MONETARY POLICY REPORT

AUGUST 2024

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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

Under the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA), the primary objective of the Central Bank of Sri Lanka is achieving and maintaining domestic price stability. By maintaining inflation at low and stable levels, the Central Bank contributes to the sustained economic growth and the economic and financial well-being of the public.

The Central Bank conducts monetary policy to achieve its primary objective of maintaining domestic price stability. According to the CBA, the Monetary Policy Board is responsible for formulating monetary policy and implementing a flexible exchange rate regime in line with the Flexible Inflation Targeting (FIT) framework. The FIT framework aims to maintain inflation at targeted levels as determined by the Monetary Policy Framework Agreement (MPFA) between the Minister of Finance and the Central Bank. The current MPFA, published in the Government Gazette on 5 October 2023, mandates the Central Bank to maintain quarterly headline inflation at 5 per cent.[1]

To achieve the inflation target, the Central Bank uses its policy instruments to guide short-term market interest rates along the desired path. The Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) are the policy interest rates of the Central Bank. SDFR and SLFR form an interest rate corridor to guide overnight interest rates in the money market. The Average Weighted Call Money Rate (AWCMR), which is a short-term money market interest rate, functions as the operating target under the current monetary policy framework. Overnight market interest rates maintained in line with the monetary policy stance are transmitted through the financial markets to the economy, ultimately affecting inflation.

Monetary policy decisions are data-driven. Since monetary policy actions take time to have their full effect on inflation, monetary policy decisions need to be forward-looking. The Monetary Policy Board of the Central Bank meets six times a year to decide on the appropriate monetary policy stance. When making monetary policy decisions, the Monetary Policy Board assesses the inflation and inflation outlook, the state of the economy and the economic outlook based on available data, forecasts, and the risks and uncertainties surrounding such forecasts. The Monetary Policy Committee, an internal technical committee chaired by the Governor, after

[1] The inflation target was communicated to the public in the Extraordinary Gazette No. 2352/20. Quarterly headline inflation refers to the simple average of the year-on-year percentage change in the monthly CCPI during the three months of the corresponding quarter.

careful deliberations, provides technical recommendations for the consideration of the Monetary Policy Board.

The Monetary Policy Report is prepared in fulfilment of Sections 27 and 80 of the CBA, requiring the Central Bank to publish a biannual report explaining recent movements in inflation, sources of inflation, medium-term projections for inflation, key risks to such projections, along with the implementation of monetary policy and the achievement of its objects. Additionally, the Report communicates to the public the current developments across various other sectors of the economy, while providing an assessment of the economic growth outlook along with associated risks.

EXECUTIVE SUMMARY

Building on the gradual economic stability witnessed in 2023, Sri Lanka has been making considerable progress in reviving the economy thus far in 2024. Inflation has been low, providing some comfort and certainty to livelihoods and business activity, especially following the recent historic high inflation episode. Domestic economic activity has continued to rebound. The Central Bank's monetary policy stance continues to be accommodative aligning with softened inflationary pressures.

Headline inflation, which recorded an uptick in early 2024 due to tax adjustments, declined notably thereafter. Sizeable downward revisions to electricity tariffs, fuel and LP gas prices, as well as a slowdown in food inflation, explain the recent shift to low inflation. In addition, demand conditions remained largely muted due to low disposable incomes, despite increasingly accommodative monetary conditions. As a result, inflation moderated considerably to levels well below the inflation target of 5 per cent towards mid-2024. However, inflation expectations remain well-anchored, especially in the medium term.

Headline inflation is projected to remain notably below the target in the forthcoming months, driven mainly by the recent downward adjustments to electricity tariffs and domestic fuel prices. Accordingly, in the near term, quarterly average headline inflation is likely to remain below the inflation target by more than the margin of 2.0 percentage points stipulated in the Monetary Policy Framework Agreement (MPFA). Meanwhile, core inflation, which excludes the effects of highly volatile expenditure items and therefore captures the underlying inflation trend of the economy, is expected to remain higher than headline inflation in the near term, but is projected to follow a relatively less volatile trajectory than headline inflation. Moreover, the effects of supply-side factors are expected to dissipate gradually, and headline inflation is expected to gather momentum towards mid-2025 before stabilising at the targeted level in the medium term, supported by appropriate policy measures.

The Central Bank has adopted a cautious approach to easing monetary policy thus far in 2024. This was due to the moderation in inflation being driven largely by supply-side factors, despite inflation remaining well below the target, inflation expectations holding steady and external sector pressures remaining subdued. Market interest rates continued to adjust downwards during H1- 2024 in line with the eased monetary policy stance of the Central Bank.

With the gradual restoration of macroeconomic stability, the economy achieved a notable recovery, recording positive real GDP growth from Q3-2023 onwards. Improving investor sentiments, eased monetary conditions and the gradual improvement in external demand conditions, coupled with a low statistical base resulting from the economic contraction in the previous year, were critical factors contributing to this recovery. Credit extended to the private sector is yet to make a sustained recovery. The accommodative monetary policy stance and the easing of market lending interest rates are expected to stimulate private credit going forward. The growth momentum of the Sri Lankan economy is expected to continue in the short-term and gradually move towards its potential over the medium term.

In terms of the balance of risks to the inflation projections, the risks are skewed to the upside in the near term due to supply-driven uncertainties on the global and domestic fronts, although headline inflation is expected to remain below the target. Alternatively, risks to medium-term inflation projections are broadly balanced. With regard to real GDP growth projections, risks remain balanced both in the near term and the medium term. The economic outlook and risks to the projections presented in this Report implicitly assume the continuation of structural reforms and the absence of any major macroeconomic policy reversals.

The content of this Report is based on the data available as of the July 2024 monetary policy round of the Central Bank, which concluded with the monetary policy announcement on 24 July 2024.

1. MONETARY POLICY SUMMARY

The Central Bank of Sri Lanka continued to reduce its key policy interest rates in line with the accommodative monetary policy stance adopted since June 2023. As inflationary pressures remained subdued, monetary policy was relaxed further thus far in 2024.

The Central Bank significantly lowered its policy interest rates, totalling 650 basis points during the latter half of 2023. In March 2024, policy interest rates were further reduced by an additional 50 basis points amidst subdued aggregate demand conditions, favourable near-term inflation dynamics, well-anchored inflation expectations, as well as the absence of excessive external sector pressures. This policy adjustment warranted a continuous downward adjustment in overall market lending rates. Allowing room for market interest rates to reduce, the Central Bank briefly kept policy interest rates on hold, before opting for an additional reduction in policy interest rates in July 2024. With the inflation outlook remaining benign, monetary policy was further eased in July 2024 by reducing policy interest rates by 25 basis points with a view to signalling the continuation of the eased monetary policy stance and inducing a further reduction in market lending rates. This policy move indicates the Central Bank's stance to keep monetary policy sufficiently accommodative in the period ahead to support the economic recovery amidst muted inflationary pressures.

The Monetary Policy Board will meet in September and November 2024 to take monetary policy decisions during the remainder of the year.

Monetary Policy Decisions since the last Monetary Policy Report (February 2024 – July 2024):

March 2024	May 2024	July 2024
Policy interest rates were reduced by 50 bps to 8.50% (SDFR) and 9.50% (SLFR)	Policy interest rates were maintained at 8.50% (SDFR) and 9.50% (SLFR)	Policy interest rates were reduced by a further 25 bps to 8.25% (SDFR) and 9.25% (SLFR)

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2. INFLATION AND ECONOMIC OUTLOOK

Medium-term macroeconomic projections made by the Central Bank staff, in support of the monetary policy decision during July 2024, are illustrated in this section, with a focus on the projections of inflation and real economic growth.[2] These projections reflect the available data, near-term forecasts of key variables, global macroeconomic projections, and assumptions and judgements made at the July 2024 monetary policy round, and are considered as the *baseline forecast* in this Report.

2.1. Baseline Forecast

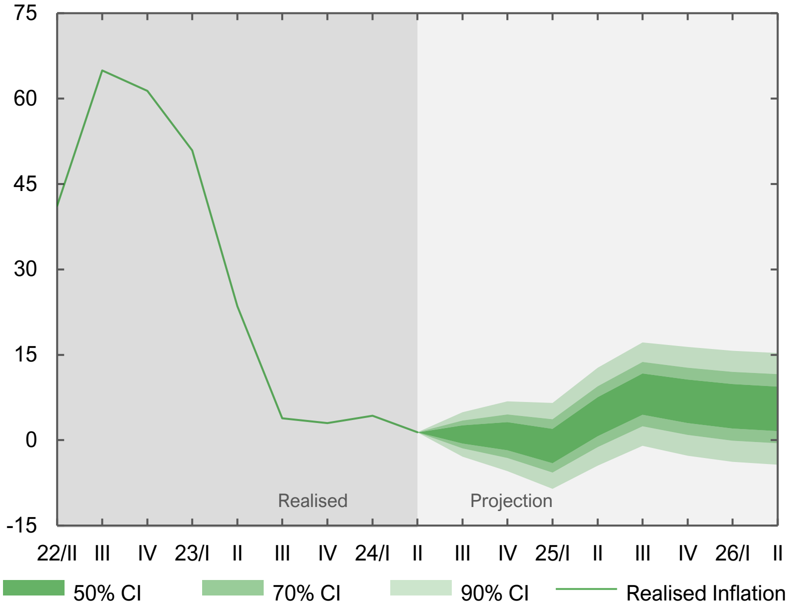
As per medium-term macroeconomic projections in the monetary policy round in July 2024, inflation is expected to slow further in the near term. This is primarily due to the recent sizeable downward revisions to the electricity tariff, while the favourable statistical base effect would also be a contributory factor, particularly towards end 2024 and early 2025. Subsequently, headline inflation is anticipated to record a temporary uptick towards the second half of 2025, mainly due to the unfavourable statistical base effect, and to gradually stabilise around the targeted level of 5 per cent (year-on-year) over the medium term. Meanwhile, the recovery in economic growth is expected to continue over the medium term with the help of appropriate policies.

Prospects for Inflation

According to the latest forecasts, year-on-year headline inflation is anticipated to experience a deceleration in the next few months, possibly driving quarterly average inflation levels during the near term to be below the inflation target of 5 per cent by more than 2 percentage points as defined in the Monetary Policy Framework Agreement (MPFA). Given that the quarterly average inflation recorded during Q2-2024 was also below the target by more than 2 percentage points, the projections imply a possible breach of the inflation target, as stipulated in Section 26(5) of the CBA, on the downside in Q3-2024 for the first time, as inflation would have been below the target by more than 2 percentage points during two consecutive quarters. As per the currently available information and projections, such a breach is likely to continue in Q4-2024 and Q1-2025 as well. The decline in headline inflation is largely attributed to recent substantial

[2] The Central Bank uses QPM, a semi-structural macroeconomic model, to arrive at medium-term macroeconomic projections, which are updated during each monetary policy round, using data on the latest economic developments, including, but not limited to, global macroeconomic forecasts and monthly releases of inflation data and quarterly releases of GDP data by DCS.

Figure 01: Projected Headline Inflation: (Quarterly, CCPI, Y-o-Y, %)
Based on the Projections during the July 2024 Monetary Policy Round



Source: Central Bank Staff Projections

Realised data up to Q4-2022 shown in the fan chart are based on CCPI (2013=100, seasonally adjusted), while data after this period are based on CCPI (2021=100, seasonally adjusted).

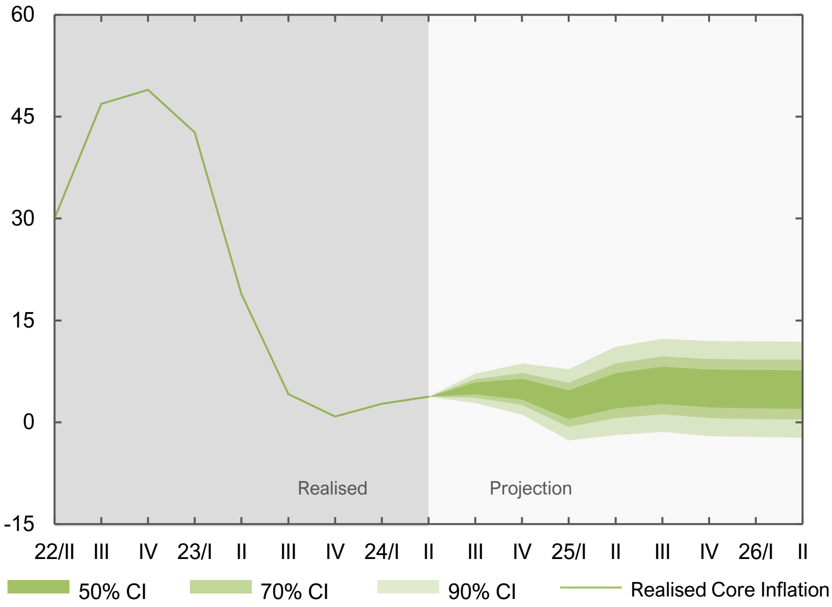
Note: A forecast is neither a promise nor a commitment
The projections reflect the available data, assumptions and judgements made at the monetary policy round in July 2024. They are conditional on the forecasts of global energy and food prices; the gradual growth recovery of Sri Lanka's major trading partners; the anticipated domestic fiscal path in line with the IMF-EFF projections under the debt restructuring scenario; and global financial conditions implied by the monetary policy stance of the US. Moreover, the projections are conditional on the model-consistent interest rate path and the resulting macroeconomic responses. Further, no major macroeconomic policy shifts are anticipated in the baseline projections. Thus, the continuation of the IMF-EFF, and efforts on fiscal consolidation and debt restructuring are implied. Any notable change in the underlying assumptions and judgements could lead to the realised inflation path deviating from the projected path. Medium-term macroeconomic projections, together with the fan charts, will be continuously updated during each monetary policy round. Given the volatile global environment and the uncertainties in the domestic economy and the political environment, the baseline forecasts are exposed to various potential upside and downside risks. Details on risks to the baseline forecast are discussed in the "Risks to Projections" section.

downward revisions to electricity tariffs. Headline inflation is anticipated to record its lowest level in the projected horizon in early 2025, during which the statistical base effects,[3] mainly due to the Value Added Tax (VAT) increases in early 2024, are expected to drive inflation down, amidst subdued momentum. At the same time, lower price levels due to the recent electricity tariff revisions could lead to a temporary increase in inflation towards the second half of 2025, as year-on-year inflation would be calculated with reference to a relatively low statistical base,

[3] For further discussion on the base effect and momentum, please refer to footnote 5, accompanied with Figure 03.

while a possible faster increase in global food prices, the impact of possible gradual depreciation of the Sri Lanka rupee against the US dollar,[4] and the demand impact due to the gradual recovery of the economy could also reinforce this inflationary behaviour. However, it is anticipated to be temporary, as the statistical base effect, which is the main cause of the uptick in inflation in late 2025, is expected to gradually normalise afterwards. Over the medium term, headline inflation is expected to eventually stabilise around the targeted level of 5 per cent and remain around that level, supported by appropriate policy measures and the normalisation of global oil and food inflation.

Figure 02: Projected Core Inflation (Quarterly, CCPI, Y-o-Y, %)
Based on the Projections during the July 2024 Monetary Policy Round



Source: Central Bank Staff Projections

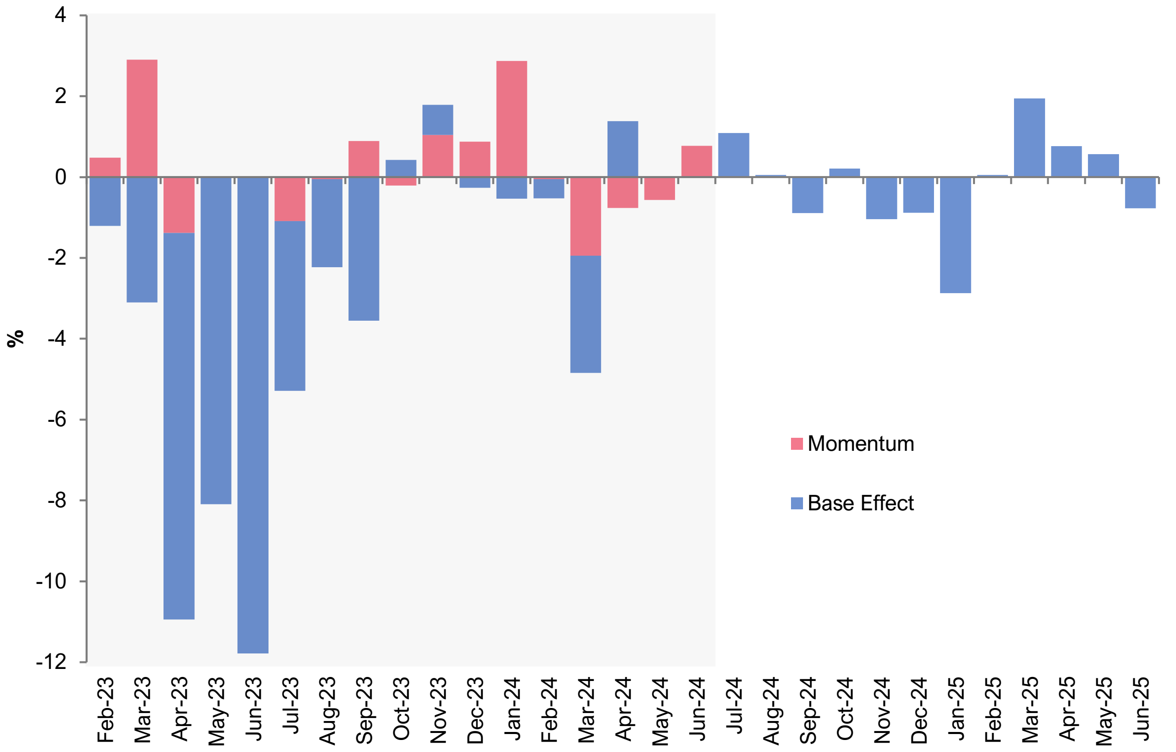
Realised data up to Q4-2022 shown in the fan chart are based on CCPI (2013=100, seasonally adjusted), while data after this period are based on CCPI (2021=100, seasonally adjusted).

See the explanatory note in Figure 01 above.

When components of inflation are considered, core inflation, which excludes goods and services with volatile prices including energy- and transport-related expenses, and thereby is usually considered a broad measure of fundamental demand pressures in the economy, is expected to follow a gradual upward trajectory in the second half of 2024. The envisaged recovery of domestic demand conditions and the anticipated increase in global food inflation,

[4] Consistent with the expectations regarding possible outflows related to debt repayments amidst a likely completion of the debt restructuring process, increased levels of imports with the recovery of economic activity and credit pickup, and the long-run trend of depreciation, the model predicts a gradual depreciation path of the Sri Lanka Rupee.

Figure 03: Headline Inflation: Momentum and Base Effect[5] (CCPI, 2021=100)



Source: Central Bank Staff Calculations

are the main factors behind the gradual increase in core inflation. As the core inflation index excludes the energy and transport prices, which are instrumental in driving the muted projected path of headline inflation, the current and expected reduction in headline inflation is not reflected in core inflation. However, as is the case with headline inflation, core inflation is also expected to be affected by the statistical base effect, particularly in early 2025, as the prices of most items in the core inflation basket increased due to the VAT hike in early 2024. Accordingly, core inflation is expected to have a temporary dip in early 2025 but remain relatively stable

[5] Inflation is commonly measured as a year-on-year change in the price level, i.e., the percentage change of the price level in a given period, which is measured by a price index (in the case of Sri Lanka, DCS compiles and publishes the two main price indices used to measure inflation in Sri Lanka, CCPI and NCPI), compared to the same period in the previous year. However, price information is made available usually at a monthly frequency. Therefore, one could calculate changes in prices on a month-on-month basis as well. The change of the year-on-year inflation from one month to the next can then be approximated by deducting the month-on-month inflation in the corresponding month of the previous year from the month-on-month inflation in the current month. (This approximation is motivated by the fact that percentage changes can be approximated by log differences.) Accordingly, the month-on-month inflation of the current month is usually termed the momentum, which represents how year-on-year inflation changes due to economic developments in the latest month. Meanwhile, the negative value of the month-on-month inflation in the corresponding month of the previous year is termed the base effect, which accounts for the statistical effect that affects how year-on-year inflation changes from one month to the next (i.e., $\pi_t^{YoY} \approx \pi_{t-1}^{YoY}$ +Momentum+Base Effect, where π represents inflation). This segregation allows analysts to evaluate key contributing factors to the dynamics of year-on-year inflation. Note that when quarterly information is used, as in the model projections of the Central Bank, the same classification of year-on-year inflation into the momentum and the base effect can be done using quarter-on-quarter inflation as well. Further, this approximation is not limited to inflation but can be applied to breaking down year-on-year changes in any variable.

thereafter with a lower degree of volatility. This is due to the relatively high level of persistence generally observed in core inflation compared to headline inflation.

In the near term, energy and transport inflation is expected to remain subdued. However, a gradual normalisation in prices is anticipated, contributing to an increase in headline inflation towards the target over the medium term. This behaviour largely reflects the expected gradual increasing trend of global oil prices and the possible gradual depreciation of the Sri Lanka rupee. The baseline projection assumes a gradual rise in oil prices, amidst the prevailing volatile geopolitical environment. However, the uncertainty related to these conditions is extremely high, as reflected by the unstable oil price behaviour in the recent past. With the transmission of the gradual rise in global price levels, domestic prices related to energy and transport sectors could experience some pressure, contributing to the normalisation of energy and transport inflation from its prevailing subdued level. Moreover, this path could be affected by possible upward revisions to electricity tariff during the next rounds of revision as well, given that there were consecutive substantial downward price revisions. Additionally, inflation in the volatile food category is expected to remain somewhat elevated in the near term. However, volatile food inflation is projected to normalise afterwards, supporting the normalisation of headline inflation.

Inflation Expectations

As per the inflation expectations survey of the Central Bank, inflation expectations of the corporate sector for all tenors declined during the June 2024 survey round compared to the previous month, in line with the trend in realised inflation. A gradual rise could be observed in expected inflation from the current month to 6 months ahead period, as per the June 2024 survey round, attributed by the respondents to the anticipated reduction in interest rates, possible increase in government expenditure, and rupee depreciation. Compared to these tenors, inflation expectations over longer tenors showed a relatively less steep increase. More importantly, expectations for longer tenors were broadly around the inflation target of 5 per cent, reflecting signs of anchored expectations.

Box A: Inflation Target Under the Flexible Inflation Targeting Framework

Introduction

The Central Bank of Sri Lanka presently conducts monetary policy in line with a Flexible Inflation Targeting (FIT) framework. At present, the **inflation target is 5%**. The presence of an explicit inflation target is expected to guide inflation expectations of the stakeholders of the economy and improve the predictability of price developments, thereby facilitating better forecasts by firms and households and assisting in improving monetary policy credibility. This article briefly discusses the monetary policy framework of the Central Bank, which requires the establishment of an inflation target; the related statutory background; the inflation target; and how a breach of the target is defined.

Evolution of the Monetary Policy Framework

The Central Bank was established in 1950 under the Monetary Law Act No. 58 of 1949 (MLA) as the monetary authority of Sri Lanka, succeeding the Currency Board System that prevailed earlier. Initially, the monetary policy framework of the Central Bank was based on a fixed exchange rate. Following the 1977 economic liberalisation, and in line with global developments, by the early 1980s, the Central Bank had moved away from the exchange rate-based regime towards Monetary Aggregate Targeting (Weerasinghe, 2018). Monetary policy modernisation initiatives began in the 2000s, and from 2015 onwards, an enhanced monetary policy framework was adopted, comprising features of both Monetary Targeting and Flexible Inflation Targeting (Central Bank of Sri Lanka, 2019a, 2023). From 2020 onwards, the Central Bank adopted FIT as its monetary policy framework, although the necessary legislative support was received only in 2023.

Formal Adoption of FIT

In order to suit the evolving nature of the economy and central banking, the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA) was enacted in September 2023, replacing the MLA. The new Act consists of many provisions enabling the formal adoption of FIT. The CBA formally recognises FIT as the monetary policy framework of the Central Bank. In particular, as per Section 11(1) of the CBA, the Monetary Policy Board of the Central Bank is charged with the formulation of monetary policy and implementation of a flexible exchange rate regime in line with the FIT framework to achieve and maintain domestic price stability.

An inflation targeting framework encompasses an announced numerical inflation target, monetary policy implementation focusing on an inflation forecast, and a high degree of transparency and accountability (Svensson, 2010). Literature suggests that a transparent and credible inflation objective helps anchor long-run inflation expectations (Gürkaynak et al., 2007). According to the former Chairman of the Federal Reserve, Ben Bernanke, inflation expectations greatly influence actual inflation (Bernanke, 2007). Since inflation expectations are often self-fulfilling, anchoring expectations can influence actual inflation. Accordingly, inflation targeting is more relatable to the public than a monetary target. Moreover, it helps reduce any information gaps between the Central Bank and the public by using a widely understood, frequently and publicly available indicator such as the inflation rate as the focus of monetary policy, thus facilitating increased transparency and accountability (Weerasinghe, 2018). Most inflation-targeting central banks around the world follow flexible inflation targeting rather than strict inflation targeting. Flexible inflation targeting focuses on stabilising both inflation and the real economy, while strict inflation targeting focuses solely on inflation without considering the stability of the real economy (Svensson, 2009). In the Sri Lankan context, Section 6(1) of the CBA stipulates the primary objective of the Central Bank as achieving and maintaining domestic price stability, thus endorsing the importance of stabilising inflation. At the same time, Section 6(4) of the CBA requires the Central Bank to take into account, inter alia, the stabilisation of output towards its potential level in pursuing its primary object, thereby laying the statutory space for FIT, which is formally recognised in Section 11(1).

Inflation Target as per the CBA

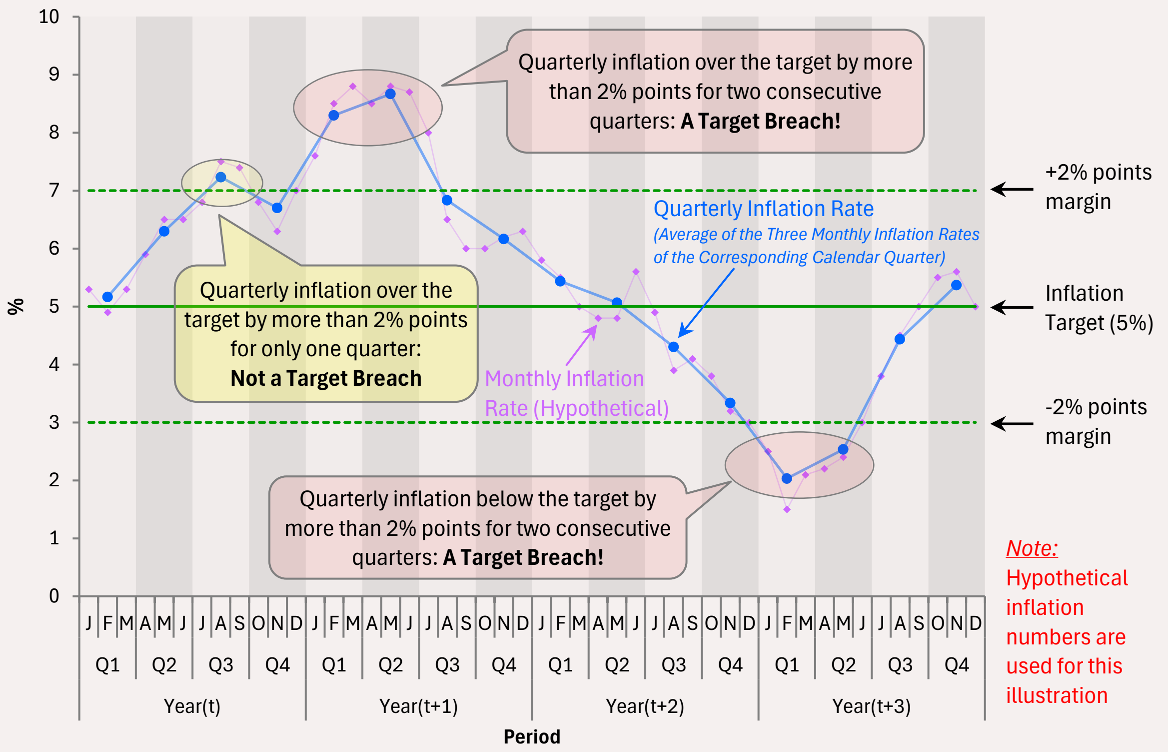
Section 26(1) of the CBA requires the Minister of Finance and the Central Bank to sign a monetary policy framework agreement, setting out the inflation target to be achieved. Accordingly, an agreement was signed fulfilling this requirement in October 2023, which was made available to the public in Extraordinary Gazette No. 2352/20. According to the monetary policy framework agreement (MPFA), the Central Bank is required to maintain the Colombo Consumer Price Index (CCPI)-based quarterly headline inflation rate at the target of 5%.[†] The determination of a quantitative inflation target jointly by the Central Bank and the Government signifies their shared commitment to achieving a low and stable inflation rate in the country. However, the Central Bank is provided with

[†] See Central Bank of Sri Lanka (2019b) for some supporting points for such an inflation target.

the freedom to perform independently to achieve this target, while being accountable to the public. In doing so, the Central Bank provides public information about its strategy and decisions aimed at meeting the inflation target. This commitment to transparency helps reduce uncertainty about the future course of monetary policy and enhances the credibility of the Central Bank.

In Section 26(5), the CBA necessitates the Monetary Policy Board to submit a report to the Parliament through the Minister of Finance, which shall also be made available to the public, if the Central Bank fails to meet the inflation target by an agreed margin for two consecutive quarters. For this purpose, a symmetric **margin** of **±2 percentage points** is agreed in the MPFA. Accordingly, a target breach would occur if the realised quarterly headline inflation deviates from the 5% target by more than 2 percentage points **during two consecutive quarters**, either from the upside or the downside of the target (an illustration of a target breach with hypothetical inflation numbers is provided in Figure A.1). The report that needs to be submitted in the event of a target breach as per Section 26(5) of the CBA must set out the reasons for the failure to achieve the inflation target, the remedial actions proposed to be taken by the Central Bank, and an estimate of the period within which the inflation target shall be achieved.

Figure A.1 : Few Select Hypothetical Examples of Target Breaches



Source: Central Bank Staff Calculations

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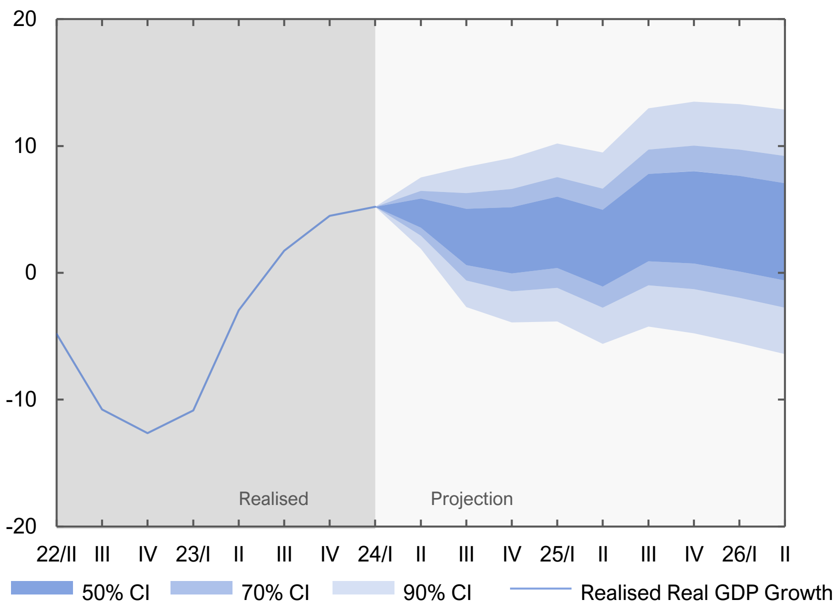
Prospects for Real Economic Growth

Based on available indicators, survey findings, and staff evaluations, the economy is expected to have recorded continued growth in Q2-2024. This performance is expected to have been driven mainly by healthy performances in Industry and Services activities. Nevertheless, it is noteworthy that the strong economic growth in H1-2024 is partly supported by the low statistical base in the corresponding period of 2023 due to the continued contraction in economic activity witnessed for several quarters in the past. Accordingly, given that the year-on-year growth would be derived with reference to a relatively high statistical base due to the positive growth rates recorded in the second half of 2023, economic growth during H2-2024 is expected to be lower than the growth in H1-2024.

Figure 04: Projected Quarterly Real GDP Growth (Y-o-Y, %)
Based on the Projections during the July 2024 Monetary Policy Round



Source: Central Bank Staff Projections

See the explanatory note in Figure 01 above.

The easing of monetary conditions is anticipated to aid in stimulating growth towards its potential by fostering investments, enhancing consumer spending and eventually boosting aggregate demand. Meanwhile, the projected strengthening of economic conditions of key trading partners is anticipated to benefit the domestic economy via increased exports. Additionally, external demand for domestic services, especially tourism, is expected to remain strong. These conditions are expected to support the recovery of the economy, narrowing the negative output gap. However, due to continued fiscal consolidation efforts, the ability of the fiscal sector to promote economic activity remains limited. Accordingly, reducing the negative output gap on a sustainable basis remains challenging.

A sustainable pickup in investment activity supported by both domestic and foreign savings would be decisive to sustain the growth momentum. The adoption of effective policies and planned structural reforms are therefore critical for the economy to achieve its full potential in the medium term. Thus, enhancing productivity, efficiency and competitiveness of the economy and tackling growth obstacles through reducing structural barriers, such as the challenges posed by a weak business environment, are crucial for attaining sustainable growth and enhancing potential.

2.2. Key Assumptions Underpinning the Forecast

A summary of the key assumptions used in arriving at medium-term forecasts is provided in this section.

Global Environment

According to the Global Projections Model Network (GPMN),[6] the world economy is projected to achieve a growth rate of 2.9 per cent in 2024, while a marginal slowdown is anticipated in 2025 due to prevailing stringent monetary policy measures worldwide. Inflation in all major economies, except China, continues to surpass targets. The export-weighted foreign output gap,[7] derived based on these projections, is expected to remain positive during most of the forecast horizon, largely driven by the anticipated recoveries in the US, UK, and Eurozone economies. According to GPMN projections, the US Federal Reserve is expected to reduce the Federal Funds Rate in September 2024. The average Brent crude oil price is expected to be higher in 2024 compared to the last year, influenced by geopolitical tensions and Organization of the Petroleum Exporting Countries' (OPEC+) supply cuts affecting global supply, amidst an optimistic demand outlook. Over the medium term, world oil prices are expected to gradually increase. Meanwhile, global food prices are expected to rise, and their increase is projected to continue as climate-related risks affect food supplies.

[6] The Central Bank uses projections of global macroeconomic indicators prepared by GPMN as inputs for medium term projections. Projections used in the July 2024 monetary policy round are based on GPMN projections received on 26 June 2024.

[7] The export-weighted foreign output gap is calculated as a weighted average of trade-partners' output gaps provided in GPMN projections by using normalised shares of exports corresponding to six major trading partners of Sri Lanka. The weighting methodology for the foreign output gap has been changed from the share of total trade to the share of exports to better capture the external demand for goods and services produced in Sri Lanka.

Fiscal Path

The debt restructuring scenario as well as the ongoing fiscal consolidation measures, in line with the continuation of the Extended Fund Facility (EFF) of the International Monetary Fund (IMF) and efforts to restore debt sustainability, are reflected in the fiscal balances used for baseline projections. Data from 2024 onwards are in line with the latest projections published in the IMF Staff Report in June 2024. The budgetary allocations for the re-capitalisation of banks are considered to be growth-neutral, while government debt is allowed to be determined by the Quarterly Projection Model (QPM), consistent with the trajectory of the budget deficit and the debt cost.

Table 01: Assumptions on Fiscal Balances (% of GDP)

	2024	2025	2026	2027	2028
Budget Deficit	8.6	5.2	4.6	4.1	3.8
Debt Cost	8.4	7.5	6.9	6.4	6.2

Source: The latest IMF Projections published in the IMF Staff Report – June 2024

External Current Account

Driven by significant inflows in the form of services exports and workers' remittances, the current account recorded a surplus in Q1-2024, even amidst the widening of the trade and the primary income account deficits. Going forward, with the relaxation of import controls, imports are expected to pick up. Although a widening of the trade deficit is anticipated towards the latter part of 2024 due to increased import expenditure, the expected improvements in the services account and the secondary income account are likely to contribute to a continuation of the positive momentum in the external sector. Therefore, a marginal surplus in the external current account is expected in 2024 as well.

2.3. Risks to Projections

There are both upside and downside risks to the baseline projections of inflation and GDP growth. An exposition of such risks, as per the monetary policy round in July 2024, is provided in this section.

Risks to Inflation Projections

When downside risks are considered, the sustained impact of diminished purchasing power of people can lead to continued low consumer spending, which in turn exerts downward pressure on demand. The possible easing of geopolitical tensions over the medium term could reduce global economic uncertainties and trade disruptions, which might alleviate upward pressures on prices for commodities and other goods. Possible larger-than-expected spillovers of energy price reductions could result in broad-based decrease in the prices of other goods and services, as lower energy costs reduce production and transportation expenses.

Several upside risks could potentially lead inflation on a higher trajectory than the projected path. As elevated price levels due to past price increases, subdued economic activity and tight fiscal conditions continue to exert pressure on real income levels on the one hand, and brain drain in multiple sectors that necessitates staff retention measures by businesses on the other, there is a possibility that the demand for higher wages to be realised. This could lead to further price increases with businesses passing such increased costs to consumers. Possible adverse weather conditions would affect agricultural production negatively, exerting upward pressure on food inflation. Upside risks to inflation could also arise due to any possibility of depreciation pressures. Moreover, any deviation from the expected fiscal consolidation path could also lead to inflationary pressures, via increased (or less restrictive than expected) spending. In addition, global oil prices have undergone some volatility in the recent past, and the recent escalation of geopolitical tensions could result in the continuation of the same. Further, there are some upside risks to global food prices, particularly in the near term, that could potentially raise domestic price levels.

Considering the higher volatility in global oil and food prices, amidst heightened geopolitical uncertainty and the related possibility of global price levels increasing, possible depreciation pressure on the Sri Lanka rupee, and the impact of adverse weather on food inflation, risks to inflation projections in the near term are assessed to be skewed to the upside. However, in the medium term, risks to inflation projections are assessed to be balanced, where both upside and downside risks are expected to exert possible pressures on price levels.

Risks to Economic Growth Projections

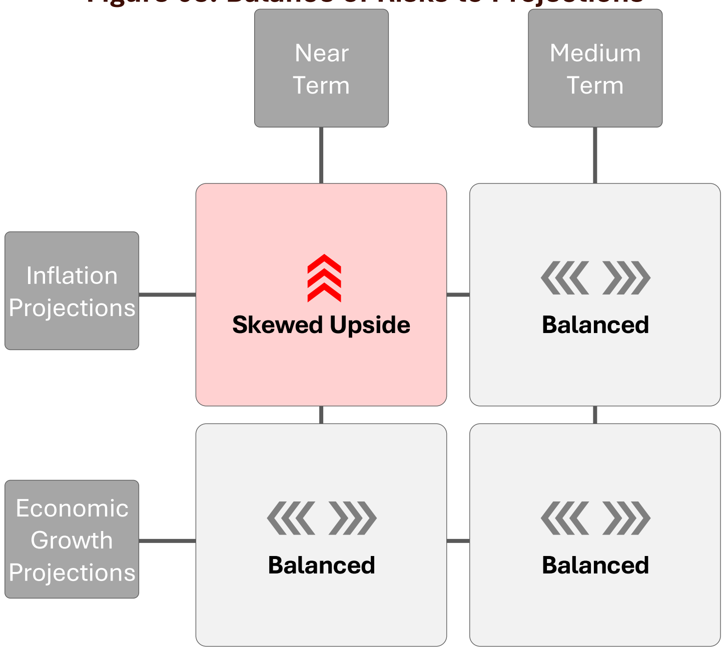
Potential major downside risks to growth projections in the near to medium term include, among others, brain drain leading to labour shortages and low productivity; any political uncertainty having negative implications on business sentiment and economic recovery; continued modest global demand for major exports, issues in trade relations particularly among large economies and their impact on the domestic economy, increased geopolitical tensions; and weather anomalies and climate change impacting economic activities negatively.

The continuation of the IMF-EFF arrangement and the progression of the envisaged structural reforms remain a key factor that influences overall macroeconomic stability and growth. Any notable deviation from this path and subsequent policy reversals would cause high economic costs to the country due to growth derailment, loss of confidence, and the protraction of negative investor sentiments.

On the upside, with the removal of remaining import restrictions, there could be a revival of import-dependent businesses. Activity pickup related to large capital infrastructure developments could contribute to improving overall economic performance. A faster-than-expected recovery in tourism could generate positive spillovers that could enhance economic growth by boosting related sectors, increasing employment, and stimulating consumer spending. Moreover, positive spillovers from the divestiture of selected State Owned Enterprises (SOEs) and potential favourable sentiments from successful debt restructuring could positively affect economic growth momentum.

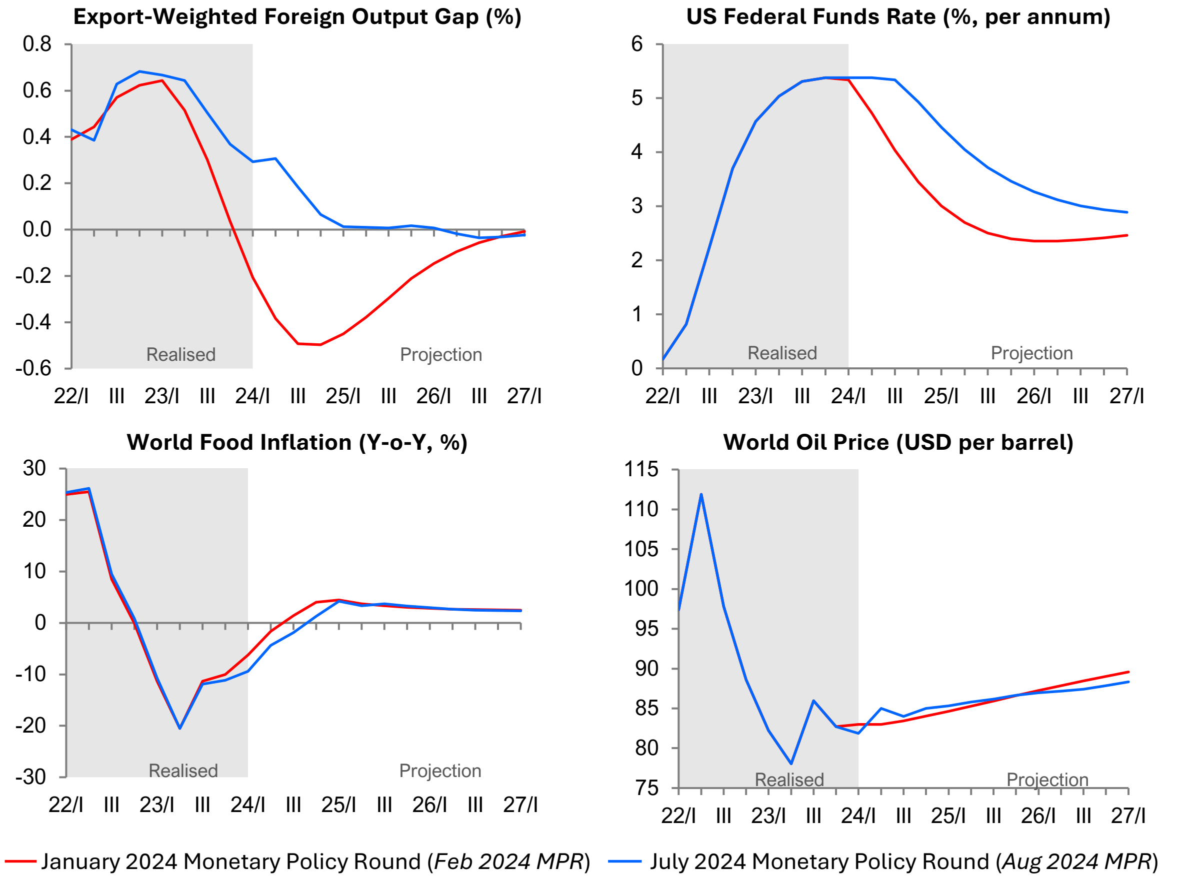
Overall, risks to growth projections in both the near term and the medium term are assessed to be balanced. This assessment is motivated by the possibility of upside risks on growth projections having an offsetting impact on the risks arising due to downside risks. Compared to the projections presented in the last monetary policy report (MPR-February 2024) the impact of upside risks is assessed to be higher in the July 2024 monetary policy round, thus upgrading the risk assessment to be balanced.

Figure 05: Balance of Risks to Projections



Source: Central Bank Staff Projections

Figure 06: Global Projections (Quarterly)



Sources: QPM, GPMN (Updated on 05/01/2024 and 26/06/2024)

2.4. Comparison with the Previous Forecast[8]

Key Assumptions Used for Medium-Term Projections

Based on global projections used during the monetary policy round in July 2024, the outlook for the export-weighted foreign output gap of Sri Lanka's major trading partners has improved compared to the information available as of January 2024. This improvement is primarily due to improved projections related to the US, Eurozone, and UK economies. Global projections used during the July 2024 monetary policy round forecast a slower increase in food inflation compared to the monetary policy round in January 2024. World food inflation, which is currently estimated to be negative, is expected to turn positive in Q4-2024 and stabilise thereafter. World oil prices remained elevated in Q2-2024 compared to the levels projected in January 2024. This trend is expected to continue in the short-term, leading to a slightly higher projected path for world oil prices than previously anticipated. Meanwhile, monetary policy loosening in the US is expected

[8] This section compares the current baseline forecast against those presented in MPR-February 2024, which was based on the information and projections as of the January 2024 monetary policy round.

to be slower than previously projected amidst the cautious approach of the US Federal Reserve. The fiscal path has been revised in the current projections, mainly for 2024, compared to the January 2024 monetary policy round. The fiscal balance for 2024 is expected to improve in comparison to the previous projections, mainly driven by anticipated increases in government revenue. Assumptions on the current account balance of the Balance of Payments (BOP) have been revised to reflect new information. Accordingly, the surplus in the current account for 2024 is now projected to be lower than the level assumed in January 2024, primarily due to an increase in imports expected in the latter part of the year.

Inflation Path

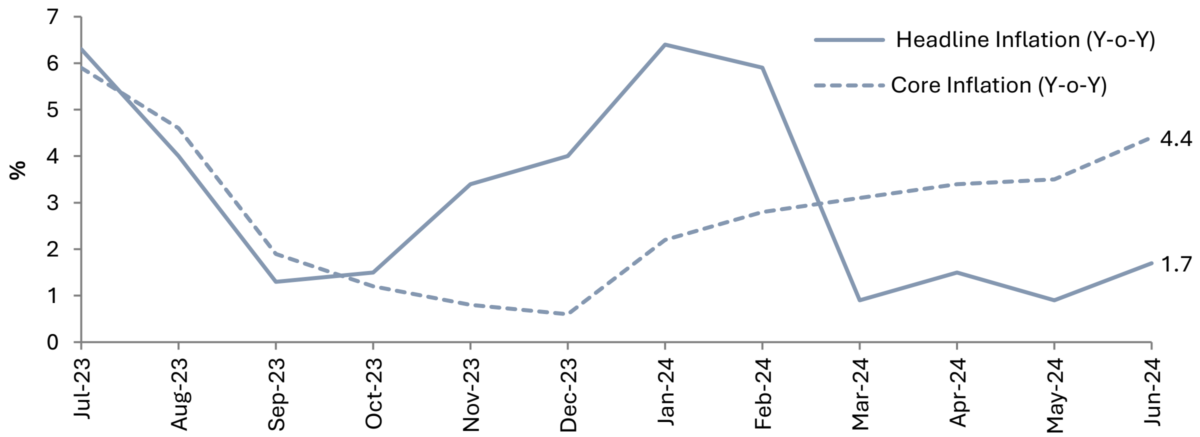
Compared to the projections published in MPR-February 2024, realised year-on-year headline inflation was below the projected levels during both Q1-2024 and Q2-2024, which was mainly due to the lower-than-expected inflation impact of the VAT adjustments and substantial electricity tariff reductions. The inflationary impact of the increases to taxes in January 2024 was incorporated into inflation projections during the January 2024 monetary policy round. However, the realised impact of such tax increases was not as large as initially anticipated and some of the VAT exemption removals considered in staff judgements were not implemented. Continued weak demand conditions that prevailed could also have contributed to the incomplete passthrough of VAT increase, wherein merchants would have been reluctant to increase prices notably. Meanwhile, the realised electricity tariff reduction in March 2024 was considerably higher than the anticipated adjustment internalised in the projections of the January 2024 monetary policy round. Moreover, information about the electricity tariff reduction undertaken in July 2024 was also not available during the January 2024 monetary policy round, and therefore, the projected path of inflation in Q3-2024 is also different from the previous path. Earlier projections indicated that inflation could experience a temporary upward movement driven by an unfavourable base effect in Q3-2024. However, driven mainly by the large electricity tariff reduction, the quarter-on-quarter disinflationary effect in Q3-2024 is expected to outweigh the unfavourable statistical base effect, thus leading to a subdued year-on-year inflation projection for Q3-2024. In addition, gradual downward revisions to fuel and LP gas prices, as well as some reduction in volatile food prices also contributed to the realised inflation deviating from its previously projected path. The previously anticipated slowdown in inflation in early 2025, owing to the statistical base effect resulting from the VAT impact in Q1-2024 is extant in current projections as well. However, unlike the January 2024 projection, the unfavourable base effect due to the recent electricity tariff reduction is expected to push year-on-year headline inflation temporarily above the target in Q3-2025. Nonetheless, similar to the previous projection, inflation is expected to gradually stabilise around the inflation target over the medium term.

3. CURRENT ECONOMIC DEVELOPMENTS

3.1. Inflation

Headline inflation, which recorded a temporary uptick in early 2024 owing to the VAT increase, decelerated thereafter and remained considerably below the inflation target of 5 per cent, contributed by downward electricity tariff revisions, alongside the easing of food, fuel and LP gas prices, amidst muted demand pressures.

Figure 07: Movements in Headline and Core Inflation (CCPI, 2021=100)



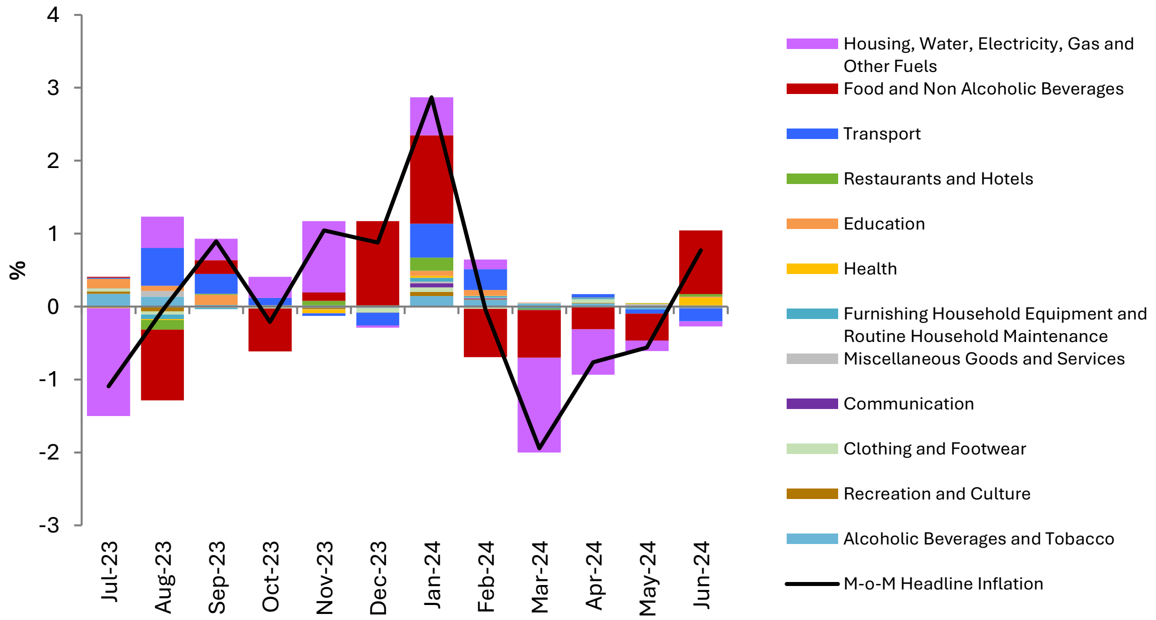
Source: Department of Census and Statistics

The Colombo Consumer Price Index (CCPI, 2021=100) based headline inflation (year-on-year), which accelerated towards the latter part of 2023 due to several supply-side factors, peaked at 6.4 per cent in January 2024 driven primarily by the increase in the VAT rate and the removal of several VAT exemptions. However, with the implementation of a significant downward revision to electricity tariffs in March 2024, headline inflation declined notably. Moreover, the direct and second-round impact of the VAT change on inflation was not as large as initially expected amidst subdued demand. The deceleration of headline inflation was also supported by the moderation in food prices. In addition, several rounds of downward revisions to domestic fuel and LP gas prices also contributed to the continued deceleration in inflation. Accordingly, CCPI-based headline inflation was recorded at 1.7 per cent (year-on-year) by June 2024.[9] Both food and non-food inflation based on CCPI remained low in June 2024. With these developments, the quarterly average of CCPI-based headline inflation decelerated to 1.4 per cent in Q2-2024 from 4.4 per cent in the previous quarter. Accordingly, realised quarterly average headline inflation during Q2-2024 was below the inflation target by more than the margin of 2.0 percentage points

[9] In July 2024, CCPI-based headline inflation was recorded at 2.4 per cent (year-on-year).

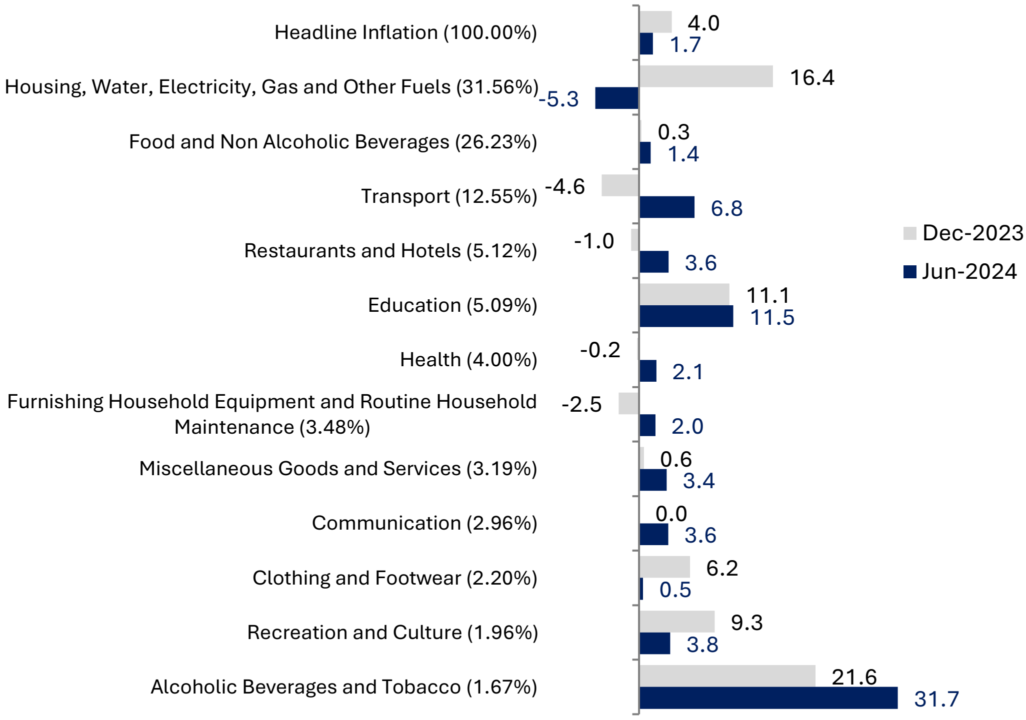
stipulated in the MPFA. Meanwhile, the National Consumer Price Index (NCPI, 2021=100) based headline inflation (year-on-year) also decelerated from 6.5 per cent in January 2024 to 2.4 per cent in June 2024.

Figure 08: Contribution to M-o-M Headline Inflation (CCPI)



Sources: Department of Census and Statistics
Central Bank Staff Calculations

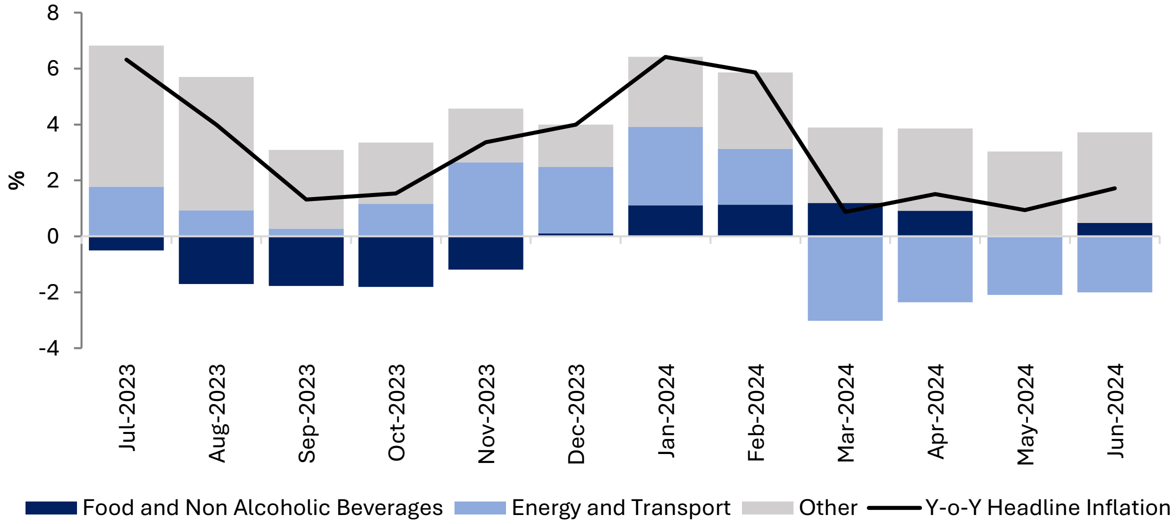
Figure 09: Category-wise Y-o-Y Headline Inflation (CCPI, %)



Note: Base weights are given within parentheses

Source: Department of Census and Statistics

Figure 10: Contribution to Y-o-Y Headline Inflation (CCPI)



Sources: Department of Census and Statistics
Central Bank Staff Calculations

CCPI-based core inflation (year-on-year), which reflects the underlying inflation trends in the economy, accelerated gradually during H1-2024 and was recorded at 4.4 per cent in June 2024.[10] This was contributed by the changes to the VAT structure along with unfavourable base effects. Meanwhile, NCPI-based core inflation (year-on-year) was recorded at 3.9 per cent in June 2024.

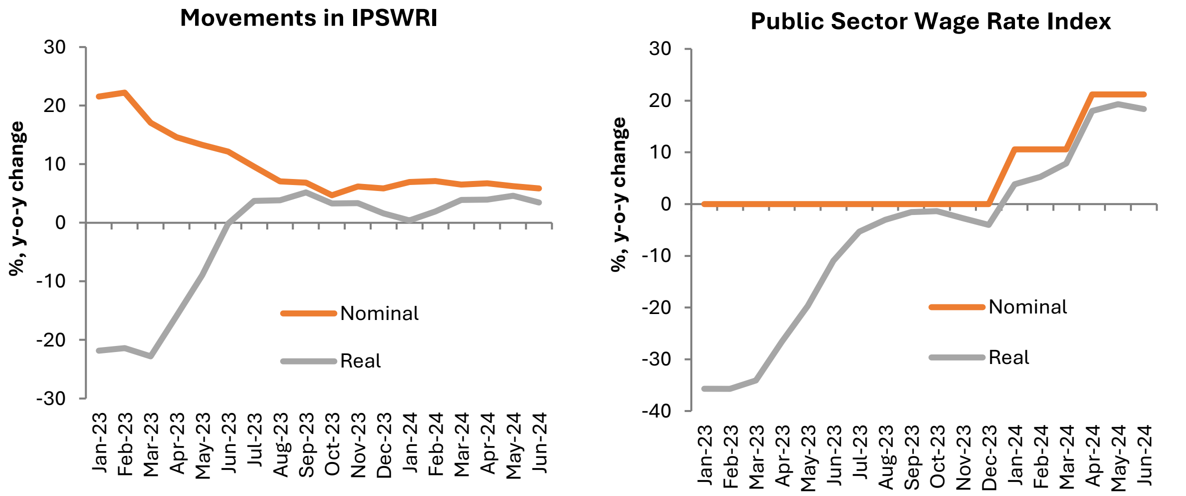
Both the Informal Private Sector Wage Rate Index (IPSWRI, 2018=100) and the Public Sector Wage Rate Index (2016=100) recorded an increase during H1-2024.

Continuing the upward trend in nominal wages observed in 2023, the IPSWRI recorded an overall increase in H1-2024. This increase was observed across all three major economic activities, with particularly higher wage growth in the Agriculture and Services activities. However, on a year-on-year basis, the growth of nominal IPSWRI slowed in line with the easing of inflationary pressure during H1-2024, compared to H1-2023. Moreover, on a year-on-year basis, the real IPSWRI continued to accelerate during H1-2024 with the continued deceleration in inflation.

The Public Sector Wage Rate Index increased during H1-2024, with the increase in the cost of living allowance for the public sector employees in January and April 2024. Meanwhile, the real wage erosion has been contained due to the deceleration in inflation.

[10] In July 2024, CCPI-based core inflation was recorded at 4.4 per cent (year-on-year).

Figure 11: Movements in the IPSWRI (2018=100) and Public Sector Wage Rate Index (2016=100)



Source: Central Bank of Sri Lanka

3.2. Real Sector

The Sri Lankan economy continued its positive growth momentum for the third consecutive quarter in Q1-2024.

As per the GDP estimates of the Department of Census and Statistics (DCS), the Sri Lankan economy grew by 5.3 per cent (year-on-year) in Q1-2024 compared to the contraction of 10.7 per cent (year-on-year) in Q1-2023, with all three major sectors recording positive growth.

Agriculture activities recorded a modest expansion during this period led by fishing, animal production and the growing of cereals. The notable growth in Industry activities was led by manufacturing, construction, and mining and quarrying activities. The positive performance of accommodation, transportation, wholesale and retail trade, real estate and insurance services were the key contributors to the growth in Services activities.

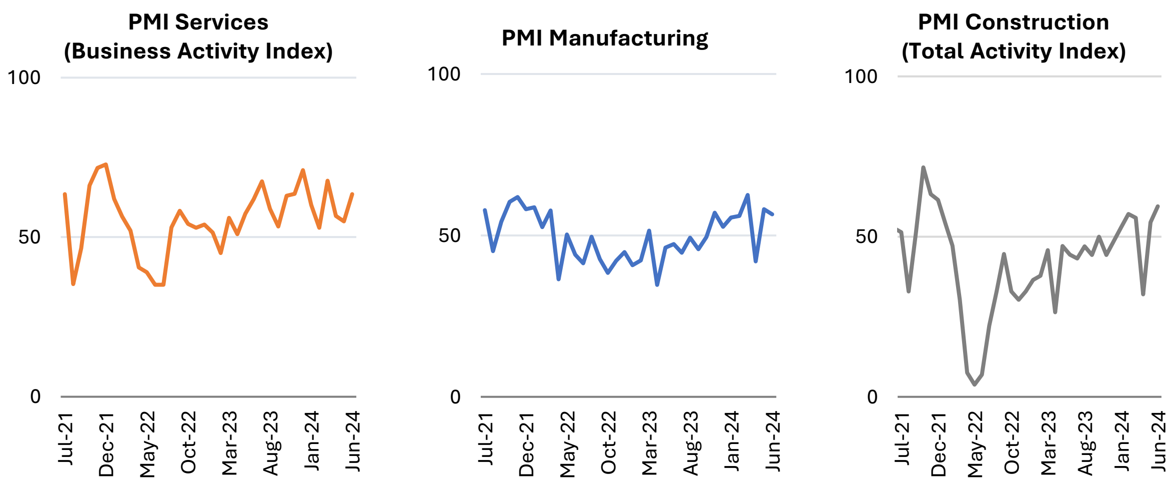
Table 02: Estimates of Real GDP Growth (Y-o-Y, %) (Provisional)

Economic Activity	2023					2024
	Q1	Q2	Q3	Q4	Annual	Q1
Agriculture	1.6	4.2	4.2	0.6	2.6	1.1
Industry	-24.3	-11.7	-0.7	7.9	-9.2	11.8
Services	-4.6	-0.5	1.7	2.8	-0.2	2.6
GDP	**-10.7**	**-3.0**	**1.6**	**4.5**	**-2.3**	**5.3**

Source: Department of Census and Statistics

Leading indicators point to the economy continuing its positive growth momentum during Q2-2024, with growth expected to be largely driven by Industry and Services activities. The Index of Industrial Production (IIP) increased on a year-on-year basis during Q2-2024. Despite the seasonal dip in April, Manufacturing Purchasing Managers' Index (PMI) grew strongly on a month-on-month basis in May and June 2024, reflecting the positive developments in manufacturing activities. Further, Construction PMI, which also recorded a seasonal decline in April 2024, expanded in May and June 2024, reflecting the gradual resumption of construction activities. Meanwhile, Services activities are also expected to have recorded a positive growth in Q2-2024, as signalled by the PMI Services (Business Activity Index). Notably, the elevated levels of tourist arrivals are expected to have positive spillovers on several key activities related to accommodation, food and beverage services, and transport activities. Agriculture activities are expected to have exhibited mixed performance amid challenging weather conditions.

Figure 12: Movements in Purchasing Managers' Indices



Source: Central Bank of Sri Lanka

On the expenditure front, in terms of constant prices, consumption expenditure, the dominant expenditure component, grew while investment expenditure rebounded driving overall economic demand during Q1-2024. Further, net external demand improved during Q1-2024 as the pace of growth of exports of goods and services outpaced that of imports of goods and services.

Table 03: Aggregate Demand (Provisional)

Item	Constant (2015) Prices					
	2023		2023 Q1		2024 Q1	
	Rs. bn	Y-o-Y, %	Rs. bn	Y-o-Y, %	Rs. bn	Y-o-Y, %
Domestic Demand	11,739	-3.4	3,128	-15.0	3,280	4.9
Consumption	9,078	-2.2	2,329	-11.0	2,342	0.5
Investment (Gross Capital Formation)	2,661	-7.4	799	-25.0	939	17.6
Net External Demand	142	1,462.6	34	124.4	49	43.4
+ Exports of goods and services	2,667	12.0	657	8.4	779	18.6
- Imports of goods and services	2,524	6.5	622	-16.5	730	17.3
GDP	**11,882**	**-2.3**	**3,162**	**-10.7**	**3,330**	**5.3**

Source: Department of Census and Statistics

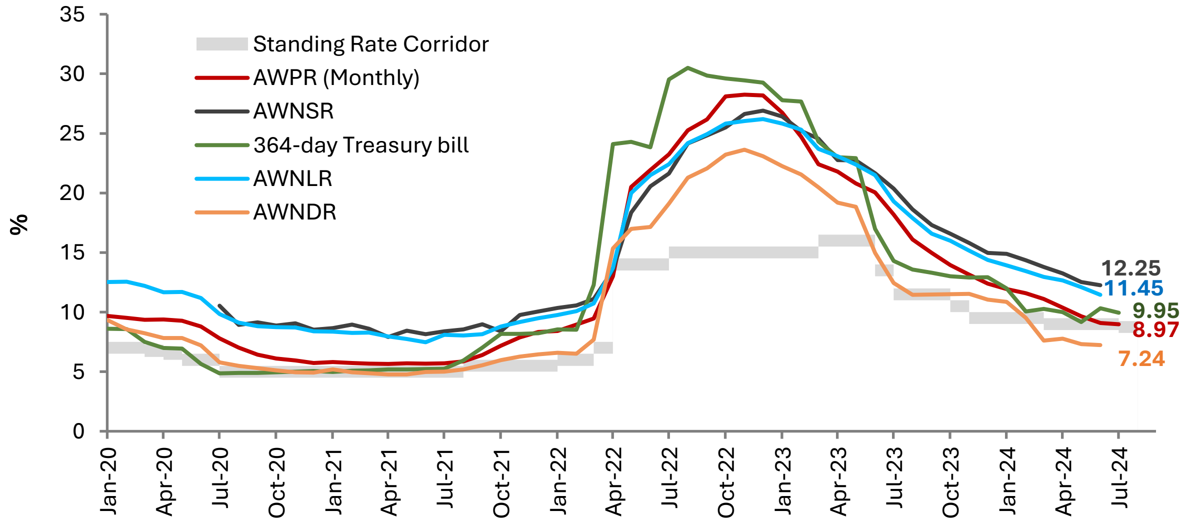
3.3. Monetary Sector

Interest Rates

In line with the accommodative monetary policy stance of the Central Bank, market interest rates have continued to decline thus far during 2024, however, space remains for the market lending interest rates to decline further.

The overall interest rate structure continued to adjust downwards with the gradual passthrough of the eased monetary policy stance, which has been in place since June 2023. Market deposit interest rates have dropped significantly in response to relaxed monetary and improved liquidity conditions, while the reduction in market lending interest rates is expected to have eased the burden on businesses and households through reduced financing costs. In particular, interest rates on lending to prime customers, as reflected by the Average Weighted Prime Lending Rate (AWPR), reduced to pre-crisis levels by late July 2024. However, the reduction in interest rates on loans of Small and Medium Enterprises (SMEs) and retail loans remains limited compared to that of deposits. The interest rate spread between new loans and deposits, as reflected by the Average Weighted New Lending Rate (AWNLR) and the Average Weighted New Deposit Rate (AWNDR), respectively, remains high as of end June 2024 compared to its historical average. This indicates the availability of further space for a reduction in market lending interest rates in the period ahead. Moreover, the reduction in overall SME lending interest rates has been mainly driven by large borrowings. That too indicates that the passthrough of eased monetary conditions for the benefit of marginal/ small-scale borrowers is not complete.

Figure 13: Movement in Selected Market Interest Rates



Source: Central Bank of Sri Lanka

Table 04: Selected Market Interest Rates

% per annum

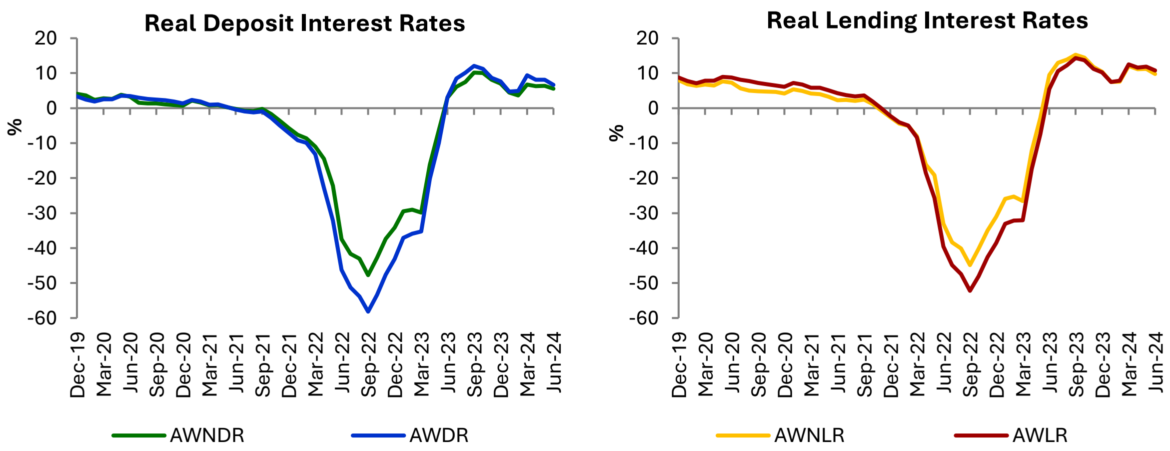
Rate	End 2023	End June 2024	Change (% pts)
AWCMR	9.24	8.75	-0.49
AWPR (Weekly)	12.13	8.78	-3.35
364-day Treasury Bill	12.93	10.31	-2.62
AWLR	14.21	12.47	-1.74
AWDR	11.64	8.38	-3.26
AWNDR	11.06	7.24	-3.82
AWNLR	14.38	11.45	-2.93
AWNSR	14.96	12.25	-2.71

Source: Central Bank of Sri Lanka

In general, yields on government securities continued to decline, on average, in line with eased monetary conditions, along with the dissipation of uncertainties related to debt restructuring strategy, improved market sentiments and lower auction sizes. However, yields showed a temporary uptick in late June 2024, mainly driven by the large auction volumes. Accordingly, the overall reduction in yields on Treasury bills thus far during the year up to 17 July 2024 was in the range of 2.86-4.96 percentage points.

Although the nominal market interest rates adjusted downward, real interest rates continue to remain high and positive, amidst prevailing low inflation levels.

Figure 14: Ex-Post Real Interest Rates



Note: The monthly real interest rate is derived by adjusting the nominal interest rate for the y-o-y headline inflation rate (CCPI based).

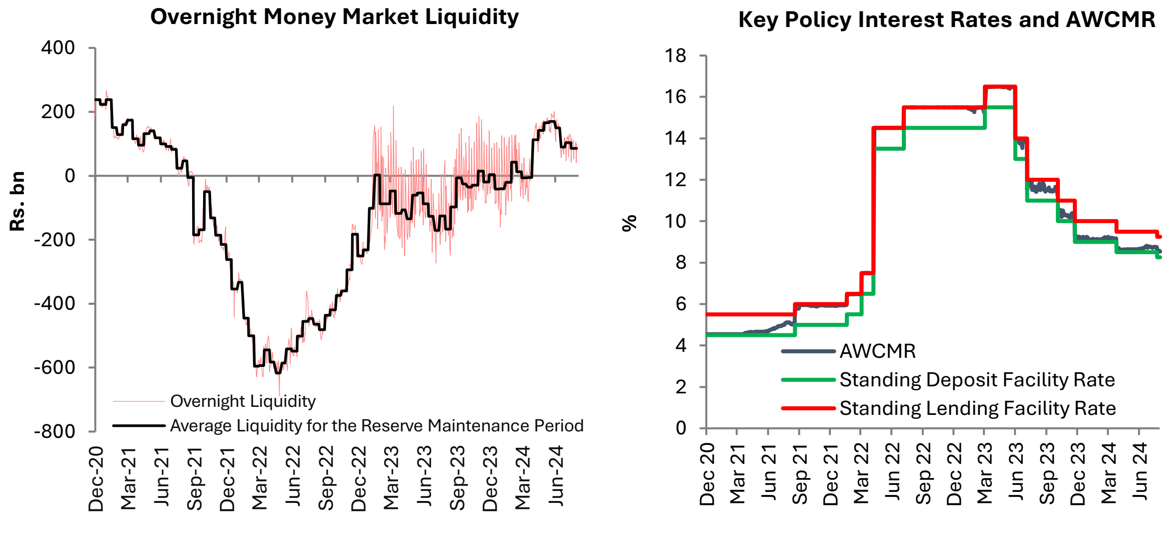
Source: Central Bank of Sri Lanka

Domestic Money Market Liquidity

Liquidity conditions in the domestic money market improved in 2024.

Liquidity in the domestic money market has recorded an improvement so far during 2024, particularly since April, when liquidity turned into surplus levels on a sustained basis, mainly due to liquidity injections through foreign exchange transactions of the Central Bank. In view of the improved liquidity levels and domestic money market activity, restrictions imposed by the Central Bank on the usage of its Standing Facilities were relaxed in February 2024 and completely removed from April 2024. Moreover, the conduct of reverse repo auctions was significantly scaled down during May and early June 2024. However, by early July 2024, the surplus liquidity levels (both overnight and structural) in the domestic money market declined on average compared to the levels observed in May 2024, primarily due to the maturities of government securities held by the Central Bank and coupon payments on government securities to the Central Bank. This decline exerted some upward pressure on short-term market interest rates. Hence, the Central Bank injected liquidity through the conduct of regular Open Market Operations (OMOs), as needed, to provide certainty on the availability of liquidity and to induce a downward adjustment in money market rates complying with the accommodative monetary policy stance. Despite the overall surplus, the distribution of liquidity in the domestic money market remains asymmetric among participatory institutions.

Figure 15: Behaviour of Overnight Liquidity, Key Policy Interest Rates and AWCMR



Source: Central Bank of Sri Lanka

The Average Weighted Call Money Rate (AWCMR), continued to remain closer to the lower bound of the Standing Rate Corridor (SRC) in line with the relaxed monetary policy stance and improved liquidity conditions in the domestic money market. Accordingly, the AWCMR remained at 8.76 per cent by 23 July 2024.[11]

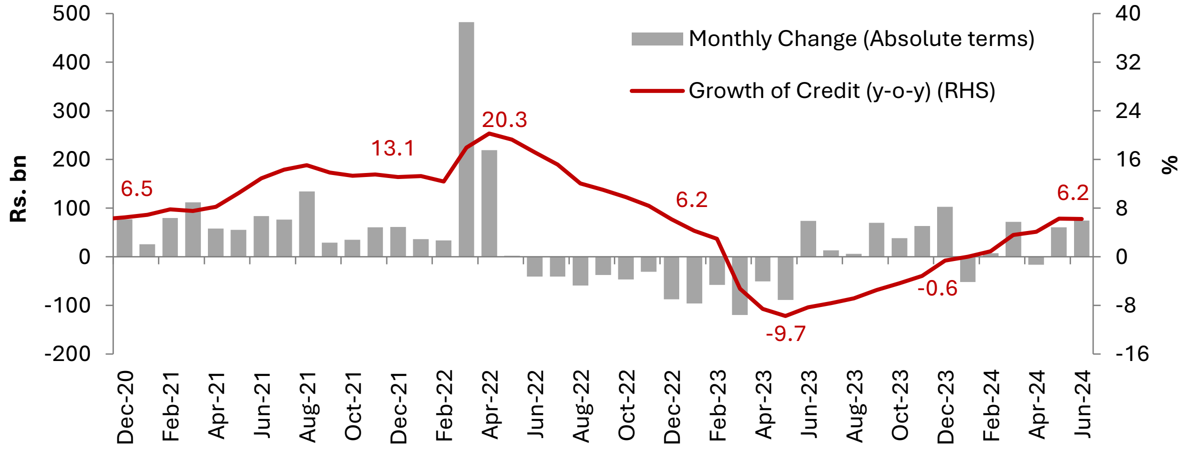
Domestic Credit Conditions and Money Supply

The gradual pickup in private sector credit and the expansion in Net Foreign Assets (NFA) of the banking sector supported the continuous expansion in broad money (M_{2b}) thus far in 2024.

While credit extended to the private sector by Licensed Commercial Banks (LCBs) has been uneven during early 2024, a noteworthy expansion of credit was recorded in May and June 2024. Credit to the private sector expanded by around Rs. 146 billion during H1- 2024, recording a year-on-year growth of 6.2 per cent by end June 2024. While the credit expansion was largely consumption oriented, an improvement was observed in credit extended to the other sectors of the economy as well. While the sluggish expansion of private sector credit thus far in 2024 is partially attributable to subdued demand in the economy with interest rates on selected retail lending products remaining relatively high, constraints on the credit supply front, such as high risk premia associated with lending, especially to SME sector, would also have contributed to this.

[11] With the reduction of policy interest rates by 25 bps on 24 July 2024, AWCMR reduced further and was recorded at 8.55 per cent by end July 2024.

Figure 16: Monthly Change in Credit to the Private Sector by LCBs

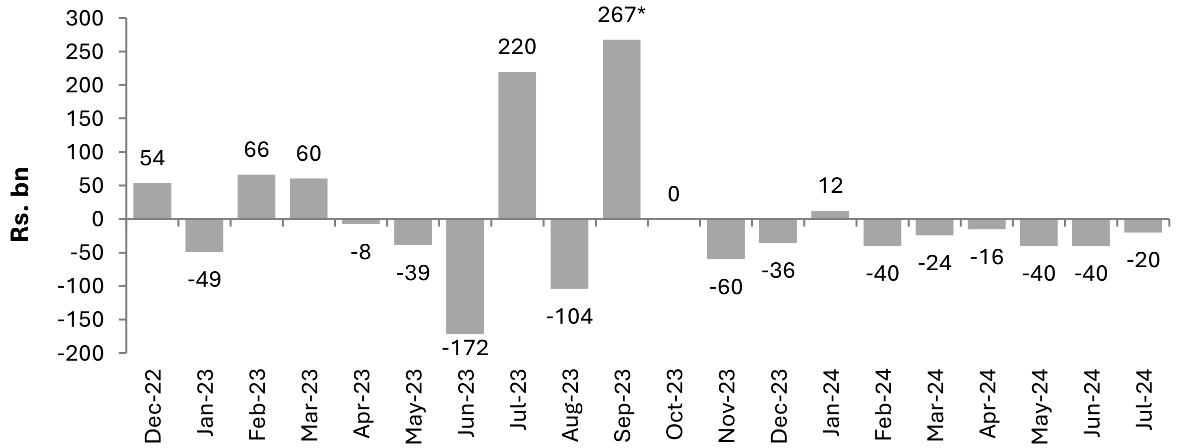


Note: The significant depreciation of the Sri Lanka rupee against the US dollar during March-May 2022 mainly contributed to the notable expansion of monetary and credit aggregates during that period.

Source: Central Bank of Sri Lanka

Net credit to the Government (NCG) by the banking system contracted during H1-2024, mainly due to the contraction in NCG by the Central Bank, while NCG by LCBs recorded an increase, reflecting the increase in their investments in government securities. NCG by the Central Bank reduced during H1-2024 mainly due to the maturity of Treasury bills and the reduction in the use of the Standing Lending Facility (SLF) by LCBs.

Figure 17: The Central Bank's Holdings of Government Securities (Monthly Change in Face Value)



** Includes the conversion of outstanding provisional advances obtained by the Government to Treasury bonds in accordance with Section 129(2) of the CBA.*

Source: Central Bank of Sri Lanka

Credit granted to State-Owned Business Enterprises (SOBEs) by LCBs contracted during H1-2024 mainly due to net repayments by the major SOBEs along with the valuation impact of the Rupee appreciation recorded during the period.

NFA of the banking system improved notably during H1-2024, turning positive for the first time since April 2020. NFA of LCBs improved due to the build-up of foreign assets while settling foreign currency exposures to non-residents. NFA of the Central Bank was built up through the net purchase of foreign exchange from the domestic foreign exchange market amidst improved external sector performance, leading to enhanced gross official reserves.

In line with these developments and the easing of monetary conditions, broad money (M_{2b}) continued to expand, recording a year-on-year growth of 9.8 per cent by end June 2024.

Table 05: Components of Broad Money (M_{2b})

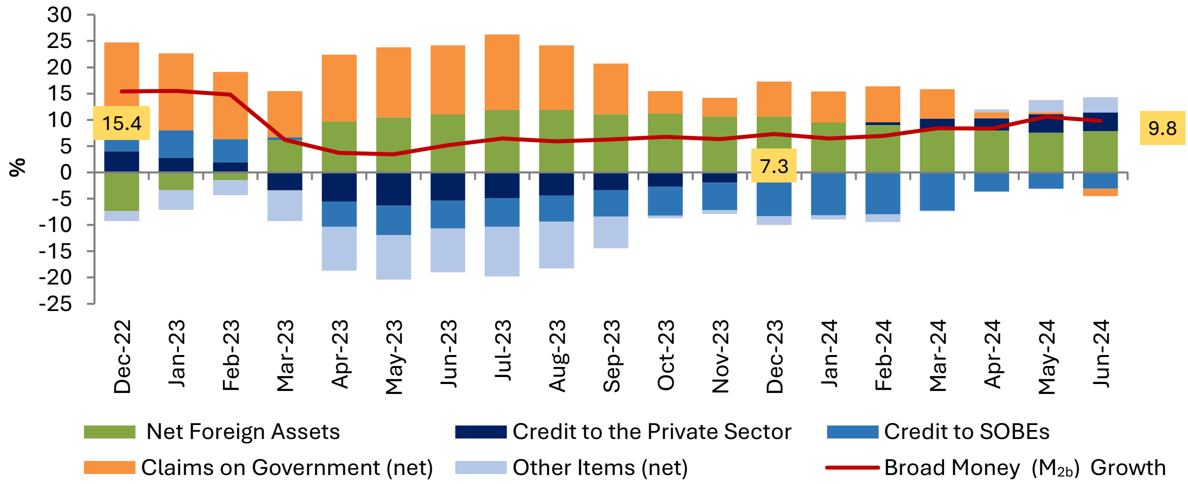
		2022	2023	2024						
				Jan	Feb	Mar	Apr	May	Jun	H1
NFA	Change (Rs. bn)	-784.8	1,310.7	56.1	79.7	148.1	119.3	146.8	86.3	636.3
NCG	Change (Rs. bn)	1,638.7	813.9(a)	50.1	-18.1	-60.4	-26.2	-75.8	-65.6	-196.1
Credit to SOBEs	Change (Rs. bn)	561.6	-979.9 (a)	-22.8	-14.0	-19.8	-11.8	-0.2	8.2	-60.4
Credit to the Private Sector	Change (Rs. bn)	430.0	-45.0	-52.2	7.3	71.9	-16.2	60.7	74.5	145.9
	Y-o-Y Growth (%)	6.2	-0.6	-0.02	0.9	3.6	4.1	6.3	6.2	
Broad Money Supply (M_{2b})	Change (Rs. bn)	1,642.3	899.5	-74.2	86.2	123.5	95.4	196.4	131.5	558.8
	Y-o-Y Growth (%)	15.4	7.3	6.4	6.9	8.4	8.3	10.6	9.8	

(a) With the approval of the Cabinet of Ministers at its meeting held on 30 January 2023, the outstanding foreign currency guaranteed debt of CPC was absorbed into central government debt with effect from December 2022. Accordingly, this adjustment was implemented in two phases, first in April 2023 and subsequently in December 2023, hence, was reflected in the balance sheets of the particular state-owned commercial banks, which caused a reduction in credit to public corporations/ SOBEs and a corresponding expansion in NCG.

Note: Annual changes are presented for years 2022 and 2023, while monthly changes are presented in the columns of January-June 2024. The final column contains the change during the first half of 2024.

Source: Central Bank of Sri Lanka

Figure 18: Contribution to Y-o-Y Growth of Broad Money (M_{2b})



Source: Central Bank of Sri Lanka

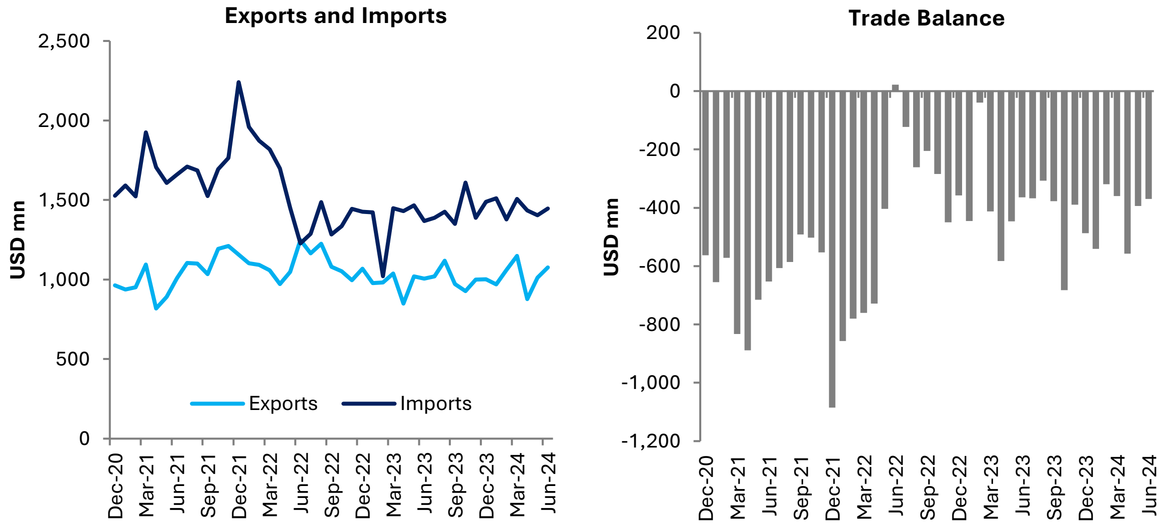
3.4. External Sector

A positive momentum was observed in the external sector thus far during 2024 with the current account recording a surplus for Q1-2024. Consequently, the liquidity conditions in the domestic forex market improved, resulting in an appreciation of the Sri Lanka Rupee in H1-2024 despite some depreciation pressure in the latter part.

Balance of Payments

The current account recorded a surplus of US dollars 706 million for Q1-2024. This was supported by significant inflows in terms of services exports and workers' remittances despite the widening of the trade and primary income account deficits. During H1-2024, the trade deficit widened to US dollars 2.5 billion. Both export earnings and import expenditure increased during the period concerned, compared to the corresponding period of 2023. The growth in merchandise exports was primarily driven by higher earnings from the export of petroleum products, food, beverages and tobacco, rubber products, and tea, among others. The increase in merchandise imports was primarily due to higher imports of machinery and equipment, textiles and textile articles, chemical products, and building materials, among others. There is a likelihood of the trade deficit widening towards the second half of the year with the anticipated increase in consumer demand and gradual relaxation of remaining import restrictions.

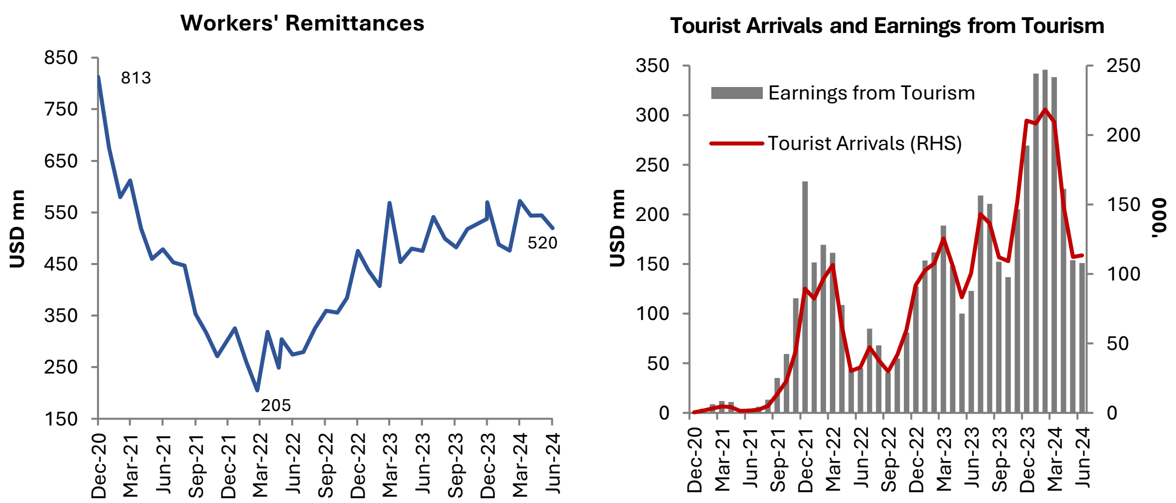
Figure 19: Trade Account



Sources: Central Bank of Sri Lanka
Sri Lanka Customs

In the services account, earnings from tourism improved significantly with arrivals surpassing one million tourists during H1-2024. Services inflows to other sectors, such as sea transport services, computer services and technical, trade-related and other business services, also recorded a growth during H1-2024. Meanwhile, workers' remittances registered a notable growth during H1-2024. Both the inflows to the services sector and workers' remittances are expected to continue to grow in the second half of 2024, helping to cushion any anticipated widening of the trade deficit.

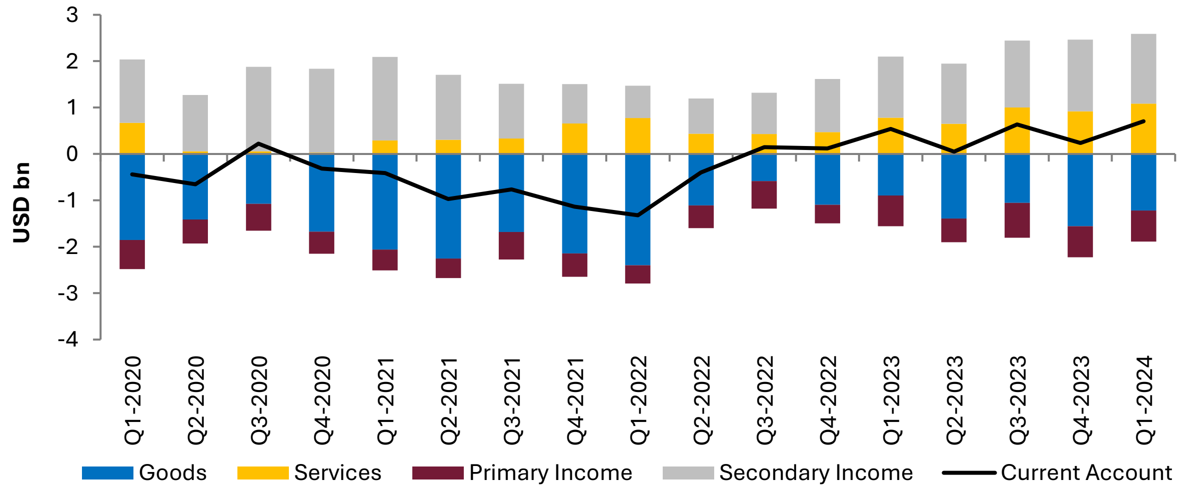
Figure 20: Workers' Remittances and Tourism



Sources: Central Bank of Sri Lanka
Licensed Banks

Sources: Central Bank of Sri Lanka
Sri Lanka Tourism Development Authority

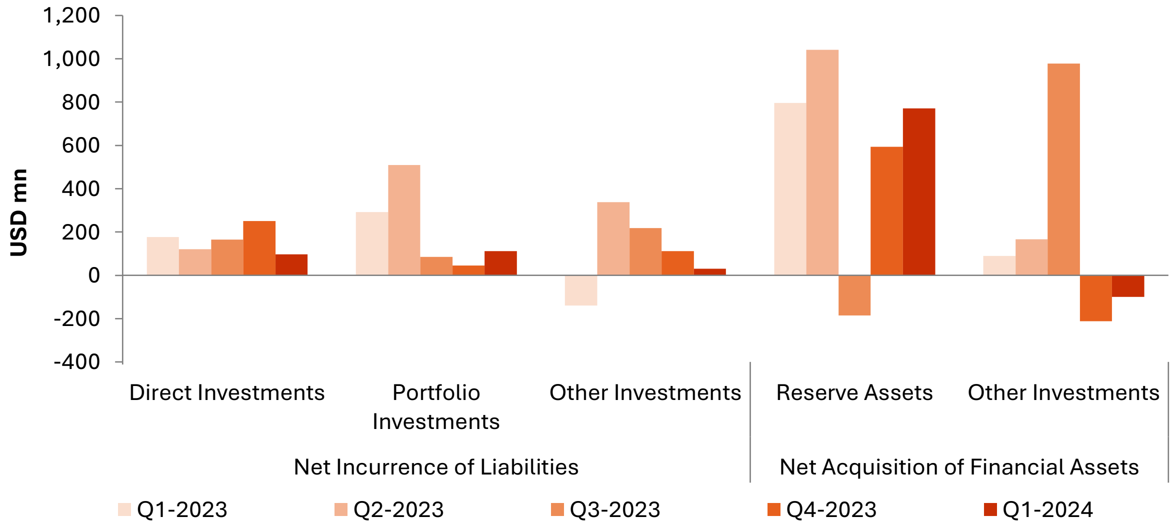
Figure 21: Current Account



Source: Central Bank of Sri Lanka

The performance of the financial account during H1-2024 remained subdued. Foreign Direct Investment (FDI) inflows in Q1-2024 remained weak. Total foreign investments in the government securities market recorded net outflows. The remaining non-resident holdings of outstanding government securities are at insignificant levels at present. Meanwhile, foreign investment inflows to the Colombo Stock Exchange (CSE), including both primary and secondary market transactions, recorded a marginal net inflow during H1-2024.

Figure 22: Financial Account

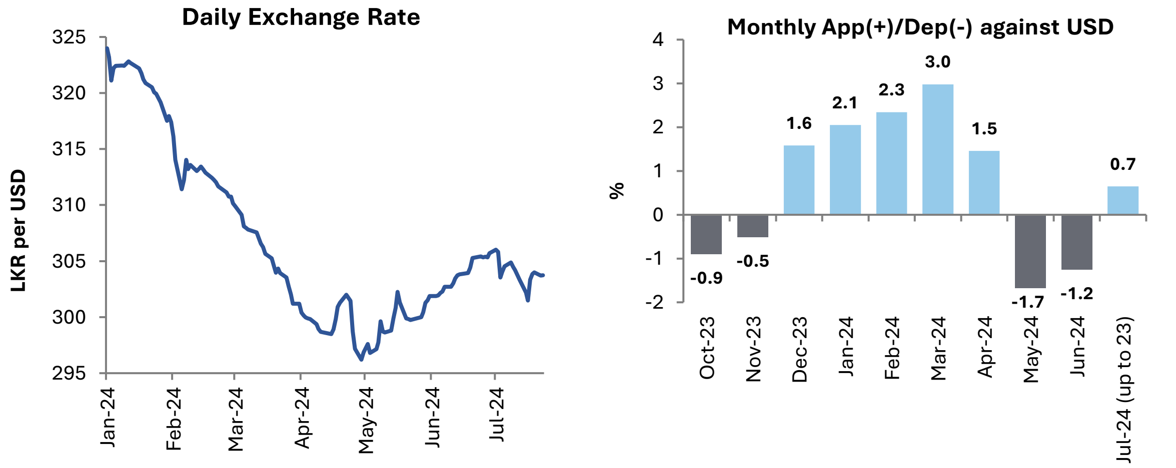


Source: Central Bank of Sri Lanka

Exchange Rate

The appreciation trend of the Sri Lanka rupee that was observed since the latter part of 2023 continued thus far in 2024 despite some depreciation pressure during May and June 2024. The liquidity conditions in the domestic forex market improved in H1-2024, with higher forex inflows from workers' remittances, increased services exports, and conversions of proceeds by merchandise exporters, along with continued improvements in market sentiments. The Sri Lanka rupee recorded an overall appreciation of 6.6 per cent against the US dollar during the year up to 23 July 2024. However, some depreciation pressures were observed during May and June 2024, mainly due to increased import payments and net outflows from the government securities market, necessitating the Central Bank to supply foreign exchange to the market on certain days to mitigate intraday fluctuations. Meanwhile, reflecting cross-currency movements, the Sri Lanka rupee appreciated against other major currencies, such as the euro, the pound sterling, the Chinese yuan, the Japanese yen, the Indian rupee, and the Australian dollar during the year up to 23 July 2024.

Figure 23: Exchange Rate Movements

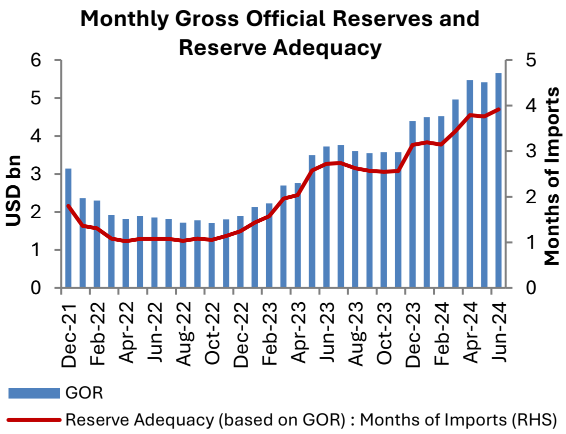


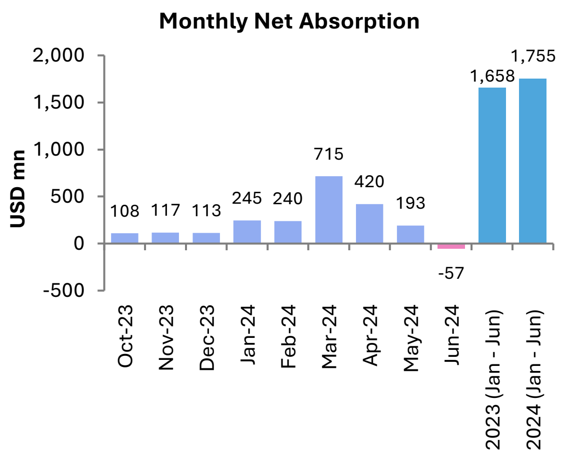
Source: Central Bank of Sri Lanka

Reserve Assets

The Gross Official Reserves (GOR) improved in H1-2024 reflecting favourable developments in the external sector. The GOR increased to US dollars 5.7 billion at end June 2024 from US dollars 4.4 billion at end 2023. The GOR includes the swap facility from the People's Bank of China (PBOC), which is subject to conditionalities on usability. The increase in GOR was mainly supported by the net purchases of the Central Bank from the domestic foreign exchange market during H1-2024 amounting to US dollars 1.8 billion (based on trade date), and the receipt of around US dollars 336 million from the IMF subsequent to the completion of the second review under the EFF Arrangement. Meanwhile, import coverage of GOR (including the PBOC swap) amounted to 3.9 months of imports as at end June 2024.

Figure 24: Monthly Gross Official Reserves, Reserve Adequacy and Net Absorption





Source: Central Bank of Sri Lanka

3.5. Fiscal Sector[12]

Fiscal sector performance continued to improve during the five months ending May 2024, owing to robust revenue-based fiscal consolidation measures implemented by the Government. These measures led to a substantial primary balance surplus and a reduced overall budget deficit.

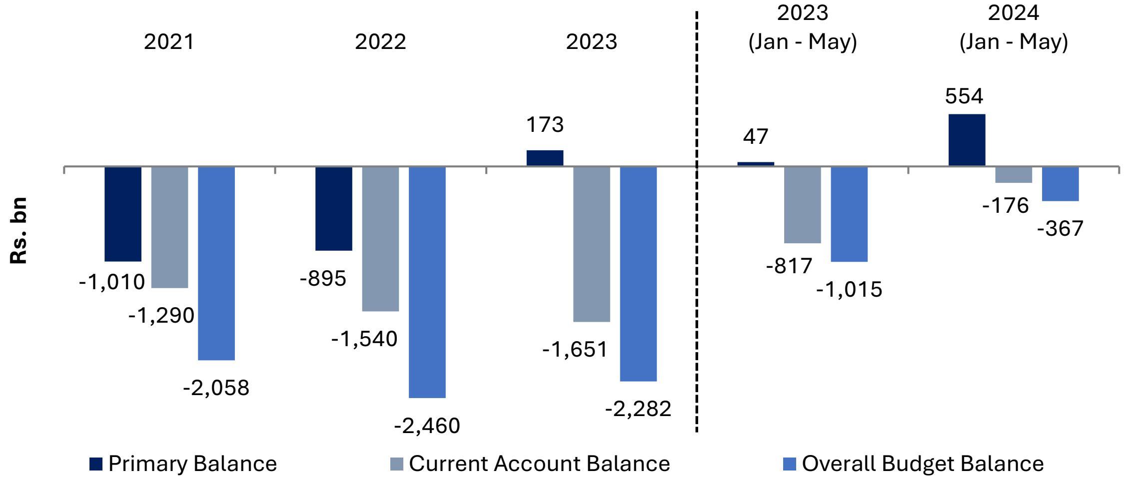
The continuation of robust fiscal consolidation measures has improved all key fiscal balances, i.e., the overall fiscal balance, current account balance, and primary balance, both in nominal terms and as a percentage of projected GDP during the five months ending May 2024. During the five months ending May 2024, the Government's total revenue and grants significantly increased, compared to the same period in 2023. This increase was primarily driven by higher tax revenues from VAT and excise duties, attributed to recent reforms in these areas. Moreover, the increased tax base due to growing economic activity as well as improved tax administrative arrangements, such as mandatory registration of professionals for income taxes, contributed to the rise in income tax collection during the five months ending May 2024 compared to the same period in 2023. Similarly, the easing of import restrictions contributed to a rise in import duty collection during the period under review. The notable increase in tax revenue collection is expected to be further augmented by the expeditious implementation of measures to enhance tax administration and institutional reforms in revenue-collecting agencies, which are also crucial for sustaining this momentum of revenue growth in the medium term. During the five

[12] The fiscal data were available only up to May 2024.

months ending May 2024, non-tax revenue also grew due to increased receipts from interest, profits and dividends, and sales and charges.

Overall total expenditure was kept in check with a marginal reduction during the five months ending May 2024 compared to the previous year, primarily due to reduced interest expenditure. Interest expenditure that contributes to the largest share in overall expenditure declined, driven by the reduction in yield rates on government securities. Additionally, capital expenditure and net lending decreased marginally during the period under review compared to the same period in 2023.

Figure 25: Key Fiscal Balances



Source: Ministry of Finance, Economic Stabilization and National Policies

During the five months ending May 2024, the Government continued to rely primarily on domestic sources to meet the budget deficit, largely due to the existing limitations in accessing the international capital markets. Meanwhile, despite a rise in the domestic debt stock, the outstanding central government debt[13] reduced in rupee terms by end May 2024, due to a reduction in the value of the foreign loan stock as a result of the appreciation of the Sri Lanka rupee against the US dollar compared to the end of 2023.

Following the successful completion of the Domestic Debt Optimisation (DDO) programme, the Government secured a US dollars 10 billion bilateral debt restructuring agreement in June 2024 with the Official Creditor Committee (OCC) and the Exim Bank of China and made progress with the Ad-Hoc Group of Bondholders in restructuring of the International Sovereign Bonds. An early

[13] The outstanding central government debt excludes several debt service payments that became overdue after 12 April 2022, the date on which the Interim Policy regarding the servicing of Sri Lanka's external public debt was announced by the Ministry of Finance, Economic Stabilization and National Policies. These debt service payments comprise overdue interest payments of affected debt.

completion of debt restructuring would enhance Sri Lanka's fiscal sustainability, boost investor confidence, and provide a stable foundation for future economic growth.

Table 06: Fiscal Performance: January – May 2024

Rs. bn

Item	2023 (a)	2023 Jan-May	2024 Jan-May	2024 Jan-May/ 2023 Jan-May Growth (%)
Total Revenue and Grants	**3,074.3**	**1,122.4**	**1,619.2**	**44.3**
Total Revenue	3,048.8	1,120.6	1,616.8	44.3
Tax Revenue	2,720.6	1,029.4	1,491.2	44.9
Non Tax Revenue	328.3	91.2	125.5	37.6
Grants	25.5	1.8	2.5	36.8
Total Expenditure	**5,356.6**	**2,137.1**	**1,986.0**	**-7.1**
Recurrent Expenditure	4,699.7	1,937.9	1,792.8	-7.5
Capital and net lending	656.9	199.2	193.2	-3.0
Current Account Balance	**-1,650.9**	**-817.3**	**-176.0**	
Primary Balance	**173.3**	**47.4**	**554.2**	
Overall Budget Balance	**-2,282.3**	**-1,014.7**	**-366.8**	
Total Financing	**2,282.3**	**1,014.7**	**366.8**	
Foreign Financing	494.7	-63.3	-27.6	
Domestic Financing	1,787.6	1,078.0	394.4	
	End 2023	**End May 2023**	**End May 2024**	
Central Government Outstanding Debt (b)	**28,695.9**	**26,080.1**	**28,062.8**	
Domestic	17,051.9	15,671.3	17,349.5	
Foreign	11,644.1	10,409.3	10,713.3	

(a) Provisional

(b) The outstanding central government debt excludes several debt service payments that became overdue after 12 April 2022, the date on which the Interim Policy regarding the servicing of Sri Lanka's external public debt was announced by the Ministry of Finance, Economic Stabilization and National Policies. These debt service payments comprise overdue interest payments of affected debt which is deemed to be capitalised as per the Interim Policy. Furthermore, the debt stock is prepared as per the manual of Government Finance Statistics by the IMF, 2014 based on the residency (i.e., resident holdings of outstanding ISBs of the Sri Lankan Government being classified under domestic debt, non-resident holdings of SLDBs being classified under foreign debt, etc) and is presented on net basis (net of deposits).

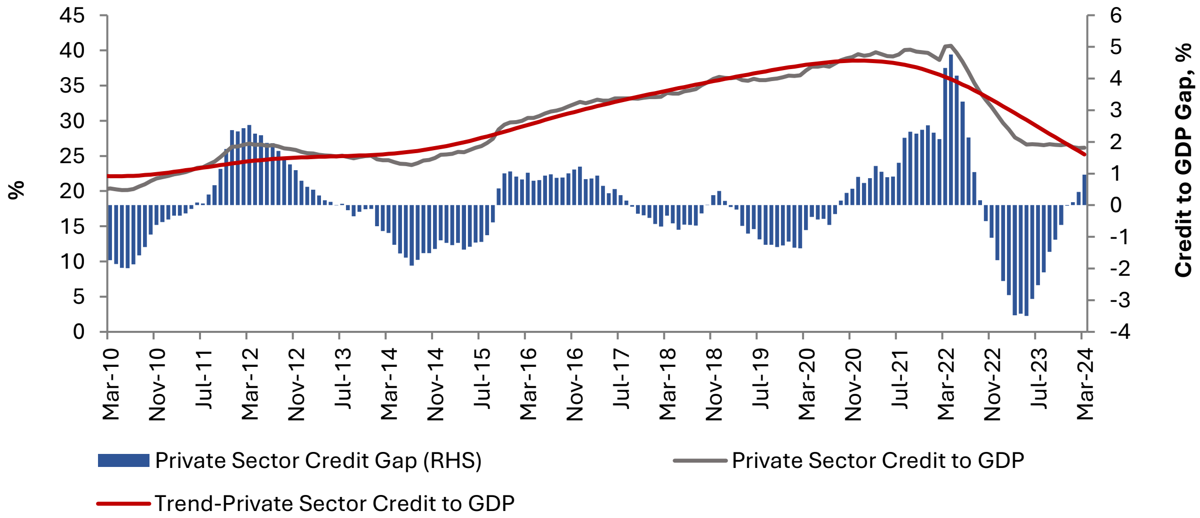
Source: Ministry of Finance, Economic Stabilization and National Policies

3.6. Financial Sector

While macrofinancial conditions have improved thus far in 2024, the lingering effects of past adverse macrofinancial developments have continued to pose challenges.

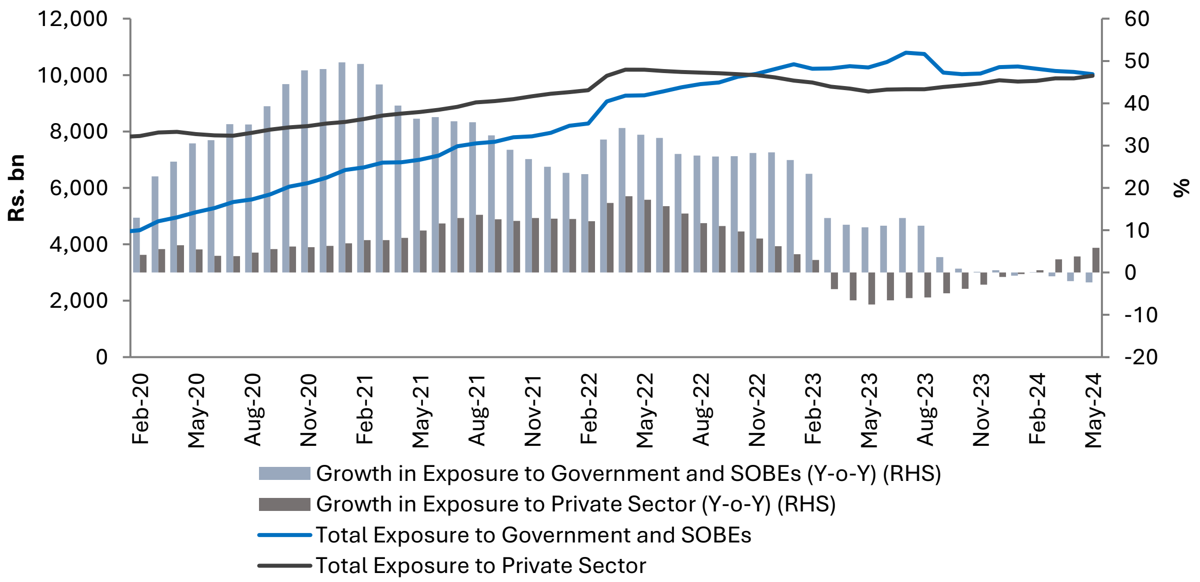
The sustained impact of the decline in real incomes has impeded the debt repayment capacities of households and firms and raised credit risk in the financial sector. Meanwhile, the credit cycle, which is reflected by the private sector credit-to-GDP gap (the Credit Gap), signalled that it is moving into the expansionary phase. With the recovery in credit to the private sector and continued fiscal consolidation, the tilt in the exposure of financial institutions to the public sector is declining.

Figure 26: Credit-to-GDP Gap



Source: Central Bank of Sri Lanka

Figure 27: Financial Sector Exposure to Public and Private Sectors*



** This reflects the exposure of the banking sector and Licensed Finance Companies to the Public and Private sectors*

Source: Central Bank of Sri Lanka

The resilience of the financial sector gradually improved during H1-2024 amidst easing macroeconomic conditions. The total assets of the banking sector expanded during the period under review mainly due to increased investments and growth of loans and receivables.

Accordingly, assets of the banking sector recorded a year-on-year growth of 7.9 per cent at end June 2024 and stood at Rs. 20.7 trillion. Gross loans and receivables of the banking sector expanded by 4.8 per cent, year-on-year, at end June 2024, amidst the easing of monetary policy.

Profit After Tax (PAT) of the banking sector significantly increased during H1-2024 compared to the corresponding period of 2023 mainly due to the substantial reduction in interest expenses. Accordingly, the banking sector reported a PAT of Rs. 112.2 billion during H1-2024 compared to Rs. 80.5 billion during H1-2023. Overall default risk of the banking sector, as reflected through the Stage 3 Loans Ratio, reduced to 12.8 per cent at end June 2024 compared to 13.5 per cent recorded at end June 2023. The growth in Stage 3 loans has also been decelerating since June 2023, indicating a stabilisation of credit risk in the banking sector.

The liquidity conditions of the banking sector, as measured by Liquidity Coverage Ratios (LCR) and the Net Stable Funding Ratio (NSFR), significantly improved at end June 2024 compared to the corresponding period of the previous year. Rupee LCR of the banking sector improved to 339.9 per cent at end June 2024 compared to 276.0 per cent at end June 2023 and stood well above the minimum regulatory requirement of 100 per cent. Despite an increase in Risk Weighted Assets (RWA), the Capital Adequacy Ratio (CAR) of the banking sector improved to 18.0 per cent at end June 2024 compared to 16.9 per cent at end June 2023, as a result of higher growth in regulatory capital. The regulatory capital of banks recorded a notable growth of 11.0 per cent on a year-on-year basis, depicting the enhancement of capital buffers that strengthens their ability to absorb potential losses.

The Licensed Finance Companies (LFCs) sector recorded a year-on-year expansion of 12.6 per cent in its loans and advances portfolio in H1-2024, mainly due to the increase in finance leases, pawning/gold loans and personal loans. Gross Stage 3 loans to total loans ratio of the sector decelerated to 13.6 per cent by end June 2024 compared to 20.3 per cent at end June 2023, indicating an improvement in non-performing loans (NPLs). The liquidity position of the sector remained above the regulatory requirement, mainly due to increased investments in government securities.

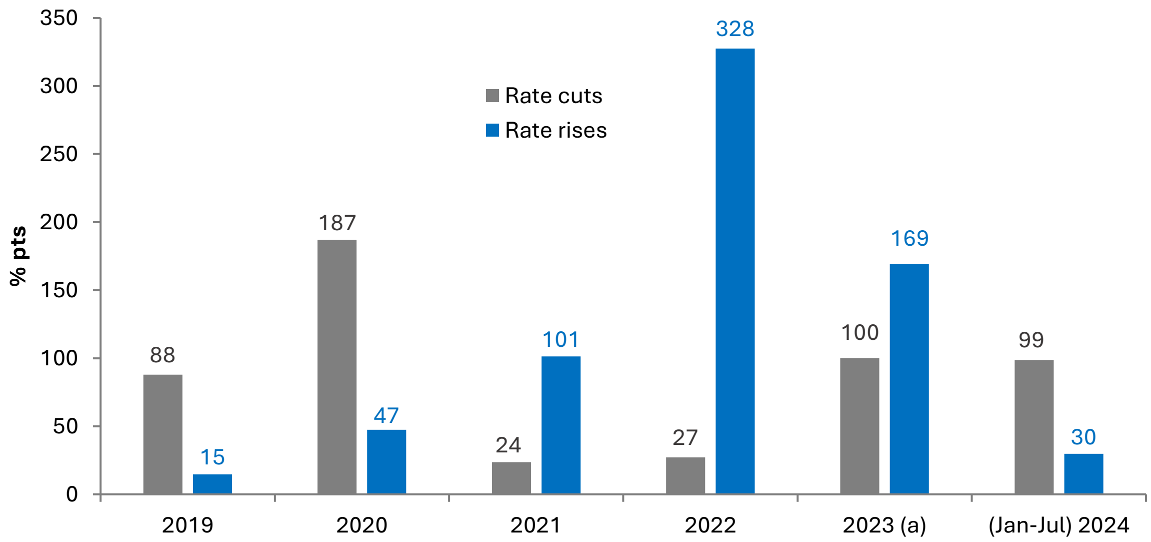
Meanwhile, the equity market registered a positive performance with 14.0 per cent and 17.0 per cent growth in the All Share Price Index (ASPI) and the Standard & Poor's Sri Lanka 20 (S&P SL20) index of the CSE, respectively, as at end June 2024 compared to the end of last year.

3.7. Global Developments

Global growth appears to be stabilising, but uncertainty surrounding the normalisation of global monetary policy persists amidst slowing disinflation.

The pace of monetary policy easing has been slower than expected given the uncertainty on the inflation outlook. However, with the focus increasingly shifting towards stabilising and stimulating economic activity, easing of monetary policy stance, particularly by the central banks of major advanced economies, is expected in the period ahead. As per the World Economic Outlook (WEO) July 2024 update, global growth is set to remain steady during 2024 and 2025, while the pace of disinflation is expected to slow in 2024 and 2025 on account of services inflation and higher commodity prices.

Figure 28: Global Policy Rate Changes

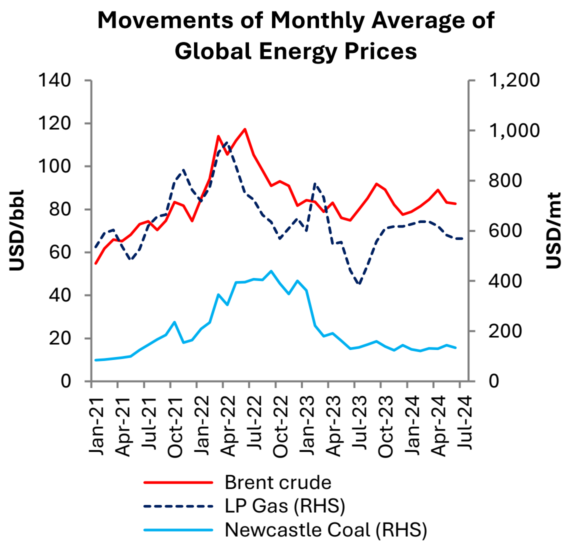


(a) Revised

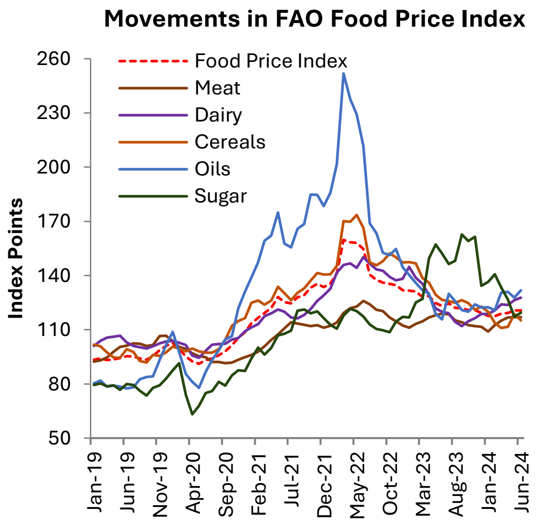
Source: https://www.cbrates.com

Global energy and food prices remain volatile around a delicate demand-supply balance. Upside risks to global energy prices persist due to ongoing geopolitical tensions in the Middle East and growing global demand driven by economic recovery. Rising input costs also contribute to this trend, while weather-related disruptions could cause significant volatility in energy supplies. Meanwhile, the Global Food Price Index remained firm in June 2024, after recording three consecutive monthly upticks.

Figure 29: Global Commodity Prices



Sources: Reuters, Bloomberg and Saudi Aramco



Source: Food and Agriculture Organization (FAO)

LIST OF ACRONYMS

ASPI	All Share Price Index
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
BOP	Balance of Payments
CAR	Capital Adequacy Ratio
CBA	Central Bank of Sri Lanka Act, No. 16 of 2023
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CI	Confidence Interval
CPC	Ceylon Petroleum Corporation
CSE	Colombo Stock Exchange
DCS	Department of Census and Statistics
DDO	Domestic Debt Optimisation
EFF	Extended Fund Facility
Exim Bank	The Export-Import Bank of China
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FIT	Flexible Inflation Targeting
GDP	Gross Domestic Product
GOR	Gross Official Reserves
GPMN	Global Projection Model Network
IIP	Index of Industrial Production
IMF	International Monetary Fund
IPSWRI	Informal Private Sector Wage Rate Index
ISB	International Sovereign Bond

LCBs	Licensed Commercial Banks
LCR	Liquidity Coverage Ratio
LFCs	Licensed Finance Companies
LP Gas	Liquefied Petroleum Gas
MLA	Monetary Law Act, No. 58 of 1949
M-o-M	Month-on-Month
MPFA	Monetary Policy Framework Agreement
MPR	Monetary Policy Report
NCG	Net Credit to the Government
NCPI	National Consumer Price Index
NFA	Net Foreign Assets
NPLs	Non-Performing Loans
NSFR	Net Stable Funding Ratio
OCC	Official Creditor Committee
OMOs	Open Market Operations
OPEC+	Organization of the Petroleum Exporting Countries and Its Allies
PAT	Profit After Tax
PBOC	People's Bank of China
PMI	Purchasing Managers' Index
QPM	Quarterly Projection Model
RWA	Risk Weighted Assets
SDFR	Standing Deposit Facility Rate
SLDB	Sri Lanka Development Bond
SLF	Standing Lending Facility
SLFR	Standing Lending Facility Rate
SMEs	Small and Medium Enterprises
SOBEs	State-Owned Business Enterprises
SOEs	State Owner Enterprises
SRC	Standing Rate Corridor
S&P SL20	Standard & Poor's Sri Lanka 20
UK	United Kingdom
US	United States

USD	United States Dollar
VAT	Value Added Tax
WEO	World Economic Outlook
Y-o-Y	Year-on-Year

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