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MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

7.1 Overview

In view of the COVID-19 pandemic that posed significant challenges for businesses and individuals, the Central Bank initiated several measures to relax monetary conditions to unprecedented levels, within a growth, recovery and stability focused monetary policy stance in 2020. Extraordinary monetary accommodation aimed at facilitating domestic investment to take off was made possible by headline and core inflation remaining at low levels, in the context of well anchored inflation expectations and subdued aggregate demand, as well as the restrictions that were imposed on non-essential imports and outward investment. In 2020, the policy interest rates were reduced five times by a total of 250 basis points, the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks (LCBs) was reduced on two occasions by a total of 3 percentage points, and the Bank Rate was reduced by 650 basis points, alongside other key policy changes. The Central Bank provided required funding for the Government throughout the year, which also contributed to enhancing market liquidity. Further, the Central Bank implemented highly concessional loan schemes for working capital purposes for businesses affected by the pandemic and also initiated direct measures to reduce certain lending rates, which were considered excessive, while imposing maximum interest rates on mortgage-backed housing loans. As a combined result of these measures, the overall interest rate structure of the economy adjusted downwards, with certain market interest rates reaching historical lows. As a result of these developments, a revival in the overall expansion of credit to the private sector was observed towards the latter part of 2020, while credit to the public sector increased substantially during the year, resulting in a rapid expansion of broad money supply.

7.2 Monetary Policy Stance of the Central Bank of Sri Lanka

The Central Bank followed an accommodative monetary policy stance throughout 2020, focusing on growth, recovery and stability, given muted inflation and well anchored inflation expectations. The COVID-19 outbreak and the resultant containment measures contracted economic activity, requiring the Central Bank to maintain an extremely accommodative monetary policy stance to support the recovery of the economy. Accordingly, the monetary easing cycle, which commenced in May 2019, continued through 2020 with a significant reduction in policy interest rates and the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks (LCBs). The Central Bank reduced the policy interest rates by a total of 250 basis points and the SRR by a total of 3 percentage points in 2020. In January 2020, the Central Bank reduced its policy interest rates, namely, the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), by 50 basis points to 6.50 per cent and 7.50 per cent, respectively. Following the outbreak of COVID-19 in the country from March 2020, the Central Bank acted promptly to maintain confidence in the market by way of a series of measures aimed at reducing the cost of funds further, increasing liquidity in the domestic money market and signalling the commitment to maintaining an accommodative policy stance in the period ahead. Accordingly, the Central Bank reduced policy rates further by a total of 100 basis points in three monetary policy reviews between March and May 2020. Moreover, to increase liquidity in the money market amidst heightened uncertainty emanating from cashflow disruptions and emergency funding requirements of financial institutions, the Central Bank reduced the SRR by 1 percentage point in March 2020, and

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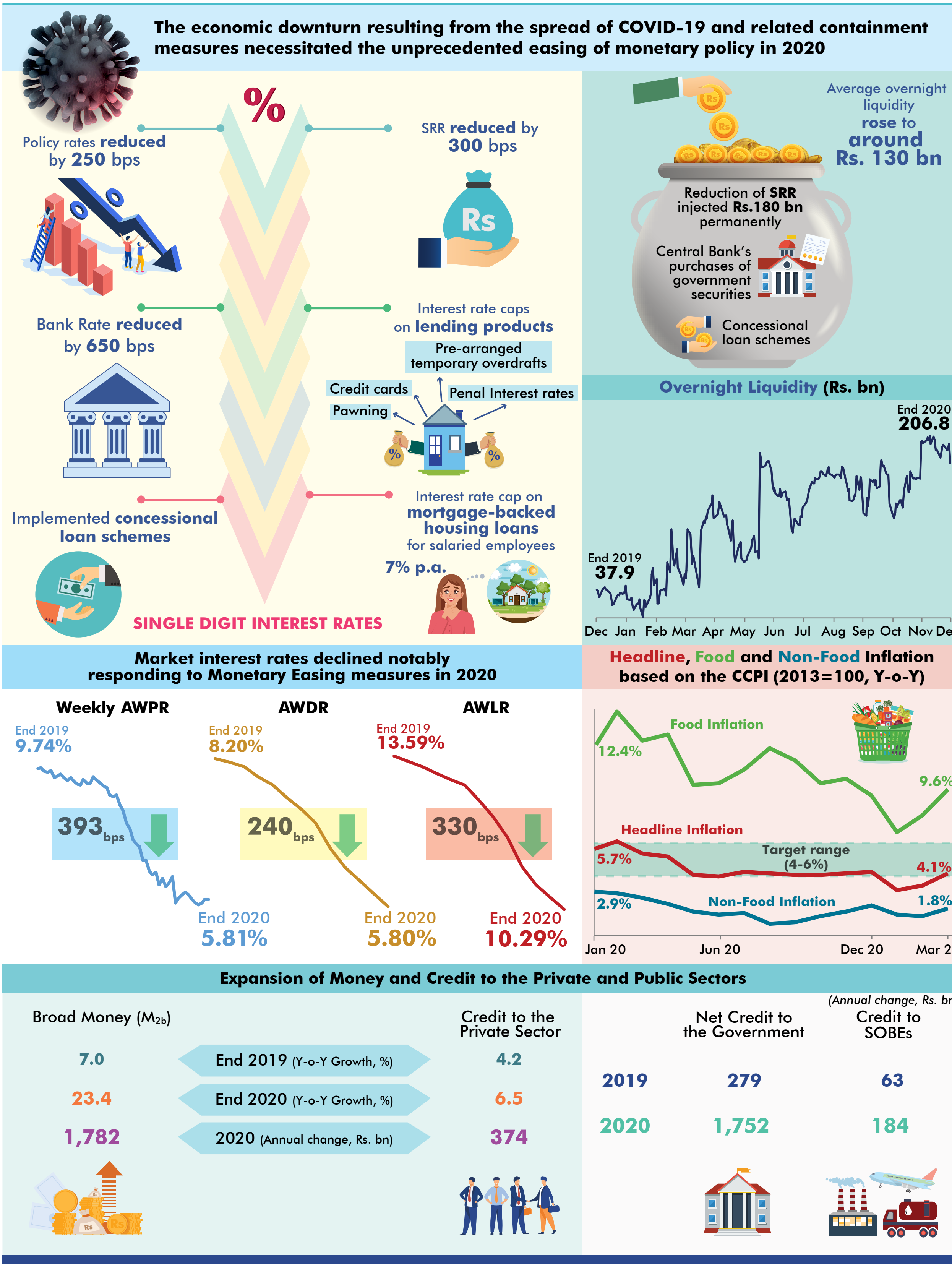
Table 7.1
Recent Monetary Policy Measures

Date	Measure
19 Feb 2016	SDFR and SLFR increased by 50 basis points to 6.50% and 8.00%, respectively.
28 Jul 2016	SDFR and SLFR increased by 50 basis points to 7.00% and 8.50%, respectively.
24 Mar 2017	SDFR and SLFR increased by 25 basis points to 7.25% and 8.75%, respectively.
04 Apr 2018	SLFR reduced by 25 basis points to 8.50%. Accordingly, the width of the SRC narrowed to 125 basis points from 150 basis points.
14 Nov 2018	SRR reduced by 1.50 percentage points to 6.00% to be effective from the reserve period commencing 16 Nov 2018. SDFR increased by 75 basis points to 8.00% and SLFR increased by 50 basis points to 9.00%. Accordingly, the width of the SRC narrowed to 100 basis points from 125 basis points.
22 Feb 2019	SRR reduced by 1.00 percentage point to 5.00% to be effective from the reserve period commencing 01 Mar 2019.
31 May 2019	SDFR and SLFR reduced by 50 basis points to 7.50% and 8.50%, respectively.
23 Aug 2019	SDFR and SLFR reduced by 50 basis points to 7.00% and 8.00%, respectively.
30 Jan 2020	SDFR and SLFR reduced by 50 basis points to 6.50% and 7.50%, respectively.
17 Mar 2020	SDFR and SLFR reduced by 25 basis points to 6.25% and 7.25%, respectively.
17 Mar 2020	SRR reduced by 1.00 percentage point to 4.00% to be effective from the reserve period commencing 16 Mar 2020.
27 Mar 2020	Introduced a concessional loan scheme, the Saubagya COVID-19 Renaissance Facility (Phase I - Refinance Scheme), up to a cumulative value of Rs. 50 billion at an interest rate of 4.00% to support the businesses affected by COVID-19.
03 Apr 2020	SDFR and SLFR reduced by 25 basis points to 6.00% and 7.00%, respectively, to be effective from the close of business on 03 Apr 2020.
16 Apr 2020	Bank Rate reduced by 500 basis points to 10.00% and allowed to automatically adjust in line with SLFR, with a margin of +300 basis points.
06 May 2020	SDFR and SLFR reduced by 50 basis points to 5.50% and 6.50%, respectively, to be effective from the close of business on 06 May 2020. Bank Rate automatically reduced to 9.50%.
16 Jun 2020	SRR reduced by 2.00 percentage points to 2.00% to be effective from the reserve period commencing 16 Jun 2020.
16 Jun 2020	Extended the concessional loan scheme introduced on 27 Mar 2020 up to Rs. 150 billion at an interest rate of 4.00% to support the businesses affected by COVID-19 (the Saubagya COVID-19 Renaissance Facility - Phase II).
09 Jul 2020	SDFR and SLFR reduced by 100 basis points to 4.50% and 5.50%, respectively. Bank Rate automatically reduced to 8.50%.

Source: Central Bank of Sri Lanka

Note: The Central Bank imposed caps on interest rates as follows:
- 26.04.2019: Imposed interest rate caps on deposit products of licensed banks and non-bank financial institutions
- 24.09.2019: Imposed caps on lending rates while withdrawing caps on deposit rates of licensed banks
- 27.04.2020: Imposed interest rate caps on pawning advances of licensed banks
- 24.08.2020: Tightened interest rate caps on selected lending products
- 26.11.2020: Introduced maximum interest rates on mortgage-backed housing loans
- 19.01.2021: Decided to introduce priority sector lending targets for the MSME sector in consultation with the banking community

Figure 7.1
Monetary Sector Performance



Broad Money (M_{2b})		Credit to the Private Sector
7.0	End 2019 (Y-o-Y Growth, %)	4.2
23.4	End 2020 (Y-o-Y Growth, %)	6.5
1,782	2020 (Annual change, Rs. bn)	374

	Net Credit to the Government	Credit to SOBEs
2019	279	63
2020	1,752	184

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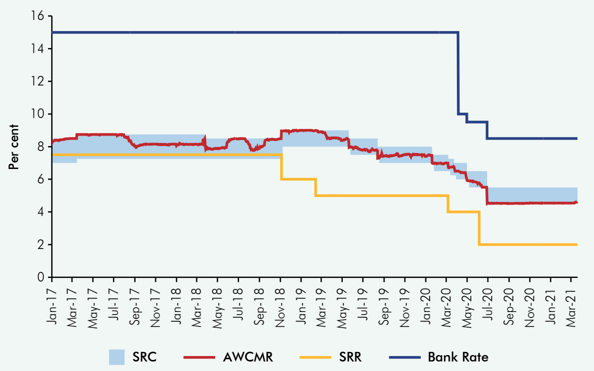
Figure 7.2
The Standing Rate Corridor (SRC), the Average Weighted Call Money Rate (AWCMR), the Statutory Reserve Ratio (SRR) and the Bank Rate



Source: Central Bank of Sri Lanka

again by 2 percentage points in June 2020, thereby releasing about Rs. 180 billion of additional liquidity. Further, the Central Bank introduced concessional credit schemes under the Saubagya COVID-19 Renaissance Facility enabling licensed banks to grant working capital loans at low interest rates to businesses affected by the pandemic. Despite the reduction in the policy interest rates and the SRR by mid-2020, the adjustment in lending rates remained sluggish. Hence, in July 2020, the Central Bank further reduced its policy rates, i.e., the SDFR and the SLFR, by 100 basis points each, to their lowest levels of 4.50 per cent and 5.50 per cent, respectively. Meanwhile, in order to signal the availability of emergency funding for the financial sector at an affordable cost, the Central Bank reduced the Bank Rate by 500 basis points in April 2020, while allowing it to be determined automatically with a margin of 300 basis points above the SLFR. Accordingly, the Bank Rate declined by a total of 650 basis points to 8.50 per cent by end 2020. The Central Bank implemented further regulatory measures in August 2020 to reduce excessive interest rates charged on credit cards, pawning, pre-arranged temporary overdrafts as well as penal interest rates, thereby quickening the monetary policy transmission process and helping marginal borrowers. Overall, measures to ease monetary policy and monetary conditions were aimed at promoting domestic investment, which had remained subdued for a prolonged period, as well as supporting the pandemic-affected economy to revert to a higher growth path early. Considering the setbacks to the government cashflows due to the pandemic, the Central Bank provided financial support to the Government by way of purchasing Treasury bills from the primary market. This helped increase market liquidity, and lower yields on government securities, which was also supported by the imposition of maximum yield rates for acceptance at primary auctions, thus reducing the Government's financing cost substantially during this period. However, the notable increase in the government securities holdings of the Central Bank reflects the likelihood of a buildup of future inflationary pressures, and therefore necessitates the timely rollback of monetary stimuli, once aggregate demand conditions normalise on a sustainable basis. Meanwhile, the Central Bank implemented further measures to revive economic activity following the second wave of COVID-19 in the country. Accordingly, the Central Bank introduced a maximum interest rate of 7 per cent per annum on mortgage-backed housing loans for a tenure of at least five years for salaried employees. Reflecting the impact of policy and regulatory measures, market lending rates declined notably during the year. With the reduction in lending rates and improved market sentiments, credit to the private sector rebounded since August 2020. However, as most of such credit was in the form of personal loans and advances, the Central Bank initiated further measures to support the needy sectors of the economy by announcing priority sector lending targets for banks on the micro, small and medium scale enterprises (MSME) sector in January 2021.

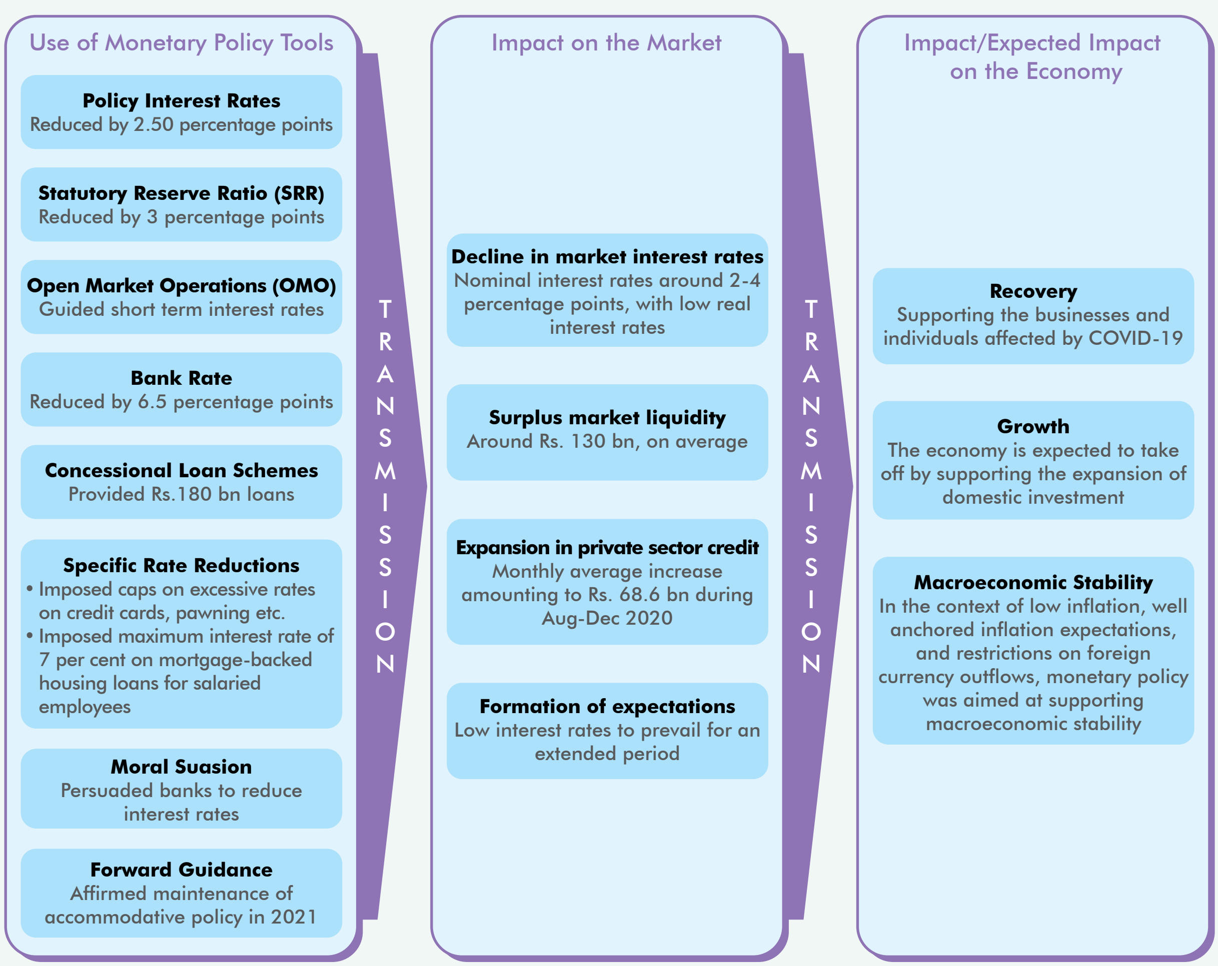
BOX 5
Monetary Policy Tools deployed by the Central Bank of Sri Lanka during 2020

The unprecedented impact of COVID-19 on economies and financial markets prompted central banks across the globe to take extraordinary measures to address the financial distress created by the pandemic and support their economies. In addition to traditional monetary policy tools, many central banks deployed unconventional monetary policies, including quantitative easing, targeted credit programmes, and forward guidance to maintain low interest rates.

The Central Bank of Sri Lanka also deployed an array of monetary policy tools in 2020, while being one of the first central banks in the world to ease monetary policy citing the outbreak of COVID-19. These policies, including unconventional measures, were executed at an extraordinary pace, size, and scope, aimed at injecting sufficient liquidity into the market and lowering borrowing costs, thus supporting financial markets and the recovery of economic activity. Subdued demand and inflationary conditions provided the necessary policy space for the undertaking of such extensive monetary policy stimulus. These monetary policy measures were complemented by the fiscal stimuli provided by the Government and a multitude of other regulatory and operational actions taken by the Central Bank.

Given the need to ensure a rapid recovery in economic activity, the return to a high growth path after a prolonged period of subdued growth, and to support macroeconomic and financial system stability, the Central Bank reduced its policy interest rates substantially by 2.50 percentage points during 2020, with a view to enhancing credit flows by lowering real interest rates, which in turn would support domestic investment, production and consumption in the economy. Further, the Central Bank lowered the Bank Rate by 6.50 percentage points during the year to signal the

Figure B 5.1
Monetary Policy Tools adopted by the Central Bank in 2020 and their Impact



availability of emergency funding for the financial sector at an affordable cost.

To enhance liquidity in the domestic money market and help financial institutions, businesses, and individuals, that were in distress due to disruptions to cashflows, the Central Bank lowered the Statutory Reserve Ratio (SRR) by a total of 3 percentage points, thereby directly injecting liquidity of around Rs. 180 billion to the market immediately, in 2020.

Open Market Operations (OMO) conducted by the Central Bank guided short term interest rates to remain at low levels while maintaining sufficient liquidity in the money market. Further, the Central Bank provided urgent financial assistance to the Government, in order to support businesses and individuals affected by the pandemic, by purchasing Treasury bills from the primary market, totaling around Rs. 625 billion, on a net basis, during the year. This also helped improve liquidity in the domestic money market and helped reduce yields on government securities by around 2-3 percentage points.

Concessional loan schemes were implemented by the Central Bank (under the Saubagya COVID-19 Renaissance Facility) to provide funding to meet working capital requirements of businesses affected by the pandemic. Total funds provided by the Central Bank under these schemes amounted to around Rs. 180 billion, at a concessional rate of 4 per cent, thereby providing direct relief to businesses, particularly to Micro, Small and Medium scale Enterprises (MSMEs), to continue operating through times of great difficulty.

The Central Bank continued to use moral suasion during 2020 to persuade commercial banks to reduce market interest rates in line with the monetary policy expectations and also influence banks to provide essential liquidity support to pandemic-affected entities, by maintaining constant dialogue with banks. Policy measures that were implemented in consultation with the banking community since 2019 to provide relief to economic activities following the Easter Sunday attacks and to ensure a sustained reduction in market lending rates also contributed to the effectiveness of this endeavour.

Forward guidance was also used as a tool by the Central Bank to convince the stakeholders of the economy that the prevailing accommodative monetary policy stance would be maintained until the economy shows strong signs of recovery. Such guidance was instrumental in dispelling adverse speculation on the possible rise in interest rates in the near future. Further, it helped maintain the momentum of declining market interest rates, while supporting the cause of ensuring a single digit interest rate structure in the medium to long term, thereby passing the benefit of the sustained low inflation environment to domestic investors.

The Central Bank also adopted targeted measures by imposing maximum interest rates on certain financial products with excessive interest rates, thereby improving the monetary policy transmission mechanism as well. Further, measures were taken to introduce priority sector lending targets for licensed banks on MSMEs.

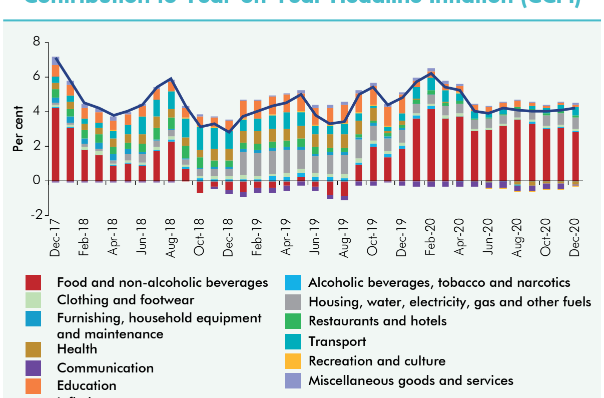
The series of monetary policy tools deployed by the Central Bank throughout 2020 amidst the COVID-19 pandemic greatly facilitated the maintenance of financial system stability under extremely challenging circumstances. Supported by such extraordinary monetary accommodation, along with the fiscal stimulus measures, the economy has already shown signs of steady recovery, and it is expected that the current low interest rate environment will help the economy to revert to a high growth path, alongside the implementation of reforms required for such growth.

Moreover, the Central Bank provided forward guidance to the market on the maintenance of accommodative monetary policy through 2021, thereby dispelling speculation of rising interest rates in the near term. The maintenance of the low interest rate structure was also supported by the prevailing restrictions on non-essential imports and other foreign exchange outflows. The conduct of monetary policy in 2020 focused more on reviving economic activity in the near term as inflation remained subdued, reflecting the impact of the pandemic on aggregate demand. The Central Bank conducted monetary policy under its flexible inflation targeting (FIT) framework with the objective of maintaining inflation within the target range of 4-6 per cent in the medium term with due regard to aggregate demand conditions.

The Central Bank strengthened its communication through various platforms during the pandemic in order to disseminate information on policy actions and provide assurance to stakeholders on the Central Bank's readiness to support the revival of the economy, while improving the transmission of monetary easing measures adopted during 2020. With the strict social distancing measures that were put in place, the Central Bank moved towards virtual communication modes during the year. Accordingly, monetary policy press conferences were conducted online while livestreaming the same on social media. Further, the Central Bank used social media networks to communicate monetary policy related information, among others. Meanwhile, the *Roadmap: Monetary and Financial Sector Policies for 2021 and Beyond,* was announced online by the Governor of the Central Bank at the beginning of 2021 to apprise the market on broad-based strategies on macroeconomic policies in the period ahead. The Central Bank announced the forthcoming publication of the 'Monetary Policy Report' (MPR) commencing 2021, with a more forward-looking focus on the economy, in addition to actual realisations. Moving towards publishing the MPR, the Central Bank commenced incorporating medium term projections on inflation into the monetary policy review press releases in 2020 to help guide inflation expectations of stakeholders. Meanwhile, information on macroeconomic developments was regularly published in the publications of the Central Bank, including the Annual Report and the Recent Economic Developments Report, in all three languages, without delay, amidst challenges encountered due to COVID-19. In addition, key macroeconomic statistics were published on the Central Bank website in daily, weekly, monthly and quarterly frequencies.

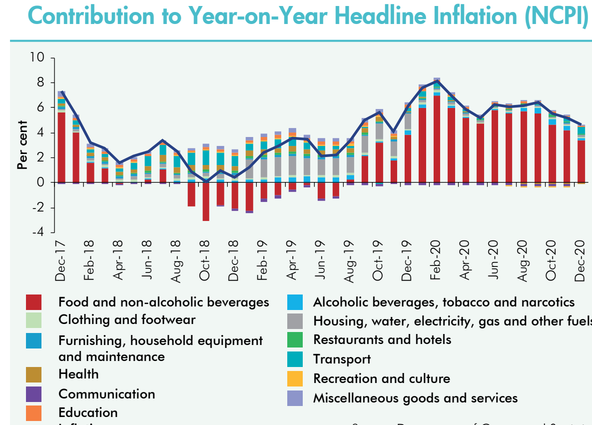
Subdued demand pressures, along with well anchored inflation expectations and administered price revisions helped maintain inflation at relatively low levels during 2020. As measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2013=100), headline inflation broadly remained within the targeted range of 4-6 per cent. Similarly, National Consumer Price Index (NCPI, 2013=100) based headline inflation, which registered an uptick at the beginning of the year, gradually subsided towards the end of the year. Headline inflation, as measured by the year-on-year change in the CCPI, peaked at 6.2 per cent in February 2020, mainly driven by high food inflation owing to adverse weather conditions. This gradually subsided along with the moderation of food and non-food inflation and recorded 4.2 per cent at the end of the year. Supply side disruptions exerted upward pressures on food inflation during the most part of 2020. On an annual average basis, CCPI based headline inflation was marginally higher at 4.6 per cent at end 2020, compared to 4.3 per cent recorded at end 2019. Year-on-year headline inflation based on the NCPI, which followed a similar pattern to that of CCPI based headline inflation, peaked at 8.1 per cent in February 2020 before gradually decelerating to 4.6 per cent by December 2020. NCPI based headline inflation remained high, compared to CCPI

Figure 7.3
Contribution to Year-on-Year Headline Inflation (CCPI)



Source: Department of Census and Statistics

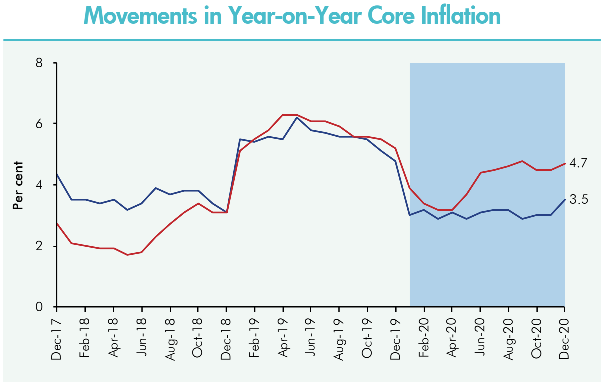
Figure 7.4
Contribution to Year-on-Year Headline Inflation (NCPI)



Source: Department of Census and Statistics based headline inflation, due to the larger weight of the food category in the NCPI basket. Annual average NCPI based headline inflation accelerated to 6.2 per cent in December 2020, compared to 3.5 per cent at end 2019, largely due to persistently high food inflation.

Core inflation, which reflects the underlying trend in inflation and hence more useful for monetary policy purposes, remained at low levels throughout 2020 reflecting subdued demand conditions. Downward adjustments to prices due to the reduction in Value Added Tax and the removal of Nation Building Tax, alongside the decline in prices of telecommunication and data services with the reduction of the Telecommunication Levy effective December 2019, eased the increase in the core inflation index at the beginning of the year. These factors, along with the favourable statistical base effect contributed to the deceleration in core inflation during 2020. Accordingly, year-on-year core inflation based on the CCPI reached 3.5 per cent at end 2020, compared to 4.8 per cent recorded at end 2019. Annual average core inflation also remained at a low level of 3.1 per cent in December 2020, in comparison to 5.5 per cent at end 2019. Following a similar trend, year-on-year core inflation based on the NCPI decelerated from 5.2 per cent at end 2019 to

Figure 7.5
Movements in Year-on-Year Core Inflation



Source: Department of Census and Statistics

4.7 per cent by end 2020. However, the statistical base effect contributed to an increase in NCPI based year-on-year core inflation in mid-2020. Annual average core inflation based on the NCPI also decelerated to 4.1 per cent, year-on-year, by end 2020 from 5.7 per cent recorded at end 2019.

As reflected in the Inflation Expectations Survey of the Central Bank, inflation expectations of the corporate sector in 2020 remained well anchored, especially during the second half of the year, while those of the household sector remained elevated. Inflation expectations of the corporate sector were on the high side during early 2020, before decelerating and settling around mid-single digit levels in the remainder of the year. Subdued aggregate demand amidst the outbreak of COVID-19 and the expected favourable developments on the domestic supply side were among the major factors that drove inflation expectations of the corporate sector. Household sector respondents expected future inflation to remain at high levels throughout the year, highlighting factors such as expected decline in domestic production along with the impact of COVID-19, import restrictions, depreciation of the Sri Lankan rupee, and increased government expenditure during the times of elections. However, both corporate and household sector respondents expected upward pressures on inflation in the period ahead due to the anticipated recovery in aggregate demand as the impact of COVID-19 fades away and due to the pent-up demand.

7.3 Movements of Interest Rates

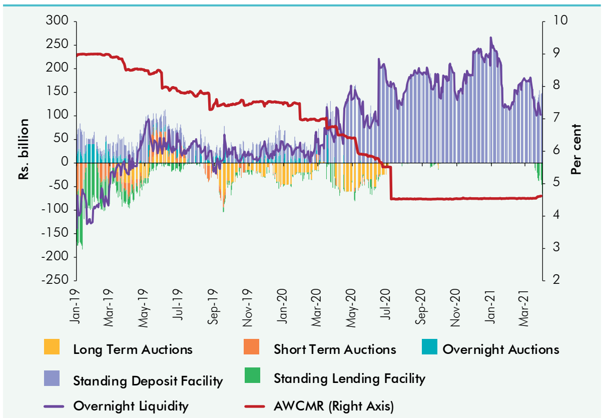
Market Liquidity and Short-Term Interest Rates

Rupee liquidity in the domestic money market remained in surplus levels during 2020, reflecting the impact of the accommodative monetary policy stance, purchase of Treasury

bills by the Central Bank from the primary market and other operational measures implemented by the Central Bank. Domestic money market liquidity, which remained broadly in surplus levels since mid-April 2019, was maintained at significantly high levels since the outbreak of COVID-19, thereby providing sufficient space for financial markets to support the affected businesses and individuals, and the recovery in economic activity. Reductions in the SRR[1] in March and June 2020, the Central Bank's purchases of government securities from the primary market, transfers of distributable profits of the Central Bank to the Government, the Central Bank's purchases of foreign currency from the domestic foreign exchange market, entering into foreign currency swap agreements with licensed banks, and the disbursement of credit through the Saubagya COVID-19 Renaissance Facility schemes, resulted in a notable increase in domestic money market liquidity during this period. Moreover, additional liquidity was provided to standalone primary dealers as required through the liquidity support facility (LSF). Subsequently, overnight money market liquidity increased to around Rs. 220 billion by mid-June 2020 and the Central Bank allowed this surplus liquidity conditions to remain in the market, thereby inducing downward pressure on market interest rates and encouraging credit disbursements. The Central Bank conducted term reverse repurchase auctions and provided liquidity through the LSF during the period from end September to mid-November 2020 amidst liquidity absorptions arising from the scheduled foreign loan repayments. Given these developments, the daily liquidity in the domestic money market, which on average remained around Rs. 30 billion in 2019, increased notably to around Rs. 130 billion in 2020. Further, driven by the purchases of government securities in the primary market by the Central Bank, money market liquidity, on average, increased to around Rs. 160 billion in the first quarter of 2021, despite occasional reductions in liquidity due to scheduled foreign loan repayments and maturities of government securities. Excess liquidity in the domestic money market was deposited at the Standing Deposit Facility (SDF) window of the Central Bank, while the access of the Standing Lending Facility (SLF) by some participants was observed during the period.

In response to the surplus liquidity conditions in the domestic money market, the AWCMR, which remained at the middle of the policy rate corridor at the beginning of 2020, declined and stayed closer to the lower bound of the policy rate corridor from end June 2020. Following the reduction in policy interest rates by 50 basis points by end January 2020, and the subsequent policy rate reductions by a total of 100 basis points during the period from March to May 2020, the AWCMR also declined, while continuing to remain around the middle of the policy rate corridor until mid-June 2020. With the reduction in the SRR by 2 percentage points in

Figure 7.6
Rupee Liquidity in the Domestic Money Market and Liquidity Management



Source: Central Bank of Sri Lanka

1 With the reduction of SRR to 2 per cent, the Central Bank also reduced the till cash adjustment for SRR compilation to 1 per cent from 2 per cent.

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Table 7.2
Selected Money Market Rates

Per cent per annum

	AWCMR		Overnight OMO Auction		SLIBOR Overnight (a)		SLIBOR 12 Month (a)	
	End Period	Average for the Month	Repo	Reverse Repo	End Period	Average for the Month	End Period	Average for the Month
Dec-17	8.15	8.13	7.25	-	8.15	8.15	12.18	12.19
Dec-18	8.95	8.96	-	8.98	9.00	9.00	11.80	11.77
Dec-19	7.45	7.51	-	7.50	7.51	7.54	10.33	10.42
Mar-20	6.75	6.87	6.76	6.76	6.75	6.87	9.13	9.40
Jun-20	5.52	5.71	-	5.88	5.53	5.74	8.50	8.51
Sep-20	4.53	4.52	-	-	-	-	-	-
Dec-20	4.55	4.54	-	-	-	-	-	-

(a) The compilation and publication of SLIBOR was discontinued with effect from 01 July 2020.

Source: Central Bank of Sri Lanka

mid-June 2020, a significant amount of additional liquidity was released to the market and the AWCMR declined towards the lower bound of the policy rate corridor. This downward adjustment in the AWCMR was also supported by the limited number of transactions in the interbank call money market amidst surplus liquidity conditions. Following the reduction in policy interest rates in July 2020, the AWCMR also declined by around 100 basis points and hovered around the lower bound of the policy rate corridor throughout the remainder of 2020. The weighted average rates on transactions in the repo market closely followed the movements of the AWCMR, in spite of some deviations due to the asymmetric distribution of liquidity, particularly among the standalone primary dealers. The weighted average rate on transactions in the repo market was recorded at 4.57 per cent by end 2020.

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Yields on Government Securities

The yields on government securities recorded a notable decline during 2020, reflecting the impact of monetary easing, investor preference for government securities amidst the pandemic, the Central Bank's purchases of government securities in primary auctions, and the imposition of maximum yield rates for acceptance on government securities auctions in the primary market. Accordingly, yields on government securities declined by 226-414 basis points, across all tenures,[2] in primary and secondary markets during the year, despite the notable increase in domestic financing by the Government amidst limited access to foreign financing. Increased uncertainties and negative sentiments due to the pandemic drove the banking sector towards risk-free assets to some extent. Maximum yield rates for acceptance were imposed by the Government on both Treasury bills and Treasury bonds at primary auctions, to guide the market on yield rates. Given the exceptional circumstances created by the pandemic, the Central Bank purchased under-allocated amounts of Treasury bills at primary market auctions, thereby fulfilling funding requirements of the Government and suppressing the yields on government securities. Nevertheless, some upward pressure on yields was observed, especially following the sovereign rating downgrades and also during the auctions conducted towards the end of the year, reflecting the market sentiments on increased financing requirements of the Government. By end 2020, primary market yields on Treasury bills with maturities of 91 days, 182 days and 364 days were lower by 282, 322 and 340 basis points, respectively, compared to end 2019. Yields on Treasury bonds in the primary market declined by 284-414 basis points across all tenures[2] during the year. The Government relied mostly on short to medium term financing during the year, as reflected by only two issuances of Treasury bonds with maturities of 10 years or more. In general, Treasury bonds with shorter maturities recorded large reductions of yield rates in the primary market, compared to Treasury bonds with longer

2 Excluding 10-year Treasury bonds as there were no new issuances since January 2020

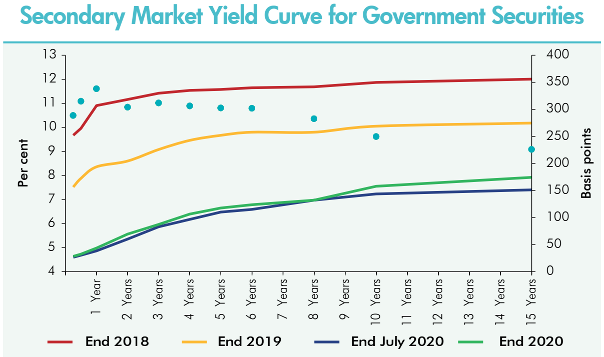
Figure 7.7
Primary Market Treasury Bill Yields (a)

(a) Yields for some weeks are not available due to non-acceptance of bids or not offering relevant tenures

Source: Central Bank of Sri Lanka

maturities. The secondary market yields on government securities also followed the trend of the primary market yields. Secondary market yields on Treasury bills declined by 288-338 basis points across all tenures, while the decline of yields on Treasury bonds ranged 226-311 basis points across all tenures. Meanwhile, the Government raised funds through US dollar denominated Sri Lanka Development Bonds (SLDBs) at various fixed and floating rates during 2020. A total of US dollars 507 million was raised from these auctions at fixed interest rates in the range of 5.70-6.87 per cent, and floating rate agreements with margins over 6-month London Inter-bank Offered Rate (LIBOR) in the range of 388-609 basis points. Driven by the negative investor sentiments following Sri Lanka's sovereign rating downgrades by international rating agencies, secondary market

Figure 7.8
Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka

yields on Sri Lanka's International Sovereign Bonds (ISBs) increased to significantly high levels and displayed continued volatility throughout the year.

Deposit and Lending Interest Rates

Market deposit rates decreased substantially in response to monetary policy easing measures. Accordingly, the Average Weighted New Deposit Rate (AWNDR)[3] and the Average Weighted New Fixed Deposit Rate (AWNFDR)[4] recorded their lowest levels of 4.93 per cent in December 2020 and 5.07 per cent in November 2020, respectively, since the beginning of their compilation in 2014. The Average Weighted Deposit Rate (AWDR)[5] reached its lowest level after August 2005, at 5.80 per cent at end 2020, and the Average Weighted Fixed Deposit Rate (AWFDR)[6] reached its lowest level after May 2015 at 7.14 per cent at end 2020. The pace of decline in deposit rates slowed in the latter part of 2020. Despite low levels of inflation, the substantial decline in deposit rates resulted in some deposit products, such as savings deposits and new short term fixed deposits, earning negative real returns, thereby affecting the segment of the population that depends on interest income from deposits. This underscores the need for alternative investment avenues in a low interest rate regime, in order to minimise the negative impact of low returns on savings, particularly in the context of rapid population ageing.

Reflecting the impact of accommodative monetary policy and other measures taken to improve the monetary transmission mechanism, market lending rates declined to historic low levels, facilitating domestic investment to take off. Accordingly, lending rates declined notably

3 AWNDR is based on interest rates pertaining to all new interest bearing rupee deposits mobilised by LCBs during a particular month.

4 AWNFDR is based on interest rates pertaining to all new interest bearing rupee time deposits mobilised by LCBs during a particular month.

5 AWDR reflects the movements in interest rates pertaining to all outstanding interest bearing rupee deposits held with LCBs.

6 AWFDR is based on interest rates pertaining to all outstanding interest bearing rupee time deposits held with LCBs.

Table 7.3
Movements of Interest Rates

Per cent per annum

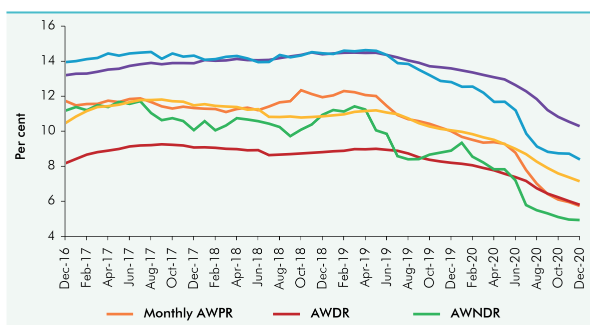
Interest Rate	End 2019	End 2020	Change in bps
Policy Interest Rates			
Standing Deposit Facility Rate (SDFR)	7.00	4.50	-250
Standing Lending Facility Rate (SLFR)	8.00	5.50	-250
Average Weighted Call Money Rate (AWCMR)	7.45	4.55	-290
Yield Rates on Government Securities			
Primary Market (a)			
Treasury bills			
91-day	7.51	4.69	-282
182-day	8.02	4.80	-322
364-day	8.45	5.05	-340
Treasury bonds			
2-year	9.79(b)	5.65(c)	-414
3-year	9.65(b)	5.99(c)	-366
4-year	-	6.32(c)	-
5-year	9.87(b)	6.79(c)	-308
10-year	10.23(b)	9.99(c)	-24
Secondary Market			
Treasury bills			
91-day	7.52	4.63	-289
182-day	7.88	4.73	-315
364-day	8.36	4.98	-338
Treasury bonds			
2-year	8.60	5.56	-304
3-year	9.08	5.96	-312
4-year	9.46	6.40	-306
5-year	9.67	6.65	-302
10-year	10.05	7.55	-250
Licensed Commercial Banks (d)			
Interest Rates on Deposits			
Savings deposits	0.20-7.50	0.10-7.00	-
1 Year Fixed Deposits (e)	3.55-15.00	0.25-15.00	-
AWDR (f)	8.20	5.80	-240
AWFDR (f)	10.05	7.14	-291
AWNDR (f)	8.89	4.93	-396
AWNFDR (f)	9.17	5.08	-409
Interest Rates on Lending			
AWPR (Monthly)	10.00	5.74	-426
AWLR	13.59	10.29	-330
AWNLR	12.80	8.38	-442
Other Financial Institutions (g)			
Interest Rates on Deposits			
National Savings Bank			
Savings Deposits	4.00	3.50	-50
1 Year Fixed Deposits	9.83	5.25	-458
Licensed Finance Companies (h)			
Savings Deposits	5.14-7.10	3.40-4.74	-
1 Year Fixed Deposits	10.98-11.97(i)	6.56-7.21	-
Interest Rates on Lending			
National Savings Bank	12.00-14.50	7.00-10.00	-
State Mortgage and Investment Bank (j)	10.25-18.00	8.73-12.50	-
Licensed Finance Companies (h)			
Finance Leasing	14.75-27.40(i)	14.31-28.97	-
Hire Purchase	13.40-24.82	13.71-20.05	-
Loans against Real Estate	15.53-16.71	19.95-22.30	-
Corporate Debt Market			
Debentures	12.30-15.50	9.00-13.25	-
Commercial Paper	13.00-16.25	6.50-15.50	-

(a) Weighted average yield rates at the latest available auction
(b) Last primary auction during 2019: 2 yr-13 Jun; 3 yr-11 Oct; 5 yr-12 Dec; 10 yr-12 Dec
(c) Last primary auction during 2020: 2 yr-28 Sep; 3 yr-11 Dec; 4 yr-12 Nov; 5 yr-11 Dec; 10 yr-13 Jan
(d) Based on the rates quoted by LCBs
(e) Maximum rate is a special rate offered by certain commercial banks.
(f) Since July 2018, AWDR and AWFDR were calculated by replacing Senior Citizens' special deposit rate of 15 per cent with relevant market interest rates to exclude the impact of special rates which are subsidised by the Government. Same method was applied to calculate AWNDR and AWNFDR since June 2018.
(g) Based on the rates quoted by other selected Financial Institutions
(h) Interest rate ranges are based on the average maximum and average minimum rates quoted by LFCs which are applicable for deposits mobilised and loans granted during the respective months. Data for 2020 are provisional.
(i) Revised
(j) Lending for housing purposes only

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

in 2020, with the weekly Average Weighted Prime Lending Rate (AWPR)[7] reducing to 5.81 per cent by end 2020. Meanwhile, the Average Weighted New Lending Rate (AWNLR)[8] and the Average Weighted Lending Rate (AWLR)[9] declined substantially to 8.38 per cent and 10.29 per cent, respectively, by end 2020. Reflecting the reduction of new lending rates, the share of new loans granted at single digit interest rates increased substantially to around 88 per cent by end 2020 from around 23 per cent at end 2019. Meanwhile, a reduction of average weighted lending rates was observed on loans granted against all types of securities by end 2020, compared to end 2019. The Central Bank conducted a new credit survey of small and medium sized enterprises (SMEs) in July 2020 to collect data on average interest rates on loans granted to SMEs by licensed banks. According to the survey results, the average interest rates on loans to the SME sector by licensed banks followed the trend of overall average lending rates of LCBs but remained higher at 10.95 per cent and 8.53 per cent for the Average Weighted SME Lending Rate (AWSR)[10] and the Average Weighted

Figure 7.9
Movement of Selected Market Interest Rates



Source: Central Bank of Sri Lanka

7 AWPR is based on interest rates applicable to short term rupee loans and advances granted by LCBs to their prime customers during a particular week.

8 AWNLR captures interest rates of all new rupee loans and advances extended by LCBs during a particular month.

9 AWLR is based on interest rates of all outstanding rupee loans and advances extended by LCBs.

10 AWSR is based on interest rates of all outstanding rupee loans and advances extended by licensed banks to the SME sector, excluding refinance schemes of the Government and the Central Bank.

BOX 6

Bank Credit to Micro, Small and Medium Sized Enterprises

Introduction

It is widely accepted that Micro, Small and Medium sized Enterprises (MSMEs) play a major role in the development of the economy due to their potential to promote inclusive growth by reducing regional inequalities of economic performance, and their capacity to develop into large organisations later on, thereby providing employment to a substantial proportion of the population and contributing to the economic growth of the country over their lifespan. The International Labour Organization (2019) reported that about 90 per cent of all enterprises in many countries consist of MSMEs, accounting for 70 per cent of employment globally. As per the economic census conducted by the Department of Census and Statistics (DCS) in 2013/14 on non-agricultural economic activities,[1] about 99 per cent of non-agricultural establishments in Sri Lanka were found to be MSMEs, while the Ministry of Industry and Commerce (2016) estimated that about 45 per cent of employment in the country is in the MSME sector.

Limited access to finance is cited as a key deterrent to the growth of MSMEs in Sri Lanka. According to the Asian Development Bank (ADB), the major factors contributing to credit constraints of the MSME sector in Sri Lanka are, a) limitations within financial institutions, such as a risk-averse banking culture and heavy reliance on collateral, b) limitations within the market infrastructure, including insufficient mechanisms to overcome information asymmetries, and c) limitations within MSMEs, for example, poor financial literacy, lack of market knowledge and lack of transparency.[2] In this regard, the lack of a regular flow of information to evaluate the amount of credit disbursed as well as interest rates charged on loans for the MSME sector remained a major information gap, hindering effective policymaking. This information gap was strongly felt in the midst of the COVID-19 pandemic, during which MSMEs were severely affected. Given the importance of such information, the Central Bank commenced a monthly survey on credit granted to MSMEs by licensed banks in July 2020. The main objective of the '*SME Credit Survey*' is to identify the average cost of credit granted to MSMEs[3] by licensed commercial banks (LCBs) and licensed specialised banks (LSBs). For this purpose, the corresponding quantum of loans is also collected to arrive at weighted average interest rates.

Findings of the SME Credit Survey

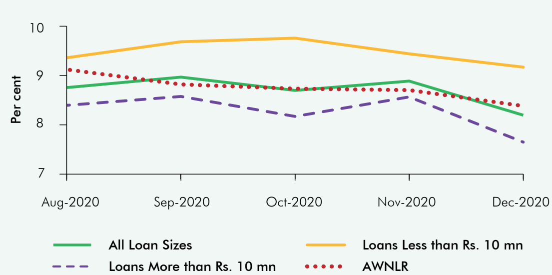
A preliminary assessment of the survey data indicated that the difference between the average interest rates on MSME lending by LCBs and the average market lending rates to all sectors, as measured in the Average Weighted Lending Rate (AWLR) and the Average Weighted New Lending Rate (AWNLR), was relatively small. However, when the interest rates were evaluated excluding large loans to the MSME sector, presumably for relatively large MSMEs with sufficiently high credit scores and collateral strength, the gap between the interest rates of lending to MSMEs and overall lending rates was large.

The recent decline in the overall market interest rates due to eased monetary conditions was observed in average lending rates to MSMEs as well. As per the

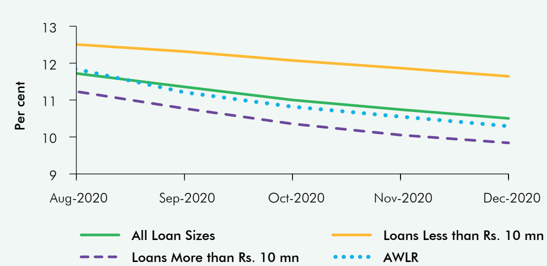
Figure B 6.1

Average Interest Rates on Loans Granted to MSMEs by LCBs

Average Interest Rates on New MSME Lending by LCBs



Average Interest Rates on the Outstanding Stock of MSME Lending by LCBs



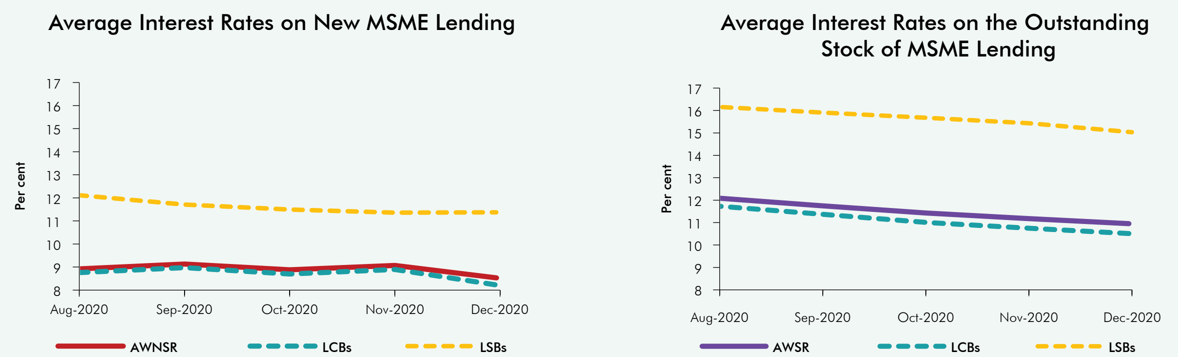
Source: Central Bank of Sri Lanka

1 See DCS (2015)

2 See ADB (2017)

3 The manner in which MSMEs are defined varies across nations. In the case of Sri Lanka, different agencies seem to use varying definitions based on their respective objectives (DCS, 2015). For the purpose of the SME Credit Survey, banks are requested to consider establishments with an annual turnover not exceeding Rs. 1 billion and employ less than 300 employees, in order to be consistent with guidelines issued under some recent Directions by the Central Bank.

Figure B 6.2
Average Interest Rates on Loans Granted to MSMEs by LCBs and LSBs



Source: Central Bank of Sri Lanka

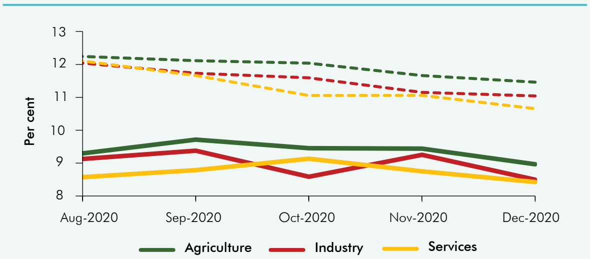
survey, the Average Weighted SME Lending Rate (AWSR), which is the weighted average interest rate of the outstanding stock of credit to MSMEs by all licensed banks, was recorded at 10.95 per cent by end 2020, while the Average Weighted New SME Lending Rate (AWNSR), which is the weighted average interest rate of new lending to MSMEs by all licensed banks, was 8.53 per cent for lending during December 2020. The average lending rates to MSMEs by LSBs, which mostly grant smaller loans in comparison to LCBs, were found to be higher than those of LCBs, making the average MSME rates of all licensed banks higher than the overall market lending rates. Of the outstanding loans granted to MSMEs by end 2020, the share of loans granted by LCBs was 90.2 per cent. Meanwhile, in terms of the number of loans granted, the share of LCBs was 50.2 per cent by end 2020.

The average interest rates on loans granted by licensed banks to MSMEs in the Agriculture sector were higher than those on loans granted to Industry and Services sectors. Further, as per the distribution of loans in terms of loan size, average interest rates on large loans remained lower than smaller loans. However, since the initiation of this survey, small size loans also seemed to have attracted relatively low rates, compared to mid-sized loan groups.

The outstanding balance of credit granted to MSMEs was Rs. 743.0 billion as at end 2020,[4] which was 11.1 per cent of total loans disbursed to the private sector by licensed banks.[5] The Industry sector accounted for the largest share of outstanding loans, as well as new loans to MSMEs, both in terms of the amount and the number of loans. The Agriculture sector constituted the smallest share of MSME loans, both in terms of the amount and the number of loans, in the outstanding balance as well as new disbursements.

Most of the new lending granted to the MSME sector during recent months had been of short-term nature, whereas the stock of lending remained mostly balanced,

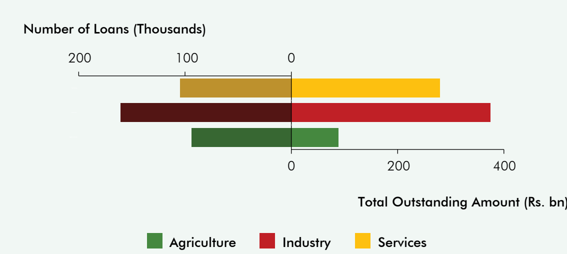
Figure B 6.3
Average Interest Rates on Loans Granted to MSMEs by Sector



Note: Thick lines represent average interest rates on new loans and dashed lines represent average interest rates on the outstanding stock of loans.

Source: Central Bank of Sri Lanka

Figure B 6.4
Sectoral Distribution of Outstanding Loans to MSMEs by end 2020

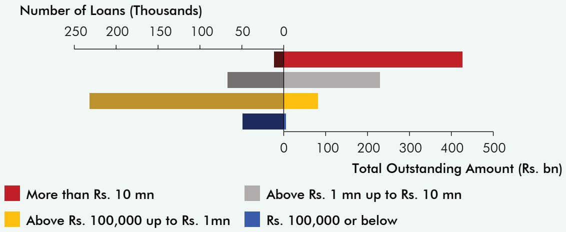


Source: Central Bank of Sri Lanka

4 Only rupee loans granted by licensed banks, excluding non-performing loans, off-balance sheet items, and amounts granted via refinance schemes of the Government and the Central Bank

5 The total stock of credit granted in Sri Lankan rupees to the private sector by LCBs (as measured in the Monetary Survey - M_2) and LSBs (as measured in the Financial Survey - M_4).

Figure B 6.5
Size Distribution of Outstanding Loans to MSMEs by end 2020



Source: Central Bank of Sri Lanka

Table B 6.1
MSME Financing in Selected Regional Counterparts

Country	Outstanding Loans to MSMEs as a Share of Total Outstanding Business Loans (End 2017,[9] %)	Interest Rate Spread Between Loans to Large Firms and MSMEs (End 2017,[9] bps)
Republic of Korea	80.2	31
Malaysia	50.6	217
Thailand	50.5	N/A
Indonesia	19.9	167
Sri Lanka	14.1[10]	246[11]

Sources: OECD (2019), Central Bank of Sri Lanka

in terms of the maturity structure.[6] This could mainly be due to the cashflow disruptions faced by the MSMEs amidst the COVID-19 pandemic. The survey findings also revealed varying MSME exposures of banks, reflecting the differences in business models.

Sri Lanka's MSME Sector Financing Compared to Regional Peers

A cross country comparison of lending to the MSME sector could be challenging due to differences in definitions of MSMEs and the relative importance of the MSME sector in respective economies. However, in a broad sense, compared to regional peers, such as the Republic of Korea, Malaysia and Thailand, whose economic progress in recent years has surpassed that of Sri Lanka, lending to the MSME sector of Sri Lanka by the formal banking sector remains comparatively weak. The share of credit granted to the MSME sector in Sri Lanka remains low,[7] while the spread between average interest rates on loans granted to MSMEs, especially on small sized loans, and average interest rates on loans granted to prime customers remains high. Relatively high interest rate spreads may reflect a multitude of contributing factors, such as the level of financial market development, poor financial literacy of MSMEs, and their approach to banking practices. The importance of promoting the MSME sector could be observed through the success experienced by the Republic of Korea, where the share of manufacturing value added of MSMEs remained over 49 per cent in 2014,[8] despite being home to some of the largest corporations in the world, such as Samsung, LG, and Hyundai.

6 Loans are classified as short term for loans up to and including one year, medium term for loans from one year up to and including five years, and long term for loans more than five years.

7 As per the SME Credit Survey, where credit granted only by licensed banks were considered.

8 See Jones and Lee (2018)

Way Forward

The new survey on bank lending to MSMEs reinforces with data that limited access to low-cost financing remains a major constraint in the MSME sector in Sri Lanka. The recent policy measures, such as the support provided with the spread of the COVID-19 pandemic, the introduction of credit scoring by the Credit Information Bureau of Sri Lanka (CRIB), encouraging MSMEs to access equity capital through the Colombo Stock Exchange (CSE) via initiatives such as the "Empower Board", and the implementation of priority sector lending targets, could help the MSME sector to weather the current economic turmoil, while reaching the growth potential over the medium to long term. Measures such as the introduction of broader credit guarantee schemes or the establishment of a permanent credit guarantee institution could be helpful in improving access to finance for MSMEs, which would address the longstanding issue of the lack of acceptable collateral in the sector.

9 The OECD (2019) scoreboard contains information for the period 2007-17.

10 The stock of MSME loans by LCBs measured in the SME Credit Survey, as a share of total credit to Agriculture, Industry and Services sectors, measured in the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, by end 2020.

11 As a corresponding interest rate for large firms is not available at present, the spread between the weighted average interest rate on new loans to MSMEs by LCBs during December 2020, as measured in the SME Credit Survey, and the monthly Average Weighted Prime Lending Rate (AWPR) for the corresponding month is considered.

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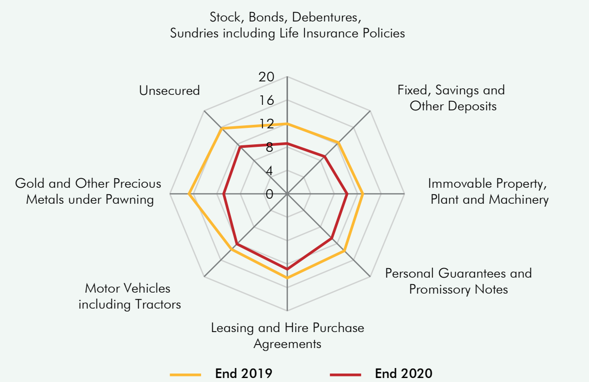
Figure 7.10
Average Weighted Lending Rates by Type of Securities (%)



Source: Central Bank of Sri Lanka

New SME Lending Rate (AWNSR),[11] respectively, at end 2020. Further, interest rates on loans granted to agriculture sector SMEs remained higher than those granted to SMEs in the industry and services sectors, on average.

The Legal Rate and the Market Rate of interest,[12] as determined by the Monetary Board and published in the Government Gazette at the end of each year, remains at 10.12 per cent per annum for 2021, compared to 11.64 per cent per annum for 2020. The Legal Rate and the Market Rate for 2021 were computed based on the simple averages of monthly AWDR and AWLR of LCBs, which prevailed during the preceding twelve months ending October 2020.

Interest Rates on Foreign Currency Deposits

7

Interest rates applicable on foreign currency deposits maintained with LCBs showed mixed movements during 2020. A substantial policy easing was implemented by central banks around the globe in 2020 to support the pandemic-hit economies. During the year, the US Federal Reserve reduced its federal funds target rate by 150 basis points, the Bank of England reduced its official bank rate by 65 basis points, while the European Central Bank kept its refinance rate unchanged at the zero level. However, the reduction of interest rates on foreign currency deposits of domestic licensed banks was not commensurate with the trend of global interest rates as they competed to attract foreign currency deposits amidst tight foreign currency liquidity conditions in the domestic foreign exchange market. Interest rates on US dollar denominated savings deposits were reported in the range of 0.03-4.00 per cent by end 2020, compared to the range of 0.02-4.50 per cent at end 2019. Interest rates pertaining to savings deposits denominated in pound sterling remained in the range of 0.03-3.00 per cent by end 2020, compared to 0.10-2.46 per cent at end 2019. Meanwhile, interest rates on time deposits denominated in US dollars were in the range of 0.10-6.00 per cent by end 2020, in comparison to the range of 0.20-5.50 per cent recorded at end 2019. Further, interest rates applicable on pound sterling denominated time deposits were in the range of 0.05-4.25 per cent by end 2020, compared to the range of 0.10-3.52 per cent at end 2019. Meanwhile, with a view to attracting foreign currency deposits to the country, the Government, in consultation with the Central Bank, allowed LCBs and National Savings Bank to mobilise foreign currency deposits into the newly introduced Special Deposit Accounts (SDA) in April 2020. These SDAs offered interest rates of 1 percentage point per annum above the normal rate for six-month deposits and 2 percentage points per annum above the normal rate for twelve-month deposits.

11 AWNSR captures interest rates of all new rupee loans and advances extended by licensed banks during a particular month to the SME sector, excluding refinance schemes of the Government and the Central Bank.

12 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.

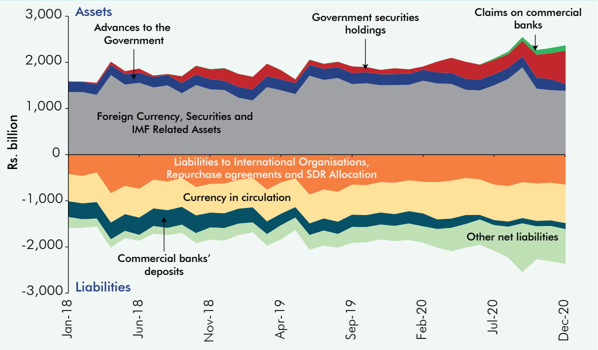
7.4 Movements in Money and Credit Aggregates

Reserve Money

Reserve money, which is the monetary base of the economy, recorded a moderate growth during 2020 mainly reflecting the combined impact of the reduction in the SRR and increase in currency in circulation. With the cumulative reduction of the SRR by 3 percentage points in 2020, about Rs. 180 billion of liquidity was released to the money market, reducing the deposits of LCBs with the Central Bank in 2020. However, as the deposit base of LCBs increased during the second half of the year, their reserves with the Central Bank recorded an increase towards end 2020. Nevertheless, by end 2020, deposits of LCBs with the Central Bank recorded a contraction of 49.1 per cent, year-on-year, by Rs. 125.0 billion during 2020 to Rs. 129.6 billion. Currency in circulation remained at elevated levels during the year due to the high demand for currency amidst the pandemic and the low opportunity cost of holding currency due to low deposit rates. With heightened uncertainty due to the pandemic and associated lockdowns, precautionary demand for money increased, resulting in a surge in currency in circulation from late March 2020 to mid-April 2020. The outbreak of the second wave of COVID-19 caused further increase in currency in circulation. Accordingly, currency in circulation increased by Rs. 156.8 billion during the year to Rs. 834.8 billion by end 2020, compared to an expansion of Rs. 37.0 billion during 2019. On a year-on-year basis, currency in circulation recorded a growth of 23.1 per cent by end 2020, compared to the growth of 5.8 per cent at end 2019. Accordingly, the impact of the substantial reduction in the SRR on reserve money was offset by the increase in currency in circulation during the year, resulting in an expansion of reserve money by 3.4 per cent, year-on-year, by end 2020, compared to the contraction of 3.0 per cent recorded at end 2019. In absolute terms, reserve money increased by Rs. 31.8 billion during the year to Rs. 964.4 billion by end 2020, compared to a contraction of Rs. 28.5 billion during 2019.

Viewed from the assets side, the increase in reserve money during 2020 was entirely due to the expansion in net domestic assets (NDA) of the Central Bank, while net foreign assets (NFA) of the Central Bank recorded a contraction. NDA of the Central Bank expanded notably during 2020, driven by the increase in net credit to the government (NCG) resulting from the purchases of government securities from the primary market, while the Central Bank's claims on LCBs also increased as a result of the implementation of concessional credit schemes amidst the COVID-19 pandemic. The holding of government securities by the Central Bank (net of repurchase transactions) increased substantially by Rs. 590.4 billion to Rs. 717.3 billion by end 2020 as the Central Bank purchased the under-allocated quantum of Treasury bills at the primary market auctions within the announced maximum yield rates for acceptance. Further, the Central Bank's claims on LCBs also increased notably during the second half of 2020 with the implementation of the Saubagya COVID-19 Renaissance Facility and

Figure 7.11
Composition of the Central Bank Balance Sheet



Source: Central Bank of Sri Lanka

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the Liquidity Facility to Contractors and Suppliers of the Government in line with the measures taken under the provisions of the Monetary Law Act No. 58 of 1949 to complement the efforts of the Government in supporting the businesses affected by the pandemic. Accordingly, the Central Bank's claims on LCBs increased notably by Rs. 112.7 billion to Rs. 114.5 billion by end 2020. The market participants continued to use the SDF window of the Central Bank to deposit unutilised surplus liquidity, mainly on an overnight basis. As a result, balances under the SDF, which remained around Rs. 25 billion, on average, in 2019 expanded to around Rs. 130 billion, on average, in 2020. Accordingly, NDA of the Central Bank increased by Rs. 401.1 billion during 2020 to Rs. 437.7 billion by end 2020, in comparison to the decline of Rs. 173.9 billion in 2019. Such expansion of NDA is expected to be rolled back upon the normalisation of aggregate demand conditions to prevent the buildup of inflationary pressures in the future. Meanwhile, NFA of the Central Bank declined by Rs. 369.2 billion during 2020 due to the combined effect of the decrease in foreign currency assets and the increase in foreign currency liabilities of the Central Bank. Foreign currency assets declined particularly towards the end of 2020 due to foreign currency debt service payments of the Government. Foreign currency liabilities of the Central Bank expanded mainly due to the repurchase agreement of US dollars 1.0 billion with the Federal Reserve Bank of New York in September 2020 and the bilateral currency swap agreement of US dollars 400 million with the Reserve Bank of India (RBI) in July 2020.

The money multiplier, which is the ratio between broad money supply (M_{2b}) and reserve money, increased notably in 2020, reflecting the effect of the reduction in the SRR and the notable growth of M_{2b}. The M_{2b} money multiplier increased to 9.75 at end 2020 from 8.18 recorded at end 2019. The reduction in the SRR during the year enhanced the space for money creation in the banking system. Meanwhile, the currency to deposits ratio increased to 7.3 per cent by end 2020 from 6.9 per cent recorded at end 2019, due to the increase in demand for currency held by the public.

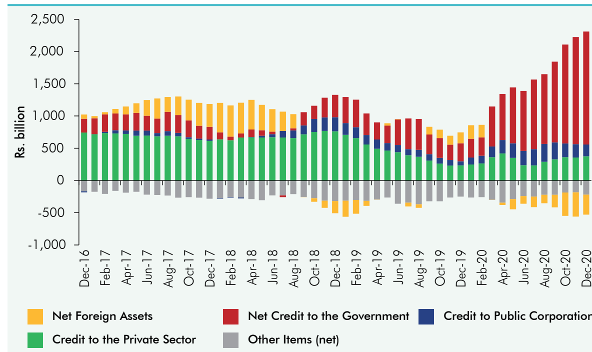
Broad Money (M_{2b}) and Domestic Credit

Broad money (M_{2b}) growth accelerated in 2020 due to the expansion in NDA of the banking system, driven mainly by the credit extended to the public sector, while NFA of the banking system contracted during the year. Reflecting the impact of the monetary easing measures, the growth of M_{2b} accelerated notably to 23.4 per cent, year-on-year, by end 2020, compared to the growth of 7.0 per cent, year-on-year, at end 2019. NDA of the banking system increased by Rs. 2,091.8 billion during 2020 mainly driven by the increase in domestic credit, particularly the increase in NCG by Rs. 1,752.1 billion during the year. NFA of the banking system contracted by Rs. 310.2 billion during 2020.

On the liability side of M_{2b}, the increase in time and savings deposits held by the public with LCBs largely contributed to the monetary expansion during 2020. Reflecting the impact of dampened consumer spending during the pandemic as well as the enhanced appetite for saving in the banking sector over the non-bank sector, time and savings deposits of LCBs increased notably, recording a year-on-year growth of 21.7 per cent by end 2020 compared to 7.3 per cent at end 2019. Meanwhile, currency and demand deposits held by the public (i.e., M_1) also increased during the year amidst the pandemic and the notable decline in market interest rates, thus increasing its contribution to the overall expansion of M_{2b} during 2020, compared to 2019.

Viewed from the asset side of M_{2b}, NFA of the banking system contracted during 2020 due to the decline in NFA of the Central Bank, although NFA of LCBs recorded an increase during the year. NFA of the Central Bank contracted notably during 2020 due to the repayment of foreign debt of the Government utilising foreign reserves. In contrast, NFA of LCBs increased during 2020, with the expansion of NFA of offshore banking units (OBUs), amidst a contraction of NFA of domestic banking units (DBUs). An increase in placements with banks abroad and lending to non-residents, along with the decline in foreign borrowings led to the expansion of NFA of OBUs during this period. However, the notable expansion in workers' remittances, which led to an increase in deposits of non-residents together with increased borrowings from abroad during 2020, resulted in a depletion in NFA of DBUs.

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



Source: Central Bank of Sri Lanka

NDA of the banking system expanded notably during 2020, mainly driven by the increase in credit to the public sector. Within NDA, NCG by the banking system increased substantially by

Table 7.4
Developments in Monetary Aggregates

Rs. billion

Item	End 2019	End 2020 (a)	Change 2019 Amount	Change 2019 %	Change 2020 Amount	Change 2020 %
1. Currency Outstanding	678.0	834.8	37.0	5.8	156.8	23.1
1.1 Currency held by the Public	494.2	641.0	21.1	4.5	146.8	29.7
1.2 Currency with Commercial Banks	183.8	193.8	15.9	9.5	10.0	5.5
2. Commercial Banks' Deposits with the Central Bank (b)	254.6	129.6	-65.5	-20.5	-125.0	-49.1
3. Government Agencies' Deposits with the Central Bank (c)	0.1	0.03				
4. Reserve Money (1+2+3)	**932.6**	**964.4**	**-28.5**	**-3.0**	**31.8**	**3.4**
5. Demand Deposits held by the Public with Commercial Banks	371.3	536.1	13.5	3.8	164.9	44.4
6. Narrow Money Supply, M_1 (1.1+5)	**865.5**	**1,177.2**	**34.7**	**4.2**	**311.7**	**36.0**
7. Time and Savings Deposits held by the Public with Commercial Banks	6,047.2	7,318.6	450.7	8.1	1,271.4	21.0
8. Broad Money Supply, M_2 (6+7)	**6,912.7**	**8,495.8**	**485.4**	**7.6**	**1,583.1**	**22.9**
9. Adjusted Foreign Currency Deposits (d)	711.4	909.9	10.4	1.5	198.5	27.9
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**7,624.1**	**9,405.7**	**495.8**	**7.0**	**1,781.6**	**23.4**
Money Multiplier, M_{2b}	**8.18**	**9.75**				
Velocity, M_{2b} (e)	**2.04**	**1.76**				

(a) Provisional
(b) Includes both Commercial Banks' Deposits with the Central Bank and balances of Primary Dealers with the Central Bank
(c) Government Agencies' Deposits with the Central Bank amounted to Rs. 55.7 million at end 2019 and Rs. 30.4 million at end 2020
(d) Includes deposits of Resident Category of Offshore Banking Units (OBUs) and a share of foreign currency deposits with Domestic Banking Units (DBUs)
(e) Average for the year

Source: Central Bank of Sri Lanka

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

Rs. billion

Item	End 2019 (a)	End 2020 (b)	Change			
			2019		2020	
			Amount	%	Amount	%
Reserve Money	**932.6**	**964.4**	**-28.5**	**-3.0**	**31.8**	**3.4**
Net Foreign Assets of the Central Bank	896.0	526.8	145.5	19.4	-369.2	-41.2
Net Domestic Assets of the Central Bank	36.6	437.7	-173.9	-82.6	401.1	1,095.6
Net Credit to the Government	363.0	868.9	-109.8	-23.2	505.9	139.3
Claims on Commercial Banks	1.8	114.5	12.9	116.4	112.7	6,181.0
Other Items (net) (c)	-328.2	-545.7	-77.1	-30.7	-217.5	-66.2
Broad Money (M_{2b})	**7,624.1**	**9,405.7**	**495.8**	**7.0**	**1,781.6**	**23.4**
Net Foreign Assets	100.7	-209.5	167.7	250.3	-310.2	-308.0
Monetary Authorities (d)	896.0	526.8	145.5	19.4	-369.2	-41.2
Commercial Banks	-795.3	-736.2	22.3	2.7	59.0	7.4
Net Domestic Assets	7,523.4	9,615.2	328.1	4.6	2,091.8	27.8
Domestic Credit	9,410.7	11,721.2	577.3	6.5	2,310.4	24.6
Net Credit to the Government	2,795.9	4,548.1	279.2	11.1	1,752.1	62.7
Central Bank	363.0	868.9	-109.8	-23.2	505.9	139.3
Commercial Banks	2,432.9	3,679.2	389.0	19.0	1,246.3	51.2
Credit to Public Corporations	818.0	1,002.2	62.6	8.3	184.2	22.5
Credit to the Private Sector	5,796.9	6,170.9	235.5	4.2	374.1	6.5
Other Items (net) (c)	-1,887.3	-2,106.0	-249.2	-15.2	-218.7	-11.6

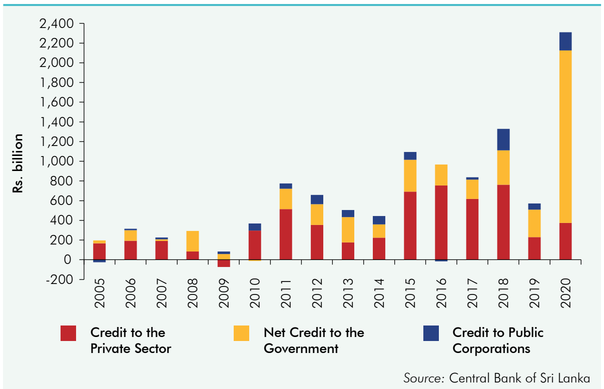
(a) Revised
(b) Provisional
(c) Computed as the difference between other assets and other liabilities
(d) This includes NFA of the Central Bank as well as the Government's Crown Agent's balance reported by the Department of State Accounts.

Source: Central Bank of Sri Lanka

Rs. 1,752.1 billion during 2020. This was mainly due to the increase in domestic financing of the Government amidst limited access to foreign financing and the decline in government revenue. Moreover, banks preferred to invest more in government securities with surplus liquidity, while being cautious in lending to the private sector amidst the pandemic. Accordingly, NCG of LCBs increased by Rs. 1,246.3 billion during 2020, driven by investments in Treasury bills, Treasury bonds and SLDBs as well as the increase in government overdraft balances. Meanwhile, NCG from the Central Bank increased by Rs. 505.9 billion during 2020, due to the net purchases of government securities by the Central Bank at primary auctions in view of the urgent financing needs of the Government caused by the pandemic. Following Parliamentary approval of the budget estimates for 2020, provisional advances to the Government by the Central Bank, which remained at Rs. 237.8 billion by end November 2020, declined to Rs. 153.1 billion by end 2020.

Credit extended to State Owned Business Enterprises (SOBEs) by the banking system recorded a notable expansion during 2020, reflecting the weak financial position of most SOBEs, aggravated by the pandemic. Accordingly, credit obtained by SOBEs from the banking system increased by Rs. 184.2 billion during 2020. Although bank borrowing by the Ceylon Petroleum Corporation (CPC) in foreign currency increased by around Rs. 74 billion, CPC maintained a large rupee deposit balance with the banking system in 2020. Meanwhile, bank borrowing by the Road Development Authority (RDA) increased by Rs. 53.6 billion during 2020. In addition, credit

Figure 7.13
Annual Increase in Domestic Credit



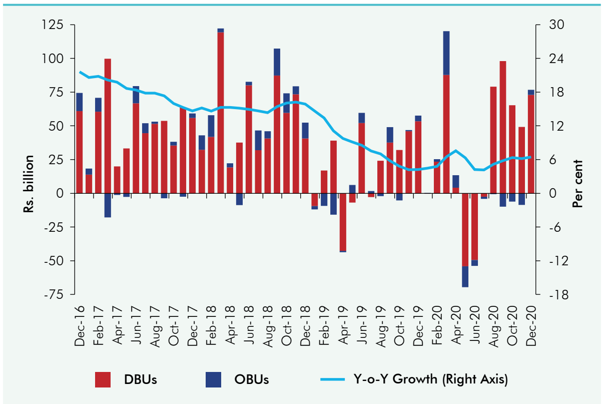
Source: Central Bank of Sri Lanka

obtained by SriLankan Airlines, National Water Supply & Drainage Board (NWS&DB), State Pharmaceuticals Corporation (SPC), Paddy Marketing Board (PMB) and Ceylon Electricity Board (CEB) increased notably during 2020, while Sri Lanka Ports Authority (SLPA) made repayments to LCBs during the year.

Credit extended to the private sector, which was significantly affected by the onset of the pandemic, recorded a gradual expansion since August 2020 supported by accommodative monetary conditions. Although some recovery was observed in the growth of credit to the private sector by LCBs during the first quarter of 2020 following a modest credit growth in 2019, the momentum changed due to the spread of COVID-19 and related lockdown measures. The low credit expansion since April 2020, in spite of large liquidity levels in the money market and relatively low market interest rates, was driven by the restrained supply of credit mainly due to the risk averse behaviour of banks towards lending during the pandemic. However, a gradual recovery in credit to the private sector was observed since August 2020 in response to eased monetary conditions, including reduction in lending rates to historic lows, along with the implementation of concessional loan schemes by the Central Bank. Accordingly, credit extended to the private sector increased by Rs. 374.1 billion during the year, recording a growth of 6.5 per cent, year-on-year, by end 2020.

The expansion of credit to the private sector in the second half of 2020 was mainly driven by Personal Loans and Advances, while direct credit to activities in the Agriculture, Industry and Services sectors of the economy remained low during the year. According to the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector, growth of credit in the form of Personal Loans and Advances accelerated notably to 15.1 per cent, year-on-year, by end 2020. Within Personal Loans and Advances, the Consumer Durables subsector recorded a notable growth of 38.4 per cent, year-on-year, by end 2020. Meanwhile, credit granted under Pawning Advances grew by 17.9 per cent, year-on-year, by end 2020 reflecting the increased appetite for such credit with the reduction in maximum interest rates and increased gold prices. However, Credit Card advances contracted by 2.5 per cent, year-on-year, by end 2020, in comparison to the growth of 22.9 per cent at end 2019. Meanwhile, credit to the Agriculture and Fishing sector recorded a moderate growth of 3.9 per cent, year-on-year, by end 2020. Within this sector, credit flows to the Tea, Paddy, Rubber,

Figure 7.14
Credit to the Private Sector by Commercial Banks



Source: Central Bank of Sri Lanka

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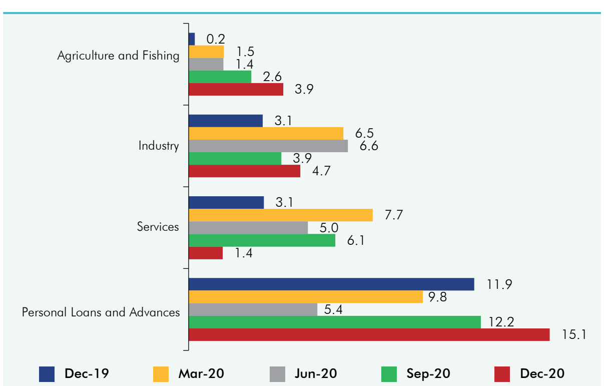
and Coconut subsectors recorded expansions in 2020, while credit granted to the Vegetable and Fruit Cultivation and Minor Food Crops, and Fisheries subsectors recorded contractions by end 2020, compared to end 2019. Meanwhile, growth of credit to the Industry sector accelerated to 4.7 per cent, year-on-year, by end 2020, from 3.1 per cent at end 2019. The construction sector, which was affected significantly by the pandemic-related lockdown during the early part of 2020, recorded a notable recovery supported by low interest rates. Accordingly, within the Industry sector, credit to the Construction subsector, which accounted for around 53 per cent of the total credit flows to the Industry sector, recorded a notable growth of 12.6 per cent, year-on-year, by end 2020. Credit to other subsectors, namely Textiles and Apparel, and Food and Beverages also grew notably by end 2020. However, credit to Fabricated Metal Products, Machinery and Transport Equipment; Chemical, Petroleum Pharmaceutical and Healthcare, and Rubber and Plastic Products; and Non-Metallic Mineral Products subsectors recorded notable contractions by end 2020, compared to end 2019. Slowdown in overall economic activity with the spread of COVID-19 and related containment measures, along with import restrictions, affected credit to the Services sector activities as well.

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



Source: Central Bank of Sri Lanka

Table 7.6
Sectoral Distribution of Loans and Advances Granted by Commercial Banks (a)(b)

Rs. billion

Sector	End 2019	End 2020 (c)	% Share 2020	% Change 2020
Agriculture and Fishing	471.1	489.7	7.7	3.9
of which, Tea	95.8	102.0	1.6	6.4
Rubber	25.9	30.8	0.5	19.0
Coconut	24.7	27.8	0.4	12.7
Paddy	38.0	38.6	0.6	1.4
Vegetable and Fruit Cultivation and Minor Food Crops	30.8	29.2	0.5	-5.3
Fisheries	21.5	20.5	0.3	-4.6
Industry	2,427.0	2,540.1	39.8	4.7
of which, Construction	1,197.6	1,348.6	21.1	12.6
Food and Beverages	130.8	148.3	2.3	13.4
Textiles and Apparel	214.6	235.1	3.7	9.5
Fabricated Metal Products, Machinery and Transport Equipment	192.3	132.9	2.1	-30.9
Services	1,692.8	1,716.7	26.9	1.4
of which, Wholesale and Retail Trade	502.4	501.8	7.9	-0.1
Tourism	235.1	261.7	4.1	11.3
Financial and Business Services	370.6	350.1	5.5	-5.5
Shipping, Aviation and Freight Forwarding	27.2	21.6	0.3	-20.6
Personal Loans and Advances (d)	1,418.5	1,632.1	25.6	15.1
of which, Consumer Durables	239.1	330.8	5.2	38.4
Pawning	211.0	248.7	3.9	17.9
Credit Cards	131.0	127.8	2.0	-2.5
Total (e)	6,009.4	6,378.6	100.0	6.1

(a) Based on the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector
Source: Central Bank of Sri Lanka
(b) Includes loans, overdrafts and bills discounted and excludes cash items in the process of collection
(c) Provisional
(d) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry' and includes Safety Net Scheme related loans
(e) Total credit to the private sector as per the Quarterly Survey differ from that in the Monetary Survey due to differences in the compilation methodologies.

Accordingly, the growth of credit extended to the Services sector decelerated to 1.4 per cent, year-on-year, by end 2020, compared to the growth of 3.1 per cent at end 2019. Contributing to the slowdown in credit to the Services sector, growth of credit to the Financial and Business Services subsector contracted by 5.5 per cent, year-on-year, by end 2020, compared to the contraction of 6.5 per cent at end 2019, amidst policy measures implemented to curtail the importation of personal motor vehicles during the year. Further, credit flows to Wholesale and Retail Trade; and Shipping, Aviation and Freight Forwarding subsectors also contracted by end 2020, compared to end 2019. Nevertheless, amidst the debt moratorium granted to tourism related industries and other measures, including special concessional loan schemes to support the pandemic-affected businesses, credit to the Tourism subsector expanded by end 2020. Further, in terms of the maturity of outstanding credit to the private sector by LCBs, a slowdown was observed in short term credit facilities, while an expansion was observed in medium and long term credit, possibly indicating a shift in customer loan portfolios towards longer maturities to benefit from low interest rates. Overall, the increase in Personal Loans and Advances contributed around 58 per cent to the expansion of credit extended to the private sector during 2020, while the increase in credit to the Industry, Services and Agriculture and Fishing sectors contributed around 31 per cent, 6 per cent and 5 per cent, respectively. As the expansion of credit towards productive sectors of the economy remained inadequate, the Central Bank, with the support of the banking community, announced priority sector lending targets for banks on lending to the MSME sector in January 2021.

Broad Money (M_4)

Growth of broad money supply (M_4), as measured by the Financial Survey,[13] accelerated to 21.4 per cent, year-on-year, by end 2020, led by the expansion in NDA of licensed banks. On the assets side of M_4, contributing to the increase in NDA, domestic credit of licensed specialised banks (LSBs) increased by Rs. 250.7 billion during 2020, while domestic credit of licensed finance companies (LFCs) recorded a contraction of Rs. 2.8 billion during the year. Within domestic credit of M_4, overall NCG increased notably by Rs. 1,882.8 billion during 2020, while NCG by LSBs and LFCs increased by Rs. 128.4 billion and Rs. 2.3 billion, respectively. As per M_4, credit extended to the private sector increased by Rs. 491.3 billion during 2020, recording a year-on-year growth of 6.3 per cent, by end 2020, compared to the growth of 3.9 per cent, year-on-year, at end 2019. Contributing around 25 per cent to the expansion of total credit extended to the private sector as per M_4, credit

13 The Financial Survey provides a broader measure of liquidity, covering all deposit taking institutions, including LSBs and LFCs, in addition to LCBs and the Central Bank.

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

Sector	Maturity	December 2019		December 2020 (c)	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	4.8	-1.2	4.5	-1.7
	Medium Term	1.9	3.5	1.7	-5.3
	Long Term	1.1	1.3	1.5	44.0
Industry	Short Term	13.5	-0.2	11.5	-9.2
	Medium Term	9.0	1.2	8.5	0.1
	Long Term	17.9	6.8	19.8	17.4
Services	Short Term	10.5	-0.6	8.6	-12.6
	Medium Term	9.2	1.9	9.1	4.3
	Long Term	8.5	9.8	9.2	15.6
Personal Loans and Advances	Short Term	10.2	14.5	9.2	-3.6
	Medium Term	5.3	10.5	5.5	10.4
	Long Term	8.1	9.7	10.8	41.5
Total	Short Term	39.0	3.0	33.9	-7.7
	Medium Term	25.5	3.4	24.8	5.5
	Long Term	35.6	8.0	41.3	23.3

(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 to five years - medium term; over five years - long term
(c) Provisional

Source: Central Bank of Sri Lanka

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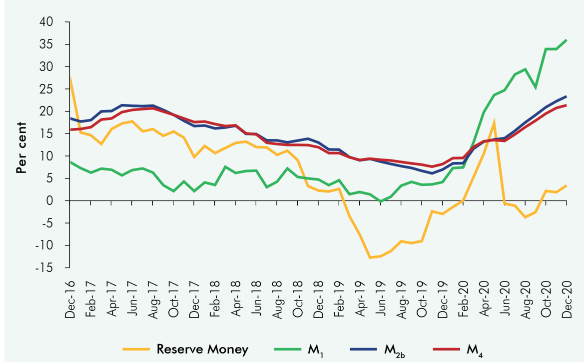
extended to the private sector by LSBs increased considerably by Rs. 122.3 billion during 2020, recording a year-on-year growth of 15.0 per cent. However, credit extended to the private sector by LFCs contracted by Rs. 5.1 billion during the year, resulting in a year-on-year contraction of 0.4 per cent by end 2020. This could be attributed to the slowdown in vehicle related loans amidst restrictions on vehicle imports and increased risk aversion due to high non-performing loans (NPLs) in the non-bank financial sector. Although overall NFA of M_4 contracted during 2020, NFA of LSBs increased by Rs. 4.3 billion during the year due to the decline in foreign liabilities. Viewed from the liabilities side of M_4, total time and savings deposits held by the public grew by 20.0 per cent, year-on-year, by end 2020, compared to the growth of 8.5 per cent, year-on-year, at end 2019. Time and savings deposits held with LSBs grew notably by 21.6 per cent, year-on-year, by end 2020, compared to 17.8 per cent at end 2019. However,

Figure 7.16
Year-on-Year Growth of Monetary Aggregates



Source: Central Bank of Sri Lanka

reflecting the impact of the termination of licenses and business activities of certain finance companies as well as the gradual shift of deposits from LFCs to banking sector institutions due to heightened uncertainties amidst the pandemic, time and savings deposits with LFCs contracted marginally by 0.7 per cent, year-on-year, by end 2020, compared to the growth of 4.9 per cent, year-on-year, at end 2019.

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

Rs. billion

Item	End 2019 (a)	End 2020 (b)	Change			
			2019		2020	
			Amount	%	Amount	%
Financial Survey (M_4)	**9,444.5**	**11,461.9**	**714.9**	**8.2**	**2,017.4**	**21.4**
Underlying Factors						
Net Foreign Assets	**88.8**	**-217.1**	**222.4**	**166.4**	**-305.9**	**-344.6**
Monetary Authorities (c)	896.0	526.8	145.5	19.4	-369.2	-41.2
LCBs	-795.3	-736.2	22.3	2.7	59.0	7.4
LSBs	-11.9	-7.6	54.7	82.1	4.3	36.0
Net Domestic Assets	**9,355.8**	**11,679.0**	**492.5**	**5.6**	**2,323.2**	**24.8**
Domestic Credit	**12,094.2**	**14,652.4**	**737.6**	**6.5**	**2,558.3**	**21.2**
Net Credit to the Government	**3,483.0**	**5,365.7**	**382.9**	**12.4**	**1,882.8**	**54.1**
Central Bank	363.0	868.9	-109.8	-23.2	505.9	139.3
LCBs	2,432.9	3,679.2	389.0	19.0	1,246.3	51.2
LSBs	613.9	742.2	95.3	18.4	128.4	20.9
LFCs	73.2	75.5	8.4	13.0	2.3	3.1
Credit to Public Corporations (LCBs)	**818.0**	**1,002.2**	**62.6**	**8.3**	**184.2**	**22.5**
Credit to the Private Sector	**7,793.3**	**8,284.5**	**292.1**	**3.9**	**491.3**	**6.3**
LCBs	5,796.9	6,170.9	235.5	4.2	374.1	6.5
LSBs	814.2	936.5	60.3	8.0	122.3	15.0
LFCs	1,182.2	1,177.1	-3.7	-0.3	-5.1	-0.4
Other Items (net) (d)	**-2,738.4**	**-2,973.4**	**-245.1**	**-9.8**	**-235.1**	**-8.6**

(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