"POLICY HOLD EXPECTED AS PRIOR TIGHTENING CONTINUES TO FILTER THROUGH"

PRE-POLICY ANALYSIS | JUL 2026

17th Jul 2026

FIRST CAPITAL RESEARCH

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Previous Pre-Policy Report: Recap – Inaccurate

The Central Bank of Sri Lanka increases the Overnight Policy Rate (OPR) by 100bps

Contrary to our expectations, the Monetary Policy Board decided to **increase the Overnight Policy Rate (OPR) by 100bps to 8.75%**, after carefully assessing the evolving global outlook and its implications for Sri Lanka.

Key Arguments Considered by CBSL for its Policy Stance Held on 25th May 2026

- ✓ The uncertainties arising from the heightened tensions in the Middle East have prompted global commodity prices, particularly petroleum, to remain high, adversely affecting the global as well as the domestic economy. High global oil prices have necessitated sharp upward adjustments to domestic energy prices, largely contributing to the 5.4%YoY inflation in Apr-26.
- ✓ While the recent increase in inflation is largely supply-driven, demand conditions in the economy have also strengthened, as shown by the continued credit expansion, credit-driven imports, and leading indicators of economic activity. Accordingly, headline inflation is likely to remain above the target of 5% in the period ahead, before easing and stabilising around it.
- ✓ While near term pressures on the external sector were expected amid global headwinds stemming from the Middle East conflict, such pressures were seen to have amplified in recent weeks due to speculative activity.
- ✓ In view of the elevated inflation forecast, the potential second-round effects on headline inflation from energy price adjustments, continued expansion in private sector credit fueling import demand, pressures on the external sector, as well as the risk of de-anchoring inflation expectations, the Board was of the view that a tightening of the monetary policy stance is appropriate at this juncture.

Expected Monetary Policy Stance

- We assign a **70% probability for a rate hold**, as global oil prices have eased from previous highs and the effects of previous tightening measures are yet to fully transmit through the economy, the need for further policy action remains limited. With credit growth expected to moderate, liquidity conditions stabilising, and market rates already elevated, additional tightening could unnecessarily weigh on economic activity.
- We also assign a **30% probability for a rate hike**, as a rate hike could be considered to support the currency, strengthen reserves, and reinforce investor confidence amid LKR depreciation and external pressures. Additionally, with inflation risks persisting, further tightening may help anchor expectations and prevent broader price pressures from becoming entrenched.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	**30%**
Policy Rates to remain unchanged	**70%**
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

As per our view, at the upcoming policy meeting there is a 70% probability for the Central Bank to maintain current policy rates, while a 30% probability is assigned for a 25bps rate hike.

Expected SRR Stance:

While the CBSL no longer announces its Statutory Reserve Ratio (SRR) decisions alongside the Monetary Policy Review, we no longer forecast SRR changes in our Pre-Policy Report.

Source: CBSL, First Capital Research

Analysis of Upcoming Policy Decision on 21st Jul

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The below-mentioned factors argue against a hike in policy rates at the upcoming policy meeting

70%

Arguments against a Policy Rate Hike

- The effects of the previous hike has yet to completely transmit into the economy
- Improving inflation expectations reduces need for further tightening
- Credit growth expected to moderate with existing measures
- Liquidity conditions expected to stabilise without further policy action
- Additional tightening could weaken growth momentum
- Foreign holdings of LKR-denominated government bonds appear to be stabilising
- AWCMR indicates existing financial conditions remain restrictive

The below-mentioned factors argue for a hike in policy rates at the upcoming policy meeting

30%

Arguments for a Policy Rate Hike

- Renewed geopolitical risks could re-intensify inflationary pressures
- The moderation in remittance inflows indicates a possible effect on the current account balance
- Supporting reserves and external sector stability

Source: First Capital Research

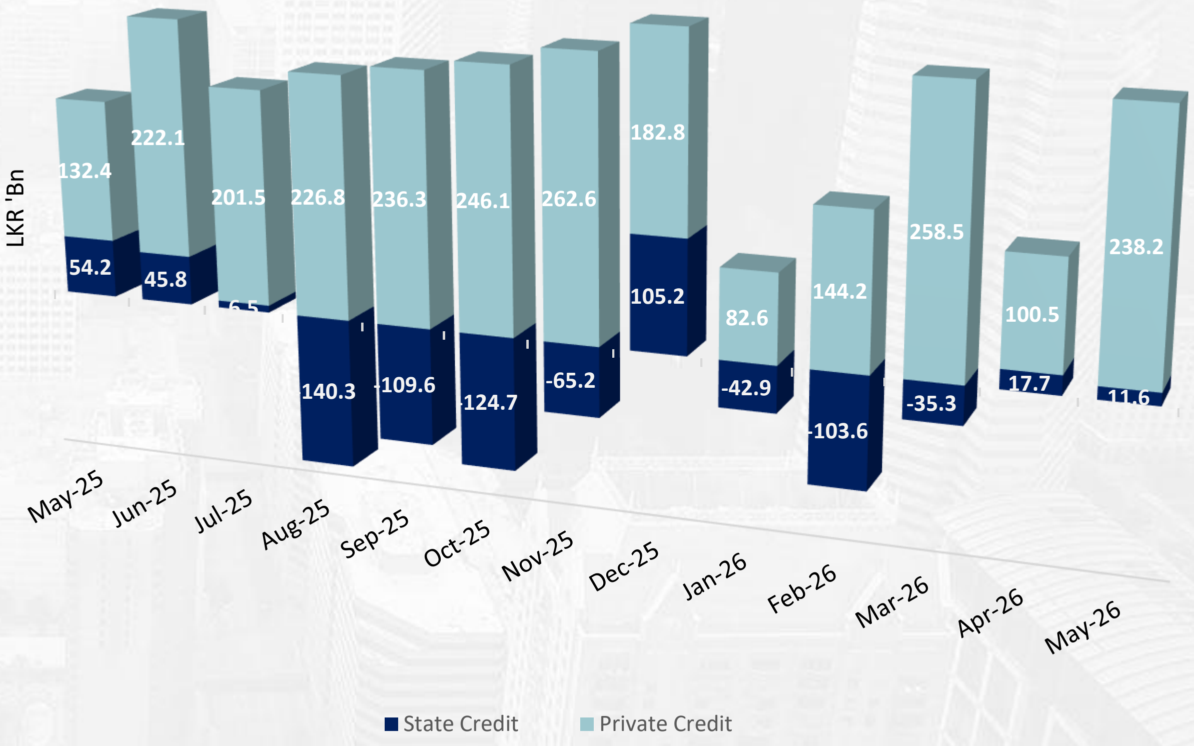
Arguments *against a hike* in monetary policy

Arguments *against a hike* in monetary policy

The effects of the previous hike has yet to completely transmit into the economy

The unexpected 100bps policy rate hike in May-26 was significant, and its full effects are unlikely to be reflected in the economy yet, given that monetary policy typically operates with a lag of around 6+ months. Key indicators remain elevated, with private sector credit growing by 27.8%YoY and the import bill increasing by 45.4%YoY in May. However, these figures largely reflect economic activity prior to the rate hike and therefore do not capture its full impact. Given these transmission lags, an additional rate hike at this stage would be premature. Allowing more time for the previous tightening to work through the economy would provide a clearer assessment of its effectiveness while reducing the risk of overtightening.

Private sector credit growth remains robust, recording 27.8% YoY growth in May-26



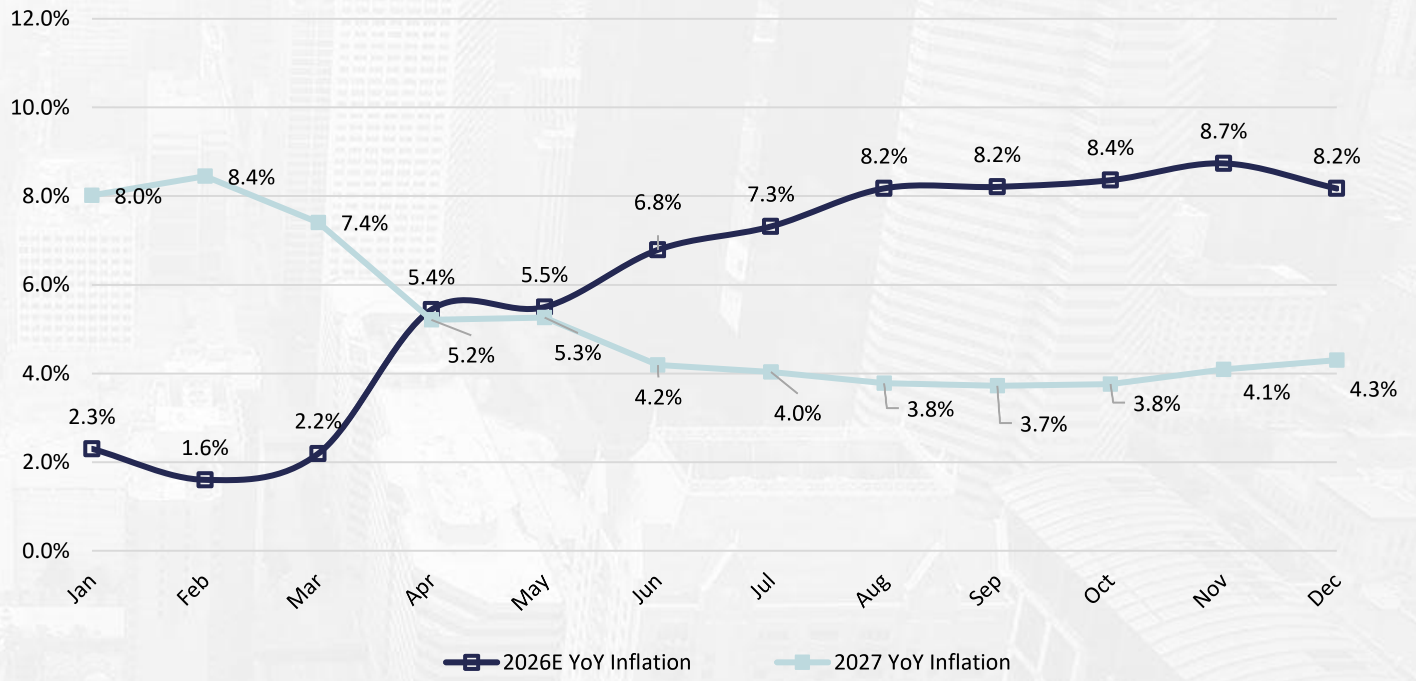
Source: CBSL

Arguments against a hike in monetary policy

Improving inflation expectations reduces need for further tightening

The medium-term inflation outlook has improved, reducing the need for additional monetary tightening in the near term. The decline in global oil prices from recent peaks is expected to ease imported inflation through lower fuel, transportation, and production costs. Domestically, this trend is already evident in recent price reductions. LP gas prices have fallen significantly, with Litro Gas reducing prices by LKR 300.0 and Laugfs by LKR 1,280.0. Fuel prices have also been lowered, with Petrol 92 Octane reduced by LKR 20.0 per litre and Auto Diesel by LKR 25.0 per litre. These developments point to easing cost-push inflation over the medium term, suggesting there is limited justification for an additional policy rate hike at this juncture.

FCR projects annual average inflation to average 6.1% in 2026E, before moderating gradually to 5.2% in 2027E



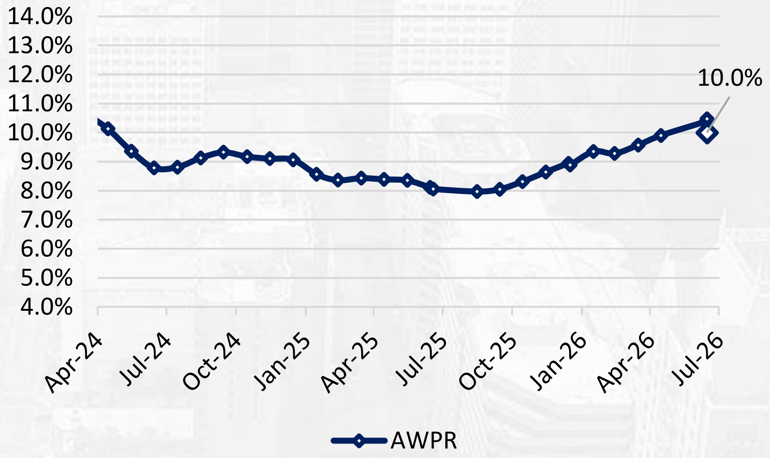
Source: CBSL

Arguments against a hike in monetary policy

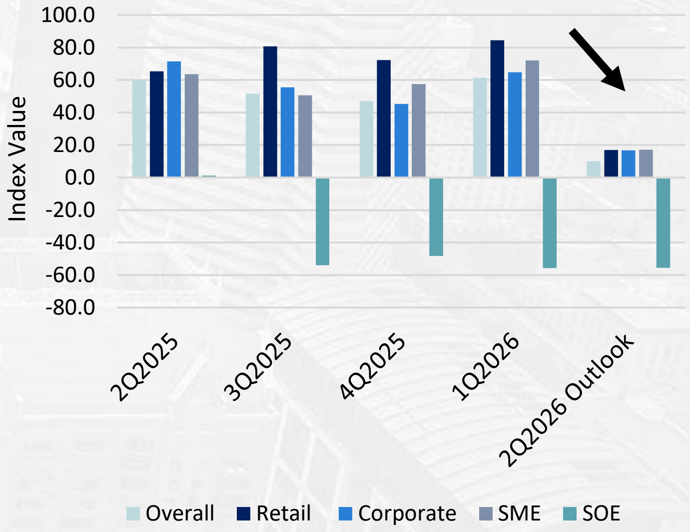
Credit growth expected to moderate with existing measures

Although private sector credit growth remained elevated at 27.8%YoY in May-26, it is expected to moderate in the coming months as the effects of recent monetary policy tightening gradually dampen borrowing demand. Lending activity is also likely to soften amid a potential slowdown in GDP growth, driven by weaker consumer demand following the successive impacts of Cyclone Ditwah, heightened geopolitical tensions in the Middle East, and tighter domestic policy measures, including the temporary 50.0% CID surcharge on vehicle imports and stricter loan-to-value (LTV) limits. The CBSL Credit Supply Survey for 1Q2026 also indicates that while banks' willingness to lend has improved alongside stronger economic conditions, lending growth is expected to moderate amid external uncertainties and evolving risk conditions. Against this backdrop, and with monetary conditions having already tightened significantly through market-based adjustments, the current financial environment provides support for maintaining policy rates at existing levels in the near term.

The AWPR has moved up above 10.00% during the past few weeks



The banks' willingness to lend is expected to increase, yet at a slower pace compared to 1Q2026



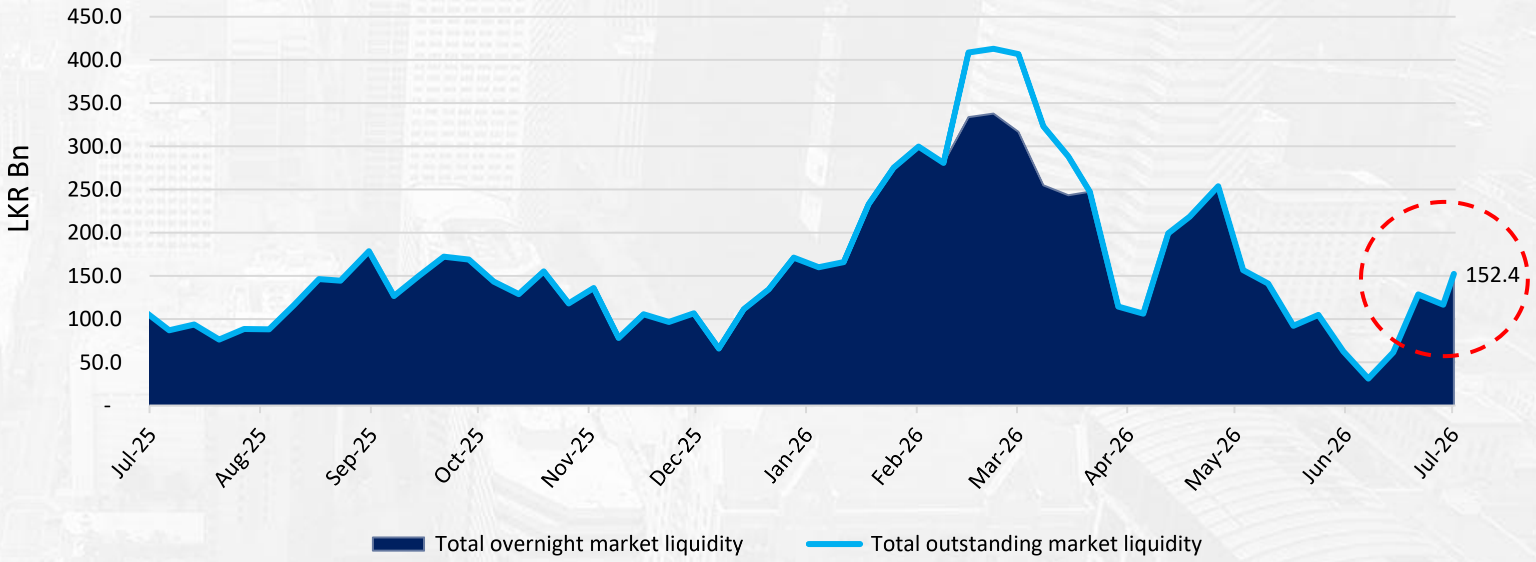
Source: CBSL

Arguments against a hike in monetary policy

Liquidity conditions expected to stabilise without further policy action

System liquidity averaged approximately LKR 170.0Bn during Apr-May 2026, down from the excess liquidity of over LKR 300.0Bn recorded earlier in the year. The recent tightening in banking sector liquidity appears to have been influenced by temporary factors, including strong private sector credit expansion and foreign exchange market operations, rather than a persistent structural liquidity shortage. The decline in the M2b multiplier from 8.86x in Apr-25 to 8.42x in Apr-26 indicates some moderation in money creation within the banking system. As private sector credit growth gradually moderates, liquidity conditions are expected to stabilize naturally. Moreover, the CBSL has now turned a net purchaser of the USD, injecting more LKR into the system. Therefore, using the policy rate to address temporary liquidity conditions may result in unnecessary tightening of broader financial conditions.

Liquidity to stabilize above LKR 100.0Bn, amid slower private sector credit growth and re-emerging USD purchases



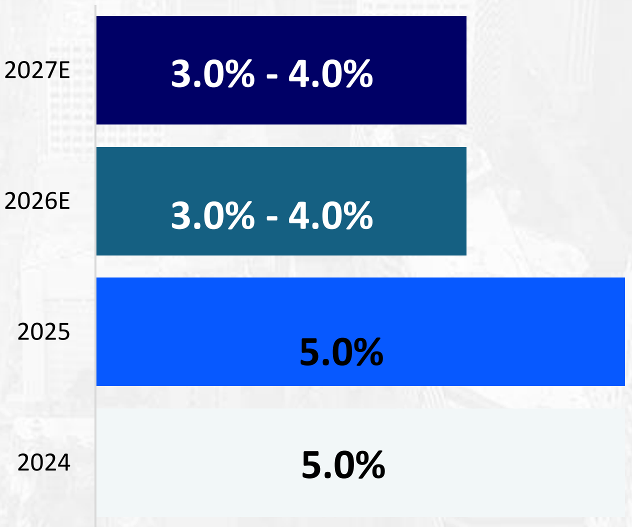
Source: CBSL

Arguments against a hike in monetary policy

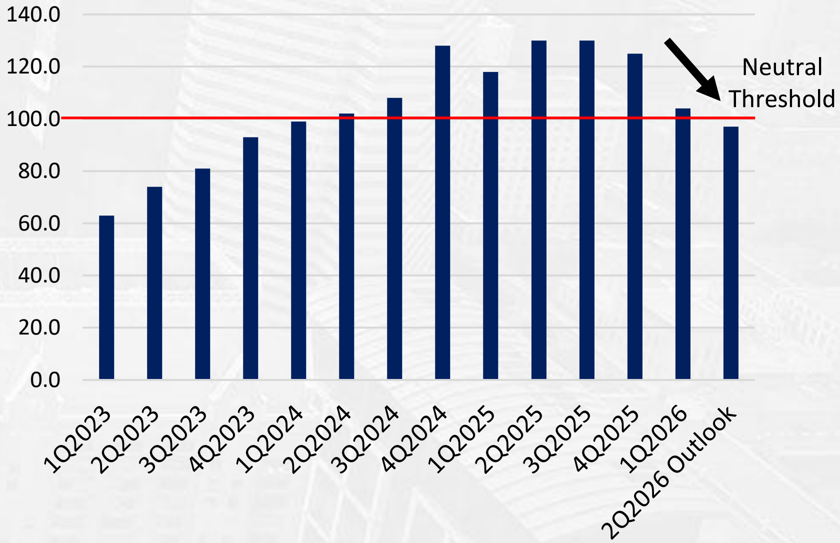
Additional tightening could weaken growth momentum

Although GDP growth remained strong at 5.1%YoY in 1Q2026, FCR expects growth to moderate to around 3.0%-4.0% in 2026E as tighter financial conditions, elevated inflation, and external uncertainties weigh on domestic demand. Higher borrowing costs are likely to constrain consumption, investment, and credit-sensitive sectors, while subdued government capital expenditure and external pressures may limit growth momentum. Meanwhile, the outlook for the CBSL Business Condition Index remains slightly below the neutral threshold, indicating a more cautious business outlook amid uncertainty, particularly from ongoing geopolitical tensions. Moreover, the LMD Business Confidence Index dipped to a 20-month low in Jun-26, registering 132 points. Given the expected moderation in growth and improving medium-term inflation outlook, a further policy rate hike could risk weakening economic activity without providing significant additional inflation benefits. Maintaining the current policy stance would allow existing measures to take effect while balancing growth and price stability objectives.

Gross Domestic Product Growth (%) to moderate to 3.0%-4.0% in 2026E



The Business Condition Index indicates a subdued growth outlook for 2Q2026



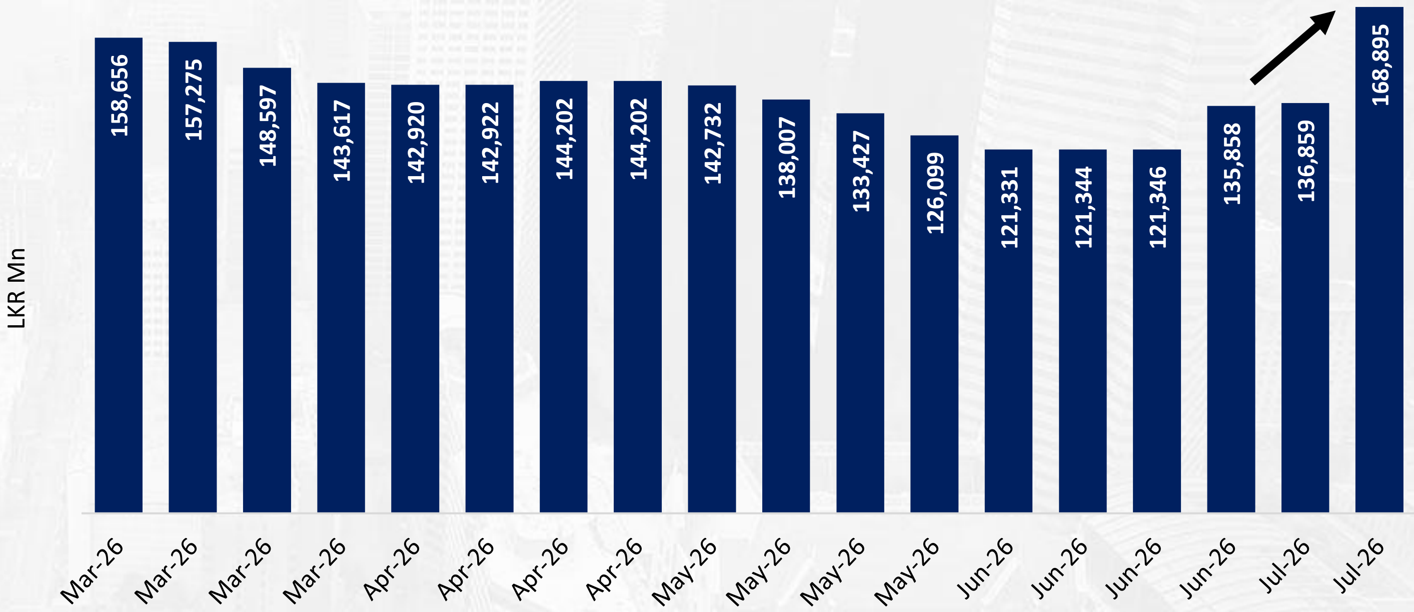
Source: CBSL, FCR

Arguments against a hike in monetary policy

Foreign holdings of LKR-denominated government bonds appear to be stabilising

Foreign investor appetite for LKR-denominated government securities has strengthened significantly, with net inflows of LKR 32.0Bn (USD 97.1Mn) in the week ended 09th Jul-26, lifting foreign holdings to LKR 168.9Bn, the highest level since Aug-23. This has reversed earlier outflows, resulting in a net inflow of USD 83.4Mn for the year to date. The recovery of the rupee from around LKR 354.0/USD in May to approximately LKR 330.0/USD has also supported renewed investor confidence. These developments indicate that foreign participation is improving without additional monetary tightening, reducing the need for a policy rate hike to attract capital inflows or support external stability.

Foreign holdings in LKR-denominated government bonds increased hit a near three-year high in early Jul-26



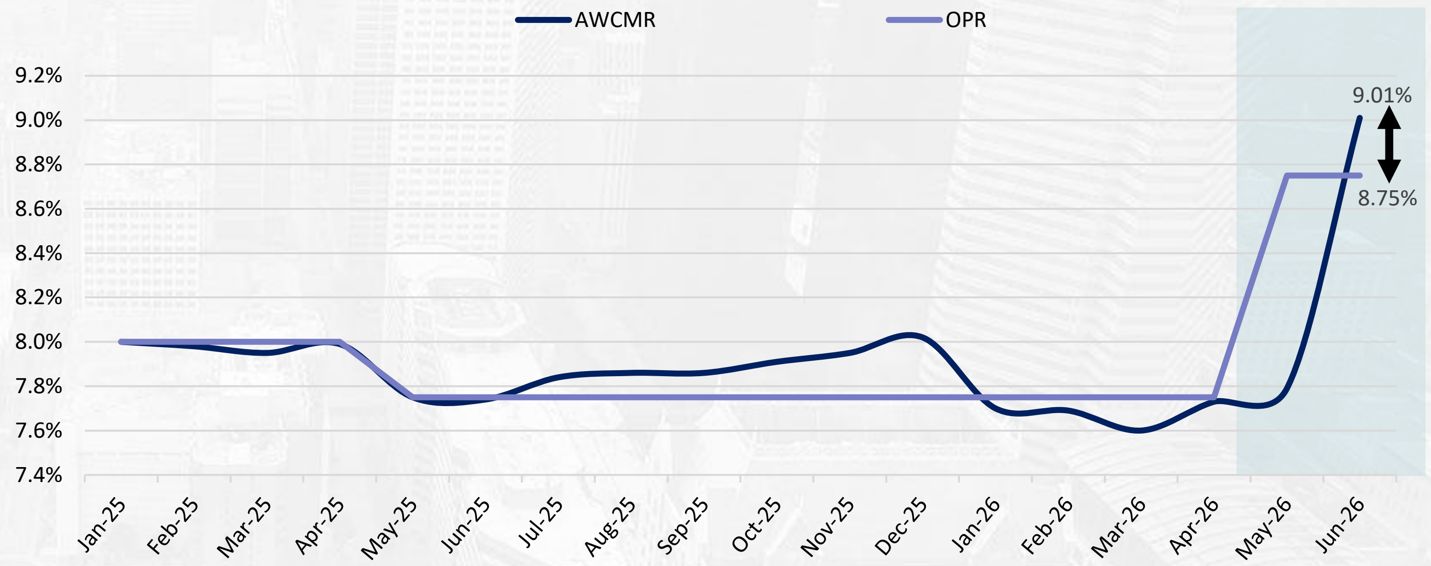
Source: CBSL, First Capital Research

Arguments against a hike in monetary policy

AWCMR indicates existing financial conditions remain restrictive

Financial conditions have already tightened considerably following the 100bps increase in policy rates, with market interest rates reflecting the transmission of previous monetary policy adjustments. The Average Weighted Call Money Rate (AWCMR) remaining above the OPR indicates relatively tight liquidity conditions and suggests that market rates have adjusted to a more restrictive monetary environment. The prevailing level of market interest rates indicates that existing policy measures are already influencing borrowing costs, credit conditions, and domestic demand conditions. Against this backdrop, a further increase in the policy rate could result in additional tightening of financial conditions, potentially placing greater pressure on private sector borrowing and investment activity, while providing limited incremental gains in terms of inflation moderation.

The AWCMR is hovering above the OPR, suggesting restrictive financial conditions



Source: CBSL, First Capital Research

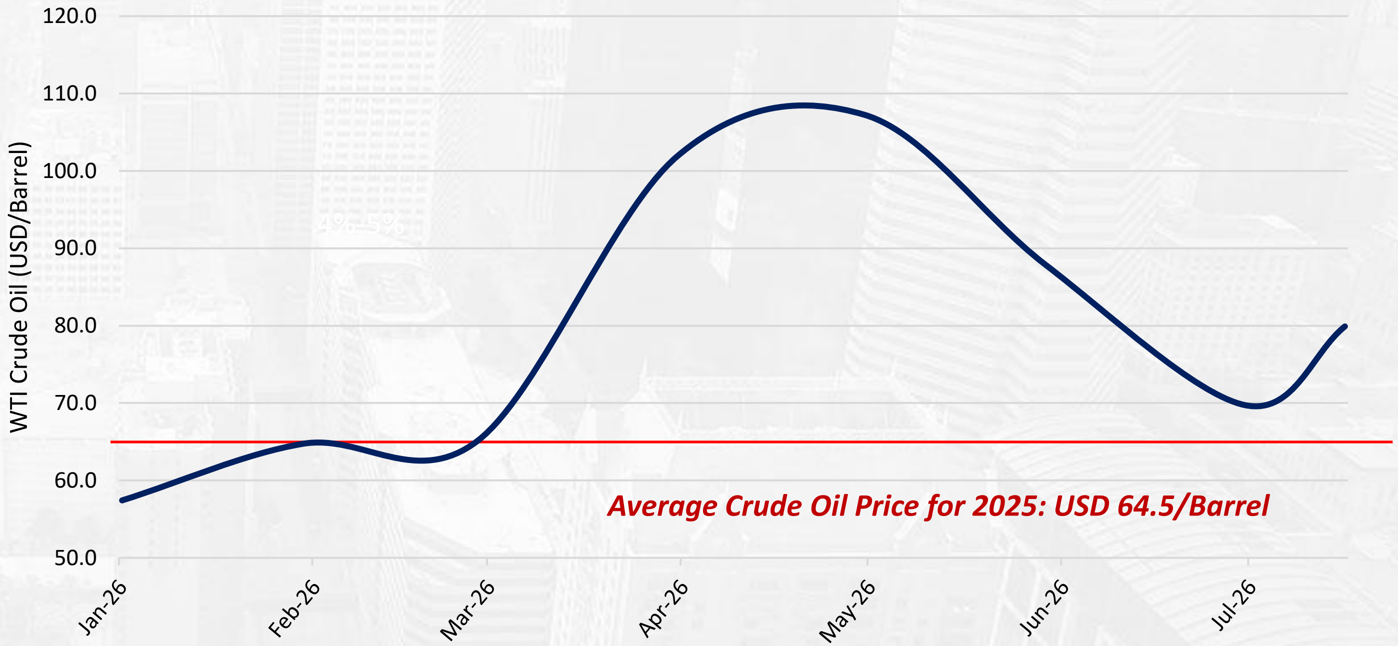
Arguments *for a hike* in monetary policy

Arguments for a hike in monetary policy

Renewed geopolitical risks could re-intensify inflationary pressures

The renewed escalation of tensions in the Middle East, particularly between the US and Iran, has disrupted trade through the Strait of Hormuz, raising the risk of another increase in global oil prices. Any sustained rise in oil prices would likely feed through to higher domestic fuel and transportation costs, adding to inflationary pressures. With inflation already approaching the upper end of the CBSL's 5.0%-7.0% target range, a further escalation could lead to stronger and more persistent price pressures. In such a scenario, a policy rate hike could help contain potential second-round effects by moderating demand, limiting the pass-through of higher costs into broader prices, and reinforcing confidence in the CBSL's commitment to price stability. The case for additional tightening would strengthen if there are signs that inflation expectations are becoming unanchored, such as sustained wage increases, rising business pricing intentions, or a broad-based acceleration in inflation.

From March to June 2026, corporates faced elevated oil premiums



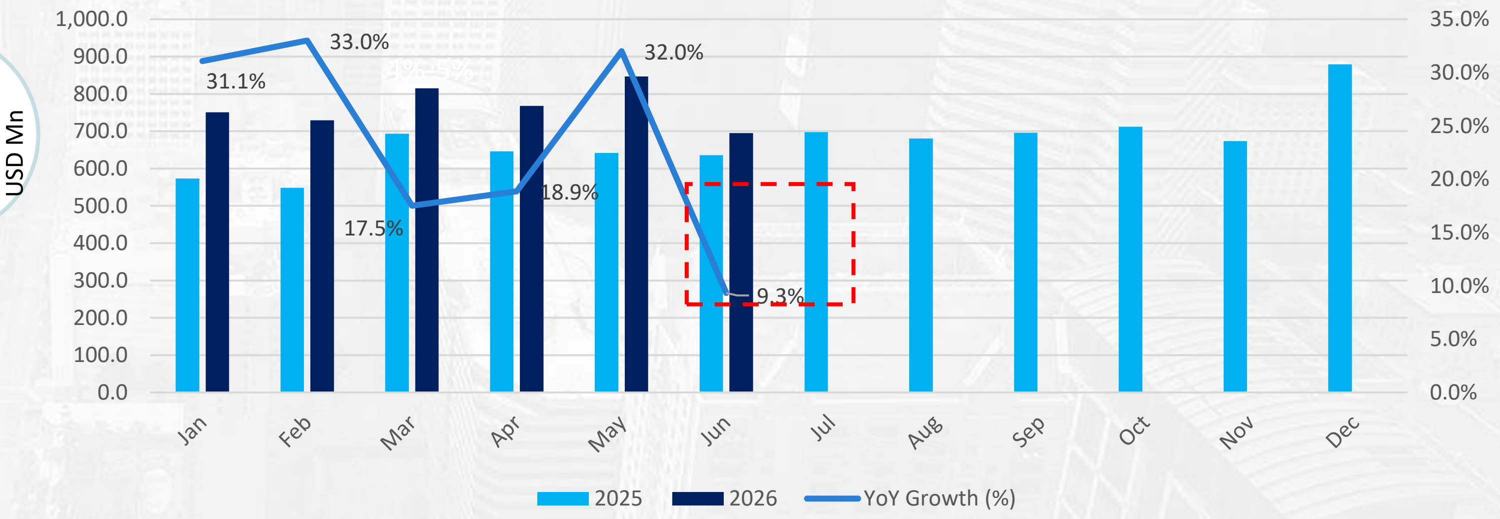
Source: CBSL

Arguments for a hike in monetary policy

The moderation in remittance inflows indicates a possible effect on the current account balance

Sri Lanka's current account has remained relatively resilient largely due to strong worker remittance inflows, which have offset the widening trade deficit amid higher fuel import costs and softer tourism earnings. While remittances grew by around 26.0%YoY during the first five months of 2026, official inflows eased to a seven-month low of USD 695Mn in Jun-26, although they remained 9.3% higher YoY. The renewed tensions in the Middle East pose a downside risk to this key source of foreign exchange. Many Sri Lankan migrant workers are employed in the hospitality, construction, and services sectors across the Gulf, where weaker tourism activity, project delays, and slower economic activity could dampen wage growth and reduce employment opportunities. If remittance inflows begin to moderate, pressures on the current account and broader external sector could intensify, reducing the pace of reserve accumulation. In such a scenario, a policy rate hike could help contain domestic demand, thereby moderating import growth and reducing demand for foreign exchange. This would help ease pressure on the balance of payments while also mitigating imported inflation and supporting overall price stability.

Worker remittances dip to a 7-month low in Jun-26



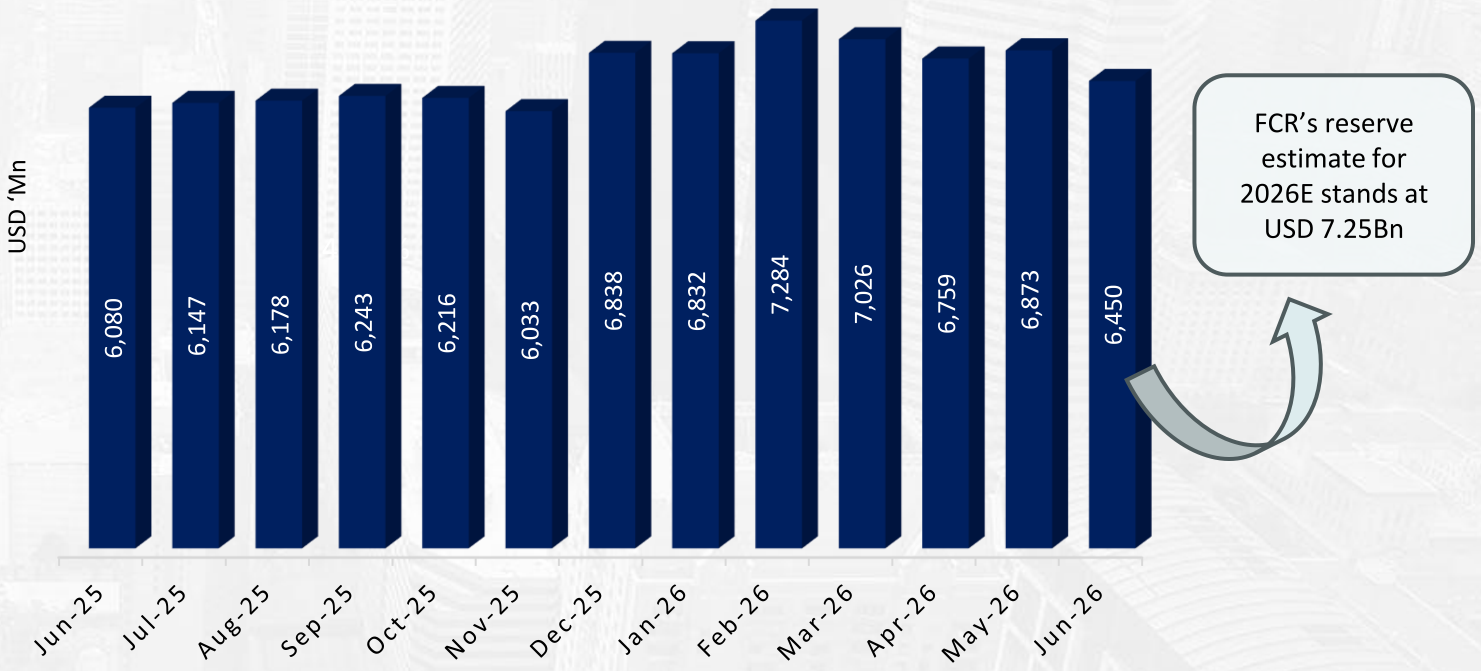
Source: CBSL

Arguments for a hike in monetary policy

Supporting reserves and external sector stability

The recent decline in Gross Official Reserves and continued external sector vulnerabilities highlight the importance of maintaining confidence in the foreign exchange market. A higher policy rate could support external stability by moderating domestic demand, reducing import-intensive consumption, and lowering demand for foreign currency. In addition, higher returns on rupee-denominated assets could improve the attractiveness of local currency investments and help reduce capital outflow pressures. Therefore, a policy rate hike aimed at maintaining an appropriately tight monetary policy stance could help attract foreign capital inflows, thereby supporting the accumulation of international reserves toward targeted levels.

Gross Official Reserves dip to USD 6.5Bn in Jun-26



Source: CBSL

Factors in Consideration at the Policy Review

Inflation
CCPI +6.8% (YoY) for Jun-26

Foreign Reserves
USD 6.5Bn by Jun-26

GDP Growth
+5.1% in 1Q2026

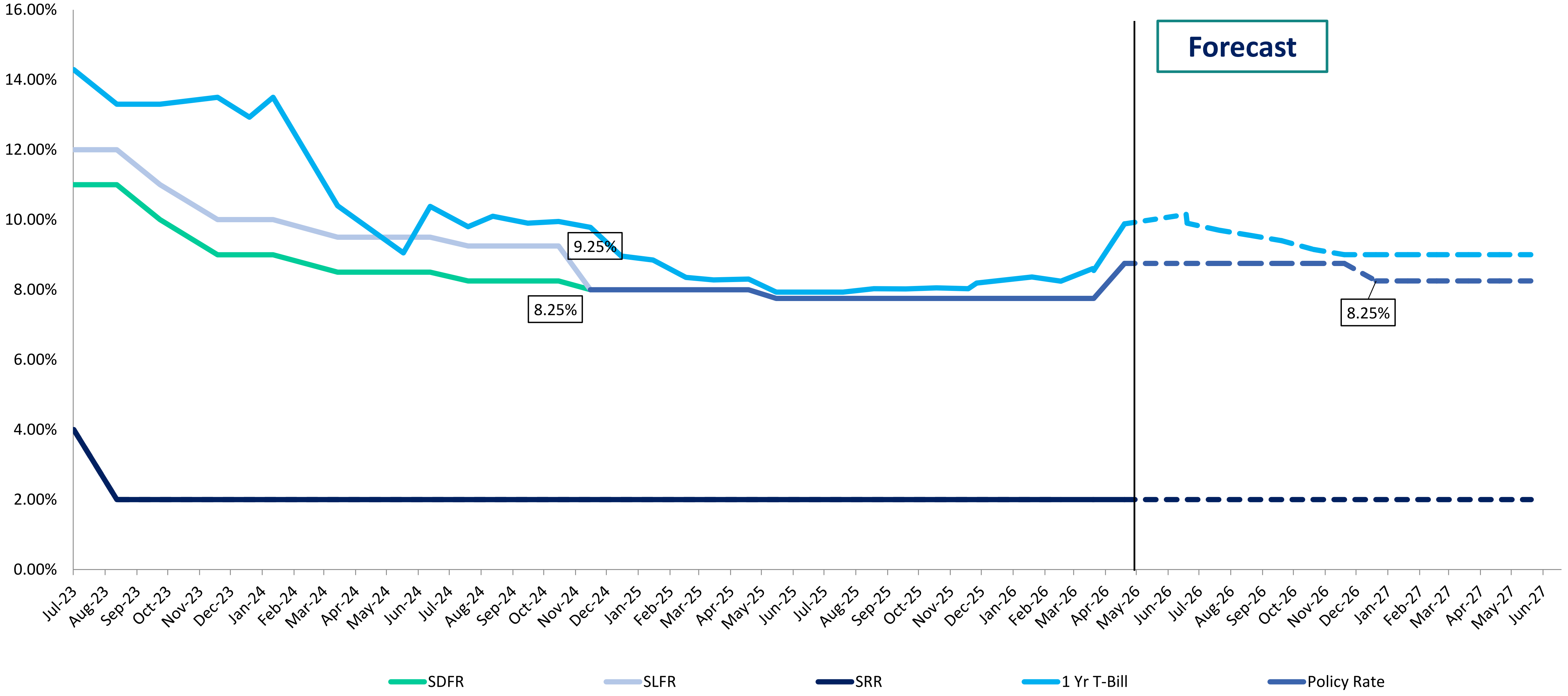
03M T-Bill Rate
10.13% as of 15th Jul-26

Total Credit Increased by LKR
249.8Bn in May-26

Liquidity and CBSL Holdings:
LKR 152.0Bn and LKR 2.5Tn
as at 14th Jul-26

BOT Deficit was
USD 967.9Mn for May-26

Monetary Policy Rates



Source: CBSL, First Capital Research

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