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POLICY HOLD EXPECTED AS PRIOR 100BP TIGHTENING PROPAGATES, AGGRESSIVE SRR CHANGES & U.S. ELECTION OVERHANG FAVOURS PATIENCE

PRE-POLICY ANALYSIS | SEP 2026

24th Sep 2026

FIRST CAPITAL RESEARCH

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Previous Pre-Policy Report: Recap – Accurate

The Central Bank of Sri Lanka maintained the Overnight Policy Rate (OPR) at 8.75%

In line with our expectations, the Monetary Policy Board decided to maintain the Overnight Policy Rate (OPR) at 8.75%, after assessing the evolving global outlook and its implications for Sri Lanka.

Key Arguments Considered by CBSL for its Policy Stance Held on 22nd July 2026

- ✓ Renewed Middle East tensions have lifted global oil prices, increasing inflation risks.
- ✓ Headline inflation accelerated to 6.8% YoY in June 2026, mainly due to higher domestic energy and food prices. While inflation is expected to remain above the 5.0% target in the near term, it is projected to gradually return towards the target level. Inflation expectations remain broadly well anchored over the medium term.
- ✓ Demand conditions have strengthened, although the May rate hike is expected to moderate credit growth and demand pressures over time.
- ✓ External sector pressures have eased somewhat; reserves remain adequate and the rupee has stabilised.
- ✓ Given elevated inflation, upside risks from geopolitical developments, and the need to allow previous policy tightening to fully transmit through the economy, the Board deemed it appropriate to maintain the OPR at 8.75% while remaining ready to act if risks to inflation emerge.



Expected Monetary Policy Stance

- We assign a **60% probability for a rate hold**, as the May 2026 100bps rate hike is still propagating through the economy, while tighter liquidity conditions through OMOs and the upcoming SRR changes are providing additional monetary restraint without the need for further policy rate increases. Although inflation remains above target, much of the recent pickup reflects supply-driven factors and base effects rather than a broad-based demand resurgence. With the USD/LKR stable, external conditions improving, and U.S. election-related uncertainty creating scope for a reversal in oil prices, we believe strategic patience remains the most appropriate policy response.
- We also assign a sizable **40% probability for a rate hike**, reflecting above-target inflation, upside risks from elevated oil prices and potential El Niño-related pressures, as well as the recent shift toward tighter monetary policy by major central banks.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	20%
Raising Policy Rates by 25bps	20%
Policy Rates to remain unchanged	60%
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

As per our view, at the upcoming policy meeting there is a 60% probability for the Central Bank to maintain current policy rates, while a 20% probability each is assigned to a 25bps and 50bps 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.

Analysis of Upcoming Policy Decision on 29th Sep

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

60%

Arguments against a Policy Rate Hike

- May's 100bps hike is still propagating through the economy
- Liquidity tightening reduces the need for additional rate hikes
- Election-related oil price uncertainty supports strategic patience
- External sector is improving with rating upgrades
- USD/LKR and money market are stabilising
- Additional tightening could weaken growth momentum
- Inflation expectations are broadly stable

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

40%

Arguments for a Policy Rate Hike

- Inflation remains above the tolerance band, keeping pressure on CBSL to reinforce its inflation-fighting credibility
- Geopolitical risks and El Niño have rekindled inflation uncertainty
- Widening external imbalances could reignite exchange-rate pressures
- Global tightening has raised the bar for maintaining policy credibility

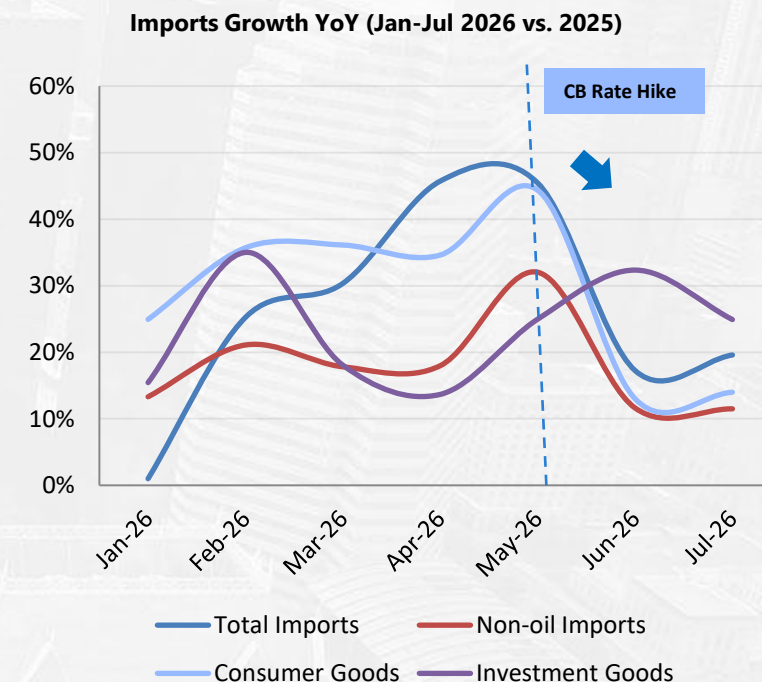
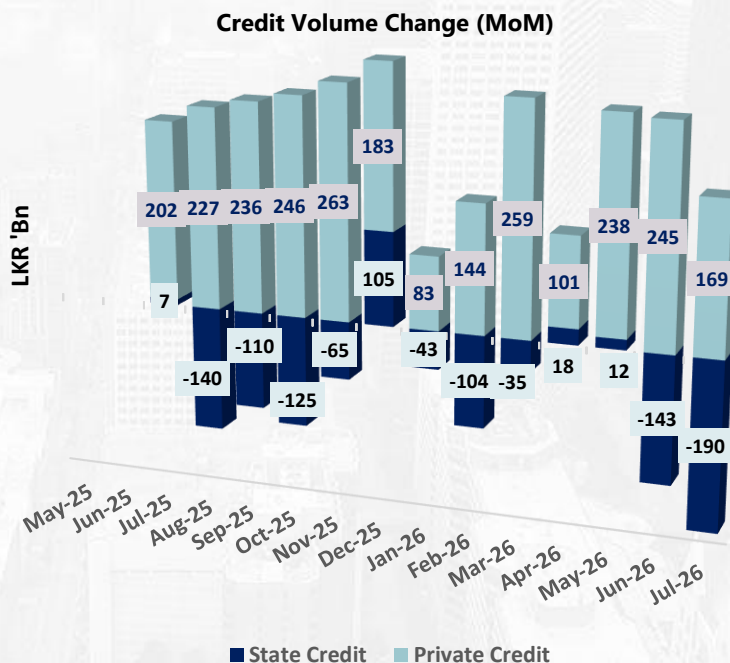


Arguments *against a hike* in monetary policy

May's 100bps hike is still propagating through the economy

The CBSL's 100bps rate hike in May 2026 was a forward-looking move aimed at containing emerging inflation risks. With only four months having passed, the full effects have yet to feed through to borrowing costs, credit demand, and economic activity. The CBSL Governor has also indicated that policy transmission could take 12-18 months to fully materialise (Aug 11, Reuters). Early signs, including moderating non-oil imports and slower credit momentum, suggest that tighter financial conditions are already taking effect. With policy transmission still underway, an additional rate hike may offer limited benefits at this stage.

Arguments against a hike in monetary policy



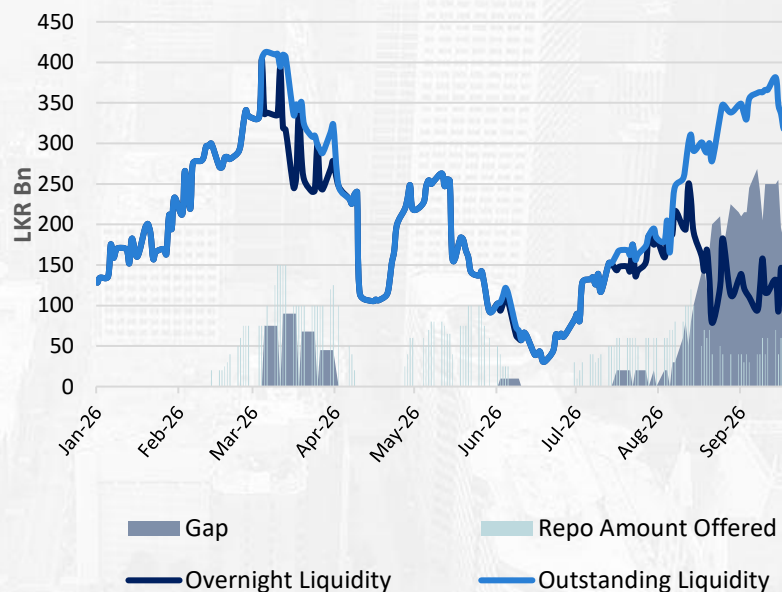
Liquidity tightening reduces the need for additional rate hikes

Interest rates are not the only tool available to the CBSL to contain inflation. Liquidity tightening is already underway through OMOs and recently announced SRR measures. The removal of the vault cash concession and the increase in the minimum daily SRR requirement from 75% to 90% (effective 30 Sep) will absorb excess liquidity and restrain credit growth. Combined with ongoing liquidity sterilisation, these measures should help contain inflationary pressures. With monetary conditions already tightening, an additional rate hike risks imposing unnecessary costs on growth and credit activity while offering limited incremental benefits for inflation control.

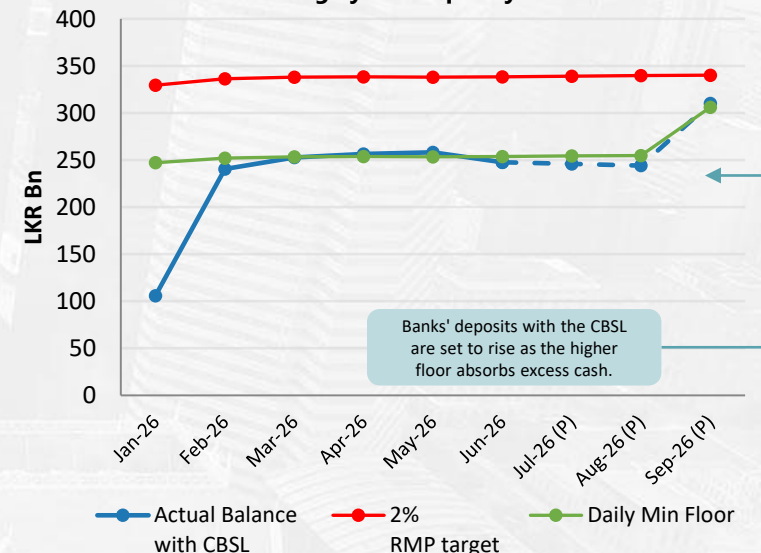
Arguments against a hike in monetary policy



CBSL has actively sterilised excess liquidity through OMOs, limiting the need for additional policy tightening



New SRR requirements, effective 30 Sep, are expected to absorb around Rs. 60-90 bn of banking-system liquidity



Banks will no longer receive a cash-holding concession for a lower SRR, while the minimum daily SRR floor will increase from 75% to 90%. (References : Gazette (Extraordinary) Notification No. 2481/09 & Circular No. 1 of 2026)

Election-related oil price uncertainty supports strategic patience

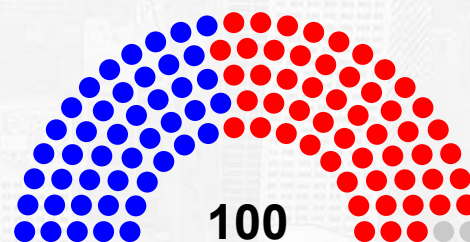
Rising oil prices linked to the Iran conflict have contributed materially to the recent inflation pickup. However, with the U.S. mid-term election on 3 November approaching and this being the final CBSL policy meeting beforehand, oil prices remain vulnerable to political developments that could quickly reverse recent gains. Given that the inflation surge is largely externally driven and the May rate hike is still propagating through the economy, further tightening may be premature. Holding rates preserves policy space while allowing CBSL to assess post-election inflation risks.



Arguments against a hike in monetary policy

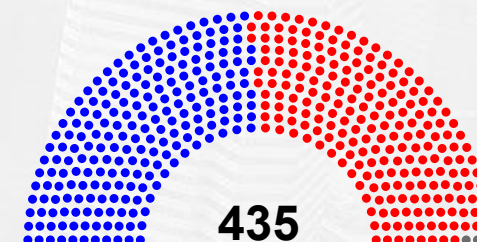
Current Congressional Composition

Senate (100 seats)



■ Republicans ■ Democrats ■ Independents

House of Representatives (435 seats)



■ Republicans ■ Democrats ■ Vacant

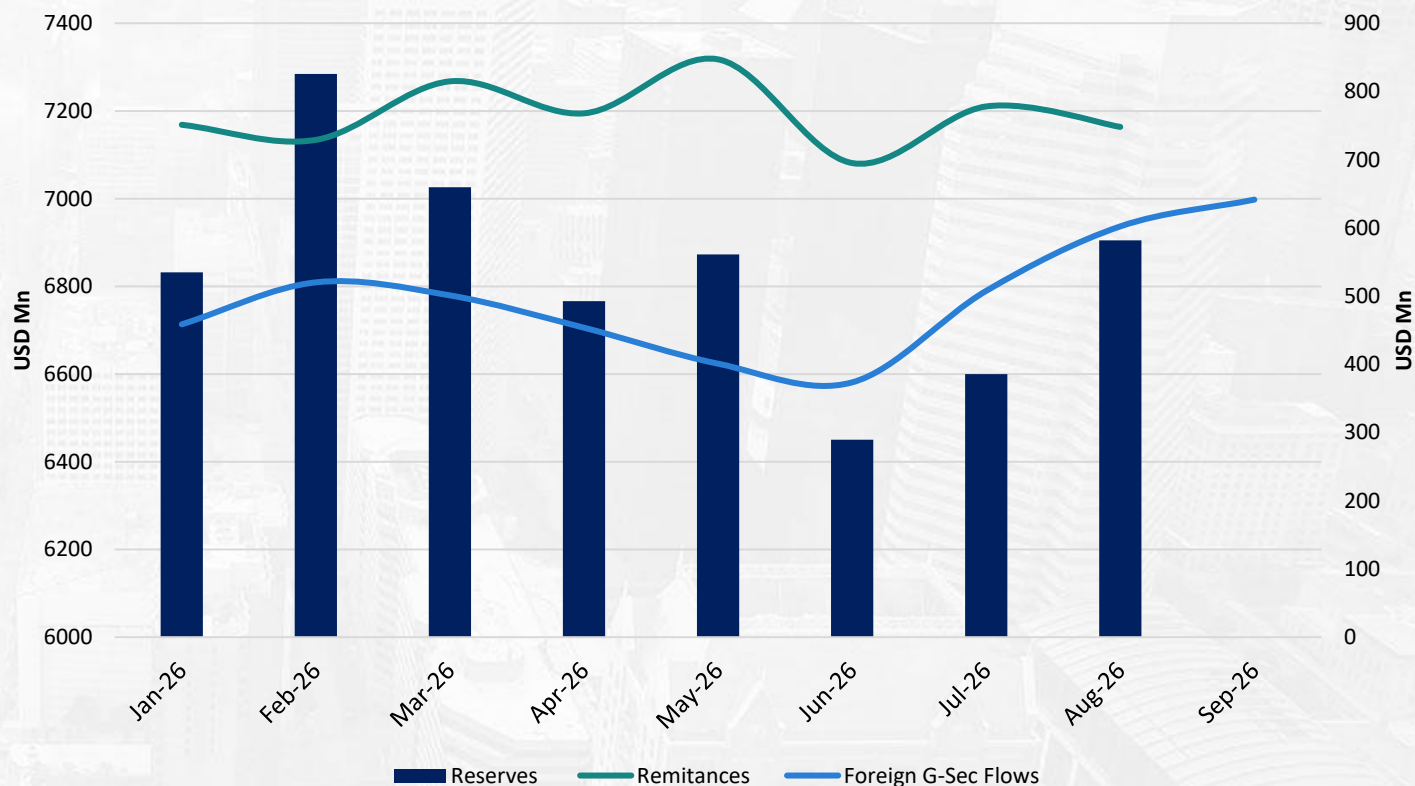
A Democratic-controlled Congress could significantly reshape Iran policy and future military engagement, with material implications for global oil prices

External Sector is improving with rating upgrades

Despite a recent rise in oil prices driven by heightened tensions in the Middle East, external sector conditions remain more favourable than at the May policy meeting. Stable foreign reserves, a lower oil import bill, robust remittance inflows, and renewed foreign investment in government securities reduce the need for further policy tightening. In addition, Fitch upgraded Sri Lanka's long-term foreign-currency default rating to 'B-' from 'CCC+' on 22 Sep, reflecting improvements in external liquidity, reserve adequacy, and debt sustainability, further supporting a stable monetary policy outlook.



Arguments against a hike in monetary policy

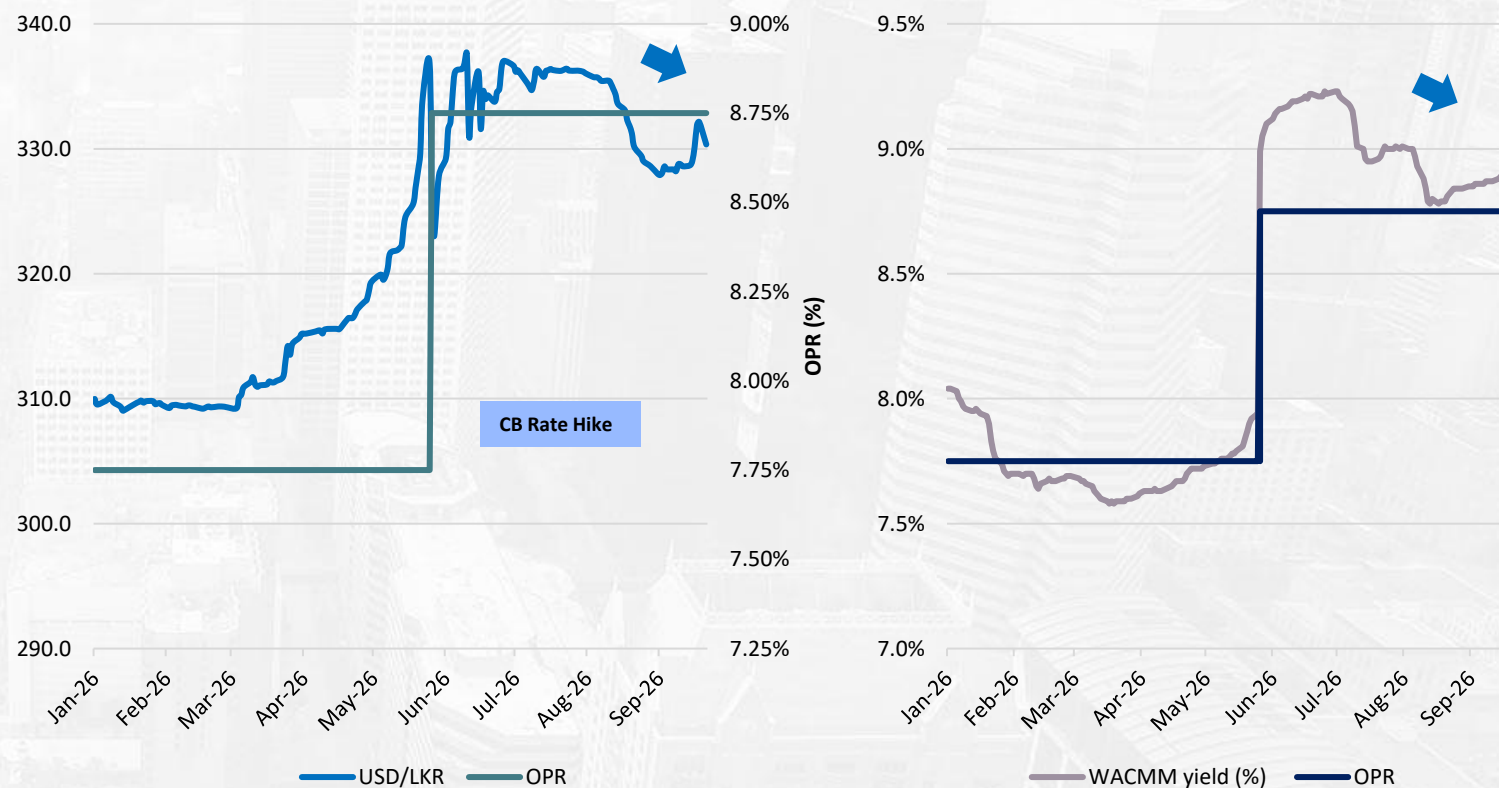


USD/LKR and money market are stabilising

Despite renewed geopolitical tensions and higher oil prices, external sector conditions remain more favourable than at the May policy meeting. The USD/LKR has appreciated by nearly 3% from its post-May peak of around 340/USD to approximately 330/USD, while money market rates have also stabilised, suggesting that previous tightening has been effective. Combined with resilient remittances, continued foreign inflows into government securities, and a still-manageable import bill, current conditions reduce the urgency for an additional policy rate hike.



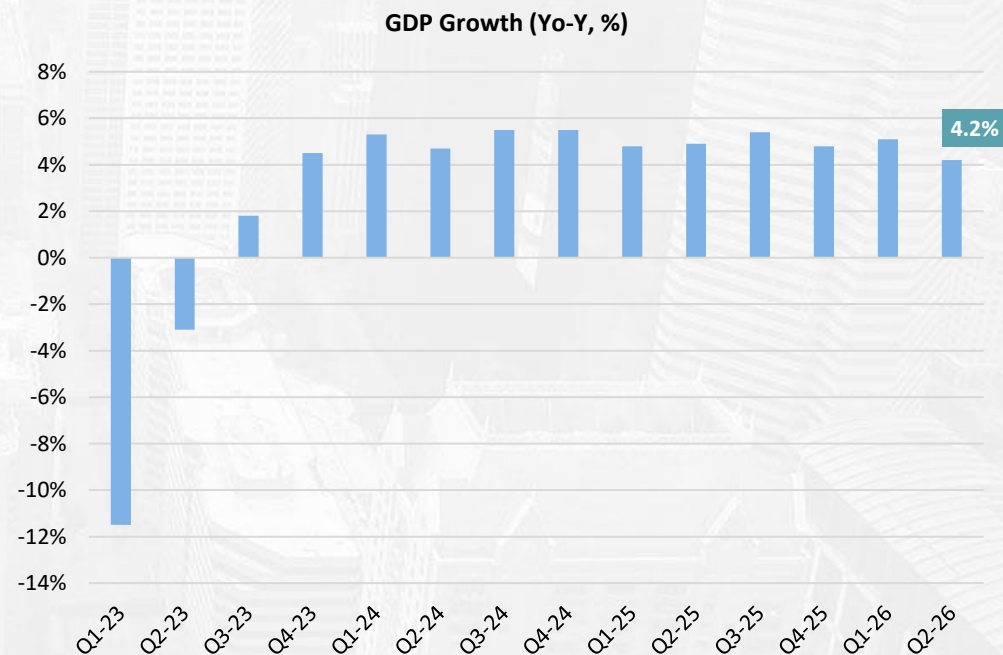
Arguments against a hike in monetary policy



Additional tightening could weaken growth momentum

Despite only one month of Q2 being affected by the May 2026 rate hike, GDP growth slowed to 4.2%YoY in Q2, suggesting that economic activity is already beginning to respond to tighter financial conditions. While inflation remains elevated, further rate hikes are likely to impose greater costs on growth than benefits for price stability. Higher borrowing costs would weigh on credit demand, investment, and consumption at a time when the effects of the May hike are still unfolding. With policy transmission underway and liquidity conditions already tightening through OMOs and SRR measures, maintaining current rates may offer a more balanced approach to preserving both growth and macroeconomic stability. In addition, August PMI indicators point to moderating business activity and demand, suggesting that policy tightening is already gaining traction in the economy.

Arguments against a hike in monetary policy

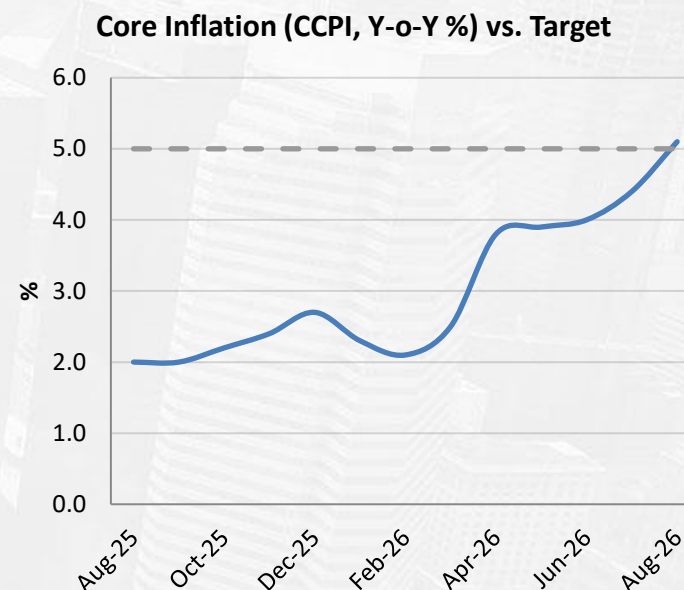
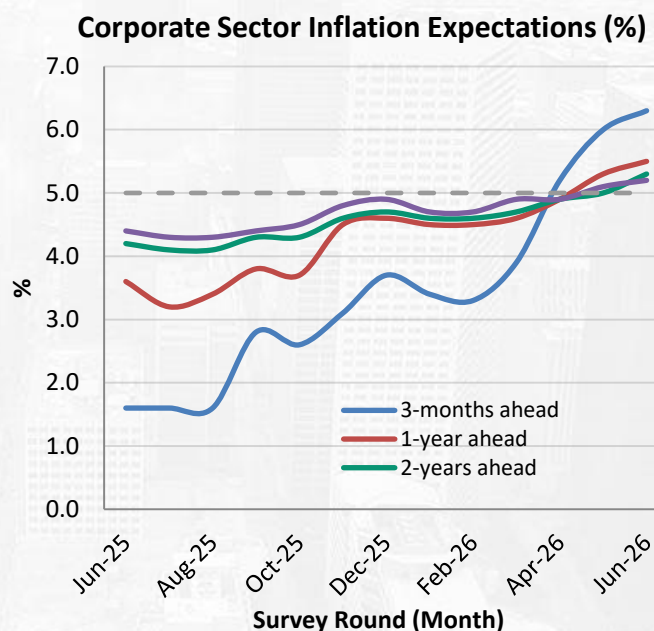


Arguments against a hike in monetary policy



Inflation expectations are broadly stable

While recent inflation pressures may lift near-term expectations, medium-term expectations remain broadly anchored. CBSL's survey suggests inflation concerns are concentrated in the near term, while core inflation remains around 5.0%, indicating contained underlying price pressures. The latest IMF Staff Visit Statement (23 Sep) is also consistent with a policy hold, noting that current inflation pressures largely reflect temporary shocks and that “the current target preserves the flexibility Sri Lanka needs amid high food and energy price volatility.”



“While headline inflation rose to 8 percent y/y in August due to the global oil price shock, expectations are broadly anchored.”

-IMF Staff Visit Statement, 23 Sep 2026



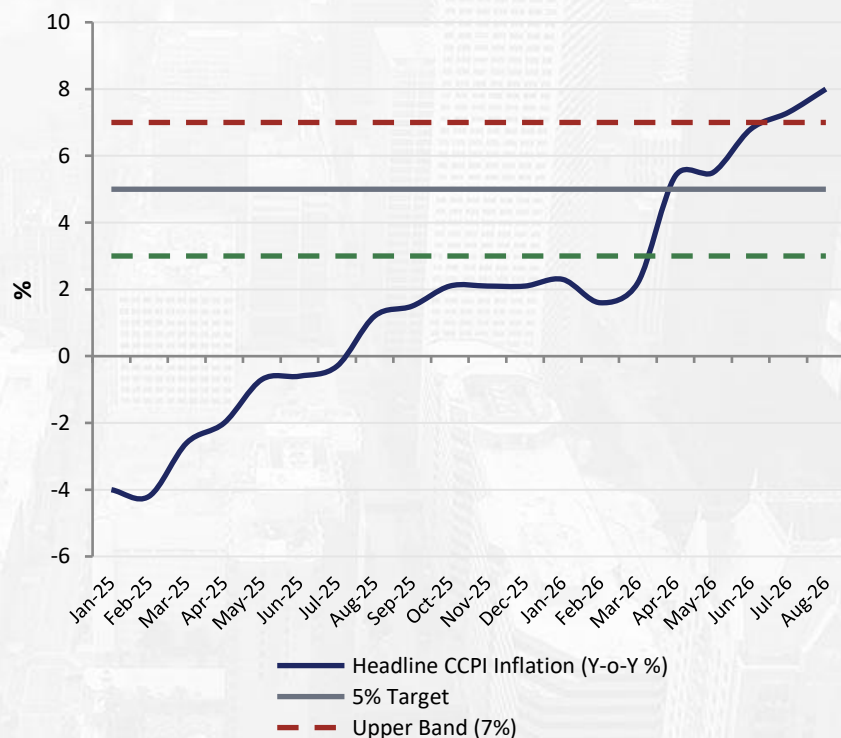
Arguments *for a* *hike* in monetary policy

Arguments for a hike in monetary policy



Inflation remains above the tolerance band, keeping pressure on CBSL to reinforce its inflation-fighting credibility

Headline inflation accelerated to 8.0%YoY in August, remaining above the CBSL's upper tolerance threshold for a second consecutive month and keeping pressure on the Central Bank to preserve policy credibility. We count this as a strong argument for a rate hike. However, inflationary pressures remain largely supply-driven, while part of the recent inflation acceleration also reflects unfavourable base effects as last year's low inflation readings roll out of the comparison period. With oil prices expected to ease and the May 2026 rate hike still propagating through the economy, we believe further monetary tightening is likely to deliver limited disinflation benefits while posing greater risks to growth.



The Breach Rule

Under the MPFA, CBSL is deemed to have missed its inflation target if headline inflation deviates by more than $\pm 2\text{pp}$ from the 5% target for two consecutive quarters.

Headline inflation averaged 7.65% in July-August, already above the upper tolerance limit.

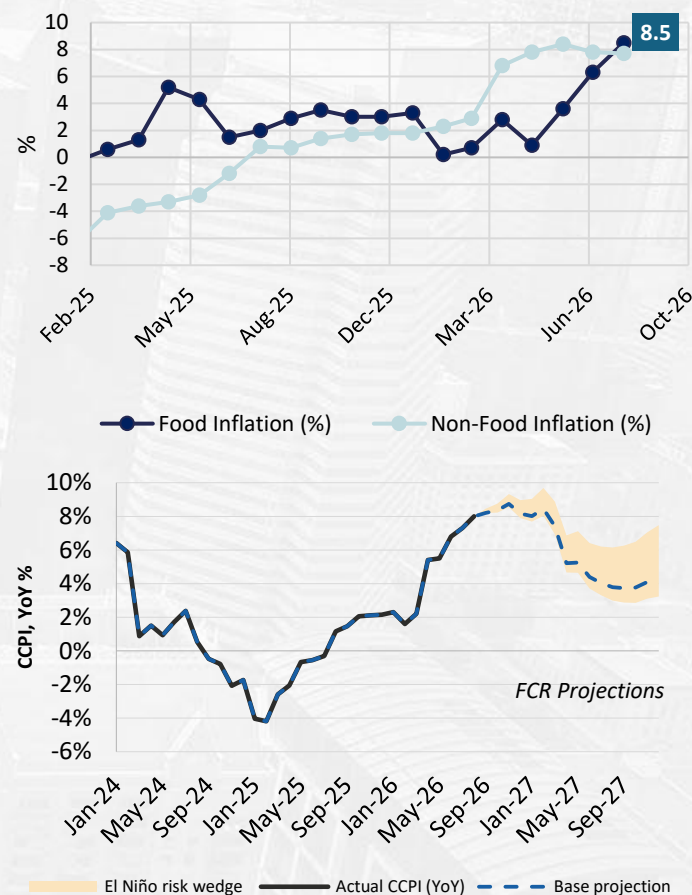
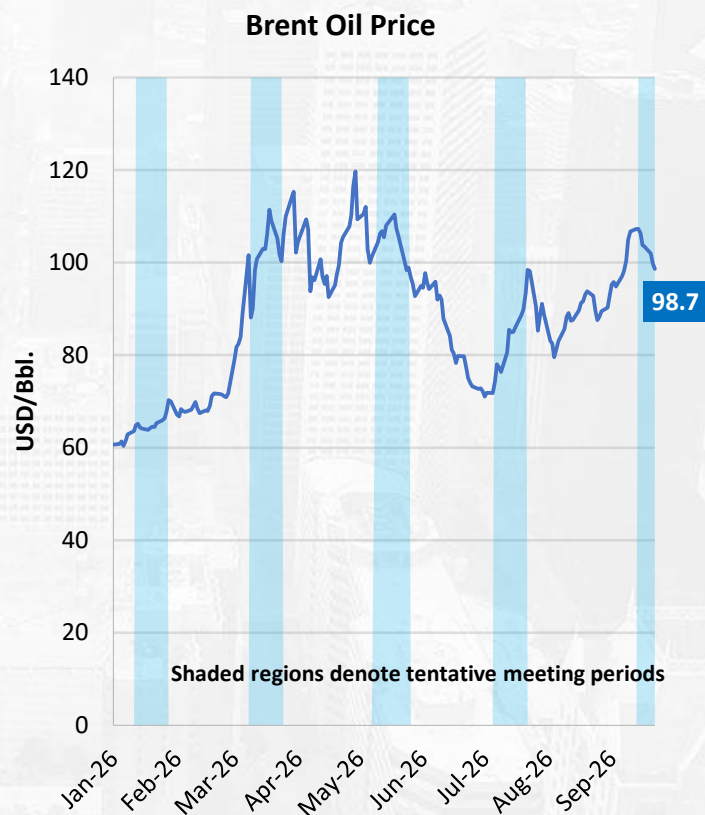
1. To keep Q3 within the target band, September inflation would need to fall below 5.7%.
2. If September remains near August's 8.0%, the Q3 average would rise to around 7.8%, placing inflation outside the tolerance band.
3. However, this alone would not constitute a breach, as the rule requires two consecutive quarterly deviations.
4. In that scenario, Q4 inflation (Oct-Dec) would need to average 7.0% or below to avoid a second consecutive deviation and an official target miss.

Arguments for a hike in monetary policy



Geopolitical risks and El Niño have rekindled inflation uncertainty

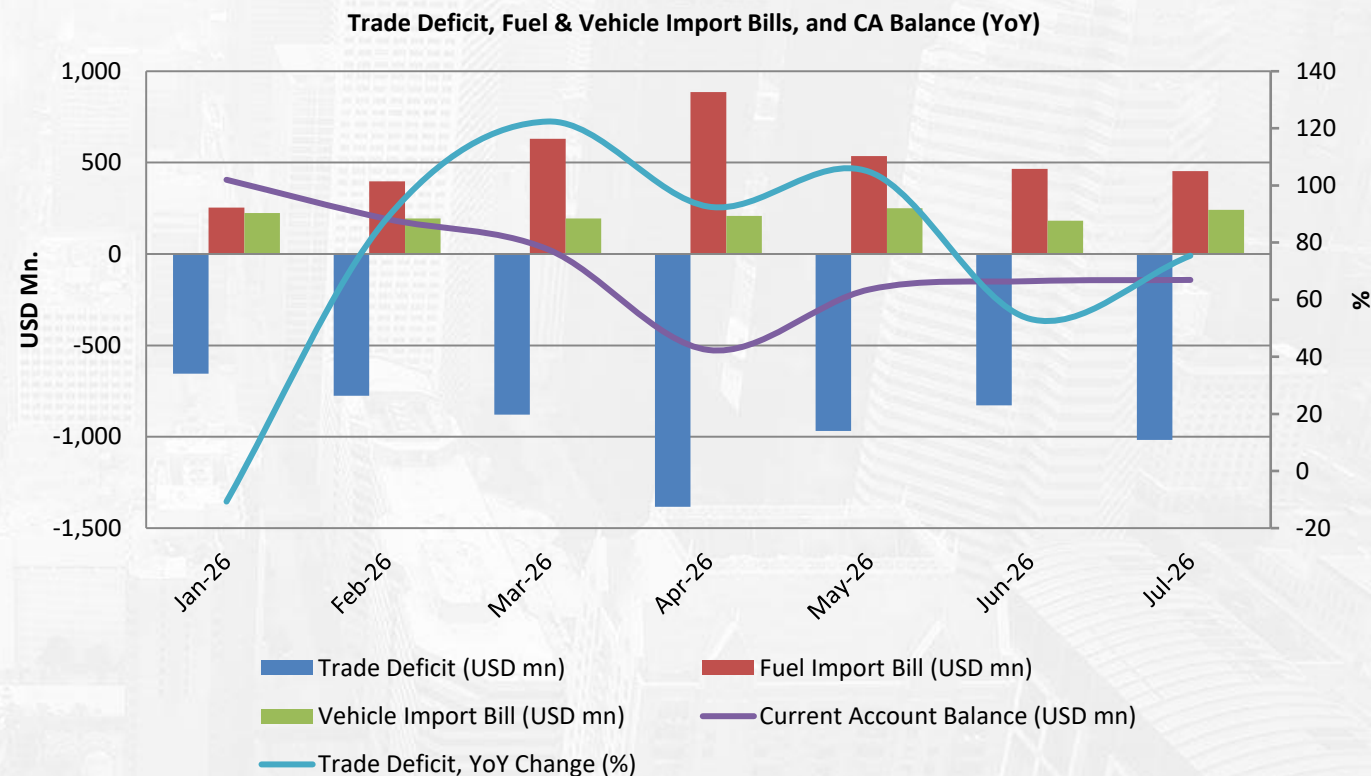
Geopolitical tensions and emerging El Niño risks have increased upside inflation uncertainty. Rising oil prices since July could raise domestic fuel, transport, and production costs, while adverse weather conditions may add further pressure to already elevated food inflation. Although these factors could strengthen the case for a tighter policy stance if inflation risks intensify, the pressures remain largely supply-driven and therefore may be less responsive to further monetary tightening.



Widening external imbalances could reignite exchange-rate pressures

The widening trade deficit and weakening current account balance point to emerging external-sector pressures. If these trends persist, they could place renewed pressure on the exchange rate and raise imported inflation risks. Should the CBSL judge these pressures to be intensifying, it may adopt a tighter policy stance to safeguard external stability and prevent a broader inflation resurgence. However, in our view, the current deterioration in external balances is not severe enough to justify an additional rate hike, particularly as the effects of previous tightening continue to propagate through the economy.

*Arguments
for a
hike
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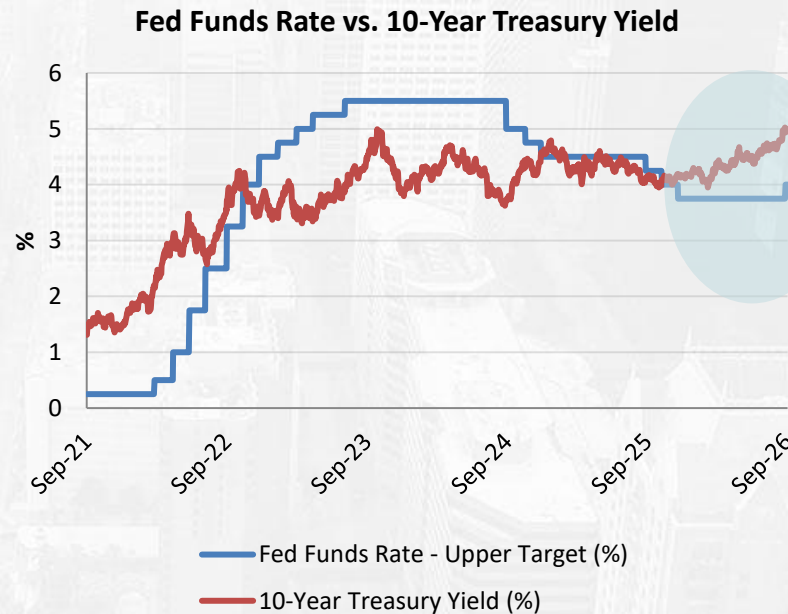


Arguments for a hike in monetary policy



Global tightening has raised the bar for maintaining policy credibility

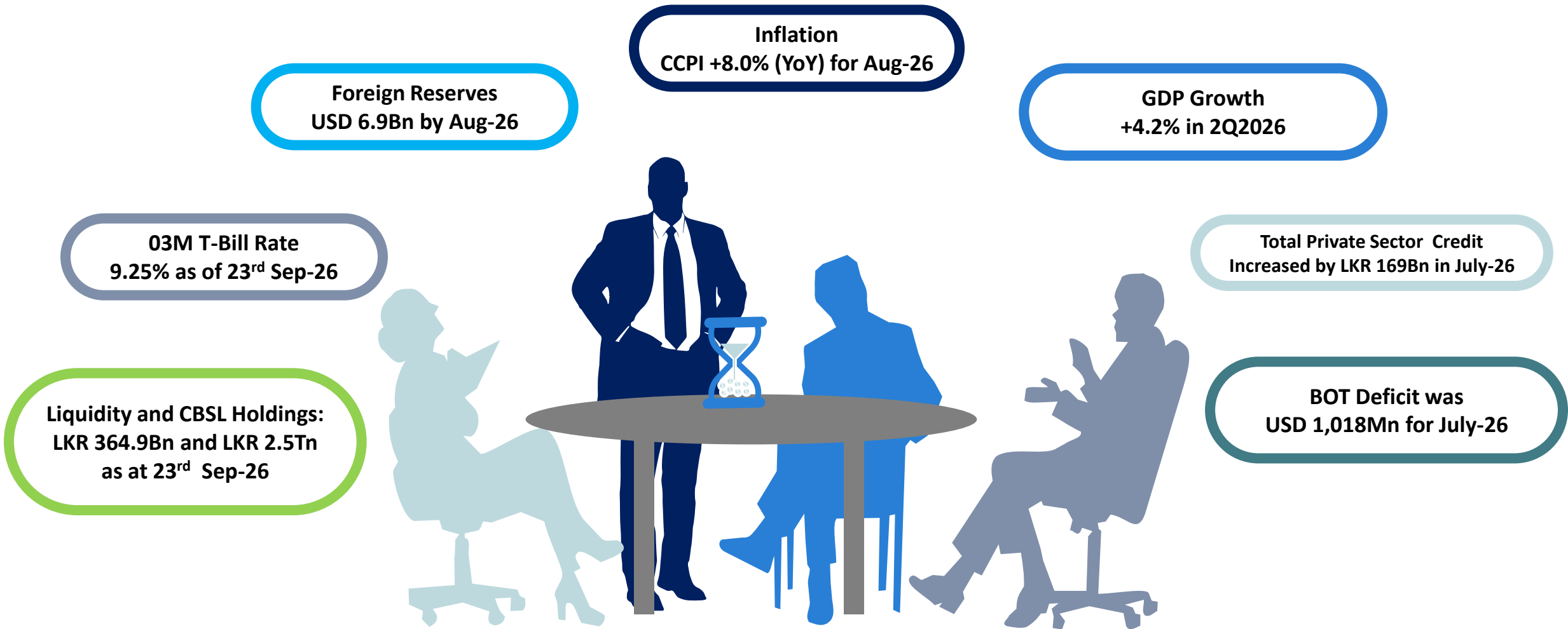
Recent rate hikes by the Fed, ECB, BoJ and other central banks, alongside record-high US Treasury yields, have increased pressure on emerging-market policymakers. These developments could strengthen the case for higher domestic rates. However, we believe the CBSL has already delivered a substantial 100bps hike in May 2026. Given that many of the recent global rate hikes occurred only in August and September, Sri Lanka's earlier policy action may have already accounted for a significant portion of the tightening now being implemented elsewhere.



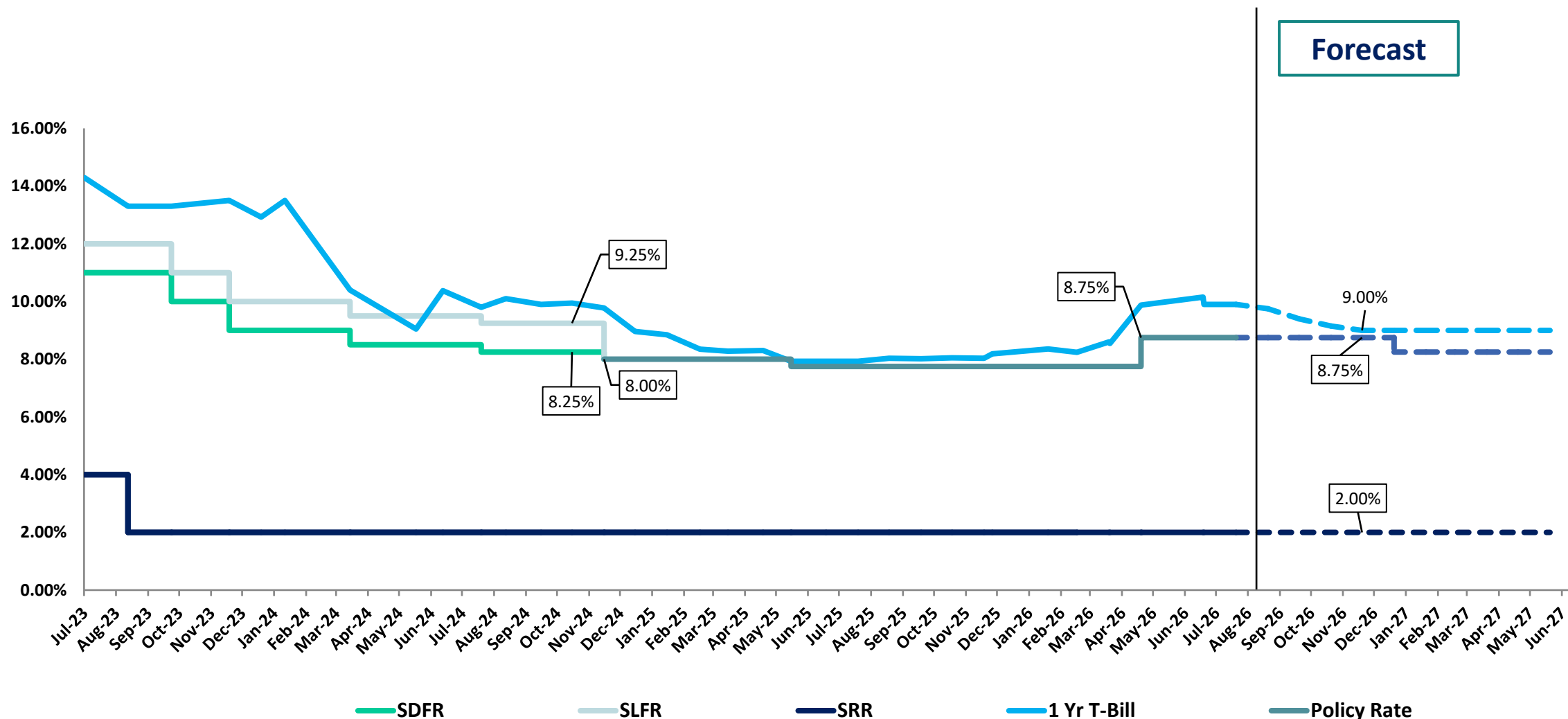
Global central bank hikes in Aug & Sep (CBSL May hike included for reference)

Latest Hike	Central Bank	Change (bps)	New Rate	# of Hikes Since War (Mar 2026)	Total bps Since war (Mar 2026)
27-May	Sri Lanka (CBSL)	100	8.75%	1	100
4-Aug	Madagascar	50	12.50%	1	50
12-Aug	Mongolia	50	12.50%	2	150
19-Aug	Iceland	25	8.00%	3	75
27-Aug	Philippines (BSP)	25	5.00%	3	75
27-Aug	Rwanda	50	8.75%	2	150
27-Aug	South Korea (BoK)	25	3.00%	2	50
2-Sep	New Zealand (RBNZ)	25	2.75%	2	50
10-Sep	Denmark	50	2.10%	2	50
10-Sep	ECB (Eurozone)	25	2.50%	2	50
16-Sep	Bahrain	25	4.50%	1	25
16-Sep	Saudi Arabia (SAMA)	25	4.50%	1	25
16-Sep	UAE	25	3.90%	1	25
16-Sep	United States (Fed)	25	4.00% (upper)	1	25
17-Sep	Hong Kong (HKMA)	25	4.25%	1	25
17-Sep	Macau	25	4.25%	1	25
17-Sep	Moldova	150	9.00%	4	400
17-Sep	Oman	25	4.50%	1	25
17-Sep	Qatar	25	4.60%	1	25
18-Sep	Japan (BoJ)	25	1.25%	2	50
18-Sep	Ukraine	100	16.00%	1	100

Factors in Consideration at the Policy Review



Monetary Policy Rates



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