



First Capital
A Janashakthi Group Company

“MONETARY PATIENCE AHEAD OF FISCAL CLARITY”

PRE-POLICY ANALYSIS

19th Sep 2025

FIRST CAPITAL RESEARCH

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Previous Pre-policy report: Recap – Inaccurate

The Central Bank of Sri Lanka keeps the Overnight Policy Rate (OPR) unchanged

Not in line with our expectations. The Monetary Policy Board decided to maintain the Overnight Policy Rate (OPR) at the current level of 7.75%. The Board arrived at this decision after carefully considering both domestic and global developments. The Board is of the view that the current monetary policy stance will help steer inflation towards the target of 5% in the period ahead while supporting growth.

Key Arguments considered by CBSL for its policy stance held on 22nd July 2025

- ✓ The movements in the Colombo Consumer Price Index (CCPI) reflected a further easing of deflationary conditions as anticipated. Inflation is projected to turn positive this quarter and steadily increase towards the target of 5% thereafter.
- ✓ The economy recorded a firm growth of 4.8% in 1Q2025. Leading economic indicators suggest this growth momentum will continue in the near term.
- ✓ Most market interest rates have declined further in response to the recent policy rate reduction. The expansion of credit to the private sector has remained robust and broad-based so far in 2025. This private sector credit expansion is expected to continue.
- ✓ External sector performance remains robust supported by inflows from tourism and remittances.
- ✓ Reserve buildup efforts continue with regular net foreign exchange purchases by the Central Bank. The fifth tranche of the IMF-EFF was received in early July 2025.



Expected Monetary Policy Stance

- As per our view, at the upcoming policy meeting there is a **50% probability for the Central Bank to maintain current policy rates**, as it may seek additional time to assess developments in key economic indicators, particularly with the National Budget 2026 scheduled for November 2025.
- However, there is a **50% probability for CBSL to reduce rates, with a 40% 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.
- 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	50%
Cutting Policy Rates by 25bps	40%
Cutting Policy Rates by 50bps	10%
Cutting Policy Rates by 100bps	0%

50%

As per our view, at the upcoming policy meeting there is a 50% probability for the Central Bank to maintain current policy rates, as it may seek additional time to assess developments in key economic indicators, particularly with the National Budget 2026 scheduled for November 2025.

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.

Analysis of upcoming policy decision on 23rd Sep

Arguments **for** a Monetary Relaxation

50%



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

- To support the potential sluggishness of the economy
- Liquidity recovers offering more space for a rate cut
- Inflation turns positive in Aug-25, yet far below CBSL envisaged targets
- Stagflation concerns in US, lowers global growth outlook

- Sustained credit momentum suggests no need for policy action
- Rising AWCMR may constrain future OPR easing
- Reserves strengthening, but challenges persist
- CBSL expected to delay moves pending budget

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

Arguments **against** a Monetary Relaxation

50%



A background image showing a pair of hands holding several coins, with a dark, semi-transparent overlay. The text is overlaid on this image.

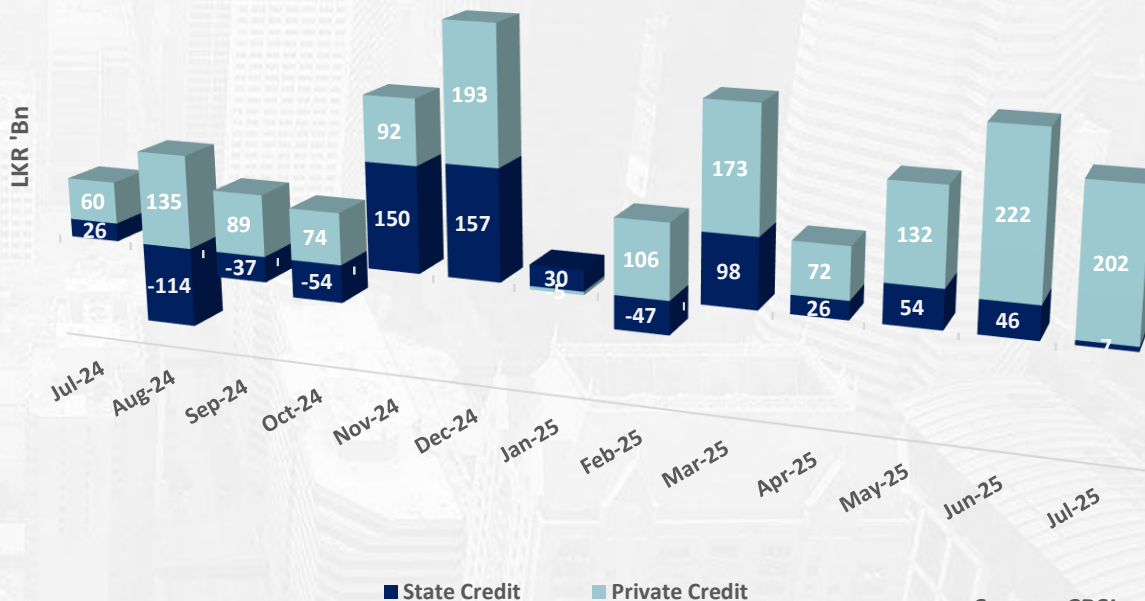
Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy



Sustained credit momentum suggests no need for policy action

Following the monetary policy easing in May 2025, private sector credit growth has accelerated. In July alone, borrowings rose by LKR 201.5Bn, pushing the total above LKR 9.5Tn for the first seven months of the year. CBSL data shows domestic bank lending to the private sector reached LKR 192.7Bn in Jul-25, up 20.7% YoY, compared to a relatively slower growth rate recorded in Jun-25. The CBSL's Willingness to Lend Index continued its nine-quarter upward trend in 2Q2025, reaching a five-quarter high. The credit supply survey also indicates that this momentum is likely to persist into 3Q2025, supported by favourable bank liquidity, ongoing economic recovery, and a positive outlook. With government capital expenditure expected to rise later in the year, and a gradual pick-up in construction activity, credit growth is likely to remain strong. As such, an additional rate cut may not be necessary at this point, given that current credit conditions are already conducive to supporting growth.



Source: CBSL

Arguments against a relaxation in monetary policy



Rising AWCMR may constrain future OPR easing

The Average Weighted Call Money Rate (AWCMR), which represents the CBSL's current operational target within its existing policy framework, has consistently remained slightly above the OPR, despite relatively higher liquidity levels. Following the policy decision in Jul-25, the OPR was held steady at 7.75%, while the AWCMR was recorded at approximately 7.86%, exceeding the OPR by about 11 basis points. A further reduction in the OPR could stimulate greater demand for credit, thereby influencing bank liquidity and potentially driving the AWCMR even higher. Given that maintaining the AWCMR in close alignment with the OPR is a primary objective for the CBSL, a reduction in the OPR at this time could be deemed counterproductive. Therefore, the CBSL may consider it inadvisable to lower the OPR under current circumstances.

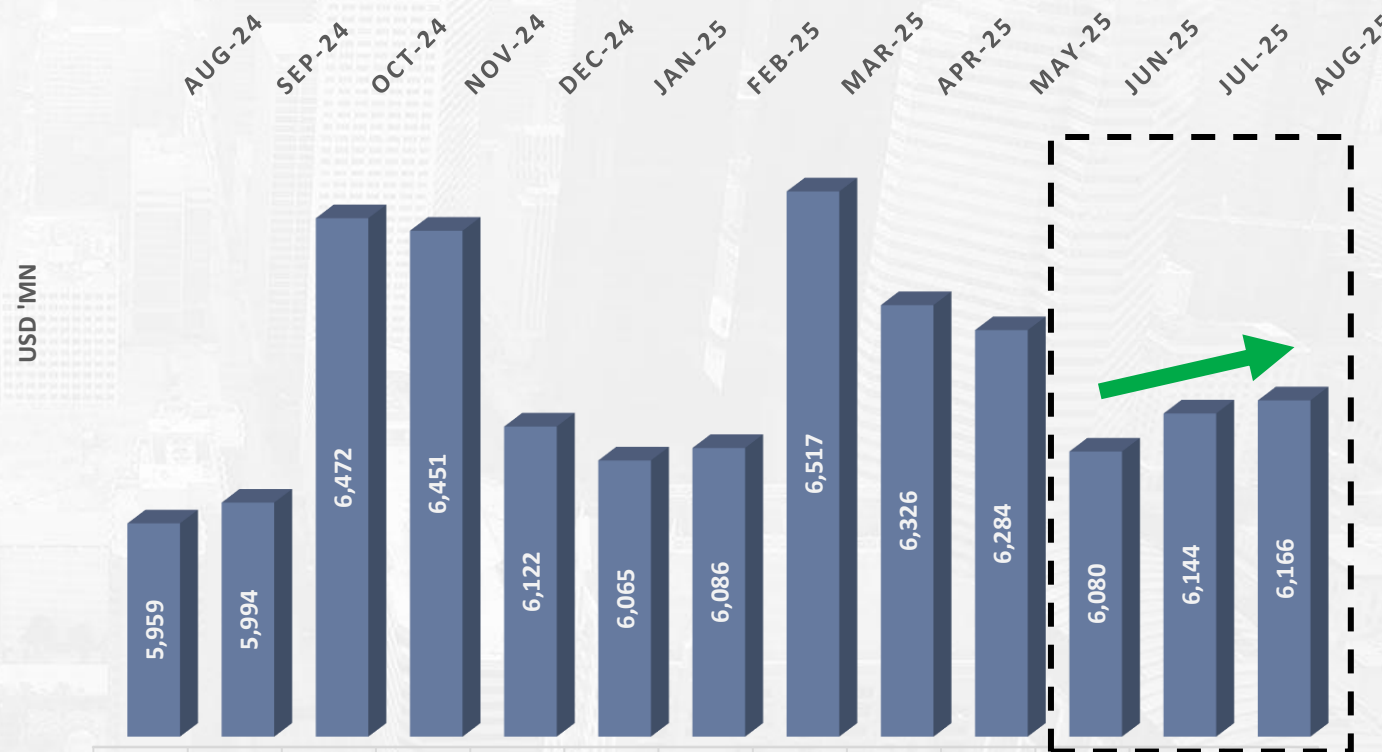


Arguments against a relaxation in monetary policy



Reserves strengthening, but challenges persist

Sri Lanka's official reserves saw a slight rise to USD 6.2Bn in August 2025 from USD 6.1Bn in July, an increase of about USD 19Mn. Reserves are expected to strengthen gradually through USD purchases, supported by higher tourism earnings during the peak season and an anticipated rise in worker remittances towards year-end. The expected IMF-EFF 6th tranche disbursement in December will also add support. Moreover, the pent-up demand from vehicle imports are also expected ease in the coming months positively impacting the BOP position of SL. However, these gains are tempered by projected FX outflows of USD 513Mn in August and USD 611Mn over the next three months, mainly due to settlement of currency swaps. Consequently, reserves are likely to remain volatile as authorities aim to meet the IMF's USD 7.2Bn target.



Arguments against a relaxation in monetary policy



CBSL expected to delay moves pending budget

The upcoming National Budget 2026, scheduled for 7 Nov 2025, is anticipated to provide greater clarity regarding the government's fiscal stance and offer guidance on the broader policy direction. In parallel, key economic indicators, such as liquidity, credit growth, and foreign reserve levels are expected to offer more definitive trends over the coming months. Given these evolving conditions, the CBSL is likely to adopt a cautious, wait-and-see approach at this stage. Premature adjustments to monetary policy ahead of the Budget announcement could lead to misalignment with forthcoming fiscal measures and potentially create unfavorable macroeconomic outcomes. As such, the Budget is expected to play a pivotal role in shaping the CBSL's policy trajectory going forward.

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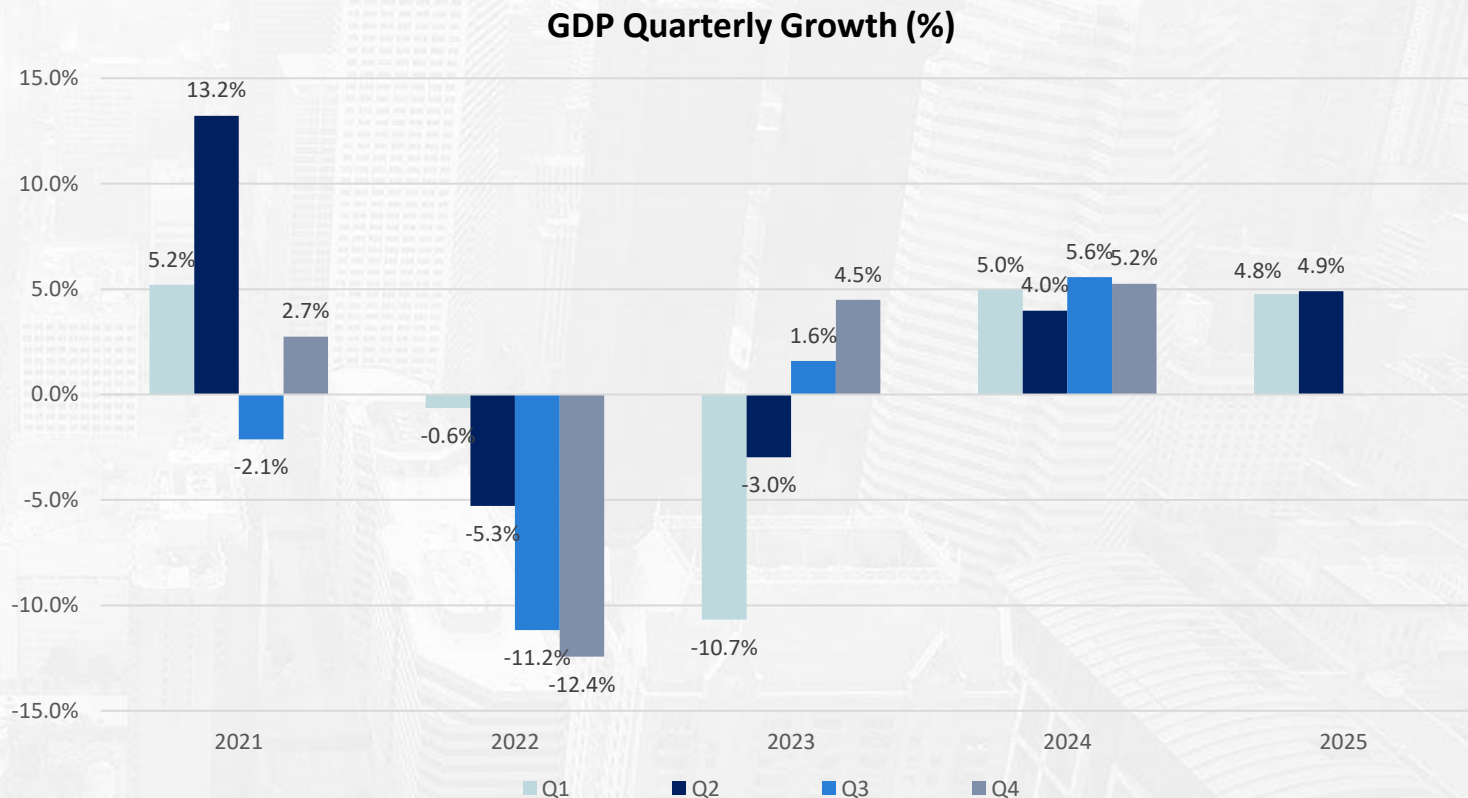
Arguments *for a relaxation* in monetary policy

Arguments for a relaxation in monetary policy



To support the potential sluggishness of the economy

GDP growth stood at 4.9% in 2Q2025, driven by broad-based expansion across key sectors. However, this momentum is expected to ease in the coming quarters, primarily due to weak public capital expenditure, with only around 20% of the LKR 1.3Tn annual capex allocation utilized as of 2Q2025. On the demand side, consumption is projected to slow as elevated taxes and rising inflation continue to weigh on disposable incomes. The combined drag from subdued household spending and restrained government investment points to a moderation in domestic demand. Externally, intensifying global headwinds, such as escalating US tariffs add further downside risks. In this context, the CBSL may consider a policy rate cut to reinvigorate growth.

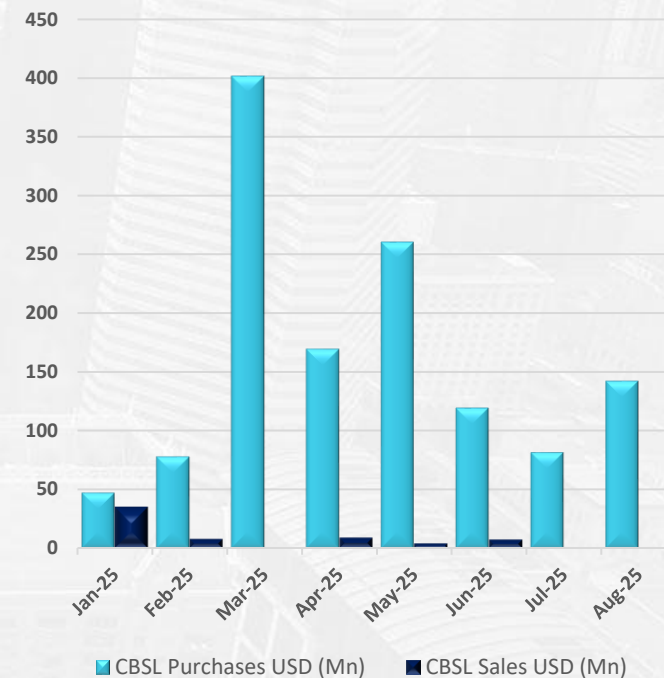
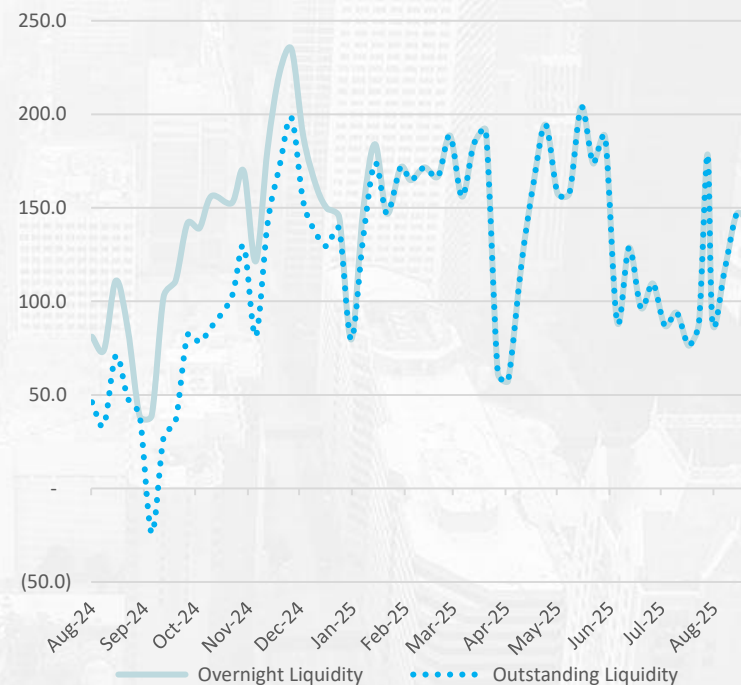


Arguments for a relaxation in monetary policy



Liquidity recovers offering more space for a rate cut

Despite the sudden drop of liquidity observed in Apr-25 to near LKR 50Bn, liquidity in the banking sector has continuously recovered and hovers between LKR 125.0Bn – LKR 175.0Bn aided by the aggressive USD purchases conducted by the CBSL, which totaled to USD 1.3Bn during the 1st 8 months of 2025. Noteworthy, the recovery in liquidity was also amidst a bump up in total credit during the concerned period, with total credit growing at LKR 1.1Tn YTD or 4.2%YTD driven by increased credit demand for vehicle imports. Looking ahead, we expect a continuous recovery in liquidity in the banking sector, with liquidity expected to hover around the previous high of LKR 200.0Bn, driven largely by the aggressive USD purchases by the CBSL in an effort to build foreign reserves to the IMF targeted level of USD 7.2Bn for 2025E. Moreover, we expect the currently high credit demand in the system to ease in the coming months, as pent-up demand for vehicle imports expected to slow.

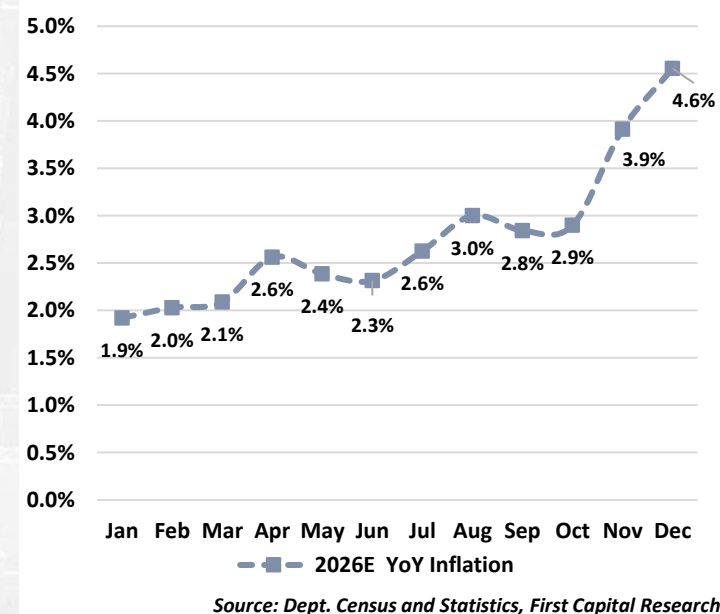
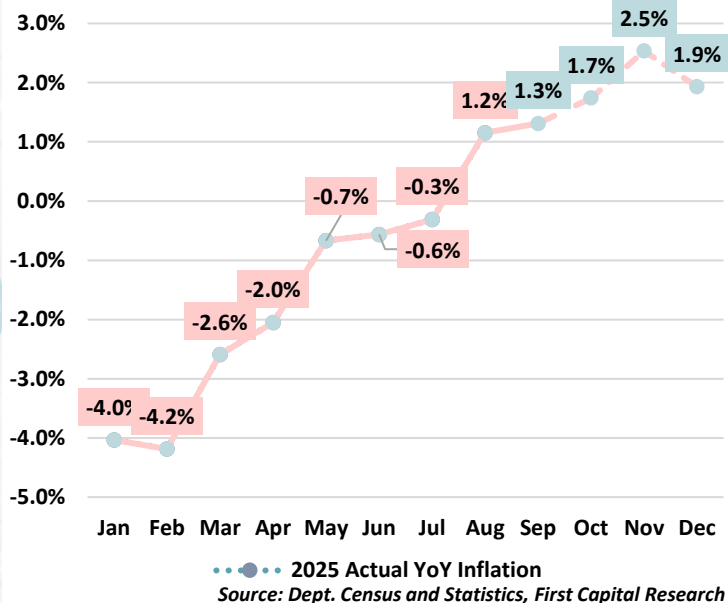


Arguments for a relaxation in monetary policy



Inflation turns positive in Aug-25, yet far below CBSL envisaged targets

Sri Lanka's CCPI inflation turned positive recording 1.2%YoY in Aug-25, after recording deflationary conditions for 11 consecutive months. The positive inflation recorded during the month was largely driven from the base effect in Aug-24 whilst gradual increase in food and non-food inflation also contributed towards the increase in prices during the concerned period. Despite the positive YoY inflation in Aug-25, CCPI inflation on MoM basis declined by -0.4% as food prices reduced whilst non-food inflation also remained intact, despite the increase in electricity tariffs in Jul-25. Looking ahead, we at FCR expects inflation to lag behind CBSL envisaged target of 5% during 4Q2025 and 2026 with annual averages expected to hover around -0.9% for 2025E and 2.8% for 2026E. This is expected largely due to the delay in passing down of benefits from economic recovery to all parts of the economy, with prevailing high tax structures limiting growth in consumption. Therefore, we believe CBSL can look to offer another rate cut to boost demand in the system and take inflation to CBSL envisaged threshold of 5% in the medium term.



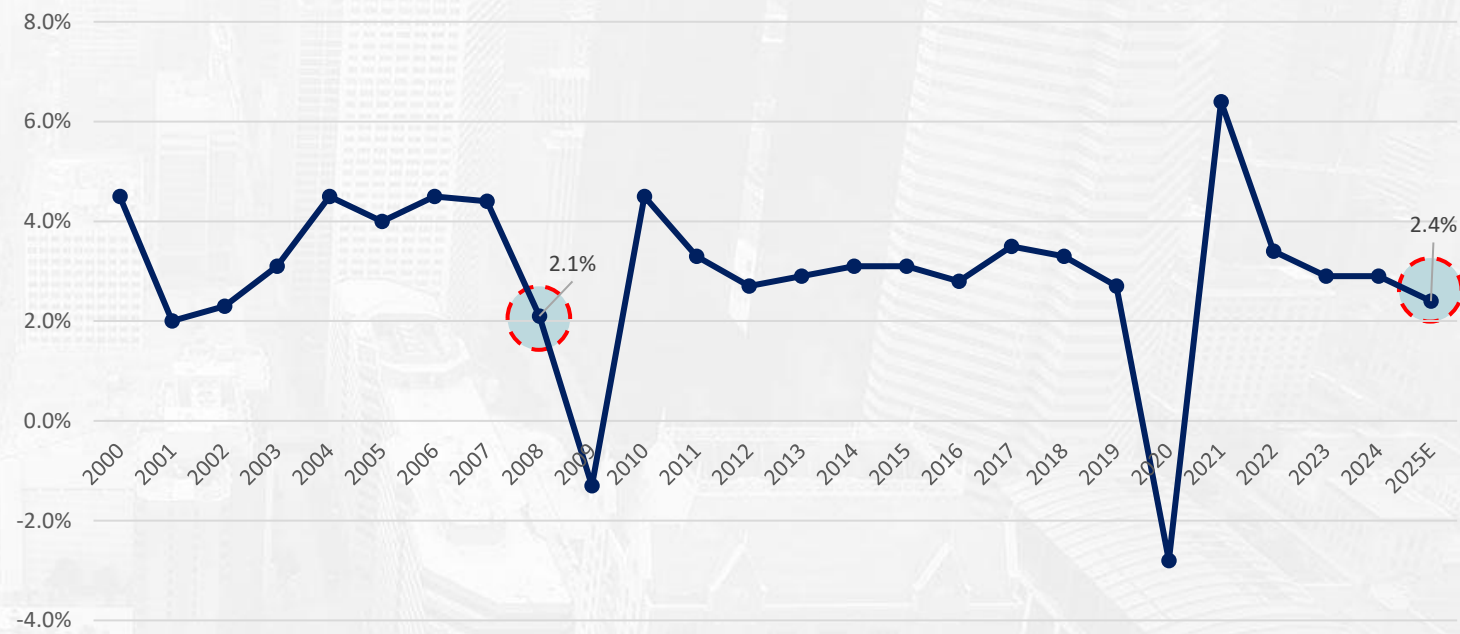
Arguments for a relaxation in monetary policy



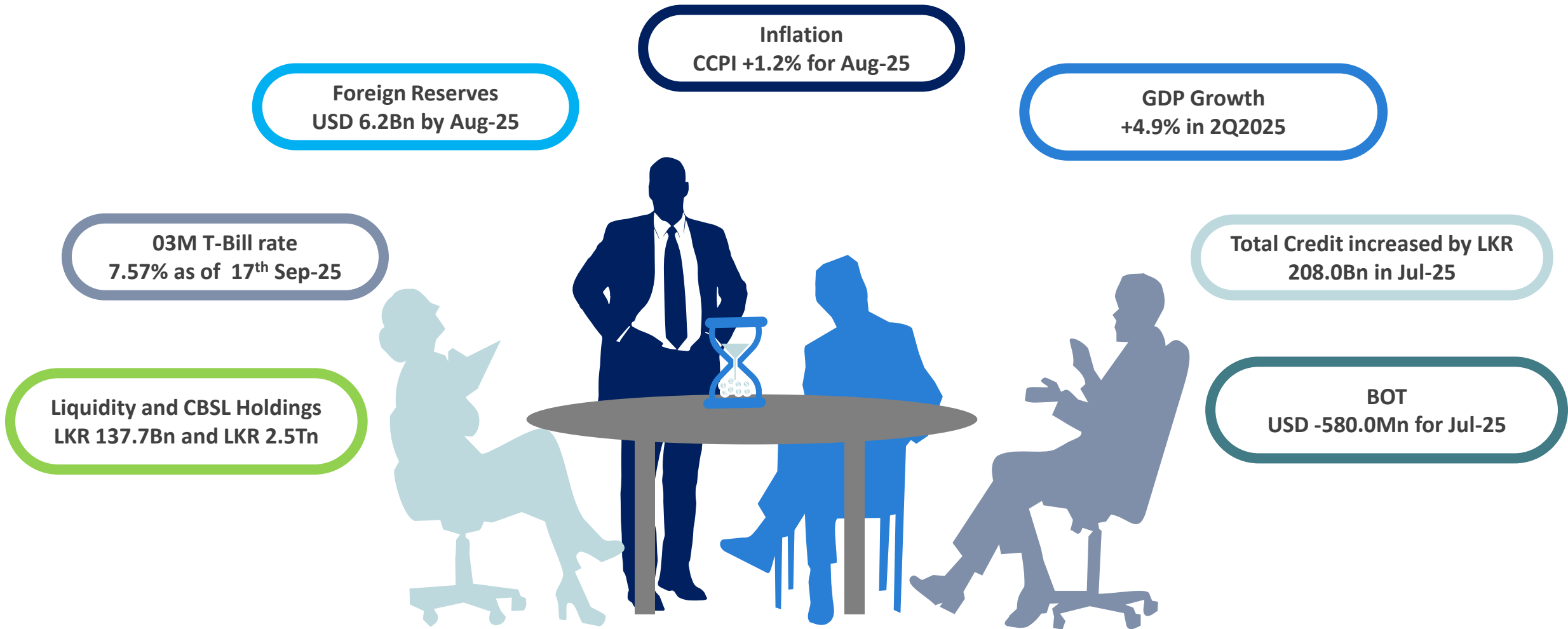
Stagflation concerns in US, lowers global growth outlook

Fitch Ratings forecasts global growth rate for 2025E at 2.4%YoY down from the previous estimate of 2.9% forecasted in Jun-25. The relatively slow growth attributable during the period is largely stemming from stagflation concerns in the US, with inflation slowly climbing up and employment growth slowing down. On the back of this, the Federal Reserve cut rates by 25bps at the Sep-25 review bringing the target range to 4.00%-4.25% whilst, another two rate cuts are also on the pipeline for the next two meetings. Considering the fact that US and other central banks are in the process of reducing rates, together with the fact that projected growth of 2.4%YoY is the slowest since 2008 (taking off 2009 and 2020), we believe that the CBSL may look to follow global central banks and cut rates to offset the possible negative impact from the potential slow growth in the global economy .

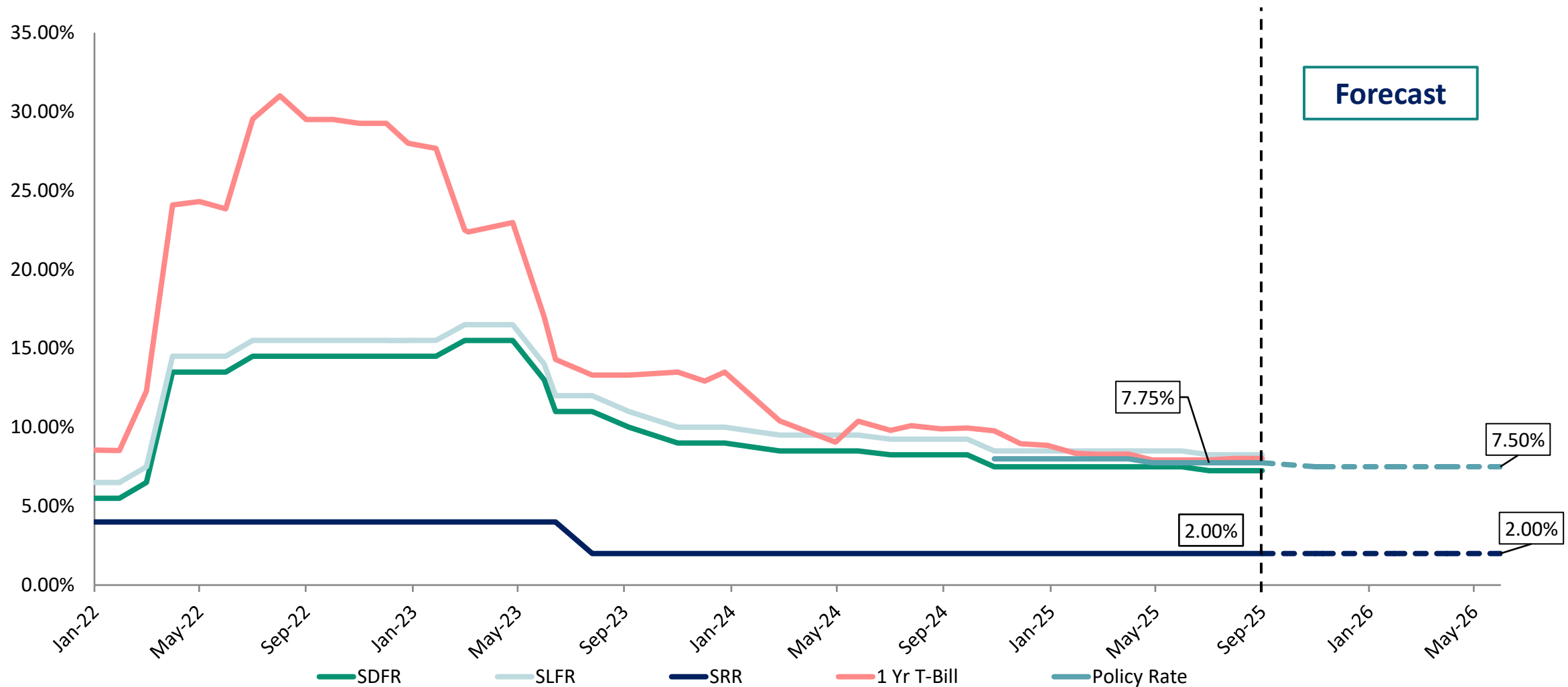
Global growth between 2000-2025



Factors in consideration at the policy review



Monetary Policy Rates



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