SRI LANKA

With the country in deep crisis, the economy contracted sharply in 2022 and is projected to contract again in 2023. Slow recovery is forecast for 2024, assuming timely progress on debt relief and much-needed reform. Inflation surged in 2022 in response to shortages but is expected to moderate somewhat in 2023 and more so in 2024 with fiscal and monetary tightening. Sri Lanka must address longstanding structural issues to resolve its economic crisis.

Economic Performance

Macroeconomic vulnerabilities that predate the pandemic were aggravated by policy missteps and exogenous shocks, leading to sovereign debt and balance-of-payment crises. The results in 2022 were steep economic contraction and soaring inflation. Persistent fiscal and current account deficits generated large and ultimately unsustainable public debt. Gross financing needs increased sharply and foreign currency debt-service requirements exceeded foreign exchange reserves. Fiscal imbalances worsened given significant tax cuts in late 2019 following a change in government. Rollback of the automatic fuel price adjustment mechanism and suspension of reform measures to strengthen public finances exacerbated the vulnerabilities. A de facto exchange rate peg was maintained from April 2021 to early March 2022 which discouraged remittances as a wide gap opened between the official and the parallel market rate, putting further pressure on foreign exchange reserves. Economic activity was undermined by fallout from a temporary ban on the import of chemical fertilizer in 2021, dwindling reserves, and foreign currency constraints that caused shortages of essentials and triggered an acute energy crisis that featured prolonged power cuts and fuel shortages. Fallout from the COVID-19 pandemic and the Russian invasion of Ukraine tipped Sri Lanka into a balance-of-payments crisis and, in 2022, forced default on its official bilateral and commercial external debt.

The economy contracted in 2022 by 7.8%, more than it had contracted in 2020. The \$3.65/day (at 2017 PPP) poverty rate is estimated to have doubled over 2021 and 2022, with stark implications for food insecurity. Worsening hardship sparked widespread protests, triggering political instability and multiple changes of administration in 2022. Adding to vulnerability and uncertainty about the economic outlook were delays in implementing measures to stabilize the situation and start addressing the root causes of the crisis.

Agriculture contracted by 4.6% in 2022. The chemical fertilizer ban, which was in effect from May to November 2021, cut average rice yield by 33.8% for the Maha 2021/2022 season, which is the country's major cropping season. Even after the fertilizer ban was rescinded, its lingering effects and foreign currency scarcity constrained fertilizer imports, hampering the cultivation of the next crop and reducing rice production in 2022 by 34.1%. Other key agricultural products such as tea, a major foreign exchange earner, and fruit and vegetables also suffered sharp declines (Figure 2.21.1).

Industry, the sector worst affected, contracted by 16.0%. Foreign exchange scarcity, import restrictions, and the difficulty of opening letters of credit curtailed supplies of imported raw materials, intermediate goods, and equipment.

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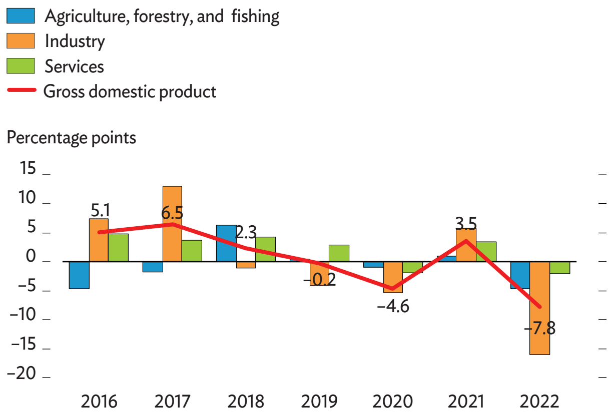
Figure 2.21.1 Gross Domestic Product Growth by Sector

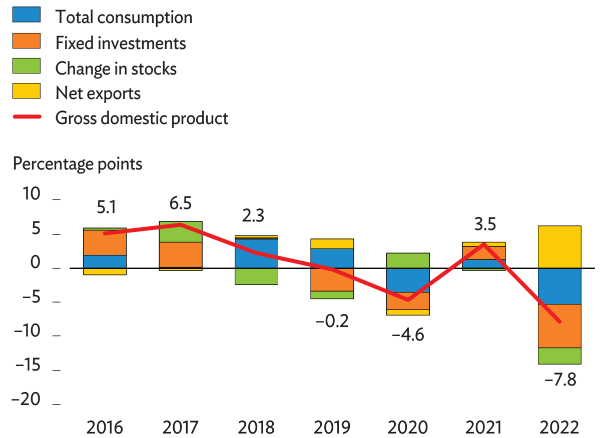
Sri Lanka recorded its sharpest contraction on record in 2022 as it faced multiple headwinds.



Source: Department of Census and Statistics of Sri Lanka.

Figure 2.21.2 Demand-Side Contibutions to Growth

Demand contracted significantly amid tight economic conditions.



Source: Department of Census and Statistics of Sri Lanka.

Added shocks were prolonged power cuts, transport bottlenecks, contractionary fiscal policy, and higher policy rates. Against this backdrop, construction contracted by 20.9% and manufacturing by 12.6%.

Services, the largest contributor to GDP, contracted by 2.0% in 2022. A pick-up in tourism in the fourth quarter (Q4) of 2022 buoyed services to some extent with contributions from accommodation and transport services. However, an 18.3% contraction in financial services and insurance offset growth in accommodation, public administration and compulsory social security, and transport amid heightened economic uncertainty and limited demand.

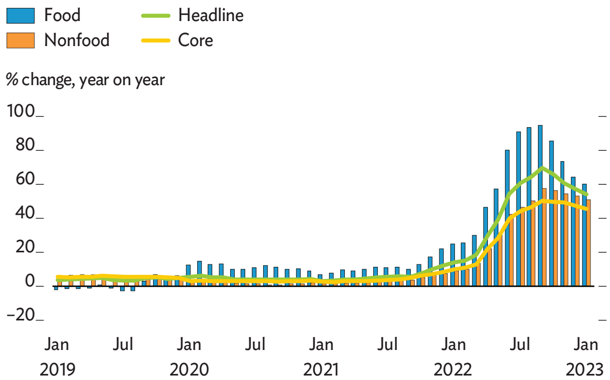
Both consumption and investment fell substantially as domestic demand weakened. Private consumption fell by 9.0% as consumer confidence weakened and inflation held spending in check. Gross capital formation led overall contraction in 2022 with a 24.9% decline amid poor business sentiment and rising interest rates. Government spending saw a slight uptick with increased outlay on social protection. Contribution of net exports to GDP was positive in 2022 because of import restrictions, foreign exchange scarcity, and recovery of global demand in the first half of 2022 (Figure 2.21.2).

Inflation intensified in 2022. Headline inflation soared from an average of 5.9% in 2021 to 46.4% because of shortages of essential goods such as food, fuel, and cooking gas; higher prices for energy in all forms; import restrictions; sharp currency depreciation; and substantial liquidity injections by the Central Bank of Sri Lanka. As inflation surged from 14.2% year on year in January 2022 to a peak of 69.8% in September 2022, food inflation peaked that month at 94.9%. With fiscal tightening, an easing of supply chain disruptions, weak demand, and a high base effect in Q4 2021, inflation gradually eased to 57.2% year on year by the end of 2022. Food inflation averaged 64.0% in the whole year and, despite slowing in Q4 2022, nonfood inflation remained elevated at 37.2%. Core inflation averaged 34.3% year on year, softening from its peak of 50.2% in September (Figure 2.21.3).

Policy rates were raised in 2022 to tackle inflationary pressures. The central bank raised policy rates by 150 basis points in Q1 2022, by an unprecedented 700 basis points in April, and by a total of 1,050 basis points from January 2022 to March 2023. To allow quicker transmission of higher policy rates, it revoked maximum interest rate caps previously imposed on banks. As a result, the average weighted prime lending rate ballooned from 7.9% in January 2022 to a peak of 29.7% in November 2022, dampening private sector credit growth from 13.1% in 2021 to 6.2% in 2022, which reduced demand and eased pressure on the exchange rate (Figure 2.21.4).

Figure 2.21.3 Inflation

Headline inflation surged, mainly as food prices soared.

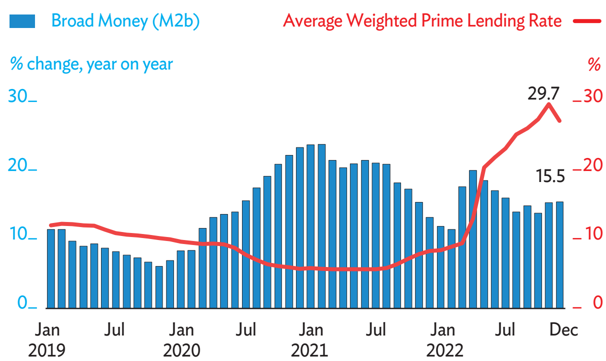


Note: Inflation reported is based on the Colombo Consumer Price Index (2013 = 100).

Source: Department of Census and Statistics of Sri Lanka.

Figure 2.21.4 Broad Money Growth versus Market Lending Rate

Following a historic rate hike, the average weighted prime lending rate neared 30% in 2022.



Note: M2b includes currency held with the public; demand, time and savings deposits of the public; and a part of foreign currency deposits held with the commercial banks.

Source: Central Bank of Sri Lanka.

To enhance bank liquidity, the central bank restricted discretionary payments, permitted capital conservation buffers to be drawn down, and extended to the end of 2023 the deadline to meet an enhanced minimum capital requirement.

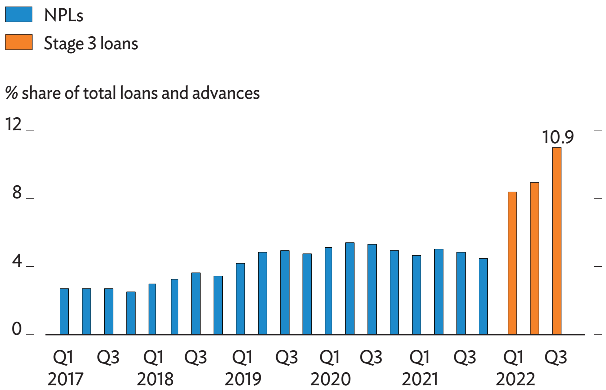
The government continued to rely on monetary financing to finance the fiscal deficit in 2022 as revenue collection remained weak. Low economic activity was one cause of revenue weakness, and another was the tax cuts in 2019. Intensifying internal and external imbalances prompted sovereign credit rating downgrades, constraining the government's access to international markets. Net credit from the central bank to the government more than doubled in 2022, raising central bank holdings of government securities by 24.1% year on year at the end of December 2022. Central bank credit accounted for 95% of the increase in banking system claims on the government, which grew by 46%, and for 61% of growth in broad money (M2b) supply, which rose from 13.2% in 2021 to 15.5%.

Prolonged macroeconomic stress undermined financial intermediation. Since the second half of 2021, domestic banks have faced foreign currency liquidity constraints because the central bank was unable to provide necessary foreign currency liquidity owing to its low reserves, and their access to foreign credit and swap lines was undermined by the country's weakening macroeconomic outlook and external sector vulnerability. Further, domestic currency liquidity pressure started mounting in Q3 2022 as historically high yields of close to 30% in the government bill market sparked an outflow from bank deposits into securities, forcing banks to curtail credit extension. Also heightening risk to financial sector stability were its exposure to sovereign debt, risk concentration from exposure to large borrowers, high interest rates, and lack of access to international markets. Banks have raised their capital buffers in line with regulatory requirements under Basel III, with the core equity tier 1 ratio at 13.2% and the capital adequacy ratio at 16.5% in Q4 2021. However, following local currency depreciation and significant economic headwinds, loans classified as credit-impaired increased from 8.4% of all loans in Q1 2022 to 10.9% in Q3 (Figure 2.21.5).

The fiscal deficit narrowed to an estimated 10.2% of GDP in 2022 as the primary deficit fell to 3.7%. Government recurrent expenditure declined from the equivalent of 15.6% of GDP in 2021 to 14.6% in 2022 as current spending did not increase in line with inflation. Capital expenditure fell from 4.4% of GDP in 2021 to 3.9% in 2022 amid spending restraints as the government was faced with resource constraints. Overall, total expenditure declined from 20.0% of GDP in 2021 to 18.5% in 2022 (Figure 2.21.6). Revenue to GDP ratio remained flat at 8.3% of GDP in 2022 as improvement in revenue collection following various revenue measures introduced in 2022 was offset

Figure 2.21.5 Impaired Loan Ratio

Stress in the financial increased in 2022.



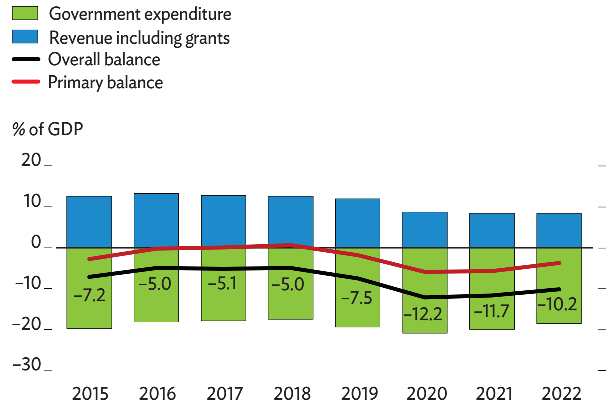
NPL = nonperforming loan.

Note: The central bank discontinued in 2022 its calculation of NPLs and introduced instead stage 3 loan classification, which gives banks more discretion to provide against high-risk assets even before default.

Source: Central Bank of Sri Lanka. Financial sector statistics.

Figure 2.21.6 Central Government Finance

Primary balance for 2022 at −3.7% of GDP outperformed the targeted −4.0%.



GDP = gross domestic product.

Notes: Figures exclude revenue and expenditure transfers to provincial councils. Data on government expenditure in 2019 and 2020, and fiscal data in 2022 are from the IMF.

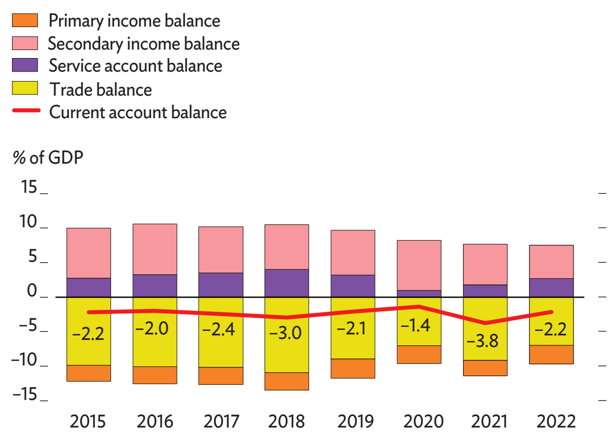
Sources: Department of Census and Statistics of Sri Lanka; International Monetary Fund; Ministry of Finance.

by declines due to the severe economic contraction and reductions in imports. Public and publicly guaranteed debt increased from the equivalent of 114.9% of GDP at the end of 2021 to 125.7% a year later.

Weaker imports and higher exports, remittances, and tourism earnings narrowed the current account deficit. It fell from the equivalent of 3.8% of GDP in 2021 to 2.2% in 2022 (Figure 2.21.7). Merchandise imports declined by 11.4% as demand contracted, the local currency depreciated, and import controls kicked in—and despite fuel bill increases following the Russian invasion of Ukraine. The import bill declined largely in line with sharply shrinking volumes (Figures 2.21.8). Merchandise exports expanded by 4.9% in 2022, led by 7.9% growth in industrial exports. Agricultural exports contracted by 5.9% because of the fertilizer ban in 2021. The merchandise trade deficit contracted by 36.3% in 2022 to its lowest in 12 years. Following some improvement in early 2022, tourism was disrupted by domestic and external headwinds for a fourth consecutive year. Arrivals increased during the traditional peak season but remained far below their pre-pandemic norms (Figure 2.21.9). Remittance inflows were 31.0% less than in 2021 and 44.8% less than the average in the pre-pandemic

Figure 2.21.7 Current Account Balance

A narrowing merchandise trade deficit and higher remittances supported the current account.



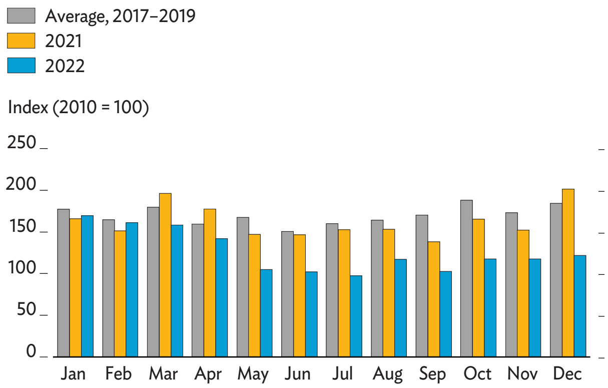
GDP = gross domestic product.

Sources: Central Bank of Sri Lanka; Department of Census and Statistics of Sri Lanka; Asian Development Bank estimates for 2022.

years 2018–2019, mainly reflecting sharp divergence between official and parallel market exchange rates, particularly at the beginning of the year. Remittances rose somewhat in the second half as the exchange rate gap narrowed (Figure 2.21.10).

Figure 2.21.8 Import Volume

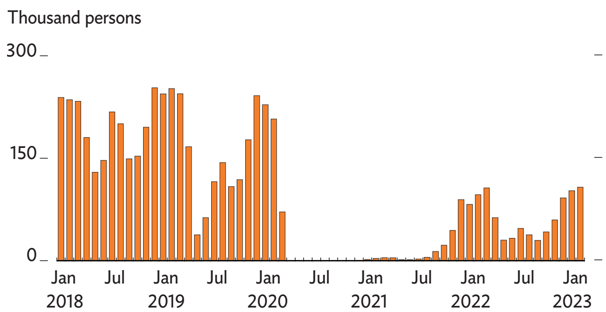
Sharp decline in import volume led to a decline in import bill despite higher unit value.



Source: Central Bank of Sri Lanka.

Figure 2.21.9 Tourist Arrivals

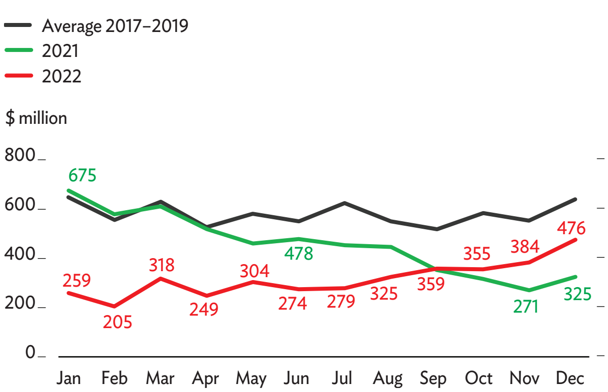
Tourist arrivals improved in the fourth quarter of 2022 but remained well below arrivals before the pandemic.



Source: Central Bank of Sri Lanka.

Figure 2.21.10 Monthly Remittance Inflow

Remittances inflow increased gradually during 2022, but remained below the 2017-2019 average.

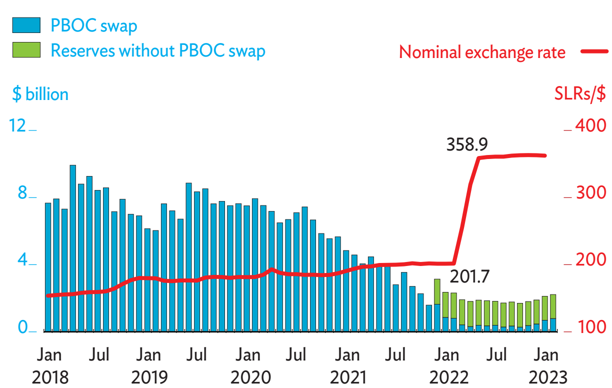


Source: Central Bank of Sri Lanka.

The balance of payments remained under pressure in 2022. With external financing risks materializing following downgrading of the country's sovereign credit rating and official reserves falling sharply to $1.92 billion in March 2022, of which only $420 million was usable, the government suspended debt service on its external debt excluding multilateral loans, trade credits, and currency swaps and initiated negotiations with the International Monetary Fund (IMF) for a new program. Heightened domestic economic uncertainty and monetary tightening in the advanced economies weakened capital inflow throughout the year. Reserves remained under $1.9 billion since April 2022 of which $1.4 billion was the swap agreement with the People's Bank of China (PBOC), which could not be used due to certain restrictions. The country did not have sufficient usable reserves even for one month of imports (Figure 2.21.11). Some net inflow was recorded into the government securities market following a staff-level agreement with the IMF in September, and as the government's fiscal consolidation efforts became clearer, but foreign holdings of government securities remained significantly lower than the SLRs104 billion held in 2019.

Figure 2.21.11 Gross Official Reserves and Nominal Exchange Rate

Usable reserves fell precariously low.



PBOC = People's Bank of China.
Source: Central Bank of Sri Lanka.

Higher inflation partly offset competitiveness gains from currency depreciation. As pressure on the currency intensified and reserves were all but depleted, the central bank abandoned in March 2022 its de facto exchange rate peg to the US dollar, which had been in place since April 2021, and introduced greater flexibility in exchange rate determination, eventually moving to a free float in March 2023. The Sri Lankan rupee depreciated by 44.8% against the US dollar in 2022. The rupee had been appreciating in real effective terms before March 2022, but it depreciated in real effective terms by 44.4% from February 2022 to May 2022. Sharp depreciation helped restore some competitiveness, but soaring inflation eroded the gains as the rupee appreciated in real effective terms in the second half of the year (Figure 2.21.12).

Table 2.21.1 Selected Economic Indicators, %

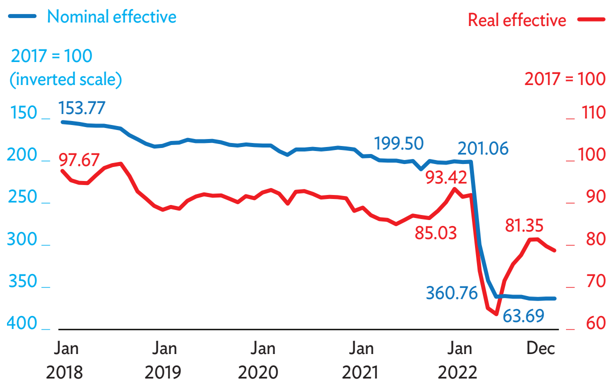
GDP will contract this year and grow modestly in 2024 as inflation falls sharply.

	2021	2022	2023	2024
GDP growth	3.5	–7.8	–3.0	1.3
Inflation	6.0	46.4	24.6	5.5

GDP = gross domestic product.
Sources: Department of Census and Statistics of Sri Lanka; Asian Development Bank estimates.

Figure 2.21.12 Exchange rates

Inflationary surge offset the real effective exchange rate depreciation eroding competitiveness.



Source: Central Bank of Sri Lanka.

Economic Prospects

Historic back-to-back contraction in 2023 is likely to be followed by only tepid recovery in 2024 (Table 2.21.1). Sri Lanka's efforts to stabilize its economy and return to recovery hinge on progress toward finalizing debt relief and its steadfast implementation of a 4-year, $3.0 billion extended fund facility agreed with the IMF in March 2023. The agreement will help unlock external financing and thereby improve confidence. Assuming these conditions are met, the economy is forecast to contract by only 3.0% in 2023 and then grow by 1.3% in 2024 as the country's debt overhang wanes.

Consumption and investment will continue to be weak in 2023 due to tight fiscal policy, high interest rates, and uncertain economic conditions. As the country implements a wide ranging reform program which includes tax increases, lower disposable income will constrain household demand. Limited fiscal space and higher corporate tax rates will constrain public and private investment. Improved remittances will, however, provide some cushion to household spending. Contribution of net exports to GDP growth will remain positive as import growth remains muted and export growth is driven by recovery in tourism. With higher corporate tax rates, continuing import controls, and limited fiscal space for public investment, industry is expected to contract for a second consecutive year. Services will see gradual recovery as consumer confidence and tourism improve. With the removal of restrictions on chemical fertilizer imports and the renewed availability of foreign exchange with which to import fertilizers, conditions in agriculture are likely to improve. Industry sector is likely to remain subdued amid weak demand, domestically and globally. Services will see gradual recovery as tourism is expected to continue improving and progress on reforms over the course of the year builds confidence.

Inflation is forecast to ease in 2023 and return to single digits in 2024. Inflation is projected to average 24.6% in 2023 as fiscal tightening and double-digit interest rates weigh on domestic demand, supply-side disruption eases, and moderating external pressures alleviate food shortages. Factoring in a high base effect, inflation is expected to be sharply lower in 2024.

The fiscal deficit is expected to decline to the equivalent of 7.9% of GDP in 2023. An improved fiscal balance depends on an expected increase in revenue from the equivalent of 8.8% of GDP in 2022 to 11.2% in 2023 following revenue measures introduced in 2022 and 2023. The primary deficit is expected to fall to 0.7% of GDP in 2023, and the government is forecasting a primary surplus of 0.8% in 2024. The budget for 2023 prioritizes social protection spending while postponing less urgent public investment. The government continued to face cash constraints in early 2023 as delays were encountered in the disbursement of social welfare payments and public sector salaries and pensions, following which further expenditure cuts were announced.

The current account balance is forecast to improve as tourism and remittances continue to recover. Export growth is likely to remain weak in 2023 as global growth slows, high inflation erodes Sri Lankan competitiveness, and skilled workers emigrate, leaving labor shortages. Imports are expected to increase, however, as foreign currency liquidity improves and import restrictions are relaxed. But imports will remain below pre-pandemic averages because of fiscal tightening and high interest rates. The expected widening of the merchandise trade deficit will be offset by rising tourism and remittance inflows. Approval of the IMF program may improve investor sentiment, encourage capital inflow, and will help unlock financing from other international financial institutions, which will bolster reserves. However, access to external capital markets remains closed while the country seeks to finalize a debt treatment plan with its official bilateral and commerical creditors.

Sri Lanka's economy faces several headwinds. The outlook is clouded by uncertainty concerning progress on debt restructuring, the timely implementation of measures under the IMF program, political developments as the country enters the electoral cycle that will likely test the authorities' will to carry out reform, and unpredictable weather patterns. Risks to the outlook could also emanate from the financial sector which has a significant sovereign exposure and faces deteriorating credit quality. Other downside risks are a global slowdown that exceeds expectations, which would hit foreign exchange earnings; political instability, which could hit tourism or delay reform; and a possible resurgence of the pandemic.

Policy Challenge—Addressing the Economic Crisis

Persistent structural impediments and weak economic management over the years left the economy vulnerable and the country entered the pandemic with limited buffers. Sri Lanka is considered a classic "twin deficit" economy, with persistent fiscal deficits as budgetary expenditure consistently exceeded revenue, which has declined relative to GDP since the 1990s, and persistent current account deficits as national savings were consistently less than national investment. Sri Lanka's public debt accumulated over time, and debt service costs increased, diverting revenue to debt service. To keep the cost of servicing external debt manageable, an exchange rate system was maintained that led to an overvalued rupee and made the economy less competitive. Regarding domestic finance, the need to finance the fiscal deficit constrained monetary policy choices and limited space for adjusting the exchange rate. This caused macroeconomic volatility and frequent balance of payment crises, impelling recourse to the IMF.

Sri Lanka's vulnerability was aggravated by policy missteps and multiple shocks. Shocks included disasters in 2016 and 2017, a constitutional crisis in 2018, the Easter Sunday terror attacks in 2019, COVID-19 in 2020 and 2021, and the Russian invasion of Ukraine in 2022. Owing to past policy shortcomings, such as a tax cut in late 2019, the country did not have adequate buffers to respond to these shocks, and in many instances it adopted ultimately counterproductive policies in the face of growing vulnerability: the ban on imports of chemical fertilizers, moving to a de facto exchange rate peg, and defending the peg despite declining reserves in April 2021. The weaknesses evident before the pandemic were exacerbated by multiple shocks as growth slowed sharply. New national account data show that growth was negative in 4 of the 8 quarters in 2018 and 2019. Internal and external imbalances continued to build up in early 2022, ultimately leading to the country's most severe economic crisis since independence.

Enhancing domestic resource mobilization will be critical to addressing macroeconomic vulnerability and imbalances. Measures already taken include increasing value-added tax rates, lowering the tax-free threshold, expanding the tax base, increasing income tax rates for the top income brackets, narrowing tax brackets, and removing discretionary tax concessions and exemptions. Measures that will strengthen tax administration and mitigate tax evasion and avoidance include simplifying procedures, digitalization, strict enforcement, and capacity building in administration and new analytical tools. Reducing reliance on indirect taxes would improve progressivity in the tax regime.

Improving state-owned enterprise performance would lighten the fiscal burden. Nearly 20 of the 52 key state-owned enterprises (SOEs) in Sri Lanka lost money on average in 2018–2022. SOE borrowing has grown to constitute a significant part of Sri Lanka's public debt, with government-guaranteed SOE debt equaling 5.7% of GDP at the end of 2022. SOEs also owe debt to one another, creating a maze of so-called circular debt. Key reform priorities include applying cost-reflective pricing and improving financial discipline; strengthening governance mechanisms to improve accountability and transparency; introducing key performance indicators; strengthening performance management systems and processes; separating government roles as policy maker, regulator, and operator; creating a conducive environment for private sector participation; and public–private partnership.

Strengthening public financial management and fiscal rules would improve fiscal discipline and monetary policy. Sri Lanka enacted the Fiscal Management (Responsibility) Act in 2003, but it has been frequently relaxed. Essential to instilling fiscal discipline are strengthened budgetary institutions, establishing hard-and-fast fiscal rules and ensuring credible commitment to them, and improved transparency and consistency. These actions would curtail the fiscal deterioration that in the past has coincided with political cycles. Along with a proposed law to strengthen central bank independence, strengthening public financial management would make monetary policy more effective.

Safeguarding bank soundness and financial sector stability are essential for growth. Government and SOE domestic borrowing has left banks with significant sovereign exposure, which is a potential source of sector vulnerability as government finances come under strain. To enhance bank soundness and prevent fragility in the banking system, its supervisory and regulatory framework should be strengthened to ensure adequate capitalization, contain excessive risk-taking by banks, and address nonperforming loans. In the near term, a crisis-preparedness framework needs to be established, including for the resolution and liquidation of financial institutions, deposit insurance, and contingency planning. Capital market development should continue to be a policy priority over the medium and long term to mobilize long-term financing for infrastructure development and risk capital for entrepreneurs. Establishing a credit guarantee institution for small and medium-sized enterprises would encourage entrepreneurs and private sector participation.

Policies are needed to make the private sector more competitive and enable it to engage more effectively in external trade. Sri Lanka has become less open to trade since 1990, and its participation in global value chains is meager. Since the 1970s, Sri Lanka's export basket has seen minimal change, with garment exports still earning over 45% of export income in 2022. Sri Lanka's lack of openness is indicated also by a low ratio of foreign direct investment to GDP, which averaged 1.2% in 2012–2028 and nearly halved to 0.7% in 2019–2021. Attracting capital inflow that does not create debt is imperative to building external sector resilience. Several measures are needed to address these shortcomings. First, investment policy to attract foreign direct investment will need to be accompanied by policies that facilitate trade. These policies include removing protectionist measures and the anti-export bias in trade policy by harmonizing tariffs, reducing para-tariffs, and simplifying trade rules. Second, the regulatory environment that impedes private investment and contributes to growth in the informal sector should be reformed. Owing to impediments to business activity, Sri Lanka's global competitiveness index ranking slipped from 62 among 142 economies in 2011 to 84 among 141 economies in 2019. Constraints that need to be alleviated relate to land access, as over 80% of land is owned by the government; a restrictive licensing and permit regime; rigid labor market regulation; delays in contract enforcement; frequent and inconsistent changes in tax and investment regimes; and weak trade facilitation.

Social protection is urgent and requires strengthened procedures and transparency. As low-income households continue to bear the brunt of the economic crisis, expenditure on social protection needs to be prioritized. The current social assistance scheme should be strengthened to improve transparency, eliminate inclusion and exclusion errors to ensure that cash transfers are received by the most vulnerable, and raise the level of support, which is low at present. The government has operationalized the Welfare Benefits Board and has already acted to establish a new social registry to improve targeting and transparency in government social assistance programs.

Corruption and poor governance have undermined economic growth and stability. In 2022, Sri Lanka ranked 101 among 180 countries on Transparency International's corruption perceptions index, sliding from 91 in 2017. Strengthening anticorruption legislation, building strong institutions, increasing transparency, and improving governance and accountability mechanisms will be essential to addressing the country's economic vulnerability and limited fiscal space. Sri Lanka also needs to continue strengthening its efforts to suppress money laundering and terror financing.