Report on the Deviation of Headline Inflation from the Inflation Target Set Out in the Monetary Policy Framework Agreement

Reference Period: Quarter 2 and Quarter 3 of 2024

Central Bank Sri Lanka

Report submitted by the Monetary Policy Board of the Central Bank of Sri Lanka to the Parliament through the Minister of Finance, fulfilling Section 26(5) of the Central Bank of Sri Lanka Act, No. 16 of 2023, since quarterly headline inflation remained below the inflation target by more than two percentage points set out in the Monetary Policy Framework Agreement for two consecutive quarters in the second and third quarters of 2024.

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December 2024

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1. Introduction

1.1. The Monetary Policy Framework Agreement (MPFA) signed between the Hon. Minister of Finance and the Central Bank of Sri Lanka on 03 October 2023,[1] under Section 26(1) of the Central Bank of Sri Lanka Act, No. 16 of 2023 (hereinafter referred to as the Central Bank Act), mandates the Central Bank to maintain quarterly headline inflation,[2] as measured by the Colombo Consumer Price Index (CCPI) compiled by the Department of Census and Statistics (DCS), at a rate of 5 per cent. Moreover, Section 26(5) of the Central Bank Act stipulates that if the Central Bank fails to meet the inflation target set out in the MPFA by a margin specified in the same for two consecutive quarters, the Monetary Policy Board of the Central Bank shall submit a report to the Parliament through the Hon. Minister of Finance, which shall also be made available to the public, setting out the reasons for the failure to achieve the inflation target; the remedial actions proposed to be taken by the Central Bank; and an estimate of the time period within which the inflation target shall be achieved. The MPFA specifies that for the purpose of Section 26(5) of the Central Bank Act, the margin is ±2 percentage points.

1.2. Based on realised data, the quarterly average of CCPI-based year-on-year headline inflation was recorded at 1.4 per cent and 0.8 per cent in the second and third quarters of 2024, respectively. Since quarterly headline inflation remained below the inflation target by more than 2 percentage points for two consecutive quarters, this Report is submitted as required under Section 26(5) of the Central Bank Act.

[1] Published in the Extraordinary Gazette No. 2352/20 dated 05 October 2023.

[2] Quarterly headline inflation rate refers to the simple average of the year-on-year percentage changes in the monthly headline CCPI for the three months of the corresponding quarter.

1.3. The Central Bank conducts monetary policy to achieve its primary objective of maintaining domestic price stability. Under the Central Bank Act, the institution is tasked with 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 targeted levels, over the medium term, as determined by the MPFA.

1.4. The deviation of headline inflation from the target in the second and third quarters of 2024 can be largely attributable to transitory supply-side factors, particularly significant reductions in energy prices. The current forecasts suggest that headline inflation will remain low in the coming months as well. However, with the dissipation of the effects of the supply-side factors along with steady demand-side factors in the period ahead, quarterly headline inflation is expected to reach levels within ±2 percentage points of the target of 5 per cent by the third quarter of 2025.

2. Reasons for the deviation from the inflation target

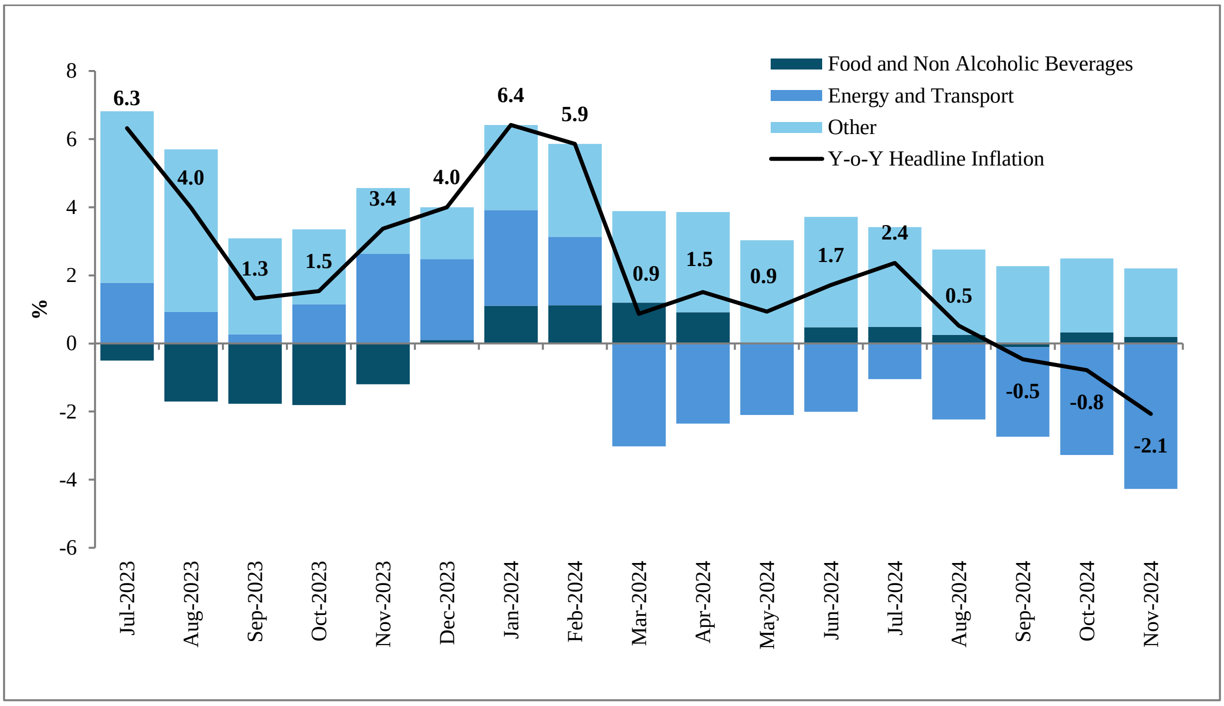
2.1. **Supply-side inflation was more benign than anticipated due to reductions in energy and transport prices and the moderation of food prices.** Low levels of inflation in both the second and third quarters of 2024 were mainly driven by a sizeable, more-than-anticipated, reduction in energy and transport-related inflation, which is primarily regarded as supply-driven. CCPI-based quarterly headline inflation decelerated from 4.4 per cent in the first quarter of 2024 to 1.4 per cent in the second quarter of 2024, driven by the significantly higher than anticipated downward revision to the electricity tariffs implemented in March 2024[3] coupled with continued domestic fuel and LP gas price reductions. Moreover, the details of a sizeable electricity tariff reduction were not available to the Central Bank before its implementation. In addition, the moderation of food prices also helped reduce overall inflation during the period under consideration. CCPI-based quarterly headline inflation decelerated further to 0.8 per cent in the third quarter of 2024, mainly due to the sizeable downward revision

[3] The electricity tariff reduction implemented in March 2024 is estimated to have directly reduced CCPI-based headline inflation by 1.9 percentage points, reflecting the decrease in monthly electricity expenditures for an average household. Additionally, the tariff reduction is expected to have an indirect impact by lowering input costs, which could lead to reduced prices for certain other goods and services considered for the CCPI.

to the electricity tariff effected in July 2024[4] and the continued price reductions of fuel and LP gas prices. In addition, the reduction introduced to the water tariffs during the period under consideration also contributed to lower headline inflation. Meanwhile, quarterly average core inflation, which is derived by excluding volatile food and energy components, and therefore is considered a better indicator of underlying demand-driven price movements, remained relatively higher than headline inflation at 3.8 per cent each in the second and third quarters of 2024, respectively.

2.2. **Meanwhile, the appreciation of the Sri Lanka rupee in 2024 helped ease inflationary pressures**. The Sri Lanka rupee appreciated by 8.2 per cent against the US dollar during the nine months ending in September 2024. This appreciation had a favourable impact on inflation by reducing import prices and triggering second-round effects associated with lower imported inflation. While this was partly reflected in the downward revisions of energy prices mentioned above, the appreciation of the rupee is expected to have also contributed to subdued prices in non-energy items within the consumer price index.

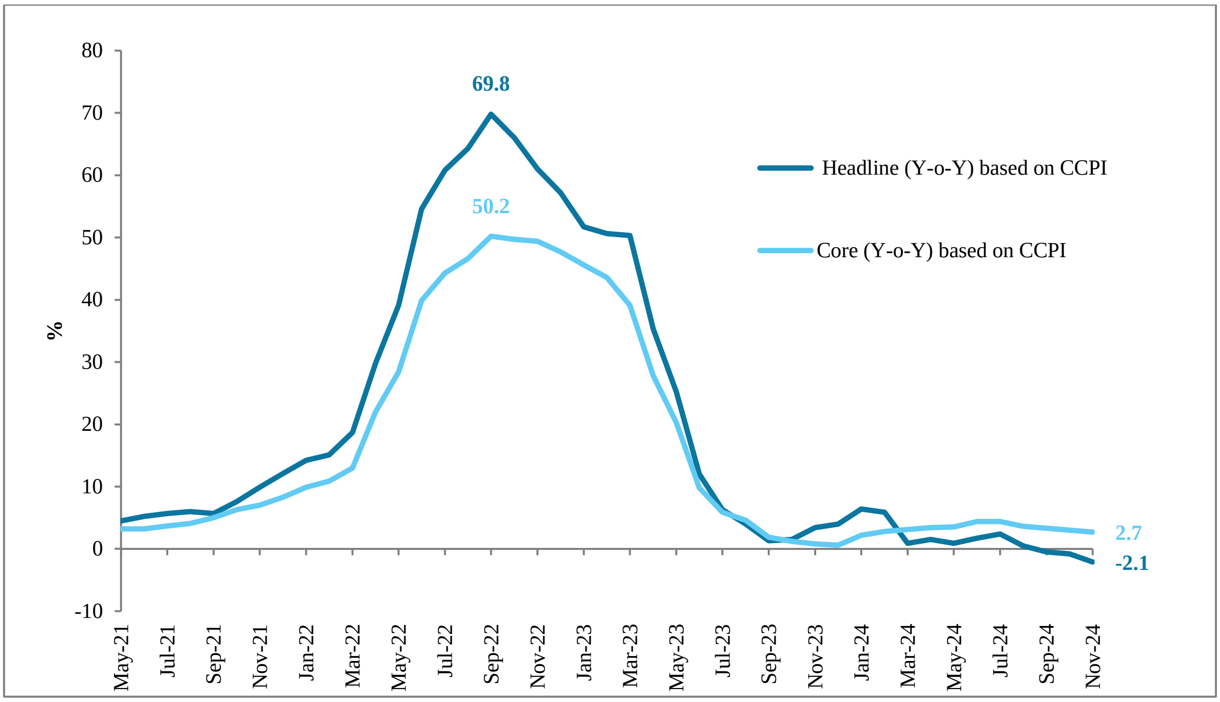
Figure 1: Contribution to Headline Inflation (CCPI, Y-o-Y, %)



Source: Department of Census and Statistics

[4] The direct impact of the electricity tariff reduction implemented in July 2024 on CCPI-based headline inflation is estimated to be 1.6 percentage points.

Figure 2: Movements of Headline and Core Inflation (CCPI, Y-o-Y, %)



Source: Department of Census and Statistics

Table 1: Category-wise Headline Inflation – 2024 (CCPI, Y-o-Y, %)

Category (Weights in the CCPI are in parenthesis)	**Jan-24**	**Feb-24**	**Mar-24**	**Apr-24**	**May-24**	**Jun-24**	**Jul-24**	**Aug-24**	**Sep-24**	**Oct-24**	**Nov-24**
Food and Non-Alcoholic Beverages (26.2%)	3.3	3.5	3.8	2.9	0.0	1.4	1.5	0.8	-0.3	1.0	0.6
Restaurants and Hotels (5.1%)	1.9	1.9	2.0	3.3	5.5	3.6	3.6	4.5	4.3	3.6	2.4
Alcoholic Beverages, Tobacco, and Narcotics (1.7%)	23.6	27.2	30.5	33.1	32.3	31.7	19.9	17.2	22.8	22.7	18.4
Clothing and Footwear (2.2%)	7.4	1.8	-0.6	0.8	1.5	0.5	-0.8	-0.4	0.1	1.1	1.8
Housing, Water, Electricity, Gas and Other Fuels (31.6%)	19.2	15.8	-4.7	-6.2	-6.1	-5.3	-0.8	-6.8	-8.4	-9.6	-13.1
Furnishing, Household Equipment and Routine Household Maintenance (3.5%)	-1.1	-0.5	-0.4	0.6	0.9	2.0	2.3	3.2	3.7	3.6	1.5
Health (4.0%)	0.4	0.2	-1.1	-1.0	-0.7	2.1	3.3	3.4	4.0	3.8	6.1
Transport (12.5%)	-1.3	-0.9	-2.0	5.0	6.4	6.8	5.4	3.5	0.8	-1.8	-2.3
Communication (3.0%)	3.0	3.7	3.7	3.7	3.7	3.6	3.6	3.6	3.6	3.6	3.6
Recreation and Culture (2.0%)	7.2	4.8	4.7	4.6	3.3	3.8	2.1	3.1	3.9	5.1	6.0
Education (5.1%)	9.4	11.1	11.2	11.2	11.2	11.5	8.0	7.2	7.0	7.0	7.0
Miscellaneous Goods and Services (3.2%)	0.6	2.1	2.8	2.7	3.3	3.4	3.5	5.1	5.3	4.7	4.8
Headline Inflation	**6.4**	**5.9**	**0.9**	**1.5**	**0.9**	**1.7**	**2.4**	**0.5**	**-0.5**	**-0.8**	**-2.1**

Source: Department of Census and Statistics

2.3. **Inflation trends in 2024 deviated from the Central Bank's projections due to an unexpected sharp drop in energy and transport-related inflation, while the impact of the Value Added Tax (VAT) amendments also remained muted.** The Central Bank's actions are guided by data-driven projections and judgments based on available information during each monetary policy round. While the initial outlook factored in moderate energy and transport inflation and the inflationary impact of the VAT amendments, subdued demand conditions were expected to keep inflation around the 5 per cent target over the medium term. However, a sharper-than-anticipated decline in energy prices offset the VAT-driven inflationary pressures, resulting in lower-than-expected inflation.

3. The remedial actions being taken by the Central Bank

3.1. **Central banks prioritise demand-side pressures while monitoring supply shocks for potential spillovers.** Central banks typically do not respond directly to transitory supply-side inflation shocks, such as those driven by energy and food prices, as their tools are designed to address demand-side pressures tied to business cycle fluctuations. Supply-side shocks have an immediate impact on prices, while monetary policy operates with a lag, making it less effective in addressing such short-term disruptions. However, the Central Bank monitors these shocks closely and may act if they significantly influence inflation expectations or lead to persistent changes in the inflation outlook through spillover effects.

3.2. **The Central Bank's accommodative stance fostered economic recovery and credit expansion.** The Central Bank commenced an accommodative monetary policy stance in June 2023. Since then policy interest rates have been reduced by 7.25 percentage points in total between June 2023 and July 2024, reversing the effects of the previous monetary policy tightening episode to a large extent. Market interest rates declined substantially in line with the accommodative monetary policy stance. The measured policy normalisation implemented in the recent period helped the recovery of economic activity while maintaining demand-driven inflationary pressures intact. There are clear signs of expansion in private sector credit and recovery of economic activity.

3.3. **The Central Bank's November 2024 policy easing aims to further support economic recovery amidst low levels of inflation.** With the latest information suggesting that the negative levels of inflation predicted over the near term could be more persistent than previously anticipated, the Monetary Policy Board of the Central Bank, at its most recent meeting held on 26 November 2024, decided to further ease the monetary policy stance of the Central Bank. This measure resulted in an effective reduction in the policy interest rate of around 50 basis points. The further moderation of underlying inflationary pressures and inflation expectations along with better-than-expected developments on the external front also supported this move. This loosening of the monetary policy stance of the Central Bank in November 2024 is expected to facilitate higher credit flows to productive activities, thus supporting the recovery of the economy in the period ahead. Moreover, the Central Bank actively engaged in Open Market Operations (OMO) to maintain short term money market rates at levels consistent with the monetary policy stance.

4. Near-term considerations

4.1. **External sector stability is a critical consideration in determining the appropriate monetary policy stance.** While the external sector has stabilised to a great extent, the higher-than-expected economic growth observed thus far in 2024 and the robust growth anticipated during the period ahead suggest a possible rise in aggregate demand going forward. In addition, the planned relaxation of motor vehicle imports after several years could also result in higher import demand and a deficit in the external current account is expected from 2025. Further, future movements of commodity prices in the global market are highly uncertain at present due to heightened geopolitical tension. In such a context, an overly accommodative monetary policy stance could exacerbate import demand at times of resumption of external debt servicing, thus posing risks to external sector stability and inducing a large depreciation of the exchange rate. Therefore, close policy coordination between the Ministry of Finance and the Central Bank would be necessary to maintain the stability of the external sector, especially in an uncertain global environment.

4.2. **Therefore, the Central Bank is of the view that the accommodative monetary policy stance that has been in place since June 2023, including the recent further loosening of monetary policy in November 2024, would be appropriate to bring inflation towards the target of 5 per cent by around the third quarter of 2025.** It is also important to note that given the exceptionally high inflation levels Sri Lanka experienced in 2022 and 2023, a brief period of lower-than-targeted inflation could provide some relief to households and businesses that are still recovering from the large increase in the cost of living and cost of production, respectively.

4.3. **The Central Bank will continue to monitor inflation and other macroeconomic developments closely and stand ready to take appropriate measures to maintain domestic price stability.** Moreover, the focus of the Central Bank will continue to be on sustained, underlying inflationary trends to ensure that future monetary policy adjustments support long-term price stability.

5. An estimate of the time period within which the inflation target shall be achieved

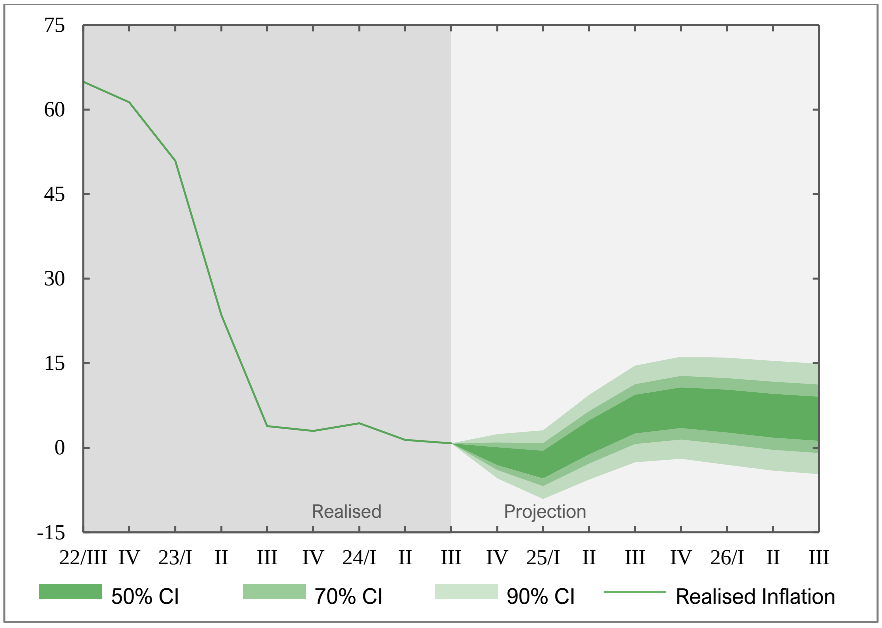
5.1. **Quarterly headline inflation is expected to gradually return to the target range by the third quarter of 2025.** Quarterly headline inflation (year-on-year) will decline further, reaching the negative territory, in the fourth quarter of 2024. The baseline forecast suggests a further decline in quarterly headline inflation (year-on-year) in the first quarter of 2025. However, inflation is expected to reach positive territory by the second quarter of 2025. Current projections indicate that headline inflation will reach within ±2 percentage points from the inflation target of 5 per cent during the third quarter of 2025. The projected path of quarterly headline inflation is depicted in the inflation fan chart in Figure 3.

5.2. **Monetary easing and price normalisation are expected to drive headline inflation toward the target, while core inflation is expected to stabilise over the medium term.** The accommodative monetary policy stance and a gradual normalisation in energy and transport inflation are expected to contribute to this increase in headline inflation towards the target. Moreover, core inflation, which is the general measure of underlying inflation, is expected to decline temporarily until the first quarter of 2025, but it is not expected to reach deflationary levels. More importantly, core inflation is forecast to rebound and remain relatively stable with a lower degree of volatility over the medium term.

5.3. **The time period specified above, within which inflation is expected to reach levels close to the target, is conditional on the set of available data, assumptions and judgements made at the forecast round in November 2024.** They are conditional on the forecasts of global energy and food prices, the continuation of a cost-reflective pricing mechanism for domestic energy prices, the anticipated domestic fiscal path in line with the International Monetary Fund - Extended Fund Facility (IMF-EFF) programme, the expected economic trajectory of Sri Lanka's major trading partners, and the forecasts of global financial conditions implied by the US monetary policy stance. Therefore, any notable change in these assumptions could lead to the realised inflation path deviating from the projected path. Moreover, given the weather-related risks and prevailing domestic and global economic uncertainties, the risks associated with the current forecasts of inflation are higher than in normal times.

Figure 3: Projected Headline Inflation (Quarterly, CCPI, Y-o-Y, %)

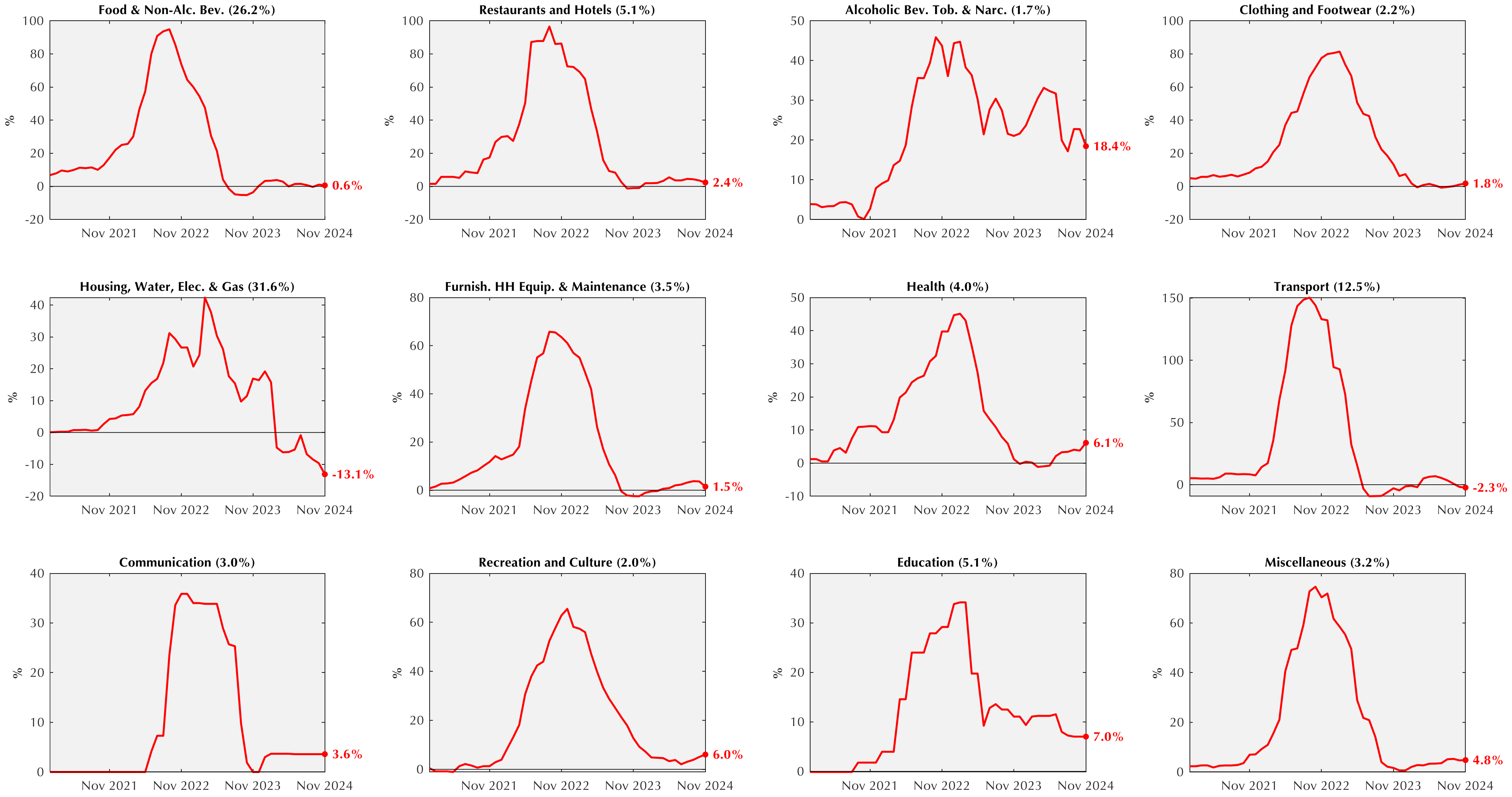
Based on the Projections during the November 2024 Monetary Policy Round



Source: Central Bank Staff Projections

Annexure

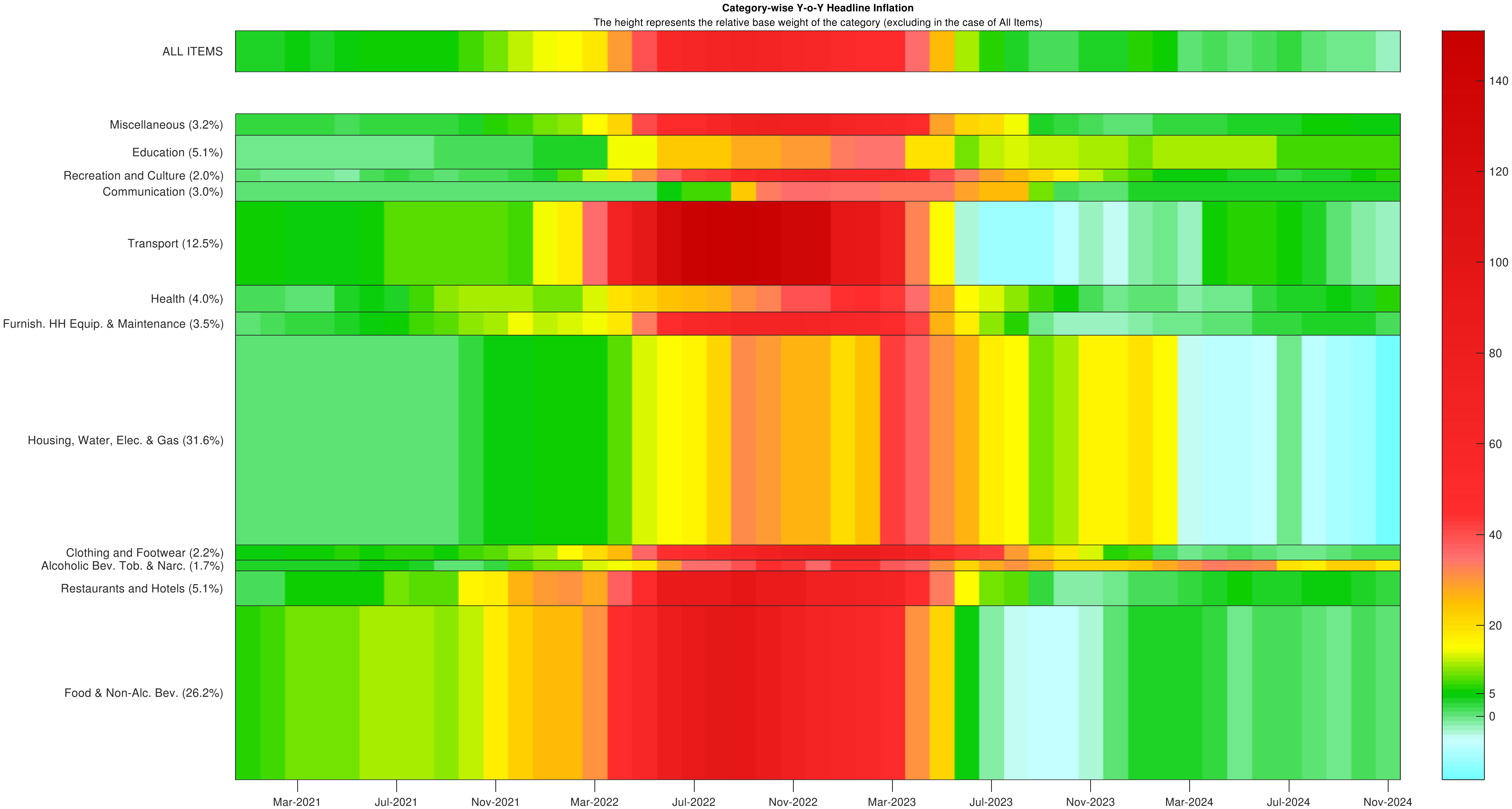
Figure 4: Category-wise Headline Inflation (CCPI, Y-o-Y, %)



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

Data preceding January 2023 are based on the CCPI (2013=100), while data commencing January 2023 are based on the CCPI (2021=100). Base weights are given in parentheses, based on the CCPI (2021=100).

Figure 5: Headline Inflation Heatmap (CCPI, Y-o-Y, %)



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

Data preceding January 2023 are based on the CCPI (2013=100), while data commencing January 2023 are based on the CCPI (2021=100). Base weights are given in parentheses, based on the CCPI (2021=100).