SRI LANKA DEVELOPMENT UPDATE

TIME TO RESET

April 2023

Standard Disclaimer:

Copyright Statement:

Photo Credits:

Cover, Part A and B: Nazly Ahmed/Sri Lanka; Executive Summary: Samitha Senadheera/ Sri Lanka.

Preface

The Sri Lanka Development Update (SLDU) has two main aims. First, it reports on key developments over the past 12 months in Sri Lanka's economy, places these in longer term and global contexts, and updates the outlook for Sri Lanka's economy. Second, the SLDU provides a more in-depth examination of selected economic and policy issues. It is intended for a wide audience, including policymakers, business leaders, financial market participants, think tanks, non-governmental organizations and the community of analysts and professionals interested in Sri Lanka's evolving economy.

The SLDU was prepared by a team consisting of Richard Walker, Kishan Abeygunawardana (Senior Economists, Macroeconomics, Public Sector, Trade and Investment (MPSTI), and Shruti Lakhtakia (Economist, MTPSI) with inputs from Tatsiana Kliatskova (Financial Sector Economist, Finance, Competitiveness & Innovation), Zoe Leiyu Xie (Senior Economist, South Asia Regional Chief Economist's Office), Nandini Krishnan (Lead Economist, Poverty), and Marta Schoch (Economist, Poverty). The team thanks Mathew Verghis (Regional Director, Equitable Growth, Finance and Institutions (EFI), South Asia Region), Faris Hadad-Zervos (Country Director for Maldives, Nepal and Sri Lanka), Chiyo Kanda (Country Manager, Maldives and Sri Lanka), Shabih Ali Mohib (Practice Manager, MPSTI), Ximena del Carpio (Practice Manager, POV), and Tae Hyun Lee (Program Leader and Lead Country Economist, EFI), for their guidance and comments on the report. Sashikala Jeyaraj provided administration support and was responsible for the layout, design, and typesetting. Dilinika Peiris, Buddhi Feelixge, and Samitha Senadheera led dissemination efforts. For questions, please contact: infosrilanka@worldbank.org

The report was prepared based on published data available on or before March 20, 2023. Data sources include the World Bank, Ministry of Finance, Central Bank of Sri Lanka, Department of Census and Statistics, and press reports.

This report, additional material and previous reports can be found at:

- www.worldbank.org/sldu

Previous editions:

- October 2022: **Protecting the Poor and Vulnerable in Time of a Crisis,** https://thedocs.worldbank.org/en/doc/6c87e47ca3f08a4b13e67f79aec8fa3b-0310062022/original/Sri-Lanka-Development-Update-October-2022-final.pdf
- April 2021: **The Economic and Poverty Impact of COVID-19,** https://openknowledge.worldbank.org/handle/10986/35833
- February 2019: **Demographic Change in Sri Lanka,** https://openknowledge.worldbank.org/handle/10986/31261
- June 2018: **More and better jobs for an upper middle-income country,** https://openknowledge.worldbank.org/handle/10986/29927
- November 2017: **Creating opportunities and managing risks for sustained growth,** openknowledge.worldbank.org/handle/10986/28826
- June 2017: **Unleashing Sri Lanka's trade potential,** openknowledge.worldbank.org/handle/10986/27519
- October 2016: **Structural challenges,** openknowledge.worldbank.org/handle/10986/25351

Stay in touch with the World Bank in Sri Lanka and South Asia via

www.worldbank.org/en/country/srilanka

@WorldBank, @WorldBankSAsia, follow hashtag #SLDU2023

www.facebook.com/worldbanksrilanka

instagram.com/worldbank/

www.linkedin.com/company/the-world-bank

Abbreviations

CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CEB	Ceylon Electricity Board
CIT	Corporate Income Tax
CPC	Ceylon Petroleum Corporation
DCS	Department of Census and Statistics
EFF	Extended Fund Facility
EMDEs	Emerging Markets and Developing Economies
GDP	Gross Domestic Product
GFN	Gross Financing Needs
IMF	International Monetary Fund
LMICs	Lower Middle-Income Countries
MoF	Ministry of Finance
NCPI	National Consumer Price Index
PIM	Public Investment Management
PMI	Purchasing Managers' Index
PIT	Personal Income Tax
SLA	Staff Level Agreement
SLAL	Sri Lankan Airlines
SLDBs	Sri Lanka Development Bonds
SLDU	Sri Lanka Development Update
SOEs	State-Owned Enterprises
UMIC	Upper Middle-Income Country
VAT	Value Added Tax

Table of Contents

LIST OF BOXES

LIST OF FIGURES

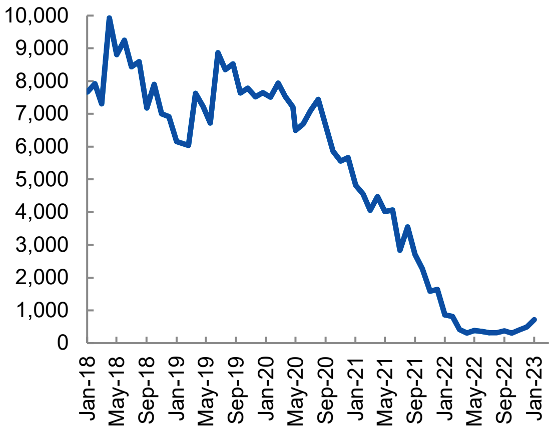
Executive Summary

Sri Lanka's longstanding structural weaknesses, which were elevated by a series of exogenous shocks, plunged the country into a severe economic crisis. Poor governance, a restrictive trade regime, a weak investment climate, and episodes of loose monetary policy and an administered exchange rate, contributed to macroeconomic imbalances in the last two decades. Fiscal indiscipline, linked to low revenue collections, led to high fiscal deficits and large gross financing needs. These weaknesses were masked by rapid growth, particularly after the end of the civil war in 2009, spurred along by risky commercial borrowing and an increasingly inward-oriented economic model. The tax cuts in 2019 further eroded weak fiscal buffers and led to a rapid growth in debt to unsustainable levels. Several exogenous shocks also contributed to this, including a political crisis in 2018, the Easter bombings in 2019, the COVID-19 pandemic in 2020, and Russia's invasion of Ukraine in 2022. Despite imminent and significant external debt service obligations, Sri Lanka lost access to international financial markets in 2020 following credit rating downgrades.

The country announced a debt repayment moratorium in 2022, amidst unsustainable debt and critically low reserves. By March 2022, official reserves and net foreign assets in the banking system were depleted, as the country continued to service debt and facilitate imports without access to international financial markets (Figure 1). The foreign exchange liquidity constraint translated into shortages of fuel, food, medicines, cooking gas, and inputs needed for economic activity. Amidst depleted reserves, Sri Lanka announced an external debt service suspension in April 2022, and commenced dialogue with creditors to restructure its debt. The suspension included outstanding Eurobonds; bilateral credits excluding swap lines between the Central Bank of Sri Lanka (CBSL) and foreign central banks; foreign currency-denominated loans and credit facilities with commercial banks or institutional lenders for which the government had provided a guarantee.

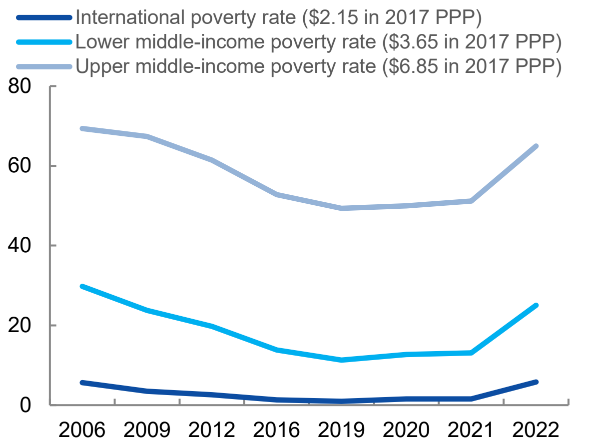
The economic crisis deepened in the second half of 2022. A delayed response by the authorities to the macroeconomic imbalances allowed the crisis to spread to all key sectors. The economy contracted by 7.8 percent (y-o-y) in 2022 due to sharp contractions in Q3 and Q4 2022. Inflation reached unprecedented levels. Due to the economic contraction, national poverty is projected to have doubled to 25 percent and urban poverty is estimated to have tripled to 15 percent in 2022. Inequality also increased and half a million jobs were lost in industry and manufacturing. The impact of the foreign exchange crisis was partially offset by Indian support (approximately US$ 3.8 billion, which facilitated essential imports) and the debt service suspension.

Figure 1: Gross official reserves
(US$ million)



Sources: Central Bank of Sri Lanka; official reserves are excluding a currency swap with the People's Bank of China

Figure 2: Poverty rate
(Percent)



Source: Department of Census and Statistics

In March 2023, the IMF Executive Board approved a 48-month Extended Fund Facility (EFF) of approximately US$3 billion to support the government's reform program. This followed a Staff-Level Agreement (SLA) reached between the authorities and IMF staff in September 2022 and adequate financing assurances from all major official creditors. Several structural reforms have been announced or initiated, including new revenue measures, the reform of state-owned enterprises (SOEs), cost-reflective pricing of utilities, better debt management, and some important legal frameworks such as a new central bank law and a public financial management law, all of which aim to improve economic governance and enhance competitiveness.

The fluid political situation and heightened fiscal, external and financial sector imbalances pose significant uncertainty for the outlook. Growth prospects are subject to high uncertainty and will depend on the progress of debt restructuring with timely and effective implementation of fiscal consolidation, and growth-enhancing structural reforms. The fiscal deficit is expected to fall gradually over the medium term due to consolidation efforts. Inflation is projected to come down from a high base, as monetization of fiscal deficits is reined in. The current account deficit is expected to narrow due to large import compression, despite decelerating exports due to weak global demand. Resources in addition to IMF financing[1] – likely from international partners – will continue to be needed in 2023 and beyond, to close the external financing gap. Poverty is projected to remain above 25 percent for the next few years due to the multiple risks to households' livelihoods.

Downside risks are significant. They include a slow debt restructuring process, limited external financing support, delay in implementation of structural reforms, a sharper global slowdown, and a prolonged recovery from the scarring effects of the current crisis. A lower-level external trade equilibrium could also have contagious effects on domestic trade, jobs and income. Adverse effects from cost-reflective pricing of utilities, revenue mobilization efforts, and a slow economic recovery could worsen the poverty outlook. The financial sector needs to be managed carefully given rising non-performing loans and large public sector exposures.

Sri Lanka can use this crisis as an opportunity to build a strong and resilient economy. Significant macroeconomic adjustments will initially adversely affect growth and poverty, but they will be essential to correct fiscal and external imbalances that have led to the crisis, help regain access to international financial markets, and build the foundation for sustainable growth. Mitigating the impacts on the poor and vulnerable remains critical during the adjustment – reducing poverty requires better-targeted social assistance, an expansion of employment in industry and services, and a recovery in the real value of incomes. On the upside, government's reform program, supported by financing from international partners, could boost confidence and attract fresh capital inflows.

[1] IMF released the EFF's first tranche of US$330 million on March 20.

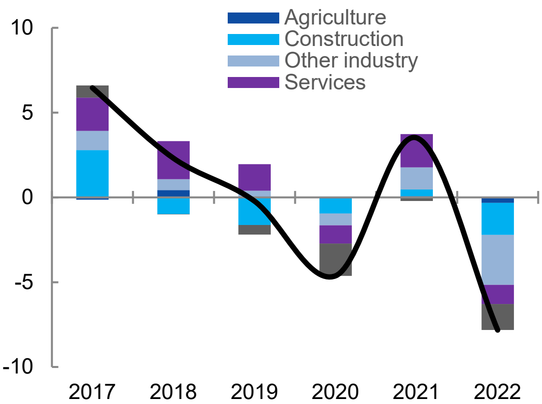
A. Recent Developments

The economy experienced an unprecedented contraction in 2022

1. **Real GDP contracted by 7.8 percent in 2022, as the macroeconomic crisis halted the recovery from the COVID-19 pandemic.** After growing by 3.5 percent (y-o-y) in 2021, all key sectors contracted in 2022, particularly in Q3 (11.5 percent, y-o-y) and Q4 (12.4 percent, y-o-y). Shortages of inputs, due to the sudden import ban of inorganic fertilizers and other chemical inputs in the latter part of 2021, substantially reduced agricultural output in 2022. Supply chain disruptions, along with input shortages, severely affected manufacturing. Suspended government projects, non-settlement of dues to contractors, high input costs, and shortages of material led to a sharp contraction in the construction sector. In the services sector, high interest rates and weak confidence led to significant contractions in financial services, insurance, and real estate sectors. There was, however, a recovery in tourism, which gained momentum towards the end of 2022. (Figure 3)

Figure 3: Contributors to growth (production side)

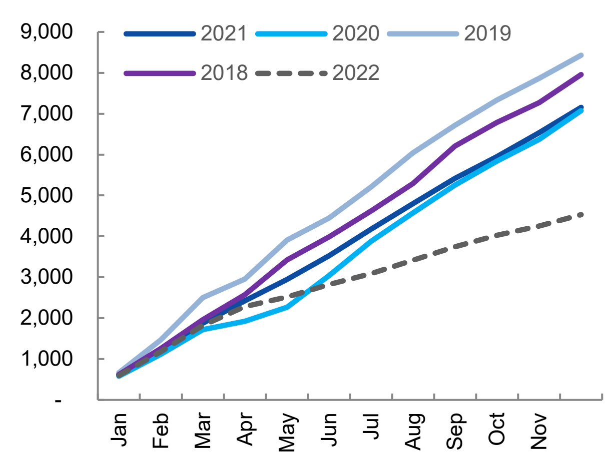
(Percentage point contribution)



Source: Department of Census and Statistics; World Bank staff calculations

Figure 4: Monthly cumulative cement consumption

(MT'000)



Source: Central Bank of Sri Lanka; World Bank staff calculations

2. **High frequency indicators showed significant stress on economic activity.** Cement consumption contracted by 52.8 percent (y-o-y) in the second half of 2022, reaching a multi-year low amid decelerating construction activity (Figure 4). Electricity sales to industrial sectors declined by 17 percent (y-o-y) in the second half of 2022 due to subdued demand and rolling power cuts. The purchasing managers' indices showed continued stress. In contrast to this general deterioration, the export sector continued to perform well in the second half of 2022, as exporters were able to source inputs with export earnings while demand for Sri Lanka's textiles remained robust.

Box 1: Global Economic Context

Following a steady deceleration in the second half of 2022, global economic activity showed signs of stabilization in early 2023, aided by the reopening of the Chinese economy after pandemic-related lockdowns. The global PMI indices showed an expansion of overall activities in February 2023, after remaining in contraction territory since August 2022. The expansion is largely driven by an improvement in the services sector, as tourism rebounded from the lifting of travel restrictions in China. In contrast, the manufacturing sector continued to contract as of February 2023, although at a slower pace than in previous months. The global goods trade contracted for most of 2022, owing to weakening demand. However, as global demand stabilizes at the beginning of 2023 and supply chain pressures continue easing, the decline in global trade is slowing down, as suggested by data from the global manufacturing new export orders PMI index.

Global energy and fertilizer prices have fallen from the high levels of mid-2022, helping ease inflationary pressures and improve the terms of trade for net energy-importing countries. In contrast, agricultural prices have fallen more slowly, putting continued pressure on food-importing countries. While risk appetite revived in early 2023 with strong capital flows into EMDEs led by a sharp uptick in flows into China, the ongoing monetary tightening in advanced economies means tight financial conditions are likely to persist. Moreover, recent failures of some banks in the US raised concerns over global financial health.

The same trends have played out in South Asia. The fall in global commodity prices from the high levels of mid-2022 has eased domestic inflationary pressures and improved the terms of trade for energy importers in the region. Continued monetary tightening in advanced economies has contributed to worsening financial conditions, continued currency depreciation pressures, and capital outflows from South Asia. The same forces have also led to declining foreign reserves in other regions which, together with a slowdown in economic activity around the world, have contributed to falling export demand. For South Asian countries, weakening export demand has been met by import compression in recent months, which helped mitigate external sector pressures, but with adverse impacts on domestic import-dependent activities. Furthermore, private consumption, which forms the lion's share of the region's economy, has stagnated due to high consumer inflation. China's opening and economic rebound have, however, helped the tourism and broader services sectors, especially in smaller countries in the region.

Source: Global Economic Prospects, February 2023 and South Asia Economic Focus, Spring 2023

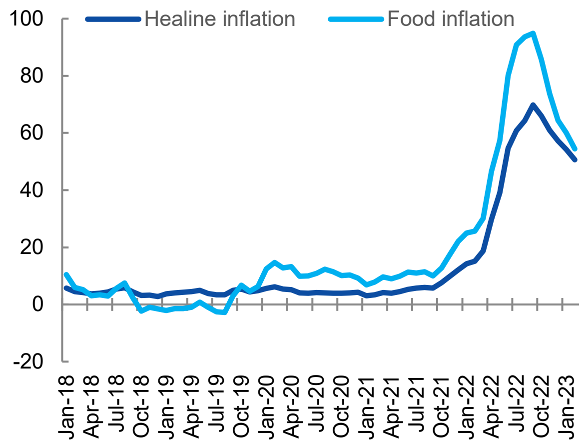
High inflation is threatening economic stability

3. **Following the unprecedented high levels of inflation in 2022, there has been some easing off in early 2023**. After peaking at 69.8 percent (y-o-y) in September, inflation, measured by the Colombo Consumer Price Index (CCPI), decelerated to 50.3 percent in March 2023. Partial monetization of the fiscal deficit and currency depreciation contributed to the rising inflation in 2022. The increase in global oil prices, accompanied by implementation of a fuel pricing formula (since March 2022) that adjusts for changes in oil prices, also raised prices across all sectors. The spillover effects of the ban on chemical fertilizers in 2021 added inflationary pressures to domestic food prices (Figure 5). Core inflation (computed excluding food and energy prices) was 39.1 percent (y-o-y) in March 2023. The National Consumer Price Index (NCPI, 2013=100) showed a similar trend to the CCPI.

4. **Despite the sharp increase in interest rates, real interest rates remained negative due to high inflation.** Rising inflation prompted the CBSL to raise policy rates by 950 basis points in 2022. Another policy rate increase of 100 basis points in March 2023 raised the policy rate corridor to 15.5 percent (Standing Deposit Facility) and 16.5 percent (Standing Lending Facility). However, market interest rates

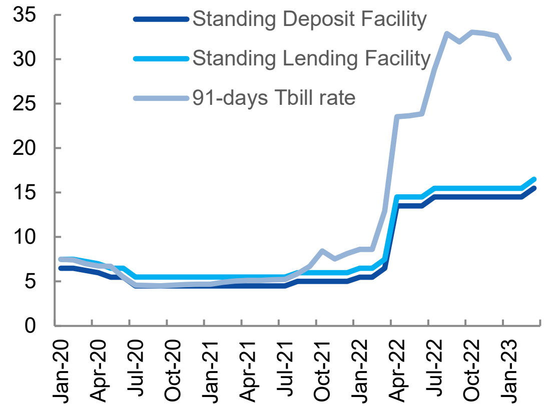
have increased faster and remained significantly above the policy rate corridor, particularly since the second half of 2022, reflecting market concerns about the possibility of domestic debt restructuring and continued high inflation. For example, 91-day Treasury bills have been auctioned at above 30 percent in the primary market since August 2022 (Figure 6). Broadly, monetary policy has not been effective in controlling interest rates and, with the high level of market rates, private credit has been falling on a m-o-m basis since June 2022.

Figure 5: Contributors to CCPI inflation
(Percent, y-o-y)



Source: Department of Census and Statistics; World Bank staff calculations

Figure 6: Policy rates and 91-days Tbill rate
(Percent)



Source: Central Bank of Sri Lanka

Financial sector stability is being tested by the ongoing crisis

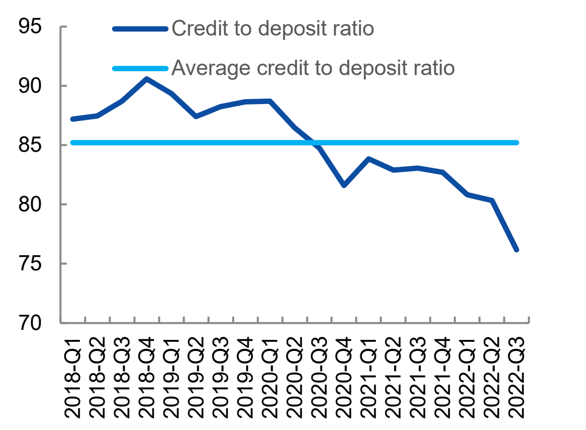
5. **The health of the financial sector has deteriorated due to the challenging macroeconomic conditions.** While some vulnerabilities are masked due to numerous regulatory forbearances, solvency, liquidity, and profitability risks persist, particularly for state-owned banks. With weaknesses in corporate balance sheets, banks experienced pressures on their asset quality, with non-performing loans (NPLs) rising from 8.4 percent in Q1 2022 to 10.9 percent in Q3 2022. Due to increasing impairment charges, the profitability of the banking sector also declined. Returns on Assets (ROA) dropped to 8.5 percent in Q3 2022 from 20.4 percent in Q1 2022. While liquidity ratios remained within regulatory limits, banks – particularly state-owned – relied heavily on the CBSL liquidity facilities to fulfill their funding needs. At the same time, Non-Bank Financial Institutions (NBFIs) experienced rapid deterioration of their asset quality, with NPLs increasing by 6.5 percentage points in 2022 to 17.5 percent by the end of the year. Capitalization, however, improved from 17 percent in 2021 to 22 percent in 2022, mainly due to the infusion of new capital to meet the regulatory requirements as per the CBSL Master Plan for Consolidation of NBFIs[2] approved at the beginning of 2022.

6. **The financial sector pressures and rising interest rates negatively impacted financial intermediation.** While exposures of the banking sector to the sovereign and SOEs remain high (32 percent of total assets), growth in credit to government and SOEs slowed down. At the same time, financial intermediation, as measured by the Credit-to-Deposit ratio, dropped substantially below the 5-year average (Figure 7). Since monetary conditions remained tight, with average interest rates on new deposits and lending reaching 23.2 and 25.8 percent, respectively, demand for loans was particularly low. At the same time, rising NPLs weighed heavily on banks' appetites and abilities to grant new loans to risky businesses. As a result, there was a contraction (m-o-m) in credit to the private sector in the second half of 2022 (Figure 8).

[2] https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20220131_master_plan_for_NBFI_e.pdf

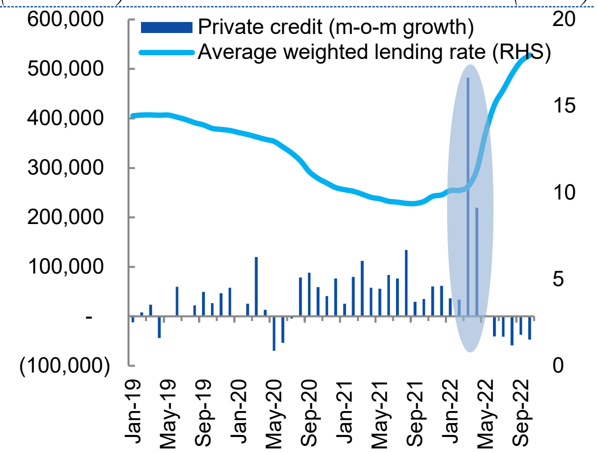
7. **CBSL took policy measures to revive the interbank market in early 2023.** Amid domestic liquidity concerns, the activity in the interbank call money market remained subdued in 2022. Some banks (mostly foreign) parked significantly large amounts at the overnight Standing Deposit Facility Window (on average LKR 318 billion per day in the second half of 2022), reflecting surplus liquidity. However, CBSL injected large volumes at the Standing Lending Facility Window (on average LKR 689 billion per day in the second half of 2022), as some banks (mostly domestic) experienced a significant shortfall. Furthermore, to enhance activity in the interbank market, CBSL, in January 2023, restricted: (i) the use of the Standing Deposit Facility Window by any individual bank to a maximum of 5 times per calendar month; and (ii) the use of the Standing Lending Facility to 90 percent of the Statutory Reserve Requirement of a licensed commercial bank at any given day. These measures have since increased liquidity in the interbank market.

Figure 7: Credit to deposit ratio
(Percent)



Source: Central Bank of Sri Lanka; World Bank staff calculations

Figure 8: Private credit and lending rates
(LKR billion) *(Percent)*



Source: Central Bank of Sri Lanka; World Bank staff calculations
Note: blue-shaded area reflects the expansion of private credit due to currency depreciation of foreign currency denominated loans.

External sector remains weak, despite some improvement in foreign exchange liquidity

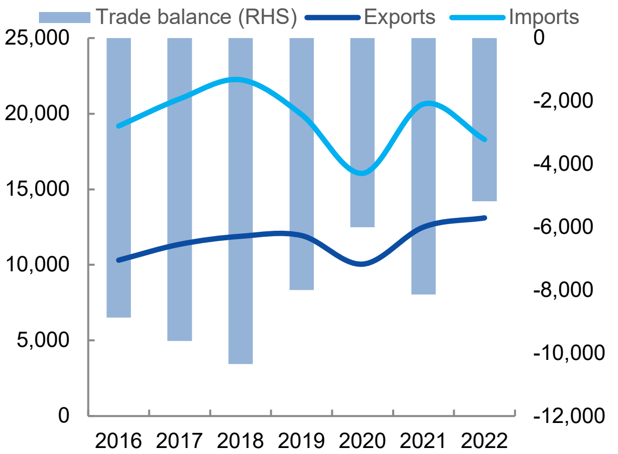
8. **Without market access, the external sector weakened further in 2022.** Official reserves plummeted from US$7.6 billion in 2019 to less than US$500 million (excluding a currency swap equivalent to US$1.4 billion with China[3]) in April 2022, as the country continued to service debt and facilitate imports using reserves. Amid depleted reserves, Sri Lanka announced an external debt service suspension in April 2022, pending debt restructuring. Since then, severe forex liquidity constraint was felt across the economy, with shortages of fuel, medicine, cooking gas, and other inputs needed for economic activity. To address the liquidity shortage, the exchange rate, which had been kept broadly fixed at an unsustainable level from August 2021 to March 2022, was floated on March 7, 2022. The CBSL eventually returned to a managed float on May 12, as the LKR depreciated by approximately 78 percent against the US Dollar during this two-month period.[4]

9. **Liquidity shortages and currency depreciation have shrunk the current account deficit in 2022, despite a sharp fall in remittances and relatively low tourism receipts.** The merchandise trade deficit declined to US$5.2 billion in 2022 from US$8.1 billion in 2021 due to a combination of a reduction in imports and an increase in exports (Figure 9). Although imports grew in the first half of 2022, owing to Indian financial assistance, they declined sharply in the second half due to liquidity shortages, currency depreciation, and lack of import demand amid the real sector contraction.[5] Overall, the merchandise import

[3] To use this currency swap, Sri Lanka needs three months import cover.
[4] The LKR depreciated by 81 percent against the US Dollar in 2022.
[5] The authorities implemented a foreign exchange management strategy (prioritization of imports, limiting imports to available cashflows, and rationing of foreign exchange) to smoothen the adjustment.

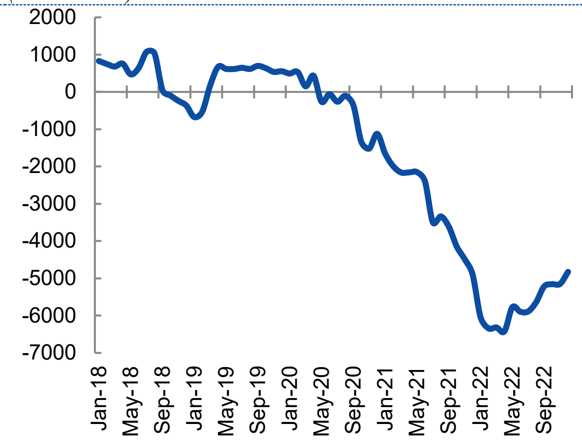
bill declined by 11.4 percent (y-o-y) to US$18.3 billion in 2022. On the other hand, merchandise exports increased by 4.9 percent to US$13.1 billion, as the garment sector rebounded. Although tourism receipts increased from a very low base, they were well below pre-COVID-19 levels, while remittances through official channels declined by 35.9 percent (y-o-y) or US$1.7 billion. Narrower merchandise trade deficit (by about US$3 billion) is estimated to have reduced the current account deficit to 1.6 percent of GDP in 2022 from 3.8 percent in 2021.

Figure 9: Merchandise trade
(US$ million)



Source: Central Bank of Sri Lanka

Figure 10: Net foreign assets in the banking system
(US$ million)



Source: Central Bank of Sri Lanka; World Bank staff calculations

10. **This foreign exchange management strategy temporarily stabilized the external sector, albeit at a low-level equilibrium, yet vulnerabilities remain.** In the absence of large debt service payments, the authorities have been able to manage the outflows (mainly the import bill) with inflows such as exports, tourism and remittances. This led to balance of payment surpluses in Q3 and Q4 of 2022, an accumulation of official reserves (US$700 million by January 2023, excluding the currency swap with China), and an improvement in net foreign assets in the banking system (US$-4.3 billion in January 2023, up from US$-6.4 billion in April 2022) (Figure 10). In addition, the lack of demand for imports from the real sectors and increasing expectations of an approval of the IMF program, contributed to a rise in foreign exchange liquidity, including through the unwinding of speculative Dollar holdings. The above factors led to a sharp appreciation of the LKR against the US Dollar (11 percent) between February 27 and 15 March 2023. Amid the currency appreciation, the central bank announced that it will transition back to a flexible exchange rate. Trade liberalization and a flexible exchange rate are important to avoid stagnation at a below-potential equilibrium.

Despite some progress in fiscal consolidation, vulnerabilities remain high

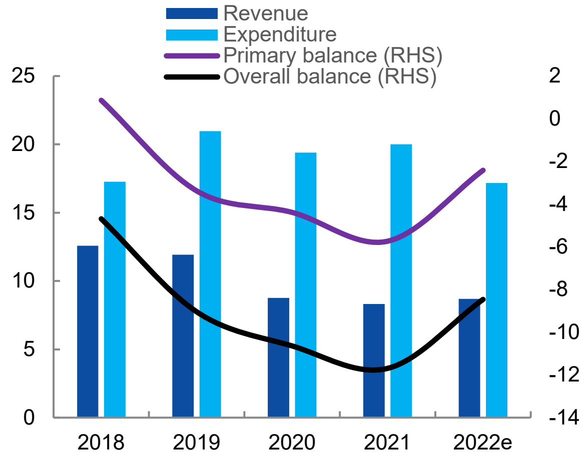
11. **The overall fiscal deficit is estimated to have declined in 2022 owing to the implementation of several new revenue measures and tightly controlled expenditures.** The increase in revenue, by about 0.4 percentage points to 8.7 percent of GDP in 2022, was estimated to have been driven by a new surcharge tax,[6] a new social security contribution levy,[7] and an increase in the VAT rate (please refer to paragraph 12).[8] At the same time, primary expenditures are estimated to have declined by 2.9 percentage points of GDP due to restrained public investment, the reduction of wages and pensions as a share of GDP

[6] Levied as a one-off tax (at a rate of 25 percent) on individuals and companies whose taxable income exceeded LKR 2,000 million for the year of assessment of 2020/21.
[7] A turnover tax of 2.5 percent imposed on businesses having a turnover of more than LKR 120 million (implemented in September 2022).
[8] The full year impact of the social security contribution levy and the VAT rate change will come in 2023.

amid high inflation, and a buildup of arrears.[9] As a result, the overall deficit is estimated to have contracted by about 3.2 percentage points to 8.5 percent of GDP in 2022. (Figure 11) With limited access to external financing and tight domestic liquidity conditions, approximately two thirds of the deficit was financed by CBSL. Moreover, interest payments continued to absorb a very high share – estimated at over 70 percent – of total revenue in 2022.

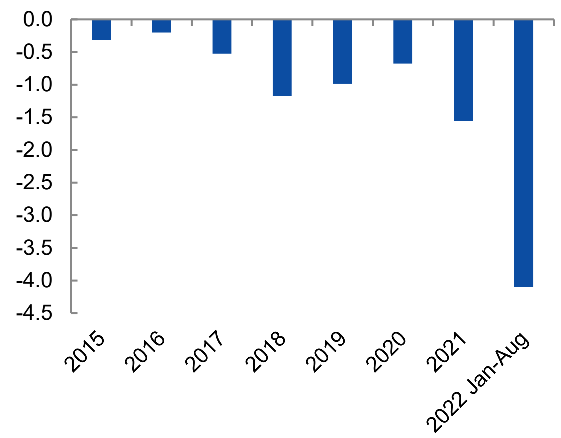
12. **Given Sri Lanka's very low tax-to-GDP ratio, increased domestic revenue mobilization is critical to bring Sri Lanka back to a fiscally sustainable path.** The government has implemented several revenue measures since May 2022 to support the fiscal adjustment. These include: (i) increasing the marginal PIT rates 6 percentage points for every LKR 500,000 per year up to a top rate of 36 percent, reducing the PIT tax-free allowance to LKR 1.2 million per annum, and introducing mandatory withholding taxes above the tax-free allowance of LKR 1.2 million per annum (all starting from January 2023); (ii) increasing the CIT rate from 24 to 30 percent and removing sector-specific exemptions from October 2022; (iii) increasing the VAT rate from 8 to 12 percent in May and to 15 percent in September 2022, and reducing the VAT registration threshold from LKR 300 to LKR 120 million per annum from October 2022; and (iv) raising fuel excises in January 2023. In addition, fiscal consolidation efforts need to emphasize continued progress in revenue administration reforms, including better information sharing, mandatory e-filing, and strengthened risk-based audits. Expenditure rationalization,[10] ensuring value for money in procurement, and stronger budget formulation and execution procedures could also bring in significant fiscal savings.

Figure 11: Key fiscal balances
(Percent of GDP)



Source: Ministry of Finance; World Bank staff calculations

Figure 12: SOE losses
(Percent of GDP)



Source: Central Bank of Sri Lanka; World Bank staff calculations

13. **The government is making progress with debt restructuring, which is essential to restore debt sustainability.** In 2022, Public and Publicly Guaranteed (PPG) debt is estimated to have increased to 122.5 percent of GDP,[11] while gross financing needs (GFN) were about 26 percent of GDP.[12] Restoring a sustainable debt path, therefore, entails reducing the unsustainable level of debt and high GFN through debt restructuring and supported by the broader fiscal adjustment. Debt management functions also need to be strengthened through the establishment of a dedicated debt management agency and by improving the: (i) legal framework; (ii) debt management strategy; (iii) timeliness and coverage of debt reporting; (iv) cashflow forecasting; and (v) borrowing operations. In Q1 2023, Sri Lanka secured financing assurances from official creditors – who agreed to offer debt relief consistent with the IMF debt sustainability framework – and engaged with private creditors in good faith to reach a collaborative agreement. This

[9] These arrears will need to be recognized as they are settled in 2023.
[10] At less than 20 percent of GDP, Sri Lanka's expenditures are not high by international standards. Salaries, pensions and interest payments account for about 60 percent of the toral expenditure, making the budget very rigid. However, efficiency gains can be achieved by improving public investment management.
[11] Excluding the currency swap with China
[12] This GFN level is among the highest in emerging markets.

progress paved the way for the IMF Board approval of the EFF. In addition, transparency in debt and fiscal management, including recognition of tax expenditures, is important to regain public confidence.

14. **Significant SOE reforms and divestment are needed to reduce macro-fiscal risks.** Several key SOEs have suffered significantly large losses in 2022 due to a combination of below-cost recovery pricing, operational inefficiencies, valuation losses on foreign currency denominated liabilities amid the LKR depreciation, and weak financial management. In the first eight months of 2022, Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB) and Sri Lankan Airlines (SLA) incurred a combined operational loss equivalent to 4.1 percent of 2022 GDP (Figure 12). Approximately two thirds of this loss came from operational losses of CPC due to the large foreign exchange exposure in its balance sheet. Immediate action is needed to restructure key SOEs, improve their governance, enhance government's oversight role, and prepare some of them for divestment. The implementation of cost-reflective pricing for electricity and fuel has been a positive initial reform to reduce losses. Moving forward, restructuring the balance sheets of CPC, CEB and SLAL will be critical for Sri Lanka's macroeconomic stabilization program.

The crisis reversed years of gains in poverty reduction and human capital development

15. **The economic crisis is estimated to have doubled the poverty rate; up from 13.1 in 2021 to 25.0 percent in 2022 (as measured at $3.65 per capita, 2017 PPP).** This increase has added an additional 2.5 million poor people, and compounds on two consecutive years of poverty increases in the country. COVID-19 had already increased poverty from 11.3 in 2019 to 12.7 percent in 2020 – a change that translated into over 300,000 new poor people that year – with a further increase in poverty by 0.4 percentage points in 2021. Vulnerability to income shocks has also increased with many non-poor households living close to the poverty line – 5.7 percent of the population lives less than 10 percent above the poverty line and a further 5.6 percent lives between 10 to 20 percent above it. All these households are highly vulnerable to falling into poverty in the event of a negative income shock.

16. **Job losses in industry and services, income losses, inflation, food insecurity and economic disruptions pose threats to multiple dimensions of wellbeing.** Households have been affected on different fronts as annual average inflation rose to 46.4 percent in 2022, impacting their purchasing power and the real value of wages and earnings. An estimated half a million jobs in services and industry were lost (pushing some workers to lower-paying agricultural jobs), while incomes from agriculture were negatively impacted by the ban on chemical fertilizers in 2021. Faced with falling incomes, many households turned to negative coping mechanisms, which deteriorated human capital outcomes. Data shows that households experiencing food insecurity are reducing their spending on health and education. Rising food insecurity has also led to increases in malnutrition and stunting – up from 7.4 percent in 2021 to 9.4 percent in 2022. The uncertain political and economic situation, and limited access to essential goods and services, also contributed to monetary and multidimensional deprivations. For example, fuel shortages and transport disruptions caused additional school closures in 2022, likely contributing to further human capital losses after two years of interrupted learning due to COVID-19. These losses are likely to worsen health and education deprivations and increase multidimensional poverty from the relatively low pre-pandemic levels – at 11.4 and 16 percent of the population in 2019 (when using, respectively, the World Bank's Multidimensional Poverty Measure and the National Multidimensional Poverty Index that also includes health deprivations).

17. **Rising inequality is also a concern.** It is estimated that overall inequality measured by the Gini co-efficient increased from 37.7 in 2019 to 38.1 in 2021 and 39.8 in 2022. Urban and rural poverty are estimated to have tripled and doubled, to respectively 15 and 26 percent in 2022, and more than half of the population in estate areas still lives in poverty.

B. Outlook and Risks

Sri Lanka has a narrow path towards stability and sustainability

18. **The economy will continue to face significant challenges in 2023 and beyond.** The baseline scenario projects the economy to contract by 4.3 percent in 2023 – following the contraction of 7.8 percent in 2022 – as demand continues to be subdued, job and income losses intensify, and supply side constraints adversely affect production. Medium-term growth prospects will depend on the progress with debt restructuring, fiscal consolidation, and effective implementation of growth enhancing structural reforms. On-going fiscal consolidation (which is central to the stabilization adjustment) will also likely dampen growth prospects, with the fiscal deficit expected to gradually fall over the medium term. Inflation is projected to come down from a high base as monetization of fiscal deficits is reined in. The current account deficit is expected to decline thanks to import compression, despite possible lackluster export performance in 2023. The gradual revival of tourism and remittances will also contribute to the reduction of the current account deficit, particularly from 2024. Additional resources – largely from international partners – will be needed in 2023 and beyond to close the external financing gap. The scarring effect of the crisis, and depletion in human capital (a large number of better skilled workers are reportedly immigrating), are expected to lead to only a fragile recovery beyond 2023.

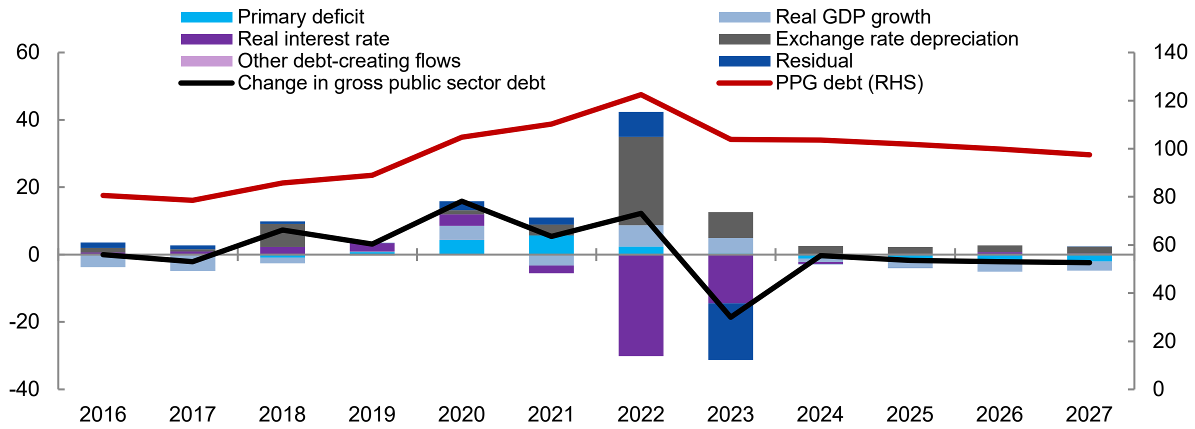
19. **The restructuring of external as well as certain domestic debt will be needed to restore debt sustainability.** Several alternatives could achieve the IMF's debt sustainability targets.[13] According to our illustrative scenario,[14] post-restructuring, the PPG debt to GDP ratio is projected to decline from 122.5 percent in 2022 to 103.9 percent in 2023, and gradually decline towards 95 percent in the outer years, broadly meeting the aggregate debt target set by the IMF. Although, GFN will remain high in the short term (on average, approximately 20 percent between 2023 and 2026), with reductions in the outer years, average GFN is projected to remain below the IMF target average of 13 percent of GDP in 2027–32. Due

13 Key debt targets of the EFF are: (i) the level of debt should decline below 95 percent of GDP by 2032; (ii) average GFN should remain below 13 percent of GDP in 2027–2032 and remain on a downward trajectory thereafter; and (iii) FX debt service should not exceed 4.5 percent of GDP in any year.

14 Our illustrative scenario assumes: (i) a principal reduction on external private debt along with a significant grace period; (ii) a maturity extension for official bilateral debt with a similar debt relief to external private debt in NPV terms; and (iii) a reprofiling of select categories of domestic debt (excluding the domestic financial sector held debt).

to restructuring of private debt, the foreign exchange share of debt service is projected to remain below the annual target of 4.5 percent of GDP.

Figure 13: Contributors to change in public and publicly guaranteed debt
(Percent of GDP)



Source: Ministry of Finance; World Bank staff calculations

20. **A strong and credible structural reform program is critical to avoid a prolonged crisis and address the root causes of the current economic difficulties.** The firm resolve of political leadership and Sri Lankan citizens will be required to overcome the crisis through several structural reforms. Meaningful outcomes of debt restructuring, and the collective support of international partners will also be needed to maintain the reform momentum and chart the course for a speedy and robust economic recovery. The necessary macroeconomic adjustments may initially adversely affect growth and poverty, but will correct overall imbalances, help regain access to international financial markets, and build the foundation for sustainable growth.

21. **Better-targeted social assistance, a recovery in more productive sectors, and an increase in the real value of incomes will be needed to reduce poverty.** Under current growth projections, poverty is expected to increase to 27.5 percent in 2023 and remain above 25 percent in the next few years due to the multiple risks to households' livelihoods. Recent reform measures, which are critically important for macroeconomic stabilization – such as electricity tariffs[15] and VAT increases – could affect the poverty outlook in the short term. As a result, additional adverse effects on living standards caused by these and other fiscal consolidation measures will need to be mitigated to prevent further increases in poverty and vulnerability. While agriculture is projected to grow by 2.4 percent in 2023, this is likely not going to be enough to absorb the shocks to other sectors. A recovery and expansion of wage employment in the services and industry sectors will be key to shift employment from lower-paying agricultural jobs, increase the value of real incomes, and make a significant dent in poverty.

Although there are considerable risks, this is an opportunity for Sri Lanka to reset its course

22. **Downside risks are significant.** The fluid political situation and heightened fiscal, external, and financial sector imbalances pose significant uncertainty for the outlook. Key risks include a slow debt restructuring process, limited external financing support, a sharper global slowdown, and a prolonged recovery from the scarring effects of the current crisis. A lower-level external trade equilibrium could have contagion effects on domestic trade, economic activity, jobs, and incomes. Combined with adverse effects

[15] Electricity tariffs at the bottom of the electricity consumption distribution increased tenfold between August 2022 and February 2023.

from revenue-mobilization efforts (essential for fiscal sustainability), this could worsen poverty projections. The financial sector needs to be managed carefully, given rising non-performing loans and large public sector exposures. On the upside, the government's reform program, supported by financing from international partners, could boost confidence and attract fresh capital inflows that are key to improve job prospects and restore livelihoods.

23. **Sri Lanka can use this crisis as an opportunity to build a strong and resilient economy.** The current crisis is not a temporary liquidity shock that can be resolved by external financing support from outside. Instead, the crisis provides a unique opportunity to implement deep and permanent structural reforms that may be difficult in normal circumstances. Examples of other countries with similar experiences suggest that unless root causes of the crisis are addressed, such crises tend to reoccur. To weather the crisis, significant burden sharing by all citizens is essential. Higher income groups, in particular, will need to take more of the burden to protect the poor and vulnerable, as Sri Lanka embarks on this journey towards a stronger and more resilient economy.

Key Economic Indicators

	2019	2020	2021	2022e	2023p	2024p	2025p	2026p
Annual percentage change								
GDP (expenditure side, constant prices)	(0.2)	(4.6)	3.5	(7.8)	(4.3)	1.2	2.0	3.0
Private consumption	3.8	(5.8)	6.2	(8.0)	(4.5)	1.3	2.1	3.4
Government consumption	6.6	3.6	3.1	(13.6)	(3.4)	(0.7)	1.0	0.1
Gross fixed capital formation	(11.9)	(1.7)	(3.8)	(11.1)	(4.2)	1.6	1.8	4.3
Exports	1.7	(29.6)	10.3	5.6	(4.0)	4.7	3.2	2.5
Imports	(3.5)	(20.1)	4.1	(5.9)	(3.9)	4.1	2.4	3.2
GDP (production, constant prices)								
Agriculture	0.5	(0.9)	0.9	(4.6)	2.4	1.5	1.5	1.5
Industry	(4.1)	(5.3)	5.7	(16.0)	(5.8)	1.0	2.2	2.8
Services	2.9	(1.9)	3.5	(2.0)	(4.5)	1.2	2.0	3.3
Share of GDP, unless otherwise stated								
External sector								
Exports of goods and services	21.8	15.5	16.9	21.4	21.7	24.4	25.0	25.4
Imports of goods and services	27.6	21.6	24.3	26.4	26.3	29.2	30.1	30.5
Remittances	7.5	8.4	6.2	5.1	6.1	6.4	6.8	7.0
Current account balance	(2.1)	(1.4)	(3.8)	(1.6)	(1.1)	(1.1)	(0.9)	(0.9)
Net foreign direct investment	0.7	0.5	0.7	0.6	1.1	1.2	1.2	1.2
Official reserves (US$ million)*	7,642	5,665	1,638	488	2,364	3,309	5,052	6,755
Official reserves (months of imports)	3.7	3.7	0.9	0.3	1.7	2.2	3.1	4.0
Inflation								
GDP deflator (percent)	3.9	3.3	8.5	48.8	21.8	8.0	7.0	6.0
CPI (annual average, percent)	4.3	4.6	6.0	46.4	21.8	8.0	7.0	6.0
Share of GDP								
Public Sector Finances								
Total revenue	11.9	8.8	8.3	8.7	11.0	12.5	13.5	13.5
Total expenditures	21.0	19.4	20.0	17.2	18.8	18.5	18.5	18.0
Overall fiscal balance	(9.0)	(10.6)	(11.7)	(8.5)	(7.8)	(6.0)	(5.0)	(4.5)
Primary balance	(3.4)	(4.4)	(5.7)	(2.4)	(0.4)	1.1	2.0	2.0
Public and publicly guaranteed debt	89.0	104.8	110.3	122.5	103.9	103.6	101.9	99.8
Memorandum items								
Nominal GDP (LKR billion)	15,911	15,672	17,600	24,148	28,127	30,733	33,546	36,628
GDP (US$ billion)	89.0	84.5	88.5	74.8	72.1	71.8	75.0	78.8

* Excluding the Chinese currency swap

Sources: Ministry of Finance, Central Bank of Sri Lanka and staff calculations.