

UNDERSTANDING FLEXIBLE INFLATION TARGETING AND MONETARY POLICY PROCESS IN SRI LANKA

Introduction

Inflation, in simple terms, is the sustained increase in general price levels across an economy. Such general price levels are usually measured by the price movements of a selected basket of goods and services consumed by an average household. In Sri Lanka, the Department of Census and Statistics (DCS) is the authorised agency that compiles these statistics, which are published monthly. The most widely used measure of inflation is year-on-year inflation, which is measured by comparing today's general price level with that from the same time a year earlier. Accordingly, if a country records an inflation rate of 5%, it means that, on average, prices of the respective basket of goods and services are 5% higher today than they were a year ago.

If inflation is too high or unpredictable, businesses may struggle to set proper prices, and people may find it hard to plan their spending. Conversely, if inflation remains negative, i.e., prices are continuously decreasing, a situation known as a deflationary episode, people may delay purchases in anticipation of lower prices. Prolonged deflation discourages producers, disrupts business activity, and can lead to a slowdown in economic growth.

The Flexible Inflation Targeting Framework

The set of strategies, tools and institutional arrangements that a central bank uses to achieve its monetary policy objective is termed its monetary policy framework. The monetary policy framework adopted by the Central Bank has evolved in response to changes in the domestic and global economic landscape. After following a framework focused on maintaining a fixed exchange rate in the early years after its establishment, the Central Bank adopted a Monetary Targeting framework by the early 1980s. Having undergone a period of gradual transitioning and capacity-building, the Central Bank adopted Flexible Inflation Targeting (FIT) as its monetary policy framework in 2020.

Monetary policy decisions influence the economy through multiple transmission channels over time. When the Central Bank adjusts its policy, it affects borrowing costs, spending behaviour, and investment decisions in the economy. For instance, if interest rates rise, individuals and businesses tend to borrow less and increase savings. This reduces real economic activity, lowering overall demand and easing inflationary pressures. Conversely, lowering interest rates can encourage spending and borrowing, which can stimulate demand and potentially increase inflation. This mechanism represents the general means of controlling inflation through monetary policy actions, which helps the Central Bank to keep inflation stable.

Under the FIT framework, the Central Bank aims to steer inflation towards a publicly announced target through its policy actions. As such, the Central Bank needs to have a clear understanding of the policy transmission process. Accordingly, the FIT framework encompasses an announced numerical inflation target, forward-looking monetary policy decision-making focused on medium-term inflation forecasts, a high degree of transparency and accountability of monetary policy, an enhanced level of independence granted to the Central Bank, a clear price stability mandate, effective fiscal-monetary coordination, a flexible exchange rate framework and strong data-driven policy analysis capabilities.

With the enactment of the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA), FIT was statutorily recognised as the monetary policy framework of the Central Bank. A number of enablers of FIT were formalised with the enactment of the CBA. The primary objective of the Central Bank was stipulated as achieving and maintaining domestic price stability. The Monetary Policy Board (MPB), the decision-making authority for monetary policy, comprising experts in economics or finance, was established and given the responsibility of formulating monetary policy and implementing a flexible exchange rate regime in line with the FIT framework. Moreover, the independence of the Central Bank in relation to monetary policy was enhanced in several important ways, including the removal of the Secretary to the Treasury from the monetary policy decision-making body and the prohibition of the Central Bank financing the Government budget. Further, space has been created for better coordination between monetary and fiscal policy. Accordingly, coupled with efforts over several years prior to the formal adoption of FIT to enhance the technical capacity of the central bank staff, the enactment of the CBA provided the statutory support required in implementing the FIT framework.

Inflation Target

The inflation target is formally announced to the public by means of the Monetary Policy Framework Agreement (MPFA), signed between the Minister of Finance and the Central Bank in October 2023 and was published in the Government Gazette on 5 October 2023. As stipulated in the MPFA, the Central Bank is required to maintain the Colombo Consumer Price Index (CCPI)-based quarterly headline inflation at 5%. The Minister of Finance and the Central Bank review the inflation target and related parameters once every three years or in case of exceptional circumstances. Choosing an achievable target, announcing it publicly, and committing to its achievement with a clear mandate help anchor inflation expectations around the target, which is a key success factor in implementing FIT.

What happens if the Central Bank fails to meet the inflation target?

Section 26(5) of the CBA states that if the Central Bank fails to meet the 5% inflation target by ± 2 percentage points for two consecutive quarters, meaning if quarterly headline inflation remains above 7% or falls below 3% for two consecutive quarters, MPB of the Central Bank must submit a report to the Parliament through the Minister of Finance. This report must also be made available to the public. This report should explain the reasons for missing the target, the proposed actions that the Central Bank will take, and the expected timeframe within which the 5% target is expected to be met. Such reports were submitted to the Minister of Finance in December 2024, March, June and August 2025, as quarterly headline inflation failed to meet the inflation target by the determined margin in the last three quarters of 2024 and the first two quarters of 2025. Subsequently, another such report is to be submitted to the Minister of Finance, with the quarterly headline inflation of the third quarter of 2025 failing to meet the same criteria.

Monetary Policy Decision-Making Process

MPB of the Central Bank, tasked with formulating monetary policy and managing a flexible exchange rate regime in line with the FIT framework, considers prevailing macroeconomic and financial conditions of the economy and its outlook into account in their decision-making process.

Given that monetary policy actions impact inflation with a lag, monetary policy decisions are forward-looking and data-driven. The MPB members shall meet at least once in two months to determine the monetary policy stance appropriately. Following each MPB meeting, a press release is issued, accompanied by an analysis of recent economic developments and the economic outlook that informs the decision. Figure 01 elaborates this decision-making process, currently employed at the Central Bank.

Improved Central Bank Autonomy and Accountability

The enactment of the CBA in 2023 granted the Central Bank the necessary autonomy to operate independently in pursuit of its primary objective of maintaining domestic price stability, while ensuring accountability to the public. To uphold this accountability, the Central Bank regularly publishes

information on its monetary policy strategy and decisions through frequent reports and publications, which are submitted to the Parliament and made available to the public, thereby maintaining transparency in monetary policy formulation and implementation. The CBA also mandates the Parliament or its Committees to summon the Governor and staff of the Central Bank at least once every four months to review the Bank's functions. Importantly, by restricting direct or indirect monetary financing of the government, CBA reinforces the fiscal discipline and safeguards the credibility of monetary policy.

Conclusion

Maintaining domestic price stability through the FIT framework is the primary objective of the Central Bank. By pursuing the 5% inflation target, supported by strong institutional independence, accountability and transparency, the Central Bank aims to anchor inflation expectations and ensure price predictability in the economy.

Although challenges such as supply shocks highlight the complexities of maintaining price stability, the use of forward-looking policy tools, robust communication and strengthened policy credibility underscore the Central Bank's unwavering commitment to safeguarding the domestic price stability. With recent reforms, such as cost-reflective pricing mechanisms in the energy sector, the ability of the Central Bank to guide inflation towards its target is expected to be enhanced in the years ahead.

