75 YEARS
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MONETARY POLICY REPORT

AUGUST 2025

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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

The Monetary Policy Report is a biannual publication. The content of the current Report is based on the data available as of the July 2025 monetary policy round of the Central Bank, which concluded with the monetary policy announcement on 23 July 2025.

ISBN 978-624-6764-08-1

15 August 2025

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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 price stability, i.e., low and stable inflation, the Central Bank contributes to promoting long-term economic growth. This, in turn, supports 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 (MPB)[1] is responsible for formulating monetary policy and implementing a flexible exchange rate regime that is consistent with the Flexible Inflation Targeting (FIT) framework. This framework aims to keep inflation aligned with the target set out in the Monetary Policy Framework Agreement (MPFA) between the Minister of Finance and the Central Bank. The current MPFA, published in the Government Gazette in October 2023, requires the Central Bank to maintain quarterly headline inflation at 5%.[2] A margin of ±2 pps is allowed under MPFA to measure potential deviations from the target and for accountability purposes. A breach of the above for two consecutive quarters requires the MPB to submit a report to Parliament through the Minister of Finance, which shall also be made available to the public.

To achieve the inflation target, the Central Bank uses its policy instruments to steer short-term market interest rates along the desired path. Since transitioning from a dual policy rate system to a single policy rate system in November 2024, the Overnight Policy Rate (OPR) has served as the primary monetary policy tool of the Central Bank. It is used for signalling and implementing the monetary policy stance. In the current framework, the Average Weighted Call Money Rate (AWCMR) is the Central Bank's operating target. Efforts are directed at maintaining AWCMR at or close to the announced OPR. Aligned with the prevailing monetary policy stance, overnight market interest rates are transmitted through financial markets to the broader economy, ultimately influencing inflation.

Monetary policy decisions are forward-looking and data-driven. Given that monetary policy actions impact inflation with a lag, a forward-looking approach is essential. The MPB of the Central Bank meets six times a year to determine the appropriate monetary policy stance. In making its decisions, the MPB evaluates current inflation and its outlook, the state of the economy and future economic

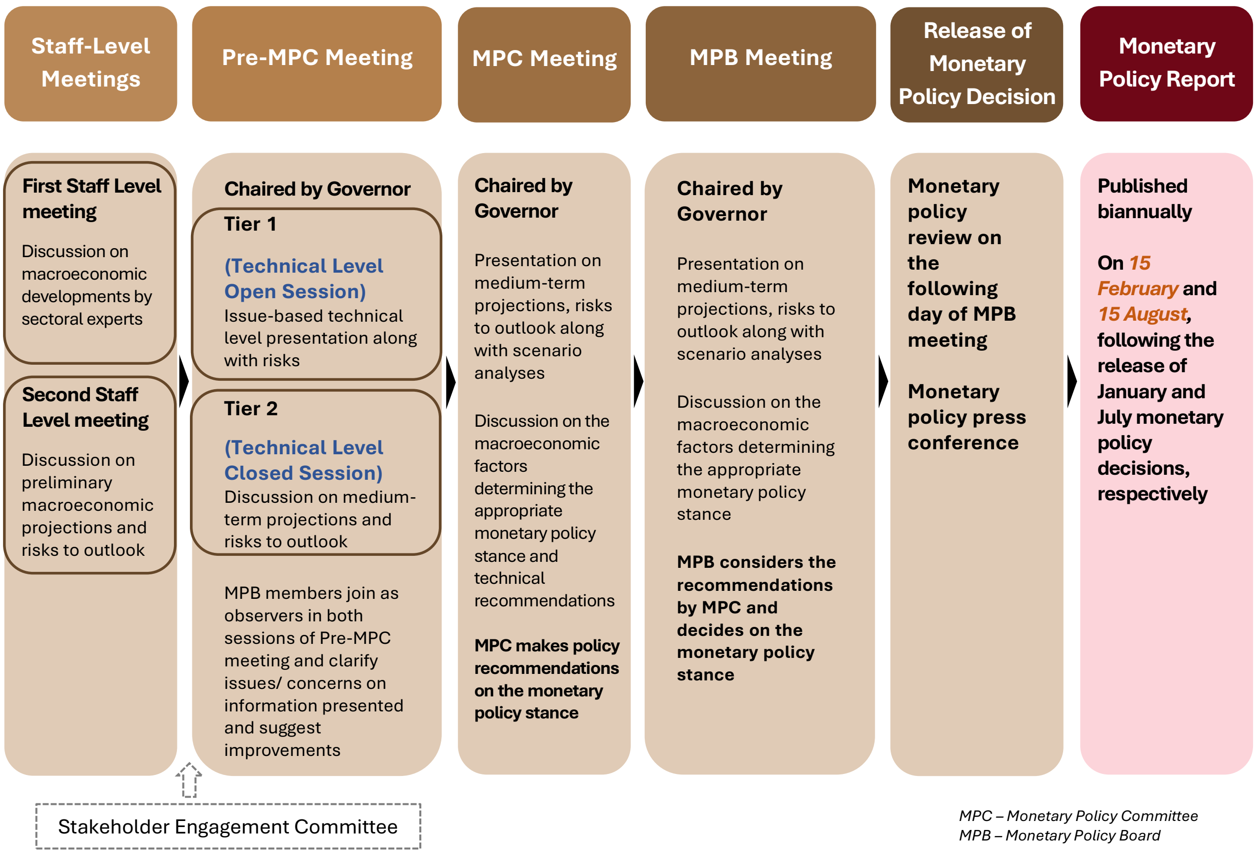
[1] The MPB of the Central Bank consists of the Governor, members of the Governing Board, the Deputy Governors in charge of price stability and financial system stability as well as two experts in the fields of Economics or Finance.

[2] 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 y-o-y percentage changes in the monthly Colombo Consumer Price Index (CCPI) during the three months of the corresponding quarter.

prospects, and the associated risks and uncertainties surrounding such forecasts. The projections discussed during these meetings are based on available data, near-term forecasts of key macroeconomic variables, projections of global indicators, as well as expert staff judgements. The Monetary Policy Committee, an internal committee chaired by the Governor, provides policy recommendations for the review of the MPB, following careful deliberations.

The Monetary Policy Report is prepared as per Sections 27 and 80 of the CBA. These sections mandate the Central Bank to publish a biannual report that explains recent trends in inflation, underlying sources of inflation, medium-term inflation projections, including key risks to those projections and implementation of its monetary policy and the achievement of its objects. The Report also serves to inform the public about current developments in the domestic economy, as well as the global economy, while providing an assessment of the economic growth outlook.

Figure 01: Monetary policy decision-making process in Sri Lanka *(Six times a year)*



EXECUTIVE SUMMARY

Inflation continued to remain in negative territory since September 2024. This deflation is largely attributable to the decline in energy and transport-related prices, as well as some easing of food prices compared to those in the previous year. However, deflationary conditions have eased since March 2025, mainly due to the acceleration of food inflation, while upward adjustments in energy prices during the year have also contributed to this. The current brief episode of deflation has not adversely impacted producer behaviour or disrupted overall economic activity, whereas it has contributed to easing somewhat the cost-of-living burden of households.

Deflation is expected to end in Q3-2025 and a gradual acceleration of inflation is expected thereafter to reach 5% in mid 2026. In the medium term, inflation is projected to stabilise around the target of 5% albeit with possible transitory peaks along the inflation path. Core inflation, which remains at a low positive level at present, is also expected to gather pace before stabilising over the medium term. There are both upside and downside risks to the realisation of the inflation projection. However, the risk assessment reveals a more balanced outlook for the realisation of the projection of inflation in the period ahead.

The Central Bank maintained a relaxed monetary policy stance amid subdued demand-driven inflationary pressures in the economy. Market interest rates have adjusted downwards notably, thus facilitating robust growth in credit flows to the private sector across all major sectors.

External sector performance showed greater resilience thus far in 2025, despite the resurgence of global economic policy uncertainties. The Sri Lanka rupee witnessed a modest depreciation against the US dollar, supported by improved inflows in terms of tourism earnings and workers' remittances, as well as the receipt of the fifth tranche under the Extended Fund Facility of the International Monetary Fund (IMF-EFF), notwithstanding widening import demand. Meanwhile, gross official reserves have been maintained above USD 6 bn, while meeting the debt servicing requirements.

Continuing the growth momentum observed thus far in 2025 and as reflected in leading economic indicators, near-term growth is likely to persist along the observed trajectory going forward. This growth momentum is expected to be supported by favourable credit expansion, recovery in aggregate demand, a stable policy environment that fosters business sentiments, as well as continued policy efforts towards addressing structural issues in the economy. However, the rapidly evolving global trade landscape, global policy uncertainties, and recurring geopolitical tensions may have an impact on the economic outlook. Sustaining the growth momentum in the medium term and ensuring its equitable benefits to all the stakeholders of the economy will require actionable growth-enhancing policies, complemented by necessary structural reforms.

1. MONETARY POLICY SUMMARY

The Central Bank of Sri Lanka maintained its accommodative monetary policy stance following the easing of monetary policy that commenced in June 2023. This marks over two years of policy easing, amidst relatively subdued aggregate demand conditions and a low inflation environment.

The Central Bank opted for a brief policy pause since the policy interest rate reduction in November 2024, allowing space for market interest rates to decline further in line with the eased monetary policy stance. Accordingly, in January and March 2025, the Central Bank kept its key policy interest rate, the Overnight Policy Rate (OPR), unchanged. This was mainly considering the projection of a gradual convergence of inflation towards the target, despite the prevalence of deflation driven by repeated reductions in energy prices. Gradual reduction in market interest rates coupled with robust credit growth and strong recovery in domestic economic activity amid resilience in the external sector supported the Central Bank's decision to hold its policy interest rate during these monetary policy reviews.

In May 2025, the Central Bank further eased its monetary policy stance by reducing the OPR by 25 bps as inflation was expected to normalise more gradually than previously expected, given the delay in electricity tariff adjustment and the likely impact on the domestic economy from rising global uncertainties. This decision was also intended to steer a further downward adjustment in market interest rates, given the moderate pace of reduction in most market lending interest rates during this period.

Meanwhile, at the latest monetary policy review round in July 2025, the OPR was kept unchanged as inflation was on track to turn positive in Q3-2025 with a steady convergence towards the target. Core inflation also indicated a gradual pick-up with the recovery of demand conditions in the economy. The decision to hold the policy interest rate was further supported by the firm economic growth momentum and robust credit growth, while renewed global policy uncertainty also warranted a prudent and cautious approach.

Accordingly, the Central Bank has reduced its policy interest rate by a total of around 800 bps (8.0 pps) over the period from June 2023 to July 2025.

The MPB will meet in September 2025 for the fifth monetary policy review of the year.

Monetary Policy Decisions since the last Monetary Policy Report (February 2025 – July 2025):

March 2025	May 2025	July 2025
Overnight Policy Rate (OPR) was maintained at 8.00%	OPR was reduced by 25 bps to 7.75%	OPR was maintained at 7.75%

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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 2025, are summarised in this section, with a focus on the projections of inflation and real economic growth.[3] These projections reflect the available data, near-term forecasts of key variables, global macroeconomic projections, and assumptions and judgements made at the July 2025 monetary policy round. These projections are considered the *baseline forecast* in this Report

2.1. Baseline Forecast

As per the latest near-term projections, the prevailing deflationary conditions are expected to ease gradually, primarily reflecting the easing of energy-related deflation. Inflation is expected to return to positive territory in Q3-2025. Medium-term projections suggest that headline inflation would continue to accelerate and reach the target of 5% in mid 2026, supported by firming demand conditions. Thereafter, following a possible uptick, inflation is projected to stabilise at the target with the implementation of appropriate policy measures. The latest nowcasts expect real Gross Domestic Product (GDP) growth for Q2-2025 to be robust, continuing the positive momentum observed in 2024 and Q1-2025. As per the currently available information, economic growth for 2025 is projected to be around 4.5%. Looking ahead, economic growth is expected to continue its modest expansionary momentum over the medium term. However, external demand conditions and evolving global geoeconomic landscape increase the level of uncertainty associated with growth prospects over the near to medium term.

Prospects for Inflation[4]

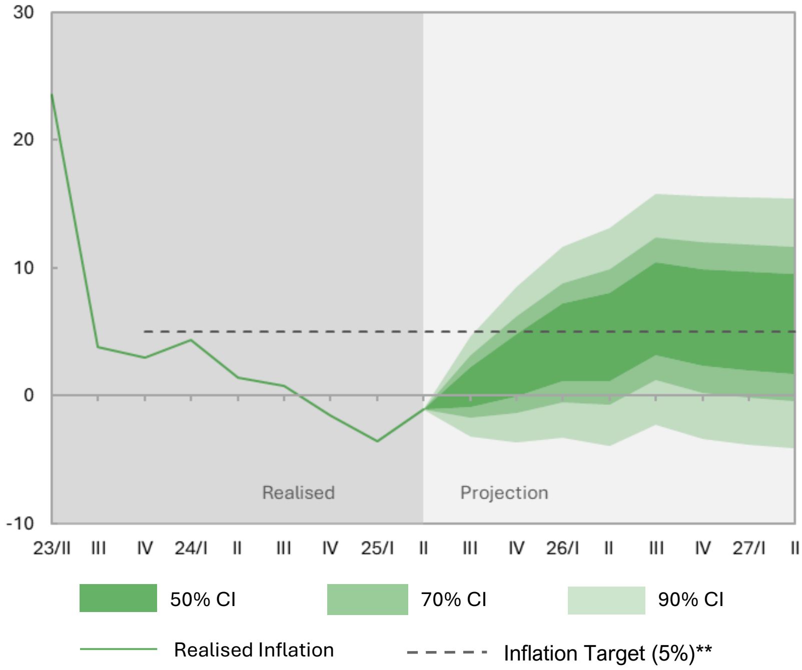
Since recording a peak level of deflation in Q1-2025, deflationary conditions have started to ease as predicted earlier. Increased food prices reinforced this trend during Q2-2025. Meanwhile, the increase in electricity tariffs in June 2025 also contributed to easing deflation levels, and its impact is expected to persist in Q3-2025 as well. In addition, the impact of the statistical base effect is expected to contribute to this trend during Q3-2025. Following three consecutive quarters of deflation, a return to inflationary conditions is anticipated in Q3-2025, along with a further increase in inflation during Q4-2025. According to the medium-term projections, headline inflation is projected to reach the target

[3] The Central Bank uses the Quarterly Projection Model (QPM), a semi-structural macroeconomic model, to arrive at medium-term macroeconomic projections. These 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).

[4] Headline inflation is measured based on the Colombo Consumer Price Index (CCPI, 2021=100)

in mid 2026. This increasing trend in inflation is expected to continue until H2-2026, recording a temporary increase beyond the target. However, inflation is expected to gradually converge towards the target of 5% thereafter, with the support of appropriate policy measures. The overall increasing trajectory in inflation can be broadly attributed to the gradual recovery in demand conditions and an anticipated gradual transition of energy and transport inflation to its usual pace after an extended period of deflation. Nonetheless, evolving global macroeconomic conditions may increase the uncertainty associated with these medium-term projections.

Figure 02: Projected Headline Inflation (Quarterly, CCPI, y-o-y, %)
Based on the Projections during the July 2025 Monetary Policy Round



***The inflation target (5%) was agreed under the Monetary Policy Framework Agreement (MPFA) signed between the Central Bank and the Minister of Finance in October 2023.*

Note: Realised data shown in the fan chart are based on the CCPI (2021=100, seasonally adjusted).

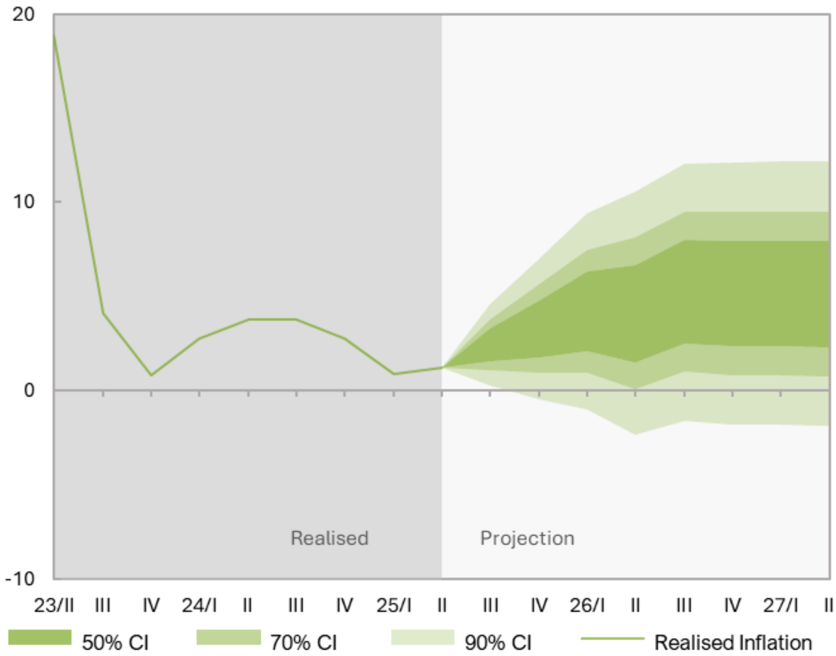
Source: Central Bank Staff Projections

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 2025. 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 fiscal path of the Government; and global financial conditions implied by the US Fed Funds rate. Moreover, the projections are conditional on the model-consistent interest rate path and the resulting macroeconomic responses, including that of the exchange rate. Further, no major macroeconomic policy shifts are anticipated in the baseline projections. Thus, the continuation of the IMF-EFF and efforts on fiscal consolidation 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, 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 Realisation of Baseline Projections" section.

Core inflation is also expected to record a gradual increase over the near term. Over the medium term, core inflation is expected to stabilise at a level consistent with the headline inflation target of 5% with a lower degree of volatility than headline inflation. The gradual normalisation of core inflation towards the headline inflation target in the period ahead is forecast to be driven by the anticipated recovery in demand conditions and by imported inflation, which is partly driven by global food prices and global inflation trends. Accordingly, the prevailing uncertainty over the projections of such world inflation developments would also affect core inflation projections to some extent.

Figure 03: Projected Core Inflation (Quarterly, CCPI, y-o-y, %)
Based on the Projections during the July 2025 Monetary Policy Round



Note: Realised data shown in the fan chart are based on the CCPI (2021=100, seasonally adjusted).
See the explanatory note in Figure 02 above.

Source: Central Bank Staff Projections

Energy and transport deflation is expected to ease further, contributing to an increase in headline inflation towards the target over the medium term. Further, the temporarily elevated global oil prices anticipated in the near term may also contribute to increasing the energy and transport inflation trajectory. However, evolving global macroeconomic conditions increase the uncertainty surrounding expectations of global oil prices. The recent rise in volatile food inflation, which was largely contributed to by supply factors, is expected to moderate in the near term due to a healthy harvest. Nevertheless, intermittent supply factors, like the impact due to sudden changes in weather patterns, will continue to affect volatile food inflation. However, such factors are not part of the projections due to their random nature and, therefore, constitute part of the risks associated with the realisation of the projections.

Box A: Understanding Momentum and Base Effect[1]

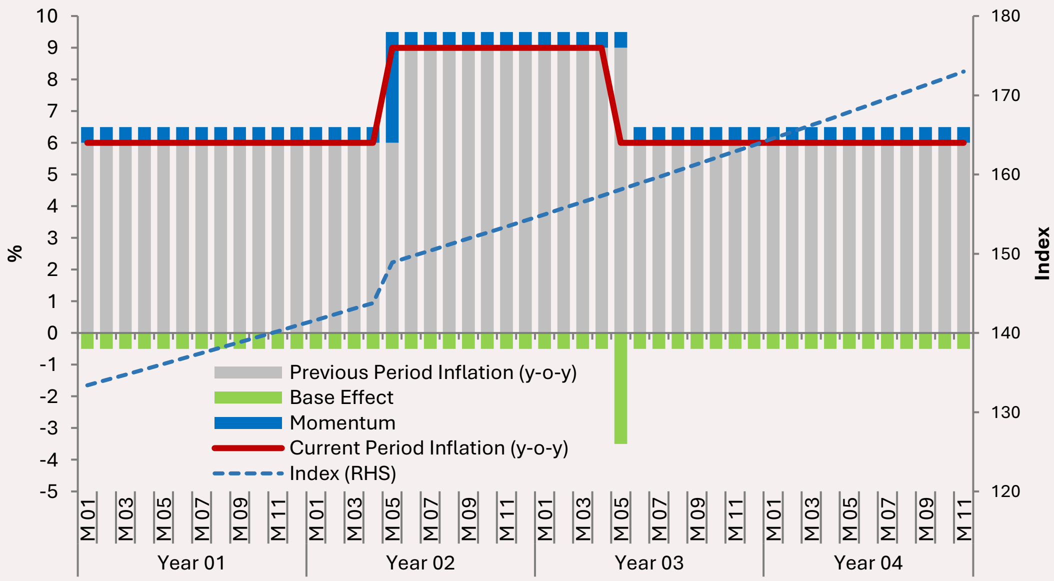
Inflation is generally measured as a percentage change in the general price level compared to the same period in the previous year (y-o-y). The general price level is measured by a consumer price index (in the case of Sri Lanka, Department of Census and Statistics (DCS) compiles and publishes the two main price indices used to measure inflation in Sri Lanka, Colombo Consumer Price Index (CCPI) and National Consumer Price Index (NCPI)). However, as price information is usually made available at a monthly frequency, changes in prices can also be calculated on a m-o-m basis.

The m-o-m inflation of the current month is usually termed as the momentum, while the negative value of the m-o-m inflation in the same month of the previous year is termed the base effect. The momentum represents how y-o-y inflation changes due to price developments in the latest month, while the base effect accounts for the statistical effect that affects how y-o-y inflation changes from one month to the next. The change of the y-o-y inflation from one month to the next can then be approximated by adding the momentum and the base effect.[2] In other words, the current month's y-o-y inflation could be derived by adding the momentum and base effect to the previous month's y-o-y inflation (i.e., $\pi_t^{YoY} \approx \pi_{t-1}^{YoY} + \text{Momentum} + \text{Base Effect}$, where π represents inflation). This segregation allows analysts to evaluate key contributing factors to the dynamics of y-o-y inflation.

The link between momentum and base effect on inflation can be further illustrated using Figure A.1. In this hypothetical example, the price level increases consistently at a rate of 0.5% in each month, i.e., m-o-m inflation remains constant at 0.5%. In turn, this leads to a constant y-o-y inflation of 6% in each month. In other words, the constant rate of price increase gives rise to equal momentum and base effect, cancelling one another and keeping y-o-y inflation unchanged. Suppose a m-o-m increase of 3.5% occurs suddenly in M 05 of Year 02, after which it reverts and continues to record 0.5% m-o-m inflation. Since the new momentum is 3.5% and the base effect remains at 0.5%, it is observed that y-o-y inflation rises by approximately 3.0% in M 05 of Year 02. It is further apparent that y-o-y inflation remains unchanged at this elevated level thereafter since the momentum and the base effect again become equal. However, by the end of the year (i.e., M 05 of Year 03), the momentum that contributed to an elevation of y-o-y inflation transforms to a base effect, which leads to a drop in y-o-y inflation by 3.0%. This implies that the base effect will have an offsetting effect with a 12-month lag, which would correct the first change that occurred in the y-o-y inflation.

While this hypothetical example attempts to illustrate the dynamics of momentum and base effect in a simplified setup by assuming constant monthly price increases, in real life, monthly price changes often fluctuate, giving rise to varying levels of momentum and base effects, as shown in Figure 04 in the current MPR.

Figure A.1 : Hypothetical Example: Dynamics of Momentum and Base Effect

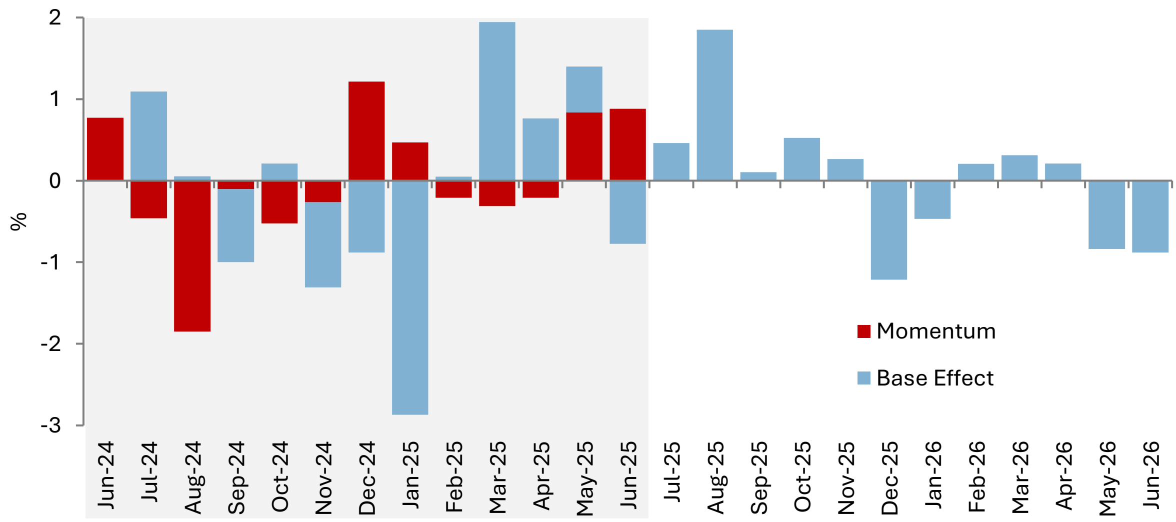


Note: Percentage changes are based on log differences

Source: Central Bank Staff Calculations

[1] For a more detailed discussion, refer to the Box article on "Sri Lanka's Disinflation Process", accessible via the Central Bank Website.
[2] This approximation is motivated by the fact that percentage changes can be approximated by log differences.

Figure 04: Headline Inflation: Momentum and Base Effect (CCPI, 2021=100)



Note: See Box A for a description on Momentum and Base Effect.

Source: Central Bank Staff Calculations

Inflation Expectations

As per the inflation expectations survey conducted by the Central Bank, short-term inflation expectations of the corporate sector broadly moved in line with the realised inflation. Accordingly, 3 months and 6 months ahead inflation expectations followed an overall declining trend from January 2025 to March 2025 and picked up thereafter. As per the July 2025 survey round, a gradual increase in expected inflation could be observed from the 3 months ahead period to the longer tenors, along with the easing of deflationary pressures. Further, the corporate sector's medium-term inflation expectations remained broadly aligned with the Central Bank's inflation projections and the inflation target of 5%.

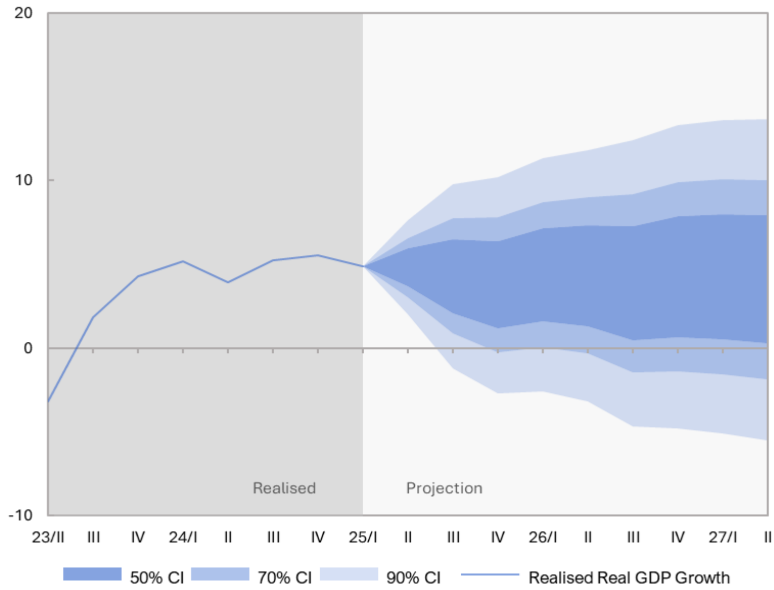
Prospects for Real Economic Growth

Nowcasts and near-term projections on economic growth, based on leading economic indicators, survey findings, and staff evaluations, suggest that real GDP growth would be robust in Q2-2025 as well, continuing the positive momentum observed in 2024 and Q1-2025. This growth is supported by strong activity, mainly in the industry and agriculture sectors. Further, real GDP growth for Q3-2025 is also expected to be strong, with positive y-o-y growth expected in all three sectors. However, the upward growth momentum could be affected by the ongoing global trade uncertainties and fragile geopolitical conditions.[5]

Over the medium term, the economy is expected to traverse along a modest growth trajectory. Relatively accommodative monetary conditions are contributing to this modest growth path. A gradual transition of the output gap into low positive levels is expected over the medium term, implying the recovery of aggregate demand. However, with the consolidation efforts, fiscal policy is expected to be contractionary over the medium term, assisting to stabilise aggregate demand. Meanwhile, the positive foreign output gap is estimated to narrow and turn negative. This negative gap is anticipated to persist over the medium term, suggesting subdued external demand driven mainly by US trade-related policies.

It is noteworthy that the economic growth trajectory over the medium term is subject to considerable uncertainty. The continuation of the notable economic recovery momentum is conditional on the expeditious and effective implementation of targeted structural reforms and growth strategies. Continued addressing of corruption vulnerabilities will be vital for fostering investor confidence and creating an environment conducive to long-term, sustained economic development, led by the private sector. This would help create a steady pickup in investment supported by both domestic and foreign savings, which would be decisive in sustaining the growth momentum.

Figure 05: Projected Quarterly Real GDP Growth (y-o-y, %)
Based on the Projections during the July 2025 Monetary Policy Round



See the explanatory note in Figure 02 above.

Source: Central Bank Staff Projections

[5] As per the latest information, the US has imposed a 20% tariff on Sri Lankan exports.

2.2. Key Assumptions Underpinning the Forecast

A summary of the key assumptions used in arriving at medium-term forecasts at the monetary policy round in July 2025 is provided in this section.

Global Environment

Global markets were rattled by the US reciprocal tariff announcements, leading to heightened worldwide economic uncertainty. Global economic growth is expected to slow, driven by increased uncertainty and ongoing geopolitical tensions. The ongoing disinflation process is expected to be slowed by increased global supply chain and trade distortions, and commodity price volatilities associated with geopolitical tensions, prompting a reassessment of the pace of interest rate cuts by central banks. According to the Global Projections Model Network (GPMN),[6] the export-weighted foreign output gap[7] is projected to decline sharply and turn negative in the near term, and remain subdued in the medium term due to the anticipated slowdown in the US and Eurozone. US CPI inflation (y-o-y) remained at around 2.6% during H1-2025. However, with increases in goods inflation and expected higher energy prices along with tariff impacts, US inflation is expected to remain slightly above the target in the coming months. A gradual easing of the US Fed Funds rate is anticipated. Brent crude oil prices initially rose due to geopolitical tensions involving the Israel-Iran-US conflict, but eased quickly following a rapid de-escalation. According to GPMN, the average Brent oil price is expected to be lower in 2025 compared to the previous year, driven by continued increases in OPEC+ production and the slowdown in global demand. The global food inflation outlook is expected to remain broadly stable in the coming years.

Fiscal Path

The assumptions related to the fiscal path incorporated in the current projections have been updated according to the Fiscal Strategy Statement 2026, published by the Ministry of Finance in June 2025.

External Current Account

A current account surplus is projected for 2025, mainly driven by the substantially large surplus recorded in the first five months of the year.

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[6] The Central Bank uses projections of global macroeconomic indicators prepared by GPMN as inputs for medium-term projections. Projections used in the July 2025 monetary policy round are based on GPMN projections received on 25 June 2025.

[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.

2.3. Risks to Realisation of Baseline Projections

There are both upside and downside risks to the realisation of baseline projections of inflation and GDP growth. An exposition of such risks, as per the monetary policy round in July 2025, is provided in this section.

Risks to Inflation Projections

Several upside risks could potentially drive inflation on a higher trajectory than the projected path. The impact of geopolitical tensions and supply disruptions upon commodity prices is already internalised to a certain extent in indicators such as global oil prices and the foreign output gap. However, the global geopolitical and macroeconomic situations are unusually volatile, and there could still be further upward impact and volatility on the global commodity prices. The baseline projections assume a gradual depreciation of the Sri Lanka rupee during 2025. Any possibility of such depreciation pressures exceeding the levels considered in baseline projections could contribute towards inflationary pressures. The gradual build-up of demand pressures remains an important factor that drives the anticipated normalisation of inflation in the period ahead. A high credit expansion has been observed in recent months, and credit is expected to continue expanding. A faster acceleration in the growth of credit to the private sector could lead to higher-than-anticipated demand pressures. Further, amidst recently observed unpredictable weather patterns, any possible adverse weather conditions affecting agricultural production negatively could exert upward pressure on food inflation. Moreover, any weather anomalies that could also be associated with climate change repercussions can impact the dependence on hydro-power for energy generation and agricultural activities, creating upside risks to both energy and food prices.

When downside risks are considered, in the near term, possible further reductions in food prices can occur amid a healthy harvest. Further, a possible persistent slowdown in global demand driven by geopolitical tensions and upward tariff revisions can lead to a more than anticipated reduction in global energy and food prices.

As per the judgements at the current monetary policy round, risks to inflation projections are assessed to be balanced in both the near and medium term.

Risks to Economic Growth Projections

Potential major downside risks to growth projections in the near to medium term include, among others, US tariff-related uncertainties weighing heavily on growth prospects. The exact impact of US tariff changes on Sri Lankan exports to the US remains ambiguous, and it can limit the performance of the external sector, market performance, market sentiments and investments. Moreover, the associated global macroeconomic uncertainties can affect the external sector via many other channels, such as overall stagnation of external demand, uncertainty created due to changes in comparative advantages, the possibility of domestic producers having to compete with new imports from countries that would be looking for alternative trade destinations, price increases of certain imports of raw materials and intermediate goods, etc. In addition, possible escalations in geopolitical tensions can drive down external demand, hinder foreign employment and remittances, and negatively impact tourism. Weather-related factors could also play an important role in the economic performance of the country over the period ahead. Moreover, climate change may affect economic activity in Sri Lanka over the medium term, given the increased sensitivity of agricultural production and food processing sectors to such events.

On the positive side, better-than-expected recovery in the agriculture sector can drive growth in the near term. Moreover, expeditious implementation of growth and export-promoting strategies could enhance economic growth prospects over the medium term.

2.4. Comparison with the Previous Forecast[8]

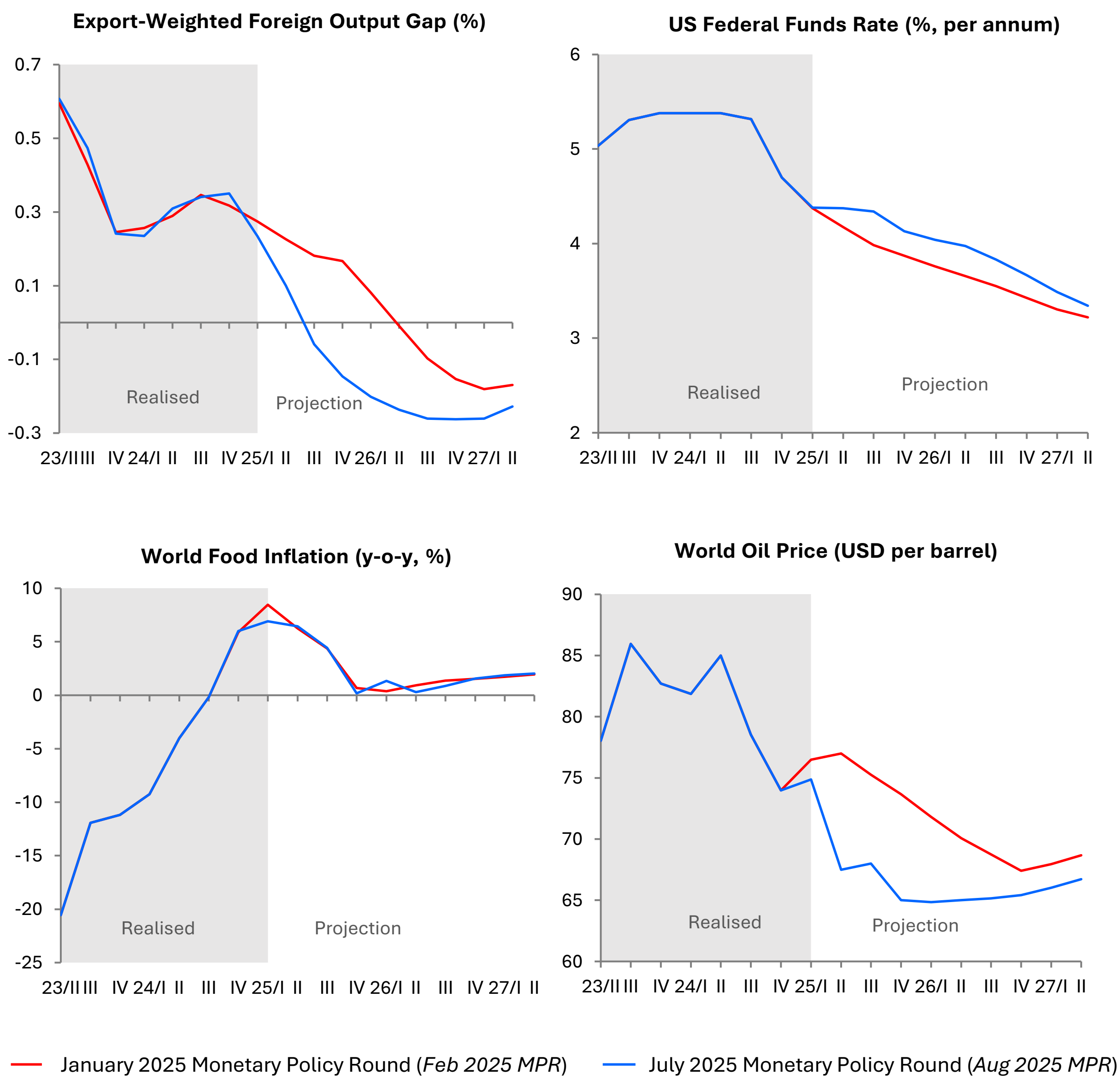
Key Assumptions Used for Medium-Term Projections

Based on global projections used during the monetary policy round in July 2025, the outlook for the export-weighted foreign output gap of Sri Lanka's major trading partners has deteriorated, compared to the information available as of January 2025, which was used in MPR-February 2025. This change was primarily due to revised projections related to the US, Eurozone, and the UK economies. Global projections used during the July 2025 monetary policy round forecast a trajectory for food inflation that is largely similar to that of the monetary policy round in January 2025. The trajectory of world oil prices was revised down substantially compared to the path projected in January 2025 due to the impact on global demand amid US tariffs and geopolitical conflicts related disruptions. Meanwhile, monetary policy loosening in the US is expected to be slower now than previously projected, amid the cautious approach by the US Federal Reserve. The fiscal path has been revised in the current projections based on the Fiscal Strategy Statement 2026, published by the Ministry of Finance in June 2025. Compared to the January 2025 monetary policy round, this update internalises a slightly higher overall deficit path while

[8] This Section compares the current forecasts with the forecast presented in the MPR in February 2025, which were derived during the January 2025 monetary policy round.

keeping the path of primary balance stable. With the latest information, a surplus in the external current account is expected for 2025, compared to the previously anticipated slight deficit in the monetary policy round in January 2025.

Figure 06: Global Projections (Quarterly)



Note: In the latest GPMN projections, Q1-2025 is considered the most recent realised time period until the complete realised data set becomes available from the multitude of countries it takes into account

Sources: QPM, GPMN (Updated on 21/01/2025 and 25/06/2025)

Inflation Path

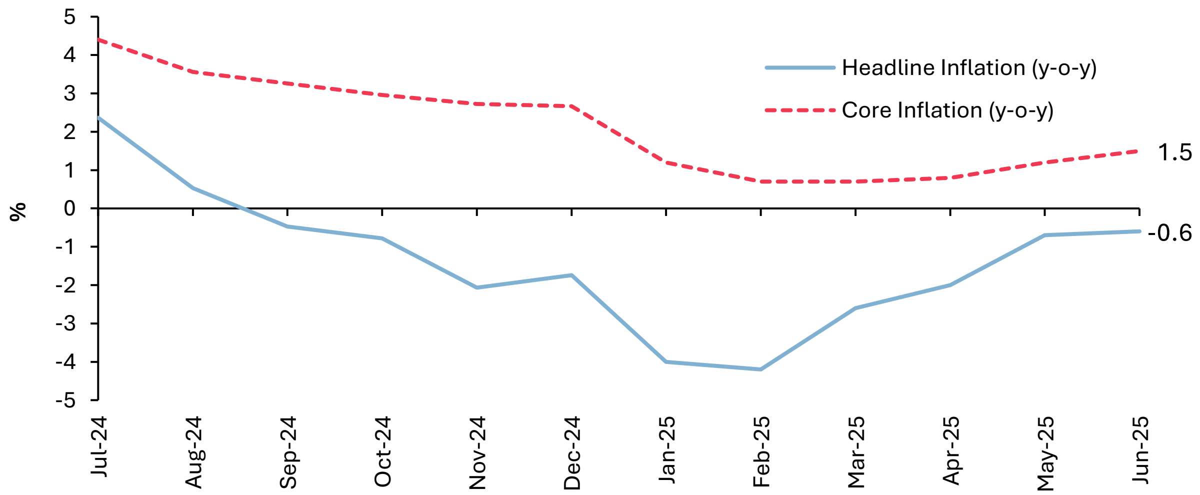
Compared to the projections published in MPR-February 2025, realised y-o-y headline inflation in Q1-2025 was recorded broadly around the projected level. However, realised inflation in Q2-2025 was below the previous projection, primarily due to a delayed upward revision to the electricity tariff than anticipated, several downward revisions to fuel prices, along with the moderation of food prices. Nevertheless, the upward revision to the electricity tariffs in June 2025 is expected to ease energy and transport deflation going forward. Meanwhile, projections over the near term also remain lower than the previous MPR, due to a lower global oil price trajectory and softening food prices. Similar to the previous projection, inflation is expected to gradually stabilise around the inflation target over the medium term with improved demand conditions in the economy. With regard to medium-term projections of core inflation, it is anticipated to remain at an elevated level compared to the previous MPR, due to a higher growth forecast driven by more favourable realised information.

3. CURRENT ECONOMIC DEVELOPMENTS

3.1. Inflation

Deflationary conditions began to ease since March 2025, owing to rising food inflation and upward adjustments to administratively determined prices.

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

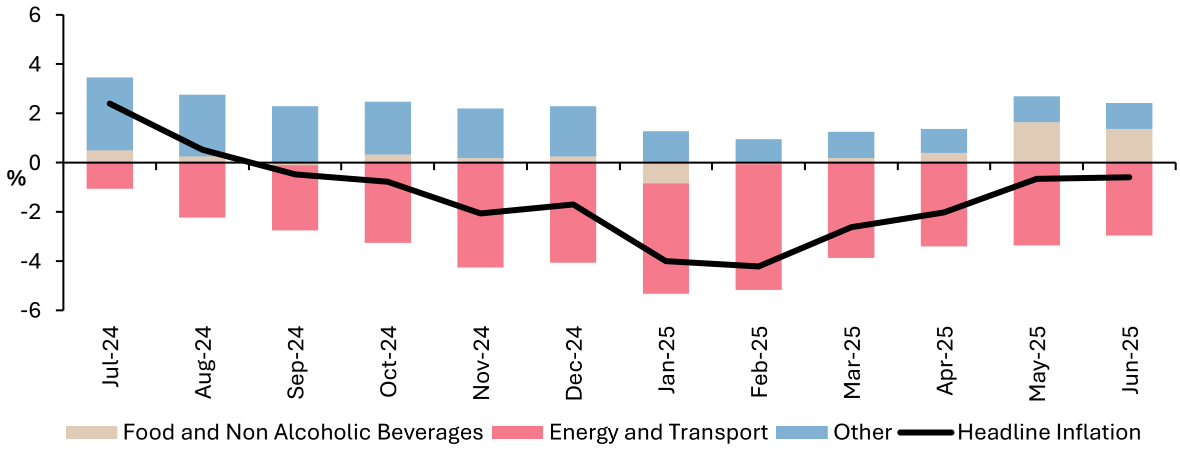


Source: Department of Census and Statistics

The Colombo Consumer Price Index (CCPI, 2021=100) based headline inflation (y-o-y) dropped significantly to -4.0% in January 2025 from -1.7% in December 2024. This sharp deceleration was mainly driven by the statistical base effect stemming from the changes to the VAT structure implemented in January 2024. The highest level of deflation at 4.2% was recorded in February 2025. This was driven by the downward revision of electricity tariffs implemented in mid-January 2025. However, deflationary conditions began to ease from March 2025 onwards, driven by the increase in food inflation. The upward revision of electricity tariffs in mid-June 2025 and the positive contribution that arose from the effect of the statistical base helped ease deflation. In spite of these developments, headline inflation continued to remain in the negative territory by June 2025, recording -0.6% (y-o-y).[9] In June 2025, CCPI-based food inflation remained positive at 4.3% (y-o-y), whereas non-food inflation continued to remain in the negative territory, recording -2.8% (y-o-y). Meanwhile, the National Consumer Price Index (NCPI, 2021=100) based headline inflation (y-o-y) showed an overall upward trend during H1-2025. After eight consecutive months of deflation, headline inflation based on NCPI turned positive in May 2025, led by rising food prices, and recorded 0.3% in June 2025.

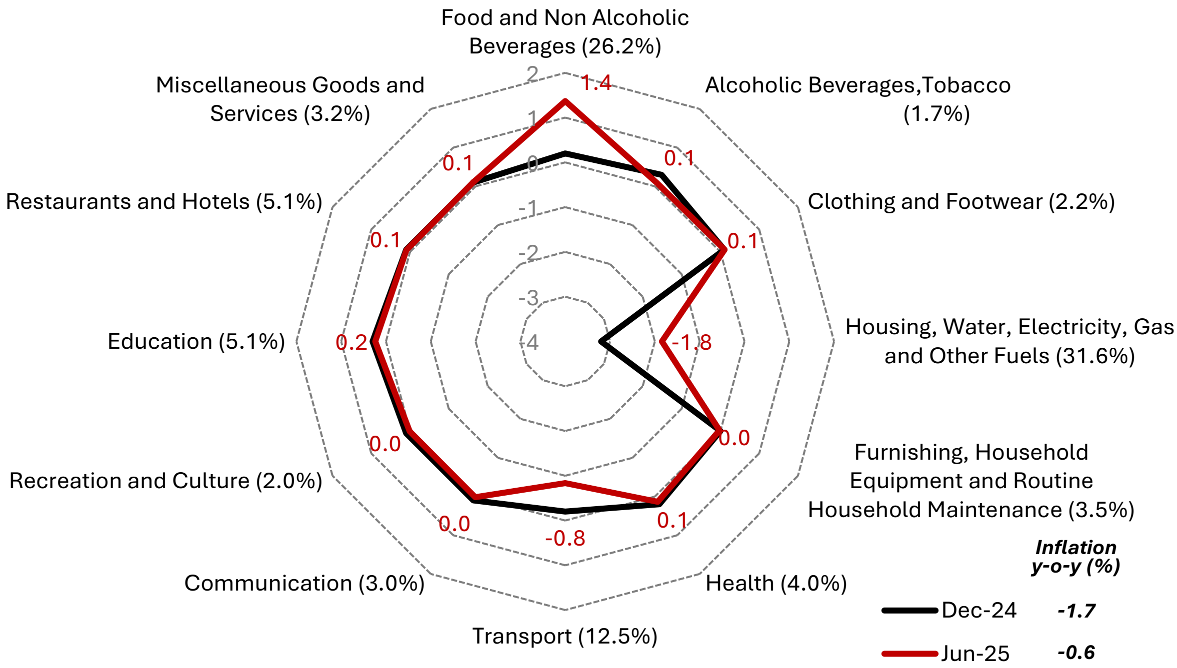
[9] In July 2025, CCPI based headline inflation (y-o-y) was recorded at -0.3%.

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



Sources: Department of Census and Statistics
Central Bank Staff Calculations

Figure 09: Subcategory-wise Contribution to y-o-y Headline Inflation (CCPI)

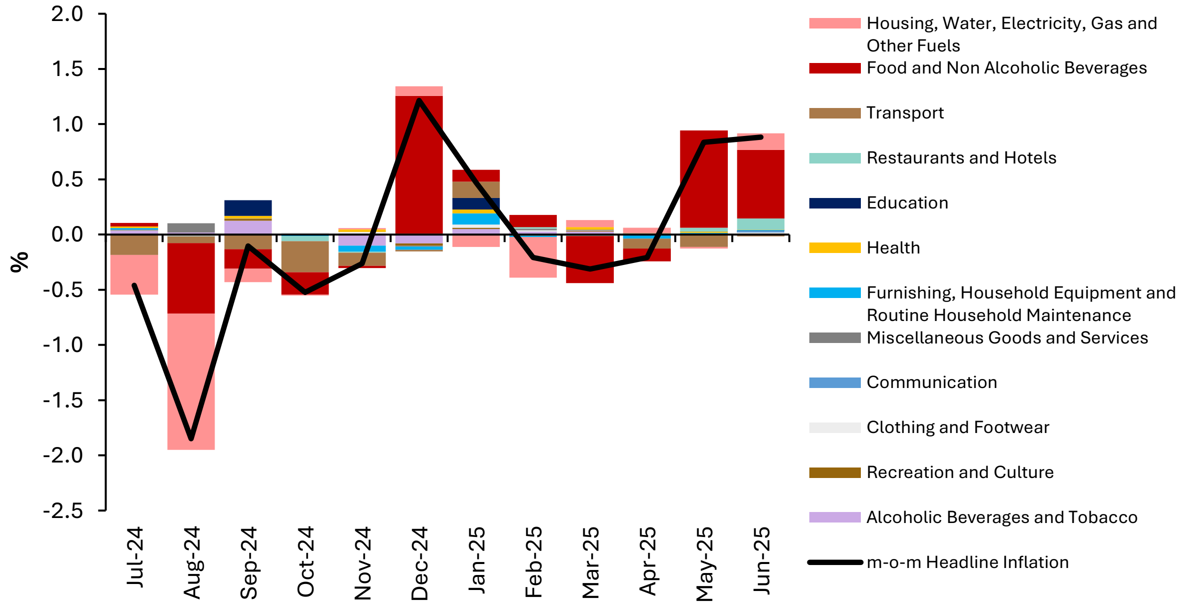


Note: Weights of subcategories in the CCPI basket are given in parentheses.

Sources: Department of Census and Statistics
Central Bank Staff Calculations

On a m-o-m basis, CCPI-based headline inflation turned negative in February 2025 following the small positivity recorded in January 2025 due to the downward revision to the electricity tariffs in January 2025. It continued to remain negative from March to April 2025, driven by easing food prices due to the Maha harvest. However, headline inflation (m-o-m) turned positive from May 2025 onwards, driven by the increase in food prices and the upward revision to electricity tariffs effected in mid-June 2025.

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



Sources: Department of Census and Statistics
Central Bank Staff Calculations

Figure 11: Headline Inflation Heatmap (CCPI, y-o-y, %)

Note: Data preceding January 2023 are based on the CCPI (2013=100), while data commencing January 2023 are based on the CCPI (2021=100). Base weights are given in parentheses, based on the CCPI (2021=100). The height in each subcategory represents the relative base weight of the category (excluding in the case of All items).

Sources: Department of Census and Statistics
Central Bank Staff Calculations

Box B: Understanding Services Inflation: Why Does It Matter?

Importance of monitoring services inflation

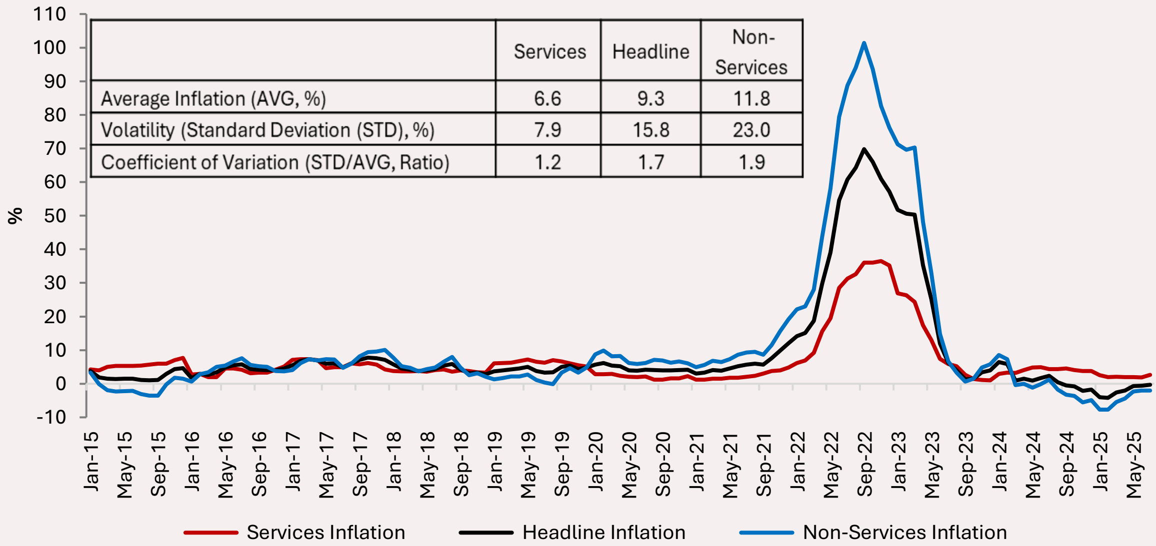
Services inflation refers to the rate of increase in prices of services. Unlike prices of goods, which respond quickly to supply-driven factors or external shocks such as fluctuations in global commodity prices, prices of services typically adjust more gradually and exhibit greater persistence. This is largely because prices of services are closely linked to domestic factors such as wages, rents, healthcare, and education, which tend to adjust slowly and are less responsive to short-term shocks (Amatyakul et al. (2024), Bils & Klenow (2004) and Jangam et al. (2024)). Further, low substitutability and contractual limitations usually make services inflation less volatile and more persistent. Moreover, as services inflation is usually less affected by global commodity prices, it serves as an indicator of domestic inflationary pressures and demand conditions. Reflecting this trend, central banks in advanced economies as well as emerging economies place greater emphasis on monitoring and analysing services inflation to better understand underlying and persistent inflationary trends.

Trends in Services Inflation in Sri Lanka

In Sri Lanka, service-specific components account for nearly half of the consumer basket[1] where services prices have a considerable impact on overall (headline) inflation and the cost of living. Strengthening the monitoring of prices in the services sector is therefore vital for deepening the understanding of inflation dynamics, improving the accuracy of forecasting models, and enabling more effective and timely policy interventions.[2]

Figure B.1 shows y-o-y services inflation in Sri Lanka during 2015-2025 (up to July), as derived from the Colombo Consumer Price Index (CCPI) (2013=100 and 2021=100). Compared to headline inflation and non-services inflation, services inflation has remained relatively stable, as indicated by both the chart and the accompanying statistical measures. Moreover, considering recent trends, services inflation in 2024 and 2025 thus far has remained at elevated levels compared to non-services inflation, further emphasising the impact of supply-driven factors in keeping headline inflation low during this period.

Figure B.1: Movement of CCPI (2013=100 and 2021=100) Based Services Inflation (y-o-y)



	Services	Headline	Non-Services
Average Inflation (AVG, %)	6.6	9.3	11.8
Volatility (Standard Deviation (STD), %)	7.9	15.8	23.0
Coefficient of Variation (STD/AVG, Ratio)	1.2	1.7	1.9

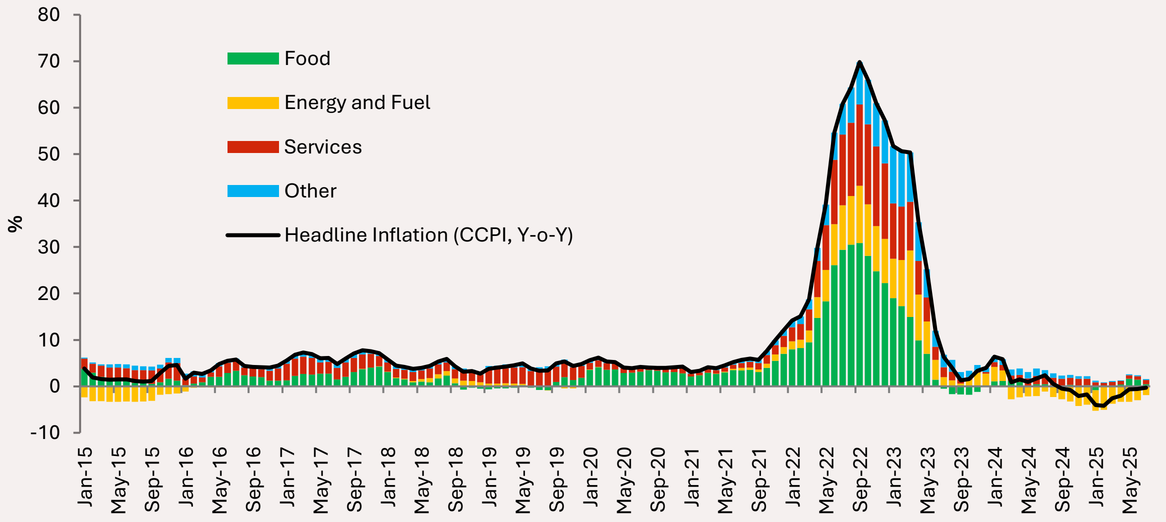
Sources: Department of Census and Statistics, Central Bank Staff Calculations

[1] Service-specific components are extracted from the overall (Headline) CPI baskets of goods and services (2013=100 and 2021=100) using the Classification of Individual Consumption According to Purpose (COICOP) 2018.

[2] In consideration of the importance of services inflation, it is essential to establish regular and systematic monitoring of the prices of services.

Figure B.2 illustrates the contribution of services inflation, food inflation, and energy and fuel inflation to headline inflation. The contribution of services inflation to headline inflation has remained sizeable. In recent months, services inflation exerted upward influence on the overall inflation, while energy and fuel inflation exerted downward influence, reflecting the recent disinflationary trend.

Figure B.2: Contribution to Headline Inflation (CCPI, 2013=100 and 2021=100)



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

The inherent characteristics of services inflation highlight the importance of incorporating its dynamics more explicitly into the overall inflation monitoring and policymaking framework, especially given its prominent role in shaping headline inflation and maintaining price stability.

References:

1. Amatyakul, P., Igan, D., & Lombardi, M. J. (2024, March 4). Sectoral price dynamics in the last mile of post-Covid-19 disinflation. *BIS Quarterly Review*. Bank for International Settlements.
2. Bils, M., & Klenow, P. J. (2004). Some evidence on the importance of sticky prices. *Journal of Political Economy*, *112(5)*, 947–985.
3. Jangam, P., Rath, B. N., & Perera, S. (2024, September 6). *Analyzing price rigidity and price convergence in the services sector of Sri Lanka* [Paper presentation]. 5th CBSL-ADBI-APAEA Joint Workshop, Central Bank of Sri Lanka. URL
4. United Nations Statistics Division. (2018). *Classification of Individual Consumption According to Purpose (COICOP) 2018*. United Nations.

CCPI-based core inflation (y-o-y), which reflects the underlying inflation trends in the economy, continued to ease until March 2025. Thereafter, it gradually began to gather pace, reaching 1.5% in June 2025.[10] Moreover, the sharp turnaround in headline inflation observed in March 2025 was not visible in core inflation as such behaviour was largely driven by volatile food and energy-related price increases, which are excluded from the core inflation basket. Meanwhile, NCPI-based core inflation (y-o-y), which briefly turned negative during January to April 2025, moved back into positive territory, recording 0.6% in June 2025.

[10] In July 2025, CCPI based core inflation (y-o-y) was recorded at 1.6%.

Since CCPI-based quarterly headline inflation deviated from the inflation target of 5% by more than the margin of ±2 pps stipulated in the Monetary Policy Framework Agreement (MPFA), from the lower side for two consecutive quarters in Q4-2024 and Q1-2025, the Report required under Section 26(5) of the CBA was submitted to the Parliament through the Hon. Minister of Finance.[11] This was the third of such reports submitted by the Central Bank and deliberated at the Committee of Public Finance (CoPF), following which it was made available to the public. Further, as the quarterly headline inflation remained below the inflation target by more than 2 pps in Q2-2025 as well, another follow-up report under Section 26(5) of the CBA will also be submitted to the Parliament in due course. Similar to the previous several quarters, the deviation of headline inflation from the target in Q1 and Q2-2025 was mainly driven by supply-side factors, particularly significant reductions in energy prices.

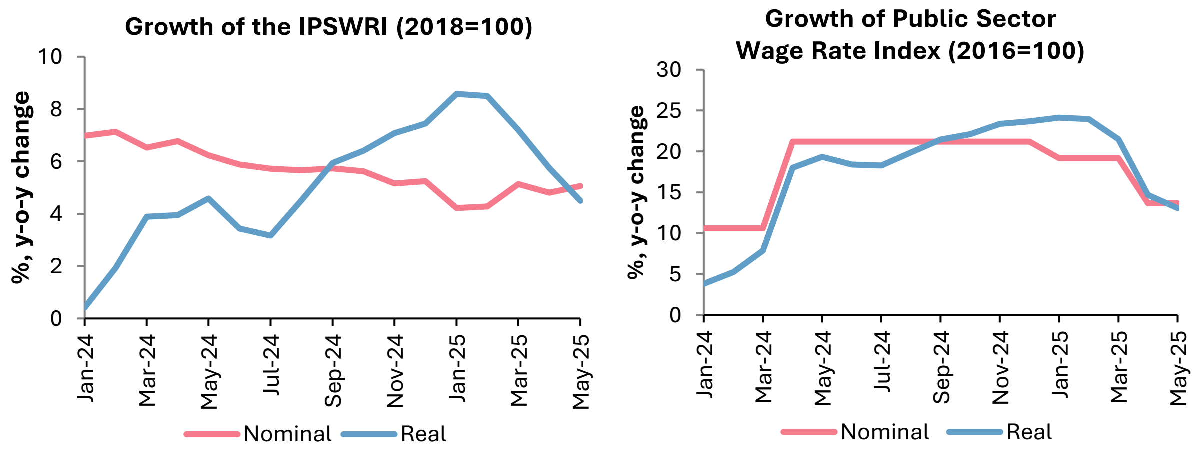
According to available information,[12] both the Informal Private Sector Wage Rate Index (IPSWRI, 2018=100) and the Public Sector Wage Rate Index (2016=100) recorded increases during 2025.

Continuing the upward trend in nominal wages observed in 2024, the nominal IPSWRI recorded an increase during January-May 2025. The wage growth was evident across Agriculture, Industry, and Services sector activities. The Agriculture sector recorded the highest increase in wages, largely attributed to the upward pressure on wages due to labour shortages in certain agricultural activities. Meanwhile, on a y-o-y basis, growth of the real IPSWRI decelerated during the same period in line with the easing of deflationary conditions.

Nominal wages of public sector employees, as measured by the Public Sector Wage Rate Index (2016=100), recorded a 13.7% increase thus far in 2025, largely due to the commencement of arrears payments for the cost-of-living allowance adjustment implemented in 2024, which were paid in three equal instalments, starting from January 2025. In addition, as announced in the Budget 2025, a revision of the public sector salary structure was made by increasing the minimum basic salary and streamlining various allowances. However, both nominal and real wage growth slowed during this period, with the latter recording a sharper drop as a result of easing deflationary conditions.

[11] The Report on Deviation of Inflation from its Target – Q4-2024 and Q1-2025 can be accessed via the Central Bank Website.
[12] Information in this section is primarily based on the public sector wage rate index (2016=100) and informal private sector wage rate index (2018=100) compiled by the Central Bank.

Figure 12: 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 sustained its positive momentum during Q1-2025, reflecting a steady growth trajectory.

As per the GDP estimates of the Department of Census and Statistics (DCS), the Sri Lankan economy grew by 4.8% (y-o-y) in Q1-2025, driven by positive performance in Industry and Services activities, while Agriculture activities recorded a marginal contraction.

The growth in Industry activities was mainly driven by manufacturing and construction activities, while financial services and accommodation services were the key contributors to the growth in Services activities. Meanwhile, the contraction in Agriculture activities was largely attributable to the decline in oleaginous fruits and freshwater fishing activities.

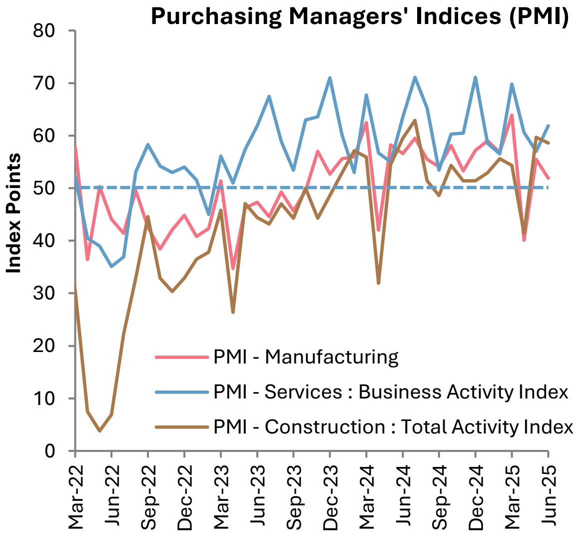
Table 01: Estimates of Real GDP Growth (y-o-y, %) (Provisional)

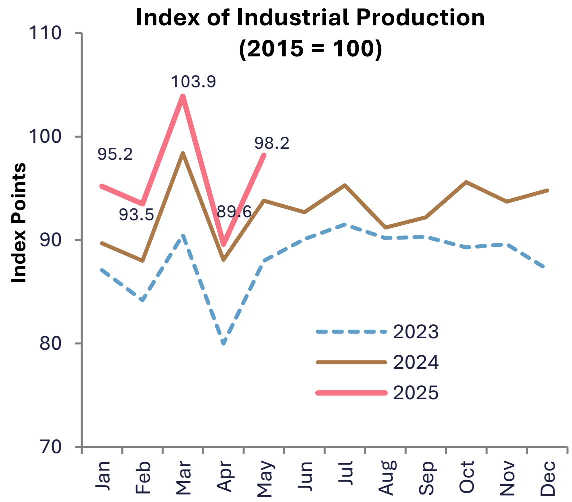
Economic Activity	2024					2025
	Q1	Q2	Q3	Q4	Annual	Q1
Agriculture	0.9	2.7	3.7	-2.2	1.2	-0.7
Industry	11.2	9.7	10.1	13.1	11.0	9.7
Services	2.5	1.9	2.6	2.5	2.4	2.8
GDP	**5.1**	**4.1**	**5.3**	**5.4**	**5.0**	**4.8**

Source: Department of Census and Statistics

The available leading indicators show a sustained growth in the economy in Q2-2025, supported by positive contributions from all three major economic activities. The industry-related indicators showed continuous improvement, with the Index of Industrial Production (IIP) recording a y-o-y growth during the April-May 2025 period, while the Purchasing Managers' Indices (PMIs) for Manufacturing and Construction rebounded after the seasonal decline in April.[13] In terms of Services activities, the PMI-Services recorded a notable growth in Q2-2025, indicating an overall improvement in the sector. Meanwhile, a revival in Agriculture activities is expected in Q2 2025, as reflected by the notable growth in tea production in April-May 2025, and the healthy paddy harvest anticipated from the 2025 Yala season.

Figure 13: Movements in Purchasing Managers' Indices and Index of Industrial Production





Sources: Central Bank of Sri Lanka
Department of Census and Statistics

On the expenditure front, both consumption and investment expenditures contributed positively to domestic demand at constant prices in Q1-2025, while net external demand recorded a contraction due to higher growth in imports of goods and services compared to the growth in exports of goods and services. In Q2-2025, consumption and investment expenditures are expected to contribute positively to the economy, while the net external demand is expected to remain contracted at constant prices.

[13] As per the latest data release, PMI Construction total activity index was at 58.6 by June 2025, indicating a continuous expansion in construction activities. Meanwhile, IIP improved to 98.5 in June 2025 compared to 98.2 in May 2025.

Table 02: Aggregate Demand (Provisional)

Item	Constant (2015) Prices					
	2024		2024 Q1		2025 Q1	
	Rs. bn	y-o-y, %	Rs. bn	y-o-y, %	Rs. bn	y-o-y, %
Domestic Demand	12,617	7.1	3,294	5.0	3,504	6.4
Consumption	9,478	3.2	2,159	-7.8	2,302	6.6
Investment (Gross Capital Formation)	3,139	21.1	1,135	42.8	1,202	5.9
Net External Demand	-144.0	-243.2	25	13.8	-27	-208.2
+ Exports of goods and services	3,020	12.5	779	19.3	828	6.3
- Imports of goods and services	3,164	22.5	754	19.5	854	13.3
GDP	**12,472**	**5.0**	**3,319**	**5.1**	**3,477**	**4.8**

Source: Department of Census and Statistics

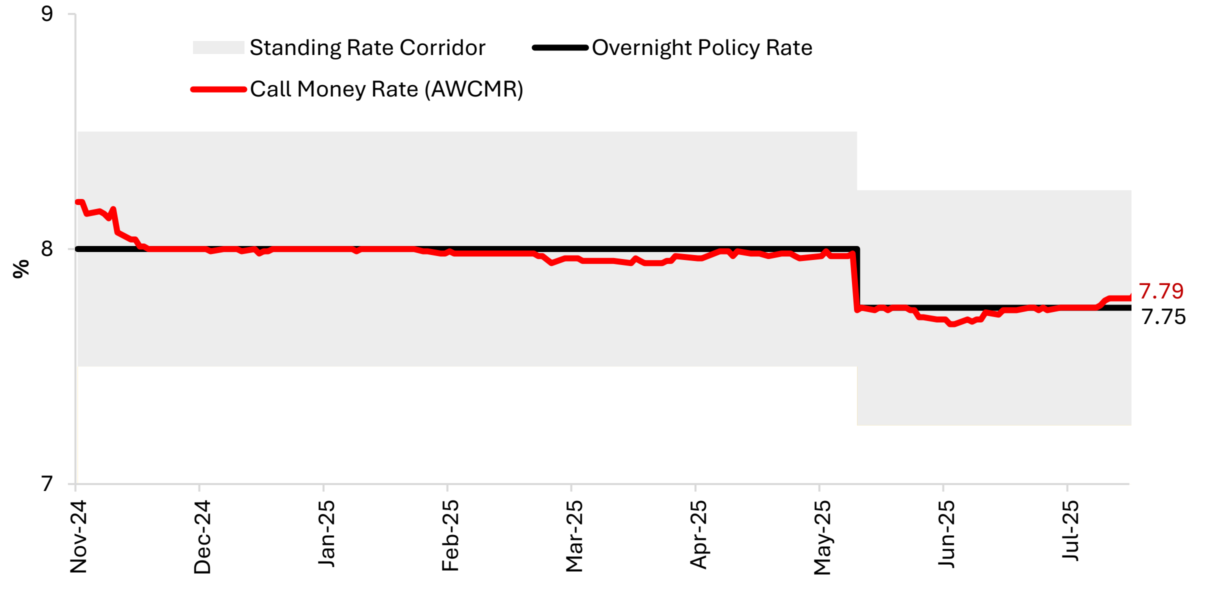
3.3. Monetary Sector

Interest Rates

In response to the accommodative monetary policy stance, a broad-based downward adjustment was observed in market interest rates, despite a slight uptick observed in yields on government securities since mid-June 2025.

In line with the latest reduction in the OPR in May 2025, short-term market interest rates adjusted downwards while the Average Weighted Call Money Rate (AWCMR) continued to hover around OPR. Following the decline in money market rates, the Average Weighted Prime Lending Rate (AWPR) continued to adjust downward and recorded 8.22% by end June 2025, resulting in a year-to-date decline of 70 bps. Other market lending and deposit interest rates also continued to adjust downward during this period, reflecting the pass-through of eased monetary policy. Meanwhile, rates applicable on new loans extended by banks to the Micro, Small and Medium Enterprise (MSME) sector, as reflected by the Average Weighted New SME Rate (AWNSR), also recorded a notable decline during January-May 2025.

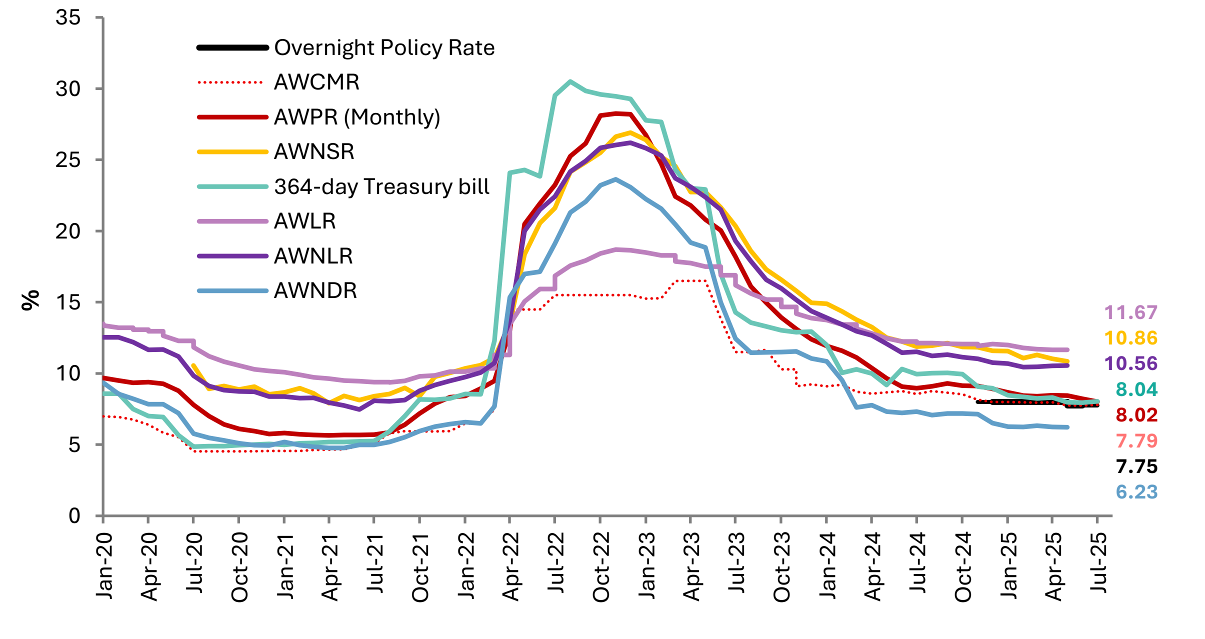
Figure 14: Movements in the OPR and AWCMR



Source: Central Bank of Sri Lanka

Despite the overall reduction in market interest rates, the spread between market lending rates and deposit rates continues to remain relatively high compared to its pre-crisis historical average, partly reflecting a more pronounced reduction in deposit interest rates compared to the lending interest rates, as well as relatively high interest rates charged on selected loan products. Normalisation of the spread is expected in the period ahead, along with an expected further reduction in market lending interest rates.

Figure 15: Movement in Selected Market Interest Rates

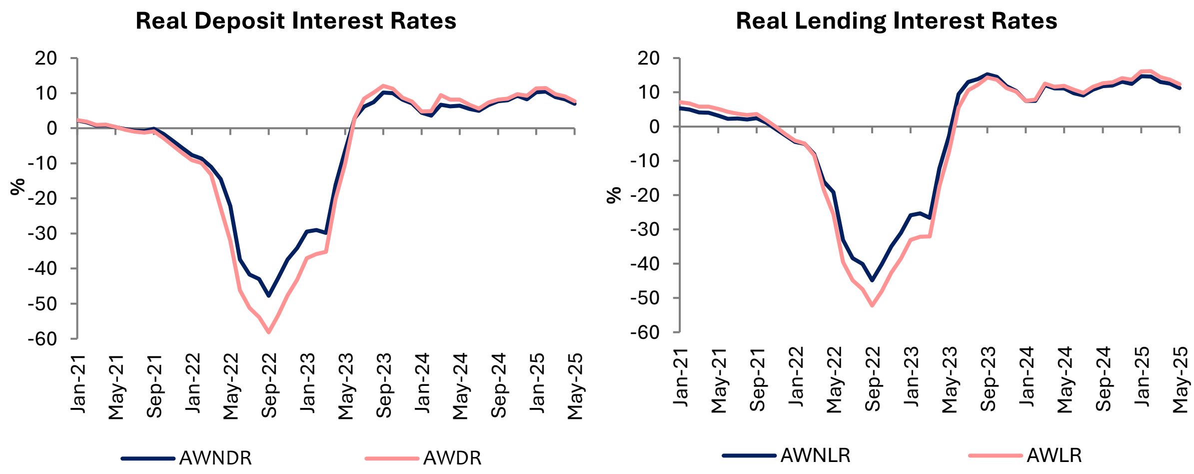


Source: Central Bank of Sri Lanka

Treasury bill yields across all maturities in the primary auctions declined by 90-100 bps during January-July 2025, supported by the low inflation environment and the policy rate reduction in May 2025. Meanwhile, longer-term yields have declined in both the primary and secondary markets, thus resulting in a normalised yield curve by end June 2025. However, a slight uptick in yields was observed since mid-June 2025.

Meanwhile, real interest rates continued to remain high throughout H1-2025. However, due to the combined impact of the easing of deflation and the downward adjustment of market interest rates, real interest rates have witnessed a drop recently. Going forward, real interest rates are likely to ease further with the expected convergence of inflation towards the target.

Figure 16: 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

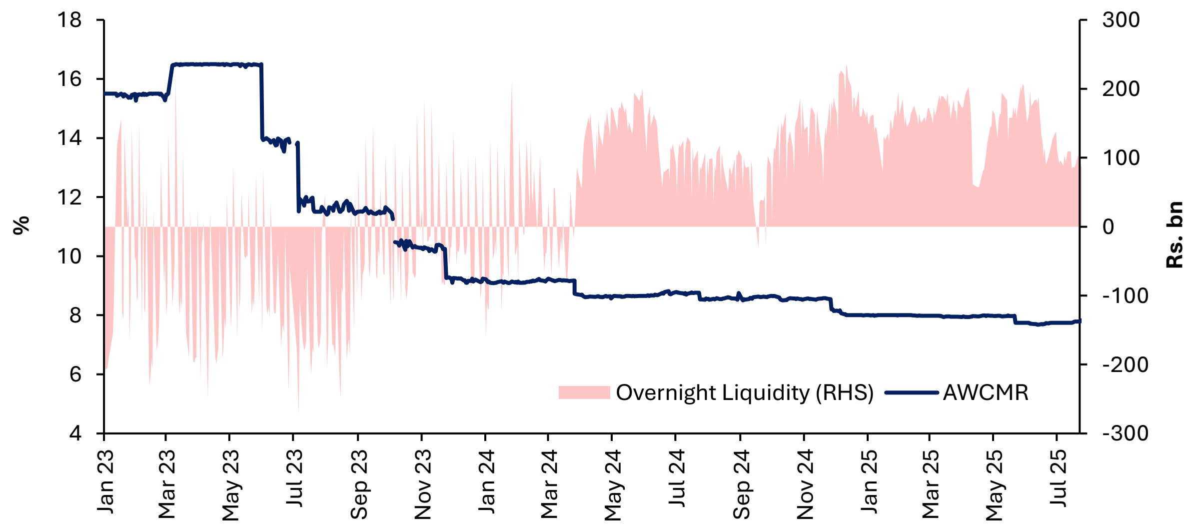
Domestic Money Market Liquidity

Liquidity conditions in the domestic money market continued to remain at a surplus thus far in 2025.

The continued surplus liquidity conditions in the domestic money market enabled the Central Bank to scale down its liquidity injection Open Market Operations (OMOs) completely from the end of January 2025, while participatory institutions that were facing liquidity shortfalls were able to fulfill their funding needs through the markets. The surplus in liquidity was primarily due to the net liquidity injections resulting from net foreign exchange purchases by the Central Bank, as well as the foreign exchange buy/sell swap arrangements that were entered into during this period. Meanwhile, the Government's purchases of foreign exchange from the Central Bank for foreign debt service payments, currency withdrawals by LCBs, maturities of the Treasury bond holdings of the Central Bank, and coupon payments for the Central Bank's holdings of Treasury bonds have collectively led to a drain in rupee liquidity in the domestic money market. Lately, overnight liquidity declined to around Rs. 100 bn level, on average, in July, primarily due to increase in currency in circulation, coupon payments to the Central Bank, and the Government's foreign exchange purchases from the Central Bank to service its foreign loan repayments.

Money markets showed improved activity thus far in 2025, amidst surplus liquidity conditions among participatory institutions. AWCMR remained broadly in line with the OPR, while the Average Weighted Repo Rate (AWRR) also moved broadly in line with the movements in AWCMR, although there has been a slight uptick towards the latter part of July 2025.

Figure 17: Behaviour of Overnight Liquidity and AWCMR



Note: AWCMR data is unavailable for certain days as no transactions were reported in the interbank call money market

Source: Central Bank of Sri Lanka

Domestic Credit Conditions and Money Supply

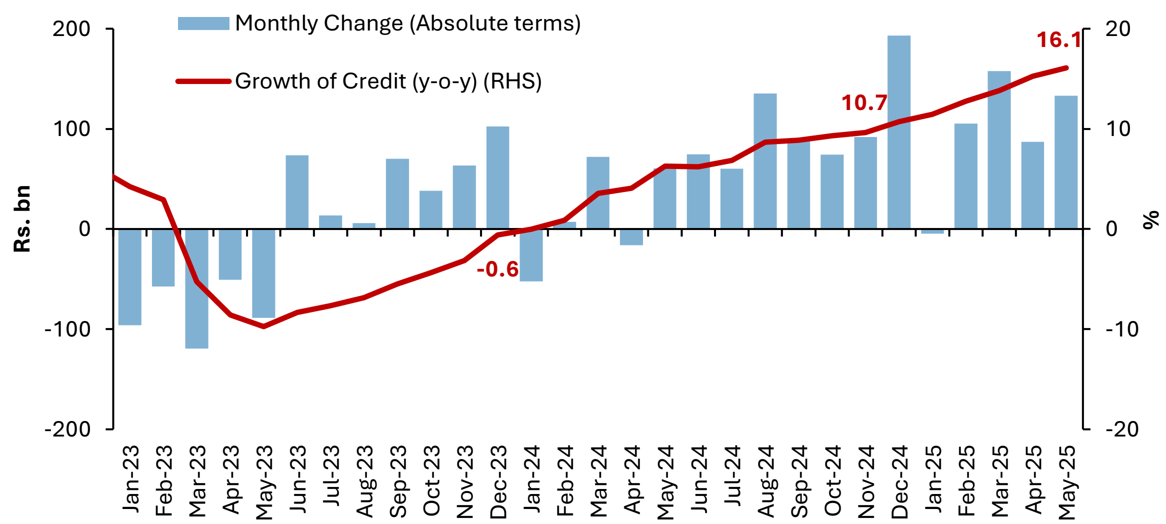
During 2025, broad money supply (M_{2b}) continued to expand, supported by the notable increase in private sector credit and the rise in Net Foreign Assets (NFA) of the banking system.

Credit to the private sector by Licensed Commercial Banks (LCBs) continued to expand thus far during 2025, with broad-based distribution across key sectors of the economy. Credit to the private sector by LCBs recorded a notable expansion of around Rs. 479 bn during the period from January-May 2025, recording a y-o-y growth of 16.1% by end May 2025. The y-o-y expansion of credit to the private sector in real terms[14] continues to remain elevated amidst deflationary conditions. Further, credit extended

[14] Real credit to the private sector by LCBs is calculated by adjusting the nominal (absolute) credit to the private sector using a backcast inflation index based on the Colombo Consumer Price Index (CCPI, 2021=100).

by Finance Companies (FCs) expanded by Rs. 228 bn, while credit extended by Licensed Specialised Banks (LSBs) recorded a marginal contraction during this period.

Figure 18: Monthly Change in Outstanding Credit to the Private Sector by LCBs



Source: Central Bank of Sri Lanka

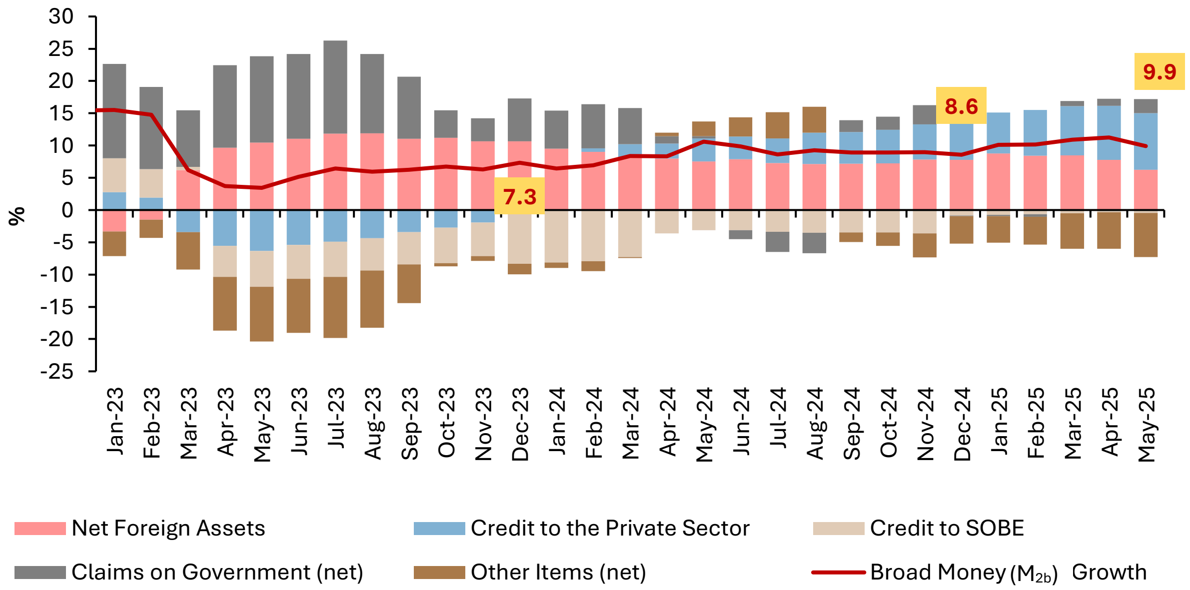
Net Credit to the Government (NCG) by the banking system increased during the period from January-May 2025, owing to the increase in NCG by both the Central Bank and LCBs. Despite the large government deposits with LCBs, the notable increase in government securities investments led NCG by LCBs to increase during this period. Meanwhile, the increase in NCG by the Central Bank reflected valuation changes, despite recording a marginal contraction in terms of face value.

Credit granted to State-Owned Business Enterprises (SOBEs) by LCBs contracted during the period from January-May 2025, mainly on account of the net repayments by the Ceylon Fertilizer Corporation, Road Development Authority and the National Water Supply and Drainage Board.

NFA of the banking system continued to improve thus far during 2025, reflecting improved external sector performance. Contributing to the overall expansion, NFA of the Central Bank rose significantly, largely supported by the Central Bank's foreign exchange purchases to strengthen its official reserves. NFA of LCBs also continued to increase mainly due to an increase in loans to non-residents and balances held with banks abroad in the absence of opportunities in investing in foreign currency denominated assets domestically.

In line with these developments, the y-o-y growth of broad money (M_{2b}) accelerated to 9.9% in May 2025 from 8.6% recorded at end 2024.

Figure 19: Contribution to y-o-y Growth of Broad Money (M_{2b})



Note: Other items (net) of the Central Bank and LCBs declined during the period from January-May 2025, mainly due to increased retained earnings and reserves.

Source: Central Bank of Sri Lanka

3.4. External Sector

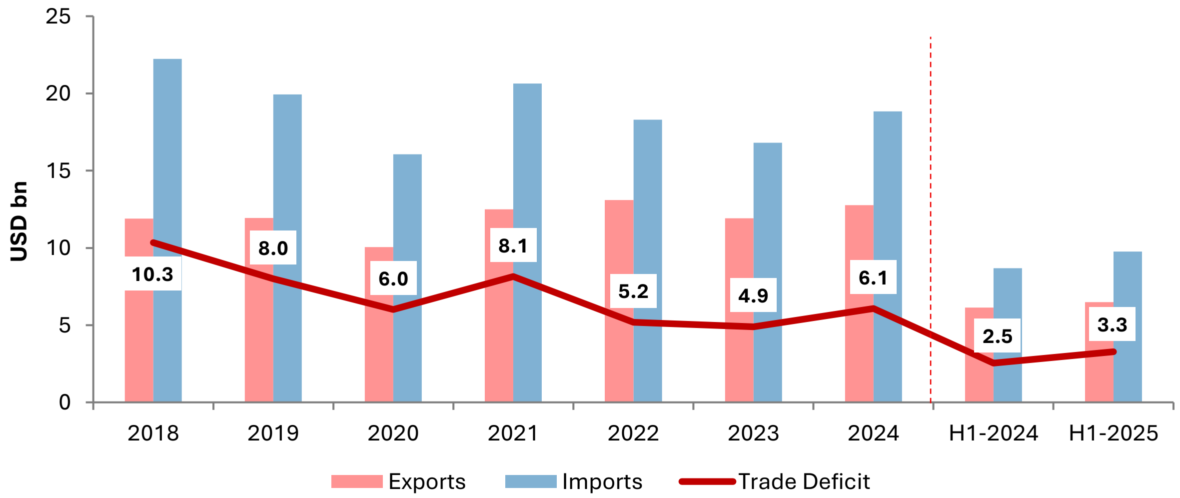
The external sector remained resilient thus far during the year and recorded a surplus in the current account during H1-2025, amidst a subdued performance in the financial account. With the receipt of the fifth tranche of the Extended Fund Facility of the International Monetary Fund (IMF-EFF) reserve position strengthened, while the exchange rate remains broadly stable.

Balance of Payments

The current account recorded a surplus of USD 1.5 bn during H1-2025. This was primarily driven by strong performances in the services and secondary income accounts, along with a significant narrowing of the primary income account deficit. The merchandise trade deficit widened to USD 3.3 bn during H1-2025. Both merchandise exports and imports increased, with export growth led by higher earnings from textiles and garments, and food, beverages, and tobacco, while the rise in imports was mainly due to increased vehicle imports. Additionally, tourism earnings contributed significantly to the current account, increasing by 10% supported by approximately 1.2 mn tourist arrivals. Workers' remittances also showed a robust growth, rising by nearly 19% y-o-y to USD 3.7 bn. Overall, strong non-merchandise trade inflows and improvements across various income components significantly contributed to strengthening the current account position.

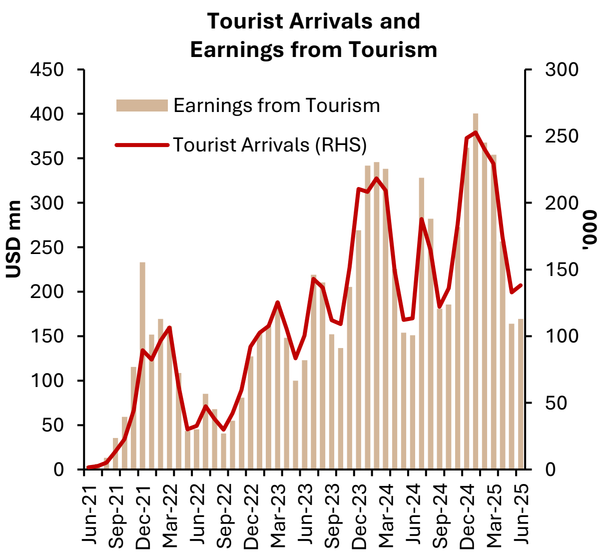
In contrast, the performance of the financial account has remained subdued so far during the year. Foreign Direct Investment (FDI) inflows, including foreign loans to direct investment enterprises (DIEs) in Q1-2025, showed an improvement compared to the corresponding period in the previous year, but remained modest overall. Meanwhile, foreign investments in the government securities market recorded a modest net inflow during H1-2025, while foreign investments in the Colombo Stock Exchange (CSE), including primary and secondary market transactions, recorded a marginal net outflow during the period from January to June 2025.

Figure 20: Merchandise Trade Account

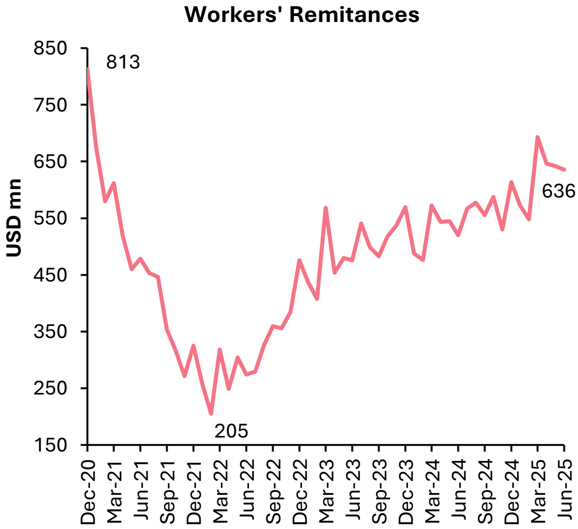


Sources: Central Bank of Sri Lanka
Sri Lanka Customs

Figure 21: Tourism and Workers' Remittances

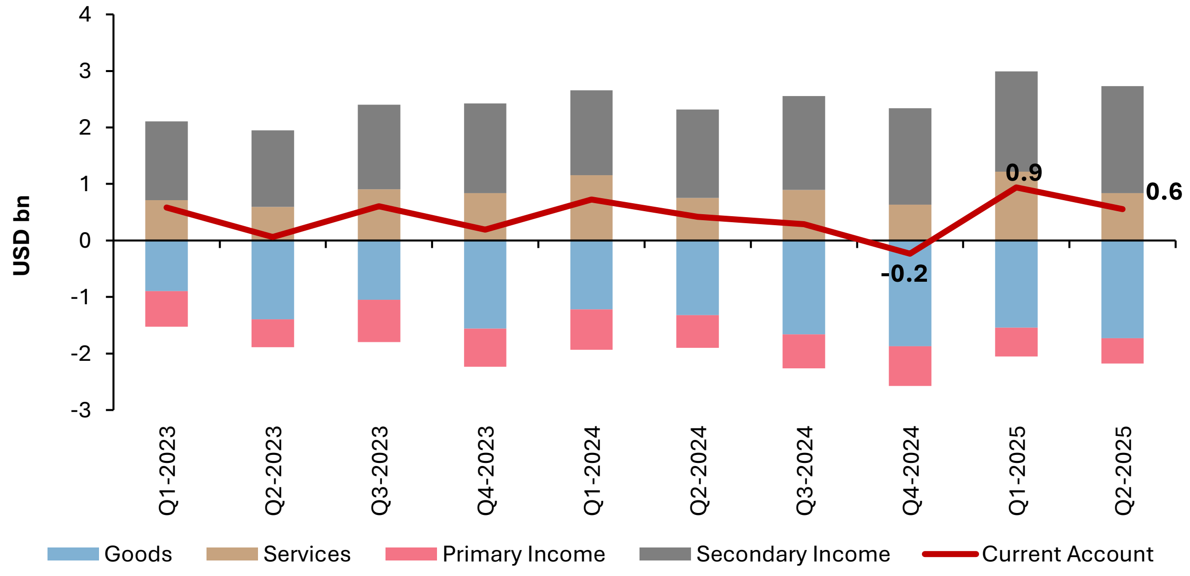


Sources: Central Bank of Sri Lanka
Sri Lanka Tourism Development Authority



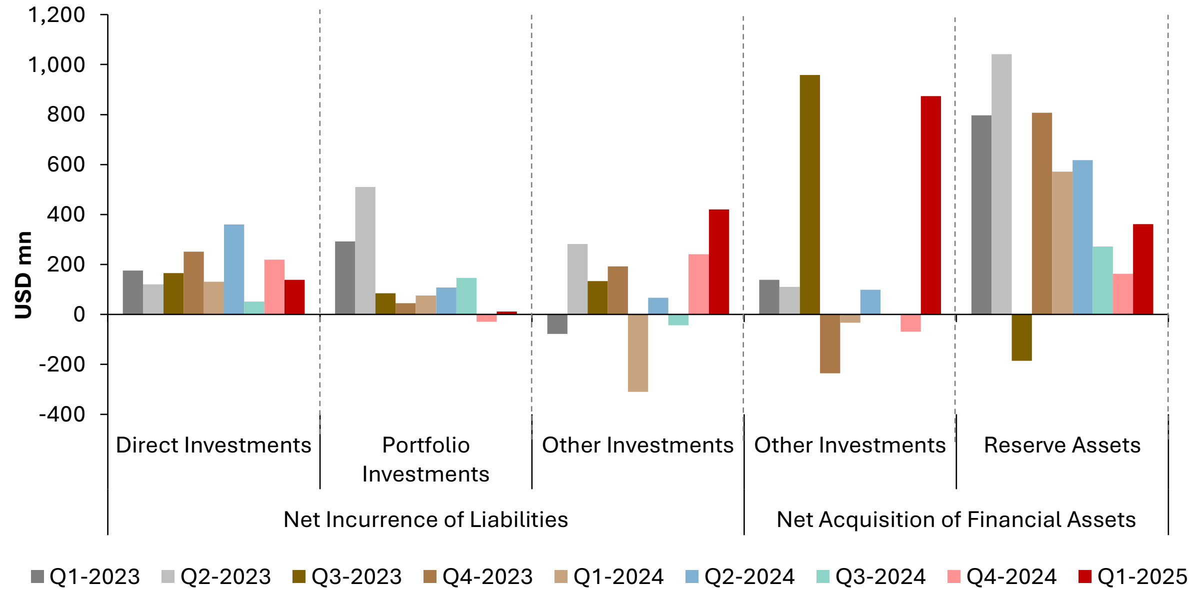
Sources: Central Bank of Sri Lanka
Licensed Banks

Figure 22: Current Account



Source: Central Bank of Sri Lanka

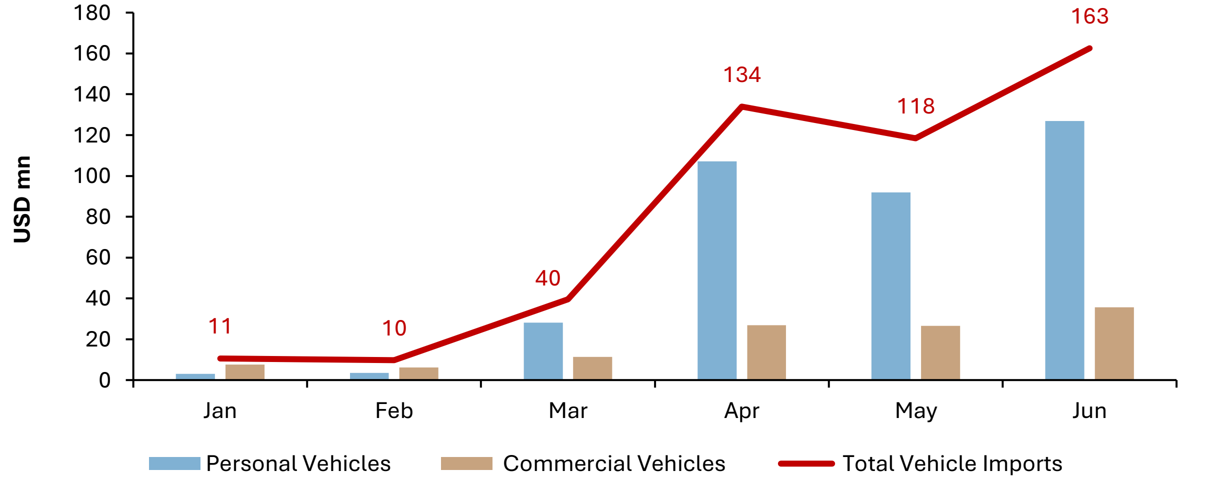
Figure 23: Financial Account



Source: Central Bank of Sri Lanka

With the relaxation of restrictions on vehicle imports in January 2025, a marked increase in vehicle imports was observed since April 2025. Accordingly, expenditure on vehicle imports, including personal and commercial vehicle imports, surged in H1-2025, reaching a total of USD 475 mn. Although vehicle demand is currently on an upward trend, it is expected to stabilise once the present surge driven by pent-up demand subsides.

Figure 24: Composition of Personal and Commercial Vehicles Imports

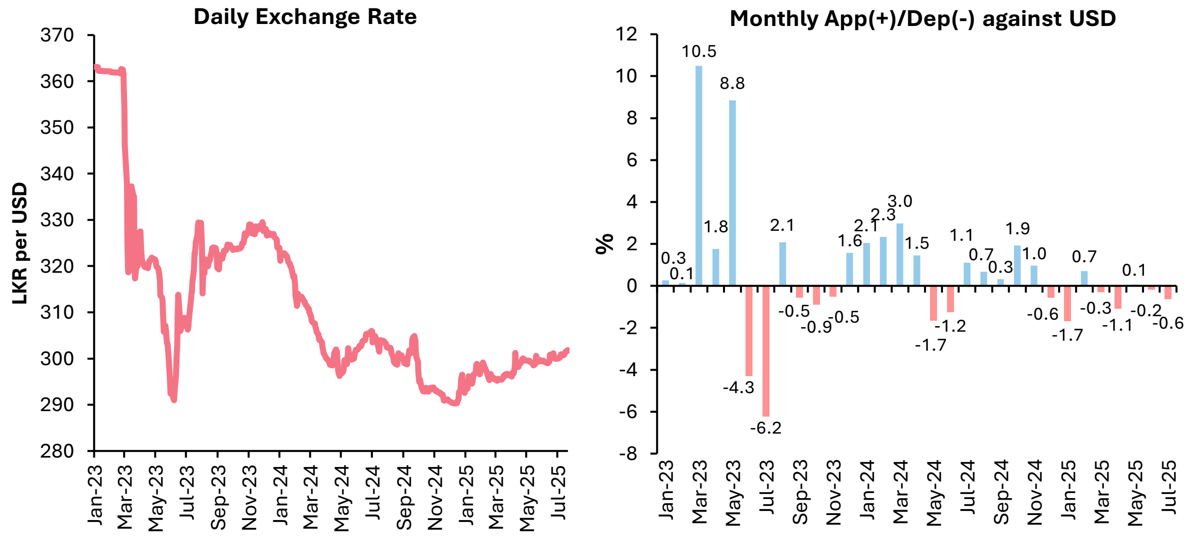


Source: Sri Lanka Customs

Exchange Rate

Amidst the relaxation of vehicle import restrictions and increasing imports, the Sri Lanka rupee recorded a modest depreciation of 3.1% against the USD as of 22 July 2025. In addition, the rupee depreciated against several other major currencies, largely reflecting the broad-based strengthening of those currencies against the USD. Both Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) decreased during the year up to 22 July, reflecting a depreciation. Accordingly, the 5-currency NEER index decreased by 7.6% and 5-currency REER index decreased by 7.4%.

Figure 25: Exchange Rate Movements



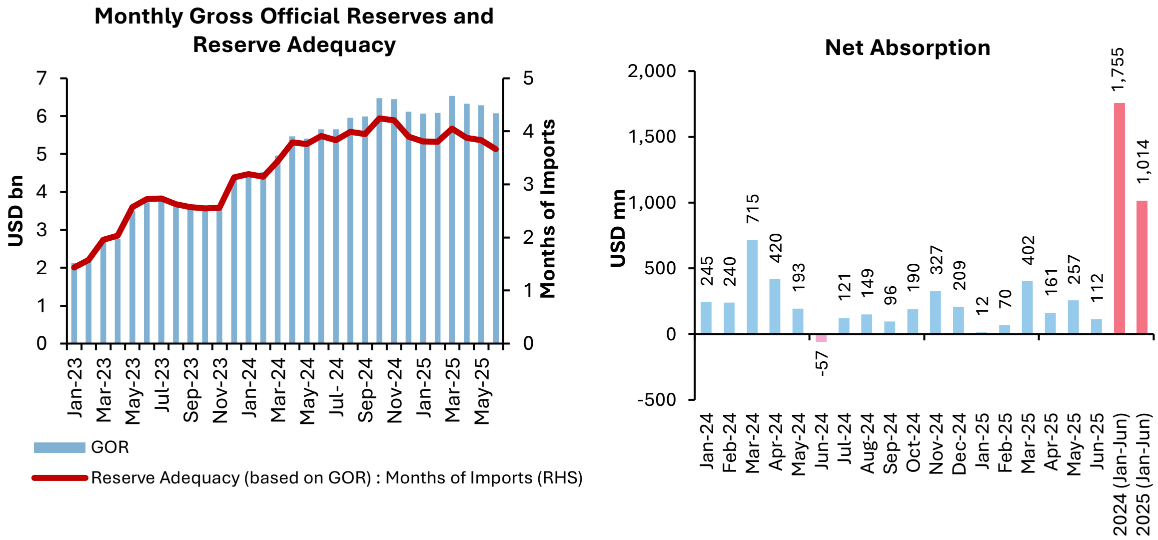
Note: Figures are updated up to 22 July 2025

Source: Central Bank of Sri Lanka

Reserve Assets

The Gross Official Reserves (GOR),[15] having risen to around USD 6.5 bn in March 2025, moderated to around USD 6.1 bn by end June 2025, largely due to the Government debt service payments, despite the continued net forex purchases by the Central Bank from the domestic forex market. The Central Bank purchased around USD 1.1 bn, on a net basis, from the domestic foreign exchange market during the year up to 22 July 2025. The receipt of the fifth tranche of the IMF-EFF amounting to about USD 350 mn also helped enhance the gross official reserves.

Figure 26: Monthly Gross Official Reserves, Reserve Adequacy and Net Absorption



Note: Monthly Gross Official Reserves include proceeds from the PBoC swap arrangement, which is subject to conditionalities on usability

Source: Central Bank of Sri Lanka

3.5. Fiscal Sector

Fiscal sector performance continued to show improvement during the period from January to May 2025,[16] driven by the Government's strong commitment to revenue-based fiscal consolidation measures. These measures led to a significant primary surplus and a reduction in the overall budget deficit during this period.

The continuation of robust fiscal consolidation measures has led to improvements across all key fiscal balances, including the overall fiscal balance, current account balance, and primary

[15] Includes the swap facility by the People's Bank of China (PBoC), which is subject to conditionalities on usability.

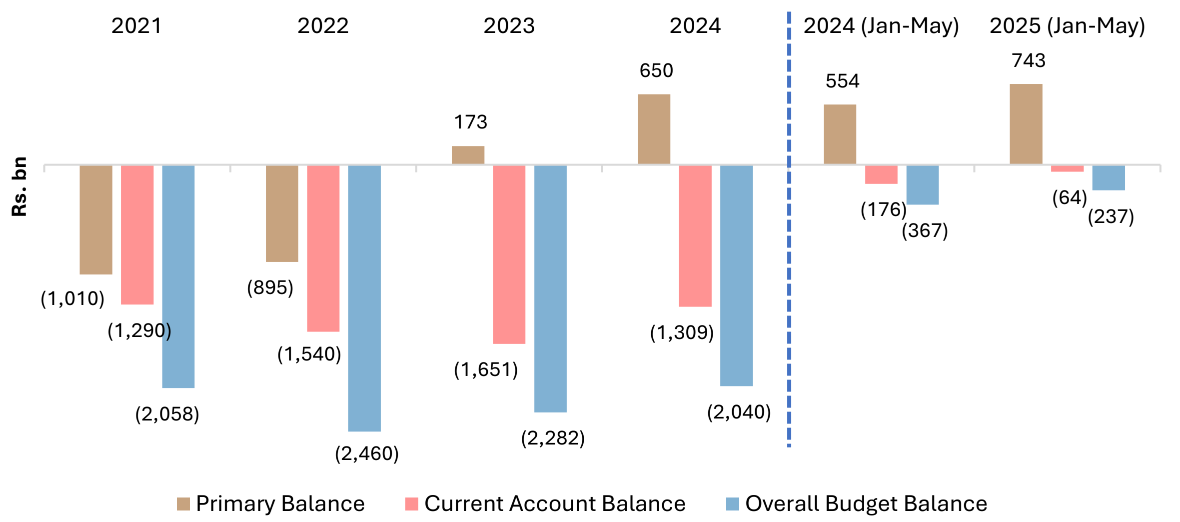
[16] As per the provisional data received from the Ministry of Finance, total revenue and grants increased by 24.7% to Rs. 2,325 bn in H1-2025, compared to Rs. 1,865 bn in the same period of 2024. Similarly, total expenditure increased by 10.9% to Rs. 2,731 bn in H1- 2025 compared to the same period of 2024. The primary surplus recorded a notable increase to Rs. 859 bn, while the budget deficit narrowed to Rs. 406 bn during H1-2025.

balance, both in nominal terms and as a share of projected GDP during the period from January-May 2025. Accordingly, the primary balance recorded a notable surplus of Rs. 742.9 bn, while the overall fiscal deficit narrowed to Rs. 236.6 bn during the same period under review.

During the period from January-May 2025, the Government's total revenue and grants recorded a significant increase compared to the same period in 2024. This increase was primarily driven by higher tax revenues, particularly from Value Added Tax (VAT), income taxes, and excise duties, reflecting the impact of tax policy reforms and recovery in economic activity. A significant portion of the revenue increase in 2025 is expected to have arisen from tax collections related to motor vehicle imports. In addition, the overall increase in tax revenue is likely to have been further supported by the timely implementation of measures to strengthen tax administration and institutional reforms in the revenue-collecting agencies, which are vital to sustaining this revenue growth momentum in the medium term. During this period, non-tax revenue also grew due to the higher receipts of interest income as well as fines, fees and charges. Meanwhile, the total expenditure and net lending recorded a y-o-y increase of 9.7% during the period from January-May 2025. This increase was mainly driven by higher spending on subsidies and transfers, salaries and wages, and interest payments, including interest paid on restructured International Sovereign Bonds. However, capital expenditure and net lending recorded a marginal decline during the period under review compared to the same period in 2024.

During the period from January-May 2025, the Government continued to rely primarily on domestic sources to finance the budget deficit, as accessing international capital markets was not being resorted to at this stage.

Figure 27: Key Fiscal Balances



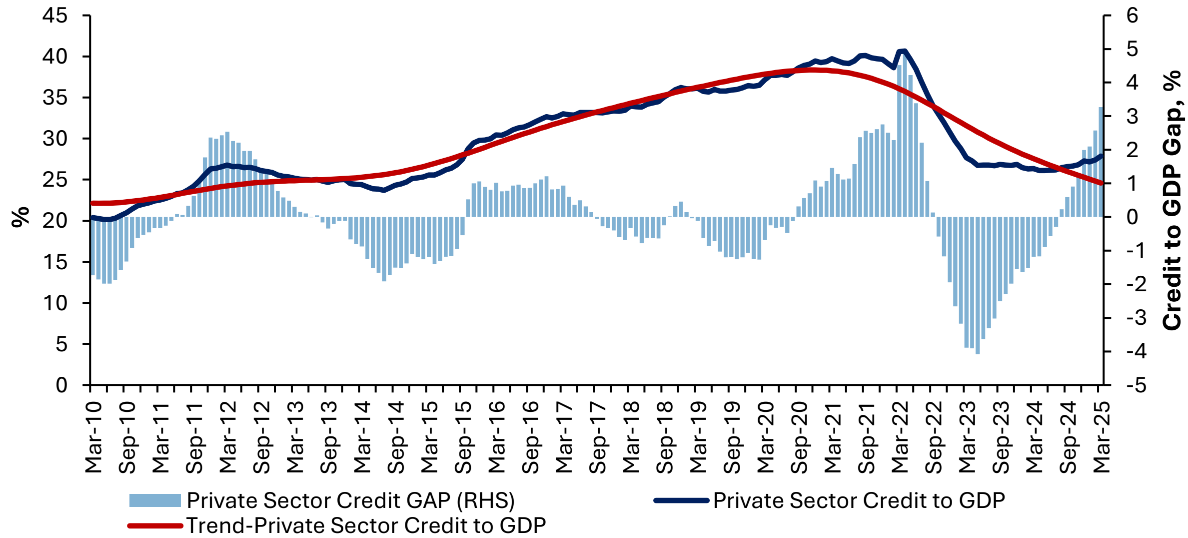
Source: Ministry of Finance, Planning and Economic Development

3.6. Financial Sector

Financial sector performance continued to improve, supported by favourable domestic macroeconomic conditions and easing financial conditions that supported credit growth.

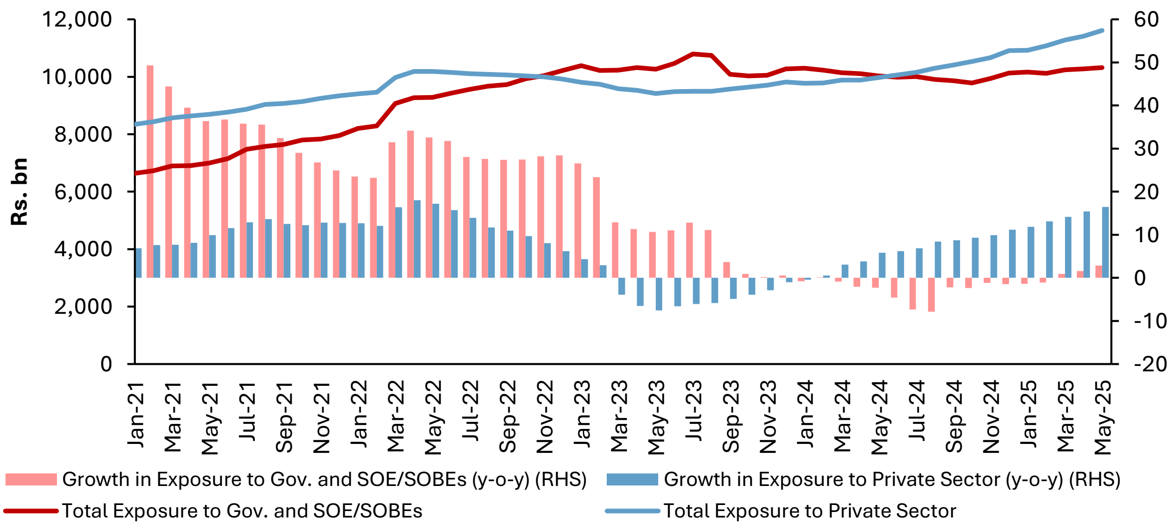
The credit cycle, which is reflected by the private sector credit-to-GDP gap (the Credit Gap), progressed within the expansionary phase. The tilt in the exposure of financial institutions to the Government and the public sector corporations continues to correct, supported by the increase in credit to the private sector amidst ongoing fiscal consolidation measures.

Figure 28: Credit-to-GDP Gap



Source: Central Bank of Sri Lanka

Figure 29: Financial Sector Exposure to Public and Private Sectors



Note: Reflects the exposure of the banking sector and Finance Companies to the Public and Private sectors

Source: Central Bank of Sri Lanka

The resilience of the financial sector gradually improved during H1-2025 amidst improving macroeconomic conditions. The total assets of the banking sector expanded during the period under review, mainly due to increased investments as well as loans and receivables. Accordingly, total assets recorded a y-o-y growth of 14.9% at end June 2025 and stood at Rs. 23.8 tn. Furthermore, the growth of gross loans and receivables notably accelerated to 11.4%, y-o-y, at end June 2025, amidst the eased monetary conditions.

Non-performing Loans (NPLs) of the banking sector, as reflected through the Stage 3 loans ratio, reduced to 12.0% at end June 2025 compared to 12.9% recorded at end June 2024, yet remained at an elevated level. Profit After Tax (PAT) of the sector significantly increased during H1-2025 compared to the corresponding period of 2024. Accordingly, banks reported a PAT of Rs. 187.5 bn during H1-2025 compared to Rs. 112.3 bn in H1-2024. In relation to profitability indicators of the banking sector, Return on Equity (ROE) improved while Return on Assets (ROA) remained at the same level during H1-2025.

Liquidity of the banking sector, as measured by Liquidity Coverage Ratios (LCRs), declined marginally in June 2025 compared to the corresponding period of the previous year. Accordingly, Rupee LCR declined to 328.6% in June 2025 compared to 339.7% in June 2024, whilst all currency LCR declined to 283.1% in June 2025 compared to 293.4% in June 2024. However, the sector LCRs were well above the minimum requirements. Meanwhile, the Total Capital Adequacy Ratio (CAR) of the banking sector improved to 19.3% at end March 2025 compared to 17.7% the year before, supported by the higher growth in total regulatory capital compared to the growth in Risk Weighted Assets (RWA). Accordingly, the regulatory capital of banks recorded a notable y-o-y growth of 19.0% at end March 2025. This was driven by increases in published retained earnings, qualifying Tier-2 capital instruments, and general reserves, and a decline in net deferred tax assets, depicting the enhancement of capital buffers of the sector.

The FCs sector also recorded a y-o-y expansion of 25.8% in its asset base at end June 2025, supported by increased loans and advances. Accordingly, the loans and advances portfolio of the sector recorded a significant growth of 35.1% at end June 2025, mainly due to increases in vehicle loans, finance leases, and gold loans. Gross NPL Ratio of the sector decelerated to 8.3% by end June 2025 compared to 13.6% at end June 2024, indicating an improvement in credit quality. However, the credit portfolio of the FCs sector was highly concentrated in loans against vehicles and gold. The liquidity position of the sector remained above the regulatory requirement at end June 2025 with a liquidity surplus of Rs. 114.6 bn. Furthermore, the sector reported a PAT of Rs. 18.0 bn for the period April - June 2025, representing the first quarter of the financial year 2025/26. In terms of capital adequacy, the FCs sector recorded a CAR of 22.0% by end June 2025.

The equity market demonstrated notable growth, with the All Share Price Index (ASPI) and the Standard & Poor's Sri Lanka 20 (S&P SL20) indices of the CSE achieving year-to-date growth rates of 13.1% and 10.1%, respectively, as of end June 2025. The upward trend was mainly boosted by heightened participation from domestic investors, given the improved corporate and economic performance and outlook, amidst eased monetary conditions.

3.7. Global Developments

Heightened global policy uncertainty, amidst recent US tariff announcements and their impact on global trade, significantly impacted global economic prospects and market sentiments. The outlook for global commodity prices remains volatile and uncertain, given the resurgence of geopolitical tensions. In response, major central banks have indicated a shift towards cautious monetary policy easing, with renewed trade tension being a key consideration in policy deliberations across many countries.

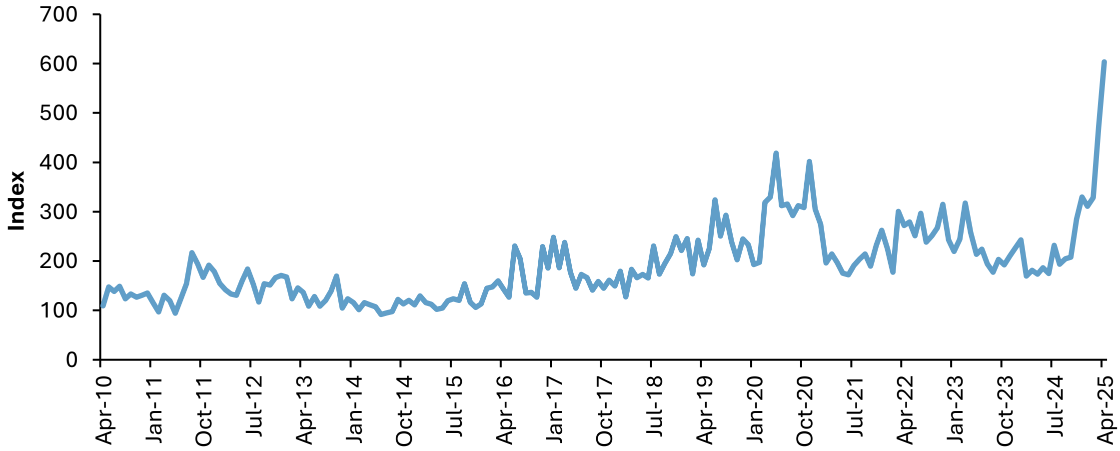
Global growth is likely to be impacted by the heightened economic and trade policy uncertainty amidst US tariff announcements. In addition, recurring geopolitical tensions remain a significant downside risk to global growth in the period ahead.[17] Higher effective US tariffs could weigh on global trade growth, with a disproportionate impact on advanced and emerging market economies. Global inflation presents mixed signals, with several economies, including the Euro area, experiencing easing of inflation, while inflation edged up in the US. However, overall global inflation is likely to remain modest in 2025, supported by subdued demand conditions and falling energy prices.[18]

Increased US tariffs on imports from its trading partners have triggered fears of trade retaliation, supply chain disruptions, and increased global production costs, which has led to the Global Economic Policy Uncertainty Index reaching an all-time high in April 2025. At the same time, advanced economies are increasingly concerned about rising debt servicing costs amid persistent deficits. Escalating geopolitical tensions and regional conflicts, which continue to weigh on the global economic outlook are adding to the uncertainty.

[17] According to the IMF's latest update of the World Economic Outlook (WEO, July 2025) released on 29 July 2025, global growth is projected to slow from 3.3% in 2024 to 3.0% in 2025 and improve marginally to 3.1% in 2026. While the latest forecast growth remains higher than the April 2025 reference forecast, it remains below the pre-COVID average.

[18] Global inflation is projected at 4.2% in 2025 and 3.6% in 2026, compared to 5.6% in 2024 with cross country variations in inflation forecast (WEO, July 2025).

Figure 30: Global Economic Policy Uncertainty Index



Source: fred.stlouisfed.org

Although many countries eased their monetary policy stance in 2025, central banks remain cautious in proceeding further amid heightened global economic uncertainty. The US Federal Reserve kept the federal funds rate unchanged thus far in 2025 as inflation continues to remain above the target and heightened uncertainty stemming from recent tariff escalations and tightening financial conditions. Further, with the quantitative tightening (QT) programme conducted by the US Federal Reserve nearing completion, the pace of QT has slowed significantly. However, the Dot-Plot projections by the officials indicate two likely rate cuts during the remainder of the year.[19] The European Central Bank (ECB) continued to ease monetary policy by reducing its key interest rate four times thus far in 2025.[20] The Bank of England (BOE) has gradually eased monetary policy since August 2024, citing easing inflation and the slack in the domestic economy. However, BOE held policy rates steady in June 2025 due to global uncertainty and inflation remaining above target.[21] The Bank of Japan (BOJ) in June 2025 kept its short-term policy interest rate unchanged, following a rate hike in January, citing heightened global trade tensions and a cautious outlook on inflation. The BOJ's decision reflects a cautious stance, retains the option to resume rate hikes once uncertainty recedes and inflation trend aligns more firmly with its target. In addition, the BOJ has announced its plan to reduce the purchase of government securities. Further, the monetary policy stance of central banks of emerging market economies remains mixed, reflecting divergent domestic inflation dynamics, exchange rate pressures, and varying responses to the evolving global economic uncertainty. Going forward, central banks are likely to act cautiously amid elevated uncertainty and the possibility that initial rises in trade costs could lead to broader price and wage pressures. The risk outlook will differ across countries: in most, policy decisions are likely to be shaped by the negative impacts of increased uncertainty and weaker exports,

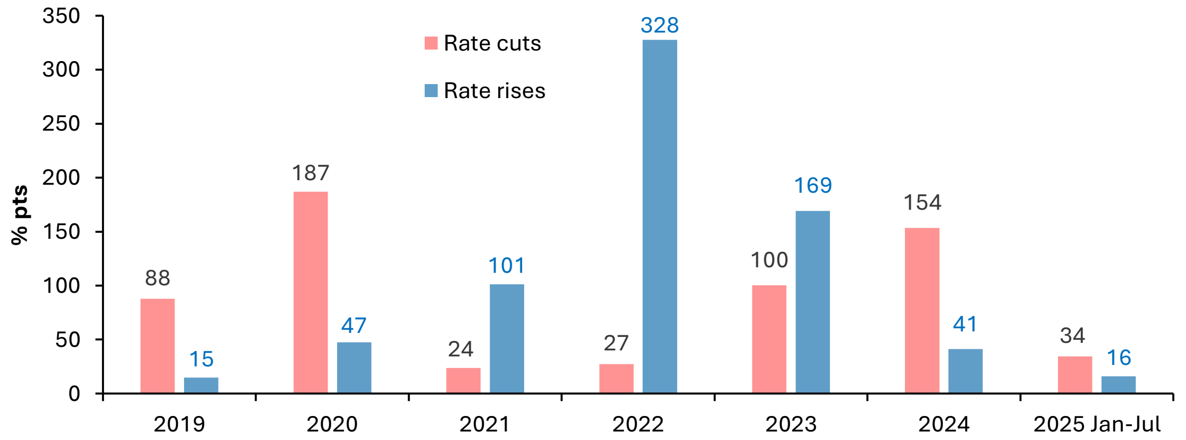
[19] The US Federal Reserve continued to maintain the Federal Funds Rate at 4.25-4.50% in July 2025 at its 5th Federal Open Market Committee (FOMC) meeting.

[20] The ECB decided to keep the three key ECB interest rates unchanged at the Governing Council Meeting held on 24 July 2025.

[21] The BOE reduced Bank Rate to 4% by 0.25 pps at the Monetary Policy Committee meeting held in August 2025.

while in countries implementing higher tariffs, the main concern may shift towards rising inflationary pressures.

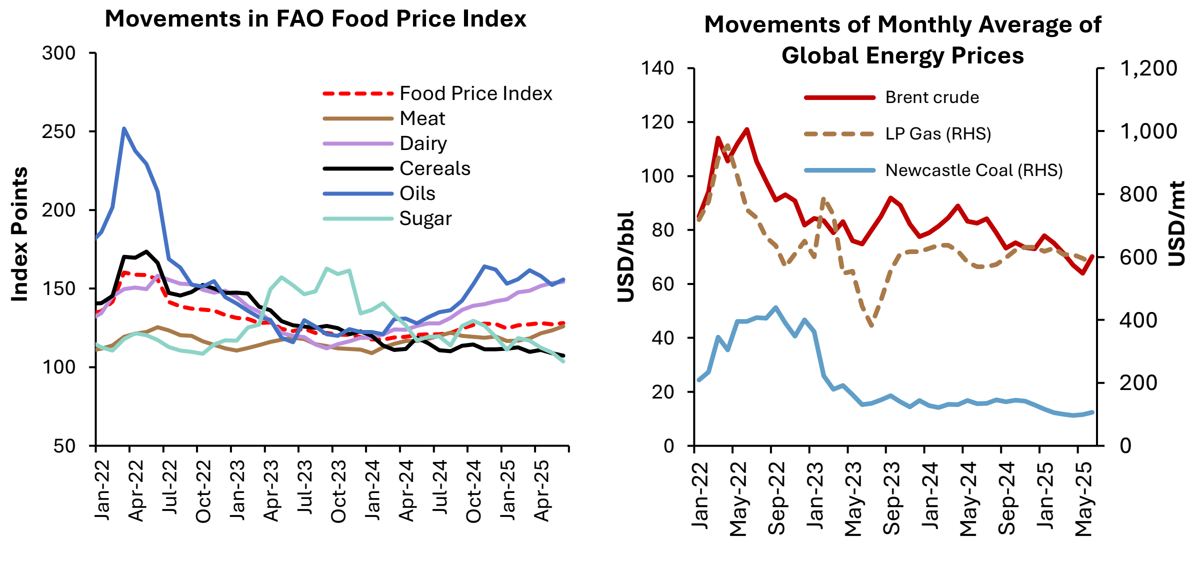
Figure 31: Global Policy Rate Changes



Note: Based on the data available as of 22 July 2025 Source: https://www.cbrates.com

The direction of global food commodity prices has remained volatile recently, influenced by both demand and supply side pressures. The Food and Agriculture Organization (FAO) food price index marginally increased to 128.0 points in June 2025 from 127.4 points recorded at the end of 2024. This was mainly due to an increase in price indices of meat and dairy products, attributed to tighter global supply amidst strong demand. Decline in price indices of cereals, oils and sugar has somewhat offset the increase in the other sub-indices. Meanwhile, global energy prices experienced some upward pressure towards the end of H1-2025, driven by supply uncertainties amid heightened geopolitical tensions in the Middle East. However, prices stabilised towards the end of June following the ceasefire agreement between Israel and Iran.

Figure 32: Global Commodity Prices



Source: Food and Agriculture Organization (FAO)

Sources: Refinitiv (reuters.com), Bloomberg and Saudi Aramco

LIST OF ACRONYMS

ADBI	Asian Development Bank Institute
APAEA	Asia-Pacific Applied Economics Association
ASPI	All Share Price Index
AVG	Average
AWCMR	Average Weighted Call Money 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
AWRR	Average Weighted Repo Rate
BIS	Bank for International Settlements
BOE	Bank of England
BOJ	Bank of Japan
bps	basis points
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
COICOP	Classification of Individual Consumption According to Purpose
CoPF	Committee on Public Finance
CPI	Consumer Price Index
CSE	Colombo Stock Exchange
DCS	Department of Census and Statistics
DIEs	Direct Investment Enterprises
ECB	European Central Bank
EFF	Extended Fund Facility
FAO	Food and Agriculture Organization
FCs	Finance Companies
FDI	Foreign Direct Investment
FIT	Flexible Inflation Targeting

FOMC	Federal Open Market Committee
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
LSBs	Licensed Specialised Banks
LCR	Liquidity Coverage Ratio
LP Gas	Liquefied Petroleum Gas
m-o-m	month-on-month
MPB	Monetary Policy Board
MPC	Monetary Policy Committee
MPFA	Monetary Policy Framework Agreement
MPR	Monetary Policy Report
MSME	Micro, Small and Medium Enterprise
NCG	Net Credit to the Government
NCPI	National Consumer Price Index
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Assets
NPL	Non-performing Loan
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
OPEC+	A Coalition of OPEC and Allied non-OPEC nations
OPR	Overnight Policy Rate
PAT	Profit After Tax
PBoC	People's Bank of China
PMI	Purchasing Managers' Index
PMIs	Purchasing Managers' Indices
pps	Percentage Points
QPM	Quarterly Projection Model
QR	Quick Response
QT	Quantitative Tightening

RHS	Right Hand Side
REER	Real Effective Exchange Rate
ROA	Return on Assets
ROE	Return on Equity
RWA	Risk Weighted Assets
SME	Small and Medium Enterprises
SOBEs	State-Owned Business Enterprises
SOE	State-Owned Enterprises
S&P SL20	Standard & Poor's Sri Lanka 20
STD	Standard Deviation
UK	United Kingdom
US	United States
USD	United States Dollar
VAT	Value Added Tax
WEO	World Economic Outlook
y-o-y	year-on-year

ISBN 978-624-6764-08-1