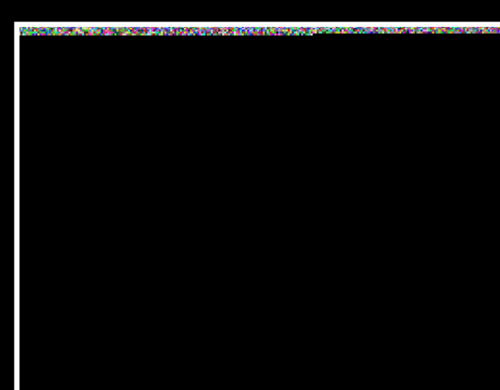
Chapter 7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

The Central Bank further strengthened its tight monetary policy stance in 2007 to restrain the rising inflationary pressures. The conduct of monetary policy in 2007 was a challenging task, as the demand pressure had to be neutralised, while minimising its adverse impact on the growth momentum in the economy. The Central Bank announced its targets for monetary aggregates at the beginning of the year and policy measures were implemented to achieve these targets. The policy interest rates, viz; Repurchase and Reverse Repurchase rates, were raised further by 50 basis points in early 2007. However, given the quantitative nature of the targets, the main strategy implemented to achieve them was conducting Open Market Operations (OMOs) aggresively to siphon off liquidity from the banking system, while imposing certain restrictions on the access to the reverse repurchase facility of the Central Bank, thereby restricting directly the credit creating capacity of banks. In addition, moral suasion was used to discourage banks from excessive credit creation, while continuing with the prudential measures introduced in 2006 to safeguard banks against unhealthy credit expansion.

The monetary policy measures were successful in maintaining reserve money well within the targeted path during the year, and thereby containing effectively the new money injection to the economy. In fact, the Central Bank was able to achieve the most restrictive growth in reserve money (10.2 per cent) in the last five years despite the relatively higher real GDP growth and inflation in 2007. Both the short-term and long-term market interest rates increased, responding to the tight monetary policy and thereby discouraging further expansion in demand for credit. As a result, broad money expansion also decelerated, but remained above the level envisaged in the monetary programme. The slowing down of the

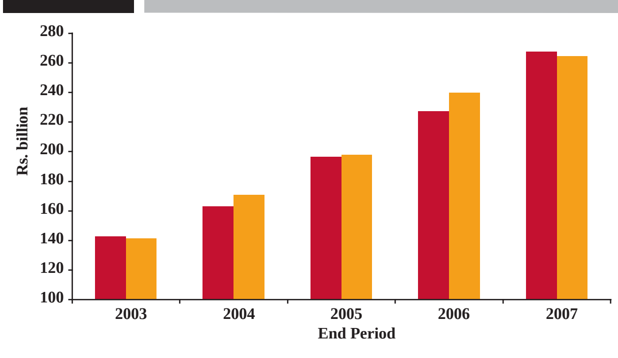


growth in credit to the private sector during the year indicated a clear sign of deceleration in broad money with its normal lag effect. However, it has been noted that credit to the public sector has not declined as desired. The full impact of the tight monetary policy stance maintained by the Central Bank is expected to yeild the salutary results in 2008 and beyond.

Inflation arising from demand pressures was notably curtailed through tight monetary policy, though it remained high due to several other factors. The Central Bank's demand management policies helped to reduce inflation gradually during the first half of 2007. However, the substantial increase in international market prices of oil and certain other commodities led to an upward adjustment in domestic prices of several goods and services. The pass-through of increases in international prices, though it led to a one time increase in prices, will have a favourable impact on containing future inflation by eliminating the need for subsidising the same through the expansionary borrowings of the government. The removal of subsidies also eliminated the suppressed inflation that was prevalent in the past, thereby helping to reduce future inflationary pressures.

The Central Bank adopted several measures during 2007 to improve the monetary policy decision making process and ensure its transparency. The Central Bank continued its efforts to improve awareness of the general public and market participants on its monetary policy framework, monetary programme, monetary policy decisions and monetary policy operations through continued dissemination of information. With the objective of enhancing the policy predictability and transparency by keeping the public informed in advance, the Central Bank announced the *Road Map for Monetary and Financial Sector Policies for 2007 and beyond* on 2nd January 2007. Also, releasing of regular and occasional press releases and communiques and conducting island-wide seminars have strengthened the communication strategy, thereby ensuring greater transparency of the Central Bank. A Monetary Policy Consultative Committee (MPCC), made up of various stakeholders drawn from the private sector and academia, was set up to independently review the Bank's monetary policy actions and make suitable recommendations for consideration by the Bank.

Chart 7.1 Reserve Money - Target vs. Actual



7.2 Monetary Policy

The Central Bank announced its monetary policy objectives, strategy and targets for 2007 in its *Road Map for Monetary and Financial Sector Policies for 2007 and beyond.* In setting monetary targets for 2007, in addition to the expected macro economic developments in 2007, the higher monetary expansion experienced in 2006 was also taken into consideration. Accordingly, a set of tighter monetary policy targets were fixed for the year, and strong measures were implemented to realise them.

The Bank continued its monetary policy operations within the monetary targeting policy framework under an independently floating exchange rate regime. In the monetary targeting framework, reserve money (high powered money) was used as the operating target, while broad money (M_{2b}) was used as the intermediate target. OMOs were conducted aggressively, while imposing certain limits on access to the reverse repurchase facility of the Central Bank to absorb liquidity and restrain credit expansion. The Statutory Reserve Ratio (SRR), was maintained at 10 per cent, while the Bank Rate remained at 15 per cent.

When compared to the annual reserve money growth rates since 2002, the growth of 10.2 per cent in 2007 was the most restrictive, despite relatively higher GDP growth and inflation. In 2006, reserve money grew by 21.2 per cent compared to the target of 15.0 per cent. Also, the average growth during the period 2002 – 2006 was 16.4 per cent. Therefore, the achievement of a very low growth in reserve money in 2007 is encouraging, in the context of the necessity for reducing the demand driven inflation in the economy. However, the favourable full impact of the deceleration in reserve money on inflation is expected to be realised with a time lag.

The Central Bank further tightened its monetary policy stance in 2007 to reduce high monetary expansion and the demand driven inflation. The policy interest rates of the Central Bank, which were raised by 300 basis points during the period 2004-2006, were further raised by 50 basis points in

February, 2007. Accordingly, the Repurchase and Reverse Repurchase rates increased to 10.50 per cent and 12.00 per cent, respectively. More emphasis was placed, however, on conducting OMOs aggressively, while imposing certain limits on the provision of the reverse repurchase facility by the Central Bank to maintain reserve money within the targets. Accordingly, the reverse repurchase facility was provided only when the market had a overall liquidity shortfall. Banks were advised to resort to this facility only as a last resort and not to lend in the interbank market and build up excess reserves against SRR, while borrowing funds through the reverse repurchase facility. Further, this facility was made available only three times within a calendar month for any bank during the period from January to March, 2007. It was slightly enhanced to four times per month from April to August before being removed completely at end August 2007, in order to ease the pressure on market interest rates. However, towards the latter part of the year, the policy was modified again in order to discourage the excessive usage of the reverse repurchase facility, while containing the volatility of interest rates. Accordingly, in addition to commercial banks, the reverse repurchase facility was made available to primary dealers as well, who had been excluded from the facility since June 2006 to prevent the possibility of the Central Bank's funds being used for building up security portfolios and undertaking arbitrage operations. The access of both commercial banks and primary dealers to the facility at the Reverse Repurchase rate was limited to four times per month per institution. They were, however, allowed access beyond this limit at a penal interest rate of 19 per cent. Nevertheless, the Central Bank continued to limit the funds extended under reverse repurchases on a particular day only to the overall liquidity shortfall as estimated by the Central Bank. In addition to these measures, moral suasion was also used to discourage undue credit expansion.

Responding to the tight monetary policy measures, market interest rates moved up significantly, thereby making credit more expensive. The average weighted call money rate increased by 185 basis points (the difference between December monthly averages) between the two years reflecting the impact of tight monetary policy measures. Meanwhile, the average weighted deposit rate (AWDR) and average weighted prime lending rate (AWPR) increased by 271 and 276 basis points, respectively. Also, the yield rate on 3-month Treasury bills increased by 854 basis points. These adjustments helped to reduce the demand for credit in the economy, facilitating the Bank to manage market liquidity at a level consistent with the targeted reserve money path. Accordingly, the Central Bank was able to operate within its quarterly targets for reserve money in 2007. Even though the credit growth to the private sector declined gradually as expected, consequent to the increase in borrowings by the Ceylon Petroleum Corporation (CPC) to meet increased expenditure on oil imports as well as increased borrowings by the government from commercial banks, broad money expansion remained at a higher rate than anticipated during 2007.

Inflation remained relatively low during the first half of 2007 due to the containment of demand pressures in the economy through tight monetary policy measures though it increased thereafter largely due to external factors. According to the New Colombo Consumers' Price Index, CCPI(N), inflation, which remained in the range of 13 -15 per cent on a point-to-point basis during the first half of 2007, increased to 18.8 per cent by end 2007. The increase in inflation was largely due to the substantial increase in international prices of oil and several other commodities, which led to upward adjustments in prices of many domestic goods and services during the second half of the year. Accordingly, the annual average inflation also increased from 10.0 per cent in 2006 to 15.8 per cent in 2007.

The Central Bank took several measures to improve the monetary policy decision-making process during 2007 to make it transparent and enhance its effectiveness on achieving price stability. As a measure of improving effectiveness of monetary policy further, key macroeconomic variables that have a bearing on monetary policy were identified and a comprehensive mechanism for monitoring their growth path was introduced at the beginning of 2007. This mechanism helped the Bank to ascertain in advance any slippages of policy variables and make recommendations to the government for early corrective action. A Monetary Policy Consultative Committee (MPCC), which comprises of various stakeholders drawn from the private sector and academia, was also established in 2007, in order to obtain their expertise to strengthen the monetary policy decision making process. The Monetary Board took into its careful consideration the views of MPCC when deciding on the monetary policy stance of the Bank.

The communication policy of the Central Bank was further improved to enhance awareness of the general public on monetary policy decisions and the outcome, through continued dissemination of information. The Central Bank published its monetary policy targets and the basis of setting such targets, in the Road Map at the beginning of the year. The monetary policy stance of the Central Bank was

Box 16

Money Printing : The Fundamentals and Process

The term "money printing" is normally used in a broader sense to indicate the amount of money released by the Central Bank to the economy during a particular period. However, the term has been rather loosely used recently to convey different meanings, ranging from the amount of currency notes and coins printed/ issued to changes in currency in circulation to the amount of credit granted to the government by the Central Bank, etc. and these misrepresentations have created continuous confusion and misconception in the minds of the public. Hence, this article outlines the composition of money released by the Central Bank, the process and fundamentals governing the release of money by the Central Bank and actual amount of money released during recent years with a view to clear such misconceptions.

The money released by the Central Bank to the economy is termed "reserve", "base" or "high-powered" money, since commercial banks are able to create more money on the basis of reserve money, by generating credit and deposits through a multiplier process. The Central Bank is the sole authority responsible for releasing reserve money. Although the Central Bank maintains adequate stocks of minted coins and printed currency notes in its vaults to be issued as money, these stocks do not become "money" until such time they are possessed by the public as assets.

Reserve money consists of currency issued by the Central Bank and deposits of commercial banks and government agencies with the Central Bank. These are liabilities of the Central Bank and are shown on its Balance Sheet. As per accounting fundamentals, these have to be backed by the assets of the Central Bank Balance Sheet. Accordingly, "issuing reserve money" or "printing money" by the Central Bank is carried out on the basis of the acquisition of assets on fundamental grounds.

There are two main channels of releasing reserve money from the Central Bank to the economy. These are: (i) acquisition of Net Domestic Assets (NDA) and (ii) acquisition of Net Foreign Assets (NFA).

The acquisition of domestic assets by the Central Bank takes place through lending to the government and/or commercial banks. As stipulated in the Monetary Law Act, the Central Bank provides to the government provisional advances amounting to 10 per cent of government's estimated annual revenue. In addition, the Bank could also provide credit to the government by purchasing government securities, mainly Treasury bills as a part of its monetary policy operations to manage liquidity in the banking system.

The government also maintains deposits with the Central Bank. The difference between the borrowings mentioned above and the deposits is called "net credit to the government" (NCG) and it represents the net amount of money released to the government. In the same manner, money can be injected to the economy when credit is extended to commercial banks by the Central Bank as the lender of last resort or to manage liquidity under its Open Market Operations (OMOs). The sum of NCG and credit to commercial banks by the Central Bank, when set off against the other domestic assets and liabilities of the Central Bank, is termed "net domestic assets" (NDA) of the Central Bank.

The Central Bank acquires foreign assets through its transactions with the government or operations in the domestic foreign exchange market. As the Banker to the government, the Central Bank purchases foreign currency receipts, mainly through foreign currency loans and grants to the government, and releases an equivalent amount in rupees. Similarly, it sells foreign exchange to the government to settle the government's foreign loan repayment and interest obligations. The Central Bank also operates in the domestic foreign exchange market to dilute undue fluctuations in the exchange rate by absorbing whenever there is an excessive supply of foreign exchange or by injecting when there is a large shortage of foreign exchange in the market. The purchases (absorptions) net of sales (injections) of foreign exchange by the Central Bank lead to a change in foreign assets, which is called "net foreign assets" (NFA) of the Central Bank, and it contributes to the change in reserve money.

The amount of money released to the economy during a particular period, (normally a year) is determined by the monetary policy targets of the Central Bank. At present, the Bank follows a monetary policy framework targeting monetary aggregates. In this framework, the final target, price stability, is to be achieved by influencing changes in broad money supply, which is linked to reserve money through a multiplier. Accordingly, reserve money serves as the operating target while the broad money serves as the intermediate target of monetary policy.

Targets are set out in the monetary programme of the Bank, which takes into account the expected developments in all the major sectors in the economy. The main purpose of the monetary programme is to estimate the amount of money that the Central Bank should inject to the economy in that particular year. The money injection should be sufficient to meet the expected expansion in economic activities without causing any pressure on the economy and markets. In other words, the growth in new money injection or reserve money should tally with the nominal growth in gross domestic product, i.e., it should be sufficient to finance expected expansion in output and the expected rate of price changes.

The planned injection of money needs to be entirely backed by the aforementioned increases in NDA and NFA (Table B 16.1). For any increase in NDA above the expected level, there should be a corresponding decline in NFA, and vice versa in order to maintain the planned amount of new money injection in a particular year.

For example, when the foreign exchange market is highly liquid through increases in foreign currency inflows, the Central Bank would need to purchase foreign currency from the market to avoid undue fluctuations in the exchange rate. This leads to an increase in NFA of the Central Bank. In the meantime, whenever the Central Bank purchases foreign currency, an equivalent amount of rupees will be injected to the economy and new money or in other words, market liquidity, would correspondingly increase. If this new money or liquidity injection is more than the desired level, the Central Bank will conduct OMOs using government securities from its holdings in order to absorb the excess liquidity, (which is called sterilisation), and

Table B 16.1
Balance Sheet of Central Bank of Sri Lanka

Rs. bn

	2002 Dec	2003 Dec	2004 Dec	2005 Dec	2006 Dec	2007 Dec
Liabilities (Use Side)						
Reserve Money	126.4	141.4	171.0	197.9	239.9	264.4
Currency in Circulation	88.3	98.8	115.9	132.4	157.2	173.4
Commercial Bank Deposits	38.1	42.6	55.1	65.5	82.6	91.1
Government Agencies Deposits	...	...	...	...	...	...
Assets (Source Side)						
Net Foreign Assets	117.4	164.6	151.7	196.9	229.9	292.9
Net Domestic Assets	9.0	-23.1	19.3	1.0	10.0	-28.5
Net Claims on Government	70.9	42.1	108.1	74.4	112.9	101.1
Claims on Government	71.1	42.7	108.7	75.3	114.3	102.5
Provisional Advances	31.0	31.2	34.8	39.7	49.0	60.7
Treasury Bills & Treasury Bonds	40.1	11.5	73.9	35.6	65.3	41.8
(Less) Government Deposits	0.2	0.6	0.5	0.9	1.3	1.4
Claims on Commercial Banks	...	...	...	2.5	2.5	2.1
Other Items (Net)	-61.9	-65.3	-88.9	-75.9	-105.4	-131.7

thereby maintain reserve money at targeted levels. Hence, there will be a corresponding adjustment in NDA, or more precisely there will be a reduction in Treasury bill holdings of the Central Bank, thereby lowering the NCG component.

Similarly, when the Central Bank provides provisional advances to the government or transfers Central Bank profits to the Treasury, new money is injected to the economy. In such a situation, if market liquidity increases above the desirable levels and hence becomes incompatible with the reserve money targets, this excess liquidity is sterilised through OMOs. Therefore, the sterilisation process is used to absorb excess liquidity created through both means, i.e., increases in NFA and NDA.

In the recent past, the annual percentage increases in new money had been set at around 15 per cent per annum while the actual percentage increases from 2002 to 2007 are set out in Table B 16. 2.

As shown in Table B 16.2, the reserve money growth rates were largely on par with expected economic growth and inflation, except in 2004 and 2006. For example, the reserve money target for 2007 was set at the stringent growth rate of 11.6 per cent or, in value terms an increase of Rs. 27.7 billion to Rs. 267.6 billion. However, the actual amount of reserve money as at end December 2007 was even below at Rs. 264.4 billion, resulting in an increase of only Rs. 24.6 billion for the year. In fact, the actual reserve money growth during 2007 was at 10.2 per cent, which was even lower than the tight target of 11.6 per cent set at the beginning of the year. As seen in Table B 16.1, the growth in reserve money was entirely due to the expansion in NFA. The Treasury bill holdings of the Central Bank declined by around Rs. 23 billion in 2007 leading to an overall decline in NCG by around Rs. 12 billion.

Effective monetary management polices adopted during 2007 helped to maintain the reserve money growth well within the targeted level enabling the Central Bank to effectively neutralise the effects of excessive reserve money expansion experienced in 2006. This has also led to a deceleration in broad money supply (M_{2b}) from a higher level of around 22 per cent in mid 2007 to 16.6 per cent by end of the year. A further deceleration of the growth in broad money is expected in 2008. Accordingly, a moderation in demand-pull inflation is expected during 2008-2009 as the deceleration in monetary aggregates would impact the final target of inflation with a time lag.

Table B 16.2
Reserve Money Injection in Recent Years

	2002	2003	2004	2005	2006	2007
Economic Growth - %	4.0	5.9	5.4	6.2	7.7	6.8
Inflation – GDP Deflator -%	8.4	5.1	8.8	10.4	11.3	14.0
Required Growth in Reserve Money (Money Printing)	**12.4**	**11.0**	**14.2**	**16.6**	**19.0**	**20.8**
Actual Reserve Money						
Amount – Rs.bn	126.4	141.4	171.0	197.9	239.9	264.4
Growth - %	**12.3**	**11.9**	**20.9**	**15.8**	**21.2**	**10.2**

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.

7.3 Developments in Money and Credit Aggregates

Money Market Liquidity

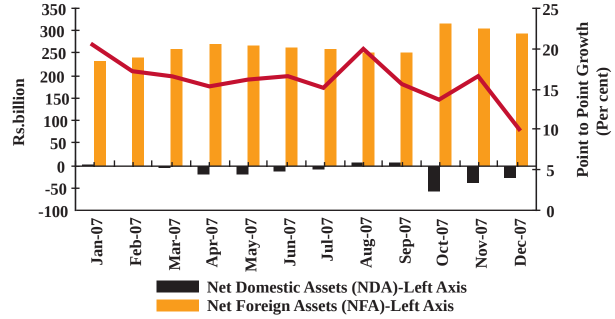
The Central Bank's strategy for the year was to maintain market liquidity at a level consistent with the planned reserve money path. In this regard, market liquidity was closely monitored during the year and several policy measures were taken to achieve the desired conditions. The management of liquidity was a challenging task as there was a large injection of liquidity to the system through inflows of foreign currency to the government and subsequent sales of those proceeds to the Central Bank. Nevertheless, monetary expansion was contained by absorbing the liquidity both on a daily and a permanent basis through aggressive OMOs. Consequently, the total amount absorbed through outright sales auctions as a permanent measure was nearly Rs. 111 billion.

Reserve Money

The tight monetary policy stance pursued by the Central Bank was successful in containing the growth in reserve money within the targeted path during the year. As a result, reserve money expansion, which was at 21.2 per cent in 2006, was brought down to 10.2 per cent in 2007. The resulting increase in reserve money, or new money injected, in 2007 was Rs. 24.6 billion compared with the increase of Rs. 42 billion in 2006.

Viewed from the source side, the expansion in reserve money was entirely due to the increase in Net Foreign Assets (NFA) of the Central Bank,

Chart 7.2 Growth and Sources of Reserve Money



which necessitated the Bank to implement policy measures to reduce Net Domestic Assets (NDA) to maintain reserve money growth within the targeted path during the year. NFA of the Central Bank increased by around Rs. 63 billion on account of the sale of foreign currency receipts of the government to the Central Bank. These consisted of the receipts from the sovereign international bond issue, disbursements of foreign project loans and grants, a syndicated foreign currency loan raised from offshore banking units (OBUs) of commercial banks, net issues of Sri Lanka Development Bonds (SLDBs) and sale of Treasury bonds to non-residents. As a large amount of rupee liquidity was injected to the market by the Central Bank through an increase in its NFA, the Bank was able to reduce its holdings of domestic assets, particularly the holdings of Treasury bills by about Rs. 23.5 billion. The provisional advances extended to the government during the year amounted to Rs.11.7 billion. Helped by an increase in net other liabilities of the Central Bank, the overall reduction in NDA was around Rs.38.5 billion.

The decline in Net Credit to the Government (NCG) from the Central Bank during 2007 largely supported to reduce NDA and, hence, maintain the reserve money targets. NCG declined to Rs.101.1 billion in 2007 from Rs.112.9 billion in 2006. The overall reduction was the net outcome of a decline in Treasury bill holdings by Rs.23.5 billion and an increase in provisional advances by Rs.11.7 billion.

From the use side of reserve money, the expansion was reflected in an increase in both currency in circulation and deposits of commercial banks with the Central Bank. Currency in circulation increased by Rs. 16.2 billion during the year demonstrating the higher demand for currency by the public for transaction purposes on account of increased economic activities and inflation. Deposits of commercial banks with the Central Bank also increased by Rs. 8.4 billion in accordance with the increase in the SRR as a result of the increased deposit liabilities of the public with commercial banks.

Narrow Money (M_1)

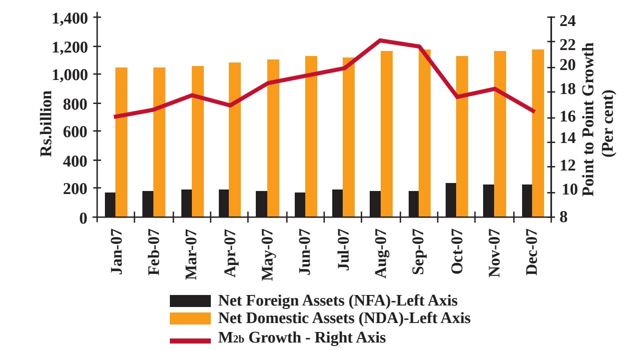
Growth in the narrow money supply further upheld its declining trend in 2007, reflecting the tight monetary policy stance adopted by the Central Bank since 2004. Narrow money, which comprises currency and demand deposits held by the public, continued its steady declining trend with the growth decelerating from a higher rate of 22.4 per cent at end 2005 to 12.6 per cent in 2006 and further to 2.7 per cent by end 2007. Currency held by the public increased by 9.0 per cent during the year, compared to 18.4 per cent in 2006, while demand deposits held by the public declined by 4.2 per cent as against the 6.9 per cent increase recorded in 2006. This slowdown in growth is attributable to the shifting of the funds of the general public from non-interest bearing instruments to interest yielding term deposits in the prevailing high interest rate regime. This also emphasises the efficacy of the tight monetary policy stance pursued by the Central Bank.

Broad Money (M_{2b})

The tight monetary policy stance of the Central Bank was instrumental in reducing the expansion in broad money, although it remained above the targeted level. The growth in broad money by end 2007 was 16.6 per cent compared to the growth of 17.8 per cent in 2006 although the target for the year was 14.8 per cent as per the monetary programme. The expansion in broad money during the year was largely led by the increase in quasi money, which consists of time and savings deposits. Time and savings deposits increased by 20.4 per cent during the year on account of the attractive higher interest rates offered for these deposits. Foreign currency deposits also increased by 17.7 per cent on account of the higher interest rates that prevailed internationally during a major part of 2006-2007.

From the asset perspective of the broad money supply, the expansion was led by the increases in both NFA and NDA of the banking system. The increase in NFA was entirely due to the increase in NFA of the Central Bank following the purchase of foreign currency receipts of the government. NFA of

Chart 7.3 Growth and Sources of M_{2b}



commercial banks, however, declined below end 2006 levels resulting from foreign currency outflows on account of settlement of petroleum import bills; raising a syndicated loan abroad by a commercial bank on behalf of the government, which raised that bank's foreign liabilities, while raising its domestic assets; utilisation of the foreign currency of commercial banks in extending syndicated loans to the government and investment in SLDBs.

NDA of the banking system, although increased substantially during the first three quarters, particularly with the increased borrowings by the government, recorded a deceleration in expansion during the last quarter, benefiting from the settlement of a part of the banking sector liabilities of the government. However, it is noted that all three components of domestic credit, i.e., NCG, credit to public corporations as well as credit to the private sector, contributed to the increase in NDA.

Table 7.1 Developments in Monetary Aggregates

Rs.billion

Item	End 2006	End 2007 (a)	Change 2006 Amount	Change 2006 %	Change 2007 Amount	Change 2007 %
1. Currecny Outstanding	157.2	173.4	24.8	18.7	16.2	10.3
1.1 Currency Held By the Public	135.0	147.2	20.9	18.4	12.2	9.0
1.2 Currency with Commercial Banks	22.2	26.2	3.9	21.2	4.0	18.0
2. Commercial Banks Deposits with the Central Bank	82.6	91.0	17.1	26.1	8.4	10.2
3. Government Agencies Deposits with the Central Bank	…	...	…	…	...	...
4. Reserve Money (1+2+3)	239.9	264.4	42.0	21.2	24.6	10.2
5. Demand Deposits held by the Public with Commercial Banks	124.7	119.4	8.1	6.9	-5.3	-4.2
6. Narrow Money Supply, M_1 (1.1+5)	259.7	266.6	29.0	12.6	6.9	2.7
7. Time and Savings Deposits held by the Public with Commercial Banks	733.6	881.2	141.4	23.9	147.6	20.1
8. Broad Money Supply, M_2 (6+7)	993.3	1,147.7	170.4	20.7	154.5	15.6
9. Foreign Currency Deposits (b)	211.3	256.3	11.9	6.0	45.0	21.3
10. Consolidated Broad Money Supply, (M_{2b}) (8+9)	1,204.6	1,404.0	182.3	17.8	199.5	16.6
Money Multiplier M_{2b}	5.02	5.31				
Velocity, M_{2b} (c)	2.65	2.73				

(a) Provisional
(b) Includes deposits of Resident category of Offshore Banking Units and a part of foreign currency deposits with Domestic Banking Units, which has been identified as domestic liabilities
(c) During the year. Based on national accounts estimates by the Department of Census and Statistics.

Source: Central Bank of Sri Lanka.

Table 7.2 **Underlying Factors of Reserve Money and Broad Money**

Rs.billion

Item	End 2006	End 2007(a)	Change 2006 Amount	Change 2006 %	Change 2007 Amount	Change 2007 %
Reserve Money	239.9	264.4	42.0	21.2	24.6	10.2
Net Foreign Assets of the Central Bank	229.9	292.9	33.0	16.7	63.1	27.4
Net Domestic Assets of the Central Bank	10.0	-28.5	9.0	892.6	-38.5	-384.9
Broad Money (M_{2b})	1,204.6	1,404.0	182.3	17.8	199.5	16.6
Net Foreign Assets	171.2	228.0	-30.2	-15.0	56.8	33.2
Monetary Authorities	229.9	292.9	32.9	16.7	63.1	27.4
Commercial Banks	-58.7	-64.9	-63.1	-1,432.0	-6.2	10.6
Net Domestic Assets	1,033.4	1,176.0	212.5	25.9	142.6	13.8
Domestic Credit	1,382.0	1,607.8	314.6	29.5	225.8	16.3
Net Credit to the Government	357.3 (b)	374.1	107.7	43.1	16.8	4.7
Monetary Authorities	112.9	101.1	38.5	51.8	-11.9	-10.5
Commercial Banks	244.3	273.0	69.2	39.5	28.7	11.7
Credit to Public Corporations	31.6	49.2	14.9	89.0	17.6	55.8
Credit to the Private Sector	993.2	1,184.5	192.1	24.0	191.3	19.3
Other Items (net)	-348.6	-431.8	-102.2	-41.5	-83.2	23.9

(a) Provisional

(b) 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.

NCG, which increased substantially during the first three quarters, eased during the last quarter with the government receiving foreign currency proceeds from its debut international bond issue. The overall increase in NCG during the year was Rs. 16.8 billion compared with the decline of Rs. 10 billion envisaged in the revised budget estimates for 2007. However, this increase was exactly similar to the original budget estimates. The increase was entirely reflected in the borrowings from commercial banks (Rs. 28.7 billion), as net borrowings from the Central Bank declined (Rs. 11.9 billion) due to the decline in Treasury bill holdings. The higher borrowings from commercial banks were reflected in the increased holdings of government securities and SLDBs by commercial banks and credit granted in foreign currency by the OBUs of commercial banks.

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

Sector	End 2006	End 2007	As a % of Total End 2007	Rs. billion Change % 2006	Rs. billion Change % 2007
Commercial	240.1	307.3	30.6	12.5	28.0
Exports	46.3	72.3	7.2	-4.4	56.1
Imports	74.9	93.3	9.3	13.8	24.6
Financial	50.7	65.1	6.5	49.2	28.3
Agricultural	32.2	40.6	4.0	14.6	26.1
Industrial (b)	72.2	82.5	8.2	14.7	13.6
Tourism	12.4	11.9	1.2	25.3	-3.6
Housing	133.6	166.6	16.6	41.4	24.7
Consumption	160.4	207.2	20.6	41.4	29.2
Services	43.4	52.2	5.2	0.4	20.3
Other	80.3	71.6	7.1	45.3	-10.8
Total	825.8	1,005.1	100	26.0	21.7

(a) Loans and advances by DBUs of Commercial Banks only. 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

Credit absorbed by the public corporations increased by Rs. 17.6 billion during the year in contrast to a reduction of Rs. 7.4 billion envisaged in the monetary programme. Credit to public corporations was largely dominated by credit utilised by the CPC, which accounted for around 77 per cent of the total outstanding credit of public corporations. During the year, credit granted to CPC increased by around Rs. 22.5 billion, which was largely due to the increased cost on oil imports which had been settled through bank credit. Meanwhile, the Ceylon Electricity Board (CEB) has been successful in gradually lowering its debt to the commercial banks by Rs. 3 billion in 2007, though its liabilities to the CPC, government and private power producers remained high.

Growth in credit to the private sector declined gradually in response to the tight monetary policy stance pursued by the Central Bank. Credit to the private sector, which grew at higher rates in the range

Chart 7.4 **Composition of Domestic Credit and Private Sector Credit Growth**

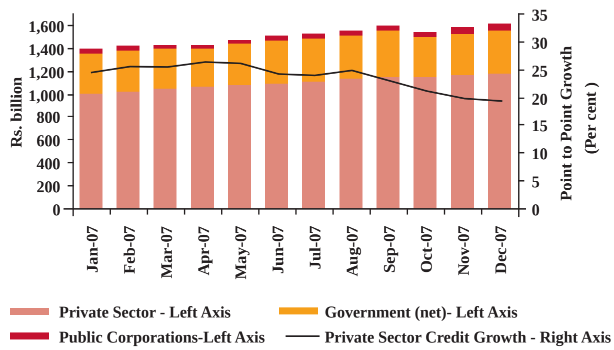
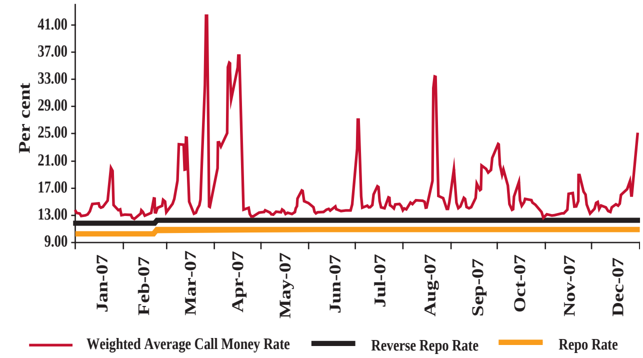


Chart 7.5 **Money Market Rates**



of 24 -26 per cent at the beginning of the year, declined steadily during the second half reaching 19.3 per cent by end December. The upward adjustment in the lending rates by commercial banks and limits on access to the Central Bank reverse repurchase facility as well as moral suasion used by the Central Bank to reduce excessive lending by commercial banks would have contributed to decelerate the growth in credit to the private sector. Of the credit granted, over 86 per cent was accounted for by the domestic banking units of commercial banks while the rest was provided by the OBUs. The purpose-wise distribution of credit reveals that the highest share of credit has been absorbed for commercial purposes, which accounted for 30.6 per cent, followed by consumption (20.6 per cent) and housing purposes (16.6 per cent).

Financial Survey

The growth in broad money as measured by the financial survey (M_4)[1] was in a range of 15-20 per cent during 2007. It increased from 16.0 per cent by end 2006 to around 20 per cent by August 2007. However, it decelerated to 16.7 per cent by end 2007 broadly in line with the deceleration in growth of the consolidated broad money supply (M_{2b}). The contribution of NDA and NFA of the banking system and registered finance companies was about 79 per cent and 21 per cent, respectively, to the growth in broad money based on financial survey.

7.4 Interest Rates

Interest rates in all the market segments increased in 2007 responding to the tight monetary policy measures. The increase in policy interest rates, absorption of excess liquidity from the market on a permanent basis and restrictions on access to the Reverse Repurchase facility of the Central Bank helped market interest rates to adjust upwards. Some moderation in market interest rates was observed immediately after the debut international bond issue in October; however, that trend reversed to some extent towards the end of the year. The upward adjustments in market interest rates helped to contain the excessive expansion in credit as expected. With

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

Table 7.4 **Financial Survey and Underlying Factors**

Rs.billion

Item	End 2006	End 2007 (a)	Change 2006 Amount	Change 2006 %	Change 2007 Amount	Change 2007 %
Financial Survey	1,501.6	1,752.7	207.7	16.0	251.1	16.7
Underlying Factors						
Net Foreign Assets	151.0	204.7	-44.8	-22.9	53.7	35.6
Net Domestic Assets	1,350.6	1,548.0	252.4	23.0	197.4	14.6
Domestic Credit	1,798.0	2,094.7	386.5	27.4	296.7	16.5
Net Credit to the Government	510.7	545.4	101.4	24.8	34.7	6.8
Credit to public Corporations	31.6	49.2	14.9	89.4	17.6	55.7
Credit to the Private Sector	1,255.7	1,500.0	270.3	27.4	244.4	19.5
Other Items (net)	-447.4	-546.7	-134.2	42.8	-99.3	22.2

(a) Provisional

Source: Central Bank of Sri Lanka.

Chart 7.6 Average Weighted Prime Lending Rate and Average Weighted Deposit Rate of Commercial Banks

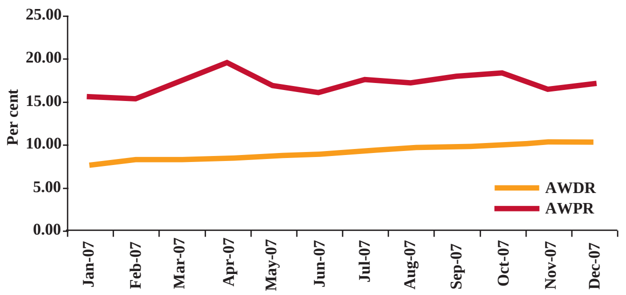


Table 7.5 Changes in Policy Interest Rates of the Central Bank

Per cent

Date	Repo Rate	Reverse Repo Rate	Bank Rate
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
28.07.2006	9.625	11.125	15.00
15.12.2006	10.00	11.50	15.00
23.02.2007	10.50	12.00	15.00

Source : Central Bank of Sri Lanka

the increase in nominal interest rates, real interest rates in many market segments also turned positive during the year.

Money Market Rates

The short-term money market rates were on an upward trend during 2007 amidst some volatility. The weighted average rate at the daily OMO auction of the Central Bank increased during the year. The repurchase auctions were held to absorb liquidity on an overnight basis on most days during the first half of the year except for a short period in March and April. Repurchase auctions were held during the last quarter as well. In addition to these daily absorptions, auctions were also held for outright sales of Treasury bills to absorb excess liquidity on a permanent basis during the first half and the last quarter. Interest rates at the outright auctions for Treasury bills of short-term maturities held by the Central Bank moved in line with increases in yield rates on Treasury bills in the primary market.

Call money market rates moved in a wider range during 2007 as the Central Bank maintained its quantity targets on reserve money, while allowing the market to determine the interest rates. The high volatility was also fuelled by some imbalances in liquidity positions among commercial banks. These rates varied in the range of 12.36 - 42.25 per cent in 2007. However, rates moved to such high levels only during a few occasions and, on average, rates remained within the range of 14-17 per cent. By end March, call rates increased to 42.25 per cent due to the liquidity shortfall created through high demand for funds during the festive season and the imbalance in liquidity among banks. With the improvement in market liquidity, rates stabilised at around 14 per cent. Even though the call rates increased again during the third quarter as the Central Bank imposed restrictions on reverse repurchase transactions, rates declined with the improved market liquidity through the receipt of bond proceeds. The tax adjusted weighted average call money rate hovered closer to the upper bound of the interest rate corridor. The Sri Lanka Inter Bank Offered Rate (SLIBOR), which is the average of offered rates for inter-bank rupee transactions by 12 commercial banks, also moved upwards following market interest rates.

Table 7.6 Money Market Rates

Per cent

	Central Bank Repo Rate	Weighted Average Repo Auction Rate	Weighted Average Call Money Rate		SLIBOR-Overnight	
			End Period	Average for the month	End Period	Average for the month
Dec - 05	8.75	9.29	10.73	10.59	10.93	10.66
Dec - 06	10.00	11.06	14.47	13.55	14.73	13.80
Mar - 07	10.50	11.89	14.95	18.93	15.38	20.65
Jun - 07	10.50	11.81	14.27	13.60	14.00	13.93
Sep - 07	10.50	11.80	21.25	16.64	21.83	17.39
Dec - 07	10.50	11.98	24.99	15.40	21.75	15.69

Source: Central Bank of Sri Lanka

Deposit and Lending Rates

Both deposit and lending rates increased responding to tight monetary policy measures. Deposit rates increased by a considerable margin during 2007 attracting more funds from the public, while lending rates also increased substantially making borrowings more costly. Meanwhile, both deposit and lending rates of long-term lending institutions other than commercial banks also increased during 2007. The interest spread, as measured by the difference between average weighted prime lending rate (AWPR)[2] and average weighted deposit rate (AWDR)[3], increased by mid 2007 due to the higher increase in lending rates than the increase in the deposit rates. However, the spread narrowed down marginally with the adjustments in deposit rates in line with the increase in the lending rates.

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

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

Table 7.7 Interest Rates on Deposits and Lending (a)

Per cent

Institution	End 2006	End 2007
Commercial Banks		
Interest Rates on Deposits		
Savings Deposits	3.00-10.50	3.00-16.50
One year Fixed Deposits	5.50-14.00	8.50-20.00
Average Weighted Deposit Rate (AWDR)	7.60	10.31
Average Weighted Fixed Deposit Rate (AWFDR)	11.50	15.49
Foriegn Currency Savings Deposits - US Dollars	0.20-4.25	0.20-4.25
Foriegn Currency Fixed Deposits (1 Year) - US Dollars	2.00-5.50	2.00-6.50
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	15.19	17.95
Average Weighted Lending Rate (AWLR)	16.56	18.08
Foriegn Currency Loans - US Dollars	4.00-10.00	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	11.00	15.00
State Mortgage and Investments Bank		
One year Fixed Deposits	13.50	16.00
DFCC Bank		
One year Fixed Deposits	12.50	18.00
Interest Rates on Lending		
National Savings Bank (b)	12.00-13.00	17.00-18.00
State Mortgage and Investments Bank (b)	15.00-16.50	15.00-16.50
DFCC Bank	15.00-18.00	20.00-25.00
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

AWPR increased during the year, but showed some volatility following the other money market rates, particularly call money market rates. As such, AWPR increased from 15.19 per cent at end 2006 to 17.95 per cent at end 2007 with some fluctuations during the year. The Average Weighted Lending Rate (AWLR) that reflects the price of the entire loan portfolio of a commercial bank also increased from 16.56 per cent to 18.08 per cent during the year. Lending rates of long-term financial institutions also increased by around 5 percentage points, during the year. Meanwhile, interest rates charged by commercial banks on outstanding payments through credit cards were in the range of 30-42 per cent compared to 21 - 42 per cent in 2006.

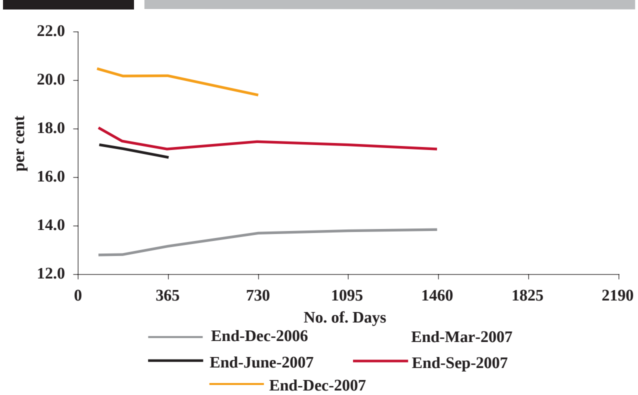
A substantial upward adjustment was observed in deposit rates. AWDR increased by around 3 percentage points to 10.31 per cent while the Average Weighted Fixed Deposit Rate (AWFDR)[4] increased by around 4 percentage points to 15.49 per cent during 2007. Interest rates on fixed deposits offered by financial institutions remained on par with the inflation, attracting more savers to those financial institutions. In line with the adjustments in deposit rates, the Legal Rate and the Market Rate[5] also increased. Accordingly, the rate applicable for the year 2008 is 9.16 per cent in comparison to 6.86 per cent for 2007. A gradual adjustment to deposit rates was also witnessed in long-term financial institutions.

Interest rates on foreign currency denominated deposits of commercial banks have increased during 2007 despite some downward adjustments in policy interest rates in some major economies. Interest rates on US dollar denominated savings deposits remained unchanged at 0.20-4.25 during 2007 while US dollar denominated time deposit rates increased from 2.00-5.50 per cent in 2006 to 2.00-6.50 per cent by end 2007.

Yield Rates on Government Securities

A substantial increase was witnessed in yield rates on government securities with a preference for short-term securities reflecting high inflation expectations in the short-term. Treasury bill rates at the primary auctions increased continuously in 2007 with market anticipating higher government borrowings, less attraction to Treasury bills due to the limited secondary market operations and high inflation expectations. Accordingly, primary market yield rates on 91-day, 182-day and 364-day Treasury bills increased by 854, 721 and 700 basis points, respectively. Accordingly those rates at end 2007 were

Chart 7.7 Government Securities - Secondary Market Yield Curve



4 AWFDR is the weighted average of the interest rates on all outstanding interest bearing fixed deposits of commercial banks.

5 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. The Legal Rate and the Market Rate applicable for a particular calendar year are computed on the same basis using the AWDR 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.

Table 7.8 Yield Rates of Government Securities

	End December 2006	End December 2007
		Per cent
Primary Market		
Treasury bills		
91 days	12.76	21.30
182 days	12.78	19.99
364 days	12.96	19.96
Treasury bonds		
2 years	12.92(a)	15.50(c)
3 years	12.16(b)	15.99(d)
4 years	12.25(b)	14.32(e)
Rupee Securities	10.60	18.40
Secondary Market		
Treasury bills		
91 days	12.70	20.37
182 days	12.73	20.13
364 days	13.07	20.11
Treasury bonds		
2 years	13.62	19.34
3 years	13.71	-
4 years	13.79	-

(a) Yield rate on 1 1/2 year Treasury bond at the last auction held at end November 2006.
(b) The last auction for 3-year and 4-year Treasury bonds was held at end October 2006.
(c) The last auction for 2-year Treasury bonds was held in November 2007.
(d) The last auction for 3-year Treasury bonds was held at end October 2007.
(e) The last auction for 4-year Treasury bonds was held at end April 2007.

Source: Central Bank of Sri Lanka

21.30 per cent, 19.99 per cent and 19.96 per cent, respectively. However, interest rates on government securities started to moderate from the beginning of 2008 with less government borrowings from the domestic market and lower medium term inflation expectations.

The higher increase in yield rates was seen in Treasury bonds but at a lower magnitude than in Treasury bills. There was a tendency towards encouraging the government to rely more on private placements and alternative funding sources in order to ease the pressure on the domestic debt market and interest rates. Yield rates on Treasury bonds with 2-5 year maturities increased in a range of 200-380 basis points in comparison to the increase of 94-126 basis points in 2006. The opening up of investments in Treasury bonds to non-residents also helped to ease the pressure on interest rates on Treasury bonds.

The secondary market yield curve on government securities has shifted upward during 2007 in line with increased yields on government securities in the primary market, yet continuing the inverted shape. During 2007, the secondary market yield curve has shifted upward. However, the curve showed an inverted shape, i.e. longer end was downward sloping as most of the higher yield rates were seen in short-term maturities. This reflects the preference of the market for short-term securities, indicating the expectation of high inflation in the short-term.

Yield Rates on Corporate Debt Securities

The high interest rate environment was also reflected in the corporate sector activities. Accordingly, yield rates on corporate debt securities increased further in 2007. Interest rates pertaining to commercial paper, a short-term debt instrument, which were in the range of 14.70 -16.95 per cent in 2006, increased to a range of 17.50-31.49 per cent by end 2007. A number of public issues of debentures were observed during the year. These issues carried either floating interest rates or fixed interest rates in the range of 13.50-17.50 per cent.

7.5 Further Developments, Issues and Outlook

The introduction of a new consumer price index, CCPI(N), which is a more representative measure of overall developments in prices compared to the old CCPI, is considered a noteworthy development, in the context of the need for an accurate and reliable measure of inflation for effective monetary policy decision making. In addition to the CCPI(N), which measures the overall inflation, a core inflation index, by removing items, prices of which are subject to a regulatory review and hence not responsive to monetary policy measures, has also been developed by the Census and Statistics Department. Accordingly, the new index would help the general public to better understand the impact of monetary policy measures on core inflation. It would however be desirable to revise the items included in the basket and their weights at least once every five years to reflect changes in consumers' spending patterns. Given that the base year of the CCPI(N) is 2002, such a revision is now immediately warranted.

A further step towards fulfilling the vital requirements for well informed monetary policy decision making was taken in 2007 by conducting monthly inflation expectation surveys on an experimental basis. These surveys have a wider coverage of economic agents including housewives and the business community and they enable the Central Bank to track the potential future inflation given the strong relationship between actual inflation and inflation expectations of economic agents. Further improvements in the effectiveness of these surveys are expected through enhancing the awareness of the respondents on the importance of expressing their views on future inflation more carefully and accurately.

Conducting monetary policy to maintain price stability is a serious challenge when a substantial part of the country's inflation is driven by external shocks. In 2007, the Central Bank started publishing its policy targets and strategies in its *Road Map: Monetary and Financial Sector Policies*. In this policy statement it was announced that the demand management policies of the Central Bank for 2007 would be based on a projected GDP growth of 7.5 per cent and an inflation rate of 8.5 per cent. It also anticipated a decline in international prices of major non-fuel consumer imports during the year. Even though the high international oil prices were identified as a major challenge at the beginning of the year, the magnitude of the shock was beyond the expectation. The actual inflation during 2007, based on the GDP deflator was 14.0 per cent while it was 15.8 per cent as measured by the CCPI(N). It is worth evaluating the reasons for higher than expected inflation experienced in 2007, given the fact that the announced monetary targets were broadly achieved.

The inflation arising from demand pressures has been notably curtailed through tight monetary policy measures, effective in containing the expansion in monetary aggregates broadly in line with the announced targets. However, several other factors, including a substantial increase in worldwide oil prices that led to substantial upward adjustments in prices of many domestically produced goods and services, unprecedented increases in international prices of several food items and high inflation expectations and wage pressures caused the overall inflation to be around 6 per cent higher than the initial projections.

The average price of crude oil imported by the CPC reached US dollars 71.96 per barrel during 2007, surpassing the initial projection, which was based on the projections of major international organisations, by over 10 per cent. Also, the prices of other commodities such as rice, wheat and milk products increased substantially in the international market during the year, against the initial assumption of a decline.

External shocks will continue to exert pressure on the Central Bank in its efforts to achieve the announced inflation projections in 2008 as well. As announced in Road Map 2008, the monetary programme assumes an average oil price of US dollars 85 per barrel and if it were to reach US dollars 90, the year-end inflation may settle at a higher level than the projected level. High oil prices, which reached around US dollars 110 towards mid March 2008, as well as the increased international prices of other essential commodities, if sustained, could lead to widen the current account deficit exerting pressure on the exchange rate. Further, it could lead to higher domestic inflation, exceeding the initial projections, irrespective of the government's policy to either adjust domestic prices in line with the international prices or subsidise domestic prices. The pass-through of international price increases, though it leads to a one-time increase in prices, will have a favourable impact on containing future inflation by eliminating the need for subsidising the same, through expansionary borrowings by the government. Therefore, continuation of the pass-through of price changes to the domestic market is essential for the benefit of the country and to contain demand. Similarly, concerted efforts of all the stakeholders on minimising oil consumption as well as conserving electricity is essential and the relevant ministries and authorities need to engage in an effective awareness programme.

Increased financing needs of high budget deficits of the government is another challenge faced by the Central Bank. In 2007, the financing needs of the government from domestic sources was maintained at a relatively lower level, thereby substantially helping to successfully conduct monetary policy, when compared to the situation that was experienced in 2006. However, increased credit to the public corporations had a large impact on high monetary expansion. When the financing needs of the public sector, i.e., government and public corporations are larger than the originally planned levels, maintaining monetary expansion in a predetermined path would naturally be more challenging. Therefore, avoiding any deviations from the expected plans of public sector financing is essential for the successful conduct of monetary policy. Further, maintaining budget deficits along the announced path as planned in the government's medium term policy framework would help the Central Bank to manage future inflation and inflation expectations and maintain price stability.

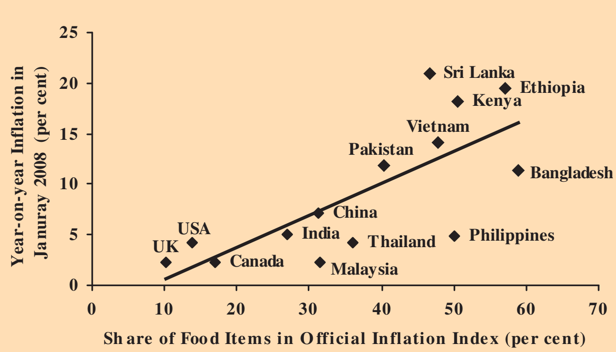
Box 17 The Challenge of Foodflation

In December 2007, the FAO Global Food Price Index compiled by the Food and Agricultural Organisation (FAO) reached 184, the highest recorded monthly average since the start of the compilation of the index in 1990, increasing by over 40 per cent on a point-to-point basis. International prices of all major food commodities, except sugar, rose significantly in 2007. By January 2008, the index has further increased sharply hitting 200 index points. Rising prices of coarse grains and vegetable oils – the commodity groups that feature most heavily in biofuel production – account for the bulk of the increase. For example, international wheat prices in January 2008 were 83 per cent higher than a year earlier.

High food prices have been triggered by a host of factors, including diminishing stocks and a continuing strong demand for cereals for bio-fuel production. According to the US Department of Agriculture (USDA), the projected US wheat stocks for the end of 2007/2008 crop year is the lowest in 60 years, in spite of increased production, as the domestic as well as the import demand increases sharply. As the US is the world's biggest exporter of wheat, this alone has a significant impact on prices.

The diversion of a significant quantity of cereals for bio-fuels, is one of the major cause of falling reserve stocks thereby leading to the price surge. It is believed that the increased use of some food items as a source of fuel is a development that could substantially alter the structure of demand for food products. Higher food prices are also driven by Asia's growing wealth and demand for meat and dairy products. It requires about two kilograms of feed to produce one kilogram of chicken, and the ratio is 4:1 for pork and 7:1 for beef.

Chart B 17.1 **Impact of Food Prices on Inflation**



Higher international food prices put upward pressure on the cost of living, both directly and through their potential impact on non-food prices. The pass-through of international prices to domestic prices in different countries varies depending on several factors. If a country imports a larger share of its food consumption, compared to its domestic production, the pass-though is usually high. Domestic prices also depend on exchange rate policies, tariff structure and government subsidies. It also depends on the margin between retail and wholesale prices as well as transportation charges. For example, the retail prices of many food items in advanced economies comprise a larger component due to labour cost, whereas this margin is not significant for developing countries. Therefore, the impact of a shock is felt more by developing countries.

For many developing countries, food accounts for a significant share of total consumer expenditure. For example, the weight of food in the consumption basket is 57 per cent in Ethiopia, whereas it is 31 per cent in China, and only 10 per cent in the United Kingdom. In Sri Lanka, according to the New Colombo Consumers' Price Index, food has a weight of 47 per cent. It is obvious that the low-income countries are more vulnerable to the direct first-round contribution of food inflation. Food prices could also increase headline CPI indirectly by raising non-food prices—for example, through a wage response to higher food prices—especially in poorer countries in which food accounts for a sizable share of total household expenditure.

A significant fraction of current inflation in Sri Lanka is driven by the one-off adjustments in price level due to the increase in international food prices. The impact of high food prices has obviously deteriorated the purchasing power of an average person, but its impact on various segments of the population is diverse. On one hand, high inflation reallocates the resources in the economy in favour of the affluent and wealthier layers of the society. At the same time, the relative increase in prices of food items raises the income of agricultural sector employees, while burdening the others. As a result, the impact of current high food prices is mostly felt by the urban poor, who are predominantly employed in manufacturing and services sectors, while rural poor has some positive impact through increased agricultural earnings. In spite of all the negative impacts of high inflation, it therefore has helped to reduce regional disparities to some extent.

In response to high food prices, various countries have formulated their own strategies to help the vulnerable populations to cope with the situation. Such measures include plans to increase the production (Malaysia), import duty waivers and reductions (Indonesia, Mongolia, Morocco, Turkey), export bans, taxes and restrictions (India, Pakistan, Vietnam, Serbia, Ukraine, Zambia), direct subsidies and price controls (China, India, Russia, Argentina, Morocco, Egypt, Mexico, Jordan, Zimbabwe, Benin, Senegal). The strategies followed by Sri Lanka are allowing to pass the shock to domestic prices without direct subsidies, plans to increase the agricultural production, import tariff reductions and directed subsidies. Therefore, Sri Lanka's current inflation reflects the true impact of the external shock, unlike the inflation in many other countries where the inflation is partially suppressed through direct subsidies and price controls.

The strategy to protect the domestic prices using subsidies and price controls is highly questionable. If governments use inflationary financing to subsidise selected food items, it would ultimately raise the overall price level. If required resources are raised from the non-bank sector, it may crowd out investments and affect future economic growth. Moreover, the largest beneficiaries of subsidies are the high-income categories who consume more, but not the poorest segments. Price controls may create a food shortage within the country. Export bans will maintain the domestic prices lower in the short-run, but it will not encourage production, the way out to resolve the root cause of the issue. On those grounds, the most appropriate policy in a long-term perspective would be to pass the shock to domestic prices, except for any directed subsidies. However, this policy may lead to the politically sensitive issue of a higher one-off increase in cost of living, which is desirable compared to continuing long-term inflation.

Chart B 17.2 **FAO Food Price Index (1998-2000=100)**

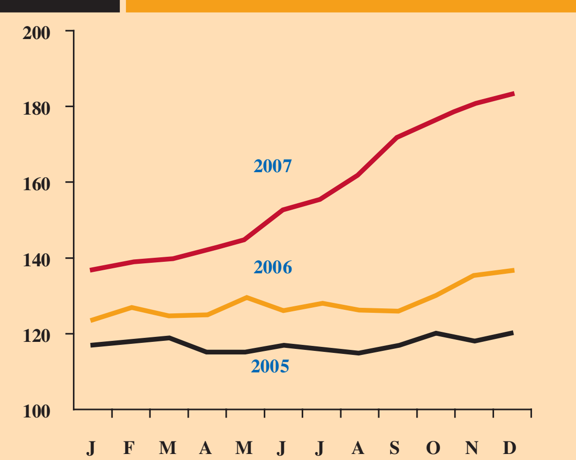


Chart B 17.3 **CCPI(N) Food Index (2002=100)**