# Report on the Deviation of Headline Inflation from the Inflation Target Set Out in the Monetary Policy Framework Agreement

## *Reference Period: Quarter 4 of 2024 and Quarter 1 of 2025*

**Central Bank of Sri Lanka**

*June 2025*

*Report submitted by the Monetary Policy Board of the Central Bank of Sri Lanka to the Parliament through the Hon. Minister of Finance, fulfilling Section 26(5) of The Central Bank of Sri Lanka Act, No. 16 of 2023, since quarterly headline inflation remained below the inflation target by more than the margin of two percentage points set out in the Monetary Policy Framework Agreement for two consecutive quarters in the fourth quarter of 2024 and the first quarter of 2025.*

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## 1. Introduction

1.1. The Monetary Policy Framework Agreement (MPFA) signed between the Hon. Minister of Finance and the Central Bank of Sri Lanka on 03 October 2023,[1] under Section 26(1) of the Central Bank of Sri Lanka Act, No. 16 of 2023 (hereinafter referred to as the Central Bank Act), mandates the Central Bank to maintain quarterly headline inflation,[2] as measured by the Colombo Consumer Price Index (CCPI) compiled by the Department of Census and Statistics (DCS), at a rate of 5 per cent. Moreover, Section 26(5) of the Central Bank Act stipulates that, if the Central Bank fails to meet the inflation target set out in the MPFA by a margin specified in the same for two consecutive quarters, the Monetary Policy Board of the Central Bank shall submit a report to the Parliament through the Hon. Minister of Finance, which shall also be made available to the public, setting out the reasons for the failure to achieve the inflation target; the remedial actions proposed to be taken by the Central Bank; and an estimate of the time period within which the inflation target shall be achieved. The MPFA specifies that for the purpose of Section 26(5) of the Central Bank Act, the margin is ±2 percentage points.

1.2. Based on realised data, the quarterly average of the CCPI-based year-on-year headline inflation was recorded at -1.5 per cent in the fourth quarter of 2024 and -3.6 per cent in the first quarter of 2025. Since quarterly headline inflation remained below the inflation target by more than 2 percentage points for two consecutive quarters (i.e., below 3.0 per cent), this Report is submitted as required

[1] Published in the Extraordinary Gazette No. 2352/20 dated 05 October 2023.

[2] Quarterly headline inflation rate refers to the simple average of the year-on-year percentage changes in the monthly headline CCPI for the three months of the corresponding quarter.

under Section 26(5) of the Central Bank Act. As quarterly headline inflation was below the target in the second, third and fourth quarters of 2024, similar Reports were submitted to the Hon. Minister of Finance in December 2024 and March 2025.[3] Further, the latest Report submitted in March 2025 anticipated inflation to remain below 3.0 per cent for a further period ahead. In this context, the current Report serves as a follow-up, as quarterly headline inflation continued to remain below the target in the first quarter of 2025 as well.

1.3. The deviation of headline inflation from the target in the fourth quarter of 2024 and the first quarter of 2025 can be largely attributable to supply-side factors, particularly significant reductions in energy prices. The current forecasts suggest the possibility of headline inflation remaining below the target through the third quarter of 2025 as well. Nevertheless, the anticipated recovery of demand in the period ahead and the gradual dissipation of the effects of the supply-side factors are expected to contribute to quarterly headline inflation reaching levels within ±2 percentage points of the target of 5 per cent thereafter. However, the prevailing volatile global macroeconomic conditions and their impact on the domestic economy lead to notable uncertainty over this estimation.

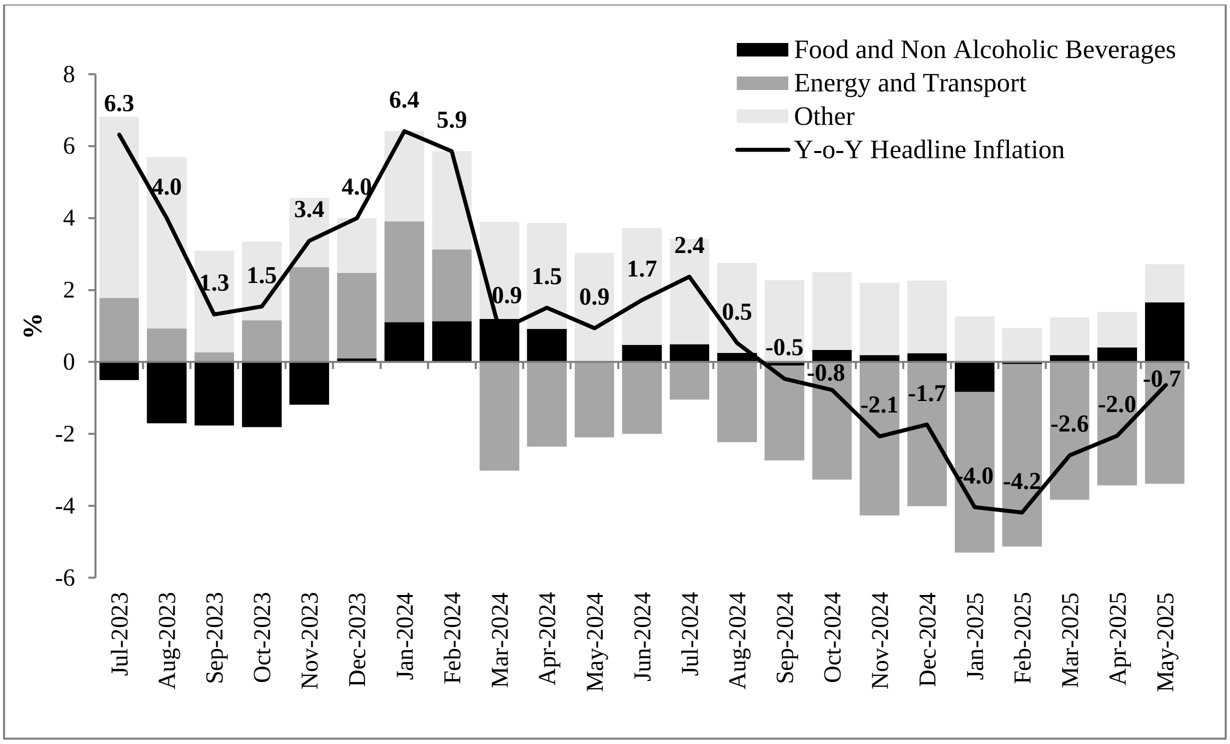
## 2. Reasons for the deviation from the inflation target

The previous Reports highlighted the reasons for headline inflation to record a decreasing trend during the second, third and fourth quarters of 2024. As explained in these Reports, the decrease in inflation during this period was mainly driven by energy and transport-related price revisions. In particular, several electricity tariff reductions, and fuel and LP-gas price reductions largely contributed to this behaviour. At the same time, some moderation of food prices and the appreciation of the Sri Lanka rupee also provided some support for the deceleration of inflation. Having explained these factors in earlier Reports, the current Report focuses mainly on the reasons for the deviation in the first quarter of 2025.

[3] The previous Reports on the deviation of headline inflation from the inflation target can be accessed via the link, https://www.cbsl.gov.lk/en/monetary-policy/monetary-policy-communication/accountability-to-parliament.

2.1. Similar to the conditions explained in previous Reports, the low level of inflation in the first quarter of 2025 was mainly driven by the continuation of low inflation in supply-related items. The CCPI-based quarterly headline inflation decelerated from -1.5 per cent in the fourth quarter of 2024 to -3.6 per cent in the first quarter of 2025. The statistical base effect owing to the increase of Value Added Tax (VAT) and the removal of VAT exemptions in early 2024 was a major driver of this behaviour (see Figure 5 in Annexure). In addition, the reduction in electricity tariff also contributed to the reduction in inflation.

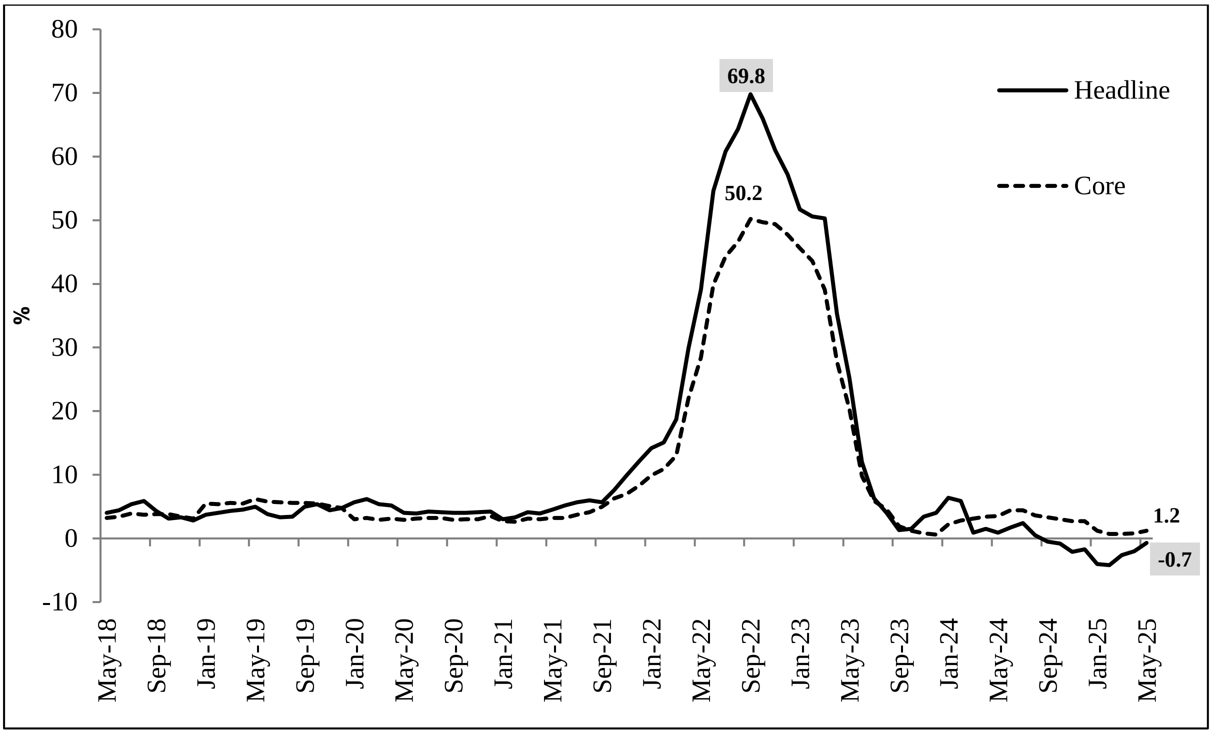
**Figure 1: Contribution to Headline Inflation (CCPI, 2021=100, Y-o-Y, %)**




*Sources: Department of Census and Statistics, Central Bank of Sri Lanka*

2.2. Meanwhile, core inflation remained higher than headline inflation, recording 0.9 per cent in the first quarter of 2025. Core inflation was also affected by the VAT-related statistical base effect in early 2025, and therefore was recorded at relatively low levels.

**Figure 2: Movements of Headline and Core Inflation (CCPI, Y-o-Y, %)**




*Source: Department of Census and Statistics*

*Data preceding January 2023 are based on the CCPI (2013=100), while data commencing January 2023 are based on the CCPI (2021=100).*

## 3. The remedial actions being taken by the Central Bank

3.1. **While monetary policy is focused on mitigating demand-side pressures on inflation, the Central Bank also monitors supply-side shocks closely and acts if they significantly influence inflation expectations or lead to persistent changes in the inflation outlook through spillover effects.** However, in the absence of such lasting impacts, monetary policy remains less effective in addressing short-term supply-side disruptions, as it operates with a lag.

3.2. **Since the Central Bank commenced an accommodative monetary policy stance in June 2023, policy interest rates have been reduced by around 7.75 percentage points in total by early May 2025.** Market interest rates declined substantially in line with the accommodative monetary policy stance. This policy normalisation helped the recovery of economic activity without giving rise to excessive demand-driven inflationary pressures. There are clear signs of expansion in private sector credit and recovery of economic activity. During 2024, private sector credit expanded by Rs. 790 billion (a year-on-year growth of 10.7 per cent), compared to a contraction of Rs. 45 billion in 2023, while it expanded by a further Rs. 274 billion during the first quarter of 2025. Meanwhile, annual economic growth was recorded at 5.0 per cent in 2024 from a contraction recorded in the previous year, while high-frequency indicators also point toward a further healthy growth in the first quarter of 2025.

3.3. **The Monetary Policy Board has carefully considered the stability of the external sector in determining the appropriate monetary policy stance.** Amidst recovering aggregate demand, relaxation of import restrictions after an extended period of restrictions, and the turbulent global economic environment, an overly accommodative monetary policy stance could exacerbate import demand along with the servicing of external debt, thus posing risks to external sector stability. Such considerations on various risks and uncertainties, coupled with the fact that low inflation was mainly driven by supply-side factors, have been carefully considered by the Central Bank in determining its monetary policy stance in recent months.

3.4. **Having maintained its policy interest rate unchanged in the January and March 2025 monetary policy rounds, the Central Bank reduced the Overnight Policy Rate (OPR) by 25 basis points in the May 2025 monetary policy round, as the latest projections showed signs of a more gradual pickup in inflation in the near term than previously anticipated.** The Monetary Policy Board was of the view that this measured policy decision was warranted amidst prevailing subdued inflationary pressures and global uncertainties. Particularly, the unpredictability stemming from frequent shifts in global trade and tariff policies could negatively impact Sri Lanka's trade performance, leading to overall growth vulnerabilities. Against this backdrop, the latest policy action is expected to result in further downward adjustments in lending rates and continued expansion of private sector credit, thereby supporting continued growth momentum during this period of subdued inflationary pressures.

3.5. **The Central Bank will continue to monitor inflation and other macroeconomic developments closely and stand ready to take appropriate measures to maintain domestic price stability.**

4. **An estimate of the time period within which the inflation target shall be achieved.**

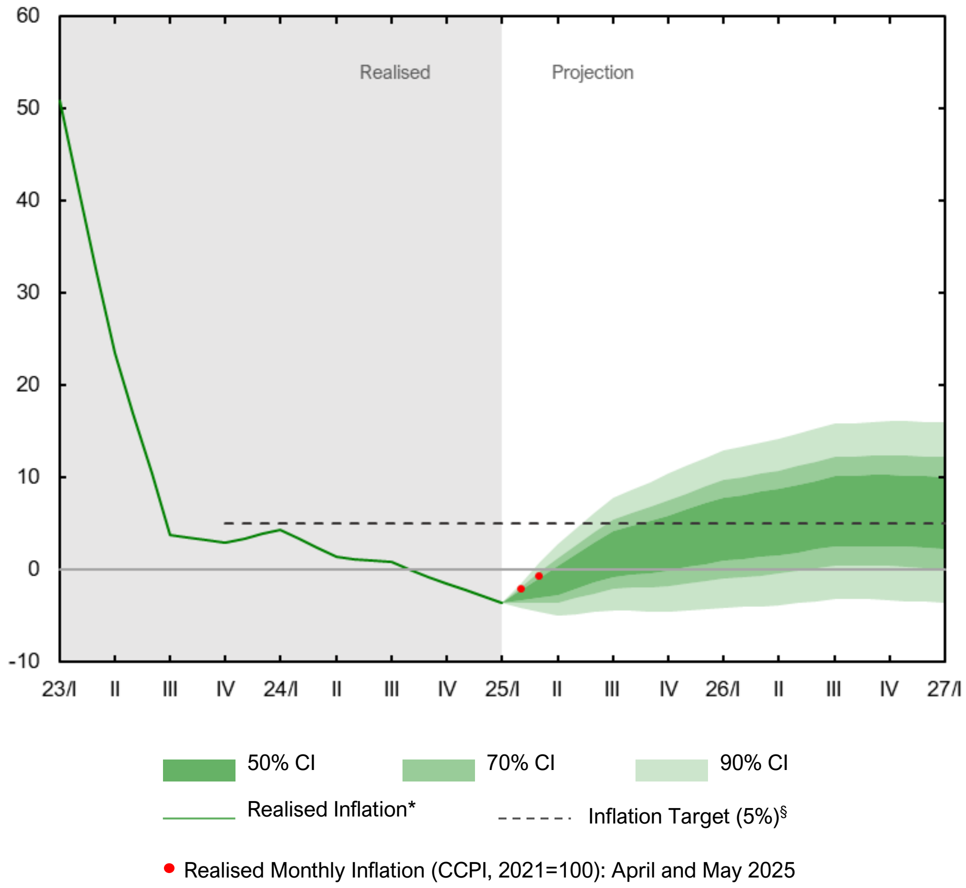
4.1. **Deflation has already commenced easing. Headline inflation is expected to turn positive in early third quarter of 2025 and gradually align with the target thereafter.** It is anticipated that quarterly headline inflation will increase and be within ±2 percentage points margin of the inflation target of 5 per cent towards the fourth quarter of 2025. The projected path of quarterly headline inflation is depicted in the inflation fan chart in Figure 3.

4.2. **The ongoing recovery of the economy, monetary easing, and energy price normalisation are expected to drive headline inflation toward the target.** Core inflation, which is the general measure of underlying inflation, is expected to continue increasing gradually toward the inflation target and remain relatively stable, with a lower degree of volatility over the medium term.

4.3. **The time period specified above, within which inflation is expected to reach levels close to the target, is conditional on available data, assumptions and judgements made at the forecast round in May 2025.** They are conditional on the forecasts of global energy and food prices, the continuation of a cost-reflective pricing mechanism for domestic energy prices, the anticipated fiscal path in line with the International Monetary Fund - Extended Fund Facility (IMF-EFF) programme, the expected economic trajectory of Sri Lanka's major trading partners, and the forecasts of global financial conditions implied by the US Federal Funds Rate. Therefore, any notable change in these assumptions could lead to the realised inflation path deviating from the projected path. The prevailing uncertainty over global macroeconomic conditions has made predicting economic trends extremely challenging, increasing the uncertainty associated with medium-term projections. There are upside risks to the realisation of inflation projections stemming from factors such as the possible adverse weather conditions affecting agricultural production, and the possibility of higher-than-anticipated demand pressures amidst strong credit growth. Meanwhile, downside risks to the realisation of inflation projections include a possible persistent slowdown in global demand, leading to a more-than-anticipated reduction in global energy prices.

**Figure 3: Projected Headline Inflation (Quarterly, CCPI, Y-o-Y, %)**

*Based on the Projections during the May 2025 Monetary Policy Round*




§ *The inflation target (5%) was agreed under the Monetary Policy Framework Agreement (MPFA) signed between the Central Bank and the Hon. Minister of Finance in October 2023.*

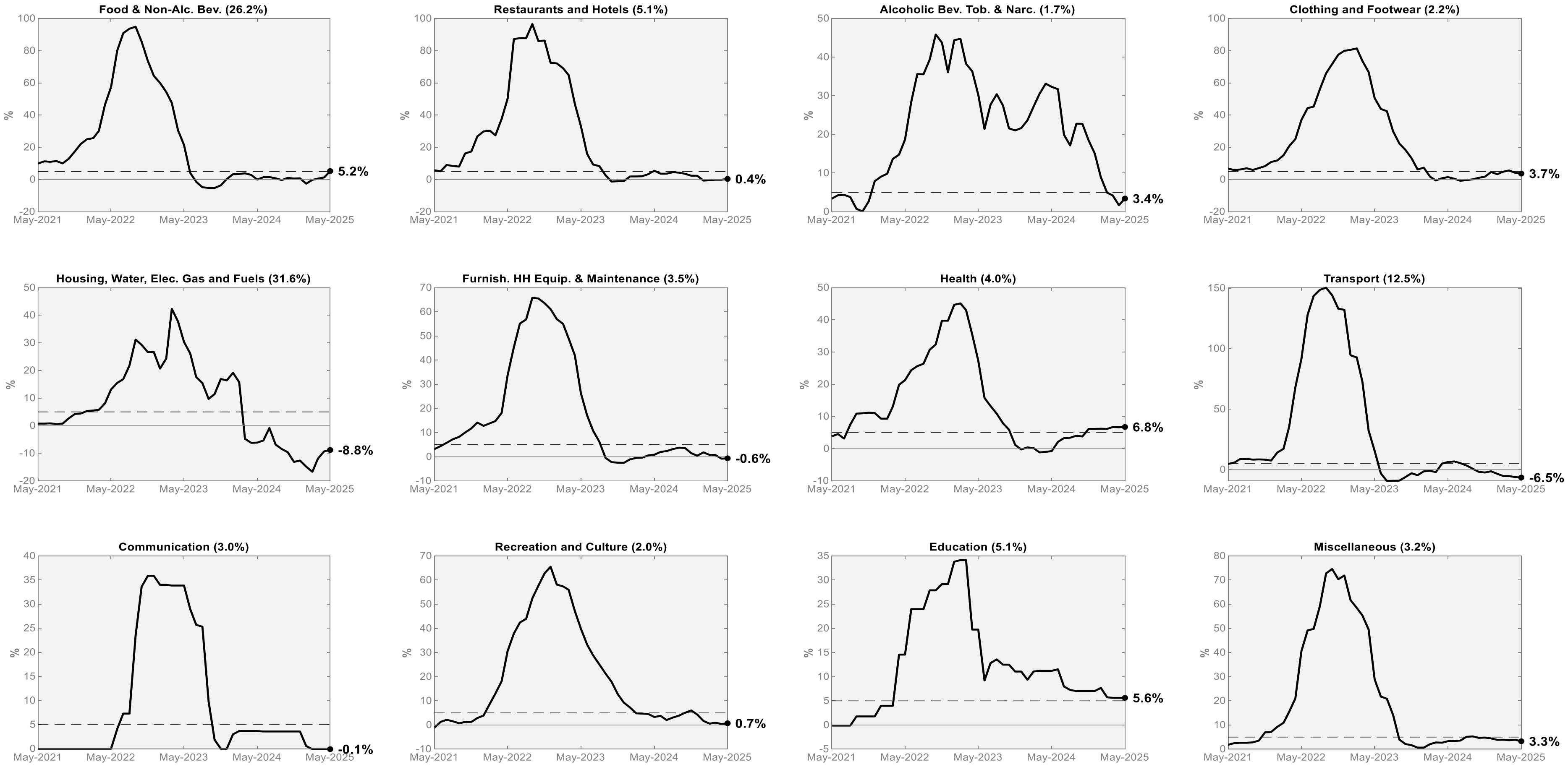
*Source: Central Bank Staff Projections*

* Realised data in the fan chart are based on the CCPI (2021=100, seasonally adjusted). Projections are based on all available data at the forecast round in May 2025.

Note: 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% confidence interval, implying that there is a 50% 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.

## Annexure

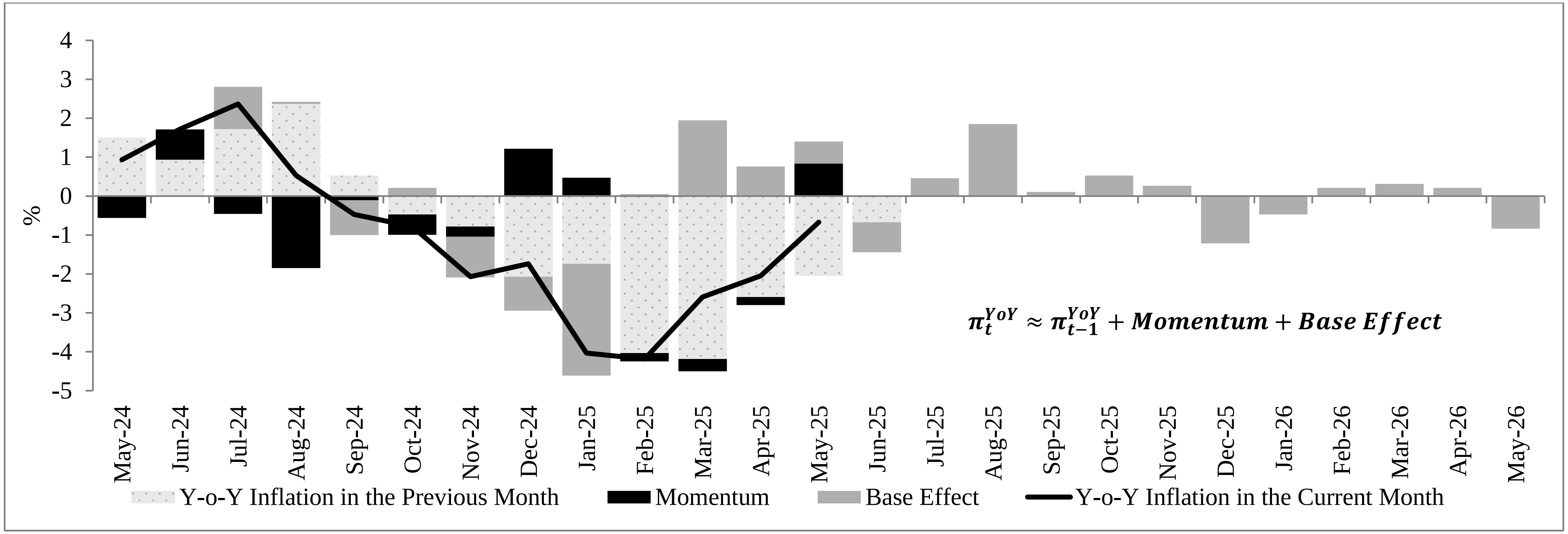
**Figure 4: Category-wise Headline Inflation (CCPI, Y-o-Y, %)**




*Sources: Department of Census and Statistics, Central Bank of Sri Lanka*

*Data preceding January 2023 are based on the CCPI (2013=100), while data commencing January 2023 are based on the CCPI (2021=100). Base weights are given in parentheses, based on the CCPI (2021=100).*

**Figure 5: Headline Inflation: Momentum and Base Effect[4] (CCPI, 2021=100)**




*Source: Central Bank Staff Calculations*

[4] Inflation is commonly measured as a y-o-y change in the price level, i.e., the percentage change of the price level in a given period, which is measured by a price index (in the case of Sri Lanka, DCS compiles and publishes the two main price indices used to measure inflation in Sri Lanka, the CCPI and the NCPI), compared to the same period in the previous year. However, price information is usually made available at a monthly frequency. Therefore, one could calculate changes in prices on a m-o-m basis as well. The change of the y-o-y inflation from one month to the next can then be approximated by deducting the m-o-m inflation in the corresponding month of the previous year from the m-o-m inflation in the current month. (This approximation is motivated by the fact that percentage changes can be approximated by log differences.) Accordingly, the m-o-m inflation of the current month is usually termed the momentum, which represents how y-o-y inflation changes due to economic developments in the latest month. Meanwhile, the negative value of the m-o-m inflation in the corresponding month of the previous year is termed the base effect, which accounts for the statistical effect that affects how y-o-y inflation changes from one month to the next (i.e., $\pi_t^{YoY} \approx \pi_{t-1}^{YoY} + \text{Momentum} + \text{Base Effect}$, where $\pi$ represents inflation). This segregation allows analysts to evaluate key contributing factors to the dynamics of y-o-y inflation. Note that when quarterly information is used, as in the model projections of the Central Bank, the same classification of y-o-y inflation into the momentum and the base effect can be done using quarter-on-quarter inflation as well. Further, this approximation is not limited to inflation but can be applied to breaking down y-o-y changes in any variable.