

Investigating Factors Affecting the Target Level of Inflation: The Case of Sri Lanka¹

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Abstract

Sri Lanka formally adopted a Flexible Inflation Targeting (FIT) monetary policy framework in 2020. Along with this transition, the target level of inflation has become a focal point for implementing FIT. This policy paper discusses several considerations when selecting a target for inflation in the context of Sri Lanka, such as the choice between headline and core inflation and the choice of the price index. It undertakes several descriptive and empirical analyses to arrive at the possible numerical value(s) of the target (or range). The results of these analyses suggest a point target for the Colombo Consumer Price Index (CCPI)-based year-on-year headline inflation at 5 per cent, with a margin of ± 2 percentage points to be suitable for Sri Lanka for considering operationalisation of FIT under the Central Bank of Sri Lanka Act No. 16 of 2023 (CBA).² This exercise should be repeated periodically to assess whether the inflation target under the Monetary Policy Framework Agreement needs to be revised, especially as economic conditions continue to evolve.

Keywords: Flexible Inflation Targeting, Headline Inflation, Monetary Policy Framework

JEL Classification: E31, E52, E58, E63

¹ This analysis was originally conducted in September 2023 with the primary objective of identifying the most appropriate inflation measure and target parameters for Sri Lanka under the Flexible Inflation Targeting (FIT) framework. The study aimed to support the Central Bank of Sri Lanka in preparing its proposal to the Government for setting the initial inflation target, as required for the signing of the first Monetary Policy Framework Agreement (MPFA) under the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA). The technical analyses contained herein reflect the assessments of the authors, and they do not necessarily indicate the views of the Central Bank of Sri Lanka.

² In line with these suggestions, the Monetary Policy Framework Agreement (MPFA) signed between the Minister of Finance and the Central Bank of Sri Lanka on 03 October 2023 mandates the Central Bank to maintain quarterly headline inflation, as measured by the CCPI, at a rate of 5 per cent. If the Central Bank fails to meet the inflation target of 5 per cent by a margin of ± 2 percentage points, as set out in the MPFA, for two consecutive quarters, the Monetary Policy Board of the Central Bank should submit a report to the Parliament through the Minister of Finance.

1. Introduction

Central banks across the globe are responsible for executing monetary policy with varied degrees of independence to maintain low and stable inflation. They use a variety of monetary policy frameworks to achieve their goal of price stability, using the policy tools at their disposal. Sri Lanka's monetary policy framework has evolved dramatically since its initial currency board setup before the establishment of the Central Bank of Sri Lanka in 1950 (Weerasinghe, 2018). Sri Lanka predominantly had a fixed exchange rate regime from 1950 to 1977, initially pegging the value of the Sri Lankan rupee to the British pound and later to the US dollar. During this period, there was no need for a particular monetary anchor to control inflation because domestic and foreign inflation were closely related. Following the abandonment of the fixed exchange rate regime in 1977, and with the adoption of a managed floating exchange rate regime, interest rates and monetary aggregates became more important. Thus, Sri Lanka implemented a monetary aggregate targeting framework for monetary policy in the early 1980s. Nevertheless, with the increasing volatility in the money multiplier and money velocity, along with the weakening of the correlation and causation between money supply and inflation, the effectiveness of the monetary target as a nominal anchor became uncertain. This also led the Central Bank's communication strategy to become quite intricate, prompting the need to explore a more suitable monetary policy framework. In the early 2000s, the Central Bank commenced a monetary policy modernisation process, while engaging in research and analysis on the new framework. As an interim arrangement, the Central Bank implemented monetary policy within an enhanced monetary policy framework that features both monetary targeting and Flexible Inflation Targeting (FIT) since 2015. In parallel, the preparatory work concerning the adoption of FIT, mainly legislative amendments, capacity building on modelling and forecasting, and internal process improvements, continued.

In 2020, the Central Bank officially adopted the FIT framework for conducting monetary policy. This framework's primary objective was to maintain inflation within the range of 4-6 per cent, over the medium term, while also facilitating the realisation of the economy's full potential. Yet, the FIT framework had not been formally recognised and agreed upon with the then Government and necessary legal provisions for the fulfilment of the key prerequisites of the FIT framework were not enacted. However, with the enactment of the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA), in September 2023, FIT was statutorily recognised as the monetary policy framework in Sri Lanka (Section 11 of the CBA). Moreover, Section 26(5) of the CBA mandates that the Central Bank submit a report to the Parliament through the Minister of Finance, if the Central Bank fails to meet the inflation target by a specified margin for two consecutive quarters. This report must outline 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.

An explicit inflation target would provide more specificity to the price stability objective, enhancing transparency and accountability for monetary policy. The Central Bank needs to be aware of the current rate of inflation and its projected path to decide on appropriate policy actions to achieve the price stability objective in line with the operationalisation of the FIT framework. Inflation refers to the increase in the general price level of an economy. It is commonly measured using indicators, such as the Consumer Price Index (CPI), the Gross Domestic Product (GDP) deflator, and the Producer Price Index (PPI), among others. In Sri Lanka, the generally accepted method of measuring inflation by the Central Bank and most economic stakeholders is to consider the year-on-year change of the CPI, compiled by the

Department of Census and Statistics (DCS). The DCS compiles two consumer price indices, namely, the Colombo Consumer Price Index (CCPI) and the National Consumer Price Index (NCPI). The NCPI captures island-wide price movements, whereas the CCPI captures price movements in the urban areas of the Colombo district. The weights of the items included in the baskets of these indices vary, reflecting the consumption patterns of the respective consumer groups. The change in overall CPI is generally considered as headline inflation. In contrast, core inflation measures the underlying inflation by excluding highly volatile items in the CPI basket (such as volatile food and energy sub-categories).

When there are multiple indices that can be used to measure changes in price levels, choosing one index for monetary policy considerations becomes a challenge. When choosing such an index as a target, it is important to consider factors such as how accurately the index captures the cost of living, its volatility, predictability, persistence, correlation with inflation expectations, timeliness of data releases, and index continuity. Accordingly, when it comes to deciding on an inflation target in the Sri Lankan context, several important parameters need to be considered, including:

- I. the choice between headline inflation vs core inflation,
- II. the choice of the price index (CCPI vs NCPI),
- III. the numerical inflation target (point vs a range target),
- IV. specific considerations when measuring deviations from the inflation target, and
- V. the time period during which inflation is expected to reach the target in response to policy actions.

This paper presents the important considerations that were taken into account when deciding on the inflation target, as established in the first Monetary Policy Framework Agreement (MPFA), signed between the Central Bank and the Minister of Finance on 03 October 2023.³ Section 2 provides some background on various contributions in the literature relevant to the discussion of a target level of inflation, while Section 3 illustrates selected details of the statistical methodologies utilised. Meanwhile, each of the above-discussed parameters is discussed in Section 4, and Section 5 provides concluding remarks.

2. Related Literature and Theoretical Underpinnings

The effectiveness of Inflation Targeting (IT) policies depends significantly on a country's prevailing economic conditions and institutional framework. Therefore, it is important to periodically review research to better understand the complexities of IT and its implications for macroeconomic stability and growth. In the context of Sri Lanka, earlier studies have proposed various inflation targets. Jayamaha *et al.*, (2002) suggest a 7 per cent target with a band of ± 1.5 percentage points (pp) and a minimum two-year target horizon. Perera (2010) recommends a 10 per cent target range with a wider band based on the historical experiences. The author also emphasised the use of core inflation, excluding administered prices, seasonal food price fluctuations, terms of trade effects, and indirect taxes, as a more stable measure in the early stages of IT adoption. Once credibility is established, the author proposed transitioning to headline inflation, which is more visible and better aligned with public expectations.

³ The MPFA is available for public access via the Extraordinary Gazette No. 2352/20.

Nevertheless, since 2009, in the post-war period, Sri Lanka experienced a period of single-digit inflation, along with an improved monetary policy framework. The average inflation of the aforementioned period is around 5 per cent. In 2019, an initial assessment by the Central Bank of Sri Lanka has concluded that “headline inflation based on an urban consumer price index, targeting mid-single digit level inflation with a reasonably wide tolerance band over a target horizon of 2-3 years, which is jointly decided by both the Government and the Central Bank would be appropriate for Sri Lanka” (Central Bank of Sri Lanka, 2019). Given the evolving economic landscape and the changes in past recommendations, further research is essential to determine an inflation target that reflects current realities. Especially under the FIT framework, the endeavour is to stabilise inflation around the targeted levels while supporting economic growth towards its potential. Therefore, the selection of an appropriate inflation target can be technically determined by assessing the correlation between economic growth and inflation across various inflation thresholds. Numerous research papers explore both theoretical and empirical inquiries regarding the connection between inflation and economic growth. For Sri Lanka, De Silva (2017) and Cooray (2013) identify 9 per cent and 7.4-9.6 per cent range as the inflation thresholds that maximise the per capita GDP growth, respectively. However, these findings need to be revisited due to the introduction of rebased series of consumer price indices and GDP for the subsequent period, and the recent shifts in inflation and growth dynamics. When the question of deciding a target level of inflation is considered, it is imperative to provide due consideration of the most recent behaviour of macro variables. Therefore, updated research is crucial to reassess the inflation threshold and guide the setting of a suitable inflation target.

When the theoretical underpinnings of the relationship between real economic growth and inflation are considered, classical economic theory suggests that inflation is largely a monetary phenomenon. The Quantity Theory of Money and monetarist views suggest that sustained growth cannot occur from monetary activities, but it is rather a result of real factors, i.e., improvements in capital accumulation, increased and efficient allocation of labour, and productivity enhancements. This is the quintessential idea behind the famous statement by Milton Friedman, “*inflation is always and everywhere a monetary phenomenon*” (Friedman, 1970). As per these views, inflation harms growth mainly through distortions such as reducing purchasing power, increasing uncertainty and discouraging long-term investments. Accordingly, policy focus should be to stabilise prices in order to reduce uncertainty and misallocations that depress investment and productivity. Moreover, rational expectations literature suggests that any short-term inflation surprise to spur growth would be short-lived and would lead to higher inflation over the long run. This is explained by the concepts of the *time-inconsistency problem* and *inflation bias*, which mean that when economic agents are rational, they would internalise the possibility of policymakers opting for a short policy easing, i.e., a short inflationary episode, to promote growth when inflation expectations are anchored, leading to de-anchoring of expectations to a higher level over the long run (Kydland and Prescott, 1977; Barro and Gordon, 1983).

On the other hand, Keynesian economic theory suggests that the relationship between economic growth and inflation can vary depending on the specific economic conditions and time frames considered. According to Keynesians, in the short term, the Aggregate Supply (AS) curve slopes upward, signifying that stimulating the demand side of the economy impacts both prices and output. In the short run, Keynesians suggest that there may be a positive relationship between inflation and economic growth. An increase in aggregate demand in the short run, caused by factors such as increased government spending or consumer spending, can result in both higher output (economic growth) and higher prices (inflation).

This is because when demand rises, businesses may respond by expanding production and hiring more workers, driving economic growth. However, if the economy is already operating at or is near its full employment capacity, further increases in demand may result in higher prices rather than increased output. Meanwhile, in the long run, the AS curve becomes vertical. The policy implication of the vertical AS curve is that demand-side policy no longer increases the level of output but only the level of prices. Accordingly, Keynesian theory also converges with the classical thought of long-run monetary neutrality.

Empirically, the relationship between growth and inflation seems to be non-linear. Low to moderate inflation appears consistent with growth, but there seems to be a threshold level of inflation, beyond which growth drops with inflation. Past contributions estimate such threshold levels to be around 2-3 per cent for developed economies, while for developing economies, they are found to be larger, at even 10-20 per cent levels (López-Villavicencio and Mignon, 2011; Kremer, Bick and Nautz, 2013; Eggoh and Khan, 2014). As illustrated earlier in this section with specific examples for Sri Lanka, specific country studies offer varying levels of estimates of these threshold inflation levels. As another country-specific example, different authors find evidence of this threshold level to be around 6-7 per cent in the case of India (see, among others, Ahluwalia (2011), Mohanty *et al.*, (2011), Mohaddes and Raissi (2016), and Rangarajan (2020)).

The past decade has given rise to another perspective on the discussion on possible inflation targets. When neutral real interest rates are at low levels, as observed over the past decade or so in many developed countries, a low inflation target can limit the policy space of central banks to revive the economy. This has given rise to a debate on whether a slightly higher target could provide some increased policy space for central banks. However, it has been noted that increasing an already established target, specifically long-established ones in many developed countries, may not be an easy task (Apel, Armelius and Claussen, 2017). This dialogue becomes even more complicated when considering the fact that policy tools, such as quantitative easing and forward guidance, that were traditionally deemed unconventional, have now become commonplace in many central banks, developed and emerging economies alike. Even though this concern is mainly focused on developed economies that have faced persistently low real interest rates, the takeaways are equally relevant for emerging markets. The lower bound of the policy rate, which is usually zero or close to zero in developed economies, often comes into the picture in this discussion. However, in the case of developing economies, the effective lower bound of the policy rate may be well above zero, due to a multitude of reasons, such as higher inflation expectations, exchange rate vulnerabilities and high risk premia, underdeveloped financial markets and low financial literacy, external debt pressures, higher non-performing loans and financial stability concerns, relatively higher growth potential leading to higher neutral rates, and challenges with respect institutional credibility. Accordingly, the need for sufficient policy space is an equally valid consideration for emerging markets as well when deciding on a target level of inflation.

3. Methodology

In the process of determining a numerical inflation target, historical data and other countries' experiences, both past and present, can be examined. Literature reveals differences between the recommended inflation targets for developing countries and advanced economies. In the case of

advanced economies, there is consensus that an inflation rate within the 1 to 3 per cent range is associated with price stability. Conversely, there is less guidance in the literature on the optimal level of inflation in developing and emerging countries, but the optimal level of inflation in these countries is likely to be higher than in advanced economies due to the Balassa-Samuelson Effect (Hammond, 2012). The Balassa-Samuelson Effect explains the difference in productivity growth in tradable and non-tradable sectors, resulting in higher inflation targets in these countries. Taking inherent measurement problems also into consideration, Škreb (1998) suggests that for emerging and transitioning economies, an inflation rate falling between 4 to 5 per cent to be treated as price stability. When exploring the related literature, the majority of academic papers examine the interplay between GDP growth and inflation, while weighing the feasibility of a target that does not have adverse effects on consumers. Some evidence could be found using technical analyses under several methodologies to determine an appropriate numerical value as an inflation target. Hence, a hybrid approach, combining descriptive analysis that considers historical data trends and the application of time series models, has been used for this purpose (more details are provided in Section 4). Specifically, we use the well-known threshold regression model that has been previously used in Sri Lankan studies as well, as seen in Cooray (2013) and De Silva (2017). With regard to data, inflation and economic growth data have been sourced from the DCS, while the remaining data have been obtained from the Central Bank.

In time series analysis, a threshold model is a statistical framework that characterises how a time series variable behaves under different regimes or states, each defined by a specific threshold or critical value. The fundamental concept behind a threshold model is that the relationship between variables or the statistical characteristics of time series data can undergo sudden or non-linear changes when a particular threshold condition is met. Such models are employed when there is a belief that the data exhibits distinct behaviours before and after surpassing a specific threshold value. Two separate threshold models are considered in this paper, viz., a threshold regression model and a Threshold Vector Auto-Regression (TVAR).

With regard to the threshold regression, following established economic theory and empirical findings of contributions such as Khan and Senhadji (2001), Bhatta (2015), Mosikari and Eita (2018) and Dholakia *et al.*, (2021), the following growth model is employed,

$$\Delta Y = \alpha + \beta_1 \pi + \beta_2 * D. (\pi - \pi^*) + \theta X + \varepsilon, \quad (1)$$

where ΔY is the GDP growth rate. π is the rate of inflation, π^* is the threshold rate of inflation, X represents other exogenous variables, and ε is $iid(0, \sigma^2)$. D is a Dummy variable such that $D = 0$ when $\pi \leq \pi^*$ and $D = 1$ when $\pi > \pi^*$.

Furthermore, we expand this analysis via a TVAR as well in order to derive further evidence on the inflation threshold limit. We estimate the following three-regime TVAR model as elucidated by Aleem and Lahiani (2014), intending to identify two threshold limits for inflation:

$$\begin{aligned} y_t &= \alpha_1 + A_1(L)y_t + \varepsilon_{1t} & \text{if } \pi_t \leq \pi_1, \\ y_t &= \alpha_2 + A_2(L)y_t + \varepsilon_{2t} & \text{if } \pi_1 \leq \pi_t \leq \pi_2, \\ y_t &= \alpha_3 + A_3(L)y_t + \varepsilon_{3t} & \text{if } \pi_t \geq \pi_2, \end{aligned} \quad (2)$$

where y_t is the vector of variables, π_t is the threshold variable and π_1 and π_2 are the threshold values. Lag polynomial $A_i(L)$ is order p and can be represented as $A_{ij}(L) = A_{i1}L + A_{i2}L^2 + \dots + A_{ip}L^p$, where $i = 1, 2$ and $j = 1, 2, \dots, p$.

Spline regression, a non-parametric statistical method employed in time series analysis, is utilised to model and scrutinise time-dependent data. It is especially valuable when the relationship between variables exhibits intricate, non-linear patterns over time. This technique entails fitting piecewise polynomial functions to the time series data, with these polynomial segments, known as ‘splines,’ seamlessly connected to form a more flexible and precise representation of the relationship between the variables. Spline regression typically employs low-degree polynomials, such as linear or cubic, within each segment to model the data. In the present analysis, we use cubic smoothing splines, where the degree of smoothness is selected so that the root-mean square error (RMSE) of out-of-sample predictions is minimised, based on evaluating several sub-samples of the full data set. This method produces a smoothed curve that captures the relationship between the two variables of the given sample data set. Unlike standard frequentist regression techniques, this approach does not assume a predefined data-generating process. We repeat the process for quarterly and annual data separately.

4. The Choice of Inflation Target

This section discusses each parameter considered when choosing an appropriate inflation target.

4.1. The Choice Between Headline and Core Inflation

Headline inflation represents the total expenditure in the consumer price index; therefore, it is more representative of the overall behaviour of prices. Core inflation is derived by excluding volatile items such as food, energy, and transport components from the overall consumer price basket to gauge underlying inflation in the economy. Many inflation-targeting countries use headline inflation as their target (Table 01), primarily because it is easy to communicate to the public and serves as a more effective anchor for inflation expectations. While core inflation is less volatile and more responsive to monetary policy, headline inflation is more widely recognised by the public, who play a key role in shaping inflation expectations. Moreover, in emerging and developing economies, the consumption baskets have a sizeable weight on food items. Since a large portion of that is eliminated in arriving at the core inflation, it lacks credibility among the public. Empirical evidence also suggests that headline inflation is more suitable as a target index than core inflation, as it has a stronger relationship with inflation expectations influenced by sensible linkages with wages and social security payments. In the case of Sri Lanka also, the outcomes of the Inflation Expectations Survey confirm that inflation expectations are more aligned with headline inflation than core inflation. It is noteworthy that while some central banks initially adopted core inflation as their inflation target, many have since transitioned to headline inflation as the key target of monetary policy. For example, the Bank of Thailand selected core inflation as its inflation target when it introduced inflation targeting in 2000, but it shifted to headline inflation in 2015 to enhance communication with the public and to strengthen the effectiveness of monetary policy in anchoring long-term inflation expectations. In light of such experiences, it is suggested that headline inflation be

considered the targeted index for monetary policy. Nevertheless, core inflation remains an important indicator and should continue to be closely monitored in the formulation of monetary policy decisions.

Table 01: Inflation Metrics of Selected Economies^(a)

	Country	Date Adopted	Target Measure	Initial Target	Current Target	Target Type	Average Target ^(b)	
							Initial	Current
Developed Countries	Australia	Early 1990s	Headline	2.00% - 3.00%	2.00% - 3.00%	Range		
	Canada	1991	Headline	2.00% +/- 1.0 pp	2.00% +/- 1.0 pp	P+T		
	Czech Republic	1998	Headline	5.50-6.50%	2.00% +/- 1.0 pp	P+T		
	Euro Area	1999	Headline	Below 2.00%	2.00%	P		
	Hungary	2001	Headline	7.00%	3.00% +/- 1 pp	P+T	3.1%	2.2%
	Japan	2013	Headline	2.00%	2.00%	P		
	New Zealand	1990	Headline	0.00-2.00%	2.00% +/- 1.0 pp	P+T		
	United Kingdom	1992	Headline	1.00-4.00%	2.00%	P		
Emerging Economies	Brazil	1999	Headline	8.00% +/- 2.0 pp	3.00% +/- 1.5 pp	P+T		
	Chile	1999	Headline	3.00% +/- 1.0 pp	3.00% +/- 1.0 pp	P+T		
	Georgia	2009	Headline	3.00%	3.00%	P		
	India	2016	Headline	4.00% +/- 2 pp	4.00% +/- 2 pp	P+T	4.5%	3.3%
	Indonesia	2005	Headline	6.0% +/- 1 pp	2.5% +/- 1 pp	P+T		
	Mongolia	2007	Headline	5.00%	6.00% +/- 2.0 pp	P+T		
	Philippines	2002	Headline	4.5-5.5%	2.00%-4.00%	P+T		
	Thailand	2000	Headline ^(c)	1.00% - 3.00%	1.00% - 3.00%	Range		

Source: Respective Central Banks

(a) The midpoint of each target, including ranges, was considered when calculating the average.

(b) Thailand shifted to target headline inflation from core inflation in 2015.

P: Point, T: Tolerance band, pp: percentage points

4.2. The Choice of the Price Index: NCPI and CCPI

When considering other measures that can be used to measure inflation, such as the GDP deflator, producer price indices, etc., using a consumer price index is advised because of its relevance to the general price levels in the market. Moreover, availability with a higher frequency, a long-established regular publishing calendar, and familiarity among most economic stakeholders also support consideration of a price index, rather than, say, an indicator like GDP deflator.

The DCS compiles two consumer price indices, the NCPI and the CCPI, which differ primarily in their geographical coverage. The NCPI covers the entire island, whereas the CCPI covers urban areas in the Colombo district.

Table 02: CCPI Vs. NCPI

Characteristic	CCPI (2021=100)	NCPI (2021=100)
Geographical Coverage	Urban areas of the Colombo district	All provinces in Sri Lanka
Target Household Units	All households in urban areas of the Colombo district	All households in each province
Average Size of the Household Unit	3.8	3.7
Average Monthly Consumption Expenditure in the Base Period	Rs. 91,880.34	Rs. 50,728.60
Value of One Index Point	Rs. 918.80	Rs. 507.29
Total Number of Items	426	485
Percentage of Total Weight		
i. Food	26.23	39.22
ii. Non-Food	73.77	60.78
Date of Release	Last working day of each month	Released with a time lag of 21 days
Price Collection Centres	10	03 price collecting outlets in each District town for each item

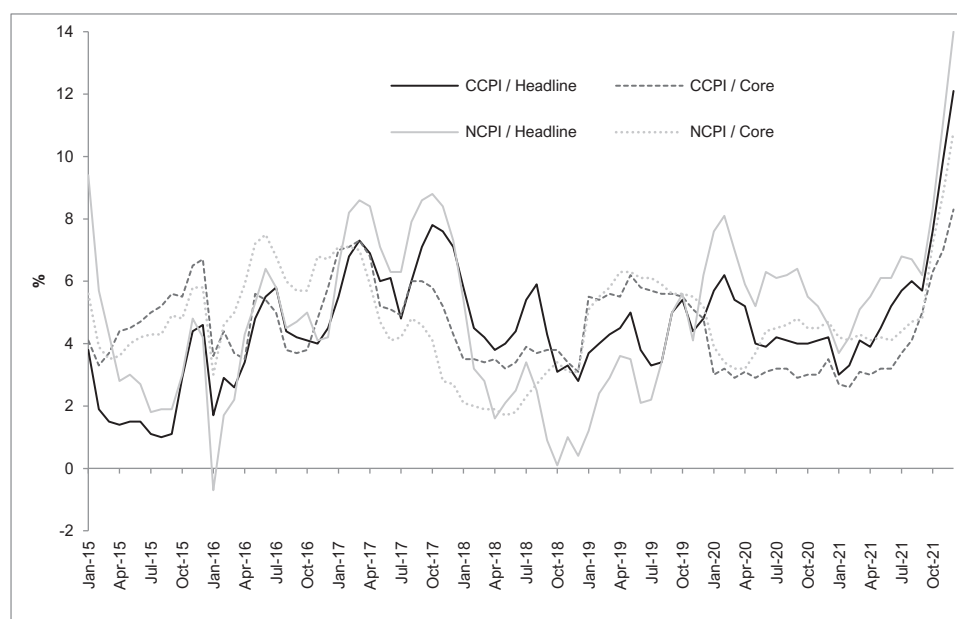
Source: Department of Census and Statistics

Apart from the geographical coverage, the share of food items and the consumption of domestically sourced commodities are other key diverging factors between the NCPI and the CCPI. The share of food items in the NCPI is larger than that of the CCPI. At the same time, the consumer expenditure and behaviour patterns at the national level could be relatively more biased towards domestically sourced items. On the other hand, when compared to their rural counterparts, urban consumers spend relatively more on non-food categories. Further, the NCPI may not adequately cover market price movements, as the rural households tend to substitute market-based products with products produced by themselves. Therefore, an urban price index, such as the CCPI, could better reflect overall changes in market prices. Meanwhile, the CCPI represents inflation dynamics in urban areas in Colombo, and therefore, it could be more indicative of overall economic conditions, given the fact that economic activity is also largely concentrated in urban areas in Colombo. Moreover, the CCPI has a longer time series commencing from January 1953 on different base years, compared to the NCPI, which commenced in January 2014. Therefore, expenditure patterns could be better examined with the CCPI, and the relatively longer sample makes economic analyses and forecasts more accurate. This is a key consideration when selecting an index for monetary policy purposes, given the considerable importance of projections in a FIT framework.

Further, since the NCPI places a greater emphasis on the food basket (around 40 per cent), it is more vulnerable to supply shocks and less responsive to monetary policy. The NCPI broadly follows the trend observed in the CCPI, but is relatively more volatile, reflecting the movements of transitory supply conditions. Hence, the controllability of the measure is somewhat lower compared to the CCPI. Moreover, as the NCPI is released with a time lag of 21 days, it would have implications for the forecasting process during the monetary policy cycles. Inflation expectations, as measured by the Central

Bank's Inflation Expectations Survey, are perceived to be largely driven by realised inflation, thus reflecting an adaptive expectations formation. Nevertheless, the correlation between inflation expectations and realised inflation also seems to be higher for the CCPI than for the NCPI.

Figure 01: Year-on-Year Inflation (2015-2021)^(a)



Source: Department of Census and Statistics

(a) The chart starts from 2015 since the year-on-year changes of NCPI become available only after this period. Data after 2021 is not displayed to better highlight the dynamics of inflation during normal times. Inflation dynamics changed drastically since the onset of the historic economic crisis in 2022 and the aftermath, with sharp disinflation and subsequent deflation. Including these data points would lead to counterintuitive inferences. Data from the 2013=100 base year series are used for this analysis.

Table 03: Average Year-on-Year Inflation and its Volatility During 2015-2021^(a)

	CCPI / Headline	CCPI / Core	NCPI / Headline	NCPI / Core
Average Inflation (%)	4.6	4.5	4.9	4.7
Standard Deviation (%)	1.9	1.3	2.6	1.6

Sources: Department of Census and Statistics, Central Bank Staff Calculations

(a) Data during 2015-2021 are considered to enable comparison between the NCPI and the CCPI, where the former commenced only from 2014 onwards, and to exclude the extraordinary inflation episode during 2022-2023. Data from the 2013=100 base year series are used in this analysis.

Table 04: Correlation^(a) Between Inflation Expectations^(b) and Realised Inflation (2016-2021)

	Current Month (1 Month Ahead) Expectation	3 Months Ahead Expectation	6 Months Ahead Expectation	12 Months Ahead Expectation
CCPI / Headline	0.81	0.55	0.52	0.25
NCPI / Headline	0.72	0.50	0.48	0.19

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

(a) Correlations are calculated with expected inflation of the corporate sector and corresponding realised year-on-year inflation (2013=100) at the given time horizon.

(b) As measured in the Inflation Expectations Survey conducted by the Statistics Department.

Therefore, given its low volatility and less susceptibility to supply factors, the availability of data for a longer period, and shorter publication lag, the CCPI may be more suitable than the NCPI as the targeted measure of inflation for monetary policy purposes.

Nevertheless, as the economy progresses, regional disparities may lessen, enhancing the relevance of the NCPI due to its broader geographical coverage. Further, with time, the predictability of the NCPI could improve with more data availability and reduced publication lag. At such a stage of development, the Central Bank could reconsider revisiting the use of the NCPI as a potential target for monetary policy.

4.3. The Choice of the Target: “Range” Vs. “Point with Tolerance margin” Vs. “Point”

The inflation target can be defined in several ways (a range target, a point target with tolerance margin, or a point target). Compared to a range target, a point target with a tolerance margin could imply a firm commitment to achieving the targeted level of inflation. This can improve the credibility of the respective central bank and enable better anchoring of inflation expectations. As a result, many inflation-targeting central banks use either a point target or a point target with a tolerance margin (Table 01). For a developing country, a point target without a tolerance margin may also be less desirable, as headline inflation is usually subject to transitory supply shocks, which can lead inflation to deviate from the target frequently. If an adequate tolerance band is not considered, possible frequent ‘target misses’ could undermine central bank credibility and, in turn, affect the anchoring of inflation expectations.

Specifically for the case of Sri Lanka, the CBA requires the Central Bank to submit a report to the Parliament if it fails to meet the inflation target by a margin specified under the Monetary Policy Framework Agreement. This provision affirms the importance of adopting a point target accompanied by an acceptable tolerance margin in the CBA. Accordingly, a point target, with a defined tolerance margin to measure the breach of the target, is recommended for Sri Lanka, in contrast to the range target (4-6%), considered prior to the enactment of the CBA.

4.4. The Numerical Value of the Inflation Target

The appropriate level of the inflation target for a country depends on various factors, including the country’s economic conditions, policy objectives, and institutional framework. Key considerations in determining an inflation target include the country’s overall economic goals, need for policy flexibility, historical and institutional context, inflation expectations, real interest rate trends, international trade and

competitiveness, structural characteristics of the economy, and the need for the target to evolve and adapt over time.

In countries where inflation is particularly sensitive to external, as well as domestic shocks, it may be appropriate to adopt a slightly higher inflation target than those typically set by developed countries. This approach can help establish a credible inflation target that accounts for heightened uncertainty and variability caused by these external factors. A relatively high inflation target provides greater policy flexibility, allowing the central bank more ‘room to manoeuvre’ in response to sudden fluctuations in exchange rates, commodity prices, other global developments and supply-side volatilities. If a country sets an inflation target that it consistently meets, it builds credibility with the public, businesses, and financial markets, fostering better long-term planning and reducing uncertainty. However, it is essential to strike a careful balance between flexibility and credibility when determining the appropriate level of the inflation target.

For most developed countries, it is common practice to adopt a small positive value as the inflation target. As illustrated in Table 01, developed countries typically set lower inflation targets than developing countries. Based on the statistics published by the World Bank, average annual inflation during 1982-2022 in low- and middle-income countries is more than double that of high-income countries. Similarly, inflation volatility in low- and middle-income countries is nearly twice as high as that of high-income countries (Table 05). Although one could expect inflation volatility to reduce with the adoption of inflation targeting, the higher volatility of inflation in developing nations could also be due to structural characteristics, such as a higher share of food items in the consumer basket, exchange rate volatility, higher susceptibility to oil and commodity price shocks, etc. Knight (2007) highlights the challenges in producing reliable inflation forecasts in emerging economies, which include unpredictable exchange movements, large economic and financial shocks, lack of long time series and the presence of structural changes in the time series estimation. These challenges translate into more forecast errors and inflation target misses. Accordingly, these factors contribute to developing and emerging market countries choosing a relatively higher target than developed countries.

**Table 05: Inflation During 1982-2022:
High-Income vs. Low & Middle-Income Countries**

	Average Annual Inflation (%)	Standard Deviation of Annual Inflation (%)
High-Income Countries	3.2	1.9
Low-& Middle-Income Countries	7.1	3.7

Source: Authors' Compilation Based on World Bank Data

Measurement errors are also another consideration when deciding the inflation target. Discrepancies between measured inflation and inflation perceived by the public, arising from issues such as low representativeness of the consumer basket and sampling weaknesses, can hinder anchoring of inflation expectations. Since such measurement errors are difficult to eliminate entirely, setting a modest positive inflation target can serve as a buffer against unintended deflation episodes.

Various technical analyses provide valuable insights that should be considered when determining the appropriate inflation target. In the case of Sri Lanka, the following evidence can be considered using technical analyses under several methodologies.

4.4.1. Threshold Inflation Regression

Threshold regression refers to a type of regression analysis that involves modelling a relationship between variables that vary based on certain threshold conditions. It is important to note that threshold regression can be complex and relies on the assumption that the relationship changes at the specified threshold. The choice of the threshold variable and the functional form of the model will significantly impact the results. This approach offers a more data-driven method for establishing an inflation target, considering the interplay between inflation and other key economic indicators at various levels, which could be valuable for countries with inflation-targeting regimes. The regression equation utilised in the analysis, which was described in a generic form in equation (1), can be expanded as follows.

$$\Delta Y = \alpha_1 + \beta_1 \pi + \beta_2 * D_i(\pi - \pi^*) + \beta_3 BD + \beta_4 CA + \beta_5 GM2 + \varepsilon \quad (3)$$

In this regression model, if inflation falls below a predefined inflation threshold, the associated dummy variable (D) takes a value of zero, resulting in a relationship between inflation and GDP growth characterised solely by the coefficient of inflation (β_1). However, when inflation exceeds the threshold, the effect of inflation on growth is a combination of the inflation coefficient and the dummy coefficient, summed together ($\beta_1 + \beta_2$).

According to Hayat and Kalirajan (2009), when conducting regressions with various threshold values, the objective is to identify the threshold value at which a significant structural break occurs, often characterised by a high R-squared value or the lowest sum of squared residuals. Moreover, it is essential that the combined sum of regression coefficients for the inflation variable and the dummy variable is positive and they are both statistically significant to establish it as the threshold level of inflation.

Table 06: Variables Considered

Variables	Definition
GGDP	ΔY = Real GDP Growth
INF	π = Inflation
BD	Budget Deficit (as % of GDP)
CA	External Current Account Balance (as % of GDP)
GM2	Broad Money Growth

Source: Authors

Dummy variables are defined as,

$$D_i = \begin{cases} 1, & INF > k_i \\ 0, & INF \leq k_i \end{cases} \quad (4)$$

where,

$$k_1 = 3, \quad k_2 = 4, \quad k_3 = 5, \quad k_4 = 6, \quad k_5 = 7, \quad k_6 = 8, \quad k_7 = 9, \quad k_8 = 10.$$

Table 07: Results of the threshold regressions (Dependent variable: Real GDP Growth)

k_t	Variables	Coefficient	Std. Error	t-statistics	Prob.	R-squared	SSR
3.0	C	3.6113	0.9562	3.7768	0.0004	0.2944	275.8
	INF	0.4167	0.3604	1.1565	0.2519		
	GM2	0.1041	0.0344	3.0229	0.0036		
	BD	0.4512	0.1256	3.5914	0.0006		
	CA	-0.3658	0.1141	-3.2068	0.0021		
	D1_DEFF1	-0.3871	0.3821	-1.0130	0.3150		
4.0	C	3.7929	0.8770	4.3247	0.0001	0.2922	276.6
	INF	0.2753	0.2475	1.1123	0.2703		
	GM2	0.1033	0.0345	2.9963	0.0039		
	BD	0.4488	0.1257	3.5699	0.0007		
	CA	-0.3691	0.1141	-3.2350	0.0019		
	D2_DEFF2	-0.2484	0.2730	-0.9097	0.3664		
5.0	C	3.5856	0.8337	4.3007	0.0001	0.3077	270.5
	INF	0.3336	0.1933	1.7258	0.0893		
	GM2	0.1028	0.0341	3.0153	0.0037		
	BD	0.4577	0.1244	3.6803	0.0005		
	CA	-0.3562	0.1133	-3.1439	0.0025		
	D3_DEFF3	-0.3275	0.2179	-1.5032	0.1378		
6.0	C	3.5910	0.7997	4.4906	0.0000	0.3151	267.7
	INF	0.2920	0.1486	1.9649	0.0538		
	GM2	0.1021	0.0339	3.0097	0.0038		
	BD	0.4503	0.1231	3.6570	0.0005		
	CA	-0.3641	0.1123	-3.2427	0.0019		
	D4_DEFF4	-0.3099	0.1800	-1.7211	0.0901		
7.0	C	3.6525	0.7878	4.6361	0.0000	0.3136	268.3
	INF	0.2462	0.1272	1.9365	0.0573		
	GM2	0.1013	0.0340	2.9795	0.0041		
	BD	0.4424	0.1230	3.5953	0.0006		
	CA	-0.3605	0.1125	-3.2037	0.0021		
	D5_DEFF5	-0.2735	0.1631	-1.6772	0.0985		

8.0	C	3.7237	0.7725	4.8206	0.0000	0.3124	268.7
	INF	0.2148	0.1125	1.9095	0.0608		
	GM2	0.1012	0.0340	2.9744	0.0042		
	BD	0.4426	0.1232	3.5940	0.0006		
	CA	-0.3632	0.1125	-3.2275	0.0020		
	D6_DEFF6	-0.2538	0.1544	-1.6437	0.1052		
9.0	C	4.0447	0.7529	5.3723	0.0000	0.2914	276.9
	INF	0.1204	0.0942	1.2775	0.2061		
	GM2	0.1043	0.0345	3.0222	0.0036		
	BD	0.4496	0.1260	3.5685	0.0007		
	CA	-0.3830	0.1146	-3.3415	0.0014		
	D7_DEFF7	-0.1242	0.1430	-0.8690	0.3882		
10.0	C	3.8761	0.7482	5.1805	0.0000	0.3074	270.7
	INF	0.1617	0.0915	1.7676	0.0820		
	GM2	0.1004	0.0342	2.9355	0.0046		
	BD	0.4432	0.1236	3.5849	0.0007		
	CA	-0.3744	0.1128	-3.3200	0.0015		
	D8_DEFF8	-0.2204	0.1476	-1.4936	0.1403		

Source: Authors' Estimates

Based on the findings described above, the determination of the threshold value takes into consideration the highest R-squared, the lowest sum of squared residuals (SSR), and the combined sum of regression coefficients for both the inflation and dummy variables. This analysis indicates that, using historical data as a reference, the optimal inflation threshold for the target level is approximately 6 per cent.

4.4.2. Analysis Using the TVAR Model

The second threshold model used is the TVAR model with three regimes. This model examines the dynamic interactions among the output gap (GDP), inflation (Inf), interest rates (Int), and the budget deficit (BD). The inflation rate is considered the threshold variable in the model. Accordingly, the vector of variables is defined as follows:

$$y_t = [\text{Inflation} \quad \text{Output gap} \quad \text{Budget Deficit} \quad \text{Interest Rate}] \quad (5)$$

The optimal lag order of 2 is selected by using the Akaike Information Criterion (AIC). However, the two threshold values, 6.5 and 7.7, are estimated endogenously as model outputs using R software. The following three equations indicate the results of the TVAR model with the inflation rate as a threshold variable.

Low inflation regime (<6.5%)

$$\begin{aligned} \text{Output Gap}_t = & -0.8516 + 0.7992^{***} \cdot \text{Output Gap}_{t-1} + 0.0555 \cdot \text{Inflation}_{t-1} \\ & + 0.6617 \cdot \text{Interest Rate}_{t-1} - 0.0289 \cdot \text{Budget Deficit}_{t-1} \\ & - 0.1038 \cdot \text{Output Gap}_{t-2} + 0.1426 \cdot \text{Inflation}_{t-2} \\ & - 0.6765 \cdot \text{Interest Rate}_{t-2} + 0.1145 \cdot \text{Budget Deficit}_{t-2} \end{aligned}$$

Middle inflation regime (6.5–7.7%)

$$\begin{aligned} \text{Output Gap}_t = & -32.3316^{**} + 1.3885^{**} \cdot \text{Output Gap}_{t-1} + 4.3076^{**} \cdot \text{Inflation}_{t-1} \\ & + 1.6654 \cdot \text{Interest Rate}_{t-1} + 0.6750 \cdot \text{Budget Deficit}_{t-1} \\ & - 0.8169 \cdot \text{Output Gap}_{t-2} + 1.0052 \cdot \text{Inflation}_{t-2} \\ & - 3.5187 \cdot \text{Interest Rate}_{t-2} + 0.9836 \cdot \text{Budget Deficit}_{t-2} \end{aligned}$$

High inflation regime (>7.7%)

$$\begin{aligned} \text{Output Gap}_t = & 0.2280 + 0.9834 \cdot \text{Output Gap}_{t-1} + 0.0317 \cdot \text{Inflation}_{t-1} \\ & + 0.0272 \cdot \text{Interest Rate}_{t-1} + 0.0218 \cdot \text{Budget Deficit}_{t-1} \\ & - 0.5195 \cdot \text{Output Gap}_{t-2} - 0.1813 \cdot \text{Inflation}_{t-2} \\ & + 0.0813 \cdot \text{Interest Rate}_{t-2} + 0.0184 \cdot \text{Budget Deficit}_{t-2} \end{aligned}$$

* significant at $\alpha = 0.05$ ** significant at $\alpha = 0.01$ *** significant at $\alpha = 0.001$

TVAR estimation identifies two significant inflation thresholds at 6.5 per cent and 7.7 per cent, which divide the sample into three regimes of inflation and output gap dynamics.⁴ In the low-inflation regime, where inflation is below 6.5 per cent, the output gap is primarily determined by its own persistence, while the effect of inflation is weak and insignificant, indicating that low inflation has little impact on the output gap. In the middle regime, when inflation is between 6.5 per cent and 7.7 per cent, the relationship between output gap and inflation strengthens considerably as inflation exerts a large and positive effect on the output gap, suggesting that moderate inflation supports demand conditions and enables the economy to operate closer to potential.⁵ In the high-inflation regime, where inflation is above 7.7 per cent, inflation remains highly persistent⁶, but its effect on the output gap diminishes, implying that higher inflation does not translate into sustained improvements in economic activity and may exacerbate macroeconomic imbalances. These findings provide further evidence to support the conjecture that moderate levels of inflation around the levels suggested by the middle regime supports preserving macroeconomic stability.

⁴ Based on the sample data, in most cases when inflation is low, the economy seems to have operated below full capacity, while at moderate levels of inflation, economic performance seems to have remained close to the full capacity levels.

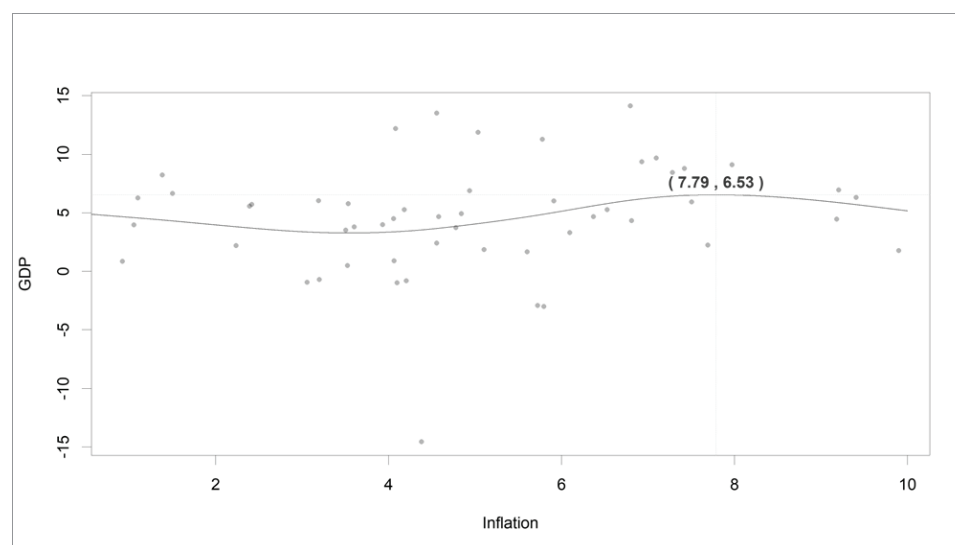
⁵ Note that in this scenario, the intercept on the output gap equation is a statistically significant, large, negative value. Accordingly, ceteris paribus, the positive statistically significant relationship with inflation can be interpreted as better support for closing the output gap.

⁶ The coefficient of the lagged inflation term in the inflation equation of the TVAR model is significant and relatively high.

4.4.3. Spline Regression

The following graphs illustrate the non-linear relationship between GDP and inflation through spline regression using R software.

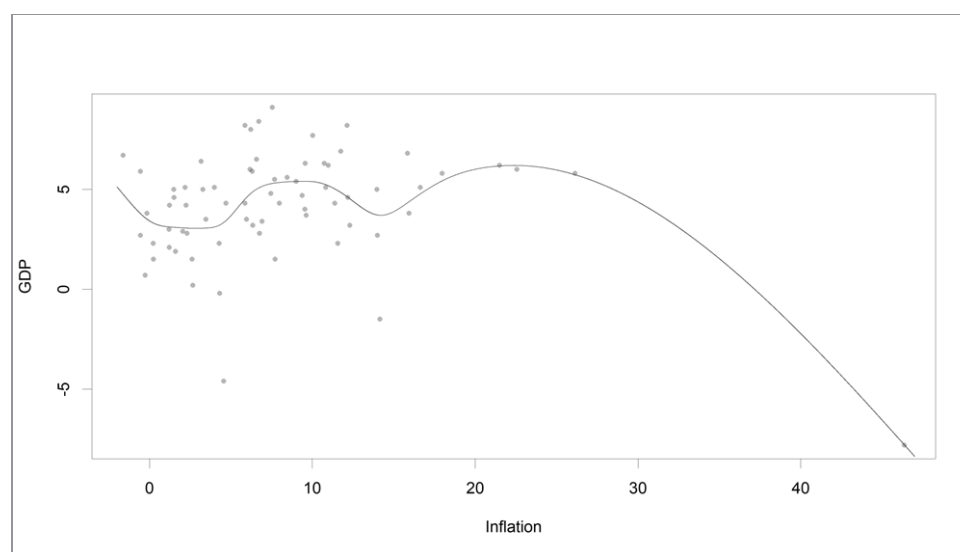
Figure 02: GDP Growth Vs. Inflation Using Spline Regression (Quarterly Data Since 2009-21)



Source: Authors' Estimates

Based on the findings from the spline regression analysis, it becomes evident that optimal growth occurs when inflation is close to 7 per cent. Beyond this threshold, a consistent reduction in GDP growth is noticeable. Furthermore, the connection between inflation and GDP growth remains positive when inflation is below 7 per cent. Notably, the impact of inflation on growth is particularly pronounced within the range of around 4 to 7 per cent inflation, thus highlighting a potential for increased manoeuvrability. It suggests that GDP growth has an increasing relationship with inflation when inflation is around 4-7 per cent.

When extending the analysis over a more extended period, using annual data since 1953, similar trends emerge. When inflation remains in the single-digit range and specifically below approximately 7 per cent, it demonstrates a strong response of GDP growth. In contrast, when inflation lies between around 7-12 per cent, inflation exhibits a weaker connection with GDP, responding with less intensity. Consequently, during this timeframe, policymakers may find it relatively manageable to stabilise growth near its potential level. Notably, optimal GDP growth tends to align with an inflation rate around the 7 per cent range. The analyses also suggest that the relationship between inflation and GDP growth has another local maximum when inflation is about 23 per cent. However, this case could not be considered, given the lower number of observations in this region under specific economic conditions.

Figure 03: GDP Growth Vs. Inflation Using Spline Regression (Annual Data Since 1953)

Source: Authors' Estimates

Taking these factors into account, it can be concluded that the optimal inflation range lies approximately between 4 and 7 per cent.

4.4.4. Historical Relationships

When the behaviour of output gap and inflation is considered, the negative output gap, calculated based on a Hodrick Prescott (HP) filter, tends to close when inflation is around 4-7 per cent. During the period, where inflation remained within single-digit levels during 2009-2021, average inflation was around 5 per cent, while the standard deviation was about 2 per cent.⁷

Monetary policy conducted by a central bank primarily influences the money supply, interest rates, and credit conditions in an economy. Its main objective is typically to maintain price stability (low and stable inflation) and thereby support sustainable economic growth. However, the direct impact of monetary policy on long-term economic growth (the growth of an economy's potential output) is limited. It can influence short-term economic fluctuations, but its effect on the underlying potential growth rate of an economy is more indirect.

The output gap measures the difference between actual output and potential output in an economy. Policymakers are often more interested in the output gap because it provides insights into the immediate health of the economy and the presence of economic slack or overheating. Policymakers often focus on short-term fluctuations (business cycles) in the output gap. These fluctuations can have significant implications for employment, inflation, and overall economic stability. Monetary policy tools, such as interest rate adjustments, can be used to smoothen out these short-term fluctuations, stabilising the economy and reducing the amplitude

⁷ During the same period, the average quarterly year-on-year growth rate is about 4 per cent and its standard deviation is about 5 per cent.

of the business cycle. Hence, the level of inflation that is consistent with a smaller amplitude of output gap can be considered more desirable as a target level of inflation.

Table 09: Average Output Gap at Different Levels of Inflation

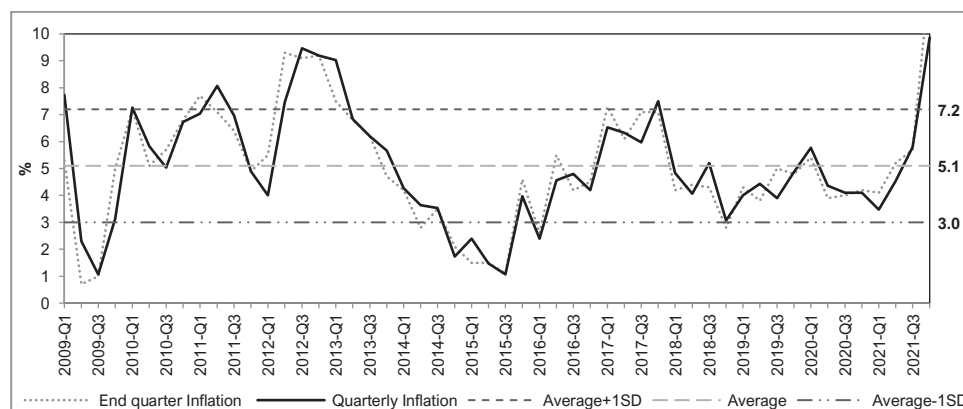
Y-o-Y Inflation Level (% Log Difference)	Less than or equal to 1	More than 1, but less than or equal to 3	More than 3, but less than or equal to 5	More than 5, but less than or equal to 7	More than 7, but less than or equal to 9	More than 9, but less than or equal to 11	More than 11, but less than or equal to 13	More than 13, but less than or equal to 15	More than 15
Average Output Gap (% Log Difference)	-0.49	-0.83	0.13	0.17	0.54	0.83	0.18	1.55	0.56
Standard Deviation of Output Gap (% Log Difference)	0.29	1.56	2.85	2.32	2.04	2.07	0.97	0.06	2.55
No. of Observations	3	9	28	15	12	4	5	2	11

Note: Data used in this analysis are based on the Quarterly Projection Model of the Central Bank.

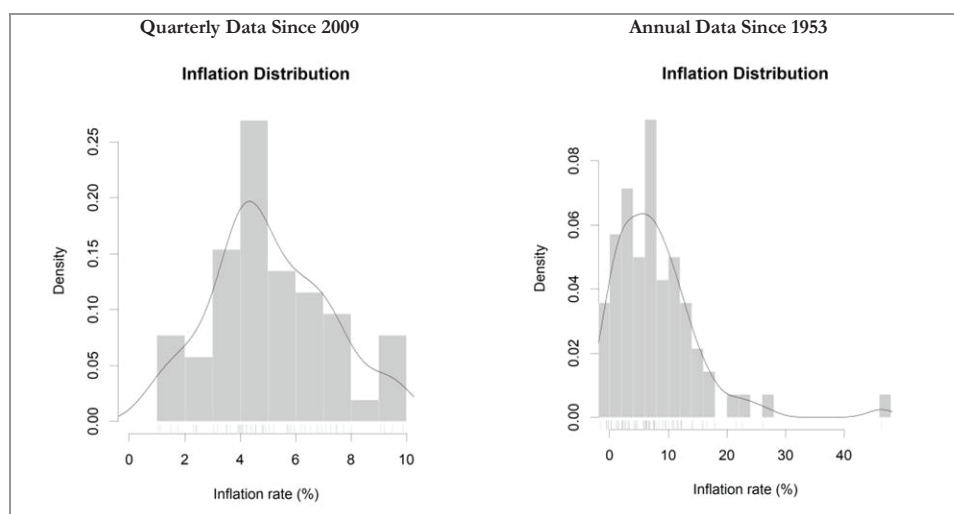
Source: Prepared by the Authors based on data from the Department of Census and Statistics

The above observations suggest that the output gap, on average, is smallest when inflation is around 3-7 per cent. Moreover, it also suggests that the output gap, on average, tends to take comparatively more extreme values when inflation is outside this region. Accordingly, inflation hovering around 3-7 per cent is consistent with a lower amplitude of the business cycle, i.e., a more stable level of economic activity. This observation does not suggest any causation but only offers a simple characteristic observation of inflation and output dynamics in the economy. Nevertheless, it still suggests that too high or too low inflation from a mid-single-digit level is accompanied by a more extreme level of the business cycle.

Figure 04: Quarterly Inflation based on the CCPI



Source: Prepared by the Authors based on data from the Department of Census and Statistics

Figure 05: Distribution of Inflation

Source: Prepared by the Authors based on data from the Department of Census and Statistics

Note: The thick line in each of the histograms displays the kernel density, estimated using R software, assuming a Gaussian kernel. The kernel density can be thought of as a way of transforming the discrete distribution given in the histogram into a smoothed continuous distribution.

When selecting a target, careful consideration of historical data patterns is essential. During the single-digit inflation era (2009-2021), the average inflation rate was 5.1 per cent, with an observed standard deviation of 2.1 per cent. These distributional characteristics can be visualised using histograms and kernel densities as given in Figure 05. Given this historical pattern, it is prudent to set a 5 per cent target with a tolerance margin of ± 2 percentage points.

Considering empirical evidence and the need to facilitate sufficient policy space to affect real economic conditions, a point inflation target of 5 per cent, with a margin of ± 2 percentage points, may be appropriate for the Sri Lankan economy. This target aligns with the country's unique circumstances, promoting stability, credibility, and sustainable growth in the face of various economic challenges. This recommended target enables compliance with the CBA while strengthening the ability to anchor inflation expectations.

Moreover, having a margin of about two percentage points, which broadly aligns with the observed standard deviation, provides some space for inflation to deviate due to factors that may be difficult to control with monetary policy. This is particularly important, given that Sri Lanka, being a small island, is prone to frequent weather shocks and susceptible to global commodity price fluctuations.

4.5. Specific Considerations When Measuring Deviations from the Target

The CBA requires the Monetary Policy Board of the Central Bank to submit a report to Parliament if the inflation target is breached for two consecutive quarters. For this purpose, it is proposed that inflation be monitored using quarterly average inflation with a margin of ± 2 percentage points. Quarterly average

inflation, calculated as the simple average of three monthly year-on-year inflation, is suggested to be considered for this purpose. Compared to other calculation methodologies,⁸ this method is proposed due to its simplicity, leading to a higher level of transparency.

4.6. The Time Horizon During which Inflation is Expected to Reach the Target, in Response to Policy Actions

The inflation target horizon is the time period during which inflation is expected to return to its target following economic shocks. Determining an appropriate target horizon requires consideration of several factors, including the behaviour of inflation expectations, the transmission lag of monetary policy (i.e., the time it takes for monetary policy actions to affect the real economy), and the economy's responsiveness to exchange rate fluctuations. Although each of these factors is subject to considerable uncertainty, they are critical in assessing how quickly inflation can return to its desired level. Further, the nature and persistence of economic shocks play a significant role in shaping the adjustment path of inflation. These dynamics are likely to evolve as the economy undergoes structural transformations.

Considering the statistical relationships among short-term interest rates, real output and inflation, based on empirical evidence from previous research and the semi-structural model employed officially, as well as the vulnerability of the Sri Lankan economy to supply shocks and external shocks, a medium-term target horizon of around 2 years is deemed appropriate for Sri Lanka.

5. Conclusion

This study examined various parameters of inflation measures to arrive at recommendations for the most appropriate target for Sri Lanka under the FIT framework. Both qualitative and quantitative analyses were carried out to determine the suitable target for inflation and the allowable deviation band that would constitute a target miss under the CBA. The objective of this policy research is to facilitate the Central Bank in proposing an inflation target for the consideration of the Government, as required for signing the first Monetary Policy Framework Agreement (MPFA) under the CBA. The key findings are summarised below.

Given its comprehensibility to the public, its reflection of total expenditure in the consumer basket, thus being closely representative of overall price developments and effectiveness of anchoring inflation expectations, headline inflation is recommended over core inflation as the target measure for monetary policy purposes. Among available indices, the CCPI is preferred over the NCPI, due to lower volatility, lower susceptibility to supply factors, availability of data for a longer period and shorter publication lag. Empirical evidence, along with the need for adequate policy room to influence real economic conditions, supports a point inflation target of 5 per cent, with a margin of ± 2 percentage points to measure the deviation of inflation from its target at this stage of the implementation of FIT. This recommended

⁸ See, for example, the method of calculating quarterly inflation as per the Monetary Policy Consultation Clause (MPCC) in the Extended Fund Facility (EFF) programme of the International Monetary Fund (IMF), where a slightly different averaging is used. These methodologies produce approximately similar values when price changes are relatively small. However, in periods where price changes are substantial, the differences between the averages widen.

target aligns with the requirements of the CBA and enhances the ability to anchor inflation expectations.⁹ A medium-term target horizon of approximately two years is appropriate for Sri Lanka. Nevertheless, these findings are contingent on prevailing economic conditions, which may evolve due to external and domestic shocks and structural changes. Therefore, it is essential to periodically revisit these analyses and strengthen them with further analytical tools to ensure the continued relevance and effectiveness of the inflation target.

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⁹ In line with these recommendations, the current MPFA mandates the Central Bank to maintain quarterly headline inflation, as measured by the CCPI, at a rate of 5 per cent. If the Central Bank fails to meet the inflation target of 5 per cent by a margin of ± 2 percentage points, as set out in the MPFA, for two consecutive quarters, the Monetary Policy Board of the Central Bank should submit a report to the Parliament through the Minister of Finance.

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