



RIS Discussion Paper # 349

Neighbourhood First Policy: India's Role in Sri Lanka's Debt Recovery

Ganeshan Wignaraja



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Neighbourhood First Policy: India's Role in Sri Lanka's Debt Recovery

Ganeshan Wignaraja*

Abstract: In April 2022, Sri Lanka became Asia's first sovereign debt defaulter of the 21st century, triggering a severe economic crisis. Under its Neighbourhood First Policy (NFP), India was the first major responder, both during the 2022 crisis, after Cyclone Ditwah in December 2025 and during the Iran war. Indian assistance, an IMF programme and prudent economic policies have supported Sri Lanka's remarkable recovery, although downside risks remain, including heightened global economic uncertainty. The time is therefore ripe for India's NFP engagement with Sri Lanka to move beyond aid towards trade and connectivity. The most effective basis for this transition would be to align Sri Lanka's domestic policy priorities with NFP initiatives. Key priorities include early engagement on a new IMF programme, supported by Indian leadership of an aid consortium; a dedicated disaster management ministry and economic reforms drawing on India's experience; conclusion of a modern India–Sri Lanka free trade agreement; and investment in a bilateral undersea oil pipeline and electricity transmission line.

Keywords: Sri Lanka, Cyclone Ditwah, Neighbourhood First Policy, Debt, India.

Introduction

The experience of Sri Lanka in the 2020s can be viewed as a test case for the effectiveness of India's Neighbourhood First Policy (NFP). India's NFP is a core element of its foreign policy aimed at prioritizing and strengthening political, economic, and security ties with immediate

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South Asian neighbours. Initiated around 2008 by the Indian government of then Prime Minister Manmohan Singh, it was later emphasised by Prime Minister Narendra Modi's government and formally launched in 2014 (Behuria, 2025). India seeks to promote regional peace, stability, connectivity and trade with a view to increasing India's regional and global influence. The peace and stability aspect of NFP is in the spotlight due to India's crisis management efforts in South Asia. India has played a primary role as first aid responder aid during recent regional disaster and economic crises in the Maldives and Sri Lanka. It also engaged in political crisis and transitions in Bangladesh, Myanmar and Nepal.

The effectiveness of NFP in South Asia has been debated in the literature. Raja Mohan (2015 and 2017) argues that NFP must undergo a fundamental reset. He asserts that the policy is currently bogged down by legacy diplomatic thinking promoting hegemony and that India should build partnerships rooted in equality, mutual economic benefit, and deep regional integration. Rajan (2024) suggests that the amount of its aid largely depends on the nature of bilateral ties India currently shares with its neighbouring countries. He shows that in India's 2024/25 budget, aid allocations were increased to Sri Lanka and Nepal while modestly reducing support to Bangladesh and the Maldives. Bhatia (2026) contends that NFP outcomes on a bilateral basis are often mixed due to actions on both sides and that it is an opportune moment to reboot the initiative to improve its effectiveness and neighbours' perceptions of India's asymmetric regional role. Similarly, Sivamurthy (2025) argues that some bilateral connectivity projects under NFP have been implemented while others have been cancelled. He suggests that politics, nationalism, and protectionism have continued to hinder the prospects of better bilateral connectivity.

India's major emergency and humanitarian aid to Sri Lanka particularly during the island's sovereign debt default in 2022 and during Cyclone Ditwah in 2025 provide insights on the NFP debate. This paper applies an economics lens to addresses two important public

policy questions on the Sri Lanka's experience: (1) how effective was NFP emergency and humanitarian aid? and (2) what might be done to shift NFP's focus from aid to a trade and connectivity relationship? It discusses Sri Lanka's economic recovery and the contribution of NFP aid, the effects of Cyclone Ditwah and the Iran war on Sri Lanka and better aligning Sri Lanka's policy priorities with NFP objectives to promote trade, connectivity and macroeconomic stability.

Sri Lanka in Recovery Mode and Indian Aid

The first question relates to the effectiveness of NFP emergency and humanitarian aid. A brief update on causes of the default/economic crisis is useful for the discussion of Sri Lanka's recovery and NFP aid's contribution.

On 12 April 2022, Sri Lanka announced a pre-emptive sovereign default on its foreign debt obligations (Ministry of Finance Sri Lanka, 2022). The government suspended payments pending an International Monetary Fund (IMF) bailout and a comprehensive debt restructuring process. Following this initial announcement, Sri Lanka formally entered a "hard default" on May 19, 2022. A 30-day grace period to come up with US\$78m of unpaid debt interest payments on bond coupons expired (Smith, 2025).

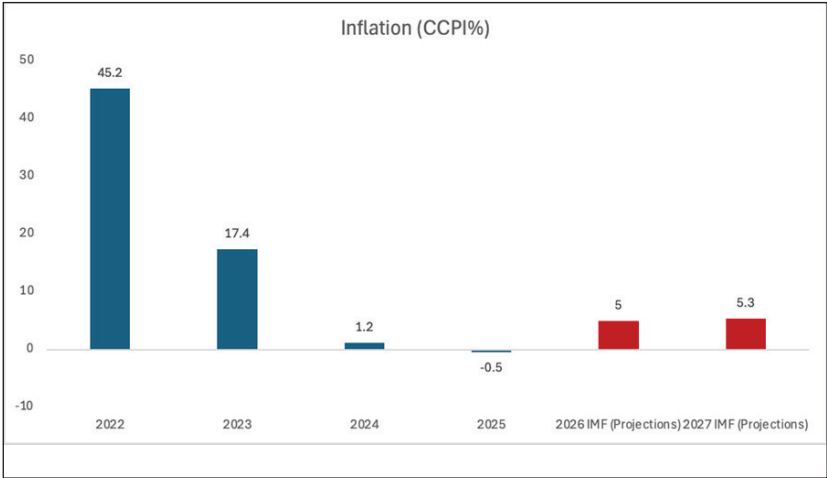
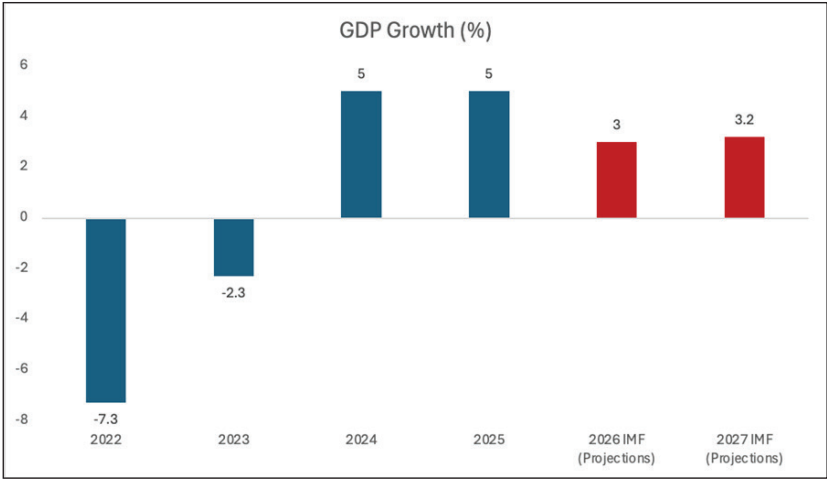
At the time of default Sri Lanka's total public debt stood at about US\$ 80 billion which was made up of about 50% external debt and 50% domestic debt (Breuer *et.al.* 2025, Table 1). External debt of US\$ 41.6 billion was dominated by private bondholders (32.2 per cent) and multilateral development banks (27.6 per cent). China was the largest bilateral creditor with 17.8 per cent while India had 4.3% per cent in bilateral loans and credit lines.¹ Meanwhile, gross foreign reserves had fallen to a mere US\$ 25 million (or less than half a day of import cover).² The default triggered the worst economic and political crisis in the country's post-independence history and made it Asia first defaulter in the 21st Century. As Figure 1 shows, the economy contracted significantly in 2022, inflation spiralled, government revenue dropped to a low

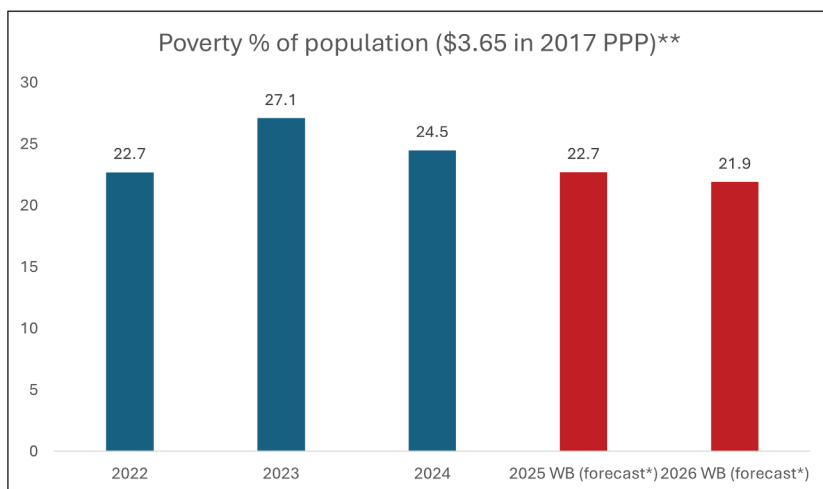
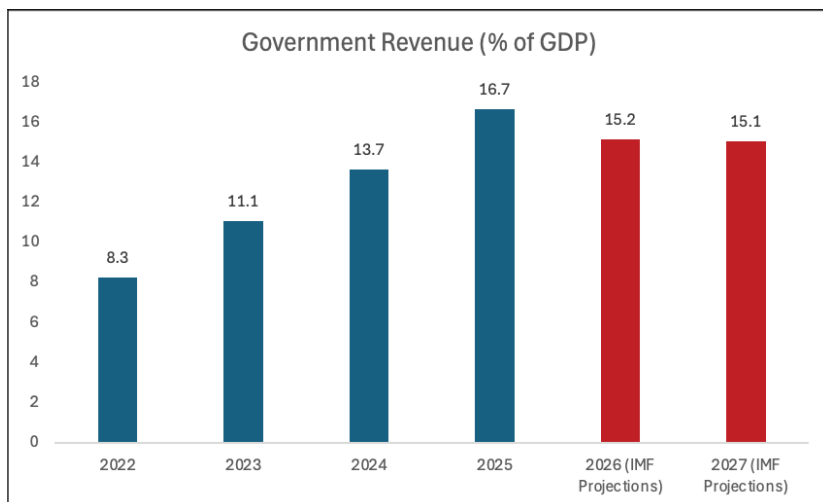
and poverty doubled. Political consequences followed with Gotabaya Rajapaksa resigning as President in July 2022 following mass protests over corruption and the escalating cost of living.

The causes of Sri Lanka's 2022 crisis are well documented (see Athukorala and Wagle, 2022, Basu, 2022 and Wignaraja, 2024a and b). In summary, this resulted from a convergence of long-term structural issues in economy and acute, public policy missteps. Key factors include (i) persistent fiscal and current account deficits run by successive governments, (ii) a heavy reliance on foreign borrowing particularly from China for low return infrastructure projects without considering potential traffic flows (including the infamous Hambantota Port and Matala Airport), (iii) multiple external shocks (such as the Covid-19 pandemic, the Ukraine war and the Easter Sunday bombings) and (iv) so-called 'home grown solutions' to the economic crisis (e.g. sudden tax cuts, an abrupt chemical fertilizer ban, a fixed exchange rate and import controls). Sri Lanka's crisis offers several policy lessons for others in debt distress including there are net benefits of going early to the IMF, strengthen safety nets to mitigate poverty and political instability, and develop effective crisis management capacity (Wignaraja, 2022).

Fast forwarding to August 2026, the good news is that Sri Lanka's is in recovery mode. It marks a successful 23 months in office for President Anura Kumara Disanayake's National Peoples Power (NPP) government. His September 2024 presidential victory as leader of the left-leaning National People's Power (NPP) coalition marked a break with Sri Lanka's long-standing dominance by established political families. His predecessor, Ranil Wickremesinghe, was elected President by the Parliament of Sri Lanka in July 2022. He secured the presidency to complete the remainder of Gotabaya Rajapaksa's term.

Figure 1 Sri Lanka: Key Macroeconomic Indicators, 2022-2026





Sources: IMF (2026) 5th and 6th reviews of Sri Lanka; World Bank (2025a) Sri Lanka Development update.

Sri Lanka's recovery was supported by external financing and public policy. These include: a US\$ 4 billion emergency Indian NFP aid package in 2022 (Box 1 has a review), a US\$ 2.9 billion 17th International

Monetary Fund (IMF) programme since 2023, and prudent monetary policy by the Central Bank of Sri Lanka. The NPP government also pragmatically continued with the demanding IMF programme despite the NPP having previously campaigned for renegotiation of its terms. Other initiatives include the 'Praja Shakthi' national program for grassroots development, 'Clean Sri Lanka', improving state efficiency, combating corruption, revision of labour laws, and education reform.

The 17th IMF programme being implemented over 2023-2027 has the toughest policy conditionality so far. It focuses on revenue-based fiscal consolidation. and seeks to raise tax revenue and increase utility prices; control inflation by raising interest rates, eliminating monetary financing and a law to create an independent central bank; rebuilding foreign exchange reserves through a flexible exchange rate; safeguarding financial stability by ensuring adequately capitalised banks and a new banking act; and reducing corruption risks by better fiscal transparency and public financial management.

Furthermore, in November 2023 Sri Lanka concluded an initial agreement with key bilateral creditors, including India and the Paris Club, to restructure US\$5.9 billion in external debt. This was important to reduce interest payments and to unlock IMF financing. This deal follows China's separate debt restructuring agreement with Sri Lanka. While the details are not public, these agreements are on similar terms, extending deadlines and lowering interest rates. In 2024, Sri Lanka successfully finalized its comprehensive debt restructuring with international private bondholders. The agreement on roughly US\$ 12.6 billion in foreign sovereign bonds features a 27 per cent principal haircut, delayed maturities, reduced interest rates, and the introduction of GDP-linked macro-bonds (Ministry of Finance, Sri Lanka, 2024).

The data in Figure 1 show Sri Lanka rapid turnaround from the economic contraction and inflationary spiral of 2022. The economy grew at 5 per cent in 2025 compared to -7.3 per cent in 2022. In 2026 Q1, growth was 5.1 per cent, year on year underlining the recovery which began in 2023Q1. Inflation (measured by the Colombo Consumer Price

Index) was -0.5 per cent in 2025 compared to 46.4 per cent in 2022. Gross foreign reserves have increased significantly to over US\$ 6.4 billion in July 2026 compared to US\$ 25 million in April 2022. However, according to IMF (2026), Sri Lanka's public debt to GDP ratio remains high at 101.1 per cent in 2025 (down from 128 per cent at end 2022). The implications of looming foreign debt repayments, a rating upgrade to access international capital market and an 18th IMF programme are discussed below. Furthermore, estimated income poverty still affects about a quarter of the population of 23 million and child malnutrition levels remain high - stains on a country once cited as a basic human need's success story by Nobel Laureate Professor Amartya Sen (1988). As early as the 1970s, Sri Lanka had high achievements in health and education compared to many poor countries. The overall cost of living also remains high for those on fixed incomes who have had modest salary rises less than inflation.

Sri Lanka's recovery enabled the passing of a welfare-oriented 2026 national budget in November 2026. The budget theme, 'Steady and Strong: Committing to Fiscal Discipline for a Resilient Economy', largely supports the IMF's path of revenue-based fiscal consolidation. It targets a primary surplus of 2.5 per cent of GDP, total government revenue of 15.4 per cent of GDP, and an overall fiscal deficit of 5.1 per cent of GDP for 2026. However, the budget's growth target of about 7 per cent in 2026 appears ambitious given the IMF's projection of half that, and global economic uncertainties. The budget also gave political relief for the NPP's base (e.g. allocations for building public housing, irrigation investment, public sector wage increases salary rises and public sector hiring). This is due to the success in raising the tax-to-GDP ratio to an estimated 16.7 per cent in 2025 (up from 8.2 per cent in 2022) by widening the tax base, revenue administration reforms and under-expenditure investment.

Table 1. Indian NFP Aid to Sri Lanka 2022 and 2025

Indian Aid for Economic Crisis - 2022/23		Indian Aid for Cyclone Ditwah - 2025	
Aid Category	Amounts (US\$)	Aid Category	Amounts (US\$)
Credit facility to import essential food, medicine & commodities	1 Billion	Concessional LOC for reconstruction of infrastructure, health and education	350 Million
LOC for fuel, Gas and energy products	500 Million	Grants for community rehabilitation and disaster resilience	100 Million
Currency swap to boost foreign reserves	400 Million	Immediate relief deliveries including 58+ tonnes of dry rations, tents, hygiene kits, 60 tonnes of equipment such as boats, generator, 185 tonnes of Bailey bridge units, field hospital and NDRF teams for rescue & medical support, deployed Chetak helicopters from INS Vikrant and MI-17 helicopters and three aircraft	Value not monetised
ACU deferment under Asian Clearing Union to ease forex pressure	2 Billion		
LOC for fertilizer	55 Million		
Humanitarian aid, including 9000MT rice, 50MT milk powder, 25MT medicines and medical supply, and kerosene	Value not monetised		
Source: Data extracted from High commission of India - India Sri Lanka bilateral relations		Source: Data extracted from High commission of India - India Sri Lanka bilateral relations	

The Effects of External Shocks on Sri Lanka

External shocks are affecting Sri Lanka's promising post-budget outlook. Between late November and early December 2025, Cyclone Ditwah brought heavy rains, floods and landslides to Sri Lanka causing extensive deaths and damage across the country. On 11th December, The UN in Sri Lanka reported that nearly 10 per cent of Sri Lanka's population were affected, with over 600 people died or missing to date (UN Sri Lanka, 2025). More than 91,000 homes have been damaged or destroyed. On 17th December 2025, the World Bank estimated the total damage from Cyclone Ditwah at US\$ 4.1 billion or about 4 per cent of Sri Lanka's total GDP. This is probably the worst natural disaster in Sri Lanka's history (World Bank, 2025).

The NPP government appealed for emergency aid (including a US\$ 200 million IMF Rapid Financing Instrument) and set up a managed Rebuild Sri Lanka Fund. But the composition and gender balance of the fund's management committee has drawn political criticism. So has the lack of early warning to the population of the path of Cyclone Ditwah, slow distribution of foreign aid to the worst affected areas of the country and small financial flows into the Fund.

Once again India acted as a first responder under NFP to Sri Lanka's appeal in a timely and significant manner. On 23 December 2025, India's External Affairs Minister S. Jaishankar held discussions in Colombo with Sri Lanka's President Dissanayake on relief and reconstruction efforts from Cyclone Ditwah. The high-level visit led to tangible aid outcomes. Minister Jaishankar announced an Indian reconstruction aid package of US\$ 450 million to Sri Lanka consisting of US\$ 100 million in grants and US\$ 350 in concessional loans (see Table 1). This package is on top of the crucial humanitarian Indian aid efforts in the aftermath of Cyclone Ditwah including helicopters from India's aircraft carrier, INS Vikrant, to help with search and rescue operations in flood affected areas in Sri Lanka. As discussed below, Prime Minister Modi also undertook a state visit to Sri Lanka in April 2025 during which key connectivity projects were initiated.

The on-going Iran war (or Operation Epic Fury) which started in late February 2026 may prove to be a more challenging external shock to Sri Lanka's economy. The Middle East region is a critical global hub for oil, gas, and professional services, and the ongoing Iran-related conflict is already creating economic ripple effects across global and vulnerable Sri Lankan economy. One immediate effect has been the increase in global oil prices. In late April and July 2026, West Texas Intermediate (WTI) crude oil was trading around US\$ 100–US\$ 101 per barrel. For Sri Lanka, this has led to higher petrol and diesel prices, affecting domestic fuel and fertilizer costs and translating into a higher cost of living. A prolonged conflict would hit worker conditions and remittances and tea exports. Sri Lanka receives about US\$8 billion annually in remittances, and roughly 50 per cent comes from Middle Eastern countries. Sri Lankan tea exports are dependent on the Middle East which absorbs half of such exports. The Iran war has also caused maritime trade and aviation stoppage and raised insurance risk premiums, affecting Sri Lanka.

India also supported Sri Lanka during the Iran war by providing emergency fuel supplies and assistance with the evacuation of Sri Lankan nationals from the conflict zone. Through Lanka IOC, the Sri Lankan subsidiary of its state-owned oil company, India dispatched an emergency consignment of 38,000 metric tons of petroleum products, including diesel and petrol, to Colombo. This support helped stabilise Sri Lanka's energy supply after the conflict in West Asia disrupted regular routes. India also assisted Sri Lanka in evacuating students and other nationals from Iran, reinforcing its role as a first responder under the NFP.

On the upside, some potential opportunities for Sri Lanka exist. Dubai, Doha, and other Gulf centres currently act as regional hubs and safe havens for capital and people. A prolonged Iran war and disruptions in the Middle East, may prompted investors and professionals to look for alternative haven locations in South and Southeast Asia including Singapore, Bangkok and Bangalore. Sri Lanka with advantages including a strategic geographic location in the Indian Ocean, a modern Colombo Port and conducive living environment for expatriates and their families offers a South Asian hub for relocation of FDI and professionals.

Table 2. Iran War Effects on Sri Lanka's Outlook – Two Possible Scenarios

Best Case (Contained Shock)	Medium Case (Persistent Disruption)
Shipping in the Strait of Hormuz continues under escort, with oil prices staying in the US\$78–90/bbl range.	A "de facto" on/off, high-risk, "war-risk premium" scenario causes big tanker delays.
This means moderate inflation (~5.4 per cent-6.1 per cent)	Oil fluctuates between US\$85–105/bbl, pushing inflation to 5.6-6.3 per cent
With small growth hit (2.7 per cent-4 per cent), but energy import dependence means higher costs.	Slowing growth (~2.4-3.5 per cent)
Modest rise in poverty	Notable rise in poverty
Public finances manageable	Public finances strained

Source: Author's estimates and perceptions. Work in progress May 2026.

Scenarios analysis offers insights for economic policy planning in Sri Lanka. Table 2 outlines my preliminary near-term Iran war shock scenarios for Sri Lanka's outlook. In the base case scenario of a contained shock, the Strait of Hormuz remains open, oil prices stay in the \$78–90 per barrel range, inflation is moderate (5.4-6.1 per cent), growth is sustained between 2.7 per cent and 4 per cent and poverty rises modestly – a somewhat manageable fiscal position. In a second scenario of a persistent disruption in the Strait of Hormuz oil rises above \$100 per barrel, inflation increases to the 5.6–6.3 per cent range, growth slows more to between 2.4 per cent and 3.5 per cent, poverty rises notably, and public finances come under increasing strain. Sri Lanka appears to be moving towards the second scenario, with a prolonged Middle East war posing major downside risks: oil-led inflation, slower growth, higher poverty and fiscal pressure.

Sri Lanka Priorities and Shifting Indian NFP

The second question explored in this paper is how to shift from an aid relationship to a trade and connectivity relationship in line with India's NFP objectives. The scenario analysis pointed to the upside issue of Sri Lanka positioning itself as an alternative safe haven for capital and professionals thereby leveraging its advantages of a strategic geographic location in the Indian Ocean, a modern Colombo Port and conducive living environment for expatriates. In an ideal world of public policy, this involves matching domestic policy priorities for recovery with NFP objectives building on previous NFP emergency and humanitarian aid. The discussion below explores key priorities for Sri Lanka to manage economic risks (both downside and upside) from the scenario analysis and fitting available/new NFP initiatives to advance these priorities. A couple of suggestions below relate to the NFP stability objective while the rest concern trade and connectivity.

First, *engage on an 18th IMF programme and an aid consortium to continue macroeconomic stability*. The current IMF programme ends in March 2027 and assumes that Sri Lanka will achieve a primary balance of 2.3 per cent of GDP while resuming large external debt repayments from 2028. It also assumes Sri Lanka's renewed access to international capital markets to issue bonds for debt servicing. Despite improved macroeconomic indicators (see Figure 1) and completed sovereign debt restructuring, it remains uncertain whether Sri Lanka can secure a sufficient sovereign credit rating upgrade. Weak external liquidity (including limited reserve rebuilding and volatile export earnings) could raise concerns about renewed default risk and delay a rating upgrade. Given that negotiations for the current IMF programme took 11 months, early planning for an 18th programme is prudent. This process should assess whether Sri Lanka needs a shadow IMF programme without financing and conditionality or a full programme with both elements, and identify the key elements required to support growth. The IMF is likely to give favourable consideration for an 18th IMF programme due to Sri Lanka's strong implementation thus far of the 17th IMF programme. For

instance, in late December 2025, Sri Lanka's strong IMF programme implementation likely facilitated the rapid approval of a US\$ 206 million IMF Rapid Financing Instrument (RFI) without additional conditionality.

As a G20 member and influential voice at the IMF, India is well placed to support Sri Lanka's request for an 18th IMF programme. Sri Lanka belongs to an IMF Executive Board constituency led by India. India also played a crucial role in enabling Sri Lanka's 17th IMF programme, both through its Executive Board representation and through high-level political support from Finance Minister Nirmala Sitharaman. But the quantum of IMF funding alone is insufficient for Sri Lanka's needs. Sri Lanka's quota directly determines the maximum amount of financial resources it can borrow from the IMF under normal access limits. An 18th IMF programme may provide only another US\$ 3 billion plus some financing from multilateral development banks. Back of the envelope calculations suggest that Sri Lanka requires financing of at least US\$ 20-25 billion between 2028-2030 to repay debt, provide essential imports, and to invest to transform the economy. India has a unique opportunity to cement its reputation as an emerging donor by leading an aid consortium for Sri Lanka, working closely with other friendly countries (e.g. Japan, the US, and the EU), the IMF and multilateral development banks. This would considerably enhance India's soft power regional role.

Second, *establish a dedicated disaster management ministry to mitigate future natural disasters*. The UN's World Meteorological Organisation is warning that the rapidly intensifying 2026 El Niño may become strong event.³ Sea surface temperatures in the central and eastern tropical Pacific are soaring—climbing to +2.1 °C in mid-July—signalling a high likelihood of a "very strong" event that will heavily disrupt global weather through spring 2027. Cyclone Ditwah exposed Sri Lanka's largely reactive emergency-response system and its weak links with local communities. The earlier abolition of the ministry responsible for natural disasters, with functions transferred to the military, appears to have overstretched the Sri Lankan security forces that are not well suited to civilian disaster coordination. A dedicated ministry would signal a more comprehensive national strategy to reduce risks and build long-term

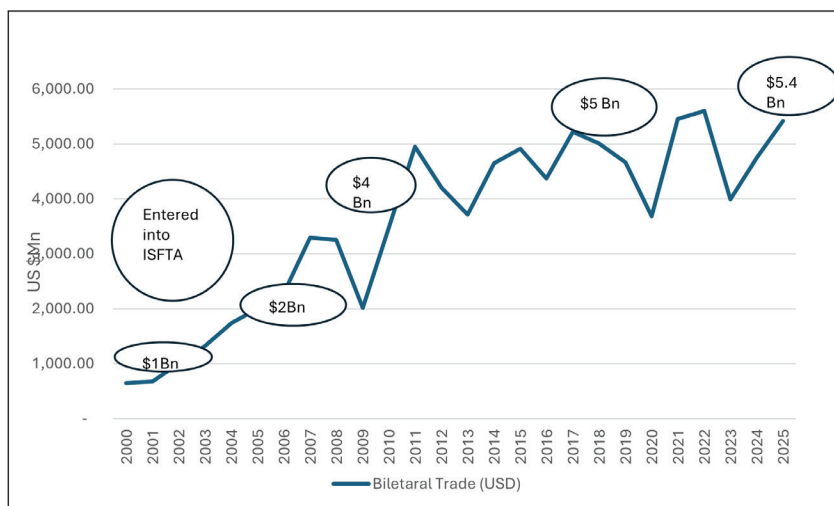
resilience in a country highly vulnerable to climate change and natural disasters. With a capable minister and secretary, it could strengthen preparedness, coordinate rapid response, allocate resources effectively and liaise across government agencies and the military.

India can support this institutional shift in Sri Lanka. Its Disaster Management Act, 2005 has provided a legally grounded framework for two decades, moving policy from reactive relief towards prevention, mitigation and preparedness through a three-tier system comprising the National Disaster Management Authority, State Disaster Management Authorities and District Disaster Management Authorities. An Indian capacity-building project could help Sri Lanka design a modern legal and institutional framework suited to its needs. Indian firms could also expand food and medicine exports to Sri Lanka during future emergencies, while Indian EXIM Bank guarantees and credit lines could support turnkey public private sector partnership (PPP) projects in disaster-resilient infrastructure, including the proposed multi-product oil pipeline from Nagapattinam to Trincomalee and Colombo. Relevant Indian institutions could also work with multilateral development banks on a costed post-reconstruction implementation strategy in Sri Lanka.

Third, *conclude a modern India-Sri Lanka Free Trade Agreement (ISFTA) to enhance bilateral trade linkages*. As Figure 2 shows, bilateral merchandise trade between India and Sri Lanka has grown significantly from a small base since the signing of FTA in 1998 to about US\$5.4 billion in 2025 indicating increased market access and business confidence. There is a long history of attempting to upgrade the limited goods only 1998 ISFTA into a broader comprehensive deal. A Comprehensive Economic Partnership (CEPA) and an Economic and Technical Cooperation Agreement (ECTA) were discussed. But these efforts have stalled partly due to domestic business pressure and political opposition within Sri Lanka. India-Sri Lanka trade talks resumed under a previous Sri Lankan government in 2023-2024 and an early harvest investment agreement focussing on investor protection was expected. However, FTA talks soon paused as the incoming NPP government appointed an expert committee to review the benefits of existing FTAs

and develop future FTA strategy chaired by the permanent secretary of the Ministry of Trade. The report is expected in late 2026.

Figure 2. India Sri Lanka Merchandise Trade 2000 to 2025 (US\$)



Source: Export Development Board Sri Lanka bilateral trade data, 2025 and India-Sri Lanka Economic and Trade Engagement <https://www.hcicolombo.gov.in/page/india-sri-lanka-economic-and-trade-engagement/>

India's commerce ministry has been pro-active in concluding comprehensive FTAs (with the EU, the UK, UAE and others) and stands ready to restart bilateral FTA talks. If Sri Lanka is to benefit meaningfully from India's supply-chain expansion, the ISFTA must be modernised.⁴ Priority reforms to the trade deal include updating rules of origin from simple value-addition thresholds to product-specific rules aligned with global production networks; liberalising trade in services—particularly IT, maritime logistics, and financial services—to enable Sri Lanka's services sector to support regional supply chains; and reducing trade costs for SMEs through digitalisation and harmonisation of customs procedures. In addition, a robust investment agreement, whether within or alongside the ISFTA, is essential to provide predictability, transparency, and investor protection. If backed by political commitment

and private-sector support, ISFTA 2.0 can underpin rules-based regional integration, crowd in investment, and embed Sri Lanka more firmly in India-centred supply chains.

Looking ahead, a modernised ISFTA should be positioned not merely as a trade agreement, but as the institutional anchor of a deeper India–Sri Lanka economic partnership. If backed by political commitment and private-sector support, ISFTA 2.0 can underpin rules-based regional integration, crowd in investment, and embed Sri Lanka more firmly in India-centred supply chains. Complementary measures—ranging from enhanced physical and energy connectivity to new export processing zones and stronger business-to-business linkages—can amplify these gains. With decisive action over the next few years, bilateral trade of US\$ 10–12 billion by 2030 is not an aspiration but a realistic and achievable outcome.⁵

Without a modern FTA with India, Sri Lanka faces significant risks of trade diversion from India’s FTAs with the EU and UK. This would hurt Sri Lanka’s garment sector which accounts for 40 per cent of exports and 15 per cent of the workforce. To alleviate domestic Sri Lankan concerns about trade and FDI opening, India can maintain asymmetrical treatment for Sri Lanka in the new deal – and consider providing some aid for trade.

Fourth, *improve physical connectivity for bilateral trade and tourism*. There have been some recent initiatives to improve bilateral connectivity. Indigo and Air India have increased flights between Indian cities and Colombo airport. Palaly Airport in Jaffna has been modernised to enable flights to and from South India and the ferry service has been re-started to cover 60 nautical miles from Nagapattinam to Kangesanthurai. This is showing results particularly in northern Sri Lanka, where projects have been co-financed by Indian aid and Sri Lankan public expenditure. The Adani Group has co-invested with John Keels Holding, Sri Lanka’s largest conglomerate, and the Sri Lanka Ports Authority in developing the West Container terminal in Colombo port which largely tranships to India. This US\$ 800 million, 35-year Build-Operate-Transfer (BOT) project is majority-owned by Adani Ports and SEZ Ltd (APSEZ).

Connectivity was discussed during Prime Minister Modi's first State Visit to Sri Lanka in early April 2025 following President Dissanayake's formation of the new government. It produced several important strategic outcomes, including more than ten agreed deliverables and seven Memorandums of Understanding covering defence, energy, digitalisation and cultural cooperation among which the implementation of India-Sri Lanka High Voltage Direct Current (HVDC) power grid link for the import/export of power and cooperation in the development of Trincomalee as an energy hub were especially significant. Indian finance for an undersea electricity transmission line and an oil pipeline, agreed to in 2023, are important next projects for Sri Lanka's energy security and supportive of power trade during off-peak times.⁶ The electricity transmission line could connect Anuradhapura in north-central Sri Lanka with Chennai in Tamil Nadu, India at an estimated cost of US\$ 1.2 billion. So too is the upgrading of Sri Lanka's digital connectivity by drawing on India's successful national rollout of digital public infrastructure. During Prime Minister Modi's visit, the two leaders also launched energy and railway projects, including the 135 MW Sampur Solar Power Plant solar power plant in Trincomalee and the inauguration of a temperature-controlled agricultural warehouse in Dambulla and two India-assisted railway projects.

There has been some discussion of building a land bridge between India and Sri Lanka (Pathfinder Foundation, 2024). However, a bridge like the Øresund Bridge motorway/railway bridge between Denmark and Sweden with a fixed link of 15.9 kms long and a cost of 4 billion euros (in today's prices) can be a daunting prospect. The sheer scale of the engineering required, along with multi-billion-dollar price tags, makes financing and construction highly complex and challenging. Building a bridge between India and Sri Lanka involves spanning the 23-kilometer Palk Strait. Key technical challenges include the severe dynamic marine environment with strong monsoonal currents, a shallow and shifting seabed, and the region's rich, highly sensitive biodiversity. Thus, an India-Sri Lanka land bridge project has provoked scepticism in Sri Lankan policy circles.

Fifth, *implement economic reforms to move towards transformative growth*. The policy space created by the 17th, and likely 18th, IMF programme for Sri Lanka should be used to develop a growth plan that revives private-sector entrepreneurship. Sri Lanka's favourable Indian Ocean location, available land and pockets of skilled labour create opportunities for domestic and foreign investors, including Indian FDI, in tourism, the digital economy, agro-processing and niche manufacturing. However, policy distortions (such as anti-export bias in the trade regime and cumbersome red tape regulations hampering business), missing markets and supply-side constraints have prevented markets from allocating resources efficiently.

ODI Global and CEPA (2025) identify six priority areas—macroeconomic stability, global supply-chain integration, improved factor markets, poverty reduction, and consensus-building—to unlock these opportunities for transformative growth in Sri Lanka. Recommendations under these areas are contained in summarised in Table 3. The study also recommends establishing an independent growth commission to formulate a national growth plan and build durable policy consensus among political parties and other key stakeholders (business and civil society) on the plan and long-term implementation. It was suggested that ideas from this work should inform the revision of the Economic Transformation Act in Sri Lanka.

Table 3. Priority Economic Reform Areas for Sri Lanka

1. Continue macroeconomic stability and enhance credibility • Complete the IMF programme • Increase tax collection • Maximise fiscal policy growth, review public investment to reallocate budgetary resources to high impact sectors • Apply rigorous selection process for all infrastructure projects	2. Promote global supply chains, exports, and FDI • Develop a FTA Strategy • Appoint Presidential tariff commission • Pursue quiet diplomacy with US • Revamp Sri Lanka's overseas missions • Cut red tape for business • Focus investment promotion on strategic markets • Invest in trade related infrastructure • Promote regional supply chain integration and encourage B2B ties
3. Improve factor markets • Upgrade workforce skills • Establish national centre of STEM education • Streamline public holidays for productivity • Increase female labour force participation • Permit temporary skill migration • Activate land bank for state land	4. Sector- and market specific policy • Review of sectoral opportunities • Rebrand Sri Lanka for tourism • Increase value addition in Agriculture • Attract Indian Aid and FDI for energy connectivity • Remove barriers to manufacturing • Invest in digital public infrastructure and payments

5. Reducing poverty • Reduce post-harvest losses and cut food prices • Better targeting of social welfare to poorest • Increase MSME's finance	6. Build policy consensus and state capacity • Appoint an independent growth commission • Better project implementation strategy • Upgrade training civil servants and parliamentarians
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Source: ODI Global and CEPA (2025).

India can offer Sri Lanka relevant reform experience, ranging from the 1991 liberalisation programme to more recent advances in digital public infrastructure. Particularly relevant examples include scalable platforms such as the Unified Payments Interface (UPI) and Aadhaar for financial inclusion and public service delivery; fiscal and trade liberalisation to strengthen balance-of-payments stability and supply-chain integration; and investment facilitation through simplified legal and tax frameworks, delivery-oriented governance and more effective dispute resolution. India's NITI Aayog (National Institution for Transforming India) also offers useful lessons in flexible policy planning and institutional reform.

Conclusion

This paper has addressed two questions on India's NFP and Sri Lanka. First, how effective was India's NFP emergency and humanitarian aid? Second, how can the focus shift from an aid relationship to a trade and connectivity relationship in line with India's other NFP objectives?

The answer to the first question is India's emergency and humanitarian assistance under the Neighbourhood First Policy (NFP) provided timely and effective support to Sri Lanka during its severe debt and economic crisis, after Cyclone Ditwah hit and during the Iran war. A significant share of India's aid budget was deployed for Sri Lanka's emergency bailout during the economic crisis and Indian military, and civilian resources were rapidly mobilised during Cyclone Ditwah. Together with the IMF programme and prudent domestic policymaking, Indian assistance was

instrumental in supporting Sri Lanka's recovery, although significant risks remain, including heightened global economic uncertainty. India provided access to scarce fuel supplies during maritime trade disruptions linked to the Iran war.

India's first aid responder role has been highly appreciated in Sri Lanka, and the conditions seem favourable for India's NFP engagement with Sri Lanka to move beyond an aid-centred relationship towards one focused on trade and connectivity. In answer to the second question, aligning Sri Lanka's domestic policy priorities with NFP initiatives would provide the most effective basis for this transition.

Suggestions include Sri Lanka engaging early on a new IMF programme with Indian advocacy and leading an aid consortium, setting up a dedicated disaster ministry and economic reforms in Sri Lanka drawing on India's long experience, concluding a modern India-Sri Lanka free trade agreement, and investing in an undersea an electricity transmission line and oil pipeline connecting India and Sri Lanka.

Supporting Sri Lanka is also in India's strategic interest. Sri Lanka's economic stabilisation was a major success for Prime Minister Modi's NFP and strengthened India's position as an emerging donor vis-à-vis China. As Sri Lanka's economy stabilises, India can deepen trade and investment ties and move the relationship beyond humanitarian assistance. This would promote regional integration and prosperity, enhance India's soft power in South Asia, and support its long-standing ambition for a seat on the UN Security Council. By contrast, renewed instability in Sri Lanka could create security risks for India, including refugee flows across the Palk Strait.

Endnotes

- ¹ Debt owed to China was US\$ 7.4 billion while India was owed US\$ 1.8 billion (Breuer et.al. 2025, Table 1).
- ² Import cover in April 2022 was estimated as US\$ 25 million/US\$ 1,699 million = 0.0147. When converted to days (0.0147*30 days, this amounts to only 0.44 days—less than 11 hours' worth of national imports. The IMF's healthy baseline for developing economies is typically a minimum of 3 months of import cover. The reserve figure was mentioned by the Governor of the Central Bank of Sri Lanka in a media interview in August 2026 while the import figure was from data published by the Central Bank of Sri Lanka.
- ³ <https://wmo.int/news/media-centre/strong-el-nino-expected-intensify>
- ⁴ Kelegama (2014) argues that while Sri Lanka has gained from the ISFTA, its full potential has not yet been realized due to market access problems in India, and limited supply capacity for some products in Sri Lanka.
- ⁵ A model-based study of the impact of tariff removal in Sri Lanka's FTAs concluded that its trade deals with India and China present, given the magnitude of the partners, the largest overall trade and output impacts for trade linkages and tariff structures. See Mendez-Parra, Ayele, and Wignaraja (2025).
- ⁶ For a review of Indian energy aid to Sri Lanka see Sharma (2026)

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