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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

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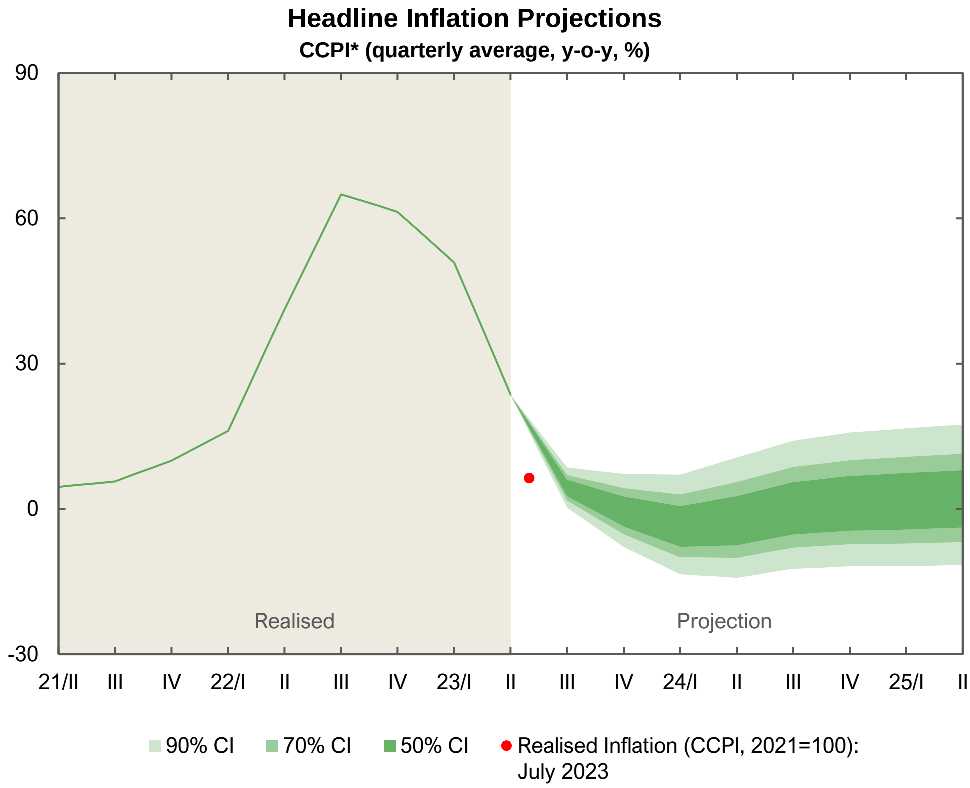
Monetary Policy Review: No. 06 - August 2023

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 23 August 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 11.00 per cent and 12.00 per cent, respectively. The Board arrived at this decision following a careful analysis of current and expected developments in the domestic as well as the global economy, while noting the significant easing of monetary conditions effected since June 2023. The Monetary Board took note of the downward adjustment of market interest rates in response to monetary policy easing measures implemented thus far and the need to allow space for further adjustment of market interest rates swiftly. However, the Board observed that market interest rates of certain lending products remain excessive and are not in line with the current monetary policy stance. Moreover, the Board anticipates a faster reduction in overall market lending interest rates in line with the recent monetary policy easing measures. Accordingly, the Board decided to adopt targeted administrative measures to reduce specific lending interest rates that it considered to be excessive and direct the licensed banks to reduce overall rupee lending interest rates by an appropriate margin in the period ahead.

The disinflation trend continues, with headline inflation reaching single digit levels

Headline inflation, measured by the year-on-year change in the Colombo Consumer Price Index (CCPI, 2021=100), decelerated to 6.3 per cent in July 2023, reaching single digit levels for the first time since November 2021. Following a similar trend, headline inflation, based on the National Consumer Price Index (NCPI, 2021=100), also decelerated to 4.6 per cent in July 2023 (year-on-year). The moderation in headline inflation was mainly driven by the softening of energy and food inflation, along with the favourable statistical base effect. Meanwhile, CCPI and NCPI based core inflation, which reflects underlying demand pressures in the economy, moderated to 6.1 per cent and 6.3 per cent, respectively, in July 2023 (year-on-year). Headline inflation is expected to moderate further over the next few months and stabilise around mid-single digit levels over the medium term.



***Note:** Realised data up to Q4 2022 shown in the fan chart are based on the CCPI (2013=100), while data after this period are based on the CCPI (2021=100). Projections are based on all available data. The above fan chart is based on the medium-term projections arrived at during the July 2023 monetary policy cycle. The fan chart and medium-term projections will be updated in the next monetary policy cycle in October 2023, along with the release of GDP data for Q2 2023 by the Department of Census and Statistics.

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

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 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.

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

The projections reflect the available data, assumptions and judgements made at the July 2023 forecast round. They are conditional on the forecasts of global energy and food prices that prevailed during the July 2023 forecast round; gradual growth recovery of Sri Lanka's major trading partners; the anticipated fiscal path in line with the IMF-EFF Staff Report under the debt restructuring scenario; and global financial conditions implied by the 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 higher than in normal times. Upside risks to inflation projections stem from various factors, including the impact of adverse weather on agricultural production and in turn possibly on food inflation, possible upward revisions to domestic prices driven by increasing global oil and commodity prices, any deviation from the envisaged fiscal consolidation path, possible exchange rate depreciation amidst import relaxations and the likelihood of wage inflation. Meanwhile, downside risks to inflation projections include, among others, the possibility of faster recovery of the economy driven by further normalisation of supply conditions and import relaxations, and the sustained impact of diminishing purchasing power of the public.

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.

Domestic economic activity is expected to recover in the second half of 2023 and gradually reach the potential level of economic growth over the medium term

Economic activity is projected to recover gradually during the second half of 2023 and reach its potential level thereafter, supported by the normalisation of monetary conditions, improvements in business confidence, enhancements in supply conditions and the relaxation of import restrictions, and the impact of growth promoting structural reforms. Leading indicators of economic activity point to a lower contraction in GDP in the second quarter of 2023, compared to the previous projections, while the second half of 2023 is expected to record a positive growth, compared to the same period in 2022. However, the impact of weather related disruptions and modest external demand conditions could weigh on expected growth in the near term.

The external sector remains resilient, allowing a gradual relaxation of balance of payments restrictions

The trade deficit decreased notably during the seven months ending July 2023 with a significant decrease in merchandise imports, despite the decrease in merchandise exports. Earnings from tourism and workers' remittances, which improved considerably from January to July 2023, in comparison to the corresponding period in the previous year, are expected to improve further in the period ahead. Despite some recent outflows from the government securities market, net foreign investment inflows remained positive during the seven months ending July 2023. In view of the improvements in the balance of payments conditions and the need to support the recovery of activity, the Government relaxed import restrictions related to 638 HS codes, including those of commercial vehicles, since June 2023. Although a significant share of import restrictions has already been relaxed, demand for imports continued to remain subdued, reflecting the tight financial conditions. The Sri Lanka rupee recorded an appreciation of around 12 per cent against the US dollar thus far during the year. The level of gross official reserves was estimated at around US dollars 3.8 billion as at end July 2023, including the swap facility from the People's Bank of China, while measures were also taken to repay a part of the swap facility with Bangladesh Bank, in addition to the repayment of maturing debt of multilateral lending agencies.

Market interest rates continue to adjust downward, although disparities in adjustments remain

Reflecting the impact of monetary policy easing measures effected since June 2023 as well as the decline in the risk premia with the announcement of the domestic debt optimisation (DDO) operation, market interest rates have declined to a certain extent. A notable reduction was also observed in the yields on government securities. However, the downward adjustment in market lending interest rates has been disproportionate to the reduction effected in market deposit interest rates. Furthermore, despite the considerable easing of monetary conditions, interest rates on certain lending products of some financial institutions continue to remain excessively high posing hardships for individuals and businesses, particularly small and medium scale enterprises. The reduction in the Statutory Reserve Ratio (SRR) from mid-August 2023 is expected to have eased liquidity strains of licensed commercial banks (LCBs) and lowered their cost of funds, facilitating a further downward adjustment in lending interest rates. Meanwhile, based on data available until July 2023, a sustained recovery in credit extended to the private sector by LCBs is yet to be observed. Therefore, it is essential that market lending interest rates are lowered by financial institutions in line with the eased monetary policy stance of the Central Bank, thereby boosting credit flows to the economy, which in turn would help the revival of economic activity.

Policy interest rates are maintained at their current levels, while measures are introduced to accelerate the reduction of market lending interest rates

In consideration of the current and expected macroeconomic developments highlighted above, the Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 23 August 2023, was of the view that it is appropriate to maintain the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank at their current levels of 11.00 per cent and 12.00 per cent, respectively. The Members noted that the Central Bank has eased its monetary policy stance considerably since early June 2023 by reducing its key policy interest rates by 450 basis points, while reducing SRR by 2.0 percentage points to inject additional liquidity into the financial markets. Further, the announcement of the DDO strategy also helped reduce the risk premium of yields on government securities, with spillovers to other market interest rates. However, considering the presence of excessive interest rates on certain lending products and the inadequate downward adjustment in market lending interest rates relative to that of deposits, the Board was of the view that the downward rigidity in lending interest rates of certain financial institutions needs to be addressed through administrative measures. Such administrative measures would also ensure the swift transmission of previous monetary policy easing measures to all sectors of the economy. Accordingly, the Board decided to impose caps on interest rates on pawning facilities at 18 per cent, per annum; on pre-arranged temporary overdrafts at 23 per cent, per annum; and on credit cards at 28 per cent, per annum, for all licensed banks. Further, the Board was of the view that penal interest rates need to be capped at 2 percentage points over the regular interest rates charged on the relevant credit facility. In addition to the above, the Board noted that other market lending interest rates on rupee loans and advances should also adjust downwards further, in line with the relaxed monetary policy stance. Directions to effect these regulated interest rates will be issued shortly. These directions will be subject to further review to ensure that the overall lending interest rate structure remains in line with the monetary policy measures of the Central Bank in the period ahead.

Monetary Policy Decision	**Policy interest rates and SRR unchanged**	
	Standing Deposit Facility Rate (SDFR)	11.00%
	Standing Lending Facility Rate (SLFR)	12.00%
	Statutory Reserve Ratio (SRR)	2.00%*

** effective 16 August 2023*

Regulated Interest Rates	**Maximum interest rates (per annum)**	
	Pawning Facilities	18.00%
	Pre-arranged Temporary Overdrafts	23.00%
	Credit Cards	28.00%
	Penal interest rate over regular interest rate	2.00 ppts

INFORMATION NOTE:

A press conference, chaired by Governor Dr. P Nandalal Weerasinghe, will be held on 24 August 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 05 October 2023.

Annexure I

Table 01: Inflation

Month		Nov 22	Dec 22		Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23
Headline Inflation (Year-on-Year % change)	CCPI (2013=100)	61.0	57.2	CCPI (2021=100)	51.7	50.6	50.3	35.3	25.2	12.0	6.3
	NCPI (2013=100)	65.0	59.2	NCPI (2021=100)	53.2	53.6	49.2	33.6	22.1	10.8	4.6
Core Inflation (Year-on-Year % change)	CCPI (2013=100)	49.4	47.7	CCPI (2021=100)	45.6	43.6	39.1	27.8	20.3	9.8	6.1
	NCPI (2013=100)	60.1	57.5	NCPI (2021=100)	52.0	50.1	44.2	31.8	21.6	11.3	6.3

Source: Department of Census and Statistics

Table 02: Monetary Sector Developments (Provisional)

Indicator	Outstanding Amount (Rs. billion)								
	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23 (a)	Apr 23 (a)	May 23 (a)	Jun 23	Jul 23
Reserve Money	1,318	1,349	1,590	1,505	1,424	1,417	1,559	1,436	1,374
Broad Money (M_{2b})	12,163	12,290	12,322	12,346	12,293	12,387	12,307	12,517	12,726
Net Foreign Assets (NFA)	(1,870)	(1,767)	(1,573)	(1,434)	(1,174)	(1,039)	(838)	(808)	(707)
Net Domestic Assets (NDA)	14,033	14,056	13,895	13,780	13,467	13,426	13,144	13,325	13,433
Net Credit to the Government (NCG)	7,293	7,471	7,612	7,471	7,568	8,091(b)	8,111	8,261	8,549
Credit to Public Corporations / SOBEs	1,760	1,747	1,748	1,712	1,605 (c)	1,147(b)(c)	1,084(c)	1,096	1,097
Credit to the Private Sector	7,499	7,414	7,318	7,260	7,141(c)	7,093(c)	7,004(c)	7,080	7,093
Broad Money (M_4)	14,676	14,840	14,891	14,906	14,868	14,981	14,885	15,094	-

(a) The appreciation of the Sri Lanka rupee against the US dollar during March-May 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).

(c) Revised

Source: Central Bank of Sri Lanka

Table 03: Interest Rates

Interest Rate (%)	End Feb 23	End Mar 23	End Apr 23	End May 23	End Jun 23	End Jul 23	As at 23 Aug 2023
Key Policy Interest Rates of the Central Bank							
Standing Deposit Facility Rate	14.50	15.50	15.50	15.50	13.00	11.00	11.00
Standing Lending Facility Rate	15.50	16.50	16.50	16.50	14.00	12.00	12.00
Average Weighted Call Money Rate (AWCMR)	15.27	16.49	16.50	16.50	13.85	11.50	11.54
Treasury Bill Yields (Primary market)							
91-day	29.72	25.99	25.74	25.65	23.00	19.96	17.97
182-day	28.67	25.79	25.27	25.29	19.49	17.69	15.03
364-day	27.67	24.31	23.00	22.91	16.99	14.29	13.31
Lending Rates							
Average Weighted Prime Lending Rate (Weekly)	23.45	21.40	21.03	20.29	19.47	17.18	16.02 (a)
Average Weighted Lending Rate (AWLR)	18.50	18.29	17.87	17.75	17.51	16.90	-
Average Weighted New Lending Rate (AWNLR)	25.31	23.70	23.09	22.39	21.51	19.30	-
Deposit Rates							
Average Weighted Deposit Rate (AWDR)	14.74	15.06	15.12	15.23	15.09	14.76	14.15
Average Weighted Fixed Deposit Rate (AWFDR)	19.23	19.80	19.72	19.84	19.70	19.02	18.26
Average Weighted New Deposit Rate (AWNDR)	21.56	20.48	19.19	18.85	14.98	12.45	-
Average Weighted New Fixed Deposit Rate (AWNFDR)	22.06	21.07	19.70	19.19	15.49	12.76	-

(a) For the week ending 18 August 2023

Source: Central Bank of Sri Lanka