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The Sri Lankan economy: The sovereign debt crisis, IMF-supported stabilization, and beyond*

Prema-chandra Athukorala

Abstract

This paper contributes to the international policy discourse on sovereign debt crises and IMF-supported stabilization reforms in emerging market and developing economies in the post-COVID-19 era through a case study of Sri Lanka. It examines the origins of Sri Lanka's unprecedented sovereign debt crisis in the aftermath of the pandemic, the process of economic stabilization under the IMF's Extended Fund Facility (EFF) programme, and the development challenges facing the country beyond the crisis. Sri Lanka's stabilization performance under the EFF programme has so far been encouraging. However, the evidence presented in this paper suggests that the programme is likely to conclude with a substantial debt overhung and persistent external payments pressures. Achieving sustained and equitable growth while carrying this heavy debt burden will remain a formidable development challenge. Placing the economy on a self-sustaining growth path beyond the stabilization phase requires complementing the standard IMF approach to macroeconomic stabilization with coherent structural reforms that address the fundamental imbalances underlying the economy's vulnerability to external shocks.

Keywords: Sri Lanka, sovereign debt crisis, IMF programme, debt restructuring

JEL codes: E58, E36, F24, F34, O23, O53

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1. Introduction

Sri Lanka has emerged as an important case study in the global policy debate on post-COVID-19 debt distress in emerging market and developing economies. Its sovereign default and subsequent IMF-supported adjustment provide a unique opportunity to examine the underlying causes of debt distress, the process of sovereign debt restructuring, and the prospects for post-default economic recovery. Sri Lanka was the only Asian country in more than two decades to default on its external sovereign debt, making the 2022 default particularly significant in assessing Sri Lanka's post-independence development record and informing future policy directions in the regional context.

Sri Lanka has been a recurrent client of the IMF, reflecting periodic bouts of macroeconomic instability since independence. The crisis that culminated in the 2022 sovereign default, however, was fundamentally different from previous episodes. Earlier crises were essentially *liquidity crises*, involving temporary shortages of foreign exchange. Once balance-of-payments pressures were relieved through external assistance, successive governments could restore external payments stability without confronting an immediate threat to debt sustainability. The 2022 crisis, by contrast, was a *solvency crisis*, reflecting a large and unsustainable debt overhang, with commercial borrowing accounting for a substantial share of external debt. In the standard distinction, a liquidity crisis arises when a sovereign lacks sufficient liquid resources or access to financing to meet its maturing obligations, whereas a solvency crisis arises when its overall debt burden cannot be serviced through feasible future primary surpluses (Trebesch et al. 2012). The IMF subsequently characterised Sri Lanka's crisis as involving significant solvency and refinancing risks and assessed its debt as unsustainable (Breuer et al. 2025). Consequently, even after macroeconomic stability has been restored, Sri Lanka will continue to face a substantial debt-servicing burden.

The country is now, in late 2026, in the final year of the Extended Fund Facility (EFF) programme with the International Monetary Fund (IMF), which was agreed in March 2023.The programme has made substantial progress towards restoring macroeconomic stability and addressing the immediate balance-of-payments crisis. Yet, the IMF's latest programme review concluded that 'performance under the program was generally strong', while cautioning that 'debt sustainability risks remain high' and that 'well-calibrated structural reforms are needed to rebuild external buffers and resilience of the economy' (IMF 2026, p. 2). In commenting on the review, the IMF Executive Board has also emphasized the

need to strike a better balance between short-term stabilization and longer-term development objectives, noting that reforms to date have placed ‘too much stress on achieving stabilisation’ (IMF 2026, p. 2). This tension lies at the heart of Sri Lanka's post-crisis policy challenge. Stabilization is indispensable for restoring confidence and debt sustainability, but stabilization alone cannot generate the sustained productivity growth, employment opportunities and foreign-exchange earnings needed to overcome the country's structural constraints.

This paper examines the sources of Sri Lanka’s vulnerability to the crisis, how the initial ad hoc ‘home grown approach deepened the crisis, the process of economic stabilization under the IMF programme, and the challenges facing the economy beyond the EFF programme. Its central argument is that restoring debt sustainability, although essential, is not sufficient to place Sri Lanka on a sustainable development path. Attention is given to the need to strengthen the tradable sector, expand export-oriented investment and employment, rebuild external buffers, and create the conditions for sustained productivity and income growth. The paper concludes by considering

Section 2 provides the analytical framework for the ensuing analysis with a succinct overview of vulnerability to the crisis in the context of the literature on emerging market economic crises. Section 3 re deals with the onset of the crisis and the government’s initial ‘muddling through’ response. Section 4 places the Sri Lankan IMF extended fund facility (EFF) programmes in the context of the debate on the purpose and modalities of such programmes. Section 5 analyses economic stabilisation and structural adjustment under the EFF programme. The final section offers some concluding remarks on the policy reforms required to reconcile macroeconomic stability with long-term development.

2. The genesis of the crisis

The COVID-19 pandemic was a global shock that affected virtually every country in the world. Yet only a handful of countries succumbed to sovereign debt crises and subsequently entered IMF-supported stabilization programs accompanied by comprehensive debt restructuring.[1] In the Asian region, Sri Lanka is the only country to become emblematic of

[1] The countries that defaulted in aftermaths of the pandemic and entered IMF-supported stabilization programs and comprehensive debt restructuring processes are Zambia (2020), Lebanon (2020), Sri Lanka (2020), Ghana (2022). Argentia, Ecuador and Venezuela remained in default throughout the pandemic, but they were not entirely new post-pandemic cases.

the post-COVID sovereign debt crisis. Why did a common global shock produce such divergent country-specific outcomes?

2.1 Vulnerably and trigger

The literature on the origins and mechanisms of emerging-market financial crises over the past four decades provides an analytical context for addressing this issue. A key lesson distilled from this literature is that a financial crisis[2] typically results from the interaction of two elements: *vulnerability* and *a trigger* (E.g. Corbo & Fischer 1995, Sachs et al. 1996, Dornbusch 2002, Athukorala and Warr 2002). Vulnerability refers to a situation in which underlying macroeconomic conditions have become unsustainable: a country's external liabilities are large relative to its assets, have relatively short maturities, and are denominated predominantly in foreign currency. Such a "bad national balance sheet" can manifest itself in various forms, including significant currency overvaluation, a widening current-account deficit, or stagnant or declining economic growth. A trigger is *the proverbial straw that breaks the camel's back*: a sudden event or shock that transforms an already vulnerable situation into a full-scale crisis. The trigger can take many forms. It may be a change in the external environment, such as a global recession; a sharp decline in commodity export earnings; investor panic or contagion arising from a crisis in another country; a pandemic, a sudden reversal of capital flows; a major policy mistake; or the collapse of a systemically important firm or bank in the country. A country with sound macroeconomic fundamentals can withstand or absorb a trigger without descending into crisis: "good [national] balance sheets, no crises" (Dornbusch 2002, p. 175).

A state of vulnerability by itself does not cause a crisis: a *trigger*, which is an unpredictable event, is needed to push a vulnerable situation into an actual collapse. There is, therefore, no hard and fast rule about the exact timing of a crisis because a trigger is naturally unpredictable: basically, an unsustainable macroeconomic situation can persist surprisingly long provided short term capital inflows camouflage the underlying vulnerability and transparency is lacking. However, understanding the state of vulnerability and its sources is necessary for taking precautionary policy actions, and understanding the growth trajectory and the policy alternatives for sustainable growth beyond the crisis.

[2] International financial crises are given different labels—currency crises, sovereign debt crises, or banking crises—depending on their point of origin. Here, we draw on these experiences to discuss the general lessons that can be learned from international financial crises.

In the aftermaths of the COVID19 pandemic, Sri Lanka succumbed to the crisis through the interaction between the pre-existing macroeconomic vulnerabilities and the pandemic shock. The COVID-19 pandemic itself was not the fundamental cause of sovereign debt distress; rather, it acted as a catalyst that exposed and magnified underlying macroeconomic weaknesses.

2.1 State of vulnerability in the Sri Lankan economy[3]

Over the period from about the early 2000 there was a massive debt build-up in the Sri Lanka economy. By 2020, the total stock of public debt stood at US$80 billion (82% of GDP), with foreign debt, which was totally denominated in foreign currency, accounting for 66% of the total stock. The composition of foreign debt had dramatically shifted from multilateral and bilateral debt to more costly private market commercial loans. The share of commercial loans in total debt increased from about 8% in the early 2000s to a half of the total, with international sovereign bonds (ISBs) accounting for over 80% of these debts.

The debt-service ratio, which averaged about 12% during 2000–2018, had risen to 35% by 2020. By then, interest payments on both external and domestic debt accounted for more than 70% of total government revenue, compared with an average of about 30% during 2000–2008. Sri Lanka had the highest ratios for both indicators among emerging market and developing economies (EMDEs).

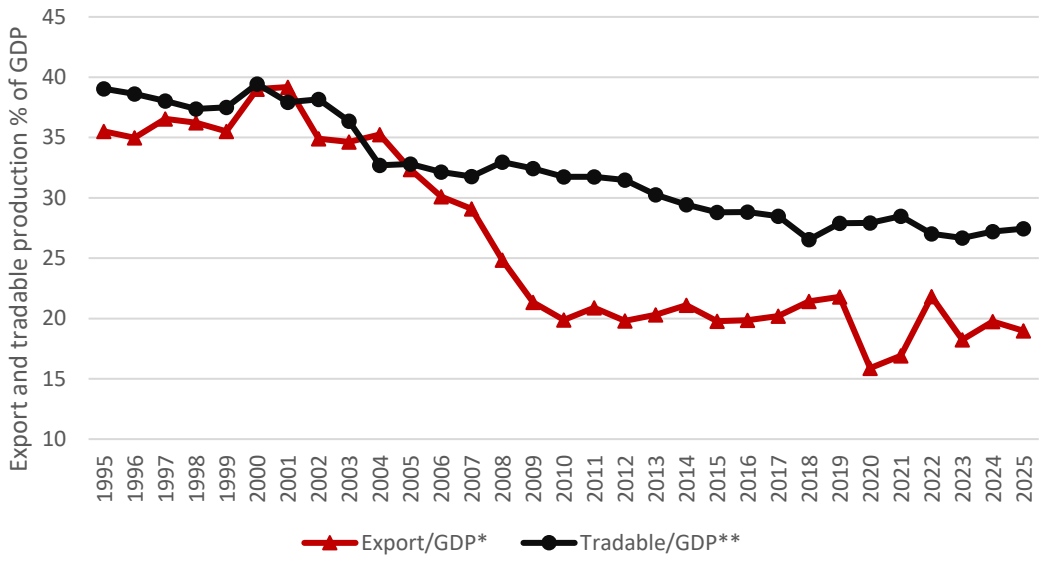
Foreign exchange reserves were adequate to cover only 1.5 months' imports and amounted to only 20% of the 'safe' reserve level estimated based on the IMF's Reserve Adequacy Composite Index (RACI), which measures whether a country's stock of official foreign exchange reserves is adequate to protect the economy against potential external shocks. The country had no fiscal space to face a crisis: a massive non-funded tax cut in November 2019, which wiped off a third of government revenue in 2020, added to vulnerability. An IMF assessment of the Sri Lankan economy had warned that strong commitment to fiscal consolidation was needed to achieve debt sustainability over the medium term. The three leading sovereign credit rating agencies had downgraded Sri Lanka's credit rating, virtually cutting off the country from global capital markets.

The build-up of the state of vulnerability was underpinned by an anti-tradable bias in the economy, reflected in a persistent decline in tradable production relative to non-tradable

[3] This section draws on Athukorala & Jayasuriya (2016), Athukorala et al. (2017) and Athukorala (2025)

domestic production. The share of tradable goods in GDP declined continuously from about 40% in the early 2000s to about 32% by the late 2010s. It is important to note that there is no clear-cut way of disaggregating national production into tradable and non-tradable sectors. The proxy measure of non-tradables used here may understate the extent of this structural shift because some agricultural products that are essentially consumed domestically, as well as some manufactured products that have become quasi-nontradable because of high protection, are included in the measured tradable sector. The export-to-GDP ratio, which provides a more precise, though partial, measure of the degree of external orientation of the economy, shows an even sharper contraction during this period, from about 35% to 18%.

Figure 1: Trade orientaion of the Sri Lankan economy (%)



Notes

*Exports of goods and services as a percentage of GDP.

** Tradable production is estimated as the sump of value added in agriculture and manufacturing from national accounts and estimated valued added in total services exports. Valued added in services is estimated as services exports (from balance of payments record) adjusted for value added in the share in the related domestic services sectors (0.55) obtained from the 2022 input-output table (https://data.adb.org/dataset/sri-lanka-input-output-economic-indicators

Source: Based on data compiled from CBSL (2025), Statistical appendices.

This structural shift originated in the debt-funded construction boom that followed the end of the civil war in 2009[4]. A massive resource inflow into an economy naturally shifts the production structure towards non-tradables and tilts relative incentives against tradable production—the phenomenon commonly referred to as the 'Dutch disease effect' (Corden 1994). In Sri Lanka, this 'construction-boom effect' was amplified by two notable developments in the overall policy regime.

First, the public investment programme was implemented in the context of a newly adopted populist policy stance that emphasised the role of the state in 'guiding' markets. The resulting interventionist trade and foreign-investment policies tilted incentives against export-oriented production.

The trade regime was the first victim of this policy reversal. The trade regime was the first victim of this policy reversal. Import substitution in both manufacturing and agriculture was reintroduced into the policy agenda, reversing the significant, though staggered, trade liberalization undertaken over the preceding three decades. New export taxes were introduced on tea and rubber exported in raw and semi-processed forms, ostensibly to promote further domestic processing of these products. There were also numerous case-by-case adjustments to import duties on manufactured goods that directly competed with domestic production. These measures resulted in higher and greater inter-industry variation in effective rates of protection.

The average total nominal tariff rate—comprising customs duties and the so-called 'para-tariffs'[5] introduced to raise revenue initially to finance the government's civil war expenditure and subsequently to fund various development projects—increased from about 13% in the early 2000s to nearly 30% by the mid-2010s. This tariff structure yielded a trade-

[4] Of course, a large-scale reconstruction effort was needed to restore connectivity with the war-torn provinces and refurbish essential infrastructure elsewhere after a quarter century of destruction and decay. However, infrastructure investment was not embedded in a coherent overall national development strategy. Moreover, many government infrastructure projects had dubious economic returns and were politically motivated, thereby unnecessarily adding to the overall cost of investment.

[5] Para-tariffs are additional taxes or levies imposed on imports, over and above ordinary customs duties. They raise the overall level of import protection and make the protective structure less transparent, although they remain subject to WTO scrutiny and applicable disciplines.

weighted average effective rate of protection (ERP)[6] of 63% for domestic manufacturing. A comparison of ERPs for domestic-market-oriented (import-substituting) and export-oriented manufacturing suggests that, on average, the trade regime made value added per unit of output 70% higher in production for the domestic market than in production for export.

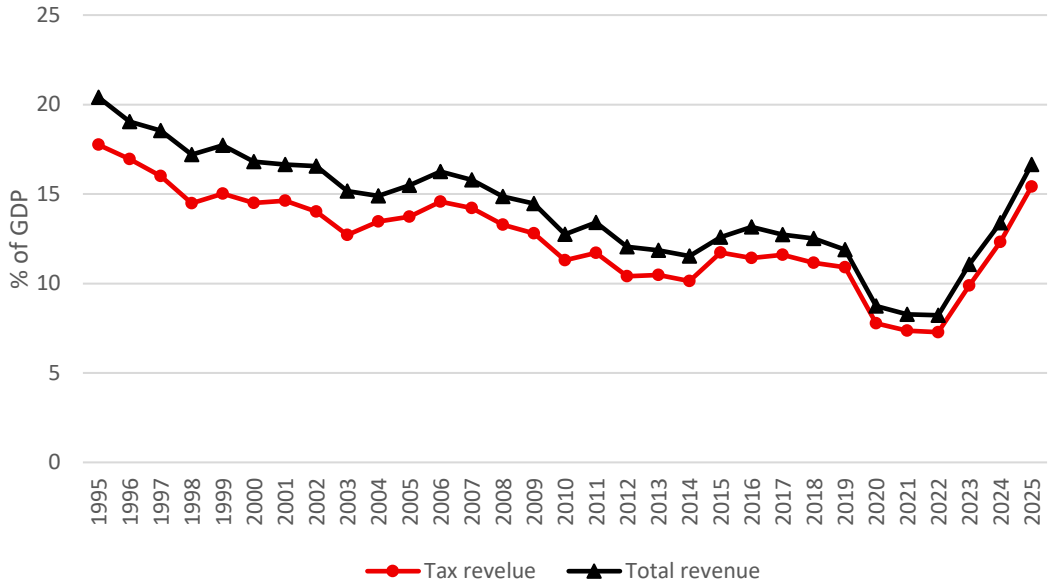
The foreign investment regime became increasingly interventionist and opaque, amid widespread allegations of corruption following the promulgation of the Strategic Development Projects Act (2008) and the Revival of Underperforming Enterprises and Underutilized Assets Act (2011). The former empowered the minister in charge of the Board of Investment (BOI) to approve investment projects deemed to be of 'national interest', with tax holidays of up to 25 years, thereby departing from the long-standing practice of the BOI of granting tax incentives primarily to export-oriented investors. The Act thus created considerable scope for ministerial discretion in investment approval, weakening the BOI's role as the principal agency for promoting and facilitating investment. The latter Act empowered the government to take over enterprises, including foreign-invested and domestically owned firms, on the basis of criteria relating to 'underperformance' or 'underutilisation' of productive capacity. The government's takeover of several enterprises, including some foreign-invested firms, some of which were reportedly profitable, severely undermined investor confidence and damaged the investment climate.

Second, on the macroeconomic front, exchange-rate policy became increasingly subordinated to short-term macroeconomic stabilisation objectives, weakening the exchange rate's role in determining the relative prices of tradable and non-tradable goods. Large infrastructure projects were largely funded by foreign borrowing. However, their implementation also required substantial domestic resources for counterpart funding and for other related government expenditures. The resulting expansion of government expenditure occurred against the backdrop of a long-standing failure by successive governments to broaden the revenue base and improve the effectiveness of tax administration (Figure 2). Tax revenue as a percentage of GDP had declined from over 16 percent in the 1mid-1990s to less than 8 percent by the 2000s. The government consequently became increasingly reliant on monetary financing of fiscal deficits. As fiscal and monetary expansion continued to fuel domestic inflation, the Central Bank maintained a relatively stable nominal exchange rate of

[6] ERP measures the proportionate increase in the per-unit value added of a product resulting from the complete system of tariffs, including tariffs on both final goods and intermediate inputs used in production.

the rupee against the US dollar as an inflation anchor and kept the domestic debt levels low in rupee terms. Persistent nominal exchange-rate stability, combined with higher domestic inflation than in Sri Lanka's trading-partner countries, resulted in an appreciation of the real effective exchange rate (REER), thereby eroding the competitiveness of tradable production, including both export-oriented and import-competing activities (Figure 3)[7]. The figure shows that doing most of the 2020s, nominal effective exchange rate remain virtually constant and the REER appreciated largely driven by increase in domestic price level relative to that of the trading partners.

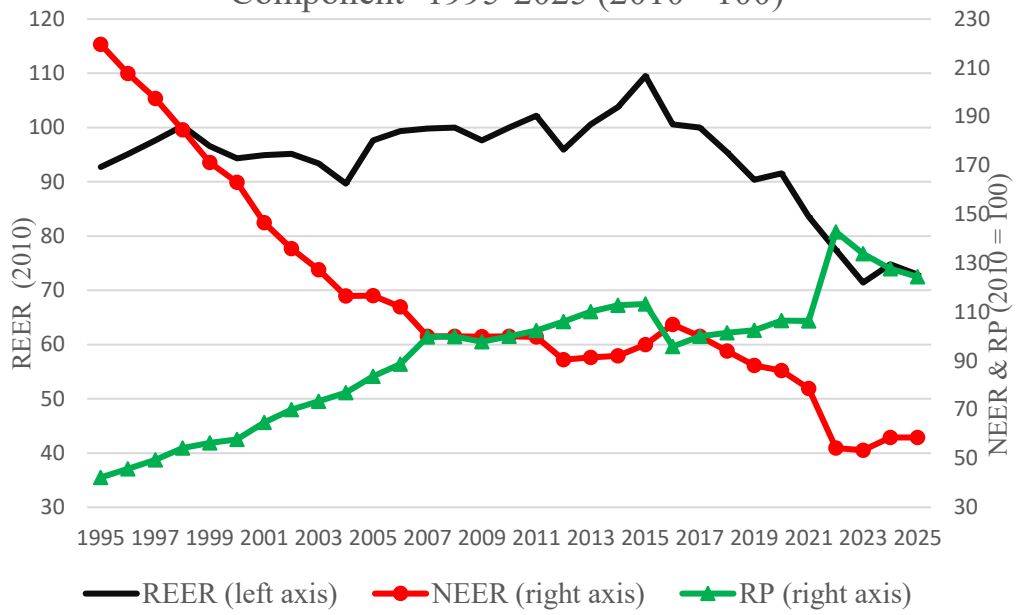
Figure 2: Government revenue relative to GDP, 1995-2026 (%)



Source: Data compiled from CBSL (2026), statistical appendices

[7] The REER index used here, which is dubbed the 'IMF REER index'), does not make a distinction between tradables and nontradables: it assumes that purchasing power parity (the law of one price) holds for both tradables and nontradables. Yet, it is presumably a reasonable proxy for the real exchange rate because the bulk of Sri Lanka's partner countries are advance economies where there are no waste defences in price patterns of tradable and nontradable (Edwards 1988).

Figure 3: Sri Lanka: Real exchange rate and its Component[1] 1995-2025 (2010 =100)



Note: (1) Nominal effective exchange rate (NEER) is Sri Lanka's trade-weighted nominal exchange rate for 24 trading parter countries (measured as foreign currency unit per rupee). Relative price (RP) is the trade weighted trading partner price level relative Sri Lanka's price level both measured by the consumer price index (CPI). Real effective exchange rate (REER) is REER = NEER & RP. An increase in the REER (an appreciation of the real exchange rate) indicates a decline in the international price competitiveness of the Sri Lankan economy; conversely, a decline in the REER indicates an increase in its international price competitiveness.

Source: Data compiled from CBSL (2026), statistical appendices.

3 Onset of the crisis, policy muddling through and going to the IMF

The onset of the pandemic in March 2020 transformed the vulnerability accumulated over the preceding one-and-a-half decades into a full-blown crisis**.** The biggest blow to the balance of payments was the collapse of tourism inflows: total estimated earnings dwindled from about US$4 billion in 2019 to US$606 million in 2020 and US$500 million in 2021. Merchandise exports declined by about 20 percent in 2020 from the previous year (from US$12 billion to US$10 billion). Formal (officially recorded) remittances by Sri Lankan overseas workers significantly increased in 2020, reflecting intensified family support money transferred during the height of the pandemic. However, inflows trough the banking system tended to contract subsequently, reflecting diversion to informal channels because of foreign exchange restrictions and fixing of the exchange rate at an overvalued level for several months.

At the time of the Covid19 shock, Sri Lanka was at the final phase of a three-year

Extended Fund Facility (EFF) programme which came into effect in June 2016.[8] The final review for the approval of the seventh tranche of the loan (about US$164) was due in June 2020. There was, therefore, an opening for the country to continue to work with IMF to face the pandemic shock. This was not to be, however.

Following the political regime shift in 2019 (the election of Gotabaya Rajapaksa as President in November 2019), Sri Lanka had already moved from the IMF-supported fiscal-adjustment programme to a deliberately non-IMF "home-grown" strategy. The Governor of the Central Bank explained the government's position as follows: "We have followed such [IMF] policies with little success, and our current policies are not adjustable (*sic*) with IMF practices." (Jayasinghe 2021).

Sri Lanka had no adverse experience with the IMF in the past. Governments of both major political persuasions considered recourse to the IMF as a conventional means of addressing balance-of-payments pressures rather than as a politically unacceptable policy choice. Even the United Front government of 1970–77, in which Dr N. M. Perera, the leading Marxist economist, was Finance Minister, negotiated two successive IMF arrangements.[9] The resistance of the government this time to follow the well-traversed path was presumably the concern that IMF conditionality could close loopholes in fiscal operation that had become the prime source of political patronage. The populist concern propagated by the government at the time was that an IMF program could involve sacrificing equity and fairness in development policy. This was, however, not consistent with the IMF's emphasis in recent decades on a more inclusive ('pro poor') approach to stabilization and structural adjustment reforms (Boughton 2009).

The view that Sri Lanka could have averted debt default by working with the IMF receives support from a comparison with Pakistan, which faced the COVID-19 shock with significant debt vulnerabilities similar to those of Sri Lanka (ADB 2020). Pakistan was also under a 39-month US$6 billion EFF programme signed in July 2019. Following the outbreak

[8] This EFF program was approved for the three-year EFF on 3 June 2016 for SDR 1.07 billion **(**about US$1.5 billion)**,** originally scheduled to expire in June 2019. In May 2019, the IMF extended it by one year to 2 June 2020 because the implementation of the program was severely intersected

[9] "We cannot brush aside and completely ignore these international institutions; we can repudiate their terms only if we are prepared to face the far-reaching distortions. … the Government's effort to put its own house in order is not the result of IMF advice but is the obvious thing to do in the national interest' Dr. N.M. Perera (Quotation from 1971 *Budget Speech*, cited in Athukorala (2021).

of COVID19 pandemic, implementation of the programme was temporarily paused by the IMF. Nonetheless IMF provided emergency financing of US$1.386 billion under its Rapid Financing Instrument (RFI) in April 2020 as Pakistani authorities remained committed to resuming the programme. Continued IMF engagement also helped catalyse substantial support from the World Bank, ADB and Islamic Development Bank and to temporarily suspend debt serving.

The so-called *home-grown solution* consisted of an *ad hoc* policy mix involving import restrictions, successive changes in the exchange-rate regime—from fixing to a free float and subsequently to a 'target-zone' system—and capital controls. At the same time, the government sought alternative sources of emergency, financing bypassing the IMF, to meet external debt-service obligations and finance essential imports. In March 2020 syndicate loan of US$1.3 billion was arranged from the China Development Bank with the involvement of the Chinese embassy in Colombo. Currency swap arrangements were made with China Central Bank[10] (March 2021: US$1.4 billion), Reserve Bank of India (RBA) (loan (July 2020: US$ 400 million; March 2022: US$1.0 billion), and Bangladesh Bank (August 2021: US$200 million). The RBA also deferred payment of approximately US$ 2 billion under the Asian Clearing Union liabilities of the Central Bank of Sri Lanka, which was subsequently restructured into a US$2.6 billion sap loan (including US$200 million interest payment)[11]. In May 2021, South Korea gave a concessional loan of US$500 million, with a repayment period of 40 years, to finance mutually agreed projects. Sri Lanka also received SDR 554.8 million (about US$787 million) under the IMF's general SDR allocation in August 2021.

On 20 April 2022, Sri Lanka requested from the IMF US$ 700mn under the Rapid Finance Facility (RFI). The IMF rejected the request because the IMF Article IV Consultation study of 2021 (issued in 2022) had already assessed that, 'public debt has become unsustainable, … [and] to restore macroeconomic stability and debt sustainability, implementing a credible and coherent strategy covering both the near and medium term is needed' (IMF 2022, p. 2).

Notwithstanding rapidly diminishing foreign exchange reserves, Sri Lanka repaid three ISBs amounting to USD 2.5 billion (US$1 each in October 2020 and in July 2021, and

[10] Signed in 2021 and renewed for another 3 years in December 2024.
[11] Total financial support received by Sri Lanka from India (the two swap loans; credit lines for petroleum, fertilizer, Covid-19 vaccines and test kits, other essential imports; and welfare support for the families in the estate sector) amount to about US$ 4.1 billion (https://www.hcicolombo.gov.in).

US$500 million in January 2022). A large portion of the money received under the IMF general allocation was immediately converted into US$ dollars and used for financing of external debt-service obligations, including the US$500 million ISB maturity in January 2022 (Central Bank (2022), Weekly Economic Indicators, 18th February, Table 4.4).

There was a highly polarized debate in the Sri Lankan media regarding the Government's decision to repay these bonds, in particular the repayments made in July 2021 and January 2022, while foreign exchange reserves were rapidly declining. Critics argued that using reserves to repay bondholders reduced Sri Lanka's ability to finance essential imports such as fuel, food, medicines, and cooking gas. They argued that the government is merely delayed an inevitable restructuring while depleting reserves, and that Sri Lanka should have entered negotiations with the IMF and sought a pre-emptive debt restructuring rather than exhausting reserves.[12] The Government, in contrast, defended the repayments as essential to maintain Sri Lanka's "unblemished record" of sovereign debt servicing and argued that bilateral loans, swaps, and other inflows would replenish reserves, and dismissed reports of imminent default as speculative and misleading.

There were also media allegations that investors who had purchased Sri Lankan bonds at deep discounts, at a time when credit-rating agencies had expressed serious doubts about the Government's ability to repay its International Sovereign Bonds (ISBs), obtained windfall gains when the Government subsequently honored the bonds at face value. These allegations were particularly prominent in connection with the US$500 million ISB that matured and repaid in January 2022. The Government had repeatedly assured investors before repayment that it would honour its debt obligations, including a firm assurance by the finance minister in Parliament that the January 2022 bond would be repaid in full (*Daily FT* 2022).

In 2020, the economy contracted by 3.6% as the first wave of the COVID-19 pandemic and the containment measures introduced in response disrupted economic activity. However, in 2021, the economy recovered to its pre-pandemic level, notwithstanding a relatively mild second wave of infections. The recovery proved short-lived, as dwindling foreign exchange reserves compelled the government to impose import restrictions. Emergency financial support from bilateral partners fell far short of the amount needed to meet the external financing requirements arising from the pandemic-induced balance-of-

[12] Media commentaries are too numerous for citing hare. However, Fernando and Rajapatirana 2022, Wijewardena (2021) are largely representative of the position of the critics. Jayasinghe (2021) and Daily FT (2022) provide a synthesis of the government position.

payments shock and maturing ISB obligations. A ban on chemical fertiliser imports, introduced amid the crisis to promote organic farming, further contributed to shortages of rice and other agricultural food products. The economy contracted by 7.8% in 2022, marking its most severe downturn in the country's post-independence history.

By the early 2022, net foreign exchange reserves (gross reserves after allowing for the Central Bank's short-term reserve related liabilities and the swap loan of US$ 1.4billion from the Peoples Bank of China (which was useable for specific transactions denominated in Yen) had dwindled to a mere 0.4 billion (two-week import equivalent). A USS 1billion ISB was to mature by the end of the year in addition to coupon payments on other bonds. Sri Lanka's sovereign bond spread (risk premium), as measured by the J.P. Morgan Emerging Market Bond Index Global (EMBIG), had risen to 3,546 basis points by early April 2022, from 1,870 basis points at the onset of the pandemic. Taking the 10-year US Treasury yield of 2.72% at the time as the benchmark risk- free rate, the implied yield on a Sri Lankan sovereign bond (that is, the interest rate of a possible new bond issue) in April 2022 would have been approximately 38.2%.

On 12 April 2022, the Sri Lankan government announced a suspension of external debt service and its intention to seek restructuring of specified external public debt. The suspension covered public-sector foreign-law-governed and foreign-currency-denominated debt owed to bilateral official and commercial creditors, while excluding debts owed to multilateral creditors, trade credits, and currency swaps between the Central Bank of Sri Lanka and foreign central banks. Following the expiry of the applicable 30-day grace periods for coupon payments on ISBs which were due in that week, Sri Lanka formally defaulted on its ISBs on 18 May 2022.

The government began discussions with the IMF on an IMF-supported programme in April 2022. In May 2022, it appointed Lazard as financial adviser and Clifford Chance LLP as international legal adviser for external debt restructuring. On 1 September 2022, the IMF and the Sri Lankan authorities reached a staff-level agreement on economic adjustment and reform policies to be supported by a four-year arrangement under the Extended Fund Facility (EFF). The IMF Executive Board approved the arrangement on 20 March 2023. Approval followed the receipt of specific and credible financing assurances from major official bilateral creditors—Paris Club creditors, India, Export-Import Bank of China, and Hungary—that they

would provide debt relief and/or financing consistent with restoring debt sustainability.[13] Approval also required an assessment that the authorities were making good-faith efforts to reach a collaborative agreement with private creditors (IMF 2023a). In the announcement of the programme's approval, IMF Managing Director Kristalina Georgieva highlighted the severe economic and social challenges facing Sri Lanka, including recession, high inflation, depleted reserves, unsustainable public debt and heightened financial sector vulnerabilities (IMF 2023, p. 1).

4. Extended Fund Facility (EFF) programme

The program involves a SDR 2.286 billion (approximately US$3 billion) loan, which amounted to 395% of Sri Lanka's IMF quota, to be disbursed in nine equal tranches (instalments) of SDR 254 million (US$335 million), Approximate annual interest rate[14], as at the time of signing the agreement, was about 5.2%. Amounts drawn under an EFF are to be repaid starting in 2027 when the total obligation to the IMF under the agreement would stand at US$ 4.5 billion. Seven instalments totaling US$ 2.4 billion have already been disbursed by September 2026.[15] The loan under the EFF is considered a liability of the government as it was entirely earmarked for budget support. Previous IMF facilities considered liabilities of CBSL as they were primarily for balance of payments support.

The estimated external resource gap of the EFF program, the amount of foreign financing that a country needs but cannot generate from its own external resources during the programme period, was $25.2bn. The IMF loan ($3billion) amounts to 12% of the gap. Another 15% is expected to come as budgetary support from the World Bank and the Asian Development Bank (US$ 3.8billion). By far the largest contribution is to come from debt

[13] Iran, Kuwait, Pakistan, and Saudi Arabi, which together accounted for about 7% of Sri Lankan's bilateral debt, wanted more time to decide.

[14] The interest rate is a variable rate determined under the IMF's General Resources Account (GRA) changing system: Base rate (SRD interest rate + IMF margin (6 percentage point)) + surcharge for large borrowings (0.2 percentage points on the proportion of IMF credit outstanding above 300% of the country's quota)+ time based surcharge (additional 7.5 percentage points on borrowing above 300%-of-quote that remain outstanding for more than 51 months + one time surcharge of 5 percentage points on each drawing and on amounts committed but not yet used.

[15] A separate US$206 million loan was released in March 2026 under the Rapid Financing Instrument (RFI) to support reconstruction following Cyclone Ditwah in November 2025.

restructuring (US$ 14.1billion), which amounts to half of the total debt subject to restructuring (US$28billion). In the final year of the program (2027), Sri Lanka is expected to raise the balance, US$1.5billion (6%), by issuing sovereign bonds. Thus, the EFF program is built on the implicit logic that the proposed debt restructuring, and reforms would restore Sri Lanka's debt sustainability so that the country can tap the Euro bond market by the end of the program period.

The IMF conditionality of the reform programme is summarised in the Appendix. The programme specifically focused on stabilizing the economy, restoring debt sustainability and regaining access to international capital markets, primarily through demand-side adjustments (IMF 2023a). The essential element of the proposed reform process is the link between the government budget, the central bank balance sheet and the balance of payments, which lies at the heart of the monetary approach to the balance of payments (Fischer 1997). Revenue based fiscal consolidation is at the heart of the stabilization program given that the untenable balance of payments position and external debt overhang rooted in unsustainable fiscal position. Fiscal consolidation is to combine with contractionary monetary policy with a floating exchange rate. Monetary policy involved limit on new central bank purchase of government securities (no monetary financing) and gradual offloading of central bank holding of government securities and significantly increasing the Centra Banks policy rate.

Commitment to flexible exchange rates and ongoing domestic disinflation is expected to support real exchange rate depreciation to redress the balance of payment disequilibrium, supporting rebuilding reserves. The real exchange was the key instrument for closing the trade deficit by redressing the anti-tradable bias in the economy. The programme is, therefore, (implicitly) based on the standard 'twin deficit' approach to economic stabilization, which postulates a unidirectional relationship between the budget deficit and the balance of payments deficit.

The program was rooted in the premise that the successful implementation of stabilization reforms requires institutional reforms to improve quality of governance and address corruption vulnerabilities. Structural benchmarks of the program specifically focused on strengthen institutions and policy framework so that short-term macroeconomic stabilization becomes durable and sustainable. The two key elements that figured prominently on the institutional reform's agenda were ensuring Central Bank independence under a Central Bank Act promulgated in 2023, revamping of revenue administration of the Inland Revenue Department, reducing corruption vulnerabilities through improving fiscal

transparency and public financial management, introducing a stronger anti-corruption legal framework. A governance diagnostic study was undertaken with IMF technical assistance 2021 to monitor these structural benchmarks.[16] The diagnostic study focused on six areas in which governance weaknesses and corruption vulnerabilities where macroeconomically critical: fiscal governance, financial sector oversight, central bank governance, market regulation, rule of law, and anti-money laundering.

It is important to place the Sri Lankan programme in the context of the envisaged role of an EFF and the relevant IMF guidelines on conditionality in order to put the ensuing analysis of the reform outcomes in perspective.

Until the early 1970s, the Stand-By Arrangement (SBA) was the IMF's principal instrument for providing financial support to member countries. The SBA was designed primarily to address relatively short-term or cyclical balance-of-payments problems, with arrangements normally lasting about one to one and a half years and repayment generally expected within three to five years. By the 1970s, however, the role of the IMF had evolved from its original mandate of overseeing the international monetary system, with a primary focus on the advanced economies, towards that of a financier and crisis manager for developing member countries facing external economic crises. Against this backdrop of a dramatically changing global economic environment, the Extended Fund Facility (EFF) was introduced in 1974 as an important expansion of the IMF's lending framework. It was intended to complement the traditional SBA by providing longer-term financial assistance to countries experiencing protracted balance-of-payments problems arising from structural weaknesses, with greater emphasis on structural adjustment and economic growth (De Varie 1986).

The rationale behind the EFF programmes was that if the country is suffering from an acute macroeconomic disequilibrium, a crucial issue was the balancing of macroeconomic stabilization through the conventional policies to compressing demand aggregate demand with the other type of structural adjustment reforms to restore competitiveness, sustain growth, and where necessary restore unsustainable debt to place the economy on a

[16] Sri Lanka is one of the 20 countries (the first country in Asia) for which IMF governance diagnostic studies have been conducted since 2018.The other countries: Republic of Congo, Equatorial Guinea; Peru; Mozambique, Democratic Republic of Congo; Guinea-Bissau; Honduras; Zimbabwe, Central African Republic; Mali; Moldova; Sudan, Paraguay; Zambia, Benin; Cameroon; Mauritania; The Gambia; and Malawi.

sustainable growth path. In the developing-country context this wider policy package often required structural elements such as trade policy reforms, reforming state-owned enterprises (SOE), and foreign direct investment policy. As these structural measures are beyond the expertise of the IMF and are in the purview of the world Bank and other multilateral institutional, coordination and cooperation of between the IMF and these institutions in designing and implementation of reprogram program, to provide reforming countries with consistent and effective assistance, was envisages as an important mode of reforms under EFFs (Cooper 1992, Corbo and Fischer 1995).

Extensive structural conditionality was an important feature of IMF-supported reform programmes during the first two decades or so following the introduction of the EFF. Since then, the IMF has streamlined and rationalized structural conditionality in response to assessments of its scope and effectiveness by independent researchers and the IMF itself. The revised guidelines advise staff to limit structural reform conditions to measures critical to achieving programme objectives, tailor implementation timetables to member countries' technical, institutional and political capacities, and give national authorities primary responsibility for selecting and implementing reforms. They emphasise avoiding excessive conditionality that could impinge on national sovereignty and undermine countries' commitment to the programme, or national 'ownership' of reforms. The guidelines also caution against 'mission creep': extending conditionality beyond the IMF's expertise and core responsibilities in ways that could divert attention and resources from restoring macroeconomic stability. They call for collaboration with other multilateral organizations, particularly the World Bank, in establishing and monitoring structural reform conditionality (IMF 2024; Khan and Sharma 2022).

Viewed agist these IMF guidelines relating to EFF conditionality, the Sri Lanka EFF seems to be an extreme case of attempting to avoid 'mission creep' – an attempt to avoid moving outside its area of macroeconomic stabilization. The 2021 Article IV consultation report of Sri Lanka, which was used as the policy blueprint for designing the policy framework for the EFF programme, in fact, emphasized the structural nature of Sri Lanka's protracted fiscal and balance of payments imbalances. It highlighted the need for trade policy reforms: rationalize para tariffs with a consideration given to its revenue implications, reforming the restrictive and cumbersome investment regime, for example through fully implementation of a national single window, reducing the role in the economy of the government and the state owned enterprises (SOES) to set the stage for a more efficient allocation of resources, fostering competitiveness and boosting productivity, reforming

private sector access to land, upgrade labour skills and enhance labour market flexibility. Nonetheless, these reform priorities are not embodied in the EFF structural conditionality. The IMF preamble to the EFF stated that, "While near-term policy measures under the EFF-supported programme would focus on stabilizing the economy and restoring debt sustainability, a structural reform agenda will be developed later in the programme, considering the authorities' capacity constraints" (IMF 2023, 26). However, the six reviews undertaken over the subsequent three years have not given comparable attention to developing and implementing this broader structural reform agenda. Nor is there clear evidence of a systematic effort to engage the World Bank, ADB, and other development partners in pursuing such structural adjustment alongside the stabilization programme.

Of course, pursuing stabilization and structural adjustment at the same time presents difficulties, particularly when adjustment had been delayed to the point at which the country's reserves and credibility had been depleted to a critical level as in Sri Lanka. Added to this, assessing authorities' political capacity and institutional and technical capabilities for structural reforms are inherently subjective and difficult. However, with hindside one can argue that much needed institutional reforms relating to trade and foreign investment regime and SOE reforms could have been effectively combined with the structural benchmarks of institutional, fiscal, governance, utility and regulatory reforms already embedded in the IMF continuality. There are indications in the contemporary policy discourse in the country, the failure of the EFF program to incorporate structural reforms has led to unnecessary and costly complaisance that stabilization per se would place the economy on a sustainable growth path, contributing to an unfortunate reform fatigue. For instance, failure to use 'the crisis as an opportunity' to commit the government to reform the distorted trade policy regime, in which the country's anti-export bias is deeply rooted, seems to have strengthened the hands of the domestic protectionist lobby. A case in point is the apparent success of domestic import-substituting industrialists in persuading the government to postpone dismantling the plethora of so-called 'para-tariffs' until 2029—possibly an election year (Daily FT 2026). These levies, introduced ostensibly as temporary revenue-raising measures, have become entrenched and constitute a major source of distortion in the incentive structure.

5 Adjustment scenario under the EFF programme

This section assesses performance and adjustment of the economy under the reforms agenda of the EFF program. It begins with regaining economic stability from the depth of the crisis. The subsequent subsections analyses growth and adjustment of the economy, with emphasis

on the implications for addressing the sources of vulnerability to the crisis, poverty and equity outcomes, and achieving debt sustainability.

5.1 Economic stability

The eye-caching evidence of Sri Lanka's records of regaining macroeconomic stability under the EFF relates to fiscal consolidation. All quantitative performance criteria have been accomplished or surpassed Table 1, Figure 4). Overall budget deficit narrowed from -6.8% in 2022 to 2.3% of GDP in 2025. Government revenue increased from a historical low of 8.2% in 2022 to 16.6% of GDP. Primary balance (budget deficit exclusive of interest payments) improved from -3.7% of GDP to 5.4 in 2025. Significant part of the recorded primary surplus (about 2.3%) was ditty increase in taxes relating to a surge in automobile imports related import duties and other related taxes after relaxing of import restriction. Allowing for this temporary revenue boost, the underlying primary surplus was around 3.2% of GDP, still comfortably above the IMF programme target of 2.3%. Preliminary data on customs duties and income-tax collections during the first half of 2026 suggest that the primary surplus is likely to exceed the IMF target of 2.3% in 2026 and, most likely, in 2027 as well, notwithstanding the increase in government expenditure associated mainly with reconstruction after the Ditwah cyclone.

The rate of inflation has come down from 46.5% in 2022 to -0.5% in 2025 and then increased to 6.7% by mid-2026. The role played by the proactive tight monetary policy stance in taming inflation over and above the supply-side factors remains an issue for further research. High interest rates are generally effective against demand-driven inflation. When inflation is driven by supply-side factors such as higher oil prices, import shortages, or exchange-rate depreciation, this policy instrument may simply increase the cost of capital without achieving the intended objective of taming inflation. Presumably, the sharp increase in inflation in the aftermath of the pandemic shock was an 'inflation bubble' due to domestic and external shocks, rather than the beginning of a prolonged inflation process. The monthly data show that the decline in the rate of inflation from the peak (62 %) in September 2022 has been driven by oil and food prices: the decline if headline inflation was much sharper compared to that is core inflation. The Central Bank has in fact observed that 'overall inflation developments were influenced by supply-side factors, and a slow recovery of aggregate demand' (CBSL 2025, p2). The recent increase in the rate of inflation, which is now above the central bank's target despite the increase in the policy rate, is also consistent with the dominant of supply side factors.

Table 1: Key indicators of economic stabilization

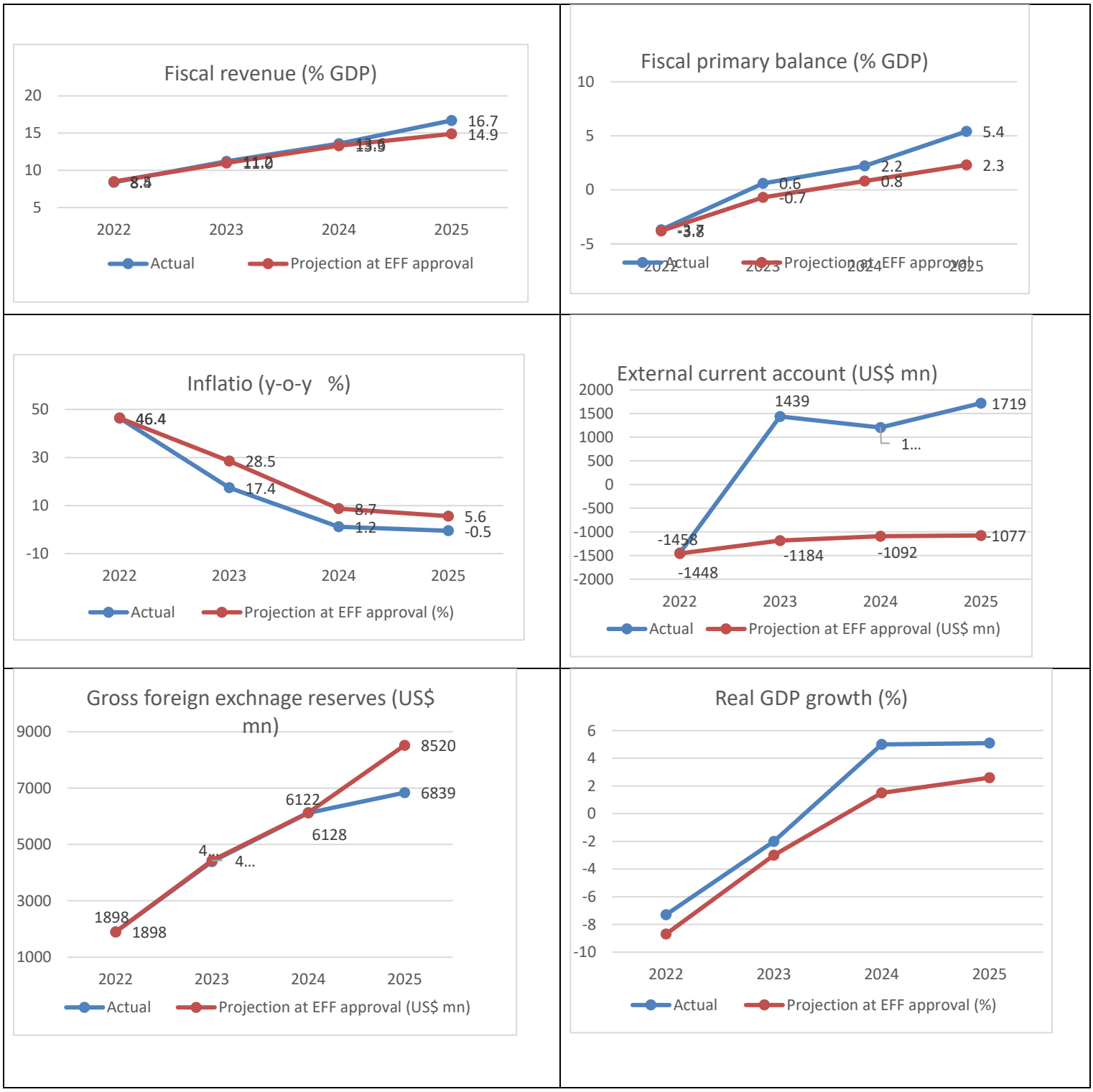
	2017-19[1]	2020-22[1]	2023	2024	2025	2026[2]	2027[2]
Public finance (% of GDP)							
Revenue and grants	12.4	8.5	11.2	13.6	16.7	15.2	15.1
Of which tax revenue	11.8	7.7	10.2	12.6	15.7	---	---
Expenditure	18.8	19.3	19.5	19	19	20.3	18.7
Primary balance	-0.9	-4.6	0.6	2.2	5.4	1.4	2.3
Overall fiscal balance	-6.4	-10.9	-8.3	-5.4	-2.3	-5.1	-3.7
Inflation (year on year)3 (%)	5.1	19.0	4.2	1.2	-0.5	5.0	5.3
US$/Rupee exchange rate	164.6	236.3	327.5	302.1	301.0	---	---
Nominal effective exchange rate (NEER)[3] (2017=100)	94.1	72.8	53.3	58.6	58.6	---	---
Rea effective exchange rate (REER)[4] (2017=100)	95.3	84.2	71.73	74.77	72.87	---	---
Trade balance (%)	-10.0	-7.7	-5.8	-6.1	-7.3	-8.2	-7.5
Current account balance (% of GDP)	-2.5	-2.3	-1.7	1.2	2.8	1.4	1.8
Gross international reserves (GIR) (US$ million)[5]	4854	3567	4392	6,122	6,838	8,645	11,779
As a percentage of based on the ARACM matrix[6]	---	6.8	24.4	53.2	59.4	73.6	96.9
Net international reserves (US$ million)[7]	---	-39.3	-404	2487	4,285.0	---	---

Notes

(1) Annual average. (2) IMF projection **(3**) Based on Colombo consumer price index (CCPI)
(4) See notes to Figure 2 for the definition of NEER and REER.
(5) date from 2021 onwards include Central Bank swap arrangement of US$1.4 with Peoples Bank of China
(5) IMF's assessing reserve adequacy composite matrix (ARACM) estimates the official foreign exchange reserves needed to protect the economy against potential external shocks, in addition to financing imports.
(7) GIR net of total outstanding debts of Central Bank (excluding SDR balances) and the Swap afflict from the Peoples' Bank of China.

Source: Data compiled from CBSL (*2025)*, statistical appendices, and IMF (2026).

Figure 4: Selected indicators of economic stabilisation relative to EFF targets



Source: IMF (2026) and CBSL (2026)

On the external front, persistent deficits in the current account of the balance of payments that had persisted for many years have turned into surplus of 1.2% of GDP in 2024 and increased to 2.8% of GDP in 2025. As discussed below, this has come from increase in tourism-led services and workers' remittance. There has not been yet a durable improvement in the external payment position from adjustment in the trade account outdistancing the significant improvement in international competitiveness (REER depreciation) resulted from the massive crisis-drive nominal depreciation followed by the flexible exchange rate regime under the EFF, coupled with decline in domestic inflation relative to trading partners.

Despite the modest improvement in the current account balance, the failure to meet the structural performance criteria relating to the accumulation of foreign exchange reserves remains the most significant slippage from the EFF targets. The stock of gross international reserves (GIRs) stood at US$6838 million in 2025 compared to the target of US$ 8520 million. This reserve level amounted to only 58.6% of the 'safety' estimated based on the level IMF's assessing reserve adequacy composite index (ARACI), which assesses official foreign exchange reserves to protect the economy against potential external shocks. The stock of net internation reserves (NRI), that is, GIRs net of Central Bank's commitments to the IMF and the US$ 1,4 billion swap arrangement with the Peoples' Bank of China (CBC) (which usable only for settling Yuan-denominated payments specified in the agreement signed with the CBC) was only 4.2 billion (roughly 36% of the ARACI level).

There are growing concerns in policy circles that the recorded improvement in the balance of payments is not being fully reflected in foreign-exchange inflows through the banking system, possibly because of heightened uncertainty about exchange-rate stability and the economy's external payment conditions. Against this backdrop, in June 2026, the Central Bank introduced a new export proceed surrender requirement for exporters to convert remaining foreign-exchange proceeds into rupees by the 10th day of the following month, subject to permitted uses.

4.2 Growth and adjustment

The growth rate of the economy in 2024 and 2025 exceeded the initial IMF productions (Figure 3). These figures, however, need to be interpreted with caution because they partly reflect the normalization of economic activity from the exceptionally low base created by the unprecedented economic contraction in 2022 which continued well into mid-2023. The IMF

currently projects that growth will moderate to 3.2% in 2027, while the World Bank projects growth of 3.8% in that year (IMF 2026; World Bank 2026).

The investment rate remains well below (30% of GDP in 2025) compared to the previous level of about 38% during 2017-19 (Table 2). Government investment has declined sharply relative to GDP, notwithstanding the significant increase in government revenue noted above. An interesting issue that warrants further scrutiny is whether the transfer of resources from the private sector to the government through taxation, notwithstanding its contribution to short-term economic stabilisation, has adversely affected private investment. Foreign direct investment (FDI) inflows, both in US dollar terms and relative to gross domestic investment, remain below their pre-crisis levels. There was a modest increase in the US dollar value of FDI inflows in 2025. More revealingly, however, data on the composition of investment by FDI-invested firms show that the share of 'FDI proper'—equity capital and reinvested earnings—in total investment declined from over 65% in the pre-crisis years to a mere 34% in 2025, with the balance largely financed through borrowing from unrelated parties, mainly banks.[17] This shift presumably mirror the reluctance of foreign investors to make substantial long-term commitments to operations in the country given the uncertainty surrounding the investment climate in the country (as discussed below). Moreover, the investment approval records of the Board of Investment, over 70% of the total approved investment during 2023-24) were in services (CBSL 2025b, Statistical Appendix, Table 24). Emerge trends of rapid increase in FDI in electronics and related industries underpinned by reconfiguration of global production networks due to geo-political upheaval is not reflected in the Sri Lanka FDI patterns (Athukorala and Hill 2026).

[17] In the late 2010s, Sri Lanka substantially relaxed restrictions on foreign-currency borrowing by licensed commercial banks and corporate entities. This enabled foreign-invested firms, as well as large domestic firms, to obtain foreign-currency financing through the banking system, partly in response to the high cost of domestic-currency bank financing. The policy, however, carried a less visible cost: by increasing foreign-currency liabilities in the private sector, it exposed the economy to greater vulnerability to external shocks, particularly sharp exchange-rate depreciation and disruptions in access to international finance.

Table 2: Growth and structural change, 2017-2020

	2017-19[1]	2020-22[1]	2023	2024	2025	2026[2]	2027[2]
Real GDP growth (%)	2.8	-2.6	-2.0	5.0	5.0	3.0	3.2
Per capita GNI at current US$[3]	4173.3	3678	3,702	4428	4910	---	---
National savings	23.8	30.1	26.0	27.6	31.2	27.4	24.2
National investment	38.3	33.1	25.0	27.1	30.2	27.9	24.3
Of which public investment	4.8	3.9	2.5	1.2	1.6	-0.5	-0.1
Foreign direct investment inflow[4] (US$ mn)	1115	637	713	759	1045		---
As % of gross domestic investment	3.2	2.5	3.5	2.9	3.2	---	---
Industrial production (2015 =100)	104.4	97.6	88.2	93.2	97.8	---	---
Export/GDP[5] (%)	21.1	18.2	18.2	19.8	19.0	---	---
Tradable products/GDP[5] (%) (2)	27.6	27.8	26.7	27.2	27.4	---	---

Notes

(1) Annual average (2) IMF projection.
(3) Gross national income per capita in rupee converted into US$ using the Wolrd Bank Atlas methods, which smooths exchange rate fluctuations though a three-year, inflation adjusted conversion factor.
(4) Including loans by foreign investment enterprises from unrelated parties
(5) See Notes to Figure 2 for definitions. --- Data not available
Source: Data compiled from CBSL (2025), statistical appendices, and IMF (2026)

There are no early signs yet of a reversal of the anti-tradable bias in the economy that, as discussed above, underpinned vulnerability to the COVID-19 shock (Figure 1; Table 2). The dramatic shift in the production structure towards non-tradables that began in the mid-1980s and gained further impetus during the debt-driven growth of the subsequent decades has continued unabated into the post-crisis years. More than two-thirds of the increase in real GDP between 2022 and 2025 originated in non-tradable sectors. The sustainability of this emerging growth pattern is questionable because growth in non-tradable sectors is ultimately constrained by the size of the domestic market. At the same time, there is little scope for a growth spurt through a public investment boom of the kind experienced in the 2010s, given the government's heavy debt-servicing burden. A palpable shift in the economic structure towards tradable production, particularly export-oriented production, is therefore needed to place the economy on a sustainable growth path.

Developments in the balance of payments closely reflect the persistent non-tradable bias in the domestic economy. The deficit in the merchandise trade account has, in fact, widened, driven by rapid import growth against virtual stagnation in exports. The modest current account surplus recorded during 2023–25 has been driven by surpluses in the services

and secondary income sub-accounts (Table 3). Services, dominated by tourist earnings[18], and remittances together outplaced merchandise exports in the composition of total current account receipt (Figure 5). The share of merchandise exports to total current account receipts declined from about 65% in 2022 to 46% in 2025. The decline is even sharper (from 63% to 42%) when petroleum products (bunkering and aviation fuel), which are virtually re-exported with little domestic value addition, are excluded, from the commodity composition. Overall, significant real exchange rate depreciation has not translated into notable increase in exports or reduction in imports through more efficient import-substituting production. There is yet no indication supporting the so-called twin-deficit hypothesis—that balance-of-payments adjustment follows automatically from real exchange rate depreciation achieved through fiscal consolidation and contractionary monetary policy.

In analysing emerging patterns of current account receipts, data on services exports needs to be treated with caution because the limitations of the gathering system (CBSL 2025). Data on merchandise trade directly come from Customs records. By contrast, as the banking system does not maintain detailed transaction records of services tractions, the Central Bank compiles services data from two other *indirect* sources: tourist earnings estimated by services by Sri Lanka Tourism Development Authority (SLTDA) and other services for surveys of identified service-providing companies. The SLIDA estimates tourist earning using the number of arrivals and length of stay of tourist obtained from immigration records at ports of entry, and the average daily expenditure per tourist derived from periodic departure surveys conducted by SIDA of foreign visitors at the airport. Revisions made in 2025 by SLIDA to its estimation process based on a comprehensive revisions data complication of average daily spending and average duration of stay casts doubt about the reliability data for previous years.[19] T

[18] The other items of services exports include computer and information technology, business processing outsourcing (BPO), port and airport services, contraction and management services.

[19] Tourist arrivals in 2025 (2.4 million) surpassed the peak in 2018 (2.3 million). However, the estimated total revenue was lower than 2018 due to downward revision in average daily spending and average duration of stay by the. This is also anecdotal evidence that some of the expenditures by tourist are met through overseas account without entering the country.

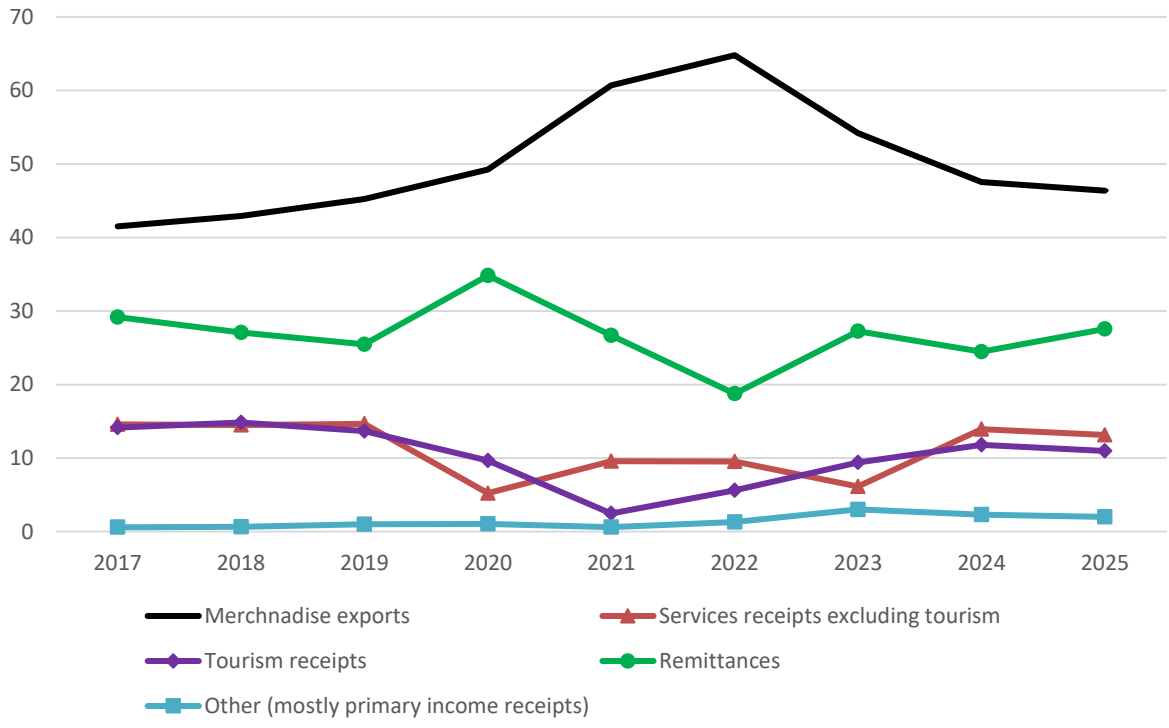
Table 3. Sri Lanka: Balance of payments: current account (US$ million)

	2017-19	2020-22	2023	2024	2025	2026[2]	2027[2]
Exports	11730	11884	11,911	12,772	13,581	14,131	14,401
Excluding petroleum products	10,296	10,606	10,603	11,337	12,075	---	---
Imports	21050	18328	16,811	18,841	21,480	23,095	22,748
Trade balance	-9320	-6444	-4,900	-6,069	-7,899	-8,964	-8,347
Services (net)	3306	1505	3,053	3,435	3,707	3,339	3,567
Primary income (net)	-2389	-2011	2,548	-2,598	-2,036	-2,530	-2,783
Secondary income (net)	6085	4973	5,834	6,439	7,947	7,621	7,448
Of which, workers' remittances net)	6965	5461	5,970	6,575	8,076	7,621	7,447
Current account balance	-2317	340	-1,439	1,207	1,719	1536	2011
Current account balance (% of GDP)	-2.5	-2.3	-1.7	1.2	2.8	1.4	1.8

Note; (1) Annual average. (2) IMF projection --- Data not available.

Source: Data compiled from Central Bank of Sri Lanka, *Annual Economic Review 2025*, statistical appendix, and IMF (2026).

Figure 5: Sri Lanka: Composition of current account receipts (%)



Based on data compiled from BCSL (2026) statistical appendices.

Remittances are the single most important item among current account receipts. Their share in total current account receipts increased from 19% in 2022 to 28% in 2025. During 2023-25 more than half of the current account deficit was filled by remittances. The data on remittances are generally more reliable compared to services data as they are based on records of the banking system. The actual remittance inflows into the economy could be even higher: the balance of payments figures rends to understating total inflows and hence increase in the dependence of the economy on labour exporting, because certain (yet unknown) percentage of total inward remittances take place though informal channel.

Remittances not only help relax the balance-of-payments constraint but also provide important income support to migrant workers' families and act as a 'safety valve' for domestic unemployment pressure. However, the net national gains from increase in remittances needs to be interpreted cautiously when assessing the recovery from the crisis, because sharp increase in labour out-migration is resource loss to the country. Labour migration is essentially a path-dependent process, in which past migrants shape prospective 'jobseeker' migrants' perceptions of the "reference wage" and possibilities seeking overseas jobs. In this context, sudden increase in the number of Sri Lankans departing for overseas employment in recent years, however, suggests that the failure to generate adequate domestic employment opportunities has been an important driver of the recent migration surge (and increase in remittances). A total of 1.234 million Sri Lankans left for overseas employment during 2022–2025, compared with 899,000 during 2016–2019—an increase of about 37 per cent.[20]

Dependence on labour outmigration remittances may also have adverse implications for long-term growth through the 'internationalisation of households'[21]—the growing ability of households, particularly affluent ones, to hold wealth abroad and relocate family members overseas, thereby insulating themselves from domestic economic and political instability. This phenomenon may weaken their loyalty to the state and reduce their incentives to exercise their voice in domestic affairs, potentially undermining support for domestic reforms.

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[20] Data are from the Sri Lanka Foreign Employment Bureau. The years 12010 and 2021 are excluded in the comparison to allow for Convid19 disruption.

[21] Carlos F. Díaz-Alejandro introduced this term and discussed the implications of this phenomenon for domestic economic policy in his influential paper on the Latin American debt crisis (Díaz-Alejandro, 1984, pp. 377–380).

4.5 Poverty and income inequality

Notwithstanding emerging signs of restored macroeconomic stability through fiscal consolidation, people's economic well-being remains substantially below pre-crisis levels. There is no tangible evidence that the EFF objective of mitigating the impact of the crisis on the poor and vulnerable through improved coverage and targeting of social safety net programmes has been achieved.

According to World Bank estimates, poverty rate (based on the lower-middle-income-country poverty threshold[22]) increased from 9.2% in 2019 to 13.1% in 2021 and then to 27.6% in 2023. This involved sifting addition 2.8 million people below the poverty line. About half of the 22 million population are concentrated within 20% above the poverty line and thus vulnerable to falling into poverty in face of unexpected income shocks. Income losses were concentrated on the bottom 40% of households, exacerbating income inequality. Since 2023, estimate poverty rate has declined marginally[23], reaching 22.1% in 2025, but it is still two times the pre-crisis (2019) rate. (Wolrd Bank 2026).

The findings of an Island-wide household survey of multidimensional poverty conducted in 2024/25 by the International Food Policy Research Institute (IFRI) in collaboration with the International Institute of Water Management (IWMI) in Sri Lanka,[24] are largely consistent with the World Bank estimates relating to the current state of poverty ((Stifel et al 2025). According to this survey, nearly one-quarter of Sri Lankan households are

[22] In 2017, the World Bank introduced two separate poverty rates for lower-middle-income countries and upper-middle-income countries in addition to the international poverty line US$3.20). In this paper we use poverty rate estimates based The Lower-middle-income-country rate because Sri Lanka is current (since 2026) raked just about the upper-middle-income threshold. This rate was initially set at US$3.65 (2017 PPP) and increased with effect from 2025 to US$4.20 (2021 PPP). The World Bank estimate poverty rates of Sri Lanka based on actual data from the 2019 Household Income and Expenditure income data from the national income accounts using the South Asian Region Poverty harmonization framework (SAR-POV).

[23] This decline is somewhat deceptive because the poverty rate is a simple extrapolation based on aggregate economic growth without considering possible structural changes in the economy in favour of high-income (non-wage) earners.

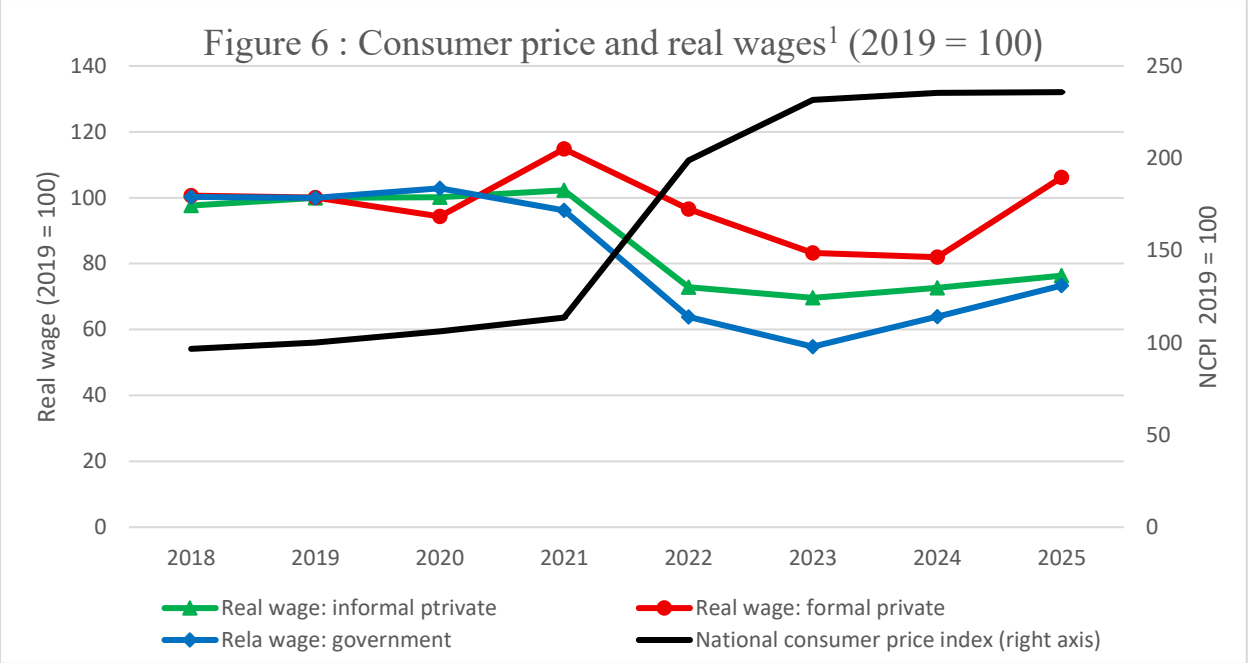
[24] The survey, termed the Building Resilient and Inclusive Growth and Holistic Transformation (BRIGHT) Survey, adopts a multidimensional approach to assessing economic well-being, encompassing such dimensions as education, health, and living standards, and covers 6,850 households.

in multidimensional poverty (MDP), and nearly one half of households are on the verge of crossing the MDP threshold. Thirty-three percent of households face moderate or severe deficiency in 2025, which was almost triple the rate in 2019. Most of the poor were disproportionally concentrated in rural areas and in the Estate (plantations) sector where over 80% of the total population live.

The Household Income and Expenditure Survey (HIES) of 2019 estimated the standard measure of income inequality, the Gini coefficient, at 37.7%. The World Bank's extrapolation of the HIES data suggests an increase in the coefficient to 38.5% in 2022, a modest increase in the dree of income inequality. The available estimates of the incidence of poverty by income categories, trends in real wages and labour income in total national income suggest that income inequality could have perhaps depend in the subsequent years.

Relating to the incidence of poverty by income groups, the World Bank observes increased concentration of households among the bottom 40% of the household in the income ladder. As already noted, the IFRI household found a increased clustering of households closer to the multi-dimensional poverty threshold. The data we have compiled on real wages and the to total remuneration for workers (labour income) in GDP are consistent these observed patterns (Figures 5 and 6).

Even though *the rate of inflation* declined from its peak of about 46% in 2022, *the price level* in 2025 was still about 7% higher than in that year. In the absence of a commensurate increase in nominal wages, on average real wages counted to remain below the precrisis level during 2021-25. The private sectors wage index does show a significant increase in 2025, following the precipitous contraction in the three preceding years. However, this index is not representative of wage trends across the country. It is based on minimum wages set by the Department of Labour under the Wages Boards Ordinance for sectors and industries accounting for only one-fifth of formal sector employment. Moreover, concerns persist about the gap between statutory minimum wages and wages actually received by workers, given weak enforcement of the Ordinance. The island wide informal sector wage index and public sector wage index are better indicators of the overall wage trends in the country. Both these indices record a contraction of real wages by about twenty percent during 2022-25 compared to the post-crisis levels (Figure 6).



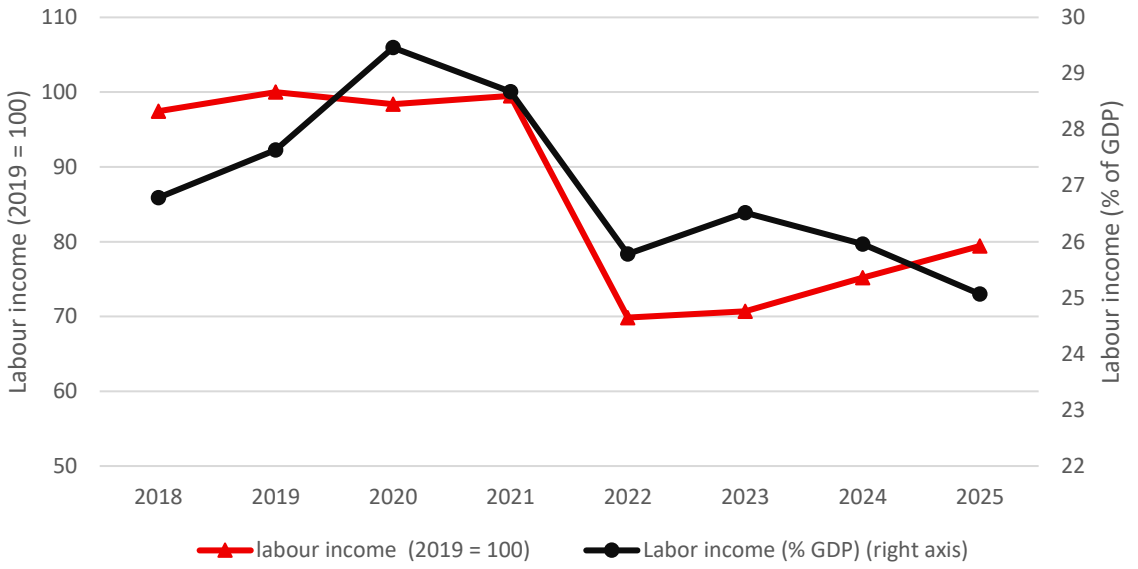
Note: Consumer price measured by the national consumer price index (NCPI). Nominal wage indices have been deflated by the NCPI. All indices are debased to 2019 to facilitate comparison.

Source: Compiled from data from CBSL (2026), statistical appendices.

Consistent with these wage trends, real labour income and the share of real wages in real GDP continued to remain well below their pre-crisis levels. Between 2023 and 2025, real GDP increased by about 10%, whereas real labour income increased by only 3.2%. Consequently, the labour income share of GDP declined from 26.1% to 25.1% over these two years, consistent with a shift in income distribution towards higher-income brackets and away from low-income ones Figure 7).

The available evidence on the impact of the COVID-19 shock and the subsequent financial crisis on micro, small and medium-sized enterprises (MSMEs) provide further support for the view that income inequality worsened in the post-crisis period. In addition to the adverse demand shock, the crisis-driven contraction and the high cost of bank financing contributed to widespread business failures and employment losses in this sector (DCS 2023; ILO 2023).

Figure 7: Real labout income (at 2015 prices), 2018-25



Source: Compiled from data from CBSL (2025), statistical appendices.

4.4 Debt sustainability

The aim of macroeconomic stabilization under the EFF program is to restore debt sustainably so that the country can renter external capital markets. Debt sustainability refers to a situation in which a country can meet its current and future debt-service obligations without requiring an excessively large adjustment in its balance of payments or fiscal position, while maintaining access to international capital markets on reasonable terms. This is vital for growth dynamism beyond the IMF program because, as a upper-middle income country Sri Lanka has limited opportunities to tractional concessional financing from bilateral donors and multilateral agencies. The key issue is whether the progress made towards macroeconomic stabilization so far been matched by progress towards restoring debt sustainability?

The stock of total national debt of Sri Lanka declined marginally from US$104 b in 2003 to US$92 bn in 2025 (Table 4). However, the IMF predict this to increase to about US$94bn by the end of the EFF programmes, which is about 20 % higher than the precrisis level (US$ 77.5%). Within the total national debt stock, total foreign debt increased from US$ 46.6bn to US$54.8 in 2025 is predicted to increase to US$ 58.9bn by 2027. This is about 13% higher than the precrisis level of about US$52bn. This increase seems to reflect the fact that debt restoring involved maturity extension and some coupon (interest rate) reduction rather than direct haircuts of ISBs and other commercial debt. This is bound to marginally increase under the interest rate arrangements for ISBs, if the growth rate increase beyond the

rate announced by the IMF (see next paragraph). In 2025, foreign debt (predominantly US$ denominated) accounted for 37% of total government debt.

Table 4, Sri Lanka: national debt and debt servicing

	2017-19[1]	2020-22[2]	2023	2024	2025	2026[2]	2027[2]
Central government debt[3]							
US$ billion	77.5	103.6	104.2	95.4	91.6	96.3	93.5
Of which foreign debt	36.9	42.5	42.3	34.7	34.6		
Interest payment/ government revenue (%)	47.6	73.6	79.9	55.9	45.5	42.8	39.7
Interest payment % of GDP)	5.4	7.0	8.9	7.6	7.6	6.5	6.0
Total external debt at market value[4]							
US$ billion	52.8	50.1	46.6	52.2	54.8	56.7	58.9
Percentage of GDP	57.2	60.4	55.4	55.4	50.3	51.7	52.7
Debt service payments (5)	5396	3895	2,751	4,254	5,149	---	---
Of which government's share (%)	61.4	78.0	52.6	33.9	47.1	---	---
Debt service ratio[6] (%)	27.5	26.2	15.9	21.6	24.9	---	---

Notes:
(1) Annual average; (2) IMF projection; (3) Includes government guaranteed debt
(4) Comprises central government debt and central bank's external liabilities (IMF credit outstanding and international currency swap arrangements, and private debt.
(5) Amortization of debt and interest payments
(6) Debt service payments as a percentage of goods and services exports.

Source: Data compiled from CBSL (2025), statistical appendices, and IMF (2026).

Whether the restructuring terms of ISBs were sufficiently favourable to Sri Lanka remains an open question. For comparison, Ghana, which experienced a sovereign debt crisis with a broadly comparable reliance on external commercial debt, secured a direct reduction (haircut) of about 37% in the claims of its international bondholders through its 2024 debt restructuring. By contrast, debt relief obtained by Sri Lanka was provided primarily through maturity extensions and reductions in coupon rates. The restructuring therefore involved mainly extending the repayment of a substantial portion of the debt beyond the agreed grace period while reducing its interest cost. The upfront reduction in debt service, largely through lower interest payments, amounted to about US$3 billion. However, under the terms agreed for the newly issued macro-linked bonds, this reduction could fall to US$1.8 billion if economic growth exceeds the IMF baseline or rises to US$4.3 billion if growth falls below the baseline. Paradoxically, therefore, stronger-than-anticipated economic growth could itself increase the debt-servicing burden. The question of whether Sri Lanka received a

comparatively favourable restructuring is further complicated by documented evidence of close operational interaction between Lazard, the financial adviser to the Sri Lankan government, and Rothschild & Co., the financial adviser to the Ad Hoc Group of international bondholders, during the restructuring negotiations. Whether this interaction had any bearing on the terms ultimately agreed remains an issue for further investigation (Ekanayake 2025).

Debt service ratio declined in 2022-2024 because of the debt standstill during restructuring period. However, it has already reached the precrisis level as the repayment of the first instalment (in 2025) of 'past due interest' (PDI) bond began in 2025 after the completion of ISB restructuring.[25] Debt service ratio would increase further after 2017 when coupon (interest) payment of ISBs and interest payment to another creditors.

Assuming a relatively conservative average interest rate of 5% on a debt stock of about US$92 billion (equivalent to 90% of GDP), annual interest payments would amount to about 4.5% of GDP, or roughly 40% of government revenue. This compares with the IMF programme target of a primary budget surplus of 2.3% of GDP. The gap implies that the government would need to rely on continued borrowing or other financing sources even to meet the interest obligations on the existing debt stock, leaving very limited fiscal space for other expenditures.

Given the massive debt overhang, with a sizeable share of it is accounted for by dollar denominated foreign debt, generating a primary fiscal surplus alone is not sufficient to service debt. This is the reason why IMF emphases the need to build up a sufficient reserve cover to manage debt. A noted, the IMF predicts that Sri Lanka needs a about stock of US$ 12 billion foreign exchange reserves (NFRs) by 2017, increasing further to over US$ 13billion by 2030 to serve external debt while protecting the economy against potential external shocks. The IMF measure of reserve adequacy (based on the IMF assessing reserve adequacy composite matrix) encompasses not only foreign exchange required to meet the import bill (conventional measured by import-month equivalent reserves) but also servicing the debt overhang and the possibility possible capital outflow in the event of investor confidence suffers a reversal. As noted, Sri Lanka's stocks of GFR (US$6.5bn) and NFR (5.4) in 2025 amounted to only 48% and 43%, respectively, of the IMF reserves target. Building reserves to the required safety level, while repaying PDIs and other debt serving

[25] In the context of sovereign debt restructuring, a Past Due Interest (PDI) bond is a bond issued to creditors to compensate them for interest payments that had accrued but were not paid when due.

commitments is indeed a challenging task. The conventionally used indicator of reserve adequacy, import-month equivalent reserves, is an inadequate indicator of the strength of reserve cover of a country which is faced with managing a large stock of debt, beyond financing imports.

Recently, the Central Bank has started reporting the sum of official foreign exchange reserves and net foreign assets of the banking system an alternative indicator of reserve adequacy. Net foreign assets of the commercial banks essentially indicate that banks are net creditors to the rest of the world. These assets are privately owned, not controlled by the government, and cannot automatically be used to serve sovereign debt and may not be readily available during a crisis because banks must meet obligations to depositors and creditors. Moreover, an increase in foreign-currency assets held by the banking system could also reflect a precautionary portfolio shift by banks away from domestic-currency assets in response to macroeconomic uncertainty associated with debt sustainability of the country (which is essentially hidden capital flight (Dornbusch et al 1990). Official foreign exchange reserves are, therefore, the country's only primary buffer against external shock: they can be used to service sovereign external debt, finance imports during crises, stabilise the exchange rate, and provide foreign currency liquidity to the banking system.

Even under the optimistic scenario of Central Bank achieve the IMF-projected required reserve levels, according to the IMF program Sri Lanka is still expected to raise initially US$ 1.5 in international bond markets to fill the external reserve gap in 2027. Following the near completion of the debt restructuring process in 2024, the major credit-rating agencies have lifted Sri Lanka's sovereign debt out of default status[26]. Technically, therefore, Sri Lanka has regained access to international private capital markets, and the external borrowing window remains open to the country to rollover external debt by taking new debt.

That said, actual re-entry into the international bond market will depend not only on the completion of debt restructuring but also market perception of the country's debt sustainability. Given the large stock of public debt, heavy interest-payment burden, and continuing economic uncertainty, Sri Lanka's sovereign credit rating remains firmly in the 'speculative grade' ('junk') category according to all three major international rating agencies: Moody's: Caa1, three notches below investment (Baa3) grade; S&P and Fitch: five

[26] Firch and Moody's lifted Sri Lanka's default status on 20 December 2024, and Standard & Poor on 11 September 2025.

notches below the investment grade (BBB). With these sovereign ratings, a new conventional dollar-denominated ISB issued by Sri Lanka would probably require a substantially higher risk premium. Measured by the J.P. Morgan EMBIG index, Sri Lanka's ISB spread had declined substantially after the ISB restructuring, from about 1,900 basis points to 520 basis points by January 2025. However, with the US 10-year Treasury yield at 4.66% in January 2025, this still implied a yield (coupon rate offer) of about 9.9% on Sri Lankan ISBs, substantially above the borrowing costs of investment-grade emerging-market sovereigns that is in the range of 5.5–6.5%. Historical evidence, of course, suggests that even repeated sovereign defaults do not necessarily deter investors from purchasing a country's sovereign bonds, provided that higher yields offer sufficient compensation for the perceived default risk (Mayer et al., 2022). The central concern, however, is that borrowing at such high interest rates would perpetuate the debt overhang, leaving a *sword of Damocles* hanging over the country's economic future and risking a trajectory of recurrent debt crises similar to Argentina's.

In the absence of adequate reserve cover, and with the cost of re-entering global capital markets virtually prohibitive, what policy options are available to Sri Lanka after the current IMF programme ends? One option, still advocated by anti-IMF ideologues, is a so-called 'home-grown' approach, similar to those pursued in the 1970s and in the immediate aftermath of the COVID-19 shock. Another, arguably both more politically palatable and economically rational, is to enter into a back-to-back IMF programme and undertake the structural adjustment reforms neglected thus far, supported by the policy discipline and financing provided by the Fund. An IMF programme provides a seal of approval for a country's macroeconomic policy framework, potentially facilitating access to financing from other development partners and bilateral creditors, including the World Bank, the Asian Development Bank and Paris Club countries. As Sri Lanka's experience under the EFF has demonstrated, an IMF agreement can also strengthen the government's hand in implementing politically difficult reforms.

6. Concluding remarks: Policy challenge beyond the EFF programme

Sri Lanka's stabilization record under the EFF programme is encouraging, but the available evidence suggests that the programme is likely to end with a substantial debt overhang still weighing on the economy. Achieving sustained and equitable growth while carrying this heavy debt burden will remain a daunting development challenge for the country beyond the

EFF programme. Overall, the Sri Lankan experience under the EFF so far supports the case for combining the standard IMF approach to macroeconomic stabilization with a coherent programme of structural adjustment reforms aimed at addressing the underlying sources of the country's vulnerability to the crisis in the first place.

Given the magnitude of the debt overhang and the large share of foreign-currency-denominated debt, Sri Lanka faces a twin challenge beyond mere stabilization: raising sufficient fiscal revenue to service the debt (the 'payment problem') and generating the foreign exchange needed to meet external debt-service obligations (the 'transfer problem'). Addressing these two challenges simultaneously and effectively requires redressing the long-standing anti-tradable bias in the economy. Opportunities for growth in non-tradable production are naturally constrained by the size of the domestic market. Moreover, government investment, which was an important source of growth in non-tradable activities during the pre-crisis period, is now constrained by the government's commitment to maintaining a primary surplus for debt servicing.

In this context, a disproportionate share of the 'new' growth needed both to generate additional government revenue and to strengthen foreign-exchange reserves in the post-crisis era must come from tradable production, particularly export-oriented activities. There is considerable evidence that countries experiencing a substantial debt overhang tend to face prolonged periods of sub-par growth, unless significant structural shifts occur towards tradable production, particularly export-oriented production (Dornbusch 2002, Reinhart, Reinhart and Rogoff 2012).

The macroeconomic policy stance introduced under the EFF is broadly consistent with the requirements of export-oriented development. A flexible exchange-rate regime that places greater emphasis on nominal exchange-rate adjustment through market forces, rather than using the exchange rate as an inflation anchor, would help create an incentive structure conducive to an export-oriented development strategy. However, the Sri Lankan experience clearly suggests that a competitive real effective exchange rate, by itself, is unlikely to generate the anticipated expansion of exports and the associated balance-of-payments adjustment, contrary to the view implicit in the conventional 'twin-deficit' approach. Exchange-rate policy therefore needs to be complemented by policies that address structural impediments to export expansion. Coherent structural reforms are required to unshackle the economy from the distorted trade and investment regimes that have long underpinned the anti-tradable bias and, in turn, contributed to the country's vulnerability to the crisis.

A protectionist trade regime draws resources into import-competing domestic

activities at the expense of export-oriented production. The resulting structure of protection weakens the international competitiveness of domestic production and constrains long-term economic growth. Trade reforms therefore need to be evidence-based, supported by a careful analysis of the structure of protection and of how the incentive structure can be tilted in favour of export-oriented production without compromising the government's revenue-raising objectives. Simply adjusting tariff rates through consultations with the domestic import-substitution protectionist lobby (*Daily FT*, 20 June 2026) would be a counterproductive approach to tariff reform.

Sri Lanka's own record—albeit one that stopped short of being fully accomplished—of diversifying its historically primary-commodity-dependent export structure into manufacturing has clearly demonstrated the pivotal role of FDI in export-oriented growth (Athukorala et al. 2017). FDI is particularly important for linking domestic manufacturing to global manufacturing value chains, which now account for more than two-thirds of global manufacturing exports. At the same time, given the country's limited scope for relying on bilateral and multilateral concessional financial support, FDI is increasingly important for supplementing domestic savings to finance investment as well as for easing the foreign-exchange constraint. Foreign investors can also strengthen domestic manufacturing through joint-venture operations and demonstration effects, by introducing new technologies and management practices and intensifying competition in domestic markets.

Therefore, reforming the distorted and politically influenced investment regime should receive high priority, *pari passu* with trade reform, on the post-crisis reform agenda. Investors who have been deterred by the distorted regime are likely to wait and see whether Sri Lanka can credibly rebuild its investment climate and international reputation. The message of commitment to FDI promotion must therefore come from the highest political level. Repealing the two Acts that laid the foundation for political contamination of the foreign investment regime and restoring the BOI's 'one-stop-shop' status in approving investment projects should figure prominently in this message.

Further fiscal consolidation through revenue mobilization is, of course, essential not only for debt servicing but also for creating fiscal space for social safety nets and development projects. However, overreliance on revenue-based consolidation may be counterproductive if the resulting tax burden constrains private investment and economic activity. More generally, excessive reliance on contractionary fiscal policy can weaken economic recovery and medium-term growth, particularly when adjustment is front-loaded, private credit is constrained, and public investment is curtailed (Baldacci et al., 2013;

Blanchard and Leigh, 2013). There is therefore a strong case for complementing revenue mobilization with efforts to generate public savings by rationalizing government expenditure, while protecting social spending and productive public investment.

The 'elephant in the room' in this connection is the massive drain on public resources from state-owned enterprises (SOEs) and statutory bodies, most of which are loss-making. Some exist only on paper, remaining dormant while continuing to absorb scarce public resources. In 2025, dividends and levies received by the government from SOEs amounted a mere 0.34% of the total assets (about US$ 55 billion) trapped in these enterprises. Quite apart from their budgetary implications, tying up scarce resources in inefficient public enterprises runs counter to the government's objective of raising productivity in domestic production. Inefficiency in SOEs producing intermediate goods can also generate negative productivity spillovers to private enterprises that depend on these goods as inputs, thereby raising their production costs and undermining their competitiveness. Independently of their budgetary implications, SOEs also have important consequences for macroeconomic stability and private-sector operations. Whether and how the government can move beyond its political commitment to state ownership and align the SOE sector with the reforms supported by the IMF will be an important issue in Sri Lanka's post-EFF development strategy. The recent rescue of Sri Lankan Airlines by the government vividly exemplifies the policy dilemma confronting the government. The total fiscal cost to the Treasury of this rescue operation was US$398 million[27]. Notably, this was higher than total government expenditure on tertiary and university education in 2025, which amounted to US$365 million.[28]

The evidence harnessed in the paper clear suggests unprecedented sovereign debt crisis in Sri Lanka was the outcome of the 'perennial' vulnerability of the economy to external shocks that was compounded by structural anti-tradable bias in the economy rooted in the debt-driven development strategy and policy reversals during the post-civil war era. Sri Lanka's policy challenge is to take the unprecedented economic crisis as the springboard for laying the foundations for building a resilient outward-oriented economy. This requires

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[27] Restructuring of the US$175 million bond plus the rupee value of massive capital injection and the government's assumption of part of the interest payments to the two state-owned banks.

[28] Figures reported in this paragraph are estimates based on reported in the *Final Budget Position Report (Annual Report) 2025* of the Sri Lankan Ministry of Finance (SLMF 2025). Rupee values given in the reports were converted into US$ using average annual exchange rate (Rs 300.9 5 per US$) in 2025

combining the standard IMF approach to macroeconomic stabilisation with coherent structural adjustment reforms, clearly articulated and effectively communicated. Equally important is the creation of a broad social consensus in support of the reforms needed to implement such a strategy. Stabilization of the economy and placing it on a self-sustained growth path is not simply a technical exercise in macroeconomic management; its success ultimately depends on the political economy of reform—on building credibility, securing public support, and sustaining the commitment needed to carry reforms through. Forward looking nature of the private sector decision making meant that effectiveness short term policies depends on their long-term consistency and credibility.

Appendix

Sri Lanka – IMF Extended Fund Facility: Cconditions for monitoring the country's progress'.[1]

Quantitative Performance Criteria (QPCs)[2]
Reduce primary deficit as a percentage of GDP from -3.8% in 2022 to 0.7% in 2013 and improve it to 2.3% from 2025.
Tax revenue target of 10% of GDP
Clear the stock of outstanding spending arrears of the government by end-June 2023
Refrain from monetary financing of the budget deficit other than Central Bank's CBSL's temporary holdings of treasury securities for short-term monetary operations)[5]
Allowing greater exchange rate flexibility and rebuilding foreign reserve buffer (Net official international reserves through CBSL's outright foreign exchange purchases on a net basis of $1.4 billion in 2023)
Indicative targets[3]
Commitment to increase tax revenue collection
Protect and increase social safety net spending: 0.6 of GDP in 2023.
Limit the issuance of treasury guarantees
Ensure consistency of bilateral payment agreements with Article VIII (continuous performance criteria).
No multiple currency practices
No import restrictions for balance-of-payments purposes

Inflation must remain within consultation bands around the programmed target
Ensure that the national budget consistent with program parameters and needed revenue measures are implemented timely fashion
Parliamentary approval of the welfare benefit payments scheme and application of the new eligibility criteria by May 2023.
Setting retail fuel prices to their cost-recovery levels with monthly formula-based adjustment, and compensate the CPC for providing any residual fuel subsidies with on-budget transfers (continuous structural benchmark)
Determine the cost-recovery based electricity tariff and government transfer requirement by December 2023
Ensuring that the CPC and the electricity sector are fully compensated for the residual fuel and electricity subsidies with on-budget transfers with no cost of non-commercial obligations for fuel and electricity
Enacting a new parliamentary fiscal management law, which clarifies the budget process, specifies the roles of government agencies, and includes a revamped fiscal rules framework, with submission to Parliament by December 2023
Strengthen the governance of SOEs and address their debt overhangs: beyond the energy pricing reforms, comprehensive strategy to restructuring the balance sheets of the CPC, CEB, the Road Development Authority, and Sri Lankan Airlines by June 2023
Strengthen the institutional framework supporting flexible infraction targeting and greater exchange rate flexibility by approve the new Central Bank Act by the Cabinet in December 2022, with Parliamentary approval expected by April 2023
By July 2023, The Central Bank develops a roadmap for financial sector restructuring and recapitalization to address capital and foreign exchange liquidity shortfalls identified through the diagnostic exercise, and to intervene in banks assessed to be non-viable.
To support compliance with the roadmap, the MOF will determine the size, timing, instruments, and terms and conditions for potential government recapitalization of viable banks which are unable to close capital shortfalls from private sources by October 2023
A full version of the Banking Act will be approved by Cabinet by June 2023 and approved by Parliament by December 2023, with a view to implementing it by January 2024 to strengthening institutional framework for financial sector supervision and management.

Commitment to advance governance and anti-corruption reforms as a central pillar of the program. the report of governance diagnostic and anti-corruption prepared by the IMF governance diagnostic mission will be published by September 2023

Notes

(1) This table is based IMF (2023), the first IMF reports that announced the Sri Lanka EFF. The Subsequent reviews retained the same broad framework while recalibrating the numerical targets and adding or revising structural benchmarks as reforms advanced.

(2) Quantitative Performance Criteria (QPCs): Mandatory numerical targets that a country must meet to receive subsequent IMF disbursements. Failure to meet quantitative performance criterion normally requires the country to obtain a formal waiver from the IMF Executive Board before further funds can be released.

(3) Structural Benchmarks (SBs): Specific policy reforms or institutional measures that support the objectives of the program. Unlike QPCs, they are not expressed as numerical targets. Structural benchmarks are intended to address underlying structural weaknesses that may impede macroeconomic stability and growth.

(4) Indicative Targets (ITs): quantitative targets used for monitoring purposes, but they are less critical than performance criteria. Missing an indicative target does not automatically interrupt IMF financing, but it signals that policies may need adjustment and is discussed during program reviews.

(5) There was a ceiling on CBSL net credit to government in the original list of conditionality. This was removed at the first review in December 2023 because direct monetary financing had effectively ceased under the new Central Bank Act.

(6) A tax revenue floor became a Quantitative Performance Criterion with effect from the second review in December 2023. It was on the indicative target list until then.

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