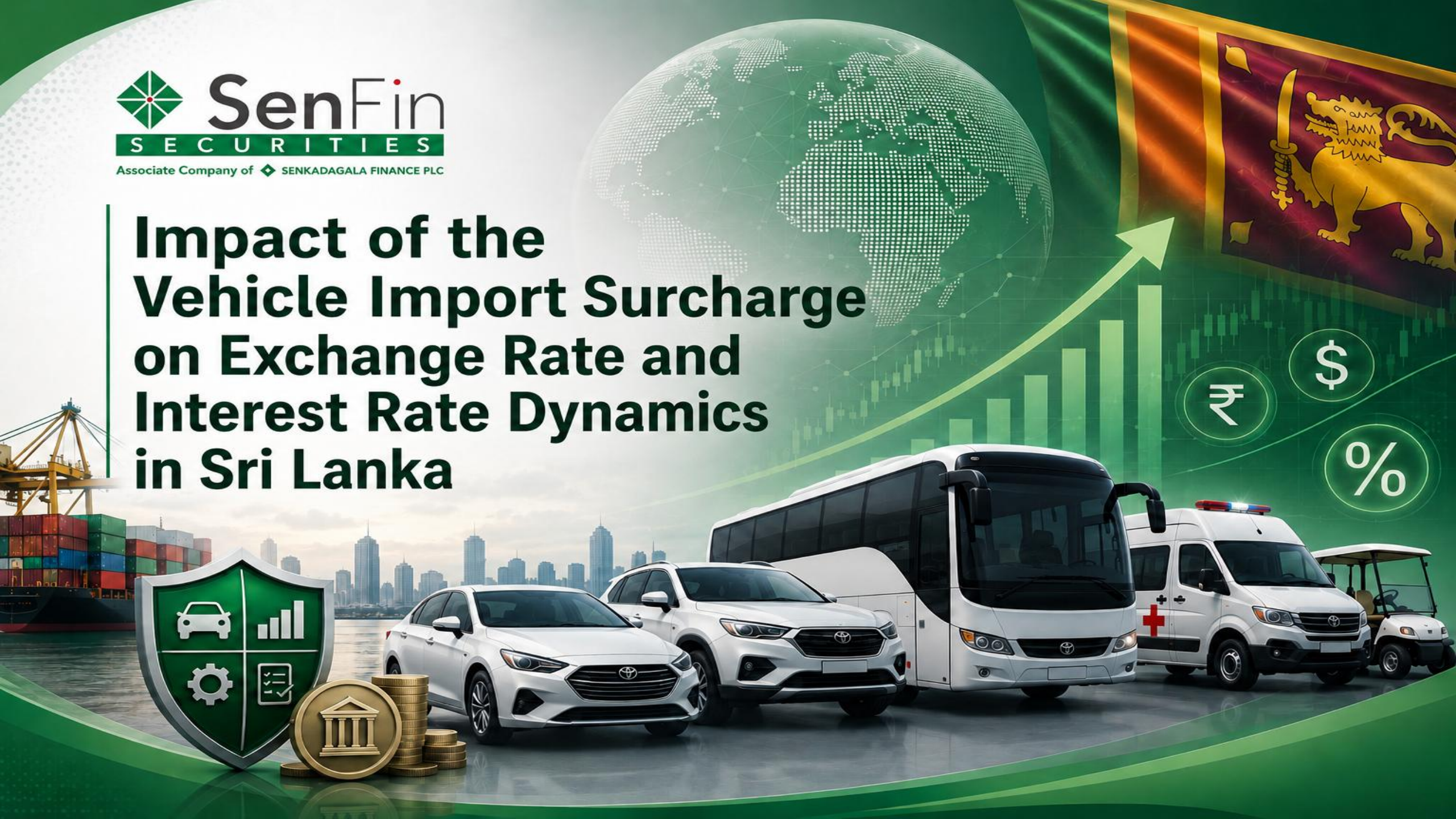


Impact of the Vehicle Import Surcharge on Exchange Rate and Interest Rate Dynamics in Sri Lanka

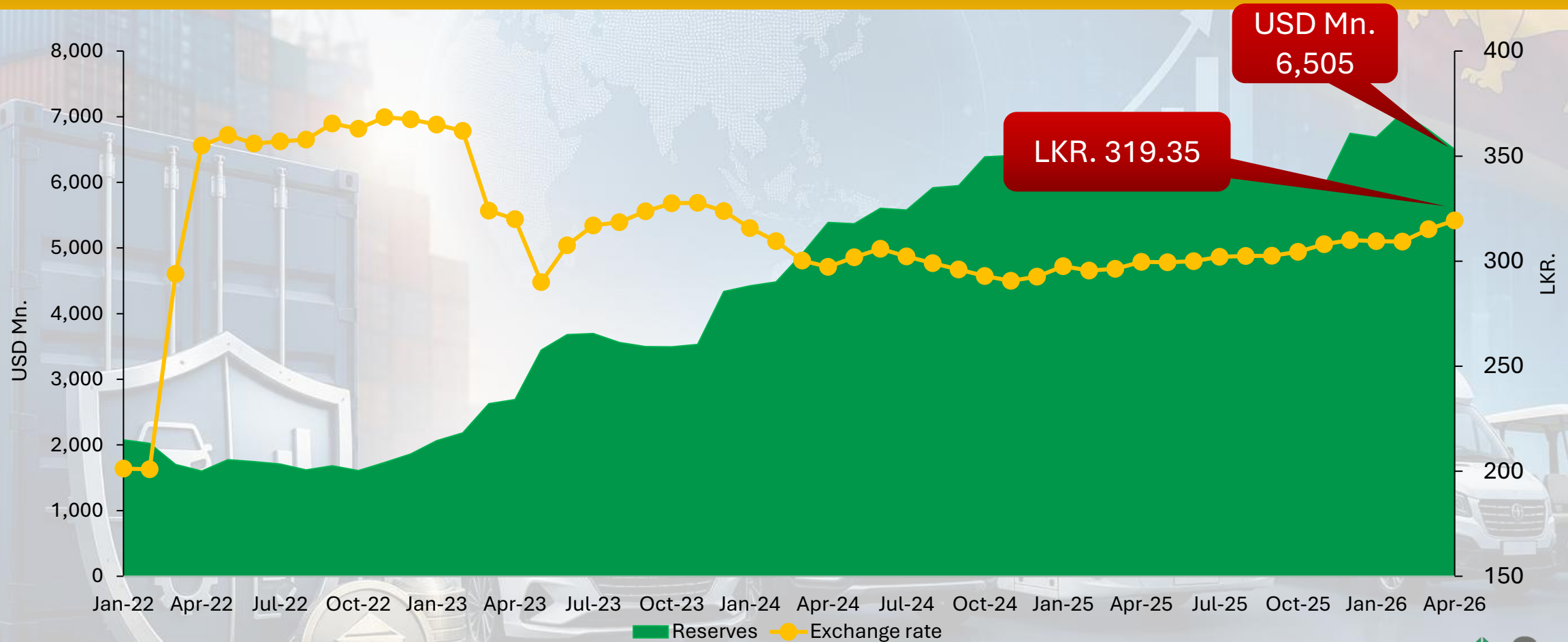


Sri Lanka's Vehicle Import Surcharge: A Macro-Stabilization Measure Amid Exchange Rate and Interest Rate Pressures

- Sri Lanka continues to operate under a fragile external sector despite a gradual post-crisis recovery. Foreign exchange reserves remain under pressure due to ongoing external debt servicing, high import dependency, and gradual recovery in domestic demand. Recent economic reporting highlights that the country still faces vulnerabilities in reserve accumulation and currency stability, making import management a key policy priority.
- Vehicle imports represent one of the largest categories of non-essential consumer imports, creating significant demand for foreign currency. With the reopening of vehicle imports after the crisis-era ban, demand for US dollars has increased, placing renewed pressure on the Sri Lankan rupee and external balances.
- In response, the Government introduced a temporary (3 month) 50% surcharge on Customs Import Duty for vehicles (effective from May 15, 2026) as a short-term macroeconomic stabilization measure. The policy aims to discourage non-essential imports, reduce foreign currency outflows, and support exchange rate stability while the economy continues its IMF-supported recovery path.

Dynamic Relationship Between Foreign Exchange Reserves and Exchange Rate Movements in Sri Lanka

Sri Lanka's gross official foreign reserves stood at USD 6,505 Mn in April 2026, while the exchange rate reached Rs. 319.35 per USD in April 2026



Link Between Vehicle Imports and Exchange Rate Pressure

Vehicle imports are a major contributor to Sri Lanka's import bill, creating significant demand for foreign currency and increasing pressure on the Sri Lankan Rupee (LKR).

Increased Vehicle Imports → Higher USD Demand

- Importers purchase US dollars from local banks to pay foreign suppliers
- Demand for USD rises in the forex market
- Higher USD demand creates depreciation pressure on the LKR

Pressure on Foreign Reserves

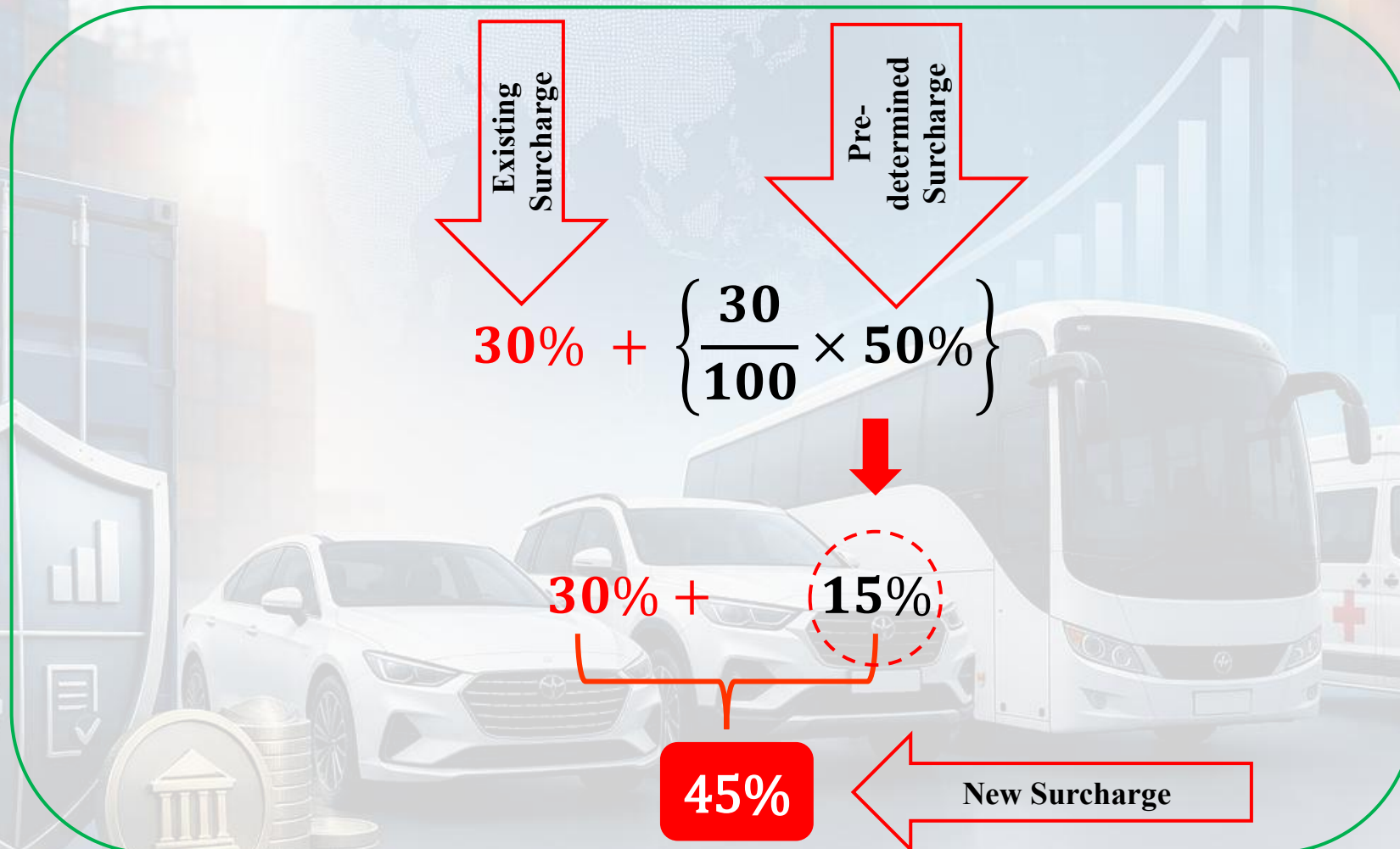
- Central Bank may sell USD reserves to stabilize the exchange rate
- Foreign reserve levels decline
- Lower reserves increase external vulnerability and crisis risk.

Purpose of the Vehicle Import Surcharge

- The temporary surcharge was introduced to : Reduce or delay vehicle imports
- Limit USD outflows
- Protect foreign reserves
- Support exchange rate stability during economic recovery

When 30% surcharge is increased by 50%

Vehicle import surcharge effectively rises from 30% to 45%, reinforcing the Government's strategy to curb non-essential imports and manage foreign exchange demand.



Interest Rates, Vehicle Imports & Policy Coordination

Tight Monetary Policy (High Interest Rates) + Fiscal Policy (Vehicle Import Surcharge) → Lower Vehicle Imports → Reduced USD Demand → Greater Exchange Rate Stability

Sri Lanka has maintained high interest rates under tight monetary policy to control inflation, reduce excessive borrowing, and limit import demand. Since vehicle purchases are largely financed through leasing and bank loans, higher interest rates increase borrowing costs and discourage vehicle demand.

Impact on Imports and Foreign Currency

Lower vehicle demand leads to:

- Reduced vehicle imports
- Lower demand for US dollars
- Reduced pressure on foreign reserves and the exchange rate

However, as interest rates gradually decline during economic recovery, access to credit improves and vehicle demand may rise again, creating renewed import and foreign currency pressure.

Role of the Vehicle Import Surcharge

The temporary vehicle import surcharge acts as a fiscal policy measure that supports monetary policy by:

- Suppressing credit-driven vehicle demand
- Preventing a sudden surge in imports
- Reducing import-led foreign currency outflows
- Supporting exchange rate and external sector stability

Why Vehicles Are Specifically Targeted

Vehicles are the ideal short-term import compression target because they generate large USD outflows while being highly sensitive to taxes and credit conditions.

Why the Government Focuses on Vehicle Imports

Vehicle imports are considered a high-impact target for import control policies because they are high-value imports that require large amounts of USD, represent largely non-essential consumption, are commonly financed through leasing and bank loans, and create significant pressure on the foreign exchange market and foreign reserves.

Economic Impact

A single vehicle import can require approximately USD 20,000 - 60,000, creating a substantial foreign currency outflow per unit. With vehicle imports already exceeding USD 600 Mn in Q1 2026, policymakers view the sector as a major contributor to rising import expenditure and external sector pressure.

Policy Rationale

The temporary surcharge on vehicle imports was introduced to:

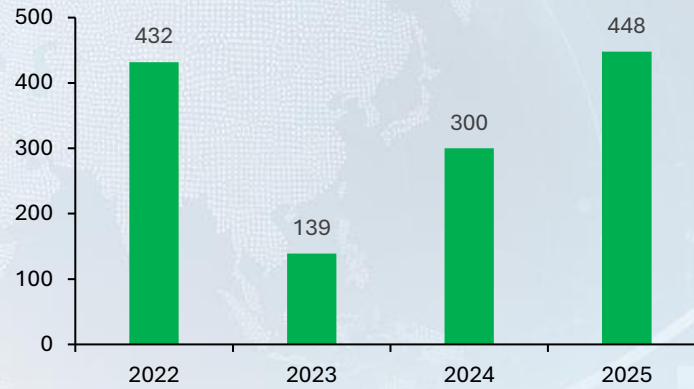
- Quickly reduce non-essential imports
- Limit foreign currency outflows
- Protect foreign exchange reserves
- Prevent renewed pressure on the Sri Lankan Rupee (LKR)

NEW REGISTRATION OF MOTOR VEHICLES

MOTOR CARS



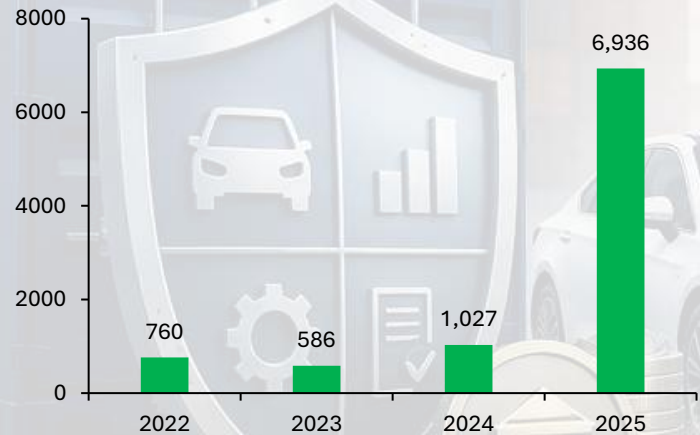
SPECIAL PURPOSE VEHICLE



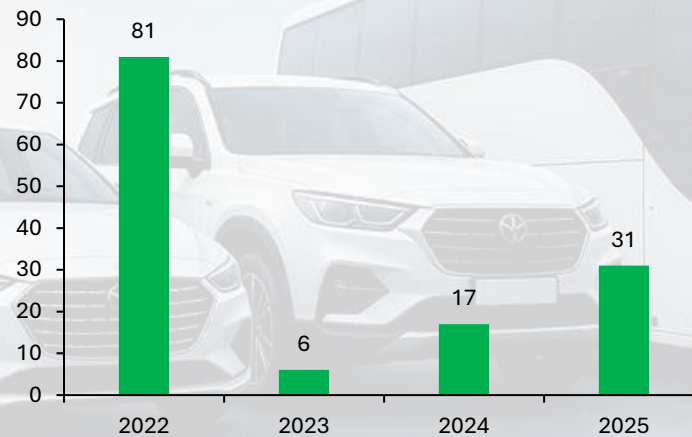
HEARSES



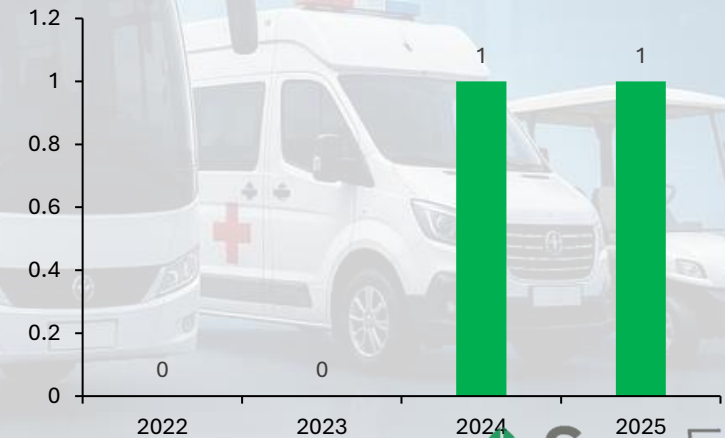
DUAL PURPOSE VEHICLES



AMBULANCES



QUADRICYCLE



SURCHARGE AFFECTED AND NON-AFFECTED VEHICLES

Affected Vehicles



Non-Affected Vehicles



vehicles for which Letters of Credit (LCs) were opened on or before May 15, 2026

Short-Term Effects of the Vehicle Import Surcharge

Short-Term Positive Impacts

- Reduces demand for US dollars (USD)
- Supports Sri Lankan Rupee (LKR) stability
- Helps preserve foreign exchange reserves
- Strengthens overall macroeconomic stability
- Limits excessive non - essential imports

Possible Negative Impacts

- Higher vehicle prices for consumers
- Slower growth in the automobile sector
- Reduced government revenue from import-related taxes
- Delayed consumer spending and vehicle purchases
- Potential impact on leasing and financing activity

Balanced Economic View

- While the surcharge supports external sector stability and reserve protection in the short term, prolonged restrictions may weaken domestic automobile-related economic activity and consumer demand over time.

Exchange Rates Movements

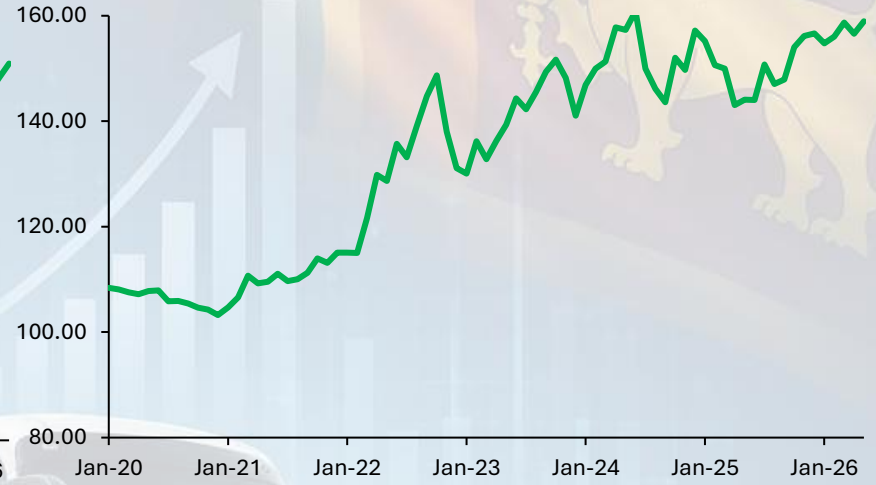
USD/CNY



USD/INR



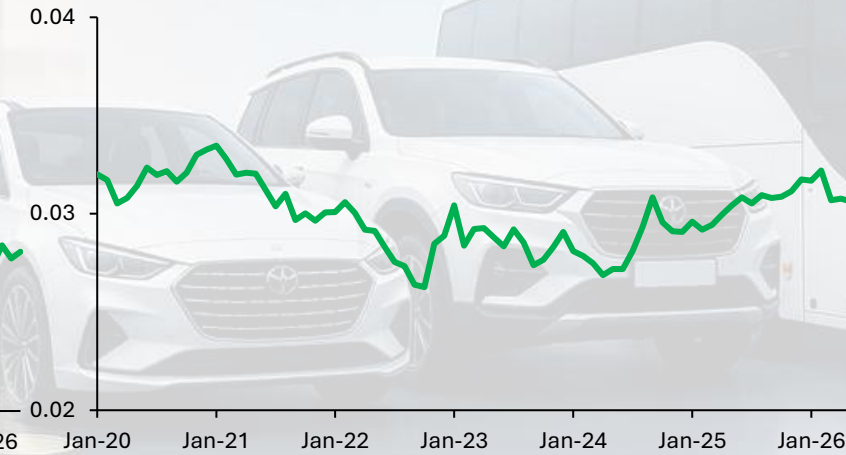
USD/JPY



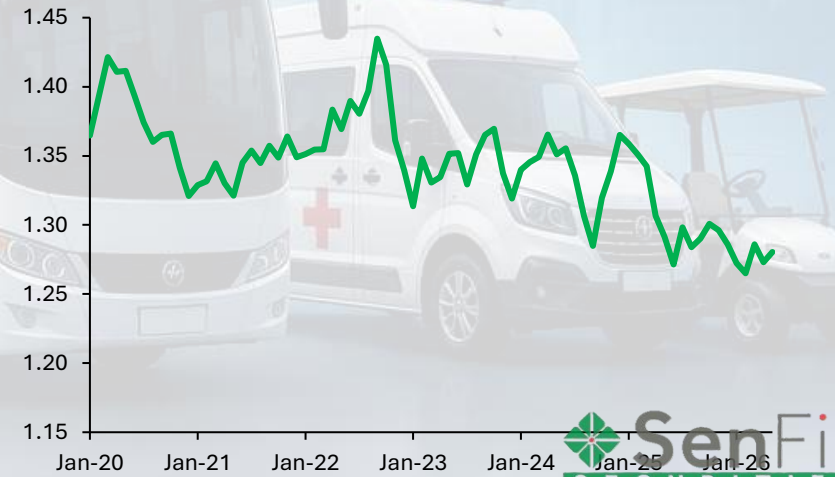
USD/EUR



USD/THB



USD/SGD



Sri Lanka's vehicle import sector has experienced a highly volatile cycle from 2020 to the present, mainly driven by exchange rate instability, foreign exchange shortages, import restrictions, and a high tax burden on vehicles. Although underlying demand for vehicles has remained strong throughout the period, actual import activity has fluctuated significantly due to macroeconomic stress and policy-driven cost increases.

During 2020 - 2021, vehicle imports were severely restricted due to government measures aimed at conserving foreign exchange during the COVID-19 period. Even though the exchange rate remained relatively stable during this phase, import controls were the dominant factor affecting the market. As a result, vehicle imports dropped sharply despite continued consumer demand, reflecting policy-driven suppression rather than market weakness.

The most severe disruption occurred in 2022, when Sri Lanka faced a full-scale balance of payments crisis. The Sri Lankan rupee depreciated sharply from around LKR 200 per USD to over LKR 320 per USD, creating extreme import cost pressure. At the same time, vehicle imports were almost completely halted due to foreign exchange shortages and restrictions. This period clearly highlights the strong negative impact of exchange rate volatility on import-dependent sectors such as vehicles.

From 2023 onwards, macroeconomic conditions began to stabilize following IMF-supported reforms. The exchange rate stabilized in the range of LKR 300 - 325 per USD, and a phased reopening of imports was introduced. However, the recovery in vehicle imports remained gradual due to persistent affordability constraints and cautious policy implementation. As of current situation, the Sri Lankan rupee is trading around LKR 325 - 330 per USD, indicating a relatively stable but slightly depreciating currency compared with the immediate post-crisis period.

A major structural factor influencing the recovery is the high tax structure imposed on vehicle imports, which can add around 50% or more to the landed cost of vehicles depending on engine capacity, category, and regulatory charges. This 50% tax burden significantly increases retail vehicle prices, making ownership far less affordable compared to the pre-crisis period. Even when import restrictions are eased, this tax structure continues to suppress demand and slows down market normalization.

In 2024 - 2025, vehicle imports show signs of gradual recovery as foreign exchange conditions improve and economic stability strengthens. However, the combined effect of a depreciated exchange rate and the 50% tax burden continues to keep vehicle prices elevated. As a result, import volumes remain below historical peaks, and recovery is uneven across vehicle categories.

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