7 MONETARY POLICY, MONEY, CREDIT AND INTEREST RATES

7.1 Overview

The Central Bank tightened its monetary policy significantly in the early months of the year considering the rapid expansion of monetary aggregates and its impact on macroeconomic stability, but was able to signal an early exit from the tight monetary policy stance in December 2012 with the expected stabilisation outcomes being realised. Driven by positive economic sentiments, credit extended to the private sector by commercial banks grew unabated from the second half of 2011, raising the risk of fuelling demand driven inflation and posing a threat to the country's external sector stability, if left unaddressed. Consequently, the Central Bank raised its policy interest rates in February and April 2012, imposed a ceiling on credit expansion by licensed banks in March 2012, by issuing a Direction under Section 101(1) of the Monetary Law Act, and allowed greater flexibility in the determination of the exchange rate. As a result of the combined impact of the restriction on the supply of bank credit and reduced demand for credit arising from higher interest rates as well as a depreciated exchange rate, higher energy costs and increased tariffs on selected non-essential imports, the expansion of credit extended to the private sector decelerated rapidly. This helped to arrest the looming demand pressure and strengthen the external sector. The growth of both reserve money and broad money decelerated notably during the year, although the expansion of credit obtained by the public sector exceeded desired levels for the second consecutive year. The sharp deceleration of credit extended to the private sector towards the end of the year together with benign inflation expectations, enabled the Central Bank to relax monetary policy in December 2012 and allow the ceiling on credit expansion to expire, thereby ending the tightening cycle, the shortest in recent years.

In comparison to the previous year, rupee liquidity in the domestic money market was broadly in balance, which was in line with the tight monetary policy stance, and these conditions and the impact of the credit ceiling were reflected in the interest rate structure. The interbank call money market rates increased during the year and remained close to the upper bound of the policy interest rate corridor until the policy interest rates were reduced in mid-December. Deposit rates also adjusted upwards in response to the tight liquidity conditions that prevailed in the market and the aggressive deposit mobilisation by financial institutions. The adjustment of lending rates of commercial banks was greater with increased policy interest rates, the credit ceiling, tight liquidity conditions in the market and increased cost of funds due to high deposit interest rates. Yield rates in the government securities market increased, responding to the high borrowing requirement of the government and tight liquidity conditions, although the upward pressure was suppressed to some extent due to increased demand by banking institutions for investments in government securities.

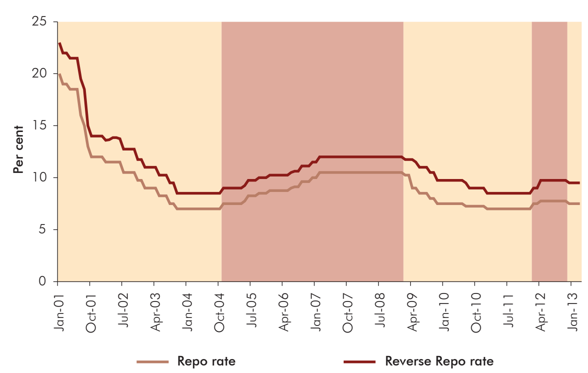
Inflation during the year was mostly supply-driven with some underlying impact from past high monetary expansion. The increase in headline inflation in 2012 was largely due to the one-off impact of the upward revision to several administratively determined prices and the depreciation of the rupee. In addition, the severe drought from July to October, followed by devastating floods in the last two months of the year disrupted domestic food supplies driving inflation further. Despite these supply-side challenges, both headline inflation and core inflation remained at single digits for the fourth consecutive year. While the tight monetary policy measures that were implemented in early 2012 helped reduce demand-driven inflationary pressures to a great extent, government actions to ease supply conditions also contained headline inflation.

Monetary policy in 2013 will focus on maintaining inflation and inflation expectations in check while facilitating the economy to achieve its full potential. Tight monetary policy in 2012, along with other measures by the Central Bank and the government, was able to deliver the expected stabilisation outcomes. Hence, it is now important to consolidate these achievements to attain sustained price stability, so as to promote a greater level of private sector activity on the back of vast improvements to the country's physical infrastructure during the past few years.

7.2 Monetary Policy

The Central Bank followed a tight monetary policy stance during the year to contain high monetary expansion with the aim of reducing demand driven inflationary pressures while supporting the strengthening of external sector stability. As the high expansion in money and credit in 2011 continued into 2012, the Central Bank raised its policy interest rates by 50 basis points each in February 2012, while allowing greater flexibility in the determination of the exchange rate. This was the first increase in policy interest rates since 2007. Subsequently, the Repurchase rate was further increased by 25 basis points to 7.75 per cent, while the Reverse Repurchase rate was increased by 75 basis points to 9.75 per cent in April 2012. The Central Bank also issued a Direction under Section 101(1) of the Monetary Law Act in March 2012 informing licensed banks to restrict their rupee credit growth to 18 per cent, or 23 per cent with respect to banks that finance the difference through funds mobilised abroad. Considering the asymmetric impact that the ceiling could have on some banks, the applicable limits with respect to such banks were set, in absolute terms, at Rs. 800 million, or Rs.1 billion, respectively. At the same time, the government also took necessary measures to curb selected non-essential imports as the prevailing high import demand was observed

Chart 7.1 Policy Interest Rate Cycles*



*Light shading denotes relaxing cycles while dark shading denotes tightening cycles.

Table 7.1 Recent Monetary Policy Measures 2010-2012

Date	Measure
9-Jul-10	Repurchase rate and Reverse Repurchase rate reduced by 25 bps to 7.25% and 9.50%, respectively
20-Aug-10	Reverse Repurchase rate reduced by 50 bps to 9.00%
11-Jan-11	Repurchase rate reduced by 25 bps to 7.00% and Reverse Repurchase rate reduced by 50 bps to 8.50%
12-Apr-11	Statutory Reserve Requirement increased by 1 percentage point to 8% (effective from the reserve week commencing 29-Apr-11)
3-Feb-12	Repurchase rate and Reverse Repurchase rate increased by 50 bps to 7.50% and 9.00%, respectively
9-Feb-12	Greater flexibility in the determination of the exchange rate allowed
12-Mar-12	Direction issued to licensed banks to limit rupee denominated credit growth to 18% or Rs. 800 mn. Additional 5% (23% or Rs. 1 bn) allowed to banks that bridge the gap with funds raised abroad
5-Apr-12	Repurchase rate increased by 25 bps to 7.75% and Reverse Repurchase rate increased by 75 bps to 9.75%, respectively
12-Dec-12	Repurchase rate and Reverse Repurchase rate reduced by 25 bps to 7.50% and 9.50%, respectively
31-Dec-12	Ceiling on rupee denominated credit growth allowed to expire

Source: Central Bank of Sri Lanka

to be a source of excessive credit expansion. With these measures, credit growth decelerated sharply thus helping the growth of money supply to moderate from the second quarter onwards. The imposition of the credit ceiling also changed the conventional monetary policy transmission mechanism with the focus shifting from interest rates to a more quantity based approach during the year. However, it helped eliminate the necessity for substantial hikes in policy interest rates as well as the need for a longer period for credit to adjust.

The efficacy of the measures implemented by the Central Bank helped the economy to achieve the desired results within a short period of time, thus enabling a policy easing by year end. As the deceleration of credit extended to the private sector was at a higher pace than expected, and also considering favourable inflation expectations for 2013, the Central Bank relaxed its monetary policy stance in December 2012, recording the shortest tightening cycle in recent years. The Central Bank reduced its policy rates by 25 basis points to induce a downward adjustment in market interest rates and also allowed the credit ceiling to expire at end 2012. This move was expected to provide an impetus to economic activity. Expansion in credit obtained by the public sector, which continually exceeds desired levels, however, is a concern from the resource allocation perspective.

Monetary policy decisions during the year were guided by the Monetary Programme, which is prepared on the basis of the expected growth of nominal GDP. The original Monetary Programme for 2012 set a growth target of 15 per cent for both reserve money and broad money as the money multiplier was expected to remain broadly unchanged during the year, as announced in the "Road Map for Monetary and Financial Sector Policies for 2012 and Beyond." These targets were based on a projected GDP growth of 8 per cent and inflation, as measured by the implicit GDP deflator, of about 6.5 per cent. Meanwhile, as per the Monetary Programme, the growth of credit extended to the private sector was expected to decelerate to about 19 per cent by end 2012. GDP growth projections were subsequently revised downwards to 7.2 per cent and again to 6.5 per cent, considering the impact of the policy measures adopted, adverse weather conditions and global developments on domestic economic activity. However, the targets for monetary aggregates were maintained unchanged as nominal GDP growth was expected to remain broadly similar to the original level due to the higher GDP deflator. Further, projections indicated that monetary aggregates were trending towards the targeted path in response to the measures implemented while demand driven inflationary pressures remained contained.

The monetary policy decision making process continued to be based on a comprehensive economic and monetary analysis of the economy. In making policy recommendations to the Monetary Board, the Monetary Policy Committee (MPC) relied on a two-pronged approach; a monetary analysis, which assesses developments in monetary aggregates vis-à-vis the monetary targets and a thorough analysis of developments in the other sectors of the economy, which constitutes the economic analysis. The Central Bank continued to engage various stakeholders in policy dialogue when designing its policies while regular discussions with the Monetary Policy Consultative Committee (MPCC) were held during the year to gain understanding of private sector insights.

In line with the tight monetary policy stance, the Central Bank managed rupee liquidity in the domestic money market more closely in 2012, thus facilitating the required upward adjustment to the interest rate structure. Daily auctions under open market operations (OMO) that were recommenced in September 2011 were continued in 2012. In addition, to address structural liquidity, the Central Bank conducted term auctions, outright sales of Treasury bills and forex swaps. Accordingly, rupee liquidity remained at around a balanced position in the last four months of the year, providing greater stability to the short end of the interest rate structure.

Inflation, although remaining at mid-single digits from end 2009, increased during the second half of 2012. Year-on-year headline inflation reached a low level of 2.7 per cent in February 2012. However, inflation increased steadily thereafter, reaching 9.2 per cent by end December from 4.9 per cent at end 2011, largely due to the one-off increase on account of the upward revision to several administratively determined prices, particularly fuel, electricity and transport, to bring domestic prices in line with the actual cost of supply, and the depreciation of the rupee. From around mid-year, drought conditions followed by heavy flooding disrupted domestic food supply continually, exerting upward pressure particularly on fresh food, and thus on inflation. Reflecting the movement in year-on-year inflation, annual average inflation, which declined in the early months of the year, picked up from around mid-year to reach 7.6 per cent by December. Relatively high inflation also reflected, atleast partly, the impact of past monetary expansion, as evident in the movement in core inflation. Core inflation rose during the year, increasing to 7.6 per cent by December 2012 from 4.7 per cent in December 2011, but is expected to turnaround from the second quarter of 2013 reflecting the deceleration in monetary expansion in 2012.

The Central Bank continued to enhance its communication with the public in order to improve the transparency of its policymaking. As is customary for the Central Bank of Sri Lanka, the Road Map for Monetary and Financial Sector Policies was presented at the beginning of the year outlining the proposed policy direction for the year. The Annual Report as well as the Recent Economic Developments carried detailed discussion of developments in the economy, while regular media communiqués and public appearances of Central Bank officials at various fora continued to play an important role in presenting the Bank's opinions and views. Meanwhile, social media networks and increased web presence have been used in recent times to reach a wider audience.

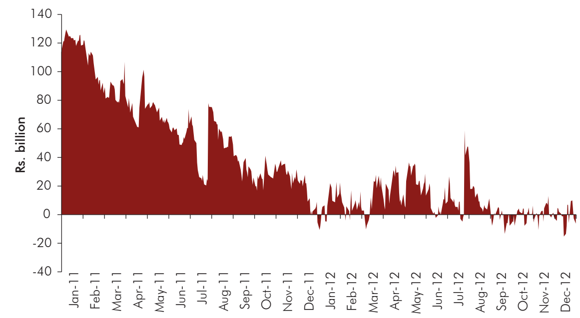
7.3 Developments in Money and Credit

Money Market Liquidity

Rupee liquidity in the domestic money market, which was broadly in excess in the first eight months of the year, remained at a balanced level on average thereafter, and the Central Bank used OMO on a long term basis to address structural liquidity imbalances. Excess liquidity, which averaged around Rs. 12.6 billion during the first 6 months of 2012, increased significantly to Rs. 58.9 billion towards end July with the Central Bank's purchase of US dollars 475 million out of the proceeds of the US dollar 1 billion international sovereign bond. In line with the tight monetary policy stance, the Central Bank undertook measures to unwind the excess liquidity on a permanent basis through term repurchase auctions and outright sales of Treasury bills from the Central Bank holdings, albeit with limited success. A turnaround in the money market liquidity conditions from a large surplus to a marginal deficit took place from September due to the reversal of forex swap arrangements and outright sales of Treasury bills from the Central Bank holdings particularly during August. However, the Central Bank's injection of rupee liquidity through the conduct of term reverse repurchase auctions, the Central Bank's purchase of Treasury bills from the primary market particularly during the last quarter of the year, and the purchase of foreign currency from the market especially during December 2012, improved domestic market liquidity. The maturing of term reverse repo agreements and retiring of Treasury bills held by the Central Bank brought liquidity in the money market to a broadly balanced position by end 2012.

Daily OMO auctions were carried out and standing facilities were provided to manage overnight liquidity. On a daily basis, reverse repurchase auctions were conducted until mid-March due to individual banks facing liquidity shortages despite the overall market being in a surplus as liquidity was concentrated amongst a few banks. 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 days when the Central Bank offered reverse repo auctions with effect from 15 March 2012. Since then, daily repurchase auctions were held except on a few days until mid-September. With overnight liquidity moving between surplus and deficit positions, daily auctions alternated between repurchase and reverse repurchase auctions during the last quarter of the year. Throughout the year, market participants accessed standing facilities provided by the Central Bank at policy interest rates.

Chart 7.2 Overnight Rupee Liquidity in the Domestic Money Market (2011-2012)



Reserve Money

The overall growth of reserve money, which remained high for over two years, was maintained within the targeted level through tight monetary policy measures. On a quarterly average basis, reserve money was maintained within the targets stipulated under the Monetary Programme during the first and the last quarters of the year while it remained marginally above the targeted levels in the second and third quarters of 2012. The growth in the currency in circulation slowed to 8.5 per cent in 2012 from 14.7 per cent in 2011. The considerable increase in interest rates on deposits during the year is likely to have contributed significantly to this deceleration as the opportunity cost of holding cash increased. Commercial bank deposits with the Central Bank, which grew by 39.5 per cent, in 2011, reflecting the high deposit growth in commercial banks as well as the increase in the statutory reserve ratio (SRR) in April 2011, increased only by 13.7 per cent in 2012 with the tightening of monetary policy during

Table 7.2 Developments in Monetary Aggregates

Rs. billion

Item	End 2011	End 2012 (a)	Change 2011 Amount	Change 2011 %	Change 2012 Amount	Change 2012 %
1. Currency Outstanding	293.2	318.1	37.6	14.7	24.8	8.5
1.1 Currency held by the Public	242.9	251.5	26.3	12.2	8.7	3.6
1.2 Currency with Commercial Banks	50.4	66.5	11.3	28.8	16.2	32.1
2. Commercial Banks' Deposits with the Central Bank	146.3	166.3	41.4	39.5	20.0	13.7
3. Government Agencies' Deposits with the Central Bank (b)	...	...	...		...	
4. Reserve Money (1+2+3)	**439.5**	**484.4**	**79.0**	**21.9**	**44.9**	**10.2**
5. Demand Deposits held by the Public with Commercial Banks	195.8	198.5	5.2	2.7	2.7	1.4
6. Narrow Money Supply, M_1 (1.1+5)	**438.7**	**450.0**	**31.5**	**7.7**	**11.3**	**2.6**
7. Time and Savings Deposits held by the Public with Commercial Banks	1,753.9	2,143.1	348.1	24.8	389.2	22.2
8. Broad Money Supply, M_2 (6+7)	**2,192.6**	**2,593.2**	**379.6**	**20.9**	**400.6**	**18.3**
9. Foreign Currency Deposits (c)	299.1	335.9	20.7	7.4	36.7	12.3
10. Consolidated Broad Money Supply, M_{2b} (8+9)	**2,491.7**	**2,929.1**	**400.3**	**19.1**	**437.3**	**17.6**
Money Multiplier, M_{2b}	5.67	6.05				
Velocity, M_{2b} (d)	2.86	2.75				

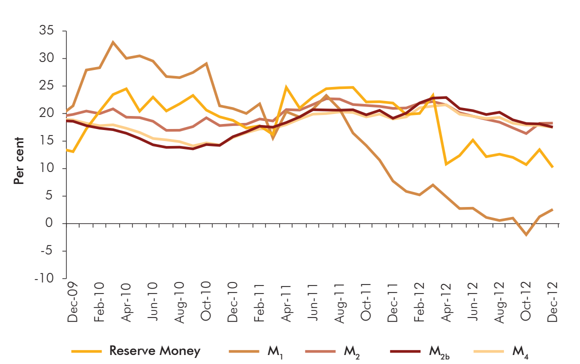
Source: Central Bank of Sri Lanka

(a) Provisional
(b) Government Agencies' Deposits with the Central Bank amounted to Rs.1.75 million at end 2011 and Rs.13.9 million at end 2012.
(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

the year. Average daily reserve money amounted to Rs. 469.8 billion in 2012 compared to Rs. 409.2 billion in 2011. This was a growth of 14.8 per cent in 2012 in comparison to the high growth rate of 22.1 per cent recorded in 2011, and within the targeted average growth of reserve money of 15 per cent in 2012.

In terms of assets, the expansion of both net foreign assets (NFA) and net domestic assets (NDA) of the Central Bank contributed to the growth of reserve money during the first eleven months of the year, although NDA declined in December with a substantial reduction in net credit to the government (NCG) from the Central Bank during the month. NFA rose during the year by Rs. 56.4 billion, as the Central Bank purchased a part of the funds raised by the government through the international bond issue. This was further raised by the Central Bank's purchase of foreign currency inflows from the market and the foreign currency swap agreements entered into during December 2012. NDA increased during the first eleven months of the year due to the increase in Treasury bill holdings of the Central Bank by around Rs. 48.4 billion while there was a substantial reduction in the Treasury bill holdings of the Central Bank during December. Provisional advances to the government by the Central Bank in 2012 amounted to around Rs. 16.5 billion, and the overall increase in NCG in 2012 was Rs. 16.1 billion in comparison to the increase of Rs. 185.8 billion in 2011. With the depreciation of the rupee in 2012, the international

Chart 7.3 Year-on-Year Growth of Monetary Aggregates



reserve revaluation gain, which is recorded as an increase in other liabilities of the Central Bank, prompted other items (net) within NDA of the Central Bank to decline by Rs. 26.5 billion during the year.

In comparison to the broad money (M_{2b}) multiplier of around 5.7 observed in 2011 and in the first quarter of 2012, the multiplier increased to around 6, on average, thereafter. The currency to deposits ratio declined due to high interest rates that prevailed in the market, which increased the opportunity cost of holding currency while encouraging the expansion of interest bearing deposits, and this led to the increase in the money multiplier.

Narrow Money (M_1)

The growth of narrow money supply (M_1), which decelerated sharply during the latter half of 2011, continued to record a low growth in 2012 impacted by tight monetary conditions and the resultant increase in interest rates. Narrow money, which comprises currency and demand deposits held by the public, grew only by 2.6 per cent, on a year-on-year basis, in December 2012 compared to a growth of 7.7 per cent recorded at end 2011. As the opportunity cost of holding non-interest bearing assets increased, currency held by the public decelerated on a year-on-year basis to 3.6 per cent by end 2012 from 12.2 per cent in the previous year. The growth of demand deposits held by the public too decelerated to 1.4 per cent in December 2012 as against the growth of 2.7 per cent at end 2011 as a result of higher rates on interest bearing deposits offered by other financial institutions along with the deceleration of credit disbursed by commercial banks.

Broad Money (M_{2b})

Broad money supply that expanded at a rapid pace in 2011, accelerated further in the first quarter of 2012, and consequent to the stringent policy actions adopted, declined towards desired levels thereafter. Year-on-year broad money growth averaged 21.9 per cent in the first four months of the year peaking at 22.9 per cent in April 2012, but declined gradually to 17.6 per cent by December responding to policy measures taken by the Central Bank. Reflecting the high growth of broad money in the early part of the year, its average growth during the year stood at 20.2 per cent, compared to the target of 15 per cent for average broad money growth in 2012.

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

Rs. billion

Item	End 2011 (a)	End 2012 (b)	Change 2011 Amount	Change 2011 %	Change 2012 Amount	Change 2012 %
Reserve Money	**439.5**	**484.4**	**79.0**	**21.9**	**44.9**	**10.2**
Net Foreign Assets of the Central Bank	340.1	396.5	-165.4	-32.7	56.4	16.6
Net Domestic Assets of the Central Bank	99.4	87.9	244.4	168.6	-11.5	-11.6
Broad Money (M_{2b})	**2,491.7**	**2,929.1**	**400.3**	**19.1**	**437.3**	**17.6**
Net Foreign Assets	98.1	-25.8	-279.4	-74.0	-123.9	-126.3
Monetary Authorities	340.1	396.5	-165.4	-32.7	56.4	16.6
Commercial Banks	-242.0	-422.3	-114.0	-89.1	-180.3	-74.5
Net Domestic Assets	2,393.7	2,954.9	679.7	39.7	561.2	23.4
Domestic Credit	3,038.0	3,696.1	775.1	34.3	658.2	21.7
Net Credit to the Government	833.6	1,045.2	206.4	32.9	211.6	25.4
Central Bank	262.7	278.8	185.8	241.7	16.1	6.1
Commercial Banks	570.9	766.4	20.6	3.7	195.5	34.2
Credit to Public Corporations	198.5	292.5	53.9	37.3	94.0	47.3
Credit to the Private Sector	2,005.9	2,358.4	514.8	34.5	352.6	17.6
Other Items (net)	-644.3	-741.2	-95.4	-17.4	-96.9	-15.0

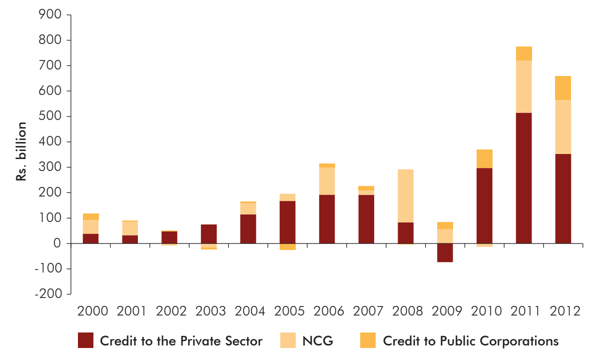
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

On the liability side, the increase in time and savings deposits (quasi money) held by the public in 2012 accounted for over 97 per cent of the year-on-year growth in money supply compared to 92 per cent in 2011, a result of the high rates of interest offered on interest-bearing deposits. The year-on-year growth of quasi money was 20.7 per cent at end 2012 compared to the growth of 21.9 per cent in 2011. A noteworthy development was the increase in foreign currency deposits with offshore banking units (OBUs) of commercial banks, growing by around 39 per cent in 2012, compared to a decline of over 4 per cent in the previous year. This increase was due to the depreciation of the rupee during the year and an increase in foreign currency balances.

On the asset front, the expansionary effect on money supply arising from the growth of credit to both public and private sectors, was somewhat offset by the decline in NFA of the banking system. Although at a slower pace than in 2011, NDA of the banking system increased during the year, with credit to both public and private sectors increasing. While monetary policy measures curbed the expansion of credit extended to the private sector by the banking system, credit obtained by the public sector remained high in 2012. The share of credit obtained by the public sector of the total increase in domestic credit from the banking system, which rose from 16.4 per cent in 2010 to 33.6 per cent in 2011, increased further to 46.4 per cent in 2012. The decline in NFA of commercial banks accounted entirely for the dampening of NFA of the banking system in 2012, mainly due to commercial banks raising fresh funds abroad and utilising existing funds invested abroad to lend domestically, thereby increasing NDA of the banking system. In addition, the depreciation of the rupee led to a further increase in banks' foreign liabilities in rupee terms. Even though NFA of the banking system declined by Rs.123.9 billion during the year, a substantial portion of funds obtained from

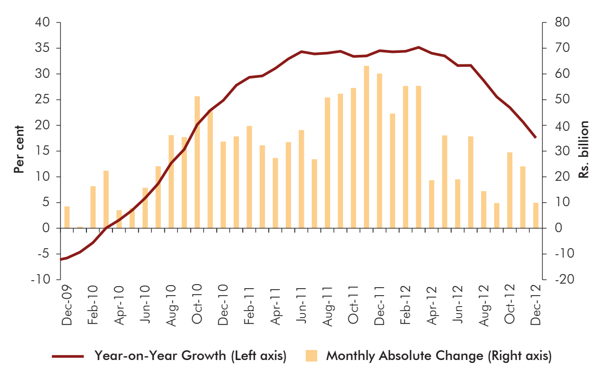
Chart 7.4 Annual Increase in Domestic Credit (2000-2012)



abroad was lent domestically in foreign currency, thereby maintaining the foreign currency exposure of the banking system at a manageable level. Foreign currency loans obtained by the Ceylon Petroleum Corporation (CPC) from the state banks, investments in Sri Lanka Development Bonds (SLDBs), and foreign funds provided to the Central Bank under forex swap arrangements mainly comprised the domestic assets of commercial banks denominated in foreign currency. NFA of the Central Bank improved by around Rs. 56 billion during the year.

The tight monetary policy measures led to a higher than expected reduction in the growth of credit extended to the private sector by commercial banks towards end 2012.

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



Underpinned by improved macroeconomic conditions and the continued growth momentum of the economy, credit obtained by the private sector from commercial banks expanded at a rapid pace from the second half of 2010 through the first quarter of 2012, prompting a tightening of monetary policy. In response to monetary policy actions, together with higher taxes on the importation of motor vehicles and the depreciation of the rupee, the quarterly growth of credit extended to the private sector by commercial banks decelerated sharply to 2.6 per cent in the final quarter of 2012, from 7.7 per cent in the first quarter. On a year-on-year basis, growth of credit to the private sector moderated to 17.6 per cent in December 2012 from its peak of 35.2 per cent in March 2012 and 34.5 per cent at end 2011. In comparison to the expansion of credit to the private sector of about Rs. 380 billion expected in the Monetary Programme for 2012, the realised increase during the year was Rs. 352.6 billion. With credit extended to the private sector slowing down towards the end of the year to a lower level than expected and as inflation expectations were under control, the Central Bank allowed the credit ceiling to expire at end 2012 and reduced policy interest rates to facilitate credit disbursements to productive sectors of the economy.

Chart 7.6 Year-on-Year Growth of Outstanding Credit to Key Sectors (%)

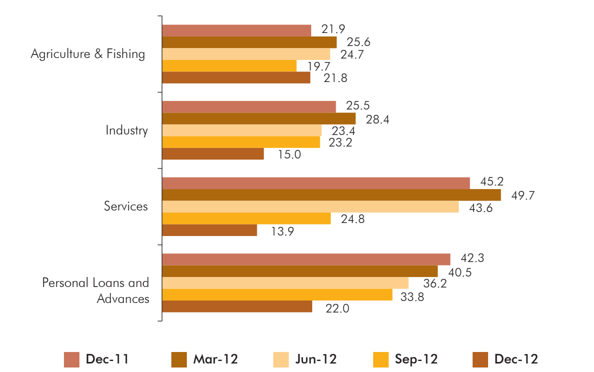


Table 7.4 Classification of Loans and Advances granted by Commercial Banks (a)(b)

Rs. billion

Sector	End 2011(c)	End 2012(d)	% Share 2012	% Change 2012
Agriculture and Fishing	**264.3**	**321.8**	**13.6**	**21.8**
of which, Tea	38.5	43.1	1.8	11.8
Rubber	17.0	14.6	0.6	-13.9
Coconut	4.6	5.1	0.2	9.8
Paddy	11.6	12.6	0.5	9.2
Vegetable, Fruit and Minor Food Crops	8.9	14.0	0.6	57.4
Fisheries	5.9	10.4	0.4	76.4
Industry	**687.0**	**789.7**	**33.4**	**15.0**
of which, Construction	268.3	329.6	13.9	22.9
Food and Beverages	42.2	53.5	2.3	26.6
Textiles and Apparel	98.5	96.3	4.1	-2.3
Fabricated Metal Products, Machinery and Transport Equipment	62.6	72.4	3.1	15.6
Services	**461.2**	**525.5**	**22.2**	**13.9**
of which, Wholesale and Retail Trade	158.8	183.2	7.7	15.4
Tourism	44.8	54.2	2.3	21.0
Financial and Business Services	116.9	121.1	5.1	3.6
Shipping, Aviation and Supply, and Freight Forwarding	8.1	6.2	0.3	-24.2
Personal Loans and Advances (e)	**575.8**	**702.7**	**29.7**	**22.0**
of which, Consumer Durables	67.4	60.5	2.6	-10.3
Pawning	281.9	339.4	14.4	20.4
Safety Net Scheme Related (e.g., Samurdhi)	**33.8**	**24.3**	**1.0**	**-28.1**
Total	**2,022.0**	**2,364.0**	**100.0**	**16.9**

(a) Based on the Quarterly Survey of commercial banks' loans and advances to the private sector
(b) Includes loans, overdrafts and bills discounted and excludes cash items in the process of collection
(c) Revised
(d) Provisional
(e) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry'

Source: Central Bank of Sri Lanka

As per the Quarterly Survey of Commercial Banks' Loans and Advances to the private sector, the growth of credit to all major categories decelerated towards end 2012. By end 2012, credit to the Agriculture and Fishing sector accounted for 13.6 per cent of total loans and advances, while credit to the Industry sector and Services sector, accounted for 33.4 per cent and 22.2 per cent, respectively. The share of credit in the form of Personal Loans and Advances amounted to nearly 30 per cent.

The growth in long term lending declined during 2012. Considering the original maturity of loans and advances as per the Quarterly Survey,

Table 7.5 Maturity Analysis of Outstanding Credit to the Private Sector by Commercial Banks (a)(b)

Item		December 2011		December 2012	
		% Share	% Growth	% Share	% Growth
Agriculture and Fishing	Short Term	10.3	33.6	10.8	22.5
	Medium Term	1.8	-7.8	2.1	31.5
	Long Term	0.9	-8.8	0.7	-6.3
Industry	Short Term	13.3	22.7	12.7	11.7
	Medium Term	8.0	35.8	8.9	31.8
	Long Term	12.5	22.9	11.7	7.8
Services	Short Term	10.7	36.3	10.8	18.3
	Medium Term	7.4	65.1	6.9	10.4
	Long Term	5.0	49.4	4.6	9.8
Personal Loans and Advances	Short Term	19.8	46.6	21.3	25.8
	Medium Term	4.9	20.8	5.1	22.7
	Long Term	3.8	55.8	3.3	1.7
Safety Net Scheme Related (e.g., Samurdhi)	Short Term	0.3	-52.4	0.3	32.4
	Medium Term	0.4	16.2	0.4	12.9
	Long Term	1.0	293.2	0.4	-58.8

(a) Based on the Quarterly Survey of commercial banks' loans and advances to the private sector
(b) 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

growth of long term credit in 2012 declined across all major categories. The ceiling on credit expansion discouraged banks from lending on a long term basis, whilst demand for long-term borrowing was also lower due to the high interest rate environment. Consequently, an increase in short and medium term credit was observed during the year, with growth of short term credit dominating in the Services and Personal Loans and Advances categories. In the Agriculture and Fishing, and Industry sectors, medium term loans and advances recorded the highest growth by end 2012.

NCG from the banking system increased substantially in 2012. NCG increased by around Rs. 212 billion during 2012, exceeding the revised budget estimate for bank borrowings of Rs. 75 billion in 2012. NCG from the Central Bank increased by only Rs. 16.1 billion during the year, mainly due to the effect of provisional advances, while Treasury bill holdings (net of repos) of the Central Bank declined by around Rs. 1.5 billion from the stock that prevailed at end 2011. However, NCG from commercial banks increased by around Rs. 196 billion during the year, accounting for over 92 per cent of the increase in NCG. Following the imposition of the ceiling on rupee lending in early 2012, a shift in commercial bank investments to government securities was observed.[1] Consequently, Treasury bill holdings (net of repos) of Domestic Banking Units (DBUs) of commercial banks increased by around Rs. 25 billion, Treasury bond holdings (net of repos) increased by around Rs. 77 billion, while other investments increased by Rs. 27 billion during 2012. Further, the government's outstanding overdraft balance with DBUs of commercial banks also increased by around Rs. 47 billion, although advances declined by around Rs. 4 billion in 2012. Also contributing to this increase in NCG from commercial banks were the investments in SLDBs by OBUs of commercial banks, which increased by around Rs. 32 billion in 2012. The outstanding NCG from the banking system surpassed Rs. 1 trillion during the year.

Increased borrowing by the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) caused credit obtained by public corporations to increase substantially by around Rs. 94 billion during 2012. Credit

[1] The credit ceiling as monitored by the Bank Supervision Department (BSD) of the Central Bank, affected all rupee lending to the private sector, public corporations and the government. However, bank investments in debt securities, including those in government securities, are not considered as credit as per the BSD classification. Nevertheless, investments in government securities by banks are considered as NCG as per the monetary classification discussed here.

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

Rs. billion

Item	End 2011(a)	End 2012(b)	Change 2011 Amount	Change 2011 %	Change 2012 Amount	Change 2012 %
Financial Survey (M_4)	3,135.8	3,685.0	499.8	19.0	549.2	17.5
Underlying Factors						
Net Foreign Assets	92.4	-35.1	-262.1	-73.9	-127.5	-138.0
Monetary Authorities	340.1	396.5	-165.4	-32.7	56.4	16.6
LCBs	-242.0	-422.3	-114.0	-89.1	-180.3	-74.5
LSBs & LFCs	-5.6	-9.2	17.3	75.4	-3.6	-63.8
Net Domestic Assets	3,043.4	3,720.1	761.9	33.4	676.7	22.2
Domestic Credit	3,940.7	4,829.1	966.8	32.5	888.4	22.5
Net Credit to the Government	1,154.6	1,389.9	222.2	23.8	235.3	20.4
Monetary Authorities	262.7	278.8	185.8	241.7	16.1	6.1
LCBs	570.9	766.4	20.6	3.7	195.5	34.2
LSBs	310.0	327.6	17.6	6.0	17.7	5.7
LFCs	11.1	17.0	-1.8	-13.9	6.0	54.0
Credit to Public Corporations	198.5	292.5	53.9	37.3	94.0	47.3
LCBs	198.5	292.5	53.9	37.3	94.0	47.3
Credit to the Private Sector	2,587.6	3,146.7	690.6	36.4	559.1	21.6
LCBs	2,005.9	2,358.4	514.8	34.5	352.6	17.6
LSBs	306.5	354.5	65.0	26.9	48.0	15.7
LFCs	275.2	433.8	110.9	67.5	158.5	57.6
Other Items (net)	-897.3	-1,109.0	-204.9	-29.6	-211.7	-23.6

(a) Revised
(b) Provisional

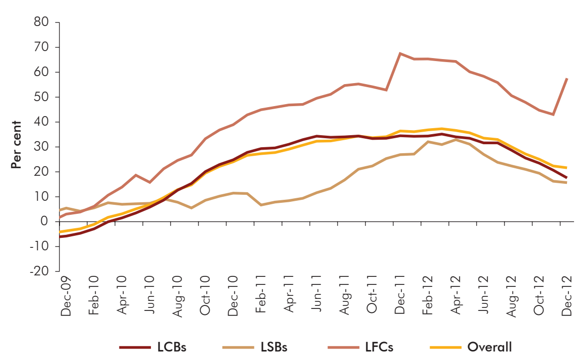
Source: Central Bank of Sri Lanka

obtained by the CPC from OBUs of commercial banks, mainly to finance its oil import bills, increased by around Rs. 78 billion during the year. However, credit obtained by the CPC from DBUs of commercial banks declined by around Rs. 24 billion during the year subsequent to the partial settlement of rupee liabilities. Moreover, credit obtained by the CEB increased notably towards the end of the year by around Rs. 30.7 billion. Credit extended to public corporations by the banking system would have been higher if not for the substantial fuel and energy price adjustments made during the year.

Broad money (M_4)[2]

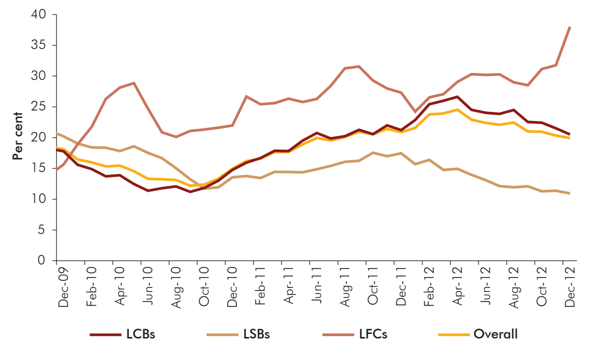
Following a trend similar to the growth of M_{2b}, the growth of broad money computed on the basis of the financial survey (M_4) continued its upward trend in the first four months of 2012 before decelerating. With the tightening of monetary policy, the growth of credit to the private sector as per M_4 declined gradually to 21.6 per cent by December 2012 from 36.4 per cent at end 2011. As the ceiling on credit expansion was only applicable to licensed banks, the share of LFCs of

Chart 7.7 Year-on-Year Growth of Credit Extended to the Private Sector



[2] Financial survey provides a broader measure of liquidity, covering licensed specialised banks (LSBs) and licensed finance companies (LFCs), in addition to licensed commercial banks (LCBs) and the Central Bank.

Chart 7.8 Year-on-Year Growth of Savings and Time Deposits



total credit to the private sector in the financial survey increased to 13.8 per cent by December 2012 from 10.6 per cent recorded in December 2011. This was also supported by an increase in the number of LFCs during the year, and particularly, obtaining of licences by the established specialised leasing companies (SLCs) to operate as LFCs. Meanwhile, the year-on-year growth of quasi money in M_4 at end 2012 was 19.9 per cent compared with 20.9 per cent at end 2011. On a year-on-year basis, the quasi money of LFCs expanded by 38 per cent by end 2012 recording an increase of Rs. 70.7 billion during the year, compared to a growth of 27.3 per cent at end 2011 (an increase of Rs. 39.9 billion in 2011). Relatively high interest rates offered by LFCs and the increase in the number of LFCs during the year contributed to the sharp increase in quasi money at LFCs. A sharp deceleration of quasi money at LSBs was observed with the growth declining from 17.1 per cent at end 2011 to 10.1 per cent by end 2012, as interest rates offered by LSBs were less competitive than those of LCBs and LFCs.

7.4 Interest Rates

Money Market Rates

Interbank call money market rates increased during the first half of 2012, reflecting the credit ceiling in place and the policy rate increases by the Central Bank, and remained stable thereafter until policy rates were reduced in mid-December. The average weighted call money rate (AWCMR) increased by around 120 basis points with the policy rate increases in February and in April 2012. The AWCMR reached its highest point of 10.71 per cent in mid-July, and stabilised thereafter at around 10.54 per cent until the policy rate reduction on 12 December 2012. The significant decline in surplus liquidity towards the latter half of 2012 contributed greatly to the stabilisation of interbank interest rates. Accordingly, the AWCMR, after adjusting for the impact of the withholding tax, remained close to the upper bound of the policy interest rate corridor from August until mid-December. With the reduction of policy interest rates and in anticipation of the expiry of the credit ceiling at end 2012, the AWCMR adjusted downwards sharply in December 2012. Meanwhile, the weighted average yield rates at the daily OMO auctions responded to the movements in policy interest rates and market liquidity and adjusted upwards gradually during the year until mid-December, before declining thereafter. The weighted average rates at term auctions varied depending on the term and reflecting the appetite of the market. The overnight Sri Lanka Interbank Offered Rate (SLIBOR) moved with the call money rate.

Chart 7.9 Average Weighted Call Money Rate and Policy Interest Rates

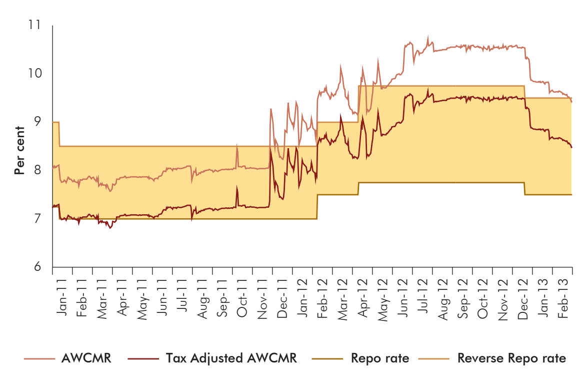


Table 7.7 Selected Money Market Rates

Per cent per annum

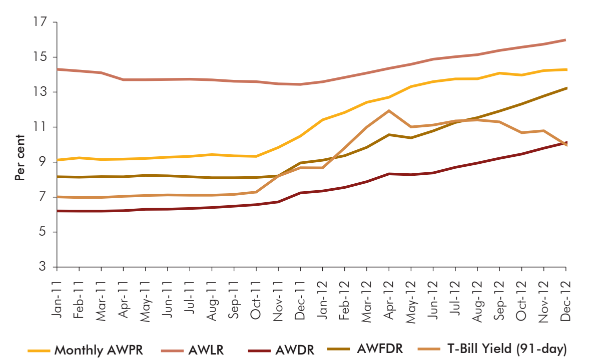
	Average Weighted Repo Auction Rate	Average Weighted Reverse Repo Auction Rate	Average Weighted Call Money Rate		SLIBOR-Overnight	
			End Period	Average for the month	End Period	Average for the month
Dec-10	-	-	8.03	8.13	8.15	8.17
Dec-11	-	8.07	8.97	8.69	9.01	8.77
Mar-12	8.21	-	9.21	9.53	9.28	9.63
Jun-12	9.28	-	10.39	10.35	10.41	10.39
Sep-12	-	9.70	10.55	10.56	10.60	10.61
Dec-12	-	-	9.83	10.22	9.92	10.30

Source: Central Bank of Sri Lanka

Deposit and Lending Rates

Deposit rates that began increasing at a fast pace during the fourth quarter of 2011, continued to increase throughout 2012. The increase in deposit rates was in response to the tight liquidity conditions that prevailed in the market and aggressive deposit mobilisation by financial institutions to capture a greater share of the market. The average weighted deposit rate (AWDR), compiled monthly, based on the stock of all interest bearing deposits held at LCBs, increased during the year to 10.10 per cent, from 7.24 per cent at end 2011. The average weighted fixed deposit rate (AWFDR), based on the stock of all term deposits held at LCBs, increased from 8.95 per cent at end 2011 to 13.21 per cent by December 2012. During 2012, deposit interest rates offered by LFCs remained high compared to commercial bank rates due to increased competition and diminishing liquidity in the market compelling intervention by the Central Bank to stabilise deposit rates offered by LFCs. The Central Bank adjusted downwards the ceiling on interest rates that could be offered by LFCs on term deposits in May 2012 by 75 basis points and in July 2012 by a further 175 basis points as a prudential measure to curtail excessive competition and safeguard the stability of the LFCs. From October 2012, the maximum annual interest rates that could be offered by LFCs for time deposits and certificates of deposit were linked to the 364-day Treasury bill rate as at end of the previous quarter, plus 200-400 basis points depending on the maturity of the deposit. The savings deposit rates offered by LFCs were linked to the 91-day Treasury bill rate as at end of the previous quarter. Financial institutions continued to offer higher interest rates on deposits of senior citizens, and the Central Bank facilitated such higher rates by introducing a common threshold age of 55 years for senior citizens.

Chart 7.10 Movement of Selected Market Interest Rates



The Legal rate and the Market rate of interest determined by the Monetary Board and published in the Government Gazette at the end of each year, were 8.59 per cent for 2013 compared to 6.48 per cent for 2012.[3] 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 immediately preceding twelve months.

Higher policy interest rates along with the credit ceiling, tight liquidity in the market and increased cost of funds due to high deposit interest rates, caused commercial banks to adjust their lending rates upwards in 2012.

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

The weekly average weighted prime lending rate (AWPR), which reflects rates applicable on loans and advances granted by commercial banks to their most creditworthy customers, was on an upward trend during the year and increased by 363 basis points to 14.40 per cent by end 2012, while the monthly average AWPR also increased. With the lowering of policy interest rates in December, the AWPR started to gradually decrease, but structural issues in the determination of prime lending rates by banks were seen to delay the downward adjustment of AWPR. The average weighted lending rate (AWLR), which reflects the movement of interest rates on outstanding credit extended to the private sector by the commercial banks also increased considerably in 2012 reflecting the high lending rates that prevailed during the year. Compared to end 2011, average weighted lending rates against all types of securities increased. Notable increases in lending rates under categories of pawning of gold and other precious metals, stock in trade and unsecured lending were observed during 2012. AWLR rose by 254 basis points to 15.98 per cent at end 2012 from 13.44 per cent at end 2011. Meanwhile, considering the trends in market interest rates, the Central Bank allowed licensed banks to increase interest rates on housing loans and on credit cards to 16 per cent and 28 per cent, respectively, from April 2012.

Table 7.8 Deposit and Lending Rates (a)

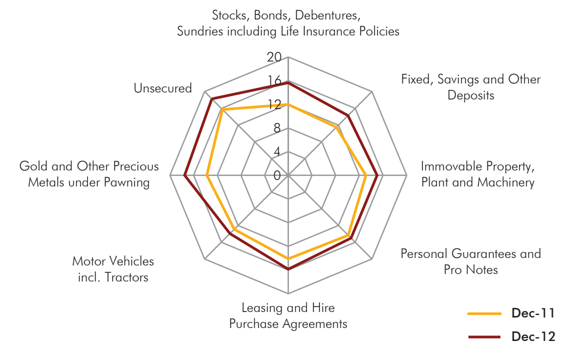
Per cent per annum

Institution	End 2011	End 2012
Licensed Commercial Banks		
Interest Rates on Deposits		
1-year Fixed Deposits	5.55-11.00 (b)	5.00-17.00
Savings Deposits	1.00-8.50	0.75-10.50
Average Weighted Deposit Rate (AWDR)	7.24	10.10
Average Weighted Fixed Deposit Rate (AWFDR)	8.95	13.21
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	10.49	14.29
Average Weighted Lending Rate (AWLR)	13.44	15.98
Other Financial Institutions		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	5.00	5.00
1-year Fixed Deposits	8.50	12.50
Licensed Finance Companies (c)		
Savings Deposits	6.16-7.50	7.79-9.69
1-year Fixed Deposits	10.72-12.74	14.94-16.66
Interest Rates on Lending		
National Savings Bank (d)	10.00-12.50	14.00-15.50
State Mortgage and Investment Bank (d)	11.50-13.50	17.00-19.00
Licensed Finance Companies (c)		
Finance Leasing	13.18-22.02(e)	17.12-26.07
Hire Purchase	13.18-19.74(e)	16.60-23.83
Loans against Real Estate	15.87-19.47(e)	20.87-24.75

(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.
(c) Average rates, based on the maximum and minimum rates quoted by the LFCs
(d) Lending for housing purposes only.
(e) Revised

Source: Central Bank of Sri Lanka

Chart 7.11 Average Weighted Lending Rates by Type of Security (%)



The interest rates applicable on foreign currency deposits remained low during 2012 due to the near zero policy interest rates of the advanced economies. The US dollar denominated savings deposits were in the range of 0.015 per cent to 2.737 per cent during 2012 compared to 0.015 per cent to 2.79 per cent in 2011, while the US dollar denominated time deposits remained in a range of 0.15 per cent to 3.82 per cent during 2012, compared to 0.10 per cent to 5.61 per cent in 2011. The pound sterling savings deposits in 2012 remained in the range of 0.10 per cent to 3.50 per cent, unchanged from 2011, while pound sterling denominated time deposits were in the range of 0.375 per cent to 5.354 per cent in 2012 compared to 0.375-6.24 per cent during 2011.

Yield Rates on Government Securities

The increase in policy interest rates, the high borrowing requirement of the government and tight liquidity conditions caused the yield rates of government securities in the primary market to increase. Yields on Treasury bills of all maturities that remained stable in the first few weeks of the year with the Central Bank purchases from the primary market, increased rapidly thereafter until mid-May 2012 reflecting market liquidity conditions. As licensed banks were directed to reduce the expansion of domestic credit with the credit ceiling in place, the appetite of commercial banks for investments in Treasury bills grew, which resulted in a decline in 91-day Treasury bill yields from May and some stabilisation of yields on other maturities thereafter. A continued decline in yields across all three maturities was seen in December 2012, due to a reduced supply of Treasury bonds resulting from the borrowing limits of the government for the year being reached and due to the reduction in policy interest rates. Treasury bonds were issued infrequently in the primary market during the first seven months of the year, and yields were higher at each subsequent auction during these issues.

Table 7.9 Yield Rates on Government Securities

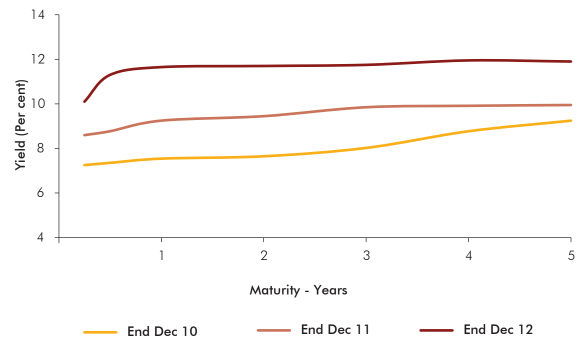
Per cent per annum

Instrument	End 2011	End 2012
Primary Market		
Treasury bills		
91-day	8.68	10.00
182-day	8.71	11.32
364-day	9.31	11.69
Treasury bonds		
2-year	7.77 (a)	13.62 (d)
3-year	7.99 (b)	13.50 (e)
4-year	8.30 (c)	14.10 (f)
Secondary Market		
Treasury bills		
91-day	8.60	10.10
182-day	8.78	11.30
364-day	9.25	11.65
Treasury bonds		
2-year	9.45	12.25
3-year	9.85	12.30
4-year	9.92	12.45

Source: Central Bank of Sri Lanka

(a) The last auction for 2-year Treasury bonds was held in February 2011.
(b) The last auction for 3-year Treasury bonds was held in January 2011.
(c) The last auction for 4-year Treasury bonds was held in June 2011.
(d) The last auction for 2-year Treasury bonds was held in July 2012.
(e) The last auction for 3-year Treasury bonds was held in May 2012.
(f) The last auction for 4-year Treasury bonds was held in July 2012.

Chart 7.12 Secondary Market Yield Curve for Government Securities



The secondary market yield curve for government securities increased until August 2012, reflecting the upward movement of the entire interest rate structure, and shifted downwards thereafter. The 91-day Treasury bill yield rates peaked in April at around 11.93 per cent, and continued to fall thereafter reaching 10.10 per cent at end 2012. The secondary market yields for Treasury bonds, moved within a range of 9.71 per cent to 14.48 per cent with the peak recorded in August 2012. The sharp decline in Treasury bill rates in the secondary market in the last few weeks of the year had not transmitted to the long end of the yield curve by end 2012.

Yield Rates on Corporate Debt Securities

In 2012, rates on corporate debt securities moved in tandem with most market interest rates. Interest rates pertaining to commercial paper, a short term debt instrument, were in the range of 11.25 per cent to 22.00 per cent during 2012, comparatively higher than 8.26 per cent to 14.00 per cent in 2011. There were six new listings of corporate debentures for the year, with a maturity of 5 years with fixed interest rates payable ranging from 10.50 per cent to 17.00 per cent, and floating interest rates payable being linked to the weighted average 182-day Treasury bill yield rate.

7.5 Future Developments, Challenges and Outlook

Monetary policy in 2013 will focus on managing aggregate demand in order to keep inflation and inflation expectations under control while facilitating the economy to achieve its full potential. The tight monetary policy stance of the Central Bank, which was in effect during most of 2012, is likely to have contained demand driven inflationary pressures, but supply side effects on inflation including those arising from upward revisions to administratively determined prices remained high. Although supply side inflation is beyond the control of monetary policy, sustained high inflation, whether driven by demand or supply, could lead to second round effects requiring policy intervention. The Central Bank will thus carefully monitor these developments while managing aggregate demand in order to deliver a low inflation environment, which is essential for growth and stability.

While the temporarily imposed credit ceiling was prominent in the process of monetary policy implementation in 2012, policy interest rates and the interest rate corridor would again become the key policy instrument in 2013. For economic activity to pick up in line with the relaxation of the monetary policy stance in December 2012, it is necessary that market interest rates reflect the easing of monetary policy. The downward rigidity of both deposit rates and lending rates in the market, as was observed in the first two months of 2013, is detrimental to the proper working of monetary transmission channels. This could also lead to sustained high interest margins reflecting increased inefficiencies in financial intermediation. The Central Bank's efforts during the year will thus focus on strengthening the pass-through mechanism in order to achieve the desired effects of monetary policy decisions within a reasonable period of time.

The increased dependence of the government and public corporations on the banking sector to finance their operations remains a key challenge to the implementation of monetary policy. In response to the monetary policy measures taken in early 2012, the growth of credit extended to the private sector decelerated sharply, but the deceleration of money supply growth was somewhat hampered by the high utilisation of credit by the public sector. This was in spite of the government's firm commitment and strong efforts towards fiscal consolidation. Such high credit to the public sector poses a challenge to liquidity management, interest rate stability, and aggregate demand management in order to contain inflationary pressures, as well as the effectiveness of monetary policy. Thus, it is essential that sustainable measures are adopted to minimise pressure on the banking sector arising from structural revenue shortfalls and inappropriate pricing of public utilities.

Recognising the fact that monetary policy decisions are essentially forward looking, over the years, the Central Bank has enhanced its efforts to improve its forecasting and policy modelling framework. For internal monetary policy discussions, the Central Bank uses the results of econometric models as a key input, and these models are constantly modified to provide improved forecasts as to the expected behaviour of macroeconomic variables. The Central Bank is also in the process of adopting more advanced modelling techniques such as Dynamic Stochastic General Equilibrium (DSGE) models to capture the structural transformations of the economy more effectively in its forecasts. These efforts are likely to aid the Central Bank to improve the monetary policy decision making and implementation processes further in order to deliver its mandate of maintaining economic and price stability more efficiently.