PRESS RELEASE
Communications Department, 30, Janadhipathi Mawatha, Colombo 01, Sri Lanka
+94 11 2477424 / +94 11 2477423 +94 11 2346257
communications@cbsl.lk / dcommunications@cbsl.lk www.cbsl.gov.lk

ශ්‍රී ලංකා මහ බැංකුව
இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

Issued By	Economic Research Department
Date	19.08.2021

Monetary Policy Review: No. 06 - August 2021

The Central Bank of Sri Lanka tightens its Monetary Policy Stance

The Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 18 August 2021, decided to increase the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 50 basis points each, to 5.00 per cent and 6.00 per cent, respectively. In addition, the Monetary Board decided to increase the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks (LCBs) by 2.0 percentage points to 4.00 per cent, with effect from the reserve maintenance period commencing on 01 September 2021. These decisions were made with a view to addressing the imbalances on the external sector of the economy and to preempt the buildup of any excessive inflationary pressures over the medium term, amidst improved growth prospects.

The global economy is set to make a gradual recovery in 2021, although normalisation of economic activity would largely be uneven across regions

As per the July 2021 update to the *World Economic Outlook* (WEO) of the International Monetary Fund (IMF), the global economy is projected to grow by 6.0 per cent in 2021 and 4.9 per cent in 2022. Economic prospects have diverged across regions and access to COVID-19 vaccines has emerged as the principal factor that drives the global economic recovery in the period ahead. Most countries have experienced transitory price pressures due to supply-demand mismatches amidst the pandemic. Such transitory pressures could become more persistent, thereby warranting preemptive action by central banks in order to ensure stability in the period ahead. Accordingly, some central banks have already commenced tightening monetary policy while several others have signalled a possible tightening of monetary policy in the period ahead.

The Sri Lankan economy is on a recovery path despite the pandemic related disruptions

Supported by fiscal and monetary stimulus measures, the Sri Lankan economy is gradually making headway following the setback in 2020. As per the estimates published by the Department of Census and Statistics (DCS), the economy witnessed a stronger than expected recovery during the first quarter of 2021, recording a real growth of 4.3 per cent, year-on-year. The economy is poised to record a higher growth rate during the second quarter of 2021, partly due to the sharp contraction observed in the corresponding quarter of the previous year. Possible disruptions to domestic economic activity from the re-emergence of the COVID-19 pandemic and related preventive measures could weaken the recovery to some extent during the second half of 2021. Nevertheless, with the successful rolling out of the national COVID-19 vaccination programme and the Government's strategy to impose only selective mobility restrictions, the momentum of activity is expected to sustain in the period ahead. Available indicators and projections suggest that the real economy would grow over 5 per cent in 2021, and this momentum would be sustained over the medium term.

Most market interest rates have reached low levels resulting in the expected acceleration in credit flows to the private sector

With the gradual transmission of accommodative monetary policy measures, most market deposit and lending interest rates declined to their historic low levels. Supported by the low interest rate environment, credit to the private sector expanded notably during the first half of 2021, surpassing the annual expansion of credit observed in 2019 and 2020. The momentum of credit expansion is expected to continue in the period ahead, with increased credit flows to productive and needy sectors of the economy. Meanwhile, credit obtained by the public sector from the banking system, particularly net credit to the Government, also increased notably thus far during the year, amidst the impact of the pandemic on government revenue and recurrent expenditure. Reflecting the impact of increased domestic credit, the growth of broad money (M_{2b}) continued to remain elevated.

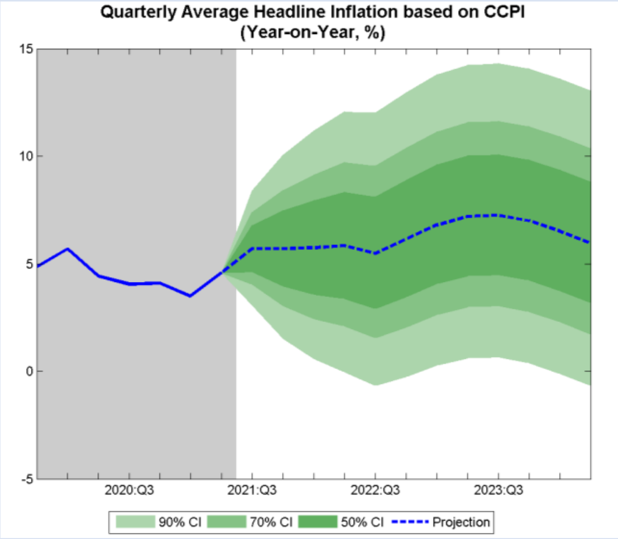
The external sector continued to face a multitude of challenges requiring coordinated measures

The implementation of the essential growth-conducive stimulus measures, which resulted in the availability of low cost credit to the private sector, led to a sustained increase in the demand for merchandise imports since mid-2020. With the increase in import expenditure outweighing the improvements observed in earnings from exports, the trade deficit continued to widen during the first half of 2021 over the corresponding period of last year. Moreover, the expected recovery in the tourism industry could be further delayed due to uncertainties associated with the resurgence of the pandemic globally. Workers' remittances, which recorded a significant growth in 2020 as well as in the first few months of 2021, have also displayed some deceleration. Limited conversion by exporters and the advancing of imports together with some speculative activity, prompted by anomalies between interest rates on the rupee and foreign currency products in the financial market, exerted undue pressure on the exchange rate in the domestic market. Amidst these developments, all debt service obligations of the Government, including the settlement of the International Sovereign Bond (ISB) of US dollars 1 billion in late July 2021, have been duly met thus far in 2021. Gross official reserves were estimated at US dollars 2.8 billion with an import cover of 1.8 months by end July 2021. This, however, does not include the bilateral currency swap facility with the People's Bank of China (PBoC) of CNY 10 billion (equivalent to approximately US dollars 1.5 billion). Measures are being taken by the Government and the Central Bank to secure foreign financing from several sources in order to reinforce the level of official reserves in the near future. Meanwhile, the Government continued to aggressively explore avenues to enhance non-debt creating foreign inflows, by strengthening the domestic production economy, which would help strengthen the external sector in the period ahead.

Possible upside pressures on inflation are being addressed through preemptive policy measures

Inflation, which remained moderate during early 2021, accelerated somewhat in recent months due to high food inflation and some acceleration in non-food inflation. Inflation is projected to hover around the upper bound of the desired 4-6 per cent target range in the near term. The envisaged improvements in aggregate demand conditions and the likely increases in global energy and other commodity prices may generate some inflationary pressures in 2022, requiring preemptive policy measures to ensure the maintenance of inflation in mid-single digit levels over the medium term.

Figure: 01



Source: CBSL Staff Projections

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

The fan chart illustrates the uncertainty surrounding the baseline projection path using confidence bands of gradually fading colors. The projection reflects the data available and assumptions and judgments made at the August 2021 forecast round.

The confidence intervals (CI) shown on the chart indicate the ranges of values within which inflation may fluctuate over the medium term. Specially, 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.

Tightening of monetary policy stance is expected to support greater economic stability

In consideration of the current and expected macroeconomic developments as highlighted above, the Monetary Board decided to rollback some extraordinary support provided to the economy at the onset of the COVID-19 pandemic. Accordingly, with effect from 19 August 2021, the Board decided to increase the policy interest rates, i.e., the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), of the Central Bank by 50 basis points each, to 5.00 per cent and 6.00 per cent, respectively. This would also result in the Bank Rate, which is linked to the SLFR with a margin of +300 basis points, automatically adjusting to 9.00 per cent. In order to induce a faster response of the market to these adjustments, the Monetary Board also decided to increase the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks (LCBs) by 2.0 percentage points to 4.00 per cent, with effect from the reserve maintenance period commencing on 01 September 2021. The Board expects these monetary policy decisions to iron out the prevailing imbalances in the domestic financial markets and the external sector of the economy, while preempting the buildup of any excessive inflationary pressures over the medium term, thereby supporting greater macroeconomic stability. The upward adjustments in market interest rates and the expected liquidity deficit in the domestic money market would also help the economy to absorb the large amount of currency held by the public observed since the onset of the pandemic in early 2020.

The Central Bank will continue to monitor domestic and global macroeconomic and financial market developments and take appropriate measures to ensure that the economy reverts to its potential, while maintaining inflation in the targeted 4-6 per cent range under its flexible inflation targeting framework.

Monetary Policy Decision: **Policy rates and SRR increased**

Standing Deposit Facility Rate (SDFR)	5.00%
Standing Lending Facility Rate (SLFR)	6.00%
Bank Rate (automatically adjusted with SLFR)	9.00%
Statutory Reserve Ratio (SRR)	4.00%

INFORMATION NOTE:

The virtual monetary policy press conference will be held on 19 August 2021 at 11.00 a.m. via Zoom and will be livestreamed on Facebook.

The release of the next regular statement on monetary policy will be on 14 October 2021.

Annexure I

Table 01: Real GDP Growth (Provisional)

Economic Activities	Year-on-Year % Change										
	2019					2020					2021
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Annual	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Annual	First Quarter
Agriculture	5.7	3.1	2.6	-5.8	**1.0**	-6.5	-8.2	3.1	1.3	**-2.4**	6.1
Industries	3.9	1.7	3.3	1.3	**2.6**	-7.9	-23.1	0.6	1.3	**-6.9**	5.5
Services	4.0	0.7	1.8	2.4	**2.2**	2.9	-12.9	2.1	1.9	**-1.5**	3.0
GDP	**4.0**	**1.3**	**2.3**	**1.6**	**2.3**	**-1.8**	**-16.4**	**1.3**	**1.3**	**-3.6**	**4.3**

Source: Department of Census and Statistics

Table 02: Inflation

Month		Dec 20	Jan 21	Feb 21	Mar 21	Apr 21	May 21	Jun 21	Jul 21
Headline Inflation (Year on year % change)	CCPI (2013=100)	4.2	3.0	3.3	4.1	3.9	4.5	5.2	5.7
	NCPI (2013=100)	4.6	3.7	4.2	5.1	5.5	6.1	6.1	-
Core Inflation (Year on year % change)	CCPI (2013=100)	3.5	2.7	2.6	3.1	3.0	3.2	3.2	3.7
	NCPI (2013=100)	4.7	4.2	4.1	4.3	4.1	4.2	4.1	-

Source: Department of Census and Statistics

Table 03: Monetary Sector Developments (Provisional)

Indicator	Outstanding Amount (Rs. billion)					Year-on-Year % Change				
	Feb 21	Mar 21	Apr 21	May 21	Jun 21	Feb 21	Mar 21	Apr 21	May 21	Jun 21
Reserve Money	978	1,029	1,031	1,036	1,065	1.5	1.5	0.9	4.0	22.6
Broad Money (M_{2b})	9,651	9,839	9,947	10,033	10,165	23.8	21.5	20.4	21.0	21.5
Net Foreign Assets (NFA)	(386)	(430)	(431)	(429)	(481)	-496.1	-1,629.0	-615.8	-778.2	-4,012.3
Net Domestic Assets (NDA)	10,037	10,269	10,378	10,462	10,646	30.4	27.2	26.9	25.4	27.1
Net Credit to the Government (NCG)	4,793	5,005	4,965	5,024	5,195	61.9	54.7	50.4	45.0	44.3
Credit to Public Corporations	1,080	1,098	1,093	1,113	1,132	29.7	26.5	17.1	16.8	19.0
Credit to the Private Sector	6,276	6,388	6,446	6,501	6,585	7.8	7.5	8.2	10.5	12.9
Broad Money (M_4)	11,790	12,010	12,154	12,265	12,402	21.9	20.4	19.6	20.2	20.9

Source: Central Bank of Sri Lanka

Table 04: Interest Rates

Interest Rate (%)	End Feb 21	End Mar 21	End Apr 21	End May 21	End Jun 21	End Jul 21	As at 18 Aug 21
Policy Rates of the Central Bank							
Standing Deposit Facility Rate	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Standing Lending Facility Rate	5.50	5.50	5.50	5.50	5.50	5.50	5.50
Average Weighted Call Money Rate (AWCMR)	4.55	4.62	4.64	4.66	4.93	5.10	5.09
Treasury bill yields (Primary market)							
91-day	4.90	5.05	5.11	5.13	5.18	5.22	5.33
182-day	4.99	5.10	5.14	5.14	5.19	5.23	5.34
364-day	5.09	5.11	5.18	5.18	5.23	5.25	5.32(a)
Lending Rates							
Average Weighted Prime Lending Rate (Weekly)	5.76	5.78	5.86	5.65	5.51	5.76	5.71(b)
Average Weighted Lending Rate (AWLR)	10.08	9.91	9.73	9.64	9.50	-	-
Average Weighted New Lending Rate (AWNLR)	8.26	8.28	7.95	7.74	7.47	-	-
Deposit Rates							
Average Weighted Deposit Rate (AWDR)	5.36	5.20	5.07	4.97	4.87	4.77	-
Average Weighted Fixed Deposit Rate (AWFDR)	6.53	6.29	6.09	5.94	5.82	5.67	-
Average Weighted New Deposit Rate (AWNDR)	4.96	4.86	4.77	4.77	4.98	-	-
Average Weighted New Fixed Deposit Rate (AWNFDR)	5.09	4.99	4.92	4.90	5.10	-	-

(a) Rate at the auction held on 11 August 2021
(b) For the week ending 13 August 2021

Source: Central Bank of Sri Lanka