

INTEREST INCOME OF DEPOSITORS: DO DEPOSITORS GAIN IN NORTH AND EAST OF SRI LANKA?

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Abstract

Central objective of this study is to investigate the nature and trends of interest rate margin and real interest rate in Sri Lanka. It also focuses the impact of interest rate spread/margin and real interest rate on depositor's income and regional economic development. Empirical data analysis reveals that interest rate margin in Sri Lanka is thicker when compare to other developing countries in Asia. Real interest rate is negative in most of years during 1978-2014 and depositors have been exploited by financial intermediaries due to the thicker interest rate margin and negative real interest rate. Average interest rate margin and average real interest rate based on average weighted lending rate, average weighted deposit rate and inflation rate during 1978 to 2014 are 2.4 and 0.3 percent respectively. Financial intermediaries have been earning more than eight times of income than depositor's real income in average during this period. From this empirical data, this study highlights capital losses to depositors is more in the North and East provinces of Sri Lanka since most of depositors in this region are relatives of Tamil Diaspora. Interest rate policy exploits financial gain from depositors to intermediaries in North and East provinces of Sri Lanka. As a result it creates capital losses and regional disparity among the regions in Sri Lanka. Government of Sri Lanka should ensure availability of data on accumulated deposits and lending from each districts of Sri Lanka. Political uncertainty due to the absent of political solution for long standing ethnic conflict in Sri Lanka discourages investment in North and East of Sri Lanka. This political environment make a room to exploit the saving from this region to other region. Permanent peace and stability in North and East of Sri Lanka plays important role to make investment sensitive to interest rate. It will prevent financial exploitation and induce long run investment in this region hence creation of employment and output.

Key words: Interest rate margin, Real interest rate, Capital gain/loss and Regional parity.

1.Introduction

Interest rate, as decision making tool for depositors and investors has been playing an important role in an economy. Like other production factors-income such as Labor-wage, Land- rent, Entrepreneur- profit, and Capital earns interest income. Owner of finance carefully investigate the behavior of interest rates in an economy and take his/her investment decision whether they invest their finance on a project or not. With other determinants of investment, various types of interest rate are being considered in investment decision making. On other hand, when other determinants of investment is unfavorable, owners of funds deposit their savings as fixed saving deposit in bank and receiving interest rate income. This activity is the least risk taking decision to earn a minimum income from their saving. It has various types of deposits with different interest rate. Are depositors protecting their saving from inflation and receiving interest income satisfactorily? While depositors and investors in a country are from different regions, the region which has more instability for investment discourages investment and encourages deposits. In this scenario, the interest rate plays as financial

exploitation tool from instability region to stability region within the county. This study tries to show the financial losses of depositors, particularly depositors from North and East region of Sri Lanka and how they have been exploited by financial intermediaries in Sri Lanka.

Banking sector plays a pivotal role in the economy, essentially functioning as the market intermediaries and the creator of credit. The core banking activity has been to mobilize deposits by paying interest and lending such funds and earn interest. In the recent past banks and other financial institutions in Sri Lanka have reduced interest on deposits on several occasions and now such rates have come down to very low levels comparatively. Interest rate which is expressed in percentage terms, is a payment paid on borrowed capital. In other words, it is a payment attached to financial instruments such as time deposits, treasury bills, debentures etc. It is an essential instrument for conducting monetary policy and financial decision making guidance to depositors and investors. Many Central Banks use the interest rate both as a source of information in determining policies and as an operating instrument for conducting monetary policy. Interest rate mechanism, among other instruments, is used for achieving objectives of the Central Bank. The objectives of the Central Bank of Sri Lanka are to maintain economic and price stability and to maintain financial system stability. In most of past the years, depositors in Sri Lanka have been earning less interest income than the interest margin income which commercial banks and other financial institutions have earned from deposits. When we consider inflation and real interest rate, interest income to depositors is very small or unattractive amount. The people, those who have more saving habits and less investment opportunities have been adversely affected by falling of real interest rate and increased interest rate margin that earned by financial institutions. It leads to regional disparity of economic development. Table one shows the interest rate margin in Asian economies.

Table -1: Interest rate margin in selected Asian countries

Countries	2012	2013	2014
Bangladesh	3.2	1.3	1.8
China	3.1	3.0	3.0
Indonesia	5.5	5.8	5.4
Korea, Rep.	1.6	1.7	1.8
Malaysia	2.0	1.8	1.6
Myanmar	5.0	5.0	5.0
Philippines	3.3	2.5	4.1
Sri Lanka	3.0	4.6	2.4

Source: World Development Indicators, World Bank

Interest rate margin / interest rate spread is defined as interest rate charged by banks on loans to private sector customers minus the interest rate paid by commercial or similar bank for demand, time, or savings deposits¹. The interest rate charged on banking facilities too were reduced accordingly. Just a snap look reveals that the average saving rate being around 7% and the short term lending rate around 19%, the banks being the market intermediary enjoys a clear margin of 12%. This seems a little high considering the real return of the depositors in an inflationary market scenario. Comparative statistics suggest that the spreads applied by the newly industrialized countries is even less than 2%.

However, certain sections of the general public are puzzled; why can't the banks also reduce interest rates charged on banking facilities, very close to deposit rates and why do banks keep a margin of around 4 per cent to 10 per cent between the deposit and lending rate, depending on the type of facility. This margin is called the "Interest Spread" and, it is high in Sri Lanka when compared to the countries in the developed world and some of

¹In most of literature, the term of interest margin and interest rate spread are used as a similar term. See A.A.Azeez and Sachithra Gamage, 2013

the countries in the region. In developed economies the interest spread is around 1 per cent to 2 percent. In some developing countries, the interest rate is around one per cent to four percent. When depositors who are owner of saving and save their income by foregoing their consumption, have been getting less interest income, financial intermediaries which have been transacting saving from depositors to investors (barrowers) have been getting more interest income than depositors in Sri Lanka. Both depositor and borrower will be able to get benefits and economic activities will be accelerated when this interest margin could be reduced in Sri Lanka. This paper focuses the nature and trends of interest rate margin, determinants of interest rate margin and consequences of this margin on depositors and overall economy in Sri Lanka by comparing with some Asian developing economies. From national level investigation, this paper also focuses that how the North and East provinces are adversely affected from this national interest rate policy in Sri Lanka.

2. Literature Review

Classical Theory of Interest

According to classical theory, money does not matter in an economy. It means that money does not involve in determination of intertest rate hence investment and output & employment. Savings are usually invested through an interest rate channel. When savings are equal to investment, the equilibrium rate of interest is determined. It assumes a positive relationship between interest rate and savings and a negative relationship between the interest rate and investment. One of the major policy instruments in the classical theory is interest rate. According to the classical theory, interest, in real terms, is the reward for the productive use of capital, which is equal to the marginal productivity of physical capital. In monetary economy, as physical capital is purchased with monetary funds, the rate of interest is taken to be the annual rate of return over money capital invested in physical capital assets. True classical theory of interest rate is the savings investment theory. It was presented in a refined form by economists like Marshall, Pigou, Taussig, and others.

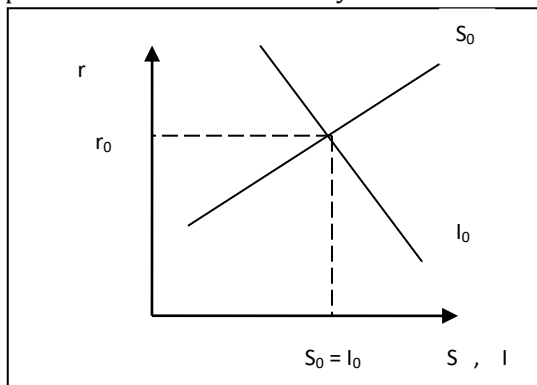


Figure 01: Determination of Interest Rate in Classical Theory

Basically, classical theory holds the proposition based on the general equilibrium theory that the rate of interest is determined by the intersection of the demand for and supply of capital. Thus, an equilibrium rate of interest is determined at a point at which the demand for capital equals its supply. Demand for capital stems from investment decisions of the entrepreneur class. Investment demand schedule, thus, reflects the demand for capital, while the supply of capital results from savings in the community. Savings schedule, thus, represents the supply of capital. It follows that savings and investment are the two real factors determining the rate of interest.

Keynesian Theory of Interest

In the Keynesian theory, money does matter; the interest rate may not determine the equilibrium level of savings and investment. Instead, the process of interest rate determination was regarded as a monetary phenomenon and the interest rate is purely a monetary phenomenon in the Keynesian's version. In this version, low interest rates were advocated to raise income.

According to Keynes, the demand for money, i.e., the liquidity preference and supply of money determine the rate of interest. It is in fact the liquidity preference for speculative motive which along with the quantity of money determines the rate of interest. As for the supply of money, it is determined by the policies of the Government and the Central Bank of the country. The total supply of money consists of coins plus notes plus bank deposits. How rate of interest is determined by the equilibrium between the liquidity preference for speculative motive and the supply of money is shown in Fig-2.

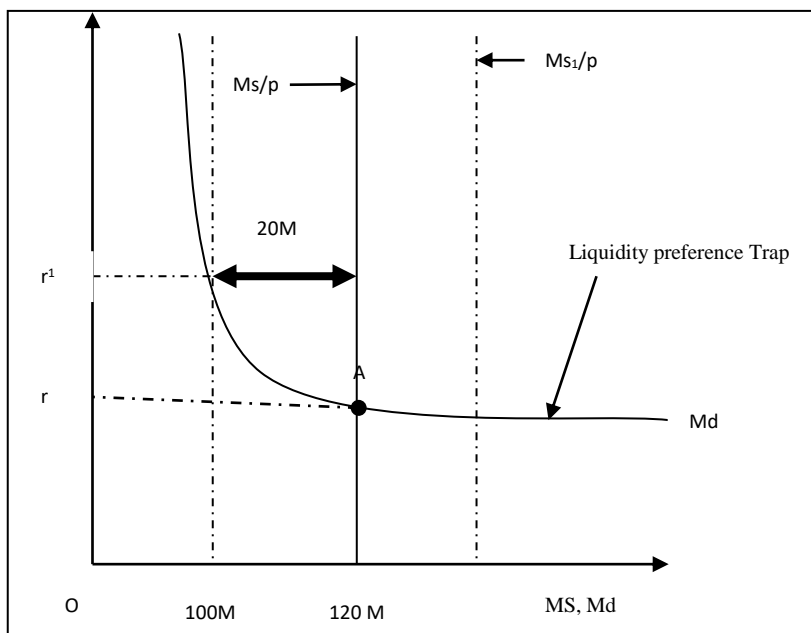


Figure 02: Determination of Interest Rate in Keynes's Theory

In Fig. 02, LP is the curve of liquidity preference for speculative motive. In other words, LP curve shows the demand for money for speculative motive. To begin with, Md is the quantity of money available for satisfying liquidity preference for speculative motive. Rate of interest will be determined where the speculative demand for money is in balance or equal to the fixed supply of money. It is clear from the figure that speculative demand for money is equal to 100M quantity of money at Or_1 rate of interest. Hence Or_1 is the equilibrium rate of interest. Assuming no change in expectations, an increase in the quantity of money to 120M (say through open market operations by central bank of a country) for the speculative motive will lower the rate of interest to r .

Neoclassical Theory of Interest

The famous Swedish economist, Knut Wicksell, expounded the loanable-funds theory of interest, also known as the neo-classical theory of interest. The loanable funds theory is an attempt to improve upon the classical theory of interest. It recognizes that money can play a disturbing role in the saving and investment processes and thereby causes variations in the level of income. Thus, it is a monetary approach to the theory of interest, as distinguished from that of the classical economists. In fact, the loanable funds theory synthesizes both the monetary and non-monetary aspects of the problem.

According to the loanable funds theory, the rate of interest is the price that equates the demand for and supply of loanable funds. Thus, fluctuations in the rate of interest arise from variations either in the demand for loans or in the supply of loans or credit funds available for lending. This implies that interest is the price that equates the demand for loanable funds with the supply of loanable funds. Loanable funds are "the sums of money supplied and demanded at any time in the money market." The supply of 'credit' or funds available for lending would be influenced by the savings of the people and the additions to the money supply (usually through credit creation by banks) during that period. Thus, the supply of loanable funds is constituted by the savings. (S) plus new money (new money supply resulting from credit creation by commercial banks). Thus, S + M is the total supply of loanable funds. The demand side of the loanable funds, on the other hand, would be determined by the demand for investment plus the demand for hoarding money. It should be noted here that if the hoarded money increases, there would be a curtailment corresponding in the supply of funds. Similarly, an increase in dishoarding will lead to an increase in the supply of loanable funds.

In short, thus, the demand for loanable funds is constituted by the investment expenditure a demand for investible fund (I) plus net hoarding (H), i.e., the demand for loanable funds for use as inactive cash balances. Thus, I + H is the total demand for loanable funds. Thus, according to the loanable funds theory, the rate of interest is determined when the demand for loanable funds (I + H) and the supply of loanable funds (S + M) balance each other. Evidently, the loanable funds theory is wider in scope than the classical theory.

The classical theory considers the rate of interest as a function of saving and investment only. Symbolically: $r = f(I, S)$,

Where, r denotes the rate of interest, I stand for investment and S for saving.

Keynesian theory considers the rate of interest as a function of demand and supply of money - $r=f(M_d, M_s)$

The loanable funds theory regards the rate of interest as the function of four variables: savings (S); investment (I); the desire to hoard (H); and the money supply (M), i.e., newly created money or bank credit (including money dishoarded). Symbolically:

$$r = f(I, S, M, H).$$

Liberalization policies which came after new classical economic thoughts did not allow controls on interest rates. McKinnon and Shaw presented a strong case against the low interest rate policy as advocated by neo-classical and Keynesian paradigms (Ross Levine (1997)). According to framework of McKinnon and Shaw, the interest rate is positively associated with the savings, investment and economic growth. They assumed an increase in interest rates stimulates savings, especially bank deposits and thereby provides more investible funds thus leading to economic growth. They advocated the removal of interest rate ceilings. Neo-structuralists expects a substitution effect to come from curb market loans to deposits when the deposit rates are raised, and therefore increasing the interest rate is likely to reduce rate of economic growth by reducing the availability of credit. Later on market failure school related equilibrium rate of interest to asymmetry of information. In this version, the government has to intervene to rectify market malpractices. Therefore, market failure school suggests having a government intervention in determining interest rates and efficient allocation of resources. The use of interest rate as a monetary policy instrument was intensified along with active open market operations. Central Bank's main policy instruments were the Bank Rate, Statutory Reserve Requirement (SRR), open market operations (OMO) and moral suasion. The interest rate at OMO is a short-term policy instrument, which is used to achieve

monetary policy targets, although the behavior of interest rate has long-term consequences on macroeconomic variables such as savings, investment, economic growth and inflation.

3. Data Analysis and Discussion

This study investigates the data from Central bank of Sri Lanka (CBSL) during the period from 1978 to 2014. This period is considered for following reasons: Firstly, Sri Lanka has been following open market economic policy since 1978. Financial sector in Sri Lanka has been liberalizing in open market Era and many reforms in financial sector have been made during this period. Secondly, this period ended with the 2014 where political changes evolved from presidential election January 2015.

Interest rate spread is computed generally from differences between average weighted lending rate (AWLR)² and average weighted deposit rate (AWDR)³. Real interest rate is computed as average weighted deposit interest rate minus inflation rate. Further, this study investigates various type of lending and deposit rate and they are compared with AWLR and AWDR.

Figure 3 shows the trends of real interest rate and interest rate margin in Sri Lanka. According to data from central bank of Sri Lanka, the average interest rate spread and average real interest rate based on AWLR, AWDR and inflation rate during 1978 to 2014 are 2.4 and 0.3 percent respectively. Beyond the reliability of data in these variables, financial intermediaries have been earning more than eight times of income than depositor's real income. This financial policy is more favorable to financial intermediaries than depositors and borrowers. A financial institution which is functioning as financial intermediaries from depositors to borrowers has been enjoying higher interest rate than interest rate for financial creators (owner of finance).

Figure 3 and 4 explain the trends of real interest rate and interest margin in Sri Lanka during 1978-2014. Interest margin on average is higher in Sri Lanka. It has two types of effects on economy: The increase in the interest spread discourages savings and deposits on one hand, and discourages borrowing on the other hand. Either way, it affects the economy adversely. It also leads to inflationary pressure in an economy. The banks would offer lower interest on deposits to keep the spreads thicker which the discouraging saving and encouraging consumption probably leading to 'demand- pull' inflation. The savers are obligated to spend saving on consumption leading to demand pull inflationary impact on the economy, or look for other avenues that would give them an extra premium creating an informal money market. Both propositions lead to adverse impact on the economy. On the other hand the banks would push up the lending rates increasing the borrowing cost of the producers probably leading to cost push inflation.

Comparatively high borrowing costs would depress business investment there by suspending or postponing the possible economic trigger activity where the operation of the economic chain, come to an end. Generally, when the business investment enhance in an economy, increased production and cost effective operation would have a downward pressure on the inflation while activating a chain reaction in the economy. Enhanced production makes way for job opportunities and speedier circulation of money resulting in economic growth. By this way, increased interest rate spread slowdowns the economic growth in an economy.

²The **Average Weighted Lending Rate (AWLR)** is calculated by the Central Bank monthly (computed quarterly up to 2010), based on all outstanding loans and advances granted by commercial banks to the private sector and the corresponding interest rates. (Annual Report of CBSL, 2015)

³ The **Average Weighted Deposit Rate (AWDR)** is calculated by the Central Bank monthly based on all outstanding interest bearing deposits of commercial banks and the corresponding interest rates. (Annual Report of CBSL, 2015)

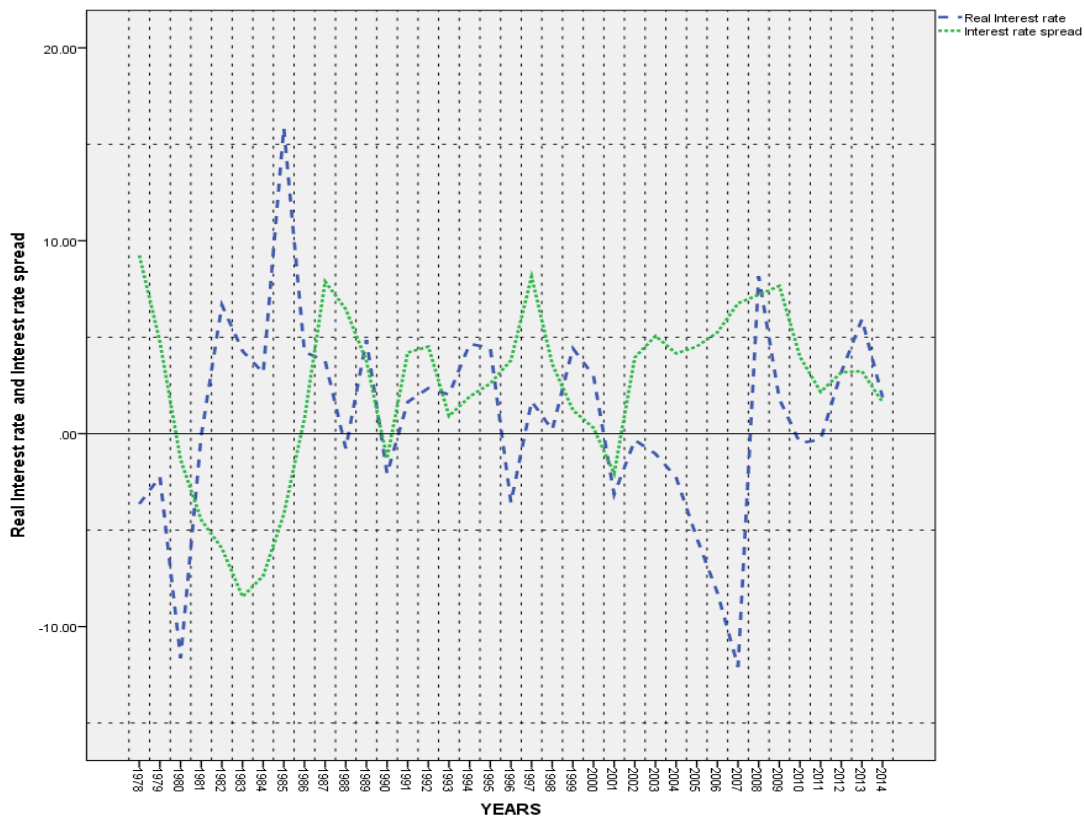


Figure 3: Real Interest Rate (AWDR-IR) and Interest Rate Margin (AWLR-AWDR)

AWLR and AWDR are published by CBSL. When we compare this rate with market interest rate in real life, AWLR is unreliable. For instance, The AWLR in 2014 is 7.83 percent, but subsidized rate of interest rate of housing loan to government officers is 9.00 percent. The ordinary people and investors have paid more than 12 percent interest to their various loans. Any one in regular financial market was unable to get financial lending facilities less than 12 percent in 2014. This clearly shows that AWLR is around 5 percent less than the market actual rates. When we consider this issue, average interest rate margin of commercial bank is more than 7.4 (2.4+5.0) percent which is equal to interest rate of 12 month fixed deposit in 2014. It indicates that financial institutions in Sri Lanka have been able to earn interest rate margin which is equal to interest of 12 months fixed deposit in 2014. Interest margin income is more than depositor's income when we consider inflation rate.

Another important issue related with inflation and real interest income in Sri Lanka is that data related to inflation also unreliable. Inflation in Sri Lanka in 2005 was reported 11.64 percent. It was reduced to 4.32 percent in 2014. During this period, the general price increases in Sri Lanka has been reduced to around one third of price increment in 2005. General public have doubt in inflation reduction⁴. They realize that general price increases is more than reported inflation rate in Sri Lanka. From this critical view, the real interest rate and income of depositors are negative and income of financial institutions is positive. However, it is more difficult task to prove statistically. On other hand, past researches show that one of the reason to higher interest rate margin in Sri Lanka is inflation.

⁴ Eran Wickremaratne (2012) and Nimal Sanderathne (2013)

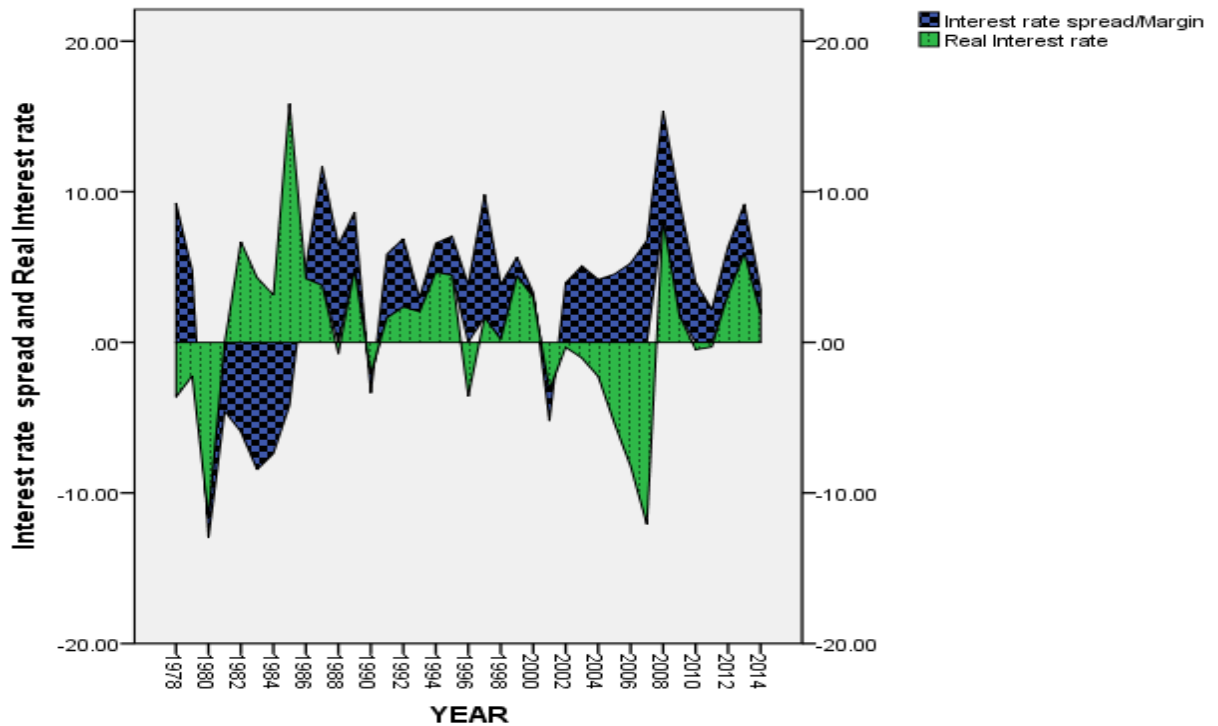


Figure 04 : Real Interest Rate (AWDR-IR) and Interest rate Margin (AWLR-AWDR)

According to the Niroshana Seneviratne (2007), he also confirmed that depositors in Sri Lanka had been affected by inflation.

Theoretically, the real return from an investment is the nominal return less the inflation rate. The application of the above principle to the depositors indicates a negative real return. The attribution of AWDR and the current inflation rate of 18.6 (As of March 2007 CBSL bulletin) to the above formulae suggest that the depositors receive a negative real return of 10.34%. A simple explanation suggest, at a static inflation rate of 18% and an AWDR of 8.26% that, a Rs.1000 worth of a good would be Rs.1,186 at the end of one year from now, where as a Rs.1000 deposit would grow up to Rs.1082.60 thereby incurring a loss of Rs 103.40." Niroshana Seneviratne (2007), p.208

In figure 04, real interest rate is negative in many years whereas interest margin except a few years, is positive during 1978-2014.

Interest rate margin is calculated from AWLR minus AWDR. Two major state commercial banks, People's bank and Bank of Ceylon play important role in determination of AWLR. A small numbers of political elites/supporters have been enjoying with low rate of lending facilities from these Banks. Both banks have been lending huge amount of loans to politicians and their supporters with low rate of interest. This politicalised lending activities lead to lower the AWLR than the general market interest rate, offered to ordinary general public. Average weighted lending rate has been lowered as it is weighted to huge lending amount of two state banks which is given to small groups of people. It clearly shows that AWLR is not a proper indicator to measure interest rate margin, earned by commercial banks of Sri Lanka.

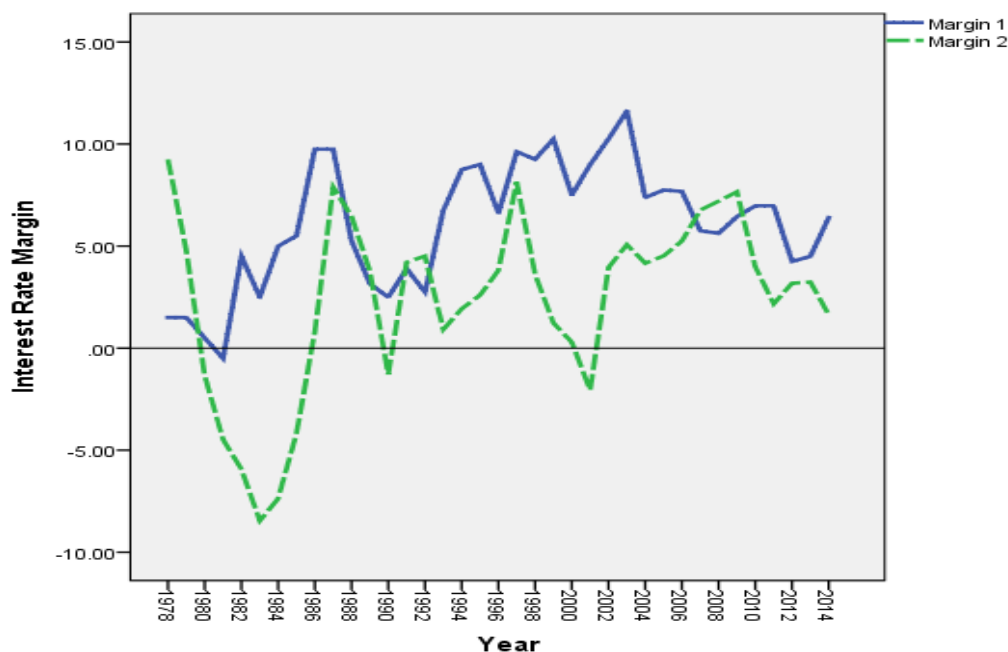


Figure 05: Interest Rate Margin 01 (ALR-ADR) and Interest Rate Margin 02(AWLR-AWDR)

Figure 05 shows the two types of interest rate margin; Margin 02 is based on AWDR and AWLR which is generally calculated by CBSL. Margin 01 is computed from average lending interest rate to immovable assets minus average interest rate of 12 months fixed deposit. Average is calculated from higher and lower rate of interest rate to deposit and lending which reported by CBSL in annual report of 2015. The Margin 01 is higher than margin 02. The average interest rate margin based on average lending and deposit rate and average weighted interest rate margin are 6.11 and 2.3 percent respectively. Interest rate margin based on average interest rate is two times higher than interest rate margin based on average weighted interest rate. Weighted rate is not rate given to ordinary public who borrowed in general financial market.

Deposits have increased in steadily in Sri Lanka. Table 2 and figure 6 shows the recent increases in deposits in Sri Lanka.

Table -2: Growth of deposits in banking and non- banking institutions in Sri Lanka (Rs M)

Year	Fixed Deposits	Saving Deposits	Certificate of Deposit	Total Deposit
2007	75,975	1,379	861	78,216
2008	99,816	2,751	910	103,477
2009	114,489	4,465	843	119,797
2010	140,196	5,074	850	146,120
2011	179,259	5,938	810	186,007
2012	248,516	4,855	747	254,117
2013	328,062	8,563	672	337,297
2014	396,351	16,984	664	413,999

Source: Central Bank Annual Report 2015.

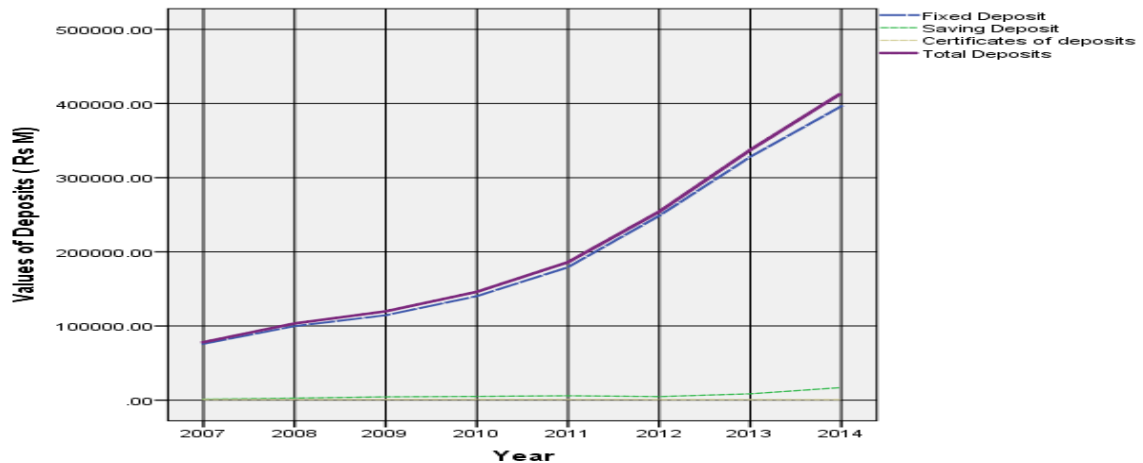


Figure 06: Growth of Deposits in Sri Lanka

From wider interest rate margin and increased deposits, commercial banks, essentially being market intermediaries, enjoy healthy margins which have been clearly reflected in their financial results for the past years. Commercial banks have shown a steady growth in their profitability, with a tremendous growth in their respective balance sheets. A closer look at the profitability of the commercial banks for the year ended 31st December 2015 suggest that, quite a number of banks have exceeded the LKR 25 billion in their profits. For instance, report bank of Ceylon (BoC) shows that it closed the 2015 financial year by recording the highest ever profit of Rs.25.3 billion, made by a single commercial entity in the country. One of the leading commercial bank in Sri Lanka, Commercial Bank of Ceylon PLC has recorded profit before tax of Rs 17.144 billion for the 12 months ended December 31, 2015. Total assets grew by a noteworthy Rs 84.195 billion or 10.58% over the 12 months to Rs 879.805 billion at December 31, 2015. Deposits from customers have been increased to Rs 624.102 billion at the end of 2015. These data clearly confirms that commercial bank in Sri Lanka have accumulated huge amount of deposits and enjoying with remarkable profits.

Many factors have been influencing in determination of thicker interest rate margin in Sri Lanka. A.A.Azeez and Sachithra Gamage (2013) lists the following factors:

1. Staff cost (+)
2. Capital cost (+)
3. Administration cost (+)
4. Tax cost (+)
5. Non- performing loans (+)
6. Management inefficiency (+)
7. Lower total loans (-)
8. Market share (+)
9. Statutory Reserve Rate (+)
10. Inflation (+)
11. Treasury bill rate (-)
12. GDP growth (-)

According to Niroshana Seneviratne (2007), the credible reasons for the thicker margins could be attributable to:

- i) Interest Insensitivity of Deposits
- ii) Lucid Behavior of Depositors

- iii) Market Structure of the Industry
- iv) Average Size of the Transaction,
- v) Pressure for Profitability
- vi) Quality of Lending
- vii) Opportunity Cost of Holding Mandatory Reserves
- viii) Impact of Tax
- ix) Economic and Market Conditions
- x) Inefficiency in the Processes.

The economy is moving very slowly, it leads to limit the activities of banking sector with the traditional functions. Limited banking activities in quantity and quality term make a business environment to depend them on thicker interest margin income from deposits. Reflecting their model of traditional commercial lending, Sri Lankan banks continue to be dependent on interest income; total interest income accounted for 84.2% of turnover in 2014. In general, banks that had higher retail and/or SME exposure have benefited from higher net interest margins (defined as interest income/average interest-bearing assets). However, lending rates across all customer segments have been driven down largely by lower market interest rates and increased competition with the revival of loan growth. The increase in the interest margin dampens savings and deposits on one hand, and discourages borrowing on the other hand. Either way, it affects the economy adversely. To keep the spreads thicker, the banks would offer lower interest on deposits discouraging saving and encouraging consumption probably leading to 'demand- pull' inflation. The impact is not much visible as most of the small time depositors are non interest sensitive. The savers are now either compelled to spend them on consumption and it leads to demand pull inflationary impact on the economy, or look for other avenues that would give them an extra premium creating an informal market. Both propositions lead to adverse impact on the economy.

On the other hand, the banks would push up the lending rates thereby increasing the borrowing cost of the producers would probably leading to cost push inflation. Relatively high borrowing costs would discourage business investment there by suspending or postponing the possible economic trigger activity where the operation of the economic chain, come to an end. Generally, when the business investment enhance in an economy, increased production and cost effective operation would have a downward pressure on the inflation while activating a chain reaction in the economy. Enhanced production makes way for job opportunities and speedier circulation of money resulting in economic growth.

With the deregulation of the financial market in Sri Lanka, the financial sector, specially, the individual banks are given the autonomy to decide on their lending rates. Banks by widening the spreads have arbitrarily set the lending rates at higher levels. The high lending rates in the market probably could send a wrong signal to the economy. High borrowing costs may discourage investments, while creating inflationary pressure through heavy production costs. It leads to issues with unemployment and curtail development in the economy.

Interest Rate Margin of Commercial Banks and North & East of Sri Lanka

Analytical part of section 3 has clearly proved that depositors in Sri Lanka have adversely affected by both thicker interest rate margin which has been enjoyed by commercial banks of Sri Lanka and negative real interest rate which based on reported inflation and unreported inflation in Sri Lanka. Statistical reports in banking and financial sector in Sri Lanka does not have clear reports on regions and districts wise disaggregated data. Namely, there are no data on that how much deposits are mobilized from all provinces and districts and how much lending facilities have been granted to provinces and districts by banking and non-financial institutions in Sri Lanka. This information is hidden. This data is important to regional planning and economic development.

As we explained earlier, instability region in country is deposit mobilizing region and stability region is lending and investment region. Economic development of North and East of Sri Lanka has been affected by conflict and war for last forty years. Economic activities have been destroyed and revival is going on after ending the war.

Table -3: Distribution of Branches of Banks and Banking Density index in Districts of Sri Lanka

Districts	Total No. of Branches	Population per Branch	Banking Density Index ⁵	Rank based on Index
Anuradhapura	134	6478	15	6
Badulla	118	6966	14	7
Colombo	748	3,110	32	1
Galle	163	6,552	15	6
Gampaha	307	7,534	15	6
Hambantota	103	5,883	13	8
Kalutara	158	7,766	17	4
Kandy	202	6,851	15	6
Kegalle	121	6,975	14	7
Kurunegala	181	8,972	11	10
Matale	80	6,113	16	5
Matara	133	6,158	16	5
Monaragala	68	6,706	15	6
Nuwara Eliya	88	8,170	12	9
Polonnaruwa	70	5,829	17	4
Puttalam	125	6,152	16	5
Ratnapura	140	7,836	13	8
Trincomalee	57	6,737	15	6
Batticaloa	91	5,813	17	4
Ampara	114	5,772	17	4
Jaffna	137	4,299	23	2
Mannar	20	5,050	20	3
Mullaitivu	19	4,895	20	3
Kilinochchi	17	6,824	15	6
Vavuniya	37	5,970	17	4

Source: Economic social statistics of Sri Lanka 2014, Central bank of Sri Lanka

The industry which registered accelerated growth in North and East of Sri Lanka during post war period is banking and financial sector. It has increased very rapidly. Compared to other development progress of North and East provinces of Sri Lanka, establishment of new bank branches, expansion of new branches of already established banks, new arrivals of leasing and insurance companies stands in first rank in this region. Even this financial sector development is needed to post war development of this region, objectives of these institutions do not promote the economic development of these region. A primary objective of these financial institutions in war affected region is mobilizing saving as fixed deposits. Table 3 shows distributions of bank and banking density index in Sri Lanka. Colombo district which contributes the highest share to GDP creation in Western province (around 45 percent of GDP created from western province) is in first rank of banking density index. Jaffna district which contributes less to GDP creation in Northern Province (around 4 percent of GDP created from

⁵ No. of Bank Branches per 100,000 persons

Northern Province) is in second rank of banking density index. According to the latest poverty data of Census department of Sri Lanka, most poverty persistence district in Sri Lanka is Mullaitivu. But, This district stands in third rank in banking density index. There is a strong positive relationship between banking density and GDP in experiences of developed countries. It is applicable in within the countries also. This relationship differs within Sri Lanka. Northern and Eastern provinces are outliers in the scatter plot.

Table 3 shows the shares of GDP and banking density index among the nine provinces of Sri Lanka in 2009(End of war) and 2014 (most recent year). Banking Density index has increased from 9.9 to 21.66. It has been increased by more than 118 percent. Share of GDP increases during this period is just 0.3 percent. It has increased just by 9 percent. Share of GDP has not been changed even the banking density index has increased by 64 percent in Eastern province during this period. Accumulated amount of deposits by commercial bank in North and East provinces and accumulated values of loans, leasing in year based are not available to public or researchers. According to the unofficial information, around 17 percent of accumulated deposits in Northern provinces have been loaned to this region during the war period. It has increased during the post war period and reached 46 percent in 2015.

Beyond the unauthorized data, Table 3 and 4 clearly imply that rapid expansion of financial services in North and East provinces of Sri Lanka did not induced the economic activities of region, hence it has not contributed to increases of shares of GDP of Sri Lanka. From This analysis, we are able to conclude that key objectives of expansion of financial institutions in North and East region of Sri Lanka is mobilizing the savings which comes from Diaspora in the forms of fixed and saving deposits.

Table -4: Banking Density index and GDP shares in provinces of Sri Lanka

Provinces	Banking Density Index (2009)	Share of GDP (2009)	Banking Density Index (2014)	Share of GDP (2014)
Western	18.3	45.1	21.18	42.0
Northern	9.9	3.3	21.66	3.6
Eastern	10.2	5.8	16.82	5.8
Southern	13.2	10.2	16.62	10.8
North Central	12.6	4.8	16.14	5.1
Uva	11.6	4.6	14.7	5.0
Subragamuwa	11.3	6.3	13.66	6.7
Central	11.5	9.6	14.49	10.4
North western	10.7	10.3	13.12	10.7

Sources: Annual Reports of central bank of Sri Lanka and http://www.cbsl.gov.lk/pics_n_docs/latest_news/press_20151028eb.pdf

On other hand, financial institutions in North and East provinces are making huge profits from other financial facilities such as leasing and insurance in this region. War affected people in this region do not have financial awareness in the liberalized economy. People particularly rural people in this region have trapped into the financial facilities which go to door by door in this region during the post war period. Many people in the region have lost their savings, gold jewelries and immovable properties due to the leasing facilities which issued by these financial intermediaries without concerning economic conditions of clients. People in this region who had above properties and did not have any financial liability during the war time. They have lost immovable properties and have more financial liabilities during post war time. Main objectives of these private financial institutions in this region have been exploiting the savings with broad interest rate margin and less/negative

real interest rate. Savings of ordinary people have been exploited in both sides, deposit side and lending/leasing side. This financial exploitation has been happening silently without the awareness to depositors and borrowers in North and East provinces of Sri Lanka during the war and post war period. Capital gain on deposits during the war period shared to government own commercial bank and a few private bank. The adverse effects of wider interest margin and negative real interest rate which explained in section 3 mostly set off to depositors in Sri Lanka. Depositors who have been mostly from North and East of Sri Lanka with foreign remittance have been getting capital losses, instead of capital gain in nature of financial policy and inflation of central government of Sri Lanka.

4. Conclusion

Statistical analysis clearly illustrates that the spreads have been on the rise in Sri Lanka and the comparative statistics suggested that interest margin in Sri Lanka was in the highest in the Asian region. Interest margin is thicker when we calculate it from average deposit and lending rate. Weighted lending rate is less than average lending rate. Huge amount of lending with low interest rate go to small percent of politically influenced borrowers. Majority of people get loans and other financial facilities at higher interest rate in general financial market which is higher than reported average weighted lending rate. Financial intermediaries have been getting financial gain due to the higher interest margin. There are some reasons for enjoying thicker margin by financial intermediaries in Sri Lanka.

Depositors in Sri Lanka have been affected by inflation also. Real interest rate in Sri Lanka in past except a few years was negative and it made capital loss to depositors. Depositors have not been realized that they are losing their deposited capital by inflation. According to some studies and observations, the reported inflation in Sri Lanka during past period is less than the actual inflation. Underestimated inflation also adversely affects the depositor's real income further. Depositors in Sri Lanka have been losing their capital (savings) by both reported inflation and unreported inflation.

Rapid expansion of financial intermediaries in North and East provinces of Sri Lanka during the post war period from 2009 to 2014 did not correlated with provincial share of GDP, hence employment creations and economic growth of this region. This result indicates that primary objective of this rapid growth of financial institutions in North and East provinces of Sri Lanka did not issue lending facilities. Instead, it is mobilizing of deposits and getting financial gain. All commercial banks of North and East region have been investing just 46 percent of their mobilized deposits as loans and advances. Adverse effects of thicker interest rate margin and negative real interest rate in Sri Lanka mostly goes to depositors from North and East region. Depositors in Sri Lanka, particularly from North and East region of Sri Lanka are not getting financial gain due to thicker interest margin and reported & unreported inflation rate. Information regarding deposits and lending should be published to public in the district wise. It will facilitate to plan regional development. Financial literacy programmes should be initiated to ordinary people in North and East region of Sri Lanka. It will leads to take proper financial decision making and to regional economic development parity. Permanent peace and stability must be achieved in Sri Lanka. It would make investment climate more attractive and interest rate will become more sensitive to investment, as such both depositors and borrowers will benefit.

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