INCLUSIVE AND SUSTAINABLE GROWTH ASSESSMENT

1. Sri Lanka country context before the pandemic and the 2022 economic crisis. Sri Lanka, an island country with a population of 22.2 million, is strategically located along key maritime routes. Despite a civil conflict from 1983 to 2009, Sri Lanka’s gross domestic product (GDP) growth averaged 4.8% during 1980–2009. After the civil conflict ended in 2009, economic growth averaged 6.7% in 2010–2015 as the country reaped “peace dividend” and attained upper-middle income status in 2018, albeit only briefly. Sri Lanka also recorded progress in human development, with its ranking on the Human Development Index (HDI) improving from 82 in 2010 to 73 in 2021. While there was progress on many fronts, vulnerabilities remained in several areas that are also causes of fragility (para. 15).

2. Macroeconomic imbalances. The country’s macroeconomic environment is characterized by repeated “twin deficits” (i.e., fiscal and current account deficits), signaling that the country’s national expenditure exceeds its national income, and that its production of tradable goods and services is inadequate. Sri Lanka’s fiscal and balance-of-payments (BOP) financing needs have led to frequent macroeconomic instability as evidenced by volatile growth, high inflationary episodes, and BOP crises. From 1965 to 2020, Sri Lanka was in 16 International Monetary Fund (IMF) arrangements, reflecting its history of macroeconomic vulnerability and its causes remaining unaddressed, policy reversals, and unfinished reforms. With changes in administration, Sri Lanka’s economic policies oscillated between inward- and outward-oriented strategies and witnessed shifts in the roles of the public sector and state-owned enterprises (SOEs) as well as in the tax policy.

A. Recent Growth, Poverty, Inequality, and Other Development Dynamics

3. Debt and balance-of-payments crises. Sri Lanka entered the coronavirus disease (COVID-19) pandemic in 2020 on a weak footing with several deeply entrenched structural problems and limited buffers that were exacerbated by various shocks that the country had witnessed since 2018, compounded by policy missteps. Significant strains on economic activity emerged in late 2021 and 2022. Foreign currency constraints, deficit monetization, a decline in agriculture production, and a global commodity price hike led to high inflation, severe food insecurity, and an acute energy crisis. With worsening macroeconomic conditions, Sri Lanka lost access to international markets, further constraining its ability to meet its foreign exchange needs.

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1 This assessment is a synthesis of various Asian Development Bank (ADB) publications and unpublished reports, which include macroeconomic assessments, sector and thematic assessments, a private sector assessment, a note on private sector participation (PSP), and a fragility and resilience assessment. It also draws upon databases and reports of the Government of Sri Lanka (GOSL); Central Bank of Sri Lanka (CBSL); Department of Census and Statistics (DCS); International Finance Corporation; International Monetary Fund (IMF); Ministry of Finance, Economic Stabilization and National Policies (MOF); and World Bank.

2 According to the World Bank classification by income level, Sri Lanka was reclassified again in 2019 as a lower-middle-income economy.

3 Sri Lanka’s HDI score was 0.782 in 2021 and compared favorably with the average score of South Asia (0.662) and all developing economies (0.685). United Nations Development Programme (UNDP), Human Development Reports.

4 Shocks included the constitutional crisis in the fourth quarter of 2018, terror attacks in April 2019, the COVID-19 pandemic in 2020 and 2021, and the Russian invasion of Ukraine in 2022. Policy missteps included tax cuts, rollback of the automatic fuel price adjustment mechanism, and suspension of reforms to strengthen public finances following a change in the government in late 2019. Other missteps included (i) the de facto exchange rate peg from April 2021 to early March 2022, which put pressure on foreign exchange reserves; (ii) a temporary ban on chemical fertilizer imports from May 2021 to November 2021, which undermined agriculture activities; and (iii) the delay in engaging with the IMF, which prolonged uncertainty and added to macroeconomic vulnerability.
requirements.\footnote{The three major rating agencies downgraded Sri Lanka’s sovereign rating multiple times during 2020–2022, which effectively locked Sri Lanka out of international markets.} The IMF staff report for the 2021 Article IV consultation assessed Sri Lanka’s debt as unsustainable and indicated that high gross financing needs (GFN) and external debt servicing posed significant rollover risks.\footnote{The public debt-to-GDP ratio increased from 89.0% at the end of 2019 to 125.7% at the end of 2022. GFN increased from 21.7% of GDP to 34.5% and government debt servicing ballooned from 19.8% of GDP to 30.9% over the same period. IMF, 2022. Sri Lanka: 2021 Article IV Consultation. IMF Country Report No. 2022/091. Washington, DC.} With severe pressure on reserves, Sri Lanka abandoned the de facto currency peg in March 2022, triggering a sharp depreciation of the currency. Sri Lanka announced a moratorium on selected external government debt service in April 2022 and defaulted on an international sovereign bond coupon payment in May 2022.

4. **Sri Lanka’s twin deficit challenge.** Sri Lanka is considered a classic twin deficit economy (para. 2). Low revenue collection, a rigid expenditure structure, and a weak public financial management (PFM) system contributed to the deterioration in Sri Lanka’s public finances. Fiscal deficit averaged 5.9% of GDP in 2010–2019 but increased to 11.4% in 2020–2022.\footnote{The primary deficit-to-GDP ratio during 2010–2019 averaged 1.0%, with small primary surpluses in 2017 and 2018. The primary deficit rose to average 5.8% in 2020–2021 but declined to 3.7% in 2022 as the expenditure did not keep up with the pace of increase in nominal GDP in a high inflation environment.} The revenue-to-GDP ratio declined from 12.6% in 2010 to 8.3% in 2022.\footnote{The revenue-to-GDP ratio has steadily declined since 1990, when it was 23.2%. Tax revenue comes predominantly from indirect taxes, which averaged 79.0% of total tax revenue during 2010–2022.} Poor performance of SOEs added to the fiscal burden. Merchandise trade deficit, which averaged 10.1% of GDP in 2010–2022, was partially offset by a surplus in the services trade (mainly tourism and transport) and net remittances. The resulting current account deficit averaged 3.0% of GDP over the same period. Interest payments on government external debt averaged 1.2% of GDP during 2012–2022 and contributed to the current account deficit. Additionally, the government’s external debt amortization was 2.2% of GDP during the same period. Intermittent shocks to the major current account inflows and commodity price increases exerted pressure on foreign exchange reserves and BOP that forced the country to turn to the IMF periodically.

5. **Crisis exposed financial sector vulnerabilities.** Sri Lanka’s financial sector faced stress as the economic crisis began in 2022 because of deteriorating credit quality, foreign exchange shortage, large public sector credit exposure, and legacy issues from past regulatory forbearances.\footnote{The sovereign-bank nexus (40% of the banking sector assets have public sector exposure) further increased stress on the banks’ balance sheets, particularly for the state-owned banks. Banks have significant portfolios of government securities because of the government’s reliance on the domestic finance sector to meet its financing needs. In addition, state-owned banks also provide loans to SOEs, which are often backed by treasury guarantees. Stage 3 loans (i.e., the sum of nonperforming loans that are overdue by more than 90 days from the due date and/or have been restructured more than twice and/or have been rescheduled) increased from 8.4% in March 2022 to 13.4% in June 2023 and remained stable in September 2023. The average banking sector capital adequacy ratio declined from 16.1% in December 2021 to 15.3% in September 2022, but improved to 16.4% in September 2023.} Banks are expected to face capital shortfalls from the impact of sovereign debt restructuring and additional provisioning for impaired loans. Further deterioration in asset quality as well as other macroeconomic shocks could lead to additional stress, with repercussions for the broader economy.

6. **New International Monetary Fund arrangement and debt restructuring.** To address long-standing macroeconomic imbalances and structural impediments, and to restore debt sustainability, Sri Lanka entered into a new 4-year $3.0 billion Extended Fund Facility program in March 2023, its 17th IMF arrangement. The program focuses on stabilization measures with
accompanying governance and structural reforms (para. 39). The program calls for Sri Lanka’s sovereign debt to be restructured.\textsuperscript{10}

7. **Economy contracted sharply in 2020–2022.** GDP growth slowed down from 3.4\% in 2016–2019 to an average contraction of 3.0\% during 2020–2022 because of the combined effects of the pandemic and the economic crisis (para. 3). In 2022, the economy shrank by 7.8\% as the industry sector contracted by 16.0\% and the agriculture sector by 4.6\%, while the services sector witnessed a lower contraction of 2.0\%. Even though GDP growth was positive in the third quarter of 2023, the economy contracted 4.9\% in the 9 months ending September 2023 as the industry and services sectors recorded contractions in the face of weak demand, with the agriculture sector recovering as fertilizer imports resumed. Recovery to the pre-COVID-19 real GDP level is expected to be protracted.

8. **Economic situation has shown signs of improvement.** The Sri Lankan economy is showing signs of stabilization and recovery in the wake of stringent contractionary monetary and fiscal policies. Inflation decelerated sharply from 69.8\% year-on-year in September 2022 to 4.0\% in December 2023 on the back of disinflation in food prices. This allowed the Central Bank of Sri Lanka (CBSL) to ease monetary policy by a cumulative 650 basis points in 2023, which, along with the completion of domestic debt exchange, helped to lower interest rates. With the removal of the guidance peg in March 2023, currency appreciated against the United States dollar because of weak demand. Gross official reserves stood at $4.4 billion at the end of December 2023, up from $1.9 billion at the end of 2022, because of net inflows into the government securities market, net purchases by CBSL, and budget support from international financial institutions.\textsuperscript{11}

9. **Inward-oriented economy, lack of economic and export diversification, and labor market outcomes.** Sri Lanka’s openness, as measured by the trade-to-GDP ratio, declined from an average of 49.2\% during 2010–2019 to 41.4\% in 2020–2022. Foreign direct investment (FDI) remained weak, averaging 1.2\% of GDP in 2010–2019 and only 0.8\% of GDP in 2020–2022. The increase in inward orientation of the economy reflects a more protectionist policy stance that constrains FDI and participation in trade, particularly in global value chains (GVCs) (paras. 19 and 20). Textiles and garments continue to account for more than 40\% of merchandise exports, indicating a lack of economic and export diversification into other sectors such as electric and electronic components, processed food and beverages, boat building, and spices and concentrates. Sri Lanka’s export basket is also characterized by a relatively low economic complexity index, another sign that it has not been able to transition into light manufacturing.\textsuperscript{12} Though Sri Lanka’s output structure shows a shift to services (with an average share of 59.2\% during 2016–2022) and away from agriculture (8.5\%), a large share of the employed are still in agriculture (26.4\%), where productivity is about 31\% of the national average. Furthermore, its manufacturing sector—a sector widely regarded as one that can gainfully employ semiskilled workers—lags in labor productivity. Though Sri Lanka’s manufacturing labor productivity is one of South Asia’s highest, it is roughly half of that in the Philippines and Thailand, and about one-third of that in Malaysia and the People’s Republic of China.\textsuperscript{13} Another sign that the Sri Lankan economy is yet to see structural transformation is the high share of informal employment—nearly

\textsuperscript{10} Multilateral debt is outside the perimeter of debt restructuring.

\textsuperscript{11} Gross official reserves include a swap from the People’s Bank of China equivalent to about $1.4 billion.


two-thirds of employment is informal. Youth unemployment has increased steadily and stood at 26.5% in 2021 and 22.7% in 2022 compared to 21.4% in 2018. Sri Lanka will need to shift to an outward-oriented and private sector-driven economy that will create formal and quality jobs, which will be essential to reducing poverty and vulnerability of falling back into poverty.

10. **Gains in poverty reduction reversed during the crisis.** Sri Lanka recorded significant progress in poverty reduction prior to the pandemic as poverty incidence, measured at the national poverty line, declined from 46.8% in 2002 to 14.3% in 2019. Over the same period, the poverty rate declined across all provinces, districts, and sectors, though significant regional disparities remain. Back-to-back crises since 2020 pushed a large number of vulnerable households into poverty. At the poverty line of $3.65 a day (2017 purchasing power parity), poverty incidence increased from 11.3% in 2019 to 25.0% in 2022, slightly above the poverty rate of 23.8% in 2009/2010—a reversal of more than a decade’s progress in poverty reduction. Nearly 16.0% of Sri Lanka’s people in 2019 were multidimensionally poor and suffered from deprivation of basic facilities, access to health facilities, drinking water, cooking fuel, and assets. Inequality, as measured by the Gini coefficient, fell from 0.40 in 2002 to 0.36 in 2009 but rose to 0.38 in 2019 and further to 0.40 in 2022 (the 2022 figure according to World Bank estimates).

11. **Food insecurity increased and child malnutrition remains a concern.** Food insecurity spiked during the crisis as nearly 28.4% of the population reported moderately acute food insecurity in May 2022. This improved to 17.0% by May 2023, helped by an easing of supply side constraints, provision of fertilizer, and expanded social protection support. Continued high levels of food insecurity will exacerbate Sri Lanka’s weak record on malnutrition—the incidence of wasting was 10.1%, stunting 9.2%, or being underweight 15.3% among children aged under 5 years in 2022. Causes of malnutrition include lack of food security because of employment insecurity and food price volatility, insufficient attention to nutrition by caregivers, and lack of regular access to safe water and adequate sanitation. Maternal and childhood malnutrition poses a risk to human capital development with ramifications for growth.

12. **Sustainable Development Goals.** Sri Lanka ranked 83rd out of 166 economies in achieving the Sustainable Development Goals (SDGs) based on the latest available data as of early 2023. Out of the 17 SDGs, Sri Lanka’s performance was 75% or more on 7 SDGs (SDGs

14 The poverty rates in 2019 at the national poverty line by province are as follows: Central = 18.7%, Eastern = 18.6%, North Central = 11.0%, North Western = 11.8%, Northern = 23.8%, Sabaragamuwa = 23.1%, Southern = 12.6%, Uva = 28.3%, and Western = 5.7%.
17 The Gini coefficient is measured from 0 (no inequality) to 1 (all consumption is by one person). In comparison, in 2019, the Gini coefficient was 0.36 in India, 0.29 in Maldives, and 0.35 in Thailand. ADB. *Key Indicators Database* (accessed 12 February 2024).
18 Food security exists when all people, at all times, have physical, social, and economic access to sufficient, safe, and nutritious food that meets their dietary needs and food preferences for an active and healthy life. Food and Agriculture Organization of the United Nations and World Food Programme. 2023. *Special Report: FAO/WFP Crop and Food Security Assessment Mission (CFSAM) to the Democratic Socialist Republic of Sri Lanka*. Rome.
19 This marks an increase compared with 2020 when the incidence of wasting was 8.6%, stunting 8.2%, and being underweight 13.1%. The three indicators recorded steady decline from 2016 to 2020. GOSL, Ministry of Health. *Family Health Bureau* (accessed 12 February 2024).
21 SDG 1 = no poverty; SDG 2 = zero hunger; SDG 3 = good health and well-being; SDG 7 = affordable and clean energy; SDG 8 = decent work and economic growth; SDG 9 = industry, innovation, and infrastructure; SDG 10 = reduced inequalities; SDG 11 = sustainable cities and communities; SDG 12 = sustainable consumption and
1, 3, 4, 8, 11, 12, and 13), with education (SDG 4) and climate action (SDG 13) highest. However, the remaining 10 SDGs (SDGs 2, 5, 6, 7, 9, 10, 14, 15, 16, and 17) scored in the range of 45%–75%, with gender (SDG 5), water and sanitation (SDG 6), and partnerships (SDG 17) scoring the lowest. With budget resources strained from the fiscal and debt crises, alternative sources of financing are needed beyond grants and borrowing, especially from private investments, to make progress on the SDGs. Frequent changes in policymaking, implementation delays, a fragmented data landscape, and lack of an SDGs-aligned development plan with a monitoring and evaluation framework also pose challenges.

13. Environmental degradation. The causes of environmental degradation are rooted in development trends linked to urbanization, industrialization, and commercialization. Degradation of natural forests and natural habitats, dilapidation of land resources, pollution of water resources, emissions that worsen air quality, erosion of coastal habitats, coastal and marine pollution, and urban environmental deterioration are the key environmental challenges faced by Sri Lanka. The impact of environmental degradation on the economy and human well-being is evident through sudden and catastrophic shocks (such as climate-induced floods and cyclones) as well as through chronic and long-term effects (slow onset climate-induced effects, health impacts because of water pollution, loss of soil productivity, loss of water retention capacity of watersheds, and saline intrusion in rivers and groundwater).

14. Climate and disaster vulnerabilities. Sri Lanka is one of the most vulnerable countries to climate-related hazards and climate change globally. The Global Climate Risk Index ranked Sri Lanka the 23rd most affected economy (out of 180) based on the impacts of extreme weather events during 2000–2019. Sri Lanka is subject to extreme weather and geophysical hazards and to slow onset climate events such as droughts and coastal erosion. Hazards of hydrometeorological origin affect almost the entire country. Sri Lanka’s high temperatures, unique and complex hydrological regime, social vulnerability factors, and exposure to climate hazards contribute to high climate change risk. Climate models predict increased variability and intensity of mean annual rainfall in Sri Lanka, a rise in average temperatures along with an increase in the number of hot days (hotter than 35 degrees Celsius), and a rise in sea level of about 0.1–0.2 meters. Sectors that contribute significantly to the economy—agriculture, fisheries, tea plantations, and tourism—are highly vulnerable to climate change. Changes in temperature and rainfall patterns will intensify existing water resource challenges, while temperature increases will generate an urban heat island effect and place strain on energy generation. Climate change is expected to impact human health because of food scarcity; heat-related deaths; and increased transmission of vector, foodborne, and waterborne diseases that will affect Sri Lanka’s poorest and most marginalized communities disproportionately. Without adequate investment in adaptation and resilience, climate change will lead to increased damages and losses.

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Estimated annual disaster losses in Sri Lanka average $313 million (SLRs50 billion at the 2017 exchange rate), of which $200 million is from floods, $68 million from cyclones and high winds, $32 million from droughts, and the rest from landslides. World Bank et.al. 2020. Contingent Liabilities from Natural Disasters: Sri Lanka. Washington, DC.
B. Key Impediments to Inclusive and Sustainable Growth

15. Sri Lanka is grappling with its most severe economic crisis since independence. The crisis has eroded development gains. Sri Lanka’s immediate objective is to ensure economic stabilization and continued economic recovery. At the same time, Sri Lanka needs to undertake deep and wide-ranging reforms to address the underlying causes of the debt and BOP crises, as well as the causes of the increase in fragility. To ensure a sustainable and inclusive recovery, Sri Lanka needs to (i) strengthen PFM and governance, reduce the role of the public sector in the economy, and address corruption vulnerabilities; (ii) promote private sector development (PSD) with a conducive business climate and trade and investment policies that support a shift from an inward-oriented to an outward-oriented growth strategy with greater regional integration; (iii) encourage small and medium-sized enterprises (SMEs) development, tourism, and the rural economy; (iv) bolster social safety nets, improve access to public services, and deepen inclusion; (v) address threats to environmental sustainability and invest in natural capital; (vi) enhance climate action and disaster resilience; (vii) foster gender equality and social inclusion; and (viii) promote digitalization.

1. Public Sector Management and Governance

16. Weak public financial management and debt management. Sri Lanka’s macroeconomic challenges stem from high fiscal deficit, elevated public debt, and high external debt servicing (paras. 3 and 4). Weak PFM and debt management, a declining revenue-to-GDP ratio, and ineffective institutions and laws combined with a lack of central bank independence led to deteriorating public finances and triggered macroeconomic imbalances, becoming a source of fragility. To address the gaps in PFM and debt management, the government plans to roll out a new PFM law (including binding fiscal rules), a new public debt management act, and a new debt management office. To enhance debt transparency, a quarterly debt report has been published since 2022. CBSL independence has been strengthened with the Central Bank of Sri Lanka Act, No. 16 of 2023, which prohibits monetary financing of fiscal deficit. Sri Lanka’s low revenue-to-GDP ratio (para. 4) stems from a narrow tax base, inadequate compliance, a plethora of tax incentives and concessions, unpredictability in tax policies, and weak tax administration (including limited digitalization). The government has made significant changes to the tax policy since 2022 to improve revenue collection. Revisions include increasing the value-added tax from 8% to 18% in multiple steps since 2022, increasing personal income tax rates with narrower brackets and reducing the tax-free threshold, increasing corporate tax rates, and making income tax withholding mandatory. Further reforms are planned, such as revamping the property tax and introducing a new wealth transfer tax and gift and inheritance tax. To identify weaknesses in tax administration, the ADB, IMF, and World Bank collaborated on a Tax Administration Diagnostic Tool Assessment. Public investment management and efficiency need to be improved to better deploy scarce resources by strengthening project screening, improving criteria for prioritization and selection, and ensuring high readiness. With several reforms related to PFM underway, there is an opportunity to “green” PFM by developing a comprehensive climate fiscal framework, integrating climate factors in planning and budget, introducing climate tagging of the budget, and enhancing accounting systems to track climate expenses.

17. Subpar financial and operational performance of state-owned enterprises. Sri Lanka’s public sector plays a dominant role in sectors such as infrastructure, health, education, banking, insurance, and hospitality. SOEs add to the fiscal and debt burden because of lack of cost-recovery pricing, social obligations, weak financial management, lack of overarching SOE legal and policy frameworks, gaps in corporate governance, fragmented ownership between MOF and line agencies, ineffective boards of the SOEs, and the absence of monitoring mechanisms.
The government has introduced cost-recovery pricing for fuel and electricity since 2022. Further, the government has approved a strategy to restructure the balance sheets of the four SOEs with significant legacy debts.26 A new SOE restructuring unit has been established. Advisors have been engaged for divestment of eight SOEs and others are under consideration. To strengthen SOE governance and enhance transparency, the government plans to introduce a statement of corporate intent for key SOEs to clarify their mandate, develop key performance indicators to hold management accountable, revise the framework for selection of independent and qualified board members for SOEs, and publish audited financial statement of the 52 major SOEs. An overarching SOE law is planned to give legislative backing to the SOE reforms afoot. The new PFM bill will include provisions that guide borrowing by SOEs.

18. Weak governance and institutions, and corruption vulnerabilities. The IMF’s governance diagnostic assessment highlighted systemic and severe governance challenges in Sri Lanka.27 Weak governance and anti-corruption frameworks are a source of fragility and have contributed to the ongoing economic crisis.28 Policy formulation by agencies with overlapping mandates has resulted in stand-alone and noncongruent policies on similar matters impacting policy certainty and contributing to delays, with ad hoc policy changes. The government has enacted the Anti-Corruption Act, No. 9 of 2023 that is aligned with the United Nations Convention against Corruption. New legislation for comprehensive asset recovery is planned. Concerns remain about the capacity in the government to implement the new anti-corruption act. Though there are detailed procurement guidelines, lack of a dedicated procurement law enhances executive discretion. Closer oversight of the procurement process and strengthened contract management would reduce opportunities for corruption. Electronic government procurement, initially supported by ADB, will help improve transparency, coordination, and monitoring. Sri Lanka’s anti-money laundering/combating financing of terrorism regime and legal framework need further enhancement to be at par with international standards.

2. Private Sector Development

19. Lack of an enabling environment for private sector participation. For Sri Lanka to take full advantage of its strategic location, it will need to promote trade and investment with a greater role for the private sector. This will require reducing tariff rates, removing barriers to FDI, and improving the enabling environment for private sector activity.29 Constraints faced by businesses include (i) macroeconomic vulnerabilities and the ensuing uncertainty, sovereign risk, and high financing cost (para. 2); (ii) a burdensome regulatory environment (e.g., limited access to land as 80% of the land is owned by the government, fragmented labor market regulations, delays in contract enforcement, and outdated insolvency law); and (iii) skills mismatch (para. 26).

26 The 4 SOEs are the Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation, Road Development Authority, and SriLankan Airlines.
Constraints in access to finance (para. 22) and the significant presence of market-distorting SOEs (para. 17) also inhibit private sector participation (PSP). Lack of policy consistency and frequent revisions to tax regime, investment incentives, and the regulatory regime, as well as the multiplicity of institutions with overlapping mandates aspects, make the operating environment complex, increase coordination costs, and create uncertainty (para. 18). Sri Lanka also falls short in trade facilitation and logistics. Lack of a conducive environment has led to a duality wherein large firms and exporters, especially those in the Board of Investment zones (which provide special facilities), are able to navigate the system with ease, whereas start-ups and SMEs face a stringent regulatory environment.

20. **Operating environment for trade, investment, and enterprise development.** To provide an enabling environment and to have synchronized and complementary trade and investment policies, the government is planning to simultaneously tackle trade and investment-related challenges. To address the anti-export bias in trade policy, the government plans to phase out the para-tariffs and replace them with customs tariffs. The government is also planning legal and institutional reforms to address coordination issues across different agencies mandated to promote trade and investment, and industrial and/or economic zones. A national strategy outlining the framework for developing economic zones and the reforms needed to strengthen institutional and governance systems for zones development and operations is needed (para. 21). Several agencies have overlapping mandates for supporting SME development. Legal and institutional reforms are planned to streamline the functions related to SME development. Developing an ecosystem, comprising business development and financing, will help nurture start-ups.

21. **A holistic approach to zone development.** In addition to a conducive regulatory environment (para. 20), the success of economic zones and corridors also depends on the availability of infrastructure and basic amenities, and access to education and health services. A multidimensional framework covering comprehensive urban planning (including for peri-urban areas), infrastructure investments (including power and logistics), skills development, and a conducive business environment is essential. Synchronizing these components is critical for broad-based economic growth and an orderly urbanization process that boosts economic competitiveness and enables cities and towns to fulfill their economic potential.

22. **Stress in the financial sector and limited sector development.** Sri Lanka’s banking sector came under severe stress as the economic crisis deepened (para. 5). The country’s financial sector has two challenges: (i) maintain sector stability and (ii) position the sector to support recovery and growth by deepening capital markets and broadening access to finance and use of sustainable finance. To safeguard financial sector stability, legislative changes have been enacted or are planned to strengthen (i) the emergency crisis management role and resolution

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30 Sri Lanka’s trade policy shows an anti-export bias wherein the prevalence of high para-tariffs and restrictions incentivizes firms to produce for domestic markets, which limits diversification of the export basket. Sri Lanka’s score on the Digital and Sustainable Trade Facilitation Survey improved from 43.0% in 2015 to 60.2% in 2023, but still fell short of Bangladesh (64.5%), India (93.6%), Indonesia (87.1%), Malaysia (87.1%), Thailand (85.0%), and Viet Nam (74.2%). Sri Lanka has made weak progress in its commitments to implement the Trade Facilitation Agreement, with only 34.9% implementation commitments compared with the global average of 78.8%, the average among lower-middle-income economies of 62.7%, and the average among upper-middle-income economies of 89.8%. Furthermore, Sri Lanka has categorized the remaining 65.1% provisions as category C, i.e., requiring technical assistance. Sri Lanka’s score on the Logistics Performance Index improved from 2.6 in 2018 to 2.8 in 2022, which was less than the score of Malaysia (3.6), Thailand (3.5), and Viet Nam (3.3). Sri Lanka’s logistics costs are 18.7% of GDP, far higher than the global average of 10.8%, Armstrong and Associates, Inc. Global 3PL Market Size Estimates (accessed 12 February 2024); United Nations. UN Global Survey on Digital and Sustainable Trade Facilitation (accessed 12 February 2024); World Trade Organization. Trade Facilitation Agreement Database (accessed 12 February 2024); and World Bank. Logistics Performance Index (accessed 12 February 2024).
authority mandate of the CBSL, (ii) deposit insurance framework, (iii) regulatory standards, and (iv) regulation and supervision of the state-owned banks. To ensure the banking system is healthy and adequately capitalized, ADB supported the asset quality review of nine major banks. A road map for banking sector recapitalization and restructuring is planned. Sri Lanka’s financial market is bank-dominated, and the capital market has not been effective in channeling savings to support private sector investments for infrastructure development and entrepreneurial activities. Bottlenecks for capital market development include inadequate enabling legal and regulatory frameworks, limited capacity of regulators for strengthening market governance and promoting innovation, and outdated market infrastructure. Financial inclusion and access to finance by SMEs are hampered by the use of collateral-based lending, which also hampers women’s access to credit as property rights are more likely to be with men. Other reasons include low financial literacy and lack of (i) digitalization, (ii) a centralized registry for movable collateral, (iii) credit guarantees from an independent entity, and (iv) a regulating authority for microfinance.

23. **Lack of enabling environment for public–private partnerships.** With limited fiscal space, greater PSP will be important in key sectors of the economy. The dominant role of SOEs and the ensuing market distortions, as well as an inadequate enabling environment for public–private partnerships (PPPs), constrain PSP. The lack of a consistent, updated, bankable, and fully functional PPP enabling framework is a key constraint to PSP in infrastructure. A national PPP policy that sets out the overall policy direction and the accompanying updated legal and regulatory frameworks for PPPs are needed. The PPP institutional framework is also fragmented with overlapping roles and responsibilities of various government agencies. Capacity of the public sector to identify, screen, prioritize, prepare, procure, and manage PPP projects is limited. A dedicated project development fund to provide technical assistance and financial support for early and midstream PPP project preparation is required. A dedicated government window to support PPPs from a financial viability and bankability perspective is lacking. The National Agency for PPP was reestablished in 2022 to serve as the centralized custodian of PPPs and support the development of robust and sustainable PPPs.

24. **Battered tourism industry.** Beginning in 2019, the tourism industry suffered severely from back-to-back shocks (footnote 4). While the industry is witnessing a recovery, long-term recovery and growth is constrained by a fragmented institutional setup responsible for regulation and promotion of the industry, lack of human resources, and few product offerings, among others. As travel normalizes, the industry needs to adjust to new requirements and reposition itself to cater to new demands. Promoting Sri Lanka as a sustainable destination will be vital in attracting the increasingly sensitized traveler and maintaining competitiveness. Tourism has the potential to make growth inclusive by attracting youth and women, and engaging communities. The revival of the tourism industry will also support backward linkages with agribusinesses, which in turn support the rural hinterlands. Protection of natural and cultural resources and heritage, attractiveness of tourist destinations, sustainable marketing and communication, and industry standards need to be strengthened.

25. **Agriculture and agribusiness growth is constrained by numerous factors.** The economic crisis has accentuated the importance of the agriculture sector, especially in terms of improving the balance of trade and addressing food security. Growth of Sri Lanka’s agriculture sector is hampered by low productivity, limited diversification, large post-harvest losses, and low value addition. Underlying causes are (i) limited knowledge and skills among farmers and agribusiness entrepreneurs; (ii) poor agricultural practices and inefficient use of water in

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agriculture; (iii) limited mechanization coupled with growing labor shortages; (iv) land fragmentation, which reduces benefits from economies of scale in production and processing; (v) crop damage because of climate variability and attacks by pests and wildlife; (vi) inefficient logistics and the lack of value chain infrastructure (e.g., cold storage, dry storage); (vii) limited investment in research and development; (viii) monopolistic behavior by intermediaries; (ix) lack of access to finance and insurance; and (x) inconsistent policies affecting the supply and demand of both inputs and outputs. The sector needs to be modernized, especially by adopting digital technologies to improve productivity and resilience.

3. Access to Social Services and Inclusion

26. Need to improve access to quality education and produce workforce-ready graduates. A major challenge Sri Lanka faces in its ambition to diversify and transform its economic base and become globally competitive is the lack of a skilled workforce in (i) science, technology, engineering, and mathematics (STEM) fields; (ii) emerging areas of climate change and environmental sustainability; and (iii) sectors with acute skill shortages that have been aggravated by the increase in outmigration since 2022. This requires improving access to employment-oriented education and training for secondary and postsecondary students, youth, and adults by creating more diverse and flexible pathways between secondary education, tertiary education, and technical and vocational education and training. Learning outcomes in STEM courses are suboptimal with significant disparities between rural (mostly provincial) and urban schools because of lack of laboratories, equipment, and teachers. The university system acts as a major bottleneck for those who wish to pursue tertiary education because of limited seats, especially in the STEM programs. Fewer women enroll in STEM programs, leading to gender disparities in employment, as the employment rate for STEM graduates (80%) is much higher than that for arts graduates (50%). Some of the other critical challenges include knowledge gaps among teachers, insufficient use of appropriate pedagogy, outdated curriculum and assessment techniques, lack of access to e-learning facilities and limited adoption of virtual learning, limited investments in research and development capabilities in higher education institutions, absence of an accreditation system for tertiary education, and lack of clarity of the roles of various government agencies in education and training. In addition, there is a lack of an enabling environment for PSP in education, training, and research and development.

27. Sri Lanka needs to strengthen its health system. Sri Lanka has recorded improvements in health outcomes—life expectancy increased from 60.7 years in 1960 to 76.4 years in 2021, and reproductive health outcomes improved as the total fertility rate declined to 2.0 per woman as of 2021 with fertility control measures since the early 1960s. The growing burden of noncommunicable diseases, lifestyle-related chronic diseases, and an aging population is placing pressure on the health sector. Significant gaps persist in the efficient provision of quality essential health care services at the primary health care level and the continuity of care for those who require secondary and tertiary care. Lack of digitization of health information management, efficient pharmaceutical supply chain management, and disease surveillance also constitute bottlenecks. Other constraints include inadequate medical waste management, poor facilities to promote disability access, gaps in disability and rehabilitation support services, and human resource shortages. The economic crisis in Sri Lanka highlighted the urgency of reforming the existing fully government-funded health system by leveraging the private sector to improve the efficiency and cost-effectiveness of the health system, utilizing government facilities through PPPs, and integrating private and government health information systems.

28. Growing old before becoming rich. Sri Lanka’s population is expected to contract after 2038, while the working-age population aged 15–64 is expected to peak in 2027. The share of
population over 65 years is projected to double from 11% in 2020 to 21% by 2045. In 2015, the share of women in the 60–64 age group was 54%, in the 70–74 age group 58%, and 60% in those aged 80 years and over. Preparing for an aging society will require increasing labor force participation and productivity of the workforce; promoting healthy aging and income security; and developing appropriate health, care, and support systems and age-friendly environments. Because of low labor force participation, women are either dependent on spouse pension or may not have access to old-age income support (except those eligible under the Aswesuma program [para. 29]). The health and education systems also need to respond with adequate facilities and capacity to develop the skills for the health and care workforce for an aging population.

29. **Social protection.** Sri Lanka has more than 25 social assistance programs, of which four were key vehicles to deliver cash transfers. These were the (i) Samurdhi program, (ii) senior citizen’s allowance, (iii) disability allowance, and (iv) chronic kidney disease illness allowance. During the COVID-19 pandemic, and since the economic crisis began, the government provided additional cash through these programs and also covered additional beneficiaries who were on the waitlist. To address shortcomings of the Samurdhi program, the government rolled out a new social welfare program from July 2023, the Aswesuma program. The new program will target about 2 million families initially, of which about 1.2 million families will be assisted for 3 years. The Welfare Benefit Board established under the MOF will implement and monitor Aswesuma, and the Department of Samurdhi Development will lead the social empowerment and financial inclusion of the beneficiaries.

30. **Disparities in access to water supply and sanitation.** Disparity in the provision of water supply is one of the key causes of multidimensional poverty and vulnerability. In 2015, piped water supply coverage was 75% in urban areas compared to 29% in rural areas. Despite adjustments in 2022 and 2023 (the first since the revision in 2012), water tariffs are not fully cost reflective and can only cover operation and maintenance (O&M) costs. O&M costs are sensitive to the electricity tariff, which in turn is being repriced. Technical and commercial losses have led to weak financial performance and high nonrevenue water (25.2%). Constraints in improving access to potable water supply and reducing nonrevenue water include (i) gaps in O&M and asset management systems, selection criteria, and decision-making mechanisms to prioritize investments; and (ii) lack of an enabling environment to attract and incentivize PSP. In 2019, 92% of the population was covered by sanitation facilities, of which only 2.1% (in a few main cities) had access to off-site piped sewerage systems. However, only a very small percentage of wastewater produced is safely managed, and most is discharged untreated. Because of a shortage of sewerage networks and wastewater treatment plants, septage disposal has become an environmental, social, and public health problem. Sri Lanka is prone to different types of natural hazards and salinity intrusion into drinking water sources, which are likely to become more severe because of climate change. The effects of climate change may worsen water scarcity and spatial inequalities in water availability and may increase waterborne disease risks after flood events, which may be exacerbated by inadequate drainage and sewerage systems. Other urban amenities, e.g., transport, solid waste management, and housing, also need improvement.

31. **Constraints to renewable energy inhibit Sri Lanka’s decarbonization efforts.** While Sri Lanka achieved near 100% electrification rate in 2016, the CEB depended on the budget and treasury guarantees to continue its operations as tariffs were not revised from 2013 to 2021. This added to the fiscal burden and the government’s contingent liabilities, and increased exposure of

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32 Nearly 13.5% of the population is multidimensionally poor and lacks access to safe, quality, and sufficient drinking water. According to another estimate, 35.6% of the population is vulnerable and deprived in relation to water sources, with vulnerability and deprivation ranging from 5.3% in Colombo district to 71.7% in Mullaitivu (footnote 16).
the state-owned banks to the sovereign. Incomplete power sector reforms (including unbundling of the CEB), weak regulation, and lack of cost-recovery tariffs hindered the sector’s financial and operational performance. These also impeded investments in low-cost generation such as development of large-scale renewables, which has kept the generation cost high. Lack of (i) land availability, (ii) investments in transmission, and (iii) a bankable contractual structure (including power purchase agreements and the necessary government guarantee to cover the CEB’s obligation) also constrain PSP in nonconventional renewable energy.

32. **Lack of resources constrains the provision of safe and energy-efficient transport infrastructure.** While the road network is dense and well laid out, its quality and capacity are not suitable for modern, efficient, and safe logistics. The coverage of the expressway network is still limited, with only about 313 kilometers. The road sector suffers from funding constraints for road maintenance (risking road safety) and new roads development, and from regulatory constraints to tolling. Per 2016 estimates, the road fatality rate per 100,000 people in Sri Lanka was 14.9, almost double that in many high-income economies, and vulnerable groups, i.e., cyclists and pedestrians, suffer the most. Key road safety issues to be addressed include the lack of clarity on institutional arrangements and funding, limited use of road safety mitigation measures, low vehicle safety standards, and poor road user behavior. There is significant congestion in and around urban areas during peak periods, increasing pollution and reducing the quality of life. Alternative and sustainable modes of public transport need to be developed. The operational efficiency of rail transport is not up to international standards because of obsolete infrastructure, aging rolling stocks, lack of electrification, lack of a modernized signaling and interlocking system, and inadequate institutional capacity and financial resources. The share of public buses in passenger transport is decreasing because of inefficient operations and poor service quality. Modern information communication technology, an environmentally friendly fleet, and proper regulation of bus operators are yet to be introduced in public bus operations. Transport planning needs to be better coordinated to explore multimodal integrated connectivity, especially for the Colombo metropolitan area.

4. **Crosscutting Priorities**

33. **Women’s participation in economic activity is limited.** Significant progress has been made in gender equality and women’s empowerment with strong government policy and institutional mandates, and high rates of literacy among women (91.6%). Despite progress, women and girls continue to suffer discrimination and violence because of structural barriers, societal norms, and patriarchal notions of masculinity. Sri Lanka ranked 110th (out of 146 economies) on the Global Gender Gap Index in 2022. The labor force participation rate in 2022 was 32.1% for women compared to 70.5% for men. In 2022, the unemployment rate for women was 6.5% (average 7.4% in 2015–2021) and 3.7% for men (average 3.3% in 2015–2021). Women’s political participation is low, with only 5.3% of Parliament seats held by women. Women’s well-being and safety suffered adversely, and their care responsibilities increased during the COVID-19 pandemic and the economic crisis. Power cuts, fuel and gas shortages, shortages in essential food and medicine, and job and income losses reduced women’s earning capacity and productive time, and adversely affected their livelihood and economic activities.

34. **Prevalence of gender-based violence.** Nearly 20% of ever-partnered women in Sri Lanka have faced physical and/or sexual violence by an intimate partner in their lifetime. Almost

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40% of women have experienced physical, sexual, emotional, and/or economic violence and/or controlling behavior by a partner in their lifetime. Women in Sri Lanka are more than twice as likely to have experienced physical violence by a partner (17.4%) rather than by a non-partner (7.2%). In a sample of 2,500 female respondents, 90% had experienced an incident of sexual harassment in buses or trains at least once in their lifetime. Most of the respondents had no awareness about the penalty for crime of sexual harassment (60%), although the majority had an idea about the laws governing sexual harassment (52%).

35. **Enhancing climate action and disaster resilience.** Sri Lanka’s vulnerability to climate change and climate-related hazards highlights the importance of investing in disaster risk reduction and climate change adaptation and mitigation initiatives in line with the country’s revised Nationally Determined Contributions (NDCs), National Adaptation Plan (NAP), Climate Prosperity Plan, and the Carbon Net Zero Road Map. Sri Lanka is a low emitter of greenhouse gas (GHG) with per capita emissions of 1.02 tons per person annually. Sri Lanka ratified the Paris Agreement and submitted its revised NDCs in September 2021, which provide the basis for a low-carbon development pathway. It has committed to reducing its GHG emissions by 14.5% by 2030. In line with its NDCs, Sri Lanka aims to generate 70% of its electricity from renewable energy sources by 2030 and achieve carbon neutrality by 2050. Significant investment in emissions reductions from power (electricity generation), transport, industry, waste, forestry, and agriculture are required. Priority climate adaptation strategies and programs identified in the NAP and the National Disaster Management Plan include interbasin water transfer schemes from the wet zone to the dry zone and integrated river basin management to improve water security and to balance competing water uses. Climate finance regulatory and institutional frameworks should be strengthened to attract socially responsible private financing for climate mitigation and adaptation. There are gaps in disaster risk governance, e.g., horizontal coordination and integration between national and local authorities. Granular disaster risk information and sector-specific risk assessments are needed for investment planning. A comprehensive and improved disaster risk financing framework can provide risk transfer solutions for unexpected disaster-related losses.

36. **Threats to environmental sustainability.** The main environmental problem associated with land resources is land degradation (through soil erosion, landslides, and loss of productivity). Water pollution caused by pollutants such as solid waste and domestic wastewater, industrial pollutants, and agrochemicals compounds the scarcity of water because of high interannual variation and uneven spatial distribution of rainfall. Degradation of forests in the catchment areas, especially in the upper watersheds, is affecting the availability (quality and quantity) of water. The major environmental challenges involved with coastal and marine resources are coastal erosion, degradation of coastal habitats, and coastal and marine pollution. Protecting and managing

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38 Of the 14.5% GHG reduction, 4.0% is unconditional to be met through domestic resources and 10.5% is conditional on external financial and technical support against a business-as-usual scenario for 2021–2030.

39 To meet the NDC targets, GOSL has proposed raising investment in green energy, including green hydrogen, hydropower, wind power, and solar power, through the installation of rooftop solar units, photovoltaic power plants, liquid natural gas, waste to energy, and biomass plants, as well as new transmission networks.
natural capital will improve sustainability of investments across all sectors while also creating an enabling environment to mobilize sustainability-linked financing.

37. **Digitalization in governance and public service delivery remains limited.** Sri Lanka ranked 95th (out of 193 economies) in the United Nations’ E-Government Development Index in 2022, down from 79th in 2016. The government is preparing a digital transformation framework for a digitally empowered Sri Lanka. The strategic thrust areas include broadband connectivity access and use; digital data services and infrastructure; digital transactions; digital safeguards; digital industry development, skills, and jobs; and digitalization of key economic sectors. Key gaps that need to be addressed include lack of a data privacy and protection law; and lack of regulations to support digital signatures, fintech, digital finance, and digital markets. Digitalizing government platforms and systems can bolster governance, strengthen PFM, enhance domestic resource mobilization, and support land administration and customs. Implementation capacity in the government needs to be strengthened while promoting digital culture.

C. **Implications for ADB Country Engagement**

38. **ADB’s operations have been successful and will adapt to the new circumstances of the country.** A validation report by ADB’s Independent Evaluation Department (IED) of the country partnership strategy (CPS) final review, 2016–2020 concluded ADB operations during this period to be relevant, effective, efficient, likely less than sustainable, likely to have satisfactory development impacts, and successful. Key recommendations for the new CPS include (i) prioritizing fiscal reform and PFM, (ii) enhancing coordination with an expanded development partner community to address debt issues, (iii) intensifying support for PSD, and (iv) maintaining flexibility in ADB country program and support.

39. **Government’s priorities.** The new administration that assumed office in July 2022 set about navigating the deep economic crisis and addressing the causes of the crisis. The Government of Sri Lanka’s objectives are to restore economic stability and debt sustainability, lay a foundation for sustained growth through structural reforms, address climate and corruption vulnerabilities, and protect poor and vulnerable people. The government’s reform agenda is set out in the Interim Budget 2022, Budget 2023, Budget 2024, and the Memorandum of Economic and Financial Policies submitted to the IMF. The President announced the contours of a “National Transformation Roadmap,” which highlights four areas: (i) fiscal and financial reforms, (ii) investment drive, (iii) social protection and governance, and (iv) SOE transformation.

40. **Reform agenda.** While the present government is yet to announce its medium-term development strategy, key priorities emerge from the budget speeches and country consultations. These include measures for revenue-based fiscal consolidation; bolstering PFM, debt management, and governance; improving performance of SOEs; and strengthening social protection with a new social protection system, central bank independence, and financial sector

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41 Under the IMF program, the government has committed to implementing a comprehensive reform program with six pillars: (i) advancing revenue-based fiscal consolidation and reforms to social safety nets, fiscal institutions, and SOEs; (ii) restoring public debt sustainability; (iii) restoring price stability and rebuilding external buffers; (iv) ensuring financial stability; (v) reducing corruption vulnerabilities; and (vi) advancing growth-enhancing structural reforms. GOSL, MOF. 2022. Interim Budget Speech 2022. Colombo; GOSL, MOF. 2022. Budget Speech 2023. Colombo; GOSL, MOF. 2023. Budget Speech 2024. Colombo; and IMF. 2023. Sri Lanka: Request for an Extended Arrangement Under the Extended Fund Facility-Press Release: Staff Report; and Statement by the Executive Director for Sri Lanka. Washington DC.

42 GOSL. Ministry of Mass Media. 2023. President presents ‘National Transformation Road Map’ Government’s objective is to develop Sri Lanka as a thriving nation by 2048. Colombo.
stability (footnotes 41 and 42). Other priorities include boosting participation in GVCs, regional integration, and PSD through measures to improve the business climate, reform factor markets (including labor and land), reform legal and institutional frameworks for trade and investment and for management of economic zones, support trade facilitation, remove the anti-export bias in the tariff structure, and enable PPPs. Reforms are also envisioned in the agriculture, tourism, water, and education sectors. Other key priorities are meeting 70% of the country’s total electricity demand from renewable energy by 2030, and carbon neutrality by 2050 in the updated NDCs.

41. **Strategic focus of ADB assistance during 2024–2028.** The overarching objective of the CPS for Sri Lanka, 2024–2028 is fostering sustainable recovery, building resilience, and reviving growth. To support Sri Lanka in its efforts to come out of this crisis and address the causes of fragility and vulnerabilities, ADB’s strategic assistance will focus on three thematic priorities cutting across three strategic objectives. The crosscutting themes are (i) climate action, disaster resilience, and environmental sustainability; (ii) gender equality and social inclusion; and (iii) governance, capacity development, and digitalization. The three strategic objectives are as follows:

(i) **Strategic objective 1: Strengthen public financial management and governance.** ADB will support PFM and debt management, domestic resource mobilization, and measures to improve the performance of SOEs. ADB will also support the government’s efforts on climate change-related regulatory and planning frameworks.

(ii) **Strategic objective 2: Foster private sector development promoting green growth.** ADB will support PSD through enhancing financial sector stability and development, and access to finance, as well as supporting the country’s efforts in sustainable finance. To spur private investment, promote regional integration, and foster trade and integration with GVCs, ADB will support SME development, business climate improvements, a holistic approach to development of economic zones, and trade finance. ADB will also support the development of a conducive environment for PPPs (upstream as well as transaction advisory services) and greater PSP in renewable energy development.

(iii) **Strategic objective 3: Improve access to climate-smart public services and deepen inclusion.** This strategic objective comprises ADB support for social protection, equitable access to quality education and health, food security and agriculture modernization, and a climate-resilient infrastructure system and services.

42. **Implementation of the new country partnership strategy.** Key implementation priorities include (i) aligning ADB support with the government’s economic policy agenda; (ii) taking a selective approach by prioritizing interventions that address causes of the crisis, the country’s development challenges, and causes of increased fragility; and promote inclusion; (iii) supporting the country with concessional resources and exploring grant financing from trust funds; (iv) being agile to respond to disasters and the evolving country situation; (v) leveraging private sector for nonsovereign operations and PPPs as well as continued support for trade finance; (vi) using the One ADB approach to implement the CPS with the country management team under ADB’s new operating model (NOM) serving as the platform to draw on expertise from across ADB; (vii) implementing the climate shift and private sector shift as envisaged in the NOM; (viii) making knowledge solutions integral to ADB operations that address the crisis, with the Serendipity Knowledge Program as the delivery vehicle; (ix) collaborating and partnering with civil society, the private sector, academia, think tanks, and development partners; and (x) continuing the monitoring of evolving risks to identify effective mitigation measures, with the resident mission playing a critical role in country surveillance.