# Monetary Policy Report

## July 2023

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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

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# MONETARY POLICY FRAMEWORK OF THE CENTRAL BANK OF SRI LANKA

The Central Bank conducts its monetary policy under a Flexible Inflation Targeting (FIT) framework, where it aims at stabilising inflation around the inflation target over the medium term, which is currently set at mid-single-digit level, while minimising potential disturbances to the real economy, thus enabling the economy to reach its growth potential.

The Central Bank uses its policy instruments to guide short term interest rates, particularly the average weighted call money rate (AWCMR), which is the operating target of the monetary policy framework, along the desired path.

The Monetary Policy Report is prepared to communicate to the public and other stakeholders the rationale for the monetary policy decisions taken during the relevant period of review and intends to provide some guidance on the way forward and what could be expected in terms of inflation and other key macroeconomic developments, going forward.

With the new Central Bank of Sri Lanka Act, the publication of the Monetary Policy Report will fulfil the statutory requirements stipulated therein.

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***This is the first Monetary Policy Report published by the Central Bank of Sri Lanka, and it will be published on a bi-annual basis.***

# EXECUTIVE SUMMARY

The Sri Lankan economy, having surpassed an extremely challenging period of turbulence in 2022, has shown stability on many economic fronts owing to the timely implementation of appropriate macroeconomic policies, including measures to implement long-overdue structural reforms. From its peak levels of about 70 per cent, year-on-year, observed in late 2022, Colombo Consumer Price Index (CCPI) based headline inflation has moderated notably at a pace faster than expected, to around 12 per cent by June 2023. Year-on-year CCPI-based core inflation, which peaked at levels more than 50 per cent, has also moderated substantially, where core inflation reached below 10 per cent by June 2023, reflecting no obvious signs of the buildup of underlying demand pressures. The realisation of the impact of tight monetary and fiscal conditions, the gradual easing of supply-side disruptions, and the easing of price pressures globally largely contributed to this decline in inflation, along with the favourable statistical base effect. A further moderation of inflation is expected in the near term, which is subsequently anticipated to stabilise at the targeted mid-single-digit level over the medium term, ensuring the achievement of price stability.

Meanwhile, domestic economic activity, which contracted in the first quarter of 2023, year-on-year, is expected to rebound in the near term supported by the easing of monetary conditions and achieve its long term potential underpinned by the growth supportive policies being implemented by the Government. This would pave the way for the domestic economy to achieve sustainable levels of growth over the medium term.

The external sector, which suffered a major setback in the preceding year, has observed clear signs of stability supported by improved foreign exchange inflows and an improved balance of payments position that has strengthened the Sri Lanka rupee. External sector vulnerabilities have reduced to a large extent, with international reserves building up gradually. The external sector is expected to remain resilient and achieve greater stability supported by further improvements in foreign exchange inflows, while merchandise trade flows, workers' remittances, and trade in services, including earnings from tourism, begin to normalise in the period ahead.

Lastly, the easing of monetary policy, improving external sector conditions and the expected improvement in domestic economic activity are likely to generate an improvement in credit to the productive sectors of the economy, thereby contributing further to the stabilisation and rebound of the Sri Lankan economy.

Projections of inflation and real economic growth are subject to both upside and downside risks. On balance, risks to inflation over the short term remain balanced, while risks to short term real economic growth projections are upward biased. Over the medium term, risks to both inflation and real economic growth projections are skewed to the upside.

*The content of this Report is mainly based on the data available as of the July 2023 monetary policy round of the Central Bank of Sri Lanka, which concluded with the monetary policy announcement on 06 July 2023.*

# 1. MONETARY POLICY SUMMARY

The Central Bank of Sri Lanka has been in a tightening monetary policy stance since August 2021 considering pressures encountered, predominantly on the fronts of inflation and balance of payments. Inflation reached its peak levels in September 2022. However, as inflation moderated faster than expected supported by the lagged impact of tight monetary and fiscal policies that were in place, easing of global commodity prices and its passthrough to domestic prices, appreciation of the exchange rate and the favourable base effect, the Central Bank commenced easing of the monetary policy stance in June 2023, and further reinforced in July 2023. This, along with the greater clarity being provided on the Domestic Debt Optimisation (DDO) operation, would facilitate the gradual moderation of market interest rates and easing of monetary conditions.

Previously, in late 2022, the Central Bank informed the banks and financial markets of the need for a downward adjustment of prevailing excessive market interest rates to create grounds for domestic economic activity to recover. However, following intensive negotiations with the International Monetary Fund (IMF), the Central Bank tightened monetary policy by raising its policy interest rates by 100 bps in March 2023 in fulfilment of one of the prior actions of the Extended Fund Facility (EFF), while reiterating its commitment to easing its stance on monetary policy no sooner the price pressures subside adequately.

**Monetary Policy Decisions during H1-2023:**

| Jan 2023 | Mar 2023 | Apr 2023 | Jun 2023 | Jul 2023 |
|---|---|---|---|---|
| Policy interest rates were maintained at 14.50% (SDFR) and 15.50% (SLFR) | Policy interest rates were raised by 100 bps to 15.50% (SDFR) and 16.50% (SLFR) | Policy interest rates were maintained at 15.50% (SDFR) and 16.50% (SLFR) | Policy interest rates were reduced by 250 bps to 13.00% (SDFR) and 14.00% (SLFR) | Policy interest rates were reduced by a further 200 bps to 11.00% (SDFR) and 12.00% (SLFR) |

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# 2. INFLATION AND ECONOMIC OUTLOOK

Medium-term macroeconomic projections arrived at by the Central Bank staff, in support of the monetary policy decision during July 2023, are illustrated in this section, with a focus on the projections of inflation and real economic growth.[1] These projections reflect the available data, assumptions and judgements made at the July 2023 forecast round and are considered as the *baseline forecast* in this Report.

## 2.1. Baseline Forecast

As per medium-term macroeconomic projections in the July 2023 monetary policy round, headline inflation is expected to continue its decelerating trend over the short term, and gradually stabilise around the targeted mid-single-digit level over the medium term. Economic growth is expected to remain subdued over the short term, but is expected to recover gradually towards its potential.

### Prospects for Inflation

According to the present baseline forecast, headline inflation is projected to temporarily dip below mid-single-digit level, and subsequently stabilise around the targeted level in the medium term. The projected path for headline inflation indicates a further declining trend, contributed by tight monetary and fiscal policy actions undertaken thus far. As illustrated in the inflation fan chart, headline inflation is expected to stabilise around mid-single-digit level over the medium term. This projection is subject to considerable uncertainty, driven by large swings recently observed in the macroeconomic indicators of Sri Lanka. Among the factors that contribute to this outlook, expected monetary and fiscal policy measures play a major role. Tight fiscal measures, characterised by reduced government spending and increased taxes, could have a contractionary effect on the economy. Further, tight monetary conditions driven by both the Real Interest Rate (RIR) and the Real Effective Exchange Rate (REER) remaining above their trends,[2] are also anticipated to have a restraining impact on the economy, dampening aggregate demand over the short- to medium term.[3] However, as policy measures are gradually normalised along

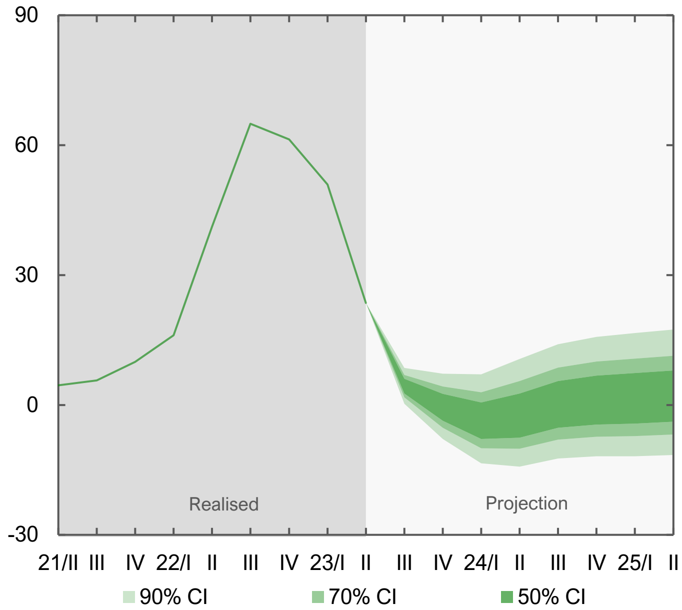
[1] The Central Bank uses a Quarterly Projection Model (QPM), a semi-structural macroeconomic model, to arrive at medium-term macroeconomic projections, with the use of available data, near-term forecasts of key variables, global macroeconomic projections, and assumptions and judgments. These projections are updated on a quarterly basis, along with the quarterly data releases on GDP by the Department of Census and Statistics.

[2] The trends of respective variables are modelled within QPM, and they are used to evaluate the gaps, which are the primary drivers of the model behaviour.

[3] In QPM, monetary conditions can be tight due to either the RIR gap or the REER gap being high. As per current projections, the real interest rate exceeds its trend over the immediate period ahead, driven by high nominal rates and falling inflation. This could lead to low growth via reduced levels of both consumption and investment expenditure amidst high borrowing costs. At the same time, in the model, the real effective exchange rate exceeds the trend due to the appreciated nominal exchange rate, and it could affect economic growth prospects negatively due to low external demand.

with the anticipated recovery of the economy, inflation is also expected to stabilise around the targeted level in the medium term.

**Figure 01: Projected Headline Inflation**
**(Quarterly, Colombo Consumer Price Index (CCPI), year-on-year, %)**

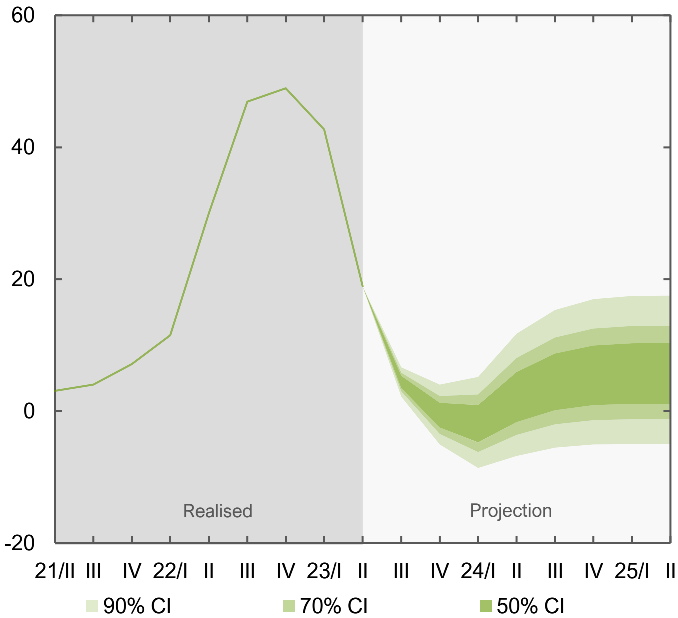



Source: Central Bank Staff Projections

***Note: A forecast is neither a promise nor a commitment***
Given the prevailing domestic and global economic uncertainties and geopolitical tensions, the risks associated with the current projections are higher than in normal times. Any notable change in the underlying assumptions and judgments could lead to the realised inflation path deviating from the projected path. Medium-term macroeconomic projections, together with the fan charts will be updated during the monetary policy cycle in October 2023, along with the release of Q2 2023 GDP data by the Department of Census and Statistics.

When components of inflation are considered, the reduction in core inflation, which excludes goods and services with volatile prices, such as food and energy, and thereby is usually considered as a broad measure of fundamental demand pressures in the economy, contributes substantially to the moderation of headline inflation, while the normalisation of volatile food inflation and energy and transport inflation also helps the same. Core inflation is also following a disinflationary trend, although at a relatively slow pace compared to headline inflation. This difference is primarily attributed to the larger disinflationary impact observed in the food, energy, and transport categories, which are not included in the core basket of the Consumer Price Index (CPI). The disinflationary trajectory of core inflation is mainly influenced by tight monetary and fiscal policies and the anchoring of inflation expectations. However, the implementation of growth-oriented policies is anticipated to improve activity in the economy, thereby bringing the output growth closer to its potential. Consequently, this is expected to contribute to the stabilisation of core inflation over the medium term along with the expected normalisation of demand conditions.

**Figure 02: Projected Core Inflation (Quarterly, CCPI, year-on-year, %)**




Source: Central Bank Staff Projections

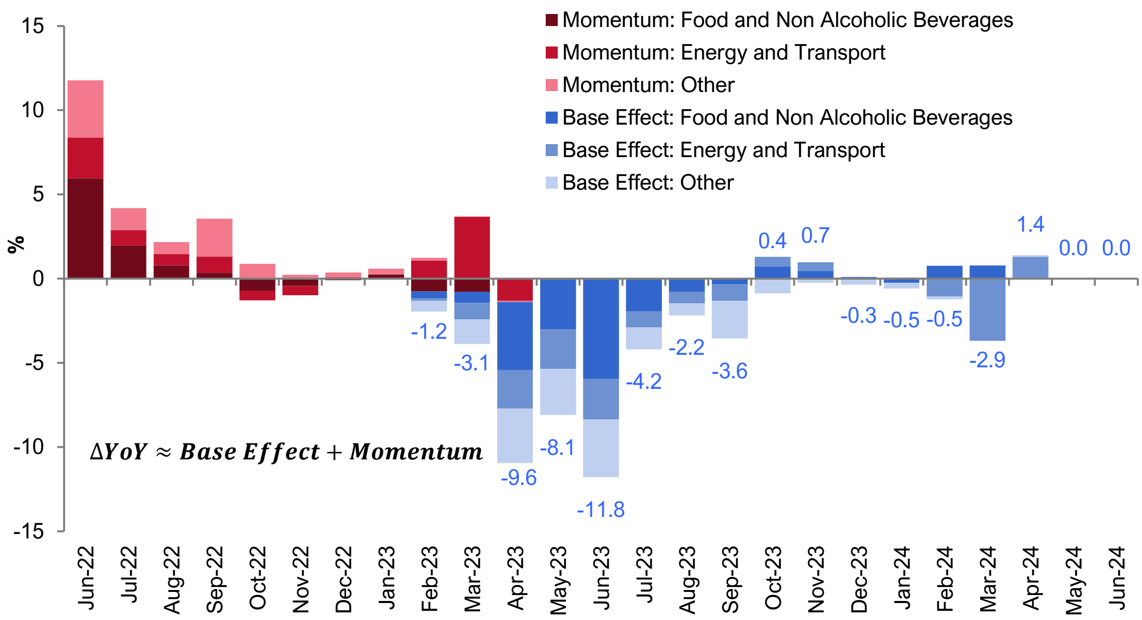
***Note: A forecast is neither a promise nor a commitment.***
Given the prevailing domestic and global economic uncertainties and geopolitical tensions, the risks associated with the current projections are higher than in normal times. Any notable change in the underlying assumptions and judgments could lead to the realised inflation path deviating from the projection.

Other important factors contributing to the envisaged decline of inflation include the expected moderation of world energy prices and food inflation. Therefore, the favourable base effect in the energy and transport categories, along with the volatile food category, contributes to the disinflation outlook.

***Inflation Expectations***

Looking at the historical data and the Central Bank's inflation expectations survey, it is evident that the corporate sector's inflation expectations for both short and longer tenures have mostly stayed within single-digit levels when headline inflation was also in single digits. In general, inflation expectations have broadly followed the trend of realised inflation. It was observed that inflation expectations in all tenures remained high until the early months of 2023. Nevertheless, the inflation expectation trend across all tenures was on a gradual downward path in line with the deceleration in actual inflation by June 2023 survey round. As per the survey responses, the anticipated softening of inflation in the period ahead would be mainly due to the relaxation of import restrictions, decreases in utility and fuel costs, and improvements in domestic supply conditions.

**Figure 03: Momentum (M-o-M Inflation) and the Base effect (Based on CCPI, 2021=100)**




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

***Note**: Inflation is usually measured as a year-on-year (y-o-y) change of the consumer price index (CPI) (i.e., by comparing the current month's prices with the prices of the corresponding month in the previous year) or a month-on-month (m-o-m) change of the same (i.e., by comparing the prices between the current month and the previous month). The difference between y-o-y inflation in two subsequent months is **approximately equal** to the difference between the m-o-m inflation in the current month (these price changes between two adjacent months reflect economic factors) and the m-o-m inflation twelve months earlier (this reflects statistical factors). Economic factors arising from the price movement of different commodities in the CPI basket can be ascribed as **momentum**. On the other hand, the statistical factors stem from the price changes twelve months earlier, which can be considered the **base effect**. The impact of the base effect is a key driver to the misunderstanding between y-o-y inflation and price level. For example, consider a month where prices had recorded a substantial increase during the corresponding month of the previous year, and remained relatively stable afterwards. In this case, y-o-y inflation would record a reduction during the current month compared to the previous month, however, compared to the price level that prevailed earlier (say 13 months before) current prices would still be at an elevated level.*

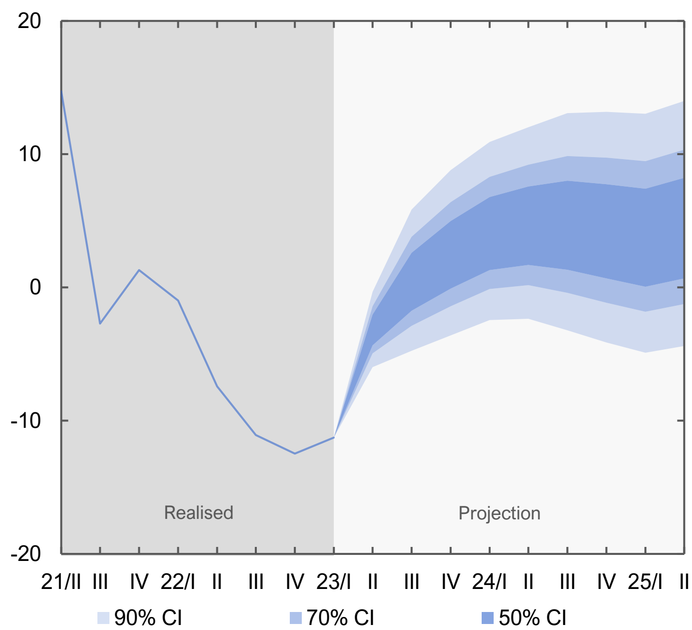
*Based on the above figure, it is evident that one of the primary drivers behind the disinflationary trend observed in the second quarter of 2023 is the base effect. This can be attributed to the substantial price increases witnessed during the second quarter of 2022. In the upcoming months, it is expected that the relatively small base effect, combined with low momentum, will contribute towards stabilising inflation.*

### Prospects for Real Economic Growth

The latest forecasts indicate that the real economy is expected to continue the contraction in the immediate period ahead as well, but a gradual rebounding is possible afterwards. On the back of the lower-than-expected growth realised in Q1 2023, available leading indicators and the overall slowdown in economic activities suggest that the economy may record a contraction in Q2 2023, although at a lower magnitude than in the first quarter. However, it is expected that the economy will gradually recover during the second half of 2023. Despite the contraction in real GDP anticipated for 2023, the magnitude of this contraction is expected to be less severe compared to the previous year.

Several favourable conditions are expected to support the economy in reaching its full capacity level over the medium term. First, the gradual easing of monetary policy is anticipated to reduce its contractionary impact on output with a delay. This accommodative monetary policy stance is likely to have a positive effect on economic growth by stimulating investment, increasing consumer spending, and ultimately driving up aggregate demand. An improvement in economic activity is predicted to emerge among Sri Lanka's major trading partners, and this development is expected to positively impact the domestic economy through increased exports. Moreover, the implementation of important structural reforms and the anticipated increased efficiency of the public sector, driven by the fiscal institutional reforms currently in progress, are also expected to support economic growth over the medium term.

**Figure 04: Projected Quarterly GDP Growth (%, Y-o-Y)**




Source: Central Bank Staff Projections

***Note: A forecast is neither a promise nor a commitment.***
Given the volatile global environment and the uncertainties in the domestic economy during the crisis, the baseline forecasts are exposed to various potential upside and downside risks. Details on the risk to the baseline forecast are discussed under the "Risks to Inflation and Economic Growth Projections" section. Any notable change in the underlying assumptions and judgments could lead to the realised growth path deviating from the projection.

## 2.2. Key Assumptions Underpinning the Forecast

### Global Environment

The economic performances of the main trading partners of Sri Lanka, relative to their respective potential levels, are expected to improve in the near term, particularly when compared against previously reported information. This improvement is mainly driven by the strong growth of major emerging economies in this year, especially, India and China. The projections of the Global Projection Model Network (GPMN)[4] on the US policy rate reflect the Federal Reserve's stance that indicates the possibility of one more rate hike this year and the assumption that policy relaxation may not commence until 2024. As per GPMN, the outlook for petroleum oil and food inflation remain broadly unchanged compared to the previous monetary policy cycles.

### Fiscal Path

For the baseline projections, the fiscal path is assumed to be in line with the projections based on the post-debt restructuring scenario.

**Table 01: Assumptions of the Fiscal Balances**

| As a % of GDP | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|
| **Budget Deficit** | 8.0 | 6.4 | 5.0 | 4.8 | 4.5 |
| **Central Government Debt** | 100.0 | 101.6 | 103.3 | 102.2 | 97.6 |
| **Debt Cost** | 7.3 | 7.2 | 7.3 | 7.1 | 6.8 |

Sources: Ministry of Finance, Economic Stabilization and National Policies , IMF Country Report, 20 March 2023

## 2.3. Risks to Inflation and Economic Growth Projections

There are both upside risks and downside risks to the baseline projections for both inflation and GDP growth. In the event that economic conditions unfold in an unforeseen manner, the assessment of the appropriate policy rate path by the Central Bank would subsequently be revised to align with the new circumstances.

[4] The Central Bank uses projections of global macroeconomic indicators prepared by GPMN as inputs for medium term projections.

### Risks to Inflation Projections

When downside risks are considered, a potential passthrough of the benefits of realised exchange rate appreciation to domestic price levels could take place, particularly amidst the pressures from the public. Moreover, faster recovery of supply conditions driven by further extensions to fertiliser distribution and recovery of sectors affected by import restrictions; the sustained impact of the diminished purchasing power of the public; any possible quicker-than-anticipated easing of world commodity prices; and any fuel price reductions due to favourable movements of global oil prices and the exchange rate could positively contribute to the disinflation process.

There could be upside risks to baseline inflation projections arising from the stickiness of passing of the downward adjustments in fuel prices to the prices of goods and services; any deviation from the expected fiscal consolidation path; exchange rate depreciation pressures, if any, with the expected further relaxation of import restrictions and capital flow measures, and relaxed monetary policy; a faster-than-expected recovery of demand owing to increased availability of imported goods and credit amidst the removal of import restrictions and monetary easing; and possible adverse weather conditions, which could affect agricultural production negatively, leading to upward pressure on food inflation.

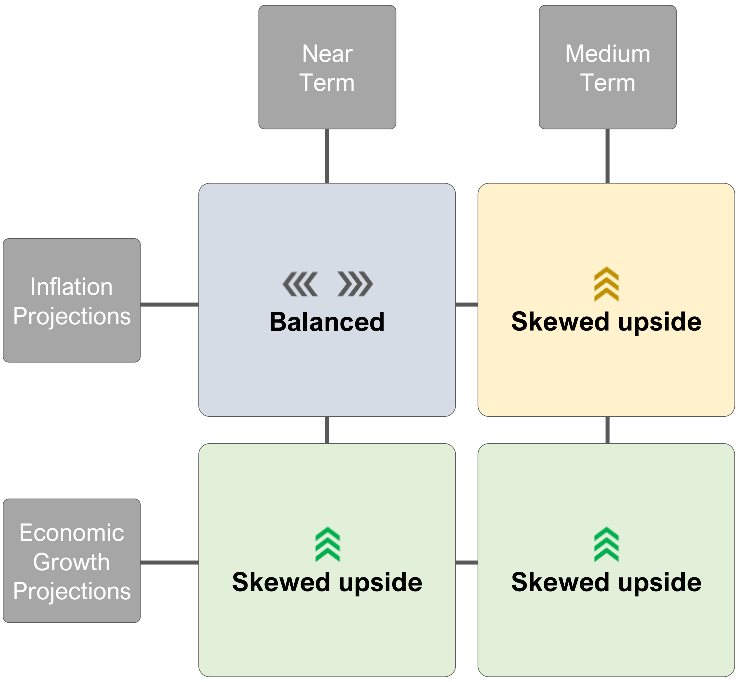
### Risks to Economic Growth Projections

Potential downside risks that could affect growth projections in the near to medium term include the weaker demand for the export sector, labour shortages and low productivity resulting from significant professional and skilled migrations, and any adverse effects of possible weather anomalies on agriculture activities.

There could be several upside risks to the growth outlook. The improved sentiments, which could lead to a faster recovery of activity, any faster-than-expected recovery of the tourism and related sectors, investment to the Port City project and other capital infrastructure developments, alongside any faster-than-expected recovery in global trading partners that could be favourable for the recovery of external demand may contribute to improving overall economic performance.

A major factor that affects the economic outlook is the timely completion of the debt restructuring process and the continuation of the reform agenda of the Government under the Extended Fund Facility supported programme of the of the International Monetary Fund (IMF).

**Figure 05: Balance of Risks to Projections**



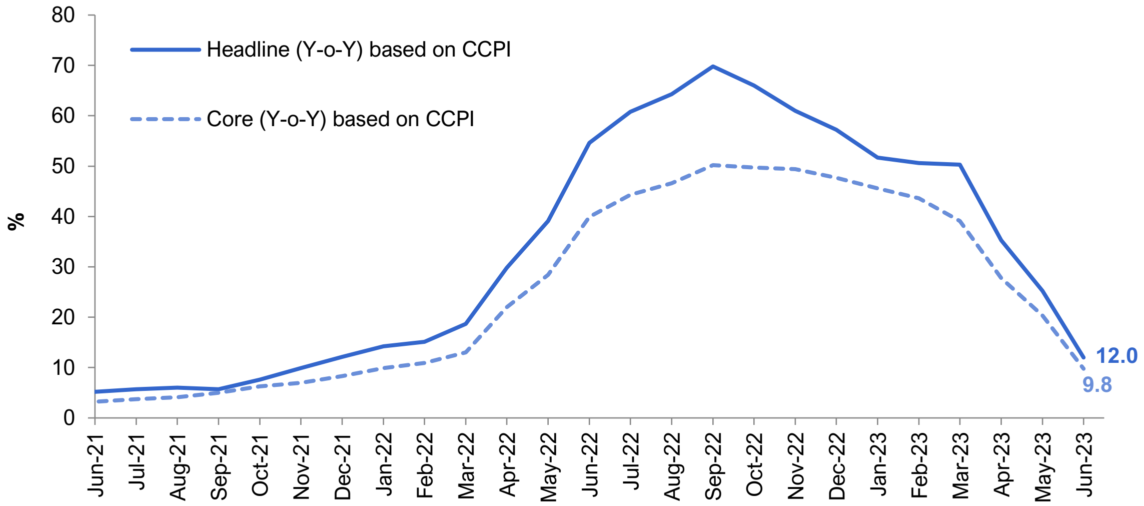

Source: Central Bank Staff Projections

# 3. CURRENT ECONOMIC CONDITIONS

## 3.1. Inflation

***Inflation continued to decelerate faster than projected and is expected to reach single-digit level in July 2023.***

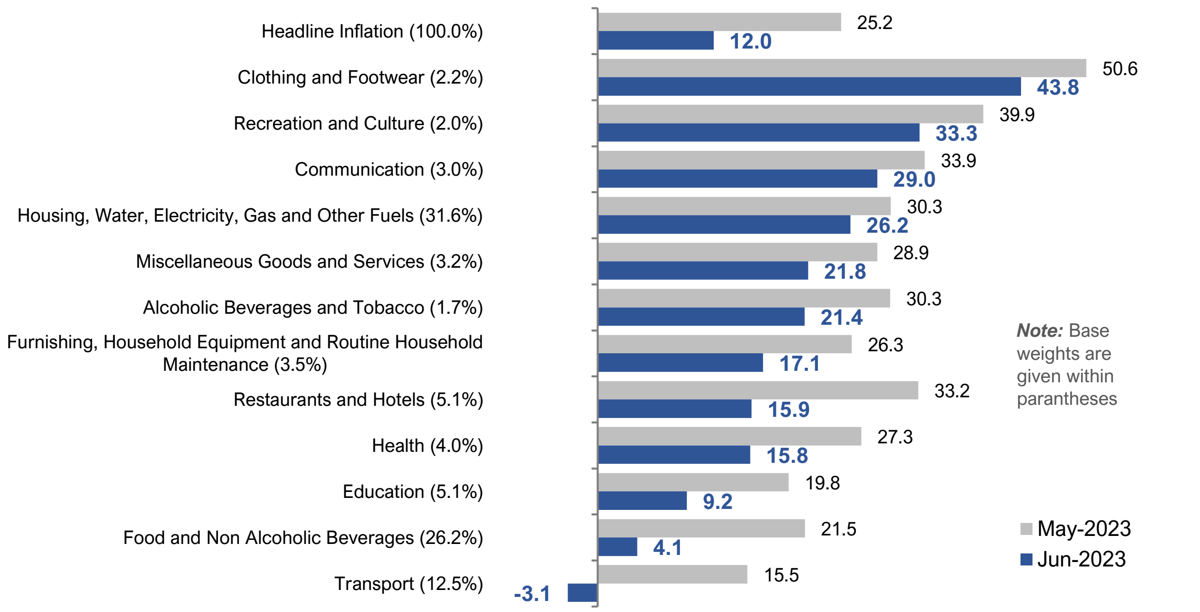
**Figure 06: Movements in Monthly Headline and Core Inflation (year-on-year, %)**




Source: Department of Census and Statistics

The unprecedented acceleration of headline inflation during 2022 was mainly due to the notable rise in food prices and other supply side disruptions, the sharp depreciation of the Sri Lanka rupee against the US dollar and the subsequent adjustments in administered prices, such as energy and transport prices and their spillovers, and unabating aggregate demand pressures owing to the lagged impact of monetary accommodation during the past few years. Subsequent to reaching a historic high in September 2022, consumer price inflation commenced a descending path thereafter with the realisation of the impact of tight monetary and fiscal conditions and the gradual easing of supply-side disruptions, also supported by the appreciation of the Sri Lanka rupee against the US dollar thus far in 2023. Accordingly, CCPI-based headline inflation (year-on-year), which accelerated to 69.8 per cent in September 2022 (CCPI, 2013=100), moderated to 57.2 per cent by December 2022 (CCPI, 2013=100). This downward trend in headline inflation continued into 2023. Although the pace of deceleration was slower in Q1-2023, driven by the impact of the upward electricity price revision effected in February 2023, headline inflation declined sharply from April 2023 onwards. Accordingly, CCPI-based headline inflation (year-on-year) decelerated to 12.0 per cent in June 2023 (CCPI, 2021=100), driven by the softening of energy and food prices along with a favourable base effect. After two years, CCPI-based food inflation (year-on-year) decreased to a single-digit level of 4.1 per cent in June 2023 (CCPI, 2021=100), while the CCPI-based non-food inflation (year-on-year) decreased further to 16.2 per cent in June 2023 (CCPI, 2021=100). Following a similar trend, the National Consumer Price Index (NCPI) based headline inflation (year-on-year) also decelerated to 22.1 per cent in May 2023 (NCPI, 2021=100), from a peak level of 73.7 per cent in September 2022 (NCPI, 2013=100) and 59.2 per cent by end 2022 (NCPI, 2013=100), owing to the deceleration in both food and non-food inflation.

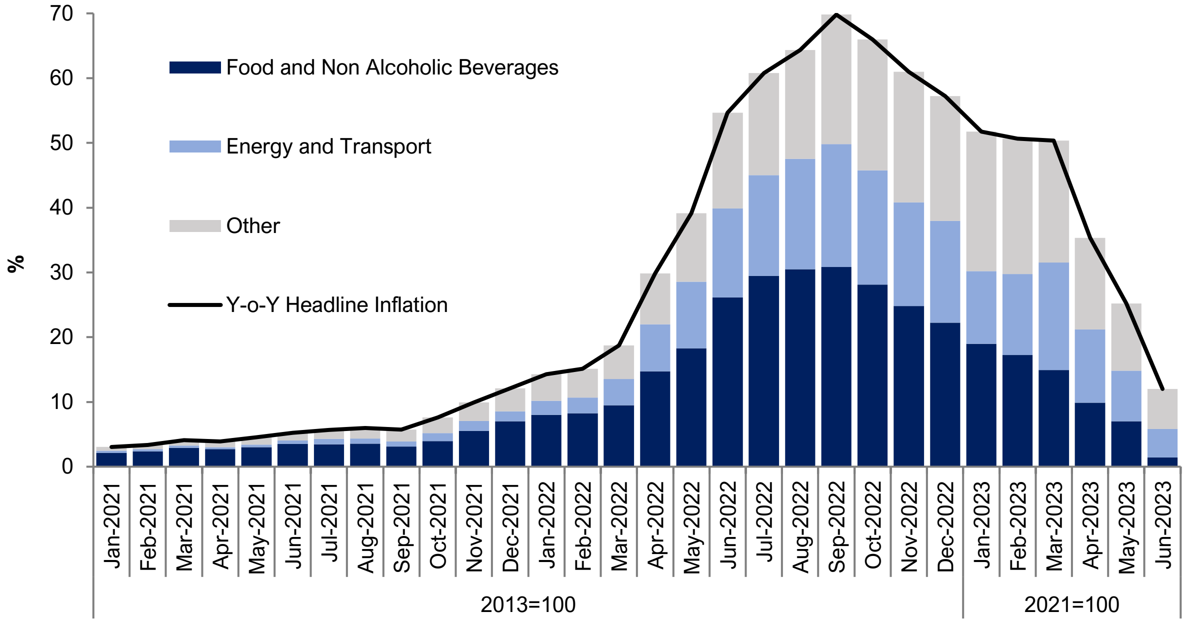
**Figure 07: Category-wise Year-on-Year Headline Inflation (CCPI, %)**




Source: Department of Census and Statistics

CCPI-based core inflation (year-on-year), which reflects underlying inflation, moderated to a single-digit level of 9.8 per cent in June 2023 (CCPI, 2021=100), compared to 47.7 per cent recorded at end 2022 (CCPI, 2013=100), while NCPI-based core inflation (year-on-year) decelerated to 21.6 per cent in May 2023 (NCPI, 2021=100), in comparison to 57.5 per cent in December 2022 (NCPI, 2013=100), contributed by a decline in momentum in the non-volatile food category, as well as a favourable base effect. The normalisation of core inflation has been slower than that of headline inflation, due to relatively larger changes observed in the volatile food and energy and transport components, which are excluded from core inflation. As a result, the relative contribution to inflation from categories other than food items and energy and transport seems to be increasing in recent months, although in absolute terms this component is also gradually declining.

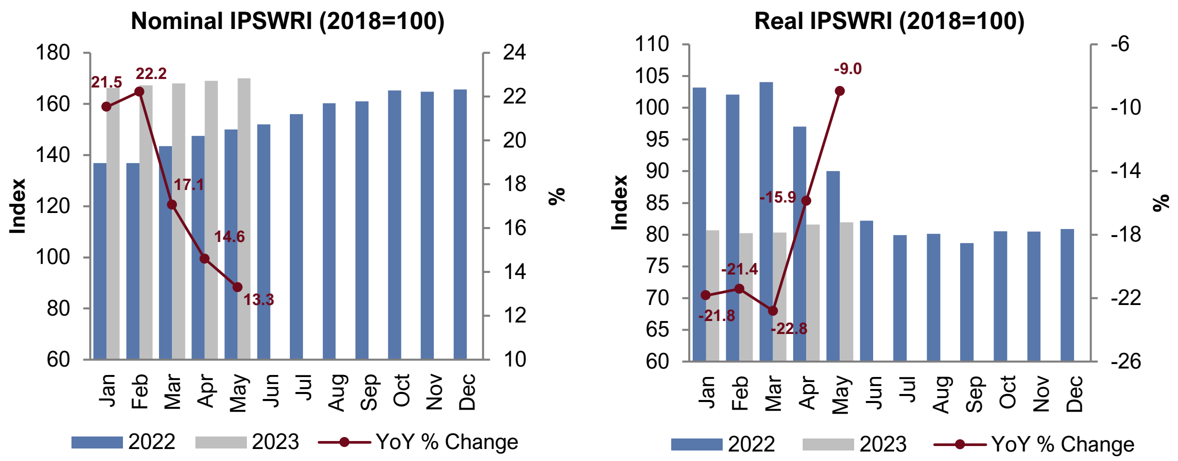
**Figure 08: Contribution to Headline Inflation (CCPI)**




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

The informal private sector wage rate index (IPSWRI) (2018=100), in nominal terms, continued to increase in May 2023, however at a slower pace compared to the preceding months. The nominal informal private sector wage rate index (IPSWRI) (2018=100) increased on a month-on-month basis by 0.6 per cent in May 2023, compared to April 2023. This rise was due to increases observed in wages of Industry (0.8 per cent) and Services (1.1 per cent) activities, while Agriculture activities remained unchanged in May 2023, compared to the previous month. In real terms, the IPSWRI decreased by 0.4 per cent in May 2023 over the previous month, while on a year-on-year basis, it recorded a decline of 9.0 per cent.

**Figure 09: Movements in the IPSWRI (2018=100)**




Source: Central Bank of Sri Lanka

## 3.2. Real Sector

***Lingering effects of the economic disturbances associated with the unprecedented economic crisis in 2022 led to a further contraction in the real economy during Q1-2023.***

As per the GDP estimates published by the Department of Census and Statistics (DCS), the real economy contracted notably by 11.5 per cent, year-on-year, in Q1-2023 over a contraction of 0.5 per cent recorded in the corresponding period of 2022.

During Q1-2023, the Agriculture sector grew marginally by 0.8 per cent (year-on-year), driven mainly by the positive performances of rice, cereals and freshwater fishing subsectors. Meanwhile, the Industry sector recorded a notable contraction of 23.4 per cent (year-on-year), largely due to lacklustre performance in the subsectors of construction, manufacturing, as well as mining and quarrying. The Services sector reported a year-on-year contraction of 5.0 per cent during the quarter, reflecting the significant contraction in financial, insurance, and real estate services.

**Table 02: Estimates of Real GDP Growth (year-on-year, %) (Provisional)**

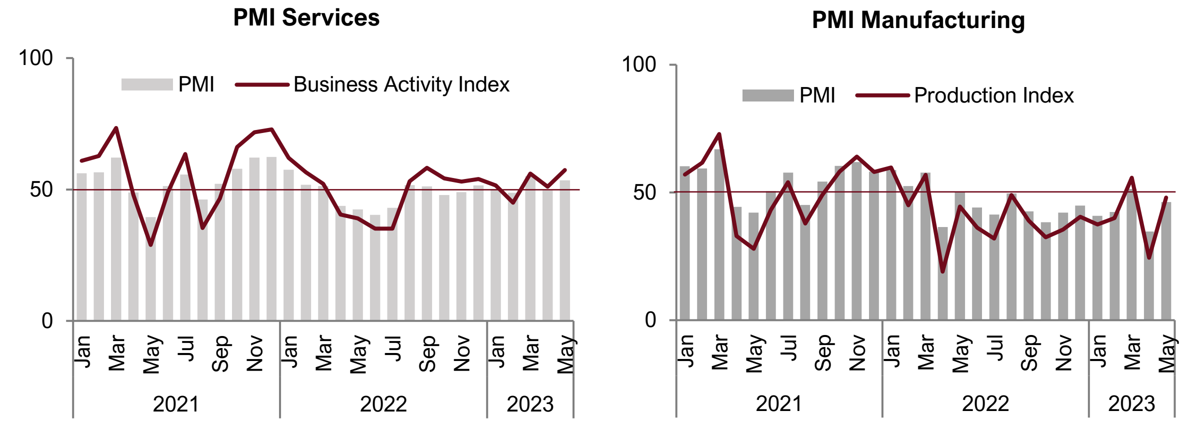
| | 2022 | | | | | 2023 |
|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Annual | Q1 |
| Agriculture | -4.4 | -7.9 | -6.7 | 0.7 | -4.6 | 0.8 |
| Industry | -3.7 | -10.1 | -21.3 | -30.1 | -16.0 | -23.4 |
| Services | 1.8 | -1.8 | -4.2 | -3.9 | -2.0 | -5.0 |
| **GDP** | **-0.5** | **-7.4** | **-11.5** | **-12.4** | **-7.8** | **-11.5** |

Source: Department of Census and Statistics

The leading indicators of economic activity showed mixed performance during April-May 2023. Services sector PMI returned to the growth territory in May 2023, following the marginal drop observed in the previous month, while manufacturing PMI declined in both the months of April and May 2023, albeit at a slower rate. However, the Index of Industrial Production (IIP), recorded a month-on-month growth of 9.9 per cent in May 2023, while recording a year-on-year contraction of 3.1 per cent during the month. Having recorded contractions since March 2022, cement availability in the domestic market recorded a year-on-year expansion of 9.0 per cent in May 2023, reflecting some demand recovery in the domestic construction sector.

During Q2-2023, services activities are expected to have recorded a contraction, largely driven by the setback in financial services, and wholesale and retail trade activities, while Industry activities are also expected to have contracted, mainly due to the contraction in manufacturing and construction activities. However, Agriculture activities are projected to have grown in Q2-2023, largely due to the recovery in the growing of rice and cereals supported by the adequate supply of required fertilisers and agrochemicals for cultivation. Overall, the real economy is expected to have contracted in Q2-2023. However, the economy is expected to gather its recovery pace towards the end of 2023 along with the gradual restoration of economic stability.

**Figure 10: Movements in Leading Economic Indicators**




Source: Central Bank of Sri Lanka

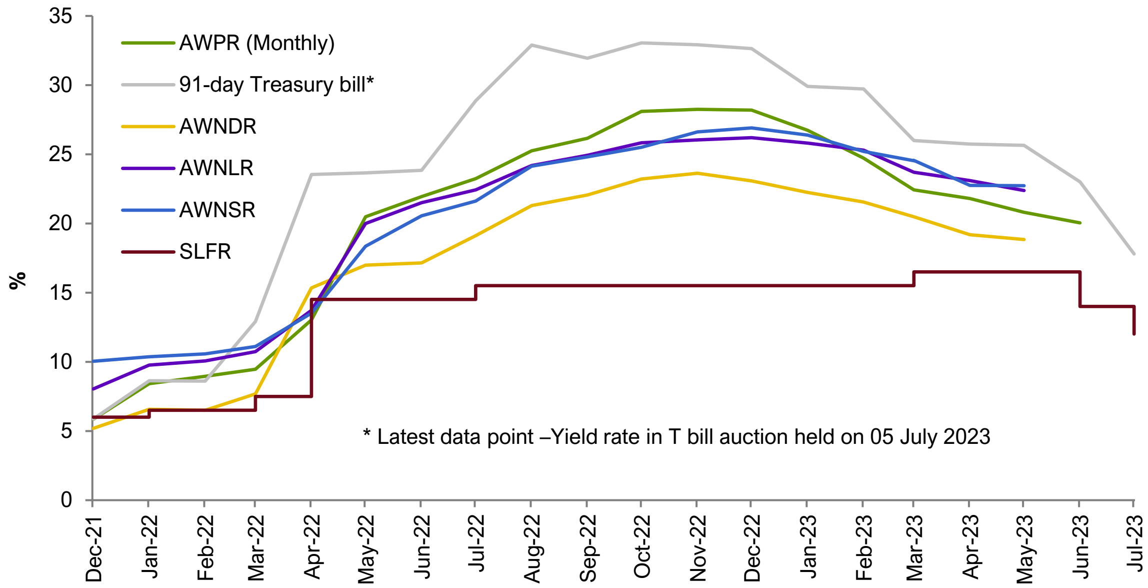
## 3.3. Monetary Sector

### Interest Rates

***Market interest rates continue to adjust downwards, and a further reduction is expected in the coming period in response to the policy rate reduction thus far in 2023. A notable reduction is observed in yields on government securities as well.***

Although both market deposit and lending interest rates have continued to adjust downwards thus far during 2023, the pace of reduction in lending rates has been slow. In particular, retail deposit interest rates have declined notably since the Central Bank commenced easing its monetary policy stance in June 2023.

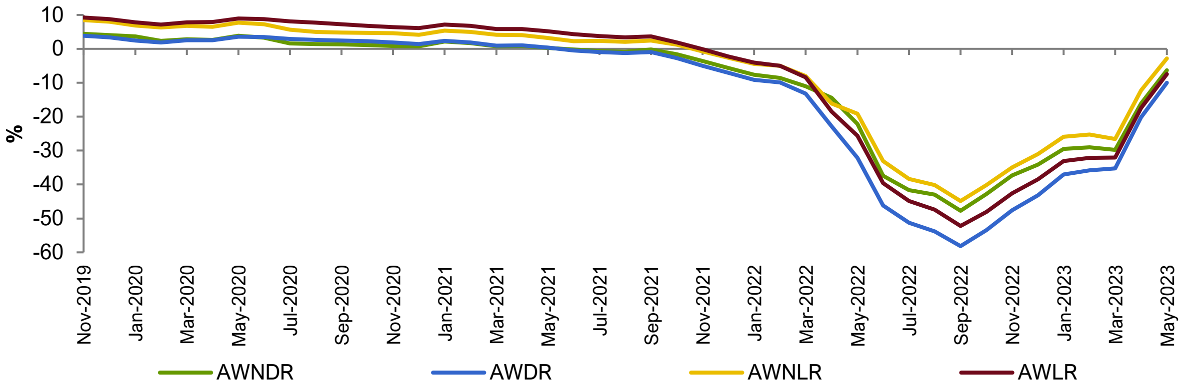
**Figure 11: Movement of Selected Market Interest Rates**




Source: Central Bank of Sri Lanka

The Average Weighted New Deposit Rate (AWNDR) and the Average Weighted New Lending Rate (AWNLR) declined by 4.2 percentage points and 3.8 percentage points, respectively, by end May 2023, compared to end 2022. Although there were some weekly volatilities, the Average Weighted Prime Lending Rate (AWPR) also adjusted downwards by 7.8 percentage points by end June 2023, compared to the levels recorded at end 2022. Yields on government securities rapidly adjusted downwards in response to the reduction in policy interest rates since June 2023. The yields on government securities declined further in July 2023 with the announcement of the DDO operation, as the risk premia associated with the uncertainties largely dissipated. Accordingly, yields on Treasury bills decreased by a range of 5.2-6.0 percentage points by 05 July 2023 since the easing of the monetary policy stance in June 2023. The DDO announcement will facilitate further reductions in other market interest rates, enabling them to stabilise at lower levels in the period ahead, along with the eased monetary policy stance. Meanwhile, given the faster than expected disinflationary path, real interest rates are less accommodative, while forward looking real interest rates are largely positive.

**Figure 12: Ex-Post Real Interest Rates**



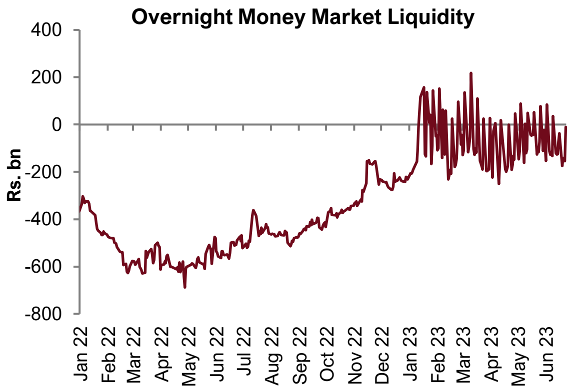

Source: Central Bank of Sri Lanka

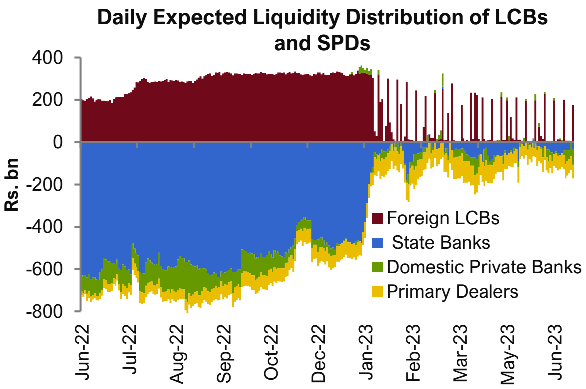
Overall, the Central Bank expects a further downward adjustment in market interest rates, particularly lending interest rates, which show signs of downward rigidity. However, if the financial sector fails to pass on the benefits of the reduction of policy interest rates and the interest rate risk premia to businesses and individuals without delay, the Central Bank will consider taking appropriate administrative measures to ensure a swifter passthrough of the effects of recent policy measures.

## Domestic Money Market Liquidity

***Overnight liquidity in the domestic money market declined recently and continues to fluctuate due to restrictions imposed on the standing facilities of the Central Bank.***

**Figure 13: Behaviour of Overnight Liquidity**




Source: Central Bank of Sri Lanka

Among the major factors that contributed to the movements in money market liquidity thus far in 2023, net foreign exchange purchases by the Central Bank were recorded as the main positive contributor, whereas net Treasury bill transactions by the Central Bank remained the main negative contributor. The asymmetric distribution of liquidity among Licensed Commercial Banks (LCBs) continued, with certain domestic banks recording persistent liquidity deficits, while foreign banks maintained large liquidity surpluses. Meanwhile, the liquidity deficit of the Standalone Primary Dealers (SPDs) somewhat declined. Reverse repo auctions were conducted on a large scale to provide sufficient liquidity to the market and induce a downward adjustment in AWCMR in line with the current monetary policy stance of the Central Bank.

## Money and Credit

***Growth of broad money ($M_{2b}$) supply moderated notably thus far in 2023 impacted by the lagged effects of the significant tightening of monetary policy, with domestic credit (excluding Net Credit to the Government (NCG)) contracting amidst an improvement in the net foreign assets (NFA) of the banking system.***

As monetary conditions remained notably tight with market lending interest rates remaining high, outstanding credit to the private sector as well as State Owned Business Enterprises (SOBEs) recorded contractions contributing to the slowing of the expansion of broad money supply. Credit extended to the private sector contracted by around Rs. 393 billion during the period from January-May 2023, recording a contraction of 9.5 per cent, year-on-year, by end May 2023. This also marks the longest streak in monthly contractions as credit to the private sector contracted for the twelfth consecutive month since June 2022. While lending to productive sectors of the economy remained subdued, credit to certain consumption related sectors recorded a considerable growth. Credit to SOBEs by LCBs contracted by around Rs. 680 billion during the period from January-May 2023 due to the net settlement of liabilities by the Ceylon Petroleum Corporation (CPC) amidst the recent appreciation of the exchange rate and the transfer of government guaranteed debt (to LCBs) obtained by CPC to the Government, causing a substantial drop in SOBEs' debt liabilities to LCBs.

**Table 03: Change in Domestic Credit**

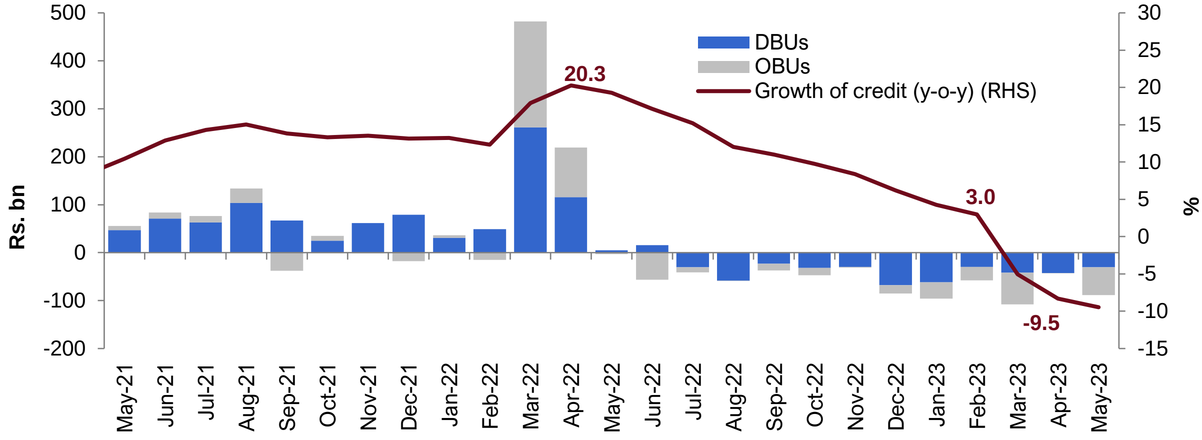
| | | 2021 | 2022 | Jan 2023 | Feb 2023 | Mar 2023 | Apr 2023 | May 2023 | Jan-May 2023 (Prov.) |
|---|---|---|---|---|---|---|---|---|---|
| NCG | Net Change (Rs. bn) | 1,284.4 | 1,638.7 | 140.5 | (140.7) | 97.2 | 523.0* | 19.8 | 639.8 |
| Credit to SOBEs | Net Change (Rs. bn) | 185.9 | 558.9 | 0.8 | (35.9) | (118.9) | (463.0)* | (63.1) | (680.2) |
| Credit to the Private Sector | Net Change (Rs. bn) | 810.5 | 432.7 | (96.1) | (57.6) | (107.6) | (43.2) | (88.8) | (393.4) |
| | Y-o-Y Growth (%) | 13.1 | 6.2 | 4.3 | 3.0 | (5.1) | (8.3) | (9.5) | (5.3) (a) |

(a) Year-to-date growth

* With the approval of the Cabinet of Ministers at its meeting held on 30 January 2023, the government guaranteed outstanding foreign currency debt of the CPC was absorbed into central government debt with effect from end December 2022, in line with the actions agreed under the IMF-EFF arrangement to restructure the balance sheets of selected 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 SOBEs and an expansion in NCG.

Source: Central Bank of Sri Lanka

**Figure 14: Monthly Change in Credit to the Private Sector by LCBs**

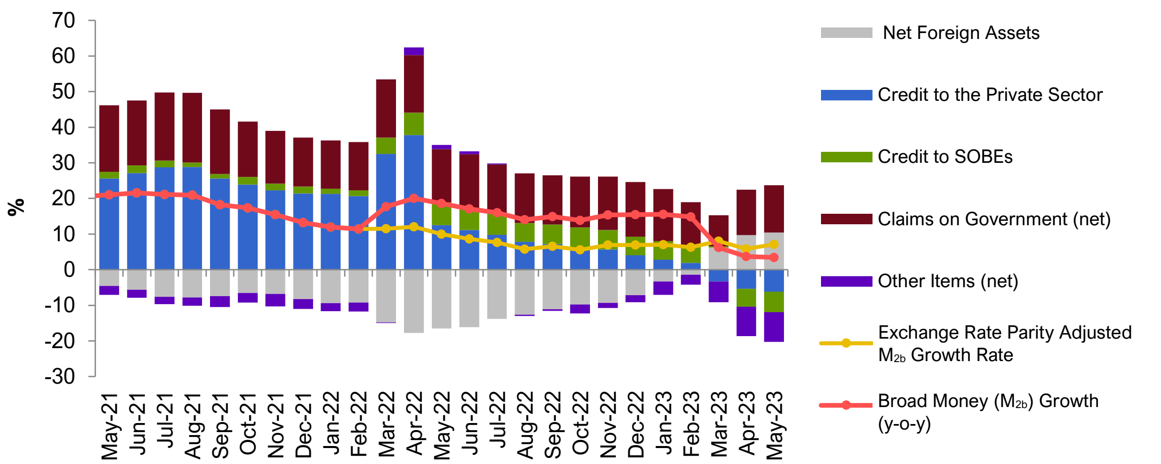



Source: Central Bank of Sri Lanka

However, NCG by the banking system continued to expand in May 2023 as NCG by LCBs increased despite a contraction in NCG by the Central Bank. Moreover, amidst the appreciation of the Sri Lanka rupee against the US dollar, NFA of the banking system improved notably by around Rs. 929 billion during the period from January-May 2023.

Driven by these developments, the year-on-year growth of broad money ($M_{2b}$) decelerated to 3.4 per cent by end May 2023. Upon adjusting for the impact of the appreciation of the exchange rate, the year-on-year growth of broad money is estimated to have accelerated to 7.1 per cent by end May 2023.

**Figure 15: Contribution to Y-o-Y Growth of Broad Money ($M_{2b}$)**



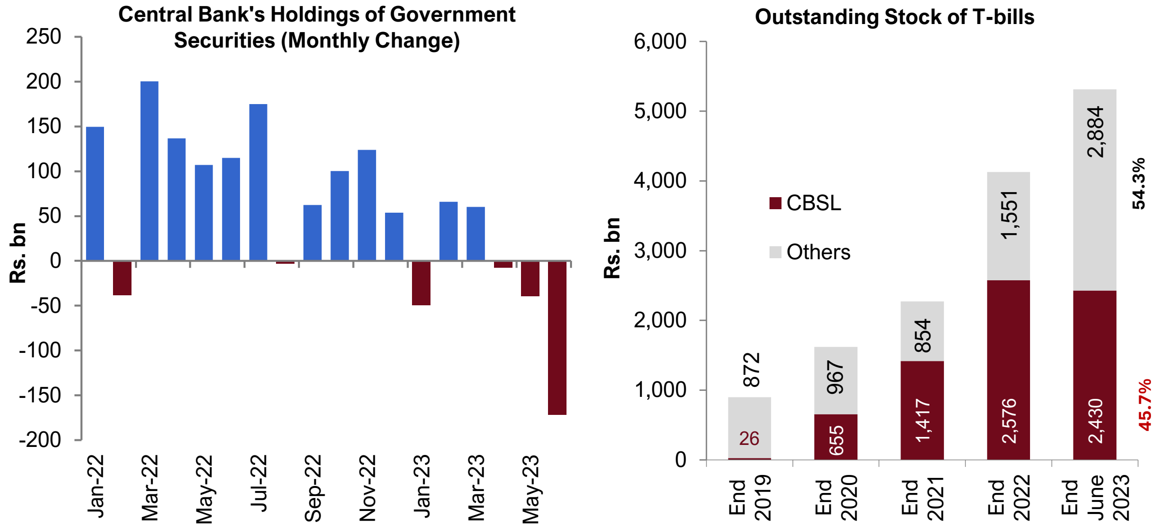

Source: Central Bank of Sri Lanka

***A notable reduction was observed in the Central Bank's holdings of government securities since April 2023.***

The Central Bank's holdings of government securities recorded a contraction during the period April-June 2023 as the upsized Treasury bill auctions and the proceeds from Phase II of the Treasury bill auctions helped offload a part of the Central Bank's holding of Treasury bills.

Accordingly, the Central Bank's holdings of Treasury bills (face value) declined to Rs. 2.4 trillion by end June 2023, compared to a high level of around Rs. 2.8 trillion in May 2023. With this, the quantitative performance criteria (QPC) under the IMF–EFF arrangement on NCG by the Central Bank for June 2023 was over-achieved.

**Figure 16: The Central Bank's Holdings of Government Securities and the Outstanding Stock of Treasury-bills**




Source: Central Bank of Sri Lanka

In terms of domestic credit by the banking system, credit to the private sector is expected to make a gradual recovery in the second half of 2023. However, due to the significant contraction of private sector credit thus far, credit growth, on a year-on-year basis, is expected to record a subdued level by the end of 2023. NCG by the banking system is set to expand during the year, albeit at a lower scale, when compared to 2022, as NCG by the Central Bank is envisaged to contract in line with the targets set for unwinding the monetary financing as per the IMF-EFF supported programme. However, NCG by LCBs is expected to remain high during the year leading to the projected expansion of NCG in 2023. Credit to SOBEs is expected to contract in 2023 due to their improved financial positions amidst cost-reflective pricing mechanisms as well as the transfer of CPC's outstanding liabilities from the banking sector to the Government. NFA of the banking system is expected to improve during the year as economic conditions improve with the envisaged foreign currency inflows to the country. Considering all these developments, broad money ($M_{2b}$) is expected to record a tepid growth over the previous year.

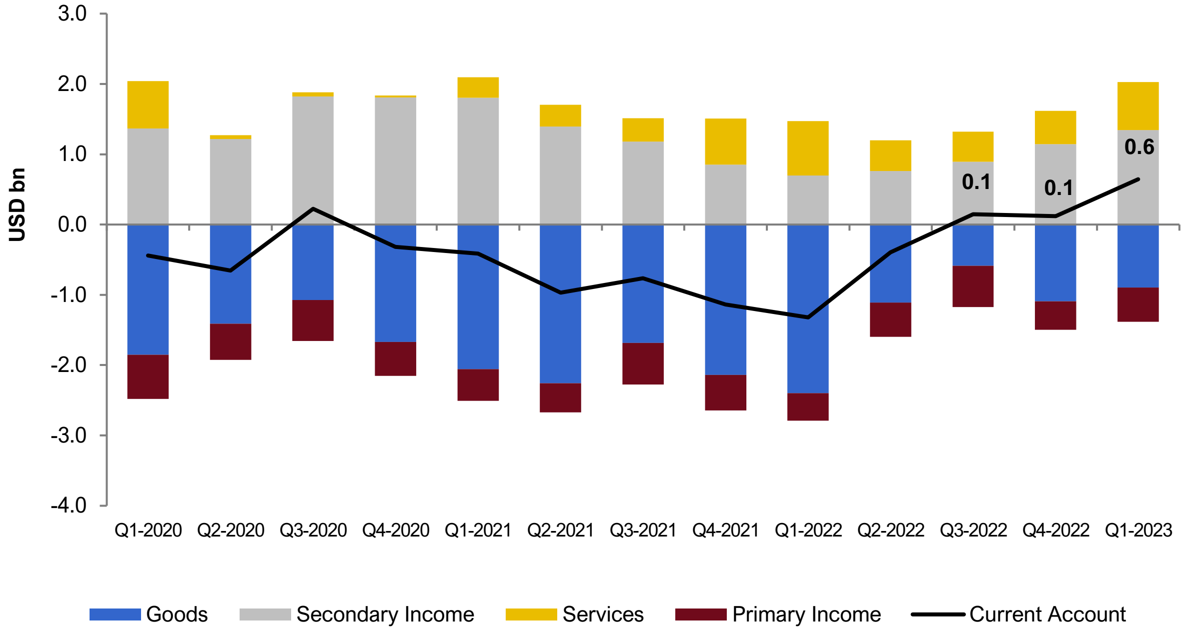
## 3.4. External Sector

***The external sector has recorded improvements on several fronts recently, despite some volatility in the exchange rate in the first half of 2023.***

### Balance of Payments

The current account recorded a notable surplus of US dollars 0.6 billion in Q1-2023. This was mainly due to a markedly lower trade deficit, resulting from a notable decline in merchandise imports despite some moderation in merchandise exports. The services account surplus decreased due to the low performance in the transport sector and the computer services sector. Relatively high reinvested earnings and higher accrued interest on government project loans led to some expansion in the deficit of the primary income account. The secondary income account recorded a notable surplus as a result of a sizeable increase in workers' remittances, particularly in March 2023.

**Figure 17: Current Account Balance**



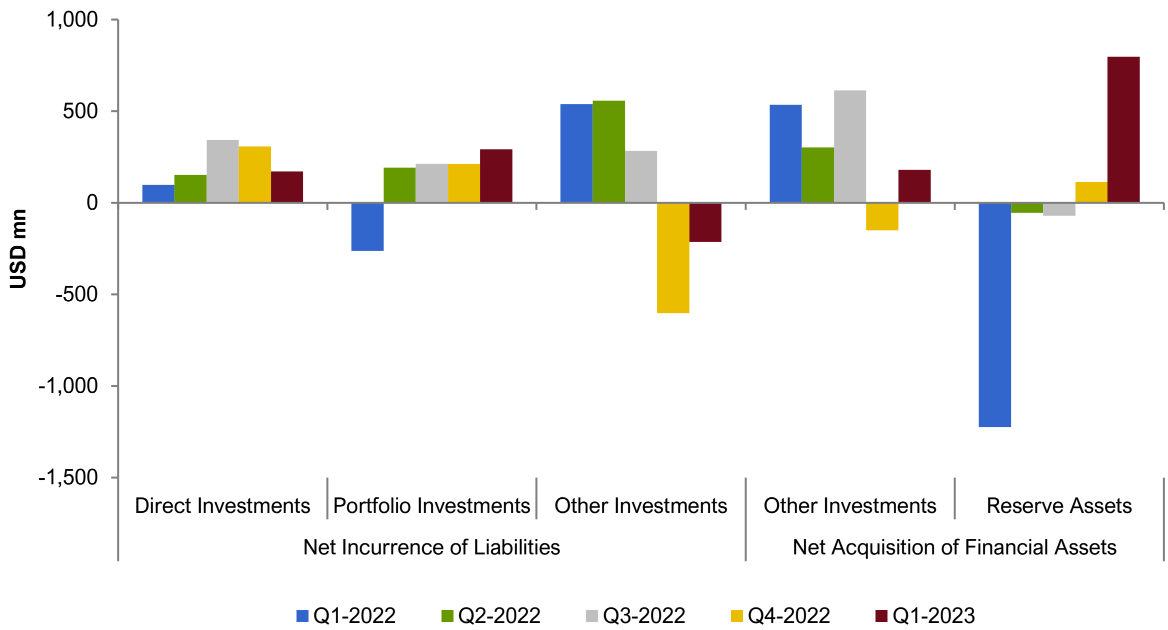

Source: Central Bank of Sri Lanka

Some favourable developments on the trade balance, tourism and workers' remittances continued beyond the first quarter of 2023. During the five months ending May 2023, the trade deficit continued to narrow notably, with a significant decrease in merchandise imports, despite a notable decrease in merchandise exports. The trade deficit amounted to US dollars 1.9 billion during January-May 2023, compared to US dollars 3.5 billion in the same period in 2022. The earnings from tourism improved to US dollars 875 million during the first half of 2023 in comparison to US dollars 680 million in the corresponding period of 2022. Workers' remittances also grew by 75.3 per cent to US dollars 2.8 billion during the first half of 2023, compared to the corresponding period in the previous year.

In view of the improvements in the Balance of Payments conditions, the need to revive economic activity and improve government tax revenue, the Government commenced relaxing import restrictions gradually in June and July 2023. Also, the Central Bank recently revoked the margin deposit requirement imposed on selected imports in 2022 and the Government, with the recommendation of the Central Bank, relaxed certain limitations/suspensions imposed on outward remittances of foreign exchange.

In the financial account, the major inflow during the first quarter of 2023 was the first tranche of the IMF-EFF supported programme. In addition, there were notable foreign investments to the government securities market in the first quarter of the year. The foreign investment inflows to the Colombo Stock Exchange (CSE) as well as the project loan inflows to the Government and the private sector remained at a minimum level due to the uncertainty that prevailed in the economy during this period. Further, foreign direct investment flows to direct investment enterprises also remained modest with some inflows materialising in the manufacturing, telecommunications, and hotels sectors. Beyond the first quarter of 2023, sizeable foreign financing assistance was received from the Asian Development Bank (ADB) and the World Bank.

**Figure 18: Financial Account**

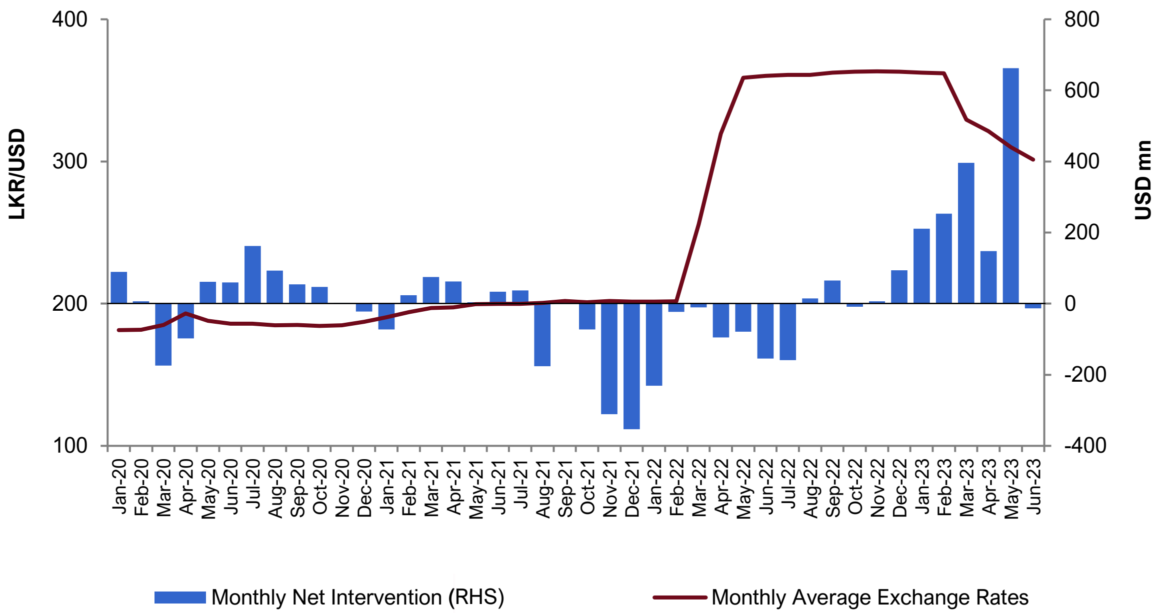



Source: Central Bank of Sri Lanka

### Exchange Rate

The liquidity conditions in the domestic forex market improved in recent months. This was mainly as a result of increased forex inflows in the form of export proceeds, workers' remittances and foreign investments to the government securities market, driving market sentiments. These favourable developments along with subdued demand for imports resulted in a notable appreciation of the Sri Lanka rupee against the US dollar in recent months despite some depreciation pressures, particularly in mid-June 2023. Overall, the Sri Lanka rupee recorded an appreciation against the US dollar by end June 2023. During the first half of the year, the Central Bank was able to accumulate a sizeable amount of foreign exchange from the domestic forex market through net purchases of around US dollars 1.7 billion.

**Figure 19: Exchange Rate and Central Bank's Intervention**




Source: Central Bank of Sri Lanka

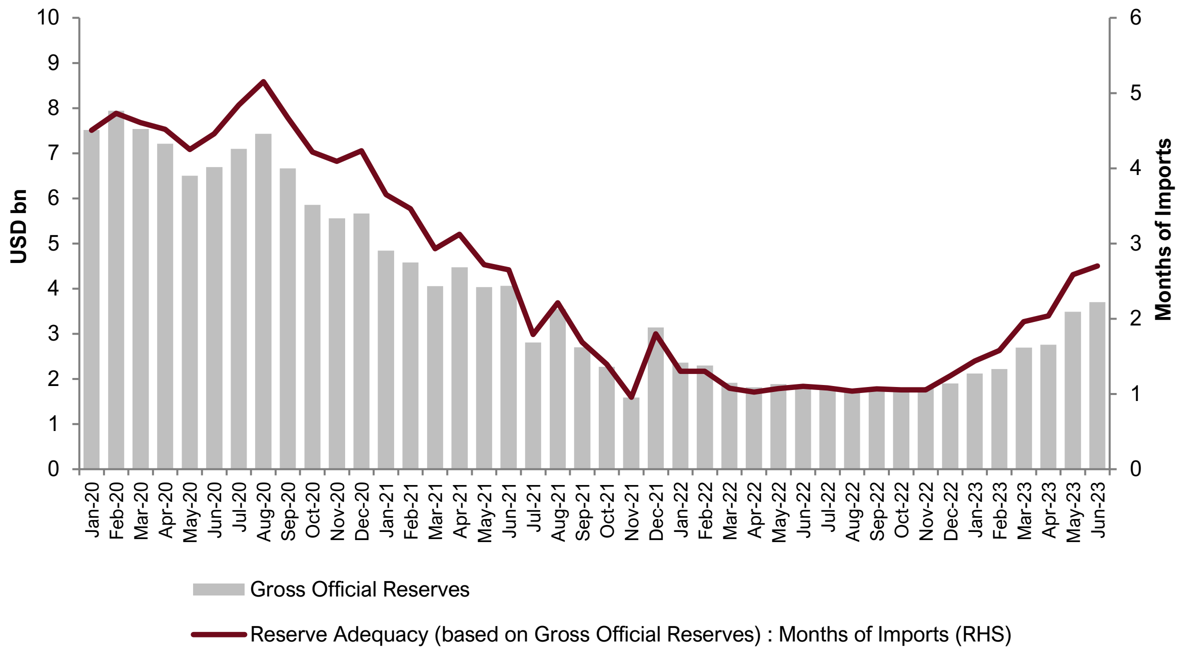
### Reserve Assets

The gross official reserve (GOR)[5] increased to US dollars 3.7 billion by end June 2023, compared to US dollars 1.9 billion recorded at end 2022. The significant increase in GOR level by end June 2023 was mainly due to the receipt of the first tranche of SDR 254 million (approximately US dollars 341 million) from the IMF-EFF supported programme in March 2023 and US dollars 350 million from ADB in May 2023, receipt of US dollars 250 million from the International

[5] The GOR at the end June 2023 and end 2022 included the international swap facility from the People's Bank of China (PBOC), which was valued in US dollar terms at US dollars 1.4 billion.

Development Association (IDA) of the World Bank and the Central Bank's intervention in the domestic foreign exchange market by absorbing foreign exchange liquidity on a net basis.

**Figure 20: Gross Official Reserves and Reserve Adequacy**




Source: Central Bank of Sri Lanka

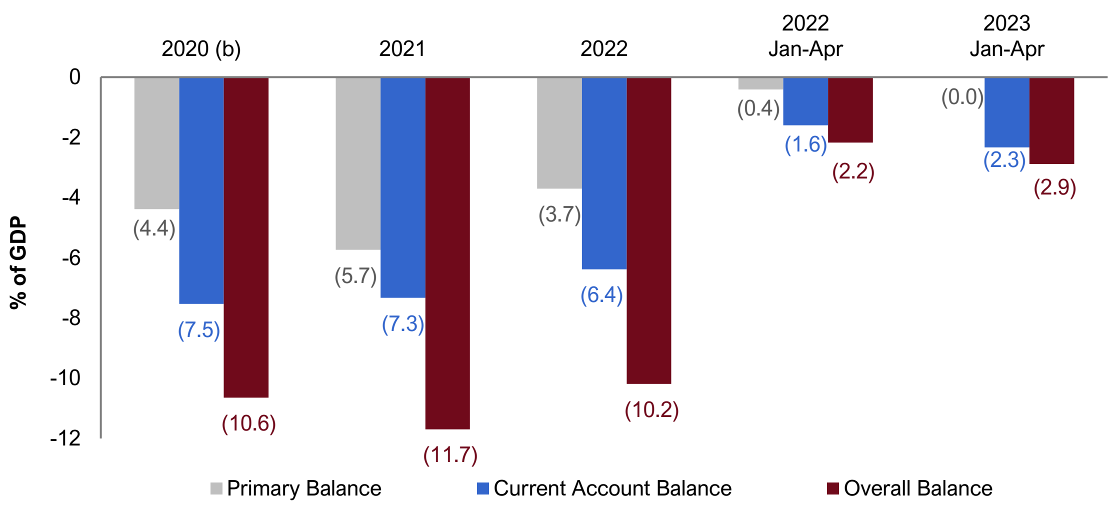
The continuation of the IMF-EFF supported programme, the successful progress on the debt restructuring, anticipated upswing in tourism would have a favourable impact, while the continuation of dampened global demand for exports, persistently tight global financial conditions and a possible surge in pent-up demand for imports with the gradual relaxation of import restrictions could weigh on the outlook in the ensuing period. Successful completion of the first review of the IMF-EFF and meeting required conditions for other foreign financing assistance would guarantee sizeable foreign exchange inflows from multilateral agencies in the remaining period of 2023, thus improving the foreign exchange availability.

The current account deficit for 2023 is projected to be broadly around the same level recorded in 2022. Despite the quarterly current account balance recording a surplus in the first quarter of 2023, the current account is likely to record deficits in the remainder of 2023, due to the envisaged expansion in the trade deficit with the anticipated increase in merchandise imports. However, the widening of the trade deficit is expected to be partly offset by the surplus in the current account in the first quarter of 2023 along with some cushioning impact of improved workers' remittances and tourism earnings.

## 3.5. Fiscal Sector[6]

The key fiscal balances, except the primary balance, deteriorated both in nominal terms and in projected GDP terms, during January-April 2023, in comparison to the same period last year. Accordingly, as a percentage of projected GDP, the overall budget deficit and current account deficit widened to 2.9 per cent (Rs. 824.3 billion) and 2.3 per cent (Rs. 664.9 billion), respectively, during the four months ending April 2023, compared to 2.2 per cent (Rs. 524.1 billion) and 1.6 per cent (Rs. 385.9 billion), respectively, recorded in the same period in the preceding year. Meantime, the cumulative surplus recorded in the primary balance until March 2023, moved into negative territory recording a deficit of Rs. 5.3 billion for the four months ending April 2023. However, reflecting the efforts of fiscal consolidation measures, the primary deficit in the first four months of 2023 declined notably, compared to Rs. 97.3 billion primary deficit recorded during the corresponding period in the previous year.

**Figure 21: Key Fiscal Balances (As a % of GDP) (a)**




(a) GDP estimates (base year 2015) released by the Department of Census and Statistics on 15 March 2023 have been used for 2020-2022 and the GDP projection of the Central Bank of Sri Lanka has been used for 2023.
(b) According to the Ministry of Finance, fiscal sector statistics for 2020 have been adjusted as announced in the Budget Speech for 2020.

Sources: Ministry of Finance, Economic Stabilization and National Policies, Central Bank of Sri Lanka

The revenue enhancement measures introduced during the second half of 2022 and early 2023 contributed to a 30.0 per cent year-on-year growth in government revenue, in nominal terms, to Rs. 820.1 billion during January-April 2023. Revisions to the personal income tax structure, amendments to the Value Added Tax (VAT) rate and VAT base, upward revisions to excise duties

[6] The fiscal data were available only up to April 2023 as of July 2023 monetary policy round.

on petroleum products and cigarettes and introduction of the Social Security Contribution Levy (SSCL) as well as high inflation that prevailed during the period have contributed to the notable growth in revenue collection. However, revenue from international trade-related taxes, such as Ports and Airport Development Levy (PAL), Special Commodity Levy (SCL) and CESS, declined during the four months ending April 2023, reflecting the impact of import restrictions on certain items and lower demand for imported goods amidst their cost escalation. Meanwhile, total expenditure and net lending increased by 42.4 per cent, year-on-year, to Rs. 1,645.6 billion during the four months ending April 2023 mainly due to the increase in recurrent expenditure on account of the high domestic interest payments. In addition, increased expenditure on subsidies and transfers and capital expenditure also contributed to the expenditure growth.

Net domestic financing of Rs. 901.8 billion and net foreign repayment of Rs. 77.5 billion were recorded during the four months ending April 2023. This is in comparison to Rs. 651.1 billion net domestic financing and Rs.127.0 billion net foreign repayments registered during the corresponding period in the previous year. With the gradual unwinding of monetary financing, a repayment of Rs. 218.2 billion to the Central Bank was recorded during January-April 2023, compared to Rs. 795.3 billion of monetary financing registered during the same period in 2022. Meanwhile, central government debt[7] declined to Rs. 26,927.9 billion by end March 2023 from Rs. 27,492.0 billion recorded as at end 2022 mainly owing to the exchange rate appreciation.

Despite the improved revenue mobilisation, the overall fiscal position could be subject to vulnerabilities due to challenging fiscal related targets stipulated under the IMF-EFF supported arrangement. This warrants concerted and urgent efforts to improve tax administration. However, the expected decline in domestic interest rates amidst the easing of monetary policy stance and the completion of DDO would result in a moderation of the interest expense burden of the Government, thereby improving the overall fiscal balance in the period ahead. Further, the expected turnaround of loss-making SOEs to profit-making entities along with the cost recovery pricing mechanism would ease the burden on fiscal operations in the period ahead. Furthermore, the envisaged second tranche of the IMF-EFF and the budgetary support from other foreign sources in the coming months may significantly ease pressures on government finances during the second half of 2023.

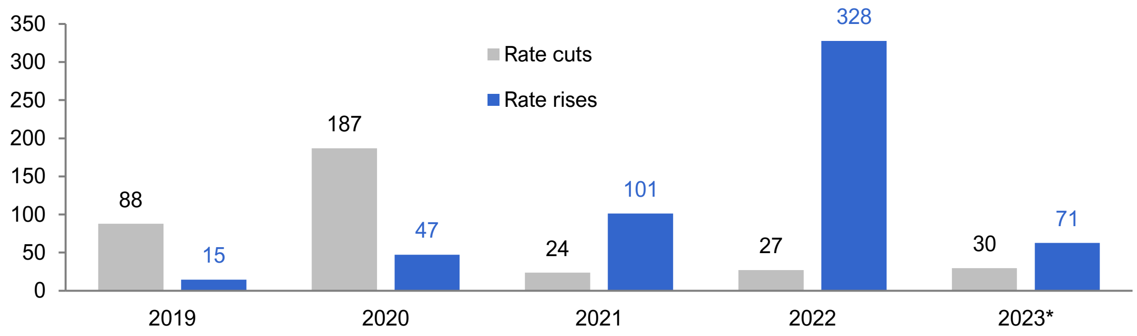
[7] The central government debt estimate is highly provisional since the recording of several foreign debt service payments, which were overdue after the announcement of the debt standstill, has not been finalised and yet to be included in the total debt stock.

## 3.6. Global Developments

***The global monetary policy stance continued to remain tight, despite the moderation in global energy and commodity prices.***

Most major central banks have stayed firm in their tight monetary policy stance, amidst financial sector concerns, signalling that interest rates will remain at a higher level to address sticky inflation. Although some signs of moderation of inflation are observed, the tightening bias remains in view of rigid core inflation. However, some relaxation in monetary policy can be expected in the period ahead with the expected easing of inflationary pressures as well as a favourable growth outlook.

**Figure 22: Global Policy Rate Changes (percentage points)**

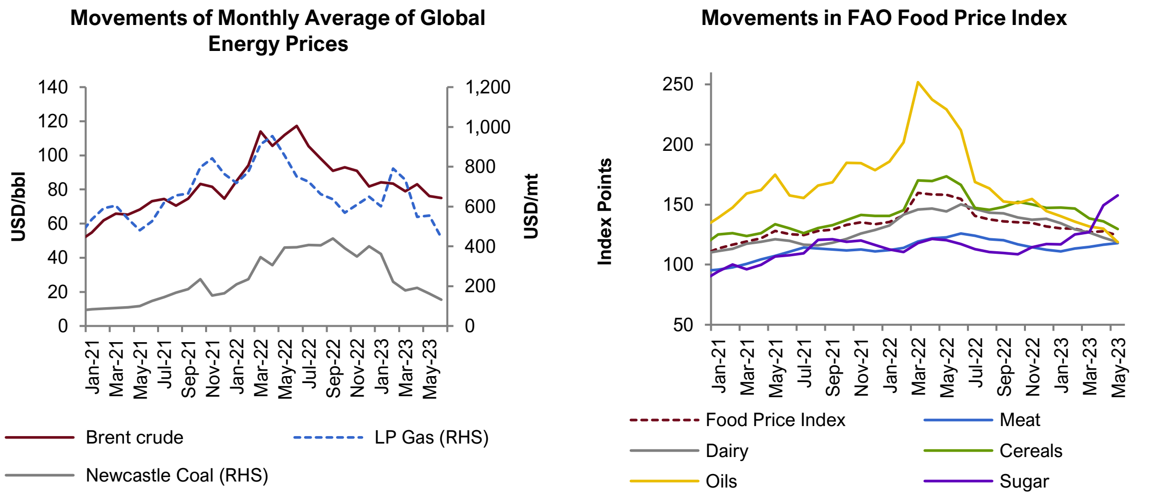



*Up to 23 June

Source: https://www.cbrates.com/

In terms of global commodity prices, a moderation has been observed in energy as well as most food prices from their peak levels. The passthrough of these to domestic prices has contributed to the slowing of domestic inflation.

**Figure 23: Global Commodity Prices**




Source: Reuters, Bloomberg, Saudi Aramco

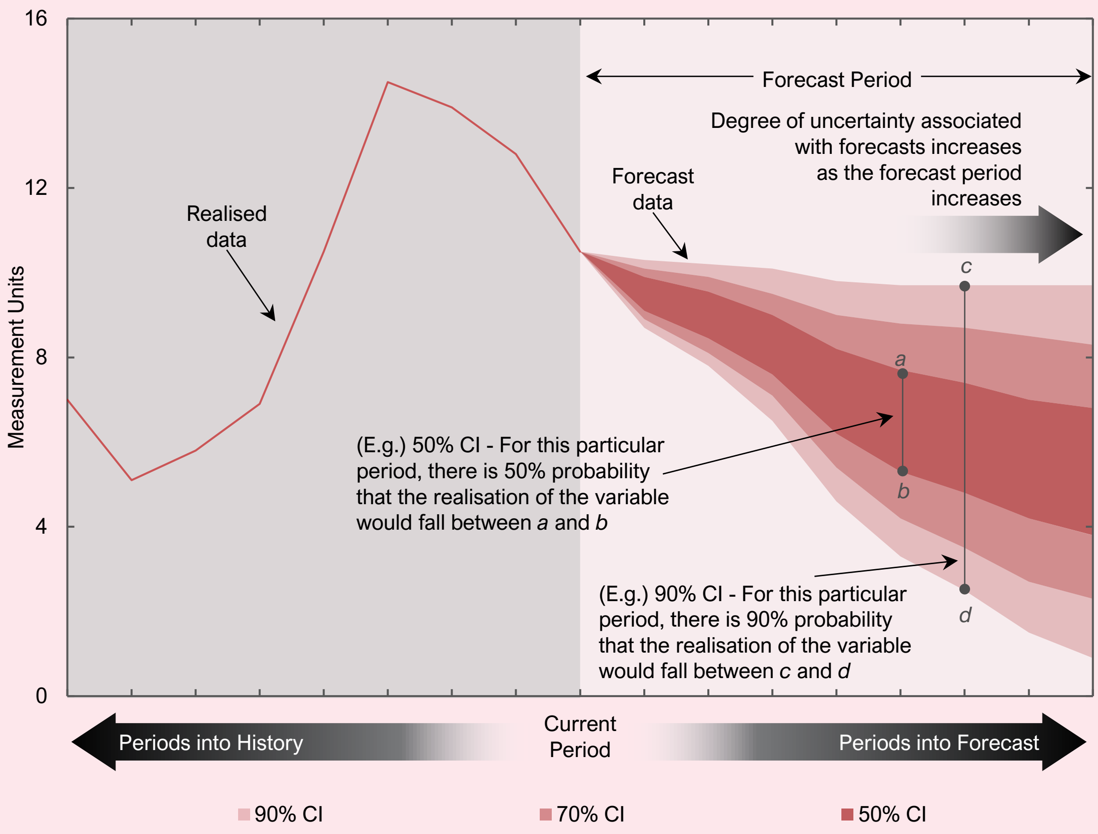
Source: Food & Agriculture Organisation (FAO)

# TECHNICAL APPENDIX

## Technical Appendix A: How to Read Fan Charts

- A fan chart for a given variable plots its realised values together with possible ranges of values that the forecasts of that variable could take in the future.
- With these ranges of possible values, a fan chart illustrates the uncertainty surrounding a forecast of a given variable.
- The Central Bank arrives at macroeconomic projections, including those on inflation and GDP growth, using a semi-structural macroeconomic model.
- These projections are usually updated on a quarterly frequency along with the release of GDP data.
- The fan charts graphically illustrate these macroeconomic projections to offer a better understanding.
- Projections are arrived at using realised data, projections of major global indicators, near-term forecasts of selected variables, and judgments.
- Accordingly, forecasts are uncertain by nature, which is represented by confidence intervals, and this uncertainty needs to be taken into consideration when such forecasts are used for various purposes.
- Confidence intervals are illustrated as areas in which the realised value of the variable would fall within, with a given level of probability (or confidence) – for example, a 50% confidence interval represents the region in which the realised variable would fall, 50 out of 100 times.

**Figure 24: Key Components of a Fan Chart (For an Arbitrary Variable)**




Source: Central Bank Staff Projections

# LIST OF ACRONYMS

| | |
|---|---|
| ADB | Asian Development Bank |
| AWCMR | Average Weighted Call Money Rate |
| AWDR | Average Weighted Deposit Rate |
| AWLR | Average Weighted Lending Rate |
| AWNDR | Average Weighted New Deposit Rate |
| AWNLR | Average Weighted New Lending Rate |
| AWNSR | Average Weighted New SME Lending Rate |
| AWPR | Average Weighted Prime Lending Rate |
| CBSL | Central Bank of Sri Lanka |
| CCPI | Colombo Consumer Price Index |
| CI | Confidence Interval |
| CPC | Ceylon Petroleum Corporation |
| CPI | Consumer Price Index |
| CSE | Colombo Stock Exchange |
| DCS | Department of Census and Statistics |
| DDO | Domestic Debt Optimisation |
| EFF | Extended Fund Facility |
| FAO | Food And Agriculture Organisation |
| FIT | Flexible Inflation Targeting |
| GDP | Gross Domestic Product |
| GOR | Gross Official Reserves |
| GPMN | Global Projection Model Network |
| IDA | International Development Association |
| IMF | International Monetary Fund |
| IPSWRI | Informal Private Sector Wage Rate Index |
| LCBs | Licensed Commercial Banks |
| LP Gas | Liquefied Petroleum Gas |
| NCG | Net Credit to the Government |
| NCPI | National Consumer Price Index |
| NFA | Net Foreign Assets |
| PAL | Ports And Airport Development Levy |
| PMI | Purchasing Managers' Index |

| | |
|---|---|
| QPC | Quantitative Performance Criteria |
| QPM | Quarterly Projection Model |
| REER | Real Effective Exchange Rate |
| RIR | Real Interest Rate |
| SCL | Special Commodity Levy |
| SDFR | Standing Deposit Facility Rate |
| SLFR | Standing Lending Facility Rate |
| SOBEs | State Owned Business Enterprises |
| SOEs | State Owned Enterprises |
| SPDs | Standalone Primary Dealers |
| SSCL | Social Security Contribution Levy |
| VAT | Value Added Tax |

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