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Monetary Policy Review: No. 01 - January 2024

The Central Bank of Sri Lanka maintains policy interest rates at their current levels

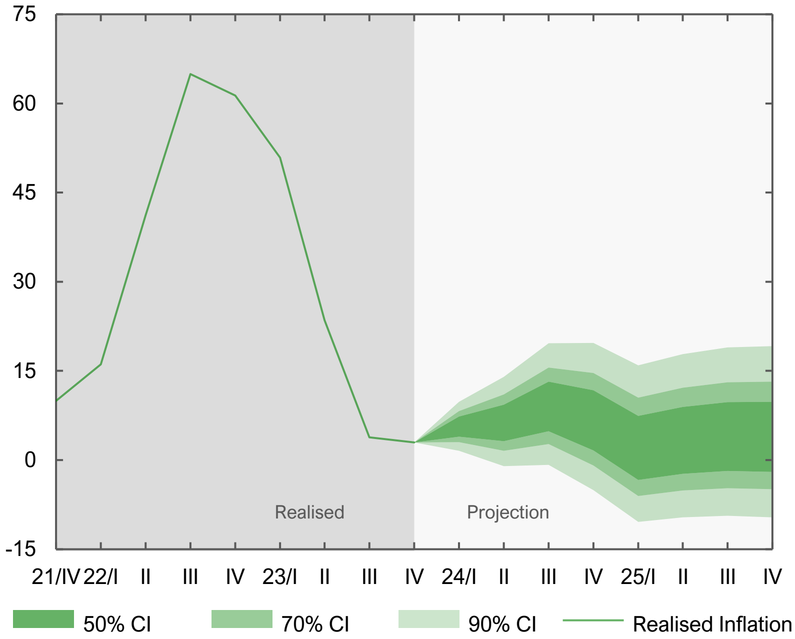
The Monetary Policy Board of the Central Bank of Sri Lanka, at its meeting held on 22 January 2024, decided to maintain the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank at their current levels of 9.00 per cent and 10.00 per cent, respectively. The Board arrived at this decision following a comprehensive assessment of domestic and international macroeconomic developments in order to maintain inflation at the targeted level of 5 per cent over the medium term, while enabling the economy to reach its potential. The Board took note of the effects of the recent developments in taxation and supply-side factors that are likely to pose upside pressures on inflation in the near term. However, the Board viewed that the impact of these developments would not materially change the medium-term inflation outlook. Further, the Board noted the space created by past monetary policy easing measures and the decline in the risk premia attached to government securities for further downward adjustment in market lending interest rates. The Board underscored that the envisaged benefit of further reduction in market lending interest rates needs to be adequately and swiftly passed on to the businesses and individuals by financial institutions.

Inflation is expected to stabilise at the desired levels as the effects of the recent tax adjustments and supply side disruptions are expected to dissipate in the near term

Headline inflation, as measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2021=100), was recorded at 4.0 per cent in December 2023, compared to 3.4 per cent in November 2023. Following five consecutive months of deflation, the food category recorded inflation (year-on-year) in December 2023 reflecting mainly the weather-related disruptions, while non-food inflation (year-on-year) moderated compared to the previous month. Despite the recent acceleration, headline inflation remains closer to the inflation target of the Central Bank and is in line with the envisaged inflation projections of the Central Bank. Meanwhile, core inflation (year-on-year) continued to moderate in December 2023, compared to the previous month, reflecting the subdued demand pressures in the economy. Headline inflation is projected to record an upward movement in the near term, as expected, driven mainly by domestic price adjustments due to the increase in the Value Added Tax (VAT) and the elimination of certain VAT exemptions effective 01 January 2024, disruptions to the domestic food supply, and the dissipation of the favourable statistical base effect. However, this acceleration of inflation in the near term is expected to be short-lived, and the spillover effects of such one-off adjustments are likely to be muted due to subdued underlying demand conditions. Therefore, over the medium term, headline inflation is expected to gradually stabilise around the targeted level of 5 per cent (year-on-year), supported by appropriate policy measures.

Headline Inflation Projections

CCPI* (quarterly average, y-o-y, %)



Source: *Central Bank Staff Projections*

***Note:** Realised data up to Q4 2022 shown in the fan chart are based on the CCPI (2013=100, seasonally adjusted), while data after this period are based on the CCPI (2021=100, seasonally adjusted). Projections are based on all available data at the forecast round in January 2024.

The fan chart illustrates the uncertainty surrounding the baseline projection path using confidence bands of gradually fading colours. The confidence intervals (CI) shown on the chart indicate the ranges of values within which inflation may fluctuate over the medium term. For example, the thick green shaded area represents the 50 per cent confidence interval, implying that there is a 50 per cent probability that the actual inflation outcome will be within this interval. The confidence bands show the increasing uncertainty in forecasting inflation over a longer horizon.

Note: A forecast is neither a promise nor a commitment.

The projections reflect the available data, assumptions and judgements made at the forecast round in January 2024. They are conditional on the forecasts of global energy and food prices; gradual growth recovery of Sri Lanka's major trading partners; the anticipated domestic fiscal path in line with the IMF-EFF projections under the debt restructuring scenario and global financial conditions implied by the monetary policy stance of the USA. Further, the projections are conditional on the model-consistent interest rate path and the resulting macroeconomic responses. Any notable change in these assumptions could lead to the realised inflation path deviating from the projected path.

Given the prevailing domestic and global economic uncertainties, adverse weather conditions and geopolitical tensions, the risks associated with the current projections are higher than in normal times. These risks arise due to the possibility of various factors deviating from the levels already internalised in projections, either explicitly or implicitly, and due to any unforeseen developments. In particular, there are upside risks to inflation projections stemming from factors such as the possibility of more than anticipated second-round impacts of increased taxation; possible wage hikes; the impact of possible adverse weather on agricultural production and in turn on food inflation; the uncertainty over global oil, energy and food prices, particularly amidst volatile geopolitical tensions, etc. Meanwhile, downside risks to inflation projections include the possibility of price reductions in domestically manufactured items amidst increased competition from imports and the sustained impact of diminished purchasing power of the public.

The Central Bank remains committed to communicating any changes to the inflation outlook to the public on a regular basis, enabling the public to make informed decisions.

A further decline in market lending interest rates is expected in the period ahead

Market interest rates continued to adjust downwards in line with eased monetary policy and administrative measures taken to reduce overall market lending interest rates. Moreover, yields on government securities continue to decline supported by falling risk premia. The Monetary Policy Board of the Central Bank of Sri Lanka is of the view that there is further space for market interest rates, especially the lending interest rates and yields on government securities to decline in the period ahead, in line with the reduction in policy interest rates effected in the recent past. Meanwhile, reflecting the transmission of the relaxed monetary policy stance, outstanding credit to the private sector by the banking sector continued to expand notably on a month-on-month basis in November as well as December 2023. The expansion in credit to the private sector is expected to be sustained in the period ahead, supported by the further easing of monetary conditions.

Domestic economic activity is expected to sustain the recovery over the medium term

The Sri Lankan economy recorded an expansion in the third quarter of 2023, following six consecutive quarters of economic contraction. Accordingly, the economy is estimated to have grown by 1.6 per cent, year-on-year, in the third quarter of 2023, as per the GDP estimates published by the Department of Census and Statistics (DCS). This was a broad-based expansion in economic activity supported by expansions recorded in Agriculture, Industry and Services sectors, on a year-on-year basis. The rebound in domestic economic activity is expected to be sustained, supported by the faster passthrough of relaxed monetary policy to broader market interest rates and the resultant firming of credit demand, improvements in business and investor sentiments, improvements in supply conditions and the gradual rebound expected in external demand conditions.

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

The merchandise trade deficit is estimated to have moderated during 2023 in comparison to 2022. This, coupled with the notable recovery in trade in services, mainly earnings from tourism, and the strong momentum of workers' remittances, is expected to have resulted in a surplus in the current account balance of the balance of payments for 2023. Gross official reserves (GOR) improved notably to US dollars 4.4 billion by end December 2023, which include the swap facility from the People's Bank of China (PBOC). This strong rebound of GOR was supported by the notable net purchases by the Central Bank from the domestic forex market and the proceeds from multilateral agencies. The Sri Lanka rupee, which appreciated by around 12 per cent against the US dollar in 2023, continued to show an appreciation so far in 2024.

Policy interest rates are maintained at their current levels

In consideration of the current and expected macroeconomic developments highlighted above, and in keeping with the forward guidance provided at the last monetary policy review in November 2023, the Monetary Policy Board of the Central Bank of Sri Lanka, at its meeting held on 22 January 2024, decided to maintain the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank at their current levels of 9.00 per cent and 10.00 per cent, respectively. The Board was of the view that there is space for market interest rates to continue to adjust downwards in line with past monetary policy easing measures and the falling risk premia attached to government securities. In particular, the Board anticipates a broad-based reduction in overall market lending interest rates in line with the monetary policy easing measures effected since June 2023. The Monetary Policy Board will continue to assess risks to inflation projections, 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.

Monetary Policy Decision	**Policy interest rates and SRR unchanged**	
	Standing Deposit Facility Rate (SDFR)	9.00%
	Standing Lending Facility Rate (SLFR)	10.00%
	Statutory Reserve Ratio (SRR)	2.00%

INFORMATION NOTE:

A press conference, chaired by Governor Dr. P Nandalal Weerasinghe, will be held on 23 January 2024 at 11.00 am 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 26 March 2024.

* **Data Annexure** is accessible at https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/mpr01_2024_e.pdf