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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

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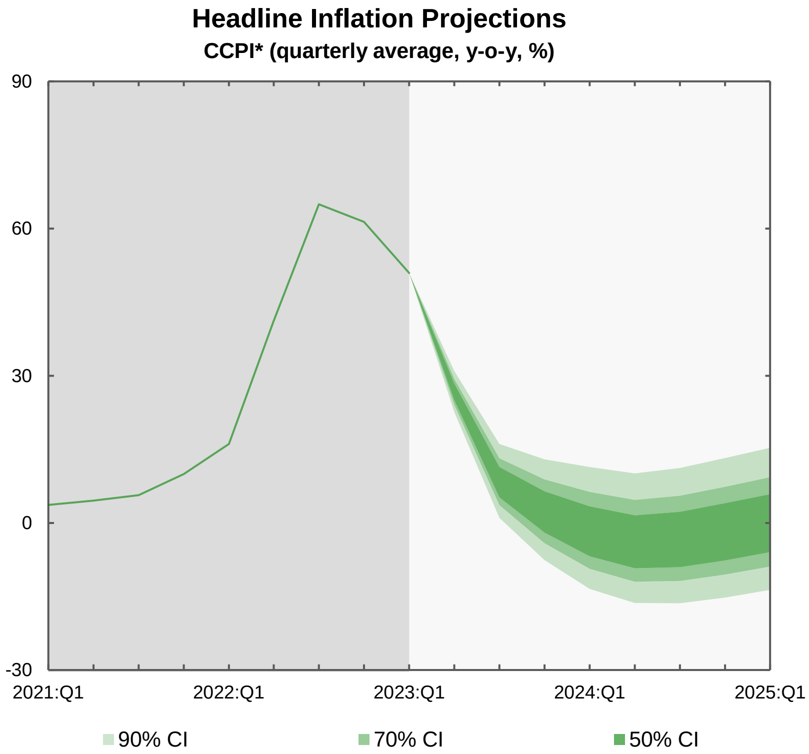
Monetary Policy Review: No. 03 - April 2023

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 04 April 2023, 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 15.50 per cent and 16.50 per cent, respectively. Having considered the recent and expected economic developments, and macroeconomic projections on domestic and global fronts, the Board viewed that the maintenance of the prevailing tight monetary policy stance is necessary to ensure that monetary conditions remain sufficiently tight to facilitate the continuation of the ongoing disinflation process amidst the improvements in market sentiments following the finalisation of the Extended Fund Facility (EFF) from the International Monetary Fund (IMF) and the downward shift in elevated market interest rates reflecting the falling risk premia.

Inflation is projected to follow a faster disinflation path, thereby further anchoring inflation expectations

Headline inflation (year-on-year) based on the Colombo Consumer Price Index (CCPI) continued to decelerate for the sixth consecutive month in March 2023. Despite a sizeable impact from the recent hike in electricity tariffs and envisaged second round effects of previous hikes, headline inflation moderated in March 2023, mainly reflecting a larger-than-expected reduction in food inflation. Meanwhile, core inflation also decelerated for the sixth consecutive month in March 2023, reflecting the continued moderation in underlying demand pressures in the economy. A faster deceleration of inflation is expected from April 2023 with the reduction in domestic prices of essentials following the greater passthrough of the moderation of global commodity prices and the recent appreciation of the Sri Lanka rupee, and the large disinflationary impact arising from the base effect. The subdued aggregate demand on account of tight monetary and fiscal policies and improved domestic supply conditions will ensure the envisaged disinflation process in the period ahead, supported also by anchoring inflation expectations. Accordingly, headline inflation is projected to reach single digit levels by end 2023 and stabilise at desired levels thereafter over the medium term.



***Note:** Realised data up to Q4 2022 are based on the CCPI (2013=100), while data for Q1 2023 are based on the CCPI (2021=100). Projections are based on all available data.

***Source:** Central Bank Staff Projections*

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

The projections reflect the available data, assumptions and judgements made at the April 2023 forecast round. They 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; the anticipated fiscal path, in line with the IMF-EFF Staff Report under the debt restructuring scenario; 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 resulting macroeconomic responses, and the achievement of medium-term fiscal targets. 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 and geopolitical tensions, the risks associated with the current projections are much higher than in normal times. In particular, there are downside risks to baseline projections arising from possible second round effects of the recent fuel and gas price revisions, softening of imported inflation, easing of world commodity prices, etc. Nevertheless, possible upside risks, mainly the second round impact of recent upward revisions to electricity tariffs, could deviate the inflation path from the projections.

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.

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 external sector outlook improved with the finalisation of the IMF-EFF, along with further financing assistance envisaged in the period ahead

The IMF's Executive Board approved the EFF, amounting to about US dollars 3 billion, that entails an economic adjustment programme to support Sri Lanka's near term recovery and medium to long term sustainability. The IMF programme is expected to unlock a sizeable amount of funding from other international financial institutions, while providing a comprehensive policy reform package with a specific implementation timeline, aimed at stabilising the economy and reinforcing country's growth potential. This, coupled with the successful implementation of the debt restructuring process, is expected to ease the balance of payments constraint significantly in the period ahead. The external current account deficit is estimated to have declined notably in 2022 driven largely by a reduction in the trade deficit owing to the robust export earnings amidst a substantial decline in import expenditure. In addition, workers' remittances continued to improve thus far in 2023 and are expected to remain healthy given the rising departures for foreign employment. The tourism sector is witnessing a notable improvement with the ongoing season for tourist arrivals. Given these developments and with a view to allowing the exchange rate to be market-determined, the Central Bank discontinued the announcement of daily guidance on the exchange rate and revoked the mandatory forex sales requirement from the converted export proceeds and workers' remittances from early March 2023. As a result of these policy measures, and the gradual improvement in liquidity in the domestic foreign exchange market and improved market sentiments, the exchange rate recorded a notable appreciation thus far during 2023, despite some volatility. Moreover, the Central Bank built up its gross official reserves, which were estimated at US dollars 2.7 billion as at end March 2023, including the swap facility from the People's Bank of China.

Market interest rates have continued to adjust downwards, and this trend is expected to persist in the period ahead with the falling risk premia

Notwithstanding the increase in policy interest rates in early March 2023, both deposit and lending interest rates have continued to decline, reflecting largely the market guidance provided by the Central Bank and the improved liquidity conditions of the domestic money market. A notable moderation in the yields on government securities was also observed driven by the improvements in market sentiments. As the broader framework of the envisaged domestic debt optimisation operation has now been made public, the large risk premia attached to the government securities are expected to dissipate in the near term, paving the way for other market interest rates that are benchmarked to the yields on government securities to moderate further.

Accordingly, the spread between policy interest rates and market interest rates is expected to narrow further, thus better aligning the market interest rates with the policy interest rates. However, forward looking real interest rates remain positive with falling inflation, thereby keeping monetary conditions sufficiently tight to tame any adverse demand pressures in the period ahead. Reflecting the impact of tight monetary and credit conditions, and the moderation in economic activity, outstanding credit to the private sector by commercial banks continued to contract for the ninth consecutive month in February 2023. The year-on-year expansion of broad money (M_{2b}) also decelerated in February 2023 despite an improvement in net foreign assets (NFA) of the banking system.

Domestic economic activity is expected to recover gradually towards late 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 has registered its deepest economic contraction since independence by recording a broad-based contraction of 7.8 per cent, year-on-year, in 2022. The economy is projected to recover gradually towards the latter part of 2023, supported by improvements in domestic supply conditions, enhancement in business and investor sentiments along with the anticipated improvements in foreign exchange inflows, envisaged reduction of market interest rates, and the impact of policy measures being implemented to strengthen the growth outlook. The recovery of activity is expected to sustain in the medium term underpinned by the implementation of the economic adjustment programme outlined in the IMF-EFF.

Global monetary policy continues to remain hawkish despite financial sector concerns

The financial sector in advanced economies showed signs of distress in March 2023 following the failure of several large banks in the United States and stresses witnessed in Europe, amidst the liquidity issues that emerged in global banking institutions. The elevated risk levels have heightened uncertainties surrounding the global economic outlook, as the current financial distress could result in a drag on global activity and financial stability. Volatility in global financial and commodity markets increased amidst the anticipation of a deviation from tighter financial conditions in advanced economies and the materialisation of downside risks, among others. Nonetheless, the major central banks continued to raise policy interest rates with a view to ensuring the timely return of inflation to their medium term targets. Furthermore, as the major central banks announced coordinated measures aimed at providing liquidity support to preserve global financial stability, some normalisation in market conditions was also witnessed.

Policy interest rates are maintained at the 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 04 April 2023, 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 15.50 per cent and 16.50 per cent, respectively. The Board reiterates its continued commitment to restoring price stability and remains confident that inflation would follow the projected disinflation path underpinned by the prevailing monetary policy stance, while supporting the economy to reach its potential over the medium term. Further, the Board is of the view that there is sufficient space for a further downward adjustment in market interest rates with the improved market sentiments along with the dissipation of elevated risk premia. The Board remains ready to act appropriately and assure the normalisation of the interest rate structure no sooner the price pressures in the economy are sufficiently contained in the period ahead.

Monetary Policy Decision	**Policy interest rates and SRR unchanged**	
	Standing Deposit Facility Rate (SDFR)	15.50%
	Standing Lending Facility Rate (SLFR)	16.50%
	Statutory Reserve Ratio (SRR)	4.00%

INFORMATION NOTE:

A press conference, chaired by Governor Dr. P Nandalal Weerasinghe, will be held on 04 April 2023 at 5.00 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 01 June 2023.

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	Third Quarter	Fourth Quarter	Annual
Agriculture	4.3	11.6	-3.3	-6.8	**0.9**	-4.4	-7.9	-6.7	0.7	**-4.6**
Industries	6.6	22.6	-1.8	0.1	**5.7**	-3.7	-10.1	-21.3	-30.1	**-16.0**
Services	4.3	7.5	-1.5	4.4	**3.5**	1.8	-1.8	-4.2	-3.9	**-2.0**
GDP	**4.5**	**13.8**	**-3.2**	**1.4**	**3.5**	**-0.5**	**-7.4**	**-11.5**	**-12.4**	**-7.8**

(a) Based on revised GDP estimates (base year 2015) released in March 2023

Source: Department of Census and Statistics

Table 02: Inflation

Month		**Aug 22**	**Sep 22**	**Oct 22**	**Nov 22**	**Dec 22**		**Jan 23**	**Feb 23**	**Mar 23**
Headline Inflation (Year-on-Year % change)	CCPI (2013=100)	64.3	69.8	66.0	61.0	57.2	CCPI (2021=100)	51.7	50.6	50.3
	NCPI (2013=100)	70.2	73.7	70.6	65.0	59.2	NCPI (2021=100)	53.2	53.6	-
Core Inflation (Year-on-Year % change)	CCPI (2013=100)	46.6	50.2	49.7	49.4	47.7	CCPI (2021=100)	45.6	43.6	39.1
	NCPI (2013=100)	60.5	64.1	62.4	60.1	57.5	NCPI (2021=100)	52.0	50.1	-

Source: Department of Census and Statistics

Table 03: Monetary Sector Developments (Provisional)

Indicator	Outstanding Amount (Rs. billion)								
	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23
Reserve Money	1,453	1,436	1,386	1,379	1,342	1,318	1,349	1,590	1,505
Broad Money (M_{2b})	11,901	11,955	11,987	12,051	12,046	12,163	12,290	12,322	12,346
Net Foreign Assets (NFA)	(2,122)	(2,124)	(2,035)	(1,893)	(1,873)	(1,870)	(1,767)	(1,573)	(1,434)
Net Domestic Assets (NDA)	14,023	14,079	14,022	13,944	13,919	14,033	14,056	13,895	13,780
Net Credit to the Government (NCG)	6,697	6,826	6,990	7,043	7,178	7,293	7,471	7,612	7,471
Credit to Public Corporations / SOBEs	1,729	1,754	1,700	1,703	1,778	1,760	1,747	1,748	1,712
Credit to the Private Sector	7,714	7,673	7,614	7,577	7,530	7,499	7,414	7,318	7,260
Broad Money (M_4)	14,335	14,410	14,451	14,540	14,547	14,676	14,840	14,891	-

Source: Central Bank of Sri Lanka

Table 04: Interest Rates

Interest Rate (%)	End Oct 22	End Nov 22	End Dec 22	End Jan 23	End Feb 23	End Mar 23	As at 04 Apr 23
Key Policy Interest Rates of the Central Bank							
Standing Deposit Facility Rate	14.50	14.50	14.50	14.50	14.50	15.50	15.50
Standing Lending Facility Rate	15.50	15.50	15.50	15.50	15.50	16.50	16.50
Average Weighted Call Money Rate (AWCMR)	15.50	15.50	15.50	15.26	15.27	16.49	16.48
Treasury bill yields (Primary market)							
91-day	33.05	32.91	32.64	29.91	29.72	25.99	24.12
182-day	32.53	32.27	32.20	28.72	28.67	25.79	24.10
364-day	29.60	29.46	29.27	27.78	27.67	24.31	22.37
Lending Rates							
Average Weighted Prime Lending Rate (Weekly)	27.46	27.89	27.24	24.82	23.45	21.40	-
Average Weighted Lending Rate (AWLR)	17.94	18.42	18.70	18.66	18.50	-	-
Average Weighted New Lending Rate (AWNLR)	25.83	26.04	26.20	25.82	25.31	-	-
Deposit Rates							
Average Weighted Deposit Rate (AWDR)	12.60	13.37	14.06	14.63	14.74	15.06	-
Average Weighted Fixed Deposit Rate (AWFDR)	16.66	17.59	18.49	19.15	19.23	19.80	-
Average Weighted New Deposit Rate (AWNDR)	23.22	23.63	23.07	22.24	21.56	-	-
Average Weighted New Fixed Deposit Rate (AWNFDR)	23.61	24.05	23.73	22.78	22.06	-	-

Source: Central Bank of Sri Lanka