7 MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

In an environment of low inflation for the third consecutive year, the Central Bank eased its monetary policy stance in January 2011, but initiated a cautious and gradual tightening of monetary policy thereafter as credit and monetary aggregates continued to grow at a higher pace than projected. The conducive environment for growth was strengthened with a further reduction in the Repurchase rate and the Reverse Repurchase rate by 25 basis points and 50 basis points, respectively, in January 2011. However, in view of the continued high excess liquidity in the domestic money market, largely an outcome of the Central Bank absorbing excess foreign exchange inflows to the country, the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks (LCBs) was adjusted upwards by one percentage point in April 2011 to permanently absorb a part of excess liquidity from the market as well as to signal the policy direction of the Bank. A further reduction in excess liquidity was effected by the injection of foreign exchange to the market by the Central Bank during the latter part of the year to maintain the stability in the foreign exchange market. These measures eliminated a large amount of liquidity and resulted in an upward shift in the short term interest rate structure. Amidst signs of credit growth remaining unabated, the Central Bank resorted to moral suasion, and with excess liquidity declining, daily auctions under open market operations (OMO) were recommenced towards the latter part of the year to contain interest rate volatility and maintain short term interest rates at desired levels. To address the impact of high credit growth on the trade deficit and on the macroeconomy, in February 2012, the Central Bank raised its Repurchase rate and the Reverse Repurchase rate by 50 basis points each while issuing a Direction to licensed banks, in March 2012, as per Section 101(1) of the Monetary Law Act to limit the growth of credit to a more desirable level.

Notwithstanding high international commodity prices and adverse domestic weather conditions at the beginning of the year, inflation remained at single digit levels in 2011. Increased domestic food supplies, including those from the Northern and Eastern provinces, a stable exchange rate, favourable inflation expectations of market participants, as well as appropriate monetary policy measures supported the maintenance of inflation at single digit levels in 2011 for the third consecutive year.

Both reserve money and broad money (M_{2b}) expanded at a higher rate than targeted in 2011. High monetary expansion was due to the increase in credit to the private and public sectors above the projected levels. The main reasons for the high demand for credit by the private sector include increased economic activity reflecting the conducive environment for investments, increased domestic demand, higher demand for imports, continued low interest rates and improved access to credit. Meanwhile, public sector borrowings from the banking system also increased with the decline in non-banking sector funding for government deficit financing. The decline in net foreign assets (NFA) of the banking system partly mitigated the expansionary impact of credit growth on money supply.

Tightening monetary conditions, as reflected by declining excess rupee liquidity in the domestic money market towards the end of the year, inflicted upward pressure on the interest rate structure. The average weighted call money rate (AWCMR) remained broadly around the middle of the policy interest rate corridor in the first three quarters of the year, but showed an upward movement with declining excess liquidity in the money market during the last quarter. Both deposit and lending rates remained relatively stable in the first three quarters of the year but increased during the fourth quarter. Yields on government securities in the primary market increased towards the end of the year, and the secondary market yield curve for government securities shifted upwards, while remaining flatter than that of the previous year.

The conduct of monetary policy in 2012 will be focused on addressing challenges from both external and internal fronts. The world economy is yet to show clear signs of recovery while prices of energy and other key commodities remain high and volatile in the international market. Globally and domestically, extreme weather conditions could disrupt supplies of key consumer items. The high trade deficit and its impact on the external sector balance are expected to ease with the monetary, exchange and fiscal policy measures adopted in early 2012 while further action will be taken to secure macroeconomic stability, if necessary. Even though these measures could have a short-run negative impact on inflation and economic growth, they would ensure stability of the Sri Lankan economy in the long term.

7.2 Monetary Policy

The Central Bank's monetary policy stance was eased further in January 2011, but the Bank commenced tightening monetary conditions gradually as the expansion of credit and monetary aggregates continued at a high rate. The monetary policy framework of the Central Bank was further strengthened with the introduction of a more comprehensive economic analysis and monetary analysis enabling the capture of ongoing structural changes in the economy together with changes in the financial practices of the general public. The Central Bank continued to focus on broad money (M_{2b}) as the intermediate target of monetary policy, which is linked to reserve money, the operating target, through the money multiplier. The developments in monetary and credit aggregates were assessed vis-à-vis the developments in the economy to ascertain appropriate levels required for a rapidly growing economy without fuelling inflationary pressures, and proactive policy action was taken to meet this end. The monetary programme, which was prepared based on the projected macroeconomic developments, continued to provide guidance in the conduct of monetary operations. The general public was kept abreast of the policy measures thus implemented together with the rationale for such measures in order to enhance transparency and effectiveness of monetary policy.

The monetary programme for 2011 envisaged an average growth of 14.5 per cent of broad money, which was consistent with the nominal growth of GDP. Initial projections for real GDP, which indicated a growth of about 8.5 per cent, and the implicit GDP deflator for the year anticipated to be about 6 per cent, formed the basis for the stipulated growth of broad money. Growth of reserve money, however, was expected to be higher at around 16.4 per cent due to the lower money multiplier on account of the higher currency to deposit ratio observed since 2009. However, in view of the upward revision to the SRR on rupee deposit liabilities of LCBs by one percentage point effective 29 April 2011 and its impact on the money multiplier, the annual average growth target for reserve money was raised to 19.5 per cent. In spite of the deceleration expected towards year end, growth of monetary aggregates continued to remain above the targeted levels largely due to the high expansion in domestic credit.

The policy stance pursued by the Central Bank during the early part of the year was gradually reversed as the Bank signalled the need for tighter monetary policy. Continuing with the policy easing carried out in the previous year, the Central Bank, enabled by the prevalent healthy outlook for future inflation, reduced its policy rates further in January 2011 with the intent of augmenting private sector investment in the economy. Accordingly, the Repurchase rate was reduced by 25 basis points to 7.00 per cent while the Reverse Repurchase rate was cut by 50 basis points to 8.50 per cent. The continued high level of excess liquidity that prevailed in the market, however, remained a concern given its potential to fuel credit at lower costs leading to eventual inflationary pressures. Therefore, the Central Bank increased the SRR in April 2011 by one percentage point through which, about Rs. 18 billion was withdrawn on a permanent basis from the market while also signalling the change in the Bank's policy stance towards a more restrictive approach. The Central Bank also engaged in discussions with the commercial banks to impress upon them the need to curb their lending portfolio to a more desirable size to minimise the expansionary impact on the money supply as well as to mitigate any threats to financial system stability arising from excessive credit growth. As market liquidity conditions tightened towards the latter part of the year, market interest rates started rising in response, while the Central Bank provided liquidity only to the extent of facilitating a smooth adjustment in short term market rates. However, as growth of credit was yet to moderate as expected during the final quarter of the year and market interest rates came under upward pressure, the Central Bank raised its policy rates by 50 basis points each in February 2012. Accordingly, the Repurchase rate and the Reverse Repurchase rate are currently at 7.50 per cent and 9.00 per cent, respectively. In addition, as per Section 101(1) of the Monetary Law Act, the Central Bank also issued a Direction to licensed banks in March 2012 to limit the growth of credit in 2012 to 18 per cent or Rs. 800 million, whichever is higher, while allowing a credit growth of 23 per cent or Rs. 1 billion, whichever is higher, for banks that bring in fresh foreign funds.

Table 7.1 Recent Monetary Policy Measures (2007-2012)

Per cent per annum

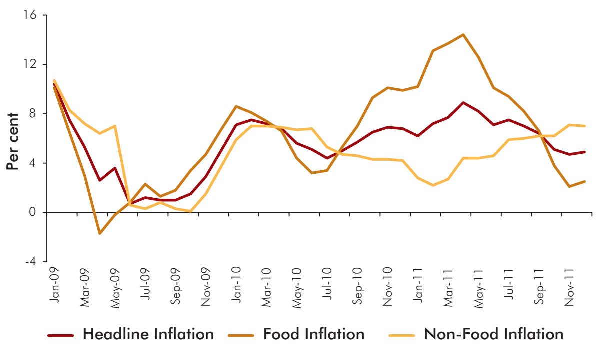
Date	Repurchase Rate	Reverse Repurchase Rate	Statutory Reserve Ratio (a)	Penal Rate on Reverse Repos
23 February 2007	10.50	12.00	-	-
21 November 2007	-	-	-	19.00 (b)
13 October 2008	-	-	9.25 (c)	-
25 November 2008	-	-	7.75 (d)	-
12 January 2009	-	-	-	17.00
11 February 2009	10.25	11.75	-	16.50
24 February 2009	-	-	7.00 (e)	-
18 March 2009	-	-	-	14.75
22 April 2009	9.00	-	-	13.00
21 May 2009	-	11.50	-	Removed
16 June 2009	8.50	11.00	-	
11 September 2009	8.00 (f)	10.50 (f)	-	
18 November 2009	7.50	9.75	-	
09 July 2010	7.25 (f)	9.50 (f)	-	
20 August 2010	-	9.00	-	
11 January 2011	7.00	8.50	-	
12 April 2011	-	-	8.00 (g)	
03 February 2012	7.50	9.00	-	

Source: Central Bank of Sri Lanka

(a) To be maintained as a percentage of rupee deposit liabilities of LCBs
(b) Effective from 03 December 2007
(c) Effective from the reserve week commencing 17 October 2008
(d) Effective from the reserve week commencing 28 November 2008
(e) Effective from the reserve week commencing 27 February 2009
(f) Effective from the close of business
(g) Effective from the reserve week commencing 29 April 2011

With excess liquidity in the money market declining to low levels towards end 2011, the Central Bank took measures to manage market liquidity in order to smooth out sharp fluctuations in market interest rates. In addition to the decline in excess liquidity due to high credit expansion, the supply of foreign exchange by the Central Bank, particularly to facilitate the settlement of petroleum import bills, led to a further reduction in rupee liquidity in the domestic money market. Excess rupee liquidity in the market, which was over Rs. 110 billion at the beginning of the year, declined steadily during 2011, turning marginally negative on a few occasions in December. In anticipation of this, the Central Bank recommenced the conduct of daily auctions under OMO from September onwards to provide better guidance to market interest rates.

Chart 7.1 Food and Non-food Inflation (Year-on-year) Derived from the CCPI (Base: 2006/07)



Consumer price inflation continued to remain at single digit levels for the third consecutive year, largely supported by notable improvements in domestic supply conditions. Inflation measured by the year-on-year change of the CCPI was 4.9 per cent at end 2011 compared to 6.8 per cent a year ago. However, reflecting higher inflation that prevailed till mid 2011, annual average inflation increased from 6.2 per cent at end 2010 to 6.7 per cent by end 2011. During the first half of the year, inflation was primarily driven by higher prices of food and beverages on account of supply side disruptions. However, this situation reversed with the substantial improvements in domestic supply during the second half of the year, which negated price pressures arising from increases in non-food consumer items. Meanwhile, core inflation also remained at single digit levels during the year recording a year-on-year change of 4.7 per cent at end 2011 compared to 8.9 per cent at end 2010. Annual average core inflation declined from 7.0 per cent at end 2010 to 6.9 per cent at end 2011.

As in the previous years, the Central Bank endeavoured to further strengthen its communication with the stakeholders and the general public to increase transparency and effectiveness of its policy decisions. The "Road Map for Monetary and Financial Sector Policies" encompassing the Bank's policy agenda for the coming year as well as the medium term was announced for the fifth consecutive year at the beginning of 2011. More comprehensive analyses of developments in the economy were presented in the annual publications such as the "Annual Report" and "Recent Economic Developments". In addition, regular communiqués over the media as well as appearances by Bank officials at various fora were used as an opportunity to share views about emerging developments, areas of concern as well as new prospects in the economy. In keeping with the practice of the Central Bank over the past few years, regular consultations were held with representatives of the private sector about emerging trends and the impact of possible counteractive measures at the monthly meetings of the Monetary Policy Consultative Committee.

7.3 Developments in Money and Credit

Money market Liquidity

Excess rupee liquidity in the domestic money market declined gradually throughout the year, turning marginally to a deficit by end December 2011. Compared to the surplus of Rs.113.5 billion at end 2010, the domestic money market recorded a deficit of Rs. 5.4 billion by end December 2011. A substantial amount of liquidity was injected to the market in July 2011 with the utilisation of the proceeds of the US dollar 1 billion sovereign bond issued by the government. However, the continued high expansion of domestic credit, as well as the increase in the SRR by one percentage point to 8 per cent in April 2011 (which absorbed about Rs.18 billion) and the supply of foreign exchange to the domestic market by the Central Bank caused the decline of liquidity during the year. However, the decline was moderated through the Central Bank's

Chart 7.2 Overnight Liquidity Position in the Domestic Money Market

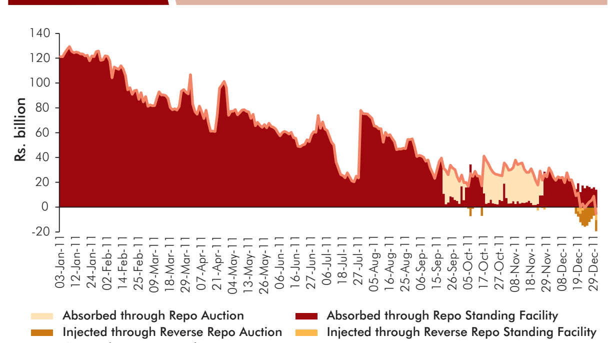


Table 7.2 Developments in Monetary Aggregates

Rs. billion

Item	End 2010	End 2011 (a)	Change 2010 Amount	Change 2010 %	Change 2011 Amount	Change 2011 %
1. Currency Outstanding	255.7	293.2	38.2	17.6	37.6	14.7
1.1 Currency held by the Public	216.5	242.9	34.7	19.1	26.3	12.2
1.2 Currency with Commercial Banks	39.1	50.4	3.5	9.9	11.3	28.8
2. Commercial Banks' Deposits with the Central Bank	104.9	146.3	18.8	21.8	41.4	39.5
3. Government Agencies' Deposits with the Central Bank (b)	...	...	...		...	
4. Reserve Money (1+2+3)	**360.5**	**439.5**	**57.0**	**18.8**	**79.0**	**21.9**
5. Demand Deposits held by the Public with Commercial Banks	190.6	195.8	35.8	23.1	5.2	2.7
6. Narrow Money Supply, M_1 (1.1+5)	**407.2**	**438.7**	**70.5**	**20.9**	**31.5**	**7.7**
7. Time and Savings Deposits held by the Public with Commercial Banks	1,405.8	1,753.9	205.8	17.1	348.1	24.8
8. Broad Money Supply, M_2 (6+7)	**1,813.0**	**2,192.6**	**276.2**	**18.0**	**379.6**	**20.9**
9. Foreign Currency Deposits (c)	278.4	299.1	9.0	3.3	20.7	7.4
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**2,091.4**	**2,491.7**	**285.2**	**15.8**	**400.3**	**19.1**
Money Multiplier, M_{2b}	**5.80**	**5.67**				
Velocity, M_{2b} (d)	**2.92**	**2.85**				

(a) Provisional

(b) Government Agencies' Deposits with the Central Bank amounted to Rs.5.71 million at end 2010 and Rs.1.75 million at end 2011.

(c) Includes deposits of the Resident Category of Offshore Banking Units and a part of foreign currency deposits with Domestic Banking Units

(d) During the year

Source: Central Bank of Sri Lanka

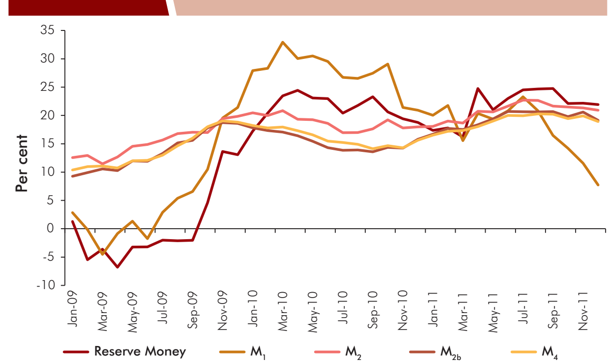
purchase of Treasury bills from the primary market particularly during the last quarter of the year, and the Bank recommenced overnight auctions under OMO from 19 September 2011 with a view to maintaining stability in the money market interest rates. Reverse repo auctions were necessary on a few occasions in early October and later, more regularly in December to provide liquidity to banks facing shortages, in order to minimise the upward pressure on market interest rates even though overall market liquidity was in surplus on some days. Such surplus, which was concentrated within a few banks and not lent in the interbank market due to their own prudential lending limits, continued to be placed with the Central Bank's standing facility window at the Repurchase rate.[1]

Reserve Money

Reserve money continued to grow at a rate above the targeted path during 2011, although some deceleration was observed towards the end of the year. While the growth of reserve money remained below 18 per cent in the first three months of the year, reserve money grew at over 20 per cent, year-on-year, thereafter. The continued expansion of reserve money was due to the increase in currency in circulation as well as commercial bank deposits with the Central Bank. The increase in SRR in April 2011 and the increase in deposits held by the public, reflecting largely the higher credit expansion, contributed to the increase in commercial bank deposits with the Central Bank. Average daily reserve money in 2011 stood at Rs. 409.2 billion recording a growth of 22.1 per cent from Rs. 335.2 billion in 2010, compared to the revised average target of 19.5 per cent for the year.

Viewed from the asset side, the growth of reserve money was driven by the expansion in net domestic assets (NDA) of the Central Bank as net foreign assets (NFA) of the Central Bank declined during the year. NDA expanded by about Rs. 244.4 billion, largely due to the increase in net

Chart 7.3 Growth of Monetary Aggregates



[1] To address the distortionary effect of this on the overnight money market, daily access to the Repo standing facility was limited to Rs. 100 million per participating institution, on the days when the Central Bank offers Reverse Repo auctions with effect from 15 March 2012.

7

MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

Table 7.3 Sources of Reserve Money and Broad Money (M_{2b})
(Computed as per the Monetary Survey)

Rs. billion

Item	End 2010 (a)	End 2011 (b)	Change 2010 Amount	Change 2010 %	Change 2011 Amount	Change 2011 %
Reserve Money	360.5	439.5	57.0	18.8	79.0	21.9
Net Foreign Assets of the Central Bank	505.5	340.1	93.3	22.6	-165.4	-32.7
Net Domestic Assets of the Central Bank	-145.0	99.4	-36.3	-33.4	244.4	168.6
Broad Money (M_{2b})	2,091.4	2,491.7	285.2	15.8	400.3	19.1
Net Foreign Assets	377.4	98.1	-24.4	-6.1	-279.4	-74.0
Monetary Authorities	505.5	340.1	93.3	22.6	-165.4	-32.7
Commercial Banks	-128.0	-242.0	-117.7	-1,140.2	-114.0	-89.1
Net Domestic Assets	1,714.0	2,393.7	309.7	22.1	679.7	39.7
Domestic Credit	2,262.9	3,038.0	355.1	18.6	775.1	34.3
Net Credit to the Government	627.2	833.6	-13.1	-2.1	206.4	32.9
Central Bank	76.9	262.7	-32.1	-29.5	185.8	241.7
Commercial Banks	550.3	570.9	19.0	3.6	20.6	3.7
Credit to Public Corporations	144.6	198.5	71.3	97.4	53.9	37.3
Credit to the Private Sector	1,491.1	2,005.9	296.9	24.9	514.8	34.5
Other Items (net)	-548.9	-644.3	-45.4	-9.0	-95.4	-17.4

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

credit to the government (NCG) by the Central Bank by Rs. 185.8 billion and the decline in other liabilities (net) of the Central Bank by Rs. 58.8 billion, which was mainly caused by the retiring of the entire stock of Central Bank Securities. The increase in NCG was the result of a substantial increase in Treasury bill holdings of the Central Bank by Rs. 167.7 billion and provisional advances of Rs 16.9 billion extended to the government by the Central Bank. Net foreign assets (NFA) of the Central Bank declined by Rs. 165.4 billion during the year 2011, mainly as a result of the supply of foreign exchange to the domestic market, and increased liabilities to the Asian Clearing Union (ACU).

Narrow Money (M_1)

The growth of narrow money supply (M_1), which remained stable during the first half of 2011, slowed down during the latter half of the year. Narrow money, which consists of currency and demand deposits held by the public, recorded a year-on-year growth of 7.7 per cent in December 2011, compared to the growth of 20.9 per cent at end 2010. On a year-on-year basis, the growth in currency held by the public decelerated to 12.2 per cent by end 2011 as against the growth of 19.1 per cent at end 2010. Similarly, the growth of demand deposits held by the public decelerated to 2.7 per cent when compared to its growth of 23.1 per cent in 2010, and this deceleration could be attributed to the rise in market interest rates particularly towards the end of the year.

Broad Money (M_{2b})

Broad money (M_{2b}) expanded at a higher rate than expected in 2011 recording a year-on-year growth of 19.1 per cent by December 2011, compared to a growth of 15.8 per cent at end 2010. The average growth of broad money during the year increased to 19.3 per cent in 2011, compared to the target of 14.5 per cent as per the monetary programme for the year.

On the liability side, the growth of broad money reflected the increase in quasi money, which includes time and savings deposits held at LCBs. Quasi money recorded a year-on-year growth of 21.9 per cent in 2011, compared to 14.6 per cent in 2010. The increase in quasi money accounted for around 92 per cent of the increase in broad money during the year, reflecting the shift towards interest bearing term deposits following higher rates of interest offered by banks on deposits to mobilise funds as liquidity in the money market declined towards the latter part of the year. The moderate performance in the stock market could be another reason for the surge in quasi money of commercial banks.

On the asset side, contributing to this accelerated growth was entirely the increase in credit granted to both the private sector and the public sector. Owing to the domestic credit expansion, NDA of the banking system increased by 39.7 per cent during the year. Consequently, the contribution of NDA to monetary expansion increased to around 170 per cent in 2011, from around 109 per cent in the previous year. The contraction in NFA of the banking system dampened the expansion of broad money. During 2011, NFA of the banking system declined substantially to Rs. 98.1 billion from Rs. 377.4 billion at end 2010. The contraction in NFA of both the Central Bank and commercial banks accounted for this decline. While the supply of foreign exchange by the Central Bank to the domestic market to lessen the pressure on the exchange rate led to the diminution in NFA of the Central Bank, the decline in NFA of commercial banks was mainly due to the shifting of foreign assets of commercial banks towards increased investments in Sri Lanka Development Bonds (SLDBs), a domestic asset, and facilitating the Ceylon Petroleum Corporation (CPC) to settle its outstanding oil import bills. In addition, the outflow of foreign exchange to finance increased imports resulted in a decline in NFA of commercial banks.

Within domestic credit, the growth of credit obtained by the private sector continued unabated with the year-on-year growth increasing to 34.5 per cent by end 2011, compared to 24.9 per cent by end 2010. Demand for credit remained high due to increased economic activity, including in the North and East, reflecting the conducive environment for investments as well as increased domestic demand. Also, borrowers benefited from the continuously low interest rates and improved access to credit with the expansion in banking facilities throughout the country. Credit to the private sector increased by around Rs.515 billion during the year, compared to Rs.297 billion in 2010.

According to the Quarterly Survey of Commercial Banks' Loans and Advances to the private sector, credit to all major categories increased. Credit to the Agriculture and Fishing sector recorded a year-on-year growth of 21.9 per cent, whilst credit to Industry and Services sectors increased by 25.7 per cent and 47.4 per cent,

Chart 7.4 Volume and Growth of Loans and Advances granted to the Private Sector by Commercial Banks

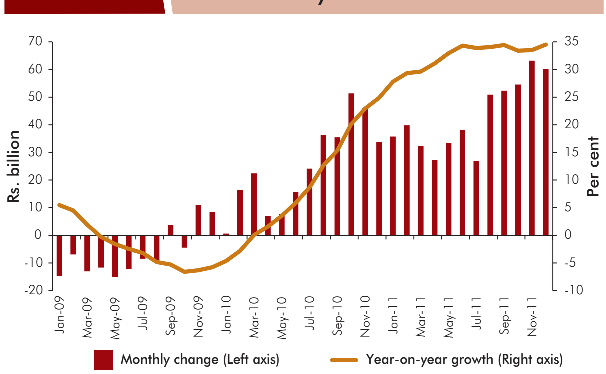


Table 7.4 Classification of Loans and Advances granted by Commercial Banks (a)(b)

Rs. billion

Category	End 2010 (c)	End 2011 (d)	% Share 2011	% Change 2011
Agriculture and Fishing	**216.8**	**264.3**	**13.0**	**21.9**
of which, Tea	45.5	38.5	1.9	-15.3
Rubber	14.4	17.0	0.8	18.2
Coconut	4.7	4.6	0.2	-2.1
Paddy	13.8	11.6	0.6	-16.6
Vegetable, Fruit and Minor Food Crops	6.9	8.9	0.4	30.1
Fisheries	4.1	5.9	0.3	43.0
Industry	**547.3**	**687.7**	**33.9**	**25.7**
of which, Construction	234.2	271.3	13.4	15.8
Food and Beverages	31.4	42.2	2.1	34.4
Textiles and Apparel	85.3	98.7	4.9	15.6
Fabricated Metal Products, Machinery and Transport Equipment	41.8	62.6	3.1	50.0
Services	**317.6**	**468.0**	**23.1**	**47.4**
of which, Wholesale and Retail Trade	108.4	160.2	7.9	47.8
Tourism	32.4	46.6	2.3	44.0
Financial and Business Services	65.8	117.2	5.8	78.1
Shipping, Aviation and Supply, and Freight Forwarding	8.9	11.4	0.6	28.4
Personal Loans and Advances (e)	**404.6**	**576.6**	**28.4**	**42.5**
of which, Consumer Durables	35.2	67.4	3.3	91.5
Pawning	166.3	281.9	13.9	69.5
Safety Net Scheme Related (e.g., Samurdhi)	**23.4**	**33.8**	**1.7**	**44.4**
Total	**1,509.7**	**2,030.4**	**100.0**	**34.5**

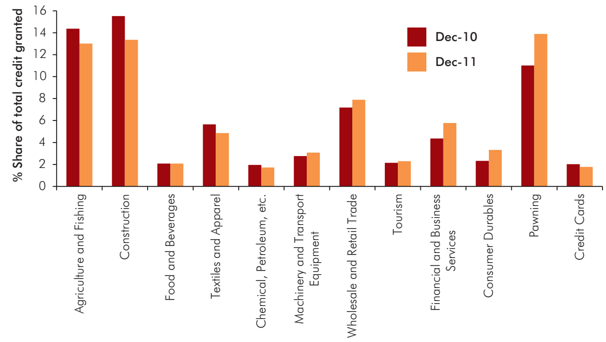
(a) Includes loans and advances of Offshore Banking Units
(b) Advances include loans, overdrafts and bills discounted and exclude cash items in the process of collection.
(c) Revised
(d) Provisional
(e) Excludes personal housing loans classified under 'Construction'

Source: Central Bank of Sri Lanka

respectively. Credit in the form of Personal Loans and Advances recorded a year-on-year growth of 42.5 per cent in 2011, compared to 33.7 per cent in the previous year, with a notable increase in the growth of advances against pawning, which recorded a year-on-year growth of 69.5 per cent by December 2011 compared to the already high growth of 49.9 per cent in the previous year. The substantial increase in the growth of advances against pawning reflected high gold prices that were observed during the year and increased competition among lending institutions engaged in the business of pawning. By the end of the year, the percentage share of total credit outstanding on pawning increased substantially, followed by credit granted for consumer durables and financial and business services while there was a notable decline in the share of credit granted to agriculture and fishing, construction, and textiles and apparel categories.

In terms of the original maturity of loans and advances as reported in the Quarterly Survey, a higher growth was seen in medium and long term credit in 2011 compared to the previous year, except in the agriculture and fishing category. Higher capital investments by Industry and Services sectors as well as increased housing construction activities and the purchase of consumer durables

Chart 7.5 Classification of Loans and Advances granted to the Private Sector by Commercial Banks



including motor vehicles by households could have caused the greater expansion of medium and long term credit. However, short term credit still accounts for a greater share of outstanding credit in all categories.

NCG increased by Rs. 206 billion during the year exceeding the estimated amount in the government budget, which was Rs. 42 billion. The holdings of government securities by the Central Bank increased significantly by around Rs. 167.7 billion during the year whilst provisional advances to the government increased by Rs. 16.9 billion in 2011. NCG by commercial banks also increased with higher investments in Sri Lanka Development Bonds (SLDBs) and other government securities.

Table 7.5 Maturity Analysis of Outstanding Credit to the Private Sector by Commercial Banks

Item		December 2010		December 2011	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	10.3	31.7	10.3	33.6
	Medium Term	2.7	92.2	1.8	-7.8
	Long Term	1.3	39.6	0.9	-8.8
Industry	Short Term	14.6	21.3	13.3	22.7
	Medium Term	7.9	5.8	8.0	35.8
	Long Term	13.7	4.4	12.5	22.9
Services	Short Term	10.5	41.8	10.7	36.3
	Medium Term	6.0	34.1	7.4	65.1
	Long Term	4.5	9.2	5.0	49.4
Personal Loans and Advances	Short Term	18.1	49.7	19.8	46.6
	Medium Term	5.4	35.9	4.9	20.8
	Long Term	3.3	-17.4	3.8	55.8
Safety Net Scheme Related (e.g., Samurdhi)	Short Term	0.8	29.6	0.3	-52.4
	Medium Term	0.4	25.9	0.4	16.2
	Long Term	0.4	204.9	1.0	293.2

Note: Classification of credit is based on original maturity and is as follows: up to one year - Short term, between one and five years - Medium term, over five years - Long term.

Source: Central Bank of Sri Lanka

Table 7.6 Sources of Broad Money (M_4)
(Computed as per the Financial Survey)

Rs. billion

Item	End 2010 (a)	End 2011 (b)	Change 2010 Amount	Change 2010 %	Change 2011 Amount	Change 2011 %
Financial Survey (M_4)	2,636.0	3,135.8	356.1	15.6	499.8	19.0
Underlying Factors						
Net Foreign Assets	354.5	92.4	-23.6	-6.2	-262.1	-73.9
Net Domestic Assets	2,281.5	3,043.4	379.7	20.0	761.9	33.4
Domestic Credit	2,973.9	3,940.7	460.0	18.3	966.8	32.5
Net Credit to the Government	932.4	1,154.6	20.9	2.3	222.2	23.8
Credit to Public Corporations	144.6	198.5	71.3	97.4	53.9	37.3
Credit to the Private Sector	1,896.9	2,587.6	367.8	24.1	690.6	36.4
Other Items (net)	-692.4	-897.3	-80.3	-13.1	-204.9	29.6

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Credit granted to public corporations increased by around Rs. 54 billion during 2011 from around Rs. 145 billion at end 2010. Offshore Banking Units (OBUs) of commercial banks mainly accommodated this increase with greater disbursements to the CPC to settle its oil import bills.

Broad Money (M_4)[2]

Growth of broad money as measured by the financial survey (M_4), increased during the year in line with the trend observed in the broad money supply measured by the monetary survey (M_{2b}). Year-on-year growth of M_4 increased to 19 per cent by end 2011 from 15.6 per cent at end 2010. This growth was purely driven by an increase in NDA since NFA decreased during this period. In absolute terms, NDA increased by Rs. 761.9 billion while NFA declined by Rs. 262.1 billion during 2011. The contraction in NFA of the Central Bank and LCBs caused the decline in NFA (in M_4), although NFA of licensed specialised banks (LSBs) increased by Rs. 17.3 billion during the year. With respect to NDA, credit to the private and public sectors increased substantially in 2011. On a year-on-year basis, credit to the private sector grew by 36.4 per cent in 2011, compared to a growth of 24.1 per cent recorded in the previous year. NCG increased by Rs. 222.2 billion in 2011 in comparison to the increase of Rs. 20.9 billion in 2010.

[2] 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.

As per the financial survey, the growth of quasi money, which comprises time and savings deposits, increased from 15 per cent (year-on-year) by end 2010 to 20.9 per cent by end 2011. The year-on-year growth of quasi money with respect to licensed finance companies (LFCs), was 27.3 per cent by end 2011 compared to 22 per cent at end December 2010. Relatively higher rates offered by LFCs for time and savings deposits, improved financial conditions of LFCs and the listing of most LFCs at the Colombo Stock Exchange (CSE) may have caused the increase in deposits held at LFCs. Meanwhile, the year-on-year growth of quasi money of LSBs also increased to 17.5 per cent by end 2011 compared to 13.5 per cent in 2010.

Credit to the private sector as per the financial survey (M_4) increased on a year-on-year basis, by 36.4 per cent compared to the 34.5 per cent growth as per the monetary survey (M_{2b}) by end 2011 due to the higher growth of credit granted by LFCs. In comparison to a growth of 38.9 per cent in 2010, credit extended to the private sector by LFCs expanded considerably by 67.5 per cent to Rs. 110.9 billion, particularly due to increased lease financing and pawning.[3] Compared to the growth of 11.5 per cent recorded at end 2010, credit granted to the private sector by LSBs increased by 26.9 per cent by end 2011.

[3] 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.

While the growth of NCG was mainly due to the increase in NCG by the Central Bank, NCG by LSBs also increased during 2011. Hence, the increase in NCG during 2011 as per the financial survey was higher at around Rs. 222.2 billion compared to Rs. 206.4 billion as per the monetary survey.

7.4 Interest Rates

Policy interest rates of the Central Bank that were adjusted downwards in January 2011 remained unchanged thereafter during the year. In order to facilitate investments further and to support continued economic expansion, the Repurchase and Reverse Repurchase rates were reduced by 25 basis points and 50 basis points, respectively, in January 2011 and stood at 7.00 per cent and 8.50 per cent, respectively, thereafter. Meanwhile, the Bank rate continued to remain unchanged at 15.00 per cent in 2011. Market interest rates including yields on government securities remained broadly stable during the first three quarters of 2011. However, with the declining excess liquidity in the domestic money market, an upward movement in market interest rates and yields on government securities was observed during the fourth quarter of 2011. Meanwhile, in February 2012, the Central Bank raised its policy rates by 50 basis points each, and accordingly, the Repurchase rate and the Reverse Repurchase rate increased to 7.50 per cent and 9.00 per cent, respectively.

Money Market Rates

In the interbank market, movements in the average weighted call money rate (AWCMR) reflected changes in market liquidity conditions during 2011. AWCMR remained broadly around the middle of the policy interest rate corridor at 7.75 per cent in the first three quarters of the year, but showed an upward movement with declining excess liquidity in the money market during the last quarter. The Central Bank recommenced daily repo auctions under OMO on 19 September 2011 to reduce interest rate volatility, and a weighted average rate of 7.08 per cent was recorded at these auctions. In spite of the market liquidity being in excess on an aggregate basis, AWCMR displayed some volatility in early October, prompting the Central Bank to hold daily reverse repo auctions during 05-14 October 2011. AWCMR since stabilised at around 8.05 per cent, but as market liquidity declined further and some banks accessed the reverse repo standing facility, AWCMR moved above the policy rate corridor since end November and showed some volatility in spite of the Central Bank conducting daily reverse repo auctions continuously during the second half of December. At the reverse repo auctions, the weighted average auction rate fluctuated between 7.25-8.25 per cent. Meanwhile, the tax adjusted AWCMR remained mostly within the policy rate corridor throughout the year although the rate moved from the lower bound of the policy rate corridor towards the upper bound during the year. The overnight Sri Lanka Interbank Offered Rate (SLIBOR), which is the average of offered rates for interbank rupee transactions by 12 selected commercial banks, moved in line with the AWCMR in 2011 while the spread between overnight and 12-month SLIBOR increased from around 40-50 basis points in September to between 110-170 basis points during the last six weeks of the year indicating market expectations of higher interest rates in future.

Table 7.7 Selected Money Market Rates

Per cent per annum

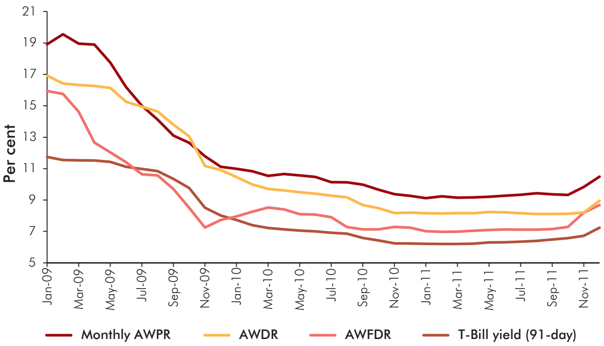
Period	Average Weighted Repo Auction Rate	Average Weighted Reverse Repo Auction Rate	Average Weighted Call Money Rate		SLIBOR-Overnight	
	End Period	End Period	End Period	Average for the Month	End Period	Average for the Month
Dec-09	8.24	-	9.07	9.00	9.03	9.10
Dec-10	-	-	8.03	8.13	8.15	8.17
Mar-11	-	-	7.62	7.72	7.88	7.88
Jun-11	-	-	8.00	7.94	7.99	7.95
Sep-11	7.08	-	8.05	8.02	8.05	8.03
Dec-11	-	8.07	8.97	8.69	9.01	8.77

Source: Central Bank of Sri Lanka

Deposit and Lending Rates

Deposit rates remained relatively stable in the first three quarters of the year but increased during the fourth quarter of 2011. The average weighted deposit rate (AWDR) compiled monthly based on the stock of all interest bearing

Chart 7.6 Selected Market Interest Rates



deposits held at LCBs, which was 6.23 per cent in December 2010, remained broadly stable in the first four months of the year. The AWDR increased gradually thereafter, and was 7.24 per cent by December 2011, thus recording an increase of 101 basis points during the year. The average weighted fixed deposit rate (AWFDR), which is based on the stock of all term deposits held at LCBs, remained in the range of 8.11-8.24 per cent during January-November 2011, before increasing significantly to 8.95 per cent in December 2011. The increase in deposit rates towards the latter months of the year was the result of increased competition to attract mainly short term deposits, particularly in the face of diminishing excess liquidity in the domestic money market. Meanwhile, deposit rates of National Savings Bank remained unchanged during the year. Deposit rates offered by LFCs on term deposits increased from a range of 8.79-10.50 per cent at end 2010 to 8.82-10.74 per cent by end 2011 on one month deposits but rates on one year deposits remained broadly unchanged in a range of 10.84-13.08 per cent at end 2010 compared to 10.72-12.74 per cent at end 2011.

The Legal rate and the Market rate, which are determined by the Monetary Board and published in the Government Gazette at the end of each year, were 6.48 per cent for 2012 compared to 7.26 per cent for 2011.[4] These rates are computed in December each year based on the weighted average rates of interest bearing rupee deposits of all commercial banks during the twelve months immediately preceding.

In line with other interest rates, lending rates also remained broadly stable during the first three quarters of the year before moving upward in the last quarter of 2011. During the year, the weekly average weighted prime lending rate (AWPR), which is based on lending rates offered by the commercial banks to their most creditworthy customers, hovered within a range of 8.92-9.96 per cent until early November before increasing substantially to reach 10.77 per cent in the last week of the year. The increase in the weekly AWPR during the year was 148 basis points. However, the average weighted lending rate (AWLR), which reflects the movement of interest rates pertaining to outstanding credit extended to the private sector by commercial banks, declined during the year as higher interest rates on loans granted in previous years were revised downwards by commercial banks and the relative share of credit granted at lower interest rates increased in 2011. Accordingly, the AWLR declined by 136 basis points from 14.80

Table 7.8 Deposit and Lending Rates (a)

Per cent per annum

Institution	End 2010	End 2011
Licensed Commercial Banks		
Interest Rates on Deposits		
One year Fixed Deposits	5.05-17.00 (b)	5.55-11.00
Savings Deposits	1.50-9.50	1.00-8.50
Average Weighted Deposit Rate (AWDR)	6.23	7.24
Average Weighted Fixed Deposit Rate (AWFDR)	8.20	8.95
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	9.27	10.49
Average Weighted Lending Rate (AWLR)	14.80	13.44
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
One year Fixed Deposits	8.50	8.50
Licensed Finance Companies		
Savings Deposits	6.37-8.25	6.16-7.50
One year Fixed Deposits	10.84-13.08	10.72-12.74
Interest Rates on Lending		
National Savings Bank		
Housing	11.00-14.00	10.00-12.50
Licensed Finance Companies		
Finance Lease	10.44-21.40	9.58-22.02
Hire Purchase	12.59-20.74	11.42-19.74
Loans against Real Estate	14.50-21.55	14.89-19.47

(a) Based on the rates quoted by commercial banks and other selected financial institutions.
(b) Maximum rate is a special rate offered by certain commercial banks.

Source: Central Bank of Sri Lanka

[4] The Legal rate is defined under the Civil Procedure Code (Amendment) Act No. 6 of 1990 and is applicable to any action for the recovery of a sum of money. The Market rate is defined under the Debt Recovery (Special Provisions) Act No. 2 of 1990 and applies only in relation to actions instituted by lending institutions for the recovery of debt exceeding Rs. 150,000 arising out of commercial transactions, where there is no agreed rate of interest.

Chart 7.7 Average Weighted Lending Rates by Type of Security (Per cent)

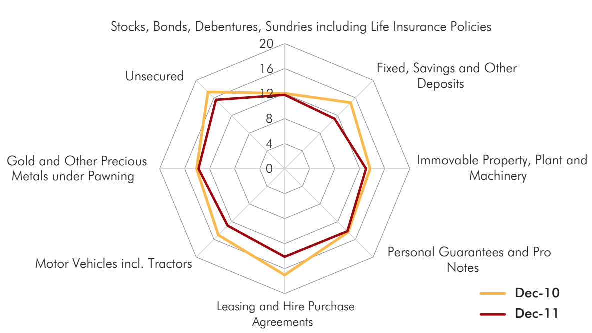
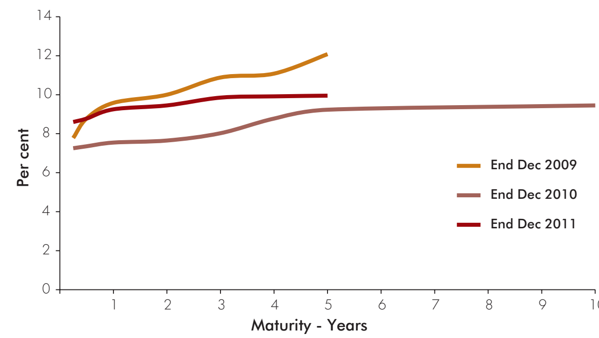


Chart 7.8 Secondary Market Yield Curve for Government Securities



per cent at end 2010 to 13.44 per cent in December 2011.[5] Average weighted lending rates across all types of securities, except on credit granted against personal guarantees and pro notes, and stocks, bonds, debentures, and sundries including life insurance policies, declined substantially in 2011.

As the low and stable interest rates in major economies continued during 2011, the rates applicable to domestic foreign currency denominated deposits held at commercial banks also remained broadly unchanged. Interest rates on US dollar denominated savings deposits were in the range of 0.015-2.79 per cent in 2011 compared to 0.015-2.66 per cent by end 2010, while the rates on US dollar denominated time deposits remained broadly unchanged in the range of 0.10-5.61 per cent during 2011. On pound sterling denominated savings deposits, the rates were in the range of 0.10-3.50 per cent in 2011, unchanged from end 2010, while the rates on pound sterling denominated time deposits were in the range of 0.375-6.24 per cent during 2011, compared to 0.375-6.40 per cent recorded in 2010.

Yield Rates on Government Securities

As the liquidity conditions tightened, the primary market yields on government securities increased towards the end of the year while Treasury bonds of up to 15 years of maturity were issued in 2011. Yield rates pertaining to Treasury bills in the primary market remained broadly stable at the auctions since the reduction in policy rates in January until end September 2011. However, rates began to increase since October 2011 with declining market liquidity. The yields on 91-day, 182-day and 364-day Treasury bills increased by 144 basis points, 136 basis points and 176 basis points, respectively, during the year. Yield rates on Treasury bonds in the primary market ranged from 7.77 per cent on 2-year bonds to 9.30 per cent at the long end, i.e., on 15-year bonds.

The secondary market yield curve for government securities shifted upwards, although remaining flatter by the end of 2011

Table 7.9 Yield Rates on Government Securities

Per cent per annum

Instrument	End 2010	End 2011
Primary Market		
Treasury Bills		
91 day	7.24	8.68
182 day	7.35	8.71
364 day	7.55	9.31
Treasury Bonds (a)		
2 year	8.27 (b)	7.77(c)
3 year	8.15	7.99(d)
4 year	8.60	8.30(e)
Secondary Market		
Treasury Bills		
91 day	7.26	8.60
182 day	7.36	8.78
364 day	7.55	9.25
Treasury Bonds		
2 year	7.65	9.45
3 year	8.03	9.85
4 year	8.78	9.92

Source: Central Bank of Sri Lanka

(a) Based on the closest maturity to the maturity period of the instrument.
(b) The last auction for 2-year Treasury bonds was held in August 2010.
(c) The last auction for 2-year Treasury bonds was held in February 2011.
(d) The last auction for 3-year Treasury bonds was held in January 2011.
(e) The last auction for 4-year Treasury bonds was held in June 2011.

[5] A notable development was that AWLR, which was computed on a quarterly basis until end 2010, was presented on a monthly basis since January 2011.

BOX 13

Asset Price Bubbles and Monetary Policy

One of the contentious issues in today's central banking is whether monetary policy should respond to asset price bubbles. Another compelling concern over monetary policy actions on asset price bubbles is whether it should respond over and above central banks mandate to stabilise inflation and the real economy. Given these questions, two positions on asset price bubbles dominate today's central banking debates. The two positions have been characterised as 'leaning' against asset price bubbles versus 'cleaning' up after the bubble burst.

The most recent event that magnified the debate on asset price bubbles is the global financial crisis of 2008-09. In the period prior to the crisis, a sharp rise in asset prices from its fundamental levels was seen across the US housing market. The deterioration of the long-held US housing price boom was considered as one of the significant prompts of the crisis. The boom in US housing prices and the subsequent economic deterioration can be compared with the boom and bust cycle of asset prices in Japan during the period 1985-92. During the 30-year period starting from 1960, the real GDP of Japan grew at an annual average rate of over 6 per cent. This generated a strong demand for both commercial real estate and shares of business firms in Japan. The stock market soared. The monetary policy was conducive where the broad M2 measure of money supply grew at double-digit rates. This monetary expansion pushed interest rates to low levels and contributed to the rising asset prices. However, asset prices started reversing in 1990. The stock market declined to half of its level in 1990 from levels seen at the beginning of the year. The asset bust soon spread to the rest of the economy and led to a sharp downturn in economic growth to less than 1 per cent during 1992-93. A similar condition was seen in the US in the 2007-09 period. In both Japan and the US, an asset price boom followed a bust, which led to an unexpected reduction in wealth, a surge in bad loans, troubles in the banking and financial sector, and widespread pessimism about the overall economic recovery. The fiscal policy response of Japan and the US has been similar; increased government spending, large budget deficits, and a surge in government debt as a share of the GDP. However, in the US, the Federal Reserve injected a huge quantity of reserves into the banking system while reducing the benchmark interest rates continuously. There are other differences that could also be important. The economy and labour markets are more dynamic in the US than in Japan. For instance, the unemployment rate increased in the US over the 2007-09 period whereas in Japan, due to the nature of its labour market, not much of a change in unemployment was noticed in the aftermath of the bubble burst. In both cases, a large monetary and fiscal stimulus was provided to resurrect the economy.

The two episodes discussed above mainly concentrate on cleaning operations of bubble burst and try to reduce the negative impact on the economy on the presumption that the cost of cleaning up after an asset price bubble burst would be low. On the contrary, it is now recognised that the cost of cleaning up after an asset price bubble burst can be very high if it is followed by a financial crisis such as the crisis of 2008-09. Another interesting feature of the recent bubble is that bubbles can occur even if there is price and output stability during the periods before its collapse, making a much stronger case for leaning against potential bubbles than cleaning afterwards.

In this debate, there are two types of asset price bubbles. The crisis of 2008-09 indicates that one type of bubble referred to as a credit driven bubble, can be highly dangerous due to its proximity to the systemically important financial sector. The second type of bubble that is far less dangerous can be referred to as an irrational exuberance bubble. An irrational exuberance bubble is driven solely by overly optimistic expectations and poses much less risk to the financial system. Therefore, instead of leaning against potential asset price bubbles, which would include both types of bubbles, there is a stronger case for leaning against credit driven bubbles.

It is far from clear as to what role monetary policy plays in asset price booms. An easy monetary policy may promote risk taking in search of yields by ignoring risk elements. The incentive schemes of financial markets also have to be blamed for excessive risk taking. Another mechanism through which an easy monetary policy that promotes risk taking operates is through income and valuation effects. As is often the case, if financial firms borrow short and lend long, an excessively easy monetary policy increases net interest margins and increases the value of firms, increasing their capacity to leverage. Also, through the asset side of balance sheets, low interest rates can boost collateral values, again enabling increased lending. The recent more predictable direction of monetary policy in almost all countries encourages risk taking in two other ways. First, a more predictable monetary policy can reduce uncertainty and contribute to financial markets underestimating risk. Second, monetary policy, which cleans up after financial disruptions can lead to a form of moral hazard where financial institutions expect policymakers to help them recover from bad investments, thereby decreasing the market making role of financial institutions.

Financial regulators and central banks often possess information about the credit conditions of lenders. Therefore, it is possible to argue that credit bubbles can be detected and cured. The experience of Australia in 2002-04 with so called open mouth operations to streamline potential imbalances in the housing market facilitates a renewed interest in exploring possibilities of leaning against asset price bubbles. From a macroprudential perspective, there is a strong case for leaning against credit bubbles. First, any strategy dealing with managing credit bubbles needs to address systemic failures (fix market failures). Recognising that market failures are the problem, it is natural to look into prudential regulatory measures to constrain credit bubbles. These measures include adequate disclosure and capital requirements, liquidity requirements, prompt corrective action, careful monitoring of an institution's risk management procedures, close supervision of financial institutions to enforce compliance with regulations, and sufficient resources and accountability for supervisors. Another approach in assessing market failures deals with monitoring on credit market aggregates. Other macroprudential policies to constrain credit bubbles include dynamic provisioning by banks, haircut requirements for repo lending during credit expansions and Pigouvian type taxes on certain liabilities of financial institutions. From a monetary policy perspective, often, moral suasion or open mouth operations are used to manage credit market aggregates. More recently, to prevent overheating in a particular segment of the economy, central banks consider managing access to standing facilities, multiple interest rate windows, market reserve neutrality and credit targets.

In conclusion, the case for leaning against potential credit bubbles–a manifestation of financial market imbalances– is much stronger than the case for leaning against asset price bubbles in fulfilling overall mandates of monetary policy. This line of thinking suggests that both monetary policy and macroprudential measures should be strengthened to restrain over exuberance in credit markets and at times monetary policy needs to be tightened to lean against financial imbalances.

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compared to that of the previous year. Similar to other interest rates, yields on both Treasury bills and bonds at the secondary market remained broadly stable during the first nine months, while recording an increase in the last three months. Yields on Treasury bills pertaining to all three maturities were in the range of 6.98-7.36 per cent up to September 2011 but increased to a range of 8.60-9.25 per cent by end December 2011. Meanwhile, the secondary market yields on Treasury bonds with maturities of 2-15 years, which were in a range of 7.33-9.40 per cent during the first nine months, also increased to a range of 9.45-9.95 per cent by end 2011.

Yield Rates on Corporate Debt Securities

In 2011, rates on corporate debt securities too moved in line with other market interest rates. Accordingly, yields on corporate debt securities remained broadly stable during the first three quarters before increasing during the fourth quarter. Interest rates pertaining to commercial paper, a short term debt instrument, were in the range of 8.26-14.00 per cent during 2011. There were five new listings of corporate debentures in 2011 with a maturity period of 3-10 years and their interest rates ranged from 11.50-13.00 per cent.

7.5 Future Developments, Challenges and Outlook

In spite of uncertain global supply conditions, headline inflation is expected to be maintained at single digit levels with appropriate monetary policy measures to contain demand side factors, supported by further improvements in domestic supply conditions. By end 2011, year-on-year inflation has been contained at single digit levels for almost 3 years. However, international commodity prices, particularly those of food and energy, remain high and volatile adding uncertainty to domestic price movements. Domestically, improved transportation and communication systems, improved productivity as well as increased production could ease pressure on consumer prices while monetary policy action taken in a forward-looking framework is expected to ensure that consumer price inflation remains at single digit levels in 2012. It is essential that any adverse developments that may arise during the year continue to be addressed through a well designed policy mix that would include fiscal, monetary and external sector policies so as to mitigate the harmful effects that could instigate in the economy.

The Central Bank will make considerable efforts to minimise the volatility in short term market interest rates given the rapidly changing conditions in money market liquidity. The abundant excess liquidity that was available to market participants over the past two years declined gradually over 2011 and market liquidity ranged between surplus and deficit positions thereafter. The skewed distribution of liquidity amongst banks and the need for better fulfillment of liquidity requirements in the interbank market at times caused undue volatility in market interest rates and warranted Central Bank intervention even at times where overall market liquidity has been in surplus. Measures to improve forecasts on liquidity, encouraging all market participants to engage in short term market operations and greater coordination with fiscal authorities with respect to their financial requirements are essential to better manage market liquidity and maintain interest rates at desired levels.

The success of the present monetary targeting framework is dependent upon projecting the desired path for the growth of money supply and maintaining money growth on the set path using tools of monetary policy. As seen in 2011, high growth of credit extended to the private sector as well as high public sector borrowings can cause overshooting of monetary aggregates. While credit to the private sector, which is interest sensitive, could be addressed through monetary policy measures, it is essential that credit obtained by the public sector from banking sources is minimised and held within the levels estimated at the beginning of the year, thus mitigating the risk to maintaining monetary aggregates at desired levels and possible crowding out of private investment of the country.

The Central Bank will continue to improve its monetary policy decision making process in 2012. In the past few years, central banks in key advanced economies have concentrated more on quantities of money and credit in the conduct of monetary policy, which is a strong indication that monetary targeting has not lost its place as a credible monetary policy framework. Going forward, pursuing a clearer target for inflation in a coherent framework with a broader set of indicators and tools of monetary policy could be useful to manage inflation expectations and deliver more effectively the objective of maintaining economic and price stability in the medium term.