

The Path to Price Stability:

Sri Lanka's 5% Inflation Target

This report examines Sri Lanka's 5% inflation target, assessing the key economic factors, policy measures, and domestic and global risks influencing the path towards price stability. It evaluates the feasibility of achieving the target, the challenges ahead, and the implications for economic growth and monetary policy.



Executive summary

8.0%

Headline CCPI inflation, Sep 2026

7.8%

Q3-2026 average, above 7% upper accountability margin

5.4%

Core inflation rose from 2.3% in January to 5.4% in September, signaling rising underlying inflationary risks.

8.75%

Current Overnight Policy Rate (The OPR remained unchanged at 8.75% in September 2026, following the 100-basis-point increase in May 2026)

Inflation is expected to remain in the high single digits through Q1 2027, before gradually easing towards the 5% target from Q2 2027 onwards.

- The April 2026 energy price increase added to inflationary pressures, with further risks depending on global oil prices and domestic fuel costs.
- Q4-2026 is likely to be a second consecutive quarter above 7%, triggering a CBSL accountability report to Parliament.
- Main threats: oil above \$100 for longer (Hormuz), El Niño food shock, and fuel-price pass-through.

What the CBSL note says

5% target retained

New MPFA signed 1 Oct 2026 keeps 5% quarterly headline CCPI target for the next three years.

2 percentage point accountability margin

With Q3 2026 headline inflation at 7.8%, exceeding the 7% upper accountability limit, the CBSL's accountability mechanism may be triggered if inflation remains outside the target range for two consecutive quarters, subject to the applicable MPFA provisions.

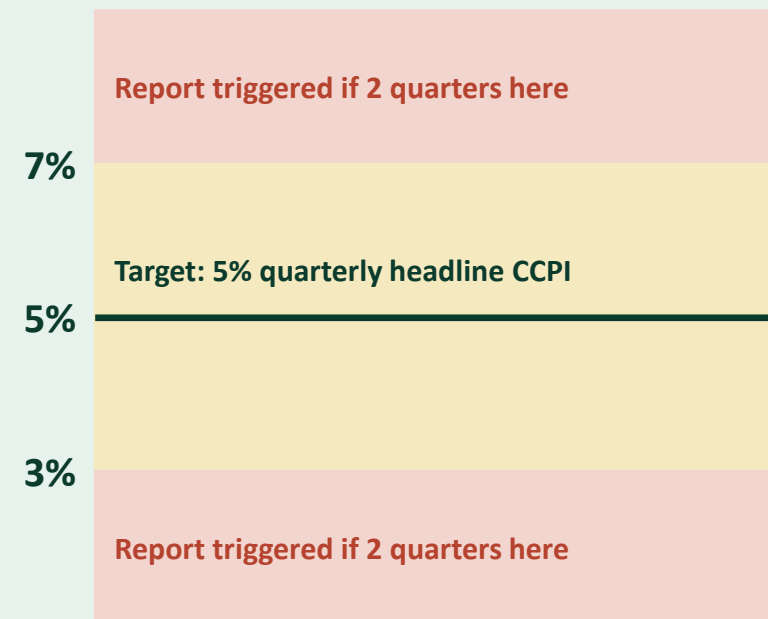
Report to Parliament

On breach, the Monetary Policy Board explains causes, remedies and time to return to target.

Why not lower?

Small, import-dependent economy exposed to supply shocks, a lower target needs tighter policy and stronger buffers.

How the accountability margin works



Source: CBSL Opinion, 'Sri Lanka's Inflation Target Review: The Case for Continuity' (Oct 2026); IMF end-of-mission statement, 23 Sep 2026.

The 2026 review debate: keep 5%, or move to 2%?

Keep 5% now

CBSL Governor

A target as low as 2% would mean giving up growth

IMF staff (Sep 2026)

Keep 5% and the ± 2 percentage point, consider lower only after a track record

CBSL panel (Harischandra, Pathberiya)

Shock is supply –driven, a 2% target would have needed a far bigger hike than 100 basis points

Advocata (Jafferjee)

Food and energy dominate, monetary policy has limited reach

Glide path down

W.A. Wijewardena, ex-Deputy Governor

5% is too high, but cut gradually: 4% $\rightarrow$ 3% $\rightarrow$ 2%

Verité (de Mel)

Credibility first: inflation undershot the 5% target by more than 200 basis points in all eight instances.

Cut to 2%

Ravi Karunanayake MP

Protect purchasing power and the rupee's value

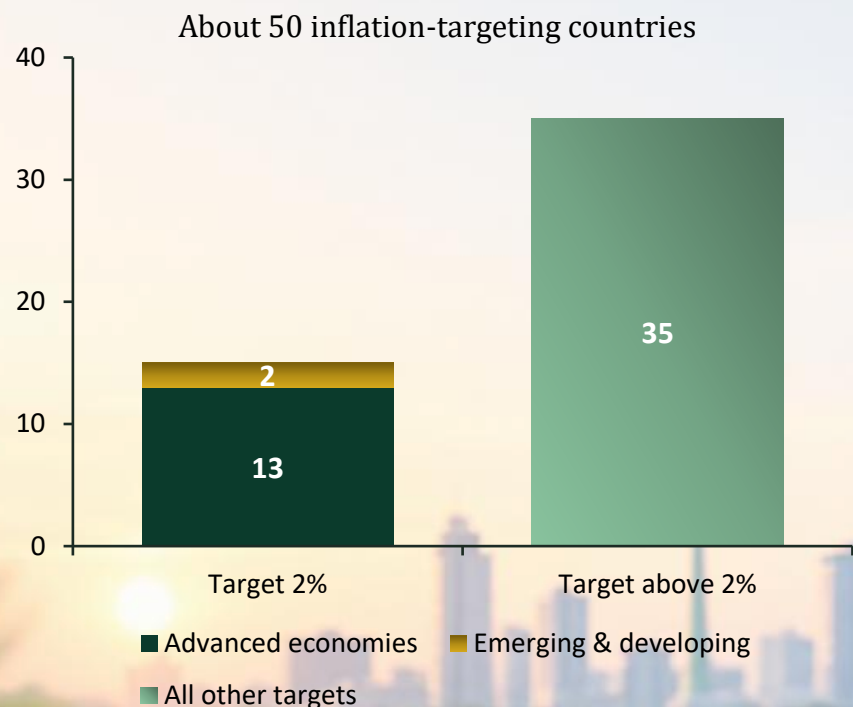
Pro-2% economists

Advanced economies target about 2%. Sri Lanka's historically high average inflation of around 11% strengthens the argument for a tighter 2% target, as it aims to break the cycle of persistently high inflation, anchor expectations, and improve long-term price stability.

Outcome (1 Oct 2026): The 5% inflation target and ± 2 percentage-point accountability margin remain unchanged until October 2029. The key question is whether inflation can return to the 5% target.

Source: Daily FT (17 Aug, 23 Jun 2026); The Morning (3 Aug, 2 Oct 2026); Colombo Telegraph (31 Aug 2026); IMF (23 Sep 2026); CBSL 'Panel Discussion on Inflation Target Review' (transcript).

Inside the CBSL panel: why 5%, not 2%



Source: CBSL, *Sri Lanka's Inflation Target: Should It Be Cut from 5% to 2%?* (2026); IMF, *How to Design and Review Inflation Targets in Emerging Market and Developing Economies* (March 2026).

Only 2 of 15 countries with a 2% inflation target are emerging economies, while emerging-market targets generally range from 3% to 6%, with around one-third set at 5% or higher.

Dr. C. Amarasekara, Senior Deputy Governor

Review covered the target, not the framework. Set forward-looking for 3 years; the current 8% was not the deciding factor. Recovery is incomplete and 2% suits advanced economies.

Dr. P.K.G. Harischandra, Assistant Governor

5% is a nominal anchor, not 'high'. Post-crisis wages are rising at double digits, so real incomes are not hurt. Protect the poor with fiscal safety nets, not monetary policy.

Dr. L.R.C. Pathberiya, Director of Economic Research

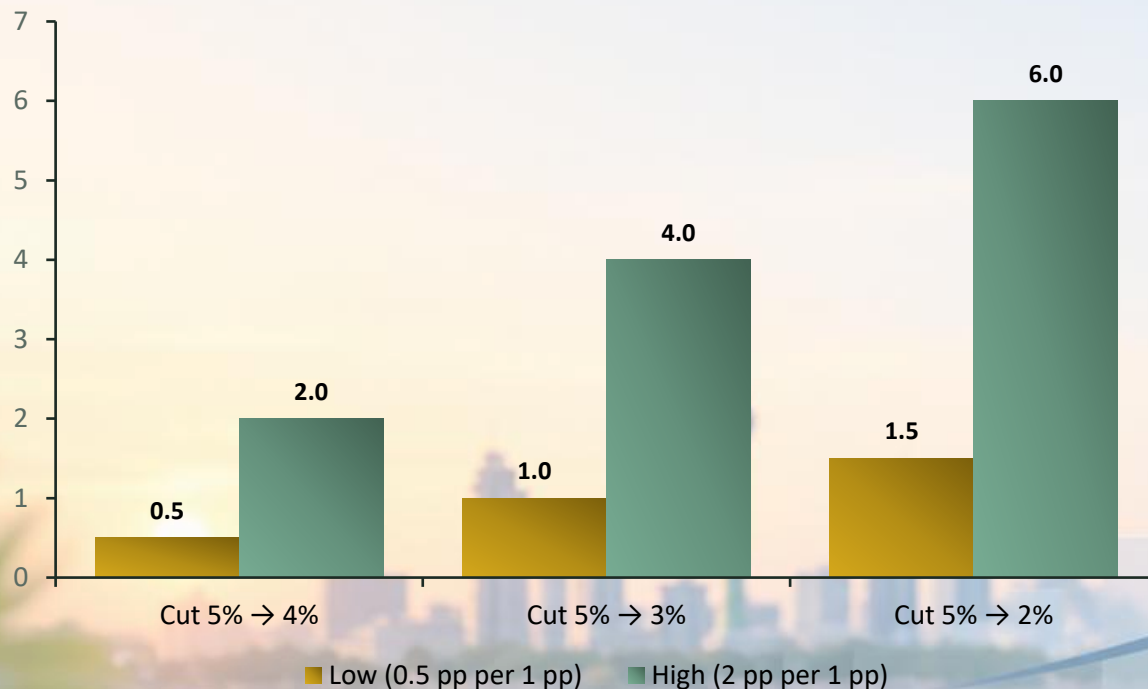
A 2% target cuts nominal GDP about 3 percentage points in steady state, worsening debt ratios. Low refinery capacity leaves Sri Lanka exposed. Diesel rose about 40% Mar-Aug.

On the 8% print (Pathberiya)

With a 2% target, May's 100 basis point hike 'would have been much, much higher'. Under 5%, CBSL can partly look through it, above-target inflation expected for some time.

CBSL's case: 5% is where Sri Lanka grows best

Output lost to lower the target (percentage points of GDP, cumulative)



Panel: A 2% inflation target could reduce nominal GDP growth by approximately 3 percentage points, while slower nominal wage growth may limit real-wage gains.

About 5%

Midpoint of Sri Lanka's inflation history once crisis periods are excluded

About 5%

Inflation level at which the output gap narrows (CBSL models)

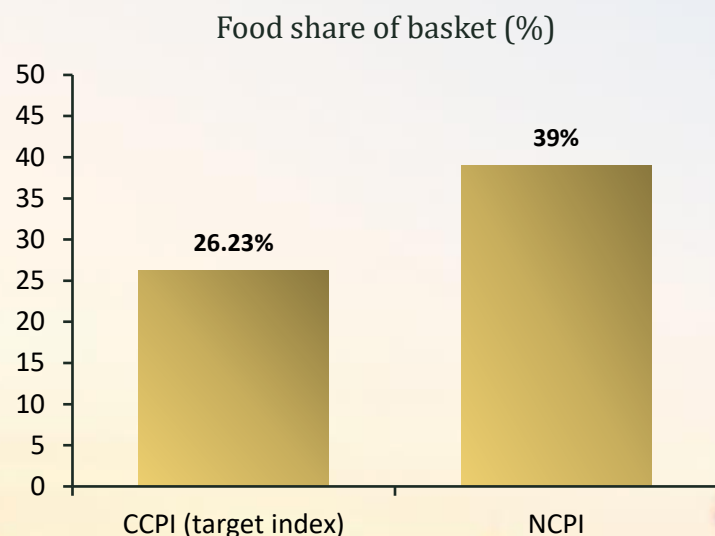
>7%

Threshold above which inflation measurably hurts GDP growth

None

No growth advantage found from inflation well below 5%

What the public said, and what a lower target needs



Why CCPI, not NCPI: released on the last day of the month (NCPI lags about 21 days), history back to 1953 (NCPI from 2014). The two have tracked closely for 4 years.

Public consultation

- Based on approximately 100 survey responses, the findings should be interpreted with caution due to the small sample size; India's 2026 inflation-target review received a substantially larger number of responses
- 5% was the single most-preferred target
- Lower targets (2–4%): protect savings. Higher targets: provide more flexibility to absorb supply shocks.
- Most backed the 2-percentage point margin and headline (not core) inflation
- Split 50/50 on CCPI vs NCPI

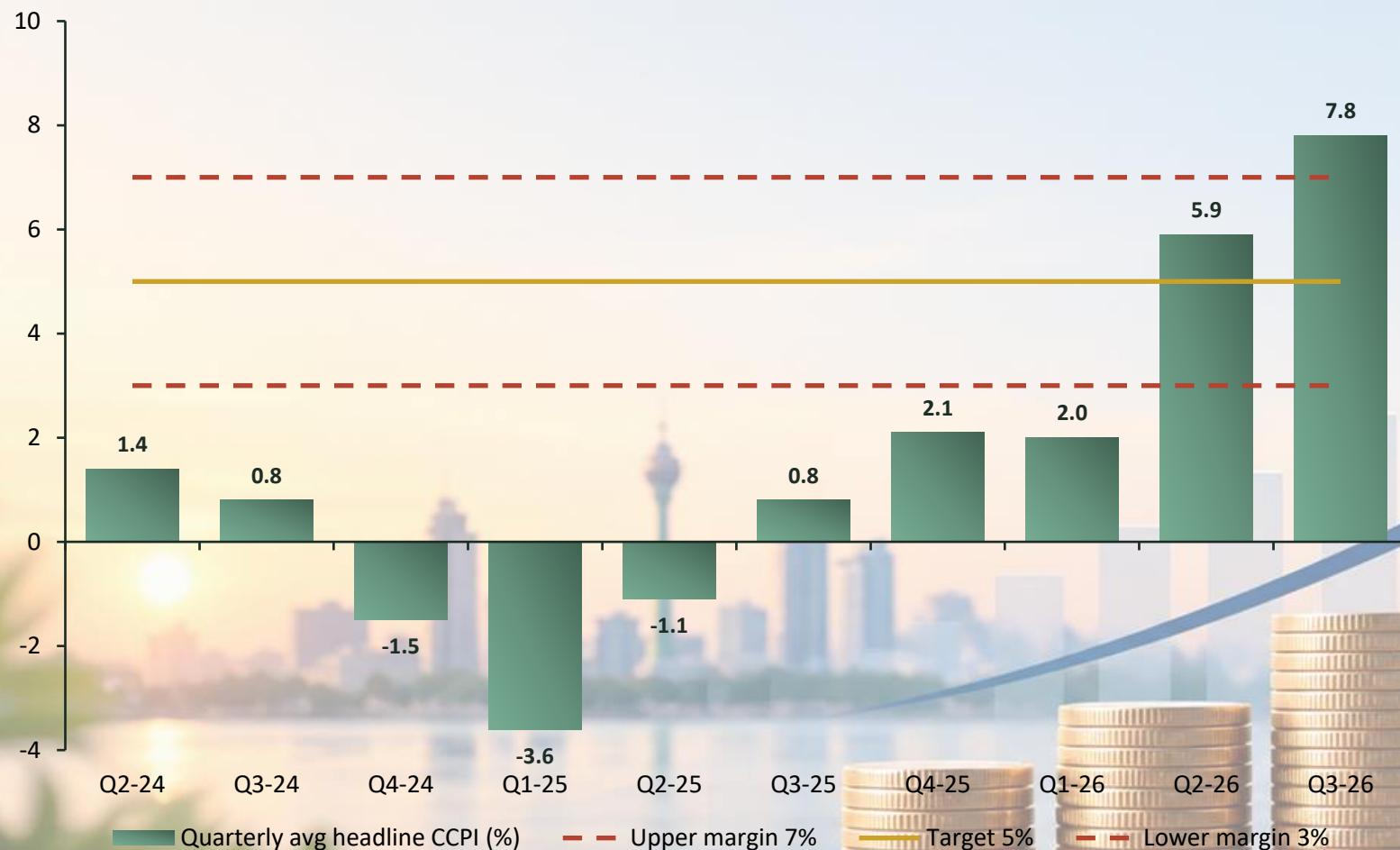
Before a lower target

- A track record of hitting 5% (framework only 3 years old)
- Expectations anchored for a long period
- Less exposure to food and energy/transport (about 20%) in the basket
- Strong fiscal and external buffers
- Peers (Brazil, Philippines, Indonesia) took 15-25 years to step down

How accountability works: 5% is a point target, 2 percentage point is an accountability margin. Two straight quarters outside 3-7% means a report to Parliament and the public. 5% is not a ceiling: the 11 months of deflation were as harmful as high inflation.

Source: CBSL panel (Oct 2026): consultation (Dr. C. Amarasekara), index choice (Dr. L.R.C. Pathberiya), audience Q&A. Food shares as stated by panellists (CCPI quoted as under 25% and about 27%).

From eight quarters below 3% to a breach above 7%



What the record shows

- Q2-24 to Q1-26: eight straight quarters below the 3% , driven by energy and transport price cuts (as the CBSL note explains).
- Q3-26: 7.8%, first quarter above the 7%.
- The target has been missed in both directions; supply shocks dominate Sri Lankan inflation.

Source: DCS / CBSL CCPI (2021=100) monthly releases; quarterly averages computed from monthly y-o-y rates (2024-25 values compiled from DCS releases).

2026: an energy shock that is now spreading to food

CCPI year-on-year inflation, 2026 (%)



Feb 28

US-Iran war begins, Hormuz traffic collapses

Apr

Domestic fuel and energy prices raised, CPI jumps 3% m/m

May-Aug

May–August: Food inflation rose from 0.9% to 8.5%, with CBSL attributing August’s sharp increase mainly to a base effect.

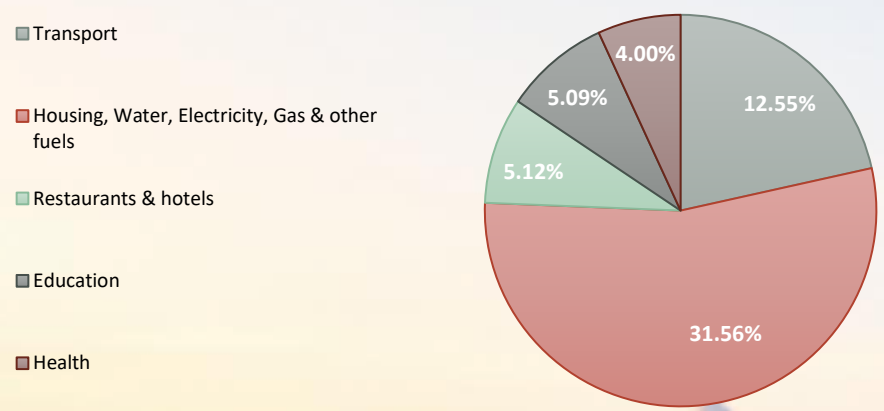
Sep

Core inflation has risen sharply from 2.3% in January to 5.4% in September, signaling growing underlying price pressures and posing a risk to the sustainability of Sri Lanka’s disinflation path

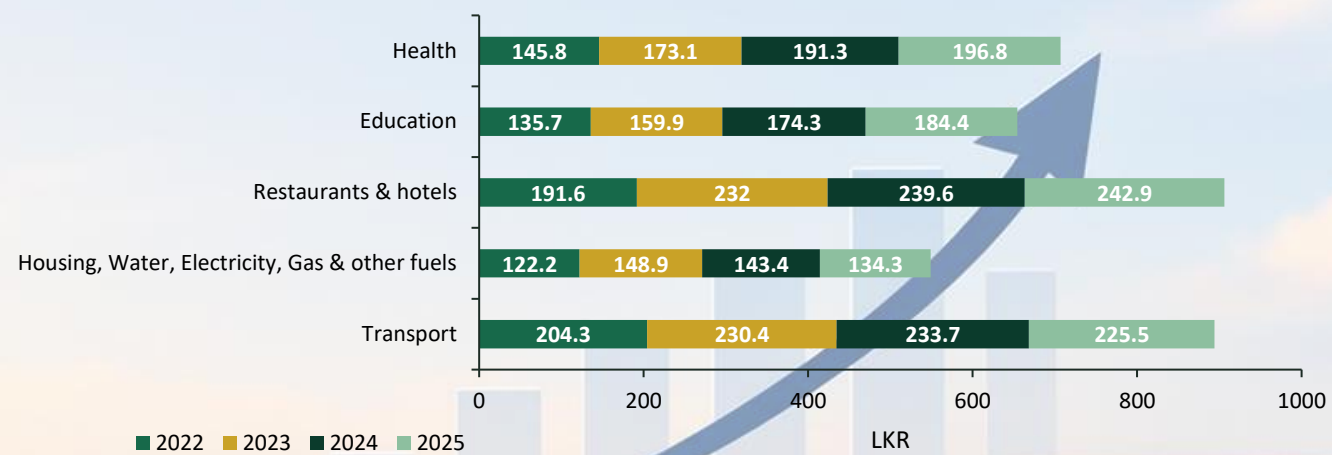
Source: DCS CCPI releases; CBSL Weekly Economic Indicators (Apr-Oct 2026); Trading Economics.

2026: an energy shock that is now spreading to food

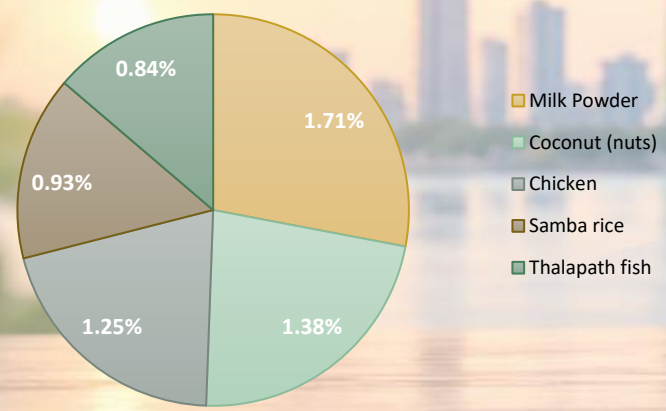
Top 5 Non -food contributors to inflation



Average weights for CCPI (Base 2021 =100)



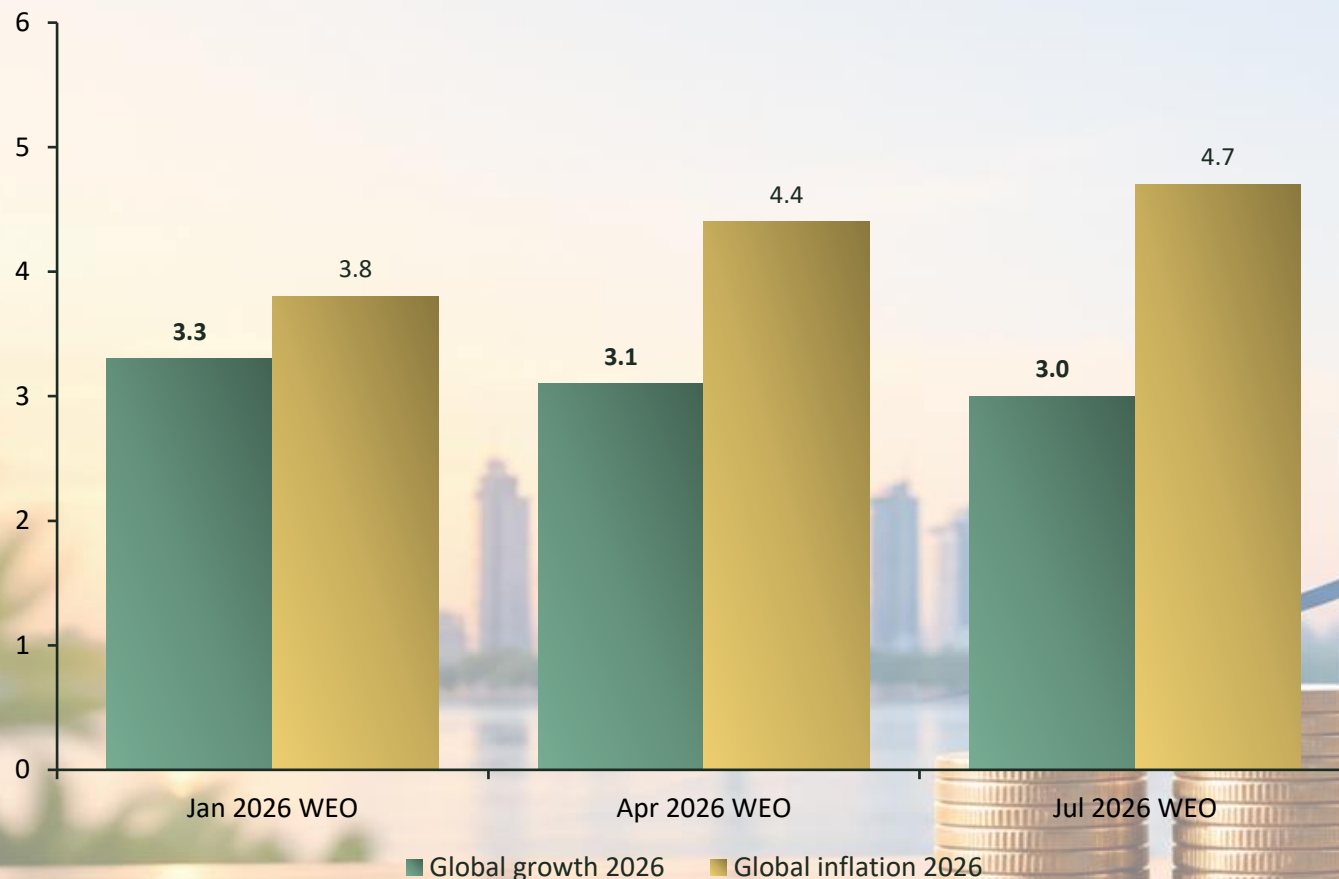
Top 5 food contributors to inflation



Rising prices of key food items, particularly sea fish, are adding upward pressure on inflation and making it more challenging to achieve Sri Lanka’s 5% inflation target. Higher energy prices could intensify this pressure by increasing transportation, fishing, refrigeration, and distribution costs, which may feed through to food prices and other goods and services. If these cost increases persist and spread across the economy, inflation could remain above the target for longer, delaying the return to price stability.

World economy: slower growth, global inflation

IMF projections for 2026 (%), by vintage



Imported inflation

Global inflation revised up 0.9 percentage point since January; Sri Lanka imports a large share of its consumption basket.

Weaker demand for exports

World trade growth slows to 3.5% in 2026 from 5% in 2025 (IMF), weighing on apparel and tea receipts.

Higher-for-longer rates

IMF flags a greater chance of elevated global rates, tightening frontier financing and pressuring the rupee.

Adverse scenario

The adverse scenario (global growth of 2.5% and inflation of 5.4%) is from the IMF's April 2026 WEO, not the July update. The same report's severe scenario projects growth slowing to 2.0% in 2026 and inflation rising to 6.1% in 2027.

Source: IMF World Economic Outlook, Jan, Apr and Jul 2026 updates (as reported by MNI, Enterprise AM, gmk.center, Outlook India).

Climate:

El Niño turns an energy shock into a food shock



Fuel



Fertiliser



Food



Prices

Wetter late-2026 risk

Sri Lanka faces the risk of a potentially very strong El Niño extending into 2027, which could disrupt food supply and increase inflationary pressures.

Imported food +20-25%

Importers warn imported food and essentials may rise 20-25% in coming months on El Niño and shipping costs.

History repeats?

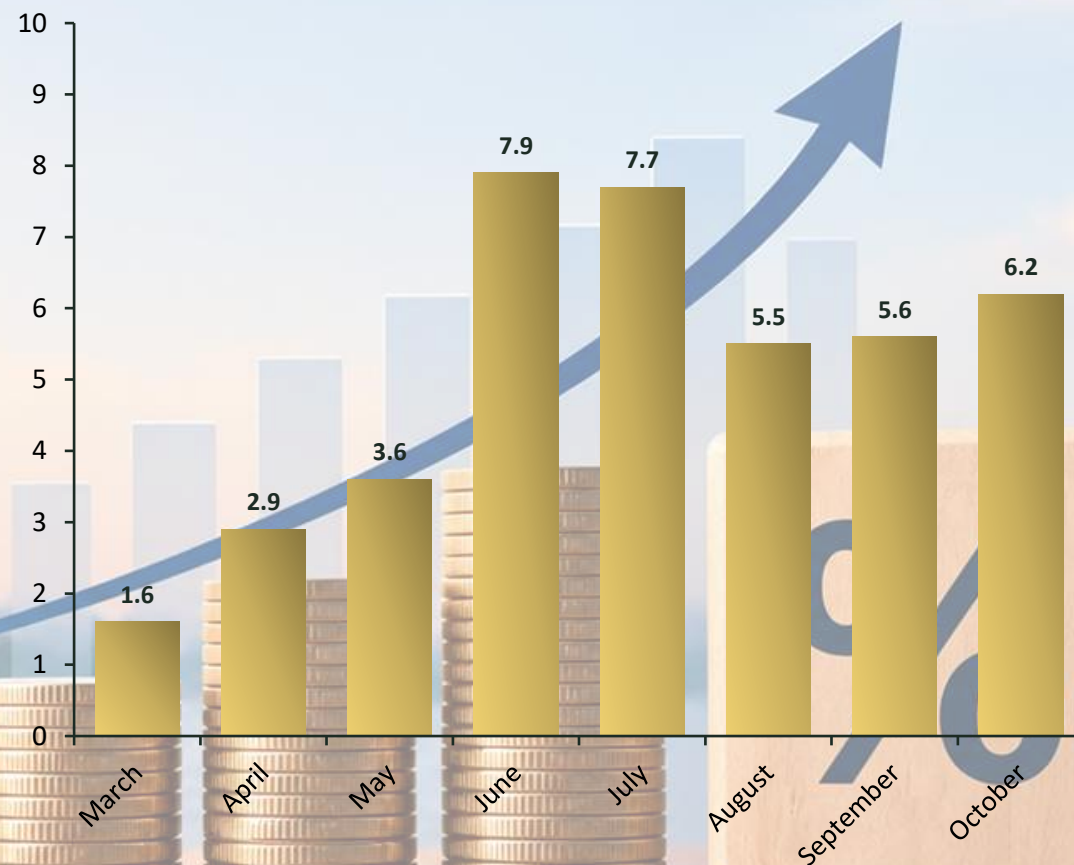
El Niño could raise food inflation by 5–7 percentage points over 12–18 months, adding an estimated 1.25–1.75 percentage points to headline inflation due to food's 25% CCPI weight and potentially delaying price stability into 2027–28.

External buffers held, but the rupee absorbed the shock

Gross official reserves, end-month 2026 (US\$ bn)

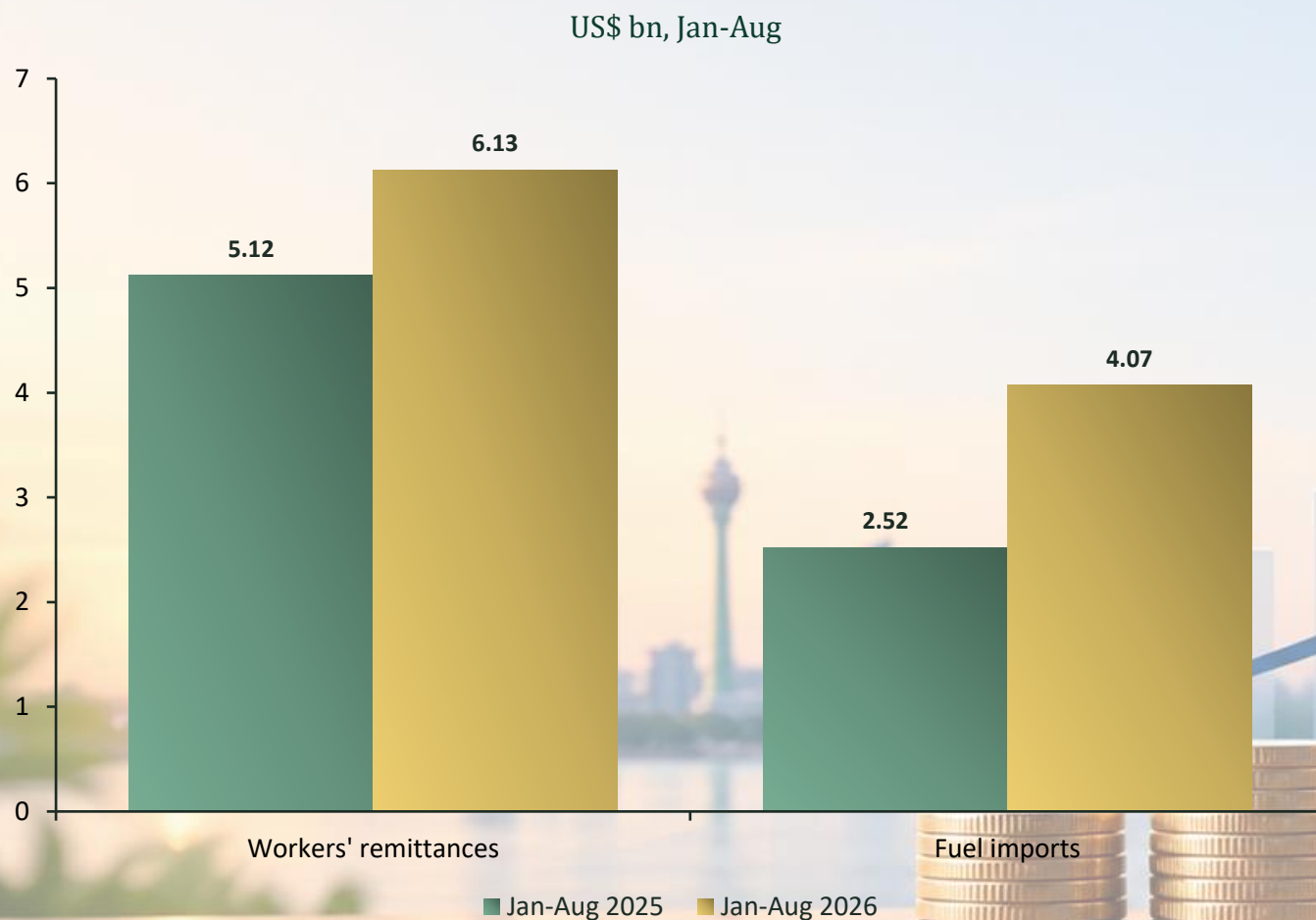


Rupee depreciation vs US\$, year-to-date (%)



Source: CBSL Weekly Economic Indicators and Monetary Policy Reviews, 2026 (reserves include PBOC swap). Depreciation peaked near 7.7% in early July before partial recovery.

Remittances are the partial shock absorber for the fuel bill



+\$1.0 bn

Extra remittances vs 2025 (+19.7%)

+\$1.55 bn

Extra fuel import spend vs 2025

Surplus

Current account back in surplus in Aug after four deficit months

Domestic policy: tight, credible and IMF-anchored

CBSL Overnight Policy Rate at each review (%)



4.7% growth

H1-2026 real GDP, 12 straight quarters of expansion. Demand is firm, not collapsing.

Credit cooling

Private credit was +27.8% y-o-y in May; moderating after the hike.

Fitch B-

Fitch's upgrade to B- marks Sri Lanka's first B-category rating since November 2020, while Moody's and S&P have yet to follow suit.

IMF 7th review

The next IMF EFF tranche is conditional on the 2027 Budget being aligned with programme targets and completion of a financing assurances review. The four-year EFF programme is scheduled to conclude in March 2027

Source: CBSL Monetary Policy Reviews (Sep 2025 - Sep 2026), Fitch Ratings (22 Sep 2026); IMF statement (5 Oct 2026).

Balance of forces: for and against hitting 5%



Working FOR the target

- Large favourable base effects from Apr-Jun 2027
- Proactive 100 bp hike, credit growth
- 5% target lets CBSL look through supply shocks (panel)
- Gross official reserves: US\$6.9 billion, including swap-related balances.
- Fitch upgrade and IMF programme anchor credibility
- core inflation contained near 5%.



Working AGAINST the target

- Brent back above \$100 in Oct, Hormuz talks stalled
- El Niño / IOD threat to Maha harvest and rice prices
- IMF wants full fuel pass-through, which adds near-term CPI
- Rupee down about 6% YTD raises import costs
- Firm demand: 4.7% growth, strong remittance-led spending
- Gulf-dependent remittances and tourism if war spreads

Verdict: achievable, with a detour

2026: No

Inflation stays about 8%; two-quarter breach of 7% margin likely

H1-2027: Converging

Base effects are expected to bring inflation back within the 3–7% range by Q2.

H2-2027: Yes

Inflation may ease towards 5% in H2 2027 if oil prices moderate and food supply remains stable. However, El Niño could delay the return to target until late 2027 or 2028.

What to watch

- Brent below \$90 and Hormuz traffic normalising
- Monthly core CCPI remaining near 5% signals persistent underlying inflationary pressures and poses a risk to price stability.
- Maha harvest outcome and rice prices (Jan-Mar 2027)
- CBSL review on 20 Nov 2026 and the 2027 Budget / IMF Board approval



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