



**First Capital**

A Janashakthi Group Company

# “POLICY HOLD EXPECTED AMID MOUNTING GROWTH CONCERNS”

PRE-POLICY ANALYSIS | MAY 2026

22<sup>nd</sup> May 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%, after carefully assessing the evolving global outlook and its implications for Sri Lanka.

### Key Arguments Considered by CBSL for its Policy Stance Held on 24<sup>th</sup> Mar 2026

- ✓ Inflation remained low at 1.6% in February 2026 despite upward pressure from higher energy prices driven by geopolitical tensions. However, inflation is now expected to reach the 5% target by 2Q2026, earlier than previously anticipated.
- ✓ Economic activity remained resilient, signaling a firm post-cyclone recovery, although prolonged geopolitical tensions and spillovers from the Middle East conflict could weigh on growth going forward.
- ✓ The external sector remained robust, supported by stronger exports, remittances, and tourism inflows, with reserves rising to USD 7.3Bn in February. While the rupee remained broadly stable, depreciation pressures emerged following the escalation of the Middle East conflict.
- ✓ Upside risks to inflation stem from heightened geopolitical tensions, elevated energy and transport costs, possible rupee depreciation, strong credit-driven demand pressures, and adverse weather-related disruptions.
- ✓ Meanwhile, downside risks include weaker-than-expected demand conditions and improved agricultural production easing food price pressures.



# Expected Monetary Policy Stance

- ❑ We assign a **60% probability for a rate hold**, considering concerns relating to growth outlook amid moderating economic activity, persistence tightening of fiscal conditions that reduce urgency for a rate hike, mechanisms already being underway to contain import-driven demand for credit and the cost-push nature of rising inflation.
- ❑ We also assign a **40% probability for a rate hike**, taking into account the necessity to curb interest rate distortions in the market, interventions required to address the rapid dwindling of the LKR and the preservation of real interest rates amid escalating inflationary pressures.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	40%
<b>Policy Rates to remain unchanged</b>	<b>60%</b>
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.

**Expected SRR Stance:**

*While the CBSL currently does not publish its SRR decisions alongside the Monetary Policy Review, we maintain our view that a probable SRR hike during the meeting or afterward may be implemented to enhance financial system stability and curb excess liquidity induced credit growth, which tends to fuel imports and add pressure on the LKR against the USD.*

# Analysis of Upcoming Policy Decision on 25<sup>th</sup> May

- Moderating economic activity raises growth concerns
- Tightening fiscal conditions reduce urgency for rate hike
- Mechanisms underway to contain import driven credit demand
- Inflation acceleration remains primarily supply driven

**Arguments against a  
Policy Rate Hike**

**60%**

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

**40%**  
**Arguments for a  
Policy Rate Hike**

- Policy intervention necessary to ease rising rate distortions
- Mounting pressure on the LKR may necessitate policy tightening
- Inflation risks warrant policy intervention

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

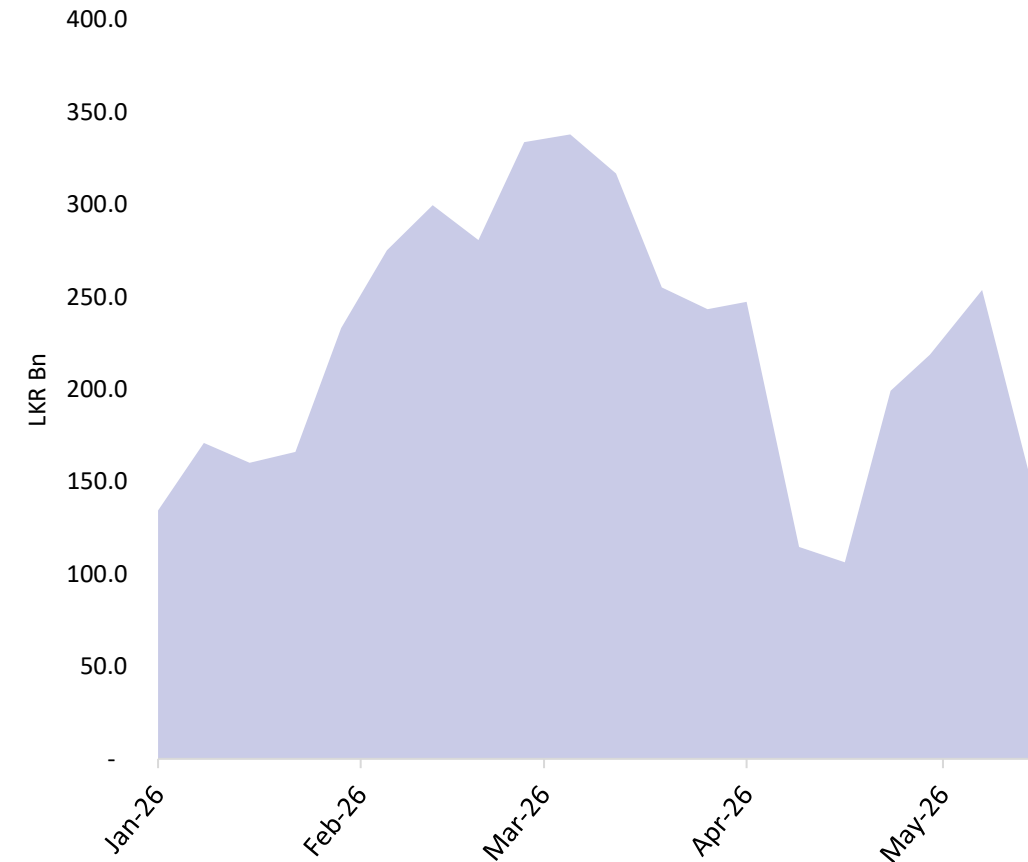
# Expected Statutory Reserve Ratio (SRR) Changes

We maintain our previous view, assigning a **60% probability for a hike in SRR** at the upcoming policy meeting or in the near term (30% each for 50 bps and 100 bps hikes), based on the following considerations:

- ✓ To strengthen financial system stability by curbing import-linked excess credit creation that would exert further pressure on the LKR.
- ✓ To reduce the reliance on costly OMOs carried out by the Central Bank and better align the OPR with the AWCMR through a more medium-term policy approach. In this regard, a 50bps increase in the SRR could permanently absorb nearly LKR 60.0Bn of excess liquidity from the banking system.
- ✓ To curtail domestic credit-driven demand-side inflationary pressures in the absence of a policy rate hike.

As the Central Bank receives upcoming IMF and ADB disbursements, it may increasingly opt to remain a net seller of USD, similar to the trend observed in April 2026. Such interventions would simultaneously absorb excess LKR liquidity from the banking system while helping stabilize domestic market rates. This outlook supports our view of a 40% probability that the CBSL will refrain from raising the SRR in the near term.

Market liquidity likely to remain above LKR 100.0Bn





# Arguments *against a hike* in monetary policy

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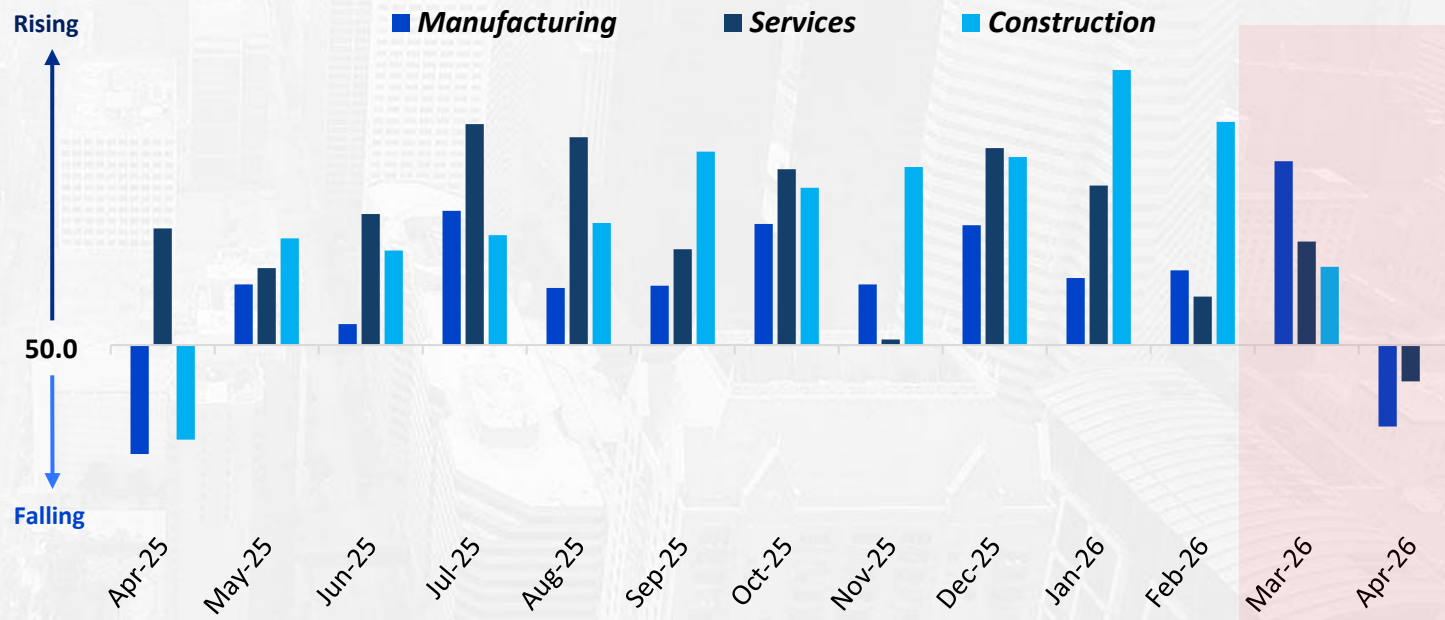
## Moderating economic activity raises growth concerns

Following robust GDP growth of 5.0% in both 2024 and 2025, Sri Lanka's economy is expected to slow in 2026E amid spillovers from the ongoing Middle East conflict. Reflecting the softer outlook, the World Bank and the ADB forecast growth rates of 3.6% and 4.0%, respectively. High-frequency indicators also signal a loss of momentum, with the Manufacturing and Services PMIs falling below the neutral 50 threshold in April 2026, while the Construction PMI moderated in March. Although the weakness in manufacturing partly reflects a customary post-festive correction, the slowdown in services appears more broad-based, with the New Business Index contracting for the first time since April 2023 due to conflict-related disruptions. Meanwhile, rising energy costs and transport bottlenecks are expected to weigh further on construction activity. Against this backdrop, CBSL is unlikely to tighten policy, as slowing growth, weakening demand conditions, and tighter fiscal settings are already exerting a meaningful drag on economic activity.

# Arguments against a hike in monetary policy



PMI slows as Middle East conflict weighs on activity



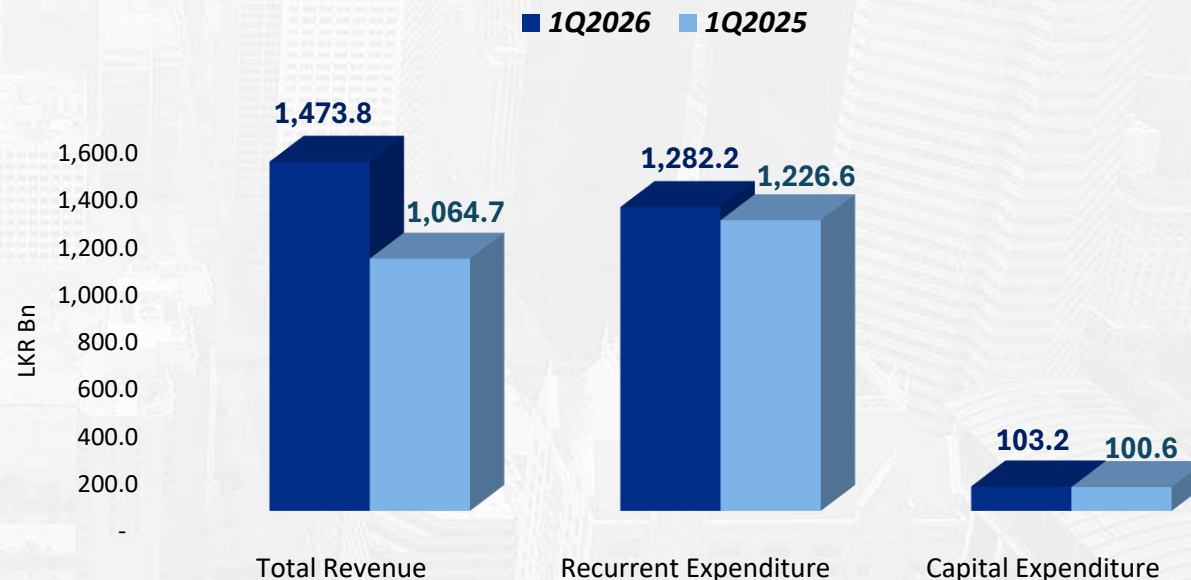
## Tightening fiscal conditions reduce urgency for rate hike

Sri Lanka continues to adhere firmly to its fiscal consolidation path, with revenue performance remaining notably strong. Fiscal conditions are expected to tighten further, particularly from July 2026 onwards, as the annual VAT registration threshold is reduced to LKR 36.0Mn from the previous LKR 60.0Mn level, thereby broadening the tax base alongside the implementation of VAT on digital services supplied by non-residents. In addition, the recently imposed 50% surcharge on vehicle imports, albeit temporary, is also expected to moderate domestic demand conditions. Consequently, demand-side pressures are likely to remain organically contained. Against this backdrop, the Central Bank may prefer to calibrate any monetary tightening measures more gradually and strategically over time, rather than front-loading policy action amid an already tightening fiscal environment.



# Arguments against a hike in monetary policy

Government revenue rose by 38.4%YoY in 1Q2026 while expenditure remained largely contained



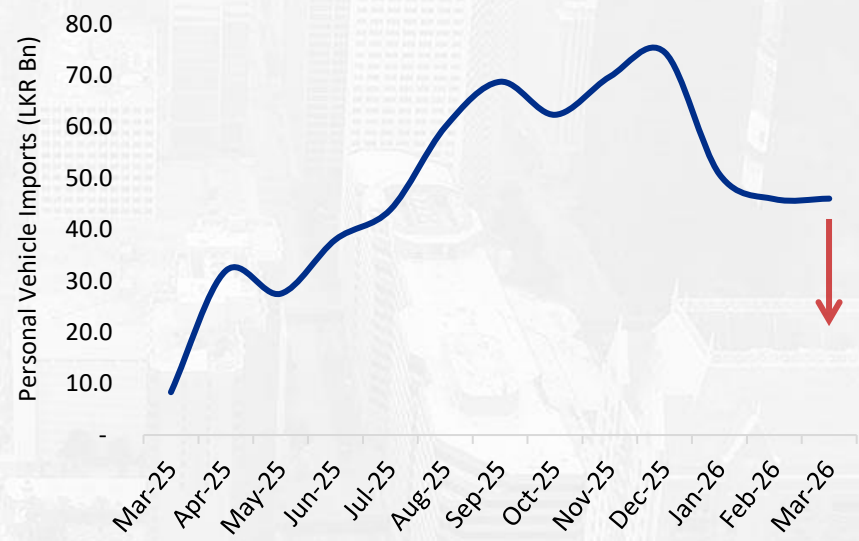
## Mechanisms underway to contain import driven credit demand

While credit to the private sector expanded by 27.1%YoY in March 2026, largely driven by seasonal demand conditions typically observed during this period, a moderation is anticipated over the medium term. This is partly attributable to the upward repricing of lending rates that has already materialized, which is expected to dampen credit demand going forward. The recently implemented 50% surcharge on vehicle imports, although temporary, is also likely to moderate credit growth, particularly given that lease receivables were a key driver behind the recent acceleration in private sector credit. Moreover, the anticipated slowdown in economic activity could further weigh on credit expansion, as lenders are likely to adopt a more risk-averse stance. Consequently, with monetary conditions already having tightened meaningfully through market-driven adjustments, the CBSL may opt to maintain policy rates at current levels for the time being.



# Arguments against a hike in monetary policy

Limiting vehicle imports would help contain import driven demand for credit



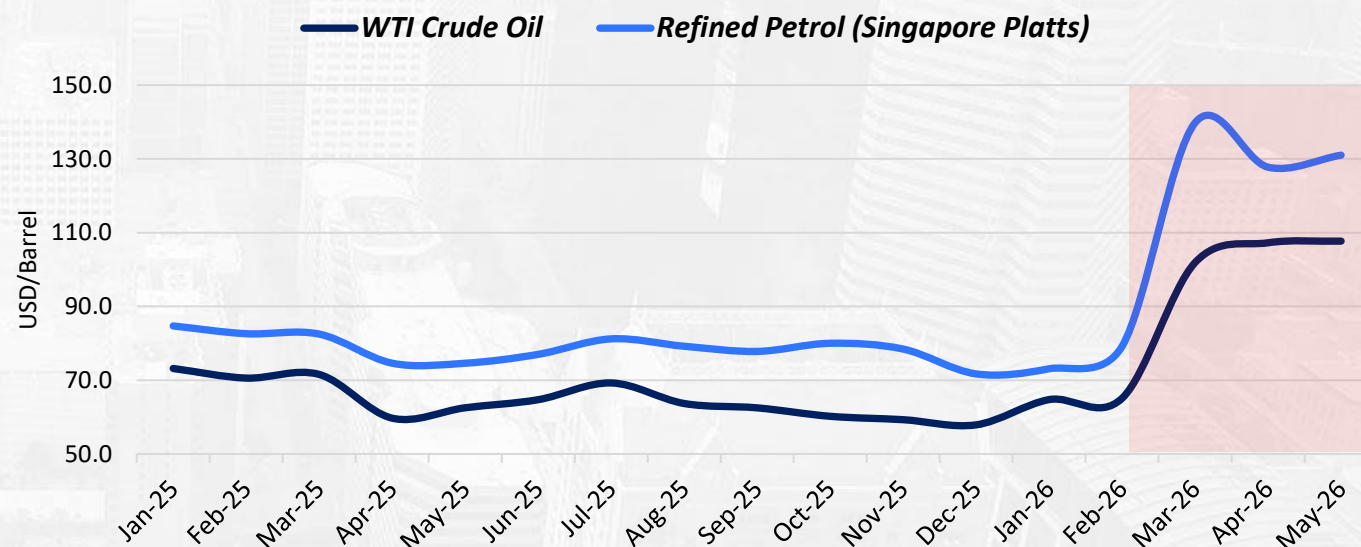
## Inflation acceleration remains primarily supply driven

The acceleration in inflation to 5.4% YoY (CCPI) in April 2026 does not appear to reflect overheating demand conditions, but rather the pass-through effects of higher energy prices. Electricity tariffs were revised upward in April, followed by a further increase in May for higher consumption brackets. At the same time, escalating geopolitical tensions in the Middle East have kept global crude oil prices near or above USD 100 per barrel, necessitating upward adjustments in domestic fuel prices. These energy-related cost pressures were the principal drivers behind inflation moving above the 5.0% threshold. As such, the current inflation dynamic remains largely supply-driven in nature, limiting the effectiveness of monetary tightening. In this context, a rate hike would likely impose additional strain on already moderating economic activity, while offering limited traction in addressing the underlying sources of inflation.



# Arguments against a hike in monetary policy

Cost-push inflation was triggered by the global energy shock following US-Israel attack on Iran



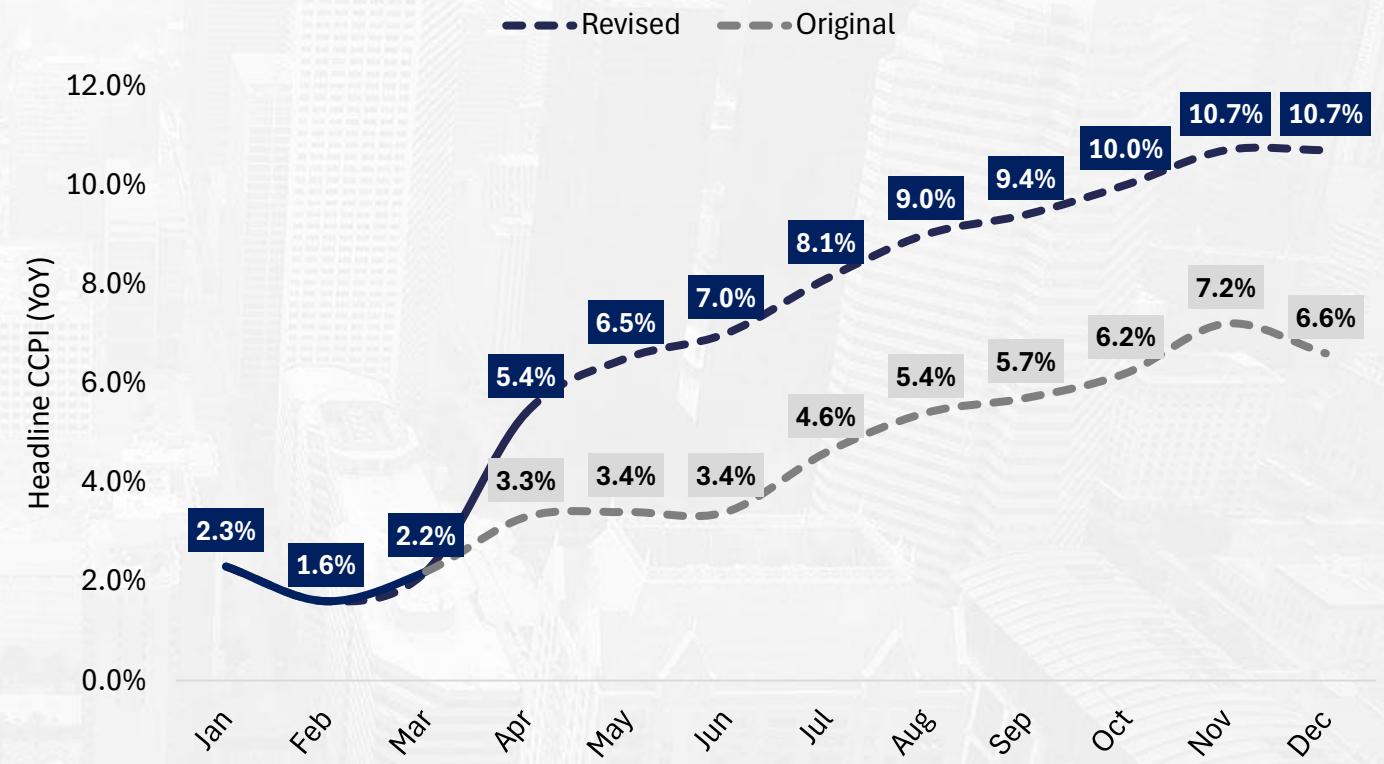
## Amid the recent surge in inflation, First Capital Research has revised its 2026E inflation forecast upward



# Arguments against a hike in monetary policy

- ✓ Headline inflation is expected to rise in May, driven by fuel and electricity tariff revisions and second-round effects from the LKR depreciation.
- ✓ Inflation is projected to remain elevated through 2026E, supported by slow normalization in global energy prices, potential further tariff adjustments, and spillovers to food inflation from higher fertilizer, labor and fuel costs.
- ✓ As a result, the annual average inflation forecast for 2026E has been revised to 6.9%.

The Annual Average Inflation for 2026E has been revised to 6.9%





# Arguments *for a* *hike* in monetary policy

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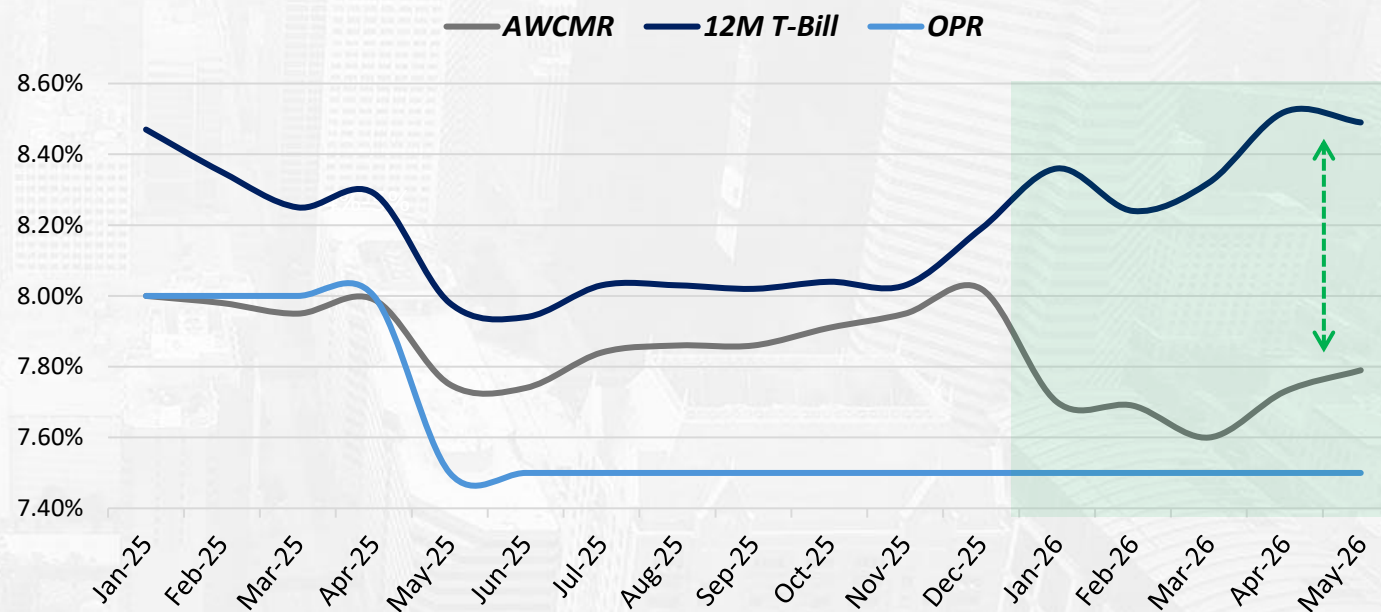
## Policy intervention necessary to ease rising rate distortions

Even in the absence of a formal policy rate hike, financial markets have already undergone an upward adjustment in interest rates. At present, the Average Weighted Call Money Rate (AWCMR) stands at 7.79%, marginally above the Overnight Policy Rate (OPR) of 7.75%. Meanwhile, primary auction T-Bill yields have also trended upward, with the average weighted yield on the 12M tenor reaching 8.49%. The spread between the AWCMR and the 12M T-Bill appears to be consistently widening, averaging at nearly 75bps through March to May. This warrants a formalization of the monetary tightening cycle that appears to have already materialized within the market. Looking ahead, with inflation expected to accelerate further, markets are likely to continue repricing rates upward, thereby reinforcing these distortions and strengthening the case for an immediate policy response.

# Arguments for a hike in monetary policy



Spread between AWCMR & 12M T-Bill continues to widen



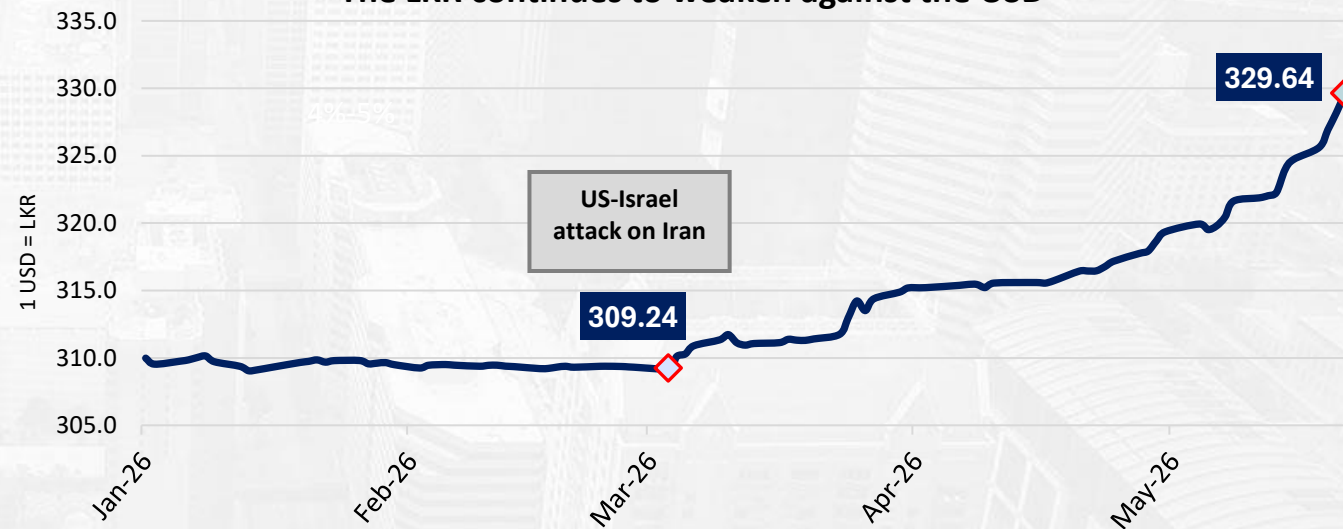
## Mounting pressure on the LKR may necessitate policy tightening

The LKR has come under substantial pressure following the escalation of geo-political tensions since late February 2026. A sharp 43.9%YoY contraction in the current account surplus during 1Q2026 fueled this trend, driven primarily by a widening trade deficit amid elevated oil prices and weakening tourism inflows. CBSL reversed its position as a net buyer of USD for the first time in 22 months, recording a net sale of USD 12.9Mn in April 2026 to moderate the pace of currency depreciation. Given the rapid weakening of the LKR, the CBSL may be compelled to tighten monetary policy partly to contain the deterioration of the external current account. Preserving external sector stability also remains critical for reserve accumulation, particularly as the IMF-prescribed end-2026 gross official reserves target of USD 8.9Bn remains materially above the current level of USD 6.8Bn. While the 5<sup>th</sup> and 6<sup>th</sup> tranches alongside inflows from the ADB may provide some comfort, proactive action remains a necessity. Monetary tightening would also complement a transition toward the CBSL remaining a net seller of USD. The subsequent absorption of LKR liquidity may require higher rates to prevent a sharp deterioration in overall market liquidity.

# Arguments for a hike in monetary policy



The LKR continues to weaken against the USD



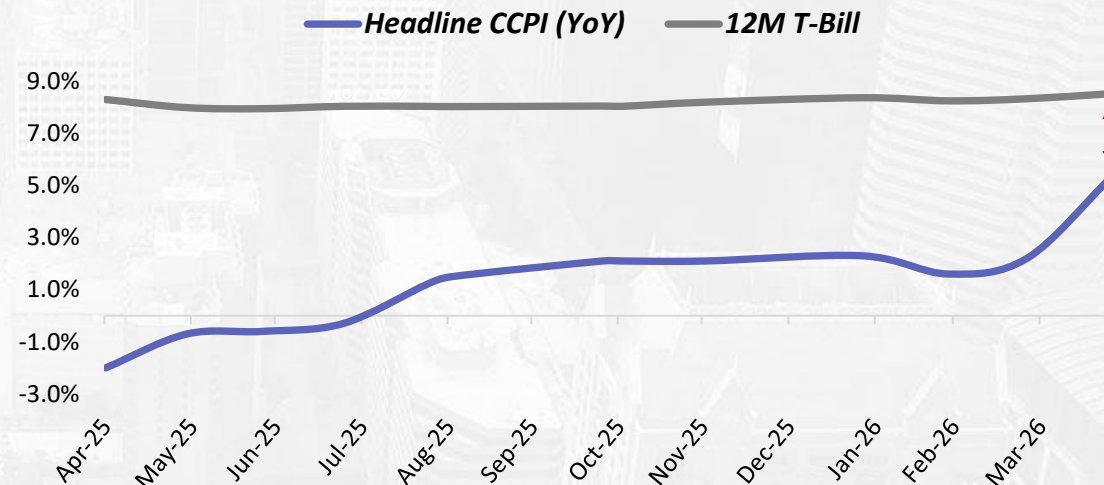
## Inflation risks warrant policy intervention

While the uptick in inflation observed in April 2026, with CCPI inflation accelerating to 5.4%YoY from 2.2% in the previous month, was largely supply driven, a formal policy intervention may nevertheless become necessary given the sharp acceleration in inflation anticipated during 2H2026. Importantly, the current 5.4% inflation does not yet fully capture the impact of the energy price revisions implemented in May, nor the exchange rate pass-through effects likely to materialize through the sharp depreciation of the LKR. In addition, food inflation has also continued to trend upward, which is expected to further intensify inflationary pressures in the second half of 2026. In the absence of formal policy intervention, real interest rates are likely to turn increasingly negative, particularly toward the latter part of the year, as inflation may remain significantly elevated, potentially even entering double-digit territory.

# Arguments for a hike in monetary policy

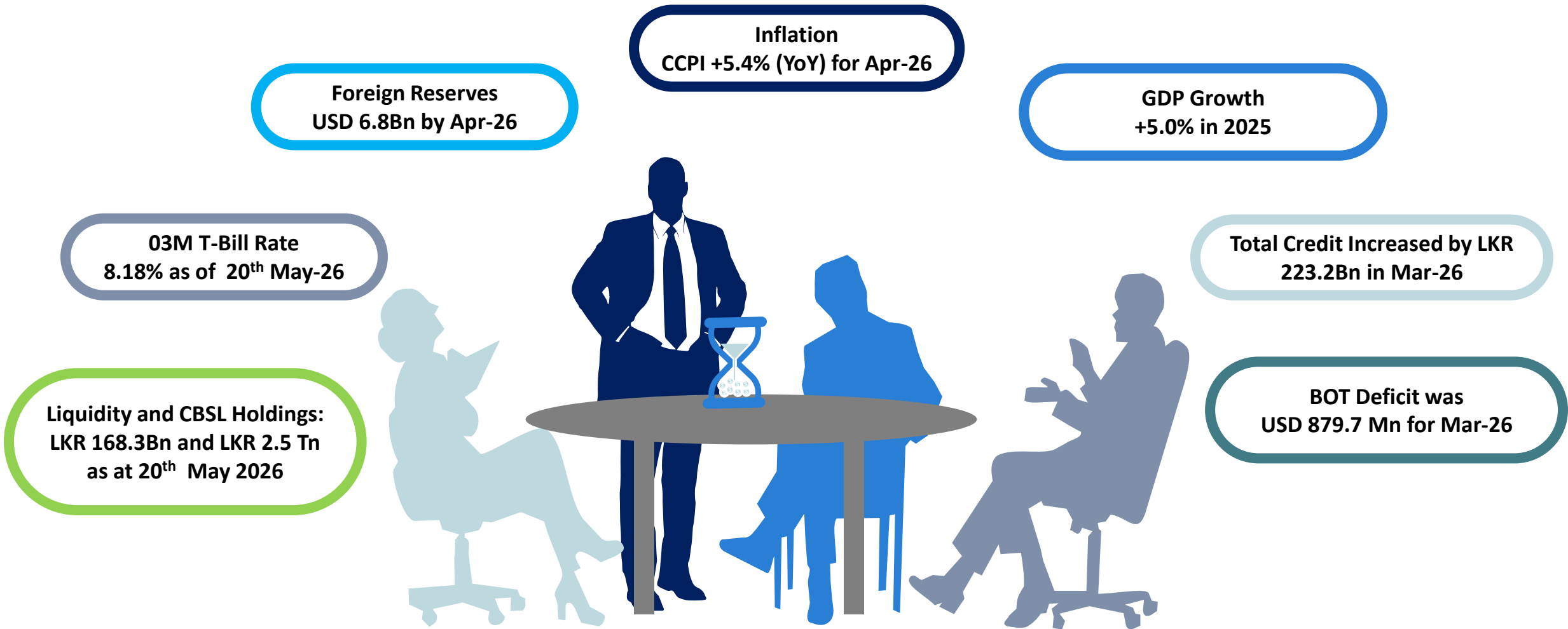


Real rates under rising pressure as inflation continues to trend up

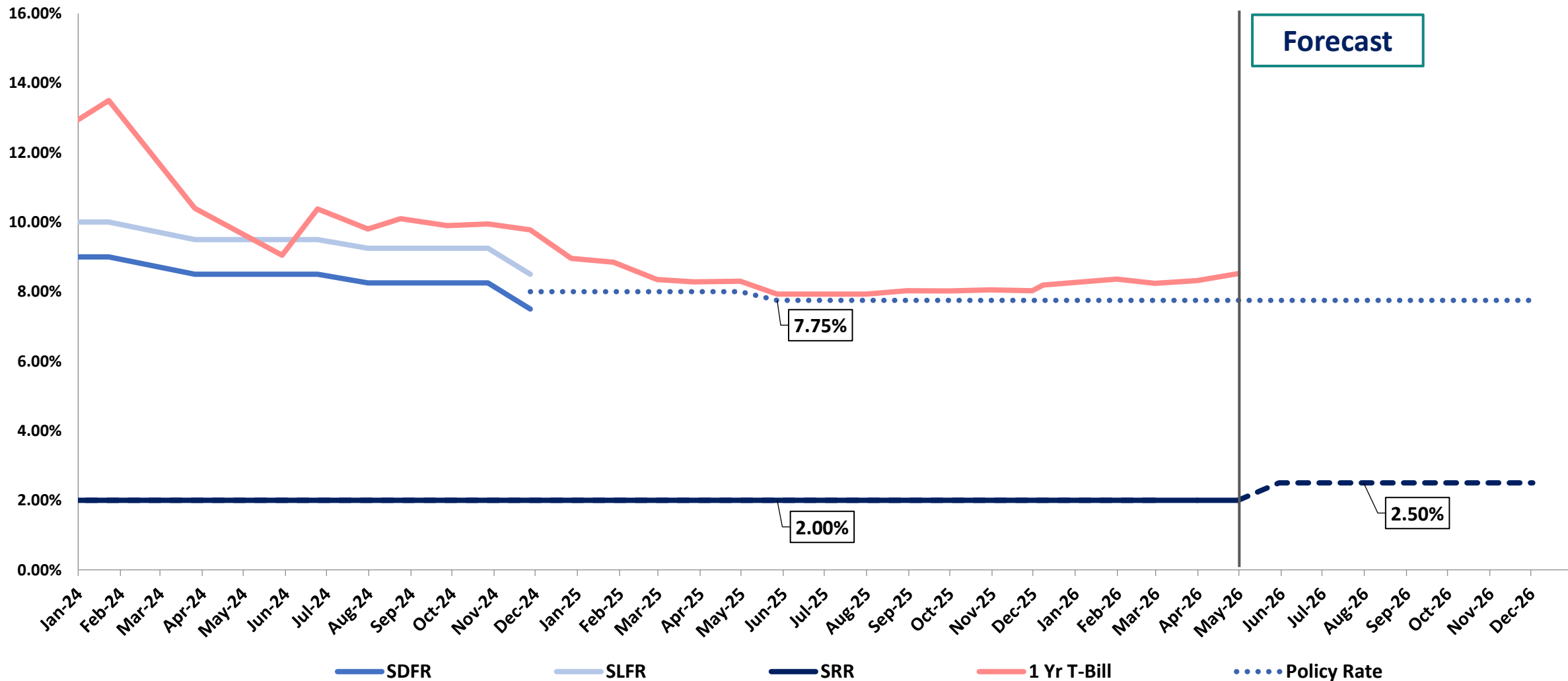


The CCPI may soon cross the 7.0% threshold, further narrowing this spread...

# Factors in Consideration at the Policy Review



# Monetary Policy Rates



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