

EXECUTIVE SUMMARY

Sri Lanka's macroeconomic stability continued to strengthen in 2025, alongside notable progress in implementing critical structural and policy reforms. Although the year was marked by both severe domestic and global shocks, the economy demonstrated resilience, underscoring the effectiveness of decisive measures to strengthen policy buffers and the meaningful progress achieved in restoring stability and reinforcing economic fundamentals.

Marking the end of an eleven-month deflationary phase, inflation turned positive in August 2025. Thereafter, inflation accelerated only gradually and remained unchanged for three consecutive months through October to December 2025. Despite temporary supply chain disruptions caused by Cyclone Ditwah, which placed some upward pressure on food prices in December, overall inflation remained stable.

Inflation is projected to accelerate gradually and is expected to move towards the 5% target by H2-2026. This increasing trajectory can be broadly attributed to the gradual recovery in demand conditions, while the expected gradual transition of energy and transport inflation to its usual pace and the relatively elevated volatile food inflation also support this path. Inflation is expected to stabilise around the 5% target over the medium term, with the support of appropriate policy measures. Core inflation is also anticipated to stabilise at a level consistent with the headline inflation target. While both upside and downside risks to the inflation outlook remain, the overall balance of risks is assessed to be broadly neutral over the near and medium term.

The Central Bank continued its accommodative monetary policy stance, supported by subdued inflationary conditions in the economy and the benign inflation outlook. Although some tightening in short-term money market interest rates was tolerated towards the latter part of 2025, this tightening eased subsequently, aided by improved liquidity conditions and a more even distribution of liquidity among banks. Overall, the market interest rate structure adjusted downwards during 2025. In the low-interest rate environment, reflecting the improving economic activity and increased vehicle imports, credit flows to the private sector continued to expand during the year.

The external sector performance improved in 2025, with the current account estimated to have recorded a surplus for the third consecutive year. The Sri Lanka rupee depreciated by 5.6% against the USD in 2025, while remaining broadly stable in early 2026. Amidst servicing the country's highest post-crisis external debt service payments, gross official reserves increased

by end-2025 supported by significant net foreign exchange purchases by the Central Bank, together with inflows from multilateral institutions.

Fiscal sector performance continued to strengthen during the first eleven months of 2025 with sustained revenue-based fiscal consolidation measures. In response to the damages caused by Cyclone Ditwah, the Government implemented a series of relief measures, including initiatives to restore affected infrastructure, supported by a supplementary budget for 2026.

The economy recorded a robust expansion during the first nine months of 2025. Despite the slowdown in economic activity immediately following the disruptions caused by Cyclone Ditwah in late 2025, timely policy interventions are expected to support a faster recovery, generate positive spillover effects across sectors, and reinforce overall economic momentum, thereby indicating greater resilience in the period ahead. Leading indicators also point to continued resilience in economic activity, while stronger credit expansion and the prevailing accommodating monetary conditions are expected to further support this momentum. However, external headwinds arising from rising global trade frictions and heightened geopolitical uncertainties could weigh on overall economic performance and growth prospects.