"GROWTH REMAINS THE FOCUS: RATE CUT ON CARDS"

PRE-POLICY ANALYSIS

18th Jul 2025

FIRST CAPITAL RESEARCH

Analysts: Ranjan Ranatunga
Akna Tennakoon

Previous Pre-policy report: Recap – Inaccurate

The Central Bank of Sri Lanka reduces the Overnight Policy Rate (OPR) by 25bps

Not in line with our expectations. The Monetary Policy Board decided to reduce the OPR by 25bps to 7.75%, thereby easing monetary policy further. The Board arrived at this decision after carefully considering the developments both domestically and globally. The Board is of the view that this measured easing of monetary policy stance will support steering inflation towards the target of 5%, amidst global uncertainties and current subdued inflationary pressures.

Key Arguments considered by CBSL for its policy stance held on 21st May 2025

- ✓ Deflationary conditions have begun to ease since March 2025, as predicted. The latest projections show signs of a more gradual pickup in inflation in the near term than previously anticipated.
- ✓ Recent leading economic indicators reflect sustained progress in domestic economic activity.
- ✓ Market interest rates expected to stabilize further, following this rate cut of 25bps.
- ✓ External sector performance remains robust supported by inflows from tourism and remittances.

Expected Monetary Policy Stance

- As per our view, at the upcoming policy meeting, there is a **60% probability for CBSL to reduce rates, with a 50% probability for rates to be reduced by 25bps and 10% probability is assigned for a rate reduction of 50bps**, offering further stimulus to accelerate the economy.
- However, we believe there is a **40% probability for CBSL to maintain the policy rates**, in order to allow further time to gain clarity on domestic and global shifts.
- Further, there is an **80% probability to keep SRR unchanged;** while considering the improved liquidity levels in the system, we consider a **20% probability for an SRR hike of 100bps**.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Policy Rates to remain unchanged	**40%**
Cutting Policy Rates by 25bps	**50%**
Cutting Policy Rates by 50bps	**10%**
Cutting Policy Rates by 100bps	0%

60%

We believe that there is an 60% probability for policy rates to be cut from their current levels, offering further stimulus towards acceleration of the economy.

Expected Stance on SRR	Probability
Raising SRR by 150bps	0%
Raising SRR by 100bps	**20%**
SRR to remain unchanged	**80%**
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Considering the reduction of SRR by 200bps to 2.0% on 09th Aug-23, we expect SRR to remain unchanged at the same level. However, there is a 20% probability for CBSL to raise SRR by 100bps.

Source: CBSL, First Capital Research

Analysis of upcoming policy decision on 22nd Jul

Arguments **for** a Monetary Relaxation

60%

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

- To support the potential sluggishness of the economy
- More room for credit expansion amidst limited state credit
- Lower supply side pressure led with relatively lower maturities in 2H2025
- Inflation is rising, but slower than expected

Arguments **against** a Monetary Relaxation

40%

- Volatility in reserves remains a concern and build up appears sluggish
- Global shifts may prompt authorities to 'wait-and-see'
- A premature rate cut may impair private credit growth momentum

The above-mentioned factors argue against a relaxation in policy rates at the upcoming policy meeting

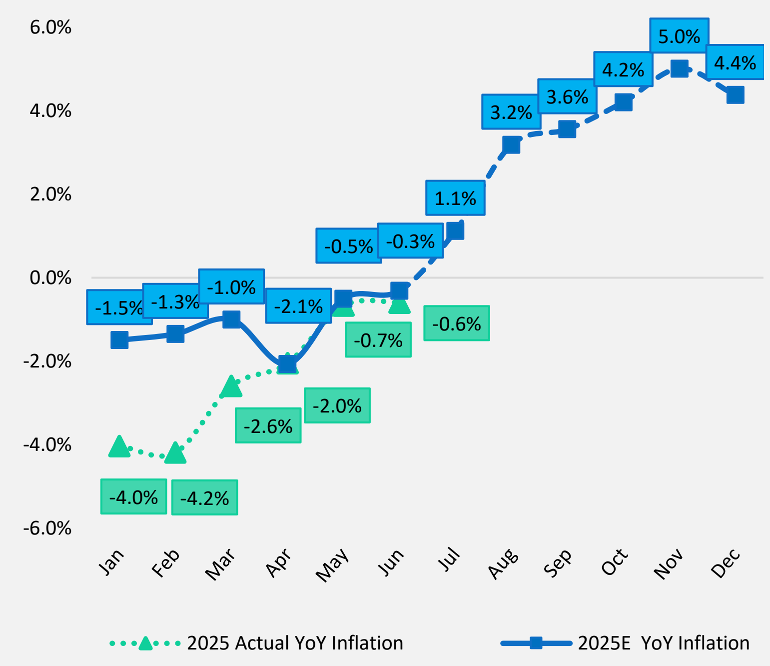
Source: CBSL, First Capital Research

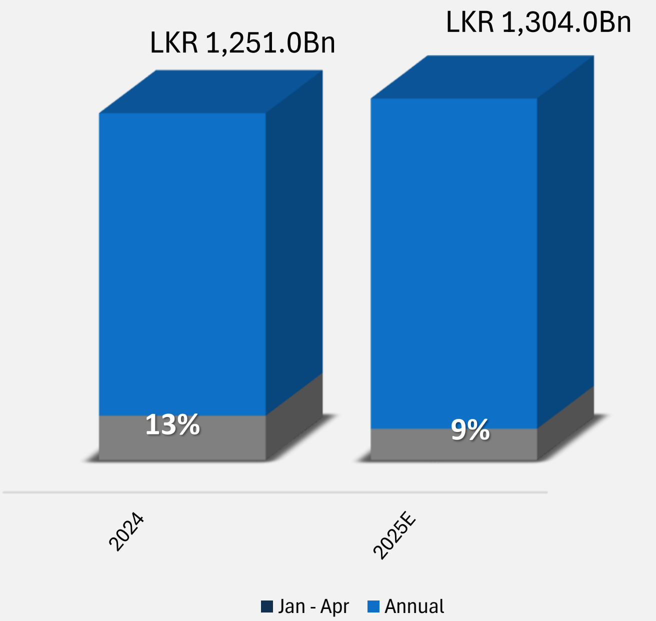
Arguments *for a relaxation* in monetary policy

Arguments for a relaxation in monetary policy

To support the potential sluggishness of the economy

GDP growth was recorded at 4.8%YoY, as it rose to LKR 3.5Tn in 1Q2025 with consumption expenditure growing by 6.6%YoY and investment income growing by 5.9%YoY. Moreover, external balance of goods and services recorded a deficit during 1Q2025 of LKR 26.8Bn cf. a surplus of LKR 13.7Bn. However, considering a QoQ basis, total consumption fell by 7.9%YoY to LKR 2.3Tn with both household and government consumption falling by 7.6%YoY and 9.5%YoY, respectively. Looking ahead, we expect consumption to grow at a relatively slower pace, contributed by weak government spending, especially through capital expenditure (capex for 1Q2025 stood at LKR 116.0Bn cf. LKR 1.3Tn allocation for 2025E from budget and LKR 160.0Bn spent in 1Q2024). Moreover, household consumption is also expected to slow, as relatively higher taxes and rising inflation as they are likely to reduce disposable income. Meanwhile, developments on the global front, led by US tariffs leading to possible slow growth globally are also expected to contribute towards slower growth during the upcoming quarters.

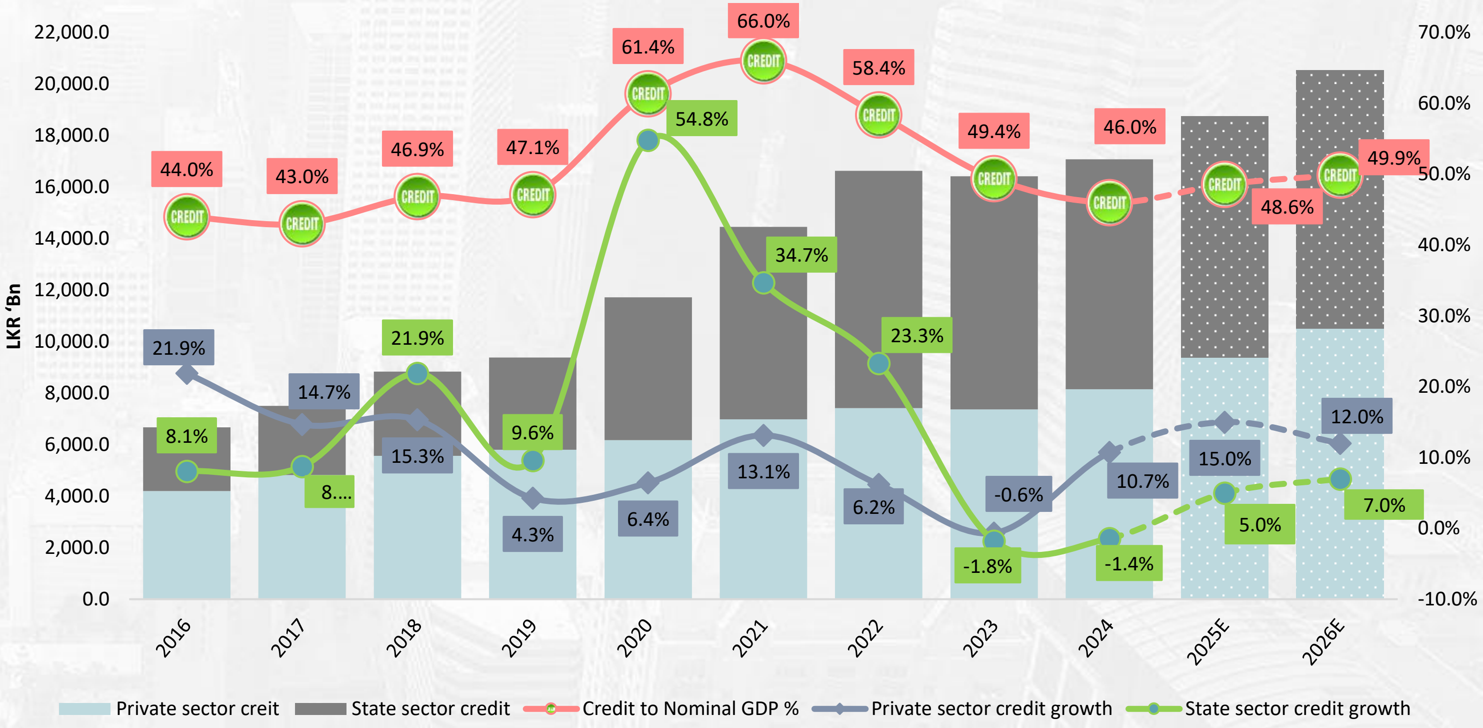




Arguments for a relaxation in monetary policy

More room for credit expansion amidst limited state credit

Total credit expanded during the month of May, rising by LKR 187.2Bn contributed by growth in both private and state sector credit, which grew by LKR 133.0Bn and LKR 54.2Bn, respectively. Meanwhile, total credit increased by a mere 2.0%YTD to LKR 639.0Bn during the 1st 5 months of 2025. The lackluster credit demand is attributed to the slow growth in state credit, which grew by LKR 160.4Mn for the 1st 5 months. Taking into consideration the past growth in total credit (averaging around 50% compared to GDP), we believe there is further room for credit growth without overheating the demand. Therefore, considering slow growth in credit demand during the 1st five months, we believe an average of LKR 139.0Bn can be absorbed by the system, enabling a growth of 15.0%YoY for private sector credit and 5.0%YoY growth for state credit in 2025E. Therefore, we believe that CBSL can offer another rate cut, without overheating the credit demand in the system.

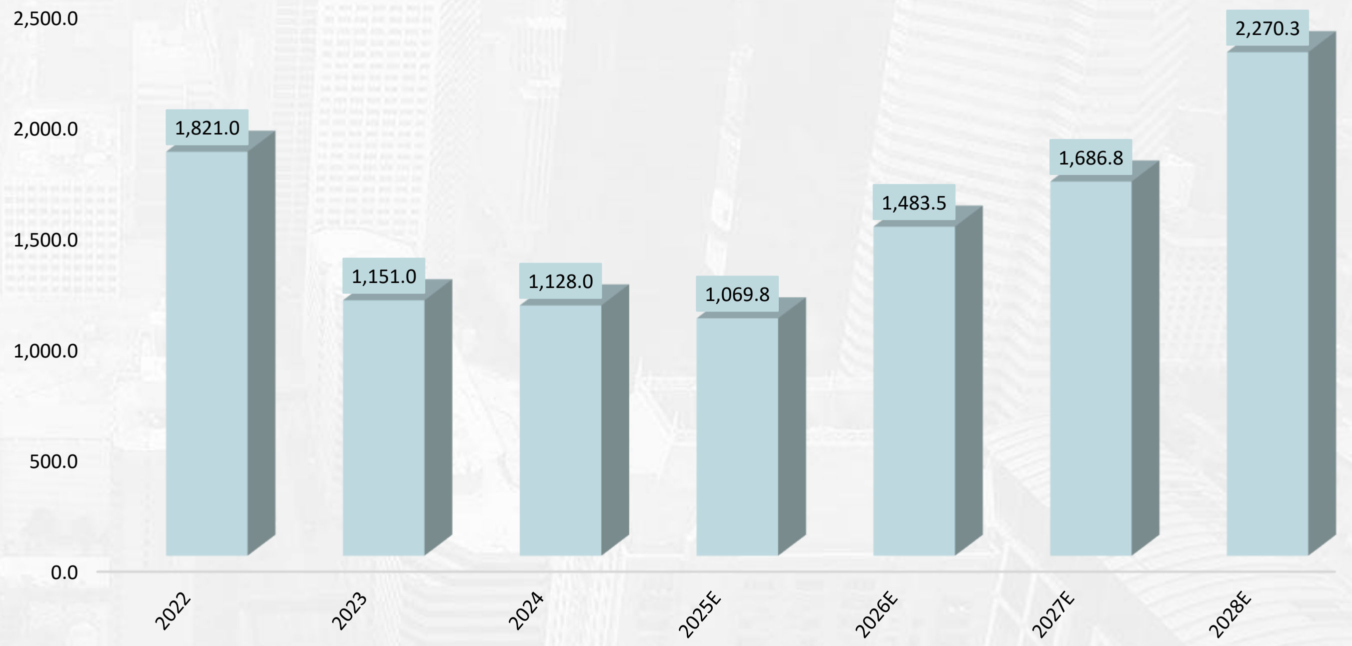


Arguments *for a relaxation* in monetary policy

Lower supply side pressure led with relatively lower maturities in 2H2025

Considering the Rupee maturities for the period of 2022-2025, the calendar year 2025 is considered a 4 year low in terms of maturities with only LKR 1.1Tn pending repayments. The 1H2025 was especially slow in terms of maturities with LKR 457.1Bn in maturities whilst 2H2025 holds slightly higher maturities of LKR 512.0Bn compared to the 1H2025E. However, this compared to the upcoming year is significantly lower with 2026E, 2027E and 2028E Rupee maturities totaling to LKR 1.5Tn, LKR 1.7Tn and LKR 2.3Tn, respectively. Considering the relatively lower supply side pressure compared to coming years, we believe a rate cut to help further lower market rates in the coming months. Moreover, considering the potential ramp up in spending to counter slowness in the system in the coming years, we expect a rate cut at current juncture to offer more benefits than a delayed rate cut in the coming policy reviews.

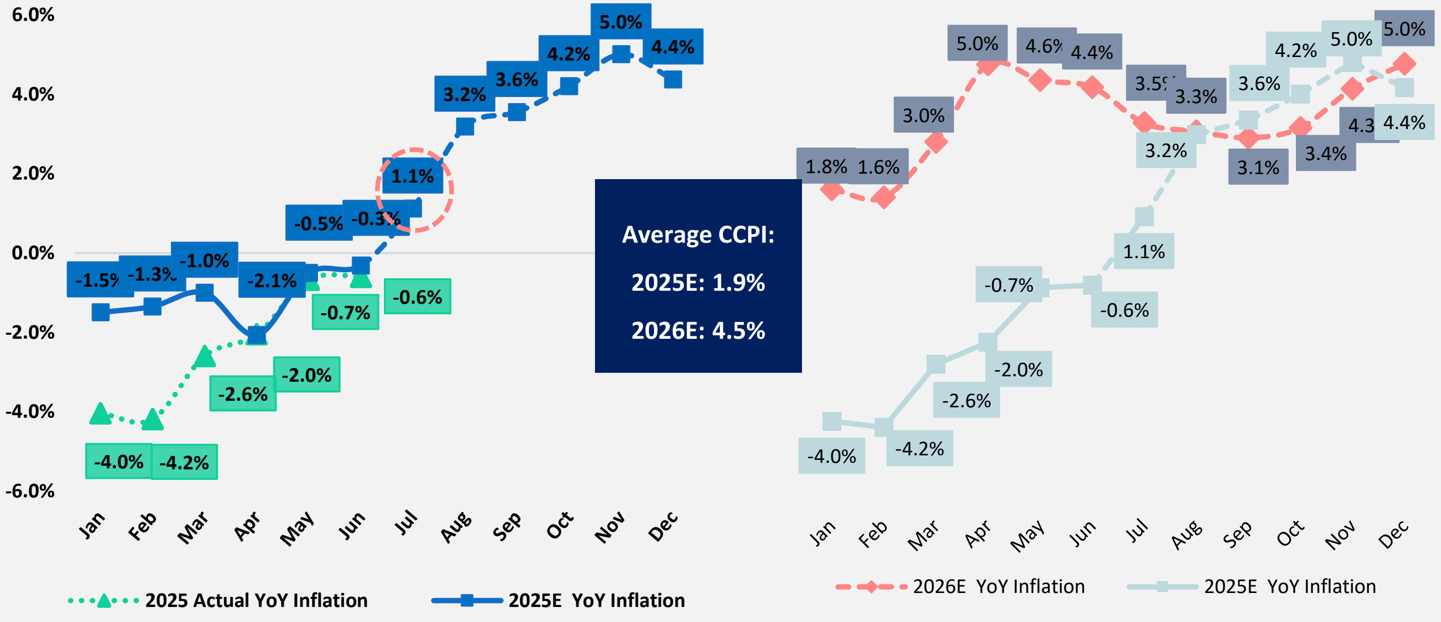
Total Rupee maturities (LKR 'Bn)



Arguments *for a relaxation* in monetary policy

Inflation is rising, but slower than expected

Since hitting the lowest level of deflation in Feb-25 of -4.2%YoY, deflationary pressures are gradually easing with deflation for Jun-25 recorded at -0.6%YoY. The upwards adjustment of electricity tariffs by 15% together with the gradual increase in food prices, contributed towards the slowdown in deflation during the concerned period. Looking ahead, we expect a gradual rise in inflation during 2H2025 contributed by electricity price adjustment and base effect, which are expected to take effect from Aug-25. However, even though deflation is expected to slowdown and gradually move towards inflation, annual average inflation is expected to hover around the 1.9%YoY mark during 2025E. Considering the fact that slow rise in inflation was one of the key factors considered towards lowering the overnight policy rate by 25bps at the May-25 policy review, we believe that the CBSL may look to cut rates further at the upcoming policy meeting to further speed up the gradual rise in inflation, which is still expected to be lower (based on our estimates) compared to the CBSL desired threshold of 5.0%. Moreover, 2026E inflation is expected to average at 4.5%YoY, between the CBSL envisaged threshold of between 3%-5%.

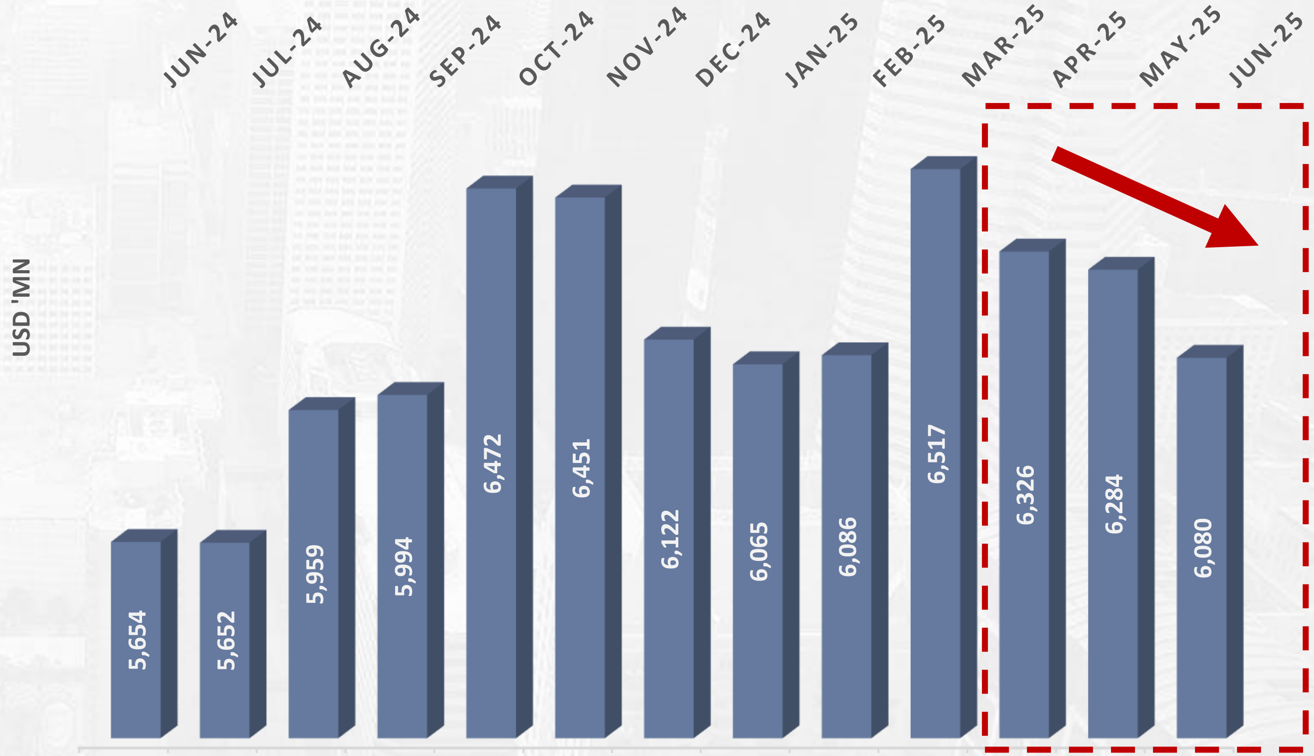


Arguments *against a relaxation* in monetary policy

Arguments *against a relaxation* in monetary policy

Volatility in reserves remains a concern and build up appears sluggish

Sri Lanka's official reserves fell to USD 6.1Bn in Jun-25, down from USD 6.3Bn in May-25, marking a decline of approximately USD 204.0Mn. This drop aligns with CBSL's anticipated outflows for June, mainly related to foreign currency loans, securities, and deposits particularly following the ISB restructuring completed in Dec-24. In early July, Sri Lanka unlocked the 5th tranche under the IMF-EFF following conclusion of the 4th review. While this inflow supports reserve stability, CBSL still anticipates outflows of around USD 183.0Mn in July and a further USD 239.0Mn over the following three months, mainly due to FX-related obligations. Moreover, rising imports also pose a concern. While they may not directly reduce reserves, they could hinder CBSL's ability to absorb USD from the market. Overall, reserve balances are expected to fluctuate as authorities work to meet the IMF's reserve target of USD 7.2Bn.



Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy

Global shifts may prompt authorities to 'wait-and-see'

Subdued global demand and escalation of global uncertainties were quoted as key concerns that prompted the OPR reduction that took place in May-25. The downward revision of US tariffs that would be imposed on Sri Lanka suggests that Sri Lankan exports would not fall too far behind in the global arena in terms of price competition, yet higher operating costs compared to peers remaining a concern. However, the uptick that was noted in merchandise exports from USD 968.4Mn in Apr-25 to USD 1,034.8Mn together with a 2.3% YoY rise suggests that a dramatic shift in global demand is far from an immediate concern at the moment. On another note, the external environment, particularly in the geopolitical front appear to be rapidly changing. Against this backdrop, the authorities may consider it prudent to embrace a wait-and-see approach and make a decision when the global landscape appears to have gained a firmer footing.

A premature rate cut may impair private credit growth momentum

Following the policy rate cut implemented in May 2025, market lending rates have begun to exhibit a gradual response. The AWPR, which stood at 8.35% at the end of May, declined to 7.88% by mid-July which indicates some pass-through of the monetary policy easing. However, a different dynamic is playing out in the government securities market. Treasury bill yields have displayed a degree of stickiness and in fact, there has been a slight upward adjustment in yields over recent weeks. Notably, the yield on the 12M T-Bill now stands at 8.05%. With T-Bill yields remaining elevated relative to lending rates, banks may find government securities to be a more attractive and lower-risk alternative. While this does not imply that lending activity will decline, it does introduce a potential dampener to the pace at which credit is transmitted to the private sector. In this context, any further policy rate reductions, if implemented prematurely may not deliver the full intended stimulus to private sector credit.

Source: Fed, ECB, BoE, Reuters, First Capital Research

Factors in consideration at the policy review

Inflation
CCPI -0.6% for Jun-25

Foreign Reserves
USD 6.1Bn by Jun-25

GDP Growth
+4.8% in 1Q2025

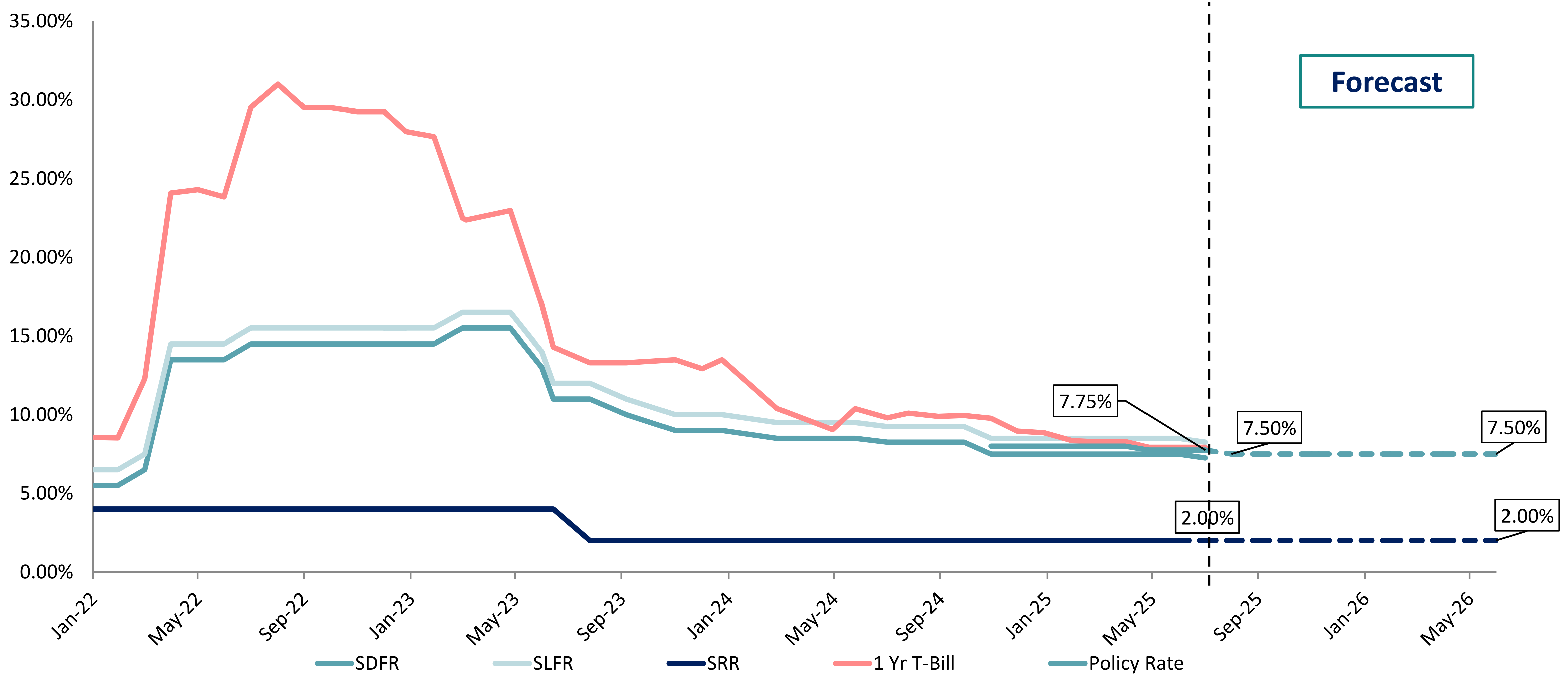
03M T-Bill rate
8.05% as of 17th Jul-25

Total Credit increased by LKR 187.2Bn in May-25

Liquidity and CBSL Holdings
LKR 85.9Bn and LKR 2.5Tn

BOT
USD -472.5Mn for May-25

Monetary Policy Rates



Source: CBSL, First Capital Research

Disclaimer

This Review is prepared and issued by First Capital Holdings PLC based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the Review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the accuracy, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or a connected person or associated person may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.

Thank you!

"SUCCESSFUL INVESTMENTS IS ABOUT MANAGING RISKS"

Contact Us

First Capital Holdings PLC
No: 02, Deal Place,
Colombo 00300,
Sri Lanka.
E: research@firstcapital.lk

Dimantha Mathew
Chief Research & Strategy Officer
T: +94 11 2639 853
E: dimantha@firstcapital.lk

Ranjan Ranatunga
Assistant Vice President – Research
T: +94 11 2639 863
E: ranjan@firstcapital.lk

Shahana Kanagaratnam
Senior Assistant Manager
T: +94 11 2639 866
E: Shahana@firstcapital.lk

Akna Tennakoon
Senior Research Analyst
T: +94 11 2639 866
E: akna@firstcapital.lk

Manusha Kandanaarachchi
Research Associate
T: +94 11 2639 866
E: manusha@firstcapital.lk

Salaama Sanoon
Research Associate
T: +94 11 2639 866
E: Salaama@firstcapital.lk