7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

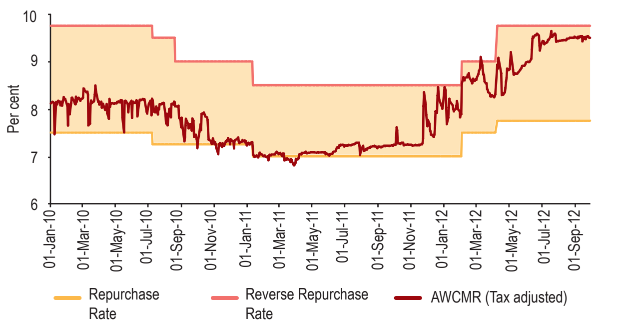
The Central Bank tightened its monetary policy stance in 2012 by raising policy rates in February and again in April 2012, and by imposing a ceiling on the maximum growth in rupee lending by licensed banks in March 2012. This significant tightening of monetary policy was necessitated by the rapid growth in credit extended to the private sector by the banking system, which contributed to a higher than targeted growth of money supply. Continued monetary expansion posed two risks to macroeconomic stability: first, while both headline and core inflation remained at single digit levels, there was a risk of the emergence of demand driven inflation in future if monetary expansion continued unchecked; second, rapid credit growth fuelled the growth of imports, leading to an expansion of the trade deficit. Active liquidity management by the Central Bank helped absorb the excess rupee liquidity that prevailed in the domestic money market during most of the period, thus supporting the overall monetary policy stance. In line with the increase in policy rates and tight monetary conditions, market interest rates rose, with both lending and deposit rates rising substantially thus far during the year. As a result of the policy measures implemented, broad money growth as well as the growth of credit extended to the private sector by banks has begun to decelerate. Further deceleration is expected during the remainder of the year and private sector credit growth is expected to be brought in line with the targets set in the Monetary Programme for 2012.

Inflation has however, increased on a year-on-year basis, to high single digits since March 2012, as a combined result of the administered price revisions introduced in February 2012, the depreciation of the rupee, disruptions to domestic food supply as well as the high monetary expansion in 2011. Despite the measures taken to moderate inflationary pressures, inflation is yet to abate to the desirable levels. Further, the deceleration of credit growth to the private sector as well as reduced public sector borrowing from the domestic banking sector are vital to ensure that growth in broad money supply is maintained at the targeted level.

Monetary Policy

- **The monetary policy stance of the Central Bank was tightened in 2012 as the Bank sought to curtail the expansion of credit and monetary aggregates as well as to contain the possible emergence of inflationary pressures and inflation expectations.** Credit disbursements began to accelerate from the second half of 2011 and continued to grow unabated in the early months of 2012 fuelling high import demand. The Central Bank together with the government adopted a series of policy measures to curtail import demand thereby addressing the widening trade balance and easing pressure on the external sector. In February, the Central Bank raised its policy rates, i.e., Repurchase and Reverse Repurchase rates, by 50 basis points each. In April, the Repurchase rate was further raised by 25 basis points while the Reverse Repurchase rate was raised by 75 basis points. In order to bring about a more rapid reduction of credit, the Central Bank issued a direction in March to all licensed banks under Section 101(1) of the Monetary Law Act, imposing a ceiling on their rupee lending during the year. Accordingly, credit growth was to be restricted to 18 per cent or Rs. 800 million, whichever was higher, while 23 per cent or Rs. 1 billion was allowed for banks that mobilised funds from abroad. The Central Bank injected liquidity through its Reverse Repurchase window to address the shortage of liquidity that prevailed for several days at the beginning of the year. However, the continuing tight liquidity conditions gradually reversed as the Central Bank entered into foreign exchange swap arrangements with several banks, and with the purchase of Treasury bills from the primary auctions and the purchase of a part of the proceeds of the international sovereign bond by the Central Bank. Excess liquidity was gradually brought down actively through open market operations towards August and was maintained at a broadly balanced position thereafter with the reversal of swap arrangements, outright sales of Treasury bills from the Central Bank's holdings and foreign loan repayments in order to maintain stability in the overnight call market rate.

Chart 7.1 Policy Rate Corridor of the Central Bank and the Average Weighted Call Money Rate (AWCMR)



- **The Central Bank continued to conduct monetary policy within a monetary targeting framework and policy measures implemented were aimed at bringing down credit and monetary expansion to levels consistent with monetary projections.** As presented in the Central Bank's policy document issued at the beginning of the year, the Road Map for Monetary and Financial Sector Policies for 2012 and Beyond, the average growth rates for both broad money as well as reserve money for the year were targeted at 15 per cent as the money multiplier was expected to remain broadly stable. This growth was based on a projected real GDP growth of 8 per cent and inflation, as measured by the implicit GDP deflator, of 6 per cent. The policy package implemented by the Central Bank and the government during February-April 2012 aimed at curtailing domestic demand required a revision to the projection for real GDP growth to 7.2 per cent. The growth projection was revised downward again to 6.8 per cent based on the growth recorded in the first half of the year while the GDP deflator was also revised to 8.2 per cent in September 2012. However, the targeted growth rate for both broad money and reserve money was maintained unchanged at 15 per cent given that nominal GDP growth remained broadly unchanged despite these revisions.

Chart 7.2 Contribution to year-on-year Inflation

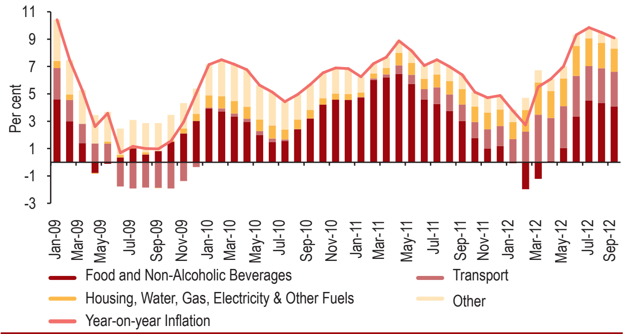
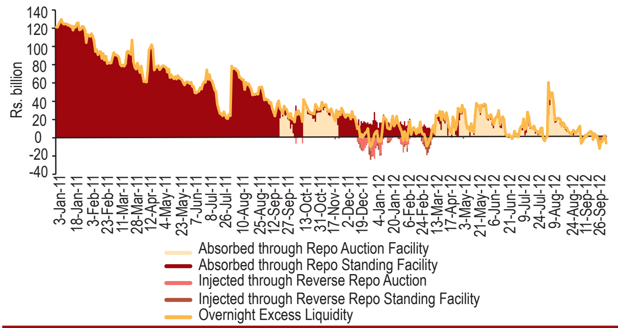


Chart 7.3 Overnight Liquidity Position in the Domestic Money Market



- **Inflation, which remained at single digit levels since February 2009, moved upwards since March 2012 largely due to the revision of administered prices, mainly of fuel.** Year-on-year inflation moderated to 2.7 per cent in February 2012, but gradually increased thereafter on account of the upward revision of domestic petroleum, gas and electricity prices and bus fares following the government's decision to pass-through the cost of higher international oil prices to consumers. In response to these price revisions as well as the depreciation of the rupee, prices of other goods and services adjusted upwards, pushing inflation higher during the ensuing period. In addition to the impact of these changes, high fresh food prices due to prevailing drought conditions led inflation to increase to a 42 month high of 9.8 per cent in July 2012, which however, eased to 9.1 per cent by September. Core inflation, which had remained broadly stable since the last quarter of 2011, also increased to 6.2 per cent by September from 4.7 per cent at end December 2011. Together with the demand management policies adopted early this year, the return of domestic food supplies to normalcy would help contain inflation within single digits by year end.

- **Rupee liquidity in the domestic money market showed substantial volatility during the first nine months.** It increased to a surplus towards mid-year but declined gradually thereafter in the third quarter. Compared to the liquidity deficit of Rs. 5.4 billion recorded at end December 2011, overnight excess liquidity averaged around Rs. 11 billion in the first nine months of 2012. During this period, liquidity was injected to the market by way of the Central Bank entering into foreign exchange swap arrangements with commercial banks, Central Bank profit transfers to the government, provisional advances extended to the government, and the Central Bank's purchases of Treasury bills from the primary market. Excess liquidity increased to Rs. 58.9 billion towards end July with the Central Bank's purchase of US dollars 475 million of the proceeds of the US dollar 1 billion international sovereign bond. Market liquidity declined gradually by September 2012 with the Central Bank actively absorbing the excess liquidity through outright sales of Treasury bills, retiring of maturing Treasury bills held by the Central Bank and reversing of foreign exchange swaps. Liquidity in the domestic money market was in a deficit of Rs. 7.7 billion by end September 2012. The Central Bank continued to provide liquidity to the market by way of overnight reverse repurchase auctions to maintain overall liquidity in a balanced position.

Reserve Money

- **The quarterly average of reserve money, which was well within the target stipulated under the Monetary Programme during the first quarter of 2012, remained marginally above the targeted levels in the second and third quarters.** The average daily reserve money in the first quarter was Rs. 450.8 billion, an increase of 21.2 per cent compared to the corresponding quarter in 2011. However, in line with policy measures taken in the early part of the year, and coupled with the effects of a higher base from the second quarter of 2011 onwards, the growth of reserve money decelerated thereafter to about 12.6 per cent by August 2012. Going forward, it is likely that average reserve money would remain broadly on the targeted path during the remainder of the year with the measures taken to curtail monetary growth. In terms of liabilities, the increase in reserve money during the period from end December 2011 to August 2012 was on account of an increase in currency in circulation of around Rs.17 billion and an increase in deposits held by commercial banks with the Central Bank of around Rs. 16 billion.

- **The expansion in both net domestic assets (NDA) and net foreign assets (NFA) of the Central Bank contributed to the growth of reserve money during the first eight months of 2012.** NDA increased by Rs.18.2 billion during the period, with the increase in net credit to the government (NCG) by the Central Bank along with an increase in short-term claims on commercial banks. However, the increase in net other liabilities dampened the expansion in NDA of the Central Bank. An increase in the Central Bank's holdings of Treasury bills of around Rs. 35 billion and provisional advances to the government by the Central Bank of around Rs.18 billion caused an increase in NCG. Meanwhile, NFA of the Central Bank expanded by around Rs.15 billion during the first eight months of the year as the government sold a part of the funds (US dollars 475 million) it raised by issuing a sovereign bond in the international market, to the Central Bank with the purpose of settling its outstanding domestic liabilities. As a result, the Central Bank's cash balances held abroad and investments in foreign securities increased.

Narrow Money (M_1)

- **Narrow money, which consists of currency and demand deposits held by the public, continued to decelerate sharply during the first eight months of 2012 and recorded a year-on-year growth of 0.6 per cent in August 2012, compared to 7.7 per cent at end 2011 and 20.9 per cent at end 2010.** Currency held by the public decelerated to 5.9 per cent, year-on-year, in August 2012, from 12.2 per cent at end 2011 and 19.1 per cent at end 2010. At the same time, year-on-year growth of demand deposits held by the public declined by 5.6 per cent in August 2012, compared to the growth of 2.7 per cent at end 2011 and 23.1 per cent at end 2010. The high interest rates offered on time and savings deposits by financial institutions is the main reason for the decline in the growth of currency and demand deposits held by the public. The deceleration of credit is also likely to have contributed to the reduction in demand deposits.

Broad Money (M_{2b})

- **Led by the high demand for credit by the private sector, broad money continued to grow unabated during the first quarter of 2012, warranting policy action to mitigate inflationary pressures.** In response to the policy measures taken by the Central Bank in the first quarter of 2012, average broad money growth decelerated to 20.9 per cent during the period from April to August 2012, from 21.6 per cent in the first quarter of 2012. However, on a year-on-year basis, money supply grew by 20.2 per cent in August 2012, which was higher than the growth of 19.1 per cent recorded in December 2011. The growth of credit to both the private and public sectors contributed to the monetary expansion, although this expansion was somewhat moderated by the decline in net foreign assets (NFA) of the banking system. On the liabilities side, the increase in time and savings deposits held by the public contributed almost entirely to the year-on-year growth in money supply.

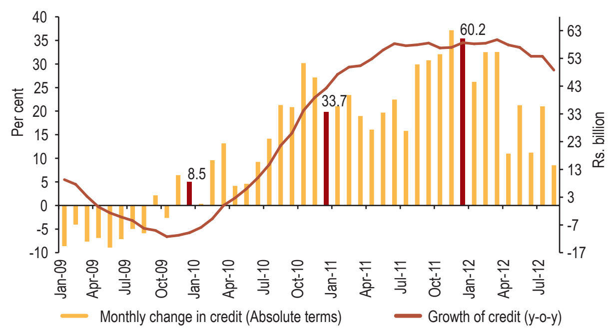
- **NFA of the banking system remained negative since May 2012, particularly due to the banking system utilising foreign resources to support domestic economic activity.** NFA of the banking system declined by Rs. 113 billion during the first eight months of 2012. The drop in NFA of commercial banks accounted entirely for this decline, driven mainly by foreign currency loan arrangements by state banks to settle oil import bills of the Ceylon Petroleum Corporation (CPC). Also during this period, some funds obtained by commercial banks from abroad were swapped with the Central Bank and the rupees obtained were utilised for domestic lending while a part of the foreign currency funds were channelled into investments in Sri Lanka Development Bonds (SLDBs). These factors, together with the depreciation of the rupee, resulted in the decline in NFA of commercial banks.

- **NDA of the banking system increased substantially during the first eight months of 2012 with significant increases in credit obtained by both the public and private sectors.** However, the impact of the expansion in NDA on overall broad money growth was dampened by the decline in NFA during this period.

- **The growth of credit extended to the private sector by commercial banks, which increased at a rapid pace since the latter part of 2010, continued unabated in 2011 and in the first quarter of 2012, before decelerating from April 2012 following the contractionary monetary policy measures taken in early 2012.** The significant tightening of monetary policy along with the depreciation of the rupee and higher taxes on the importation of motor vehicles, resulted in the year-on-year growth of credit to the private sector slowing down to 28.7 per cent by August 2012 from 35.2 per cent in March 2012 and 34.5 per cent at end 2011. Credit growth from end 2011 to August 2012 was 13.9 per cent. A further moderation in the growth of credit to the private sector is expected during the balance part of 2012 as banks are committed to meet the credit ceiling, thereby containing the growth in private sector credit within the target set out in the Monetary Programme. As a result, growth of broad money is also expected to moderate further to a lower level by year end.

- **Based on the Quarterly Survey of Loans and Advances to the private sector by commercial banks, growth of credit decelerated to 3.3 per cent in the second quarter from 7.8 per cent in the first quarter of 2012 with a broad based deceleration in credit to all sectors.** Quarter-on-quarter growth in credit to the Industry sector, which accounts for 33.6 per cent of all loans and advances, declined from 5.6 per cent in the first quarter to 4.3 per cent in the second quarter. Growth of credit in the form of Personal Loans and Advances, which accounts for 28.2 per cent of all loans and advances, decelerated significantly to 1.4 per cent in the second quarter, from 8.6 per cent in the previous quarter. Credit to the Services sector, with a share of 23.2 per cent, also decelerated significantly from 12 per cent in the first quarter to 1.3 per cent in the quarter ending June 2012, while the quarter-on-quarter growth of credit to the Agriculture and Fishing sector, accounting for nearly 14 per cent

Chart 7.4 Credit Granted by Commercial Banks to the Private Sector



of total loans and advances, declined to 6.2 per cent from 9.6 per cent in the previous quarter.

- **NCG from the banking system increased by Rs.198 billion during the first eight months of 2012, largely due to credit granted to the government by commercial banks by way of increased holdings of government securities.** A notable development observed following the imposition of the ceiling on rupee lending in March this year was a shift in investments by commercial banks to government securities. Treasury bond holdings of DBUs of commercial banks alone increased by around Rs. 49 billion during the first eight months of the year, whilst the outstanding government overdraft balance increased by around Rs. 25 billion. Increased investments in SLDBs by OBUs of commercial banks also contributed to this increase (by around Rs. 45 billion). Meanwhile, the increase in the holdings of Treasury bills by around Rs. 35 billion, along with the provisional advances to the government (amounting to Rs. 18 billion) contributed to the increase in NCG by the Central Bank.

- **A substantial increase in credit obtained by public corporations was seen in the first eight months of 2012 with increased borrowing by the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB).** Credit obtained by public corporations increased by Rs. 65.3 billion during the period, of which around Rs. 50.7 billion was borrowed by the CPC to settle its oil import bills. Credit obtained by the CPC from OBUs of commercial banks amounted to around Rs. 75 billion, although credit obtained from DBUs of commercial banks declined by around Rs. 24 billion following the repayment of rupee liabilities during the period under consideration. The CEB also obtained credit amounting to around Rs. 16 billion from commercial banks during this period.

Financial Survey (M_4)[1]

- **Growth of broad money supply as measured by the financial survey, remained over 19 per cent during the first eight months of 2012.** Year-on-year growth of broad money (M_4) was 19.3 per cent in August 2012 compared to 19 per cent at end 2011. However, compared to the average quarterly growth of 20.6 per cent of broad money for the first quarter of 2012, the average growth of broad money decelerated to 19.9 per cent for the period from April to August in 2012. The growth of M_4 was driven by an increase in NDA since NFA declined during this period. Increased credit extended to the private and public sectors contributed to the expansion of NDA. On a year-on-year basis, growth of credit to the private sector decelerated to 30 per cent by August 2012 from 36.4 per cent at end 2011. Compared to the average quarterly growth of 36.8 per cent of credit extended to the private sector for the first quarter of 2012, the average growth of credit extended to the private sector decelerated to 33.8 per cent for the period from April to August in 2012, reflecting the impact of the policy measures taken in the early months of the year. In absolute terms, the increase in credit to the private sector in the first eight months was Rs. 358.9 billion, while NCG increased by Rs. 204 billion.

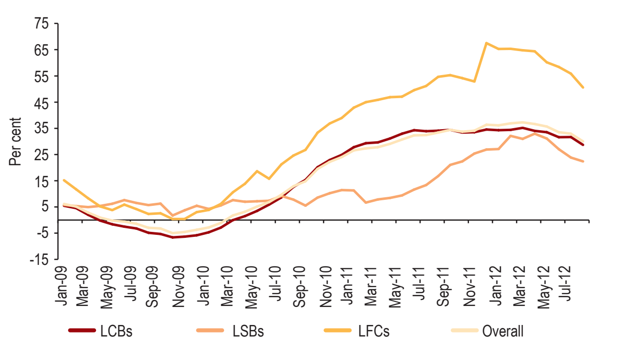
- **On a year-on-year basis, credit to the private sector as per the financial survey, grew by 30 per cent in August 2012 compared to the growth of 28.7 per cent as per the monetary survey (M_{2b}).** In absolute terms, credit extended by LFCs to the private sector increased by Rs. 53 billion during the first eight months of 2012, contributing to 14.8 per cent of the overall increase in private sector credit. Compared to the growth of 26.9 per cent recorded at end December 2011, credit granted to the private

1 Financial survey provides a broader measure of liquidity, covering licensed specialised banks and licensed finance companies, in addition to licensed commercial banks and the Central Bank. However, M_{2b} is used for monetary policy purposes by the Central Bank.

sector by LSBs increased to 32.9 per cent in April but decelerated again to 22.4 per cent by August 2012. In absolute terms, credit extended by LSBs to the private sector increased by Rs. 26.6 billion, contributing to 7.4 per cent of the overall increase in private sector credit during the first eight months of 2012.

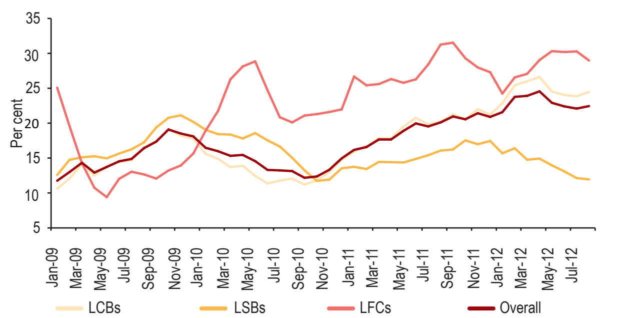
- **As per the financial survey, the growth of quasi money, which comprises time and savings deposits, remained above 20 per cent during the first eight month of 2012 and stood at 22.4 per cent (year-on-year) by August 2012 compared to 20.9 per cent at end 2011.** In absolute terms, overall quasi money, increased by Rs. 380.4 billion during the first eight months of 2012. The year-on-year growth of quasi money with respect to LFCs increased to 29 per cent in August 2012 compared to 27.3 per cent in December 2011. In absolute terms, quasi money held at LFCs increased by Rs. 41.3 billion contributing to 10.9 per cent of the overall increase in time and savings deposits in the first eight months of the year. Mobilisation of time and savings deposits increased during this period mainly due to the relatively higher rates offered by LFCs compared to commercial banks. As a prudential measure to curtail excessive competition and to safeguard the stability of the LFCs, the Central Bank adjusted downwards the ceiling on interest rates that could be offered by LFCs on term deposits in May (by 75 basis points) and July 2012 (by 175 basis points). Meanwhile, the year-on-year growth of quasi money of LSBs declined to 12 per cent by end August 2012 reflecting relatively lower rates offered by them. In absolute terms, quasi money of LSBs increased only by Rs. 23.2 billion, contributing to 6 per cent of the overall increase in time and savings deposits during the first eight months of 2012.

Chart 7.5 Private Sector Credit Growth



Note: The sharp increase in credit to the private sector by LFCs observed in December 2011 was mainly due to an already established specialised leasing company (SLC) obtaining a LFC licence in December 2011.

Chart 7.6 Growth in Savings and Time Deposits



Interest Rates

- **Taking into consideration the need to curtail the high growth in credit extended to the private sector by commercial banks, the Central Bank increased its policy interest rates in two steps in February and April 2012.** To stem the widening trade deficit and current account deficit by curbing import related credit and to reduce demand pressures on inflation, the Central Bank increased its Repurchase rate and the Reverse Repurchase rate upwards by 50 basis points each with effect from 3 February 2012. The Repurchase rate and the Reverse Repurchase rate were further increased by 25 basis points and 75 basis points, respectively, effective 5 April 2012. Accordingly, the Repurchase rate and the Reverse Repurchase rate are currently at 7.75 per cent and 9.75 per cent, respectively, providing an interest rate corridor of 200 basis points to guide the overnight money market rates.

- **Movements in the average weighted call money rate (AWCMR) in the interbank market reflected policy rate adjustments and volatility in market liquidity during the first nine months of 2012.** The tax adjusted AWCMR, which remained near the repo rate, i.e., the lower bound of the policy rate corridor in 2011, increased and remained near the upper bound of the corridor in 2012 except for most days in the month of May where it declined to around the middle of the corridor on account of a higher level of excess rupee liquidity in the market. The tax adjusted AWCMR has increased by 143 basis points to 9.50 per cent by end September 2012 from end 2011. With the realisation of a part of the proceeds from the international sovereign bond, excess liquidity in the domestic money market increased considerably but only resulted in a marginal decline in the AWCMR as the Central Bank rapidly absorbed the excess. The AWCMR including tax, however, remained above the policy interest rate corridor from mid-December 2011 except for a few days during April and May 2012.

- **The increase in policy interest rates, the higher borrowing requirement of the government, and tight liquidity conditions pushed yields on government securities upwards in both the primary and the secondary markets until end August 2012.** Yield rates on government securities in the primary market remained broadly stable during January but recorded a mixed performance thereafter. Yields on Treasury bills across all maturities increased continuously from February up to mid-May 2012 due to the shortage of liquidity in the money market. However, yields on Treasury bills pertaining to all maturities remained broadly stable throughout July and August 2012 and declined from mid-September 2012 reflecting lower borrowings by the government. The yield rates on 91-day, 182-day and 364-day Treasury bills have increased by 262 basis points, 386 basis points and 371 basis points, respectively, from end 2011 to 11.30 per cent, 12.57 per cent and 13.02 per cent, respectively, by end September 2012. The primary market yields on Treasury bonds, which were in the range of 9.45 per cent to 14.75 per cent in 2012 for the short end (2 year maturity) and the longer end (9 years and 6 months maturity) remained high compared to 7.77 per cent to 9.30 per cent for the short end and long end, respectively, in 2011 due to the high borrowing requirement of the government and market anticipation of higher interest rates. Treasury bonds including new issues and reissues in the primary market during the first nine months of 2012 amounted to Rs. 767.5 billion (face value), which marked a significant shift from short to longer term maturities resulting in an improvement in the maturity profile, and was supported by increased appetite of foreign investors for Treasury bonds. Foreign investment in Treasury bonds increased remarkably to around Rs. 96.2 billion during the first nine months of 2012 compared to the Rs.12.1 billion recorded during the corresponding period of 2011.

- **The secondary market yield curve for government securities during the first nine months of 2012 shifted upwards mainly due to the comparatively high yield rates for government securities in the primary market and changing market expectations during this period.** Transaction volumes in Treasury bonds on outright basis declined to Rs. 390.2 billion by end September 2012 from Rs. 471.3

Chart 7.7 Secondary Market Yield Curve

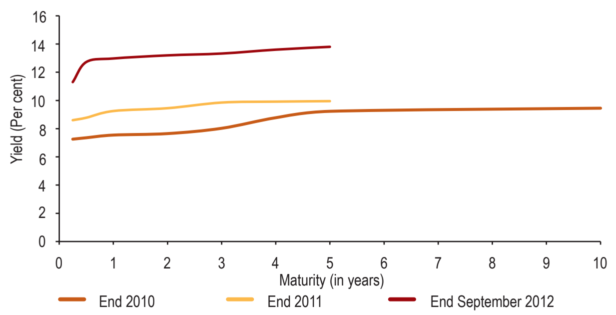


Table 7.1 **Movements in Interest Rates: 2010 - 2012**

Per cent per annum

Interest Rate	End Dec 10	End Dec 11	Change (Dec 10-Dec 11) in bps	End Mar 12	End Jun 12	End Sep 12	Change (Dec 11-Sep 12) in bps
Policy Rates of the Central Bank							
Repurchase Rate	7.25	7.00	-25	7.50	7.75	7.75	75
Reverse Repurchase Rate	9.00	8.50	-50	9.00	9.75	9.75	125
Average Weighted Call Money Rate (with tax)	8.03	8.97	94	9.21	10.39	10.55	158
Average Weighted Call Money Rate (Tax adjusted)	7.23	8.07	84	8.29	9.35	9.50	143
Average Weighted OMO Auction Rate (Repo)	7.68 (a)	7.58 (b)	-10	8.21	9.28	9.37 (c)	179
Average Weighted OMO Auction Rate (Reverse Repo)	-	8.07	-	8.93 (d)	9.58 (e)	9.70	163
Treasury Bill Yield Rates							
91-day	7.24	8.68	144	11.00	11.12	11.30	262
182-day	7.35	8.71	136	11.06	12.61	12.57	386
364-day	7.55	9.31	176	11.32	12.88	13.02	371
Lending Rates of Commercial Banks							
Average Weighted Prime Lending Rate (AWPR) - Weekly	9.29	10.77	148	12.80	13.39	14.15	338
Average Weighted Prime Lending Rate - Monthly	9.27	10.49	122	12.42	13.60	14.08	359
Average Weighted Lending Rate (AWLR) (f)	14.80	13.44	-136	14.09	14.88	15.38	194
Deposit Rates							
Average Weighted Deposit Rate (AWDR)	6.23	7.24	101	7.88	8.38	9.22	198
Average Weighted Fixed Deposit Rate (AWFDR)	8.20	8.95	75	9.84	10.78	11.92	297

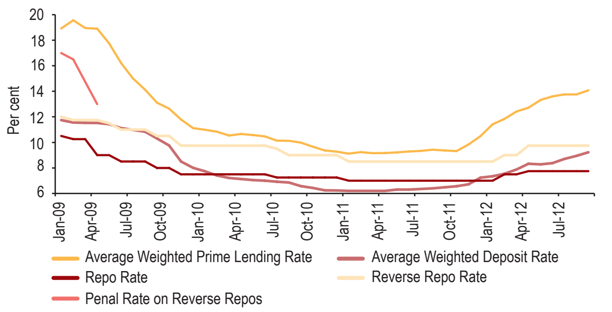
(a) Auction held on 19th October 2010
(b) Auction held on 25th November 2011
(c) Auction held on 17th September 2012
(d) Auction held on 12th March 2012
(e) Auction held on 22nd June 2012
(f) AWLR is compiled on a monthly basis from January 2011 onwards

billion during the corresponding period of 2011 mainly due to higher yields on Treasury bills. Nevertheless, transaction volumes of Treasury bills in the secondary market on outright basis during the first nine months of 2012 increased significantly to Rs. 819 billion compared to Rs. 465.1 billion recorded during the same period of 2011.

- **Deposit rates increased during the first nine months of 2012 in response to the tight monetary conditions.** The average weighted deposit rate (AWDR), which reflects the movement of interest rates pertaining to all interest bearing deposits held by the public with commercial banks, increased by 198 basis points by end September 2012 and was 9.22 per cent compared to 7.24 per cent in December 2011. The average weighted fixed deposit rate (AWFDR) also showed a similar trend, increasing by 297 basis points, during the first nine months of 2012, to 11.92 per cent by end September. In terms of type of deposit, interest rates on term deposits of shorter maturities increased sharply during this period. Many commercial banks increased their deposit rates regularly during this period to attract deposits in light of the tight liquidity conditions prevailing in the market.

- **Commercial banks also adjusted their lending rates upwards as the cost of funds of the commercial banks increased.** The weekly average weighted prime lending rate (AWPR), which reflects rates applicable on loans and advances granted by commercial banks to their prime customers, increased and remained volatile while the monthly AWPR increased to 14.08

Chart 7.8 Policy Rates and Market Interest Rates



per cent in September 2012, which is 359 basis points higher than 10.49 per cent recorded in December 2011. The average weighted lending rate (AWLR), which reflects interest rates pertaining to all existing lending by commercial banks to the private sector, also increased during the first nine months of 2012 and reached 15.38 per cent in September 2012, which is an increase of 194 basis points from 13.44 per cent at end 2011.

- **Even though domestic market interest rates moved upwards during the first nine months of 2012, interest rates applicable on foreign currency denominated deposits remained low and broadly stable reflecting the continuing low interest rate environment in major economies.** Interest rates applicable on US dollar denominated savings deposits were in a range of 0.02-2.76 per cent by end September 2012 compared to a range of 0.02-2.79 per cent at end December 2011. By end September 2012, depositors holding US dollar denominated time deposits were paid interest rates ranging from 0.15-6.14 per cent by commercial banks compared to a range of 0.15-5.61 per cent at end 2011. Interest rates on pound sterling denominated savings deposits were in a range of 0.10-3.00 per cent in September 2012, compared to a range of 0.10-3.50 per cent at end December 2011 while interest rates on pound sterling denominated time deposits were in a range of 0.40-6.24 per cent in September 2012 compared to a range of 0.38-6.24 per cent at end December 2011.

- **Interest rates on debt instruments issued by the corporate sector also increased during the first nine months of 2012.** Accordingly, interest rates relating to commercial paper, a short-term debt instrument issued by commercial banks, were in the range of 11.25-20.00 per cent during the first nine months of 2012 compared to a range of 8.26-14.00 at end 2011. Meanwhile, there were six listings of corporate debentures by two banking institutions amounting to Rs. 7 billion with maturity periods of 5 years listed between January and September 2012. The debentures were at fixed rates of interest ranging between 10.50–11.50 per cent while one debenture was issued with a floating interest rate.

Monetary Policy in Other Countries

- **Monetary policy was relaxed further in many advanced economies by way of either rate cuts or through quantitative easing to offer additional monetary stimulus to support the domestic economy.** These measures were also aimed at bolstering confidence and business sentiment, which was weighed down by widespread uncertainty about the euro area. Economic activity in the United States decelerated somewhat during the first half of the year and employment generation has been subdued while unemployment remains elevated. Inflation moderated from a year earlier, largely on account of lower crude oil prices and inflation expectations appear to have stabilised. Amidst expectations of inflation remaining subdued, the Federal Reserve reiterated the need for exceptionally low interest rates to support stronger economic recovery and employment generation. In this context, the Federal Reserve expects to continue to maintain interest rates at around zero until at least mid-2015 to offer extended support to the economy. Also, the

Federal Reserve intends to continue with the maturity extension programme to ease pressure on longer-term interest rates, thereby easing overall financial market conditions and stimulating growth. Under this programme, the Federal Reserve intends to purchase Treasury securities with remaining maturities of 6 years to 30 years at the current pace and to sell or redeem an equal amount of Treasury securities with remaining maturities of approximately 3 years or less. Along similar lines, the Bank of England has also maintained policy rates at 0.5 per cent since 2009 to support economic activity. However, as economic growth appears to have slackened in the preceding quarters and inflation is likely to edge further down, the Bank of England opted for enhanced monetary stimulus to counter the dampening impact of the euro zone concerns as well as tight credit conditions domestically. Towards this end, the asset purchase programme of pound sterling (GBP) 200 billion initiated in 2009 and increased to GBP 275 billion last year, was increased by GBP 100 billion in two equal steps in February and July this year. Amidst fresh tension over financial stability in the euro area as some previously identified downside risks materialised, growth in the region remains weak and perception of future inflation has weakened. Credit growth has also remained weak indicating the cautious approach adopted by financial institutions, corporates and households. In view of these developments, the European Central Bank decided to lower the benchmark interest rate by 25 basis points to 0.75 per cent in July to bolster confidence and revive growth. Several other countries that had previously raised their rates to safeguard against inflation lowered policy rates towards mid-2012 as concerns over slowing global demand gathered momentum and declining external demand impacted domestic growth. The Reserve Bank of Australia reduced its Cash Rate in May and June by a total of 75 basis points to encourage credit growth. Sweden moved to reduce the Repo rate by 25 basis points early in 2012 as the slowdown in the euro area became more severe than previously anticipated. A further rate cut of 25 basis points was effected in mid-September to support economic activity and to prevent inflation from falling below the 2 per cent target. The Bank of Korea lowered the benchmark interest rate by 25 basis points in July as economic growth weakened from the previous projections and a negative output gap was likely to prevail in the period ahead. Meanwhile, the Bank of Japan kept its overnight call rate target between zero to 0.1 per cent during the first half of 2012.

- **Many emerging economies in Asia eased their policy stance during the year to support falling growth as concern over economic growth surpassed concerns over price stability.** India, which hiked policy rates sharply since 2010 to combat inflationary pressures reversed its monetary policy stance in 2012. Inflation, which declined from the high levels that prevailed earlier, remained sticky and above the desired level due to high food prices as well as upward revisions to some administered prices. However, economic growth continued to fall as a result of the tight monetary policy adopted in the previous period as well as slowing external demand. With the narrowing of the output gap, the Reserve Bank of India was cautious in easing its policy stance as it would encourage inflationary pressures. The Statutory Liquidity Ratio was reduced by 1 percentage point to 23 per cent, effective 11 August to ensure that liquidity constraints do not hinder credit flows to productive sectors of the economy. Similar reasons underpinned a rate cut of 25 basis points in Thailand's benchmark interest rate to 3 per cent, which was considered to be adequate to support domestic economic activity. Domestic demand remained firm and the rapid recovery in the Thai economy saw actual economic growth close to potential though some downside risks were expected from a fall in exports. China reduced its key policy rate consecutively in June and July amidst moderating inflationary pressures and signs that bank borrowing may be slowing. China's economic growth has been slowing down and is expected to be lower in the

Table 7.2 Changes in the Policy Interest Rates of Selected Central Banks

	Key Policy Rate	End 2009	End 2010	End 2011	Sep 2012
Emerging Economies					
India	Repo rate	4.75	6.25	8.50	8.00
Malaysia	Overnight policy rate	2.00	2.75	3.00	3.00
Thailand	1-day bilateral repo rate	1.25	2.00	3.25	3.00
China	1-year yuan lending	5.31	5.81	6.56	6.00
Indonesia	Benchmark Rate	6.50	6.50	6.00	5.75
Advanced Economies					
USA	Federal funds rate	0-0.25	0-0.25	0-0.25	0-0.25
Canada	Overnight funding rate	0.25	1.00	1.00	1.00
UK	Bank rate	0.50	0.50	0.50	0.50
ECB	Refinance rate	1.00	1.00	1.00	0.75
Sweden	Repo rate	0.25	1.25	1.75	1.25
Japan	Overnight Call rate	0-0.10	0-0.10	0-0.10	0-0.10
South Korea	Overnight Target rate	2.00	2.50	3.25	3.00
Australia	Cash rate	3.75	4.75	4.25	3.50

Source: Websites of respective Central Banks

forthcoming period. However, concerns remain as to whether the low interest rates will be sufficient to spur economic growth in the face of sluggish external demand. Malaysia, in the meantime, opted to hold policy rates unchanged in the first three quarters as domestic demand was expected to remain resilient, anchoring economic activity. Given the excess spare capacity in the economy, headline inflation was expected to remain moderate despite strong domestic demand. Indonesia lowered its policy rate by 25 basis points to 5.75 per cent in February in order to support economic activity amidst an uncertain global economic environment.

Expected Developments in 2013

- **The limit on the growth of credit extended by licensed banks currently in place is expected to support maintaining credit granted to the private sector by commercial banks at the targeted level in 2012 and the Central Bank will continue with measures to ensure that credit growth does not exceed a desired level in 2013.** The high growth of credit in 2010 and 2011 helped normalise the sharp dip in credit that was seen prior to mid-2010, and the targeted growth of credit to the private sector in 2012 would help maintain a balance between economic growth and restraining demand driven inflationary pressures. Going forward, the Central Bank will continue to take measures to contain the growth of credit at a level consistent with the expected economic activity to help maintain overall monetary expansion at a level consistent with the nominal growth in GDP in 2013. Nevertheless, as a higher level of investment is required to accelerate the growth process, it is necessary for the private sector to explore other sources of funding from global financial markets and domestic corporate debt and capital markets.

- **However, the expansion of credit to the public sector, which includes the government and public corporations remains a concern.** Being less sensitive to changes in interest rates, NCG depends on the budget deficit and the government's strategy to finance the deficit, while credit to public corporations depends mainly on the operational losses they incur. It is essential that public sector borrowing from the banking sector is restricted to the budgeted levels, in order for the monetary authority to maintain monetary expansion at the targeted level, which is essential for the success of monetary policy implementation.

- **Measures taken by the Central Bank and improvements to domestic supply have helped maintain inflation at single digit levels in the past 3½ years and this trend is expected to continue in the year ahead with a further moderation from the current levels from around April 2013.** Recent movements in inflation have indicated that while the impact of global supply conditions on domestic inflation has moderated, continued action is necessary to strengthen domestic supply conditions further in order to sustainably maintain inflation at mid-single digit levels. At the same time, the Central Bank will continue to be vigilant and take timely monetary policy action to maintain monetary growth at sustainable levels and stem any demand driven inflationary pressures to maintain inflation at mid-single digit levels in the medium term.