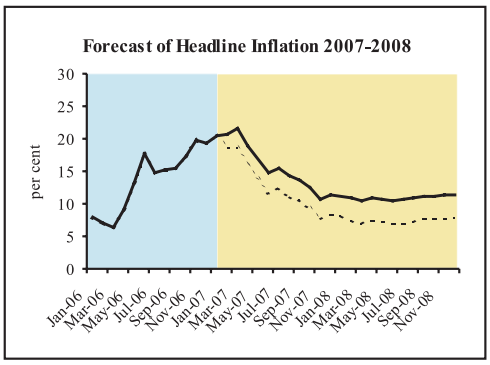
Chapter 7



MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

The focus of monetary policy in 2006 was to contain high monetary expansion, without interupting the growth momentum of the economy. Hence, monetary policy was carefully tightened during the year, and the Central Bank's policy interest rates, viz; Repurchase and Reverse Repurchase rates, were raised in four steps in 2006. The excess liquidity in the banking system was also absorbed through aggressive Open Market Operations while discouraging banks from using the reverse repurchase facility to borrow funds from the Central Bank.

Simultaneously, other measures such as imposing margin requirements on Letters of Credit opened for imports of some identified goods and restricting credit facilities to meet such requirements as well as moral suasion to discourage banks from excessive credit creation were also implemented during the year. These efforts were complemented by the prudential requirements imposed on banks.

Meeting monetary targets was a challenge in 2006 as credit demand by public sector as well as the private sector remained high. Market interest rates rose in line with policy rate changes thereby discouraging further expansion in demand for credit. Accordingly, both the reserve money and broad money growth decelerated by August 2006. However, with the increased borrowings by the public sector during the last few months of the year, the growth in monetary aggregates began to accelerate resulting in a deviation from the targeted path. However, the deviation could have been even higher if tight monetary policy measures had not been taken.

Inflation which decelerated until March 2006, commenced rising thereafter. This was mainly a result of higher monetary expansion, as indicated by the rise in core inflation. The increase in administrative prices including domestic oil price adjustments due to the elimination of the petroleum subsidy also resulted in a one-off increase in inflation. The removal in subsidies is expected to have a favourable impact on future inflation through lower budget deficits.

In January 2007, the Central Bank announced the planned monetary policy path for 2007 in its policy announcement " Road Map for Monetary and Financial Sector Policies for 2007 and beyond", and took several measures to achieve price and economic stability. In that exercise, the exessive growth in monetary aggregates in 2006 was taken into consideration in setting the monetary targets for 2007. Those targets and the Central Bank's strategies were announced to the public in order to enhance the transparency of the monetary policy implementation process and to demonstrate the Central Bank's commitment to achieve the announced monetary targets. A monitoring mechanism of key macroeconomic variables of fiscal, monetary and external sectors was established to identify any possible deviation from the targets in advance so that nesessary action could be taken early to ensure that the targets are achieved. A Monetary Policy Consultative Committee (MPCC) was set up, comprising of representatives from other stakeholders in order to obtain their views on monetary policy implementation. In consultation with the Central Bank, the National Economic Council (NEC) chaired by H.E. the President directed several other institutions to take the necessary measures to reduce inflation to a desirable level during the year. The successful implementation of such measures are expected to reduce inflation, while maintaining economic growth at a desirable level.

7.2 Monetary Policy

The monetary policy of the Central Bank in 2006 was focussed on reducing high inflation and inflationary expectations while supporting a sustainable high economic growth. The Bank continued its monetary policy operations within the monetary targeting policy framework under an independently floating exchange rate system. In the monetary targeting framework, growth in reserve money (high powered money) is used as the operational target while the growth in broad money (M_{2b}) is used as the intermediate target. Active open market operations were used as the main monetary policy instrument which was operated through an interest rate corridor formed by the Repurchase and Reverse Repurchase rates of the Central Bank. The Statutory Reserve Requirement (SRR) was maintained at 10 per cent, while the Bank rate remained at 15 per cent.

The tight monetary policy stance adopted from end 2004 was continued during 2006 in view of rising inflationary pressures. Accordingly, the Central Bank raised its policy interest rates by 125 basis points in four steps during 2006, which was in addition to the increase of 175 basis points during 2004 and 2005. The Central Bank has also been conducting Open Market Operations (OMO) aggressively, to manage the liquidity in the market consistently with the targeted reserve money path. The increased rupee liquidity due to purchases of foreign currency inflows to the government by the Central Bank was needed to be absorbed on a permanent basis through outright sales of Treasury bills by the Central Bank. Also, the 100 per cent margin requirement on Letters of Credit (LC) for the importation of several categories of vehicles, which was introduced in 2004, was further strengthened by instructing banks not to grant credit to meet this requirement. At the same time, banks were instructed not to open LCs for the importation of several luxury items unless such LCs were covered by a minimum cash margin of 50 per cent of imported value deposited with banks. A similar margin requirement was imposed against importation of non-essential items on Documents on Acceptance (DA) terms. In addition to these measures, moral suasion was used to discourage the usage of reverse repurchase facility and lending to unproductive sectors by commercial banks.

In addition to the monetary policy measures, several prudential measures were also introduced in 2006 to contain high credit expansion. A general provisioning requirement of 1 per cent was imposed on all performing advances of commercial banks with effect from the fourth quarter of 2006 and such provision is required to be met within ten quarters. Further, risk weights in respect of loans secured by primary mortgages over residential properties were increased from 50 per cent to 55 per cent, and risk weights in respect of loans categorised as other loans and advances were increased from 100 per cent to 110 per cent, in the computation of capital adequacy. These measures were expected to slow down the private sector credit expansion as well.

Responding to the tight monetary policy measures market interest rates increased more than the policy rate increases, thereby making credit more expensive. With the increase in Central Bank's Repurchase and Reverse Repurchase rates by 125 basis points each and aggressive conduct of OMOs, the weighted average OMO auction rate increased by 177 basis points in 2006. Call money rates also increased by 374 basis points, while the Average Weighted Deposit Rate (AWDR) and the Average Weighted Prime Lending Rate (AWPR) increased by 136 and 295 basis points, respectively. With these developments, the monetary aggregates decelerated to a certain extent by the third quarter of the year. However, the decelerating trend reversed towards the end of 2006 with the surge in borrowings by the government due to increased recurrent expenditure and increase in borrowings by the Ceylon Petroleum Corporation (CPC). Accordingly, these increased borrowings became one of the main challenges in the endeavour to achieve the monetary targets. However, the current higher interest rates, supported by complementary fiscal measures are expected to induce a significant deceleration in the monetary expansion during 2007.

Demand side factors, exacerbated by supply shortages also had an impact on inflation. As measured by the point-to-point change in Colombo Consumers' Price Index (CCPI), inflation declined to 6.4 per cent in March 2006 from 8 per cent at end 2005, but increased sharply to 19.3 per cent by end 2006. Meanwhile, the average inflation increased from 11.6 per cent at end 2005 to 13.7 per cent at end 2006. The point-to-point inflation, measured using the Sri Lanka Consumers' Price Index (SLCPI), increased from 3.6 per cent as at end 2005 to 17.9 per cent as at end 2006. Although, changes in the administrative prices contributed to one-off increase in the cost of living, it was desirable for combating the long-term inflation. This is because such price adjustments obviate the necessity for subsidising such products through money supply increases.

The Central Bank took several measures to improve monetary transmission and the monetary policy decision-making process to enhance its effectiveness on achieving price stability. As a measure of improving effectiveness of monetary policy further, a comprehensive monitoring mechanism has been introduced at the beginning of 2007 on key variables, which affect the realising of monetary policy targets. Contemporaneous developments of these variables in external, fiscal and monetary sectors are due to be monitored and compared with targets to take timely corrective measures.

The communication policy of the Central Bank was intensively used to enhance public awareness of developments in the economy, policy measures taken and their expected impact on future developments. The Central Bank published the monetary policy targets with explanatory notes at the beginning of the year, while the monetary policy stance of the Central Bank was reviewed on a monthly basis and the public was kept informed of the decisions according to an advance release calendar. In addition, the Central Bank continued to make available information on key macroeconomic developments, to enable market participants as well as the general public to arrive at informed decisions. Also, the Bank announced the "Road Map: Monetary and Financial Sector Policies for 2007 and beyond" at the beginning of 2007 enhancing the transparency and accountability of the Central Bank.

7.3 Developments in Money and Credit Aggregates

Money Market Liquidity

The Central Bank attempted to maintain market liquidity broadly in balance throughout the year. OMOs were conducted aggressively to absorb excess liquidity, both on an overnight basis and permanently. Lending to commercial banks through the reverse repurchase facility was also monitored carefully in view of its expansionary impact on monetary aggregates.

Reserve Money

Reserve money, the operational target of the monetary policy, remained above the desired path during most of the year but its expansion was contained through the tight monetary policy stance. The tight monetary policy measures helped to contain the excessive growth of reserve money, which decelerated to 16 per cent by the third quarter of the year. However, by the end of 2006, the high growth re-emerged to around 21 per cent, mainly due to increased borrowings of the government through the banking system.

The increase in reserve money during the year is reflected in the increase in both Net Foreign Assets (NFA) and Net Domestic Assets (NDA) of the Central Bank. NFA increased by around Rs.22 billion (net of rupee valuation changes) mainly due to the purchases of foreign currency proceeds received by the government by way of foreign project and programme loans, foreign currency loans raised from the Offshore Banking Units (OBU) of licensed commercial banks and net issues of Sri Lanka Development Bonds (SLDBs). NDA increased by around Rs.20 billion reflecting the increase in provisional advances given to the government by Rs. 9 billion and the increase in Treasury bill holdings of the Central Bank by around Rs. 30 billion, the impact of which was partly offset by the increased liabilities of the Central Bank.

The reserve money expansion was reflected in the increase in currency in circulation and commercial bank deposits with the Central Bank. Currency in circulation increased by Rs. 25 billion in 2006, reflecting the increased demand for currency while the deposits of commercial banks with the Central Bank increased by Rs. 17 billion in line with the increased rupee deposit liabilities of commercial banks.

Box 9 Core Inflation

The concept of core inflation, introduced in 1975 by Robert J. Gordon, is based on the idea of identifying the persistent non-reversible trend of price movements by separating short-run fluctuations from the 'headline inflation', the inflation measured by using available price indices. The headline inflation is often subject to large and temporary fluctuations, arising from supply side shocks, for example, declines in production due to unfavourable weather conditions or changes in taxes or administered prices. Since the impact of supply shocks is temporary, it is inappropriate to base demand management policies, such as monetary policy, on such changes without making suitable adjustments. Monetary authorities need to be concerned with changes in prices resulting from changes in the aggregate demand. Hence, a measure of inflation representing changes due to the aggregate demand is deemed to be more appropriate for conducting monetary policy. Consequently, a growing number of countries are adopting the concept of core inflation in making monetary policy decisions.

Core inflation, or underlying inflation, is measured in several ways. The most common approach is the 'exclusion method', which derives the core inflation behaviourally by recompiling price indices after removing a fixed number of items from the original index in each period consistently. The items usually excluded are the items with highly volatile prices and items that have administered prices, usually energy and food items. In the United States and Canada, for example, both food and energy prices are excluded, as they tend to be highly volatile. In the United Kingdom, mortgage interest costs are excluded from the index to compute the core inflation as they are directly influenced by changes in the policy interest rates. The exclusion method is used by central banks more frequently than other methods as that method is computationally simple, easy to understand and derivable without any time lag.

The volatile components are also removed from the indices through statistical approaches. For example, the 'Trimmed Mean' measure removes both very high and very low deviations from the index. This method too is based on recompiling the index after removing certain items, but differs from the behavioural approach, as the items so excluded are not consistent over time. In trimmed mean method, items with highest volatility in each month are excluded instead, based on their standard deviations. Another statistical method is reweighing the items in the index using the inverse of standard deviation. Despite the qualitative superiority of the statistical approach, central banks use them less commonly than the exclusion method, primarily because the statistical approaches are not easy to explain to the public and difficult to replicate. Some researches have recognised the centred median as a good measure of core inflation, but this method is of less operational use as its deriving involves a time lag. However, several central banks use weighted median as a practical alternative to the centred median.

There are econometric approaches too for estimating core inflation such as the Structural Vector Auto Regression (SVAR) model estimate. The major weakness of econometric modeling is past observations being changed when a new observation is added. Therefore, this measure is not a suitable candidate as the official core inflation measure, which in turn has to be announced to the general public. Though used by central banks less prominently, some researchers have also considered economic approaches, by trying to derive a measure of core inflation using the long-run neutrality assumption of monetary theory.

Many countries use core inflation in the conduct of monetary policy, as core inflation is an indicator that could be targeted by monetary policy with a greater effectiveness. The most common approach to measure core inflation is the exclusion method. As shown in Table B 9.1, food, energy and mortgage interest payments are some of the items excluded by various countries. Unlike developed countries, the share of food items in a CPI of a developing country is significantly large. This has motivated many developing countries to exclude selected more volatile food items, instead of all food items, when deriving the core inflation.

Table B 9.1
Core Inflation - Selected Cross-Country Indices

Country	Official Core Inflation Measure	Other Measures Used Internally by Central Bank
Advanced Economies		
United States	CPI excluding food and energy	
Canada	CPI excluding food, energy and first round effects of indirect taxes with a weight of 26.3%	(i) CPI excluding eight most volatile components (16%) and then adjusting the remaining components for the effects of indirect taxes (ii) Weighted median (iii) Trimmed mean (15%)
United Kingdom	Retail Price Index excluding mortgage interest rates (RPIX)	Weighted median
Australia	CPI excluding interest charges and administered prices	(i) Trimmed mean (ii) Weighted median
New Zealand	CPI excluding interest charges	
Singapore	CPI excluding costs of private road transport and costs of accommodation	(i) CPI excluding volatile items (30%) (ii) Weighted median (iii) Trimmed mean (15%) (iv) Structural Vector Auto Regression (SVAR) model estimate
Japan	CPI excluding fresh food	
Netherlands	CPI excluding energy and unprocessed food (fruits and vegetables)	
Germany	CPI excluding indirect taxes	
Spain	CPI excluding energy and unprocessed food (IPSEBENE)	
Ireland	(i) CPI excluding mortgage interest payments (ii) CPI excluding mortgage interest payments, food and energy	
Portugal	CPI excluding unprocessed food and energy	
Norway	CPI excluding electricity prices and indirect taxes	
Korea	CPI excluding energy and non-grain agriculture	
Emerging Market Economies		
India	Wholesale Price Index (WPI) excluding food and fuel items	
Pakistan	CPI excluding food and energy items (NFNE)	
Thailand	CPI excluding fresh food and energy (23%)	Trimmed mean (10%)
Malaysia	CPI excluding food and fuel	
Philippines	CPI excluding selected food and energy items	
South Africa	CPI excluding certain food items, cost of mortgage bonds and certain indirect taxes	
Poland	(i) CPI excluding officially controlled prices (ii) CPI excluding prices with highest volatilities (iii) 15 % trimmed mean	
Colombia	CPI excluding agricultural food, public services, and transport	
Chile	CPI excluding 20% with higher (-) variations and 8% with higher (+) variations	
Peru	CPI excluding 9 volatile items (food, fruits and vegetables, and urban transport, about 21.2 %)	

Source: various central banks

Colombo Consumer Price Index (CCPI) is the official cost of living index of the country, as well as the measure of inflation widely used by firms and individuals in planning current and future consumption and investment, thereby affecting inflation expectations, despite the weaknesses as a representative index. Thus, CCPI is the headline inflation measure most appropriate for deriving an official measure of core inflation for Sri Lanka until a proper index is introduced, and the exclusion method appears to be the most appropriate method.

It is important to note that a core inflation measure can represent the actual trend of underlying inflation only to the extent that the relevant headline inflation measure is representative of real household consumption patterns. Core inflation, therefore, does not help to overcome the deficiencies of headline inflation measure arising from misrepresentation and misweighting, which needs to be corrected by revising the CCPI basket and the weights. Hence, a core inflation measure based on the proposed new index would be the most appropriate index to measure the demand driven inflation.

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Narrow Money (M_1)

Narrow money (M_1), which consists of currency and demand deposits held by public, indicated a declining growth trend during the year. Growth in narrow money declined from around 22 per cent at end 2005 to around 12.6 per cent by end 2006. This decline could be attributed to the lower growth in demand deposits resulting from the general public moving from demand deposits to interest bearing deposits in view of rising interest rates, a likely outcome of the tight monetary policy stance adopted by the Central Bank.

Broad Money (M_{2b})

Although the Monetary policy measures were successful in decelerating monetary expansion, the expansion was yet above the desired target. The growth in broad money declined from 19.1 per cent at end 2005 to 17.8 per cent at end 2006, compared to the targeted growth of 15 per cent. The increases in currency held by the public, as well as all the deposits held by the public contributed to the expansion in broad money. Reflecting the increased transaction demand for money, currency held by the public increased by 18.3 per cent while deposits increased by 17.8 per cent. However,

Table 7.1 **Developments in MonetaryAggregates**

Rs.billion

Item	End 2005	End 2006 (a)	Change 2005 Amount	Change 2005 %	Change 2006 Amount	Change 2006 %
1. Currecny Outstanding	132.4	157.2	16.5	14.3	24.8	18.7
1.1 Currency Held By the Public	114.1	135.0	14.4	14.4	20.9	18.3
1.2 Currency with Commercial Banks	18.3	22.2	2.1	13.0	3.9	21.2
2. Commercial Banks Deposits with the Central Bank	65.5	82.6	10.4	18.9	17.1	26.1
3. Government Agencies Deposits with the Central Bank	…	…	…	…	…	…
4. Reserve Money (1+2+3)	197.9	239.9	26.9	15.8	42.0	21.2
5. Demand Deposits Held by the Public With Commercial Banks	116.6	124.7	27.8	31.4	8.1	6.9
6. Narrow Money Supply, M_1 (1.1+5)	230.7	259.7	42.2	22.4	29.0	12.6
7. Time and Savings Deposits held by the Public with Commercial Banks	592.2	733.6	92.7	18.6	141.4	23.9
8. Broad Money Supply, M_2 (6+7)	822.9	993.3	134.9	19.6	170.4	20.7
9. Foreign Currency Deposits (b)	199.4	211.3	28.7	16.8	11.9	6.0
10. Consolidated Broad Money Supply, M_{2b} (8+9)	1,022.3	1,204.6	163.6	19.1	182.3	17.8
Money Multiplier M_{2b}	5.16	5.02				
Velocity, M_{2b} (c)	2.53	2.53				

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

Source: Central Bank of Sri Lanka.

demand deposits grew at a relatively lower rate of 7 percent, while the time and savings deposits increased by 19.4 per cent. The continued efforts by banks to attract more deposits through various deposit promotion schemes largely contributed to the growth in time and savings deposits. However, the deposit mobilisation by state banks was not sufficient, compared to their credit growth thereby raising the credit to deposit ratio. Foreign currency deposits also increased by 8.3 per cent, which could be attributed to the attractive interest rates offered by banks on such deposits following the increase in interest rates in major international markets.

The expansion of domestic assets of the banking system was the main contributor to the rapid expansion in broad money. The increase in broad money was entirely caused by the increase in NDA of the banking system, as the NFA of the banking system declined during the year despite the increase in NFA of the Central Bank. The NFA of the Central Bank increased mainly due to the purchases of foreign currency proceeds received by the government and foreign currency loans raised by the government from the OBUs of licensed commercial banks. However, the NFA of commercial banks declined following foreign currency loans provided to the government, investments in SLDBs raised by the government and utilisation of foreign currency deposits as well as foreign currency borrowings by the CPC from commercial banks to settle its oil bills.

The expansion in NDA of the banking system was due to the higher increase in domestic credit to the private and public sectors (which includes government and public corporations). In view of the continued expansion in economic activities, innovative credit schemes offered by banks at competitive rates and relatively low real interest rates, credit to the private sector increased at a higher rate during 2006. The credit growth remained in the range of 22 – 25 per cent. About 92 per cent of the credit growth was from domestic banking units of commercial banks and the balance was from OBUs. The purpose-wise classification of credit indicates that a major share of credit has been towards trading (29 per cent), consumption related activities (19 per cent) and real estate development and housing (16 per cent).

The utilisation of credit from the banking sector by the government increased due to higher than expected government recurrent expenditure and less utilisation of the resources available in the non-bank sector during 2006. Net Credit to the Government (NCG) from the banking system during the year increased by Rs.88 billion against the Rs.6 billion expected in the monetary programme and the increase of Rs 26 billion in 2005. NCG from the Central Bank on account of increased holdings of Treasury bills and provisional advances increased by Rs. 38 billion while the balance Rs.50 billion came from commercial banks. NCG from commercial banks increased due to foreign currency borrowings by the government from OBUs, net issues of SLDBs to commercial banks, increased overdraft facilities and increased holdings of government securities.

Increased borrowings by some public corporations also contributed to the excessive monetary expansion in 2006. Credit to public corporations increased significantly, particularly towards the latter part of the year with CPC raising its borrowings from commercial banks. The overall increase during 2006 was at Rs. 15 billion while credit granted to CPC

Table 7.2 Underlying Factors of Reserve Money and Broad Money

Rs.billion

Item	End 2005 (b)	End 2006 (a) (b)	Change 2005 Amount	Change 2005 %	Change 2006 Amount	Change 2006 %
Reserve Money	197.9	239.9	27.0	15.8	42.0	21.2
Net Foreign Assets of the Central Bank	196.9	229.9	45.2	29.8	33.0	16.7
Net Domestic Assets of the Central Bank	1.0	10.0	-18.3	-94.8	9.0	892.6
Broad Money (M_{2b})	1,022.3	1,204.6	163.7	19.1	182.3	17.8
Net Foreign Assets	201.3	171.2	34.6	20.3	-30.2	-15.0
Monetary Authorities	196.9	229.9	45.2	29.8	32.9	16.7
Commercial Banks	4.4	-58.7	-10.6	-57.3	-63.1	-1,434.1
Net Domestic Assets	820.9	1,033.4	129.1	18.7	212.5	25.9
Domestic Credit	1,067.4	1,382.0	138.5	15.5	314.6	29.5
Net Credit to the Government	249.6	357.3	26.3	11.9	107.7(c)	43.1
Monetary Authorities	74.4	112.9	-33.7	-31.2	38.5	51.8
Commercial Banks	175.1	244.3	60.0	53.4	69.2	39.5
Credit to Public Corporations	16.7	31.6	-24.5	-59.5	14.9	89.0
Credit to the Private Sector	801.1	993.2	136.7	21.5	192.1	24.0
Other Items (net)	-246.4	-348.6	-9.4	-4.5	-102.2	-41.5

(a) Provisional

(b) Includes assets and liabilities of National Development Bank which merged with NDB Bank Ltd. with effect from August 2005.

(c) Restructuring bonds worth Rs. 19.4 billion which were issued by the government to the two state banks have been converted to Treasury bonds upon their maturity in October 2006. This amount, which previously appeared under Other Assets, has been included in Net Credit to the Government since October 2006.

Source: Central Bank of Sri Lanka.

alone amounted to Rs.14.5 billion. The balance increase in credit was absorbed by the Ceylon Electricity Board and the Ceylon Fertiliser Corporation.

Financial Survey

The growth in broad money as measured by the financial survey (M_4) increased in a range of 15-19 per cent during 2006. Although the broad money based on financial survey increased at a high rate, it is lower than the recorded growth rate in the consolidated broad money (M_{2b})[1] . The expansion in money supply as measured in the financial survey was entirely due to the increase in NDA of the banking system and registered finance companies.

7.4 Interest Rates

Market interest rates moved up by end 2006 following the increase in Central Bank policy rates during the second half of the year, the decline in market liquidity and increase in inflation and inflation expectations. Market liquidity declined with the Central Bank mopping up excess liquidity on a permanent basis. Moral suasion to discourage commercial banks relying on reverse repurchase

Table 7.3 Sectoral Distribution of Loans and Advances by Commercial Banks (a)

Rs.billion

Sector	End 2005	End 2006	As a % of Total End 2006	Change % 2005	Change % 2006
Commercial	213.4	240.1	29.1	14.7	12.5
of which: Exports	48.5	46.3	5.6	-4.0	-4.4
Imports	65.8	74.9	9.1	3.3	13.8
Financial	34.0	50.7	6.1	36.1	49.2
Agricultural	28.1	32.2	3.9	41.7	14.6
Industrial (b)	63.4	72.2	8.7	21.2	14.7
Tourism	9.9	12.4	1.5	40.6	25.3
Housing	94.5	133.6	16.2	27.0	41.4
Consumption	113.4	160.4	19.4	33.5	41.4
Services	43.3	43.4	5.3	13.6	0.4
Other	55.3	80.3	9.7	67.3	45.3
Total	655.3	825.8	100.0	25.8	26.0

(a) Advances include loans, overdrafts and bills discounted and exclude cash items in process of Collection.

(b) Includes advances granted for engineering and building trade, mining and fishing.

Source : Central Bank of Sri Lanka

[1] The financial survey is a broader measure of liquidity, which includes the activities of licensed specialised banks and registered finance companies in addition to the Central Bank and licensed commercial banks. Some of the assets included in the financial survey are less liquid than the assets included in M_{2b}. Therefore, M_{2b} is considered to be a better measure as an intermediate target in the conduct of monetary policy than the measure of liquidity provided by the financial survey.

Table 7.4 **Finacial Survey and Underlying Factors**

Rs.billion

Item	End 2005	End 2006 (a)	Change			
			2005		2006	
			Amount	%	Amount	%
Financial Survey	1,293.9	1,501.6	199.9	18.3	207.7	16.1
Underlying factors						
Net Foreign Assets	195.8	151.0	34.3	21.2	-44.8	-22.9
Net Domestic Assets	1,098.2	1,350.6	165.6	17.8	252.4	23.0
Domestic Credit	1,411.4	1,797.9	206.2	17.1	386.5	27.4
Net Credit to the Government	409.4	510.7	55.2	15.6	101.4	24.8
Credit to Public Corporations	16.7	31.6	-25.0	-59.9	14.9	89.4
Credit to the Private Sector	985.4	1255.7	175.9	21.7	270.3	27.4
Other Items (net)	-313.2	-447.4	-40.6	14.9	-134.2	42.8

(a) Provisional

Source: Central Bank of Sri Lanka.

facility also had an impact on market interest rates to increase. Following the upward revisions in policy interest rates of major economies, international market interest rates also increased, leading to increases in interest rates applicable to foreign currency denominated deposits and lending during the year.

Money Market Rates

Money market interest rates were volatile during 2006, reflecting the volatility in overall market liquidity, but the trend broadly followed the policy rate revisions of the Central Bank. The daily OMO auctions were not held on most days during the second half of 2006, as the liquidity in the market was broadly in balance and to discourage the regular use of Reverse Repo facility by the commercial banks. The weighted average yield rate at the daily OMO auctions increased from 9.29 per cent at end 2005 to 11.06 per cent at end 2006. The weighted average OMO rate was mostly within the policy interest rate corridor during the year.

An upward trend amidst some volatility was seen in other short-term interest rates as well reflecting higher inflation expectations especially during the second half of 2006. The weighted average call money rate was quite volatile in a range of 9.89-16.01 per cent during 2006. It reached 14.47 per cent at the end of 2006, which is higher by 374 basis points compared to 10.73 per cent at end 2005. Despite the impact on call market rates from increased policy rates, the main reason for the large upward movement was due to the discouragement of the provision of liquidity through Reverse Repurchase facility. The tax adjusted weighted average call money rate moved above the upper bound of the interest rate corridor towards the end of 2006, reflecting the deficit in market liquidity. It remained around 13.00 per cent by end December 2006. Similarly, the Sri Lanka Inter Bank Offered Rate (SLIBOR)[2] also has been volatile in 2006. The rise in market interest rates however is expected to contain excessive growth in private sector credit in 2007.

[2] SLIBOR is the average of the offered rates for inter-bank rupee transactions by 12 commercial banks.

Table 7.5 **Changes in Policy Interest Rates of the Central Bank**

Per cent

Date	Repo Rate	Reverse Repo Rate	Bank Rate
07.01.2003	9.00	11.00	18.00
09.05.2003	8.25	10.25	18.00
15.08.2003	7.50	9.50	15.00
16.10.2003	7.00	8.50	15.00
10.11.2004 (Close of Business)	7.50	9.00	15.00
13.05.2005	7.75	9.25	15.00
15.06.2005	8.25	9.75	15.00
13.09.2005	8.50	10.00	15.00
22.12.2005	8.75	10.25	15.00
16.06.2006	9.00	10.50	15.00
24.07.2006	9.125	10.625	15.00
28.09.2006	9.625	11.125	15.00
15.12.2006	10.00	11.50	15.00

Source: Central Bank of Sri Lanka

Box 10

An Update on the Comparison of Interest Spread and Interest Margin in South Asia

The Central Bank Annual Report 2004 presented a regional comparison of interest spread[1] and interest margin[2] in Box Article 2 and an update was set out in Box Article 16 of the Annual Report of 2005. Updated information up to 2005 reveals that both interest spread and interest margin in the Sri Lankan banking sector are still the highest in the region.

The issue of high spreads maintained by banks needs to be addressed through economising operational costs at a sustainable low level while improving the overall risk management. Consolidation in the banking sector may help reduce the intermediation cost by improving returns to scale in the banking industry. Further, improvements to operational efficiency of state banks and diversification of banking operations beyond the core business would help reduce dependence on net interest income and assist reducing the interest spread.

Table B 10.1
Interest Spread and Interest Margin of Commercial Banks : 2002 - 2005

(% of Assets)

	India	Pakistan	Bangladesh	Sri Lanka
Interest Spread				
2002	2.2	1.8	0.5	3.8
2003	2.6	2.2	1.6	4.7
2004	2.9	2.1	1.2	4.2
2005	2.6	3.0	2.5	4.2
Interest Margin				
2002	2.8	3.1	1.0	3.8
2003	3.1	3.0	1.9	4.2
2004	3.1	2.9	2.0	3.9
2005	3.0	4.1	2.4	4.1
Operational Cost				
2002	2.2	2.7	1.9	3.8
2003	2.4	2.5	1.8	4.0
2004	2.3	2.4	1.8	3.9
2005	2.3	2.4	1.9	3.6
Return on Assets				
2002	1.0	0.6	0.5	0.9
2003	1.2	1.2	0.5	1.1
2004	1.0	1.3	0.7	1.1
2005	1.0	2.0	0.8	1.2
Return on Equity				
2002	17.5	14.3	12.4	20.5
2003	19.0	20.5	10.6	21.1
2004	14.1	19.8	14.3	18.3
2005	16.5	25.4	14.5	16.8

Source: Central Bank of Sri Lanka

[1] Interest Spread (%) = $\left[\frac{\text{Interest Income}}{\text{Average of (Interest Earning Assets + NPLs + Statutory Reserves with Central Bank + Cash in Hand)}}\right]$ (%) - $\left[\frac{\text{Interest Expenses}}{\text{Total Deposits and Borrowings}}\right]$ (%)

[2] Interest Margin = $\frac{\text{Interest Income - Interest Expenses}}{\text{Average Assets}}$ (%)

Table 7.6 Money Market Rates (a)

Per cent

	Central Bank Repo Rate	Weighted Average Repo Auction Rate	Weighted Average Call Money Rate	SLIBOR-Overnight
Dec-04	7.50	7.84	9.73	9.66
Dec-05	8.75	9.29	10.73	10.93
Mar-06	8.75	9.27	10.33	10.47
Jun-06	9.00	9.76	10.58	11.10
Sep-06	9.63	13.83	14.36	15.25
Dec-06	10.00	11.06	14.47	14.73

(a) Month-end values

Source: Central Bank of Sri Lanka

Deposit and Lending Rates

Both deposit and lending rates of commercial banks as well as other long term lending institutions increased in 2006. Interest spread measured by the difference between average interest income and average interest expenditure narrowed during the first half of 2006, with relatively larger upward adjustments in deposit rates by the banks with a view of increasing their deposit base. However, it widened during the second half of 2006, since the lending rates increased notably along with upward adjustments in the market interest rates without much upward adjustments in the deposit rates.

Table 7.7 Interest Rates on Deposits and Lending (a)

Per cent

Institution	End 2005	End 2006
Commercial Banks		
Interest Rates on Deposits		
Savings Deposits	3.00-10.25	3.0-10.50
Average Weighted Deposit Rate (AWDR)	6.24	7.60
Average Weighted Fixed Deposit Rate (AWFDR)	9.25	11.50
Foreign Currency Savings Deposits - US Dollars	0.20-3.00	0.20-4.25
Foreign Currency Fixed Deposits (1-Year)-Dollars	1.50-4.60	2.00-5.50
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	12.24	15.19
Average Weighted Lending Rate (AWLR)	15.36	16.56
Foreign Currency Loans - US Dollars	2.00-7.00	4.00-10.00
Non-Commercial Bank Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
One year Fixed Deposits	9.00	11.00
State Mortgage and Investments Bank		
One year Fixed Deposits	9.20	13.50
DFCC Bank		
One year Fixed Deposits	10.00	12.50
Interest Rates on Lending		
National Savings Bank (b)	10.00-12.00	12.00-13.00
State Mortgage and Investments Bank (b)	12.00-13.25	15.00-16.50
DFCC Bank	5.00-17.00	15.00-18.00
National Housing Development Authority (b)	11.00	11.00

(a) Based on the rates quoted by commercial banks and non-commercial bank financial institutions
(b) Lending for housing purposes only.

Source: Central Bank of Sri Lanka

The Average Weighted Prime Lending Rate (AWPR)[3] declined in first half of 2006, but increased thereafter following the other market interest rates. The decline during the first half of 2006 was a reflection of increased market liquidity. However, during the second half of the year though it had some volatility, generally there was an upward trend. Accordingly, AWPR increased by 295 basis points from 12.24 per cent at end 2005 to 15.19 per cent by end of 2006. The Average Weighted Lending Rate (AWLR), which is the lending rate applicable to the entire loan portfolio of domestic banking units of commercial banks, increased gradually during 2006.

The Legal Rate and the Market Rate increased with the increase in deposits rates of the commercial banks. The Legal Rate and the Market Rate[4] applicable for a particular calendar year are computed on the same basis using the Average Weighted Deposit Rate (AWDR)[5] of all the commercial banks and are published in the Government Gazette at the end of the preceding year. Hence, both the Legal Rate and Market Rate are identical. The rate applicable for the year 2007 is 6.86 per cent compared with 5.70 per cent for 2006.

Interest rate applicable to foreign currency deposits and lending also increased in 2006 with the increase in international interest rates following tightening of monetary policy in major economies.

[3] AWPR is the average weighted lending rate charged by commercial banks from their most creditworthy (prime) customers.

[4] 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.

[5] AWDR is the weighted average of the interest rates on all outstanding interest bearing deposits of commercial banks.

Yields on Government Securities

Yields on government securities increased at a slower rate during the first nine months of 2006 and increased at a relatively higher rate thereafter in line with the increases in policy interest rates and inflation expectations. Market preference was seen for short-term and medium-term maturities, which could be due to uncertainities about future interest rate changes.

The increase in yields on Treasury bonds was lower than the increase in yields on Treasury bills, since the number of market based issues of Treasury bonds were lower in 2006 as the government relied more on private placements and bank borrowings. Yields on Treasury bills increased in a range of 246-266 basis points during the year, while yields on Treasury bonds with 3-5 year maturities increased in a range of 94-126 basis points. The issue of Treasury bonds was made mainly through private placements.

The secondary market yield curve on government securities moved upward particularly towards the end of 2006. The yield curve was less steep, as evidenced by the yield spread between 1-year Treasury bills and 4-year Treasury bonds which was only 72 basis points compared to 97 basis points in 2005, possibly reflecting market uncertainties of future inflation and interest rate movements. The spread between the primary market yields and secondary market yields narrowed down, with the upward movement of yields in the primary market by the end of the year.

7.5 Further Developments and Monetary Policy Issues

Having a more representative index to reliably measure movements in the aggregate price level is imperative for effective monetary policy decision making. It needs to reflect the current consumption pattern of an average consumer and should cover broader geographical spread. Considering this vital requirement, measures have already been taken to compile a new price index by the Department of Census and Statistics in 2007.

As inflation expectations of market participants has a strong relationship with inflation, the Central Bank recognises this need to take measures to deal with inflation expectations in its monetary policy formulation. As this necessitates measuring inflation expectations, the Central Bank has already conducted an inflation expectation survey with a wider coverage of market participants and further improvements expected to be made to enhance its effectiveness.

The achievement of monetary targets largely depends on the fiscal consolidation, and therefore reliance of fiscal sector on banking resources has to be in line with the expectations in the government budget. Any increase in borrowings from the banking sector would exert inflationary pressures while limiting the availability of resources for investment in the private sector, which in turn will affect growth objectives of the economy.