



**First Capital**  
A Janashakthi Group Company

# “POLICY HOLD EXPECTED WITH IMPORTED INFLATION ON THE RISE”

PRE-POLICY ANALYSIS | MARCH 2026

20<sup>th</sup> March 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 Policy Board decided to **maintain the Overnight Policy Rate (OPR) at 7.75%**, noting that this stance would help steer inflation toward the 5% target amid domestic and global uncertainties. In addition, **the Statutory Reserve Ratio (SRR) was left unchanged at 2% level.**

### Key Arguments Considered by CBSL for its Policy Stance Held on 27<sup>th</sup> Jan 2026

- ✓ Inflation held at 2.1% in December 2025, with food prices lifted by Cyclone Ditwah disruptions and festive demand. Inflation is expected to gradually rise toward 5% by 2H2026, with core inflation firming.
- ✓ Growth remained resilient, with the economy expanding 5.0% in the first nine months of 2025. Private-sector credit grew strongly, supported by better demand, higher vehicle imports, and post-cyclone rebuilding.
- ✓ The current account posted a sizeable surplus in 2025 despite a wider trade deficit. Remittances and FX purchases lifted reserves to USD 6.8Bn, while the rupee depreciated 5.6% in 2025 but stayed broadly stable early in 2026.
- ✓ Upside inflation risks stem from strong credit growth, cyclone-related relief spending, potential rupee depreciation, adverse weather, and geopolitical tensions affecting global supply chains.
- ✓ Downside risks include persistently low inflation, faster agricultural recovery, and lower than expected fuel and transport costs.

# Expected Monetary Policy Stance

- ❑ We assign a **65% probability to a rate hold**, considering the rising inflation risks and the pressure on domestic prices from higher fuel and freight costs, along with the expected increase in electricity tariffs, following the recent Middle East conflict, as well as the need to maintain external sector stability.
- ❑ We also assign a **35% probability of a rate cut**, reflecting growth considerations, as business activity has slowed and firms are facing tighter cash-flow and funding pressures, with a cut helping to ease financing costs amid the uncertainty created by the Middle East conflict.
- ❑ We assign a **60% probability of an SRR hike**, as excess liquidity has increased sharply in recent months, which made the CBSL conduct costly open-market operations to absorb the liquidity, making this a good juncture to begin implementing the SRR tightening outlined in the CBSL's 2026 policy agenda.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
<b>Policy Rates to remain unchanged</b>	<b>65%</b>
Cutting Policy Rates by 25bps	35%
Cutting Policy Rates by 50bps	0

As per our view, at the upcoming policy meeting there is a 65% 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%
<b>Raising SRR by 100bps</b>	<b>30%</b>
<b>Raising SRR by 50bps</b>	<b>30%</b>
<b>SRR to remain unchanged</b>	<b>40%</b>
Cutting SRR by 50bps	0%

With excess liquidity rising rapidly, we see a 60% chance of an SRR hike, while the remaining 40% reflects the possibility that the CBSL may prefer to retain higher liquidity as a precaution during the current period of uncertainty.

# Analysis of Upcoming Policy Decision on 24<sup>th</sup> March

- Inflation Pressure Is Building: Oil Up, Electricity Tariffs Likely Up
- Reserve Build-up Priority Amid USD/LKR Pressure and Soft External Inflows
- Precedents From the Asian And Major Central Banks
- Rising Excess Liquidity
- Structural Lending Constraints Limit the Effectiveness of Rate Cuts

## Arguments against a Monetary Relaxation

**65%**

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

## Arguments for a Monetary Relaxation

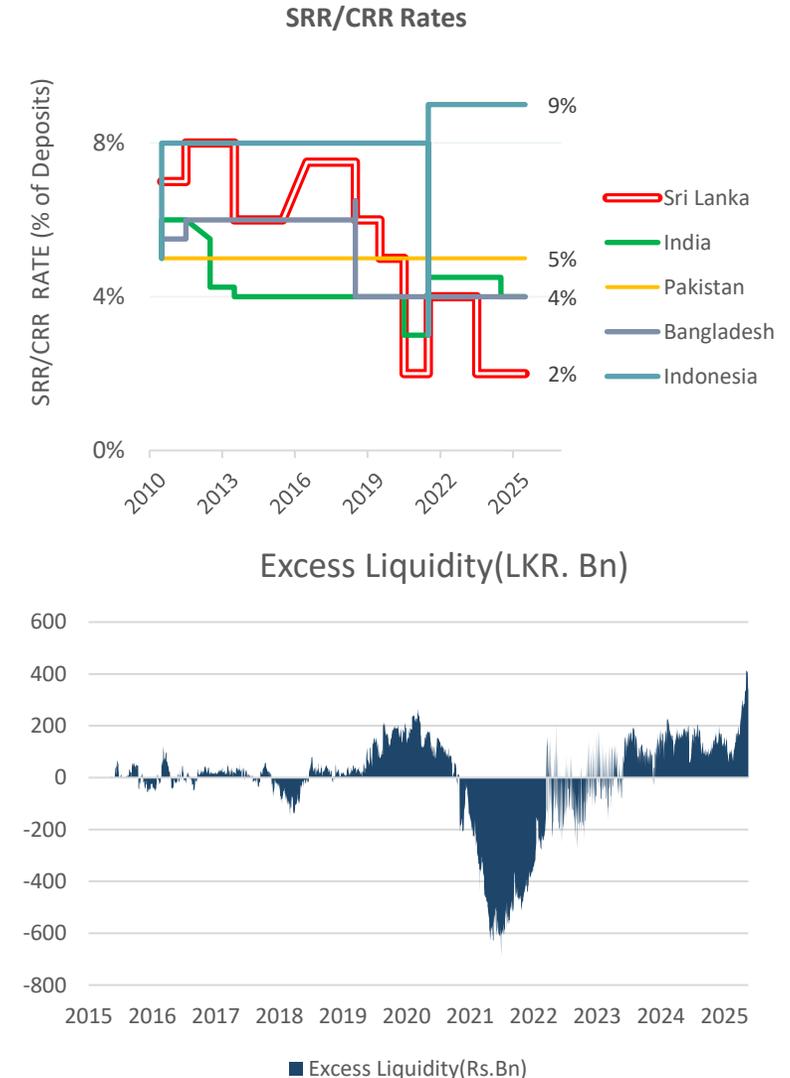
**35%**

- Supporting Growth Impacted by Middle-East Tensions
- Inflation Still Below the CBSL's 5% Target (For Now)
- Real Rates Still Remain Positive (For Now)

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

# Expected Statutory Reserve Ratio (SRR) Changes

- We assign a combined **60% probability that the CBSL will increase the SRR** at the upcoming policy meeting (30% each for 50 bps and 100 bps hikes), based on the following considerations:
  - Recently, the excess liquidity in the banking system has risen to historically high levels, surpassing Rs. 400.0Bn, and the Average Weighted Call Money Rate (AWCMR) has fallen to around 7.60%, below the Overnight Policy Rate (OPR) of 7.75%. In response, the CBSL has been conducting costly overnight and term repo operations to absorb this excess liquidity.
  - Instead, a 50bp increase in the Statutory Reserve Ratio (SRR) could permanently absorb approximately LKR 60.0Bn, strengthening financial system stability and improving the effectiveness of monetary policy transmission.
  - The CBSL's 2026 policy roadmap also highlighted the intention to gradually normalise the SRR, as the current 2% level is well below historical and peer benchmarks.
  - In addition, a higher SRR would help moderate domestic demand pressures amid rising imported inflation risks, without the need for a policy rate hike.
- Reasons to maintain the SRR unchanged include the CBSL potentially preferring higher liquidity as a precautionary buffer during the current period of elevated uncertainty.





Arguments *against a*  
*relaxation* in monetary  
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## Inflation Pressure Is Building: Oil Up, Electricity Tariffs Likely Up

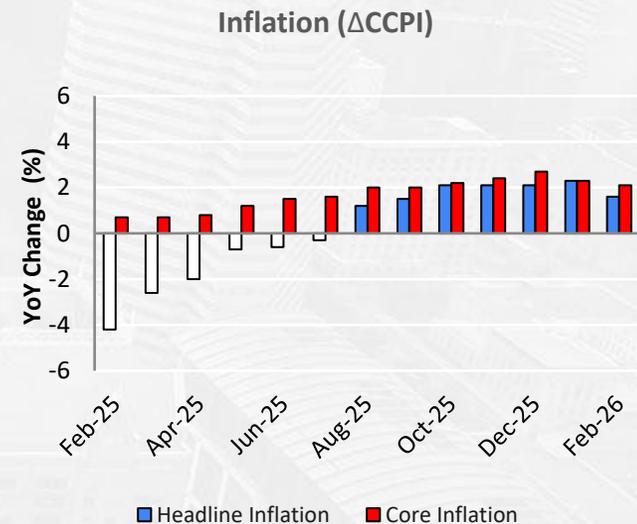
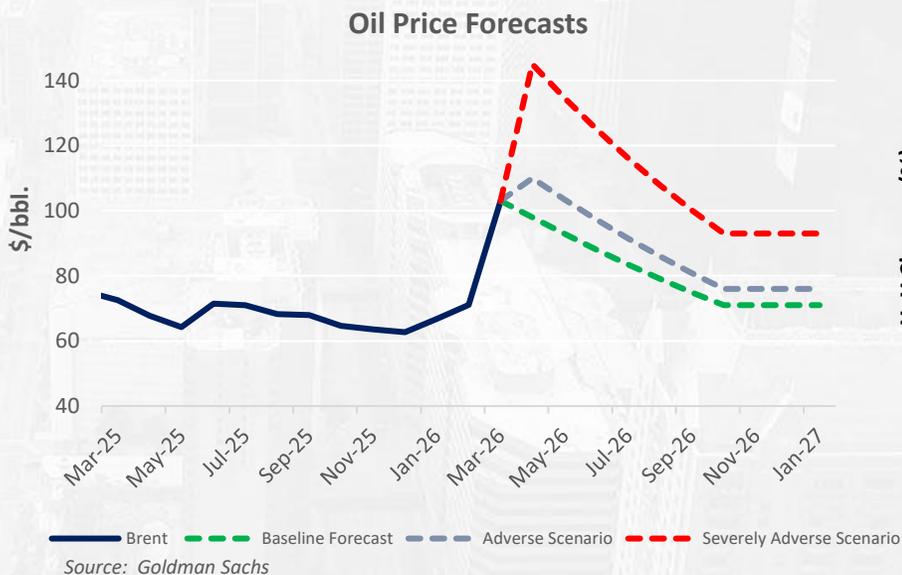
In the January Monetary Policy Meeting, the CBSL signaled confidence in inflation converging toward the 5% target, but in February CCPI eased to 1.6% mainly due to some temporary price declines. Since then, the escalation of the Middle East conflict, fresh inflationary pressure is now building from two fronts: rising oil prices and a likely electricity tariff hike (13.56%, pending PUCSL approval) effective April 2026.

With Brent above USD 100 and major forecasters projecting USD 85-110 in the near term, a 30-35% increase in Sri Lanka's effective oil cost would add an estimated 2.1-2.5% to CCPI directly, and around 3-4% including second-round effects through Food, Manufacturing, and Restaurants & Hotels. On top of this, another pass-through is expected from the electricity tariff revision, which would directly raise the utilities category and indirectly affect food processing, restaurants, manufacturing, and retail, while lifting inflation expectations.

Taken together, these pressures could push inflation toward the CBSL's 5% target in the near term, making a hold in policy rates the more prudent stance for the CBSL rather than further easing.



# Arguments against a relaxation in monetary policy



Source: CBSL, GS, MS, BNPP, Bloomberg

## Reserve Build-Up Priority Amid USD/LKR Pressure and Soft External Inflows

Sri Lanka's reserves surpassed USD 7Bn. in February, but further accumulation remains essential to meet upcoming external debt obligations. The Central Bank's dollar purchases, previously supported by strong remittance inflows, tourism earnings, and a relatively stable USD/LKR exchange rate, have been a key driver of recent reserve build-up. However, with Middle East tensions adding pressure on the currency, and both remittances and tourism earnings showing early signs of softness, reserve-building efforts are likely to come under increasing strain. Under these conditions, a reduction in policy rates would exacerbate the cost of reserve accumulation and undermine external-sector stability at a critical time.

# Arguments against a relaxation in monetary policy



## Precedents from the Asian and Major Central Banks

The tensions in the Middle East and the slowdown in global growth have created a common external shock that central banks must balance alongside domestic conditions. Reviewing policy decisions made between 27 February and to date shows a clear pattern: no major central bank has cut rates following the conflict, even where growth concerns exist. Instead, most monetary authorities have chosen to hold policy rates steady (or moderate hikes), citing rising oil and freight prices, elevated uncertainty, and renewed inflation risks.



# Arguments against a relaxation in monetary policy

### Central Bank Responses After the Conflict

Monetary Authority	First Policy Meeting after the Iran War	Decision
Bank Negara Malaysia	5 March	Held rates; acknowledged uncertainties stemming from the conflict despite an upbeat domestic outlook.
State Bank of Pakistan	9 March	Held rates; explicitly cited higher global fuel prices, freight and insurance costs, and renewed inflation pressures caused by the conflict.
RBA (Australia)	17-March	25 bps rate hike with a split decision; noted domestic price pressures and Middle East-related uncertainties.
BI (Indonesia)	17 March	Held rates; highlighted global volatility and inflation risk; prioritise stability and upward pressure on the rupiah.
FRB (US)	18 March	Held rate; cited higher energy prices due to middle east will push up overall inflation.

## Rising Excess Liquidity

Excess liquidity in the market rose to a historical high of LKR 404.0Bn on 4 March, in the period following the January policy meeting. High liquidity has multiple ripple effects: it can eventually spill over into higher consumption, pushing up inflation, especially when imported inflation is rising, and increase pressure on the exchange rate as excess liquidity chases imports and foreign assets.

This level of liquidity suggests that the banking system holds more funds than it can readily deploy. As a result, the constraint on credit growth is less likely to be the cost of funds and more likely to reflect factors such as banks' risk appetite and the availability of creditworthy borrowers, as also implied in the recent CBSL's credit survey. In this environment, a rate cut may have limited effectiveness and could potentially amplify inflationary pressures.



**Arguments  
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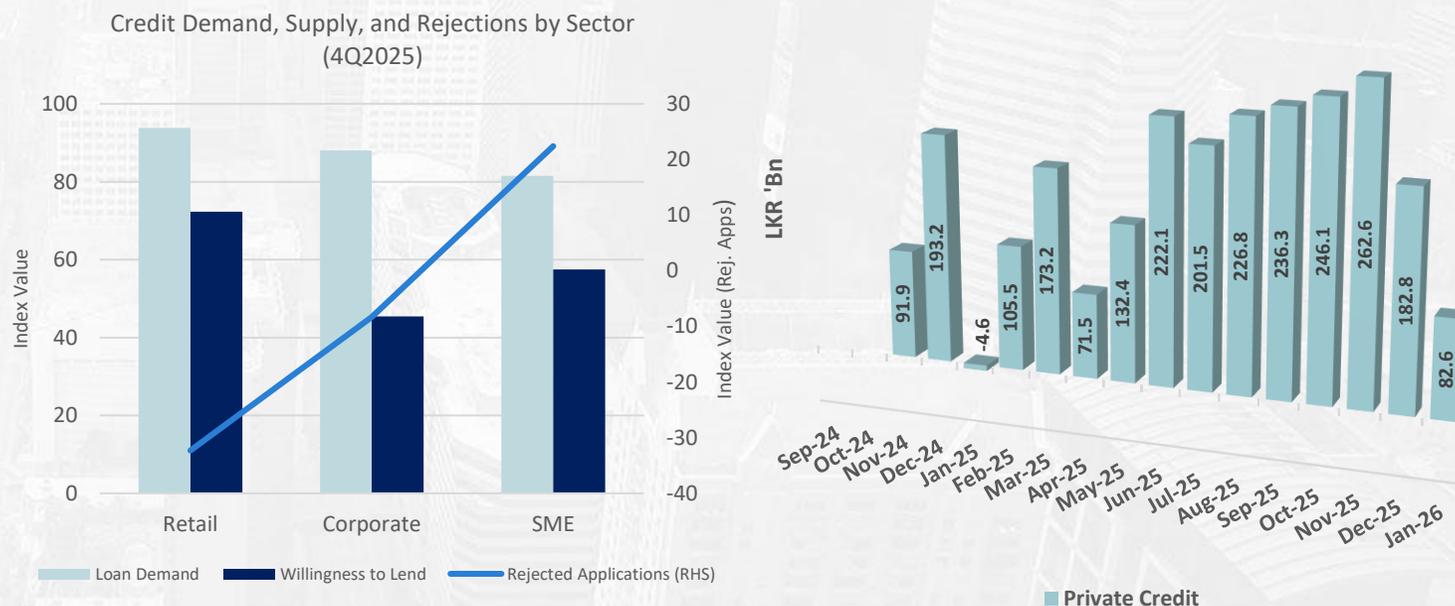
## Structural Lending Constraints Limit the Effectiveness of Rate Cuts

Credit growth gained strong momentum through 2025, rising steadily and peaking in November, before some moderation emerged more recently. The CBSL Credit Supply Survey (4Q2025) shows that banks' lending decisions remain constrained by risk factors despite strong loan demand. For example, SME lending, in particular, faces higher rejection rates and cautious screening even as liquidity improves.



# Arguments against a relaxation in monetary policy

These patterns indicate that structural constraints, including collateral quality, repayment capacity, sectoral risk exposure, and prudential lending norms, rather than the cost of borrowing, are the primary factors limiting credit growth. As a result, lowering policy rates further is unlikely to meaningfully increase credit flows because banks will not expand lending simply due to cheaper funding when underlying risks, which have been further amplified by the Middle East tensions, remain unchanged.





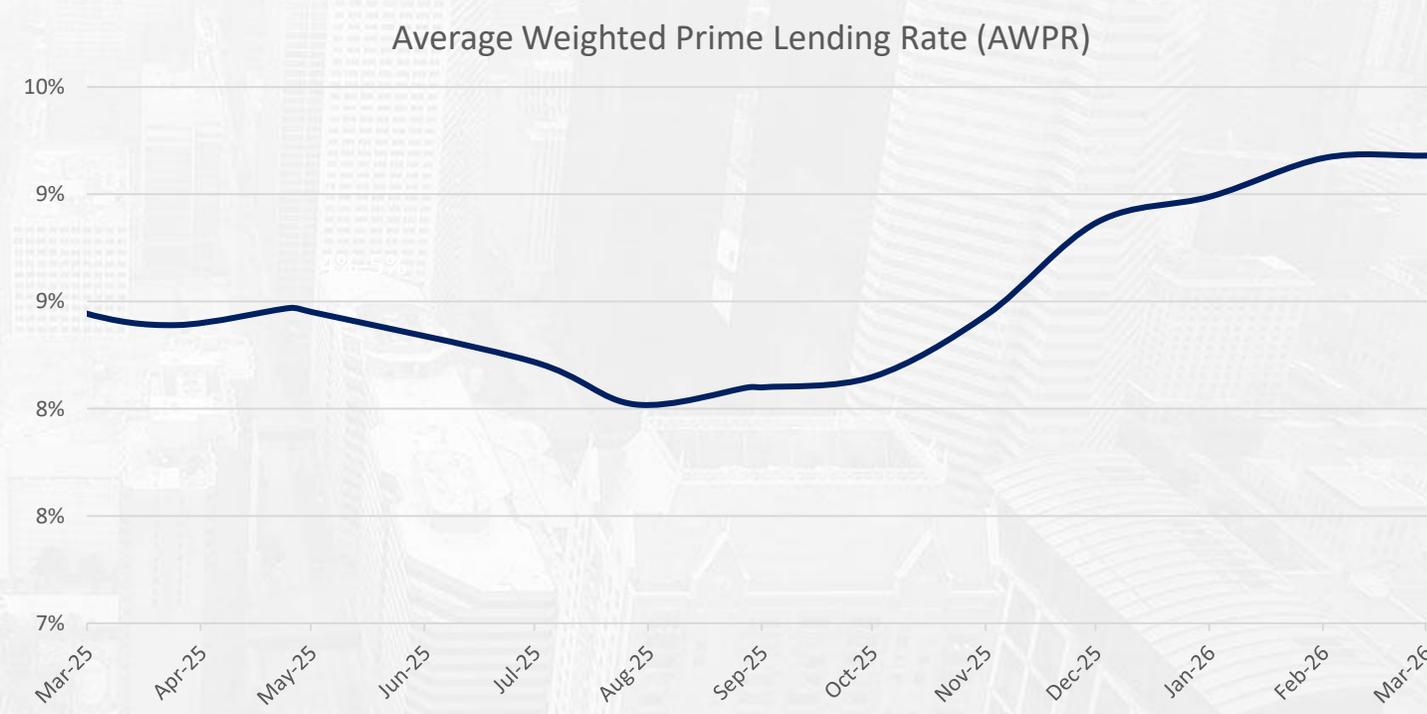
Arguments *for a*  
*relaxation* in monetary  
policy

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## Supporting Growth Impacted by Middle-East Tensions

Lending rates in Sri Lanka remained broadly low through 2025 as a result of the Central Bank of Sri Lanka's accommodative monetary policy, even though disruptions from Cyclone Ditwah in late 2025 weakened the lending environment and strained borrowers' cash flows. More recently, spillover effects from the Middle East conflict have tightened cash flows further, especially in tourism, exports, and overall business sentiment. In this context, a moderate relaxation in policy rates could provide short-term support to affected sectors and firms by improving access to cheaper funds for working capital and helping cushion growth amid continued uncertainty. However, the emergence of inflationary pressures limits the scope for aggressive rate reductions, as lowering rates too much could undermine the central bank's price stability objectives.

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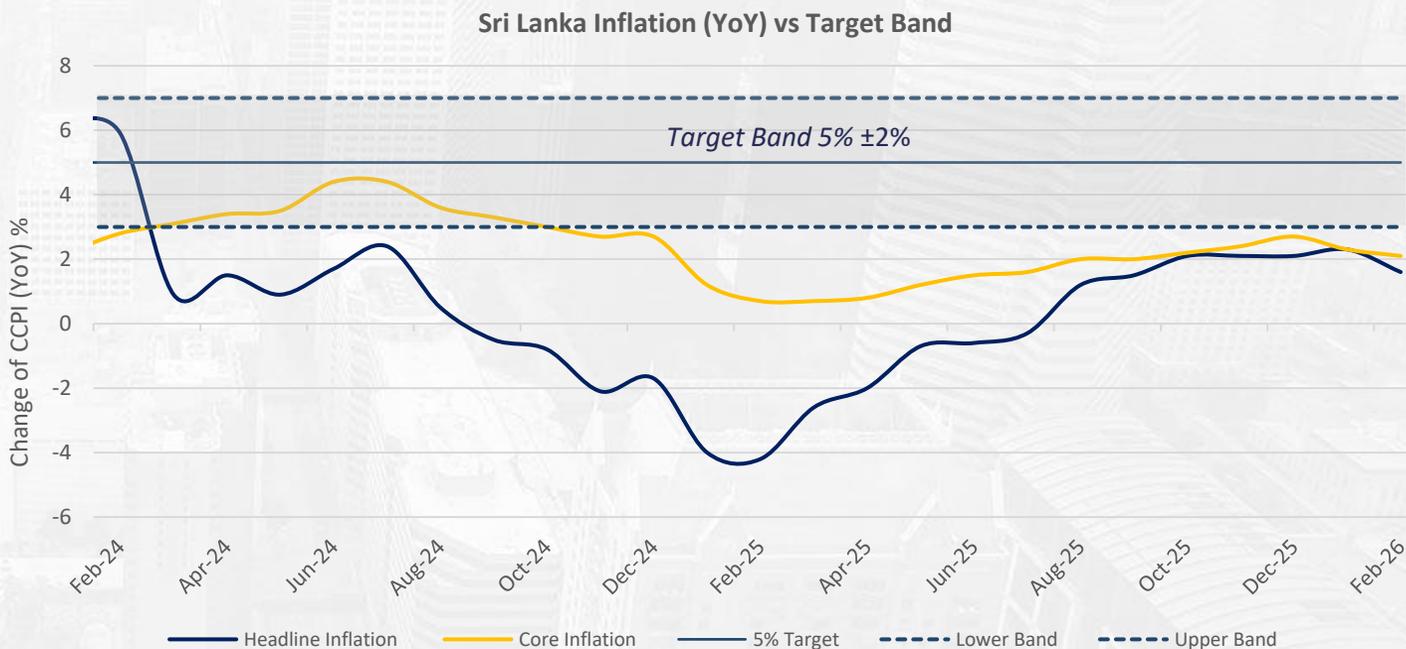


## Inflation Still Below the CBSL's 5% Target (For Now)

Inflation remains below the CBSL's 5% target, creating some space for potential policy easing. While the CBSL Governor (with CNBC) mentioned this gap can be used to absorb pressures stemming from Middle Eastern tensions, whether it is sufficient to absorb the additional inflationary burden also that would arise from that rate reduction depend on the CBSL's assessments.

Our view is that February's unusually low inflation reading (1.6%) was mainly driven by a sharp drop in vegetable prices, which is a temporary effect. With increased costs now feeding into CCPI components that were previously soft, this low inflation is unlikely to persist. Therefore, while some room exists for a policy rate cut based on current inflation, from a forward-looking perspective, accommodating the added inflationary pressure from a rate cut without jeopardizing stability will be challenging.

**Arguments  
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# Arguments for a relaxation in monetary policy

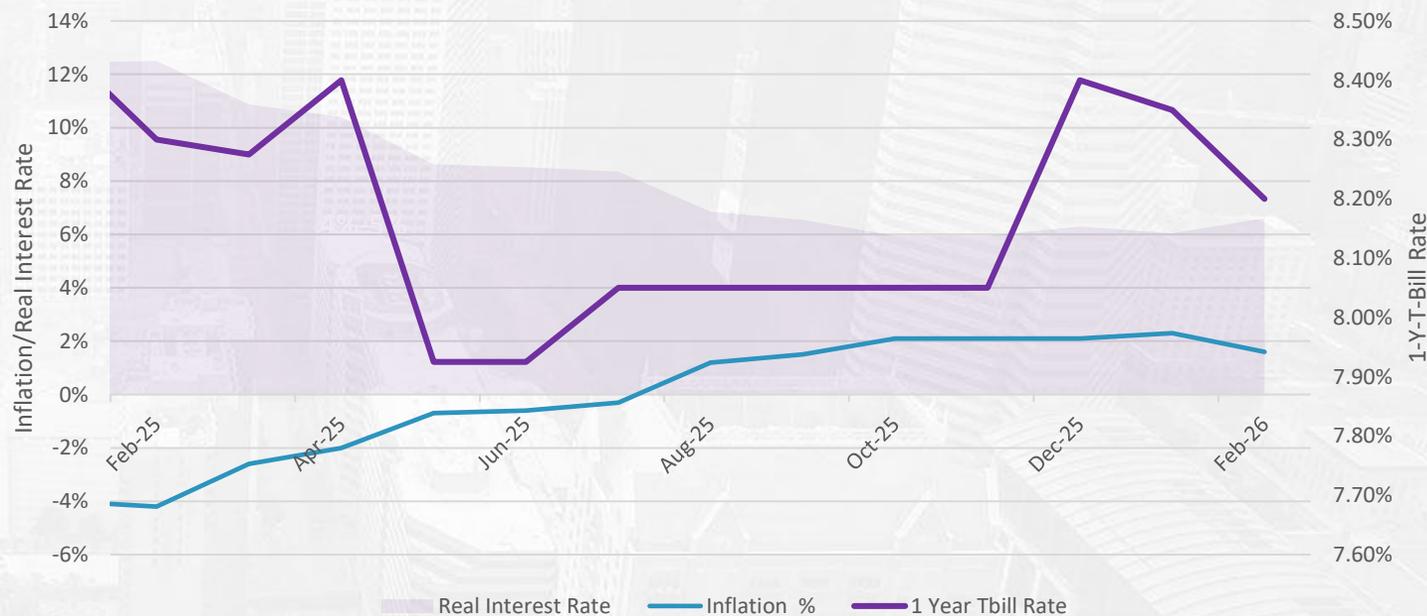


## Real Rates Still Remain Positive (For Now)

With short-term investment rates in the 7.5%–8.5% range, against current inflation of roughly 2%–3%, real interest rates remain positive. This suggests that savers' purchasing power (excluding tax considerations) is still preserved, even after a modest 25bp policy rate reduction. Therefore, the CBSL could argue that there is room for a moderate rate cut while still maintaining positive real returns and easing financing conditions..

However, as inflation is expected to rise, the same caution we applied in the earlier argument holds here too.

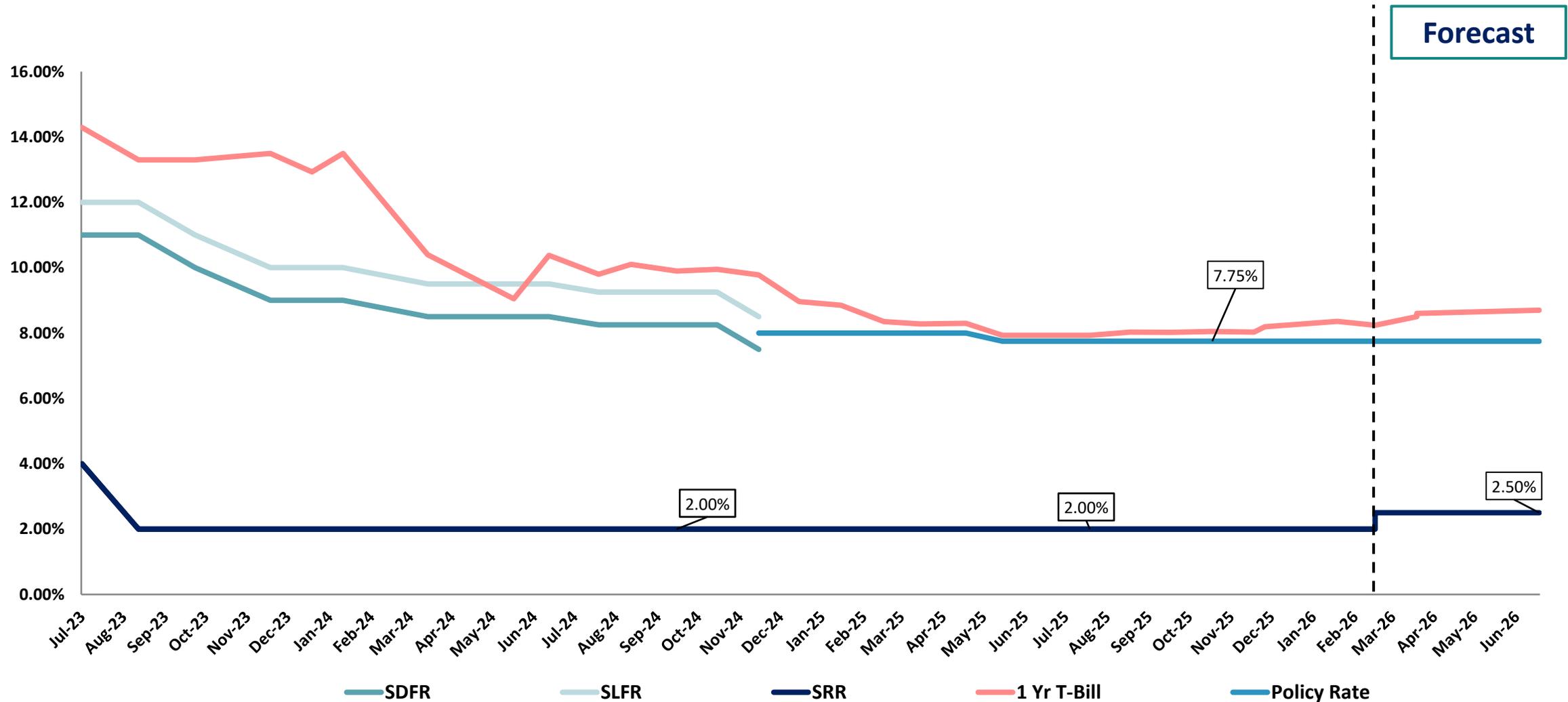
Inflation, Real Interest Rate, and 1-Year Treasury Bill Rate



# Factors in Consideration at the Policy Review



# Monetary Policy Rates



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