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The stabilisation is done.
The hard part starts now.

 S R I L A N K A

Deep Dive into the IMF Report

Fifth & Sixth Reviews Under Extended Fund Facility

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FIRST CAPITAL RESEARCH

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***Please refer page 9 for an important disclaimer*

Overview



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- The latest IMF report (May 2026) shows that Sri Lanka's reform programme is delivering results
- The country has moved past the crisis: debt is stabilising, reserves are rebuilding, and fiscal targets are being met
- However, the programme ends in March 2027, and what follows is uncharted territory
- In this context, we analyze the report and highlight FIVE key questions shaping Sri Lanka's post-crisis trajectory

Central Questions

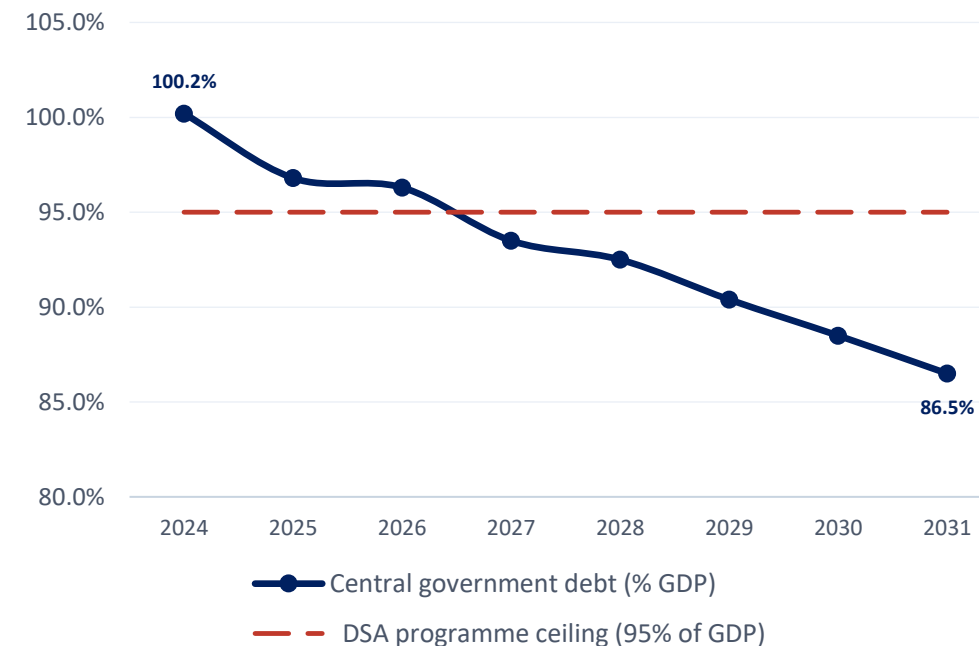
1. Is Debt Sustainable Going Forward?
2. Is Fiscal Consolidation on Track?
3. Can Sri Lanka Meet Its External Financing Needs?
4. How Far Have Reforms Progressed, and What Remains?
5. Where Is Growth Coming From - and Is It Sustainable?

1. Is Debt Sustainable Going Forward?



- Debt sustainability, both domestic and external, has improved significantly since the 2022 crisis
- Key indicators have strengthened: debt-to-GDP (public*: 125.8% to 101.1%; central government: 116% to 96.8% over 2022–2025), gross financing needs declined from 33.9% to 19.0%, and the interest-to-revenue ratio improved from 79% to 46%.
- Yet, the IMF cautions that sustainability is restored only under the baseline scenario
- Risks remain elevated, with progress dependent on continued reforms; any policy slippage, external shocks, or disruptions to debt restructuring could reverse these gains

IMF Projection - Central Government Debt to GDP



Key Risk Indicators

- Risk of Gross Financial Needs **High**
- Interest to Revenue **High**

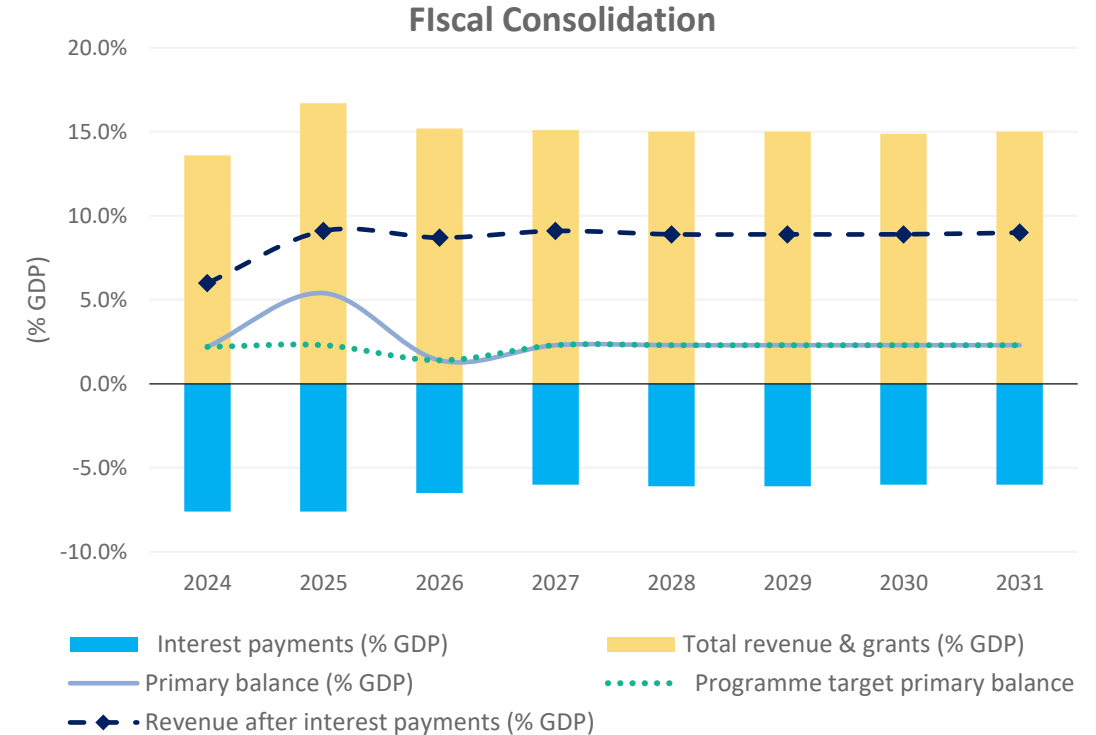
*Comprising central government debt, publicly guaranteed debt, and CBSL external liabilities (i.e., Fund credit outstanding and international currency swap arrangements). The debt statistics currently assume the external debt restructuring to have been completed at end 2023.

2. Is Fiscal Consolidation on Track?



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- Fiscal consolidation, reducing deficits and stabilising debt, has been a key pillar of the programme
- It has been one of the strongest-performing areas, supported by tax revenue generated through the relaxation of vehicle imports in 2025, with the primary surplus reaching 5.4% in 2025, well above the target.
- For 2026, the IMF has lowered the primary surplus target to 1.4% to accommodate post-cyclone reconstruction and mitigate the impact of Middle East tensions.
- However, the target rises again from 2027, as sustaining fiscal gains will be critical once one-off revenue boosts begin to fade



Key Milestones

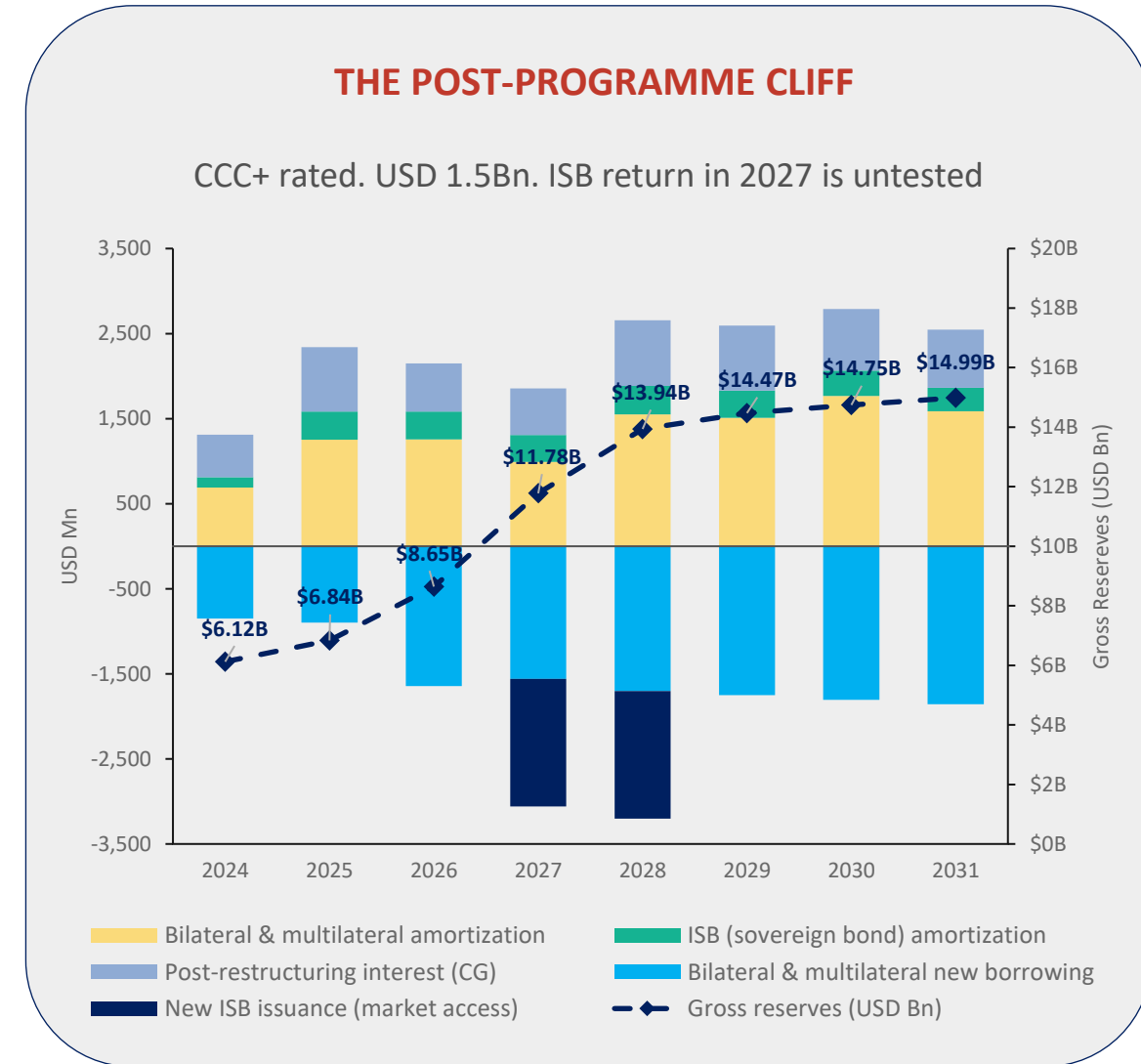
- Tax/GDP 12.3% (2024) is up to 2025 actual 15.4% : +3.1pp surge from VAT & excise
- Primary surplus 5.4% (2025) - smashed programme target of 2.3% for the year

3. Can Sri Lanka Meet Its External Financing Needs?



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- External financing remains a critical constraint, separate from overall debt sustainability
- The report highlights persistent external obligations (debt amortization and interest) offset by new financing and borrowing flows
- A key inflection point is 2027-2028, where external financing needs rise sharply alongside reliance on new ISB issuance
- Reserves are projected to improve steadily but the buildup is gradual through these new financing sources
- This underlines a core risk: reserve accumulation and external stability depend heavily on sustained market access and successful financing operation



4. How Far Have Reforms Progressed, and What Remains?



- Structural reforms show mixed progress, with some key areas on track but others lagging
- Energy pricing and monetary policy reforms are progressing, but cost recovery has been only partially achieved, while the monetary framework continues to strengthen
- The financial sector is stabilising, with recapitalisation and declining NPLs, but it remains under watch for residual vulnerabilities
- Key vulnerabilities persist in SOEs, where restructuring is slow and fiscal risks remain elevated
- Exchange rate flexibility and **external sector reforms remain insufficient**, leaving Sri Lanka exposed to future external shocks

On Track

Energy Pricing

On Track

Monetary Policy

Watchful

Financial Sector

Incomplete

SOEs (CEB, Airlines)

Incomplete

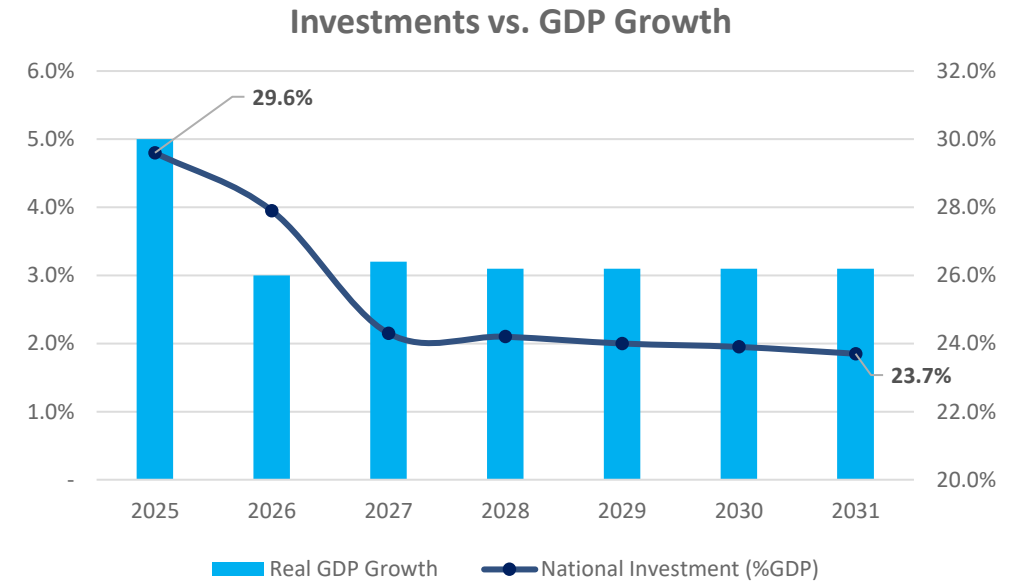
Export Diversification

5. Where Is Growth Coming From - And Is It Sustainable?



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- Growth has rebounded, with GDP expanding 4.8% in 2025Q4 despite external shocks, driven by tourism, services, and recovering demand
- However, 2026 growth is projected at 3.0%, reflecting downside risks, including external shocks
- The recovery is largely consumption-led, supported by rising incomes, remittances, and strong credit growth (private credit +25% YoY)
- Yet, investment and export diversification, key to sustainable growth, remain weak
- Without structural reforms (trade, labour, regulation, infrastructure), long-term growth potential remains constrained



Key Milestones

▲ 2025 GDP: 5.0%

- Strongest growth since 2012

▼ 2026 GDP (Expected): 3.0%

- Weaker growth due to Middle East shocks

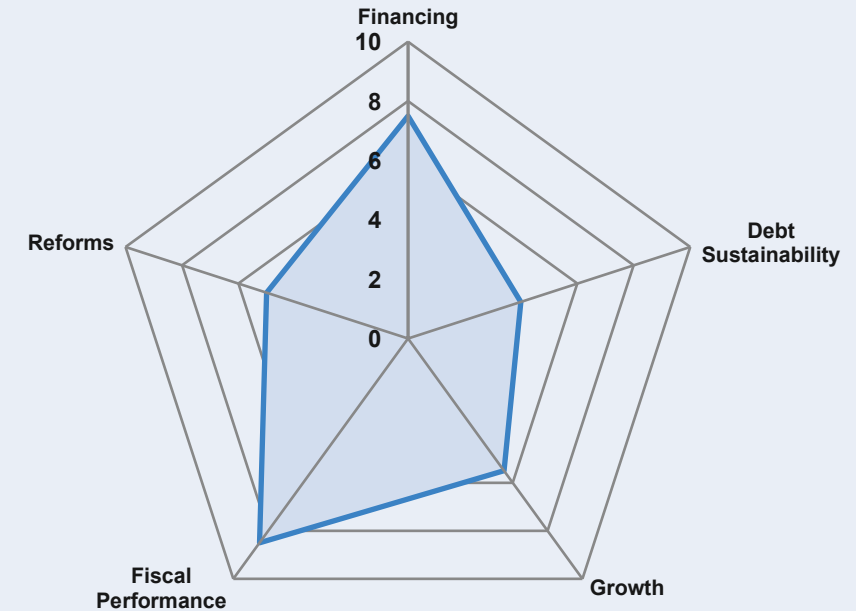
▼ Investment Outlook:

- Investment projected to fall from 29.6% to 23.7% of GDP (2028–2031), likely capping long-term growth at around 3.1%

Summary



- Sri Lanka has stabilised, but vulnerabilities remain elevated across key areas
- Financing conditions have improved, but 2027 ISB issuance will be the first real test of market confidence
- Debt is declining but remains fragile with risks building post-2028
- Growth is narrow and consumption-led, with weak investment and no meaningful structural transformation
- Fiscal performance is strong but reliant on rate-driven revenues
- Reforms are incomplete - progress in some areas, but SOEs and exports lag



Five axes covering Financing, Debt Sustainability, Growth, Fiscal Performance, and Reforms, each scored 0–10 using a normalised scale based on the IMF report.



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MANAGING RISKS”*



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