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## Monetary Policy Review: No. 07 - October 2022

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

The Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 05 October 2022, 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 14.50 per cent and 15.50 per cent, respectively. In arriving at this decision, the Board considered the latest macroeconomic conditions, expected developments and macroeconomic projections. The Board noted the tight monetary conditions prevailing at present, the decelerating pace of inflation, and the envisaged disinflation path in the near term supported by both domestic and global factors. The Board was of the view that the monetary conditions remain sufficiently tight to achieve the envisaged disinflation path in the period ahead. The contractionary fiscal policies would complement the effects of tight monetary policy measures already in place, helping to mitigate any build-up of aggregate demand pressures, thereby anchoring inflation expectations and bringing down headline inflation to the targeted level of 4-6 per cent over the medium term.

### Domestic economic activity is expected to remain subdued during 2022, before recovering in 2023

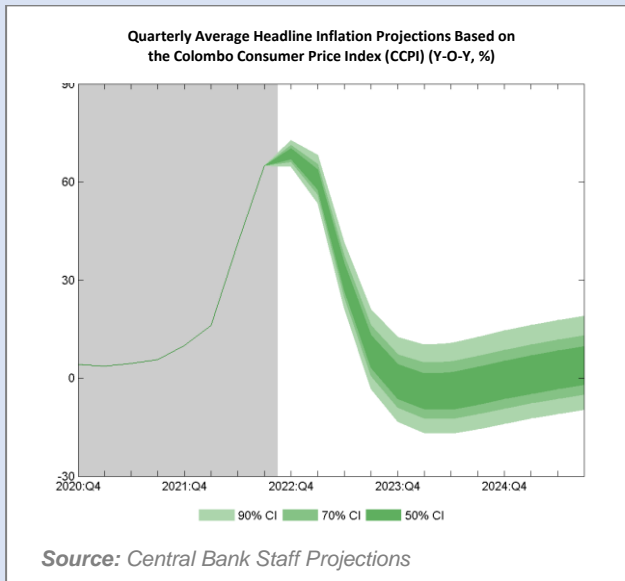
As per the GDP estimates published by the Department of Census and Statistics (DCS), the real economy is estimated to have contracted by 4.8 per cent in the first half of 2022, on a year-on-year basis. The economy is expected to contract in the second half of 2022 as well, impacted by tighter monetary and fiscal conditions, along with the continuation of supply-side constraints and uncertainty surrounding the business environment amidst shortages of foreign exchange in the domestic foreign exchange market, among others. However, a recovery in economic activity is expected in 2023 with the envisaged improvements in the supply-side, along with the timely implementation of the required reforms.

## **Private sector credit continues to contract due to tight monetary and liquidity conditions**

Market interest rates are continuously adjusting upwards reflecting the tight liquidity conditions in the domestic money market and the further passthrough of significant monetary policy tightening measures introduced thus far by the Central Bank. With relatively high deposit interest rates offered by licensed banks, a return of currency in circulation to the banking system is also observed. In August 2022, outstanding credit extended to the private sector by commercial banks contracted for the third consecutive month in absolute terms, reflecting the impact of increased effective market lending interest rates, a moderation of economic activity, and measures to curtail non-urgent imports. Accordingly, the current declining trend in the year-on-year growth of credit to the private sector is expected to continue during the remainder of the year, while a similar trend is expected in the growth of broad money ( $M_{2b}$ ) supply as well. Meanwhile, the need for further monetary financing is expected to reduce gradually, supported by the envisaged fiscal consolidation measures and planned reforms of major state owned business enterprises.

## **Headline inflation is expected to follow a disinflationary path in the near term**

Headline inflation, based on the Colombo Consumer Price Index (CCPI), edged up in September 2022, driven mainly by the recent revision of electricity and water tariffs and the increase in Value Added Tax (VAT). However, headline inflation is expected to follow a disinflation path in the period ahead. Subdued aggregate demand pressures resulting from tight monetary and fiscal conditions, expected improvements in domestic supply conditions, normalisation in global food and other commodity prices, and the timely passthrough of such reductions to domestic prices, along with the favourable statistical base effect, will be instrumental in bringing down inflation over the medium term.



**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 colours. 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 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.

The projection reflects the available data, and assumptions and judgements made at the October 2022 forecast round. The projections are conditional on current forecasts of global fuel and food prices that are anticipated to ease gradually, which in turn are expected to be reflected in domestic prices; below potential level growth in Sri Lanka's major trading

partners; and tightening global financial conditions implied by the current and anticipated monetary policy stance of the USA. Further, the projections are conditional on the model-consistent interest rate path and the achievement of medium-term fiscal targets. Moreover, domestic food supply conditions are assumed to ease in 2023. Given the prevailing domestic and global economic uncertainties and geopolitical tensions, the risks associated with the current projections are much higher than in normal times. Any notable change in these assumptions could lead to the realised inflation path deviating from the above. The Central Bank remains committed to communicating anticipated changes in the inflation outlook to the public on a regular basis, to enable them to make informed decisions.

## Positive developments are observed in the external sector despite heightened challenges

The merchandise trade deficit contracted significantly during the eight months ending August 2022, compared to the same period in 2021, driven by an increase in export earnings, while also reflecting the impact of policy measures taken to curtail non-essential imports. An improvement in monthly workers' remittances has been observed recently, while the tourism sector is anticipated to recover in the upcoming season. Foreign exchange liquidity in the domestic banking system recorded some improvements supported by increased inflows in the form of export proceeds and workers' remittances. Such improvements in foreign exchange liquidity conditions, despite underlying pressures in the foreign exchange market, are expected to facilitate the continuous provision of essential imports, including fuel, coal, and other commodities, in the period ahead. Meanwhile, the weighted average spot exchange rate remains unchanged since mid-September 2022 due to relatively low volume of transactions in the interbank spot market. The gross official reserves are estimated at US dollars 1.8 billion as at end September 2022, including the swap facility from the People's Bank of China, equivalent to around US dollars 1.4 billion, which is subject to conditionalities on usability. Subsequent to the staff-level agreement reached with the IMF on the Extended Fund Facility (EFF) arrangement, the authorities are expediting negotiations with the country's external creditors, assisted by financial and legal advisors, to advance the debt restructuring process.

## Policy rates are maintained at current levels

In consideration of the current and expected macroeconomic developments as highlighted above, the Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 05 October 2022, 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 14.50 per cent and 15.50 per cent, respectively. The Board was also of the view that the recently introduced tight fiscal policy measures would also help curtail any further build-up of demand pressures in the economy, complementing the effects of tight monetary policy already in place. However, the Central Bank will continue to monitor macroeconomic conditions and expected developments on the domestic and global fronts and stand ready to take measures swiftly and proactively, as appropriate. The Board reiterates its commitment to restoring price stability and remains confident that the already implemented tight monetary policy measures would help rein in any inflationary pressures, while supporting the economy to reach its potential over the medium term.

<b>Monetary Policy Decision</b>	<b>Policy rates and SRR unchanged</b>	
	Standing Deposit Facility Rate (SDFR)	14.50%
	Standing Lending Facility Rate (SLFR)	15.50%
	Statutory Reserve Ratio (SRR)	4.00%

### INFORMATION NOTE:

A press conference, chaired by Governor Dr. P Nandalal Weerasinghe, will be held on 06 October 2022 at 01.00 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 24 November 2022.

## Annexure I

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

Economic Activities	Year-on-Year % Change (a)							
	2021					2022		
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Annual	First Quarter	Second Quarter	First Half
<b>Agriculture</b>	6.4	11.2	-2.8	-3.1	<b>2.5</b>	-6.8	-8.4	<b>-7.6</b>
<b>Industries</b>	6.0	21.6	-2.0	1.4	<b>5.6</b>	-4.7	-10.0	<b>-7.1</b>
<b>Services</b>	3.5	8.3	-1.7	4.3	<b>3.3</b>	0.7	-2.2	<b>-0.6</b>
<b>GDP</b>	<b>4.0</b>	<b>16.3</b>	<b>-5.8</b>	<b>2.0</b>	<b>3.3</b>	<b>-1.6</b>	<b>-8.4</b>	<b>-4.8</b>

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

Source: Department of Census and Statistics

**Table 02: Inflation**

Month		Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22
<b>Headline Inflation (Year-on-Year % change)</b>	CCPI (2013=100)	15.1	18.7	29.8	39.1	54.6	60.8	64.3	69.8
	NCPI (2013=100)	17.5	21.5	33.8	45.3	58.9	66.7	70.2	-
<b>Core Inflation (Year-on-Year % change)</b>	CCPI (2013=100)	10.9	13.0	22.0	28.4	39.9	44.3	46.6	50.2
	NCPI (2013=100)	14.1	17.3	27.9	37.7	49.3	57.3	60.5	-

Source: Department of Census and Statistics

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

Indicator	Outstanding Amount (Rs. billion)								
	Dec 21	Jan 22	Feb 22	Mar 22 (a)	Apr 22 (a)	May 22 (a)	Jun 22	Jul 22	Aug 22
Reserve Money	1,306	1,337	1,324	1,387	1,482	1,415	1,453	1,436	1,386
Broad Money (M <sub>2b</sub> )	10,647	10,668	10,755	11,576	11,941	11,897	11,901	11,955	11,987
Net Foreign Assets (NFA)	(982)	(1,216)	(1,275)	(1,889)	(2,195)	(2,083)	(2,122)	(2,124)	(2,035)
Net Domestic Assets (NDA)	11,629	11,883	12,030	13,464	14,136	13,980	14,023	14,079	14,022
Net Credit to the Government (NCG)	5,832	6,054(b)	6,100(b)	6,556(b)	6,569(b)	6,523(b)	6,697(b)	6,826	6,990
Credit to Public Corporations / SOBEs	1,188	1,192	1,238	1,548	1,725	1,750	1,729	1,754	1,700
Credit to the Private Sector	6,981	7,018(b)	7,051	7,534(b)	7,753	7,755(b)	7,714	7,673	7,614
Broad Money (M <sub>4</sub> )	12,985	13,058	13,167	13,992	14,356	14,340	14,335	14,410	-

(a) The sharp depreciation of the Sri Lanka rupee during March to May 2022 remains the key reason for the augmentation of monetary and credit aggregates during that period.

(b) Revised

Source: Central Bank of Sri Lanka

**Table 04: Interest Rates**

Interest Rate (%)	End Apr 22	End May 22	End Jun 22	End Jul 22	End Aug 22	End Sep 22	As at 05 Oct 22
<b>Key Policy Interest Rates of the Central Bank</b>							
Standing Deposit Facility Rate	13.50	13.50	13.50	14.50	14.50	14.50	14.50
Standing Lending Facility Rate	14.50	14.50	14.50	15.50	15.50	15.50	15.50
<b>Bank Rate</b>	17.50	17.50	17.50	18.50	18.50	18.50	18.50
<b>Average Weighted Call Money Rate (AWCMR)(a)</b>	14.50	14.50	14.50	15.50	15.50	15.50	-
<b>Treasury bill yields (Primary market)</b>							
91-day	23.53	23.65	23.85	28.86	32.89	31.94	32.34
182-day	23.96	24.22	24.40	29.24	31.28	30.59	30.61
364-day	24.09	24.30	23.84	29.53	30.50	29.85	29.75
<b>Lending Rates</b>							
Average Weighted Prime Lending Rate (Weekly)	16.38	22.11	22.62	24.94	25.76	25.95	-
Average Weighted Lending Rate (AWLR)	11.31	13.46	15.06	15.94	16.86	-	-
Average Weighted New Lending Rate (AWNLR)	13.72	20.00	21.50	22.42	24.18	-	-
<b>Deposit Rates</b>							
Average Weighted Deposit Rate (AWDR)	5.52	6.99	8.41	9.56	10.49	11.63	-
Average Weighted Fixed Deposit Rate (AWFDR)	6.84	8.97	11.06	12.60	13.90	15.41	-
Average Weighted New Deposit Rate (AWNDR)	15.35	16.98	17.15	19.11	21.29	-	-
Average Weighted New Fixed Deposit Rate (AWNDFDR)	15.63	17.19	17.45	19.42	21.62	-	-

(a) No transactions were reported in the Call Money Market during 01 to 05 October 2022

Source: Central Bank of Sri Lanka