Public Disclosure Authorized

SRI LANKA

Table 1	2021
Population, million	22.0
GDP, current US$ billion	82.5
GDP per capita, current US$	3750.2
International poverty rate ($1.9)[a]	0.9
Lower middle-income poverty rate ($3.2)[a]	11.0
Upper middle-income poverty rate ($5.5)[a]	42.0
Gini index[a]	39.3
School enrollment, primary (% gross)[b]	100.2
Life expectancy at birth, years[b]	77.0
Total GHG Emissions (mtCO2e)	36.7

Source: WDI, Macro Poverty Outlook, and official data.
a/ Most recent value (2016), 2011 PPPs.
b/ Most recent WDI value (2019).

Sri Lanka faces unsustainable debt and significant balance of payments challenges. The economic outlook is highly uncertain due to the fiscal and external imbalances. Urgent policy measures are needed to address the high levels of debt and debt service, reduce the fiscal deficit, restore external stability, and mitigate the adverse impacts on the poor and vulnerable. The forecasts have been finalized on March 17, 2022.

Key conditions and challenges

Due to the COVID-19 pandemic, the economy contracted by 3.6 percent in 2020, raising the $3.20 poverty rate to an estimated 11.7 percent. In 2021, an expeditious vaccination campaign contributed to economic recovery. However, fiscal deficits sharply widened and public debt significantly increased due the pandemic and pre-pandemic tax cuts. Foreign exchange earnings declined, while large international sovereign bond repayments came due. Heightened fiscal and external risks led to a series of sovereign credit rating downgrades, preventing market-based refinancing. Official reserves declined to critically low levels and a foreign exchange shortage has affected the supply of some essentials. Inadequate fuel supply for thermal generation resulted in scheduled power cuts.

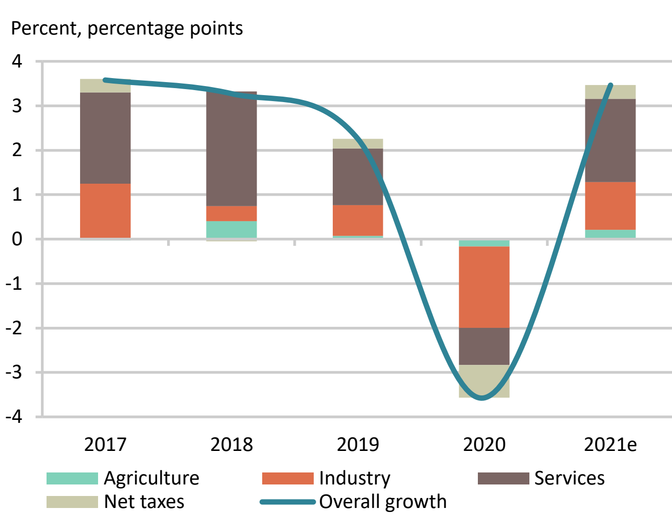
Sri Lanka's macroeconomic challenges are linked to years of high fiscal deficits, driven primarily by low revenue collection, and erosion of export competitiveness due to a restrictive trade regime and weak investment climate. Growth slowed to an average 3.1 percent between 2017 and 2019 from the 6.2 percent between 2010 and 2016, as a peace dividend and a policy thrust toward reconstruction faded away and macroeconomic shocks adversely impacted growth. Structural adjustments are needed to restore debt sustainability, significantly increase revenue collection, and to improve the investment climate, restore competition, and support reforms to improve productivity in agriculture. Public investments and future borrowings should prioritize key sectors and address immediate needs and induce sustainable and resilient growth through economic transformation.

Recent developments

Real GDP is estimated to have expanded by 3.5 percent in 2021 thanks to a strong 12.3 percent, year-on-year, rebound from a low base in the second quarter of the year. Significant contributions came from manufacturing, financial services, construction, transport, and real estate activity. Despite still low tourism receipts, exports expanded significantly, led by the textile industry. Higher imports of intermediate and capital goods increased imports. The $3.20 poverty rate is estimated to have slightly declined to 10.9 percent in 2021, still above pre-pandemic levels.

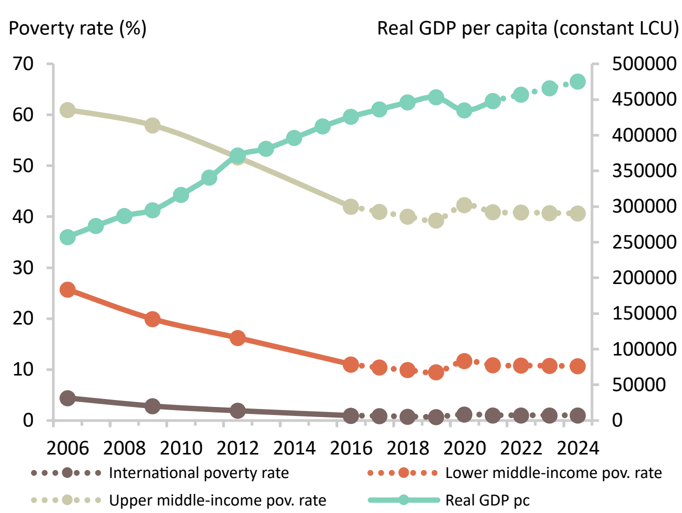
Year-on-year inflation accelerated to 17.5 percent in February 2022, mostly due to high food inflation at 24.7 percent, amid rising global commodity prices, adjustments to fuel prices, and partial monetization of the fiscal deficit. Moreover, an agrochemical imports ban between May and November reduced agricultural production. The increase in prices affected the ability of households to cover living expenses, leading to a deterioration of welfare and more food insecurity. Since August 2021, the central bank has increased policy rates and the statutory

FIGURE 1 Sri Lanka / Real GDP growth and contributions to real GDP growth (production side)



Sources: Department of Census and Statistics, World Bank staff calculations.

FIGURE 2 Sri Lanka / Actual and projected poverty rates and real GDP per capita



Sources: World Bank. Notes: see Table 2.

reserve ratio by 200 basis points to mitigate the pressures.

The trade deficit widened to USD 8.1 billion in 2021 from USD 6 billion in 2020 as a rising import bill offset the increase in export earnings, despite import restrictions on non-essential goods. Declines in remittances (22.7 percent) and tourism receipts (61.7 percent) are estimated to have further widened the current account deficit to USD 3.2 billion (or 3.8 percent of GDP) in 2021.

The government has mobilized external financing from bilateral partners, including a financial assistance package from India worth US$ 1.4 billion in January 2022 to pay for essential imports and boost foreign exchange liquidity. A further US$ 1 billion support from India was signed on March 17, 2022. However, official reserves at US$ 2.3 billion in February 2022 (equivalent to 1.3 months of imports) remain low relative to foreign currency debt service, estimated at USD 5.6 billion from April to December 2022 (including domestic instruments issued in foreign currency). Net foreign assets of the banking system declined to US$ -4.9 billion in December 2021, showing escalating foreign exchange liquidity shortages. After keeping the exchange rate broadly fixed around 201 LKR/US$ for seven months, the CBSL floated the currency on March 07 to stem reserve losses. By March 15, the currency had depreciated by 31 percent.

The fiscal deficit is estimated to have remained at 11.1 percent of GDP in 2021, and public and publicly guaranteed debt to have increased to 117 percent of GDP. The fiscal deficit was mostly financed by domestic resources, including the central bank. Fitch, S&P, and Moody's downgraded the sovereign rating deeper into the substantial risk investment category.

Outlook

The heightened fiscal and external risks as well as challenging political situation pose significant uncertainty to the economic outlook and Sri Lanka faces an external financing gap in 2022 and beyond. The real GDP growth outlook is subject to the continuing fiscal and external imbalances. Despite expected further tightening of monetary policy, inflation will likely stay elevated, due the recent currency depreciation and high commodity prices, partly related to the Russia-Ukraine War and associated sanctions. The fiscal deficit is projected to stay high amid low revenue generation and rigid expenditures. The current account deficit is expected to increase due to the high global commodity prices, partially offset by gradually increasing remittances due to the float of the currency. Poverty at $3.20 per day is projected to remain broadly unchanged from 2021. A shortfall of external financing, larger than expected impacts of the Russia-Ukraine War and associated sanctions on commodity prices and tourism, as well as the possible emergence of new COVID variants pose downside risks. On the upside, an opening of China could provide a boost to tourism.

Sri Lanka needs to address the structural sources of its vulnerabilities. This would require reducing fiscal deficits especially through strengthening domestic revenue mobilization. Fiscal consolidation needs to be accompanied by tighter monetary policy to contain pressures on inflation. Sri Lanka also needs to find feasible options to restore debt sustainability. The financial sector needs to be carefully monitored amid high exposure to the public sector and the impact of the recent currency depreciation on banks' balance sheets. The necessary adjustments may adversely affect growth and impact poverty initially but will correct the significant imbalances, subsequently providing the foundation for stronger and sustainable growth and access to international financial markets. Mitigating the impacts on the poor and vulnerable would remain critical.

TABLE 2 Sri Lanka / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2019	2020	2021e	2022f	2023f	2024f
Real GDP growth, at constant market prices	2.3	-3.6	3.5	2.4	2.3	2.3
Private Consumption	3.0	-3.0	3.6	2.3	2.2	2.4
Government Consumption	13.0	4.4	4.4	0.8	-1.3	-0.5
Gross Fixed Capital Investment	1.0	-9.5	5.8	2.3	1.0	1.5
Exports, Goods and Services	7.2	-9.6	18.2	8.9	5.8	2.8
Imports, Goods and Services	-5.8	-11.4	15.7	5.9	2.2	1.3
Real GDP growth, at constant factor prices	2.2	-3.1	3.5	2.4	2.3	2.3
Agriculture	1.0	-2.4	3.0	1.0	1.5	1.5
Industry	2.6	-6.9	4.2	2.3	2.3	2.2
Services	2.2	-1.5	3.2	2.6	2.4	2.5
Inflation (Consumer Price Index)	4.3	4.6	6.0	15.2	8.3	6.1
Current Account Balance (% of GDP)	-2.2	-1.3	-3.8	-4.3	-3.4	-2.9
Net Foreign Direct Investment (% of GDP)	0.7	0.6	0.8	1.1	1.3	1.3
Fiscal Balance (% of GDP)	-9.6	-11.1	-11.1	-9.1	-9.6	-9.7
Debt (% of GDP)	94.3	109.7	117.0	122.7	124.3	125.4
Primary Balance (% of GDP)	-3.6	-4.6	-4.6	-2.0	-2.0	-1.7
International poverty rate ($1.9 in 2011 PPP)[a,b]	0.7	1.2	1.0	1.0	1.0	1.0
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	9.5	11.7	10.9	10.8	10.8	10.7
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	39.3	42.3	40.9	40.8	40.7	40.6
GHG emissions growth (mtCO2e)	-0.1	-4.0	3.1	2.7	2.4	2.4
Energy related GHG emissions (% of total)	63.8	64.4	65.7	67.0	67.9	68.7

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices. Emissions data sourced from CAIT and OECD.
a/ Calculations based on SAR-POV harmonization, using 2016-HIES.Actual data: 2016. Nowcast: 2017-2021. Forecasts are from 2022 to 2024.
b/ Estimates for 2017-2019 and 2021 use a neutral distribution (2016) and assume a medium pass-through (0.87) based on GDP per capita in constant LCU. Estimate for 2020 based on microsimulation of COVID19 impacts. Estimates for 2022-2024 assume a very low pass-through (0.10) based also on GDP per capita.