75	7.26	8.74	8.75	8.75	12.47	12.47
Sep-17	8.11	8.05	7.25	-	8.11	8.15	11.99	12.24
Dec-17	8.15	8.13	7.25	-	8.15	8.15	12.18	12.19

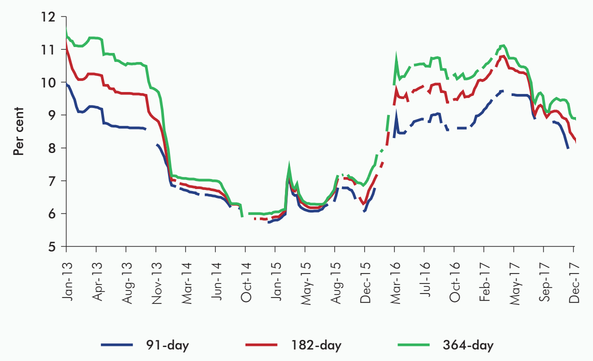
Source: Central Bank of Sri Lanka

Accordingly, during the period from mid February to mid July 2017, the Central Bank mostly conducted overnight reverse repurchase auctions in order to inject liquidity into the domestic money market to maintain interest rate stability. However, liquidity conditions in the money market turned positive since mid July 2017 and as a result overnight interest rates started to adjust downwards. With the support of OMO conducted by the Central Bank to stabilise interest rates, the AWCMR declined gradually thereafter from 8.75 per cent towards the middle of the standing rate corridor by end September 2017. The AWCMR continued to remain at around the same level of 8.15 per cent until the year end. Meanwhile, Sri Lanka Inter Bank Offered Rates (SLIBOR) also moved downwards during the year, in line with the movements in the AWCMR and market liquidity conditions. Accordingly, by end 2017, the overnight and 3-month SLIBOR stood at 8.15 per cent and 10.05 per cent, respectively, compared to 8.44 per cent and 11.01 per cent, respectively, reported at end 2016. However, SLIBOR for longer tenors, which are mostly inactive, moved slightly upwards during the year. With improvements in market liquidity, the Central Bank conducted overnight repurchase auctions to absorb the excess, thereby steering overnight interest rates to be in line with the monetary policy stance. Reflecting these movements, weighted average yields at OMO repurchase auctions decreased to 7.25 per cent by end 2017, from 7.43 per cent at end 2016.

Yields on Government Securities

Yields on government securities declined substantially during the second half of 2017, correcting a significant gap that existed between the policy rates and the yields, along with the modifications to the Treasury bond auction system and favourable market sentiments, supported by the availability of foreign financing to the government. Reflecting the increased borrowing requirement of the government, the move to a purely auction based system for issuing government securities from early 2015 and the tight monetary conditions that prevailed in the economy, yields on Treasury bills in the primary market showed upward movements during the first four months of 2017. Accordingly, by end April 2017, yields on 91-day, 182-day and 364-day Treasury bills increased by 101 basis points, 107 basis points and 85 basis points, respectively, compared to the yields that prevailed at end 2016. Thereafter, yield rates adjusted downwards, indicating a correction of the excessive increase in yields from early 2015, supported by the excess liquidity in the domestic market, increased government revenue and favourable market sentiments due to the continuation of the IMF-EFF programme. In addition, the pressure in the government securities market reduced substantially since March 2017 in view of increased foreign inflows to the government securities market as well as the receipt of the proceeds of the ISB amounting to US dollars 1.5 billion, the syndicated loan proceeds totalling US dollar 1.0 billion and the proceeds of the divestment of Hambantota port amounting US dollars 292.1 million. Accordingly, yields on 91-day, 182-day and 364-day Treasury bills in the primary market

Chart 7.6
Primary Market Treasury Bill Yields (a)



Source: Central Bank of Sri Lanka

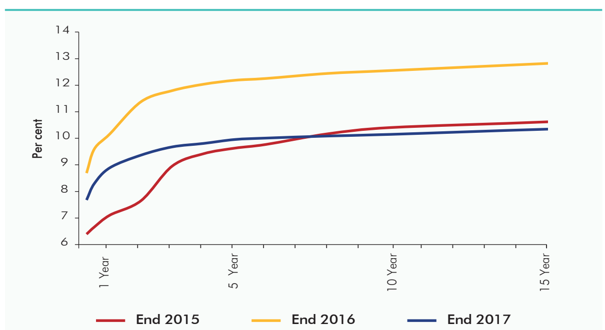
(a) Yield rates for some weeks are not available due to non-acceptance of bids or not offering relevant tenors

decreased by 204, 249 and 221 basis points to 7.69 per cent, 8.30 per cent and 8.90 per cent, respectively, by end December 2017, compared to the peak yield levels recorded in April 2017.

Primary market yields on Treasury bonds up to 10-year maturities exhibited a downward trend in 2017, while Treasury bonds with more than 10-year maturities were not issued, given the high market interest rates. Similar to the yields on Treasury bills in the primary market, yields on Treasury bonds also increased during the first quarter of 2017 in view of the high borrowing requirement of the government. The yields on 5-year Treasury bonds increased from 12.16 per cent since early January 2017 and reached its peak of 12.89 per cent by February 2017 before moderating to 10.20 per cent by end 2017. Similar movements were observed in the yields pertaining to Treasury bonds of other maturities as well. The highest yield of 13.14 per cent was recorded in March 2017 for Treasury bonds with a maturity of 7-years. The issuance of foreign currency denominated debt securities, such as Sri Lanka Development Bonds (SLDBs) and ISBs, helped ease the pressure on yields of domestic debt instruments in the second half of 2017 to a certain extent. This was reinforced by the introduction of a new primary issuance system for Treasury bonds by the Central Bank since end July 2017, to increase the efficiency and transparency of domestic borrowings of the government. Meanwhile, in order to improve investment planning as well as consistency and predictability of the government borrowing programme, a quarterly Treasury bond advance auction calendar was published. These improvements to the auction process also helped ease pressure on yield rates on Treasury bonds during the second half of 2017.

The secondary market yield curve for government securities shifted downwards and remained relatively flat in 2017. Compared to the short end of the yield curve, a sharp downward movement was observed in the longer end of the yield curve. Narrowing down in the term premium was facilitated by improvements in investor sentiment as well as anchored inflation expectations. Accordingly, yields on Treasury bills in respect of all three maturities in the secondary market decreased by 101 to 130 basis points to a range of 7.68 to 8.89 per cent by end 2017 in comparison to yields that prevailed at end 2016. A similar movement was observed in Treasury bond yields of all maturities as well, although the decline was higher than that of Treasury bills. Accordingly, the yields on Treasury bonds of all maturities in the secondary market were in a range of 9.37 per cent to 10.68 per cent by end 2017.

Chart 7.7
Secondary Market Yield Curve for Government Securities



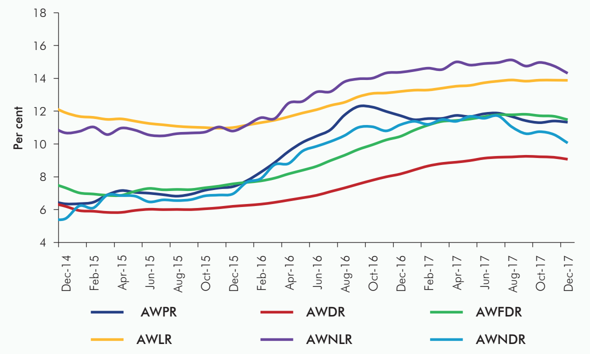
Source: Central Bank of Sri Lanka

7

Deposit and Lending Interest Rates

Reflecting tight monetary conditions, deposit interest rates of commercial banks continued to increase during 2017, although some moderation was observed towards the end of the year. The average weighted deposit rate (AWDR), which reflects the movements in interest rate of all outstanding interest bearing deposits held with commercial banks, increased by 108 basis points to a peak of 9.25 per cent by end September 2017 from 8.17 per cent at end 2016. Similarly, the average weighted fixed deposit rate (AWFDR), which is based on interest rates of all outstanding time deposits held with commercial banks, also increased by 135 basis points to a peak of 11.81 per cent by end September 2017 from 10.46 per cent at end 2016. However, following the downward movements in short term interest rates, particularly yields on short term government securities with improved liquidity in the market, both AWDR and AWFDR moved downwards gradually since October 2017 and reached 9.07 per cent and 11.48 per cent, respectively, by end 2017, while remaining higher than the interest rates recorded at end 2016. Accordingly, the increase in AWDR and AWFDR was 90 basis points and 102 basis points, respectively, from end 2016 to end 2017. Moreover, as reflected in the movements in the AWFDR, a substantial increase in interest rates was observed, particularly for 1-year and 2-year time deposits during 2017. Meanwhile, the average weighted new deposit rate (AWNDR), which captures the interest rates of all new interest bearing deposits during a month, increased by 55 basis points to a peak of 11.72 per cent by end July 2017, from 11.17 per cent at end December 2016. However, following the declining trend in other short term interest rates, AWNDR declined from August 2017, reaching 10.06 per cent by end 2017.

Chart 7.8
Commercial Bank Lending and Deposit Rates



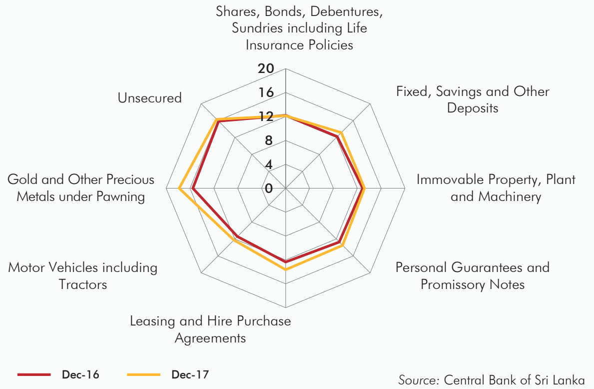
Source: Central Bank of Sri Lanka

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 9.08 per cent per annum for 2018 compared to 7.06 per cent per annum for 2017. These rates were computed in December of each year based on simple averages of monthly AWDR of all commercial banks during the preceding twelve months and are applicable for the following year.

Lending rates of commercial banks continued to increase in 2017, reflecting tight monetary conditions, and stabilised at elevated levels towards the end of the year. The average weighted lending rate (AWLR), which is based on interest rates of all outstanding rupee denominated loans and advances extended by Licensed Commercial Banks (LCBs) to the private sector, increased by 68 basis points to 13.88 per cent by end 2017 from 13.20 per cent at end 2016. Bank-wise AWLR also increased to a range of 10.22 - 16.23 per cent by end 2017 compared to the range of 10.12 - 15.66 per cent that prevailed at end 2016. Moreover, lending rates against most types of

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.

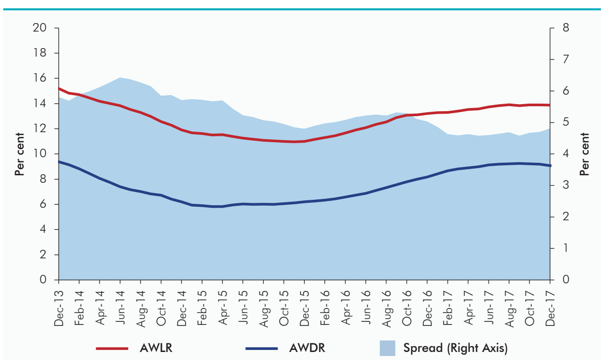
Chart 7.9
Average Weighted Lending Rates by Type of Security (%)



Source: Central Bank of Sri Lanka

securities also increased during 2017. In particular, interest rates on loans and advances secured by Gold and Other Precious Metals under Pawning, Leasing and Hire Purchase Agreements as well as Fixed, Savings and Other Deposits increased considerably during the year. The interest rate spread between AWDR and AWLR declined during 2017 compared to levels seen in 2016, although a marginal increase was observed towards the end of the year with the downward movement in deposit rates. 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 by 75 basis points to a peak of 15.12 per cent by end August 2017 compared to

Chart 7.10
Spread between Average Lending and Deposit Rates



Source: Central Bank of Sri Lanka

14.37 per cent at end December 2016. However, in line with the movements in short term interest rates, the AWNLR declined gradually thereafter recording at 14.31 per cent by end December 2017. The spread between AWNDR and AWNLR showed an increasing trend during 2017, particularly towards the end of the year, as the decline in the AWNDR was higher than the decline in the AWNLR. Meanwhile, the weekly average weighted prime lending rate (AWPR), which is based on interest rates applicable on short term loans and advances granted by commercial banks to their prime customers during a week, increased by 74 basis points to a peak of 12.26 per cent by end July 2017 from 11.52 per cent at end 2016. However, given improved market liquidity levels, the weekly AWPR also moved downwards to reach 11.55 per cent by end 2017, while monthly AWPR, which is the monthly average of weekly AWPR, reached 11.33 per cent by end 2017, decreasing by 40 basis points, compared to the rates at end 2016.

Interest Rates on Debt Instruments

Interest rates applicable on corporate debt securities also remained high during 2017. Interest rates on commercial paper, which is a short term debt instrument, increased to a range of 13.75 - 16.50 per cent during 2017, compared to the range of 8.70 - 14.80 per cent reported for 2016. Meanwhile, thirteen new listings of corporate debentures were reported by six corporates in 2017 with maturities of 2 to 8 years. Most of these debentures were issued with fixed interest rates, while a few were issued on the basis of floating rates. Fixed interest rates applicable on those debentures were in the range of 12.50 - 15.00 per cent in 2017, compared to the range of 9.60 - 13.75 per cent witnessed in 2016.

Table 7.3
Movements of Interest Rates

Per cent per annum

Interest Rate	End 2016	End 2017
Policy Interest Rates		
Standing Deposit Facility Rate	7.00	7.25
Standing Lending Facility Rate	8.50	8.75
Average Weighted Call Money Rate (AWCMR)	8.42	8.15
Yield Rates on Government Securities		
Primary Market (a)		
Treasury bills		
91-day	8.72	7.69
182-day	9.63	8.30
364-day	10.17	8.90
Treasury bonds		
2-year	11.04	9.83
3-year	11.62	9.55
4-year	11.94	11.14
5-year	11.76	10.20
10-year	12.11	10.36
Secondary Market		
Treasury bills		
91-day	8.69	7.68
182-day	9.60	8.30
364-day	10.17	8.89
Treasury bonds		
2-year	11.38	9.37
3-year	11.80	9.68
4-year	12.04	9.81
5-year	12.18	9.96
10-year	12.55	10.15
Licensed Commercial Banks (b)		
Interest Rates on Deposits		
Savings deposits	0.50-9.00	0.50-9.50
1 Year Fixed Deposits (c)	4.50-15.00	4.89-15.00
Average Weighted Deposit Rate (AWDR)	8.17	9.07
Average Weighted Fixed Deposit Rate (AWFDR)	10.46	11.48
Average Weighted New Deposit Rate (AWNDR)	11.17	10.06
Average Weighted New Fixed Deposit Rate (AWNFDR)	11.44	10.65
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	11.73	11.33
Average Weighted Lending Rate (AWLR)	13.20	13.88
Average Weighted New Lending Rate (AWNLR)	14.37	14.31
Other Financial Institutions (d)		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	4.25	4.00
1 Year Fixed Deposits	11.00	11.00
Licensed Finance Companies (e)		
Savings Deposits	5.38-7.74	5.43-7.99
1 Year Fixed Deposits	12.13-14.06	12.15-13.71
Interest Rates on Lending		
National Savings Bank (e)	9.75-15.00	13.00-16.00
State Mortgage and Investment Bank (f)	10.50-20.00	10.50-20.00
Licensed Finance Companies (e)		
Finance Leasing	17.48-25.97	17.40-28.03
Hire Purchase	17.51-22.65	15.00-20.84
Loans against Real Estate	19.12-20.80	17.95-20.18
Corporate Debt Market		
Debentures	9.60-13.75	12.50-15.00
Commercial Paper	8.70-14.80	13.75-16.50

(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.
(f) Lending for housing purposes only.

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

Interest Rates on Foreign Currency Deposits

Interest rates applicable on foreign currency denominated deposits maintained with commercial banks increased marginally during 2017, reflecting the gradual rise in global interest rates. Following the increases in the Federal Funds target rate in the US during 2017, interest rates offered by commercial banks on US dollar denominated savings deposits were recorded in a range of 0.02 - 4.38 per cent by end 2017 compared to the range of 0.02 - 3.62 per cent reported at end 2016. Interest rates pertaining to US dollar denominated time deposits remained broadly unchanged in a range of 0.15 - 5.03 per cent by end 2017 compared to the range of 0.15 - 5.00 per cent at end 2016. Meanwhile, following the policy rate increases by the Bank of England in November 2017, interest rates on savings deposits denominated in pound sterling also increased to a range of 0.10 - 2.25 per cent by end 2017 in comparison to the range of 0.05 - 2.01 per cent recorded at end 2016. Interest rates applicable on pound sterling denominated time deposits were in a range of 0.20 - 4.57 per cent by end 2017, whereas the comparable rates were 0.25 - 4.02 per cent at end 2016.

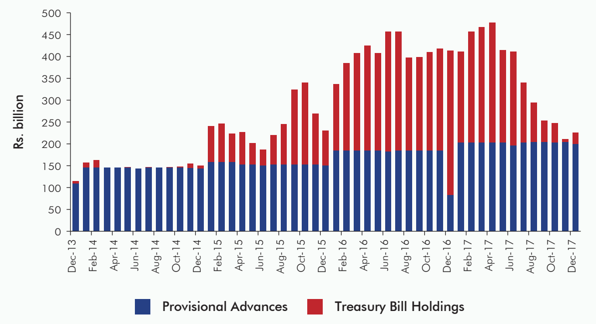
7.4 Movements of Monetary and Credit Aggregates

Reserve Money

Reserve money expanded moderately during 2017 mainly due to the impact arising from the high base observed in 2016, on account of the upward adjustment to SRR in January 2016. Accordingly, on a year-on-year basis, reserve money growth decelerated to 9.8 per cent by end 2017, from a high growth of 27.1 per cent recorded at end 2016. In absolute terms, reserve money expanded only by Rs. 83.6 billion during 2017 to reach Rs. 939.8 billion by the end of the year, compared to the notable expansion of Rs. 182.7 billion in 2016. With regard to the liability side of reserve money, both currency in circulation and commercial banks' deposits with the Central Bank contributed to the increase in reserve money in 2017. Reflecting the increased opportunity cost of holding money in an environment of high market interest rates, currency in circulation increased at a lower rate of 8.2 per cent, year-on-year, by end 2017, compared to a growth of 12.4 per cent by end 2016. In absolute terms, currency in circulation increased by Rs. 45.3 billion to Rs. 598.1 billion by end 2017, compared to the increase of Rs. 61.1 billion reported during 2016. Meanwhile, in 2017, commercial banks' deposits with the Central Bank increased by Rs. 38.5 billion to Rs. 341.7 billion compared to the significant increase of Rs. 121.5 billion in 2016 resulting from the upward adjustment to SRR. The year-on-year growth of commercial banks' deposits was 12.7 per cent by end 2017, in comparison to the growth of 66.9 per cent at end 2016. With these developments, by the end of 2017, reserve money remained well below the target agreed with the IMF under the EFF programme.

Based on the assets side of the Central Bank balance sheet, the expansion in reserve money during 2017 was entirely driven by the increase in NFA of the Central Bank. In contrast to the developments in 2016 where reserve money expansion was driven entirely by the increase in Net Domestic Assets (NDA), NFA of the Central Bank increased substantially by Rs. 287.5 billion to Rs. 846.1 billion in 2017, compared to the decline of Rs. 17.6 billion in 2016. This was mainly as a result of the increase in reserve assets of the Central Bank in terms of investments in foreign securities and increase in cash and balances abroad held by the Central Bank, following the net foreign exchange purchases by the Central Bank from the domestic foreign exchange market as well as the receipt of the proceeds of the ISB issuance and syndicated loans obtained by the government during the year. Contributing to a further increase in NFA of the Central Bank, foreign financial liabilities of the Central Bank declined by Rs. 8.9 billion during 2017 due to a decrease in liabilities to foreign central banks and international organisations, along with the completion of repayment under the Stand-By Arrangement (SBA) Facility of the IMF. Nevertheless, the Central Bank's financial liabilities in terms of liabilities to the Asian Clearing Union (ACU) and liabilities under the IMF-EFF increased during the period under review. In contrast to the increase in NFA, NDA of the Central Bank declined considerably by Rs. 203.9 billion to Rs. 93.7 billion during 2017, as against an increase of Rs. 200.3 billion in 2016. The sharp decline in NDA reflected the contraction in net credit to the government (NCG) by the Central Bank. In view of the Central Bank's actions to unwind its Treasury bill holdings, NCG by the Central Bank declined significantly by Rs. 187.9 billion to Rs. 225.1 billion during 2017, in contrast to the increase of Rs. 183.1 billion reported during 2016. With the maturing of Treasury bills by the Central Bank and the outright sales of Treasury bills by the Central Bank to absorb excess rupee liquidity from the domestic market on a permanent basis since mid July 2017, Treasury bill holdings (net of repurchase transactions) of the Central Bank declined by Rs. 304.5 billion to Rs. 25.6 billion by end 2017, compared to the historically highest level of Rs. 330.0 billion recorded at end 2016. However, within NCG, provisional advances extended to the government by the Central Bank increased by Rs. 120.4 billion to Rs. 203.7 billion in January 2017, from Rs. 83.3 billion at end 2016,

Chart 7.11
Central Bank Treasury Bill Holdings and Provisional Advances to the Government



Source: Central Bank of Sri Lanka

with the full utilisation of the amount entitled under the Monetary Law Act (MLA) for 2017. The sharp increase in provisional advances in January 2017 was mainly due to the settlement of provisional advances by the government in December 2016, using funds raised through the issuance of Treasury bills worth Rs. 100 billion to the Central Bank during the month and utilisation of total amount of advances in January 2017. By end 2017, the outstanding amount of provisional advances extended to the government by the Central Bank recorded Rs. 199.8 billion. Moreover, contributing to the decline in NDA, other items (net) of the Central Bank, which is the difference between other assets and other liabilities of the Central Bank, declined by Rs. 21.0 billion during 2017 mainly on account of an increase in retained earnings.

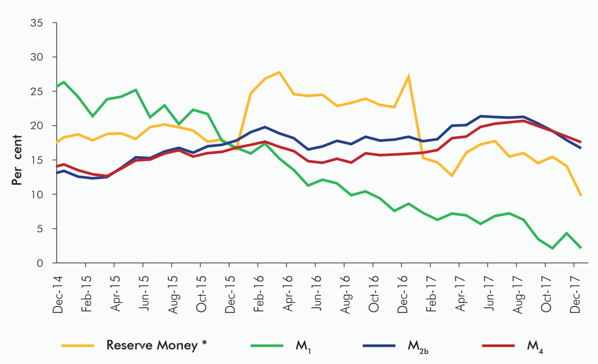
7

The money multiplier, which links reserve money and broad money (M_{2b}), increased to 6.71 by end 2017 from 6.31 recorded at end 2016, mainly due to the gradual decrease in the currency to deposit ratio in an environment of high market interest rates. The currency to deposit ratio declined to 7.5 per cent by end 2017 from 8.6 per cent and 9.3 per cent recorded at end 2016 and end 2015, respectively. On average, the money multiplier increased to 6.63 during 2017, compared to 6.38 in 2016.

Narrow Money (M_1)

Reflecting the impact of the high interest rate environment, the year-on-year growth of narrow money (M_1) moderated further during 2017. M_1, which comprises currency and demand deposits held by the public, recorded a lower year-on-year growth of 2.1 per cent by end 2017 in comparison to a 8.6 per cent growth witnessed at end 2016. Currency held by the public increased by 2.3 per cent, year-on-year, to Rs. 439.4 billion by end 2017, in comparison to a 10.7 per cent growth at end 2016, contributing to around 59 per cent of the total expansion in narrow money during the year. Meanwhile, in view of the high interest rate environment, demand deposits held by the public with commercial banks grew at a slower rate of 2.0 per cent, year-on-year, by end 2017, compared to the growth of 6.2 per cent reported at end 2016. In absolute terms, demand deposits held by the public with commercial banks increased only by Rs. 6.8 billion, reaching Rs. 353.9 billion by end 2017, in comparison to the increase of Rs. 20.2 billion in 2016.

Chart 7.12
Year-on-Year Growth of Monetary Aggregates



Source: Central Bank of Sri Lanka

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

Table 7.4
Developments in Monetary Aggregates

Rs. billion

Item	End 2016	End 2017 (a)	Change 2016 Amount	Change 2016 %	Change 2017 Amount	Change 2017 %
1. Currency Outstanding	552.8	598.1	61.1	12.4	45.3	8.2
1.1 Currency held by the Public	429.5	439.4	41.4	10.7	9.9	2.3
1.2 Currency with Commercial Banks	123.3	158.7	19.6	18.9	35.4	28.7
2. Commercial Banks' Deposits with the Central Bank (b)	303.3	341.7	121.5	66.9	38.5	12.7
3. Government Agencies' Deposits with the Central Bank (c)	…	…				
4. Reserve Money (1+2+3)	**856.1**	**939.8**	**182.7**	**27.1**	**83.6**	**9.8**
5. Demand Deposits held by the Public with Commercial Banks	347.1	353.9	20.2	6.2	6.8	2.0
6. Narrow Money Supply, M_1 (1.1+5)	**776.6**	**793.3**	**61.6**	**8.6**	**16.7**	**2.1**
7. Time and Savings Deposits held by the Public with Commercial Banks	4,046.9	4,872.0	704.7	21.1	825.1	20.4
8. Broad Money Supply, M_2 (6+7)	**4,823.6**	**5,665.3**	**766.3**	**18.9**	**841.8**	**17.5**
9. Adjusted Foreign Currency Deposits (d)	582.0	642.7	73.3	14.4	60.7	10.4
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**5,405.6**	**6,308.1**	**839.7**	**18.4**	**902.5**	**16.7**
Money Multiplier, M_{2b}	6.31	6.71				
Velocity, M_{2b} (e) (f)	2.41	2.25				

(a) Provisional
(b) Includes both Commercial Banks' reserve balances with the Central Bank and balances of Primary Dealers with the Central Bank
(c) Government Agencies' Deposits with the Central Bank amounted to Rs. 117.6 million at end 2016 and Rs. 27.2 million at end 2017
(d) Includes deposits of Resident Category of Offshore Banking Units (OBUs) and a part of foreign currency deposits with Domestic Banking Units (DBUs)
(e) Average for the year
(f) Revised

Source: Central Bank of Sri Lanka

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

Broad money growth (M_{2b}), which remained high during most of 2017, gradually decelerated towards the latter part of the year on account of declining domestic credit growth. The year-on-year growth of M_{2b} peaked at 21.4 per cent in May 2017, compared to a growth of 18.4 per cent at end 2016, and decelerated gradually thereafter to 16.7 per cent by end 2017, as expected. Meanwhile, average broad money growth was 19.6 per cent in 2017, compared to 18.1 per cent in 2016. Monetary growth during 2017 was attributable to the expansion in both NDA and NFA of the banking system. NDA contributed to around 61 per cent of the year-on-year expansion of broad money in 2017, compared to its significant contribution of 92 per cent recorded in 2016, indicating a slowdown of the expansion in domestic credit flows. Meanwhile, the build-up of NFA since April 2017, along with the reserve accumulation of the Central Bank as well as the improvements in the net position of financial assets of commercial banks contributed to increase the relative share of monetary growth.

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 2017. With high interest rates in the market, time and savings deposits held by the public grew by 19.1 per cent, year-on-year, by end 2017, compared to the growth of 20.2 per cent recorded at end 2016, thus contributing to around 98 per cent of the expansion of M_{2b}. Accordingly, compared to the increase of Rs. 778.0 billion in 2016, time and savings deposits held by the public with commercial banks increased by Rs. 885.8 billion in 2017 to record a total interest bearing deposit base of Rs. 5.5 trillion. Meanwhile, demand deposits held by the public with commercial banks grew by 2.0 per cent, year-on-year, in 2017 in comparison to 6.2 per cent in 2016.

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

Rs. billion

Item	End 2016	End 2017 (a)	Change 2016 Amount	Change 2016 %	Change 2017 Amount	Change 2017 %
Reserve Money	**856.1**	**939.8**	**182.7**	**27.1**	**83.6**	**9.8**
Net Foreign Assets of the Central Bank	558.6	846.1	-17.6	-3.1	287.5	51.5
Net Domestic Assets of the Central Bank	297.6	93.7	200.3	206.0	-203.9	-68.5
Broad Money (M_{2b})	**5,405.6**	**6,308.1**	**839.7**	**18.4**	**902.5**	**16.7**
Net Foreign Assets	-231.2	121.5	66.9	22.4	352.8	152.6
Monetary Authorities (b)	558.6	846.1	-17.6	-3.1	287.5	51.5
Commercial Banks	-789.8	-724.6	84.5	9.7	65.2	8.3
Net Domestic Assets	5,636.8	6,186.5	772.8	15.9	549.7	9.8
Domestic Credit	6,671.7	7,504.7	939.6	16.4	833.0	12.5
Net Credit to the Government	1,972.1	2,168.5	212.6	12.1	196.4	10.0
Central Bank	413.0	225.1	183.1	79.6	-187.9	-45.5
Commercial Banks	1,559.1	1,943.4	29.6	1.9	384.3	24.6
Credit to Public Corporations	495.1	514.4	-27.9	-5.3	19.2	3.9
Credit to the Private Sector	4,204.4	4,821.8	754.9	21.9	617.4	14.7
Other Items (net) (c)	-1,034.8	-1,318.2	-166.9	-19.2	-283.3	-27.4

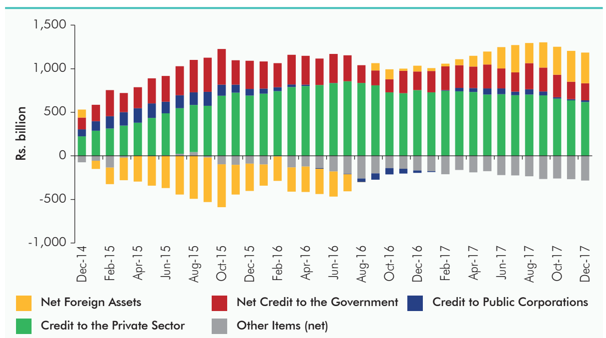
(a) Provisional
(b) This includes NFA of the Central Bank as well as the government Crown Agent's balance reported by the Department of State Accounts
(c) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

Contributing to the expansion of M_{2b}, on the assets side, NFA of the banking sector increased substantially in 2017, turning the outstanding amount of NFA to positive levels. The overall NFA position of the banking system, which remained in the negative territory since December 2014, turned positive from September 2017, reflecting improvements in NFA of both the Central Bank and the commercial banking sector. Accordingly, the overall NFA of the banking sector expanded significantly by Rs. 352.8 billion in 2017 in comparison to the moderate increase of Rs. 66.9 billion in 2016. Accounting for around 82 per cent of the increase in overall NFA position, NFA of the Central Bank expanded by Rs. 287.5 billion, mainly due to the increase in reserve assets of the Central Bank with its continued foreign exchange purchases from the market. Further, supporting the improvement in NFA of the Central Bank, foreign financial liabilities of the Central Bank recorded a decline in 2017. Meanwhile, NFA of commercial banks increased by Rs. 65.2 billion with the decline in foreign borrowings by commercial banks during the period under review. NFA of Domestic Banking Units (DBUs) increased by Rs. 34.9 billion, mainly on account of the considerable decline in foreign borrowings together with the increase in foreign currency placements with banks abroad, despite the increase in foreign currency deposit liabilities of non-residents held with commercial banks during the year. In the meantime, NFA of Offshore Banking Units (OBUs) also increased in 2017 entirely driven by the decline in financial liabilities of the OBUs.

The expansion in NDA of the banking sector continued at a slower pace during 2017. In absolute terms, the increase in NDA of the banking

Chart 7.13
Contribution to Year-on-Year Change in Broad Money - M_{2b} (Assets Side)

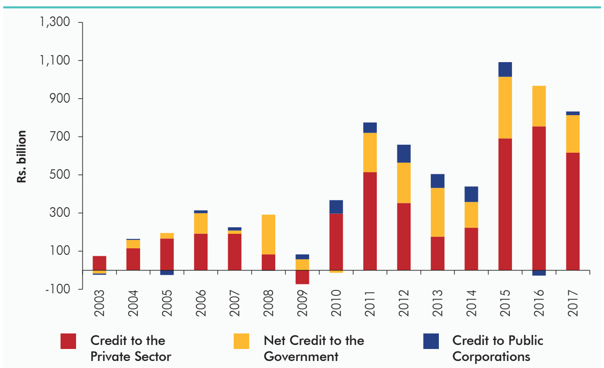


Source: Central Bank of Sri Lanka

system was limited to Rs. 549.7 billion in 2017 mainly on account of the slowdown in disbursements in domestic credit observed during the second half of the year. In comparison, the increase in NDA was high at Rs. 1,003.4 billion and Rs. 772.8 billion in 2015 and 2016, respectively. The moderate expansion in NDA during 2017 was mainly attributable to the slowdown observed in credit disbursements to both the government and the private sector, along with a negative impact stemming from increased other liabilities of commercial banks, particularly on account of increased capital funds of commercial banks.

Within NDA, NCG by the banking system continued to increase in 2017, albeit at a slower pace than in 2016. During the year, NCG by the banking sector increased by Rs. 196.4 billion compared to the increase of Rs. 212.6 billion in 2016, reflecting the slowdown observed during the second half of the year. The increase in NCG was driven entirely by the significant expansion in NCG from commercial banks, while NCG from the Central Bank contracted considerably during the period under review. Accordingly, indicating a compositional shift in bank borrowings of the government, NCG from commercial banks increased by Rs. 384.3 billion in 2017 in comparison to the moderate increase of Rs. 29.6 billion in 2016. Contributing to the expansion in NCG from commercial banks, NCG by DBUs increased substantially by Rs. 322.1 billion in 2017,

Chart 7.14
Annual Increase in Domestic Credit



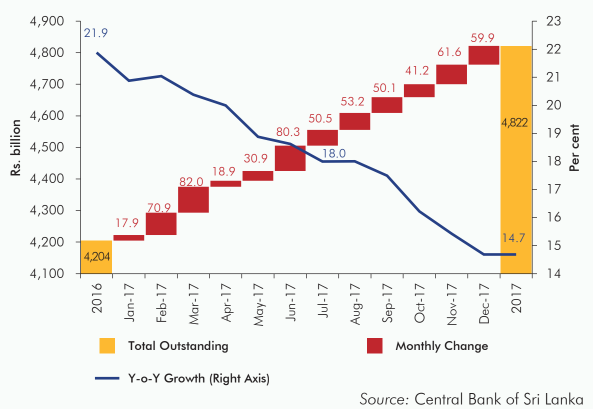
Source: Central Bank of Sri Lanka

compared to the increase of Rs. 96.6 billion in 2016, largely on account of investments in Treasury bills and Treasury bonds amounting to Rs. 245.2 billion. Moreover, government overdraft balances with commercial banks also increased by Rs. 50.4 billion, while investments in SLDBs increased by Rs. 40.8 billion during the period under review. Meanwhile, in 2017, NCG by OBUs of commercial banks increased by Rs. 62.2 billion in comparison to the decline of Rs. 67.1 billion recorded in 2016. This was largely due to the increase in investments in SLDBs, amounting to Rs. 23.3 billion, and the increase in direct foreign currency loans to the government, amounting to Rs. 38.9 billion, during the year. Meanwhile, reflecting the government's lower reliance on the Central Bank for financing, coupled with the Central Bank's decision to unwind its Treasury bill holdings and to refrain from purchasing Treasury bills at primary auctions, NCG from the Central Bank decreased considerably by Rs. 187.9 billion in 2017, compared to the increase of Rs. 183.1 billion in 2016.

Reflecting the increased borrowing requirements of several state owned business enterprises (SOBEs), credit granted to public corporations by commercial banks increased in 2017 although there were repayments by key SOBEs. Continuing the increasing trend observed since September 2016, credit to public corporations recorded a cumulative increase of Rs. 66.6 billion during the first five months of 2017 mainly on account of borrowings by the Ceylon Petroleum Corporation (CPC) amounting to Rs. 41.0 billion. Nevertheless, reversing this trend, credit obtained by public corporations declined during the period between June to October before picking up again towards the latter part of 2017. Subsequently, credit to SOBEs recorded a cumulative increase of Rs. 19.2 billion during 2017 as against a decline of Rs. 27.9 billion in 2016. Contributing to this increase, credit obtained by Road Development Authority (RDA), National Water Supply and Drainage Board and SriLankan Airlines increased by Rs. 19.0 billion, Rs. 18.6 billion and Rs. 7.7 billion, respectively, during the year. Borrowings by several other public corporations including Co-operative Wholesale Establishment (CWE) and Sri Lanka Ports Authority also increased during the period under review. Meanwhile, CPC settled around Rs. 15.5 billion of its outstanding foreign currency liabilities to commercial banks in 2017, utilising balances in its rupee deposits with commercial banks. Moreover, during 2017, Ceylon Fertilizer Company Ltd, Urban Development Authority and Ceylon Electricity Board (CEB) also made partial repayments amounting to around Rs. 5.2 billion, Rs. 5.8 billion and Rs. 3.8 billion, respectively.

The expansion in credit extended to the private sector by commercial banks continued to decelerate in 2017 and reached desired levels by the end of the year. The economy's response to the tight monetary policy stance maintained by the Central Bank leading to high market interest rates, as well as macroprudential measures and tariff adjustments to discourage selected imports, contributed towards lowering credit growth in 2017. Moreover, the removal of interest rate caps on credit cards, other loans and

Chart 7.15
Credit to the Private Sector by Commercial Banks



Source: Central Bank of Sri Lanka

advances as well as penal interest rates charged on overdue loans and advances by licensed banks with effect from July 2017 may also have contributed to discourage private sector demand for credit to some extent. Accordingly, the year-on-year growth of credit to the private sector was 14.7 per cent by end 2017, in comparison to 21.9 per cent at end 2016, while the average growth of credit to the private sector recorded a lower growth of 18.3 per cent in 2017 in comparison to 25.9 per cent in 2016. In absolute terms, the expansion in credit extended to the private sector was limited to Rs. 617.4 billion during 2017 compared to the increase of Rs. 754.9 billion in 2016. As per the security wise analysis of advances, the cumulative increase in credit against Immovable Property, Plant and Machinery as well as Personal Guarantees and Promissory Notes accounted for around 62 per cent to the overall expansion in advances during the year. Meanwhile, the growth of credit in terms of Leasing and Hire Purchase Agreements decelerated to 8.3 per cent by end 2017 from 12.7 per cent in 2016, indicating the impact of higher interest rates and macroprudential policy measures adopted to curtail imports of vehicles during the period under review.

As per the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, credit disbursed to all major sectors of the economy displayed a declining trend during 2017, except for Personal Loans and Advances. On a year-on-year basis, credit flows to the Services and Industry sectors expanded by 8.3 per cent and 19.6 per cent, respectively, during 2017, compared to the growth rates of 35.4 per cent and 22.2 per cent, respectively, recorded for 2016. Contributing to the slowdown in credit to the Services sector, growth of credit disbursed to Financial and Business Services, Communication and Information Technology and Shipping, Aviation

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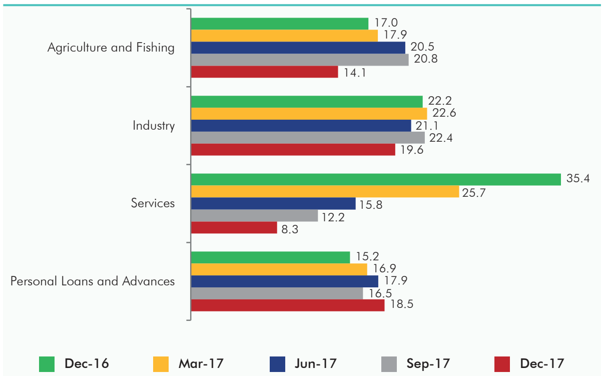
Chart 7.16
Year-on-Year Growth of Private Sector Credit to Key Sectors (%)



Source: Central Bank of Sri Lanka

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

Rs. billion

Sector		End 2016	End 2017 (d)	% Share 2017	% Change 2017
Agriculture and Fishing		361.5	412.4	8.4	14.1
of which,	Tea	82.4	91.0	1.9	10.4
	Rubber	23.8	24.4	0.5	2.6
	Coconut	16.3	20.4	0.4	25.7
	Paddy	28.9	32.6	0.7	12.6
	Vegetable and Fruit Cultivation and Minor Food Crops	25.1	29.3	0.6	16.9
	Fisheries	14.0	17.5	0.4	24.6
Industry		1,707.5	2,041.4	41.7	19.6
of which,	Construction	811.2	993.5	20.3	22.5
	Food and Beverages	95.3	105.1	2.1	10.3
	Textiles and Apparel	159.4	174.7	3.6	9.6
	Fabricated Metal Products, Machinery and Transport Equipment	148.8	170.3	3.5	14.4
Services		1,287.6	1,393.9	28.4	8.3
of which,	Wholesale and Retail Trade	387.3	435.8	8.9	12.5
	Tourism	138.7	172.0	3.5	24.0
	Financial and Business Services	308.1	306.5	6.3	-0.5
	Shipping, Aviation and Freight Forwarding	28.1	19.2	0.4	-31.7
Personal Loans and Advances (e)		888.6	1,053.2	21.5	18.5
of which,	Consumer Durables	198.1	210.2	4.3	6.1
	Pawning	132.4	148.4	3.0	12.1
	Credit Cards	75.9	91.5	1.9	20.4
Total		4,245.1	4,900.9	100.0	15.4

(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

and Freight Forwarding subsectors declined during 2017. The slowdown observed in credit disbursed to Financial and Business Services was mainly due to slower growth in credit to leasing companies by the banking sector during the year. Nevertheless, credit flows to other subsectors, particularly, Tourism, Printing and Publishing, Education, Health, Wholesale and Retail Trade, and Transport recorded positive growth during 2017. Within the Industry sector, the Construction subsector, which accounted for around 49 per cent of total loans disbursed to the Industry sector, grew by 22.5 per cent, year-on-year, by end 2017. Meanwhile, other key subsectors also attracted notable credit flows in 2017. Credit to the Agriculture and Fisheries sector grew by 14.1 per cent, year-on-year, by end 2017, compared to the growth of 17.0 per cent recorded in 2016. Within this sector, credit flows directed to the subsectors of Livestock and Dairy Farming, Coconut, Fisheries, Vegetable, Fruit Cultivation and Minor Food Crops, Paddy and Tea recorded notable growth rates. Meanwhile, credit under the Personal Loans and Advances category grew by 18.5 per cent, year-on-year, by end 2017, compared to the growth of 15.2 per cent recorded at end 2016. Within the Personal Loans and Advances category, growth of credit on account of credit cards accelerated to 20.4 per cent, year-on-year, by end 2017, compared to 17.5 per cent at end 2016. Moreover, credit to all other subsectors in the Personal Loans and Advances category recorded increases during 2017. In particular, Pawning advances, which continued to contract since 2013, recovered during 2017 and grew by 12.1 per cent, year-on-year, by end 2017. Moreover, in terms of the maturity wise classification of loans and advances, a slowdown was observed across all maturities. Accordingly, both medium term and long term credit growth slowed substantially to 10.6 per cent and 19.0 per cent, respectively, by end 2017, compared to 22.8 per cent and 29.9 per cent, respectively, observed in 2016. Short term credit grew by 15.0 per cent by end 2017, compared to a growth of 19.9 per cent recorded in the previous year.

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

Sector	Maturity	December 2016		December 2017	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	5.5	16.5	5.6	17.6
	Medium Term	1.9	24.3	1.7	4.2
	Long Term	1.1	7.7	1.0	13.9
Industry	Short Term	13.3	23.7	14.0	21.4
	Medium Term	10.1	13.8	10.1	16.2
	Long Term	16.9	26.5	17.5	20.1
Services	Short Term	12.2	35.0	11.0	4.3
	Medium Term	10.6	41.3	10.0	9.7
	Long Term	7.6	28.5	7.4	12.6
Personal Loans and Advances	Short Term	8.6	1.0	8.8	18.8
	Medium Term	5.6	10.9	5.5	11.4
	Long Term	6.7	46.4	7.2	24.1
Total	Short Term	39.6	19.9	39.4	15.0
	Medium Term	28.2	22.8	27.4	10.6
	Long Term	32.2	29.9	33.2	19.0

(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)

Following the same trend observed in M_{2b}, growth of broad money (M_4)[2] as measured by the financial survey remained elevated before moderating during the latter part of 2017. The year-on-year growth of M_4 peaked at 20.7 per cent in August 2017 but moderated to 17.6 per cent by end 2017, although it remained above the growth of 15.9 per cent recorded at end 2016. On average, M_4 growth was 18.8 per cent in 2017 compared to 15.9 per cent observed in 2016. Contributing to around 70 per cent of the expansion in M_4, NDA of the banking system and Licensed Finance Companies (LFCs) increased by Rs. 816.6 billion in 2017 supported by credit disbursements to both private and public sectors. Meanwhile, the overall NFA position also improved during the year by Rs. 349.0 billion on account of improvements in NFA of the Central Bank and Licensed Commercial Banks (LCBs).

Time and savings deposits held by the public with licensed banks and LFCs grew at a higher rate in 2017. Accordingly, the year-on-year growth of time and savings deposits held at these financial institutions was 19.7 per cent by end 2017, compared to 17.1 per cent observed at end 2016. The year-on-year growth of total time and savings deposits held by the public at LCBs was at 19.5 per cent by end 2017, compared to 19.3 per cent by end 2016, while that of Licensed Specialised Banks (LSBs) increased to 15.2 per cent by end 2017, from 10.7 per cent at end 2016. Meanwhile, reflecting relatively high rates offered by LFCs to their depositors, year-on-year growth of time and saving deposits held by the public with LFCs increased significantly by 29.4 per cent at end 2017, from 9.7 per cent at end 2016.

As per M_4, the year-on-year growth of credit extended to the private sector continued to decelerate during 2017. Private sector credit growth based on M_4 decelerated to 14.6 per cent, year-on-year, by end 2017, compared to 20.6 per cent recorded at end 2016, while averaging 17.7 per cent for 2017, compared to 23.0 per cent in 2016. In absolute terms, credit to the private sector expanded by Rs. 836.2 billion in 2017 in comparison to

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

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

Rs. billion

Item	End 2016 (a)	End 2017 (b)	Change 2016 (a) Amount	Change 2016 (a) %	Change 2017 Amount	Change 2017 %
Financial Survey (M_4)	6,630.3	7,795.9	910.0	15.9	1,165.7	17.6
Underlying Factors						
Net Foreign Assets	-383.2	-34.2	61.0	13.7	349.0	91.1
Monetary Authorities (c)	558.6	846.1	-17.6	-3.1	287.5	51.5
LCBs	-789.8	-724.6	84.5	9.7	65.2	8.3
LSBs and LFCs	-152.0	-155.7	-6.0	-4.1	-3.8	-2.5
Net Domestic Assets	7,013.5	7,830.1	849.1	13.8	816.6	11.6
Domestic Credit	8,763.3	9,841.8	1,159.6	15.3	1,078.5	12.3
Net Credit to the Government	2,555.9	2,778.9	211.6	9.0	223.1	8.7
Monetary Authorities	413.0	225.1	183.1	79.6	-187.9	-45.5
LCBs	1,559.1	1,943.4	29.6	1.9	384.3	24.6
LSBs	515.7	545.6	-13.6	-2.6	30.0	5.8
LFCs	68.1	64.8	12.5	22.5	-3.3	-4.9
Credit to Public Corporations (LCBs)	495.1	514.4	-27.9	-5.3	19.2	3.9
Credit to the Private Sector	5,712.3	6,548.5	975.9	20.6	836.2	14.6
LCBs	4,204.4	4,821.8	754.9	21.9	617.4	14.7
LSBs	562.2	676.8	80.5	16.7	114.6	20.4
LFCs	945.7	1,049.8	140.5	17.4	104.2	11.0
Other Items (net) (d)	-1,749.8	-2,011.7	-310.6	-21.6	-261.8	-15.0

(a) Revised
(b) Provisional
(c) This includes NFA of the Central Bank as well as the government's Crown Agent's balance reported by the Department of State Accounts
(d) Computed as the difference between other assets and other liabilities

Source: Central Bank of Sri Lanka

Rs. 975.9 billion in 2016, largely on account of the credit expansion of LCBs. Following the declining trend observed in overall credit growth by end 2017, credit growth of LFCs also moderated to 11.0 per cent, year-on-year, from 17.4 per cent in 2016, while recording an absolute increase of Rs. 104.2 billion during the year. Nevertheless, credit growth of LSBs displayed an increasing trend, recording a growth of 20.4 per cent by end December 2017, compared to the 16.7 per cent growth reported at end 2016. The absolute increase in credit extended by LSBs amounted to Rs. 114.6 billion during 2017, compared to Rs. 80.5 billion in 2016. Further, as per M_4, NCG increased by Rs. 223.1 billion in 2017 with LSBs contributing Rs. 30.0 billion, while NCG from LFCs contracting by Rs. 3.3 billion in 2017.

7.5 Future Developments, Challenges and Outlook

The Central Bank has been successful in managing demand driven inflation and inflation expectations, the weather affected increases in food prices on account of factors beyond the control of the Central Bank and going forward the Bank is expected to continue to proactively adopt appropriate policy measures to ensure medium term price stability. Despite the decline in volatile food prices and the favourable effect of the base, which caused inflation to recede to desired levels by early 2018, a number of risks could challenge the Central Bank's efforts to keep inflation low and stable. In particular, the implementation of price revisions to domestic energy sources, in view of upward trending international energy prices, could exert some pressure on inflation in the short term.

Wage pressure, which has been subdued could also impact on core inflation and needs to be monitored carefully. Similarly, undue supply side disruptions, resulting from adverse and unpredictable weather conditions, could also cause transitory shocks on domestic prices. Inflationary pressures emanating from such supply disruptions can appropriately be addressed by timely supply side policies of the government, as monetary policy measures would be ineffective in curbing transitory supply side inflationary pressures. To this end, the government must focus on improving the resilience of the supply chain by way of enhancing the productive capacity of the agriculture sector and maintaining adequate buffer stocks of food supply, whilst also ensuring the timely importation of essential food items during periods of low harvest. Supportive adjustments to tariffs would also aid in bringing down prices of essential items. Nevertheless, in spite of the source of inflation, the Central Bank will continue to be vigilant to take appropriate policy measures and provide timely advice to the government, to ensure that inflation expectations are checked in order to prevent the build-up of wage pressures.

The transition to an effective FIT framework will pave the way for sustained price stability for the country to progress as an upper middle income economy over the medium term. Since the announcement of the transition to FIT in early 2017, the Central Bank has devised a 'Road Map' for the adoption of FIT, outlining the necessary reforms and innovations relevant to institutional features, operational features, monetary policy implementation, exchange rate policy and foreign exchange operations as well as capacity building, to facilitate the smooth transition to the new regime. Also, the Central Bank continued to enhance monetary policy communication with stakeholders, considering the growing importance of effective communication in monetary policy transmission. The culmination of the transition lies in the alignment of both fiscal and monetary policy towards achieving inflation targets, which are set in a coherent manner. The Central Bank has made notable progress in fulfilling the requirements pertaining to such a framework. However, this process is to be complemented by strengthening the Central Bank's mandate, credibility and autonomy through necessary legislative amendments. Currently, the Central Bank is engaged in a consultation process with relevant stakeholders to revise the MLA to enhance the focus of the mandate while strengthening Central Bank autonomy, governance, transparency and accountability. Moreover, in order to sustain the macroeconomic environment, the Central Bank will continue to adopt an appropriate exchange rate policy to ensure increased market-orientation in exchange rate determination.

Fiscal discipline with continued fiscal consolidation is a crucial prerequisite for the successful implementation of FIT. Though a notable improvement in the primary fiscal balance was recorded in 2017, expenditure overruns and slippages in revenue collection, compared to the targets, challenge the envisaged fiscal consolidation path, thereby affecting the conduct of monetary policy. Addressing prolonged imbalances in the fiscal sector should be the utmost priority in resolving structural issues in the economy. High fiscal deficits and monetisation of such fiscal deficits would lead to fiscal dominance over monetary policy, which is detrimental to the monetary stability of the economy as well as overall macroeconomic stability. The effective implementation of the Active Liability Management Act, together with the new hybrid auction system in issuing government securities and envisaged reforms in the monetary policy framework, will alleviate any fiscal dominance in monetary policy making. In particular, as the Central Bank has embarked on adopting a FIT framework in the medium term, establishing fiscal discipline and sustaining fiscal consolidation are prime necessities to maintain long term price stability, which is a pre-requirement for high growth and upgraded living standards.