75 YEARS
STABILITY FOR PROSPERITY
1950-2025

MONETARY POLICY REPORT

FEBRUARY 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 January 2025 monetary policy round of the Central Bank, which concluded with the monetary policy announcement on 29 January 2025.

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TABLE OF CONTENTS

MONETARY POLICY FRAMEWORK OF THE CENTRAL BANK OF SRI LANKA

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

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

To achieve the inflation target, the Central Bank uses its policy instruments to guide short-term market interest rates along the desired path. Aimed at improving the transmission of monetary policy and simplifying monetary policy communication, the Central Bank moved to a single policy rate mechanism from its dual policy rates mechanism, effective from 27 November 2024. Accordingly, the Overnight Policy Rate (OPR) was introduced as the primary monetary policy tool of the Central Bank to signal and operationalise its monetary policy stance.[2] With this change, the Central Bank will target to maintain the Average Weighted Call Money Rate (AWCMR), the rate at which banks transact with each other in the interbank market, at or around the announced OPR. AWCMR continues to remain the operating target of the Central Bank under the FIT framework. Overnight market interest rates maintained in line with the monetary policy stance are transmitted through the financial markets to the economy, ultimately affecting inflation.

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

[2] The Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) are no longer considered policy interest rates of the Central Bank, but continue to serve as the rates applicable for standing facilities for participatory institutions for overnight transactions with the Central Bank. SDFR and SLFR are linked to OPR with a pre-determined margin. For more details, refer to the information series note on the introduction of OPR, available on the Central Bank Website.

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

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

EXECUTIVE SUMMARY

The Sri Lankan economy continued to demonstrate resilience in 2024 with domestic economic activity strengthening amidst restored macroeconomic stability. Inflation, which remained low following the high inflation episode of 2022/23, eased further in 2024, turning negative in the latter half. This decline in price pressures alleviated, to some extent, the burden on businesses and households in the post-crisis period, gradually restoring purchasing power, alongside improving incomes. The Central Bank continued with its accommodative monetary policy stance in 2024, thereby supporting domestic economic activity in an environment of subdued inflationary pressures.

Successive downward revisions to electricity tariffs, fuel and LP gas prices and transport costs, along with declining food prices, contributed to the slowing of inflation, eventually turning negative towards the end of the year. Inflation expectations remained subdued.

Headline inflation is projected to remain negative in early 2025 before rising to positive levels driven by strengthening underlying demand conditions and as the impact of the statistical base effect in lowering y-o-y inflation diminishes. While headline inflation may edge above the target between late 2025 and mid-2026, projections indicate that this deviation will be short-lived. Meanwhile, core inflation is also projected to experience a temporary drop in early 2025, but stabilise thereafter.

The Central Bank maintained its accommodative monetary policy stance throughout the year, with further relaxation in November 2024 alongside the introduction of a single policy interest rate - the Overnight Policy Rate (OPR). Monetary policy easing was pursued with caution, as the tentative deflationary conditions were primarily driven by favourable supply-side conditions rather than underlying demand dynamics. Reflecting the eased monetary policy stance, market interest rates declined further, facilitating a broad-based expansion of credit to the private sector.

Supported by accommodative monetary conditions, increased credit flows to the private sector, improved business and consumer confidence, and robust external demand, the economy experienced a strong recovery in 2024, with an estimated annual growth of around 5 per cent, which is the highest growth recorded since 2017. With the effective implementation of necessary structural reforms and growth-oriented policies, the growth momentum is expected to be sustained over the medium term.

A careful assessment of the risks to inflation and growth projections suggests a broadly balanced outlook in both the near and medium term.

1. MONETARY POLICY SUMMARY

Continuing the accommodative monetary policy stance adopted since June 2023, the Central Bank of Sri Lanka further eased its monetary policy stance during 2024 and maintained this stance into early 2025.

The Central Bank lowered key policy rates by a total of 125 bps during the year 2024 in three monetary policy review rounds, following the notable reduction of 650 bps during H2-2023. In March 2024, policy interest rates were reduced by 50 bps, followed by a further cut of 25 bps in July 2024 after allowing some space for market interest rates to adjust in line with the downward adjustment in policy interest rates. These policy adjustments were largely underpinned by muted inflationary pressures, low inflation expectations as well as renewed resilience in the external sector. Further, the rigidity observed in downward adjustments to selected market lending interest rates also warranted a further policy stimulus to enhance the effective passthrough of monetary policy actions.

Meanwhile, with the policy easing yielding the expected outcomes, particularly in terms of the continued decline in market lending interest rates, expansion of credit to the private sector, and revitalising domestic economic activity amidst a low inflation environment, the Central Bank opted for a temporary pause in policy rate adjustments since August 2024, before implementing an additional cut in November 2024 ahead of the deeper-than-expected deflation conditions in the near term. A key milestone in monetary policy formulation and implementation was reached in 2024 with the Central Bank's shift to a single policy interest rate mechanism from its dual policy interest rate mechanism. Accordingly, the Overnight Policy Rate (OPR) was introduced as the primary monetary policy tool of the Central Bank in November 2024. At the time of introduction, OPR was set at 8.00 per cent, reflecting an effective reduction of around 50 bps in the policy rate.

In January 2025, the policy interest rate was kept unchanged considering the projected convergence of inflation towards the inflation target by H2-2025, despite the possible deepening of deflation in the immediate future which is predominantly due to supply-side factors.

The Monetary Policy Board will meet in March 2025 for the second monetary policy review of the year.

Monetary Policy Decisions since the last Monetary Policy Report (August 2024 – January 2025):

September 2024	November 2024	January 2025
Policy interest rates were maintained at 8.25% (SDFR) and 9.25% (SLFR)	Overnight Policy Rate (OPR) was introduced as the primary monetary policy tool and set at 8.00%, with an effective reduction of around 50 bps	OPR was maintained at 8.00%

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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 January 2025, are illustrated 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 January 2025 monetary policy round. These projections are considered as the *baseline forecast* in this Report.

2.1. Baseline Forecast

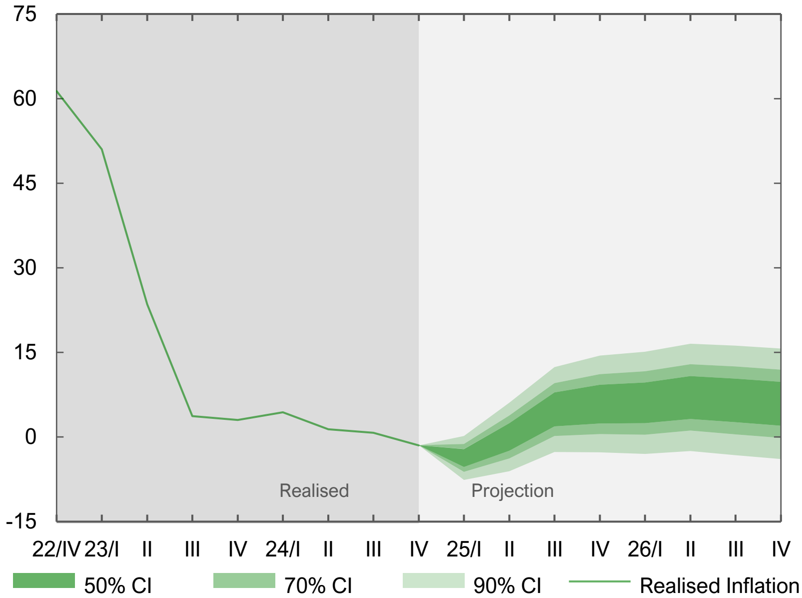
As per the latest near-term projections, y-o-y headline inflation is forecast to decline further in Q1-2025, primarily reflecting the downward revision to energy tariffs, and the statistical base effect contributing to lowering inflation. However, it is forecast to increase in Q2-2025. As per the medium-term projections, headline inflation is projected to increase sizeably in Q3-2025, with the possibility of it hovering around 2 percentage points above the inflation target in mid-2026. Nonetheless, headline inflation is forecast to converge to the targeted 5 per cent level over the medium term, supported by the implementation of appropriate policy measures. Latest nowcasts indicate that real GDP growth for Q4-2024 is expected to be robust, sustaining the momentum in the first three quarters of 2024. Looking ahead, economic growth is expected to continue its rebound over the medium term, although at a moderate pace. The eased monetary conditions are anticipated to spur growth, whereas the expected continuation of fiscal consolidation efforts continue to pose a contractionary effect over the medium term. Moreover, the medium-term growth outlook is subject to considerable uncertainty driven by the global geopolitical landscape.

Prospects for Inflation

As per the latest near-term projections, the Colombo Consumer Price Index (CCPI)-based deflation (y-o-y) is projected to be deeper than expected, on average, in Q1-2025, driven by the substantial downward revision to the electricity tariffs that came into effect on 18 January 2025, along with expectations of relatively subdued volatile food inflation. In addition, the statistical base effect will also contribute to lowering y-o-y inflation during Q1-2025, due to the

[3] The Central Bank uses the 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, %)
Based on the Projections during the January 2025 Monetary Policy Round



Source: Central Bank Staff Projections

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).

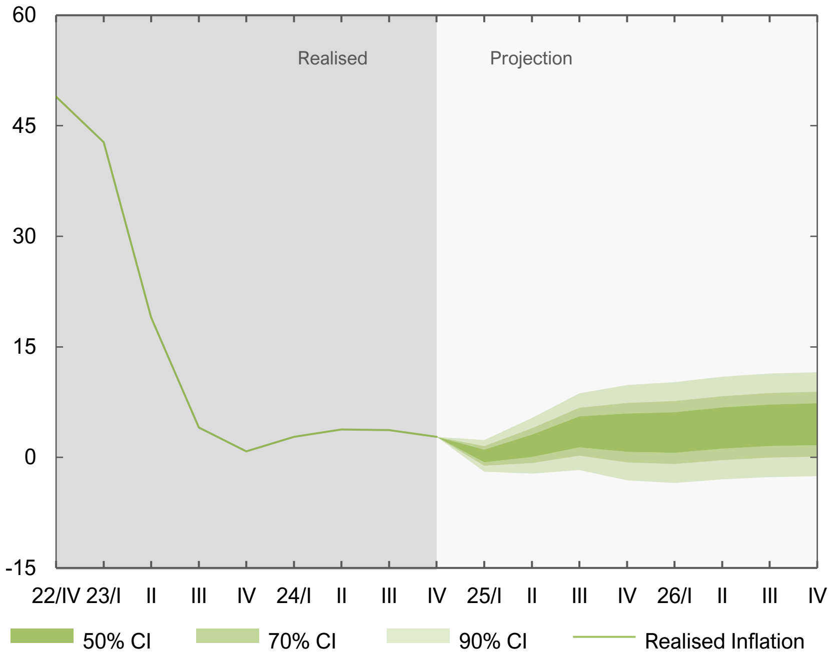
Note: A forecast is neither a promise nor a commitment

The projections reflect the available data, assumptions and judgements made at the monetary policy round in January 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 domestic fiscal path in line with the IMF-EFF projections; and global financial conditions implied by the monetary policy stance of the US. Moreover, the projections are conditional on the model-consistent interest rate path and the resulting macroeconomic responses. Further, no major macroeconomic policy shifts are anticipated in the baseline projections. Thus, the continuation of the IMF-EFF and efforts on fiscal consolidation 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 Projections" section.

increase in prices in early 2024 on account of the Value Added Tax (VAT) adjustments and the notable food inflation amidst supply-side disruptions caused by adverse weather conditions. As per the latest projections, headline inflation is expected to increase and average nearly zero in Q2-2025. During Q3-2025, inflation is forecast to increase further, approaching the inflation target of 5 per cent. The sharp acceleration in headline inflation anticipated in Q2-2025 and Q3-2025 is primarily due to the substantial unfavourable base effect, a faster increase in world food inflation and the gradual development of demand pressures. Headline inflation is expected to accelerate in Q4-2025 and Q1-2026 as well, and peak around 2 percentage points above the inflation target during Q2-2026. However, the surge in inflation is not expected to persist as the impact of the base effect, which is a large driver of the estimated surge, is envisaged to subside in the subsequent quarters. Accordingly, headline inflation is expected to decline gradually from Q3-2026 onwards and eventually stabilise around the targeted level of 5 per cent over the medium term, supported by appropriate policy measures.

When components of inflation are considered, core inflation, which excludes goods and services with volatile prices to derive underlying demand pressures, is expected to remain broadly steady in the medium term. Similar to headline inflation, core inflation is also expected to be affected by the base effect in Q1-2025 as the expenditures of most items in the core inflation basket increased due to the VAT adjustments effected in January 2024. Accordingly, core inflation is expected to have a temporary dip in Q1-2025, but is expected to normalise consistent with the target for headline inflation thereafter with a lower degree of volatility. As the core inflation index largely excludes the items in the energy and transport-related category, which are instrumental in driving down headline inflation, the recent reduction in headline inflation is not reflected at a similar magnitude in core inflation. Meanwhile, core inflation is also partly affected by global food prices and the movements in the exchange rate.

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



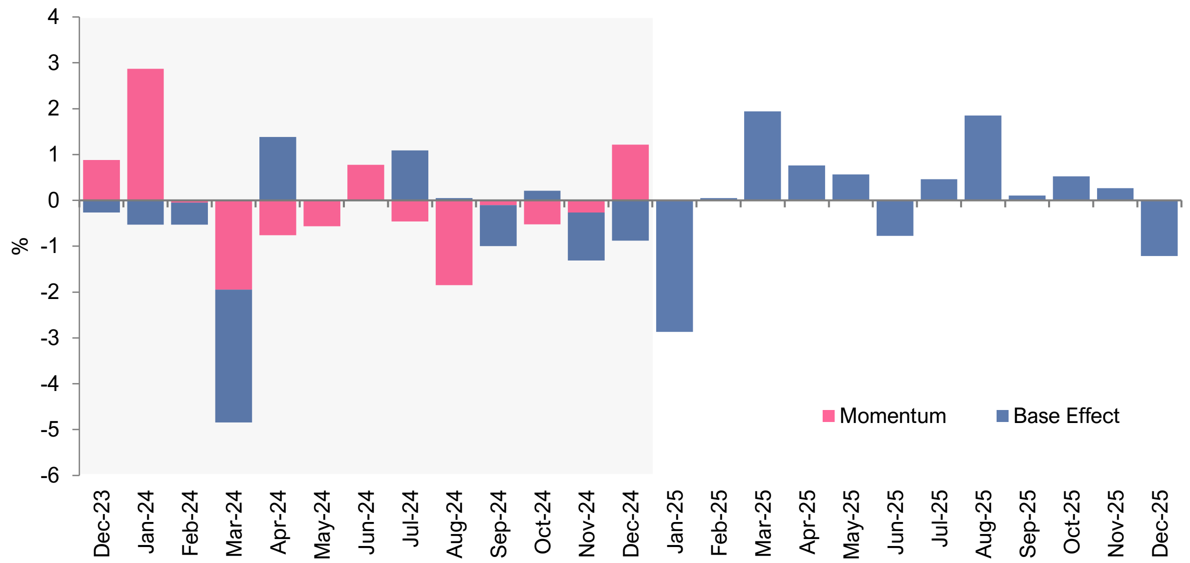
Source: Central Bank Staff Projections

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).

See the explanatory note in Figure 01 above.

Energy and transport inflation is expected to remain subdued, contributing negatively to the y-o-y headline inflation in the near term. However, a gradual normalisation in energy and transport-related prices is projected. With the movements of the Sri Lanka rupee, coupled with global price levels amidst volatility, domestic prices related to energy and transport sectors could experience some upward pressure, contributing to the normalisation of energy and transport inflation from its prevailing subdued level. Moreover, this trajectory could be influenced by revisions to the electricity tariff during the upcoming rounds of revisions as well. However, uncertainties related to the above forecasts are extremely high, as reflected by the unstable global oil price behaviour in recent months, and uncertainty in the electricity generation mix due to uncertain weather patterns. Additionally, inflation in the volatile food category, which is largely contributed by supply factors, is expected to remain somewhat elevated in the near term. Low agricultural output expected in the near term, particularly due to the expected subdued performance of the Agriculture sector in Q4-2024, also contributes to this behaviour.

Figure 03: Headline Inflation: Momentum and Base Effect[4] (CCPI, 2021=100)



Source: Central Bank Staff Calculations

[4] Inflation is commonly measured as a y-o-y change in the price level, i.e., the percentage change of the price level in a given period, which is measured by a price index (in the case of Sri Lanka, DCS compiles and publishes the two main price indices used to measure inflation in Sri Lanka, CCPI and NCPI), compared to the same period in the previous year. However, price information is made available usually at a monthly frequency. Therefore, one could calculate changes in prices on a m-o-m basis as well. The change of the y-o-y inflation from one month to the next can then be approximated by deducting the m-o-m inflation in the corresponding month of the previous year from the m-o-m inflation in the current month. (This approximation is motivated by the fact that percentage changes can be approximated by log differences.) Accordingly, the m-o-m inflation of the current month is usually termed the momentum, which represents how y-o-y inflation changes due to economic developments in the latest month. Meanwhile, the negative value of the m-o-m inflation in the corresponding month of the previous year is termed the base effect, which accounts for the statistical effect that affects how y-o-y inflation changes from one month to the next (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. Note that when quarterly information is used, as in the model projections of the Central Bank, the same classification of y-o-y 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 y-o-y changes in any variable.

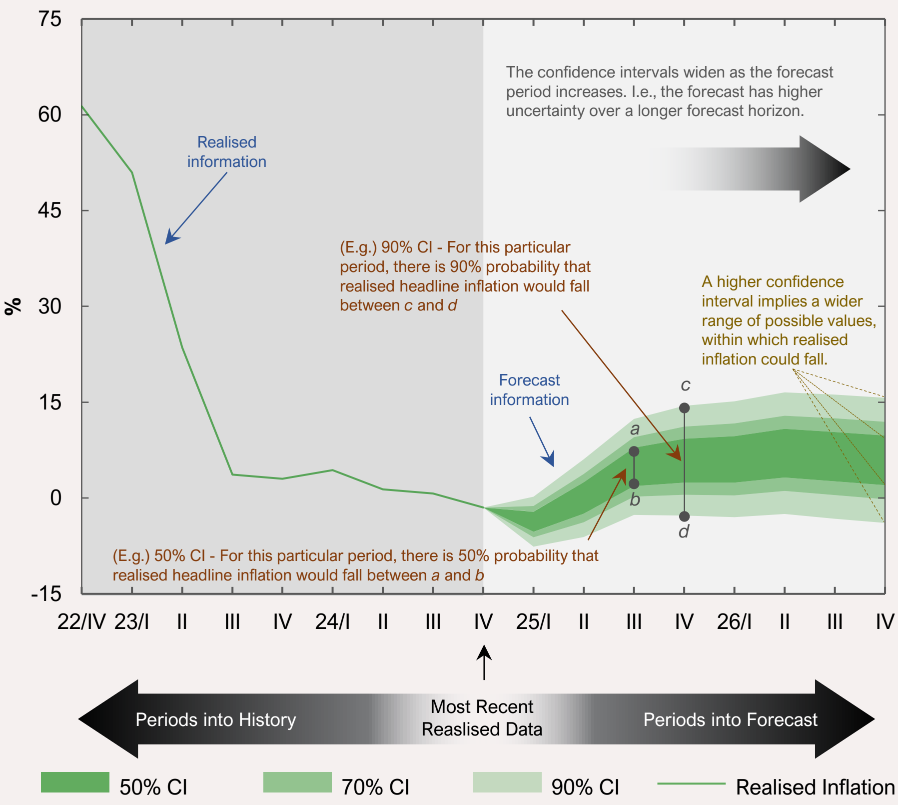
Box A: How to Read the Inflation Fan Chart§

The inflation fan chart is a way of communicating the inflation forecast, along with an indication of the associated uncertainty over the forecast. In general, forecasts of a far-away future are more uncertain than forecasts over the near term. Therefore, fan charts are often characterised by confidence intervals that gradually widen when moving farther into the future. In practice, fan charts also comprise some information about the values realised in recent history. Many central banks use fan charts as a communication tool to convey their forecasts of macroeconomic variables to economic stakeholders.

The Central Bank of Sri Lanka regularly publishes the inflation fan chart, highlighting the forecast path of headline inflation, which is updated at each monetary policy round. The Central Bank arrives at medium term inflation forecasts along with forecasts of other major macroeconomic variables using a semi-structural macroeconomic model. Projections are made using realised data, projections of major global indicators, near-term forecasts of selected variables, and judgements.

When the inflation fan chart is considered, the Central Bank publishes the 50%, 70% and 90% confidence intervals, as areas with gradually fading colours. These confidence intervals can be interpreted as representing the possible values that the realised inflation can fall upon, given the available information at the projection date. For example, Figure A.1 illustrates the inflation fan chart generated during the forecast round in January 2025. The 50% confidence interval in this fan chart represents the region within which the realised inflation could fall with a 50 per cent chance, forecast based on the information available during the January 2025 forecast round.

Figure A.1 : Key Components of an Inflation Fan Chart
Headline Inflation Projection (Quarterly, CCPI, y-o-y, %)
Based on the Projections during the January 2025 Monetary Policy Round



Source: Central Bank Staff Projections

§ For a more detailed discussion, refer to the information series article on "ABCs of the Inflation Fan Chart", accessible via the Central Bank Website.

Inflation Expectations

As per the inflation expectations survey of the Central Bank, inflation expectations of the corporate sector increased across most of the tenors in the January 2025 survey round compared to the previous month, in line with the slight reduction in deflation seen in December 2024. Meanwhile, a gradual rise could be observed in expected inflation from the 3 months to longer tenors, as per the January 2025 survey round, due to the anticipated increase in government expenditure and wages, rupee depreciation with the relaxation of the import ban on personal-use vehicles, increase in global commodity prices and high demand during the festive months. However, the level of inflation expectation remains well below the inflation target of 5 per cent across tenors, reflecting current deflationary conditions.

Prospects for Real Economic Growth

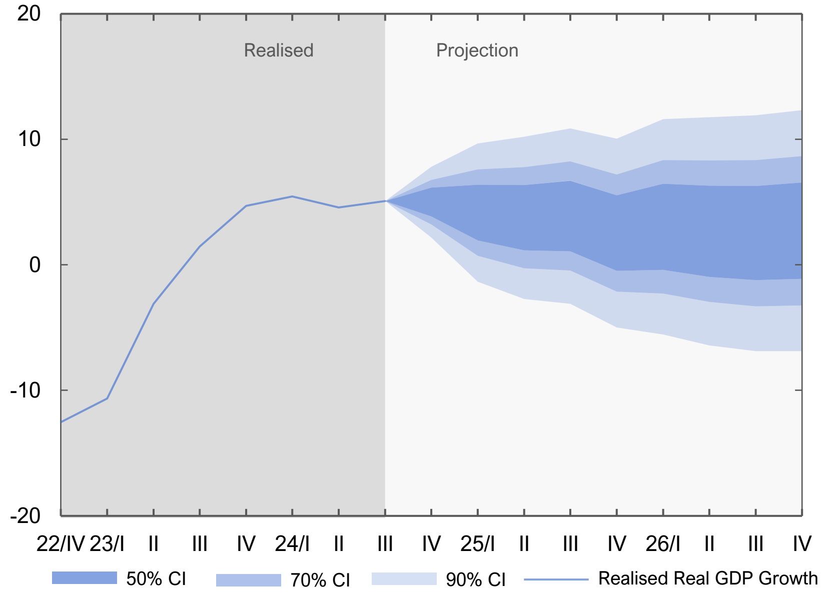
Based on leading economic indicators, survey findings, and staff evaluations, real GDP growth in Q4-2024 is expected to be robust, continuing the positive momentum observed in the first three quarters of 2024. This performance is anticipated to have been driven mainly by healthy performances in Industry activities. Accordingly, the annual economic growth for 2024 is projected to be around 5 per cent.

The near-term economic growth trajectory suggests a moderate growth in real GDP. There could be some expansionary growth support from fiscal policy in the near term, primarily due to the increased fiscal space, compared to previous projections, from lower interest rates. Moreover, the positive output gap is expected to temporarily widen due to expansionary growth support from fiscal space. Based on currently available information, which does not include any pro-growth structural reforms, the economy is projected to operate below its full capacity over the medium term.

The expected easing of the tight real monetary conditions is anticipated to stimulate growth by fostering investments, enhancing consumer spending, and eventually boosting aggregate demand. Meanwhile, the growth projections for Sri Lanka's major trading partners point to a rebound in certain economies. Nonetheless, the positive foreign output gap is estimated to narrow and turn negative over the medium term, suggesting a stagnation in external demand. However, changes in trade-related policies of the US could weigh on this trajectory in the period ahead. Additionally, external demand for domestic services, especially tourism, is expected to remain strong.

It is noteworthy that the economic growth trajectory over the medium term is subject to considerable uncertainty. In this context, a sustained pickup in investment activity supported by both domestic and foreign savings would be decisive in maintaining the current growth momentum. Meanwhile, the continuation and implementation of planned structural reforms would be crucial for the economy to achieve its full potential in the medium term. In this regard, enhancing productivity, increasing export potential and tackling growth obstacles through reducing structural barriers, are key to attaining high growth sustainably.

Figure 04: Projected Quarterly Real GDP Growth (y-o-y, %)
Based on the Projections during the January 2025 Monetary Policy Round



Source: Central Bank Staff Projections

See the explanatory note in Figure 01 above.

2.2. Key Assumptions Underpinning the Forecast

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

Global Environment

According to the Global Projections Model Network (GPMN),[5] the world economy is projected to have grown by 3.1 per cent in 2024. A marginal slowdown in global growth is anticipated over the

[5] The Central Bank uses projections of global macroeconomic indicators prepared by GPMN as inputs for medium-term projections. Projections used in the January 2025 monetary policy round are based on preliminary GPMN projections received on 21 January 2025.

medium term. The export-weighted foreign output gap,[6] derived based on these projections, is expected to remain positive in the near term mainly due to the anticipated recovery in the US. Nonetheless, the export-weighted foreign output gap is expected to turn negative from mid-2026, driven by the anticipated slowdown in the US, UK and Eurozone. Headline inflation is expected to remain above the targets of central banks in many major economies, especially due to persistent services inflation. According to GPMN projections, the US Federal Reserve is expected to follow a cautious approach in reducing the Federal Funds Rate in 2025. The average Brent crude oil price is expected to be lower in 2025 compared to the last year, with a further decline anticipated in 2026. The ceasefire agreement in the Middle East, increased production by the economies that do not fall under the Organization of the Petroleum Exporting Countries (OPEC), and expectations of easing global demand argue in favour of the above trajectory. Meanwhile, global food prices are expected to rise, with the Food and Agriculture Organization (FAO) food price index expected to average higher than in 2024. The gradual increase in global food prices reflects the risks of repeating weather-related disturbances, such as droughts and floods.

Fiscal Path

The post-debt restructuring scenario, as well as the ongoing fiscal consolidation measures, in line with the Extended Fund Facility (EFF) of the International Monetary Fund (IMF), are reflected in the fiscal balances used for baseline projections.

External Current Account

A healthy current account surplus and a marginal deficit are assumed for 2024 and 2025, respectively. The surplus assumed for 2024 is revised to be higher in the current monetary policy round owing to a lower trade deficit than the initial projections, improvements in earnings from tourism and increased workers' remittances. The deficit assumed for 2025 is mainly driven by the anticipated higher trade deficit due to the resumption of vehicle imports.

[6] 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 Projections

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

Risks to Inflation Projections

When downside risks are considered, recent energy-related price reductions could result in higher-than-anticipated second-round effects, driving down inflation. The Government has also promised numerous measures to relieve the elevated cost of living of the public, although the timing and magnitude of such anticipated price revisions remain uncertain. The finalisation of the upcoming National Budget 2025 will offer some certainty on the realisation of the projected path. This additional information would be incorporated in the upcoming monetary policy rounds, once these are made available. In addition, the sustained impact of the diminished purchasing power of the public could keep demand conditions suppressed for a longer period than anticipated, thereby exerting downward price pressures.

Several upside risks could potentially lead inflation on a higher trajectory than the projected path. Possible adverse weather conditions could affect agricultural production negatively, which could create upward pressure on food inflation, particularly if rainy weather continues into the harvesting period. Moreover, over the medium term, any unpredictable weather patterns can impact the dependence on hydropower for energy generation, creating upside risks to energy prices. Wage increases in the private sector could lead to further price increases, with businesses passing such increased costs on to consumers. Meanwhile, if realised, the risk of possible deviations from the envisaged fiscal consolidation path could lead to inflationary pressures via increased spending. Additionally, any possible continuation of supply constraints related to essentials can lead to further price hikes in the near term. Further, any possible rupee depreciation at a higher level could also lead to inflationary pressures. With the US policy changes, upside risks to US inflation have increased, driven by the tariff increases on imported items and the policy measures that could tighten labour markets. Moreover, the increased uncertainty over global food and energy prices persists with some possibility of global price hikes. The materialisation of such risks could have spillover effects on the global inflation outlook, which could adversely affect Sri Lanka's inflation outlook due to higher imported inflation.

With the possibility of second-round effects of the electricity tariff reductions implemented thus far, along with upside risks from several factors such as the impact of adverse weather on food inflation, possible depreciation pressure on the Sri Lanka rupee and higher volatility in global oil and food prices amidst heightened global uncertainty, the risks for inflation projections are assessed to be balanced in both the near and medium term.

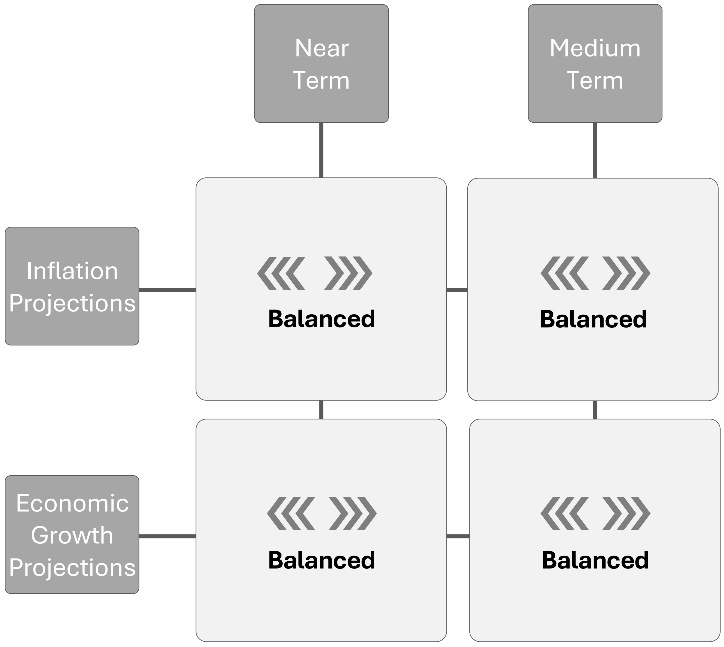
Risks to Economic Growth Projections

Potential major downside risks to growth projections in the near to medium term include, among others, the impact of the large-scale departure of workers for foreign employment and the migration of professionals that happen before, which may lead to gaps within firms, as the loss of experienced personnel could cause a sustained decline in productivity and disruptions to overall economic output. In addition, climate change may affect economic activity in Sri Lanka over the medium term, given the increased sensitivity of agricultural production and food processing sectors, and electricity generation to such events. Additionally, global uncertainties, particularly due to political shifts in the US, could have implications on external sector performance. Major policy changes in the US can lead to fluctuations in global trade, investment, capital flows, growth and inflation, which are critical to Sri Lanka's external sector.

On the upside, the impact of the successful completion of the debt restructuring process and a sovereign rating upgrade could spur growth via improved investor sentiments and the likely relaxation of certain credit constraints. The Government has promised numerous growth-oriented policies, which are yet to be formalised through the Budget. If these policies are implemented effectively as planned, they could support the corresponding sectors directly, while possible improvements in the doing business environment and governance would help enhance the growth potential of the economy. Further, any faster-than-expected improvements in tourism and related sectors could contribute to improved economic activity. Meanwhile, with the activity pickup related to large capital infrastructure developments, a boost in economic activity could be witnessed, leading to higher growth.

Overall, risks to growth projections in both the near term and the medium term are assessed to be balanced. This assessment is motivated by the possibility of upside risks on growth projections having an offsetting impact on the risks arising due to downside risks.

Figure 05: Balance of Risks to Projections



Source: Central Bank Staff Projections

2.4. Comparison with the Previous Forecast[7]

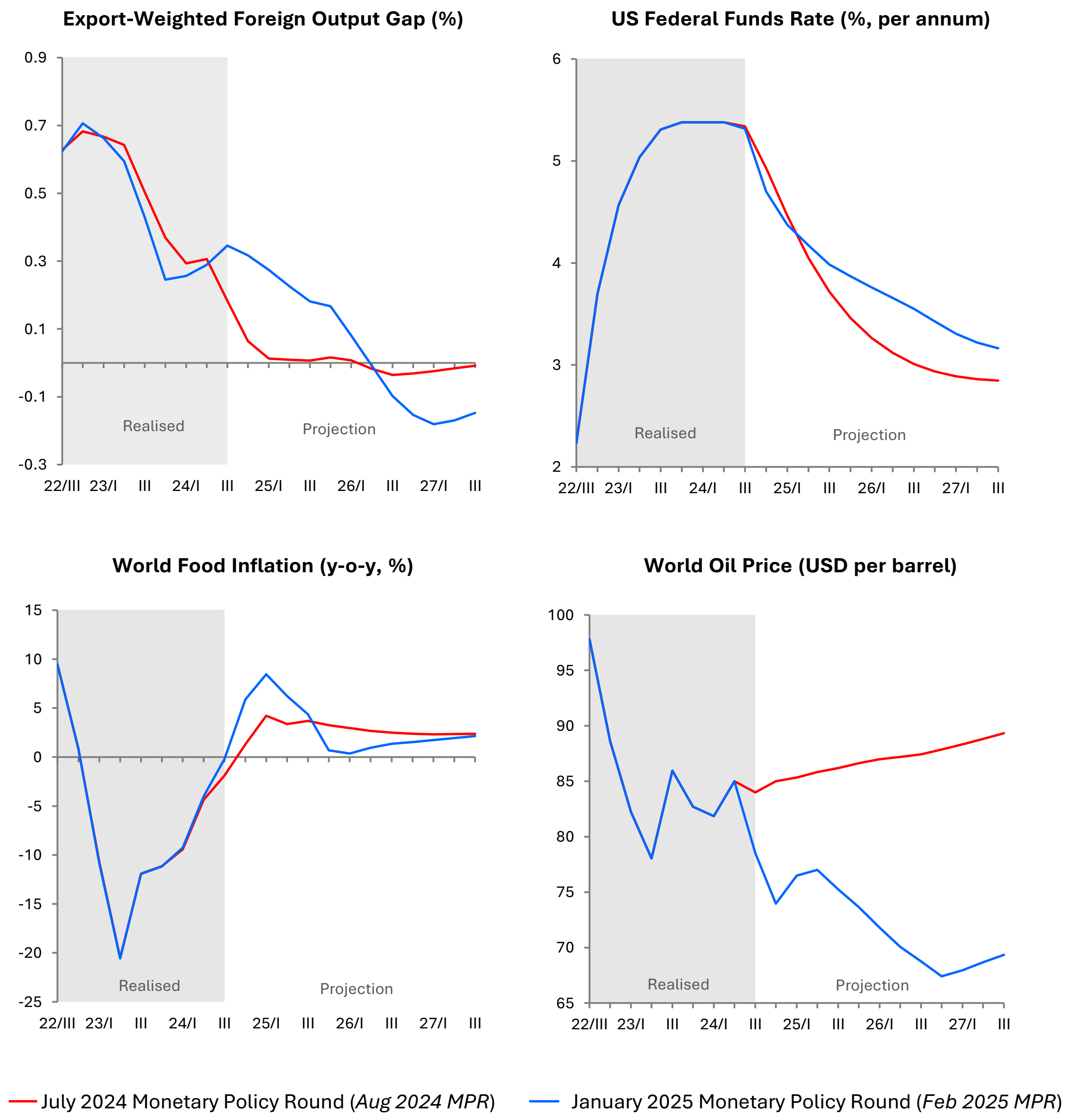
Key Assumptions Used for Medium-Term Projections

Based on global projections used during the monetary policy round in January 2025, the outlook for the export-weighted foreign output gap of Sri Lanka's major trading partners has improved for the near term, but deteriorated over the medium term, compared to the information available as of July 2024, which were used in MPR-August 2024. This change is primarily due to revised projections related to the US, Eurozone, and UK economies. Global projections used during the January 2025 monetary policy round forecast a sharper increase in food inflation compared to the monetary policy round in July 2024. World food inflation is expected to remain elevated in 2025 and stabilise thereafter. The trajectory of world oil prices was revised down substantially compared to the path projected in July 2024. Meanwhile, monetary policy loosening in the US is expected to be slower than previously projected amidst the cautious approach of the US Federal Reserve. The fiscal path has been revised in the current projections, mainly for 2024, compared to the July 2024 monetary policy round. The fiscal balance for 2024 is expected to improve in comparison to the previous projections, mainly driven by the increases in government revenue

[7] This Section compares the current forecasts with the forecast presented in the Monetary Policy Report in August 2024, which were derived during the July 2024 monetary policy round.

amidst a strong economic growth projected for 2024. Assumptions on the current account balance of the Balance of Payments (BOP) have been revised to reflect new information. Accordingly, the surplus in the current account for 2024 is now projected to be higher than the level assumed in July 2024, primarily due to the lower-than-expected increase in imports in 2024.

Figure 06: Global Projections (Quarterly)



Sources: QPM, GPMN (Updated on 26/06/2024 and 21/01/2025)

Inflation Path

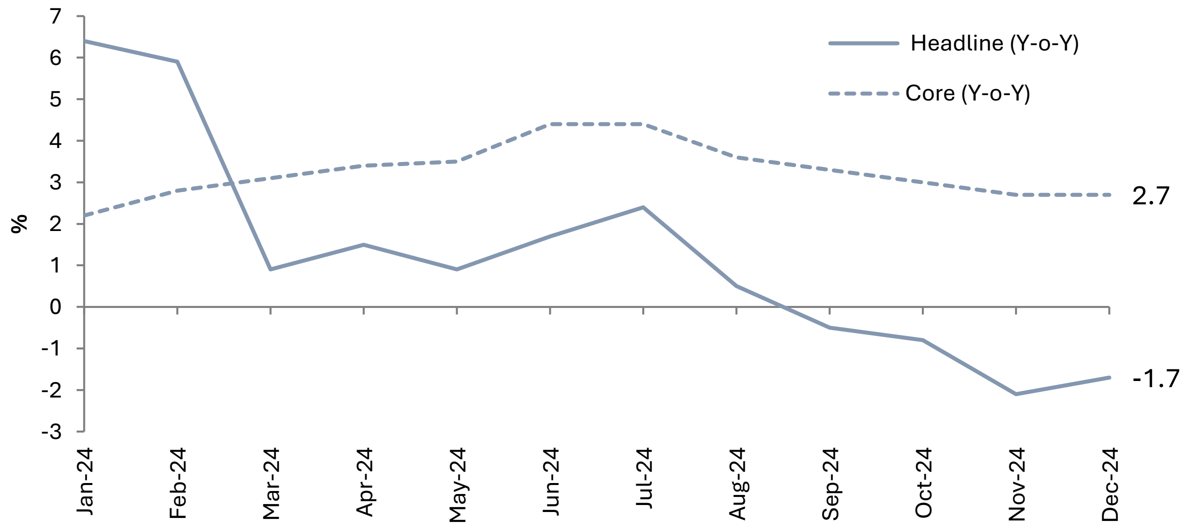
Compared to the projections published in MPR-August 2024, realised y-o-y headline inflation was below the projected levels during both Q3-2024 and Q4-2024, which was contributed by the deviation of the realised electricity tariff adjustments compared to the previously assumed path, along with the subdued levels of domestic fuel prices and the reduction in water tariffs. Amidst limited information about future electricity tariff adjustments, a slight increase in electricity tariffs had been assumed to be implemented in Q4-2024 during the July 2024 projections. However, such tariff increases did not materialise, and a substantial downward tariff revision was implemented in January 2025. The realised y-o-y headline inflation for Q3-2024 was slightly lower than the previous projection, mainly contributed by the downward water tariff revision. In Q4-2024, the unrealised anticipated electricity tariff increase and gradual downward revisions to fuel prices contributed to the realised inflation deviating from its previously projected path. In addition, the passthrough of the strengthening of the Sri Lanka rupee against the US dollar in 2024 is estimated to have contributed to this deviation as well. The previously anticipated decline in inflation in early 2025, owing to the statistical base effect resulting from the VAT impact in Q1-2024, is present in current projections as well. Similar to the July 2024 projection, the unfavourable base effect due to continued energy price reductions is expected to push y-o-y headline inflation upward in late 2025. However, in the current projections, the peak of the anticipated inflation path has shifted forward with a lesser magnitude, contributed by the less-than-anticipated realised inflation, and downward revisions to the near-term projections mainly due to the most recent electricity tariff revisions. At the same time, similar to the previous projection, inflation is expected to gradually stabilise around the inflation target over the medium term.

3. CURRENT ECONOMIC DEVELOPMENTS

3.1. Inflation

Headline inflation recorded a declining trend during H2-2024, and it remained in the negative territory since September 2024, owing mainly to reductions in administrative prices.

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

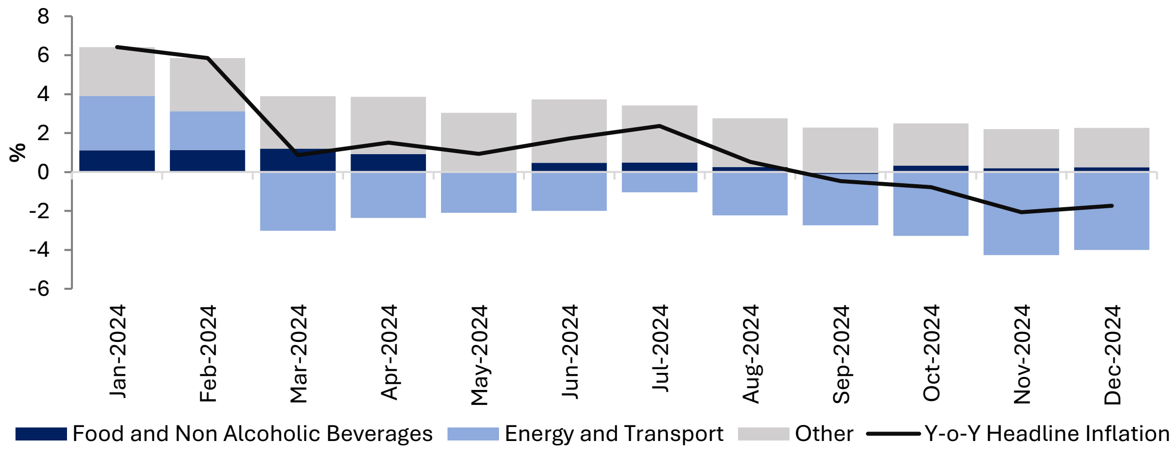


Source: Department of Census and Statistics

The Colombo Consumer Price Index (CCPI, 2021=100) based headline inflation (y-o-y), followed an overall declining trend from 2.4 per cent recorded in July 2024. It continued to remain in the negative territory from September 2024. This deflationary trend was mainly driven by the price reductions in the non-food category, where the main contribution came from the notable downward revisions to the electricity tariff in July 2024. In addition, frequent downward revisions to domestic fuel and LP gas prices and downward revisions to water tariff in August 2024 and bus fare in July and August 2024, as well as moderation in food prices, also contributed towards the decline. Accordingly, CCPI-based headline inflation was recorded at -1.7 per cent (y-o-y) by December 2024.[8] The CCPI based food inflation remained positive at 0.8 per cent (y-o-y), whereas non-food inflation remained at -3.0 per cent (y-o-y) in December 2024. Meanwhile, the National Consumer Price Index (NCPI, 2021=100) based headline inflation (y-o-y) also decelerated from 2.5 per cent in July 2024 to -2.0 per cent in December 2024.

[8] In January 2025, CCPI-based headline inflation was recorded at -4.0 per cent (y-o-y).

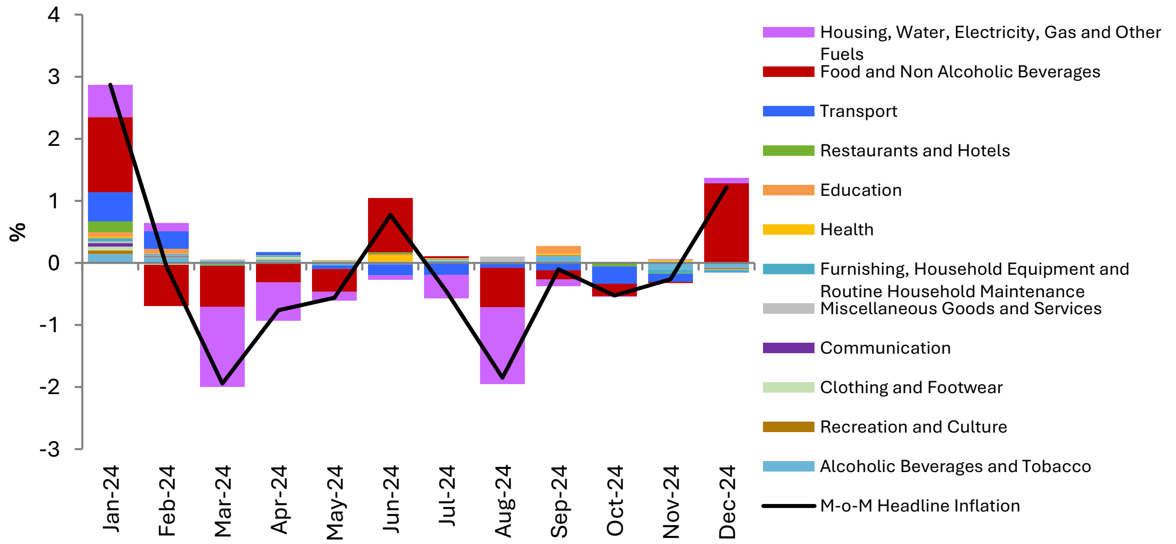
Figure 08: Contribution to y-o-y Headline Inflation (CCPI)



Sources: Department of Census and Statistics
Central Bank Staff Calculations

On a m-o-m basis, CCPI-based headline inflation remained mostly negative during several months in 2024 due to reductions in electricity tariffs, fuel prices and transport costs and easing food prices.

Figure 09: Contribution to m-o-m Headline Inflation (CCPI)



Sources: Department of Census and Statistics
Central Bank Staff Calculations

CCPI-based core inflation (y-o-y), which reflects the underlying inflation trends in the economy, remained modest during H2-2024 and was recorded at 2.7 per cent in December 2024.[9] Meanwhile, NCPI-based core inflation (y-o-y) was recorded at 1.3 per cent in December 2024.

Since the CCPI-based quarterly headline inflation deviated from the inflation target by more than the margin of ±2 percentage points stipulated in the Monetary Policy Framework Agreement

[9] In January 2025, CCPI-based core inflation was recorded at 1.2 per cent (y-o-y).

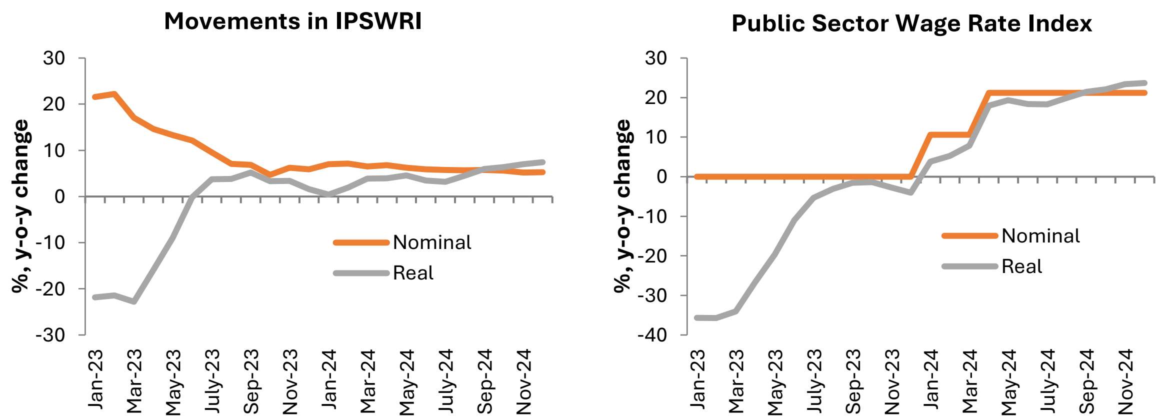
(MPFA), from the lower side for two consecutive quarters in Q2-2024 and Q3-2024, the Report required under Section 26(5) of the CBA was submitted to Parliament through the Hon. Minister of Finance. Subsequently, the contents of the Report were deliberated in detail at the Committee on Public Finance (CoPF), and the Report was made available to the public.[10] Since quarterly headline inflation remained below the inflation target by more than 2 percentage points in Q4-2024 as well, a follow-up report under Section 26(5) of the CBA will also be submitted to the Parliament.

According to available information,[11] both the Informal Private Sector Wage Rate Index (IPSWRI, 2018=100) and the Public Sector Wage Rate Index (2016=100) recorded increases during 2024.

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

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

Figure 10: Movements in the IPSWRI (2018=100) and Public Sector Wage Rate Index (2016=100)



Source: Central Bank of Sri Lanka

[10] The Report on Deviation of Inflation from its Target - Q2 and Q3 2024 can be accessed via the Central Bank Website.

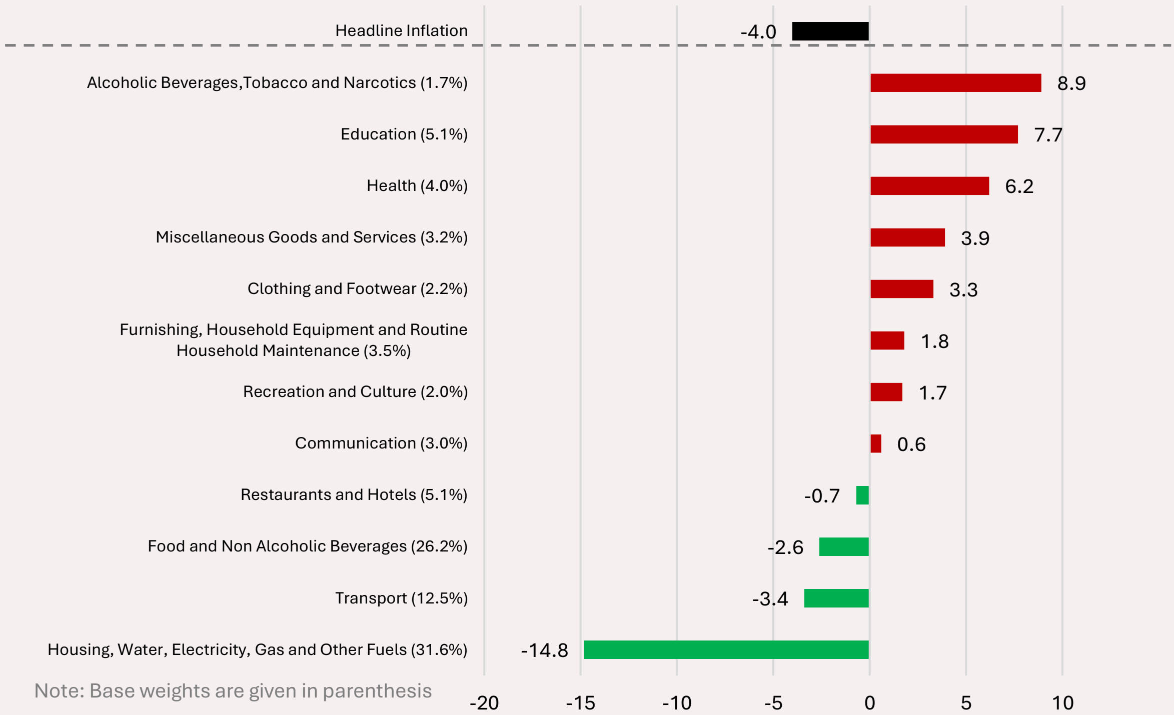
[11] Information in this section is primarily based on the public sector wage rate index (2016=100) and informal private sector wage rate index (2018=100) compiled by the Central Bank.

Box B: Price Trends Driving Sri Lanka's Deflation and Public Perceptions

Sri Lanka experienced deflation for the fifth consecutive month in January 2025, with the Colombo Consumer Price Index (CCPI)-based headline inflation (y-o-y) remaining in the negative territory. Deflation is characterised by a decline in the aggregate price level of an economy, as measured by a consumer price index, compared to the same period a year ago. The aggregate price level represents a weighted average of the prices of goods and services consumed by a typical household, based on their consumption shares. However, a decline in the aggregate price level does not imply a reduction in the prices of all goods and services consumed. Typically, goods and services could exhibit heterogenous price movements over a given period. Some prices could increase, others may remain unchanged, while some could decline. Deflation occurs when the overall impact of price declines outweighs the impact of rising prices over a given period, resulting in a reduction in the aggregate price level.

In January 2025, CCPI-based headline inflation (y-o-y) was recorded at -4.0 per cent (or deflation of 4.0 per cent). This indicates that the aggregate price level, as measured by the CCPI, has declined over the period under consideration. However, as noted above, not all prices have declined. Although the aggregate price level has fallen, certain goods and services have experienced price increases. The decline in CCPI reflects that the overall impact of the price declines in certain categories of items has outweighed the impact of rising prices in others over the past year.

Figure B.1 : Category-wise Headline Inflation – Jan 2025 (CCPI-based, y-o-y, %)

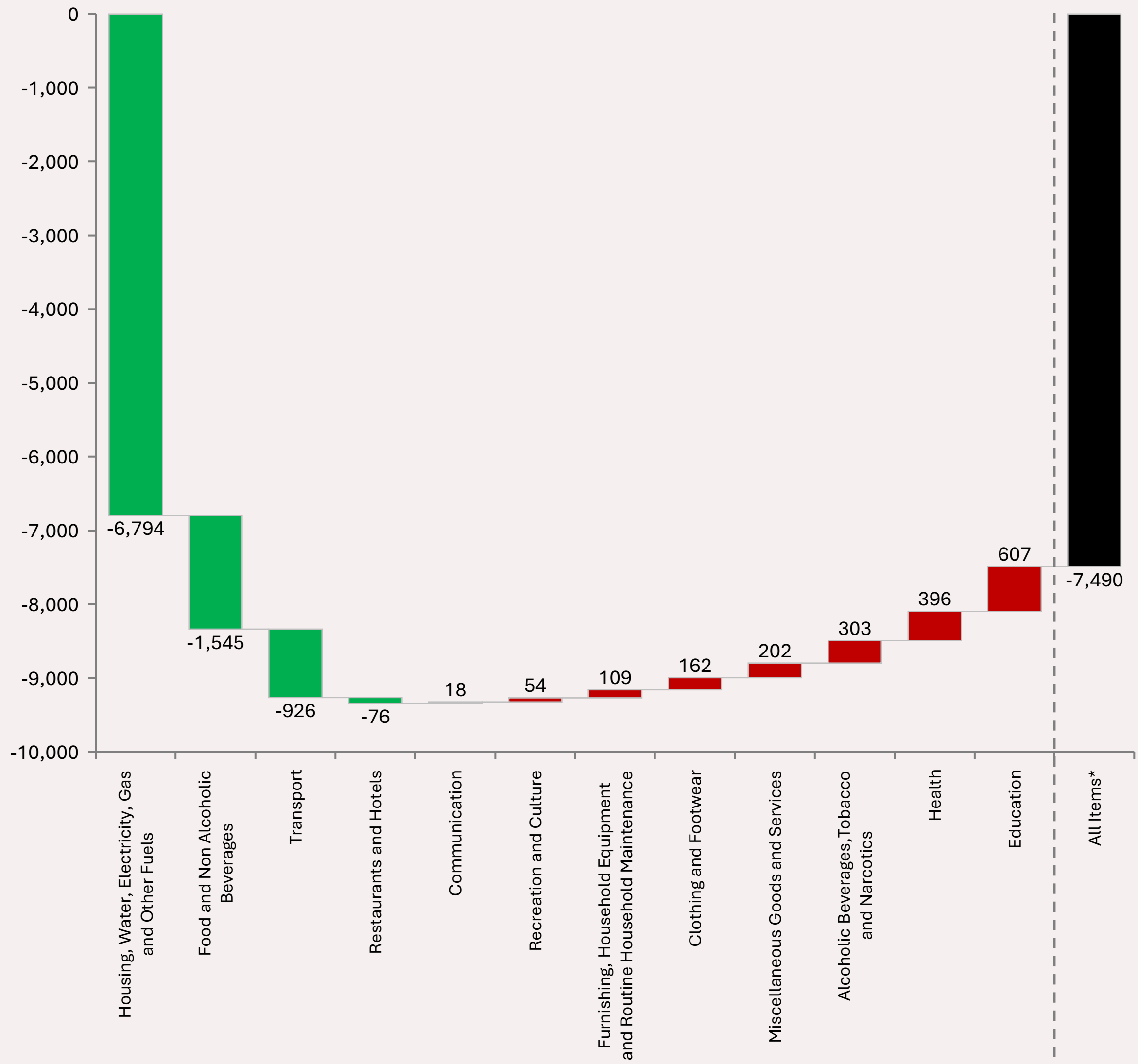


Source: Department of Census and Statistics

Figure B.1 depicts the y-o-y price changes across the main categories of CCPI in January 2025. The Food and Non-Alcoholic Beverages;[§] Restaurants and Hotels; Housing, Water, Electricity, Gas and Other Fuels; and Transport categories recorded price declines, on a net basis, whereas the other categories witnessed price increases. However, the net effect led to an overall decline in the CCPI, indicating that the impact of price declines outweighs that of rising prices elsewhere. Furthermore, the change in monthly household spending of the main categories of CCPI from January 2024 to January 2025, as published by the Department of Census and Statistics (DCS), reaffirms this.

[§] Prices of certain food items have declined over the corresponding period, while prices of certain other food items have increased. The overall impact was a reduction in total expenditure under the Food category.

Figure B.2 : Contribution to decline in household spending from January 2024 to January 2025 (CCPI-based, Rs.)



Source: Department of Census and Statistics

* This means that compared to January 2024, typical household expenditure has reduced by Rs. 7,490, which corresponds to a y-o-y inflation of -4.0 per cent in January 2025.

Note: Y-o-y change in household expenditures as published by DCS. Available at www.statistics.gov.lk/InflationAndPrices/StaticalInformation/MonthlyCCPI/CCPI_20250131E.

Figure B.2 illustrates the contribution from different categories to the reduction of total household expenditure from January 2024 to January 2025. The figure shows that Housing, Water, Electricity, Gas and Other Fuels; Food and Non-Alcoholic Beverages; and Transport categories are the largest contributors to the reduction in household expenditure, surpassing the expenditure increases in other categories, thereby resulting in a reduction in total household spending compared to the same period in the previous year. In order to provide further details on the decline in household expenditure of certain categories of the CCPI amidst heterogenous price movements, Table B.1 presents the y-o-y expenditure reductions of certain selected items in the Food and Non-Alcoholic Beverages; Housing, Water, Electricity, Gas and Other Fuels; and Transport categories.

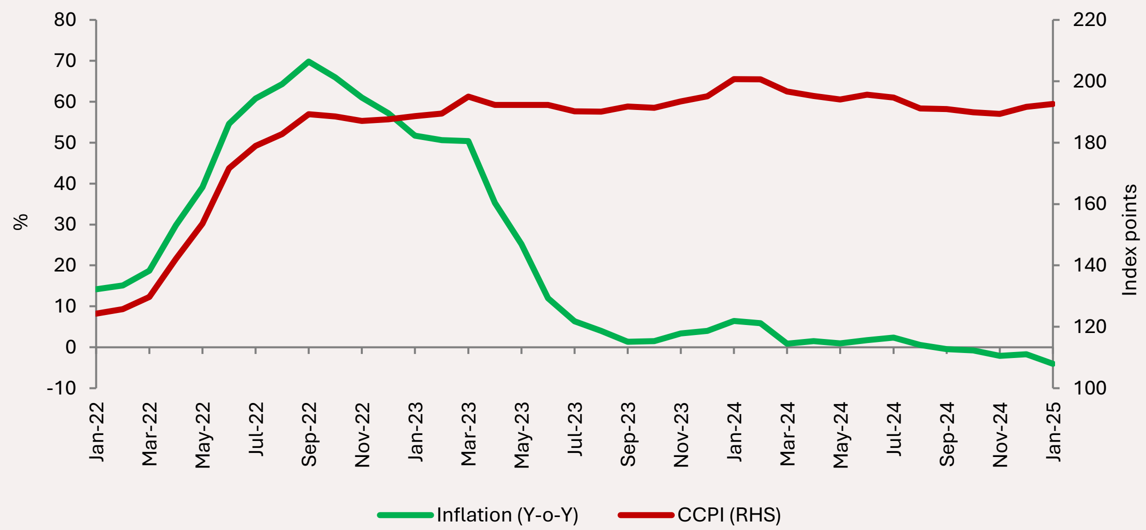
Table B.1: Change in monthly household expenses on selected categories of items from January 2024 to January 2025 (CCPI-based, Rs.)

Category/Commodity	Change (Rs.)	Contribution to inflation (%)	
Housing, Water, Electricity, Gas and Other Fuels	**-6,794.18**	**-3.68**	
o/w Housing rent	145.93	0.08	+
Water bill	-240.98	-0.13	-
Electricity bill	-6,432.42	-3.49	
LP gas	-271.07	-0.15	
Food and Non Alcoholic Beverages	**-1,544.77**	**-0.83**	
o/w Rice	666.66	0.36	+
Coconuts	1,537.81	0.83	
Coconut oil	297.65	0.16	
Bread (normal)	-137.44	-0.07	-
Chicken	-292.76	-0.16	
Canned fish	-349.53	-0.19	
Fresh fruits	-376.99	-0.20	
Vegetable	-1,450.60	-0.79	
Big onions	-788.10	-0.43	
Sugar	-178.08	-0.10	
Chilli powder	-139.71	-0.08	
Dried chillies	-180.26	-0.10	
Transport	**-925.97**	**-0.50**	
o/w Vehicle maintenance expenses	201.39	0.11	+
Petrol	-1,210.61	-0.66	-
Diesel	-200.51	-0.11	
Bus fare	-187.93	-0.10	

Source: Department of Census and Statistics

Note: Y-o-y change in household expenditures as published by DCS. Available at www.statistics.gov.lk/InflationAndPrices/StaticalInformation/MonthlyCCPI/CCPI_20250131E.

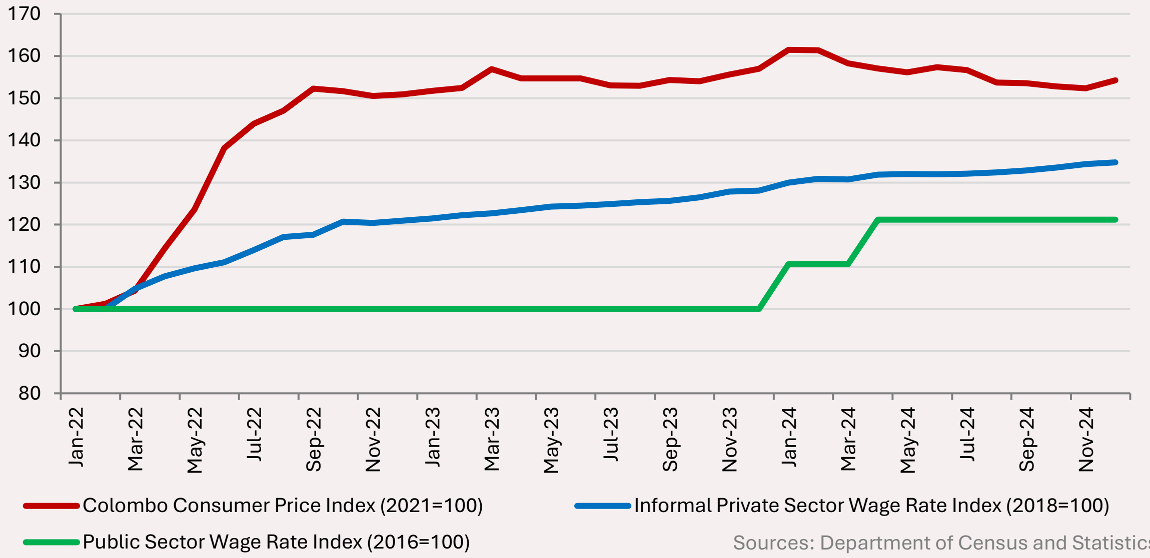
Figure B.3 : Movements in the CCPI and Inflation



Source: Department of Census and Statistics

Even though there has been deflation for the last few months, some segments of the public claim that it is hardly reflected through a relief in the cost of living. One possible reason for this could be the already elevated price levels. Although the pace of increase in the aggregate price level has reduced and turned negative for a couple of months, it remains significantly elevated compared to its levels prior to 2022, as shown in Figure B.3. The CCPI represents the total monthly expenses of a typical household. Therefore, the CCPI remaining at elevated levels indicates that the monthly household expenditure, on average, still remains high. Moreover, the income levels of many segments of the population are unlikely to have been fully adjusted to offset the impact of past inflationary episodes. This is evident in Figure B.4, which compares the increase in the CCPI against that of the wage rate indices. Therefore, the modest reduction in total monthly expenses observed in recent months may not provide significant relief to households in an environment where their real income levels have gradually eroded in the past few years.

Figure B.4 : Movements in the CCPI and Wage Rate Indices (Jan. 2022 normalised to 100)



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

In addition, there could be psychological and behavioural aspects for perceived inflation to be different from realised inflation. Research shows that price changes in frequently purchased items affect perceived inflation more than the changes in prices of items that are less frequently bought, regardless of the expenditure share (e.g., D'Acunto et al. (2021) and Georganas et al. (2014)). In Sri Lanka, there has been a significant reduction in the electricity tariffs, but the electricity bill is paid once a month. On the other hand, prices of rice and coconuts have increased, and those items are bought several times a month at a higher frequency. Therefore, although the saving of electricity tariff reduction is greater than the increase in expenses due to increased rice and coconut prices, the latter could have a greater impact on perceived inflation. In addition, the lack of awareness of the concept of inflation could also contribute to the aforementioned difference.

Given the exceptionally high levels of inflation Sri Lanka experienced in 2022 and 2023, a brief period of deflation could provide some relief to households that are still recovering from the large increase in the cost of living. However, prolonged deflation is undesirable, as such episodes are often associated with economic stagnation and rising unemployment. In Sri Lanka's case, sustained deflation is unlikely, with inflation expected to gradually converge to the target over the medium term.

References:

1. D'Acunto, F., Malmendier, U., Ospina, J., & Weber, M. (2021). Exposure to grocery prices and inflation expectations. *Journal of Political Economy*, 129(5), 1615-1639.
2. Georganas, S., Healy, P. J., & Li, N. (2014). Frequency bias in consumers' perceptions of inflation: An experimental study. *European Economic Review*, 67, 144-158.

3.2. Real Sector

Reflecting the continuous strong recovery, the Sri Lankan economy expanded in Q3 2024 and exhibited positive growth momentum in the first nine months of 2024.

As per the GDP estimates of the Department of Census and Statistics (DCS), the Sri Lankan economy grew by 5.5 per cent (y-o-y) in Q3-2024, with positive contributions from all three major sectors.

During this period, Agriculture activities recorded an expansion largely driven by animal production, growing of tea and fruits. The significant growth in Industry activities was led by construction, manufacturing, and mining and quarrying activities. Meanwhile, the expansion in Services activities was largely supported by the positive growth in accommodation, transportation, IT programming, and financial service activities.

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

Economic Activity	2023					2024			
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	9M
Agriculture	1.6	4.2	4.2	0.6	2.6	1.1	1.7	3.0	1.9
Industry	-24.3	-11.7	-0.7	7.9	-9.2	11.8	10.9	10.8	11.2
Services	-4.6	-0.5	1.7	2.8	-0.2	2.6	2.5	2.6	2.6
GDP	**-10.7**	**-3.0**	**1.6**	**4.5**	**-2.3**	**5.3**	**4.7**	**5.5**	**5.2**

Source: Department of Census and Statistics

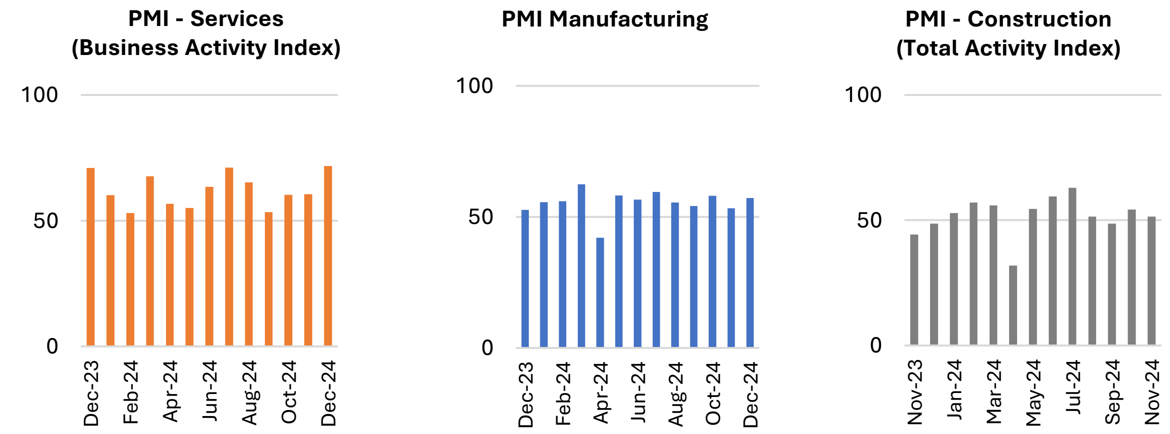
The available leading indicators reflect that the Industry and Services activities continued to lead the positive growth momentum of the economy during Q4-2024. The Index of Industrial Production (IIP) increased on a y-o-y basis in October and November 2024.[12] Reflecting the positive improvements, the Manufacturing Purchasing Managers' Index (PMI) recorded expansions in all three months of the quarter. Meanwhile, Construction PMI also expanded in October and November 2024,[13] reflecting the recovery in construction activities. In terms of Services activities, the strong resilience of PMI Services (Business Activity Index) indicates a positive growth in overall services activities during Q4-2024. Additionally, positive developments in several key activities related to accommodation, food and beverage services, and transport, benefitting from the surge in tourist arrivals, also expected to have contributed to the

[12] As per the latest available data, a similar trend is observed in December 2024 as well.

[13] Construction PMI stood at 51.4 in December 2024, indicating a continued expansion in construction activities.

developments in services activities. Influenced largely by the adverse weather conditions, Agriculture activities are expected to have mixed performances during Q4-2024.

Figure 11: Movements in Purchasing Managers' Indices



Source: Central Bank of Sri Lanka

On the expenditure front, in terms of constant prices, consumption expenditure, which is the dominant expenditure component, continued to record positive growth, while investment expenditure also exhibited a considerable expansion during Q3-2024. On the other hand, net external demand recorded a decline during Q3-2024 as the pace of growth of imports of goods and services was higher than that of exports, in real terms.

Table 02: Aggregate Demand (Provisional)

Item	Constant (2015) Prices							
	2023 Q3		2024 Q3		2023 9M		2024 9M	
	Rs. bn	y-o-y, %	Rs. bn	y-o-y, %	Rs. bn	y-o-y, %	Rs. bn	y-o-y, %
Domestic Demand	2,881	0.2	3,172	10.1	8,653	-6.1	9,236	6.7
Consumption	2,415	0.8	2,503	3.6	6,808	-4.8	6,971	2.4
Investment (Gross Capital Formation)	466	-2.8	669	43.6	1,845	-10.8	2,265	22.8
Net External Demand	107	65.3	-20	-119	140	1,208.8	14	-90.1
+ Exports of goods and services	729	28.9	794	8.9	1,997	11.5	2,259	13.1
- Imports of goods and services	622	24.2	814	30.8	1,857	3.0	2,245	20.9
GDP	**2,988**	**1.6**	**3,152**	**5.5**	**8,794**	**-4.5**	**9,250**	**5.2**

Source: Department of Census and Statistics

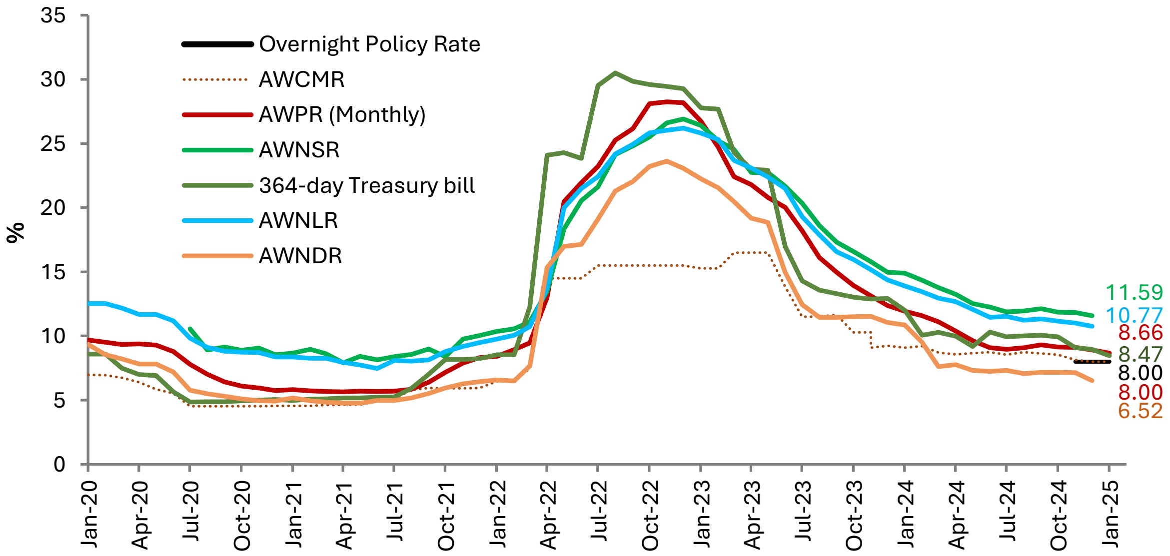
3.3. Monetary Sector

Interest Rates

In response to the eased monetary policy stance and reduced sovereign risk premia, market interest rates, including yields on government securities, declined notably in 2024 and early 2025.

Reflecting the passthrough of the accommodative monetary policy stance of the Central Bank, the overall interest rate structure continued to shift downwards. The introduction of the OPR, which is the single policy interest rate of the Central Bank, in November 2024, helped enhance monetary policy signalling. Accordingly, the Average Weighted Call Money Rate (AWCMR), which is the operating target of the Central Bank under the Flexible Inflation Targeting (FIT) framework, adjusted in line with the OPR supported by increased activity in the domestic money market. Both market deposit and lending interest rates have declined notably, with the reduction in deposit interest rates remaining more pronounced during the period. Interest rates on lending to prime customers by Licensed Commercial Banks (LCBs), as reflected by the Average Weighted Prime Lending Rate (AWPR), reduced notably by January 2025, remaining below 9.00 per cent for several consecutive weeks. Meanwhile, interest rates on new loans extended to Micro, Small and Medium Enterprises (MSMEs), as reflected by the Average Weighted New SME Rate (AWNSR), also reduced notably during 2024. However, despite the reduction in overall market lending interest rates, rates on loans extended to small-scale borrowers remained relatively rigid compared to other market lending interest rates.

Figure 12: Movement in Selected Market Interest Rates

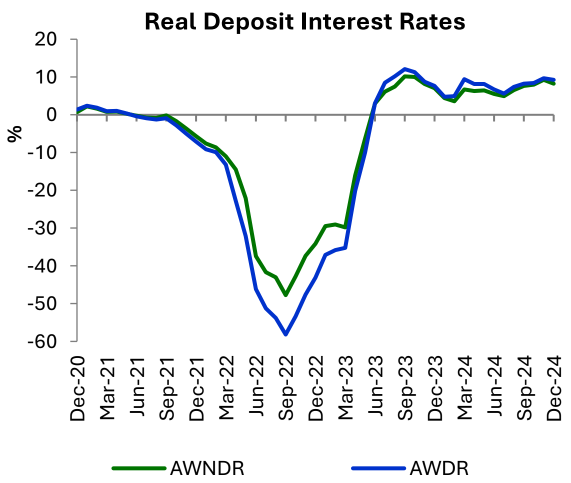


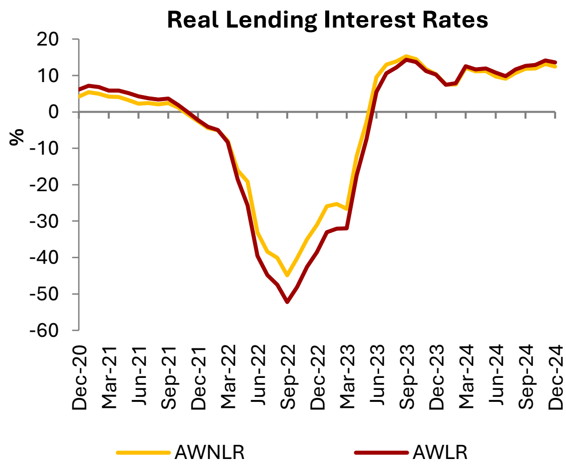
Source: Central Bank of Sri Lanka

Yields on government securities continued to decline sharply since mid-November 2024, reflecting eased monetary conditions, improved fiscal performance, and positive market sentiment driven by the progress of the debt restructuring process. Accordingly, from end 2023 to end January 2025, yields on Treasury bills declined by 4.46–6.58 percentage points.

Despite the decline in nominal market interest rates, real interest rates, when measured using realised inflation levels, continue to remain positive due to prevailing deflationary conditions. However, the anticipated convergence of inflation towards the target in H2-2025 points towards a likely decline in real interest rates.

Figure 13: Ex-Post Real Interest Rates





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

Source: Central Bank of Sri Lanka

Domestic Money Market Liquidity

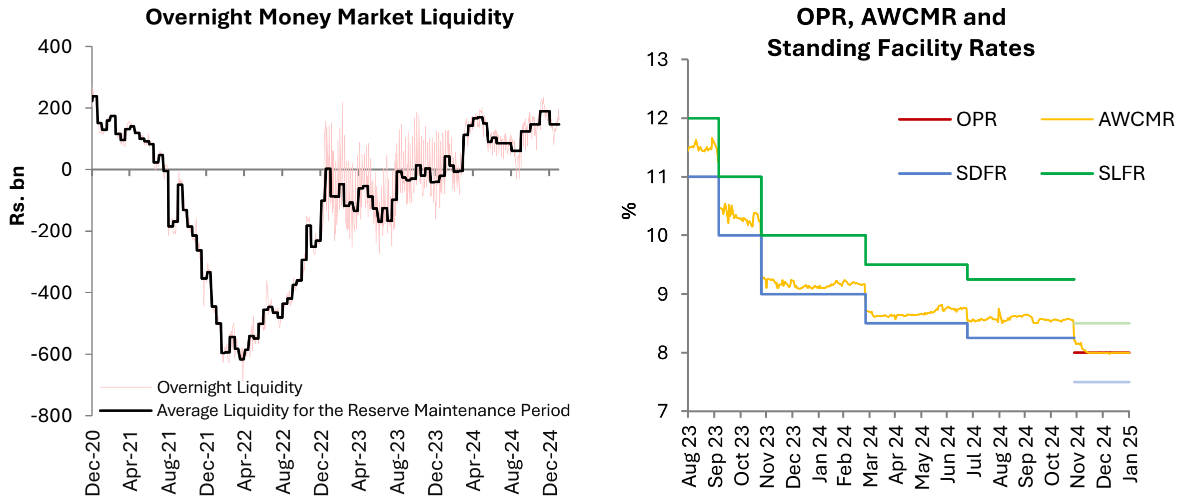
Liquidity conditions in the domestic money market improved notably in 2024 mainly due to foreign exchange transactions of the Central Bank.

Liquidity conditions in the domestic money market improved notably, particularly in Q4-2024, mainly due to net foreign exchange purchases by the Central Bank. However, maturities of the Treasury bill and part of the Treasury bond holding of the Central Bank, coupon payments to the Central Bank on account of the Central Bank's holding of Treasury bonds, and the currency withdrawals, on a net basis, caused a reduction in liquidity in the domestic money market during 2024. The improved liquidity conditions continued in early 2025, averaging around Rs. 150 billion.

However, a continuation of the asymmetric distribution of liquidity among participatory institutions was observed.

The Central Bank infused liquidity on a need basis through overnight and short-term reverse repo auctions under the Open Market Operations (OMOs), to provide certainty on the availability of liquidity among market participants. However, as liquidity conditions remained at notable surplus levels with improved activity among market participants, the Central Bank gradually scaled down OMOs. AWCMR continued to remain at or around the OPR since the second half of December 2024, while the Average Weighted Repo Rate (AWRR) also moved broadly in line with the movements in AWCMR.

Figure 14: Behaviour of Overnight Liquidity, OPR, AWCMR and Standing Facility Rates



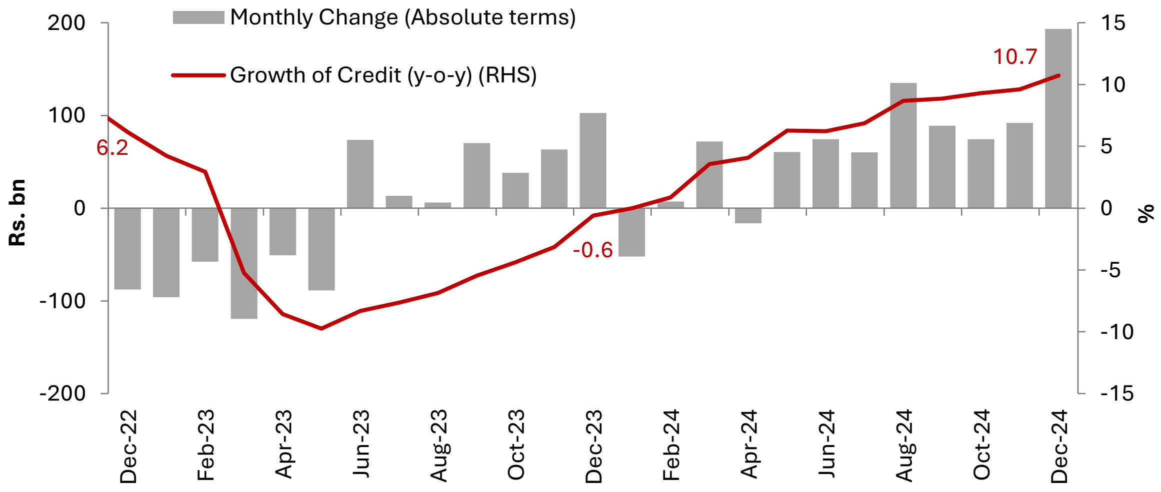
Source: Central Bank of Sri Lanka

Domestic Credit Conditions and Money Supply

The robust pickup in private sector credit along with the expansion in Net Foreign Assets (NFA) of the banking system supported the continuous expansion of broad money supply (M_{2b}) during 2024.

The expansion of credit to the private sector by LCBs has been robust since May 2024 and has expanded at a faster rate than expected in recent months. During 2024, credit to the private sector by LCBs expanded notably by around Rs. 790 billion, recording an annual growth of 10.7 per cent. The growth of credit to the private sector is expected to sustain in the period ahead supported by lower market lending interest rates and the expected continuous expansion in import demand and domestic economic activity.

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



Source: Central Bank of Sri Lanka

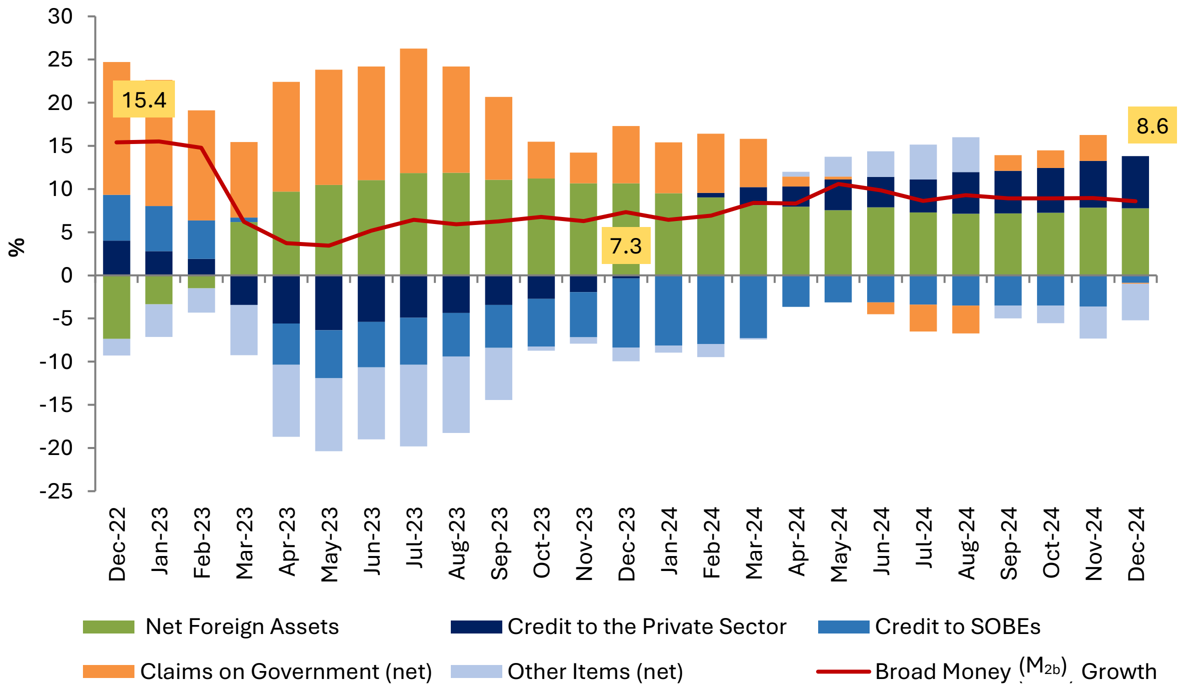
Net Credit to the Government (NCG) by the banking system contracted marginally during 2024, mainly due to the contraction in NCG by the Central Bank, while NCG by LCBs recorded an increase. NCG by the Central Bank recorded a substantial reduction during 2024 mainly due to the offloading of Treasury bills and the reduction in the use of the Standing Lending Facility (SLF) by LCBs. Meanwhile, NCG by LCBs recorded an increase during the year, reflecting the increase in their investments in government securities.

Credit granted to State-Owned Business Enterprises (SOBEs) by LCBs recorded contractions during 2024 mainly due to net repayments by the major SOBEs including the Ceylon Petroleum Corporation (CPC), Road Development Authority (RDA), Colombo Commercial Fertilizer, National Water Supply & Drainage Board, Ceylon Electricity Board (CEB) and SriLankan Airlines.

Reflecting the improvements observed in the external sector, NFA of the Central Bank improved notably during 2024. This reflects the net purchase of foreign exchange from the domestic foreign exchange market, which led to enhanced gross official reserves. NFA of the Central Bank, which was at negative levels for around three consecutive years turned positive in October 2024. Meanwhile, NFA of LCBs contracted during 2024 mainly due to the revaluation effects resulting from the appreciation of the Sri Lanka rupee during the year.

In line with these developments and the easing of monetary conditions, the annual growth of broad money (M_{2b}) accelerated to 8.6 per cent in 2024 compared to 7.3 per cent in 2023.

Figure 16: Contribution to y-o-y Growth of Broad Money (M_{2b})



Source: Central Bank of Sri Lanka

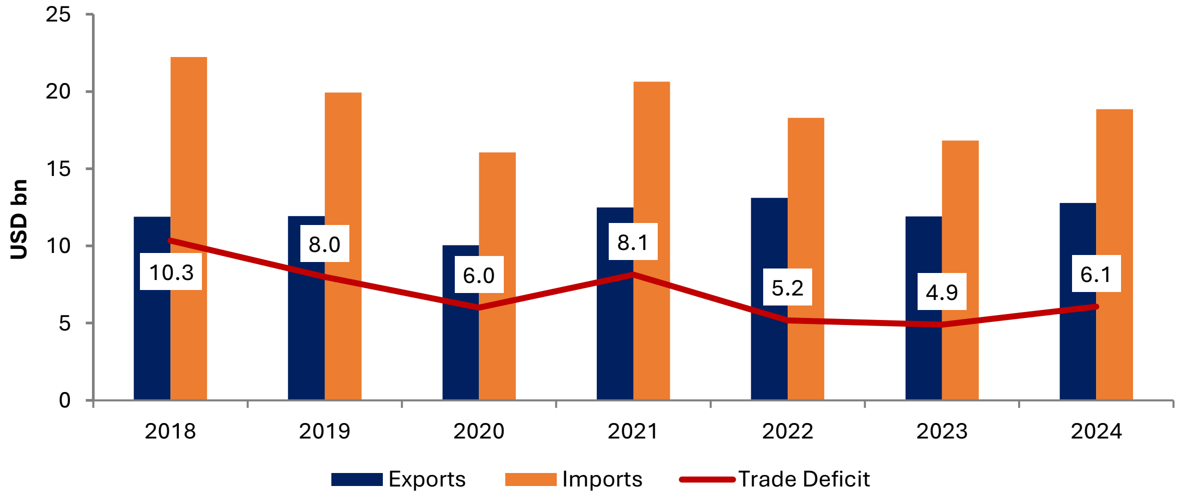
3.4. External Sector

The external sector continued its positive momentum in 2024, characterised by an estimated current account surplus caused by increased inflows, a strengthened reserve position and further stability of the Sri Lanka rupee.

Balance of Payments

The current account balance is estimated to have recorded a surplus in 2024 for the second consecutive year reflecting positive developments during the year. The trade deficit widened to US dollars 6.1 billion in 2024 compared to US dollars 4.9 billion in 2023. This was mainly due to the larger expansion in import expenditure (by 12.1 per cent) outpacing that of export earnings in 2024 (by 7.2 per cent) compared to 2023. However, inflows in terms of earnings from tourism, workers' remittances related inflows and other services inflows have performed better than anticipated levels.

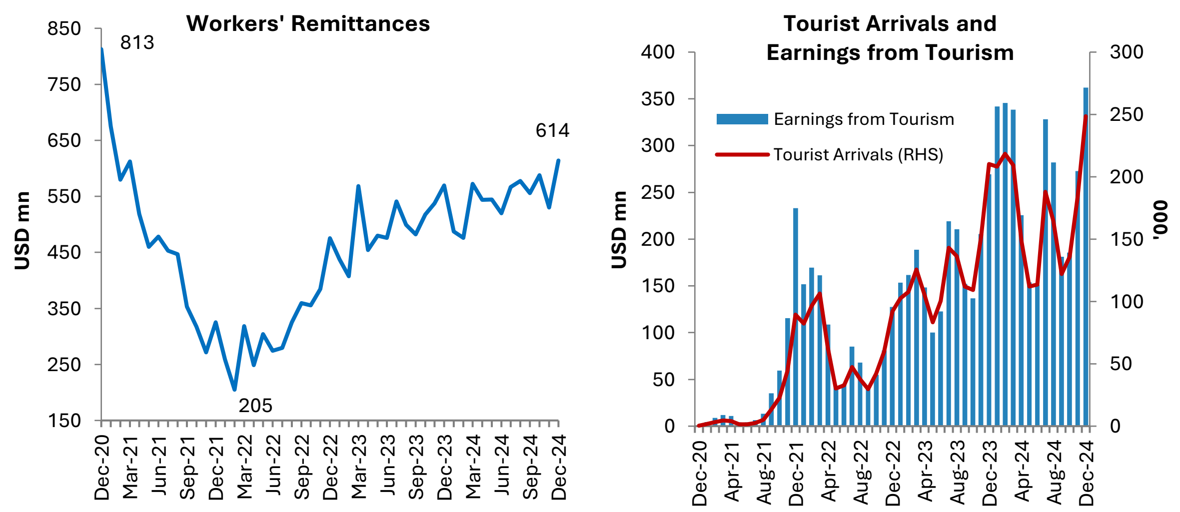
Figure 17: Trade Account



Sources: Central Bank of Sri Lanka
Sri Lanka Customs

With more than 2 million tourist arrivals in 2024, estimated earnings from tourism improved to US dollars 3.2 billion, recording a growth of 53.2 per cent compared to 2023. Excluding earnings from tourism, sea transport services and computer & IT/BPO related services were the other major contributors to inflows to the services sector in 2024. Accordingly, inflows to the services sector excluding tourism amounted to US dollars 3.7 billion in 2024 compared to US dollars 3.3 billion in 2023. Workers' remittances also improved to US dollars 6.6 billion in 2024 compared to US dollars 6.0 billion in 2023, recording a growth of 10.1 per cent.

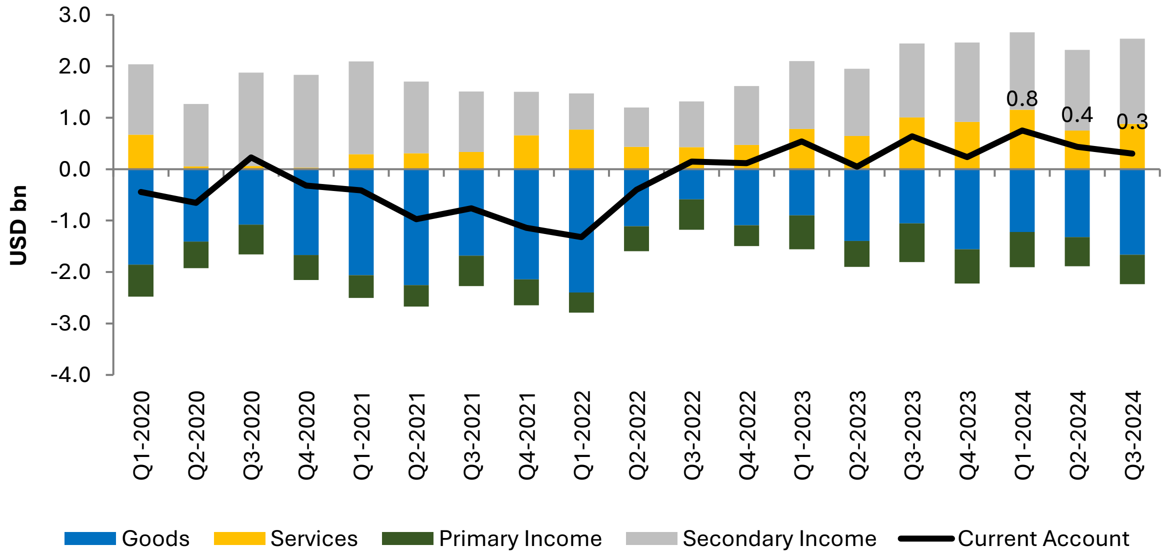
Figure 18: Workers' Remittances and Tourism



Sources: Central Bank of Sri Lanka
Licensed Banks

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

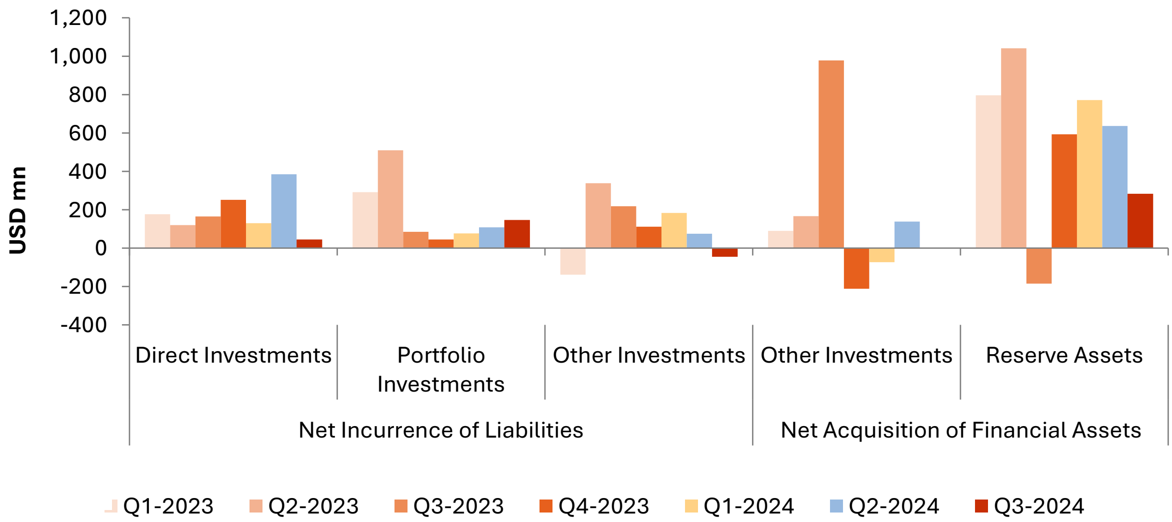
Figure 19: Current Account



Source: Central Bank of Sri Lanka

Although the performance of the current account showed positive developments in 2024, the financial account remained subdued with limited flows. Foreign direct investment (FDI) inflows including foreign loans to direct investment enterprises (DIEs) showed a marginal increase in 2024 compared to 2023. Foreign investments in the government securities market recorded a net outflow of US dollars 179 million in 2024. However, the trend changed to net inflows in the last three months of the year. Meanwhile, foreign investments in the Colombo Stock Exchange (CSE) recorded a net inflow of US dollars 33 million driven by foreign investment inflows in the primary market.

Figure 20: Financial Account

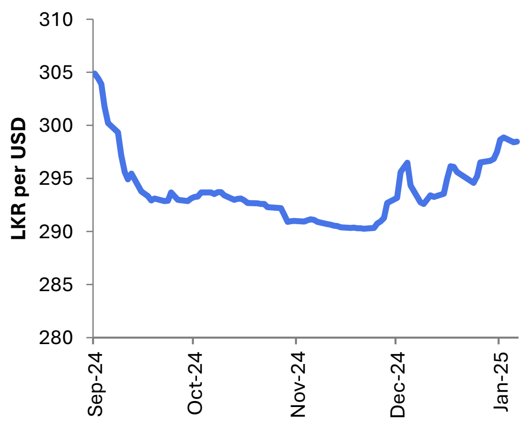


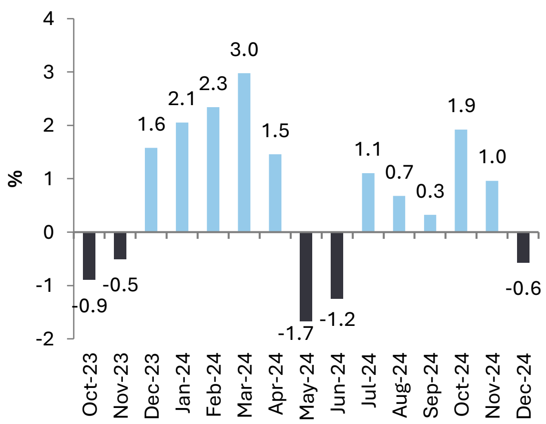
Source: Central Bank of Sri Lanka

Exchange Rate

The Sri Lanka rupee maintained its appreciation trend from H1-2024 throughout the year, despite some intermittent depreciation pressures in H2-2024. Although foreign exchange inflows remained strong supported by increased workers' remittances, higher services exports, and export proceeds conversions, liquidity in the domestic foreign exchange market declined occasionally, particularly in August, September, and December 2024. These pressures were mainly driven by increased import payments and required the Central Bank to intervene on certain days to smoothen intraday fluctuations. However, the Central Bank purchased more than US dollars 2.8 billion, on a net basis, marking the highest-ever annual net purchases of foreign exchange from the domestic foreign exchange market in 2024. Even amidst heavy purchases by the Central Bank, the rupee appreciated by 10.7 per cent against the US dollar in 2024. However, some volatility has been observed in early 2025, with the rupee depreciating by 2.0 per cent as of 28 January 2025. Meanwhile, reflecting cross-currency movements, the Sri Lanka rupee appreciated against other major currencies, such as the Euro, the Pound sterling, the Chinese yuan, the Japanese yen, the Indian rupee, and the Australian dollar during 2024.

Figure 21: Exchange Rate Movements



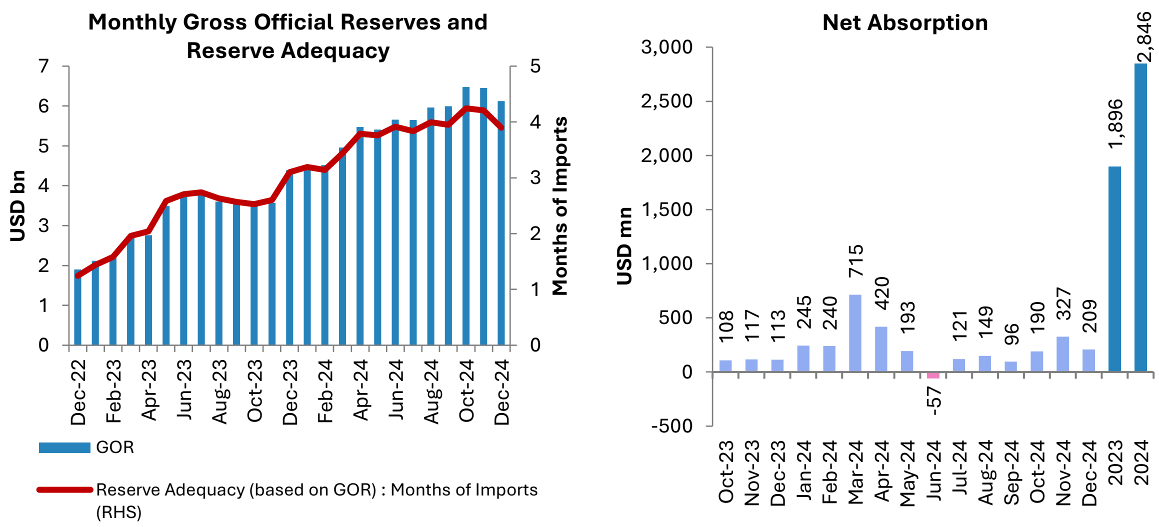


Source: Central Bank of Sri Lanka

Reserve Assets

The Gross Official Reserves (GOR) increased to US dollars 6.1 billion by end 2024, compared to US dollars 4.4 billion recorded as of end 2023. GOR at end 2023 and end 2024 included the swap facility from the People's Bank of China (PBOC) which is subject to conditionalities on usability. The notable increase in reserves was primarily driven by the Central Bank's substantial net forex absorptions from the domestic foreign exchange market in 2024 and inflows from multilateral institutions, including the third tranche of the IMF-EFF. Meanwhile, import coverage of GOR (including the PBOC swap) amounted to 3.9 months of imports as of end December 2024.

Figure 22: Monthly Gross Official Reserves, Reserve Adequacy and Net Absorption



Source: Central Bank of Sri Lanka

3.5. Fiscal Sector[14]

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

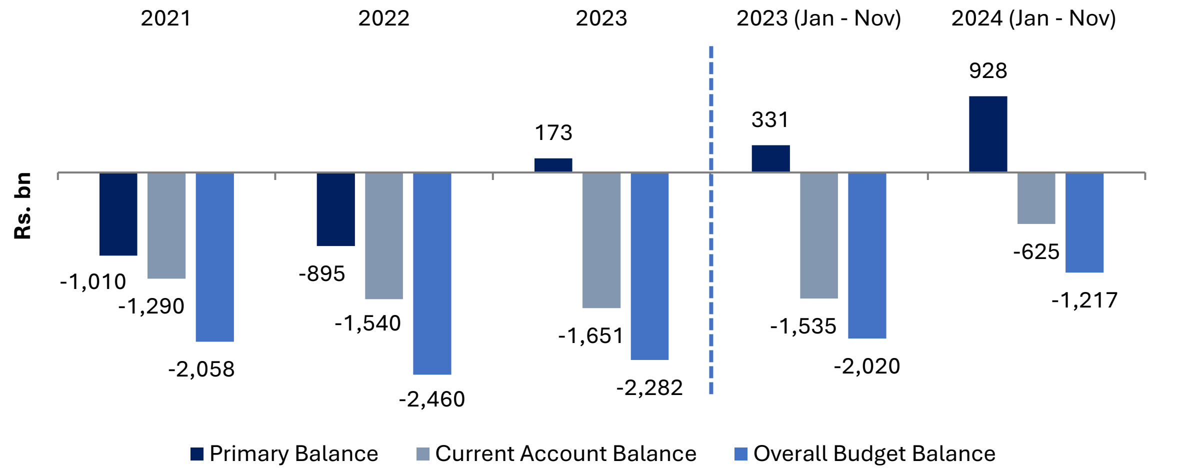
The continuation of robust fiscal consolidation measures has improved all key fiscal balances, i.e., the overall fiscal balance, current account balance, and primary balance, both in nominal terms and as a percentage of projected GDP during the eleven months ending November 2024. Accordingly, the primary balance achieved a notable surplus of Rs. 927.8 billion for the first eleven months of 2024, while the overall fiscal deficit narrowed to Rs. 1,217.3 billion during the same period under review.

During the eleven months ending November 2024, the Government's total revenue and grants increased significantly, compared to the corresponding period in 2023. This increase was primarily driven by higher tax revenues from VAT and excise duties, attributed to recent tax reforms in these areas, and partly due to expanding economic activity. At the same time,

[14] The fiscal data were available only up to November 2024.

continued policy reforms and improved tax administration measures have resulted in a notable y-o-y increase in the income tax collection during the eleven months ending 2024, representing a share of 28.8 per cent of the total tax revenue collection. During the eleven months ending November 2024, non-tax revenue also grew mainly due to increased receipts from interest income. Meanwhile, the total expenditure registered a modest y-o-y increase during the eleven months ending 2024 compared to the previous year. Although capital expenditure and net lending as well as current expenditure on salaries, and subsidies and transfers increased during the period under review, the interest expenses recorded a significant reduction, due to the decrease in government securities yields, benefiting from a relaxed monetary policy stance and reduced risk premium.

Figure 23: Key Fiscal Balances



Source: Ministry of Finance, Planning and Economic Development

During the eleven months ending November 2024, the Government continued to rely primarily on domestic sources to meet the budget deficit, largely due to the existing limitations in accessing the international capital markets. Meanwhile, the net outstanding central government debt[15] reduced marginally in rupee terms by end November 2024 to Rs. 28.2 trillion from the Rs. 28.7 trillion recorded at end 2023.

Furthermore, marking a major milestone in the country's journey of economic recovery, the Government completed its debt restructuring process successfully, except for a small portion,

[15] The outstanding central government debt excludes several debt service payments that became overdue after 12 April 2022, the date on which the Interim Policy regarding the servicing of Sri Lanka's external public debt was announced by the Ministry of Finance, Planning and Economic Development. These debt service payments comprise overdue interest payments of affected debt. Furthermore, the debt statistics are presented on net basis (net of deposits).

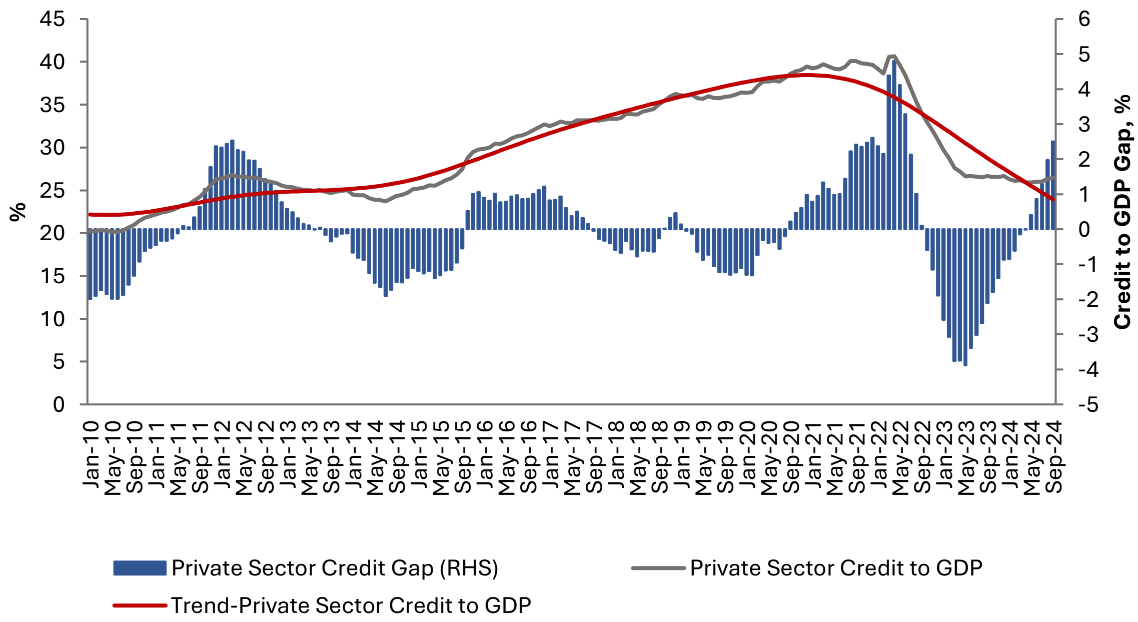
by end 2024, paving the way for the normalisation of relations with creditors and external partners. Following these developments, leading international rating agencies, Fitch and Moody's upgraded Sri Lanka's foreign currency credit ratings in December 2024 to CCC+ and Caa1 from RD and Ca, respectively, notably reducing the country's risk premium. These upgrades reflect the international community's recognition of Sri Lanka's progress in addressing external vulnerabilities and its efforts toward achieving sustainable growth.

3.6. Financial Sector

With the gradual restoration of macroeconomic stability, domestic macrofinancial conditions continued to improve in 2024.

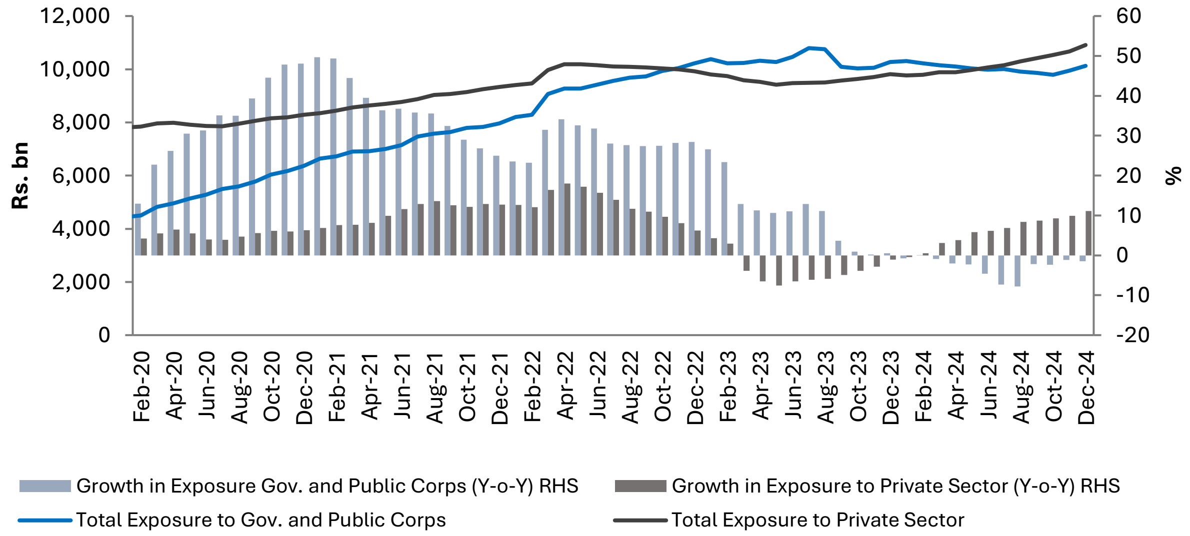
Owing to favourable economic growth and deflationary conditions, the pressure on households' and firms' balance sheets is somewhat relieved, improving the debt repayment capacities and lowering credit risk in the financial sector. The credit cycle, which is reflected by the private sector credit-to-GDP gap (the Credit Gap), progressed within the expansionary phase, with the gradual widening of the credit gap. With the recovery in credit to the private sector and continued fiscal consolidation, the tilt in the exposure of financial institutions to the public sector is declining.

Figure 24: Credit-to-GDP Gap



Source: Central Bank of Sri Lanka

Figure 25: Financial Sector Exposure to Public and Private Sectors*



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

Source: Central Bank of Sri Lanka

The resilience of the financial sector gradually improved during 2024 amidst easing macroeconomic conditions. The total assets of the banking sector grew during the period under review mainly due to increased investments and loans and receivables. Accordingly, assets of the banking sector recorded a y-o-y growth of 8.7 per cent at end 2024 and stood at Rs. 22.2 trillion. Gross loans and receivables of the banking sector grew by 4.1 per cent, y-o-y, at end 2024, amidst the easing monetary policy stance.

Overall default risk of the banking sector, as reflected through the Stage 3 Loans Ratio, reduced to 12.3 per cent at end 2024 compared to 12.8 per cent recorded at end 2023, yet it remained above the Stage 3 Loans Ratio of the Finance Companies (FCs) sector which amounted to 11.3 per cent at end 2024. The Stage 3 loans have also been contracting since June 2024 on a y-o-y basis, indicating a gradual easing of credit risk in the banking sector. Profit After Tax (PAT) of the banking sector significantly increased during 2024 compared to the previous year. Accordingly, the banking sector reported a PAT of Rs. 309.8 billion in 2024 compared to Rs. 188.4 billion in 2023.

Liquidity conditions of the banking sector, as measured by Liquidity Coverage Ratios (LCR) and the Net Stable Funding Ratio (NSFR) improved at end 2024 compared to the end of the previous year. Rupee LCR of the banking sector improved to 349.9 per cent at end 2024 compared to 340.8 per cent at end 2023 and stood well above the minimum regulatory requirement of 100 per cent. Despite an increase in Risk Weighted Assets (RWA), the Capital Adequacy Ratio (CAR) of the banking sector significantly improved to 18.4 per cent at end 2024 compared to 17.0 per cent at end 2023, as a result of higher growth in regulatory capital. The regulatory capital of banks recorded a notable growth of 15.5 per cent on a y-o-y basis, driven by increases in published retained earnings and qualifying Tier-2 capital instruments and a decline in net deferred tax assets, depicting the enhancement of capital buffers that strengthens their ability to absorb potential losses.

The FCs sector recorded a y-o-y expansion of 20.9 per cent in its loans and advances portfolio at end December 2024, mainly due to the increase in finance leases, pawning/gold loans and personal loans. Gross non-performing loans ratio of the sector decelerated to 11.3 per cent by end December 2024 compared to 18.0 per cent at end December 2023, indicating an improvement in credit quality. The liquidity position of the sector remained above the regulatory requirement at end December 2024. Further, the sector reported a PAT of Rs. 43.1 billion for the first nine months of the financial year 2024/25 and at end December 2024, the sector recorded a CAR of 21.2 per cent.

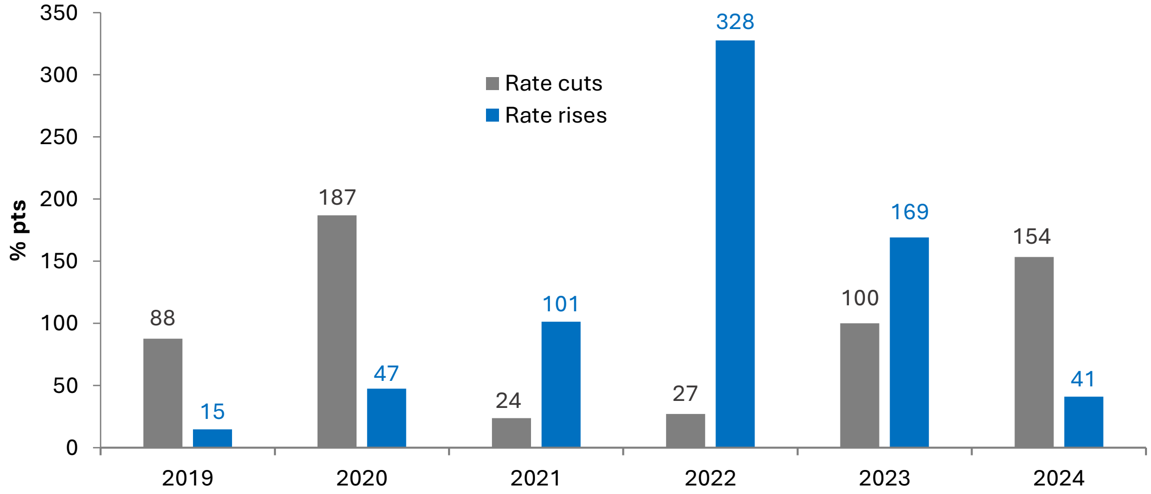
On the equity market front, the CSE recorded notable gains during 2024 recording a growth of 49.7 per cent in the All Share Price Index (ASPI) and 58.5 per cent in the Standard & Poor's Sri Lanka 20 (S&P SL20) during 2024. The positive momentum continued into 2025 with the ASPI surpassing 17,000 index points for the first time in its history reflecting improved investor sentiment amidst a low interest rate environment.

3.7. Global Developments

Global growth is expected to stabilise with modest inflation, leading major central banks to cautiously ease monetary policy, but heightened global uncertainties and policy shifts could slow the pace of normalisation of monetary policy, posing risks to growth prospects.

As inflation decelerates globally, most central banks have begun easing their monetary policy stance at a slower pace to stimulate economic activity, while remaining cautious to ensure inflation stays on track to meet its target. However, heightened global uncertainties, including geopolitical tensions, potential global effects of a policy shift in the US under the new president, and inflationary developments in some regions, have delayed the normalisation of monetary policy, posing risks to global growth prospects. As per the IMF's World Economic Outlook (WEO) January 2025 update, global growth is projected to stabilise in 2025 and 2026, below the historical average, while the global disinflation trend is expected to continue, although progress is slowing due to elevated services inflation in some countries.

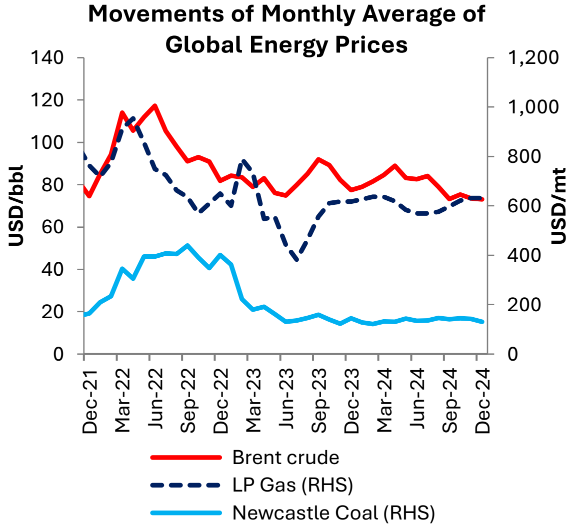
Figure 26: Global Policy Rate Changes



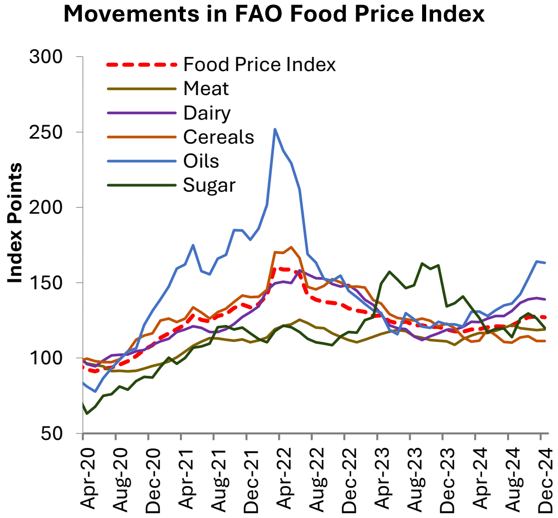
Source: https://www.cbrates.com

Global commodity prices remained volatile due to supply and demand imbalances caused by geopolitical tensions and extreme weather conditions that disrupt supply chains, as well as changing global demand conditions resulting from the uneven economic recovery. Despite steady monthly increases in food prices for most of 2024, the Global Food Price Index, on average, remained below its 2023 level. Meanwhile, global energy prices also continued to remain volatile during 2024.

Figure 27: Global Commodity Prices



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



Source: Food and Agriculture Organization (FAO)

LIST OF ACRONYMS

ASPI	All Share Price Index
AWCMR	Average Weighted Call Money Rate
AWDR	Average Weighted Deposit Rate
AWLR	Average Weighted Lending Rate
AWNDR	Average Weighted New Deposit Rate
AWNLR	Average Weighted New Lending Rate
AWNSR	Average Weighted New SME Lending Rate
AWPR	Average Weighted Prime Lending Rate
AWRR	Average Weighted Repo Rate
BOP	Balance of Payments
bps	basis points
CAR	Capital Adequacy Ratio
CBA	Central Bank of Sri Lanka Act, No. 16 of 2023
CCPI	Colombo Consumer Price Index
CI	Confidence Interval
CEB	Ceylon Electricity Board
CoPF	Committee on Public Finance
CPC	Ceylon Petroleum Corporation
CSE	Colombo Stock Exchange
DCS	Department of Census and Statistics
DIEs	Direct Investment Enterprises
EFF	Extended Fund Facility
FAO	Food and Agriculture Organization
FCs	Finance Companies
FDI	Foreign Direct Investment
FIT	Flexible Inflation Targeting
GDP	Gross Domestic Product
GOR	Gross Official Reserves
GPMN	Global Projection Model Network
IIP	Index of Industrial Production
IMF	International Monetary Fund
IPSWRI	Informal Private Sector Wage Rate Index

ISB	International Sovereign Bond
IT/BPO	Information Technology/Business Process Outsourcing
LCBs	Licensed Commercial Banks
LCR	Liquidity Coverage Ratio
LP Gas	Liquefied Petroleum Gas
m-o-m	month-on-month
MPFA	Monetary Policy Framework Agreement
MPR	Monetary Policy Report
MSMEs	Micro, Small and Medium Enterprises
NCG	Net Credit to the Government
NCPI	National Consumer Price Index
NFA	Net Foreign Assets
NSFR	Net Stable Funding Ratio
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
OPR	Overnight Policy Rate
PAT	Profit After Tax
PBOC	People's Bank of China
PMI	Purchasing Managers' Index
QPM	Quarterly Projection Model
QR	Quick Response
RHS	Right Hand Side
RD	Restricted Default
RDA	Road Development Authority
RWA	Risk Weighted Assets
SDFR	Standing Deposit Facility Rate
SLDB	Sri Lanka Development Bond
SLF	Standing Lending Facility
SLFR	Standing Lending Facility Rate
SMEs	Small and Medium Enterprises
SOBEs	State-Owned Business Enterprises
S&P SL20	Standard & Poor's Sri Lanka 20
UK	United Kingdom
US	United States

USD	United States Dollar
VAT	Value Added Tax
WEO	World Economic Outlook
y-o-y	year-on-year

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