



First Capital
A Janashakthi Group Company

“POLICY HOLD EXPECTED, WITH LIMITED ROOM FOR EASING”

PRE-POLICY ANALYSIS | JANUARY 2026

21st Jan 2026

FIRST CAPITAL RESEARCH

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Previous Pre-Policy Report: Recap – Accurate

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

In line with expectations, the Monetary Board decided to maintain the Overnight Policy Rate (OPR) at 7.75%. The Board noted that the current stance would help steer inflation toward the 5% target while supporting economic recovery. **In addition, the Statutory Reserve Ratio (SRR) was left unchanged.**

Key Arguments Considered by CBSL for its Policy Stance Held on 25th Nov 2025

- ✓ Headline inflation (CCPI) accelerated for the third consecutive month in October. Inflation is now expected to rise more gradually than earlier projections and move toward 5% by H2-2026. Core inflation will increase modestly as demand strengthens.
- ✓ Leading indicators suggest continued growth momentum. Private-sector credit has shown broad-based expansion in 2025, supported by the low-interest-rate environment and pent-up demand of vehicle imports.
- ✓ In the external front imports have risen, widening the trade deficit, but tourism and remittances have cushioned the impact. Reserves remain above USD 6.0 billion, aided by FX purchases and expected multilateral inflows.
- ✓ Upside risks include strong credit growth and possible rupee depreciation. Global financial conditions have eased somewhat, but geopolitical uncertainties persist.
- ✓ Downside risks include lower-than-expected fuel costs and slower inflation in energy and transport sectors, likely to keep inflation subdued for some time.



Expected Monetary Policy Stance

- We assign a **70% probability to a rate hold**, reflecting a non-easing bias driven by credit-growth, external-stability, and CB's buffer-building priorities. We also assign a **30% probability to a rate cut, comprising 25% for a 25-bps cut and 5% for a 50-bps cut**, supported by growth considerations and post-"Ditwah" reconstruction needs. Notwithstanding these factors, the scope for monetary easing remains limited at this stage.
- Further, we assign a **70% probability that the SRR remains unchanged**, given ongoing liquidity asymmetry in the banking system. However, amid improving liquidity conditions and CBSL's 2026 agenda, which points toward tighter SRR-related operational reforms, we assign a **30% probability to a SRR hike**.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	70%
Cutting Policy Rates by 25bps	25%
Cutting Policy Rates by 50bps	5%

As per our view, at the upcoming policy meeting there is a 70% probability for the Central Bank to maintain current policy rates, given that key economic indicators provide no justification for a rate cut at this stage.

Expected Stance on SRR	Probability
Raising SRR by 150bps	0%
Raising SRR by 100bps	15%
Raising SRR by 50bps	15%
SRR to remain unchanged	70%
Cutting SRR by 50bps	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, we assign a combined 30% probability to an SRR increase by the CBSL, with a 15% probability of a 50 bps hike and a further 15% probability of a 100 bps hike.

Analysis of Upcoming Policy Decision on 27th Jan

- Credit Growth is Underway and Core Inflation is Rising
- Market Signals and Liquidity Conditions
- Keeping Policy Powder Dry to Rebuild Buffers
- Managing LKR Depreciation within Policy Agenda

Arguments **against** a Monetary Relaxation

70%

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

Arguments **for** a Monetary Relaxation

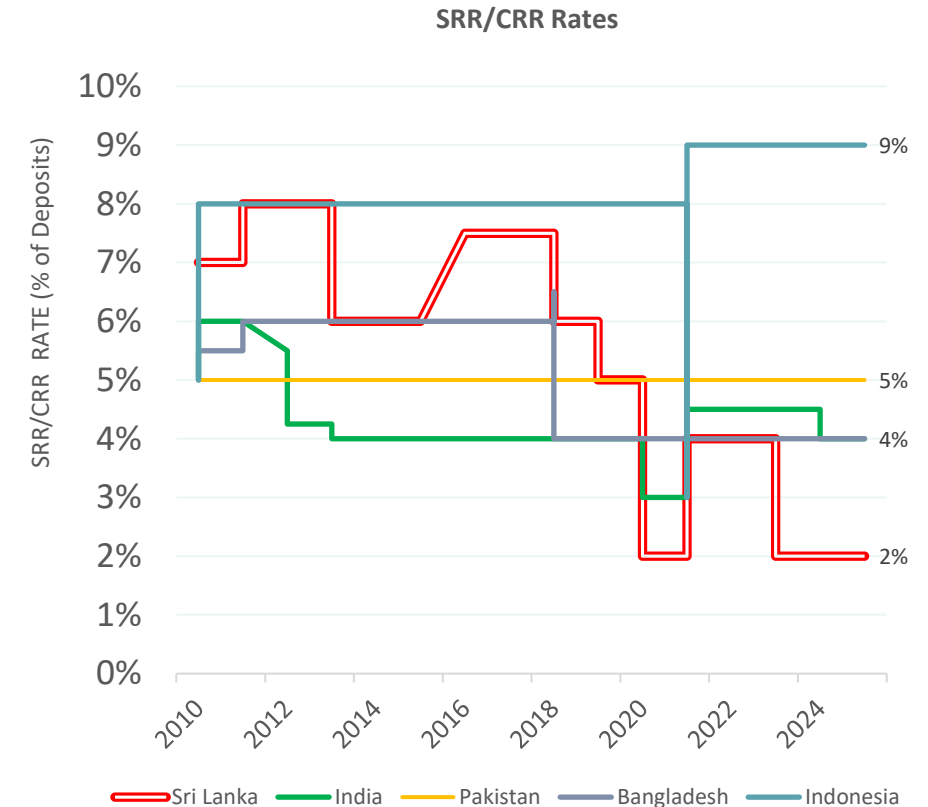
30%

- Headline Inflation is Still Below the CBSL's 5% Target
- Post-Cyclone Reconstruction and Growth Support
- Real Rates Positive: With Inflation Low, Real Interest Rates Remain Positive

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

Expected Statutory Reserve Ratio (SRR) Changes

- Current 2% SRR remains at COVID-era relaxed levels, well below its historical norm and regional peers, while the CBSL's 2026 Policy Agenda references operational tightening and possibly towards a headline (policy-rate) tightening.
- While an SRR hike tightens banking-system liquidity and tempers credit growth, such moves can also be paired with or sequenced around policy-rate decisions to shape overall monetary conditions.
- Historically (2000-2025):
 - In past tightening cycles, the CBSL has used SRR increases as the first turning of the wheel, ahead of policy-rate hikes (2016: SRR +150 bp followed by rates +50 bp; 2021–22: SRR +200 bp, then corridor hikes +50 bp from Jan 2022).
 - In easing cycles, it has cut rates first and later increased SRR to absorb excess liquidity (2011: rates cut then SRR +100 bp).
- Accordingly, **an SRR hike would signal a forward tightening bias** even in the absence of an immediate rate increase. However, FC assigns only a 30% probability to an SRR hike in January, as the CBSL is likely to preserve policy flexibility amid prevailing liquidity asymmetries, while keeping operational tools in reserve for future adjustment.



Peer and regional comparisons indicate that Sri Lanka's SRR is set at a relatively low level compared with peer and regional economies, providing the Central Bank with additional scope to revise the rate if warranted.

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

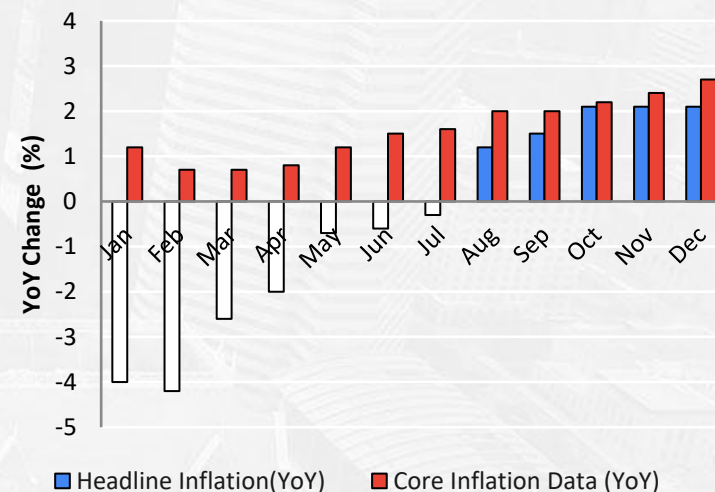
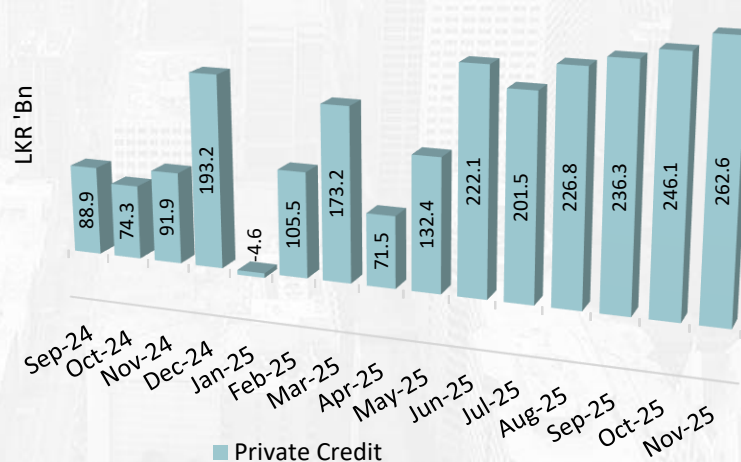
Credit Growth is Underway and Core Inflation is Rising

Total and private sector credit growth continues to show strong momentum. Private credit expanded by LKR 26.3 Bn, reaching LKR 262.6 Bn in November 2025, compared to LKR 236.3 Bn in September, which was the reference point for the previous policy meeting.



Arguments against a relaxation in monetary policy

Although headline inflation remained relatively stagnant during November and December, the rise in core inflation (2.7% in Dec) signals underlying price pressures and inflation persistence. Activity indicators corroborate this. PMI readings show that both Manufacturing (60.9) and Services (67.9) expanded sharply in December 2025, reflecting reasonable demand alongside some supply-side frictions, which argues for maintaining the current policy stance to keep inflation on a trajectory toward the 5% target.



Market Signals and Liquidity Conditions

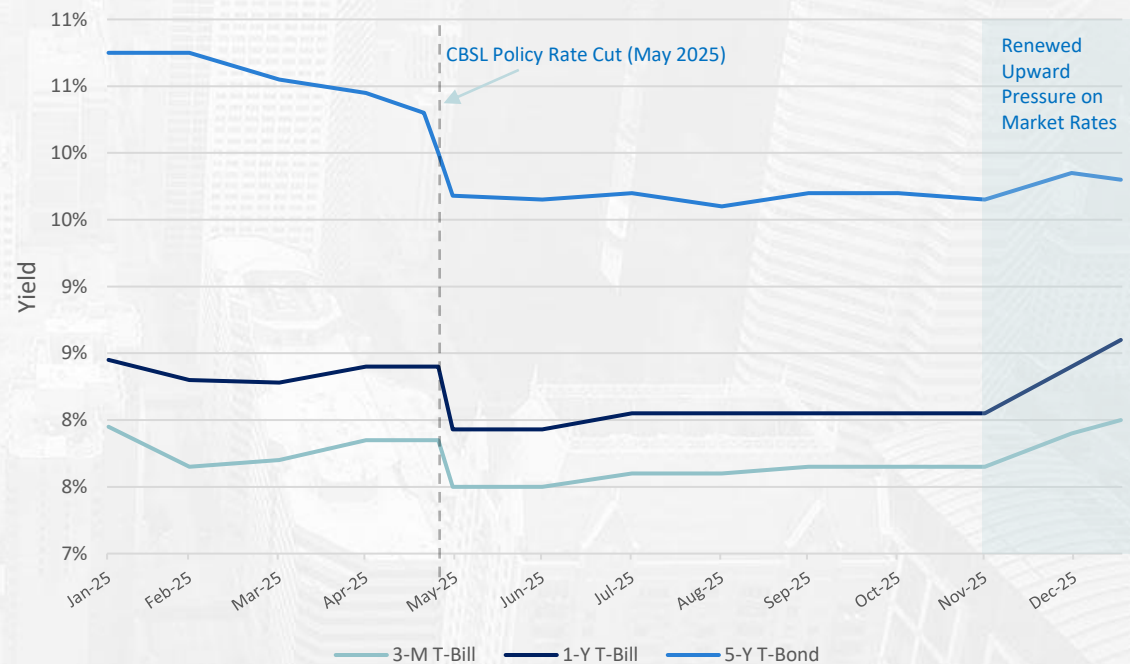
The upward revision of the maximum interest rate on deposits for Finance Companies by 100 basis points for one year (as per the directive dated 12th January), together with rising yields on Treasury bills and bonds in recent auctions, reflects market expectations of higher risk premia.



In addition, while overall excess liquidity remains elevated due to Central Bank foreign exchange operations, there are signs of tightening liquidity in certain market segments, which reinforces the need for caution. Reducing policy rates under these conditions could amplify volatility and misalign with prevailing market dynamics.

Arguments against a relaxation in monetary policy

Trends in T-Bill and Government Bond Yields



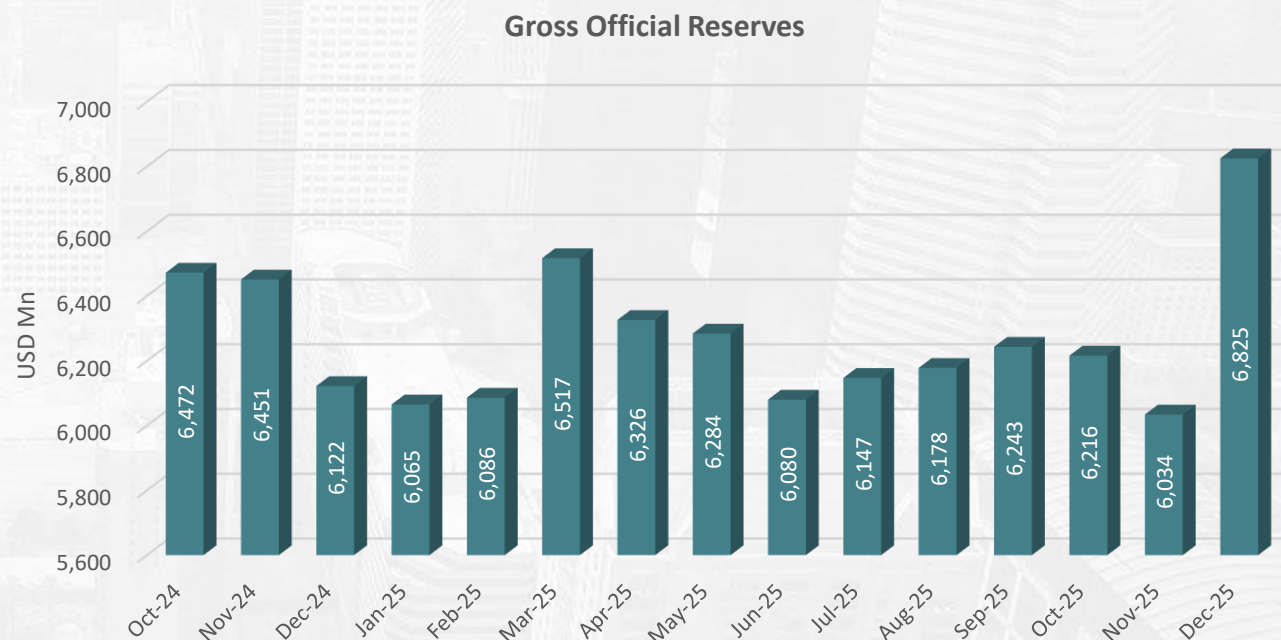
Arguments against a relaxation in monetary policy



Keeping Policy Powder Dry to Rebuild Buffers

Sri Lanka's policy rates are already near historic lows, leaving the CBSL with limited scope for further cuts without **'running out of ammunition.'** In a restricted policy environment, this constraint is key, and it is compounded by the 2023 Central Bank Act restriction on primary-market purchases of government securities, which removes a previously controversial but notable easing tool. Additionally, very low rates would undermine reserve-building efforts, as attractive yields are essential to sustain foreign inflows and strengthen FX buffers.

Therefore, keeping rates unchanged preserves policy flexibility. With inflation projected to converge toward the 5% target, maintaining current rates supports continued reserve accumulation and stronger external buffers, which are key goals in CBSL's Policy Agenda for 2026 and Beyond. By protecting buffers now, the CBSL retains room to respond to future shocks without destabilizing expectations, aligning with its stability-and-resilience mandate.



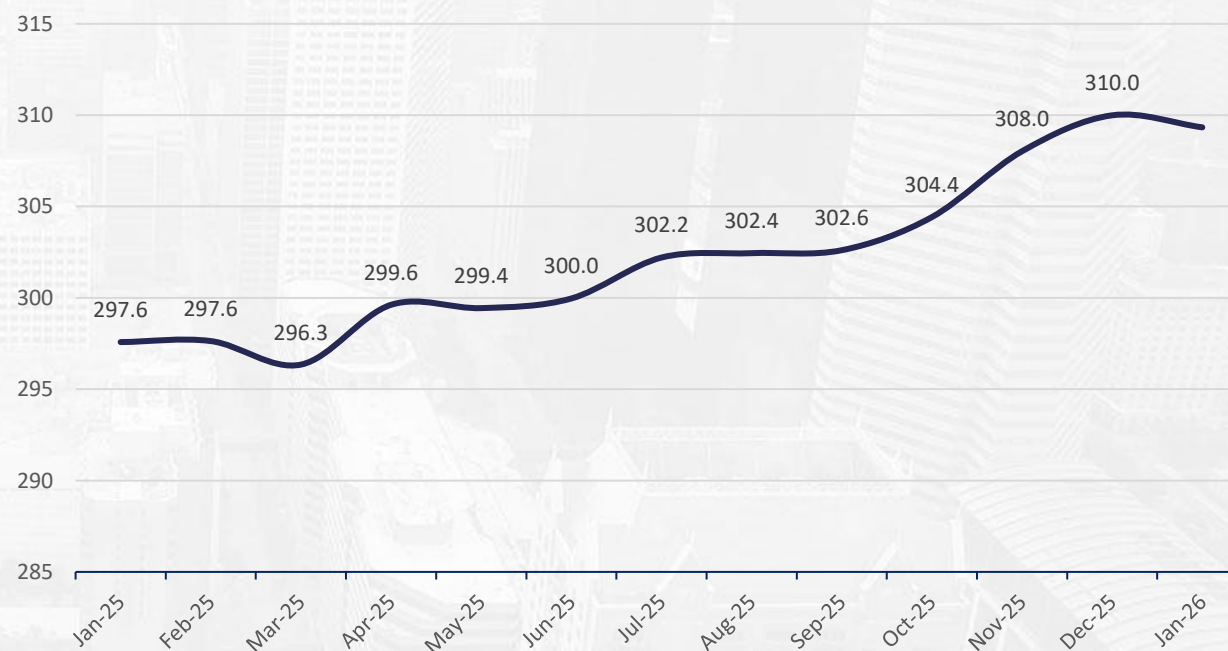
Managing LKR Depreciation within Policy Agenda

Over the past year, the LKR has depreciated by nearly 5.5%, with an additional 2.2% decline in the last three months, reaching CBSL's indicative high of 310.14 on 08th Jan 2026. Further easing now could accelerate this trend and increase import-driven inflation in fuel, food, and intermediate goods. Holding rates helps anchor FX expectations and limit an abrupt inflation pass-through while supporting the 2026 Policy Agenda priority of maintaining strong buffers, including reserves, to absorb future shocks. This approach also contains volatility, safeguards external stability, and aligns with CBSL's long-term resilience objectives.



*Arguments
against a
relaxation in
monetary policy*

USDLKR Exchange Rate



Source: Central Bank of Sri Lanka (CBSL), End-of-Month Indicative Exchange Rates

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Arguments *for a relaxation* in monetary policy

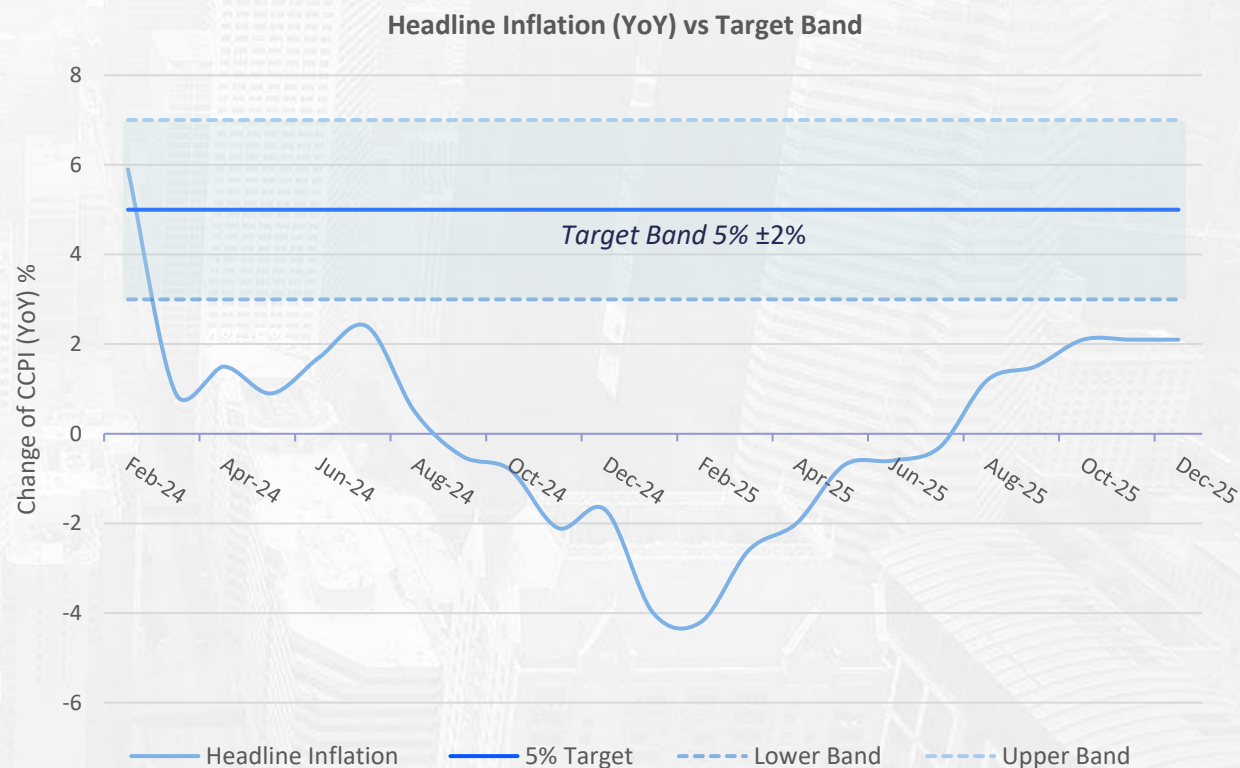
Arguments for a relaxation in monetary policy



Headline Inflation is Still Below the CBSL's 5% Target

Inflation remains below the 5% target (headline 2.1%, core 2.7%). Under the MPFA (03 Oct 2023) and Section 26(5) of the CBSL Act, No. 16 of 2023, the CBSL must aim for quarterly headline inflation of 5% \pm 2pp and report to Parliament if outcomes breach this band for two consecutive quarters.

The CBSL's Aug 2025 deviation report projects a return within the \pm 2pp band toward Q1 2026; however, the improvement observed thus far remains modest. In this context, the CBSL could be inclined to consider a modest policy rate reduction to support fast convergence toward the 5% target to be remained within the accountability framework.



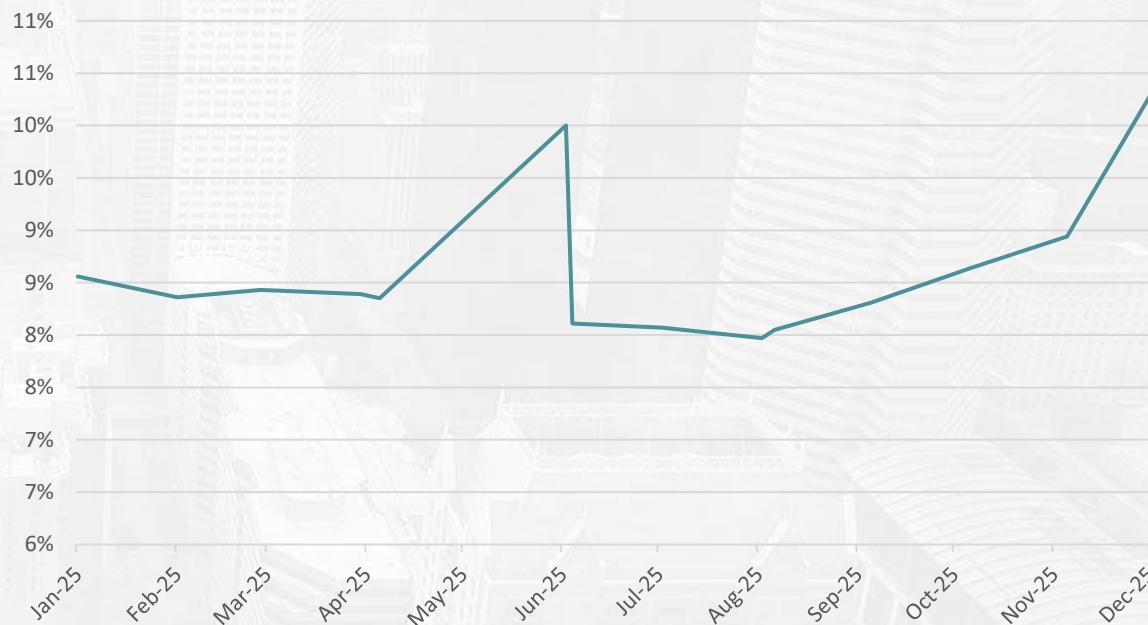
Post-Cyclone Reconstruction and Growth Support

The Cyclone “Ditwah” has been one of the most devastating climate events to occur since the CBSL’s previous monetary policy meeting, resulting in significant infrastructure damage and widespread disruption to livelihoods. The scale of destruction necessitates a reconstruction phase aimed at restoring essential services, housing, and economic activity, which will require increased borrowing by both the public and private sectors. In this context, a supportive monetary policy stance that lowers financing costs would help facilitate reconstruction, accelerate recovery, and support near-term growth without undermining broader macroeconomic stability.

Arguments for a relaxation in monetary policy



Weighted Avg Prime Rate (WAPR)



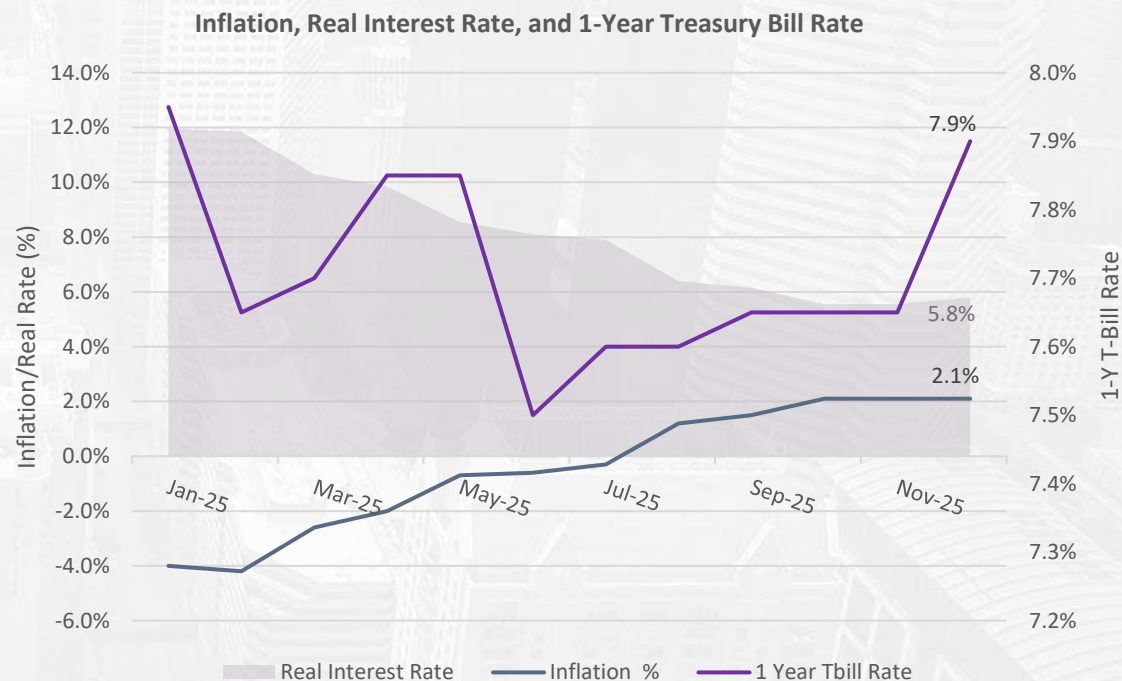
Arguments for a relaxation in monetary policy



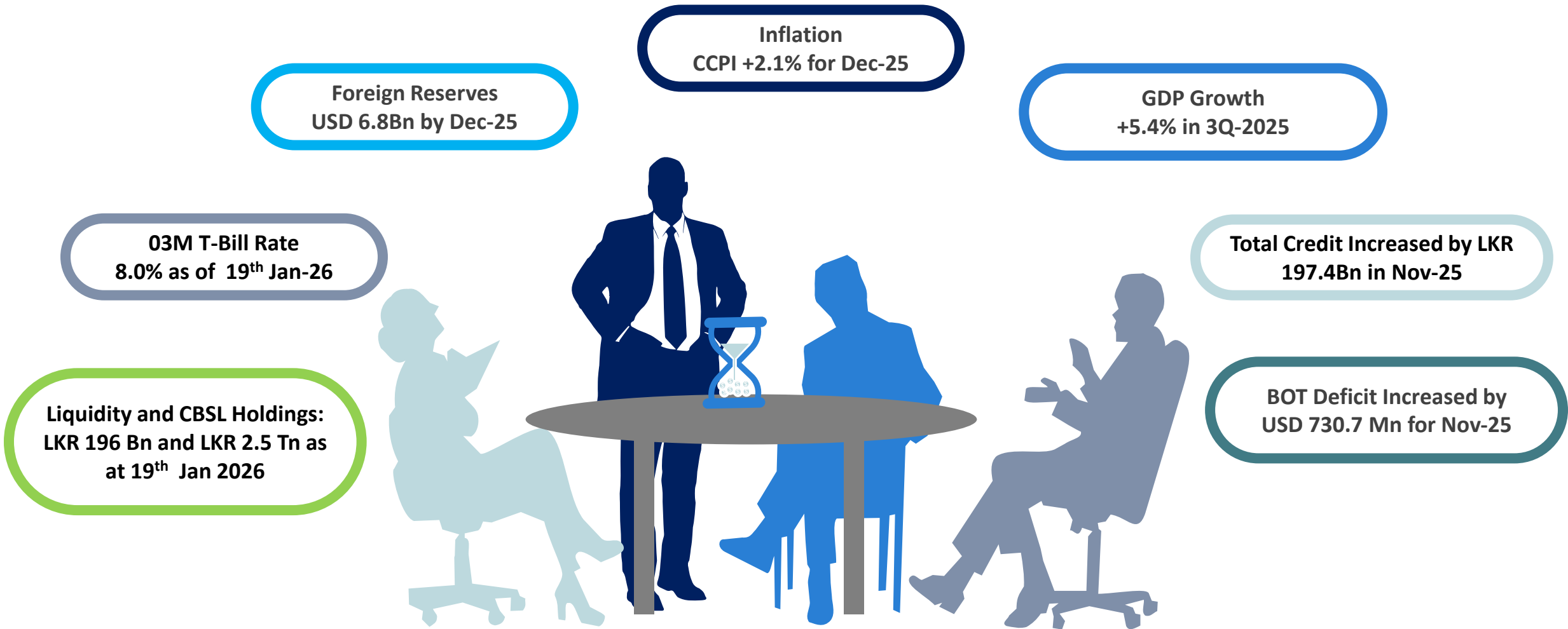
Real Rates Positive: With Inflation Low, Real Interest Rates Remain Positive

With short-term fixed-deposit and short-term Treasury bill rates in the 7.5% to 8.5% range against inflation of roughly 2% to 3%, real interest rates remain positive. This configuration indicates that purchasing power for savers, notwithstanding tax impacts, is still preserved, even after a modest 25 to 50 bp policy rate reduction.

Therefore, the CBSL could frame this situation as room for a moderate rate cut, maintaining positive real rates while easing financing costs. This would improve the affordability of working capital and term lending for productive activity, encourage an accelerated pickup in credit formation, allow demand to strengthen beyond a “hold” scenario, and ultimately contribute to higher GDP growth.



Factors in Consideration at the Policy Review



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MANAGING RISKS”*

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