MONETARY POLICY REPORT

FEBRUARY 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

Marking a significant milestone in the Central Bank's history, the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA) was enacted on 15 September 2023, repealing the Monetary Law Act, No. 58 of 1949. As per the CBA, the Monetary Policy Board is charged with the formulation of monetary policy and the implementation of a flexible exchange rate regime in line with the flexible inflation targeting (FIT) framework in order to achieve and maintain domestic price stability. Further, the Minister of Finance and the Central Bank shall sign a monetary policy framework agreement with regard to setting out the inflation target to be achieved by the Central Bank. Accordingly, the Minister and the Central Bank have entered into a Monetary Policy Framework Agreement[1] stipulating the inflation target to be achieved by the Central Bank. As per the Agreement, the Central Bank is expected to target the Colombo Consumer Price Index (CCPI)-based quarterly headline inflation rate at 5 per cent.

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, to maintain domestic price stability.

In keeping with Sections 27 and 80 of the CBA, the Central Bank is expected to publish a report biannually, explaining recent movements in inflation, sources of inflation, and medium-term projections for inflation and key risks to such projections, as well as the implementation of monetary policy. Accordingly, 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, while providing guidance on the inflation and economic growth outlook along with an assessment of risks to the outlook.

[1] The Monetary Policy Framework Agreement was gazetted on 05 October 2023.

EXECUTIVE SUMMARY

The Sri Lankan economy progressed on the path towards restored macroeconomic stability in 2023 where inflation was brought down from its highest levels in history observed in 2022, to single-digit levels. Moreover, amidst uncertainties and challenging conditions following the worst crisis in the country's history, economic activity resumed gradually supported by the gradual easing of monetary policy and monetary conditions and the revival in the external sector.

Corrective macroeconomic policies and the implementation of required structural reforms were instrumental in achieving domestic price stability, thereby reinforcing overall macroeconomic stability. Following the rapid disinflation observed in the first half of 2023, year-on-year headline inflation, as measured by the CCPI, moderated to single-digit levels, dropping to as low as 1.3 per cent in September 2023 within a year since striking its peak. Inflation accelerated somewhat to 4.0 per cent by end 2023 due to supply-driven factors and the dissipating effect of the favourable base. Core inflation based on the CCPI also moderated significantly during 2023 reflecting subdued underlying demand pressures.

Meanwhile, the domestic economy made a steadfast recovery in 2023 benefitting from the gradual return of overall macroeconomic stability with the implementation of long-term-oriented economic policies by the Government and related authorities. Moreover, the strong commitment to reviving the economy through the adoption of such policies helped improve investor sentiments. Accordingly, with uncertainties dissipating and improvements observed on all macroeconomic fronts, the economy recorded an expansion in its activity in Q3-2023, after six consecutive quarters of contraction. Supported by the easing of monetary policy and improvement in domestic economic activity, an expansion in credit to the private sector was observed since mid-2023, and this momentum is expected to continue in the period ahead.

The Central Bank continued to relax monetary policy during the second half of 2023 as the economy reached a state of stability with inflation remaining low and inflation expectations remaining anchored, while external sector pressures eased. Following the rapid disinflation process, current inflation remains closer to the inflation target. However, projections indicate a deviation of inflation from the target, primarily due to amendments to Value Added Tax (VAT) introduced in January 2024, before it retraces towards the target from around end 2024. This uptick in inflation is expected to be short-lived, thereby posing no significant threat to maintaining inflation at the targeted level of 5 per cent over the medium term. On the whole, risks to the near-term inflation projections are skewed to the upside, largely due to supply-side factors, while risks to medium-term inflation projections are balanced. Economic growth is expected to remain subdued in the short term but is expected to recover gradually towards its potential. Risks to real economic growth projections are skewed to the downside both in the near term as well as in the medium term, as economic activity is susceptible to adverse developments in the global front that affect export recovery, as well as loss in productivity due to outmigration of skilled labour and structural impediments to growth.

The content of this Report is mainly based on the data available as of the January 2024 monetary policy round of the Central Bank, which concluded with the monetary policy announcement on 23 January 2024.

1. MONETARY POLICY SUMMARY

The Central Bank of Sri Lanka, having commenced easing its monetary policy stance in June 2023, continued to relax monetary policy during the latter half of the year as clear signs were evident of demand-driven inflationary pressures remaining subdued.

Accordingly, after the initial policy interest rate adjustments in June and July 2023, the Central Bank reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities by 2 percentage points to 2 per cent in August 2023, while administrative measures were introduced later in that month to reduce excessive interest rates of specific loan products and accelerate the reduction of overall market lending interest rates. With inflation remaining low and inflation expectations remaining well-anchored, monetary policy was further eased in October and November 2023, paving the way for overall market interest rates, particularly interest rates on lending products, to decline. Along with these changes, the Central Bank provided forward guidance in the monetary policy round in November 2023 to the markets by conveying that further easing of monetary policy will be paused in the near term, considering sufficient space available for market interest rates to reduce further in line with the eased monetary conditions.

Monetary Policy Decisions since the last Monetary Policy Report (August 2023 – January 2024):

Aug 2023		Oct 2023	Nov 2023	Jan 2024
Statutory Reserve Ratio (SRR) was reduced by 2 % pts to 2% w.e.f. 16 August	Policy interest rates were maintained at 11.00% (SDFR) and 12.00% (SLFR)	Policy interest rates were reduced by 100 bps to 10.00% (SDFR) and 11.00% (SLFR)	Policy interest rates were reduced by a further 100 bps to 9.00% (SDFR) and 10.00% (SLFR)	Policy interest rates were maintained at 9.00% (SDFR) and 10.00% (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 January 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 January 2024 monetary policy round, and are considered as the *baseline forecast* in this Report.

2.1. Baseline Forecast

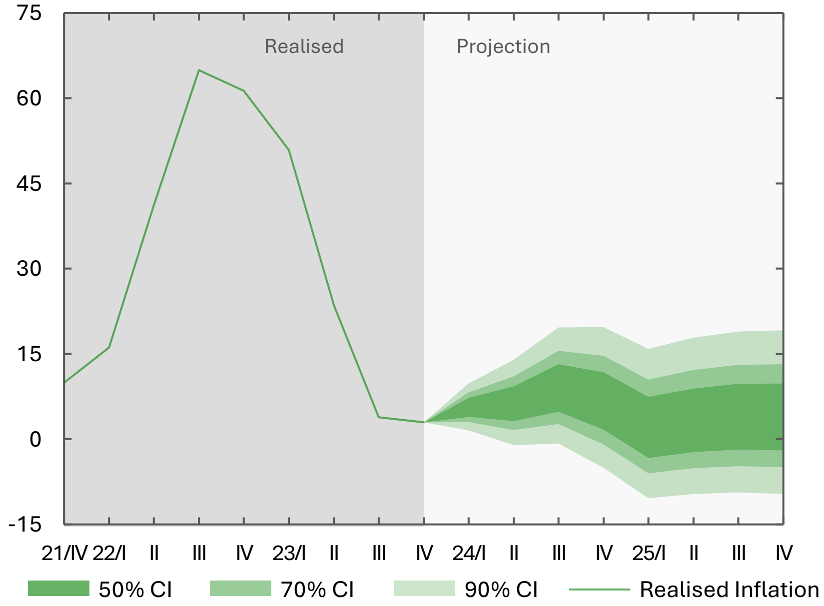
As per medium-term macroeconomic projections in the January 2024 monetary policy round, following a short-lived acceleration of inflation in the near term on account of the recent tax adjustments and supply-side disruptions, headline inflation is anticipated to gradually stabilise around the targeted level of 5 per cent (year-on-year) over the medium term. Meanwhile, the rebound of domestic economic activity witnessed in Q3-2023 is expected to continue, assisting the economy to gradually reach its potential 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 short-lived acceleration from early 2024, driving quarterly average inflation levels during the year somewhat above the 5 per cent target. The increase in headline inflation is primarily attributed to the price rises expected due to the increase in the VAT from 15 per cent to 18 per cent and the removal of certain exemptions. Headline inflation is expected to peak in Q3-2024, mainly on account of the unfavourable base effect stemming from sharp disinflation recorded in Q3-2023. However, the near-term surge in headline inflation is unlikely to persist due to subdued demand conditions, as the economy is projected to operate below its full capacity for an extended period. Accordingly, despite current inflation projections exceeding the targeted level in the near term, model projections of inflation indicate a potential dip below the target before stabilising around it in the medium term, which is mainly attributed to the base effect driven by the expected near-term increase in inflation.

[2] The Central Bank uses a Quarterly Projection Model (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 the Department of Census and Statistics (DCS).

Figure 01: Projected Headline Inflation: (Quarterly, CCPI, Y-o-Y, %)

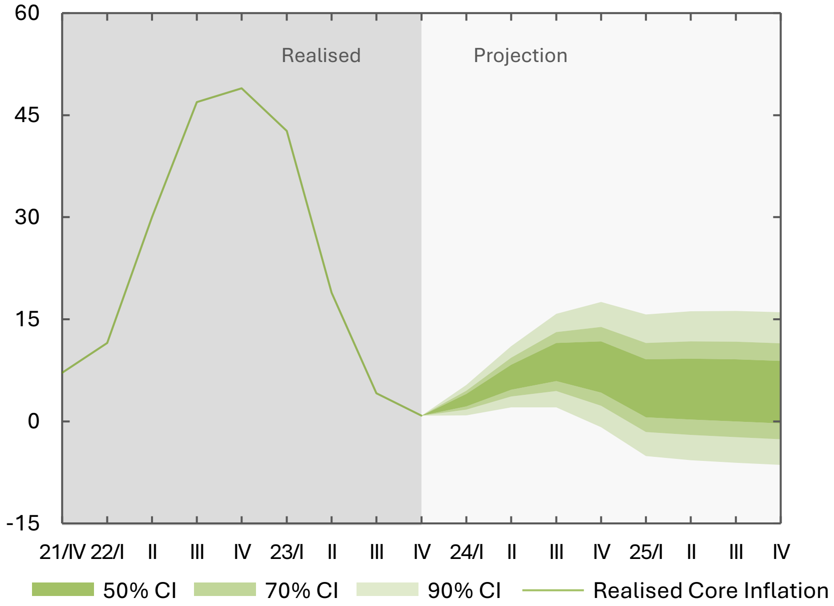


Source: Central Bank Staff Projections

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 continuously updated during each monetary policy round. Realised data up to Q4-2022 shown in the fan chart are based on the CCPI (2013=100, seasonally adjusted), while data after this period are based on the CCPI (2021=100, seasonally adjusted). Projections are based on all available data at the monetary policy round in January 2024.

When components of inflation are considered, core inflation, which excludes goods and services with volatile prices and thereby is usually considered a broad measure of fundamental demand pressures in the economy, is expected to follow an upward trajectory in line with the changes expected in headline inflation over the next few quarters. As most items in the core basket of goods and services are also subject to the VAT amendments, the upward movement expected in the near term for core inflation is primarily influenced by the changes to the VAT structure, even though economic growth is expected to remain below potential levels. As the case in headline inflation, core inflation is also expected to be affected by the base effect in several periods in its projected path. Over the medium term, core inflation is also expected to stabilise around the target for headline inflation. Despite the gradual normalisation of demand conditions amidst improved economic activity, appropriate adjustments in monetary conditions and the anchoring of inflation expectations are expected to contribute towards the stabilisation of core inflation.

Figure 02: Projected Core Inflation (Quarterly, CCPI, Y-o-Y, %)



Source: Central Bank Staff Projections

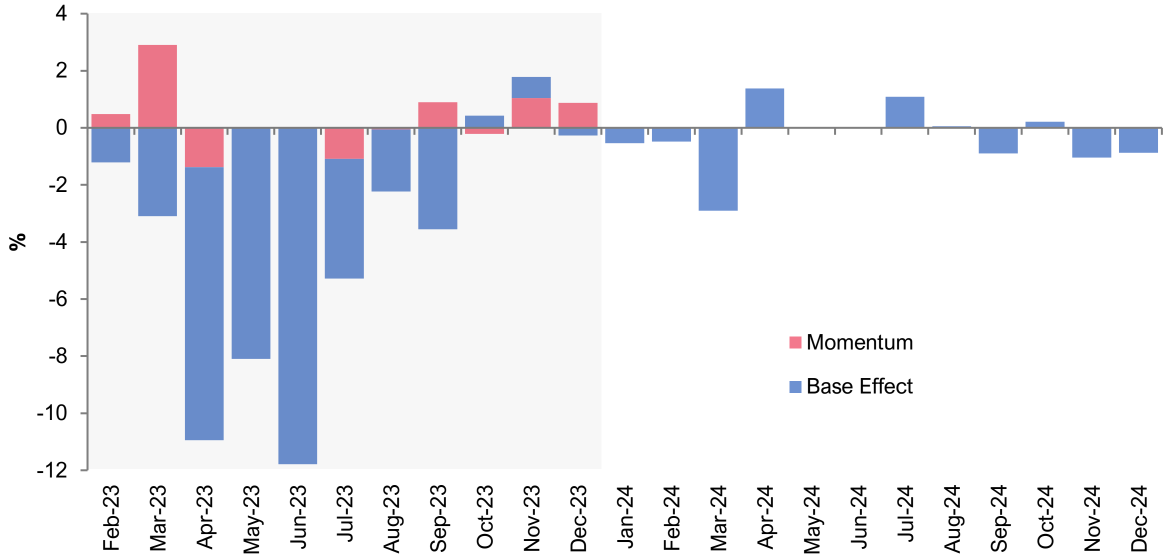
Note: ***A forecast is neither a promise nor a commitment***
Given the prevailing domestic and global economic uncertainties and geopolitical tensions, the risks associated with the current projections are higher than in normal times. Any notable change in the underlying assumptions and judgments could lead to the realised inflation path deviating from the projection. Realised data up to Q4-2022 shown in the fan chart are based on the CCPI (2013=100, seasonally adjusted), while data after this period are based on the CCPI (2021=100, seasonally adjusted). Projections are based on all available data at the monetary policy round in January 2024.

Meanwhile, the near-term outlook for global energy prices remains stable. However, there is considerable uncertainty regarding such projections amidst the prevailing unstable geopolitical environment that is leading to frequent revisions to the global energy price forecasts in recent times. Therefore, despite energy and transport inflation anticipated over the near term remaining subdued, particularly when compared to the levels that were recorded in the recent past, the uncertainties over global energy prices translate into an uncertain outlook for energy and transport inflation as well. In addition, inflation in the volatile food category, which represents food items that reflect frequent price movements, is expected to remain elevated in early 2024 and is likely to record a disinflation afterwards. However, inflation in the volatile food category could record an acceleration over the medium term, similar to the projected path of world food inflation.

Inflation Expectations

Inflation expectations, in general, have broadly followed the trend of realised inflation. Looking at the historical data and findings of 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. With the recent uptick in headline inflation, inflation expectations of the corporate sector increased in the December 2023 survey round compared to the previous month. As per the survey responses, the expected increases in taxes, fuel and utility costs were the main determinants for the anticipated increase in inflation over the next 12-month period. However, inflation expectations showed a declining trend thereafter reflecting the anticipated softening of inflation over the medium term. The fact that the Central Bank now has a binding commitment to meet the inflation target as per the CBA could also contribute to anchoring inflation expectations over the medium term around the inflation target.

Figure 03: Headline Inflation: Momentum and Base Effect[3] (CCPI, 2021=100)



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

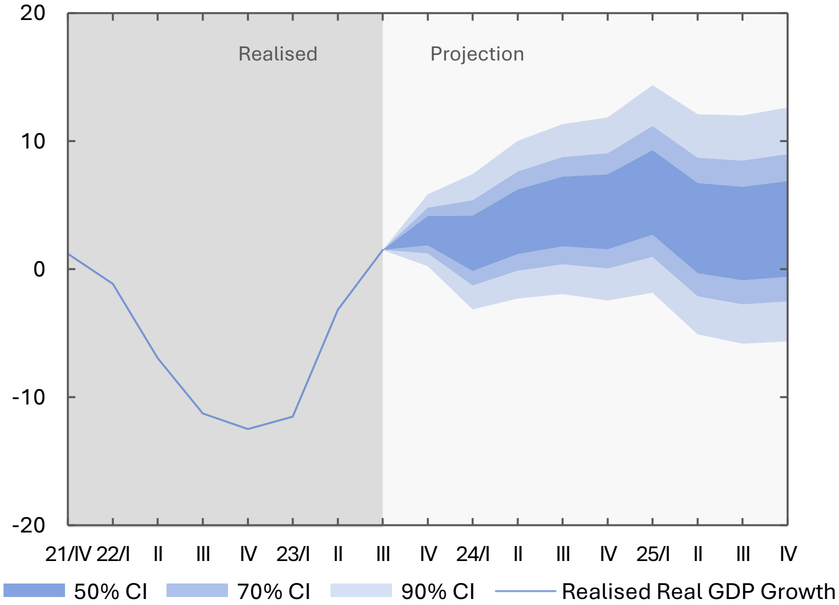
Prospects for Real Economic Growth

Based on various indicators, survey findings, recent developments, and expert evaluations, the economy is expected to have grown at a higher pace in Q4-2023, following a mild expansion

[3] 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, the DCS compiles and publishes the two main price indices used to measure inflation in Sri Lanka, the CCPI and the 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.

recorded for Q3-2023. However, the overall real gross domestic product (GDP) growth for 2023 is anticipated to be moderately negative, representing a milder contraction compared to the preceding year, while economic growth is expected to remain positive during 2024.

Figure 04: Projected Quarterly Real 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, the baseline forecasts are exposed to various potential upside and downside risks. Details on risks 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.

The economic growth trajectory toward reaching full capacity levels may encounter some fluctuations in the period ahead. The fiscal deficit[4] is expected to be higher over the near term owing to budgetary allocation for the expected recapitalisation of selected banks. However, the effects of overall tight fiscal policy are expected to be contractionary, contributing to the negative output gap. Nevertheless, the transmission of the gradual relaxation of monetary policy to broader market interest rates, and the resultant normalisation of nominal interest rates, are anticipated to stimulate growth towards its potential level by fostering investments, enhancing consumer spending and ultimately boosting aggregate demand, thereby alleviating the ongoing contractionary impact on output. Meanwhile, a negative trade-weighted foreign output gap is expected to last for around two years, thereby impacting the domestic economy through

[4] In general, a primary deficit of the Government could contribute positively to real GDP growth.

exports. However, external demand for domestic services, particularly through tourism, is expected to remain elevated. Notwithstanding the above, improving productivity and addressing growth impediments by minimising structural limitations, such as the weak doing-business environment, remain pivotal to achieving a sustainable growth path and elevating the economy's potential.

2.2. Key Assumptions Underpinning the Forecast

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

Global Environment

As per the forecasts of the Global Projection Model Network (GPMN),[5] the trade-weighted foreign output gap[6] is expected to remain negative over the near to medium term, reflecting the possibility for activity levels of most trading partners remaining below the respective trend levels, despite some economies recording a recovery in activity compared to the recent past. Contributed by sluggish economic growth in the US, the trade-weighted foreign output gap is anticipated to continue deteriorating over the near term before starting to recover from around end 2024. Stabilising inflation in the US is expected to influence the US Federal Reserve's decision to initiate the easing cycle, although rate cuts are expected to be gradual. Amidst heightened geopolitical tensions, global oil prices have shown increased volatility in the recent past. Although GPMN expects the short-term outlook for oil prices to remain stable, risks are tilted to the upside, given increased uncertainties weighing on the global oil supply and the degree of revival in global demand for oil. Despite a further decline in food price projections, deflation in global food prices is expected to diminish gradually. Meanwhile, risks are skewed to the upside. Besides adverse weather conditions, lingering uncertainties surrounding India's rice export restrictions and the end of the Black Sea grain deal pose considerable threats to global food supplies.

Fiscal Path

For the baseline projections, the fiscal path is in line with the latest projections of the International Monetary Fund (IMF) as reflected in the Staff Report published in December 2023.

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

[6] The trade-weighted foreign output gap is calculated as a weighted average of trade-partners' output gaps provided in GPMN projections by using normalised shares of total trade corresponding to six major trading partners of Sri Lanka.

In particular, the capital transfer appropriations for the planned recapitalisation of the selected banks are included in government expenditure in the scenario considered for the baseline projection.

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

	2023	2024	2025	2026	2027	2028
Budget Deficit	8.8	9.4	5.3	4.7	4.2	3.9
Debt Cost	8.1	8.1	7.6	7.0	6.5	6.2
Central Government Debt	107.8	110.3	111.4	110.8	108.0	104.6

Source: IMF Staff Report, December 2023

External Current Account

Recent data suggests an improvement in the current account balance, driven by a modest trade deficit and higher inflows to the services and secondary accounts. Accordingly, the current account is expected to have recorded a surplus in 2023. Although a widening of the trade deficit is anticipated due to increased import expenditure, the expected improvements in the services account and secondary income are likely to contribute to a continuation of the positive momentum in the external sector in 2024 as well.

2.3. Risks to Inflation and Economic Growth Projections

There are both upside and downside risks to the baseline projections for both inflation and GDP growth. If 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.

Risks to Inflation Projections

When downside risks are considered, the increased availability of imported items could contribute to moderate prices of some manufactured items due to competition from imports. At the same time, the sustained impact of the diminished purchasing power of the public could keep demand conditions suppressed, thereby exerting downward price pressures at levels larger than those captured in model projections via policy tightening. Moreover, possible faster recovery of supply conditions driven by the recovery of sectors affected by import restrictions could also contribute to arresting inflationary pressures.

There could be upside risks to baseline inflation projections arising from various factors. In particular, factors such as the possibility of more than anticipated second-round impacts of increased taxation; possible wage hikes; the impact of possible adverse weather on agricultural production and supply chain limitations, which in turn may affect food inflation; and the uncertainty over global oil, energy and food prices, particularly amidst volatile geopolitical tensions, could pose upside risks to inflation projections.

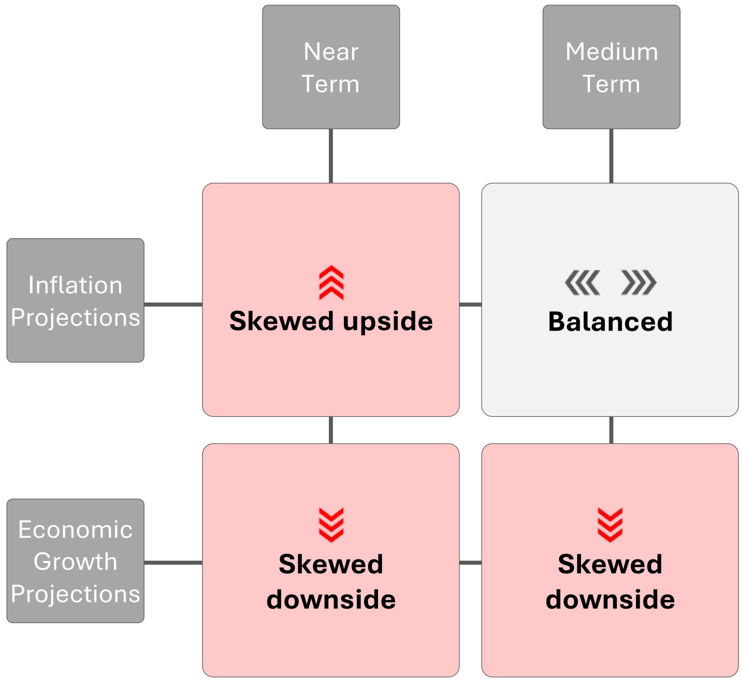
Risks to Economic Growth Projections

Potential downside risks that could affect growth projections in the near to medium term include, among others, weaker demand for exports amidst the slow recovery of trading partners and increased geopolitical tensions; labour shortages and low productivity resulting from significant professional and skilled outmigrations; any adverse effects of possible weather anomalies on agriculture activities; and unfavourable effects on investment activity and demand conditions due to increased taxes.

On the upside, any faster-than-expected recovery of tourism and related sectors could contribute to improving economic activity. The relaxation of import restrictions could have growth-positive effects, since it can result in the recovery of some sectors that have remained muted over the past two years, such as import businesses, construction, and certain manufacturing industries. The Colombo Port City and other infrastructure developments have shown some increased levels of activity, and they could contribute to improving overall economic performance. Meanwhile, any faster-than-expected recovery in global trading partners could be favourable for the recovery of external demand.

A major factor that influences the economic outlook is the continuation of the IMF - Extended Fund Facility (EFF) arrangement and the progression of the envisaged structural reforms. Any disruption to this programme would create high economic costs to the country due to growth derailment, loss of confidence, and the protraction of negative investor sentiments.

Figure 05: Balance of Risks to Projections



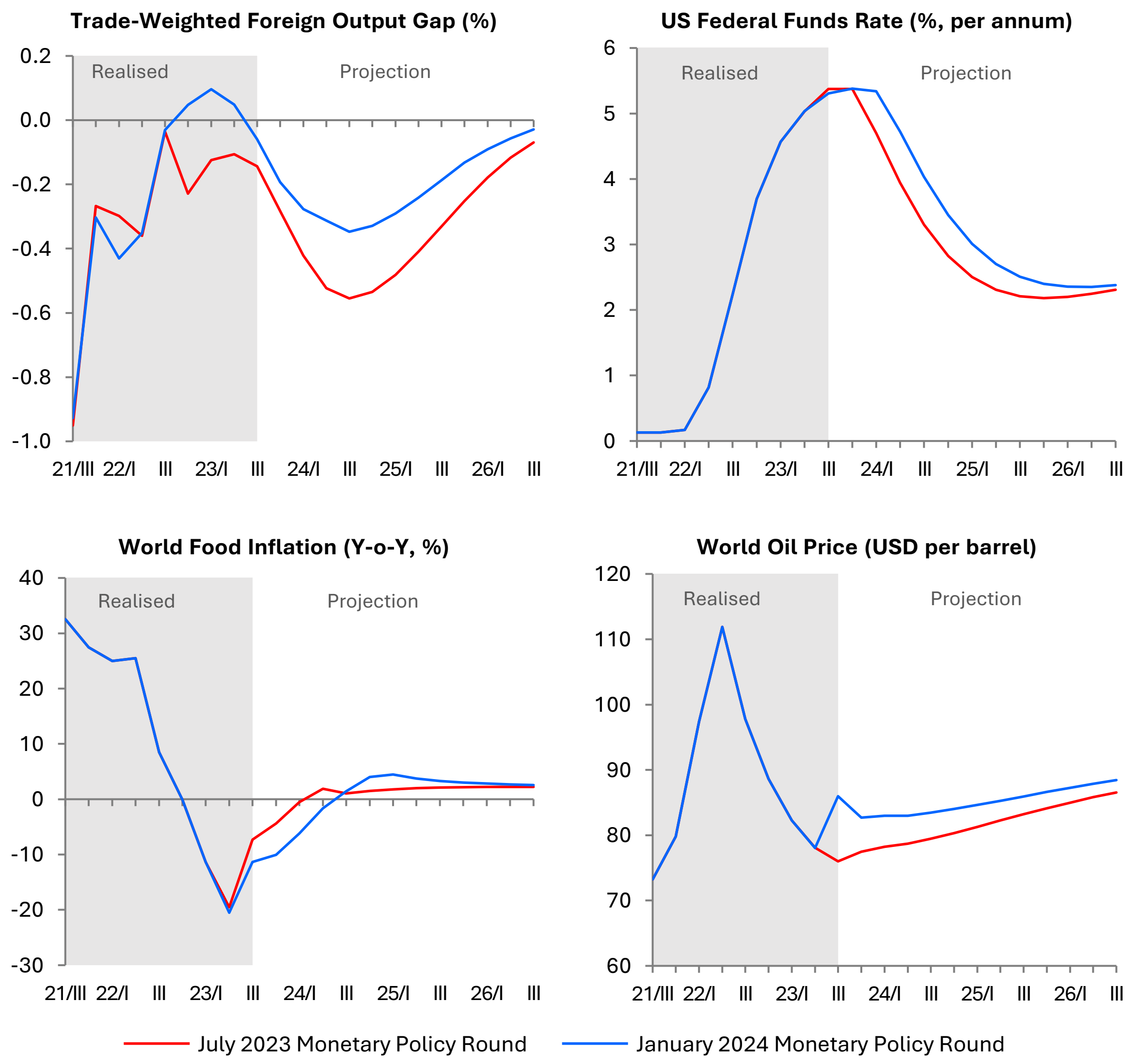
Source: Central Bank Staff Projections

2.4. Comparison with the Previous Forecast

Key Assumptions Used for Medium-Term Projections

Based on global projections used during the January 2024 monetary policy round, the trade-weighted foreign output gap of trading partners has improved, compared to the information that was available during the monetary policy round in July 2023. This was mainly contributed by improved activity levels in the US, driven by resilient consumer spending and the better-than-anticipated economic performance in India. Meanwhile, amidst the cautious behaviour of the Federal Reserve, monetary policy loosening in the US is expected to be slower compared to previous projections. When world food prices are considered, similar to the monetary policy round in July 2023, world food price inflation remains negative. However, the latest projections imply a slower normalisation in world food inflation, while the projected food inflation over the medium term is now coupled with a higher inflationary path compared to previous projections. World oil prices, which showed substantial volatility amidst heightened geopolitical tensions, experienced a spike compared to previous projections. The latest projections anticipate somewhat stable levels of oil prices in the near term, which are subsequently expected to move on a gradual inflationary path. Nevertheless, the current projected path of world oil prices is anticipated to be at a higher level than the path previously expected.

Figure 06: Global Projections (Quarterly)



Sources: QPM, GPMN (Updates as of 28/06/2023 and 05/01/2024)

The fiscal path has changed to some extent in the current projections, compared to those used in July 2023, mainly due to the increase in fiscal deficit. The assumption of the planned recapitalisation of banks is a major reason for the increase of the budget deficit in 2024. Thus, the progress of this recapitalisation process could potentially be a factor that could lead to changes in the fiscal path in future projections.

The assumptions on the current account balance of the Balance of Payments (BOP) have also been updated to reflect new information, where a current account surplus is now anticipated for 2023, compared to the deficit assumed in the monetary policy round in July 2023.

Inflation Path

Realised year-on-year headline inflation for Q3-2023 was largely within the projected path in the previous monetary policy report, i.e., the projections during the July 2023 monetary policy round. However, the realised inflation in Q4-2023 showed an upward deviation from the previously anticipated level, which was mainly due to higher-than-anticipated price movements caused by the upward price revisions to domestic energy prices, particularly electricity tariffs, as well as spikes in volatile food prices induced by supply-side disruptions, especially in the latter part of the year. Although current projections expect a temporary uptick in inflation from the first quarter of 2024, mainly due to tax adjustments, such a surge was not foreseen in the July 2023 monetary policy round, as the details on VAT adjustment were not available in July 2023. Nevertheless, similar to previous projections, over the medium term, inflation is anticipated to stabilise around the inflation target in the current projections as well.

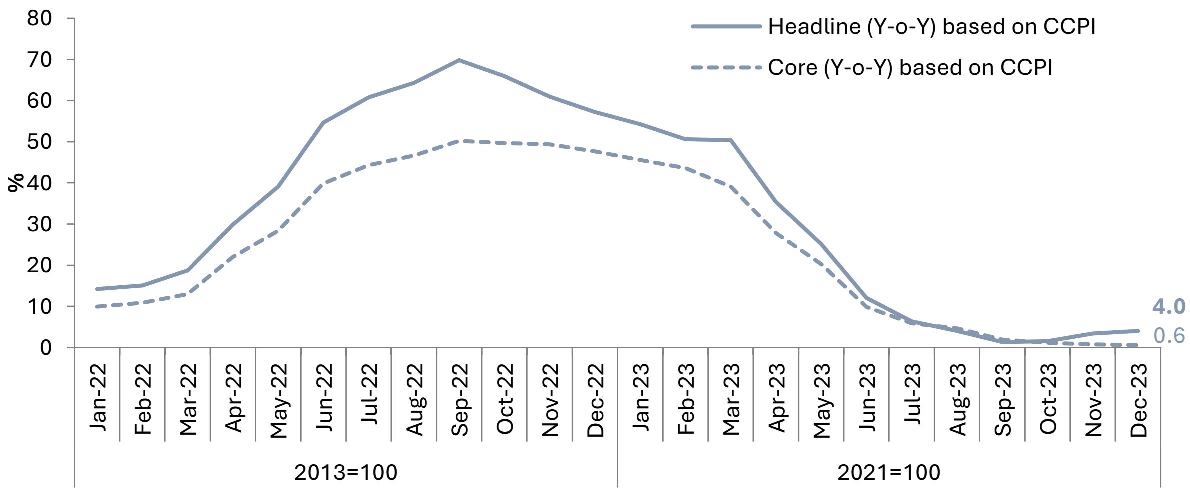
3. CURRENT ECONOMIC DEVELOPMENTS

3.1. Inflation

Inflation retreated to lower single-digit levels before witnessing an uptick towards the end of 2023 propagated by supply-side factors.

After reaching single-digit levels in July 2023, consumer price inflation continued its descending path until September 2023 due to subdued demand resulting from the lagged effects of tight monetary policy, eased supply side disruptions, the strengthened Sri Lanka Rupee against the US dollar and restrictive fiscal policy, along with the favourable base effect. Accordingly, CCPI-based headline inflation (year-on-year), which peaked at 69.8 per cent in September 2022 decelerated to 1.3 per cent in September 2023.[7] However, several supply-side factors including upward revisions to electricity tariffs in October 2023, increased food prices due to crop damages instigated by adverse weather conditions and upward revisions to LP gas and fuel prices, amidst the dissipating impact of the favourable base, caused CCPI-based headline inflation to accelerate somewhat to reach 4.0 per cent in December 2023.

Figure 07: Movements in Monthly Headline and Core Inflation (year-on-year, %)



Source: Department of Census and Statistics

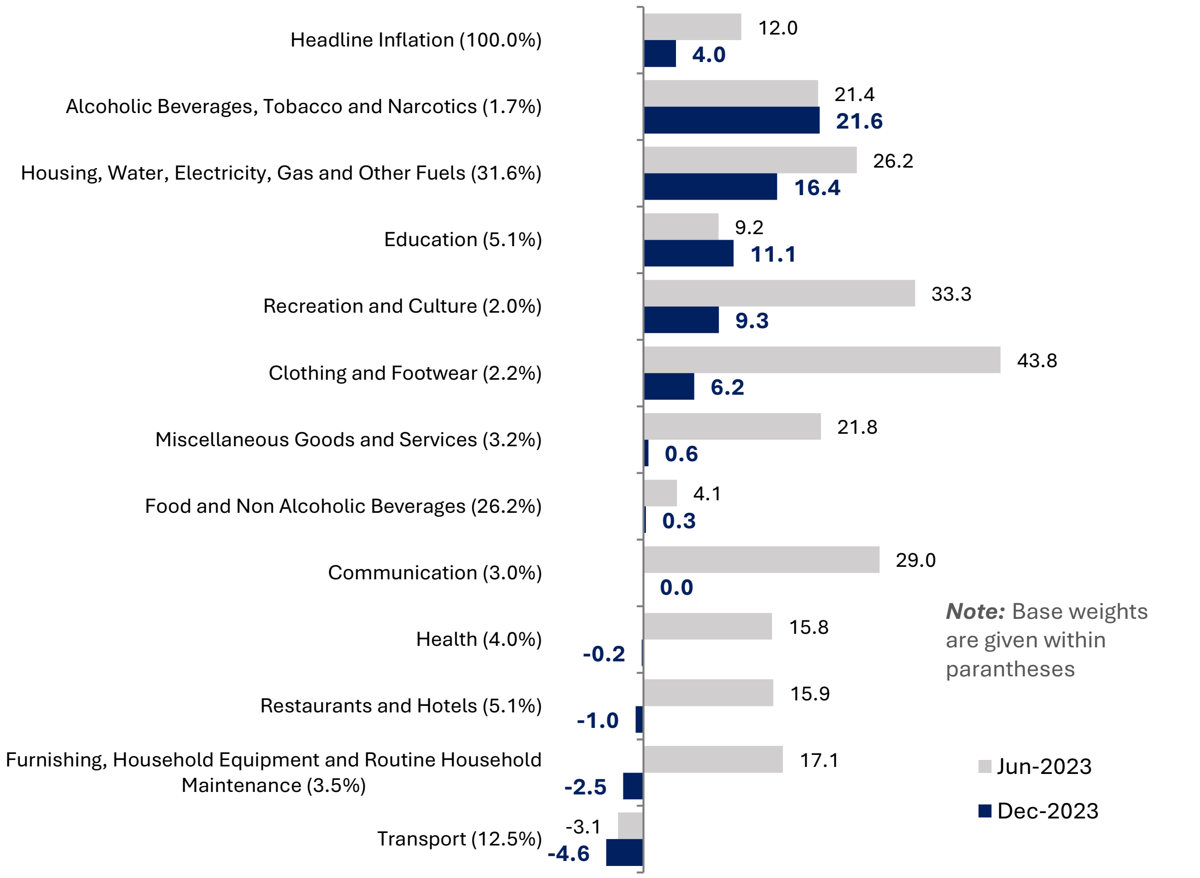
Food deflation, as measured by the CCPI, was recorded at 1.4 per cent (year-on-year) in July 2023. This was the first time that food deflation was recorded in nearly four years and the trend continued till November 2023. However, in December 2023, the notable escalation in food prices amidst adverse weather conditions caused CCPI-based food inflation to rise to 0.3 per

[7] The DCS commenced publishing the CCPI under the new base year, 2021=100, from the data release of February 2023 and discontinued the publication of the CCPI with the old base year, 2013=100.

cent (year-on-year). Meanwhile, CCPI-based non-food inflation followed an overall declining trend to reach 5.8 per cent (year-on-year) in December 2023.

National Consumer Price Index (NCPI)-based headline inflation also followed a disinflationary path to reach 0.8 per cent (year-on-year) in September 2023, before accelerating gradually to reach 4.2 per cent (year-on-year) in December 2023.[8]

Figure 08: Category-wise Y-o-Y Headline Inflation (CCPI, %)

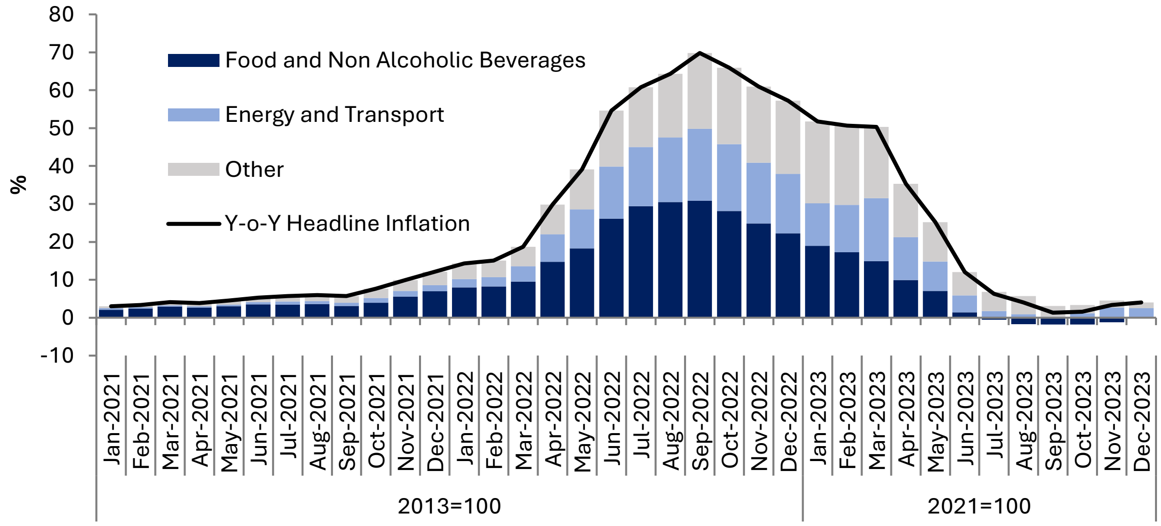


Source: Department of Census and Statistics

Reflecting subdued demand conditions in the economy, CCPI-based core inflation (year-on-year) moderated to 0.6 per cent in December 2023 from the peak of 50.2 per cent at end September 2022. The moderation in core inflation was driven mainly by the decline in the price momentum in the non-volatile food category in the consumer basket and the favourable statistical base effect. NCPI-based core inflation (year-on-year) also slowed to 0.9 per cent in December 2023 from the peak of 64.1 per cent at end September 2022.

[8] The DCS commenced publishing the NCPI under the new base year, 2021=100, from the data release of January 2023 and discontinued the publication of the NCPI with the old base year, 2013=100.

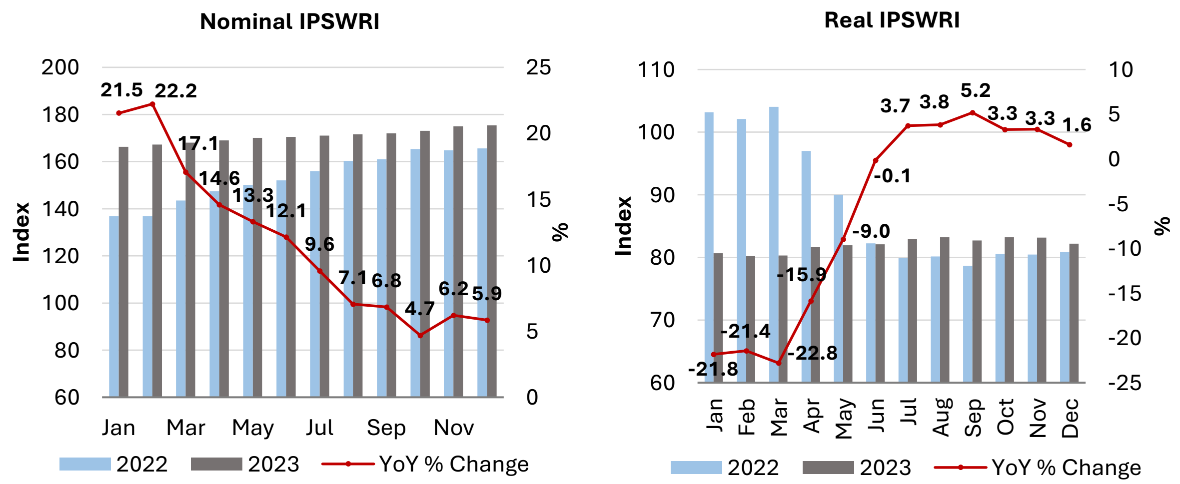
Figure 09: Contribution to Headline Inflation (CCPI)



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

Following a notable increase in nominal wages in 2022, a further increase was observed in 2023 as reflected by the informal private sector wage rate index (IPSWRI, 2018=100), primarily driven by the wage demands of daily wage earners in response to the high cost of living in the country. However, on a year-on-year basis, the growth of nominal IPSWRI slowed during the year, largely due to notable adjustments in nominal wages in 2022 compared to 2023 (statistical base effect). Meanwhile, the real wage index recorded a growth of 3.7 per cent on a year-on-year basis, in July 2023, reaching the positive territory after 15 months and remained positive thereafter, primarily due to the favourable developments in inflation. However, a slowdown in the growth of the real wage index to 1.6 per cent (year-on-year) was observed in December 2023.

Figure 10: Movements in the IPSWRI (2018=100)



Source: Central Bank of Sri Lanka

3.2 Real Sector

Economic growth turned positive in Q3-2023 after six consecutive quarters of contraction, indicating signs of recovery from the economic crisis.

As per the GDP estimates published by the Department of Census and Statistics (DCS), the Sri Lankan economy, which contracted for six consecutive quarters on a year-on-year basis from Q1-2022, recorded positive growth in Q3-2023. During the nine months ending September 2023 (9M-2023), the economy contracted by 4.9 per cent (year-on-year), compared to the contraction of 6.3 per cent (year-on-year) recorded in the corresponding period of 2022. Agriculture activities continued its growth momentum into 2023 recording an expansion of 2.5 per cent (year-on-year) during the 9M-2023, led by the improved performance in the subsectors of rice and cereals, and agriculture support activities. Meanwhile, Industry and Services activities, which contracted in both Q1-2023 and Q2-2023 (year-on-year) turned positive in Q3-2023. During 9M-2023, the Industry sector recorded a notable contraction of 12.6 per cent (year-on-year), driven by the subpar performance of construction, manufacturing as well as mining and quarrying activities. Further, the contraction of 1.7 per cent (year-on-year) in Services activities during 9M-2023 was mainly owing to the subdued performance in financial, real estate and computer programming services.

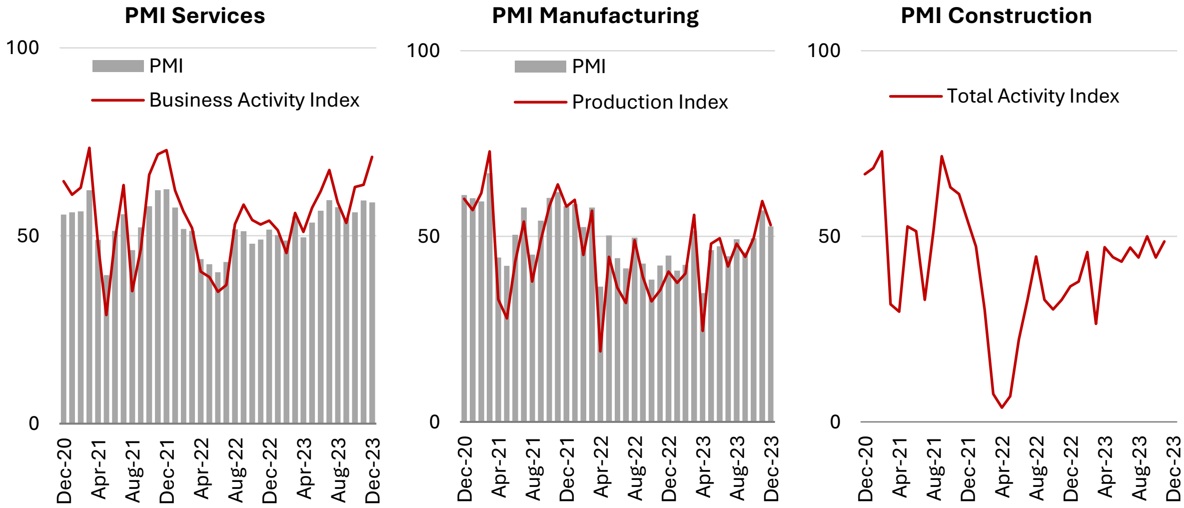
Table 02: Real GDP Growth Estimates (Y-o-Y, %) (Provisional)

Economic Activity	2022						2023			
	Q1	Q2	Q3	Q4	9M (Jan-Sep)	Annual	Q1	Q2	Q3	9M (Jan-Sep)
Agriculture	-4.4	-7.9	-6.7	0.7	-6.4	-4.6	0.8	3.6	3.0	2.5
Industry	-3.7	-10.1	-21.3	-30.1	-11.6	-16.0	-23.4	-11.5	0.3	-12.6
Services	1.8	-1.8	-4.2	-3.9	-1.3	-2.0	-5.0	-0.8	1.3	-1.7
GDP	**-0.5**	**-7.4**	**-11.5**	**-12.4**	**-6.3**	**-7.8**	**-11.5**	**-3.1**	**1.6**	**-4.9**

Source: Department of Census and Statistics

As per the available leading indicators, economic growth is expected to sustain its positive momentum in Q4-2023. Most Services activities indicate favourable developments during Q4-2023 as reflected by the Services sector Purchasing Managers' Index (PMI). Significant improvements were observed in business activities related to other personal activities and accommodation, food and beverage services, driven by the sharp increase in tourist arrivals. Industry activities are also expected to grow, mainly due to the recovery in manufacturing activities. The Index of Industrial Production (IIP), on a year-on-year basis, increased during both October and November 2023. Although Manufacturing PMI declined in October 2023, it expanded in both November and December 2023, indicating a gradual recovery in Manufacturing activities. Meanwhile, Construction PMI that reached the neutral threshold of 50.0 in October 2023 after twenty consecutive months of contraction, remained below the threshold in November and December 2023, with fewer new projects and the decline in work related to ongoing projects as most of the larger projects are in the final stages. With regard to Agriculture, although tea and fish production increased, many agricultural activities, mainly rubber, were affected by adverse weather conditions, which is expected to hamper the overall growth of Agriculture-related activities in Q4-2023.

Figure 11: Movements in Leading Economic Indicators



Source: Central Bank of Sri Lanka

On the Expenditure front, at current prices, consumption expenditure recorded a growth of 16.8 per cent, while investment expenditure grew by 7.3 per cent during 9M-2023. Moreover, net external demand increased at a faster pace of 50.4 per cent during 9M-2023, as exports of goods and services grew by 9.5 per cent, compared to the 0.9 per cent increase in the import of goods and services during this period. Consequently, GDP at current market prices grew by 16.0 per cent during 9M-2023, compared to the growth of 36.5 per cent recorded in the corresponding period of 2022. Meanwhile, at constant prices, investment expenditure and net external demand grew, while consumption expenditure declined, resulting in an overall contraction of GDP by 4.9 per cent during 9M-2023.

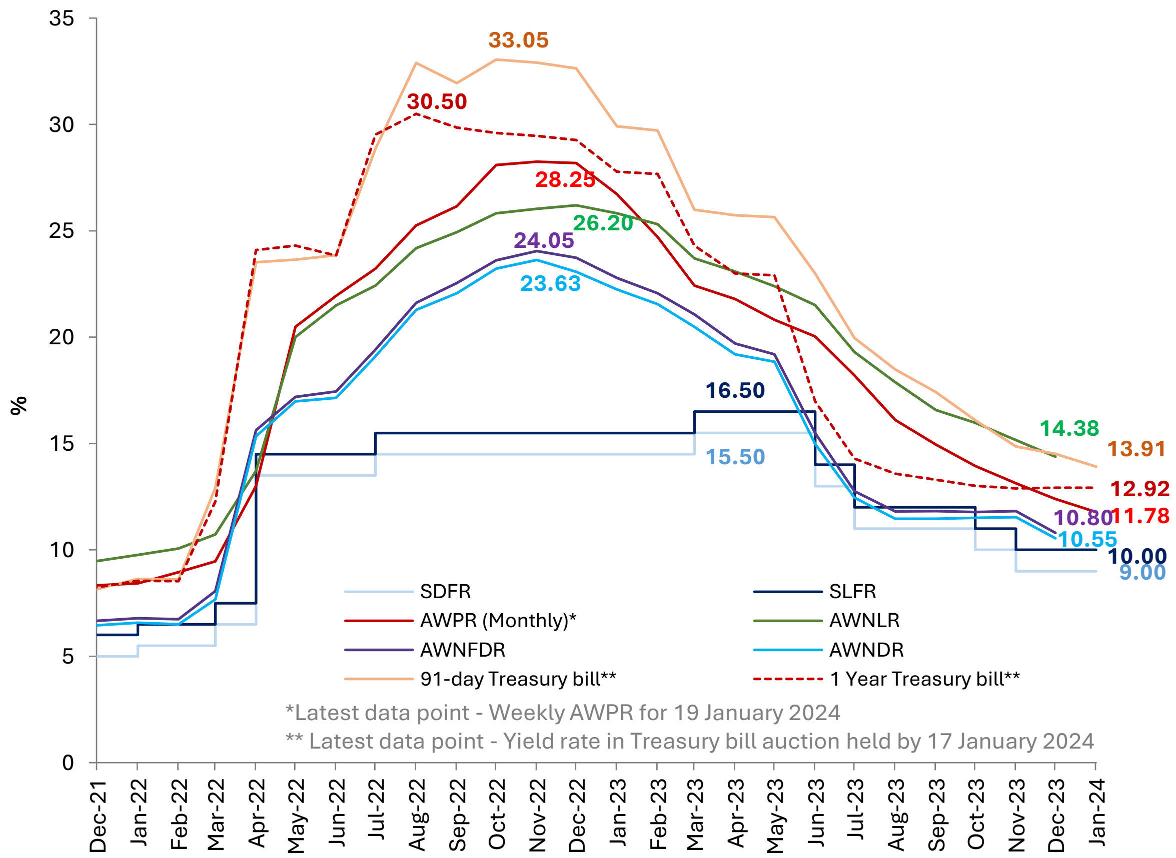
3.3. Monetary Sector

Interest Rates

Underpinned by monetary policy easing measures, falling risk premia and administrative measures to reduce excessive as well as overall lending interest rates, market interest rates, including yields on government securities, declined notably during 2023.

The interest rate structure across all products has shown a notable downward shift during 2023 compared to end 2022. In response to eased monetary policy, the administrative measures introduced in late August 2023 to reduce excessive lending interest rates, and broader guidelines that were introduced to induce a gradual reduction in other market interest rates on rupee loans and advances during the latter part of the year, market lending rates have declined reflecting an appreciable passthrough. This reduction was also supported by the falling risk premia attached to government securities.

Figure 12: Movement in Selected Market Interest Rates



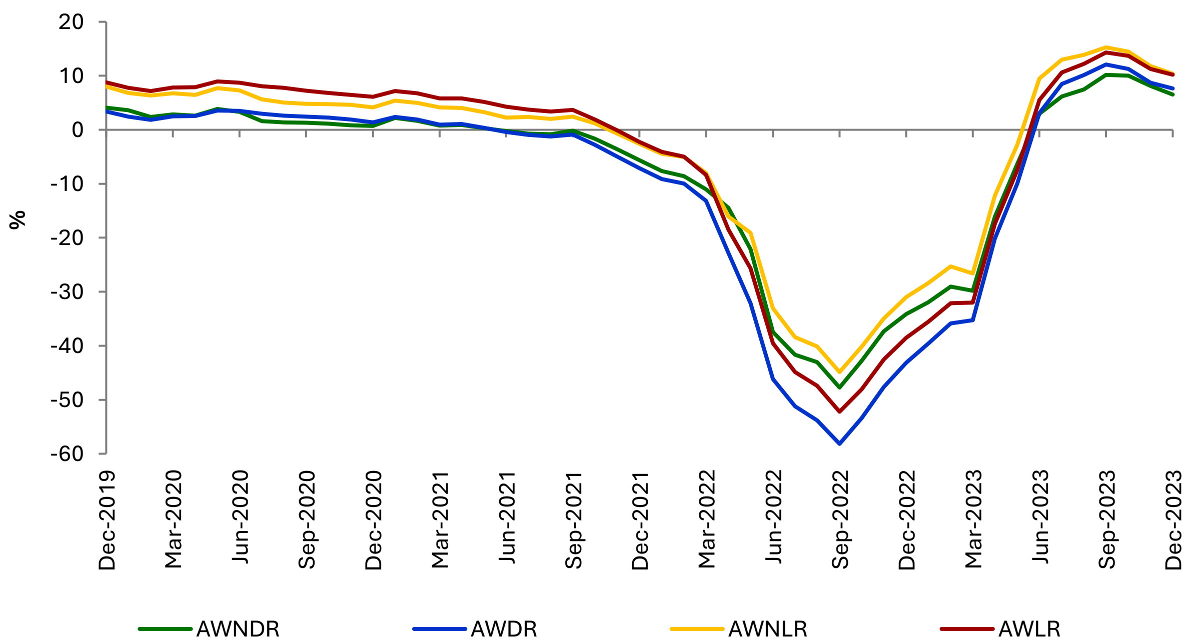
Source: Central Bank of Sri Lanka

The Average Weighted New Lending Rate (AWNLR) declined by 11.8 percentage points to 14.38 per cent by end 2023 compared to end 2022, with a larger portion of the decline taking place since June 2023 with the relaxation of the monetary policy stance by the Central Bank. The weekly Average Weighted Prime Lending Rate (AWPR) also declined notably by 15.1 percentage points during the year to 12.13 per cent by end 2023. As of 19 January 2024, weekly AWPR further adjusted downwards to 11.78 per cent. The Average Weighted New Deposit Rate (AWNDR) also declined by 12.5 percentage points during the year to 10.55 per cent in December 2023, although a marginal increase in deposit interest rates was observed during September-November 2023.

Yields on Treasury bills that declined notably with the announcement of the domestic debt optimisation (DDO) operation in July 2023, continued to reduce further, underpinned by the easing of monetary policy and a further decline in associated risk premia with the receipt of funding from multilateral organisations, improvement in government revenue, the build-up of buffer funds for cashflow operations by the Government and improved market sentiments. Accordingly, yields on Treasury bills decreased by a range of 10.0-11.7 percentage points by 17 January 2024 since the easing of the monetary policy stance in June 2023, while Treasury bond yields also moderated, paving the way for a normalised upward-sloping yield curve.

Despite the decline in market interest rates, real interest rates remain positive, given the low level of inflation.

Figure 13: Ex-Post Real Interest Rates

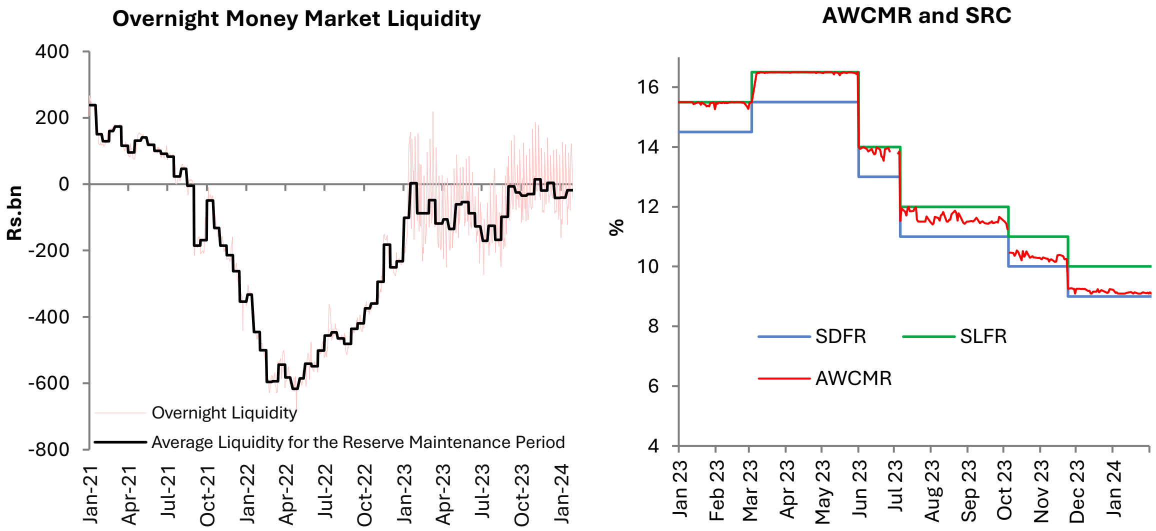


Source: Central Bank of Sri Lanka

Domestic Money Market Liquidity

Overnight liquidity in the domestic money market improved notably in 2023 and thus far in 2024.

Figure 14: Behaviour of Overnight Liquidity



Source: Central Bank of Sri Lanka

Overall rupee liquidity in the domestic money market improved in 2023 and thus far in 2024 mainly due to net foreign exchange purchases by the Central Bank, liquidity provision to the Licensed Commercial Banks (LCBs) through term reverse repo auctions, and special liquidity assistance facilities to certain banks. Meanwhile, the Central Bank also regularly infused liquidity through the overnight and term reverse repo auctions under Open Market Operations (OMOs) since mid-April 2023, to provide certainty on the availability of liquidity and induce a downward adjustment in the short-term money market rates in line with the relaxed monetary policy stance of the Central Bank. However, overnight liquidity remained volatile during the period due to restrictions imposed on the Standing Facilities by the Central Bank. The asymmetric distribution of liquidity among LCBs continued, while foreign banks maintained large liquidity surpluses. Meanwhile, the liquidity deficit of Standalone Primary Dealers (SPDs) declined during the period.

The Central Bank imposed restrictions on the utilisation of the Standing Facilities in mid-January 2023[9] to discourage the overreliance of LCBs on the Standing Facilities, and to reactivate the domestic money market, particularly the call market activities. As expected, reactivation of the

[9] On 08 February 2024, the Central Bank decided to relax the restrictions imposed on the Standing Facilities effective 16 February 2024.

domestic money market was observed thereafter. Further, LCBs introduced internal corrective measures as access to Standing Facilities was constrained.

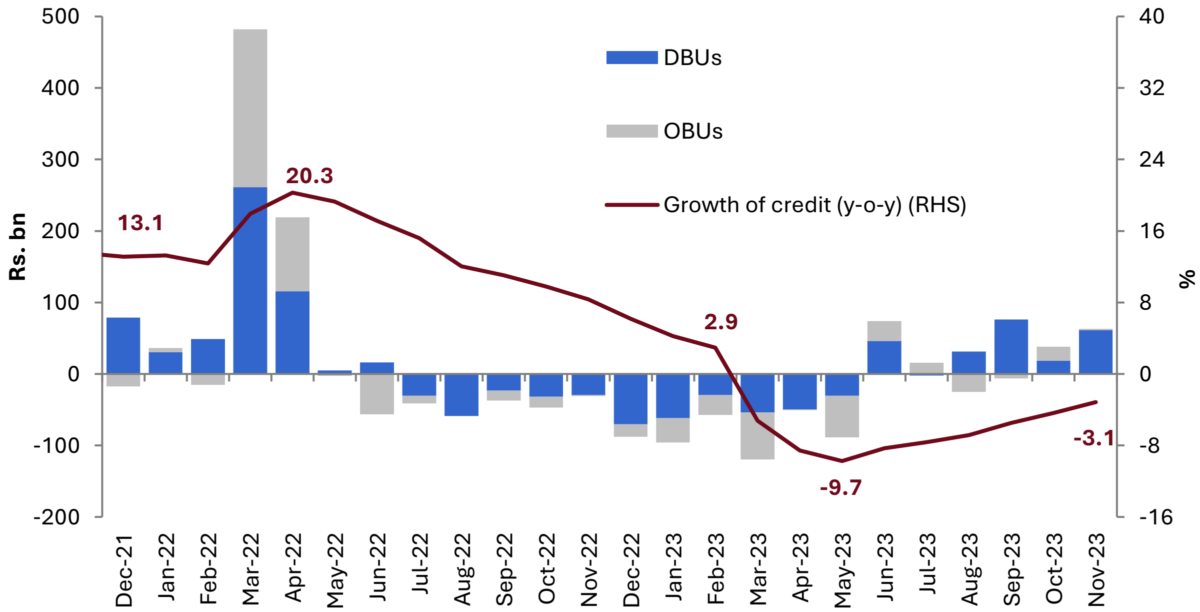
With the easing of the monetary policy stance together with the improvements in liquidity conditions amidst aggressive OMOs, AWCMR, which is the operating target of the FIT framework, adjusted towards the lower bound of SRC since early September 2023, thus facilitating the overall reduction in the interest rate structure.

Money and Credit

Growth of broad money (M_{2b}) supply remained moderate during the eleven months ending November 2023 mainly on account of the contractions recorded in credit to the private sector and State-Owned Business Enterprises (SOBEs) by LCBs, while expansions recorded in Net Credit to the Government (NCG) and Net Foreign Assets (NFA) of the banking system contributed positively to M_{2b} growth.

Outstanding credit to the private sector by LCBs, which recorded significant contractions during January-May 2023, started increasing thereafter, reflecting the gradual transmission of monetary policy easing and improving domestic economic activity. The cumulative expansion in private sector credit during June-November 2023 was recorded at Rs. 264.9 billion. Despite the recovery, outstanding credit to the private sector recorded a contraction of 3.1 per cent (year-on-year) in November 2023, compared to the growth of 6.2 per cent at end 2022.

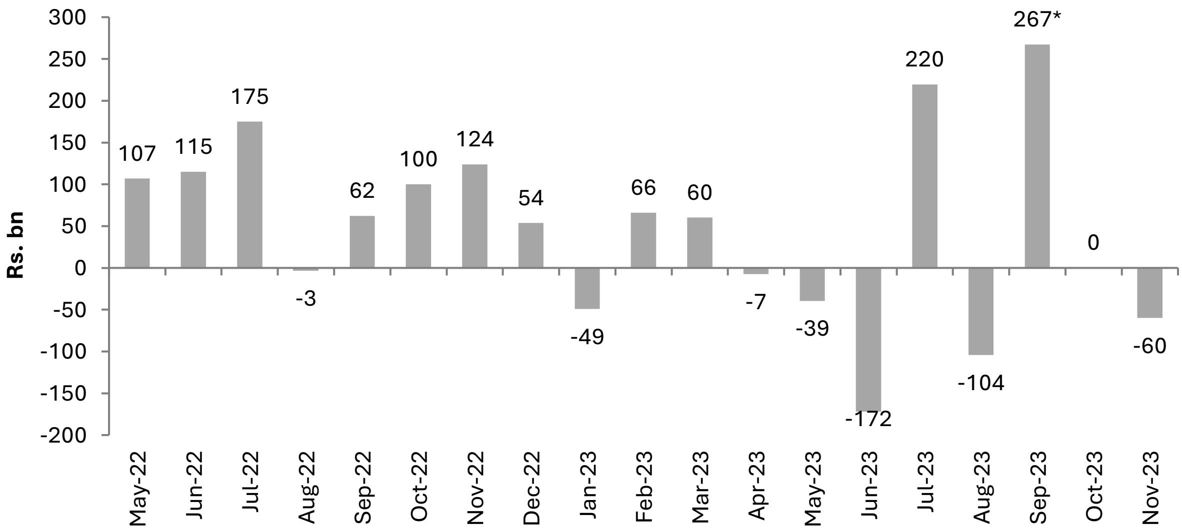
Figure 15: Monthly Change in Credit to the Private Sector by LCBs



Source: Central Bank of Sri Lanka

NCG by the banking system increased by Rs. 251.4 billion during the eleven months ending November 2023, but remained lower than the expansion recorded during the corresponding period of 2022. NCG by LCBs recorded an increase of Rs. 1,366.5 billion during the period reflecting an increase in investments in government securities by LCBs, and the transfer of government-guaranteed outstanding foreign currency debt of the Ceylon Petroleum Corporation (CPC) to the Government. In contrast, NCG by the Central Bank recorded a substantial reduction of Rs. 1,115.1 billion during this period mainly due to the offloading of Treasury bills and the reduction in the use of the Standing Lending Facility of the Central Bank by LCBs. However, the Central Bank's holdings of government securities (face value) increased in 2023 mainly due to the conversion of provisional advances to Treasury bonds under the DDO operation in September 2023. Meanwhile, credit granted to SOBEs by LCBs declined during January-November 2023 by Rs. 626.7 billion mainly due to their improved financial performance following the implementation of cost-reflective pricing and the transfer of government-guaranteed foreign currency debt obtained by CPC from LCBs to the Government. Meanwhile, NFA of the banking system improved notably by Rs. 1,194.5 billion during the period from January to November 2023 due to the decline in foreign liabilities and the build-up of foreign assets, reflecting an improvement in the external sector performance. Driven by these developments, the year-on-year growth of broad money (M_{2b}) decelerated to 6.3 per cent by end November 2023 from 15.3 per cent at end 2022.

Figure 16: The Central Bank's Holdings of Government Securities (Monthly Change)



* 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

Table 03: Change in Domestic Credit

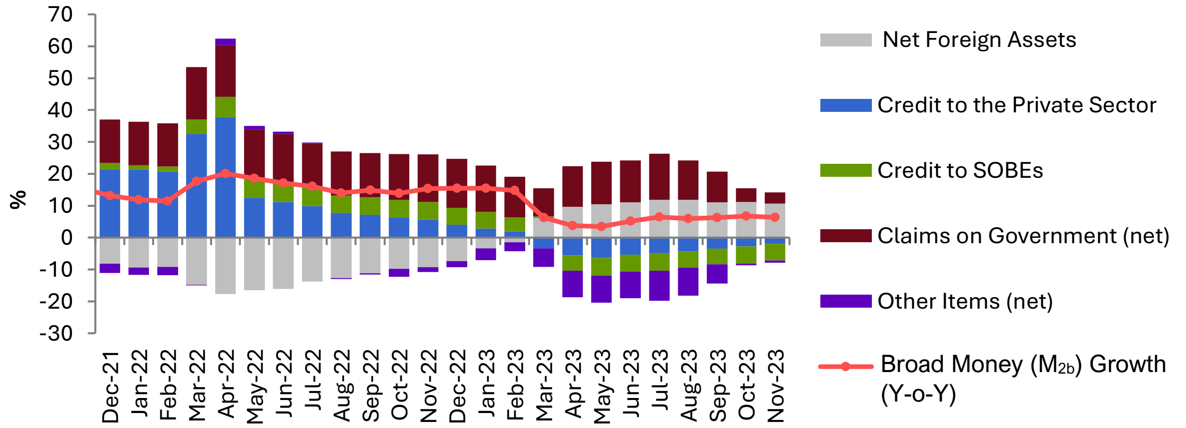
		2021	2022	Mar 2023	Jun 2023	Sep 2023	Oct 2023	Nov 2023	Jan-Nov 2023 (Prov.)
NCG	Net Change (Rs. bn)	1,284.4	1,638.7	97.2	150.1	(678.3)	(94.5)	30.1	251.4
Credit to SOBEs	Net Change (Rs. bn)	185.9	561.6	(107.0)	14.4	7.5	10.8	10.0	(624.3)
Credit to the Private Sector	Net Change (Rs. bn)	810.5	430.0	(119.5)	73.7	70.1	38.3	63.3	(147.6)
	Y-o-Y Growth (%)	13.1	6.2	(5.2)	(8.3)	(5.5)	(4.4)	(3.1)	(2.0)(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 17: Contribution to Y-o-Y Growth of Broad Money (M_{2b})



Source: Central Bank of Sri Lanka

Credit to the private sector is expected to continue its expansionary momentum through 2024. The extension of credit to the public sector from the banking system is expected to be lower than in previous years due to the implementation of decisive fiscal reforms, such as increasing taxes, introducing cost-reflective pricing, etc. NCG by the Central Bank is expected to decline, particularly due to the limitations imposed on monetary financing and the need to unwind the Central Bank's holdings of government securities as stipulated in the CBA. However, NCG by LCBs may remain elevated with the increase in subscriptions to government securities in the primary market. Credit to SOBEs is expected to record a moderate expansion in 2024, although their reliance on bank funding is likely to be low amidst cost recovery pricing mechanisms. NFA of the banking system is expected to improve further with the envisaged foreign currency inflows to the country. Considering these developments, broad money (M_{2b}) is expected to record a growth of around 15.0 per cent, year-on-year, by end 2024.

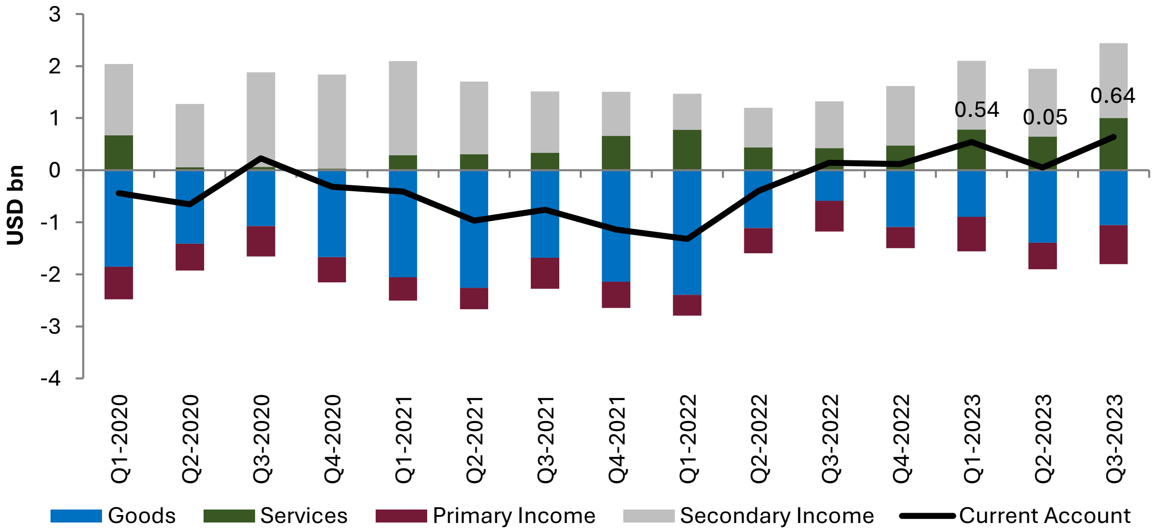
3.4. External Sector

The external sector displayed greater stability towards the latter part of 2023 reflecting continued improvements on many fronts.

Balance of Payments

The successful continuation of the IMF-EFF programme led to greater stability in the external sector. Notable reduction in the trade deficit supported by compressed imports, significant improvement in workers' remittances and inflows to the services sector resulted in notable improvements in the current account in 2023. The current account is estimated to have recorded a surplus in 2023, for the first time since 1977. However, inflows to the financial account remained limited in 2023. Meanwhile, the gross official reserves (GOR) improved significantly due to the notable net forex purchases by the Central Bank from the domestic forex market, disbursements under the IMF-EFF and foreign financing from multilateral agencies. The exchange rate appreciated during 2023 amidst improved forex liquidity and market sentiments, despite recording some intermittent volatilities.

Figure 18: Current Account Balance

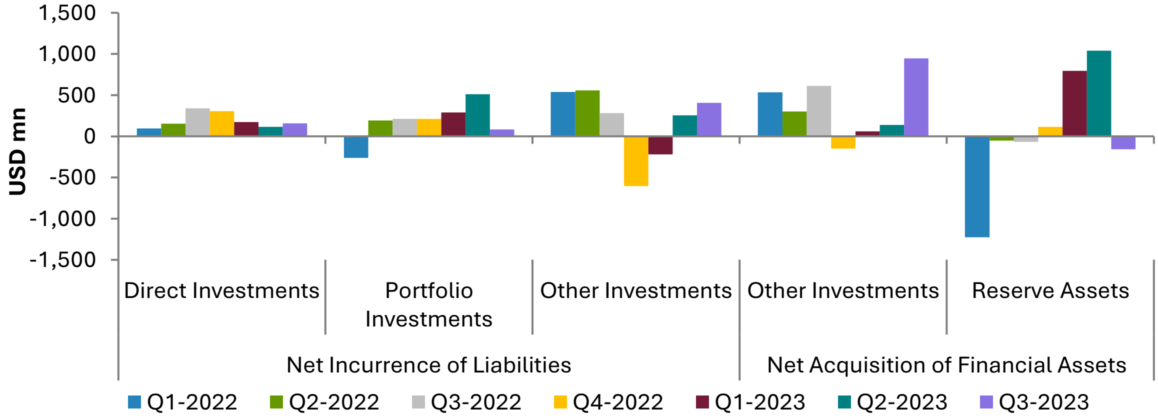


Source: Central Bank of Sri Lanka

The current account balance for 2023 is estimated to have recorded a surplus compared to a deficit of US dollars 1.5 billion recorded in 2022. The estimated surplus for 2023 is assisted by the moderated trade deficit of US dollars 4.9 billion in 2023 compared to a trade deficit of US dollars 5.2 billion recorded in 2022. The services account surplus is estimated to have increased notably due to the improvement in earnings from tourism, which increased to US dollars 2.1 billion in 2023 in comparison to US dollars 1.1 billion in 2022. The surplus in the secondary income account is estimated to have improved significantly with higher workers' remittances, which grew by 57.5 per cent, year-on-year, to US dollars 6.0 billion. The deficit in the primary income account increased in 2023 due to higher interest payments on foreign loans, including arrears.

Despite the positive developments in the current account, the financial account recorded a subdued performance in 2023. Foreign direct investment (FDI) remained modest in 2023. However, sizeable foreign financing assistance was received from the World Bank, Asian Development Bank (ADB) and the IMF during 2023. Meanwhile, foreign investments in the government securities market and the Colombo Stock Exchange (CSE) recorded net inflows in 2023.

Figure 19: Financial Account

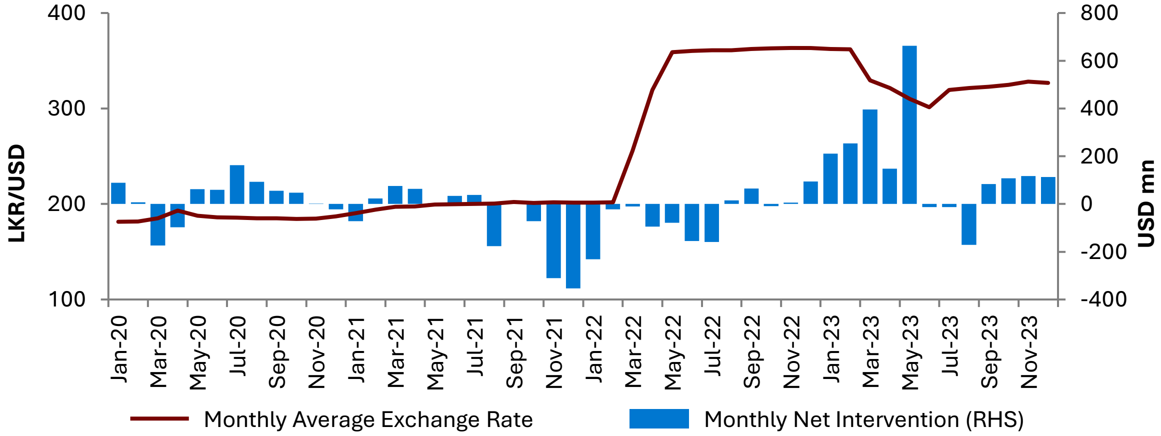


Source: Central Bank of Sri Lanka

Exchange Rate

The liquidity conditions in the domestic forex market improved in 2023, mainly in the first half of the year, with subdued import demand and increased forex inflows in terms of workers' remittances and foreign investments to the government securities market. This, along with improved market sentiments, led to a notable appreciation of the exchange rate. However, some depreciation pressures were observed at the beginning of the second half of the year mainly due to tight forex liquidity conditions due to increased forex demand from banks following the settlement of Sri Lanka Development Bonds (SLDBs) in local currency as part of DDO. The currency remained broadly stable since then and recorded an appreciation of 12.1 per cent against the US dollar by end 2023 as opposed to the depreciation of 44.8 per cent recorded in 2022. The exchange rate continued its appreciating trend in early 2024 recording an appreciation of 1.2 per cent against the US dollar by 23 January 2024.

Figure 20: Exchange Rate and Central Bank's Intervention

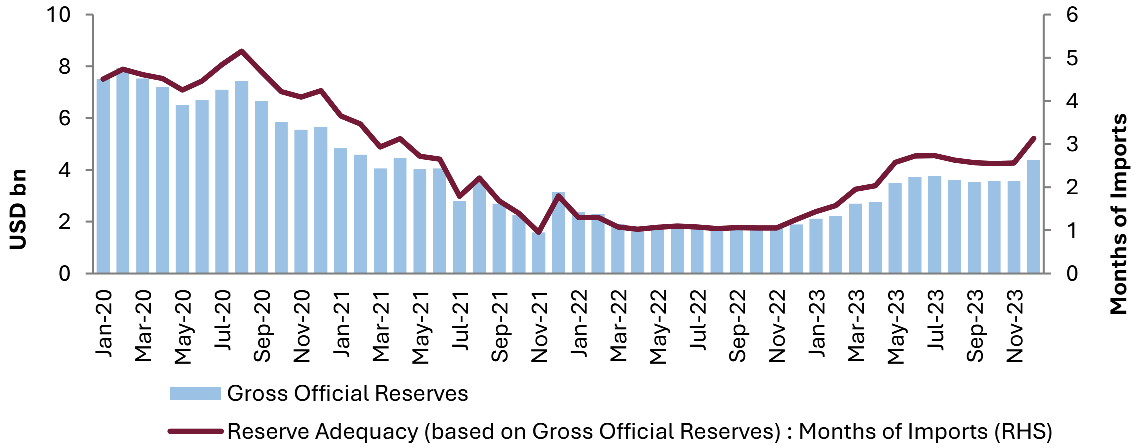


Source: Central Bank of Sri Lanka

Reserve Assets

The GOR increased to US dollars 4.4 billion by end 2023, compared to US dollars 1.9 billion recorded at end 2022. GOR at end 2022 and end 2023 included the swap facility from the People's Bank of China (PBOC) equivalent to around US dollars 1.4 billion which is subject to conditionalities on usability. This significant increase in GOR was mainly supported by the sizeable net forex absorptions of US dollars 1.7 billion (based on value date) by the Central Bank from the domestic forex market, proceeds of US dollars 648 million received from the first two tranches of the IMF-EFF, and receipts from the ADB and the World Bank.

Figure 21: Gross Official Reserves and Reserve Adequacy



Source: Central Bank of Sri Lanka

The external sector is expected to maintain the positive momentum supported by the continuation of the IMF-EFF programme, the significant progress in the debt restructuring process, and the anticipated improvement in the services exports and workers' remittances in the period ahead. The trade deficit is expected to widen in 2024 due to the possible increase in import expenditure with the gradual relaxation of import restrictions, improved economic activity and higher crude oil prices due to uncertainty in the Middle Eastern region, despite the expected growth in export earnings in 2024. The surplus in the services account is expected to improve with the anticipated higher inflows on account of earnings from tourism and other inflows to the services account. Further, the momentum of workers' remittances is expected to continue in 2024. Foreign financing assistance from multilateral agencies such as the IMF, ADB and the World Bank is expected to enhance inflows to the financial account while also strengthening the GOR in 2024. Further, some improvement in other financial flows is expected with positive investor sentiments owing to the successful continuation of the IMF-EFF programme and the debt restructuring process.

3.5. Fiscal Sector

Benefiting from the strong revenue-based fiscal consolidation measures, the Government recorded a significant increase in the revenue collection achieving a surplus in the primary balance continuously for four months up to end November 2023.

The primary balance recorded a surplus of Rs. 331.4 billion (1.2 per cent of projected GDP[10]) during the period from January to November 2023, marking a significant improvement from the Rs. 352.2 billion (1.5 per cent of GDP) deficit recorded in the corresponding period in 2022. However, the overall fiscal balance and the current account balance deteriorated both in nominal terms and in projected GDP terms compared to the same period in 2022 due to escalated interest expenditure. Accordingly, as a percentage of projected GDP, the overall budget deficit and the current account deficit widened to 7.1 per cent (Rs. 2,020.3 billion) and 5.4 per cent (Rs. 1,534.8 billion), respectively, during the period from January to November 2023, compared to 6.6 per cent (Rs. 1,601.3 billion) and 4.7 per cent (Rs. 1,138.4 billion), recorded in the corresponding period of 2022.

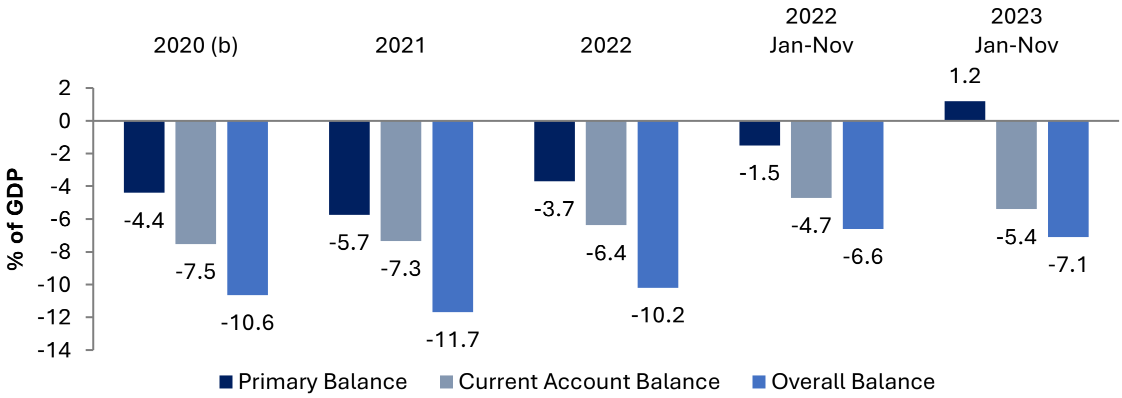
Total revenue of the Government increased significantly by 52.7 per cent to Rs. 2,758.0 billion during the eleven months ending November 2023. Upward revisions to tax rates (personal income tax, corporate income tax, VAT, excise duties) and expanding the tax base (reducing tax-free thresholds for income taxes) mainly contributed to the significant improvement in revenue collection. In addition, the Social Security Contribution Levy (SSCL), which was introduced in October 2022, also contributed notably to the growth in revenue during 2023. With the easing of import restrictions, except for vehicles, since mid-2023, revenue from international trade-

[10] Based on the projections of the Central Bank.

related taxes such as Import Duties and the Special Commodity Levy (SCL), improved during the period from January to November 2023.

Total expenditure and net lending also increased by 40.5 per cent, year-on-year, to Rs. 4,791.7 billion during the period from January to November 2023, mainly due to the increase in recurrent expenditure on account of the high domestic interest payments. However, the interest cost of the Government is expected to decline in the period ahead with the declining market interest rates including yields on government securities amidst easing monetary policy stance as well as with narrowing risk premia. Furthermore, heightened spending on subsidies and transfers as well as capital expenditure also played a role in the overall growth in expenditure during the review period.

Figure 22: 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.

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

During the period from January to November 2023, net domestic financing increased to Rs. 1,993.9 billion in comparison to Rs. 1,541.9 billion recorded in the corresponding period in 2022. Meanwhile, net foreign financing declined to Rs. 26.4 billion during the eleven months ending November 2023, compared to Rs. 59.4 billion recorded in the same period in 2022. With the gradual unwinding of monetary financing, a net repayment of Rs. 1,115.1 billion to the Central Bank was recorded during January-November 2023, compared to Rs. 1,275.7 billion of monetary financing registered during the same period in 2022. Meanwhile, central government debt increased to Rs. 28,094.7 billion by end October 2023 from Rs. 27,492.0 billion recorded at end 2022.[11]

[11] The outstanding central government debt excludes several debt service payments that became overdue after 12 April 2022, the date of 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 deemed to be capitalised as per the Interim Policy. Further, the December 2022 balance excluded the value of principal payments that was due to be settled in relation to SLDBs from April 2022 till end 2022.

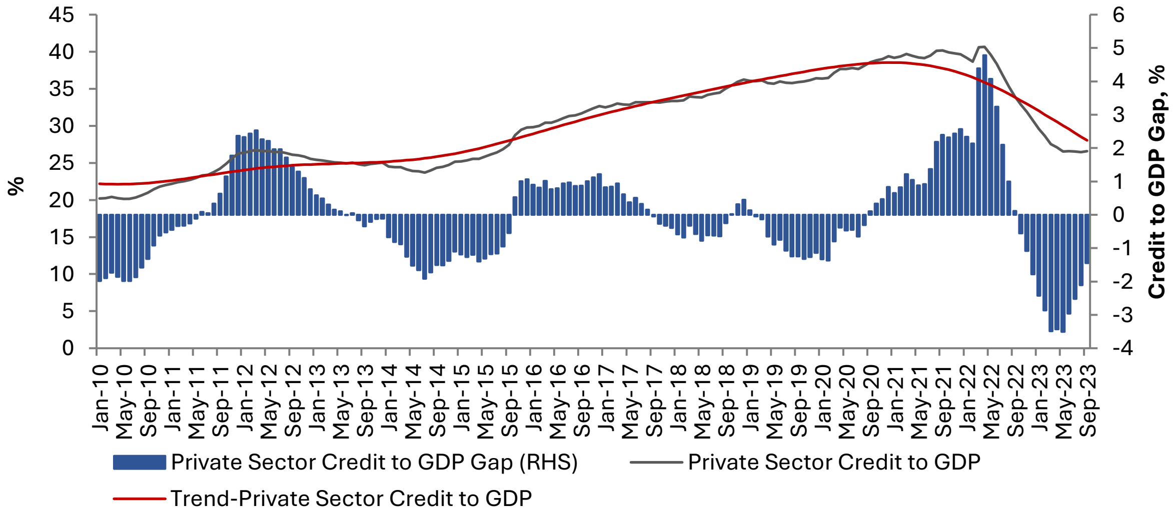
Following the successful completion of the DDO operation, the Government has actively engaged with external creditors to negotiate relief on external debt, aiming to steer the debt trajectory towards a sustainable level. Subsequently, an Agreement in Principle (AIP) has been reached with the Official Creditor Committee (OCC) and the Export-Import Bank of China (Exim Bank), and the Government is negotiating with private debt holders. The overall level of public debt and debt servicing are projected to reduce to manageable levels once the debt restructuring process is fully completed. In addition, the recently adopted tax reforms, such as the removal of VAT exemptions and upward revision in the VAT rate, are expected to strengthen revenue collection in the period ahead, thereby reducing the financing requirements of the Government. Furthermore, financial support from the IMF and other multilateral agencies in the forthcoming period is expected to ease the pressure on government finances. However, measures taken to improve tax administration and institutional reforms in revenue-collecting agencies need to be expedited in order to sustain the growth in revenue collection in the medium term.

3.6. Financial Sector

Lingering effects of adverse macrofinancial developments posed challenges to financial stability during 2023.

The private sector credit-to-GDP gap (the Credit Gap) indicated that the current credit cycle had passed its trough and entered the recovery phase of a high oscillation cycle, in which challenging macrofinancial conditions transpired. Accordingly, reflecting the sluggish economic performance, upward tax adjustments and elevated price levels, a rise in Non-Performing Loans (NPLs) ratios was observed as households and corporates faced balance sheet strains and narrowed debt repayment capacities. However, some improvements were observed in this regard since June 2023. Market interest rates shifted downwards and the secondary market yield curve of government securities, which remained inverted and irregular in the past, showed signs of correction in January 2024. Meanwhile, the high exposure of financial institutions to the Government intensified the Sovereign-Bank Nexus and created a tilt in financial intermediation towards the Sovereign. Amidst this tilt, financial intermediation by banks, as reflected by the credit-to-deposit ratio of the banking sector continued to decline in 2023. Domestic financial markets showed some level of stabilisation towards the end of 2023 after experiencing a turbulent period in the past.

Figure 23: Credit-to-GDP Gap

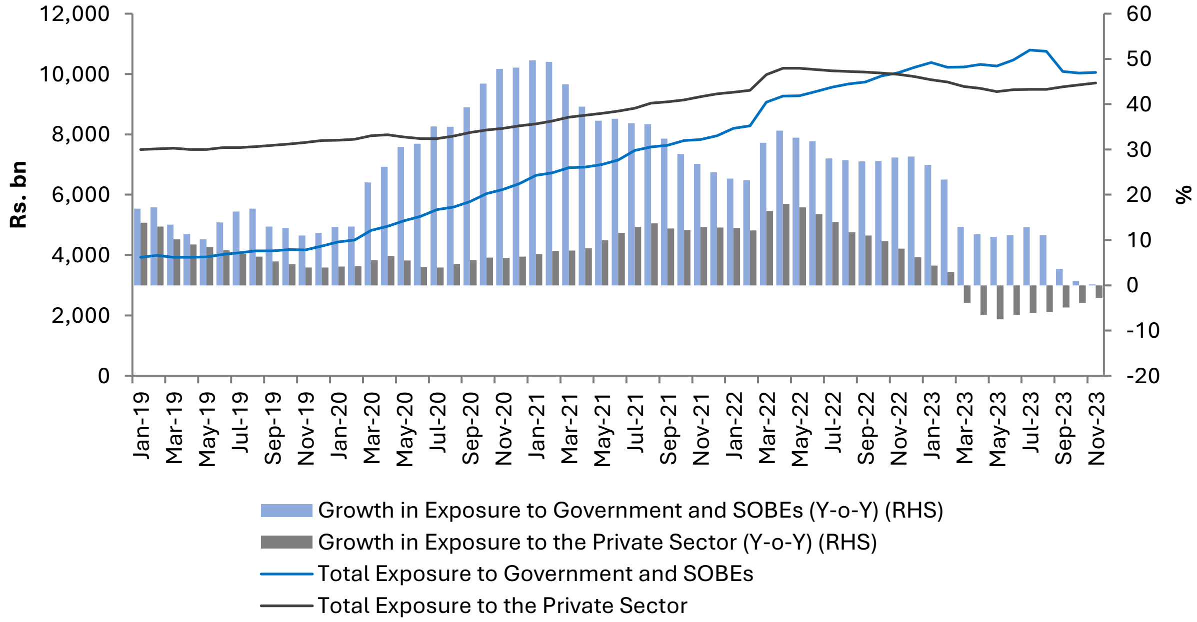


Source: Central Bank of Sri Lanka

The banking sector continued to operate in a challenging environment during the financial year ending December 2023. However, the total assets of the banking sector expanded during the period under review mainly due to increased investments in government securities. Accordingly, assets of the banking sector recorded a year-on-year growth of 5.1 per cent at end December 2023 and stood at Rs. 20.4 trillion. Loans and receivables of the banking sector contracted by 2.8 per cent during the year ending December 2023, amidst the tight monetary policy stance that was in place until June 2023. However, a gradual increase in credit was witnessed during the second half of 2023 with the easing of policy interest rates by the Central Bank. Overall default risk of the sector, as reflected through the Stage 3 Loans Ratio, remained at an elevated level of 12.8 per cent at end December 2023 compared to the corresponding period of the previous year. However, the growth in Stage 3 loans has been decelerating since June 2023 with the expansion in loans and receivables, indicating a stabilisation of credit risk in the banking sector. The sovereign-bank nexus remained elevated as the banking sector's exposure to the Central Government and State-Owned Enterprises increased to Rs. 9.0 trillion at end December 2023, particularly through investments in Rupee-denominated government securities. As a result, liquid asset ratios of the banking sector significantly increased. This was reflected by the expansion in the Statutory Liquid Assets Ratio of Domestic Banking Units to 44.9 per cent at end December 2023 compared to 29.9 per cent at end of the corresponding period of the previous year. Capital adequacy of the sector recorded an improvement at end September 2023 compared to end 2022, as risk-weighted assets declined during the period, mainly due to the overall credit contraction, increased investments in government securities, and the appreciation of the Sri Lanka Rupee. The Licensed Finance Companies (LFCs) sector recorded a contraction in its loans and advances portfolio in 2023, due to challenges in its core business of leasing and hire purchase. The asset quality of the sector deteriorated as indicated by the elevated Gross

Stage 3 Loans Ratio of 17.8 per cent at the end of December 2023 compared to 17.4 per cent at end December 2022. However, the Stage 3 loans to total loans ratio of the sector has recorded a deceleration from its highest level of 20.5 per cent observed in May 2023, indicating an improvement in default risk during the second half of 2023. The liquidity position of the sector remained above the regulatory requirement, mainly due to increased investments in government securities. Capital adequacy of the sector improved with higher growth in regulatory capital compared to risk-weighted assets. However, there is a need for continued consolidation within the sector to ensure resilience.

Figure 24: Exposure to Public and Private Sectors



Source: Central Bank of Sri Lanka

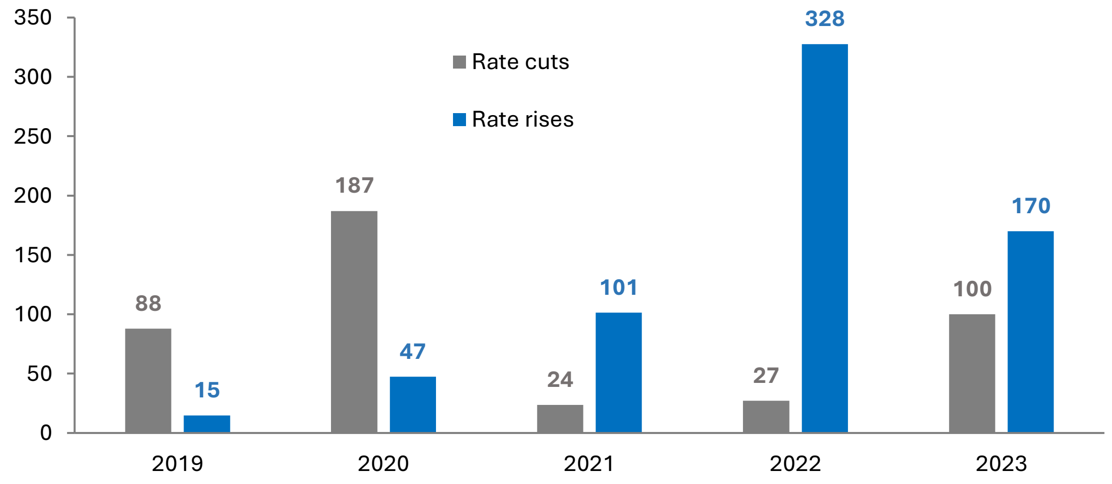
Meanwhile, the equity market displayed resilience amidst uncertainties with indices marking an improvement by end 2023 compared to the end of last year. Foreign interest in the equity market was also low, although, on a net basis, foreign investments remained positive in 2023.

3.7. Global Developments

The global monetary policy stance remains tight, and some relaxation can be expected in the period ahead.

Most major central banks have stayed firm in their restrictive monetary policy stance but have indicated their intention to reduce policy interest rates cautiously in the period ahead. Globally, the frequency of policy interest rate tightening slowed gradually, while the frequency of policy interest rate easing increased with some central banks shifting focus to stimulating economic activity amidst low levels of inflation and anchoring inflation expectations.

Figure 25: Global Policy Rate Changes (percentage points)

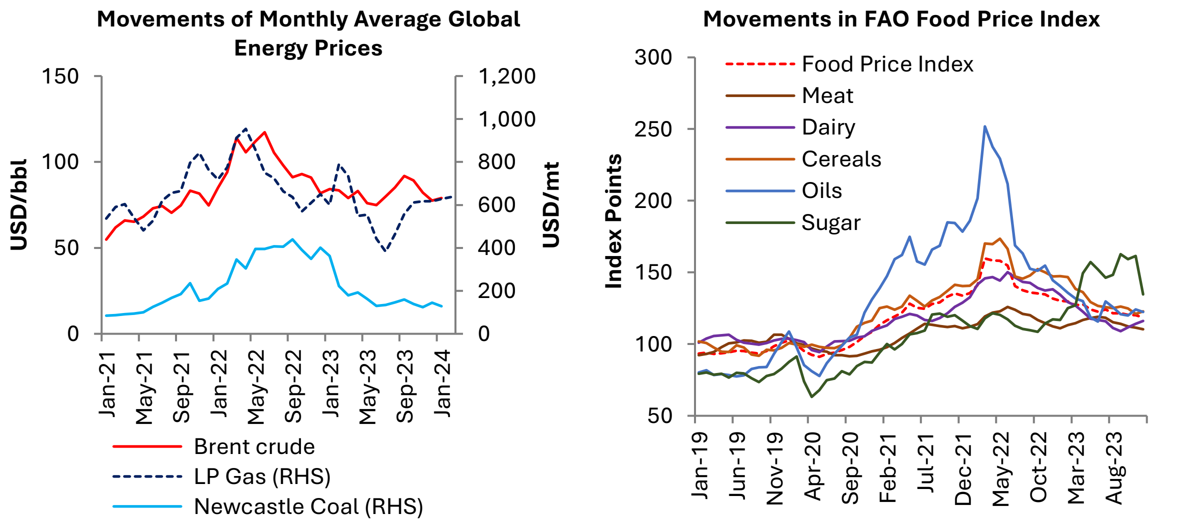


Source: https://www.cbrates.com/

Despite transient fluctuations due to demand and supply imbalances, global energy prices have remained broadly stable in recent months. Global food prices also remained moderate, despite some price acceleration in several commodities including sugar and rice. Global prices remain vulnerable to the escalation of geopolitical tensions in the Middle East.

Global growth is expected to recover in 2024 as global monetary and financial conditions became increasingly accommodative. Meanwhile, global inflation is expected to fall amidst the easing of supply-side disruptions and restrictive monetary policy.

Figure 26: Global Commodity Prices



Source: Reuters, Bloomberg, Saudi Aramco

Source: Food & Agriculture Organization (FAO)

LIST OF ACRONYMS

ADB	Asian Development Bank
AIP	Agreement in Principle
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
AWPR	Average Weighted Prime Lending Rate
BOP	Balance of Payments
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
LCBs	Licensed Commercial Banks
LFCs	Licensed Finance Companies

LP Gas	Liquefied Petroleum Gas
NCG	Net Credit to the Government
NCPI	National Consumer Price Index
NFA	Net Foreign Assets
NPLs	Non-Performing Loans
OCC	Official Creditor Committee
OMO	Open Market Operations
PBOC	People's Bank of China
PMI	Purchasing Managers' Index
QPM	Quarterly Projection Model
SCL	Special Commodity Levy
SDFR	Standing Deposit Facility Rate
SLDBs	Sri Lanka Development Bonds
SLFR	Standing Lending Facility Rate
SOBEs	State-Owned Business Enterprises
SOEs	State Owner Enterprises
SPDs	Standalone Primary Dealers
SRC	Standing Rate Corridor
SRR	Statutory Reserve Ratio
SSCL	Social Security Contribution Levy
VAT	Value Added Tax
9M-2023	Nine months ending September 2023

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