

The Future of the Sri Lankan Stock Market and the Current Political Situation

Executive Summary

This report examines the future prospects of the Sri Lankan stock market in the context of the country's current political situation. Sri Lanka has undergone significant political changes with the election of President Anura Kumara Dissanayake in September 2024 and his National People's Power (NPP) coalition securing a parliamentary majority in November 2024. This political shift represents a break from traditional political oligarchies and has coincided with a strong stock market performance, with the CSE All Share Index showing a 38.60% year-to-date increase as of March 2025.

The Sri Lankan economy is showing signs of recovery from the severe crisis of 2022, with positive growth, low inflation, and a boom in tourism. The government is implementing economic reforms under an IMF program while attempting to balance fiscal discipline with growth initiatives. The stock market outlook for 2025 remains cautiously optimistic, with market capitalization projected to reach US\$15.49 billion and key sectors such as export-oriented companies, renewable energy, and tourism showing particular promise.

However, significant challenges remain, including the government's ability to implement economic reforms while maintaining social stability, compliance with IMF program targets, and navigating geopolitical relationships. The relationship between political developments and market performance will continue to be a critical factor for investors in Sri Lankan equities.

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1. Introduction

Sri Lanka, an island nation in South Asia, has experienced significant economic and political turbulence in recent years. The country faced a severe economic crisis in 2022 that led to the resignation of then-President Gotabaya Rajapaksa amid mass protests. Since then, Sri Lanka has been on a path to recovery, implementing economic reforms under an IMF program and experiencing a major political shift with the election of Anura Kumara Dissanayake as president in September 2024.

This report examines the current state and future prospects of the Sri Lankan stock market in the context of these political developments. It analyzes how political factors influence market performance, identifies key sectors for investment, and assesses the regulatory environment. The report aims to provide a comprehensive understanding of the interplay between politics and the stock market in Sri Lanka, offering insights for investors, policymakers, and analysts interested in the country's economic future.

2. Current Stock Market Performance

Market Indicators

The Colombo Stock Exchange (CSE) has shown strong performance in early 2025, with the CSE All Share Price Index (ASPI) at 15,847.80 as of March 26, 2025. Despite a daily decrease of 0.38% (-60.43 points), the index has recorded an impressive year-to-date performance of +38.60%. The S&P SL20 Index, which tracks the performance of the 20 largest and most liquid companies, stands at 4,741.90 with a daily change of -0.33%.

Market Statistics

- **Market Capitalization:** Rs. 5,610,644,943,708.00 (approximately US\$15.49 billion)
- **Value of Turnover:** Rs. 1,638,382,850.00
- **Volume of Turnover:** 88,143,440.00 shares
- **Number of Trades:** 10,911
- **Listed Companies:** 285
- **Traded Companies:** 255

Valuation Metrics

The Sri Lankan stock market currently displays relatively attractive valuation metrics compared to many emerging markets:

- **Market P/E Ratio:** 8.3
- **Market Price to Book Value (PBV):** 1.1
- **Market Dividend Yield (DY):** 3.5%

Domestic vs Foreign Investment

The market shows a predominance of domestic investment activity:

- **Domestic Purchases:** Rs. 1,495,247,230.00
- **Domestic Sales:** Rs. 1,629,038,080.00
- **Foreign Purchases:** Rs. 143,135,632.00
- **Foreign Sales:** Rs. 9,344,786.00
- **Domestic Trading Volume:** 85,892,160.00 shares (97.4% of total)
- **Foreign Trading Volume:** 2,251,276.00 shares (2.6% of total)

This data indicates a market that has performed strongly in 2025 despite recent daily fluctuations, with domestic investors dominating trading activity while foreign investors remain cautious.

3. Political Landscape in Sri Lanka

Recent Political Changes

Sri Lankan politics underwent a significant transformation in 2024 with the election of Anura Kumara Dissanayake, a Marxist lawmaker from the left-wing National People's Power (NPP) alliance, as president in September. This was followed by his coalition winning a substantial majority in the snap general election held in November 2024, providing him with the legislative power needed to implement his agenda.

This election represented a critical break from the political oligarchies that have long dominated Sri Lankan politics, as voters rejected the traditional political establishment following years of economic mismanagement that culminated in the 2022 crisis.

Current Government

- **President:** Anura Kumara Dissanayake (commonly referred to by his initials AKD)
- **Ruling Coalition:** National People's Power (NPP) alliance, led by the Janatha Vimukthi Peramuna (JVP)
- **Political Orientation:** Left-wing/Marxist
- **Parliamentary Position:** Strong majority secured in November 2024 general election

Political Stability

While the government has achieved political stability in its first six months, it faces the challenge of maintaining this stability while implementing potentially difficult economic reforms. The memory of the 2022 protests that led to the resignation of the previous president remains fresh, creating political pressure to avoid austerity measures that could trigger similar unrest.

International Relations

The new government is navigating relationships with major powers including India and China, with reports mentioning an "Adani controversy" related to Sri Lanka's energy policy. The government's approach to these relationships will have implications for foreign investment and economic development.

4. Economic Reforms and Challenges

IMF Program and Fiscal Targets

Sri Lanka is implementing economic reforms under an IMF Extended Fund Facility (EFF) program. The IMF Executive Board completed the third review under this program in February 2025, confirming the country's progress in restoring macroeconomic stability and debt sustainability.

Key fiscal targets include:

- Maintaining a primary account surplus of 2.3% of GDP for 2025
- Reducing the budget deficit to 5.2% in 2025 from 7.6% in 2024
- Increasing public investment from 13% of government expenditure in 2024 to 18% in 2025

Reform Implementation Challenges

The government faces several challenges in implementing economic reforms:

Fiscal Challenges

- **Limited Fiscal Space:** With restricted financial resources and an economy still finding its footing, the government faces pressure to improve public finances while supporting growth.
- **Revenue Generation:** The IMF emphasizes the importance of continuing to deliver revenues needed for essential government services, including by limiting tax exemptions.

Political Challenges

- **Balancing Reform with Social Protection:** The government must balance economic reforms with protecting the poor and vulnerable, a politically sensitive issue.
- **Public Expectations:** After winning on a platform of change, the NPP government faces high public expectations for economic improvement while implementing potentially painful reforms.

Structural Challenges

- **Legacy Issues:** Sri Lanka defaulted in 2022 amid unsustainable debt and depleted reserves, driven by macroeconomic mismanagement and long-standing structural weaknesses.
- **Economic System Reform:** The government has stated it is "prepared to implement the economic policy framework needed to address challenges in our economic system this year" (Presidential Media Division, January 2025).

Economic Recovery Signs

Despite these challenges, the economy is showing signs of stabilization in early 2025:

- Positive growth, with the Central Bank expecting growth above 3% in 2025
- Low inflation
- A boom in tourism
- Improved external sector performance, approaching or surpassing the levels achieved in 2019

5. Stock Market Outlook and Key Sectors

Market Outlook for 2025

The investment landscape for the Sri Lankan stock market in 2025 presents a cautiously optimistic outlook:

- **Growth Projection:** Market capitalization is projected to reach US\$15.49 billion in 2025 (Statista)
- **Performance Expectation:** Stock market returns are expected to remain positive, with extreme bullishness in Q1 2025 and a potential slowdown during the second half of the year (First Capital)
- **Investor Sentiment:** Investment landscape presents a cautiously optimistic outlook as the country transitions toward fiscal stability and economic recovery (Echelon)

Key Sectors for Investment

Based on current trends and government policies, several sectors show particular promise for investment in 2025:

Export-oriented Companies

- Notable companies: Teejay Lanka, Hayleys
- Benefiting from government focus on export growth and improved external sector performance

Renewable Energy

- Notable companies: WindForce, Vallibel Power
- Aligned with government's environmental policies and energy independence goals

Infrastructure & Construction

- Poised to benefit from increased public investment (18% of government expenditure in 2025)

Tourism

- Experiencing a boom in early 2025
- Key contributor to economic stabilization and foreign exchange earnings

Digital and IT/BPO

- Identified as a key growth sector by the Ceylon Chamber of Commerce
- Potential for growth in global services exports

Agriculture

- Focus area in the Ceylon Chamber's Outlook 2025 report
- Important for food security and rural development

Investment Strategies

- **First Capital Recommendation:** Positive on equities for 2025, particularly in Q1
- **Investor Roundtable Consensus:** 2025 will be good for equities as the country continues its recovery
- **Foreign Investment Perspective:** "While returns might moderate over time, the longer Sri Lanka stays on this path [of stability], the more confidence foreign investors will have in the market" (Echelon, January 2025)

6. Regulatory Environment and Reforms

Recent Regulatory Developments

Demutualization of the Colombo Stock Exchange

- The Demutualization of the Colombo Stock Exchange Act (January 2025) aims to convert the CSE from a company limited by guarantee into a company limited by shares.
- This reform is designed to modernize the exchange structure, improve governance, and potentially attract more investment to the market.

Budget 2025 Regulatory Reforms

The Sri Lanka Budget 2025 has introduced significant policy changes affecting the financial sector:

1. Exchange of Information between State Institutions Act

- Aims to improve information sharing and transparency

2. Investment Protection Act

- Designed to strengthen investor protections and rights
- Expected to boost investor confidence, particularly for foreign investors

3. State Business Enterprises Management Act

- Will reform governance of state-owned enterprises
- May impact listed companies with state ownership

Central Bank Reforms

- **Central Bank Act of 2023:** Provides a framework for flexible inflation targeting and Central Bank independence

- **Implementation in 2025:** The Central Bank can now refuse to finance government deficits, improving monetary policy credibility

Foreign Investment Regulations

- **Opportunity for Foreign Investors:** The CSE presents significant opportunities for USD-based investments considering Sri Lanka's potential GDP growth
- **Foreign Currency Considerations:** Regulatory changes to facilitate raising capital in foreign currency

Future Regulatory Outlook

- **Continued Reform Agenda:** The government is expected to continue implementing market-friendly reforms as part of the broader economic transformation strategy
- **Alignment with International Standards:** Ongoing efforts to align Sri Lankan market regulations with international best practices
- **Digital Transformation:** Potential regulatory updates to accommodate technological advancements in trading and settlement systems

7. Relationship Between Political Situation and Stock Market

Political Factors Influencing the Stock Market

Political Stability and Investor Confidence

- **Post-Election Stability:** A stable political environment following the 2024 elections has generally boosted investor sentiment by reducing uncertainty and providing a clearer outlook on economic policies.
- **Market Performance:** The Colombo Stock Exchange has demonstrated growth influenced by improved political stability, with the CSE All-Share index showing a 38.60% year-to-date increase as of March 2025.
- **Foreign Investment Impact:** "While returns might moderate over time, the longer Sri Lanka stays on this path [of stability], the more confidence foreign investors will have in the market" (Echelon, January 2025).

Government Policy Implementation

- **Budget Compliance:** The government's commitment to maintaining a primary account surplus of 2.3% of GDP in line with IMF requirements for 2025 has provided policy predictability that markets value.
- **Deficit Reduction Targets:** Under its agreement with the IMF, Sri Lanka has to trim its budget deficit to 5.2% in 2025 from 7.6% in 2024, which impacts government spending and economic activity.
- **Reform Credibility:** Markets have rewarded Sri Lanka's reforms with sharp declines in domestic borrowing costs from 30% in 2023 to 8% in early 2025, demonstrating investor confidence in the government's economic management.

Political Leadership and Market Sentiment

- **Transition Impact:** The election of President Anura Kumara Dissanayake and his NPP coalition marked a significant shift from traditional political oligarchies, initially creating market uncertainty but later stabilizing as policy directions became clearer.
- **Corruption Perception:** "Sri Lanka's political climate has been marred by instability and allegations of corruption, leading to a loss of investor trust, both locally and internationally" (Lanka Business Online, September 2024). The new government's anti-corruption stance may improve market integrity perceptions.
- **Legislative Support:** The NPP's strong parliamentary majority provides the legislative power needed to implement economic reforms, reducing policy implementation risks that investors typically factor into market decisions.

Stock Market Response to Political Developments

Market Volatility During Political Transitions

- **Election Period Fluctuations:** Sri Lankan stocks dipped as the presidential vote approached in 2024, with energy and real estate losses pushing the CSE All Share index down.
- **Post-Election Rally:** Following the election results and formation of a stable government, the market demonstrated renewed confidence with the CSE All-Share index rising significantly.
- **Sector-Specific Impacts:** Utilities and communication services showed particular strength during political transition periods, suggesting these sectors may be perceived as more stable during political changes.

Economic Reform Impact on Market Sectors

- **Export-Oriented Companies:** The government's focus on export growth has positively impacted export-oriented companies.
- **Infrastructure & Construction:** The increase in public investment from 13% to 18% of government expenditure in 2025 has created positive sentiment for infrastructure and construction stocks.
- **State-Owned Enterprise Reforms:** The proposed State Business Enterprises Management Act may impact listed companies with state ownership, creating both opportunities and risks depending on implementation.

8. Future Prospects and Investment Considerations

Key Political Risks for the Market

Reform Implementation Challenges

The government's ability to implement economic reforms while maintaining social stability remains a key risk factor for market performance. Any significant social unrest similar to the 2022 protests could derail market confidence and economic recovery.

IMF Program Compliance

Any deviation from IMF program targets could negatively impact investor confidence and market performance. The government must navigate the delicate balance between meeting IMF requirements and addressing domestic political pressures.

Ideological Tensions

Despite coming from a Marxist background, Dissanayake's government has largely continued market-oriented reforms, but any shift toward more interventionist policies could create market uncertainty. Investors should monitor policy statements and implementation for signs of ideological shifts.

Positive Political Catalysts

Regulatory Improvements

The Demutualization of the Colombo Stock Exchange Act and other regulatory reforms are expected to enhance market efficiency and attract more investment, potentially leading to increased market liquidity and foreign participation.

Economic Growth Policies

The government's target of 5% growth in 2025 through improved productivity, boosted exports, and foreign investments creates positive sentiment for equities. Successful implementation of these policies could drive sustained market growth.

Debt Restructuring Progress

Continued progress on debt restructuring negotiations, supported by political stability, would significantly reduce market risk perceptions and potentially lead to credit rating improvements, lowering borrowing costs for both the government and corporations.

Investment Considerations

Sector Selection

Investors should consider sectors aligned with government priorities and economic reform agenda, particularly export-oriented companies, renewable energy, infrastructure, tourism, and digital services.

Valuation Opportunities

The relatively low P/E ratio (8.3) compared to many emerging markets suggests potential undervaluation, possibly reflecting lingering political risk premiums. This may present opportunities for investors with a higher risk tolerance and longer investment horizon.

Foreign vs. Domestic Investment Approach

Local investors have shown strong interest despite some foreign sell-offs during political transitions, indicating different risk assessments between domestic and international investors. Foreign investors may benefit from partnering with local expertise to navigate the market.

Long-term Perspective

If the government successfully implements structural reforms to address long-standing weaknesses, the stock market could see sustained growth beyond short-term fluctuations. Investors with a long-term perspective may benefit from the country's economic transformation.

9. Conclusion

The Sri Lankan stock market stands at a pivotal juncture in early 2025, influenced by both the country's ongoing economic recovery and significant political changes. The election of President Anura Kumara Disanayake and his NPP coalition has brought political stability and a commitment to economic reforms, contributing to the strong market performance observed in early 2025.

The market outlook remains cautiously optimistic, with projected growth in market capitalization and positive sentiment in key sectors such as export-oriented companies, renewable energy, and tourism. The regulatory environment is improving with reforms like the Demutualization of the Colombo Stock Exchange Act and other measures aimed at enhancing market efficiency and investor protection.

However, significant challenges remain. The government must navigate the delicate balance between implementing IMF-mandated reforms and maintaining social stability. Any deviation from IMF program targets or emergence of social unrest could negatively impact market performance. Additionally, the government's ideological background creates uncertainty about potential policy shifts that could affect market sentiment.

For investors, Sri Lanka presents both opportunities and risks. The relatively low valuation metrics suggest potential undervaluation, but this reflects the political and economic risks that remain. Sectors aligned with government priorities offer the most promising investment prospects, while a long-term perspective may be necessary to benefit from the country's economic transformation.

In conclusion, the future of the Sri Lankan stock market is inextricably linked to the country's political situation. The current political stability and reform commitment provide a positive foundation for market growth, but continued vigilance of political developments remains essential for investors in Sri Lankan equities.

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