

Chapter 4

MACROECONOMIC OUTLOOK

Summary

With restored macroeconomic stability and the gradual dissipation of domestic uncertainties, the Sri Lankan economy is expected to continue its recovery path. Though possible headwinds from the global economy could weigh on the economic outlook, timely, proactive and reactive policy measures are expected to soften any adverse impacts. Economic growth in the near to medium term is envisaged to be buoyed by the low and stable inflation, lower interest rate environment, positive market sentiments and stable economic and political conditions. Current deflationary conditions are expected to dissipate within the first half of 2025, and inflation is expected to stabilise around the targeted level of 5% in the medium term. Geopolitical conflicts, effects of the US policy adjustments and retaliatory measures by other major economies, as well as climate change induced weather disturbances, could pose risks to the growth and inflation forecasts. The Central Bank's monetary policy measures would continue to be forward looking and data driven. Private sector credit growth is anticipated to remain healthy in the backdrop of lower interest rates and the easing of crowding out pressures. The exposure of the banking sector to the public sector is likely to remain modest, largely supported by envisaged improvements in fiscal performance. On the external front, the trade deficit is expected to widen with the removal of restrictions on motor vehicle imports and the revival of economic activity but would remain at a manageable level with the envisaged healthy growth in foreign exchange inflows. Supported by the rising tourism earnings, strong performance in other services exports, steady growth in remittances, and reduced burden on the primary income account after debt restructuring, the external current account is likely to record a surplus, though marginal, for the third consecutive year in 2025. Beyond 2025, the external current account is expected to remain in deficit, but at a sustainable level. Meanwhile, the external financial account is anticipated to reflect net inflows, bolstered by the expected restoration of debt sustainability and the continuation of International Monetary Fund-Extended Fund Facility (IMF-EFF) programme. The Central Bank will continue to implement a flexible exchange rate regime while building external buffers over the medium term, creating a cushion to withstand external shocks. The fiscal sector, which recorded a notable turnaround during the past two years, is expected to continue its healthy performance in the forthcoming years, buttressed by the new legislative framework for public financial management and the ongoing reform agenda. Meanwhile, financial sector performance is expected to remain healthy in the coming

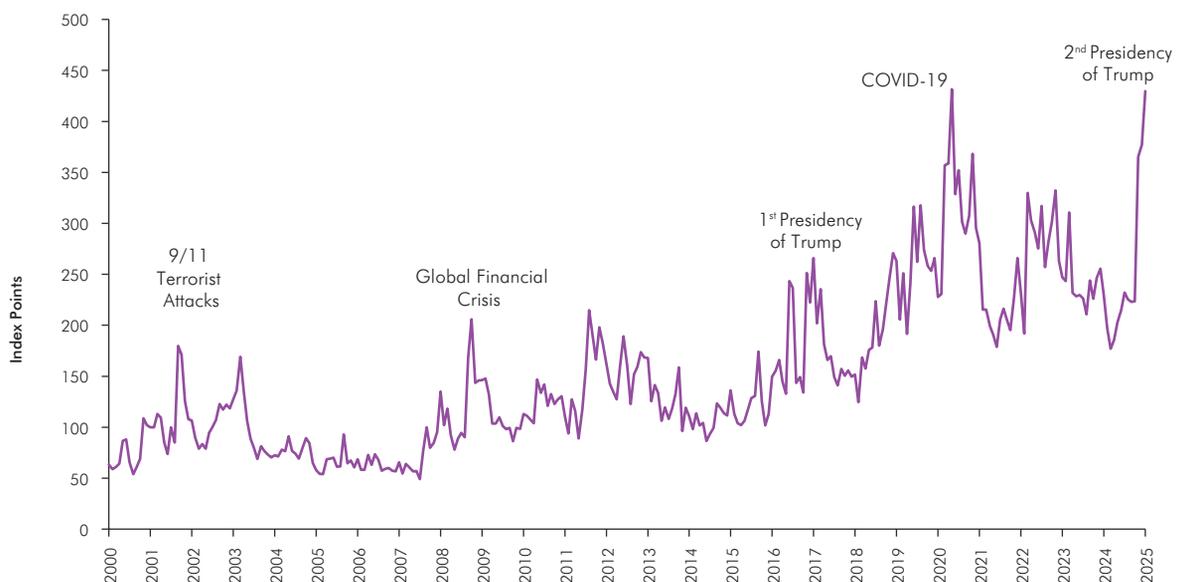
period with the improved macro financial conditions. The risk levels of credit portfolios of the financial institutions would reduce with the improved repayment capacity of the borrowers amidst steady recovery of economic activities and a low interest rate structure. The Central Bank's continued efforts for strengthening legislative and regulatory framework, improving supervision and consolidation of the financial sector would fortify the stability and resilience of the financial system. Given the restoration of economic stability to a greater extent, continuation of the IMF-EFF programme, and implementation of necessary structural reforms will help the Sri Lankan economy to achieve a sustainable growth in the medium term.

4.1 Global Economic Environment and Outlook

Global economic uncertainty remains high as shifting trade policy dynamics and escalating geopolitical tensions increase the geoeconomic fragmentation, weighing on global growth prospects, financial conditions, and international cooperation. According to the World Economic Outlook (WEO) update of the IMF released in January 2025, global growth was estimated to have moderated from 3.3% in 2023 to 3.2% in 2024 and it was projected to remain subdued, at 3.3% in both 2025 and 2026, below the historical average of 3.7% (2000–2019). However, the global political

and economic landscape has changed notably since, suggesting possible revisions to these projections in the period ahead. The lingering uncertainty is mainly stemming from the scale and pace of policy shifts by the US government and countermeasures by other nations. There are indications of a reciprocal tariff regime, although no formal announcement has been made at the time of finalising this Report. Moreover, the US administration has set out an import substitution agenda aimed at boosting US manufacturing and reducing the trade deficit, while also planning to withdraw from some of its international commitments related to foreign aid, climate change and sustainable development.

Figure 4.1: Global Economic Policy Uncertainty Index



Source: Baker, Scott R.; Bloom, Nick; Davis, Stephen J. via Federal Reserve Economic Data

The ongoing global policy shifts are set to reshape the global economic outlook driven by trade uncertainty, supply chain disruptions, inflationary pressures, and changes in foreign aid distribution and capital flows. One of the most immediate consequences of US policy changes is heightened trade uncertainty, which may disrupt global value chains and distort global trade flows. US tariff increases have triggered retaliatory trade actions by affected economies that may act as a drag, particularly on global investment and trade, potentially leading to slower global growth. The Federal Reserve's latest economic projections released in March 2025 reveal expectations of slower growth in the US economy from a growth rate of 2.5% in 2024 to 1.7% projected for 2025, reflecting the expected impact of new US tariffs and consequential retaliation. Countries with strong trade linkages with the US are expected to experience economic headwinds due to rising costs and declining export competitiveness. While Euro zone economies may experience limited direct economic effects from the tariff measures, heightened geopolitical and policy uncertainty could still pose some challenges to the region's growth prospects. Potential aggressive fiscal easing in China could partly cushion the impact of US tariff hikes on China's near-term growth prospects. Moreover, plans by the US to withdraw from international commitments including the United States Agency for International Development (USAID), the World Health Organisation (WHO) and the Paris Agreement on climate change could disrupt global efforts to address critical issues, such as climate change, health crises and sustainable development.

As tariffs continue to rise, the global disinflation trend could be disrupted, leading to renewed inflationary pressures.

Tariffs on key imports, including raw materials and commodities like steel and aluminium, may lead to price volatility and inflationary

pressures. While some tariff affected economies may experience lower inflation due to weaker consumer demand and slower growth, some countries may experience pressure on inflation due to retaliatory tariffs, supply disruptions and weaker currencies. However, global energy prices are expected to decline over the next two years, reflecting the weak Chinese demand, possible weakening of global demand for energy and expectations of higher supply from oil exporting countries, including the US. Central banks globally would remain vigilant given heightened uncertainty and the potential for higher trade costs to push up wages and price pressures. While some central banks in tariff affected countries may opt to lower interest rates to stimulate growth, others may consider tightening monetary policy to ensure that underlying inflation pressures are durably contained. However, the risk of prolonged high interest rates could add strain to global financial conditions and capital markets.

The global monetary policy stance, which remained largely tight in early 2024, gradually turned accommodative in the latter half of the year and early 2025 as inflationary concerns moderated amidst the slowing of economic activity. Despite the moderation of headline inflation, advanced economy central banks were reluctant to ease monetary policy until strong evidence of contained inflationary pressures was seen. Moreover, rigid core inflation and strong labour market conditions led advanced economy central banks to adopt a more cautious approach to their monetary policymaking in early 2024. However, as economic activity slowed alongside a benign outlook on inflation, a gradual easing of monetary policy was effected in the latter part of 2024 and early 2025. Meanwhile, the monetary policy stance of emerging market economies has been mixed during 2024 and early 2025. While weak domestic demand and subdued inflation drove some central banks to adopt a loose monetary

policy stance, others kept monetary policy tight to manage inflationary pressures arising from volatile food and energy prices and stabilise domestic currencies amidst global economic uncertainty. Going forward, factors such as geopolitical uncertainties, global supply chain disruptions, currency fluctuations and their impact on inflation could influence the course of policy action pursued by central banks worldwide.

Rising protectionism, geopolitical uncertainty and weaker global growth prospects could affect the Sri Lankan economy through multiple channels.

One of the primary channels of concern is trade, as the evolving US tariff policies may have implications on Sri Lanka's export dynamics. On average, Sri Lanka's exports and imports to and from the US amount to around USD 3 bn and USD 0.5 bn, respectively, resulting in a trade surplus of around USD 2.5 bn in favour of Sri Lanka. Any reciprocal tariff imposed and implemented on Sri Lanka's exports by the US could have a notable impact on the country's export sector. In addition, potential impact of US policy adjustments on Sri Lanka's other major trading partners could also weigh negatively on Sri Lanka's exports. The projected decline in global oil prices could have a positive impact on the trade balance. However, workers' remittances to Sri Lanka could be affected due to the possible global economic downturn due to US tariff policies. Similarly, a prolonged period of subdued economic growth in major source countries of Sri Lanka's tourism industry may affect the currently observed positive momentum in the tourism sector. Global monetary policy divergences, driven by US policy shifts, could impact monetary conditions and influence financial flows to Sri Lanka's capital markets. At the time of finalising this Report, the US economic policies and their impact remained uncertain and unpredictable.

Countries worldwide are adopting a cautious approach to navigate the evolving global policy shifts and their potential impacts. Given the uncertainty of the global

environment, actively pursuing new free trade agreements (FTAs) and enhancing policy preparedness to leverage trade diversion opportunities is vital. Revisiting tariff structures in anticipation of reciprocal tariffs is essential, alongside closely monitoring emerging macroeconomic vulnerabilities for early intervention. As economic fragmentation intensifies, countries are considering strengthening regional trade alliances and peer collaborations to reduce reliance on a particular market and foster intra-regional trade. On the other hand, fiscal discipline is needed to ensure debt sustainability, to maintain the ability for governments to react to future shocks and to accommodate current and future spending pressures.

4.2 Domestic Economic Outlook

4.2.1 Inflation Outlook

Following a period of deflation from late 2024 to early 2025, headline inflation is projected to turn positive by mid-2025 and stabilise around the 5% target over the medium term, supported by appropriate policy measures. The deflationary condition witnessed towards the end of 2024 continued into the first three months of 2025. Deflation (y-o-y) in the first quarter of 2025 was deeper than the deflation recorded at the end of 2024. This was mainly influenced by the statistical base effect contributing to lowering y-o-y inflation. In addition, the significant reduction in electricity tariffs effective from January 2025 also contributed to the deflation in the first quarter of 2025. However, headline inflation is forecast to increase from the deflationary conditions and turn positive by around mid-2025. This pickup in headline inflation is expected to be contributed by a faster increase in world food inflation, the gradual development of demand pressures, and the statistical base effect. The current projections indicate a gradual increase in headline inflation until the second half of 2026. However, the increasing trend in headline

inflation is not expected to persist, and it is expected to decline gradually from late 2026, eventually stabilising around the targeted level of 5% over the medium term, supported by appropriate policy measures. Meanwhile, core inflation, which excludes goods and services with volatile prices to derive underlying demand pressures in the economy, is expected to remain broadly steady in the medium term. Similar to headline inflation, core inflation was also affected by the statistical base effect in the first quarter of 2025. This resulted in a temporary dip in core inflation. However, as the core inflation index largely excludes the items in the energy and transport-related category, which are instrumental in driving down headline inflation, the recent reduction in headline inflation is not reflected at a similar magnitude in core inflation. Going forward, core inflation is expected to normalise in the forthcoming period consistent with the target for headline inflation, with a

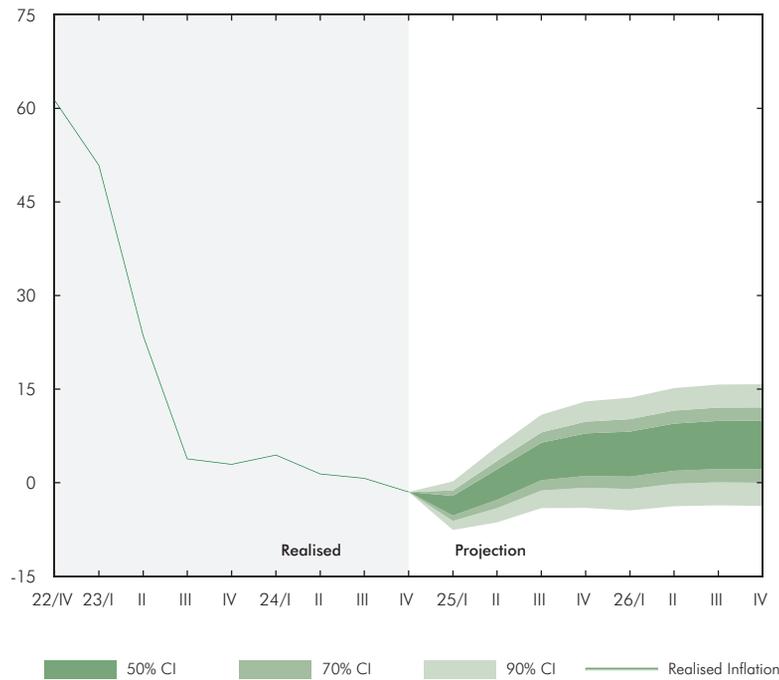
lower degree of volatility. The trajectory of core inflation is expected to be supported by the gradual improvement in demand conditions amidst the expected sustained economic recovery.

Amidst ongoing global economic uncertainties coupled with unfavourable domestic weather conditions, risks to the current projections remain elevated compared to normal times.

These projections hinge on the forecasts of global energy and food prices, the expected economic trajectory of Sri Lanka’s major trading partners, the anticipated domestic fiscal path in line with the IMF-EFF projections, the assumption that electricity and petroleum price adjustments will remain cost reflective, and global financial conditions implied by the monetary policy stance of the US. Further, the projections are conditional on the model-consistent interest rate path and



Figure 4.2: Headline Inflation Projections* (quarterly average, CCPI, y-o-y, %)



*Realised data in Q4 2022 shown in the fan chart is based on CCPI (2013=100, seasonally adjusted), while data after this period are based on CCPI (2021=100, seasonally adjusted).

Note: A forecast is neither a promise nor a commitment

The projections reflect the available data, assumptions and judgements made at the forecast round in March 2025.

The fan chart illustrates the uncertainty surrounding the baseline projection path using confidence bands of gradually fading colours. The confidence intervals (CI) shown on the chart indicate the ranges of values within which inflation may fluctuate over the medium term. For example, the thick green shaded area represents the 50% confidence interval, implying that there is a 50% probability that the realised inflation outcome will be within this interval. The confidence bands show the increasing uncertainty in forecasting inflation over a longer horizon.

resulting macroeconomic responses. Moreover, no major macroeconomic policy shifts are anticipated in the baseline projections. Any notable change in the underlying assumptions and judgements could lead to the realised inflation path deviating from the projected path. Risks to the outlook stem from the possibility of various factors deviating from the levels already internalised in projections, either explicitly or implicitly, and due to any unforeseen developments. In particular, there are substantial upside risks to inflation projections stemming from factors, such as the demand impact of possible higher wages, the impact of the possible adverse weather conditions affecting agricultural production, any possible deviation from the envisaged fiscal consolidation path, and possible rupee depreciation at higher levels. Meanwhile, downside risks to inflation projections include, among others, a further moderation in global commodity prices due to possible global growth slowdown. The Central Bank will continue to communicate to the public the possible deviations in the inflation outlook based on upcoming changes to domestic and global economic conditions at each monetary policy round, underpinned by data-driven monetary policy formulation within the FIT framework.

4.2.2 Monetary Sector Outlook

The Central Bank will continue to adopt a data-driven approach to its monetary policymaking going forward, considering the developments on the domestic front and possible implications of dynamic global economic conditions. Following transitory supply-driven deflation, the inflation is expected to converge toward the target in the latter part of 2025, and the Central Bank will closely monitor potential risks of demand-side pressures in order to take necessary steps to arrest any medium term disruptions to achieve the inflation target. Further, the dynamic economic and financial environment globally

due to the policies that are being adopted by the US and uncertainties surrounding the same could have some implications on the domestic economy and the formulation of monetary policy. Meanwhile, domestic market interest rates are likely to remain stable at low levels, with further downward adjustments to interest rates on selected lending products which currently remain above acceptable levels. Further, yields on government securities are likely to remain normalised supported by accommodative monetary policy, improved fiscal performance and reduced risk premia following sovereign rating upgrades.

Monetary expansion is expected to persist in the period ahead, supported by the eased monetary conditions.

Low levels of interest rates will reduce the cost of borrowing for businesses and households, thereby stimulating the flow of credit for both consumption and other productive sectors of the economy amidst the envisaged expansion of import demand and improved domestic economic activity. In the meantime, the exposure of the banking sector to the public sector is likely to remain modest, largely supported by envisaged improvements in fiscal performance coupled with the ongoing restructuring of State Owned Business Enterprises (SOBEs), availing more credit to the private sector. It is essential to maintain sufficient financial buffers by the Government to smoothen out any volatilities in the yields on government securities. Meanwhile, continued purchases of foreign exchange by the Central Bank to strengthen the international reserves position is expected to further enhance foreign assets of the banking system in the period ahead, thereby enhancing buffers to withstand possible external shocks. As part of the proactive monetary policymaking under the FIT framework along with the flexible exchange rate regime, the Central Bank will continue to communicate its policies and expected macroeconomic outcomes to enhance

transparency and foster public confidence. Strengthening communication efforts will play a crucial role in managing public expectations, thereby supporting the achievement of both price stability and broader macroeconomic stability. As part of these initiatives, the Central Bank will continue the publication of its Monetary Policy Report biannually, in addition to other periodic publications and communiqués to keep all stakeholders informed.

4.2.3 External Sector Outlook

Sri Lanka's external sector is expected to continue its resilience in the near term, while the challenging global economic outlook necessitates timely actions to counter any adverse consequences.

The successful continuation of the IMF-EFF programme and the completion of the external debt restructuring process are expected to support the near-term outlook of the external sector amidst a stable domestic socioeconomic and political environment. However, there are likely near term uncertainties on the external front with expected foreign policy changes in the US. The direct and spillover effects of this on Sri Lanka's external sector is uncertain. The recent dynamics in the external current account and currently available information suggest that the current account would record a surplus in 2025 as well. However, this outlook is subject to global headwinds and domestic responses to these challenges.

In 2025, the merchandise trade deficit is projected to widen due to increased import demand, reflecting the relaxation of import restrictions alongside improved economic activity and higher spending capacity of businesses and households amidst easing monetary conditions. The immediate demand for the vehicle imports remained softer than expected, though a gradual pickup in demand cannot be ruled out. Despite global crude oil prices forecasted to remain lower

in 2025, a slightly higher petroleum import expenditure compared to 2024 is estimated for 2025 due to the increase in volumes that could result from the expected recovery in domestic economic activities and accounting for possible adverse price fluctuations due to geopolitical tensions. Similarly, expenditure on other intermediate goods and investment goods is expected to increase in 2025 in line with the anticipated recovery in economic activity. Overall, the trade deficit is expected to remain at manageable levels in the medium term, supported by a steady expansion in exports despite the persistent growth in imports. The services account surplus is anticipated to strengthen further in 2025 and over the medium term, driven by rising tourism earnings and improved competitiveness in other service exports. Sri Lanka is poised to benefit from the ongoing tourism boom, aided by global recognition for Sri Lanka's tourism and continued initiatives to maximise sectoral potential. Additionally, the services account surplus is expected to be supported by the revival of sea and air transport services and strong performance in the Information Technology and Business Process Outsourcing (IT/BPO) sector. Other services sectors, such as construction, management consulting and architectural and engineering services are also likely to play a prominent role in the medium term. Promotion and facilitation of these emerging sectors with high potential is timely to reach the full benefits for the country. The deficit in the primary income account is likely to narrow in 2025 due to reduced interest payments following the external debt restructuring. However, outflows from the primary income account are expected to increase gradually due to continued interest and dividend outflows from Direct Investment Enterprises (DIEs) that have invested in Sri Lanka. Meanwhile, workers' remittances are expected to increase steadily in 2025 and beyond, helped by the momentum in foreign employment departures and increasing

adoption of formal channels for money transfer by the migrant workers. Overall, the current account is expected to record a surplus in 2025, contingent on the magnitude of the impact of relaxed vehicle import restrictions. Nevertheless, the current account is likely to record sustainable deficits in the medium term.

Inflows to the financial account are expected to be bolstered by positive investor sentiments and proposed reforms on enhancing the business environment.

However, overall inflows to the financial account are likely to remain modest in the near term as there is likely to be some investment uncertainty with the ambiguities in the global growth and financial conditions outlook.

Despite these headwinds, foreign financing assistance from multilateral agencies is anticipated in both the near and medium term, alongside the expected resumption of bilateral funding in the upcoming period. These inflows will not only support the financial account, but also contribute to strengthening the gross official reserves in 2025 and beyond. The materialisation of concerted efforts to improve the investment climate would attract non-debt-creating foreign inflows, particularly foreign direct investments (FDIs), which remained at moderate levels in recent years. Foreign investments in the government securities market and the Colombo Stock Exchange (CSE) are expected to remain modest. Meanwhile, the Central Bank's gross official reserves are projected to improve progressively, driven by anticipated net purchases from the domestic foreign exchange market, while it continues to reduce its foreign liabilities. The Central Bank remains vigilant in building foreign reserve buffers to mitigate potential external sector risks that could arise from a possible surge in imports, upcoming debt repayment commitments, and global geopolitical developments that could exert pressure on the balance of payments (BOP) and the exchange rate in the medium term.

4.2.4 Financial Sector Outlook

The resilience of the financial sector is expected to strengthen further in 2025, driven by the positive impact of macroeconomic recovery, policy actions, and reforms. With the easing of monetary policy, the relaxation of trade-related restrictions, and improvements in the macroeconomic environment, credit growth in both the banking and Finance Companies (FCs) sectors began to recover gradually in 2024. As private sector credit rebounded following a prolonged contraction, the credit cycle transitioned into an expansionary phase. The continued favourable macroeconomic outlook and low interest rates are expected to further support the expansion of private sector credit, sustaining the expansionary phase of the credit cycle. As a result, credit in both the banking and FCs sectors is expected to continue growing. In response, the Central Bank continues to vigilantly monitor the financial system for the emergence of any systemic risks which may arise in the expansionary phase of credit cycle and will utilise its macroprudential policies to mitigate such risks as necessary. Furthermore, as private sector credit picks up, the tilt in Fls' lending exposures to the Government showed signs of correction during 2024. These sovereign credit exposures are expected to further decrease with the anticipated rise in credit demand from households and corporates. The phased adoption of the Large Exposure measure will ensure a gradual reduction in the exposures of Licensed Banks (LBs) to State-Owned Enterprises (SOEs), thereby lowering the sovereign-bank nexus. Although the restructuring of the sovereign debt encompassing the debt of SOEs was completed with minimal impacts to the banking sector, banks shall remain mindful of the sovereign-bank nexus. With the enhanced repayment capacity of the borrowers in a comparatively low-interest rate environment and steady recovery of the economic activities, the quality

of credit portfolios of LBs and FCs is expected to further improve. The restructuring of International Sovereign Bonds (ISBs) positively impacted the foreign currency liquidity levels of banks, as illiquid foreign currency sovereign instruments were exchanged for liquid sovereign instruments. However, banks must manage their foreign currency liquidity positions prudently to guard against risks associated with exchange rate fluctuations, external imbalances and foreign currency funding gaps. The profitability of the banking sector rebounded in 2024, and with favourable macrofinancial conditions in place, the profit outlook for the sector remains positive. Further, in light of recent operational risk related events reported by banks, continued investment in IT systems and cybersecurity is essential to minimise the IT related risks as the reliance on technology-based banking solutions increases.

Resolution plans are being developed for banks, while amendments to the Finance Business Act are underway to establish a resolution framework for FCs, alongside measures to strengthen the Financial Stability Fund with the Government support.

Financial and institutional capacity of the Sri Lanka Deposit Insurance Scheme (SLDIS) is being strengthened through investment project financing from the World Bank and policy-based improvements under the Financial Sector Safety Net Strengthening Project (FSSNP). Further, the Central Bank will continue to strengthen financial consumer protection by advancing complaint handling processes, market conduct supervision, and financial consumer education.

A comprehensive range of structural, legal, and policy-level reforms and innovations will continue to be implemented to safeguard the stability of the financial system. With the successful completion of Phase I of the Consolidation Master Plan, Phase II commenced in December 2024 and is set to continue in 2025, further strengthening the resilience and efficiency of the FCs sector. Significant increase in digital

transactions, alongside a gradual decline in cash and cheque usage for payments, is expected over the medium to long term, largely driven by the growing adoption of the country's Instant Payment System facilitated through online banking and mobile payment applications. The Central Bank plans to increase public awareness initiatives on digital payment methods in the period ahead and will collaborate with FIs to promote digital payment solutions and ensure their secure use while providing affordable and accessible payment services. However, the increasing risks associated with global interconnectedness, including cyber threats and online frauds pose significant challenges to the stability of the financial system. To mitigate these technology-related risks, it is essential to continuously enhance payment and information infrastructure, foster coordinated efforts among stakeholders, and strengthen customer awareness. Furthermore, to strengthen the country's payment systems and mitigate associated risks, the legal and regulatory framework would also need to be updated in parallel to the technological advancements taking place and changing customer demands. Accordingly, a new Payment and Settlement Systems Act will be enacted, further strengthening the regulatory framework applicable to payment systems and associated payment services. It is expected that these measures will ensure payment system stability while ensuring the continued growth of digital payment adoption in Sri Lanka.

Sri Lanka is preparing for its third Mutual Evaluation (ME) in 2026, demonstrating its commitment to strengthen AML/CFT framework in accordance with the global standards. Sri Lanka's performance in this regard is crucial to remain compliant and to avoid being placed on the Financial Actions Task Force (FATF) grey list, which would have significant adverse financial, economic, and reputational consequences. Further, the Central Bank envisages conducting a post-

implementation analysis to assess the overall impact of the existing financial inclusion strategies, followed by a national-level demand-side survey. Phase II of the National Financial Inclusion Strategy (NFIS) is expected to be developed as an evidence-based policy framework and is scheduled for implementation in mid-2026. The Sustainable Finance Roadmap 2.0, developed with the assistance from the International Finance Corporation, will be launched in 2025 and implemented over five years. In collaboration with key financial sector stakeholders, it will address priority environmental and social aspects of sustainable financing.

4.2.5 Fiscal Sector Outlook

The Government's commitment and perseverance towards revenue-based fiscal consolidation and maintenance of fiscal discipline are expected to continue.

The Government's fiscal operations, including the publication of an annual Fiscal Strategy Statement and a rolling five-year Medium-Term Fiscal Framework (MTFF) are mandated under the Public Financial Management Act, No. 44 of 2024 (PFMA). The current fiscal strategy is anchored around revenue-based consolidation, aligned with the quantitative targets of the IMF-EFF programme and the requirements of the PFMA. Accordingly, the MTFF 2024–2029, outlined in the Budget, Economic, and Fiscal Position Report for 2025 published by the Ministry of Finance, Planning and Economic Development, sets out the Government's fiscal targets over the medium term. The Government aims to increase revenue to 15.0% of GDP in 2025 and further enhance it in the medium term, while maintaining primary expenditure below 13.0% of GDP. Efforts will be directed towards containing the overall budget deficit below 5.0% of GDP from 2026 onwards, while striving to maintain a primary surplus of at least 2.3% of GDP from 2025 and beyond. Maintaining fiscal discipline by adhering to the fiscal rule on primary expenditure as stipulated

in the PFMA and achieving a primary surplus are paramount to bring the debt levels to a sustainable trajectory and strengthen fiscal sustainability. Accordingly, the current MTFF also focuses on gradually reducing central government debt to a sustainable level over the medium term. It is noteworthy that the series of reform adjustments under the IMF-EFF programme are yielding positive results in macroeconomic stability and ensuring long-term fiscal and debt sustainability.

Continuation of the ongoing reform agenda is critical to reach revenue targets of the Government as well as to mitigate the fiscal risks in the forthcoming period.

Sri Lanka's fiscal reform journey, initiated in mid-2022 amidst the peak of the economic crisis, has begun to yield tangible results. Over the past two years, government finances have strengthened, marked by consecutive positive primary balance positions for two years, substantial growth in tax revenue collection, and rationalised expenditure, which is a trend unprecedented in recent history. Given that the major tax reforms have already been implemented, expected future growth in revenue mobilisation needs to be achieved through the reforms in tax administration. In this regard, increasing tax compliance, particularly through enhanced Value Added Tax (VAT) adherence, is crucial. Additionally, the introduction of an online portal for simplified individual tax filing, the integration of tax collection processes through the Revenue Administration and Management Information System (RAMIS), alongside the Government's digitalisation drive, are anticipated to strengthen revenue collection. Together with the expected revenue collection from the liberalisation of vehicle imports, these measures are needed to significantly enhance tax collection to reach the ambitious target of 15% of GDP for 2025. Additionally, implementation of necessary reforms of State-Owned Enterprises (SOEs) is critical to improve their financial viability, strengthen governance

and minimise the fiscal risks posed by them. Adherence to cost reflective pricing mechanisms for utilities is paramount to avoid contingent liabilities of the Government and possible pressures on the domestic financial system through increased borrowings by the SOEs.

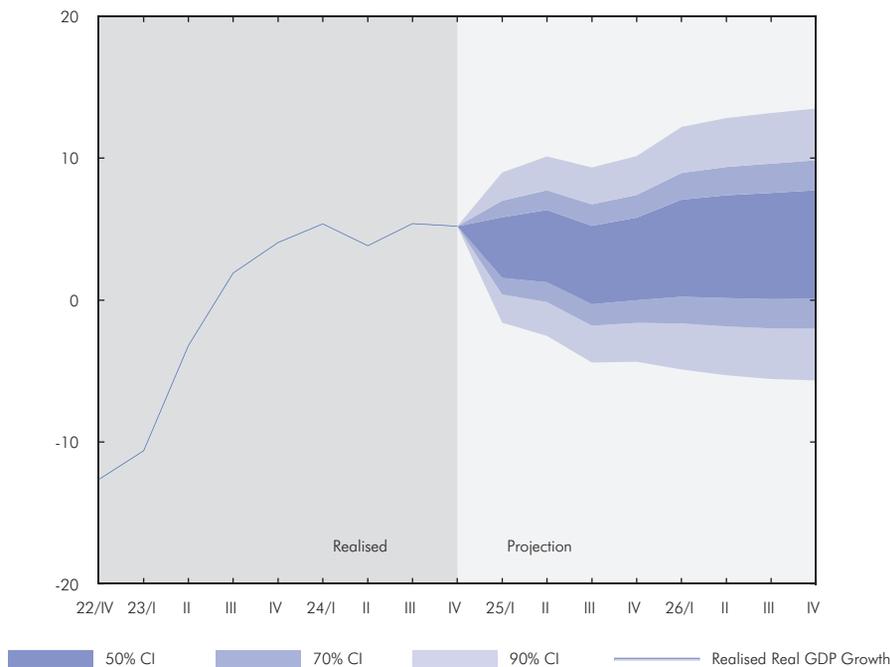
4.2.6 Growth Prospects

With the restoration of macroeconomic stability, the Sri Lankan economy, which recorded a substantial turnaround in 2024, is expected to maintain its positive growth momentum over the medium term.

Economic and political stability, low interest rate and inflation environment and positive investor sentiments are anticipated to spur growth over the medium term. The industry sector is expected to strengthen its growth momentum, especially following the removal of import restrictions, which has improved the availability of inputs. In particular, the construction sector is expected

to record a steady growth, supported by lower interest rates, improved access to raw materials and possible recommencement of donor-funded construction work and private sector and household constructions. Services sector outlook in the near to medium term is also healthy, particularly supported by the prospects in the tourism industry and the spillover effects of this recovery in other related sectors. However, the agriculture sector has faced considerable setbacks due to weather disruptions in late 2024 and early 2025, which are expected to weigh negatively on the performance of the sector. The risk of weather disruptions in the near-term, and the long-term impacts of climate change, will have to be proactively monitored as supply side shocks could create vulnerabilities in the economy’s performance on multiple fronts. Meanwhile, the expected continuation of fiscal consolidation efforts may pose contractionary effects due to expenditure

Figure 4.3: Projected Quarterly Real GDP Growth (y-o-y, %)



Note: A forecast is neither a promise nor a commitment

The projections reflect the available data, assumptions and judgements made at the forecast round in March 2025.

The fan chart illustrates the uncertainty surrounding the baseline projection path using confidence bands of gradually fading colours. The confidence intervals (CI) shown on the chart indicate the ranges of values within which real GDP growth may fluctuate over the medium term. For example, the thick blue shaded area represents the 50% confidence interval, implying that there is a 50% probability that the realised real GDP growth will be within this interval. The confidence bands show the increasing uncertainty in forecasting macroeconomic variables over a longer horizon. Given the volatile global environment and the uncertainties in the domestic economy, the baseline forecasts are exposed to various potential upside and downside risks. Any notable change in the underlying assumptions and judgements could lead to the realised growth path deviating from the projection.

Source: Central Bank Staff Projections

rationalisation. On the other hand, improved fiscal performance through fiscal consolidation and public sector reforms could release more resources for the productive private sector, boosting economic efficiency and investor sentiments, thereby limiting the contractionary effects of fiscal austerity.

To bolster economic expansion in a sustainable and inclusive manner amidst the challenging global environment, long-overdue reforms should be implemented with vigour in the period ahead.

External headwinds persist, particularly due to protectionist policies and geoeconomic fragmentation. This reiterates the importance of efforts to improve the country's external resilience through measures that can improve Sri Lanka's export performance, such as export diversification, strengthening Sri Lanka's network of FTAs and regional integration. Recent emigration of workers, especially from the young and skilled cohort, poses some challenge to the economy's human capital base at a time of population aging. In addition, under-utilisation of labour resources, as reflected in the substantially low female labour force participation rate and higher unemployment rate among educated youth, hinders the economy from reaching its true potential. Addressing these issues will require appropriate near- and medium-term policy measures, particularly in light of Sri Lanka's rapidly aging population. Strengthening of safety nets has to be prioritised in the near-term, considering that a sizable segment of the population continues to live on the brink of poverty, limiting their ability to fully contribute to the growth momentum of the economy. The envisaged streamlining and modernisation of the existing labour laws into a unified employment law on par with international standards would enhance the labour productivity and contribute to the overall economic efficiency. Further, the anticipated land reforms, new national policy for industry

development and medium-term strategic plan to boost the country's manufacturing and external sector performance, together with energetic plans of the Government in building a digital economy would synergise a paradigm shift of the Sri Lankan economy. In addition, investing in education, skill development, and research is paramount to unlock the potential of human resources, while fostering innovation is needed to enhance productivity across sectors through technological advancements. Moreover, addressing the issues in public sector efficiency is critical to ensure better resource allocation and service delivery. Furthermore, creating a favourable investment climate through institutional reforms is crucial for attracting foreign direct investment to accelerate growth. These measures should concentrate on broadening the economic inclusiveness and empowerment of the underprivileged segments to graduate into a higher income status, thus enabling them to escape the vicious cycle of poverty. Furthermore, policy consistency and certainty are critical to sustaining economic growth and building investor confidence. The timely addressing of systemic weaknesses in governance, corruption and law enforcement is also macro-critical to ensure the economy progresses on an inclusive and sustainable growth trajectory.

4.3 Concluding Remarks

Sri Lanka's economic prosperity in the period ahead will largely hinge on the preservation of hard-earned macroeconomic stability and the implementation of appropriate growth-oriented reforms. Misaligned policies and repeated policy reversals have back-pedalled the Sri Lankan economy by many years, on numerous occasions. The economic downturn, the hardships that the citizens have undergone during the recent crisis, and the accumulated economic vulnerabilities offer no room for further policy errors. The current reform

efforts provide the necessary framework for fiscal and debt sustainability and to correct the long-standing structural barriers for sustained economic stability and growth. In this context, unwavering commitment towards adhering to the ongoing macroeconomic adjustment and growth enhancing structural reform programme will be imperative to ensure long term gains for all the stakeholders of the economy. Heightened external headwinds, particularly due to protectionist policies and geoeconomic fragmentation globally, could amplify Sri Lanka's external sector vulnerability. This reiterates the importance of improving the performance and resilience of the external sector through diversification of merchandise and service exports, and strengthening the country's global and regional integration. This would ensure enhanced foreign exchange earning capacity, facilitating a further building of external buffers. Meanwhile, the sustainability of the post-crisis revival depends on the country's ability to embrace foreign investments to productive and foreign exchange generating

sectors. Assuring a fair and secure business environment for foreign as well as domestic investors, that is free from corruption vulnerabilities, and an efficient legal system require urgent reforms on enhancing business ready environment. Policies that target structural economic transformation, particularly through technology adoption, digital inclusiveness and skill enhancement, are critical to expand the growth potential of the economy. Since the Government has to manoeuvre within a narrow fiscal space to ensure long term fiscal sustainability, the ability to boost the economic growth through fiscal expansion is limited in the near to medium term. Therefore, catalysing the economic expansion by fostering the private sector participation through consistent policies and the necessary legal, regulatory, and institutional support is essential. Hence, the implementation and continuation of these envisaged structural reforms will be of utmost importance to sustain domestic economic stability, and pave way for the country's progress towards inclusive and sustainable economic growth.

