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

Reference Period: Quarter 3 and 4 of 2025

Central Bank of Sri Lanka

March 2026

Report submitted by the Monetary Policy Board of the Central Bank of Sri Lanka to the Parliament through the Hon. 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 the margin of two percentage points set out in the Monetary Policy Framework Agreement for two consecutive quarters in the third and fourth quarters of 2025.

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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%. 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 the CCPI-based year-on-year headline inflation was 0.8% and 2.1% in the third and fourth quarters of 2025, respectively. As inflation remained below the 5% target by more than 2 percentage points (i.e., below 3.0%) for two consecutive quarters, this Report is submitted as required under Section 26(5) of the Central Bank Act. Since quarterly headline inflation was below the target during the last three quarters of 2024 and the first three quarters of 2025, similar Reports were submitted in December 2024, March, June, August and

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

[2] The 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.

December 2025.[3] Accordingly, this Report serves as a follow-up to the previously submitted Reports, since quarterly headline inflation continued to remain below the target in the fourth quarter of 2025.

1.3. Headline inflation, having recovered from its deflationary phase and returned to positive territory in the third quarter of 2025, continued its gradual accelerating trajectory in the fourth quarter. However, it remained below 3%, recording a deviation from the target from the downside. Cyclone Ditwah-related disruptions had a limited impact on inflation during this period. The currently available official inflation forecasts, released at the January 2026 Monetary Policy Round, suggest the accelerating trend of inflation to continue, partly contributed by a pickup in demand. Nonetheless, the inflation path indicated in these projections remains lower than previously anticipated, indicating that headline inflation could remain below 3% at least through the first half of 2026. However, the US-Iran War, which has transpired after the release of the above forecasts, has led to a substantial and still evolving global energy price surge, which is expected to has ten the acceleration of inflation. Given the fluid nature of the crisis and its potential to create substantial negative economic spillovers, macroeconomic projections remain extremely volatile in the current context. When these latest developments are considered, there is a high possibility of quarterly headline inflation remaining within a ±2 percentage points margin of the target from the second quarter of 2026 onwards and stabilise around the target over the medium term, supported by appropriate policy measures.

2. Reasons for the deviation from the inflation target

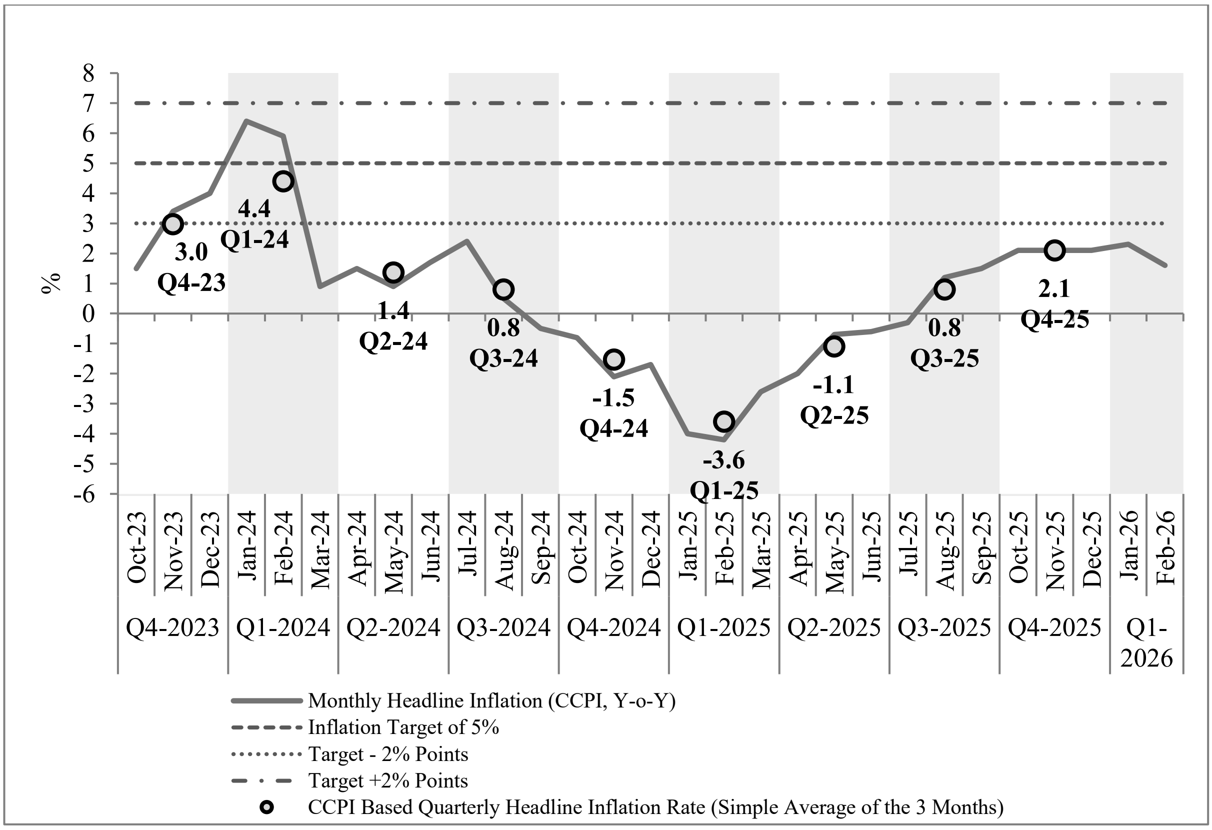
Inflation over the recent period has been influenced more by supply-side factors, amidst a slow recovery of aggregate demand. As highlighted in previous Reports, the inflation path during the last three quarters of 2024 and the first three quarters of 2025 was largely driven by adjustments in electricity tariffs, and fuel and LP-gas prices, as well as changes in food prices. Movements in the exchange rate have also played a role in shaping inflation dynamics, mainly through their impact on import prices and domestic cost conditions. Accurately forecasting

[3] The previous Reports on the deviation of headline inflation from the inflation target can be accessed via the link, https://www.cbsl.gov.lk/en/monetary-policy/monetary-policy-communication/accountability-to-parliament.

some of the expected price adjustments, especially electricity tariffs, has proven to be challenging owing to significant variations in outcomes, both in pricing and timing. Having explained these factors in earlier Reports, the current Report focuses on the continued deviation from the target during the fourth quarter of 2025.

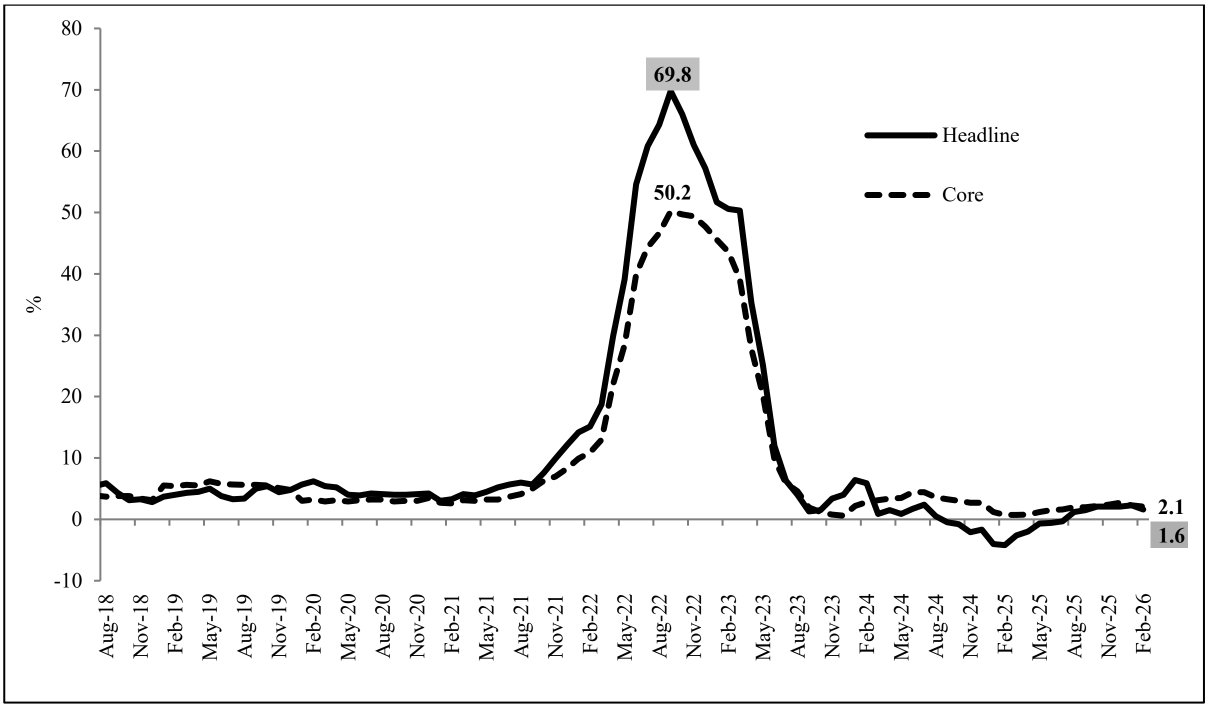
2.1. As anticipated, inflation continued its gradual acceleration in the fourth quarter of 2025, following its return to positive territory in the third quarter of 2025, which marked the end of an eleven-month deflationary episode. This acceleration was mainly driven by price increases in certain food items, alongside the easing of deflationary pressures in energy and transport-related prices. Nevertheless, overall price increases were broadly gradual amidst relatively low core inflation and continued deflation in energy and transport categories, resulting in the CCPI recording a quarterly inflation rate of 2.1% in the fourth quarter of 2025, thereby remaining below 3.0%.

Figure 1: Quarterly Headline Inflation (CCPI, 2021=100, y-o-y, %)



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

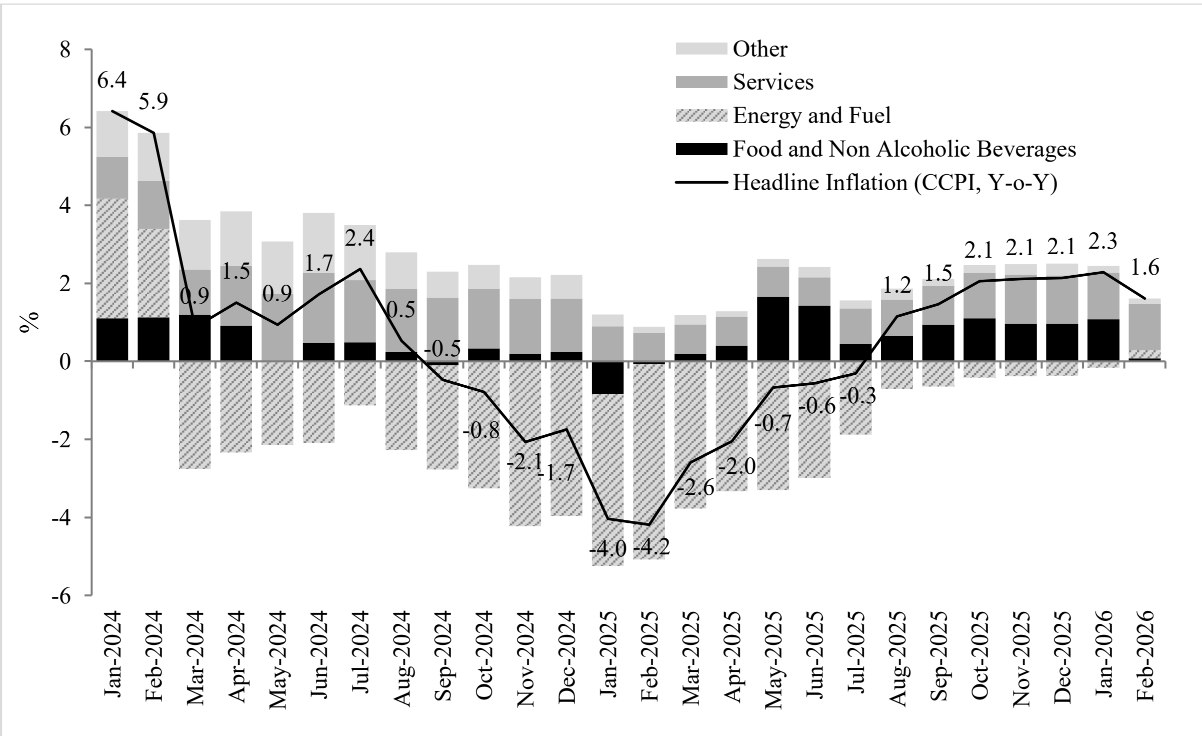
Figure 2: Movements of Headline and Core Inflation (CCPI, y-o-y, %)



Source: Department of Census and Statistics

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

Figure 3: Contribution to Headline Inflation (CCPI, 2021=100, y-o-y, %)



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

2.2. Meanwhile, core inflation continued to remain at low positive levels, recording 2.4% in the fourth quarter of 2025, reflecting subdued demand conditions in the economy. Core inflation recorded a gradual acceleration compared to the third quarter of 2025, largely driven by the increase in non-food prices, particularly in the 'Education' and 'Housing, Water, Electricity, Gas and Other Fuel' categories. The slow pace of core inflation suggests the pickup in demand could be somewhat slower than implied by other indicators, such as the sharp rise in credit to the private sector and an increase in imports. A gradual increase in core inflation is expected over the period ahead and is expected to stabilise at a level consistent with the headline inflation target, with a lower degree of volatility. However, the spillover effects from possible energy and transport-related prices could contribute to leading core inflation also on a relatively accelerated trajectory.

2.3. Energy and fuel inflation, which had remained in negative levels for an extended period, has recorded a gradual acceleration, thus contributing to the acceleration of headline inflation. However, its acceleration has remained slower than expected amidst certain price increases that were expected previously not being realised. Services inflation, which had remained relatively stable even during the recent months, when headline inflation was at deflationary levels, has also commenced a gradual upward trajectory. On the other hand, the contribution of volatile food inflation to the acceleration of headline inflation has remained steady in the recent past. The supply disruptions due to Cyclone Ditwah led to some price increases in food items in early December 2025, but it did not have a substantial impact on year-on-year inflation, as month-on-month price pressures were offset by a favourable statistical base effect.

2.4. Compared to the projections presented in the December 2025 Report applicable for Q2 and Q3 2025, the projected inflation path in the January 2026 Monetary Policy Round remains broadly lower, reflecting revisions to several key assumptions. As previously assumed electricity tariff increase in Q1 2026 was not realised, energy and transport inflation increased more gradually than previously projected. In addition, the lower-than-anticipated increase in underlying prices, as reflected in the gradual rise in core inflation, has also contributed to the lower inflation trajectory. Assumptions on global developments are based on the Global Projections Model

Network (GPMN). Compared to the previous Report, the global outlook was revised with changes in assumptions relating to global output, financial conditions, global food prices, and oil prices. Global growth was expected to be stronger than previously projected, reflecting more resilient economic activity across major economies despite trade-related frictions, geopolitical uncertainties, and restrictive financial conditions. Global food inflation was projected to follow a lower trajectory during 2026, followed by a slightly higher path in 2027. The path for world oil prices had been revised downward relative to the previous Report, reflecting expectations of improved supply, while geopolitical risks remained elevated. Meanwhile, monetary policy easing in the United States was expected to proceed faster than previously anticipated, implying a lower policy rate path over the medium term. Domestic fiscal sector-related assumptions had also been updated based on the Supplementary Budget Estimate 2026, with the then latest projections incorporating a higher budget deficit for 2026. These revisions to assumptions collectively contributed to a revision of the previously expected path of inflation.

3. The remedial actions being taken by the Central Bank

3.1. **While monetary policy is focused on mitigating demand-side pressures on inflation, the Central Bank also monitors supply-side shocks closely and acts if they significantly influence inflation expectations or lead to persistent changes in the inflation outlook through spillover effects.** However, in the absence of such lasting impacts, monetary policy remains less effective in addressing short-term supply-side disruptions, as it operates with a lag.

3.2. **Since adopting an accommodative monetary policy stance in June 2023, policy interest rates have been reduced by around 8.00 percentage points in total, including the last reduction of 25 bps in May 2025.[4]**

3.3. **In the January 2026 monetary policy round, the Central Bank decided to maintain the Overnight Policy Rate (OPR) at its current level of 7.75%.** The Monetary Policy Board was of the view that the current monetary policy stance will

[4] Current policy interest rates remain at relatively low levels compared to historical trends. Further, the Statutory Reserve Ratio (SRR) was reduced to 2% in August 2023 and has been maintained at this low level since then.

support steering inflation towards the target of 5%, without leading to excessive demand pressures. Meanwhile, the economy recorded a growth of 4.8% in Q4-2025, with annual growth of 5.0% for 2025. Credit disbursed to the private sector by commercial banks and other financial institutions continued its notable expansion in late 2025. Moreover, the external current account is estimated to have recorded a sizeable surplus in 2025, despite the widening of the trade deficit amidst heightened imports. Foreign remittances remained healthy during 2025. Despite large debt service payments during the year, Gross Official Reserves were built up to US dollar 6.8 billion by the end of 2025, mainly supported by the net foreign exchange purchases by the Central Bank and inflows from multilateral agencies. The Sri Lanka rupee depreciated against the US dollar by 5.6% in 2025.

3.4. **In this context, the Monetary Policy Board remains focused on implementing appropriate policy measures to ensure that inflation stabilises around the target, while supporting the economy to reach its potential.** Should any growth-negative shocks materialise amid the volatile external environment and domestic uncertainties, there is room for policy accommodation. However, any further policy accommodation will be weighed against the risk of possible overheating of the economy with a lag, particularly with the economy continuing its growth momentum, supported by favourable credit expansion and gradual recovery in aggregate demand. The Central Bank will continue to communicate proactively to manage expectations, while conducting its operations in a timely and appropriate manner to ensure the effective implementation of monetary policy.

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

4.1. **As per the projections during the January 2026 Monetary Policy Round, which represent the latest official inflation forecast as of yet, headline inflation was expected to gradually accelerate and remain within ±2 percentage points margin of the inflation target by H2-2026.** As per these projections, the acceleration of inflation was expected to be more gradual than previously forecast, reflecting the non-materialisation of the expected upward revision to electricity tariffs in January 2026, lower fuel price adjustments than anticipated, price reduction of imported milk powder and its spillover effects, a slower-than-expected pickup in demand conditions, as evidenced by the relatively slow pickup in core inflation in recent months, and in general, a higher persistence of inflation than anticipated over the recent months. The projected path of quarterly headline inflation during the above forecast round is depicted in the inflation fan chart in Figure 4. As projections are made under assumptions and judgements, they are inherently associated with uncertainty, and this is reflected in the fan chart. The assessment of headline inflation falling within the 3-7% range discussed above is derived based on the mean path of the distribution of projections. Meanwhile, based on the forecast distribution underlying the fan chart, the probability of inflation remaining within the 3–7% range by the second half of 2026 can be estimated to be at least around 37%. The ongoing recovery of the economy, monetary easing, gradual depreciation of the Sri Lanka rupee, and the expected dissipation of deflation in the energy and transport sectors were expected to drive headline inflation toward the target. Core inflation, which is the general measure of underlying inflation, was also expected to increase gradually towards a level consistent with the headline inflation target and remain relatively stable, with a lower degree of volatility over the medium term.

4.2. **The time period specified above, within which inflation is expected to reach levels close to the target, is conditional on available data, assumptions and judgements made at the forecast round in January 2026.** They are conditional on a number of factors, including the forecasts of global energy and food prices, the expected growth path of Sri Lanka's major trading partners, the anticipated fiscal path of the Government, global financial conditions implied by the Fed Funds Rate, and anticipated developments in the external sector, including the external current account balance. Therefore, any notable change in these assumptions could lead to the realised inflation path deviating from the projected path. In particular, the recent changes to global commodity prices would most likely lead to a considerable shift in the projected inflation trajectory.

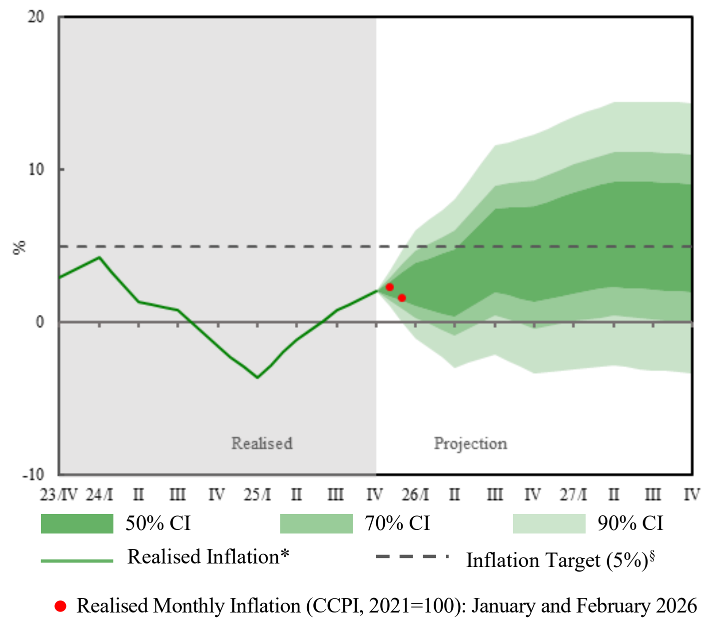
4.3. **Notwithstanding the above projections, the recent developments with respect to the US-Iran War have created considerable upward pressures on prices, particularly on energy and fuel, thus creating a high possibility of headline inflation remaining within the ±2 percentage points margin of the inflation target by Q2-2026.**

4.4. The latest global developments related to the Middle East Crisis warrant a considerable revision of the forecast path of inflation. Several upward price revisions in response to these changes have already taken place. Depending on evolving conditions, further price revisions, particularly to energy and fuel, could be expected, along with their spillover effects. Accordingly, there is a high possibility of a faster acceleration of inflation than expected in the January 2026 projections, most probably leading inflation to remain within ±2 percentage points from the inflation target during the second quarter of 2026.

4.5. Thus, there are upside risks to the realisation of inflation projections stemming from several factors. Heightened geopolitical tensions in the Middle East, particularly following the recent escalation of the US–Iran War, have significantly increased global uncertainty and disrupted oil, commodity, shipping, and financial markets. Given the evolving nature of these developments, the current global economic environment remains highly uncertain. These developments have already led to increases in global oil prices and shipping costs, transmitting to higher domestic energy and transport prices. Together with possible supply disruptions and necessary precautionary measures, sudden demand pressures and spillover effects on domestic prices may arise. In addition, possible depreciation of the Sri Lanka rupee at higher levels, higher-than-anticipated demand pressures fuelled by the lagged impact of strong credit growth, and increases in the cost of agricultural inputs, including fertiliser, which could adversely affect agricultural production and food prices, as well as possible adverse weather events affecting the agriculture and energy sectors could exert further upward pressure on inflation. Meanwhile, downside risks to the realisation of inflation projections include improved continuity in recultivation activities following Ditwah-related disruptions and their possible positive spillovers supporting agricultural output and easing food price pressures. Given the fluid nature of the conflict in the Middle East, the impact on prices and economic activity still remains very uncertain. Such volatile economic conditions will be carefully considered by the Monetary Policy Board in calibrating monetary policy in the period ahead. Meanwhile, inflation projections of the Central Bank will be fine-tuned in accordance with incoming information and communicated to the public through monetary policy-related communication channels.

Figure 4: Projected Headline Inflation (Quarterly, CCPI, y-o-y, %)

Based on the Projections during the January 2026 Monetary Policy Round



Source: Central Bank Staff Projections

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

* Realised data in the fan chart are based on the CCPI (2021=100, seasonally adjusted). Projections are based on all available data at the forecast round in January 2026.

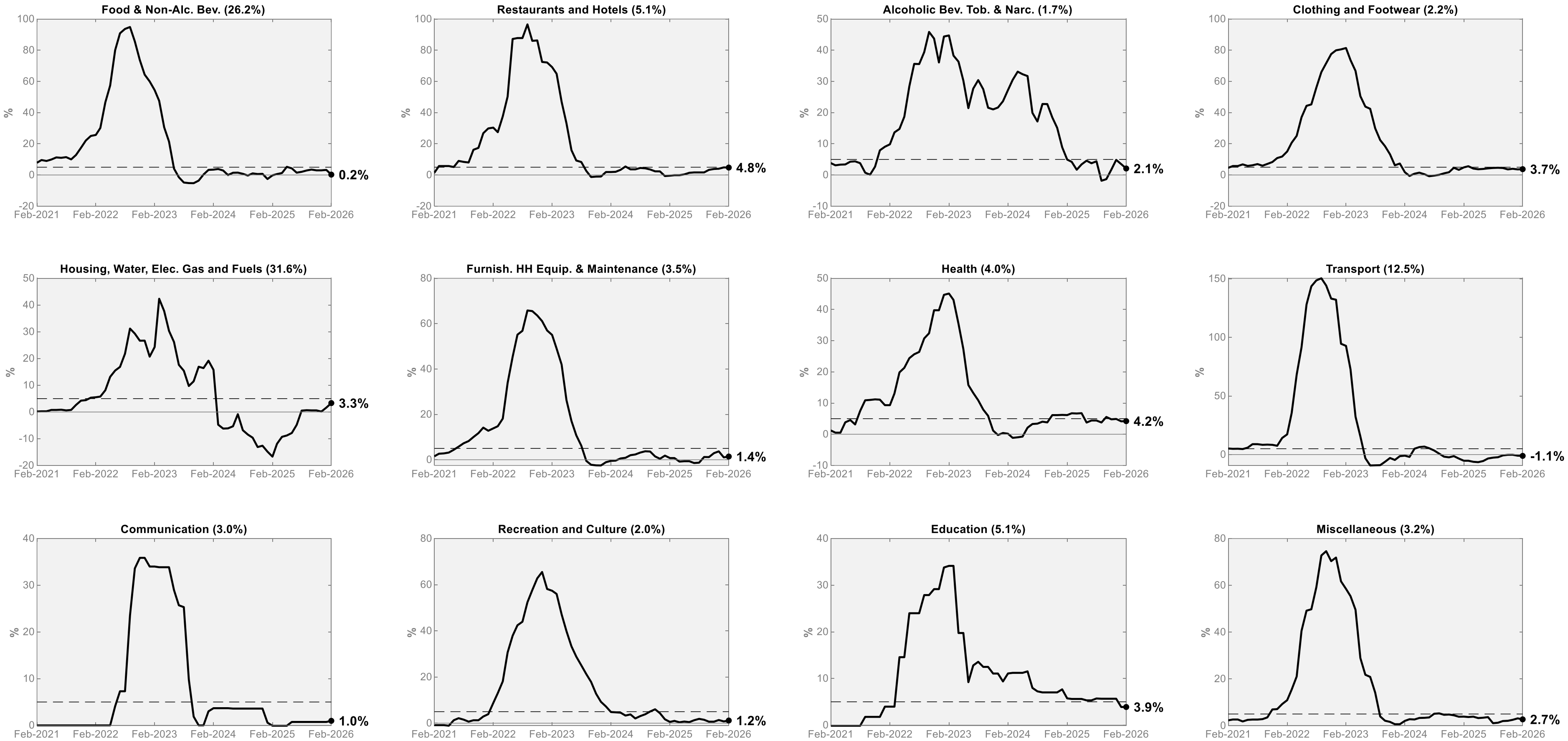
Note: A forecast is neither a promise nor a commitment.

The fan chart illustrates the uncertainty surrounding the baseline projection path using confidence bands of gradually fading colours. The confidence intervals (CI) shown on the chart indicate the ranges of values within which inflation may fluctuate over the medium term. For example, the thick green shaded area represents the 50% confidence interval, implying that there is a 50% probability that the actual inflation outcome will be within this interval. The confidence bands show the increasing uncertainty in forecasting inflation over a longer horizon.

The above forecasts were made before the outbreak of the US-Iran War. Accordingly, the resulting global commodity price increases and their widespread impacts are yet to be reflected in medium inflation projections.

Annexure

Figure 5: Category-wise Headline Inflation (CCPI, y-o-y, %)



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

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