

Chapter 4

MACROECONOMIC OUTLOOK



Summary

Sri Lanka's macroeconomic outlook is shaped by improved domestic economic resilience amid an increasingly uncertain global environment. Global economic prospects, already characterised by increased trade tensions, protectionist tendencies, and climate-related risks, have become more uncertain following the escalation of geopolitical tensions in the Middle East. These developments are expected to weigh on growth and exert upward pressure on inflation across countries around the world, driven by higher energy and shipping costs, supply chain disruptions, and increased volatility in financial markets. Accordingly, risks to the global disinflation process have heightened, warranting continued caution in the conduct of monetary policy. However, considerable uncertainty remains regarding the magnitude and duration of these effects, with the trajectory of the Middle East war remaining a key determinant. Despite these risks, Sri Lanka's outlook is supported by the restoration of macroeconomic stability and the continued buildup of buffers across sectors in recent years. Inflation remains low at present, although it is expected to increase towards the 5% target faster than previously anticipated, mainly due to higher energy and transport costs and their spillover impacts linked to global developments. Nevertheless, conditional on currently available information, inflation is projected to stabilise around the target thereafter, supported by appropriate policy measures. Under the Flexible Inflation Targeting (FIT) framework, monetary policy will remain data-driven and forward-looking. Credit to the private sector is expected to expand in 2026, albeit at a slower pace compared to recent months, supported by accommodative monetary conditions and reconstruction activity following *Cyclone Ditrwah*, although heightened uncertainty and rising costs may weigh on investment. The external sector is likely to face downside risks from geopolitical developments, with potential implications for tourism, trade, remittances, and investor sentiment. However, the sector has strengthened significantly in recent years, supported by sustained current account surpluses and reserve accumulation, thereby enhancing resilience. The ongoing International Monetary Fund's Extended Fund Facility (IMF-EFF) programme and the completion of external debt restructuring are expected to support foreign exchange inflows, while the flexible exchange rate will continue to serve as a shock absorber. The financial sector remains stable, supported by adequate capital and liquidity buffers and improving asset quality, although close monitoring is warranted given global uncertainties and rapid credit expansion. Fiscal policy remains anchored in revenue-based

consolidation in line with the IMF-EFF programme and the Public Financial Management Act, No. 44 of 2024, despite additional expenditure pressures, with continued reforms expected to support medium-term fiscal sustainability. Overall, the restoration of macroeconomic stability, the continued buildup of buffers, and ongoing structural reforms have created conditions conducive to sustained growth. However, external shocks, geopolitical tensions, and climate-related risks pose downside risks. In this backdrop, maintaining policy discipline, preserving buffers across economic sectors and building climate and disaster resilience remain critical for strengthening the economy's capacity to withstand shocks. While these would also facilitate sustained recovery, improving the growth potential necessitates advancing structural reforms to boost productivity, competitiveness, and export diversification, and continuing to invest in infrastructure.

4.1 Global Economic Environment and Outlook

4 Recent resilience in the global economy amid trade policy shifts and rising geoeconomic fragmentation is being challenged by the intensification of the current Middle East war that began in late February 2026. According to the World Economic Outlook (WEO) update of the International Monetary Fund (IMF) released in January 2026, prior to the current Middle East war, global growth was projected to reach 3.3% in 2026 and 3.2% in 2027, marking a modest deceleration from the estimated 3.3% outturn in 2025. The IMF attributed this steady performance to the balancing of divergent forces, with headwinds from shifting trade policies and lingering uncertainty that were partly offset by strong investment in technology-related sectors, including Artificial Intelligence (AI), alongside policy stimuli and accommodative financial conditions. Growth in advanced economies was projected to remain moderate over the near term, with the continued expansion in the United States (US) supported by fiscal policy, easing financial conditions, and investment incentives. Growth in the Euro area was anticipated to remain relatively subdued but stable, aided by increased public spending in some economies. Meanwhile, emerging markets and developing economies were expected to continue to

drive global growth, bolstered by resilient domestic demand and policy stimulus in major economies such as China and India, although the growth momentum was projected to moderate gradually by 2027. However, amid the escalation of the Middle East war, the global political and economic landscape has shifted notably since the release of the January 2026 WEO update, suggesting that these projections may be subject to significant revisions in the period ahead, depending on the prolongation of the war.

Renewed geopolitical tensions following the onset of the current Middle East war could significantly affect global economic prospects, depending on the war's severity and duration, while heightening global uncertainty across multiple dimensions.

In particular, the growth prospects of most economies could be negatively affected by adverse spillovers, ranging from elevated energy and commodity prices, disruptions to global trade and shipping routes, tightening global financial conditions and elevated risk premia, as well as weakened investor and consumer confidence and heightened policy uncertainty. The escalation has led to immediate disruptions to major shipping routes, critical supply chains, global oil and commodity markets and air travel, thereby affecting international trade and global economic activity. Oil prices and shipping costs have risen

markedly, while financial markets have shown increased volatility in response to the shock. Although it is still too early to assess the global economic impact of the current Middle East war, the Middle East's strategic role in global energy trade and aviation emphasises the potential magnitude of the shock. The region serves as a major global aviation hub, hosting some of the world's busiest airports and key air corridors linking Europe and Asia, with airspace closures already forcing widespread flight cancellations and costly rerouting. At the same time, the Strait of Hormuz, through which nearly one-fifth of global oil shipments pass, remains the most critical chokepoint in global energy trade, heightening concerns over supply disruptions and price volatility. Even without a formal blockade of the Strait of Hormuz, rising shipping insurance premiums, vessel rerouting, and longer transit times have increased freight and logistics costs, adding further pressure on global supply chains. In this context, persistently elevated energy and transportation costs could weigh on global trade volumes, inflation and economic activity, with the adverse effects likely to be more pronounced for energy-import-dependent economies with limited policy buffers if tensions persist.

As geopolitical tensions in the Middle East escalate, the global disinflation trend could be halted, potentially causing renewed inflationary pressures. Although the IMF's January 2026 projections anticipated global inflation continuing to decline, with headline inflation expected to fall to 3.8% in 2026 and 3.4% in 2027, reflecting softening demand and lower energy prices, the recent escalation in geopolitical tensions could alter this trajectory by pushing energy prices higher. While the IMF's January 2026 projections anticipated average oil prices of around USD 62 per barrel in 2026 and 2027, recent developments have led to a sharp surge and volatility in oil prices, with Brent crude oil prices exceeding

USD 100 per barrel at times. Such increases in energy prices could exert upward pressure on global inflation, particularly in the near term. In addition, higher shipping, insurance, and transportation costs, together with potential supply shortages arising from disrupted supply chains, could contribute to rising imported inflation across many economies. Any damage to key energy or transport infrastructure could further constrain supply and intensify upward pressure on global commodity prices, while also delaying normalisation even after the cessation of hostilities. In this context, central banks may need to remain cautious and calibrate monetary policy carefully to safeguard price stability amid evolving global conditions. Economies facing supply-driven inflation shocks could face complex policy trade-offs, particularly in balancing the risks of slower growth with the possibility of persistent inflation that could de-anchor medium-term inflation expectations.

Against this backdrop, the global monetary policy stance in 2026 is likely to be more cautious than in 2025, particularly if uncertainty surrounding geopolitical developments persists. Commencing from the second half of 2024, central banks of both advanced economies and emerging market economies broadly aligned towards a more accommodative monetary policy stance, supported by the steady decline in global inflation, though some divergence of policy easing was observed, given country-specific macroeconomic conditions. During the first half of 2025, emerging market economies opted for more aggressive easing amid faster disinflation and expected growth concerns from tariff-related uncertainties. However, advanced economies showed a more gradual transition towards cautious easing, with inflationary pressures moderating, yet remaining elevated and above target in most major economies. The policy trajectories of major central banks in advanced economies, including the US

4 Federal Reserve, the European Central Bank, and the Bank of England, were characterised by measured policy rate reductions in 2025, resulting in tighter-than-expected financial conditions globally. Nevertheless, the pace of normalisation in the global monetary policy stance moderated in the latter part of 2025, with most central banks shifting towards a more cautious policy approach amid intensifying global headwinds. These included heightened policy uncertainty, escalating trade tensions stemming from US tariff policy, and persistent geopolitical risks. In 2026, a majority of the central banks have shifted towards a more cautious calibration of monetary policy, amid heightened uncertainty surrounding the scale and persistence of the war in the Middle East. Looking ahead, geopolitical fragmentation, trade policy uncertainty, potential supply chain disruptions arising from extreme weather events, and heightened exchange rate volatility are likely to play a critical role in shaping the global monetary policy stance. At the same time, if one were to look beyond prevailing uncertainties, the pace and scale of AI adoption could be a key driver of medium-term growth prospects across economies, while it could also affect monetary policy calibration by influencing productivity, investment, and the level of real neutral interest rates.

The escalation in geopolitical tensions in the Middle East could have significant implications for the Sri Lankan economy through several channels, particularly if the war persists for a prolonged period.

Sri Lanka's substantial reliance on Gulf-sourced energy exposes the economy to potential increases in global oil and gas prices, which could raise the fuel import bill, widen the trade deficit, and thereby exert upward pressure on inflation. Further, the war could drive up fertiliser import prices and disrupt fertiliser supply, adversely affecting Sri Lanka's agricultural sector. Remittance inflows, a critical

source of foreign exchange for the Sri Lankan economy, may also be affected, given that around 45% of remittances originate from Gulf countries. Hence, any disruption to labour markets or labour migration due to the possible prolongation of the war could reduce remittance inflows and heighten exchange rate volatility. At the same time, there remains the potential for positive spillovers should hostilities subside in the near term and an infrastructure-led reconstruction drive materialise, although this outcome is highly contingent on the future trajectory of the war. Trade linkages with the Middle East, which account for a notable share of Sri Lanka's exports, including tea, could be directly affected through changes in regional demand conditions. Moreover, a broader slowdown in global economic activity amid heightened geopolitical uncertainty could dampen external demand, posing additional downside risks to Sri Lanka's export performance across markets. In addition, broader disruptions to global shipping routes and higher freight and insurance costs could also weigh on overall export performance, irrespective of destination markets. In the tourism sector, although arrivals directly from the Middle East represent a modest share, Middle Eastern airlines account for more than 30% of total tourist arrivals to Sri Lanka through Middle East connections. Therefore, regional airspace constraints and risk perceptions could disrupt transit flows, affecting total tourist arrivals. Heightened global uncertainty could also adversely affect financial flows, including foreign direct investment and portfolio inflows, thereby exerting additional pressure on the balance of payments. Collectively, these developments could place upward pressure on the exchange rate as well as domestic prices, although weaker domestic demand may partially offset inflationary pressures. Hence, a protracted escalation of these geopolitical tensions could

pose significant risks to Sri Lanka's external balances, inflation trajectory, and overall macroeconomic stability. Moreover, these spillovers could have a potential impact on the financial system as well, particularly through credit and liquidity channels, if the effects of the Middle East war persist.

4.2 Domestic Economic Outlook

4.2.1 Inflation Outlook¹

Headline inflation is expected to accelerate toward the target of 5% in the near term at a faster pace than previously anticipated, driven mainly by energy price adjustments amid spillovers from the ongoing Middle East war, while remaining broadly within the ± 2 pps margin around the target. Inflation is expected to be stabilised around the target over the medium term, supported by appropriate policy measures. Since returning to positive levels in August 2025, headline inflation has remained on a gradually accelerating trend, supported by the dissipation of deflationary pressures in the energy and transport category, alongside moderate food inflation and the gradual normalisation of demand conditions. As per projections made prior to the escalation of the Middle East war, inflation was expected to continue its gradual acceleration and move towards the target of 5% by the second half of 2026. However, the substantial external shock to the economy from the impact of the Middle East war has necessitated considerable revisions in macroeconomic projections. In particular, energy and transport inflation is expected to accelerate at a faster pace in the near term, driven by recent price adjustments and elevated global energy prices amid the current Middle East war and

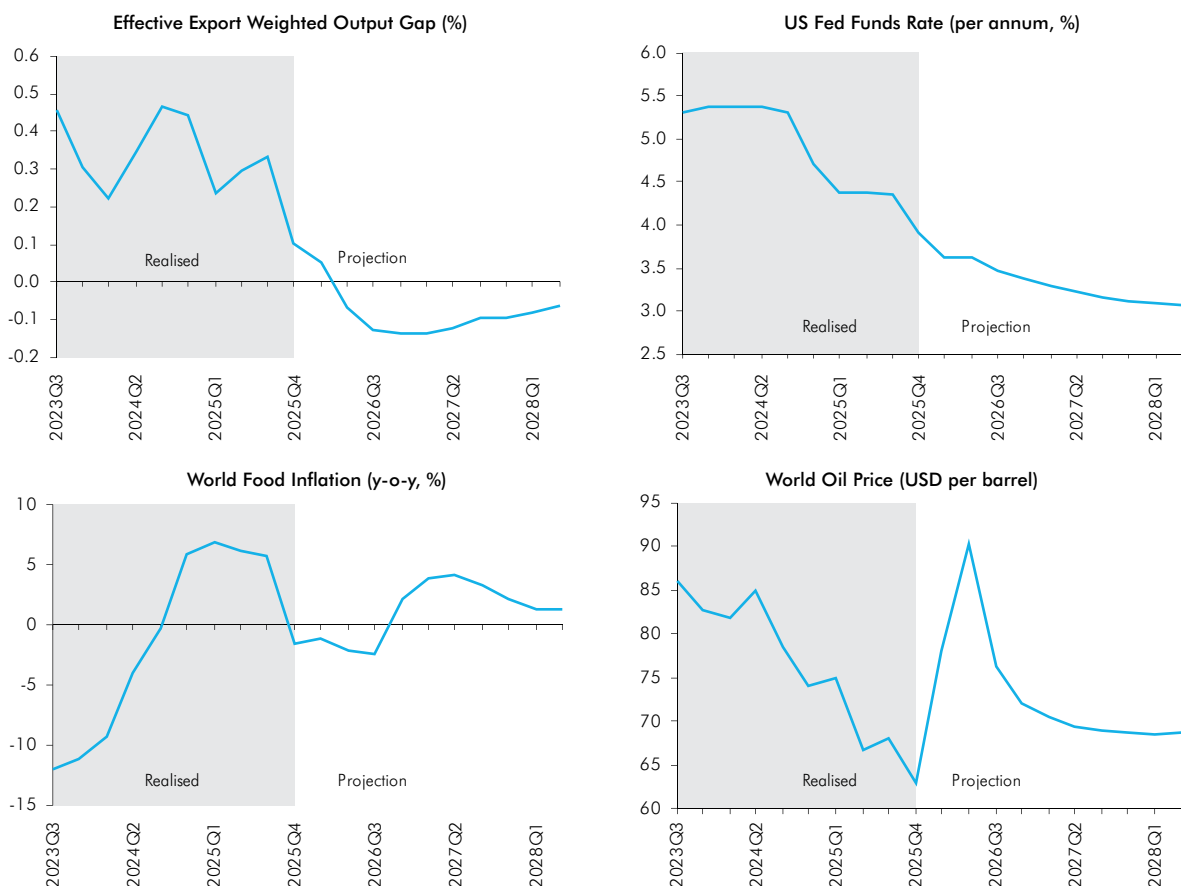
related spillover effects. Contributed by these dynamics, headline inflation is also expected to accelerate. However, as per currently available information, inflation is projected to remain within the ± 2 pps margin of the target in the period ahead. The current assumption internalised in the projections, based on available information, is that the effects of the Middle East war would be transitory and that economic activity would gradually return to normal afterwards, although there is severe uncertainty regarding the duration and magnitude of these effects. Reflecting this assessment, inflation is expected to record some corrective downward adjustment during 2027. Over the medium term, inflation is expected to stabilise around the 5% target, supported by appropriate policy measures. Meanwhile, core inflation is expected to gradually move towards the headline inflation target, contributed by spillover effects from energy and transport prices, improving demand conditions, and imported inflation dynamics. However, the pace of normalisation in core inflation is expected to be somewhat slower due to relatively subdued economic activity, partly reflecting the spillover effects of the Middle East war on the domestic economy.

Uncertainty surrounding the inflation outlook remains considerably higher than in normal times, particularly in the context of the ongoing Middle East war and its potential spillovers to global energy markets, trade flows, and domestic price dynamics. These projections are conditional on the assumed path of global energy and food prices; the expected growth path of Sri Lanka's major trading partners; the anticipated fiscal path of the Government; expected developments in the external sector, including the external current account balance; and global financial conditions implied by the Fed Funds rate. Further, the projections are conditional on the model-consistent interest

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¹ The projections discussed here are based on information available as of the conclusion of the monetary policy round in March 2026. Amid the fluid nature of the prevailing Middle East war and its wide-ranging spillovers across both global and domestic economic activity, the present macroeconomic outlook remains subject to elevated uncertainty. Accordingly, any significant changes from underlying conditions could lead to notable deviations from these projections.

Figure 4.1
Global Projections (Quarterly)



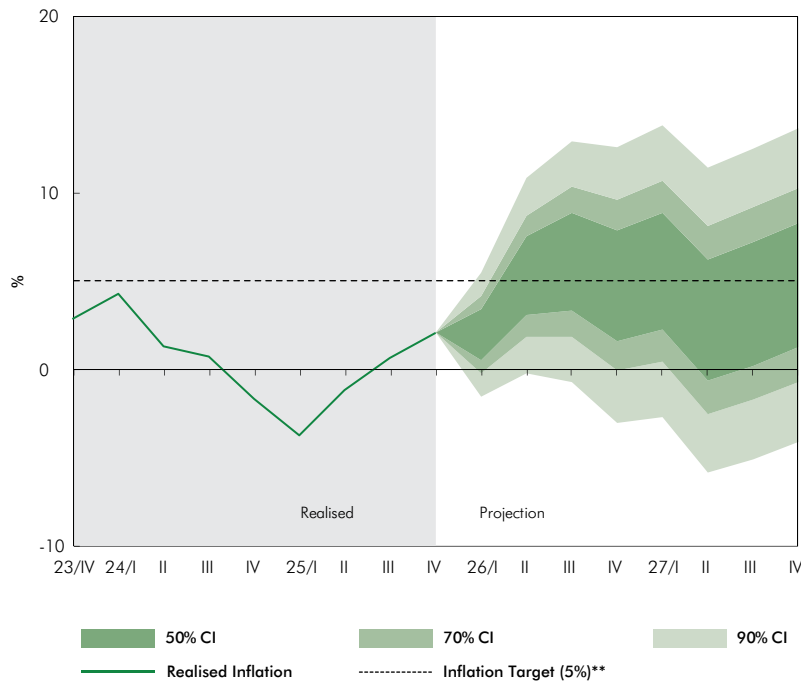
Note: The charts are based on the latest projections released on 25 March 2026. As the March 2026 monetary policy round was completed prior to the release of these projections, a preliminary version of the GPMN projections received on 16 March 2026 has been used in the projections of the March 2026 monetary policy round, from which the fan charts presented in this chapter are based on.

Sources: Global Projection Model Network (GPMN, 25 March 2026 Release), Quarterly Projection Model (QPM)

rate path and the resulting macroeconomic responses. These projections are based on information available as of the monetary policy round in March 2026 and are subject to change in the event of significant shifts in underlying global and domestic conditions. There are upside risks to the realisation of inflation projections stemming from factors such as intensified geopolitical tensions, which could disrupt global commodity markets, energy supplies, and shipping routes, potentially leading to higher-than-anticipated increases in domestic energy and transport costs, and fertiliser prices; possible depreciation of the Sri Lanka rupee at higher levels; higher-than-anticipated demand pressures fuelled by the lagged

impact of strong credit growth; and possible repeated adverse weather events affecting the agriculture and energy sectors, thereby exerting upward pressure on food and energy inflation. Meanwhile, downside risks to the realisation of inflation projections include the possibility of demand conditions remaining weaker than expected, leading to a more gradual recovery in core inflation, and any possibility of improved agricultural production helping to ease pressures on food prices. The Central Bank of Sri Lanka will continue to closely monitor evolving developments and communicate any deviations from the projected path in a timely manner, consistent with its data-driven monetary policy framework under Flexible Inflation Targeting (FIT).

Figure 4.2
Baseline Quarterly Headline Inflation Forecast* (CCPI, y-o-y)



* Realised data in the fan chart are based on the CCPI (2021 = 100, seasonally adjusted).
 ** The inflation target (5%) was agreed under the Monetary Policy Framework Agreement (MPFA) signed between the Central Bank and the Minister of Finance in October 2023.

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 2026. Amid the fluid nature of the prevailing Middle East war and its wide-ranging spillovers across both global and domestic economic activity, the present inflation outlook remains subject to elevated uncertainty. Accordingly, any significant changes from underlying conditions could lead to notable deviations from these projections.

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.

Source: Central Bank Staff Projections

4.2.2 Monetary Sector Outlook

The monetary policy decision-making process will remain data-driven and forward-looking, with close consideration of evolving domestic macroeconomic conditions and potential spillovers from global policy shocks and uncertainties.

Amid the anticipated acceleration of inflation towards the target at a pace faster than previously projected, the Central Bank will closely monitor potential inflationary pressures and stand ready to take necessary measures to address any demand-side risks, to achieve the inflation target over the medium term. The interest rate path is expected to remain aligned with the monetary policy stance of the Central Bank, which will be proactively calibrated to

ensure domestic price stability. Further, yields on government securities are likely to remain broadly normalised, supported by improved fiscal performance and reduced risk premia following sovereign rating upgrades, although transitory volatility is likely amid possible macroeconomic uncertainties.

With improved economic activity, firming demand conditions, and reconstruction and restoration efforts following Cyclone Ditwah, the growth momentum of credit to the private sector is likely to continue, although spillovers from the Middle East war could weigh on this outlook. Some slowdown in credit demand is possible, as recent adverse geopolitical events are likely to reduce global demand for domestic goods



and services, along with other possible negative developments in the domestic economy stemming from the Middle East war. Accordingly, overall credit growth is expected to be relatively moderate in 2026, with a likely slowdown towards the latter part of the year. Credit to the public sector by the banking system is expected to moderate, supported by the continuation of fiscal consolidation, accompanied by major structural reforms, including the restructuring of State-Owned Business Enterprises (SOBEs). Meanwhile, in the absence of direct Central Bank financing to the Government, the Government is likely to rely more on alternative domestic financing options amid limited access to external financing, necessitating the maintenance of adequate financial buffers to withstand both global and domestic shocks and thereby ensuring the smooth functioning of government operations. Further expansion in Net Foreign Assets (NFA) of the banking system is expected in the period ahead, supported by the expected increase in foreign exchange inflows, and the Central Bank's foreign exchange purchases to enhance its official reserves. Accordingly, monetary expansion is expected to persist in the period ahead, albeit at a slower pace. The Central Bank remains ready to adjust its monetary policy stance in a data-driven and forward-looking manner. Within the conduct of monetary policy, effective monetary policy communication will remain vital for managing public expectations of inflation and supporting the achievement of low and stable inflation, thereby ensuring price stability. In this regard, the Central Bank will not only continue to communicate its policy decisions promptly to the public through various channels, but will also assess the effectiveness and the public understanding of its messages. This would enhance transparency and accountability in monetary policy actions and reinforce public confidence.

4.2.3 External Sector Outlook

The external sector performance, which improved notably from 2023 onwards, is facing a delicate situation amid downside risks from the Middle East war, particularly in relation to tourism, trade, and remittances. Sri Lanka has built external sector buffers to a certain extent over the last few years through current account surpluses and reserve accumulation, enhancing the economy's capacity to withstand external shocks. Moreover, the country is expecting to leverage on the market-driven flexible exchange rate to serve as a shock absorber against external shocks in an increasingly volatile global environment. Continuation of the International Monetary Fund's Extended Fund Facility (IMF-EFF) programme, along with the completion of the external debt restructuring process, is expected to support the near to medium-term outlook of Sri Lanka's external sector.

The merchandise trade deficit is expected to widen in 2026, mainly driven by higher import expenditure, which is projected to outpace growth in export earnings.

Sri Lanka's fuel import expenditure in the near term could increase due to the elevated petroleum oil and other energy prices with the escalation of the Middle East war, despite a possible slowdown in domestic demand, which could partly moderate demand for petroleum products and other imports. In addition to fuel imports, expenditure on other intermediate and investment goods is also expected to increase, mainly driven by the Government's public investment drive and broader economic recovery. Although the demand for vehicle imports remains elevated, it is expected to gradually moderate in the near term, as the domestic market is expected to approach saturation levels. Meanwhile, export earnings are projected to grow moderately over the

medium term, although the ongoing Middle East war may pose heightened challenges in the near term. In particular, tea exports could be adversely affected in the near term due to the Middle East war, given that the Middle East region is a major export destination for Sri Lankan tea. Meanwhile, apparel exports may also face pressure due to increased shipping costs arising from disruptions to sea routes passing through the conflict-affected area. However, the overall trade deficit is expected to remain at sustainable levels in the near- to medium-term.

The services account of the Balance of Payments (BOP) is expected to grow over the medium term. Earnings from tourism are expected to grow gradually over the medium term, despite the possible short-term effect due to the Middle East war. Meanwhile, a strong momentum in the Information Technology and Business Process Outsourcing (IT/BPO) sector is expected in the medium term. Other emerging service industries, such as construction, management consulting, and architectural and engineering services, are expected to support the earnings to the services account, highlighting the importance of timely promotion and facilitation of these high-potential sectors to secure long-term benefits.

Sri Lanka's primary income account deficit is projected to narrow in 2026, largely reflecting reduced interest payments following the external debt restructuring. However, over the medium term, an expansion in the primary income account deficit may materialise due to continued interest obligations and dividend repatriations by Direct Investment Enterprises (DIEs). In the secondary income account, workers' remittances, which recorded notable growth rates in recent years, are expected to maintain at least moderate growth in the near to medium term. However, a prolonged war could adversely affect workers'

remittances in 2026, as Middle Eastern countries account for a considerable share of total inflows.

Overall, with the above developments, following three consecutive years of current account surpluses, Sri Lanka's current account is expected to remain at sustainable levels going forward. However, the outlook remains subject to the duration of the Middle East war and its impact on Sri Lanka's balance of payments, as well as other global headwinds, including evolving global trade dynamics.

Meanwhile, the financial account is expected to record continued inflows in 2026 and over the medium term, supported by positive investor sentiment arising from the continuation of the IMF-EFF programme. Multilateral financing from the IMF, the Asian Development Bank (ADB), and the World Bank, together with the resumption of bilateral funding, is expected to support inflows to the financial account in 2026 and beyond. Non-debt creating inflows, in the form of foreign direct investment (FDI), which have remained moderate in past years, are expected to pick up gradually over the medium term. Reforms aimed at improving the investment climate and addressing longstanding business environment challenges are expected to enhance investor appetite to attract FDIs to Sri Lanka. Nevertheless, continuous commitment to improving the investment climate is essential to continue attracting healthy flows of FDI. Further, greater foreign investments are expected in the government securities market and the Colombo Stock Exchange (CSE) over the medium term. Any prolongation of the Middle East war, which could lead to tighter global financial conditions, could negatively affect such portfolio flows in the near term, as investors may adopt risk-averse strategies.

Gross official reserves, which increased notably in 2025 and thus far in 2026, are expected to remain at healthy levels, supported by absorptions of foreign exchange from the domestic forex market and other financing flows to reserves. Meanwhile, the Central Bank remains committed to maintaining a flexible, market-determined exchange rate under the FIT framework, while building reserves and ironing out excessive short-term volatilities in the exchange rate through forex interventions. Although these factors are expected to support external sector resilience over the medium term, the external sector outlook will remain contingent on evolving global challenges, which may necessitate timely and well-targeted policy interventions to mitigate possible adverse effects.

4.2.4 Financial Sector Outlook

The financial sector remains stable, supported by robust credit growth and improved asset quality, along with strong capital buffers, even amid rising global uncertainties linked to geopolitical tensions that pose potential risks. Amid eased monetary policy, relaxation of motor vehicle import restrictions, and improved macroeconomic conditions in 2025, credit granted by the banking sector and the Finance Companies (FCs) sector expanded rapidly. With the expansion of credit to the private sector, the credit cycle moved further into the expansionary phase, contributing to a widening of the credit-to-GDP gap. Therefore, the Central Bank closely monitors and remains vigilant to detect early signs of potential imbalances and excessive buildup of risks to financial stability. The asset quality of both the banking sector and the FCs sector improved during 2025 compared to the previous year, contributing to stronger balance sheets and reduced credit losses of financial institutions. However, credit quality in these sectors is

subject to heightened downside risks, given potential delays in recoveries and increased impairment requirements following the impact of *Cyclone Ditwah*, as well as possible pressures on the repayment capacity of households and corporates arising from spillovers of ongoing geopolitical tensions. In terms of liquidity, the banking sector remained well above minimum regulatory requirements by the end of 2025. However, banks need to be vigilant about foreign currency liquidity management, given the relaxation of vehicle import restrictions and potential adverse spillover effects from the war in the Middle East. Moreover, the FCs sector also recorded liquidity levels well above the minimum regulatory requirements. However, continued monitoring is warranted to ensure that liquidity positions remain resilient amid evolving funding conditions and potential pressures arising from increased credit expansion. Although the capital adequacy ratios of the banking sector have improved through retained profits and the issuance of Basel III-eligible Tier II instruments, maintaining these ratios may be challenging amid rapid credit expansion, potential deterioration in asset quality, and the materialisation of other risks and losses.

Financial sector reforms, digitalisation initiatives, and strengthened regulatory frameworks are expected to enhance resilience, inclusion, and stability of the financial system in 2026. Phase II of the Masterplan for Consolidation of FCs will continue to be implemented in 2026, further strengthening the resilience of the FCs sector. Further, digital payments adoption is expected to sustain its growth momentum, driven by strong demand from consumers, businesses, and government institutions, along with conducive policy changes encouraging broader participation, FinTech innovations and the Government's digitalisation agenda. However, several socio-economic factors

have the potential to challenge this growth momentum, including lower financial literacy on digital payment channels and communication infrastructure issues, such as limited internet access in certain rural areas. The Central Bank will continue to address these challenges by conducting awareness programmes in collaboration with relevant stakeholders. Moreover, with the increased reliance on digital platforms, to ensure resilience of the financial system against technology-related risks, all financial institutions must implement robust internal controls, enhance customer awareness to minimise the risk of cyber incidents, comply with regulatory frameworks and standards, adopt international best practices, and continuously strengthen fraud monitoring and prevention mechanisms across their systems. The Central Bank has taken several measures to strengthen the Anti-Money Laundering/ Countering the Financing of Terrorism/ Countering Proliferation Financing (AML/CFT/CPF) framework of the country by strengthening the laws and regulations related to the AML/CFT/CPF framework, improving risk assessments and supervisory approaches. These policy measures will further strengthen the resilience and integrity of the financial system. Further, the Central Bank is actively preparing for the upcoming mutual evaluation in 2026, a process that is strengthening interagency coordination and alignment with international standards. Moreover, Phase II of the National Financial Inclusion Strategy (NFIS) is expected to be developed in the second half of 2026, contributing to further strengthening financial system stability by broadening access to formal financial services.

4.2.5 Fiscal Sector Outlook

The Government's commitment to prudent fiscal management and the revenue-based fiscal consolidation programme is expected to continue. The Government

presented the Budget for 2026 with a fiscal strategy firmly anchored on revenue-based fiscal consolidation, aligned with the Quantitative Performance Criteria (QPC) of the IMF-EFF programme as well as the fiscal rule and requirements stipulated under the Public Financial Management Act, No. 44 of 2024 (PFMA). However, the unprecedented impact of *Cyclone Ditrwah* at the end of 2025 caused significant disruptions to livelihoods and infrastructure, necessitating additional fiscal support for economic recovery and reconstruction efforts. In response, the Government presented a Supplementary Estimate to Parliament to allocate an additional Rs. 500 bn, in excess of the approved 2026 budget estimate, from existing cash reserves to restore affected communities and rebuild the damaged infrastructure. As a result, the Medium Term Fiscal Framework (MTFF) 2025–2030, outlined in the Budget, Economic and Fiscal Position Report for 2026, was revised for 2026 to accommodate the additional expenditure requirements arising from the disaster. Moreover, spillovers from the Middle East war could pose additional pressures on fiscal outcomes.

Medium term fiscal targets are expected to be supported by sustained revenue mobilisation efforts and continued fiscal reforms. As outlined in the MTFF, building on the progress achieved thus far, the Government aims to sustain these gains over the medium term, with government revenue projected to remain above 15% of Gross Domestic Product (GDP), while maintaining the overall budget deficit below 5% of GDP and achieving a primary surplus of around 2.6% of GDP from 2027 onwards. Continued commitment to the implementation of fiscal reforms remains essential to achieving these medium term fiscal targets. In this regard, the proposed amendments to the Inland Revenue Act, No. 24 of 2017, scheduled for 2026, are expected to further strengthen revenue

mobilisation. These amendments include revisions to capital gains tax, withholding taxes, and other key tax measures aimed at broadening the tax base and enhancing the effectiveness of the tax system. Meanwhile, several major tax policy measures, including the reduction in the Value Added Tax (VAT) and the Social Security Contribution Levy (SSCL) registration thresholds, introduced under the Budget for 2026, are also expected to support revenue mobilisation over the medium term. However, following the surge in vehicle-related tax revenue in 2025, driven by pent-up demand after the removal of vehicle import restrictions, the anticipated gradual normalisation of vehicle imports is expected to moderate vehicle-related tax revenue in the period ahead. Therefore, given the significant contribution of vehicle import-related taxes to the strong tax revenue performance in 2025, the Government may need to carefully calibrate policy measures to address the potential revenue shortfall arising from a slowdown in vehicle imports.

Furthermore, revenue generation is expected to be strengthened through institutional reforms and improvements in public sector efficiency, with a greater emphasis on digitalisation and technological integration across government institutions. Key initiatives include expanding digital access across government institutions, establishing a Trade National Single Window System for trade facilitation based on digital technology, developing a centralised digital system for land information management, and promoting investments in emerging technologies such as AI, cloud computing, and data centres. These measures will strengthen tax administration by improving data integration across agencies, enhancing transparency and traceability of transactions, and reducing leakages and compliance gaps. Accordingly, the

digitalisation of revenue collection agencies and the broader digital economy is expected to play a pivotal role in enhancing revenue performance.

Additionally, the continued implementation of structural reforms in State Owned Enterprises (SOEs) remains important to strengthen their financial position, improve governance and reduce the fiscal risks associated with them.

The implementation of cost-reflective pricing mechanisms has helped alleviate longstanding financial pressures faced by several SOEs, limiting the risk of the burden of SOE losses on the government budget. Meanwhile, the Government has decided to address SriLankan Airlines' (SLA) legacy debt burden, which has been a major constraint on its financial performance. Accordingly, the Government has successfully restructured the outstanding government-guaranteed debt of SLA. The continuation of such policies, together with ongoing SOE reform initiatives, is expected to further reduce the fiscal burden posed by these entities in the period ahead.

Nevertheless, the fiscal outlook remains subject to several downside risks stemming from the evolving global and domestic environment. In particular, the Middle East war could create fiscal pressures on both the government revenue and expenditure fronts. A prolonged escalation of the Middle East war could dampen global and domestic economic activity, slowing trade, tourism, and investment flows, thereby adversely affecting revenue collection. At the same time, a sharp increase in energy prices could necessitate policy interventions to cushion the impact on vulnerable segments of the economy, potentially requiring the Government to absorb part of the cost through targeted subsidies or other support measures. This, in turn, may increase recurrent expenditure or reduce revenue, thereby placing additional pressure

on fiscal balances. Moreover, elevated global commodity prices and import costs could increase the cost of ongoing and planned public investment projects, potentially leading to capital expenditure that may exceed initial government budgetary allocations. In addition, any potential climate-related shocks may lead to deviations in the implementation of ongoing fiscal reforms, thereby posing risks to maintaining a sustainable fiscal path. Given recent experiences, there is a possibility that such climate-related shocks may become more frequent in the period ahead. Such developments may pose challenges to the ongoing fiscal reforms and exert pressure on fiscal balances, potentially affecting the country's fiscal sustainability. Despite these risks, continued and concerted efforts by the Government, supported by both domestic and international stakeholders, are expected to help address these challenges, thereby restoring fiscal sustainability over the medium term.

4.2.6 Growth Prospects

Regaining macroeconomic stability in the aftermath of Sri Lanka's recent economic crisis, along with the rebuilding of external and fiscal buffers, has positioned Sri Lanka on a stronger footing, although external and domestic headwinds pose significant challenges to sustaining the country's growth momentum in the period ahead.

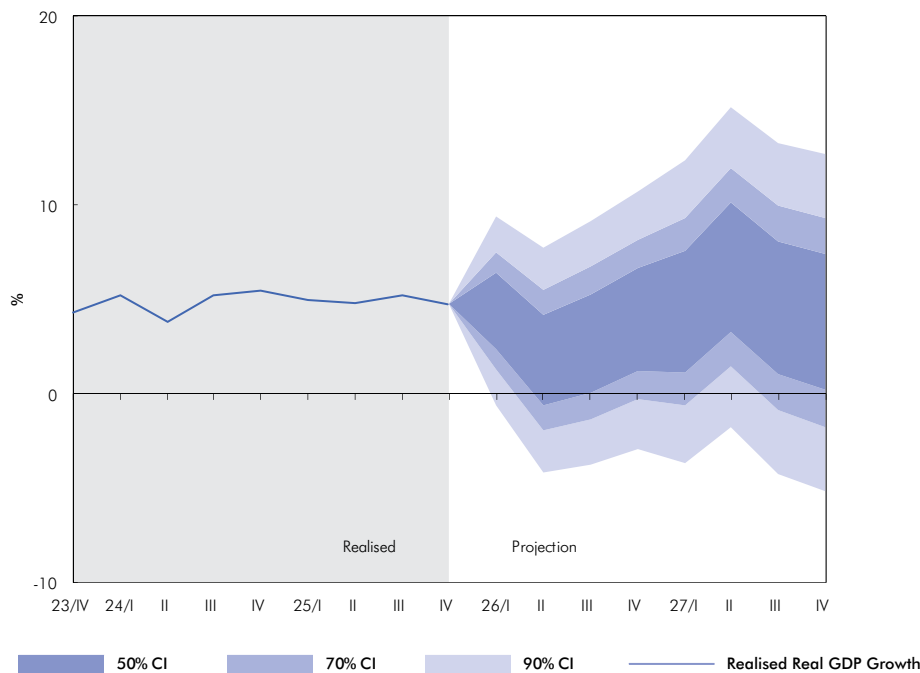
Despite severe destruction caused by *Cyclone Dityah*, leading economic indicators show that economic activities have remained resilient in the aftermath of the disaster. The current low inflation environment, relatively low interest rate structure, strong fiscal performance, improved governance and ongoing structural reforms create a conducive environment for a stronger economic recovery. However, the growth momentum could be disrupted to some extent mainly by the heightened geopolitical tensions stemming from the Middle East war, adverse

global trade policies and climate-related risks to which the Sri Lankan economy is highly vulnerable. In this context, strong private sector credit growth supported by accommodative monetary conditions and sustained domestic demand is expected to support economic activity. This broad-based growth in private sector credit, alongside a gradual decline in banking sector lending to the Government and public sector corporations observed in recent months, is expected to underpin economic growth. The expansion in credit flows to the private sector observed in recent periods is expected to support investment and consumption in the period ahead. Growth prospects across the industrial, services, and agricultural sectors are expected to remain positive, albeit with downside risks from global uncertainties. While broader domestic economic conditions remain conducive to sustained growth in the industrial sector, supported by reconstruction activities and the resumption of infrastructure projects, global tensions could weigh on its outlook through higher input costs, supply chain disruptions, and weaker external demand. The services sector is expected to remain the key driver of growth, with continued momentum in tourism, ports, and trade activities, although geopolitical tensions, elevated shipping costs, and rising prices may pose downside risks. The agricultural sector, despite weather-related challenges in 2024 and 2025, is expected to recover gradually, supported by improvements in key sub-sectors such as paddy and coconut, although rising input costs and climate-related risks remain concerns.

The Government has initiated measures to advance the digital economy, with a view to strengthening growth momentum.

Digitalisation enables the economy to align with global trends such as wide-ranging adaptations of AI, while ensuring continuity of essential activities during periods of global

Figure 4.3
Baseline Quarterly Real GDP Growth Forecast (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 2026.

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 from the underlying assumptions and judgements could lead to the realised growth path deviating from the projection.

Source: Central Bank Staff Projections

disruption. In this context, it is important to broaden the scope of digitalisation to encompass a majority of government operations. A digitalised economy would support more effective tax administration, generate cost and time efficiencies, improve the delivery of public services, and strengthen statistical data collection, among other benefits.

Sri Lanka's energy security improved during 2025, although some challenges have emerged recently due to disruptions in global supply chains for petroleum products, largely stemming from geopolitical tensions in the Middle East.

A prolonged continuation of the Middle East war could exert significant pressure on key sectors, including transportation, power generation, and manufacturing, through disruptions to energy supplies and higher energy prices. Meanwhile, growth in non-conventional renewable energy sources continued during the post-economic crisis period. This supports the transition towards sustainable energy in line with Sri Lanka's Carbon Net Zero 2050 Roadmap and Strategic Plan. Such a transition is expected to not only strengthen energy security but also reduce the economy's vulnerability to external shocks.

Featured Chart 4.1
Recent Economic Shocks in Sri Lanka: Uncertainty is the New Normal



In recent years, the Sri Lankan economy has faced more frequent and intense domestic and external shocks. Whilst some of these shocks have emanated from natural disasters, others were triggered by domestic and global man-made actions. Heightened uncertainties caused by frequent and intense economic shocks affect consumption and savings decisions of households and production and investment decisions of businesses, hindering the growth potential of the country. Further, macro level decision making and policy formulation have become increasingly challenging due to these heightened uncertainties, since policy transmission channels weaken and policy responses become less predictable during economic crises.

The socio-economic impacts of these shocks are multifaceted and can leave lasting scars on the economy. Generally, such shocks disproportionately burden vulnerable segments of the population, thereby exacerbating economic inequalities.

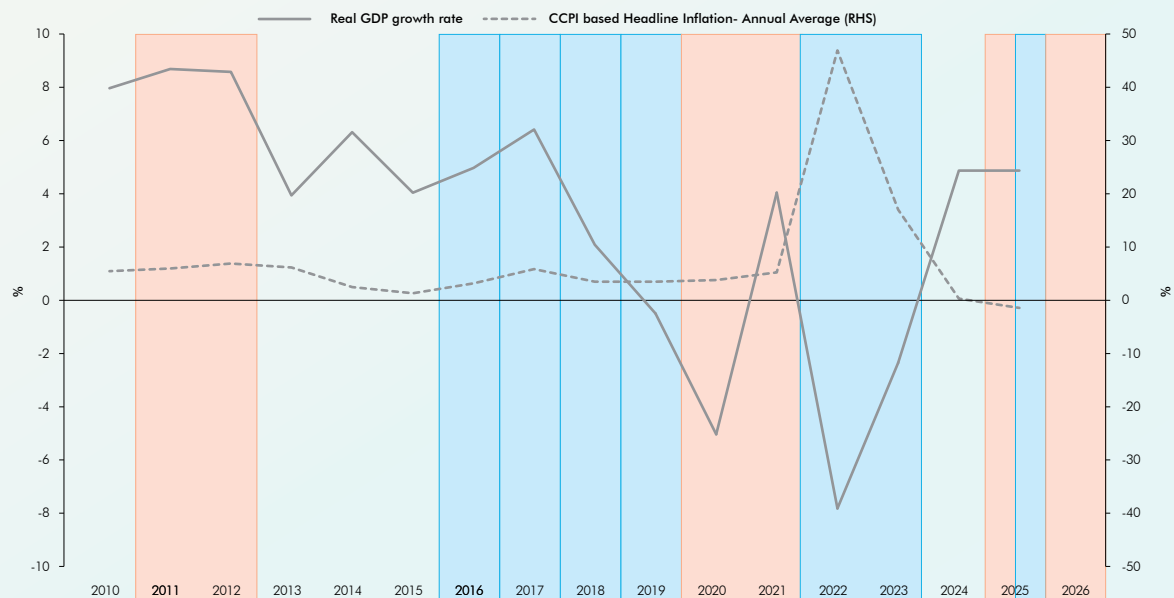
As uncertainty has become the 'new normal', future holds more challenges due to rapidly

evolving technology, increased global conflicts, geopolitical fragmentation, climate change induced natural disasters, transition into renewable energy, increased protectionism and various other shocks.

Based on recent experiences during the pandemic and domestic economic crisis, these shocks can lead to significant macroeconomic instability, including setbacks in economic growth and episodes of high and volatile inflation, particularly when the economy lacks sufficient external and fiscal buffers and limited monetary policy space. Therefore, the buildup of adequate and efficient fiscal and external buffers are paramount to steer the economy through turbulent times. The importance of maintaining adequate buffers became evident during and in the aftermath of *Cyclone Dityah*. In addition, strengthening crisis preparedness and promoting risk sharing mechanisms, such as insurance, can help economic agents mitigate the impacts of climate-related risks. Well-targeted yet sufficiently flexible social safety nets are also vital to cushion the adverse effects of economic shocks on vulnerable groups.



Major Domestic and External Disturbances (Shocks) Faced by the Sri Lankan Economy in Recent Years



- External Shocks**
- **2011-12**- Global Oil Price Surge - The intensified sovereign debt crisis in the Euro area and geopolitical uncertainties in some oil producing Middle Eastern and North African countries
 - **2020-21**- COVID-19 pandemic that resulted in prolonged periods of lockdowns, including the closure of airports, seaports and domestic mobility restrictions affected all key economic sectors
 - **2025** - Uncertainties caused by US tariff policy revisions
 - **2026 Q1**- US-Israel-Iran war and geopolitical tensions have created a larger uncertainty with impacts on global trade and supply chain disruptions

- Internal Shocks**
- **2016**- Domestic floods and landslides
 - **2017**- Drought conditions that continued from 2016
 - **2018**- Political instability
 - **2019**- Easter Sunday attack - Tourism sector heavily impacted
 - **2022-23**- Economic Crisis leading to public anxiety and political upheaval
 - **2025**- Weather related disruptions due to Cyclone Dityah

Sources: Central Bank of Sri Lanka
 Department of Census and Statistics

The continued pursuit of structural reforms, underpinned by sustained policy discipline, remains vital to further strengthening Sri Lanka's economic resilience and securing sustainable economic growth in an era of heightened uncertainty. The global and regional landscape is increasingly characterised by severe and frequent economic shocks, underscoring the imperative of building and preserving adequate buffers across fiscal, external, and monetary fronts to safeguard macroeconomic stability. The value of such buffers has been clearly demonstrated through their role in absorbing the impact of Cyclone Ditwah and mitigating potential spillovers from the Middle East war. Preserving and reinforcing these hard-earned gains in macroeconomic stabilisation

requires unwavering commitment to fiscal consolidation to enhance debt sustainability and maintain policy credibility. In this context, the successful completion of the current IMF-supported programme in 2027 will be pivotal in reinforcing investor confidence, while any need for subsequent arrangements remains contingent on future developments. Looking ahead, sustaining the growth momentum will depend critically on strengthening economic diversification, enhancing competitiveness, and raising productivity. In an increasingly volatile and shock-prone environment, the country's capacity to respond with timely, well-calibrated, and credible policy actions will be central to preserving macroeconomic stability and ensuring a resilient, inclusive, and sustainable growth trajectory for Sri Lanka.

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