**MEMORANDUM OF THE PRESIDENT
OF THE IDA TO THE EXECUTIVE DIRECTORS
ON THE FULL COMPLIANCE BY THE
THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA
WITH THE TRANCHE RELEASE CONDITIONS FOR THE
RESILIENCE, STABILITY AND ECONOMIC TURNAROUND (RESET)
DEVELOPMENT POLICY OPERATION
(IDA CREDIT NO. 7354-LK)**

1. On June 28, 2023, the Executive Directors approved a two-tranche IDA credit of US$500 million to the Democratic Socialist Republic of Sri Lanka for SDR 371.2 million (US$500 million equivalent) for the Sri Lanka Resilience, Stability and Economic Turnaround Development Policy Operation (DPO; Credit 7354-LK). The two-tranche credit was declared effective on June 29, 2023, and the first tranche of US$250 million was released on June 29, 2023. The Financing Agreement requires as conditions for the release of the second tranche satisfactory progress in carrying out the reform Program, an adequate macroeconomic policy framework, and enactment of the Banking (Special Provisions) Act aimed at strengthening the deposit insurance and problem bank resolution framework.

2. The attached Tranche Release Document summarizes the progress in the implementation of the government Program and the actions taken by the Government of the Democratic Socialist Republic of Sri Lanka to meet the specific conditions for releasing the second tranche. It concludes that the Democratic Socialist Republic of Sri Lanka has made satisfactory progress overall in implementing the program supported by the credit and has fully met the three conditions for the release of the second tranche.

3. In view of the above, the Regional Vice President for South Asia has approved the disbursement of the second tranche of SDR 185.6 million (US$250 million equivalent).

Ajay Banga
President

Washington DC
December 13, 2023

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Sri Lanka
Resilience, Stability and Economic Turnaround (RESET) Development Policy Operation
Tranche Release Document

This document summarizes the progress made under the first Resilience, Stability and Economic Turnaround (RESET) Development Policy Operation (DPO1) for which IDA's Board of Executive Directors approved a credit to the Democratic Socialist Republic of Sri Lanka, on June 28, 2023. The two-tranche SDR371.2 million credit (US$500 million equivalent) was declared effective on June 29, 2023, and the first tranche of US$250 million was released on June 29, 2023. The Financing Agreement requires as conditions for the release of the second tranche, satisfactory progress in carrying out the reform Program, an adequate macroeconomic policy framework, and enactment of the Banking (Special Provisions) Act aimed at strengthening the deposit insurance and problem bank resolution framework. The Democratic Socialist Republic of Sri Lanka has satisfied these conditions as described below.

I. BACKGROUND

1. **The DPO1 is the first of a programmatic series of two operations that supports the Government of Sri Lanka to restore macroeconomic stability, mitigate the impact of the crisis on the poor and vulnerable, and support private-sector-led inclusive growth through three pillars**: 1) improving economic governance, 2) enhancing growth and competitiveness, and 3) protecting the poor and vulnerable. The DPO is an integral part of the World Bank's multi-sectoral support, as outlined in the Sri Lanka *Country Partnership Framework FY24-FY27*.

2. **The DPO1 was calibrated with the ongoing IMF Extended Fund Facility (EFF) program and coordinated with other development partners (DPs).** The IMF approved a 48-month EFF program for SDR2.286 billion (US$1.3 billion equivalent) on March 20, 2023, and the first review of the EFF was successfully completed on December 12, 2023. The reforms in the DPO series are sequenced and coordinated with the EFF program and other support by DPs. Significant technical assistance is also being provided by the Bank and others to support the implementation, and ultimately, sustainability of reforms.

II. MACROECONOMIC POLICY FRAMEWORK

A. Recent economic developments

3. **Since Board approval of DPO1, the economy has continued to stabilize.** Headline inflation moderated faster than expected, declining from a peak of 69.8 percent (y-o-y) in September 2022 to 3.4 percent (y-o-y) in November 2023. Moderating inflation allowed the Central Bank of Sri Lanka to return to a loosening cycle mid-year. However, the economy contracted by 7.9 percent in the first half of 2023, amid shrinking private credit, shortages of inputs, and supply chain disruptions, and high-frequency indicators continue to remain depressed. After nearly doubling between 2021 and 2022, poverty is expected to have increased further in 2023, although at a slower rate.

4. **External buffers improved significantly thanks to a current account surplus and improved capital inflows in the first nine months of 2023.** An improved trade balance and a significant recovery in remittances and tourism are estimated to have contributed to a small current account surplus in January-September 2023. The continued external debt service suspension and inflows from DPs helped build usable official reserves to about 5-6 weeks of imports (US$2.2 billion by end-October 2023). The net foreign asset position of the banking system also improved and the Sri Lankan Rupee appreciated by 9.4 percent against the US Dollar in 2023 (by end-November).

5. **The primary balance registered a surplus in the first nine months of 2023, compared to the corresponding period in 2022, due to the implementation of new revenue measures.** Primary expenditures increased in the first nine months of 2023 (y-o-y), as welfare costs rose and spending on

goods and services and public investment increased amid higher inflation. Despite the rise in primary expenditures, the primary balance registered a surplus in this period, as total revenues increased. However, an increase in interest payments expanded the overall deficit

6. **Debt restructuring made significant progress.** As of end-November 2023, an Agreement in Principle was reached with the Official Creditors and China Exim Bank, in line with the IMF debt targets. Negotiations with foreign commercial creditors continue in parallel. The Domestic Debt Optimization (DDO) is expected to reduce annual Gross Financing Needs (GFN) by 1.5 percent of GDP in 2027-2032 (on average). The financial sector-held domestic currency denominated securities were excluded from the DDO to reduce the risks to the sector's stability.

7. **While the immediate risks to stability have subsided, the financial sector remains vulnerable and financial intermediation continues to be under pressure.** While banks were exempted from the DDO, vulnerabilities in the financial sector remain. Banks are experiencing asset quality pressures, with official non-performing loans (NPLs) still rising in some segments. There are additional unrecognized credit risks, while provisioning levels are low. The tightening of net interest margins and rising impairment charges are putting pressure on profitability and capital. Credit growth to the private sector remains negative. These risks are being mitigated by ongoing reforms in the financial sector (see Section III), supported by the DPO series, IMF EFF and an Asian Development Bank policy-based loan (PBL).

B. Macroeconomic outlook and debt sustainability

8. **The economy is expected to contract by 3.8 percent in 2023 and grow moderately in 2024 and thereafter, as domestic demand remains weak.** The economic contraction in 2023 is projected to be lower than in 2022, on account of the base effect and expected financial inflows towards the end of the year. Beyond 2023, the scarring effect of the crisis, depletion in human capital and tight external financing are likely to affect domestic trade, jobs and incomes of households. This is expected to lead to a fragile recovery. Poverty reduction could resume from 2024, but this depends on continued implementation of structural reforms and a restoration of economic growth. Inflation is expected to stay in single digits.

9. **The current account is expected to remain benign.** It is projected to record a small surplus in 2023 (0.2 percent of GDP) despite weak export performance, due to a strong recovery in remittances, higher tourism inflows, and weak import demand. Although the removal of import restrictions (except on motor vehicles) will widen the trade deficit in 2024 and beyond, the current account deficit is expected to remain benign as tourism and remittances improve further. The external financing gap is expected to be closed given the projected International Financial Institution (IFI) financing and other inflows.

10. **Fiscal balances are projected to improve with higher revenue collection and continued rationalization of expenditures.** New revenue measures and some expenditure savings are expected to contribute to a further improvement in the primary balance (excluding an allocation for bank recapitalization in 2024) over 2023-26.[1] The overall fiscal deficit is expected to increase in 2024, driven by higher interest payments. Debt restructuring and continued revenue-based fiscal consolidation are projected to reduce the overall deficit in 2025-26 and beyond.

11. **The macroeconomic policy framework is assessed as adequate for the release of the second tranche of DPO1.** This assumes a successful implementation of debt restructuring, continuation of the IMF EFF and fiscal reform program, and currently expected levels of financing from IFIs. While recent macroeconomic performance has been better than anticipated, risks over the medium-term continue to be high, given a narrow path to recovery and limited buffers. On the upside, faster-than-expected growth, driven by a rapid recovery in tourism and remittances, could foster recovery and build additional buffers.

[1] Higher overall spending in 2024 is driven by a one-time allocation for bank recapitalization (1.5 percent of GDP).

III. PROGRESS WITH THE PROGRAM

12. **The government has successfully carried out the Program as outlined in the *Letter of Development Policy* with progress along all areas supported by the DPO.** These include:

- Tax policy and administration measures have been put in place to restore fiscal sustainability, including rate increases to value-added, personal and corporate income taxes, reinstatement of mandatory withholding of certain taxes, and the enforcement of third-party data sharing.
- Implementing a package of institutional reforms to strengthen fiscal and debt management – comprising the approval of new Public Financial Management and Debt Management Laws, and establishment of a Parliamentary Budget Office and a Unified Debt Management Office.
- Commitment to safeguard financial sector stability through the establishment of a Financial Sector Crisis Management Committee and approval of an updated Emergency Liquidity Assistance framework. A revised regulation with prudential limits for bank exposure to single borrowers and group of connected borrowers, a revised circular on business revival units, as well as restructuring plans for the largest State-Owned Banks are currently under preparation.
- Moving to remove constraints to economic growth through the maintenance of a flexible exchange rate, simplification of the tariff structure (i.e. reduction of para-tariffs), and the expected approval of a new Unified Investment Law and National Tariff Policy.
- Implementing measures to level the playing field between the private and public sector by, for example, introducing market-based principles in the management of State-Owned Enterprises (SOEs) (e.g. cost-reflective utility pricing). This is being complemented by a process to restructure and divest SOEs, which is ongoing.
- Important reforms to improve the targeting – via the new social registry – and adequacy – via the new Aswesuma program – of social safety nets to shield the poor and vulnerable from the most acute impacts of the crisis and macroeconomic adjustment.
- Preparation of legislation to uphold gender equality principles and reduce barriers to female labor force participation.

IV. THE TRANCHE RELEASE ACTION STATUS UPDATE

Second Tranche Release Condition: To maintain stability and confidence in the banking system, the Recipient has enacted the Banking (Special Provisions) Act aimed at strengthening the deposit insurance and problem bank resolution framework, as evidenced by the publication in the Recipient's official gazette of the Banking (Special Provisions) Act as certified by the speaker of Parliament.

13. **The condition has been met**. On September 14, 2023, the speaker of Sri Lanka's Parliament certified enactment of the Banking (Special Provisions) Act, which then became effective on November 15, 2023. The act establishes the legal and institutional framework – in line with international best practice – to enable the resolution of problematic financial institutions in a prompt and cost-effective fashion, and to strengthen the deposit insurance scheme in order to maintain the public's confidence in the banking system and protect the savings of depositors in failed institutions.

V. CONCLUSION

14. In view of the satisfactory implementation of the Program supported by the credit, achievement of the second tranche release condition, and maintenance of a satisfactory macroeconomic policy framework, the Bank has informed the Recipient of the availability of the second tranche for the amount of US$250 million.