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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

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Monetary Policy Review: No. 04 - June 2023

The Central Bank of Sri Lanka relaxes its Monetary Policy Stance

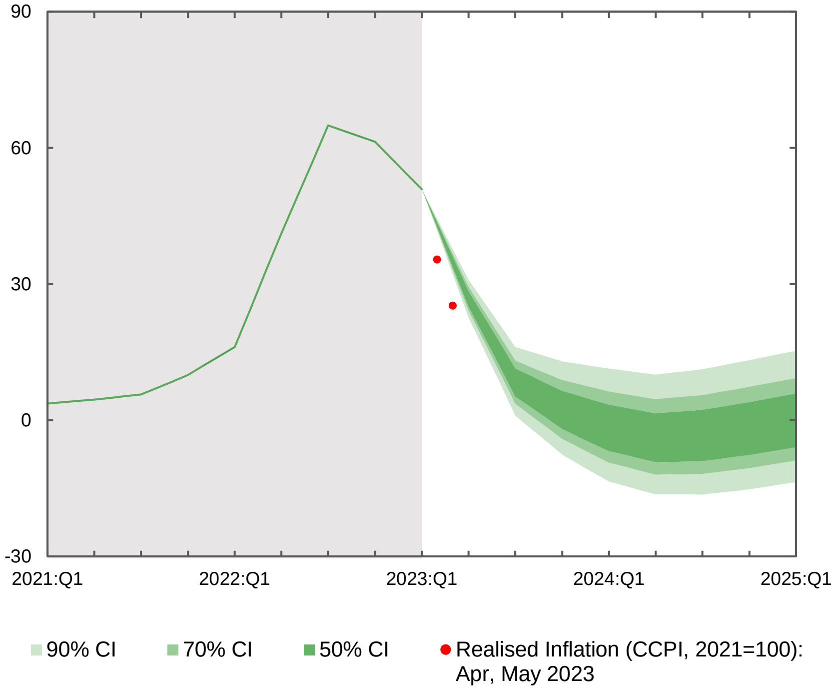
The Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 31 May 2023, decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 250 basis points to 13.00 per cent and 14.00 per cent, respectively. The Board arrived at this decision with a view to easing monetary conditions in line with the faster than expected slowing of inflation, gradual dissipation of inflationary pressures and further anchoring of inflation expectations. The commencing of such monetary easing is expected to provide an impetus for the economy to rebound from the historic contraction of activity witnessed in 2022, while easing pressures in the financial markets.

Inflation is projected to decelerate notably in the period ahead, reaching single digit levels earlier than expected

Headline inflation (year-on-year), based on the Colombo Consumer Price Index (CCPI), continued the deceleration path, faster-than-projected earlier, supported by the lagged impact of tight monetary and fiscal policies, strengthening of the Sri Lanka rupee, reduction in fuel and gas prices, normalisation of food prices and the favourable impact of the statistical base effect. The full passthrough of the large appreciation of the exchange rate observed recently is yet to be reflected in the price levels, and it would quicken the disinflation process, as the prices of imported goods are expected to decline further in the period ahead. The favourable statistical base effect due to large month-on-month inflation that materialised during the last year is expected to slow inflation significantly in the next few months as well. Accordingly, as per the latest projections of the Central Bank, headline inflation is forecast to reach single digit levels in early Q3-2023, and stabilise around mid single digit levels over the medium term.

Headline Inflation Projections

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



***Note:** Realised data up to Q4 2022 shown in the fan chart 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 domestic 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. 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 the baseline projections arising from faster normalisation of supply conditions, possible quicker than expected easing of world commodity prices, softening of imported inflation, and expected downward revisions to the electricity tariffs, etc. Nevertheless, possible upside risks, such as potential demand pressures that could develop with the expected revival of activity and any large depreciation of the exchange rate could exert upward pressures on 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. Especially, 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, which underwent an unprecedented setback in 2022, begins to demonstrate improved performance

During the four months ending April 2023, the trade deficit decreased notably, compared to a year earlier, reflecting mainly the subdued import expenditure, which outweighed the impact of moderation of external demand for merchandise exports. Inflows to the domestic forex market remain robust following the approval of the Extended Fund Facility (EFF) from the International Monetary Fund (IMF). The significant revival of workers' remittances and earnings from tourism continued to build resilience in the external sector. The renewed foreign investor appetite for short term government securities has also helped improve forex liquidity in the recent months. The exchange rate, which is allowed to be determined by market forces, continues to reflect positive market sentiments underpinned by the improvement in liquidity in the domestic forex market. The Central Bank has absorbed a sizeable amount of foreign exchange from the domestic forex market thus far in 2023, resulting in a steady increase in gross official reserves (GOR). As of end May 2023, the level of GOR is estimated to have surpassed US dollars 3 billion, including the swap facility from the People's Bank of China. Reflecting the improved balance of payments (BOP) conditions, the Central Bank relaxed the cash margin deposit requirements imposed on selected imports in May 2023, and further measures will be initiated to loosen capital flow restrictions in the period ahead. Further, the Monetary Board viewed that a gradual phasing out of the existing import restrictions would need to commence soon. The continuation of the IMF-EFF supported programme, further financial assistance from international development partners, such as the Asian Development Bank (ADB) and the World Bank, and renewed investor appetite, coupled with the advances in the debt restructuring process, are expected to ease the BOP constraint significantly in the period ahead, supporting the recovery in domestic economic activity.

The downward adjustment in market interest rates will accelerate in line with the envisaged single digit inflation, thereby supporting credit to the private sector and softening the pressures in the financial sector

Both deposit and lending interest rates have continued to adjust downwards with the market guidance provided by the Central Bank along with the improvement in liquidity conditions of the domestic money market. The yields on government securities are expected to decline further as risk premia are likely to subside substantially with the announcement of the domestic debt optimisation operation in the period ahead. Moreover, foreign financing inflows in the form of budget support would reduce the need for proportionately large domestic financing, thereby easing pressures on government securities' yields further. Credit to the private sector by licensed commercial banks (LCBs), including the SME sector, which continued to contract since June 2022, is expected to turnaround gradually with the easing of monetary conditions and the envisaged rebound of economic activity. Net credit to the Government by the banking system that notably expanded in 2022 is expected to moderate with the receipt of substantial foreign financing to the Government. Meanwhile, credit to the State Owned Business Enterprises (SOBEs) by the banking system is expected to reduce significantly in the period ahead, underpinned by the cost recovery pricing adopted by major SOBEs.

Domestic economic activity is expected to rebound gradually from late 2023

As reflected by leading indicators, economic activity remains subdued thus far during 2023, reflecting the protracted impact of the severe economic stresses in 2022 and the resultant tighter monetary and fiscal policies needed to support the restoration of macroeconomic stability. The economy is projected to rebound gradually from late 2023, supported by the easing of monetary conditions, improvements in business and investor sentiments along with the realisation of improved foreign exchange inflows, the faster recovery of the tourism sector, and the implementation of growth promoting policy measures.

Policy interest rates reduced in view of the faster deceleration of inflation, benign inflation outlook and the easing of BOP pressures, thereby reinforcing the rebound of the economy

With greater macroeconomic stability being achieved through corrective policy measures, particularly in terms of faster-than-expected deceleration of inflation thus far during 2023 and the benign inflation outlook and the easing of the BOP pressures, the Monetary Board of the Central Bank of Sri Lanka, upon carefully assessing the current and expected developments, decided to relax the stance of monetary policy and reduce the policy interest rates. This move is expected to accelerate the normalisation of the interest rate structure in the period ahead and broadbase the recovery of activity in the economy and ease pressures in the financial markets, thereby steering the economy towards a rebound phase. Accordingly, at the meeting held on 31 May 2023, the Board decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 250 basis points to 13.00 per cent and 14.00 per cent, respectively.

The Board assessed both upside and downside risks to the inflation projections in the near to medium term and viewed that risks to the inflation projections, on balance, are tilted to the downside in the medium term. Faster deceleration of inflation and lower probability of excessive demand pressures during the economic rebound phase creates space for a gradual policy relaxation in the period ahead. The Board underscored the need for a quicker passthrough of the benefit of the relaxed monetary policy stance to the stakeholders of the economy. The financial institutions, led by LCBs, are expected to adjust the market interest rates swiftly in line with the changes in the policy interest rates. Furthermore, the Board also recommended requesting the Government to consider phasing out the remaining restrictions on most items of merchandise imports. The Monetary Board will continue to assess risks to both inflation and GDP growth projections, among others, and stand ready to take appropriate measures to ensure and sustain macroeconomic stability in the event of crystallising any risks to the baseline projections.

Monetary Policy Decision	**Policy interest rates reduced and SRR unchanged**	
	Standing Deposit Facility Rate (SDFR)	13.00%
	Standing Lending Facility Rate (SLFR)	14.00%
	Statutory Reserve Ratio (SRR)	4.00%

INFORMATION NOTE:

A press conference, chaired by Governor Dr. P Nandalal Weerasinghe, will be held on 01 June 2023 at 1.30 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 06 July 2023.

Annexure I

Table 01: Inflation

Month		Sep 22	Oct 22	Nov 22	Dec 22		Jan 23	Feb 23	Mar 23	Apr 23	May 23
Headline Inflation (Year-on-Year % change)	CCPI (2013=100)	69.8	66.0	61.0	57.2	CCPI (2021=100)	51.7	50.6	50.3	35.3	25.2
	NCPI (2013=100)	73.7	70.6	65.0	59.2	NCPI (2021=100)	53.2	53.6	49.2	33.6	-
Core Inflation (Year-on-Year % change)	CCPI (2013=100)	50.2	49.7	49.4	47.7	CCPI (2021=100)	45.6	43.6	39.1	27.8	20.3
	NCPI (2013=100)	64.1	62.4	60.1	57.5	NCPI (2021=100)	52.0	50.1	44.2	31.8	-

Source: Department of Census and Statistics

Table 02: Monetary Sector Developments (Provisional)

Indicator	Outstanding Amount (Rs. billion)								
	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23 (a)	Apr 23 (a)
Reserve Money	1,386	1,379	1,342	1,318	1,349	1,590	1,505	1,424	1,417
Broad Money (M_{2b})	11,987	12,051	12,046	12,163	12,290	12,322	12,346	12,293	12,387
Net Foreign Assets (NFA)	(2,035)	(1,893)	(1,873)	(1,870)	(1,767)	(1,573)	(1,434)	(1,174)	(1,039)
Net Domestic Assets (NDA)	14,022	13,944	13,919	14,033	14,056	13,895	13,780	13,467	13,426
Net Credit to the Government (NCG)	6,990	7,043	7,178	7,293	7,471	7,612	7,471	7,568	8,091 (b)
Credit to Public Corporations / SOBEs	1,700	1,703	1,778	1,760	1,747	1,748	1,712	1,593	1,130 (b)
Credit to the Private Sector	7,614	7,577	7,530	7,499	7,414	7,318	7,260	7,153	7,110
Broad Money (M_4)	14,451	14,540	14,547	14,676	14,840	14,891	14,906	14,868	-

(a) The appreciation of the Sri Lanka rupee against the US dollar during March-April 2023 mainly contributed to the moderation of monetary and credit aggregates during that period.

(b) With the approval of the Cabinet of Ministers at its meeting held on 30 January 2023, the outstanding foreign currency guaranteed debt of the Ceylon Petroleum Corporation (CPC) was absorbed into central government debt with effect from December 2022, in line with the actions agreed under the IMF-EFF arrangement to restructure the balance sheets of selected State Owned Business Enterprises (SOBEs). Accordingly, a part of this adjustment was effected in April 2023, hence, was reflected in the balance sheet of the particular state-owned commercial bank, which caused a reduction in credit to public corporations/ SOBEs and an expansion in net credit to the government (NCG).

Source: Central Bank of Sri Lanka

Table 03: Interest Rates

Interest Rate (%)	End Nov 22	End Dec 22	End Jan 23	End Feb 23	End Mar 23	End Apr 23	End May 23
Key Policy Interest Rates of the Central Bank							
Standing Deposit Facility Rate	14.50	14.50	14.50	14.50	15.50	15.50	15.50
Standing Lending Facility Rate	15.50	15.50	15.50	15.50	16.50	16.50	16.50
Average Weighted Call Money Rate (AWCMR)	15.50	15.50	15.26	15.27	16.49	16.50	16.50
Treasury bill yields (Primary market)							
91-day	32.91	32.64	29.91	29.72	25.99	25.74	25.65
182-day	32.27	32.20	28.72	28.67	25.79	25.27	25.29
364-day	29.46	29.27	27.78	27.67	24.31	23.00	22.91
Lending Rates							
Average Weighted Prime Lending Rate (Weekly)	27.89	27.24	24.82	23.45	21.40	21.03	21.28 (a)
Average Weighted Lending Rate (AWLR)	18.42	18.70	18.66	18.50	18.29	17.87	-
Average Weighted New Lending Rate (AWNLR)	26.04	26.20	25.82	25.31	23.70	23.09	-
Deposit Rates							
Average Weighted Deposit Rate (AWDR)	13.37	14.06	14.63	14.74	15.06	15.12	15.23
Average Weighted Fixed Deposit Rate (AWFDR)	17.59	18.49	19.15	19.23	19.80	19.72	19.84
Average Weighted New Deposit Rate (AWNDR)	23.63	23.07	22.24	21.56	20.48	19.19	-
Average Weighted New Fixed Deposit Rate (AWNFDR)	24.05	23.73	22.78	22.06	21.07	19.70	-

(a) For the week ending 26 May 2023

Source: Central Bank of Sri Lanka