GDP contracted in 2023, but green shoots of recovery are emerging. Growth revived in the second half of 2023 and is expected to continue in 2024 and 2025. Inflation decelerated to single digits last year following a peak in 2022 and will remain below 10% in 2024 and 2025. Challenges remain, and the upcoming electoral cycle must not delay the reforms required to address the recent economic crisis. Sri Lanka needs to address vulnerability to poverty to ensure inclusive growth.

Economic Performance

**Signs of recovery are emerging with stronger reserves and currency appreciation.** Agriculture, industry, and services recorded growth year on year in the second half of 2023, and inflation decelerated. Official reserves excluding a People’s Bank of China currency swap strengthened from $500 million at the end of 2022 to $3.0 billion at the end of December 2023 on multilateral funding and Central Bank of Sri Lanka net purchases of $1.75 billion (Figure 2.21.1). Foreign exchange inflow improved, and continuing suspensions of debt service on commercial and official bilateral public debt helped reduce outflow, easing pressure on the balance of payments. After depreciating sharply in 2022, the Sri Lankan rupee appreciated by 12.1% against the dollar in 2023 as the country moved to a flexible exchange rate (Figure 2.21.2).

**An International Monetary Fund (IMF) Extended Fund Facility program approved in March 2023 is making progress.** Following approval by the IMF executive board of the 48-month, $3.0 billion Extended Fund Facility arrangement, a total of

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This chapter was written by Lakshini Fernando, Nirukthi P. Kariyawasam, and Dinuk de Silva of the Sri Lanka Resident Mission, ADB, Colombo.
$670 million was disbursed in two tranches in March and December 2023. In September 2023, the IMF released a governance diagnostic report on Sri Lanka, its first in Asia, highlighting systemic and severe governance weaknesses and vulnerability to corruption across state functions. In February 2024, the government issued an action plan to address these vulnerabilities.

The economy contracted in the first half of 2023 but grew by 3.0% in the second half. The agriculture and services sectors grew 2.5% and 7.0%, respectively, compared with the first half of 2023 while the industry sector contracted 0.1%. With improved harvests of rice, fruit, vegetables, and spices, agriculture grew by 2.6% in 2023 despite inclement weather dampening the sector’s performance. Industry shrank by 9.2% as manufacturing contracted by 3.2% and construction by 20.8%, constrained by higher taxes and low demand. Despite accommodation and food and beverage services increasing by 26.0% as tourist arrivals improved, the whole service sector declined by 0.2%, buffered by higher direct and indirect taxes and dampened consumer and investor sentiment (Figure 2.21.3).

Weak domestic demand dragged down economic performance. Consumption fell by 2.2% in 2023, with private consumption declining by 1.6%, constrained by higher prices, and government consumption declining by 5.4%, constrained by tight fiscal space. Gross capital formation also declined by 7.9%, as gross fixed capital formation declined by 9.3%. Growth in net exports of goods and services remained positive because of import restrictions in the first half of 2023 (Figure 2.21.4).

Headline inflation measured by the Colombo consumer price index dropped to an average of 17.4% in 2023, compared to 46.4% in 2022. Primary contributors were lower fuel prices, subdued demand, better supply, and tight monetary policy measures until mid-2023, including high policy rates and low liquidity injections. Food inflation eased to an average of 12.1% compared to 64.7% in 2022 and a peak of 94.9% in September 2022 (Figure 2.21.5). Core inflation declined from its peak of 50.2% in September 2022 to an average of 14.5% in 2023. As inflation eased, the central bank reduced its policy rates by 700 basis points from June 2023 to March 2024. The statutory reserve ratio was also reduced for the first time in almost 2 years, by 2.0 percentage points. With market
interest rates falling below 15% and early signs of an economic recovery, the contraction in credit demand eased (Figure 2.21.6).

**The finance sector has stabilized, but vulnerabilities remain.** Banks have maintained capital buffers in line with regulatory requirements under Basel III, resulting in a core equity Tier 1 ratio of 13.5% and capital adequacy ratio of 16.3% in the third quarter (Q3) of 2023. However, the stage 3 loan ratio, which allows early recognition of nonperforming loans, was high at 11.6% in Q4 2022, compared with 8.4% in Q1 2022, and even higher at 13.4% in Q3 2023 (Figure 2.21.7). Although adequate provision for impairment has been made for international sovereign bonds held by banks, any rise in impaired loans that would require additional provisioning, and any unexpected economic shock, could further stress the sector.

**Revenue-based fiscal consolidation under the IMF Extended Fund Facility was a central area of focus in 2023.** Following tax increases implemented in 2022, the authorities raised personal income tax rates and introduced narrower brackets at the start of 2023. As a result, the IMF estimates government revenue and grants to have reached 10.2% of GDP, improving from 8.3% in 2022. Expenditure is expected to reach 19.0% of GDP, marginally higher than 18.5% in 2022. Expenditure remained high because of interest paid on domestic refinancing. Higher revenue coupled with higher nominal GDP lowered the budget deficit to 8.8% of GDP in 2023 from 10.2% in 2022 (Figure 2.21.8). Official data indicates a primary surplus of SLRs124 billion from January to September 2023, amounting to 0.6% of GDP. This greatly improved compared to an IMF program primary deficit target of SLRs160 billion and was a key indicator of the progress in reforms thus far.

**Total public debt increased as debt restructuring negotiations continued.** Domestic public debt reached 63.4% of GDP in Q3 2023 from 60.8% in 2022. The total public debt-to-GDP ratio increased

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**Figure 2.21.6 Private Sector Credit Growth versus the Prime Lending Rate**

*The contraction in credit demand eased as interest rates declined.*

![Graph showing credit to the private sector and average weighted prime lending rate from January 2019 to January 2024.](image)

Note: The average weighted prime lending rate is compiled weekly by the Central Bank of Sri Lanka using weekly lending rates commercial banks offered to their prime customers.

Source: Central Bank of Sri Lanka.

**Figure 2.21.7 Impaired Loan Ratio**

*A rising impaired loan ratio is a cause for concern.*

![Graph showing nonperforming loans and stage 3 loans percentage from Q1 2019 to Q3 2023.](image)

Note: The average weighted prime lending rate is compiled weekly by the Central Bank of Sri Lanka using weekly lending rates commercial banks offered to their prime customers.

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


**Figure 2.21.8 Central Government Finances**

*Both the primary and the overall fiscal balance improved in 2023.*

![Graph showing revenue including grants, overall balance, government expenditure, and primary balance percentages of GDP from 2019 to 2023.](image)

GDP = gross domestic product, IMF = International Monetary Fund.

Note: IMF forecasts used for 2023. Data on government expenditure for 2019 and 2020 are from the October 2021 edition of the IMF World Economic Outlook Database and adjusted for the new GDP base, 2015 =100.

Sources: Central Bank of Sri Lanka; IMF. World Economic Outlook Database, October 2023; Ministry of Finance; IMF estimates.
from 89.0% at the end of 2019 to 125.7% by the end of 2022, at which point central government debt reached 115.5% of GDP. Public debt declined to 115.7% at the end of 2023, as growth in debt was outpaced by that of nominal GDP due to inflation. An agreement in principle was reached with the official creditor committee in November 2023, and a preliminary agreement was reached in October 2023 with the Export–Import Bank of China regarding restructuring public external debt held by them. Domestic debt optimization was completed in 2023. An agreement in principle with commercial creditors has yet to be reached.

**Sri Lanka’s current account surplus in 2023, the first surplus since 1977, is estimated equal to 1.4% of GDP (Figure 2.21.9).** It came as imports fell and tourism and migrant remittances grew. Merchandise exports recorded a 9.1% decline in 2023 because of subdued global demand for garments, but tourism earnings rose sharply to $2.1 billion, up by 82.0% from 2022, as tourist arrivals rebounded by 107%, albeit remaining below the 2017–2018 average of 2.2 million arrivals (Figure 2.21.10). In the first 9 months of 2023, export earnings from transport services also increased by 140%. Remittance inflow rose by 57.5% to reach $6.0 billion, still below the pre-pandemic average of $7.0 billion in 2017–2019 (Figure 2.21.11). Imports fell by 8.1% as import restrictions were imposed for most of the first half of 2023 and as lower purchasing power and higher taxes dampened import demand.

**Figure 2.21.9 Key Balance of Payments Indicators**

The current account improved in 2023 as the trade deficit narrowed.

![Graph showing Key Balance of Payments Indicators](image)

GDP = gross domestic product.


**Figure 2.21.10 Tourist Arrivals**

Tourist arrivals sharply improved in 2023.

![Graph showing Tourist Arrivals](image)

Source: Central Bank of Sri Lanka.

**Figure 2.21.11 Monthly Remittance Inflow**

Remittance inflow improved in 2023 but remained below the recent yearly average.

![Graph showing Monthly Remittance Inflow](image)

Source: Central Bank of Sri Lanka.

**Economic Prospects**

The economy will recover gradually in 2024 and 2025. Key forward-looking indicators like the purchasing managers’ index and the industrial, index of production, are improving. Construction, stalled during the height of the crisis, is resuming but will be tempered by an increase in the value-added tax, which will raise raw material prices and dampen housing construction. The service sector will be supported by higher tourist arrivals and receipts, and the finance sector by lower interest rates and consequently higher demand for credit. Industry will see a resumption in construction projects and higher manufacturing, and agriculture will be supported by cheaper fertilizer. However, the higher costs of raw materials, higher taxes, and unpredictable weather will likely weigh on growth across sectors. With gradual economic stabilization, consumer and business sentiment will improve, leading to a cautious recovery.
in private consumption and investment, but this is likely to be dampened by the higher prices following the value-added tax increase and uncertainty from the electoral cycle. Limited fiscal space will likely restrain government expenditure. With the removal of most import restrictions in the second half of 2023, net exports of goods and services are likely to turn negative in 2024.

**Against this background and with the low base effect from 2023, economic growth is forecast at 1.9% in 2024 and 2.5% in 2025 (Table 2.21.1).** The resumption of growth hinges on the assumed continuation of reforms and better supply conditions. Crucial reforms include the expected enactment in 2024 of a public financial management act, which will strengthen fiscal discipline, and a debt management law to mitigate medium-term refinancing risks, as well as the completion of external debt restructuring.

### Table 2.21.1 Selected Economic Indicators, %

<table>
<thead>
<tr>
<th></th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
<th>2025</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>–7.3</td>
<td>–2.3</td>
<td>1.9</td>
<td>2.5</td>
</tr>
<tr>
<td>Inflation</td>
<td>46.4</td>
<td>17.4</td>
<td>7.5</td>
<td>5.5</td>
</tr>
</tbody>
</table>

**GDP** = gross domestic product.

**Note:** In January 2023, the Department of Census and Statistics revised the inflation base measured by the Colombo consumer price index from 2013 to 2021.

**Sources:** Department of Census and Statistics of Sri Lanka; Asian Development Bank estimates.

**Inflation is expected to average 7.5% in 2024 and fall within the central bank target range in 2025.** Weak transmission to market interest rates and higher taxes will dampen growth in domestic demand, pushing inflation down substantially in 2024 and into the central bank’s target range of 4%–6% in 2025. Consumer demand will see a gradual pickup as credit demand improves, adding inflationary pressure.

**High recurrent expenditure will add pressure on the fiscal balance.** The IMF projects total revenue to increase to 13.0% of GDP in 2024 from an estimated 10.2% of GDP in 2023 through higher direct and indirect taxes and efforts to widen the taxpayer base. However, the domestic debt burden will increase interest costs to 8.4% of GDP in 2024, resulting in total expenditure increasing to 20.3% of GDP in 2024 despite lower capital expenditure. The recapitalization of banks will add another 1.4% of GDP in expenditure. Public sector salaries and interest costs are expected to account for 54.1% of expenditure in 2024. Commitment to maintaining a primary surplus is expected to continue, but the fiscal deficit is likely to widen because the government expects recurrent expenditure to increase from 15.8% of GDP in 2023 to 16.8% in 2024. Any divestment of state-owned assets under consideration should improve the fiscal balance.

**The current account surplus will narrow in 2024 due to an increasing trade deficit.** Despite improving business sentiment, exports are expected to remain flat due to subdued global demand. The loosening of import restrictions in 2023 and possibly those on vehicle imports in 2024 will push imports higher, though limited purchasing power will continue to curtail significant import demand. The service and transfer balance will improve with a rebound in tourism, growth in other export services from improved business confidence, and strong remittance inflow, but will be tempered by a growing deficit in goods trade, narrowing the current account surplus. External debt servicing may resume in 2024 if the external debt restructuring is completed which may exert pressure on the Sri Lankan rupee that has thus far appreciated in 2024.

**Risks to the outlook tend to the downside.** Among them, the most important is uncertainty associated with the upcoming elections, including any possible impact on fiscal policy and reform implementation. Commitment to the reform program will also be tested by efforts to balance public sentiment with the implementation of the IMF program. Delays in the completion of a debt restructuring agreement and any barriers to passing key legislation could dampen sentiment and derail growth. Sri Lanka is reeling from high outmigration, particularly by the young, leading to higher skills mismatch, which could impact forecasts if prolonged. Weakness in the finance sector may prolong a full recovery. Additionally, weather vagaries could adversely impact agriculture and food security. Weaker-than-expected growth in key export markets could lead to increasingly tepid demand for exports, and geopolitical uncertainty could impinge on growth.
Policy Challenge—Addressing Poverty Vulnerability as the Economy Recovers

The pandemic and the subsequent socioeconomic crisis reversed more than a decade of gains against poverty. The World Bank estimates that the $3.65/day poverty rate rose to 25.0% in 2022 from 11.3% in 2019 and 23.8% in 2009/10 and forecasts the rate to reach 27.5% in 2024 (Figure 2.21.12). The multidimensional vulnerability index developed by the United Nations Development Programme estimates that over half of the population faces overlapping vulnerabilities beyond income that lead them into poverty traps; 82% of such vulnerable people live in rural areas. Rural residents, in particular workers on large plantations, suffered from loss of economic opportunity, and the urban poor faced the dual vulnerability of inconsistent earnings with limited private coping mechanisms and restricted access to social protection. The impact of severe supply shortages and elevated inflation had disproportionate effects on households headed by women, the elderly, children, the disabled, and other vulnerable groups. While inflation has subsided to single digits, prices continued to be elevated, with the average index 91.8% higher in 2023 than in 2021. Wages have failed to keep up with rising prices, prolonging the squeeze on purchasing power and pushing more people into poverty. Rising maternal and child malnutrition poses a serious threat to human capital development and growth.

Figure 2.21.12 Poverty Rate

Back-to-back shocks to the economy since 2020 have eroded a decade of gains against poverty.

<table>
<thead>
<tr>
<th>Year</th>
<th>Poverty rate at $2.15 2017 PPP</th>
<th>Poverty rate at $3.65 2017 PPP (lower–middle income level)</th>
<th>Poverty rate at $6.85 2017 PPP (upper–middle income level)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>11.3%</td>
<td>23.8%</td>
<td>50.0%</td>
</tr>
<tr>
<td>2009</td>
<td>11.3%</td>
<td>23.8%</td>
<td>50.0%</td>
</tr>
<tr>
<td>2013</td>
<td>11.3%</td>
<td>23.8%</td>
<td>50.0%</td>
</tr>
<tr>
<td>2016</td>
<td>11.3%</td>
<td>23.8%</td>
<td>50.0%</td>
</tr>
<tr>
<td>2019</td>
<td>11.3%</td>
<td>23.8%</td>
<td>50.0%</td>
</tr>
<tr>
<td>2021</td>
<td>25.0%</td>
<td>50.0%</td>
<td>75.0%</td>
</tr>
<tr>
<td>2022</td>
<td>25.0%</td>
<td>50.0%</td>
<td>75.0%</td>
</tr>
</tbody>
</table>


The near-term priority during economic recovery is to lay institutional and structural frameworks for an inclusive social protection system. In the absence of a cohesive social protection strategy and governance mechanism, programs in the past have been fragmented, with low coverage, poor targeting, high inclusion and exclusion errors, and low payments. In 2023, however, the government introduced the Asuwemma program to consolidate over 25 state-sponsored cash-transfer programs that were previously managed by several government agencies. The new social protection program covers nearly 40% of the population at various income levels and includes a self-registry database for a more objective and streamlined selection process aimed at minimizing leakage. This program can be further strengthened with increased individual support, better forward planning and an effective graduation mechanism with technical and life skills training, better financial literacy education, and enhanced social and financial inclusion. The government must establish a comprehensive long-term strategy for poverty eradication that monitors progress and incorporates regular social dialogue to ensure the representation and participation of all stakeholders.

Addressing gender inequality is a key priority. In an economically active population of 8.5 million in 2022, female labor force participation was only 32.1%, down from 33.6% in 2018 prior to the economic crisis. Key reasons for this include a lack of safe and affordable childcare facilities, inadequate provision for flexible working hours, onerous household responsibilities and care duties socially imposed on women, and public transport inadequacies for women. While the private sector has addressed these shortcomings to some extent, the government can tackle gender inequality through a more supportive framework for female labor participation by introducing flexible work hours and mandating equal pay. Reforming labor laws is also essential to formalize informal employment and protect workers from exploitation. Given the absence of an employment-linked support system, a contributory unemployment insurance scheme and related laws may be considered.

The government should enhance access to public services to mitigate inequalities and better target poverty alleviation efforts. The integration of social protection programs with other public services such as education and health care would ensure universal
access to essential services, improve targeting and coverage, and expand social inclusion. In this regard, government efforts to revamp education policy with updated curricula, improved teacher training, and digitalization are welcome. While the state-sponsored universal health-care coverage and subsidized medicine provide considerable support to the poor, the government can better leverage the health-care system for more targeted measures and promote health insurance programs to protect the poor and vulnerable. The government should intensify efforts to train and retain health and care staff, particularly considering significant outmigration by professionals. Given fiscal constraints, expanding access to services could be achieved by enabling greater private sector participation in essential services. Investments in infrastructure for water supply, road connectivity, and energy are needed to address inequality in income and opportunity, and in access to resources.

Creating jobs and fostering sustainable livelihoods would go a long way toward alleviating poverty. This can begin by improving workforce productivity, particularly in agriculture, which employs 27% of the labor force but contributes little to GDP. The government must prioritize modernizing agriculture by resolving issues regarding farmland, investing to improve land productivity, and promoting greater value addition and diversification in agricultural exports. Policies targeting structural economic transformation—by promoting investment in manufacturing and technology, digital inclusion, the adoption of global best practices in industry, and skill enhancement—would ensure increased job creation outside of agriculture with high productivity and thus bolster worker earning capacity across the economy. To catalyze economic expansion, development, and job creation, the government should promote private sector participation through consistent policies and the regulatory, legal, and institutional support necessary for private sector development. Embracing pro-poor tourism policies by providing the necessary regulatory support and capacity building would ensure optimal transfers of benefits to local communities.