



BOX 01
Recent Deflation Episode in Sri Lanka

Introduction¹

After reaching a historic peak in September 2022, headline inflation moderated thereafter, turning negative by September 2024 and remaining in deflation for 11 months until August 2025. This marked the first episode of deflation since March 1995.² While the disinflation process reflected proactive tight monetary policy actions, the subsequent deflationary episode was driven primarily by large price reductions in the energy and transport category. These price reductions were supported by favourable weather conditions, which enabled a larger share of hydroelectricity generation and moderated global energy prices. Statistical base effects also played a role in the deflation process in early 2025, particularly those arising from Value Added Tax (VAT)-induced price increases and elevated food inflation in early 2024. Reflecting these cumulative influences, deflation deepened in February 2025 before gradually easing thereafter. However, some price pressures that heightened in the crisis period, dampened in the deflationary episode, alleviating the burden

on businesses and households and easing cost pressures, to some extent. The accommodative monetary policy stance since June 2023 has supported a gradual recovery in aggregate demand, contributing to an increase in headline inflation. In addition, increases in food inflation, the upward revision of electricity tariffs in mid-June 2025, and the upward contribution from the statistical base, also collectively contributed to the end of the deflationary episode and the gradual acceleration of inflation thereafter.

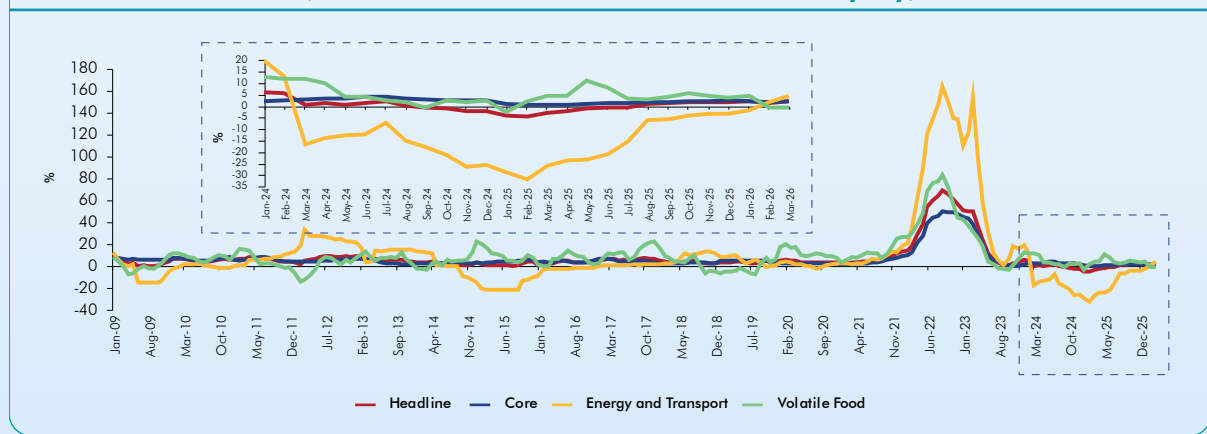
Figure B1.1 illustrates the movements of headline inflation, core inflation, energy and transport inflation and volatile food inflation. Among these, energy and transport inflation display greater volatility, with substantially larger fluctuations than the other components over the recent years.

Developments in Core Inflation

Core inflation, derived by excluding volatile food and energy and transport categories from the Consumer Price Index (CPI), serves as an indicator of underlying inflationary pressures in the economy and is more closely linked to demand conditions and monetary policy transmission. As such, it provides a clearer signal of persistent inflation trends by abstracting from temporary supply-side shocks. Notably, core inflation remained positive

1 This Box Article is broadly based on the Box article published in the Monetary Policy Report - February 2026 of the Central Bank of Sri Lanka under the title *Digging Deeper into the Recent Deflation Episode in Sri Lanka*.
2 Headline Inflation is derived based on the most recent base year series applicable for the respective period, i.e., when splicing, prominence is given to the most recent base year for periods where multiple observations exist. It is noteworthy that when considering the Colombo Consumer Price Index (CCPI) published in the respective month, negative inflation has been published in July-Sep 2015 using 2006/07=100 base. However, when the 2013=100 base is used, such deflation cannot be observed during 2015.

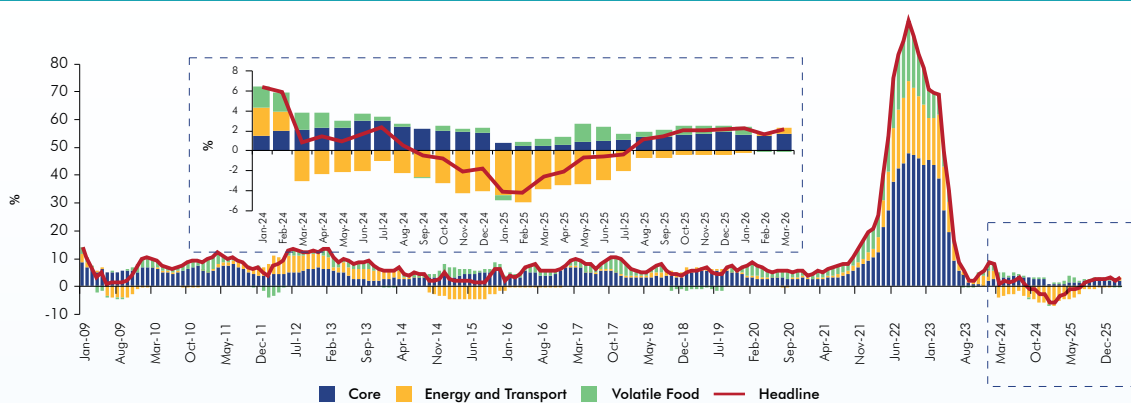
Figure B 1.1
Movements of Headline, Core, Energy and Transport and Volatile Food Inflation (CCPI, 2006/ 07=100, 2013=100, 2021=100, y-o-y)



Note: Inflation rates for each category have been derived based on the respective base year applicable during the period. When splicing, prominence is given to the most recent base year for periods where multiple observations exist.

Sources: Department of Census and Statistics, Central Bank Staff Calculations

Figure B 1.2
Contribution to Headline Inflation (CCPI, 2006/ 07=100, 2013=100 and 2021=100, y-o-y)



Note: Contribution to y-o-y headline inflation from each category has been derived based on the respective base year applicable during the period. When splicing, prominence is given to the most recent base year for periods where multiple observations exist.

Sources: Department of Census and Statistics, Central Bank Staff Calculations

throughout the recent deflationary episode, indicating that underlying demand conditions remained steady, albeit subdued, despite the decline in headline inflation. This behaviour suggests that the observed deflation was largely driven by transitory factors, such as easing energy prices and favourable base effects, rather than a broad-based and sustained weakening in underlying inflation. Moreover, this is also reflected in the overall behaviour of inflation expectations, where the expectations of both the corporate and household sectors for horizons of six months or more remained positive throughout the period, as recorded in the Inflation Expectations Survey of the Central Bank.

Meanwhile, Figure B1.2 illustrates the contribution of core inflation, energy and transport inflation and volatile food inflation to headline inflation. In recent periods, energy and transport inflation has made a significant negative contribution to headline inflation. At the same time, the contribution of core inflation, albeit being positive, has remained low relative to pre-crisis periods.

Economic Growth Amid Deflation

The recent deflationary episode did not coincide with a slowdown in economic activity. Instead, growth momentum strengthened following the economic crisis, with real GDP growth of 5% in both 2024 and 2025. Alongside this robust growth, a low unemployment rate and a gradual

increase in labour force participation compared with recent periods, signals a possible expansion of the economy rather than a slowdown. At the same time, leading indicators of economic activity, such as credit to the private sector and import demand, also recorded notable increases, signalling strengthening growth momentum. Accordingly, the deflationary episode can be characterised as transitory and mostly supply-driven rather than reflecting a persistent demand side weakness with risks of a deflationary spiral.

Sustained Low Inflation

Despite returning to positive territory in August 2025, the pace of acceleration in headline inflation remained moderate. This partly reflects the substantial upward reset in the consumer prices in the CPI basket during the high inflation episode of 2022, when prices increased broadly across sectors, as well as compressed disposable incomes from tight fiscal consolidation. Against this backdrop, firms appear to have exercised greater price restraint than in normal times, leading to persistently low inflation despite the economic recovery. Moreover, when countries which have experienced similar inflation dynamics, with substantially high inflation, followed by a quick disinflation episode, are compared, a period of lower-than-average inflation can be observed across several economies.³

³ Such behaviours can be observed in several developing economies, including regional peers such as the Philippines, Indonesia, and Pakistan, although the respective periods and the underlying drivers of the inflation dynamics are not common across the countries.

Conclusion

Following the earlier inflation surge, the economy experienced a deflationary episode driven mainly by significant reductions in energy and transport prices, supported by favourable weather conditions, lower global energy prices, and statistical base effects. As inflation returned to positive territory in late 2025, the pace of increase remained moderate, indicating a gradual and orderly normalisation of price dynamics. Economic growth and core inflation dynamics suggest that underlying demand conditions did not weaken significantly during the deflationary period episode. Moreover, other macroeconomic indicators also suggest that economic activity continued to increase, rather than recording a persistent slowdown. Taken

together, these developments suggest that the recent persistence in inflation largely reflects the gradual normalisation of price dynamics amid a high cost base, rather than a sustained contraction in demand. While the recent deflationary episode and persistently low inflation may suggest scope for a lower inflation target, such considerations need to be viewed in the context of Sri Lanka's structural characteristics. As a small, open economy that is more susceptible to supply-side shocks, including weather-related disruptions and external shocks, Sri Lanka requires a relatively higher inflation target and a wider deviation margin compared to larger and more advanced economies to accommodate such fluctuations and ensure effective policy implementation.

