

Chapter 3

REVIEW OF THE CENTRAL BANK'S POLICIES



Summary

By sustaining price and financial system stability, the Central Bank's policies in 2025 supported a conducive environment for high and sustainable economic growth. The Central Bank's monetary easing cycle that commenced in mid-2023 continued throughout 2025, with one downward adjustment to the Overnight Policy Rate in May. This stance was retained in view of domestic deflationary conditions, well-anchored inflation expectations, weakening global demand, and ongoing trade-related uncertainties. Money market liquidity remained in surplus during the year, largely supported by substantial net foreign exchange purchases by the Central Bank. With improved liquidity conditions, the Central Bank suspended liquidity-injecting Open Market Operations from end January 2025. The overall easing of monetary conditions supported broad declines in interest rates and strong growth in private sector credit, while inflation returned to positive territory from August 2025. However, in the second half of 2025, a temporary uptick in short-term market interest rates was observed owing to uneven distribution of rupee liquidity among participatory institutions and increased government financing needs, particularly in the aftermath of *Cyclone Ditrwah*. Despite this, the Central Bank refrained from injecting liquidity into the market, given the overall excess liquidity and continued growth of private sector credit. By early 2026, short term interest rates adjusted downwards as rupee liquidity became more evenly distributed. As the inflation rate remained more than 2 pps below the target of 5% from the second quarter of 2024 onward, the Central Bank submitted four reports to Parliament in 2025 and made them available to the public, explaining the reasons for failing to meet the inflation target, the remedial actions proposed by the Central Bank, and an estimate of the time frame within which the inflation target will be achieved, and thereby ensuring the Central Bank's transparency and accountability.

While maintaining a flexible exchange rate policy, the Central Bank continued to rebuild gross official reserves through foreign exchange purchases. Considering the improved external sector conditions, the Central Bank also relaxed several capital flow management measures that were imposed since 2020, while providing observations and recommendations to the Government on the full relaxation of import restrictions, including those on motor vehicles. Although the removal of vehicle import restrictions contributed to a widening trade deficit, it also resulted in a notable increase in government revenue during 2025.

As the macroprudential authority, the Central Bank advanced financial sector resilience by updating the framework for designating Domestic Systemically Important Banks and revising loan to value (LTV) ratios to curb excessive exposure to vehicle loans. The Central Bank issued several prudential regulations for licensed banks, emphasising stronger technology risk management and cybersecurity preparedness. Banks were also required to prepare Recovery Plans under the Banking (Special Provisions) Act. For Finance Companies, the Central Bank tightened regulation through enhanced liquidity and credit risk management directives, imposed caps on deposit and debt instrument rates to promote sustainable business practices, while commencing monitoring under Phase II of the Consolidation Masterplan. Microfinance Companies were brought under a strengthened credit risk management framework by the Central Bank, and enforcement measures were taken against unauthorised deposit taking entities. Meanwhile, the Central Bank facilitated the smooth transfer of public debt management functions handled by the Bank in the past to the Public Debt Management Office (PDMO) by the end of 2025, enhancing institutional clarity between fiscal and monetary responsibilities.

The Central Bank also partnered with academic and international institutions to develop curricula aimed at improving financial inclusion. In the payments landscape, the Central Bank promoted digital transactions through fee reductions, increased payment limits, and enhanced global compatibility of LANKAQR. Progress continued in anti money laundering, countering the financing of terrorism, and countering proliferation financing (AML/CFT/CPF) initiatives, supported by legislative reforms and preparations for Sri Lanka's upcoming mutual evaluation. The Central Bank strengthened financial consumer protection in 2025 by assessing policy gaps, aligning the financial consumer protection framework with international best practices, and enhancing institutional capacity. The Central Bank also reinforced the deposit insurance and resolution framework by extending resolution provisions to all financial institutions, establishing an independent panel of valuers to strengthen resolution preparedness. Additionally, the launch of the Sustainable Finance Roadmap 2.0 in 2025 signalled the Central Bank's commitment to integrating climate and social considerations into financial sector activities.

Taken together, the policy measures implemented by the Central Bank contributed towards its objectives of maintaining domestic price stability and financial system stability. During 2025, policies were carefully calibrated to steer inflation towards the target. The return of economic activity to normalcy was supported by continued accommodative monetary conditions, enabling a stronger expansion in private sector credit. Frequent interactions with a wide range of stakeholders indicate that the Central Bank's efforts to strengthen transparency and accountability have been effective in improving the understanding of monetary policy and the operations. The financial sector remained resilient amid considerable challenges, reflecting the Central Bank's role in safeguarding financial system stability.

3.1 Monetary Policy Framework

Under the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA), the primary objective of the Central Bank is to achieve and maintain domestic price stability, while

monetary policy is conducted within the Flexible Inflation Targeting (FIT) framework.

The CBA mandates the Central Bank to formulate monetary policy and implement a flexible exchange rate regime within the FIT framework in pursuit of its primary objective.

The FIT framework aims to maintain inflation

at targeted levels set by the Monetary Policy Framework Agreement (MPFA) signed between the Minister of Finance and the Central Bank. The current MPFA, published in the Government Gazette on 5 October 2023, mandates the Central Bank to maintain quarterly headline inflation at 5%. Further, a margin of ± 2 pps is allowed under the MPFA to measure potential deviations of realised inflation from the target, and for accountability purposes.

To achieve the inflation target, the Central Bank uses its policy instruments to steer short-term market interest rates along the desired path. Since transitioning from a dual policy rate mechanism to a single policy rate mechanism in November 2024, the Overnight Policy Rate (OPR) serves as the Central Bank's primary monetary policy instrument to signal its monetary policy stance. The Average Weighted Call Money Rate (AWCMR), which is a short-term money market interest rate, serves as the operating target under the FIT Framework. The OPR is periodically reviewed and, if necessary, adjusted by the Monetary Policy Board of the Central Bank to guide short-term interest rates. Once the OPR is announced, the Central Bank conducts and calibrates its monetary operations to maintain the AWCMR at or around the announced OPR, taking into consideration prevailing and anticipated domestic liquidity conditions. Overnight market interest rates, aligned with the monetary policy stance through this process, are transmitted to the broader economy through financial markets, ultimately influencing inflation.

The CBA provides greater independence to effectively carry out the Central Bank's mandate while requiring it to improve transparency and public accountability. In relation to price stability, if the Central Bank fails to meet the inflation target by the ± 2 pps margin specified in the MPFA (i.e., if quarterly headline inflation falls outside 3.0%-7.0%) for two consecutive quarters, the CBA necessitates the Monetary Policy Board of the Central Bank

to submit a report to Parliament through the Minister of Finance, which shall also be made available to the public. The report needs to set out the reasons for the failure to meet the inflation target, the remedial actions proposed by the Central Bank, and an estimate of the time frame within which the inflation target will be achieved. As quarterly headline inflation was below the target consecutively during the last three quarters of 2024 and during 2025, five such reports were submitted to Parliament through the Minister of Finance in December 2024, March, June, August and December 2025, respectively, while the sixth report was also submitted to the Minister of Finance in March 2026. The public can access these reports on the Central Bank's official website.¹ Further, the Central Bank publishes the biannual Monetary Policy Report in February and August each year, explaining movements in inflation, sources of inflation, medium-term inflation projections, and key risks to those projections, as well as the implementation of monetary policy and the achievement of its objectives. As part of its broader monetary policy communication framework, the Central Bank also continued the publication of the bi-annual Market Operations Report in 2025, which provides detailed information on monetary policy operations, including Open Market Operations (OMOs), liquidity management, short-term interest rate developments, and the Statutory Reserve Requirement (SRR). The Governor, members of the Governing and Monetary Policy Boards, and Deputy Governors shall also be called upon by Parliament or its committees to deliberate on the Central Bank's functions. In this regard, the Board members and the senior management of the Central Bank apprised Parliament and/or its committees in January, June, and November 2025, and in February and March 2026, in addition to the Central Bank officials attending parliamentary committees at the request of such committees. Enhanced coordination between

¹ The Reports on the Deviation of Headline Inflation from the Inflation Target Set Out in the Monetary Policy Framework Agreement is accessible on <https://www.cbsl.gov.lk/en/monetary-policy/monetary-policy-communication/accountability-to-parliament>

BOX 04

Monetary and Fiscal Policy Coordination in Sri Lanka

Effective coordination between monetary and fiscal policies plays an important role in maintaining macroeconomic stability and supporting sustainable economic growth. Monetary policy encompasses actions undertaken by the central bank to maintain price stability, while fiscal policy involves government decisions on taxation, public expenditure, and debt management. Monetary policy and fiscal policy may have either complimentary or competing objectives and different time horizons to achieve such objectives. For example, as observed during the 2022 economic crisis, both monetary policy and fiscal policy had to be focused on regaining economic stability. However, at times, the objectives of these policies may differ. Monetary policy needs to prioritise price stability by raising interest rates when there is a looming threat of inflation, which may contradict with the fiscal policy objectives that prioritise economic growth and employment creation in the immediate future. There may also be instances where excessive aggregate demand created by loose fiscal policy may require tightening of monetary policy in order to curtail price pressures in the economy. In spite of such divergences, effective monetary-fiscal coordination with due regard to each other's objectives, independence, and accountability, serves a nation well in its journey towards long term stability and growth.

In Sri Lanka, monetary-fiscal coordination has evolved considerably over time. Under the Monetary Law Act, No. 58 of 1949 (MLA), coordination between monetary and fiscal policy was closely integrated, however, for most of this period, fiscal dominance prevailed, limiting monetary autonomy and often requiring the Central Bank to accommodate deficit financing needs. This framework has since transitioned to a more robust and clearly delineated institutional arrangement under the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA). The new legal framework strengthens central bank independence, enhances accountability and transparency, clearly defines policy mandates, and facilitates effective monetary-fiscal coordination, while safeguarding macroeconomic and financial stability.

Monetary and Fiscal Policy Coordination Prior to the CBA

Since the enactment of the MLA, monetary-fiscal coordination has been embedded within the country's institutional framework. The MLA established the Central Bank as the authority responsible for the administration, supervision, and regulation of Sri Lanka's monetary, financial, and payments system. It also provided a structured framework within which monetary policy operates in alignment with the government's fiscal policy. The Secretary to the Ministry of Finance was included in the Monetary Board of the Central Bank and the Central Bank was designated as the fiscal agent, banker, and financial adviser to the Government. The MLA also permitted the Central Bank to facilitate monetary financing to the government in the form of provisional advances and other forms of credit. From 1950s onward, fiscal authorities and the Central Bank operated in coordination, seeking to promote economic growth, price stability and employment, while addressing macroeconomic challenges. However, when fiscal deficits became persistent and large in the Sri Lankan economy, greater reliance on monetary financing contributed to inflationary pressures and external imbalances, particularly when fiscal expansion exceeded the economy's absorptive capacity. This situation also illustrates the concept of "Unpleasant Monetarist Arithmetic" (Sargent & Wallace, 1981),¹ whereby tight monetary policy aimed at controlling inflation can be rendered ineffective if fiscal authorities continue to run unsustainable deficits, forcing the central bank to eventually accommodate fiscal deficits through monetary expansion, thereby undermining future price stability. Although the MLA provided a formal framework that facilitated policy coordination, it also permitted a high degree of fiscal reliance on monetary financing, giving rise to fiscal dominance. The unprecedented socio-economic crisis experienced in 2022 can be partly traced to this structural weakness, as monetary policy was insufficiently insulated from fiscal pressures, thereby undermining the Central Bank's ability to operate with effective independence.

¹ Sargent, T. J., & Wallace, N. (1981). Some unpleasant monetarist arithmetic. In *Monetarism in the United Kingdom* (pp. 15-41). London: Palgrave Macmillan UK.

Recent Structural Reforms in Strengthening Central Bank Independence

Recognising the shortcomings of the former legal and monetary policy framework and observing international best practices, the CBA was introduced in September 2023 by repealing the MLA. The CBA significantly restricts avenues for fiscal dominance, thereby strengthening the Central Bank's operational independence and enhancing the effectiveness of monetary policy. A notable reform under the CBA is the exclusion of the Secretary to the Treasury (ST) from the Central Bank's Governing Board and Monetary Policy Board, a change that structurally removes direct fiscal representation and strengthens the independence of monetary policy. While the CBA restricts direct monetary financing, it permits limited provisional advances to the Government to manage short-term cash flow needs. However, with improved fiscal discipline and performance, the Government has not invoked this provision since the CBA's enactment in 2023. In addition to the above, provisions exist to enable monetary financing under exceptional circumstances, such as a global health emergency, subject to the approval of Parliament. Meanwhile, in accordance with the provisions of the Public Debt Management Act, No. 33 of 2024 (PDMA), the transfer of public debt management responsibilities from the Central Bank to Public Debt Management Office (PDMO) further enhances the Central Bank's institutional independence in conducting monetary policy. Alongside the CBA, the enactment of the Public Financial Management Act, No. 44 of 2024 (PFMA), has significantly strengthened the fiscal discipline, thereby reinforcing the effectiveness of monetary-fiscal policy coordination. Enacted in August 2024, the PFMA serves as the cornerstone of fiscal governance reforms by establishing a clear legal framework for the budget process, strengthening accountability and enhancing transparency in fiscal operations.

Current Monetary-Fiscal Policy Coordination in Sri Lanka

With the clear separation of fiscal and monetary policy frameworks under the recent legislative amendments, the CBA has made special provisions to institutionalise monetary-

fiscal policy coordination by establishing the Council for the Coordination of Fiscal, Monetary and Financial System Stability Policies. The Coordination Council serves as the formal platform for information sharing and dialogue between the Ministry of Finance, Planning and Economic Development (MoF) and the Central Bank on macroeconomic developments, outlook, and risks. With the Governor of the Central Bank and the ST as members, the Coordination Council brings together senior officials from both the fiscal authority and the Central Bank. Convening quarterly, it facilitates the exchange of relevant monetary and fiscal information, thereby supporting more informed and coherent policy decision-making. Since of late, in line with the Coordination Council meetings, technical-level meetings are also held among relevant officials of the monetary and fiscal authorities to facilitate the proceedings of the Coordination Council meetings and further strengthen analytical engagement and operational coordination between the Central Bank and MoF.

In addition to the Coordination Council, the CBA provides effective inter-agency coordination to safeguard financial system stability through the Financial System Oversight Committee (FSOC). Chaired by the Governor of the Central Bank of Sri Lanka, the FSOC brings together senior officials from the Central Bank, a Deputy Secretary to the Treasury (DST) nominated by the ST, and other regulatory institutions. This cross-institutional composition facilitates timely information exchange, informed policy dialogue, and coordinated assessments of systemic risks within a macroprudential framework, thereby supporting coherent and well-aligned policy responses to strengthen overall financial system stability. Additionally, to strengthen policy coordination between the Central Bank and the MoF and enhance crisis preparedness, and to minimise spillover effects of the recent economic crisis on the financial sector, the Financial Sector Crisis Management Committee (FCCMC) was established under the Banking (Special Provisions) Act, No. 17 of 2023. The Committee enabled effective coordination among relevant authorities in addressing evolving risks.

Meanwhile, a Public Debt Coordinating Committee (PDCC) has been established under the PDMA. Chaired by a DST, the PDCC comprises nine members, including two representatives appointed from the Central Bank. The PDCC is tasked with ensuring that the public debt management strategy is aligned with overall macroeconomic policies, evaluating borrowing plans, and assessing conditions in domestic and international markets. The Central Bank's representation on the PDCC facilitates ongoing coordination between monetary and fiscal authorities in support of public debt management, without granting the Central Bank direct influence over government debt management decisions.

Effective monetary and fiscal policy coordination is further reinforced by close and continuous engagement between the Governor of the Central Bank and the ST on matters of macroeconomic significance. On key economic policy issues, both institutions maintain regular communication and coordination to ensure consistency and coherence in decision-making. In addition, the Central Bank engages constructively with other line ministries and public sector institutions on matters requiring coordination, reflecting a holistic approach to economic policy. Importantly, during periods of heightened domestic or global uncertainty, such as US tariff policy changes, extreme weather-related disruptions caused by *Cyclone Ditwah*, and evolving geopolitical tensions in the Middle East, well-coordinated policy engagement between the Government and the Central Bank helped assess risks and implement timely policy responses, thereby safeguarding macroeconomic stability and supporting economic resilience.

Moreover, as per the provisions of CBA, under the Flexible Inflation Targeting (FIT) framework, the inflation target is determined jointly by the Government and the Central Bank following a thorough assessment, with a high degree of coordination between the authorities.

Sri Lanka's earlier-than-expected recovery from the 2022 economic crisis emphasises the critical importance of effective coordination between monetary and fiscal policies in restoring macroeconomic stability. Supported by the IMF's Extended Fund Facility (EFF), the implementation of disciplined fiscal measures, prudent monetary policy as well as structural reforms enabled the country to stabilise inflation, strengthen public finances, and gradually revive economic activity. This coordinated policy approach played a vital role in navigating a period of severe economic distress and placing the economy back on a path towards economic stability.

Conclusion

Recent legislative reforms introduced in the aftermath of the socio-economic crisis in 2022 have established a clearer delineation and strengthened the monetary and fiscal policy frameworks, underpinned by enhanced accountability and transparency. At the same time, these reforms preserve robust mechanisms for monetary-fiscal policy coordination, supporting macroeconomic stability and sustainable economic growth. Going forward, sustained and constructive coordination between monetary and fiscal authorities will remain essential to achieving improved economic outcomes for the country.



fiscal, monetary, and financial stability policies is facilitated through the Coordination Council established under the CBA, which meets quarterly to exchange views on macroeconomic developments, outlook, risks, and matters involving both the Central Bank and the Ministry of Finance. In line with the Coordination Council meetings, technical-level meetings are also held among relevant officials of the

fiscal and monetary authorities to facilitate the proceedings of the Coordination Council meetings. These engagements have enhanced overall stakeholder understanding of the Central Bank's policies, operations, and mandate, while also providing a platform for the Central Bank to receive feedback and perspectives from diverse stakeholders, thereby strengthening policy formulation and accountability.

3.2 Monetary Policy Stance and Measures

The Central Bank maintained an accommodative monetary policy stance that commenced in mid-2023 through 2025, amid a low-inflation environment and well-anchored inflation expectations.

During the early part of 2025, the Central Bank maintained the policy pause that had been in place since the policy rate reduction in November 2024. This allowed market interest rates to gradually adjust downward in line with the eased monetary policy stance, while domestic economic activity strengthened and private sector credit continued to grow. Despite the low interest rate environment and the extended period of monetary easing, inflation remained below the target, partly reflecting the impact of lower energy prices. Consequently, inflation was expected to normalise more gradually than previously anticipated. Against this backdrop and the heightened global uncertainties with potential implications for Sri Lanka, the Central Bank reduced the policy rate by a further 25 bps in May 2025, marking the only policy rate adjustment made during the year. Supported by this reduction, the overall market interest rate structure adjusted downwards during 2025, although there was a temporary increase in short-term interest rates towards the latter part of the year. With inflation returning to positive territory in August 2025, following eleven consecutive months of deflation, and credit to the private sector continuing to expand robustly, the Central Bank kept the policy rate unchanged during the remainder of the year, and in early 2026. Accordingly, the cumulative reduction in the policy rate during the current monetary policy easing cycle amounted to around 800 bps by March 2026.

Amid improved liquidity conditions and activity in the domestic money market, the Central Bank gradually scaled back and discontinued liquidity injections through

Open Market Operations (OMOs) in early 2025. With the surplus liquidity prevailing, the Central Bank closely monitored liquidity conditions and overnight interest rate movements. During the first half of 2025, reflecting surplus liquidity in the domestic money market, placements in the Standing Deposit Facility, particularly by foreign and state banks, remained relatively elevated. As liquidity in the domestic money market continued to increase, supported by the Central Bank's foreign exchange operations, the AWC MR gradually converged towards the OPR in early 2026 and with liquidity surplus increasing further, the Central Bank commenced repo auctions both on an overnight and short-term basis from mid-February 2026.

Throughout 2025, the Central Bank continued to maintain a flexible exchange rate regime in line with the Flexible Inflation Targeting (FIT) framework. A flexible exchange rate acts as an automatic stabiliser, allowing the currency to adjust in response to external and domestic shocks. Such adjustments help facilitate the correction of balance of payments imbalances, thereby supporting external stability. Moreover, exchange rate flexibility strengthens the Central Bank's monetary policy independence, as it reduces the need to utilise foreign exchange reserves to defend any predetermined exchange rate level. During the year, the Central Bank's foreign exchange market interventions were primarily aimed at minimising excessive volatility in the exchange rate, while also supporting the accumulation of foreign exchange reserves to strengthen external sector buffers.

The Central Bank continued to strengthen its monetary policy communication to effectively manage the expectations of a broad range of stakeholders during 2025. While maintaining the use of traditional communication tools, the Central Bank also expanded its communication through modern and digital media platforms to enhance reach and accessibility. The Central Bank continued to rely on its core monetary

BOX 05

Strengthening the Price Discovery Mechanism in the Domestic Foreign Exchange Market in Sri Lanka

Introduction

The exchange rate, a key macroeconomic variable in open economies, shapes trade flows, capital movements, and the transmission of monetary policy by significantly influencing trade competitiveness, domestic price stability, and the overall macroeconomic performance of economies. Exchange rate movements in particular, attract significant attention in small open economies such as Sri Lanka, which are highly dependent on imports and foreign exchange (FX) earnings from exports, tourism, workers' remittances, and financial flows.

The domestic FX market in Sri Lanka has undergone a structural transformation following the enactment of the Central Bank of Sri Lanka Act No. 16 of 2023, which established a flexible exchange rate regime under a Flexible Inflation Targeting (FIT) framework, institutionalising market-based price discovery as the foundation of exchange rate determination.

This article examines the process of price discovery in the domestic FX market in Sri Lanka, its importance, the role of market participants, recent initiatives by the Central Bank of Sri Lanka (CBSL) and the way forward.

Price Discovery in the Foreign Exchange Market

Price discovery is the process through which market prices are determined based on actual transactions, reflecting supply, demand, risk perceptions, availability of information and prevailing economic conditions (Rosenberg and Traub, 2009).

The FX market plays a central role in price discovery, as it determines exchange rates through the interaction of supply and demand for currencies, reflecting economic conditions and market sentiments. The FX market remains highly sensitive to new information, with exchange rates adjusting swiftly to changes in economic data, policy announcements, and geopolitical developments.

Price discovery in the FX market materialises through the interaction of diverse participants; central banks, commercial banks, institutional investors, corporates, and retail traders each with unique goals and risk preferences. Their collective trading, shaped by macroeconomic trends, capital flows, and expectations, determines exchange rates in real time, making the FX market highly efficient and information-rich for price formation (Bank for International Settlements, 2023).

Importance of Price Discovery and Economic Benefits

Through effective price discovery in the FX market, exchange rate functions as a real-time signal of an economy's competitiveness. Without market-driven price discovery, economic signals become distorted leading to mispriced trade, inefficient investment decisions and ultimately, misallocation of resources, slower growth, weakened monetary policy transmission and greater vulnerability to external shocks.

Effective price discovery ensures the exchange rate reflects actual supply and demand conditions, supporting trade competitiveness, investment decisions, and business planning, thereby fostering productivity and economic growth. Further, it supports foreign direct investment and portfolio inflows by providing confidence for investors that the currency valuation is transparent and market determined.

Furthermore, price discovery strengthens the monetary policy transmission mechanism by allowing the exchange rate to move in tandem with interest rate decisions. Under an inflation targeting framework, a market-determined exchange rate acts as a shock absorber, complementing interest rate policy and transmitting monetary policy by reflecting underlying economic fundamentals. Furthermore, transparent price discovery reduces the scope for speculative manipulation and parallel market exchange rates. Finally, it contributes to financial deepening by creating conditions for the development of derivative markets, allowing businesses to hedge against exchange rate risk.

For Sri Lanka, robust price discovery has become increasingly important following the introduction of a flexible exchange rate regime and the effective operationalisation of the FIT framework to achieve domestic price stability. By improving transparency and anchoring expectations, it contributes to macroeconomic stability and strengthens long-term economic resilience.

Effective price discovery has been a key driver of the recovery and stabilization of Sri Lanka's FX market. The improvement in market-based pricing enabled the CBSL to rebuild Gross Official Reserves from critically low levels in 2022 to a stronger position by end-2025, without creating market distortions. This was further supported by increased interbank market activity, particularly following the introduction of the FX Matching platform in 2025, which enhanced competitive pricing, liquidity, and market depth. The Sri Lanka rupee appreciated notably during 2023 and 2024, while eliminating parallel market premia, reinforcing the role of a transparent, unified exchange rate as the credible benchmark for all FX transactions.

Role of Market Participants in Price Discovery

The efficiency of price discovery is shaped by the diversity and conduct of market participants, alongside the role of the central banks in ensuring orderly market conditions and sustaining confidence, while allowing exchange rates to be guided by market forces (Osler, Mende and Menkhoff, 2011). In Sri Lanka, Licensed Banks, act as primary intermediaries and market makers, supporting interbank and customer transactions. Further, exporters, importers, institutional investors, foreign portfolio investors, and migrant workers contribute through trade and investment driven FX demand and supply. Active participation from a wide range of agents ensures that the exchange rate captures the economic fundamentals.

The CBSL actively intervenes in the FX market primarily to build reserves and ensure orderly market conditions, while exchange rates are determined through market-based price discovery. Ongoing infrastructure initiatives of the CBSL further enhance transparency, efficiency, and market depth.

Introduction of a Reference Exchange Rate in Sri Lanka

The CBSL has been introducing initiatives to improve liquidity and enhance transparency. A key milestone was the adoption of the FX Global Code in 2024 by the CBSL, all Licensed Commercial Banks (LCBs), and the National Savings Bank (NSB), aligning the domestic FX market with global standards.

As announced in the Policy Agenda of the CBSL for 2026, a benchmark exchange rate ("Reference Exchange Rate") is to be introduced to the domestic FX market in 2026 to enhance price discovery by providing a transparent, market-reflective reference point. Its design follows international best practices, particularly the International Organization of Securities Commission Principles (IOSCO) for Financial Benchmarks (2013), which provides a comprehensive framework for ensuring the integrity, governance, and accountability of financial benchmarks.

The benchmark design includes broadening the transaction base to capture a wider range of actual market activity, thereby ensuring the rate reflects underlying dynamics in the FX market. It incorporates strengthened data validation processes, including filters for anomalies, ensuring both accuracy and reliability. The introduction follows the launch of an FX matching platform for the domestic interbank market, in early 2025 featuring a central limit order book for spot USD/LKR transactions (Central Bank of Sri Lanka, 2025; Bloomberg, 2025).

Governance arrangements of reference exchange rate are being reinforced through the establishment of an independent oversight structure with an Oversight Committee already formed comprising representatives from the Sri Lanka Forex Association (SLFA) and the CBSL. The CBSL further strengthened this initiative by obtaining technical assistance from the IMF, knowledge and experience of peer countries and consultations with domestic FX market stakeholders to ensure practical relevance.

The proposed Reference Exchange Rate is expected to facilitate the development of hedging instruments such as forwards, swaps,

and options, strengthening market confidence through alignment with international standards whilst improving the transmission of monetary and exchange rate policies by offering a clear signal of market conditions.

Conclusion

Efficient price discovery is essential for the proper functioning of the domestic FX market and the broader macroeconomic framework. Ensuring that it is determined through a transparent and well-governed market process is therefore critical. The CBSL's ongoing reform agenda represents a

comprehensive approach to strengthening price discovery and deepening the domestic FX market and these measures are expected to support Sri Lanka's sustained real economic performance.

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policy communication tools, including monetary policy press releases and press conferences chaired by the Governor, to convey its monetary policy decisions and policy stance to the broader economy. These press releases and press conferences provided insights into monetary policy decisions and the rationale underpinning them, as well as a broader assessment of the economic outlook, particularly regarding inflation projections. Following the release of each Monetary Policy Report, the Central Bank conducted technical sessions with journalists, academics, and sectoral experts to facilitate informed dialogue and enhance understanding of the monetary policy decision-making process and economic outlook, particularly on inflation. These initiatives contributed to reducing information asymmetries and further strengthening the anchoring of inflation expectations. Throughout the year, the Central Bank further strengthened its engagement with the mass media through interviews and discussions on monetary policy developments, facilitating informed public discourse on monetary policy and macroeconomic conditions. In parallel, the Central Bank expanded its use of digital and social media platforms and adopted simplified communication formats to improve public outreach. These initiatives included social media posts, single-page policy briefs,

short video clips, and newspaper comics published in all national languages to enhance public understanding of monetary policy and developments. Stakeholder engagement was also broadened through targeted awareness programmes and public outreach activities, including Open Day programmes and educational sessions conducted for students, teachers, and government officials, thereby strengthening the Central Bank's engagement with the wider community.

The Central Bank continued its efforts to achieve the Central Bank related targets set under the IMF-EFF programme.

Accordingly, the Central Bank met the quantitative performance criterion under the EFF relating to net credit to the Government. Further, the Central Bank's foreign exchange purchases from the market contributed to achieving the net international reserves target under the programme.

3.3 External Sector Policies

Exchange Restrictions and Capital Flow Management Measures (CFMs)

The relaxation of temporary suspensions and restrictions on capital account transactions, introduced in 2020 as capital

flow management measures (CFMs), continued during 2025, in view of favourable developments in the domestic foreign exchange market and strengthened external sector buffers.

Consequently, the limits on outward investments through Outward Investment Accounts (OIAs), along with limits on outward remittances for capital transactions through Business Foreign Currency Accounts (BFCAs), were substantially relaxed in 2025, allowing local enterprises to expand their global footprint. Meanwhile, the permitted limit on capital transactions through Personal Foreign Currency Accounts (PFCAs) of residents was also increased, thereby providing individuals with greater flexibility for legitimate outward capital transactions, subject to existing regulatory and reporting requirements. The Central Bank remains committed to phasing out the remaining CFMs implemented under the Foreign Exchange Act, No. 12 of 2017 (FEA), gradually and sequentially, in line with the developments in the balance of payments and domestic foreign exchange market conditions.

The Central Bank implemented several measures in 2025 to strengthen compliance among the dealers of foreign exchange transactions.

During 2025, the Central Bank issued revised directions to Authorised Money Changers (AMCs) accompanied by a comprehensive guide, aimed at enhancing the operational transparency and regulatory oversight. These revisions focused on strengthening operational standards, reporting requirements, and compliance frameworks, thereby supporting the integrity and efficiency of the foreign exchange transactions. Further, the Central Bank initiated the development of a web-based application to record and monitor foreign currency issuances by Authorised Dealers (ADs) and AMCs on real-time basis to effectively operationalise the regulatory framework. This initiative is scheduled for full deployment across all ADs and AMCs in

2026. Furthermore, continuous improvements were made to the Export Proceeds Monitoring System (EPMS), to enhance the accuracy of reconciliation of export values with the export proceeds repatriated to the country. Moreover, the regulatory mechanism implemented in collaboration with Sri Lanka Customs on the importation of goods on advance payment terms was streamlined, enhancing the monitoring of current international transactions. Meanwhile, the Central Bank continued its engagement in the process of amending the FEA, with a view to strengthening the foreign exchange legal and regulatory framework.

Relaxation of Import Restrictions

The Government, in consultation with the Central Bank, fully lifted all import restrictions, including those on vehicle imports during 2025.

The relaxation of motor vehicle import restrictions was implemented in a phased manner following the approval of the Cabinet of Ministers in September 2024. Accordingly, the first stage permitted the importation of public passenger transport vehicles, special purpose vehicles, and non-motorised goods in December 2024. This was followed by the relaxation of restrictions on commercial and goods transport vehicles and personal motor vehicles in January 2025, effectively ending restrictions on vehicle imports that had been in place for nearly five years amid foreign exchange constraints. Consequently, import expenditure increased considerably in 2025, driven by a surge in motor vehicle imports, which widened the trade deficit despite several tariff and non-tariff measures implemented by the Government to moderate the anticipated rise in demand following the prolonged restriction period. Nevertheless, government revenue from motor vehicle imports exceeded expectations, resulting in a notable improvement in overall fiscal balance.

3.4 Financial Sector Policy Measures

Macprudential Policies

As the macroprudential authority, the Central Bank is empowered to formulate and implement macroprudential policies aimed at strengthening the resilience and stability of the financial system. Accordingly, the Central Bank is mandated to adopt and apply enhanced macroprudential oversight over systemically important financial sector participants and to take pre-emptive measures to identify, assess, mitigate and continuously monitor systemic risks that threaten financial system stability. In this context, during 2025, the Central Bank reviewed and published the framework for designating Domestic Systemically Important Banks (DSIBs). Accordingly, five Licensed Banks (LBs) were designated as DSIBs in April 2025. These banks are required to maintain an additional capital surcharge to enhance their resilience to adverse shocks. This additional capital buffer increases the loss-absorbing capacity of DSIBs, thereby reducing the likelihood of systemic disruptions. Furthermore, the Central Bank conducts risk assessments to identify risks and vulnerabilities arising from DSIBs and to formulate policy recommendations aimed at safeguarding overall financial system stability.

Revisions were introduced to the loan-to-value (LTV) caps applicable to credit facilities granted in respect of motor vehicles in July 2025. This revision was intended to enhance the effectiveness of LTV caps as a macroprudential policy tool by aligning their application solely with macroprudential objectives. Further, considering the significant growth in credit facilities granted in respect of motor vehicles by LBs and Finance Companies (FCs), the Central Bank further tightened the LTV limits in November 2025 for certain categories of unregistered vehicles and registered vehicles that have been used in

Sri Lanka for less than one year. This policy is expected to slow the expansion of credit granted for motor vehicle financing, thereby mitigating the potential build-up of systemic risk associated with high credit growth.

Policy Measures Related to Licensed Banks

The Central Bank issued several prudential regulations and implemented policy measures to reinforce the resilience of the banking sector during 2025, and strengthened risk management and compliance, while promoting sound governance practices across LBs. Improving technology risk management and resilience of LBs was one of the key focus areas of the Central Bank in 2025. Accordingly, during the first half of 2025, Circular No. 02 of 2025 on “Reporting of Information Technology and Cybersecurity Incidents of LBs” was issued further to the Banking Act Directions No. 16 of 2021 on “Regulatory Framework on Technology Risk Management and Resilience for LBs” to enhance the reporting requirements for Information Technology and cybersecurity incidents, with a view to strengthening the operational resilience of LBs amidst growing reliance on digital infrastructure and related risks. To reinforce stability and resilience of the banking sector, Directions were issued in September 2025, informing LBs to prepare Recovery Plans (RCPs) considering the nature, scale, structure, complexity, and interconnectedness of the bank, in line with the Banking (Special Provisions) Act, No. 17 of 2023 (BSPA) and submit the Board approved RCPs to the Central Bank. Further, in December 2025, the Central Bank issued Circular No. 04 of 2025 on “Relief Measures to Assist Individuals and Businesses affected by recent Cyclonic and Flood Disasters” to all LBs requesting to provide relief measures to the individuals and businesses whose income or business has been directly affected by the *Cyclone Ditwah* and flood related disasters.

Accordingly, affected individuals and businesses have submitted applications and are able to access the relief measures granted under this circular. Furthermore, a framework was developed to facilitate the consolidation of LBs, with the objectives of strengthening capital levels, improving operational efficiencies through synergies, diversifying risks, and advancing technology-driven financial services of banks. In addition to the above, the Central Bank introduced several regulatory measures during 2025 to ensure smooth functioning of the banking system. These regulations include an addendum on enhancing implementation of relief measures for Small and Medium Enterprises (SMEs), an addendum strengthening corporate governance by restricting the participation of certain shareholder-appointed directors in key board decisions to mitigate conflicts of interest; amendments to regulations on accommodations to related parties by specifying the letter of undertaking issued by the General Treasury as an approved security, for opening Letters of Credit (LCs) by LBs on behalf of Government Ministries, Departments, and State-Owned Enterprises, along with related reporting requirements; a circular outlining revised approval requirements for the provision of banking services through mobile banking units; and a Banking Act Determination specifying the annual licence fee structure for LBs based on asset size.

Policies Related to Finance Companies, Licensed Microfinance Companies (LMFCs) and Primary Dealer Companies (PDCs)

With the aim of improving risk management practices of the FCs sector, in line with the market developments and international best practices, the Central Bank issued directions on the liquidity risk management framework of FCs. These directions required companies to focus on critical components of the liquidity

risk management framework, including the formulation of appropriate risk management strategies, policies and procedures, governance structures, and systems to identify, measure, monitor and control risks.

To promote sustainable business practices when soliciting deposits and issuing debt instruments by FCs, a direction on maximum interest rates on deposit and debt instruments was issued, providing a methodology for determining the maximum interest rates on deposit and debt instruments offered or paid by FCs. Further, a consultation paper on proposed amendments to the Finance Business Act, No.42 of 2011 (FBA) was issued to obtain the observations/comments from the public and stakeholders. The proposed amendments to the Act mainly aim to introduce stronger regulations to strengthen the stability of FCs sector, enhance the transparency of FCs for the benefit of the public, establish a formal framework for resolving and winding up non-viable FCs and enhance powers of the Central Bank on investigation and prosecution of unauthorised deposit taking activities.

With the introduction of the revised framework for Phase II of the Masterplan for Consolidation of FCs in December 2024, the Central Bank commenced quarterly monitoring of FCs based on the scores (assigned to the data reported) they achieved. Phase II of the Masterplan aims to develop a more resilient FCs sector with an execution period of three years, commencing from 31 March 2025 to 31 March 2028. Regulatory oversight of financial institutions (FIs) was further strengthened by continuing to examine the measures and controls implemented by FCs in response to enhanced regulatory requirements, while improving the risk-based Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) supervision process. Restrictions on deposits, lending and borrowings imposed for two FCs were lifted considering the compliance with relevant prudential directions

by those companies. Further, during 2025, resolution actions were initiated on an FC, which has continuously been violating/contravening provisions of FBA and an administrator was appointed.

Liquidation measures relating to failed FCs were pursued, with several discussions held with liquidators of such companies to expedite the liquidation process.

Several investigations have been initiated against unauthorised deposit taking and finance businesses based on the complaints and information received by the Central Bank. During 2025, a few entities have been determined as engaging in unauthorised finance business/deposit taking.

The Central Bank issued directions on credit risk management framework of Microfinance Companies with the aim of improving risk management practices.

Further, a direction on minimum core capital requirements for PDCs was issued to strengthen the resilience of PDCs sector by requiring companies to maintain adequate financial buffer to absorb potential risks and unexpected losses.

Public Debt Management Policies

The public debt management function, previously carried out by the Central Bank as an agent to the Government, was transferred to the Public Debt Management Office (PDMO) of the Ministry of Finance, Planning and Economic Development (MoF) in December 2025. With a view to strengthening institutional accountability and enhancing the efficiency and transparency of Sri Lanka's debt management framework, the PDMO was established under the Public Debt Management Act, No. 33 of 2024 (PDMA) and it was fully operationalised in December 2025. With the cessation of the public debt management agency function, performed by the Public Debt Department (PDD) of the Central Bank since 1950, the Central Bank's

institutional framework for monetary policy formulation has been strengthened. Under the relevant provisions of the PDMA and the CBA, the operations of the Scripless Securities Settlement System and the Central Depository System for government securities, carried out by PDD, have been entrusted to the Payments and Settlement Department of the Central Bank. To facilitate this transition, the PDD provided technical inputs, consultations, and capacity-building support to the MoF and multilateral technical assistance missions, from the drafting stage of the PDMA through to the full operationalisation of PDMO. In this context, the PDD conducted on-the-job training and knowledge transfer sessions for PDMO officials in 2025. Further, commencing in October 2025, and during the transitional period leading up to the full operationalisation of the PDMO, designated PDMO officials performed relevant debt management functions at the Central Bank premises. Throughout the transition, the Central Bank maintained regular and transparent communication with market participants to mitigate potential market disruptions.

Policies for Financial Inclusion

The promotion of financial inclusion in Sri Lanka has been recognised as a function of the Central Bank with the enactment of the CBA. Accordingly, the Central Bank continued to advance the implementation of the National Financial Inclusion Strategy (NFIS) in 2025. Following the completion of Phase I (2021–2024) of the NFIS at the end of 2024, an end term evaluation is being conducted to assess progress and key lessons for future policy direction. In parallel, measures have been initiated to conduct a national-level Financial Inclusion Survey, with the support from the Alliance for Financial Inclusion (AFI), to generate updated, comprehensive data on the state of financial inclusion in the country. These efforts are expected to inform the formulation of NFIS Phase II, scheduled for the

second half of 2026, through a consultative process involving key stakeholders. Financial literacy and capacity building constitutes one of the four strategic pillars of the NFIS, with the Central Bank entrusted with the primary responsibility for driving the implementation of related policy actions with relevant stakeholders. Accordingly, the Financial Literacy Roadmap of Sri Lanka (2024–2028) was launched, and its Action Plan is currently being implemented. As part of this effort, with the financial support from the United Nations Development Programme (UNDP), the Central Bank collaborated with academia to strengthen strategic cooperation, promote knowledge exchange, and harness academic expertise in the design and delivery of targeted financial education initiatives to foster a financially literate and empowered society.

Payments and Settlements Related Policies

The Central Bank implemented several policy measures in 2025 to promote the adoption of digital payments while enhancing the efficiency and stability of the payment system. To improve the affordability and accessibility of digital payment services, especially instant account-to-account payments, the maximum per transaction fees for all Common Electronic Fund Transfer Switch (CEFTS) based platforms were reduced. Accordingly, fees for customer instant fund transfer were capped at Rs. 25. To encourage bank account based instant payments to government institutions, transactions effected through the GovPay² was set at Rs. 15, while the maximum fee applicable for transactions effected through the LankaPay Online Payment Platform (LPOPP), which facilitates payments such as taxes and customs duties to Government Institutions, was reduced from Rs. 50 to Rs. 25. To facilitate larger value transactions via digital channels

and accommodate evolving transaction requirements, the maximum per transaction value for customer-initiated fund transfers via the Sri Lanka Interbank Payment System (SLIPS), which processes batchwise deferred settlements, was increased from Rs. 5 mn to Rs. 10 mn. As the government sector was fast adopting digital payments, a higher limit of Rs. 50 mn was granted for government-related transactions processed through SLIPS via accounts maintained at the Central Bank.

Continuing the policy of increasing global connectivity of LANKAQR and enhancing payment convenience for inbound travellers, approval was granted to LankaPay (Pvt) Limited (LPPL) to partner with AliPay Singapore E-Commerce Private Limited, enabling tourists to use AliPay+ enabled applications at LANKAQR merchants. This partnership extended LANKAQR integration from India's UPI-enabled applications to Alipay+ applications, which are available in many Asian countries.

The Central Bank, together with the National Payments Council (NPC), developed the National Payment System Roadmap 2026-2027, which is built upon six strategic pillars designed to promote inclusion, efficiency, security and global connectivity. The Roadmap will provide the strategic direction for expanding and upgrading Sri Lanka's payment system to meet future demand for digital payments.

In addition to the above, Money or Value Transfer Service (MVTs) Providers Regulations were amended, expanding the regulatory perimeter to include overseas money transfer service providers and enhancing the supervisory oversight.

Further, during the year 2025, the Central Bank was engaged in the formulation of a new Payment and Settlement Systems Act, with a view to strengthening the legal and regulatory

² GovPay - launched in February 2025, is a platform that enables government institutions without dedicated IT systems to accept instant digital payments.

framework governing payment and settlement infrastructure consistent with the Principles of Financial Market Infrastructure.

Policies Related to Anti-Money Laundering (AML), Countering the Financing of Terrorism (CFT) and Countering the Proliferation Financing (CPF)

The Financial Intelligence Unit (FIU) of Sri Lanka continued to strengthen the national anti-money laundering/countering the financing of terrorism/countering the proliferation financing (AML/CFT/CPF) framework in 2025 through enhanced intelligence generation, strengthened supervision, legislative reforms and strategic coordination. Accordingly, FIU implemented a number of policies in view of strengthening the AML/CFT/CPF system of Sri Lanka and to ensure Sri Lanka is well prepared for its third Mutual Evaluation (ME) by the Asia Pacific Group on Money Laundering (APG) in 2026. In view of these preparations, several measures were taken under the guidance of the AML/CFT National Coordinating Committee, chaired by the Governor of the Central Bank. These measures include continuous monitoring of stakeholder-wise action plans by the AML/CFT Task Force, and completion of the National Risk Assessment (NRA) 2024/25 covering money laundering, terrorist financing and, for the first time, proliferation financing risks.

Legislative reforms are being processed with amendments to key AML/CFT laws. Accordingly, amendments were made to the Financial Transactions Reporting Act, No. 06 of 2006 (FTRA), the Prevention of Money Laundering Act, No. 05 of 2006, and the Convention on the Suppression of Terrorist Financing Act, No. 25 of 2005, while providing technical contributions to new enactments including the Proceeds of Crime Act, No. 05 of 2025, the Companies (Amendment) Act, No. 12 of 2025, the Gambling Regulatory Authority Act, No. 17 of 2025, Institute

of Real Estate Professionals Sri Lanka Act, Trusts (Amendments) Bill, Non-Government Organizations (Registration and Supervision) Bill, Foreign Terrorist Fighters Bill. Moreover, FIU is currently implementing a phased-out AML/CFT/CPF supervisory framework for Virtual Asset (VAs) and Virtual Asset Service Providers (VASPs) which will be supported by the upcoming amendments to FTRA while a Sub Committee chaired by the Deputy Minister of Digital Economy has been established to explore the prudential regulatory requirements for VASPs.

Policies for Financial Consumer Protection

With the aim of identifying policy gaps and evaluating reform priorities, the Central Bank commenced a comprehensive assessment of the existing financial consumer protection framework in the fourth quarter of 2025, with technical assistance from the Asian Development Bank. This review seeks to benchmark the current framework against international best practices and identify areas for strengthening the legal framework, enhancing regulation, strengthening institutions, and improving supervisory effectiveness. In addition, the Central Bank plans to complete stakeholder consultations and update the financial consumer protection policy framework in 2026.

Further strengthening its institutional capacity, the Central Bank became a full member of the International Financial Consumer Protection Organisation in 2025. This membership is expected to enhance knowledge exchange, facilitate exposure to global best practices, and support continued policy development within the Central Bank.

Policies on Deposit Insurance and Resolution of Financial Institutions

The Central Bank further strengthened its policy framework on banks and FCs resolution to ensure consistency,

preparedness and effective crisis management across the financial system in 2025. Accordingly, a key policy development was the extension of resolution provisions under Part I and Part II of the BSPA, to all FCs through an Order issued under Section 57 of the Act. This measure ensures that both LBs and FCs are subject to a standardised resolution regime, enabling timely intervention and orderly resolution of distressed institutions. The extension enhances the mitigation of risks to depositors and the broader financial system.

As part of the Central Bank's efforts to strengthen resolution preparedness, the Central Bank constituted a Governing Board-approved Panel of Independent Professional Valuers under Section 16 of the BSPA, with effect from 06 August 2025. The Panel supports key resolution functions, including independent valuation of assets and liabilities of the relevant LB or FC, determination of failing-or-likely-to-fail conditions, assessment of resolution options, and application of the "No Creditor Worse Off than in Liquidation" safeguard. The establishment of the Panel enhances credibility, transparency and legal robustness.

In addition, during 2025, the Central Bank issued BSPA Direction No. 02 of 2025 on "Display of Membership with the Sri Lanka Deposit Insurance Scheme and availability of Deposit Insurance Coverage" to Member Institutions (MIs) of the Sri Lanka Deposit Insurance Scheme (SLDIS). This Direction requires the mandatory display of their membership in SLDIS and the availability of deposit insurance coverage, as part of the Central Bank activities to enhance public awareness on deposit insurance and to strengthen depositor confidence in the financial system. Accordingly, MIs are required to clearly and prominently display their SLDIS membership

status and relevant information relating to deposit insurance coverage in compliance with the prescribed guidelines.

Policies on Sustainable Finance

The Sustainable Finance Roadmap 2.0 developed with the support of the International Finance Corporation (IFC) was launched in May 2025, representing a significant milestone in advancing sustainable finance within Sri Lanka's financial sector. Developed through extensive

consultations with financial sector stakeholders and international partners, Roadmap provides a structured and practical framework to guide FIs in aligning their operations with national environmental and social development priorities while remaining consistent with the Central Bank's mandates to maintain price and financial system stability. A key enhancement under Roadmap 2.0 is the integration of the social dimension of sustainability, with a strong emphasis on promoting inclusiveness and supporting a broader spectrum of economic activities. In parallel, Roadmap places increased focus on addressing climate-related financial risks, thereby strengthening the resilience of the financial system to climate-induced shocks and supporting a more sustainable economic transition. Looking ahead, the Central Bank intends to further strengthen the enabling framework for sustainable finance by enhancing the existing Green Finance Taxonomy, which is currently being updated with support from the IFC. This initiative is expected to improve the alignment of financial flows with national sustainability priorities while incorporating evolving global best practices. Moreover, the Central Bank is continuously engaged in promoting sustainable finance activities of LBs and new Banking Act Directions in this regard will be issued to LBs in 2026.