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## Monetary Policy Review: No. 05 - July 2022

### The Central Bank of Sri Lanka further tightens its Monetary Policy Stance

The Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 06 July 2022, decided to increase the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 100 basis points to 14.50 per cent and 15.50 per cent, respectively. Having noted the higher than expected escalation of headline inflation recently and the increased persistence of high inflation in the period ahead, the Board was of the view that a further monetary policy tightening would be necessary to contain any build-up of adverse inflation expectations. In arriving at this decision, the Board weighed the impact of tighter monetary conditions on overall economic activity, including the micro, small, and medium scale businesses, and the financial sector performance, among others, against far reaching adverse consequences of any escalation of price pressures across all sectors of the economy in the near term. On balance, the Board was of the view that this policy adjustment would help guide inflation expectations to be anchored around the targeted level of headline inflation over the medium term, while curtailing any build-up of underlying demand pressures in the economy.

#### Central banks have become increasingly hawkish across the globe

Central banks from around the world continue to tighten their monetary policies to counter sustained inflationary pressures, exacerbated by high petroleum and food prices arising from geopolitical tensions, and destabilising inflation expectations. Nevertheless, the outlook for the global economy has deteriorated recently amidst the global spread of inflation, substantial interest rate hikes, and escalation of geopolitical tensions. The unfolding of these events could have large negative spillover effects on emerging market and developing economies in the period ahead.

#### Domestic economic activity is expected to record a notable downturn in the near term

As per the GDP estimates published by the Department of Census and Statistics (DCS), the Sri Lankan economy is estimated to have recorded a contraction of 1.6 per cent, year-on-year, in the first quarter of 2022. Domestic economic activity during the second quarter of 2022 is expected to have been severely affected by the continued supply side disruptions, primarily due to the shortages of power and energy. Amidst adverse developments on the domestic front, geopolitical tensions in Eastern Europe that have affected global commodity markets and supply chains could pose further risks to domestic economic growth in the near term.

## **The external sector continues to face heightened challenges**

The trade deficit narrowed significantly in May 2022 over the corresponding period of last year, largely supported by the policy measures that were aimed at discouraging non urgent imports, alongside the constrained foreign exchange liquidity in the domestic foreign exchange market. Foreign exchange inflows in the form of workers' remittances and tourism earnings remain lower than expected, impacted by unfavourable conditions both domestically and globally. The exchange rate, which underwent a severe bout of depreciation in March 2022, remains broadly stable with the introduction of market guidance from mid-May 2022. Gross official reserves, as at end June 2022, are estimated at US dollars 1.9 billion, including the swap facility from the People's Bank of China equivalent to around US dollars 1.5 billion, which is subject to conditionalities on usability. Significant progress has been made with respect to negotiations with the International Monetary Fund (IMF) towards reaching a staff-level agreement on the Extended Fund Facility (EFF) arrangement in the near term, while negotiations with several bilateral and multilateral partners are ongoing to secure bridging financing. Moreover, expeditious arrangements are being made with regard to the external debt restructuring process.

Ensuring external sector stability and overall macroeconomic stability requires commitment from all stakeholders of the economy, given the unprecedented balance of payments pressures and severe stresses experienced at present across all sectors of the economy. The measures introduced by the Central Bank to ensure domestic monetary stability and external stability of the Sri Lanka rupee, need to be supported by coherent and consistent actions on the part of the Government, state-owned enterprises, private sector corporates, and banking and non-banking financial institutions, among others. Such co-ordinated response to crisis management would ensure public support and eventually help bring about normalcy to economic activity in the period ahead.

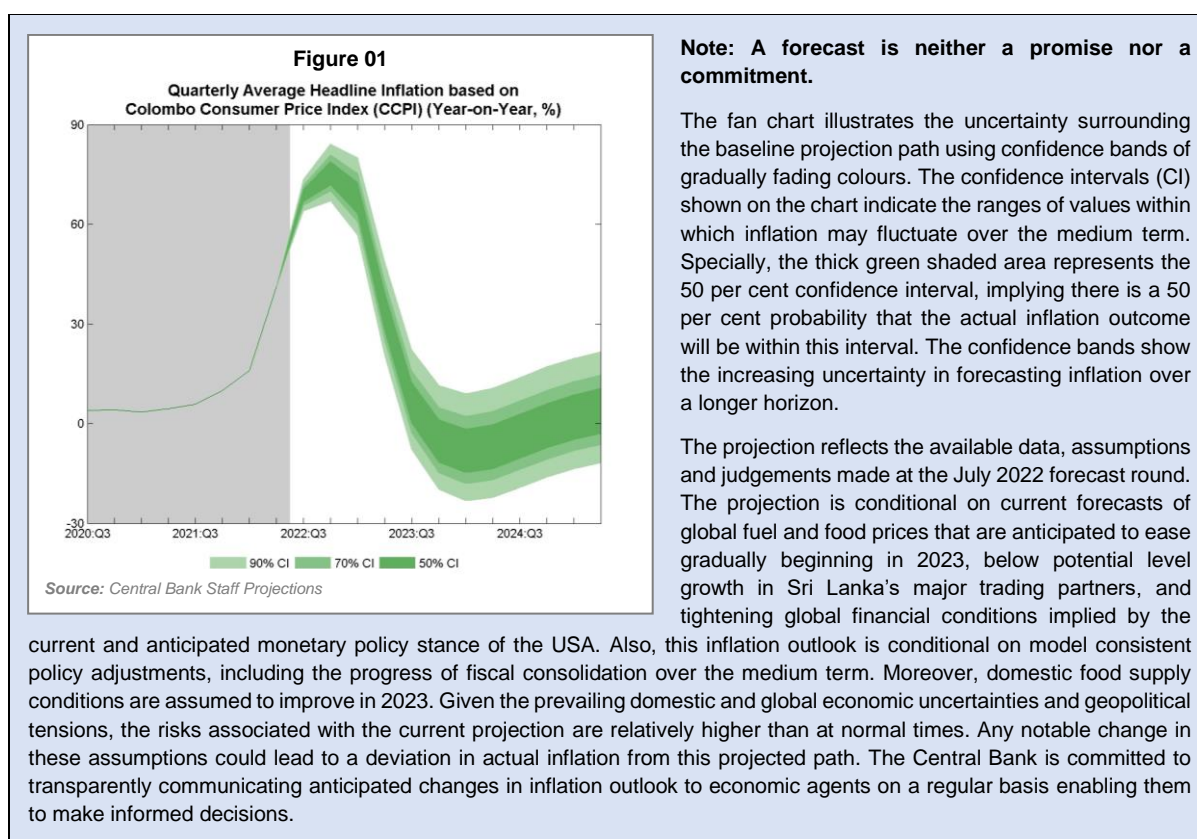
## **Market interest rates continue to adjust upwards in response to tight monetary and liquidity conditions**

With the transmission of significant monetary policy tightening measures introduced thus far, market interest rates have adjusted upwards considerably. Yields on government securities have also risen recently, reflecting the impact of heightened uncertainties, escalation of inflation, and the continued large borrowing requirement of the Government. These developments have also resulted in the build-up of anomalies in the interest rate structure of selected financial instruments. Meanwhile, the growth of credit to the private sector, once adjusted for the impact of the depreciation of the Sri Lanka rupee against the US dollar, recorded signs of slowing in May 2022, year-on-year, while the expansion of broad money has been weighed down by the contraction in net foreign assets of the banking system. The elevated lending interest rates are expected to slow the expansion of money and credit aggregates in the period ahead, while the high deposit interest rates are expected to draw a significant amount of money in circulation into the banking system.

Faster implementation of the expected fiscal reforms aimed at strengthening government revenue mobilisation and expenditure rationalisation is needed to reinforce fiscal consolidation efforts, including the expected improvements in the financial position of state-owned business enterprises. Such adjustment in fiscal sector performance would result in a decline in gross financing needs of the Government in the period ahead, and help scale down monetary financing at a faster pace.

## Although inflation is projected to remain elevated during the remainder of the year, a sharp disinflation path is expected thereafter with appropriate policy measures

Headline inflation has accelerated to an unprecedentedly high level predominantly due to global energy and food price hikes and associated passthrough to domestic prices, domestic supply side disruptions along with the impact of the depreciation of the rupee, tax adjustments and the lagged impact of monetary accommodation. Headline inflation is expected to further increase in the near term driven by these factors and their second round effects. With continued and appropriate corrective policy measures, alongside the expected normalisation of world commodity prices with the normalisation of supply conditions over the medium term, headline inflation is expected to trend downwards, and is projected to be in line with the desired range over the medium term. The subdued aggregate demand stemming from tight monetary and fiscal conditions and the favourable statistical base effect would also aid in softening inflationary pressures, going forward.



## Policy rates are increased further to rein in inflationary pressures

After carefully considering the current and expected macroeconomic developments both globally and domestically, the Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 06 July 2022, decided to increase the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank by 100 basis points to 14.50 per cent and 15.50 per cent, respectively. While recognising the possible ramifications on domestic economic activity, among others, the Board was of the view that a further tightening of the stance of monetary policy was necessary to ensure macroeconomic stability, by further curtailing any underlying demand pressures

in the economy. Such monetary policy tightening is expected to ensure that inflation expectations remain anchored around the targeted level of headline inflation over the medium term. The Board, however, wishes to reiterate that the remedial policy measures adopted by the Central Bank need to be complemented by timely and appropriate policy adjustments by the Government, including the need for the expeditious implementation of fiscal consolidation measures, alongside efficient and effective social welfare programmes to support the vulnerable groups of the society. The Central Bank would continue to closely monitor domestic and global macroeconomic and financial market developments and be prepared to take further policy measures as appropriate to help reinforce greater stability in the economy in the period ahead, while ensuring a faster return of inflation to the targeted 4-6 per cent range over the medium term, under the flexible inflation targeting framework.

**Monetary Policy Decision:      Policy rates increased and SRR unchanged**

Standing Deposit Facility Rate (SDFR)	14.50%
Standing Lending Facility Rate (SLFR)	15.50%
Statutory Reserve Ratio (SRR)	4.00%

**INFORMATION NOTE:**

A press conference, chaired by Governor Dr. P Nandalal Weerasinghe, will be held on 07 July 2022 at 11.00 am at the Atrium of the Central Bank of Sri Lanka, and proceedings will be livestreamed on Facebook and YouTube.

The release of the next regular statement on monetary policy review will be on 18 August 2022.

## Annexure I

**Table 01: Real GDP Growth (Provisional)**

Economic Activities	Year-on-Year % Change (a)										
	2020					2021					2022
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Annual	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Annual	First Quarter
<b>Agriculture</b>	-5.5	-4.0	3.9	-0.4	-1.4	6.4	11.2	-2.8	-3.1	2.5	-6.8
<b>Industries</b>	-4.2	-18.7	-0.7	1.1	-5.3	6.0	21.6	-2.0	1.4	5.6	-4.7
<b>Services</b>	2.8	-13.1	0.5	1.0	-1.9	3.5	8.3	-1.7	4.3	3.3	0.7
<b>GDP</b>	<b>-0.9</b>	<b>-14.8</b>	<b>1.5</b>	<b>-0.7</b>	<b>-3.5</b>	<b>4.0</b>	<b>16.3</b>	<b>-5.8</b>	<b>2.0</b>	<b>3.3</b>	<b>-1.6</b>

(a) Based on rebased GDP estimates (base year 2015)

Source: Department of Census and Statistics

**Table 02: Inflation**

Month		Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22
<b>Headline Inflation (Year on year % change)</b>	CCPI (2013=100)	9.9	12.1	14.2	15.1	18.7	29.8	39.1	54.6
	NCPI (2013=100)	11.1	14.0	16.8	17.5	21.5	33.8	45.3	-
<b>Core Inflation (Year on year % change)</b>	CCPI (2013=100)	7.0	8.3	9.9	10.9	13.0	22.0	28.4	39.9
	NCPI (2013=100)	8.8	10.8	12.9	14.1	17.3	27.9	37.7	-

Source: Department of Census and Statistics

**Table 03: Monetary Sector Developments (Provisional)**

Indicator	Outstanding Amount (Rs. billion)								
	Sep 21	Oct 21	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22 (a)	Apr 22 (a)	May 22 (a)
Reserve Money	1,296	1,286	1,288	1,306	1,337	1,324	1,387	1,482	1,415
Broad Money (M <sub>2b</sub> )	10,488	10,582	10,546	10,647	10,668	10,755	11,576(b)	11,941	11,897
Net Foreign Assets (NFA)	(722)	(837)	(906)	(982)	(1,216)	(1,275)	(1,889)	(2,195)	(2,083)
Net Domestic Assets (NDA)	11,210	11,418	11,452	11,629	11,883	12,030	13,464	14,136	13,980
Net Credit to the Government (NCG)	5,595	5,665	5,714	5,832	6,048(b)	6,094	6,544(b)	6,548	6,499
Credit to Public Corporations / SOBEs	1,123	1,194	1,185	1,188	1,192	1,238	1,548	1,725	1,750
Credit to the Private Sector	6,825	6,860	6,920	6,981	7,017	7,051	7,533(b)	7,753	7,754
Broad Money (M <sub>4</sub> )	12,742	12,873	12,862	12,985	13,058	13,167	13,992	14,356	14,340

(a) The sharp depreciation of the Sri Lanka rupee during March-May 2022 remains the key reason for the augmentation of monetary and credit aggregates in rupee terms from March-May 2022.

(b) Revised

Source: Central Bank of Sri Lanka

**Table 04: Interest Rates**

Interest Rate (%)	End Jan 22	End Feb 22	End Mar 22	End Apr 22	End May 22	End Jun 22	As at 06 Jul 22
<b>Key Policy Interest Rates of the Central Bank</b>							
Standing Deposit Facility Rate	5.50	5.50	6.50	13.50	13.50	13.50	13.50
Standing Lending Facility Rate	6.50	6.50	7.50	14.50	14.50	14.50	14.50
<b>Bank Rate</b>	9.50	9.50	10.50	17.50	17.50	17.50	17.50
<b>Average Weighted Call Money Rate (AWCMR)</b>	6.48	6.48	7.49	14.50	14.50	14.50	14.50
<b>Treasury bill yields (Primary market)</b>							
91-day	8.63	8.61	12.92	23.53	23.65	23.85	28.08
182-day	8.55	8.53	12.25	23.96	24.22	24.40	28.74
364-day	8.55	8.53	12.28	24.09	24.30	23.84	28.11
<b>Lending Rates</b>							
Average Weighted Prime Lending Rate (Weekly)	8.52	8.99	9.85	16.38	22.11	22.62	-
Average Weighted Lending Rate (AWLR)	10.12	10.13	10.35	11.31	13.46	-	-
Average Weighted New Lending Rate (AWNLR)	9.76	10.07	10.73	13.72	20.00	-	-
<b>Deposit Rates</b>							
Average Weighted Deposit Rate (AWDR)	5.01	5.07	5.17	5.52	6.99	8.41	-
Average Weighted Fixed Deposit Rate (AWFDR)	6.05	6.15	6.30	6.84	8.97	11.06	-
Average Weighted New Deposit Rate (AWNDR)	6.58	6.50	7.68	15.35	16.98	-	-
Average Weighted New Fixed Deposit Rate (AWNDFDR)	6.79	6.75	8.06	15.63	17.19	-	-

Source: Central Bank of Sri Lanka