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## Monetary Policy Review: No. 07 - October 2023

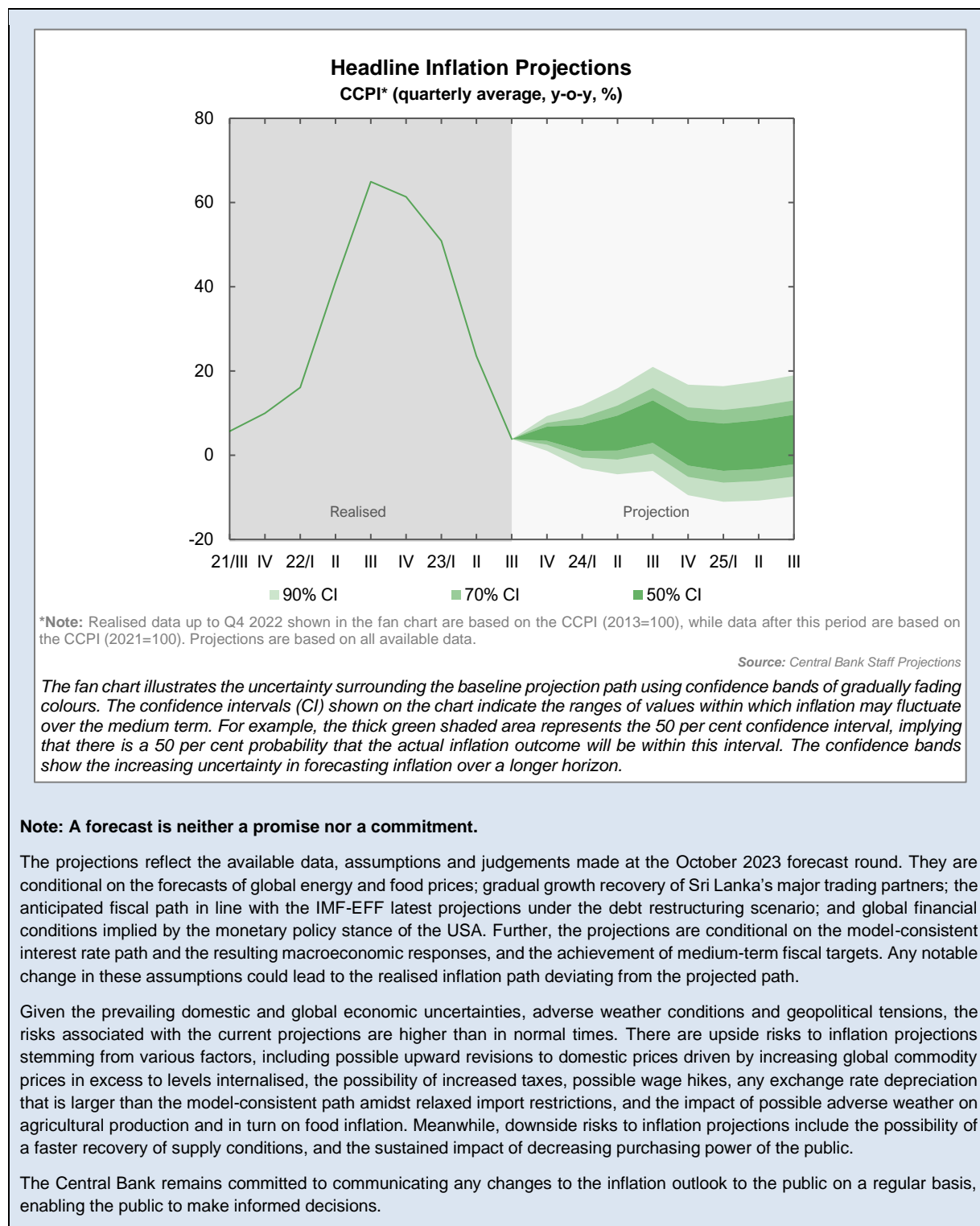
### The Central Bank of Sri Lanka further reduces policy interest rates

The first monetary policy review by the Monetary Policy Board under the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA) was held on 04 October 2023. In this review, the Board decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 100 basis points (bps) to 10.00 per cent and 11.00 per cent, respectively. The Board arrived at this decision following a careful analysis of the current and expected developments, including low inflation and benign inflation expectations in the domestic economy, with the aim of stabilising inflation at the envisaged 5 per cent level in the medium term, thereby enabling the economy to reach its potential growth. The Board expects that this reduction of policy interest rates, along with the significant easing of monetary policy effected previously, including the directions issued by the Central Bank to licensed banks to reduce interest rates, and the significant reduction of risk premia on government securities, would accelerate the downward adjustment in market interest rates, particularly lending rates, in the period ahead. The financial sector is urged to pass on the benefits of the continued easing of monetary conditions to individuals and businesses adequately and swiftly, thereby supporting the envisaged rebound of the economy.

### The significant deceleration of inflation has helped ease inflation expectations notably

Colombo Consumer Price Index (CCPI) (2021=100) based headline inflation (year-on-year) decelerated significantly below the target to 1.3 per cent in September 2023 driven by declines in both food and non-food inflation. Food items recorded deflation (year-on-year) for the third consecutive month in September 2023, while non-food inflation continued to moderate due to the easing of price pressures across many categories of the CCPI basket. CCPI based core inflation (year-on-year), which reflects underlying demand pressures in the economy, also moderated further in September 2023, reinforcing the disinflation process. However, this disinflation process is expected to turnaround from September 2023, with the dissipating impact of the favourable base, and converge towards the targeted level of inflation. Nevertheless, if the planned upward adjustments to administratively determined prices and tariffs, including electricity, as well as any

tax measures are implemented by the Government, a short-lived upward movement in headline inflation beyond the target is likely in the near term. Headline inflation is expected to stabilise at the target rate of 5 per cent over the medium term as reflected by the latest projections of the Central Bank.



## **Domestic economic activity is expected to rebound gradually during the second half of 2023 and sustain the recovery over the medium term**

As per the GDP estimates published by the Department of Census and Statistics (DCS), the economy is estimated to have contracted by 3.1 per cent, year-on-year, in the second quarter of 2023. Industry and Services activities recorded a contraction during this period, while Agriculture activities recorded an expansion. The economy is projected to record a positive growth, year-on-year, in the latter half of 2023, supported by a broad-based expansion in all major economic sectors. While the continued normalisation of monetary policy and monetary conditions, improvements in business and investor sentiments, the relaxation of import restrictions, improvements in supply conditions, and the impact of growth promoting structural reforms are expected to support economic recovery in the period ahead, modest external demand conditions could weigh on expected growth in the near term.

## **The external sector is expected to remain resilient in the period ahead**

During the eight months ending in August 2023, the trade deficit decreased notably, with a significant decrease in merchandise imports due to lower demand and import restrictions, and a relatively low decline in merchandise exports. Earnings from tourism and workers' remittances improved considerably thus far in 2023 and are expected to improve further in the period ahead. Net foreign investment inflows were recorded in the government securities market so far during the year despite some sizeable outflows in recent months. The Sri Lanka rupee recorded an appreciation of around 12 per cent against the US dollar thus far during the year. Following the settlement of the bilateral currency swap with Bangladesh Bank and the provision of liquidity to the domestic foreign exchange market to facilitate the restructuring of Sri Lanka Development Bonds as part of the domestic debt optimisation (DDO) operation, the level of gross official reserves was estimated at around US dollars 3.5 billion as at end September 2023, including the swap facility from the People's Bank of China.

## **Market interest rates have declined notably from their high levels while further decline is expected in the period ahead**

Market interest rates, particularly lending rates, displayed noteworthy reductions in recent months as reflected by interest rate indicators. However, considering the presence of excessive interest rates on certain lending products and the inadequate downward adjustment in market lending interest rates relative to those of deposits, caps on interest rates on selected lending products were imposed by the Central Bank in late August 2023. In addition, broader guidelines were

issued to induce a downward adjustment in overall market lending interest rates on rupee loans and advances in line with the relaxed monetary policy stance of the Central Bank. The reduction of policy interest rates by 100 bps in this monetary policy review is expected to accelerate the reduction of market interest rates in the period ahead. Meanwhile, a reduction was also observed in the yields on government securities with falling risk premia following the finalisation of the debt treatment on rupee denominated instruments under the DDO operation. Although credit extended to the private sector by licensed commercial banks recorded some expansion during the period from June to August 2023, a noteworthy recovery is yet to be observed. However, the envisaged further reduction in market lending interest rates in line with the policy measures introduced thus far by the Central Bank and improved economic conditions would help boost credit flows to the economy in the period ahead.

### **Policy interest rates are further reduced in view of the faster deceleration of inflation**

In consideration of the current and expected macroeconomic developments highlighted above, the Monetary Policy Board of the Central Bank of Sri Lanka, at its meeting held on 04 October 2023, decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 100 bps to 10.00 per cent and 11.00 per cent, respectively. The Board anticipates a swift and sizeable reduction in overall market lending interest rates in line with the monetary policy easing measures. The Central Bank will continue to closely monitor the developments in market lending interest rates and review the administrative measures appropriately. The Monetary Policy Board will continue to assess risks to the inflation outlook, among others, and stand ready to take appropriate measures to maintain domestic price stability in the period ahead while supporting the economy to reach its potential.

<b>Monetary Policy Decision</b>	<b>Policy interest rates reduced and SRR unchanged</b>	
	Standing Deposit Facility Rate (SDFR)	10.00%
	Standing Lending Facility Rate (SLFR)	11.00%
	Statutory Reserve Ratio (SRR)	2.00%

**INFORMATION NOTE:**

A press conference, chaired by Governor Dr. P Nandalal Weerasinghe, will be held on 05 October 2023 at 1.30 pm at the Atrium of the Central Bank of Sri Lanka, and proceedings will be livestreamed on Facebook and YouTube.

The release of the next regular statement on monetary policy review will be on 23 November 2023.

## Annexure I

**Table 01: Real GDP Growth (Provisional)**

Economic Activities	Year-on-Year % Change (a)							
	2022					2023		
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Annual	First Quarter	Second Quarter	First Half
<b>Agriculture</b>	-4.4	-7.9	-6.7	0.7	<b>-4.6</b>	0.8	3.6	<b>2.2</b>
<b>Industries</b>	-3.7	-10.1	-21.3	-30.1	<b>-16.0</b>	-23.4	-11.5	<b>-18.3</b>
<b>Services</b>	1.8	-1.8	-4.2	-3.9	<b>-2.0</b>	-5.0	-0.8	<b>-3.2</b>
<b>GDP</b>	<b>-0.5</b>	<b>-7.4</b>	<b>-11.5</b>	<b>-12.4</b>	<b>-7.8</b>	<b>-11.5</b>	<b>-3.1</b>	<b>-7.9</b>

(a) Based on rebased GDP estimates (base year 2015)

Source: Department of Census and Statistics

**Table 02: Inflation**

Month		Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23	Sep 23
<b>Headline Inflation (Year-on-Year % change)</b>	CCPI (2021=100)	51.7	50.6	50.3	35.3	25.2	12.0	6.3	4.0	1.3
	NCPI (2021=100)	53.2	53.6	49.2	33.6	22.1	10.8	4.6	2.1	-
<b>Core Inflation (Year-on-Year % change)</b>	CCPI (2021=100)	45.6	43.6	39.1	27.8	20.3	9.8	5.9 (a)	4.6	1.9
	NCPI (2021=100)	52.0	50.1	44.2	31.8	21.6	11.3	6.3	4.1	-

(a) Revised

Source: Department of Census and Statistics

**Table 03: Monetary Sector Developments (Provisional)**

Indicator	Outstanding Amount (Rs. billion) (a)								
	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23
Reserve Money	1,349	1,590	1,505	1,424	1,417	1,559	1,436	1,374	1,407
Broad Money (M <sub>2b</sub> )	12,290	12,322	12,346	12,293	12,387	12,307	12,517	12,726	12,698
Net Foreign Assets (NFA)	(1,767)	(1,573)	(1,434)	(1,174)	(1,039)	(838)	(808)	(707)	(612)
Net Domestic Assets (NDA)	14,056	13,895	13,780	13,467	13,426	13,144	13,325	13,433	13,309
Net Credit to the Government (NCG)	7,471	7,612	7,471	7,568	8,091(b)	8,111	8,261	8,549	8,465
Credit to Public Corporations / SOBEs	1,747	1,748	1,712	1,605	1,147(b)	1,084	1,096	1,097	1,091
Credit to the Private Sector	7,414	7,318	7,260	7,141	7,093	7,004	7,080	7,093	7,098
Broad Money (M <sub>4</sub> )	14,840	14,891	14,906	14,868	14,981	14,885	15,093(c)	15,335	-

(a) Valuation changes arising from changes in the exchange rate have led to significant changes in monetary and credit aggregates during the period starting from March 2022.

(b) With the approval of the Cabinet of Ministers at its meeting held on 30 January 2023, the outstanding foreign currency guaranteed debt of the Ceylon Petroleum Corporation (CPC) was absorbed into central government debt with effect from December 2022, in line with the actions agreed under the IMF-EFF arrangement to restructure the balance sheets of selected State Owned Business Enterprises (SOBEs). Accordingly, a part of this adjustment was effected in April 2023, hence, was reflected in the balance sheet of the particular state-owned commercial bank, which caused a reduction in credit to public corporations/ SOBEs and an expansion in net credit to the government (NCG).

(c) Revised

Source: Central Bank of Sri Lanka

**Table 04: Interest Rates**

Interest Rate (%)	End Apr 23	End May 23	End Jun 23	End Jul 23	End Aug 23	End Sep 23	As at 04 Oct 2023
<b>Key Policy Interest Rates of the Central Bank</b>							
Standing Deposit Facility Rate	15.50	15.50	13.00	11.00	11.00	11.00	11.00
Standing Lending Facility Rate	16.50	16.50	14.00	12.00	12.00	12.00	12.00
<b>Average Weighted Call Money Rate (AWCMR)</b>	16.50	16.50	13.85	11.50	11.50	11.66	11.25
<b>Treasury Bill Yields (Primary market)</b>							
91-day	25.74	25.65	23.00	19.96	18.48	17.42	17.22
182-day	25.27	25.29	19.49	17.69	15.36	15.13	15.09
364-day	23.00	22.91	16.99	14.29	13.58	13.30	13.16
<b>Lending Rates</b>							
Average Weighted Prime Lending Rate (Weekly)	21.03	20.29	19.47	17.18	15.29	14.67	-
Average Weighted Lending Rate (AWLR)	17.87	17.75	17.51	16.90	16.20	-	-
Average Weighted New Lending Rate (AWNLR)	23.09	22.39	21.51	19.30	17.89	-	-
<b>Deposit Rates</b>							
Average Weighted Deposit Rate (AWDR)	15.12	15.23	15.09	14.76	14.15	13.39	-
Average Weighted Fixed Deposit Rate (AWFDR)	19.72	19.84	19.70	19.02	18.26	17.24	-
Average Weighted New Deposit Rate (AWNDR)	19.19	18.85	14.98	12.45	11.46	-	-
Average Weighted New Fixed Deposit Rate (AWNFDR)	19.70	19.19	15.49	12.76	11.81	-	-

Source: Central Bank of Sri Lanka