7 MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

The Central Bank continued to tighten monetary policy during the year to contain inflation and inflation expectations. *In implementing monetary policy, the Central Bank relied more on quantity control strategies through further tightening of the growth of reserve money, while allowing market interest rates to adjust accordingly to reflect the cost of funds. Hence, market interest rates moved upwards as desired and remained a check on nominal aggregate demand growth. The continued tight monetary policy measures were instrumental in achieving the quarterly reserve money targets during the first three quarters of the year. As a result of the tight liquidity situation and resulting high interest rates, credit to the private sector decelerated substantially leading to a lower broad money expansion. Meanwhile, credit to public corporations has also declined during the first eight months of the year. However, credit to the government from the banking sector during this period has exceeded the originally anticipated level. The tight monetary policy stance has continued to dampen the growing aggregate demand and serves as a check on inflation, which began to decline from July 2008.*

Monetary Policy

- **The Central Bank published the *Road Map: Monetary and Financial Sector Policies for 2008 and beyond* in January 2008 for the second consecutive year,** continuing the practice of publicly announcing the Central Bank's policy strategies for achieving price and financial system stability. Enhancing the transparency of the Central Bank's policy actions, the document explains the Bank's policies for strengthening the macroeconomy, mainly, its monetary policy strategies and policies for financial system stability.

- **In view of the rising inflationary pressures in the economy, which showed signs of firming up, the Central Bank further tightened its monetary policy stance in 2008 by setting more stringent quantitative targets for reserve money.** The original targets were tightened further on two occasions to check the growth in broad money supply when the inflation rate began to accelerate towards the middle of the year. The Central Bank has mainly relied on aggressive open market operations to maintain market liquidity at a level consistent with the reserve money targets. These were streamlined by limiting access to the Reverse repurchase facility at the Reverse repurchase rate by commercial banks and primary dealers to only 3 times per calendar month from November 2007. Further, the Central Bank has continued to limit the funds extended on a given day under Reverse repurchase agreements, at the Reverse repo rate, to an amount equivalent to the liquidity shortfall as estimated by the Central Bank. Banks and primary dealers are however allowed access to the Central Bank's Reverse repurchase window beyond these limits at a penal rate of 19 per cent. Also, the Central Bank has refrained from purchasing Treasury bills at primary auctions or special issues as far as possible to avoid the injection of excess liquidity to the system. Moral suasion was also used to discourage undue credit expansion. The prudential regulations introduced by the Central Bank further supported the tightening of credit extended by financial institutions.

- **However, in the face of the servere adverse developments in the global financial markets, the Central Bank took several measures to mitigate their impact on the domestic financial market.** To avert any risks arising from sharp movements in interest rates due to liquidity constraints, the number of times per calendar month that participating financial institutions could access the Reverse repurchase facility of the Central Bank at the Reverse repurchase rate on days when the market is short in liquidity, was increased to 6 with effect from 2 October 2008. With effect from 15 October 2008, this was further increased to a maximum of 10 times per calendar month, to be effective until 31 December 2008. Further, as a precautionary measure, to maintain stability in the domestic financial market, the Central Bank decided to reduce the Statutory Reserve Requirement (SRR) on all rupee deposit liabilities of commercial banks by 75 basis points to 9.25 per cent, effective from the Reserve Week commencing 17 October 2008, also to be effective till 31 December 2008.

- **Inflation increased significantly during the first half of 2008 due to the pass-through of external**

Table 7.1

Reserve Money Targets - 2008

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual Average
Original Targets:					
Rs. billion	281.5	294.1	291.8	306.3	
Growth %	14.9	15.0	14.0	15.0	14.7
Revised Targets in April:					
Rs. billion		286.3	289.4	301.7	
Growth %		12.0	13.0	13.3	12.50
Revised Targets in July :					
Rs. billion			285.2	301.7	
Growth %			11.4	13.3	11.75
Actual:					
Rs. billion	273.6	283.0	280.6		
Growth %	11.7	10.7	9.6		

supply shocks as well as demand pressures in the economy. Inflation, as measured by the year-on-year increase in the revised Colombo Consumers' Price Index (CCPI), was on a steady upward path during the first half and reached 28.2 per cent by June 2008 from 18.8 per cent at end 2007. This was largely due to the upward adjustments in administered prices of certain items such as kerosene, petrol and diesel and the subsequent adjustment in transport fares. In addition, continued increases in commodity prices in the international market until April has had a significant impact on the prices of imported commodities. However, a reversal of the increasing trend in world commodity prices was observed since May 2008. The upward trend in headline inflation reversed in July and the year-on-year increase in the revised CCPI declined to 24.3 per cent by September, mainly due to some deceleration in domestic food prices. It is expected that this declining trend would continue, supported by continued demand management policies as well as favourable developments expected on the supply side.

- **The communication policy of the Central Bank was further strengthened to improve the informed decision making process of market participants and the general public.** The Central Bank continued its efforts to improve awareness of the general public and market participants through continued dissemination of information on the monetary policy framework, monetary sector developments and targets, monetary policy decisions and monetary policy operations. The announcing of the *Road Map,* releasing of regular and occasional press releases and communiqués and conducting seminars and lectures have strengthened the communication strategy thereby ensuring the greater transparency of the Central Bank's policies. Also, the Monetary Policy Consultative Committee, which comprises stakeholders, experts and professionals in the private sector, was consulted by the Central Bank in its policy decision making process. Through continuous communication with the public by way of several media, the Central Bank has been able to align inflation expectations of the public, particularly those of investors, with the anticipated developments in the general price level as per the information available to the Bank. This has been evident in the results of the inflation expectations survey conducted by the Bank.

Money, Credit and Interest Rates

Reserve Money

- **Reserve money, the operating target of monetary policy, was maintained well within its quarterly targets during the first three quarters of the year.** Improving further on the quarterly targeting system, reserve money targets for 2008 were designed on the quarterly averages of the daily reserve money. This strategy ensures a more disciplined and smooth expansion of reserve money during the given periods.

- **The original reserve money targets for 2008 set at the beginning of the year were revised further downward on two occasions, in April and July, considering the necessity of further tightening market liquidity to avoid second round impacts of increased food and energy prices on inflation**. Accordingly, the original annual reserve money growth target of 14.7 per cent for the year was revised downwards to 11.75 per cent in July. The aggressive open market operations with limits on access to the Reverse repurchase facility of the Central Bank and allowing market

Chart 7.1
Reserve Money - Target vs. Actual

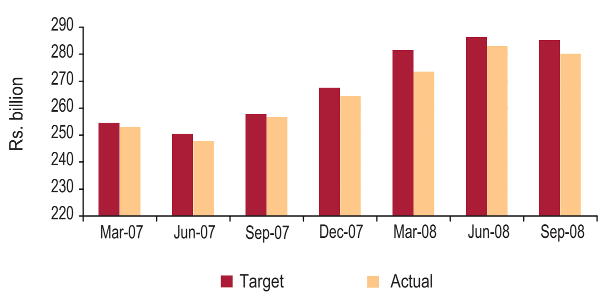
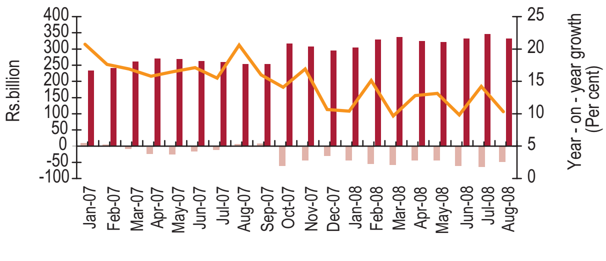


Chart 7.2

Growth and Sources of Reserve Money



interest rates to rise in accordance with the tight monetary conditions helped maintain reserve money within the targeted levels in the first three quarters.

- **The expansion in reserve money during the first eight months was entirely due to an increase in Net Foreign Assets (NFA) of the Central Bank as Net Domestic Assets (NDA) declined during the period.** NFA increased mainly due to the absorption of foreign exchange from the market during the first quarter. Even though this trend reversed somewhat thereafter, the purchases of the proceeds of the loans raised by the government from Offshore Banking Units (OBUs) amounting to US dollars 77 million, a syndicated loan of US dollars 150 million obtained by the government from an overseas bank, and the net sale of Sri Lanka Development Bonds (SLDBs) amounting to US dollars 25 million as well as the disbursement of scheduled foreign loans to the government, supported the increase in NFA during the period. NDA of the Central Bank declined as the Bank absorbed surplus liquidity from the market through open market operations. The decline in NDA was on account of the reduction in Treasury bills held by the Central Bank.

Narrow Money

- **The narrow money supply (M_1), which consists of currency and demand deposits held by the public, grew by 3.7 per cent on a year-on-year basis by end August 2008.** While narrow money growth has continued to decelerate over the past two years, the deceleration in the growth of both currency and demand deposits has contributed to this slower growth. This trend may be attributable to the prevalent high interest rate environment, which has shifted the public focus in favour of interest bearing term deposits from non-interest bearing demand deposits.

Broad Money

- **The year-on-year growth in the broad money supply (M_{2b}) during the first eight months declined further** to 10.3 per cent from 16.6 per cent at end 2007. This was in line with the more restrictive reserve money growth and resulting high interest rates, which have helped decelerate credit expansion.

- **An increase in both NFA and NDA of the banking system contributed to the expansion in broad money up to July while the contribution from NFA declined in August.** During the first eight months, NFA of the banking system increased by about Rs. 3 billion. Even though NFA of the Central Bank increased up to July, it declined during August largely due to foreign loan settlements and intervention in the foreign exchange market. NFA of commercial banks also declined, and there has been a shift in the assets of commercial banks, from foreign assets to domestic assets. The decline in NFA of commercial banks was partly due to the government raising a foreign currency loan from OBUs amounting to US dollars 77 million (subsequently converted to SLDBs) and issues of SLDBs amounting to US dollars 275 million (net issues amounted to US dollars 25 million).

- **The increase in NDA within the banking system was entirely due to the expansion in credit extended by the commercial banks to the government and the private sector.** However, the growth in credit to the private sector, the largest component within domestic credit, declined steadily to reach 9.5 per cent by end August 2008 from the peak of 26 per cent recorded by mid-2007, in response to the tight monetary policy stance of the Central Bank. The latest survey on the purpose-wise distribution of credit indicates that the deceleration has mostly arisen from consumption and housing categories.

- **Net credit to the government (NCG) increased during the first eight months of 2008 despite a decline in credit to the government by the Central Bank, as the credit extended by commercial banks to the government increased.** NCG, which declined during the first quarter, resurged during the subsequent months due to the government's increased use of credit from commercial banks. Although NCG from the Central Bank declined by around Rs. 25 billion during the first eight months, credit extended by the commercial banks increased by around Rs. 57 billion, resulting in a net increase in NCG from the banking system by Rs. 32 billion, which is in excess of the budget estimate of Rs.9.7 billion for the year. The increase in NCG of commercial banks was reflected in their holdings of government securities, the overdraft facilities afforded to the government, their investments in SLDBs and a draw-down of government deposits from state banks.

Chart 7.3
Growth and Sources of M_{2b}

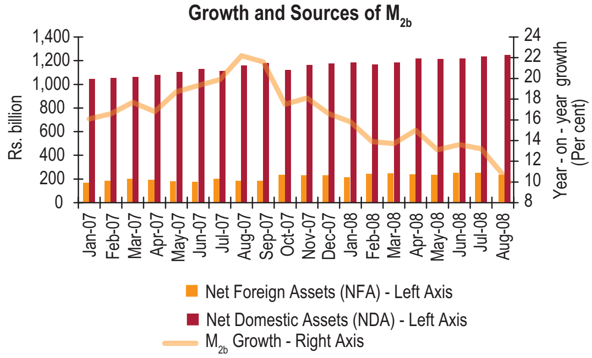


Chart 7.4
Composition of Domestic Credit & Private Sector Credit Growth

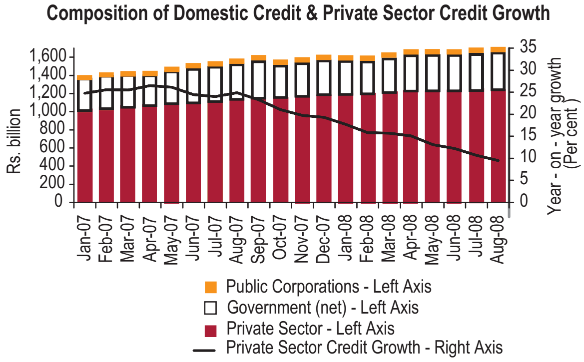
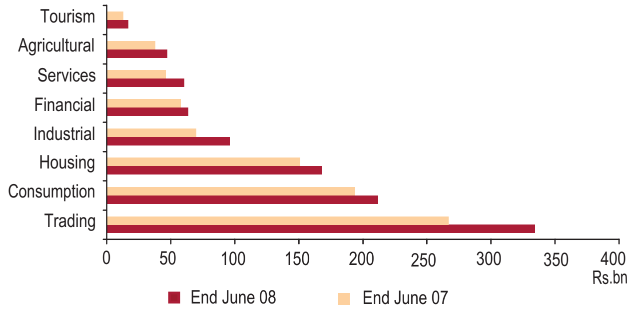


Chart 7.5
Distribution of Private Sector Credit



- **Credit to public corporations, which showed a healthy turnaround from February 2008, indicating a decline, increased during June - August.** Outstanding credit of the public corporations, which reached its peak of Rs. 56 billion in January, began declining thereafter broadly in line with the repayments made by the Ceylon Petroleum Corporation (CPC). Accordingly, outstanding credit to corporations moderated till May but increased to Rs. 41 billion by end August 2008 compared to Rs. 49 billion at end 2007.

Financial Survey

- **The growth in broad money supply, as measured by the financial survey (M_4)[1], decelerated broadly in line with the growth in broad money as measured by the monetary survey (M_{2b}).** Growth in the broad money supply, as measured by the financial survey, was in the range of 13-16 per cent, similar to that of broad money,

[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.

as measured by the monetary survey, during the first half of 2008. Accordingly, broad money growth as per the financial survey also confirms the decelerating trend in monetary aggregates due to the tight monetary policy stance of the Central Bank.

- **Both NFA and NDA contributed to the growth in M_4.** The main contributory factor in the expansion in NDA was the increase in credit extended to the government and the private sector. In contrast to the deceleration in credit granted to the private sector by licensed commercial banks and licensed specialised banks, the growth in credit granted to the private sector by registered finance companies still remains at high levels of over 20 per cent. Nevertheless, credit to the private sector as per the financial survey also decelerated to 13.0 per cent, year-on-year, by June 2008, from 28.6 per cent an year ago, which is similar to the deceleration shown in the monetary survey.

Interest Rates

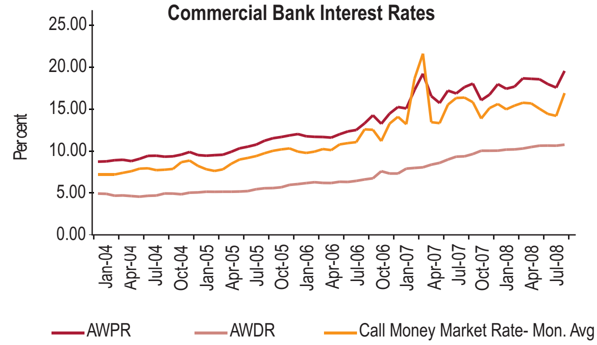
- **The policy interest rates of the Central Bank were maintained unchanged in 2008 as the Central Bank relied more on quantity control strategies.** Accordingly, the Repurchase rate and the Reverse repurchase rate of the Central Bank, which were raised to 10.50 per cent and 12.00 per cent, respectively, in February 2007, remain at the same levels. The weighted average rate at daily OMO repo auctions during 2008 so far, has mostly fluctuated in a range of 11.50-12.00 per cent. The weighted average rate at OMO auctions for the outright sale of securities with maturities up to 50 days has been in a range of around 14.50 – 18.70 per cent during this period. The weighted average inter-bank call money rate became more stable in 2008 as compared to 2007, due to the provision of the Reverse repurchase facility to participating institutions by the Central Bank at the penal rate of 19 per cent. It fluctuated in a range of 12.50 – 21.15 per cent during the first seven months of 2008, along with fluctuations in the level of market liquidity. Since the end of July, with market liquidity gradually declining and turning into a deficit position by mid-September, the weighted average inter-bank call money rate increased gradually, to around 19.35 per cent by end-September.

- **Yields on government securities continued to decline during the first nine months of 2008, although there was some increase during the last week of September.** The opening up of rupee denominated Treasury bills to foreign investors in May 2008 and limiting the issue of 91-day Treasury bills since around the end of the second quarter of 2008 to avoid bunching problems in the shorter end of the maturity spectrum, contributed to this decline. The primary market yields on 91-day, 182-day and 364-day Treasury bills were 17.22 per cent, 18.28 per cent and 19.06 per cent, respectively, by end-September, having declined by 408 basis points, 171 basis points and 90 basis points, respectively, during the year up to then.

- **The secondary market yield curve for government securities continued to be short during the first half of 2008, reflecting the uncertainty with regard to the longer maturities.** Although the high inflation environment has tended to discourage trading in the secondary market for government securities at the medium-to-longer end of the yield curve, a gradual improvement has been evident in this regard with inflation declining since June

Chart 7. 6

Commercial Bank Interest Rates



2008. Primary market yields on 2-year, 3-year and 4-year Treasury bonds were 19.33 per cent, 19.22 per cent and 19.09 per cent, respectively, by end-September 2008.

- **Both lending and deposit rates in the banking sector were on an upward path during the first nine months of 2008.** Commercial banks' short term lending rates, mainly reflected in the monthly Average Weighted Prime Lending Rate (AWPR), increased during the first nine months of the year, making borrowing more expensive. The AWPR for September had increased by 282 basis points since end-2007 to 19.82 per cent. The Average Weighted Lending Rate (AWLR), which takes into account all lending by commercial banks increased to around 19.0 per cent by June 2008 from around 18.0 per cent at end -2007 and around 17.0 per cent in June 2007. The Average Weighted Deposit Rate (AWDR) and the Average Weighted Fixed Deposit Rate (AWFDR) meanwhile, had increased by around 70 basis points and 100 basis points, respectively, during the first nine months of 2008, to 11.03 per cent and 16.50 per cent, by end-September 2008. Since around the latter part of the second quarter most of the commercial banks offer interest rates ranging from 12.00 - 14.00 per cent on specially designed savings deposits, compared to around 5.00 per cent offered on ordinary savings deposits, to attract savings from the general public. The interest spread, as measured by the difference between the monthly AWPR and the AWDR was 8.79 per cent by September 2008 compared to 6.69 per cent for December 2007. The deposit rates of long-term savings institutions were in a range of 5.00- 14.00 per cent for savings deposits and 15.00-20.00 per cent for 1-year fixed deposits, by July 2008.

Monetary Policy in Other Countries

- **Monetary policy in most advanced economies is currently focused on bringing stability to their financial markets and preventing a prolonged recession.** The financial crisis, which emerged in the USA and is now gripping the economies of several industrialised countries including the USA and the UK, now assumes global proportions and international financial markets continue to be tight and fragile. The US Federal Reserve, the Bank of England and the European Central Bank (ECB) decided to inject liquidity on a significant scale to support their financial systems and have also lowered their policy interest rates to support their economies, which have slowed down markedly. The US and UK economies have already slid into recession. In a coordinated move, on 8 October 2008, six major Central Banks, that is, the US Federal Reserve, the ECB, the Bank of England and central banks of Canada, Sweden and Switzerland lowered their policy rates by half a percentage point.

- **Earlier in the year, as commodity prices continued to rise, peaking in July, rising inflation pressures globally, were accompanied by a continued tightening of the monetary policy stance by several central banks, with a view to containing inflation and inflation expectations.** As per the latest available information, about 50 countries are grappling with double-digit inflation while at least 16 Central Banks raised interest rates during June 2008. The European Central Bank raised its

Table 7.2

Key Interest Rates of Selected Economies

Country	Key interest rate	End 2006	End 2007	End July 2008	As at 20 October 2008
US	Federal funds rate	5.25	4.25	2.00	1.50
Canada	Overnight funding rate	4.25	4.25	3.00	2.50
UK	Bank rate	5.00	5.50	5.25	4.50
EU	Refinance rate	3.50	4.00	4.25	3.75
Sweden	Repo rate	3.00	4.00	4.75	4.25
Japan	Overnight call rate	0.25	0.50	0.50	0.50
South Korea	Base rate	4.00	5.00	5.25*	5.00
Australia	Cash rate	6.25	6.75	7.25	6.00
China	1- year yuan lending rate	6.12	7.47	7.47	6.93
Malaysia	Overnight policy rate	3.50	3.50	3.25	3.50
India	Repo rate	6.00	7.50	8.50**	8.00

* As at 7 August 2008
** With effect from 30 August 2008

benchmark rate by a quarter-point to 4.25 per cent in July 2008 while the Federal Reserve Bank of the United States paused after seven rate cuts since September 2007 to turn its attention to spiralling inflation. Bank of Canada too held rates steady at 3 per cent in June 2008, signalling an end to its rate cuts from December 2007 while Australia raised rates four times to take its cash rate to a 12-year high of 7.25 per cent before the rate cut in October.

- **In emerging and regional economies, monetary policy was gradually tightened in 2008, up to early October, in a bid to prevent a further intensification of inflationary pressures.** India tightened its key lending rates as well as its cash reserve ratio while Pakistan introduced a package of measures to dampen inflationary expectations. In similar moves, Malaysia and Indonesia also raised their policy interest rates during the year to curb inflationary pressures. Beginning in October, however, policy measures have been introduced by Central Banks in Asia and the Middle East also, to enhance money market liquidity and support their economies, in the context of the global credit crunch, which ensued the drying up of credit in the USA and most other industrialised countries. The Central Banks of China, Taiwan, South Korea, Kuwait, the United Arab Emirates, and Hong Kong reduced their policy interest rates, closely following the policy responses of the USA and the EU to the financial crisis while the Reserve Bank of India reduced its Cash reserve ratio, releasing liquidity to the financial system and also reduced its Repurchase rate.

Prospects for 2009

- **In setting out the monetary targets for 2009, the key focus would be on assailing inflationary pressures in the economy while supporting financial system stability and economic growth.** The targets in the monetary programme will be based on the projected rate of economic growth and inflation as per the GDP deflator. The current tight monetary policy stance is expected to be pursued further till inflationary pressures in the economy abate.