SRI LANKA DEVELOPMENT UPDATE

OPENING UP TO THE FUTURE

October 2024

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Preface

The Sri Lanka Development Update (SLDU) has two main aims. First, it reports on key developments over the past 12 months in Sri Lanka's economy, places these in longer term and global contexts, and updates the outlook for Sri Lanka's economy. Second, the SLDU provides a more in-depth examination of selected economic and policy issues. It is intended for a wide audience, including policymakers, business leaders, financial market participants, think tanks, non-governmental organizations and the community of analysts and professionals interested in Sri Lanka's evolving economy.

The SLDU was prepared by a team consisting of Shruti Lakhtakia (Economist, Macroeconomics, Public Sector, Trade and Investment (MPSTI)), Udahiruni Atapattu (Research Analyst, MPSTI), and Richard Walker (Senior Economist, MPSTI), with inputs from Tatsiana Kliatskova (Financial Sector Economist, Finance, Competitiveness and Innovation (FCI)), Karina Baba (Senior Financial Sector Specialist, FCI), Marta Schoch (Economist, Poverty), Tiloka de Silva (Consultant, Poverty), Nandini Krishnan (Lead Economist, Poverty), Verena Phipps (Senior Social Development Specialist, Social Development (SSA), Kamani Jinadasa (Consultant, SSA), Isis Gaddis (Senior Economist, SSA), and Zoe Leiyu Xie (Senior Economist, South Asia Regional Chief Economist's Office (SARCE)).

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Abbreviations

ADB	Asian Development Bank
Bps	Basis points
BOI	Board of Investment
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CEDAW	Convention on the Elimination of All Forms of Discrimination against Women
ECI	Economic Complexity Index
EFF	Extended Fund Facility
EMDEs	Emerging Market and Developing Economies
EPZs	Export Processing Zones
ERP	Effective Rate of Protection
ETA	Economic Transformation Act
FDI	Foreign Direct Investment
FLFP	Female Labor Force Participation
FX	Foreign Exchange
GDP	Gross Domestic Product
GFN	Gross Financing Needs
GVCs	Global Value Chains
IMF	International Monetary Fund
LFP	Labor Force Participation
LKR	Sri Lankan Rupee
MSMEs	Micro, Small and Medium Enterprises
NCW	National Commission on Women
NFA	Net Foreign Assets
NPLs	Non-Performing Loans
NSW	National Single Window
NTP	National Tariff Policy
OCC	Official Creditor Committee
PAL	Ports and Airport Levy
PPP	Purchasing Power Parity
SAR	South Asia Region
SMEs	Small and Medium Enterprises
SOEs	State-Owned Enterprises
SVAT	Simplified Value Added Tax
T-bill	Treasury Bill
ULL	Unified Labor Law
UMI	Upper Middle Income
VAT	Value Added Tax
WDR	World Development Report
WE	Women Empowerment (Act)
y-o-y	Year-on-year

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Executive Summary

A. Macroeconomic Developments

The economy has stabilized, recording four quarters of growth, after critical structural and policy reforms. However, the recovery remains fragile and is predicated on continued macroeconomic stability, a successful debt restructuring, and sustained structural reforms that can strengthen prospects for medium-term growth and poverty reduction.

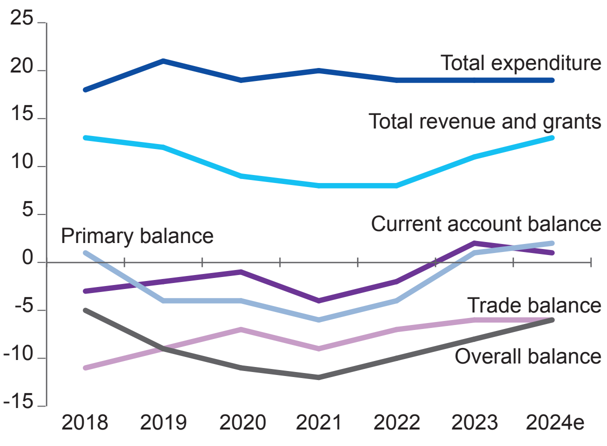
The economy grew by 5 percent (year-on-year, y-o-y) in H1 2024, and external balances improved. Growth was driven by a rebound in the industrial sector, as well as strong performance in tourism-related service sectors. Headline inflation remained in the low single digits throughout 2024. This allowed the further easing of monetary policy, which contributed to a decline in interest rates. There was positive, albeit weak, growth in credit to the private sector. The current account strengthened, driven by increased tourism receipts and remittances, whilst external debt servicing remained suspended. This contributed to an estimated balance of payments surplus and helped build usable official reserves to about three months of imports, compared to 1-2 weeks at the depths of the crisis (end-2022).

Fiscal balances continued to strengthen as revenues improved, primary expenditures stayed low, and the interest bill declined. Increased revenues and careful management of expenditures strengthened the primary balance and led to a reduction in the fiscal deficit in the first half of 2024 (Figure 1). Tax revenue increased by 42.6 percent (y-o-y) in the first six months of the year, driven by higher Value-Added Tax (VAT) collection.

Despite the economic expansion, households remain under pressure. Poverty and vulnerability are elevated, food insecurity is widespread, health outcomes have deteriorated, and labor force participation (LFP) continues to decline (Figure 2).

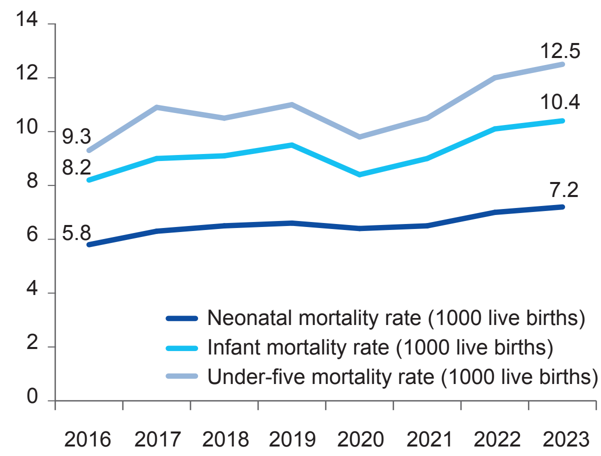
Faster than expected macroeconomic stabilization has improved the short-term growth outlook to an average of 4 percent (y-o-y) over 2024-25. Growth is expected to recover from a low base in the short-term, and return to a modest path over the medium-term, reflecting the scarring effects of the crisis. A significant and continued reform effort is key to raising medium- to long-term growth potential. Poverty (measured by a $3.65 per person per day poverty line, 2017 purchasing power parity, PPP) is expected to decline gradually in 2024–25

Figure 1: Improvements in the external and fiscal balances helped stabilize the economy
(Percent of GDP)



Source: Central Bank of Sri Lanka, World Bank calculations

Figure 2: Child mortality is rising
(Percent)



Source: Family Health Bureau Sri Lanka

but remain above 20 percent until 2026. Inflation is likely to remain well below the central bank's target of 5 percent in 2024, and gradually increase towards the target as demand picks up. The current account is projected to remain in surplus in 2024, driven by the performance of tourism and remittances, and with the restriction on imports of personal vehicles only being phased out from 2025 onwards. Debt restructuring and continued fiscal consolidation are expected to reduce the overall fiscal balance in the medium-term.

Sri Lanka's path towards stability and sustainable economic growth remains narrow. While recent economic performance has been sound, macroeconomic stability remains fragile and is predicated on the continued implementation of prudent fiscal, financial, and monetary policies. Near-term risks include policy uncertainty, and a protracted or insufficiently deep debt restructuring. There will also be pressure to roll over or replace maturing Treasury bills (T-bills) (currently 13.2 percent of Gross Domestic Product, GDP) at reasonable cost.

Scarring effects of the crisis will weigh on medium-term growth potential. Concerns persist over the impact of food insecurity and lower spending on health and education on future human capital, and inequality is expected to remain high. Elevated non-performing loans (NPLs) and high exposure to the sovereign mean financial sector risks need to be carefully monitored. On the upside, a strong and sustained implementation of the structural reform program could boost confidence and attract fresh, non-debt-creating capital inflows.

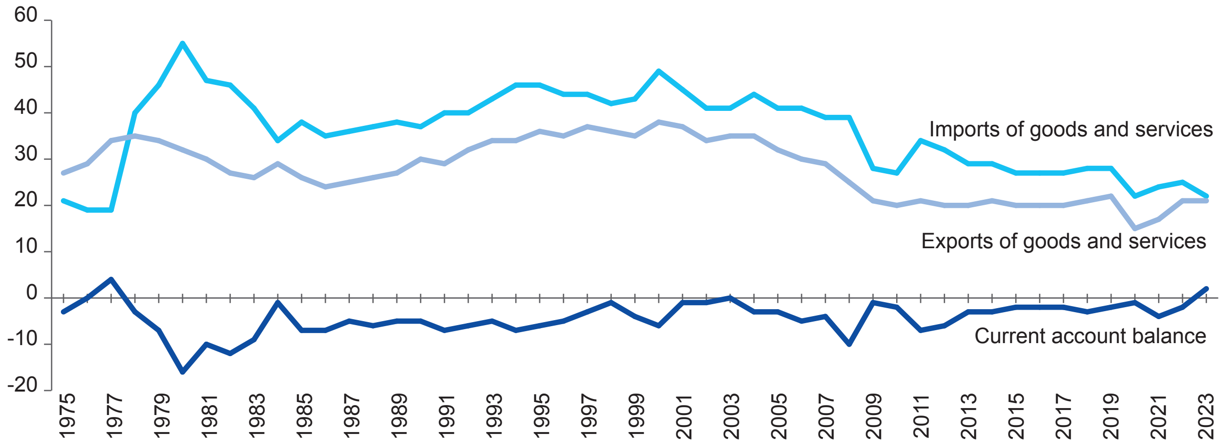
Reforms are vital for a strong and inclusive recovery. Completing the external debt restructuring is critical to bring Sri Lanka's debt back to a sustainable path. Prudent fiscal, monetary, and financial sector policies are needed to preserve macroeconomic gains and maintain stability. These measures need to be accompanied by the continued implementation of key structural reforms – related to debt management, social assistance, State-Owned Enterprises (SOEs), trade and investment, and governance and anti-corruption – that will determine the prospects for medium-term growth and poverty reduction.

B. Opening Up to the Future

Reviving exports is key to a higher and sustainable growth path. Sri Lanka's emergence from the economic crisis this past year was supported by an adjustment in external balances. The country sustained a current account surplus in 2023 for the first time since 1977. Enhancing and sustaining growth requires higher private investment, exports, and productivity growth. This special topic looks at why Sri Lanka must boost exports and investment as engines of growth to create better jobs, reduce poverty, and increase productivity.

Over the past two decades, exports (especially goods) performed poorly, and investment faltered. The share of goods and services exports to GDP had been falling since 2000 and reached its lowest point of 15 percent in 2020 (Figure 3). There has also been little export diversification – clothing and tea still dominate goods exports, and transport and travel dominate services. Net foreign direct investment (FDI) inflows accounted for around 1.2 percent of GDP over the last three decades and have mostly reflected "market seeking" FDI catering to inward looking sectors (e.g., construction), instead of focusing on "efficiency seeking" FDI aimed at increasing exports and generating foreign exchange (FX) (Figure 4).

Figure 3: Exports of goods and services have been declining since 2000
(Percent of GDP)

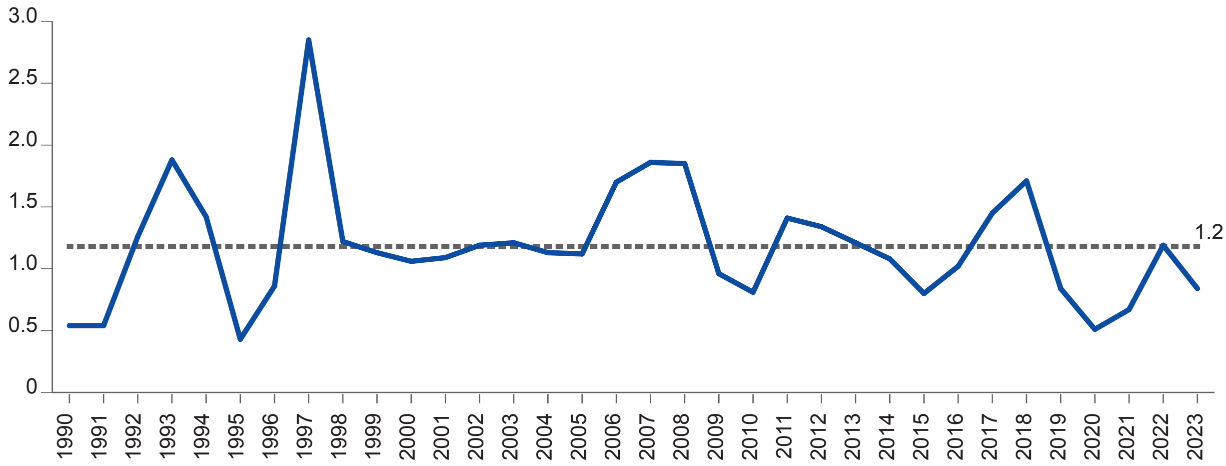


Source: Central Bank of Sri Lanka, World Bank calculations

Sri Lanka's untapped export potential is about US$10 billion annually and tapping this potential could create an estimated 142,500 additional jobs. Export performance in the post-conflict decade (2010–19) was below potential in Sri Lanka. Comparator countries in East and South Asia performed much better during the same period. Most manufacturing[1] subsectors (except clothing and rubber products) export less than potential, suggesting 'missing' exports.

[1]Manufacturing and indutrial exports have been used interchangeably throughout the report.

Figure 4: Net FDI inflows have averaged 1.2 percent of GDP over the past 3 decades
(Percent of GDP)



Source: Central Bank of Sri Lanka, World Bank calculations

The potential for successful diversification and expansion of exports in manufacturing, services, and agriculture is high if structural reforms are implemented. This requires liberalized trade and a better investment climate to increase the competitiveness and export orientation of the economy. Sri Lanka has the largest port in a dynamic economic region, substantial existing capacity in export markets, and a middle-skilled workforce. The latter is particularly valuable given the rise in skill-intensity of global value chains (GVCs). In addition, there is potential for increased quality and higher value addition in critical sectors, including agri-business and sustainable high value tourism.

Sri Lanka has an opportunity to capitalize on shifts in GVCs precipitated by a changing geopolitical landscape, supply chain disruptions, and geopolitical instability. The proximity of South Asian and East Asian countries with their prospects for growth, and the shedding of export capacity by China, provide the space to enhance participation in GVCs, for example, through the signing of deep trade agreements. As global trade rebounds, global supply chains are reshaped, and companies diversify their sourcing strategies, Sri Lanka is also in a good position to benefit from these shifts.

Sri Lanka's recent history of poor economic governance – especially with reform reversals, fragmented policy making, and frequent policy changes – needs to be addressed for sustaining higher exports and private investment. It is critical to ensure that the process of formulating regulations and making policy changes is open, transparent, and consistent. Discretionary approaches – in the form of complex and inconsistent trade and investment policies and tax advantages to certain industries, firms, or interest groups – are detrimental to better economic and governance-related outcomes. Addressing these issues with improved governance will increase economic efficiency, reduce corruption, improve the government's credibility, and help prevent future crises.

Table 5 in the special topic section presents a set of priority reforms that focus on: (i) reducing and maintaining low tariffs and facilitate exporters' access to imported inputs; (ii) simplifying and digitizing cross-border trade procedures through the implementation of a National Single Window (NSW); (iii) revamping the FDI attracting regime through the operationalization of the Economic Transformation Act (ETA) and signing of deep trade agreements; and (iv) complementary policies pertaining to digital connectivity and the labor market.

A. Macroeconomic Developments

1. Context

Sri Lanka has restored stability and a path of growth after a severe and unprecedented economic crisis in 2022 and 2023. The country defaulted on its external debt, amid unsustainable debt and depleted reserves. The implementation of key structural and policy reforms has helped stabilize the economy since mid-2023.

1. **In April 2022, Sri Lanka defaulted on its external debt, which plunged the country into a deep crisis.** This followed years of economic mismanagement and governance failures, which were exacerbated by exogenous shocks. Prior to the crisis, fiscal indiscipline had led to high fiscal deficits and large gross financing needs (GFN).[2] Risky commercial borrowing had elevated debt vulnerabilities and led to a rapid growth in debt to unsustainable levels. Monetary indiscipline had led to monetary instability and high inflation. With the loss of access to international financial markets, official reserves dropped sharply, and the FX liquidity constraint caused severe shortages of essential goods. Poverty doubled from 13.1 percent in 2021 to 25.9 percent in 2023 (at $3.65 per capita, PPP). After having been almost eradicated in the decade following the conflict, extreme poverty increased from less than 1 percent in 2019 to above 5 percent in 2023.

2. **The government implemented structural and policy reforms that restored macroeconomic stability.** These included cost-reflective utility pricing, new revenue measures, a return to prudent monetary policy, and domestic debt restructuring. New legislation – including on public debt management, public financial management, central bank independence, electricity sector reforms, and the investment climate – has been enacted. Other key reforms related to the financial sector, trade, investment, SOEs, and governance and anti-corruption continue to advance. An agreement on the restructuring of official debt was reached in June 2024, and negotiations with commercial creditors have made considerable progress.

[2] Government's GFN refers to the sum of amortization, interest payments, and the primary balance.

3. **The reforms helped stabilize the economy as external and fiscal balances improved and economic growth was restored.** After contracting by 7.3 percent (y-o-y) in 2022, the economy grew in the last two quarters of 2023, limiting the annual contraction to 2.3 percent. Inflation moderated to single digits in mid-2023, down from a peak of 69.8 percent (y-o-y) in September 2022. The rupee appreciated by 10.8 percent (y-o-y) in 2023 after sharply depreciating 81.2 percent the year before. Due to the recovery of tourism receipts and remittances and increased inflows from development partners, usable official reserves increased to US$3 billion by end-2023 (equivalent to 2.1 months of imports), compared to US$500 million at end-2022. However, household budgets remained stretched throughout 2023 due to tax and price increases, and loss of jobs and income. Food insecurity remains high, and human capital outcomes are regressing.

2. Recent Economic Developments

Positive growth, low inflation, a steady exchange rate, and improved fiscal and external balances throughout 2024 have contributed to greater stability and a nascent recovery, amid the continued external debt service suspension. Poverty remains high and LFP continues to decline.

The pick-up in industry and services revived growth

4. **GDP growth was robust at 5 percent (y-o-y) in H1 2024.** Following six quarters of contraction, the economy began to expand from Q3 2023. Real GDP grew, led by a rebound in industry (11.4 percent, y-o-y) after a cumulative contraction of 23.7 percent between 2021 and 2023. The recovery of the construction sector (as government arrears were cleared and some project financing resumed) and the resilience of food and beverage manufacturing underpinned the growth of industry. Strong performance in tourism-related sectors, including accommodation, food and beverage services, and transport helped the service sector post a growth of 2.6 percent (y-o-y). Agricultural growth was limited (1.4 percent, y-o-y) due to the impact of localized weather disruptions, pests, and diseases during the *Maha* season.[3]

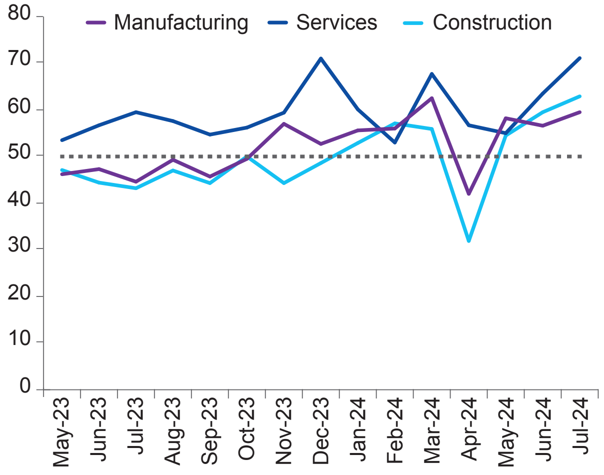
5. **High frequency indicators indicate a continued upswing in industry and services.** Total cement consumption increased by 16.3 percent (y-o-y) in the first six months of 2024, reflecting the pick-up in the construction sector. Electricity sales to industries also increased by 8.8 percent (y-o-y) in the same period, as industrial output expanded. Reflecting these improvements in activity, the Index of Industrial Production expanded in the first half of 2024. Despite seasonal dips in April, in line with the annual holiday period, the Purchasing Managers' Index for manufacturing, services, and construction continued to improve (Figure 5).

6. **Investment and the external sector were key drivers of growth.** Investment expanded significantly, growing at 17.6 percent (y-o-y) - its fastest rate since Q1 2021 (Figure 6).[4] The net external balance (exports minus imports) grew by 43.4 percent (y-o-y), as both exports and imports picked up; however, the contribution of the sector to growth was low, as export growth only marginally outpaced import growth. Growth in

[3] https://reliefweb.int/report/sri-lanka/giews-country-brief-sri-lanka-24-june-2024
[4] GDP expenditure data is limited to Q1 2024, whereas production data is available until Q2 2024.

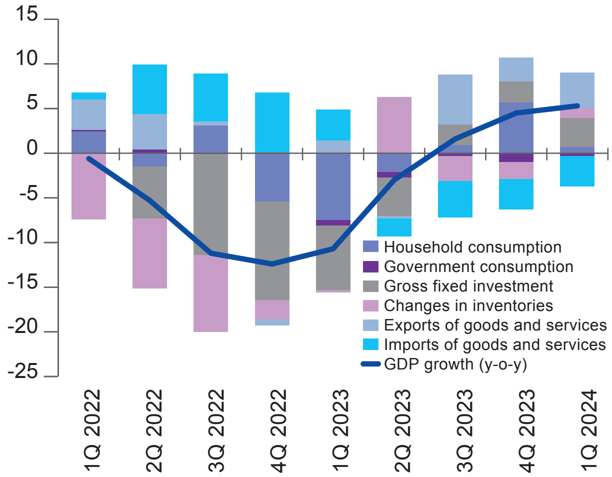
consumption was limited (0.5 percent, y-o-y) by weak demand from households – due to the impact of higher taxes, sluggish private credit growth, and depleted buffers of disposable incomes – and a continued contraction in government consumption (3.2 percent, y-o-y), driven by the ongoing fiscal consolidation efforts.

Figure 5: Purchasing Managers' Index has been expanding as activity has picked up
(Index)



Source: Central Bank of Sri Lanka
Note: An index value above 50 indicates a month-on-month expansion in the sector.

Figure 6: Investment and net export demand contributed to the uptick in growth
(Percent y-o-y and percentage point contribution)



Source: Department of Census and Statistics, World Bank calculations

Box 1: Global economic conditions remain challenging

After surprising positively over the past six months, global growth is now on track to slow. Signs of weakness emerged in mid-2024, as global manufacturing activity contracted unexpectedly. However, the continued solid expansion in global services mitigated the impact on growth (Figure 7).

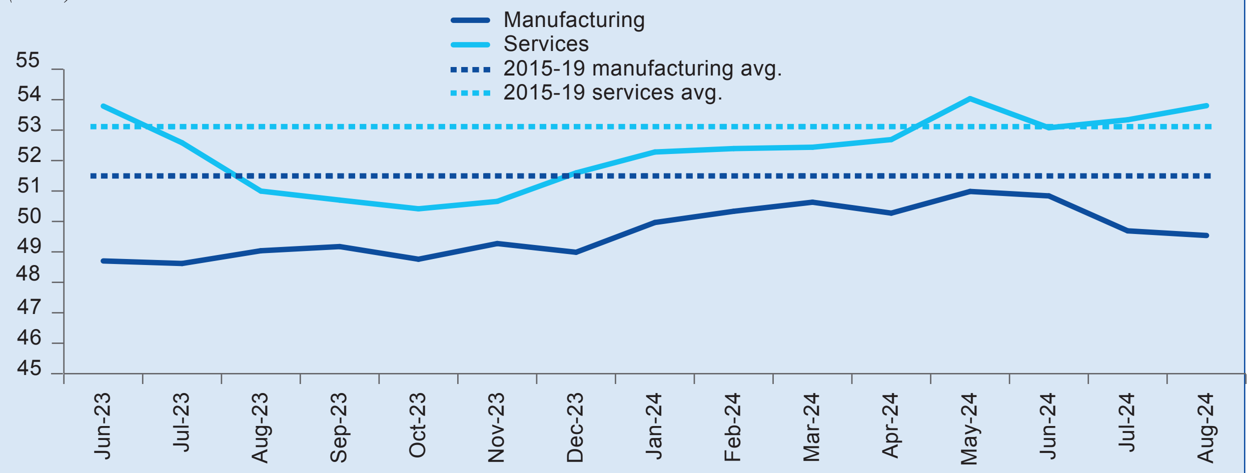
Major economies show mixed trends. In the United States, while growth expectations for 2024 have been upgraded vis-à-vis January 2024, growth is projected to slow compared to 2023 levels. Moderating inflation and signs of a cooling labor market allowed the U.S. Federal Reserve to cut the monetary policy rate in September 2024. Economic activity in the euro area has recovered steadily, and growth for 2024 is expected to exceed earlier expectations – led by the services sector, as manufacturing continues to stagnate with subdued growth in investment and exports. Finally, activity in emerging market and developing economies (EMDEs) appears to be firming, except in China, where growth has slowed since June 2024. China's moderation reflects softening domestic consumption, but solid external demand continues to support exports – with China remaining a key source of Sri Lanka's imports. The People's Bank of China lowered its policy interest rate in July and reportedly plans to boost consumption by lowering effective lending rates for small loans and easing mortgage lending requirements.

Global inflation continues to slow but remains above pre-pandemic averages amid broadly stable commodity prices. Slowing inflation has allowed central banks in some EMDEs to ease monetary policy and is expected to lead to monetary easing in major advanced economies in late 2024.

After a brief expansion in April and May 2024, global trade flows returned to their contractionary trend, driven by shrinking merchandise exports, continued conflict, and continued use of trade-restricting measures. Services exports continued to expand, albeit at a decelerating pace. While global trade growth is expected to accelerate in 2025, it will remain below the 2015–19 average.[5] This growth in trade is expected to be driven increasingly by trade among countries that are aligned on foreign policy.

[5] Global Economic Prospects, June 2024.

Figure 7: Global manufacturing contracted mid-year but the services Purchasing Managers' Index continues to expand
(Index)



Note: Readings above (below) 50 indicate expansion (contraction). Last observation is August 2024.

Source: South Asia Development Update, October 2024

Inflation remained low, supported by a reduction in administered prices

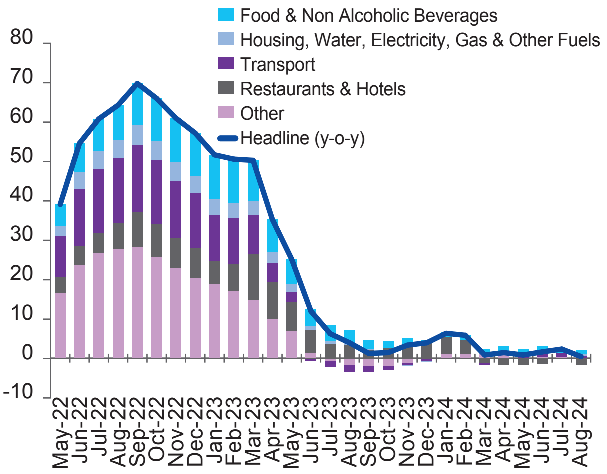
7. **Headline inflation, measured by the Colombo Consumer Price Index (CCPI), remained low in the first eight months of 2024.** Despite an increase in the first two months of the year due to the impact of agricultural disruptions and new tax measures, inflation remained in single digits throughout the year, falling to 0.5 percent (y-o-y) in August 2024 – the lowest level since January 2021.[6] Low inflation was mainly driven by downward adjustments in utility prices (including for petroleum, electricity and water),[7] and supported by moderating global commodity prices, an appreciating currency, improved supply conditions, subdued demand, and the phasing out of monetary financing (Figure 8). Decelerating inflation was beneficial for households' welfare, and helped limit further increases in food insecurity and malnutrition, especially among poorer households. Core inflation (computed excluding food and energy prices) fell to 3.6 percent (y-o-y) in August but remained higher than headline inflation for most of 2024, reflecting the nascent recovery in demand. The National Consumer Price Index shows a similar trend to the CCPI.

8. **As inflation remained well below target, the Central Bank of Sri Lanka (CBSL) continued to maintain an accommodative stance.** Slowing inflation has allowed CBSL to cut policy rates by a cumulative 725 basis points (bps) since May 2023. In 2024, rates were cut by 50 bps in March and 25 bps in July, bringing the Standing Deposit Facility rate down to 8.25 percent and Standing Lending Facility rate to 9.25 percent. Lower policy rates pushed commercial bank lending and deposit rates downwards (Figure 9). 91-day T-bill rates continued to decline (close to a 1,000 bps reduction compared to end-July 2023) as monetary conditions improved: (i) given the completion of the domestic debt restructuring in September 2023, and (ii) driven by lower auction sizes due to reduced government financing needs amid fiscal consolidation. Stable monetary aggregates allowed CBSL to remove restrictions on the use of standing facilities by market participants.

[6] Since the introduction of the new CCPI series with 2021 as the base.

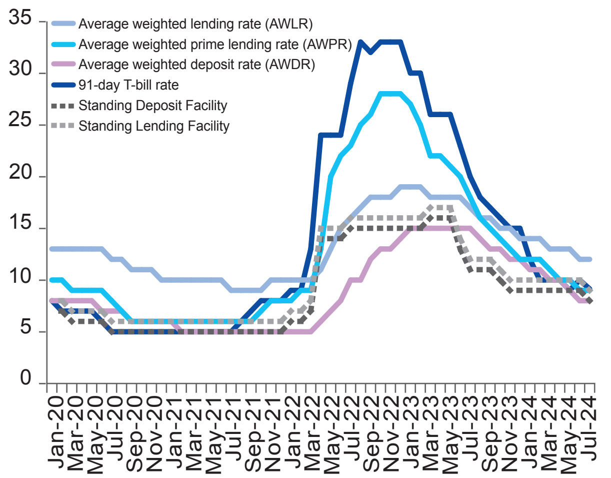
[7] Electricity tariffs were cut by 21.9 percent in March 2024, and further by 22.5 percent in July 2024. Water tariffs were cut up to 10 percent in August. Fuel prices (mainly petroleum and diesel) were also reduced, most recently in September.

Figure 8: Downward revisions in utility prices contributed to low inflation in 2024
(Inflation in percent y-o-y and percentage point contribution)



Source: Department of Census and Statistics, World Bank calculations

Figure 9: CBSL's accommodative stance pushed lending and deposit rates downwards
(Percent)



Source: Central Bank of Sri Lanka

Financial sector vulnerabilities remain high despite improved economic conditions

9. **Monetary policy easing and improvements in economic conditions contributed to the revival of financial intermediation in 2024.** Average weighted lending rates dropped from a maximum of 18.7 percent in December 2022 to 12.3 percent in July 2024, with interest rates for new lending at 11.5 percent. After continuous decline in 2023, and buoyed by economic growth, private credit growth (6.9 percent, y-o-y, July 2024) showed some signs of recovery, but remained sluggish (Figure 10). Some sectors that were heavily hit by the macroeconomic crisis, notably micro, small and medium enterprises (MSMEs), continue to face difficulties in repayment of existing debts and accessing credit at favorable terms. To support the private sector, the government is reforming credit infrastructure[8] and has launched a number of initiatives targeted at MSMEs, including the establishment of the National Credit Guarantee Institution. Average weighted deposit rates have decreased faster than lending rates, reaching 7.9 percent in August 2024, as compared to a maximum of 15.2 percent in May 2023, improving banks' net interest margins. Deposits grew by 12.1 percent (y-o-y) in June 2024, driven by improved economic conditions and a fall in macroeconomic uncertainty (Figure 11).

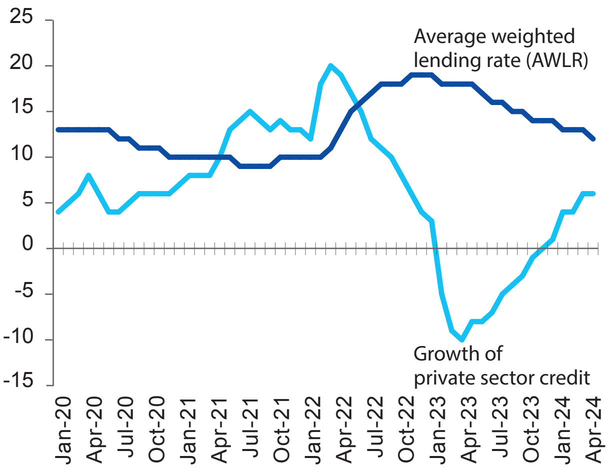
10. **Vulnerabilities in the banking sector persist on account of still-elevated sovereign exposures and asset quality pressures.** Despite some moderation and progress towards restructuring of specific SOE exposures, the sovereign-bank nexus remains large, with exposures to government securities and SOEs accounting for roughly 34 percent of total assets in June 2024. Total lending by commercial banks to the sovereign and SOEs increased by 8.9 percent (y-o-y, July 2024), with the majority of this in the form of lending to the sovereign. For most part of 2024, lending to SOEs declined, in part due to the tightening of lending standards to SOEs.[9] Despite some improvements, pressures on asset quality continue to be high, with NPLs/Stage 3 loans accounting for 12.9 percent of total loans in Q2 2024 (13.5 and 12.9 percent in Q2 and Q3 2023, respectively). Recognition and recovery of NPLs could be further delayed, given the temporary

[8] For example, the enactment of the Secured Transactions Act in April 2024 and the approval of the Insolvency Bill by the Cabinet of Ministers in September 2024.

[9] Between July 2023 and July 2024, lending to SOEs by commercial banks decreased by 39.1 percent, mostly driven by the restructuring of specific SOE exposures (including Ceylon Petroleum Corporation debt). In March 2024, the CBSL introduced a new regulation for large exposures, including to SOEs. While the regulation includes transitional arrangements, commercial banks have already taken steps in preparation for the new requirements.

Figure 10: Private sector credit growth has improved but remains sluggish

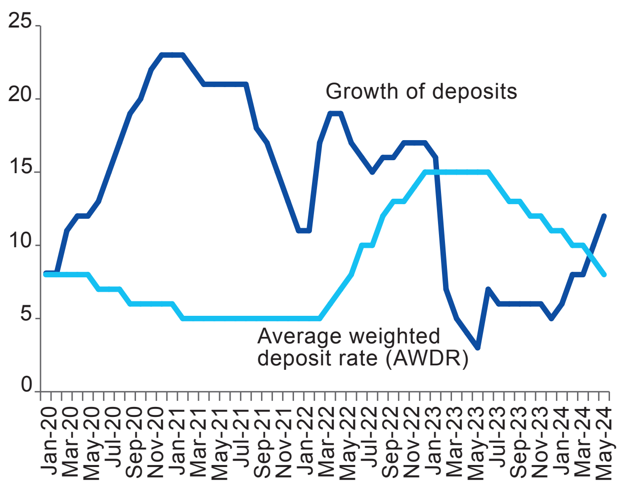
(Percent/percentage points, y-o-y)



Source: Central Bank of Sri Lanka, World Bank calculations

Figure 11: Deposits are increasing due to improved economic conditions

(Percent/percentage points, y-o-y)



Source: Central Bank of Sri Lanka, World Bank calculations

suspension of *parate* execution, a debt enforcement procedure used by banks, until 15 December 2024.[10] This may also lead to an overstatement in reported capital adequacy levels (17.9 percent in Q2 2024). Supported by stronger net interest margins, banks have observed modest improvements in profits, with return on assets at 1.1 percent during the same period. Liquidity positions remain stable with the ratio of liquid assets to deposits standing at 41.8 percent in Q2 2024 (41.1 percent in Q2 2023). Net foreign assets (NFA) of commercial banks improved – reaching Sri Lankan Rupee (LKR) 0.4 billion in July 2024, up from minus LKR 0.2 billion at end-2022. The share of foreign-currency liabilities and loans gradually declined over the last 12 months.

Strong FX inflows continue to boost liquidity

11. **Despite a widening merchandise deficit, inflows from tourism and remittances buoyed the current account.** The merchandise trade deficit increased by 18.3 percent (y-o-y) in the first seven months of 2024 as imports recovered faster than exports. Despite a decline in garment exports (amid weak global demand), merchandise exports increased by 5.6 percent (y-o-y) over this period (Figure 12). This was primarily driven by a spike in bunkering and aviation fuel exports as marine vessels are taking longer routes to avoid possible attacks in the Red Sea.[11] On the other hand, imports increased by 9.1 percent (y-o-y), as all import restrictions (except on vehicles) were lifted,[12] and improved economic activity led to an increase in imports of intermediate goods (primarily chemicals, plastics and base metals) and investment goods (primarily machinery and equipment) (Figure 13). The net balance on the services account improved as inflows (led by tourism and transport services) increased by 34.9 percent (or over US$1 billion), outpacing actual outflows, which increased 57.3 percent (y-o-y) from a low base. Earnings from tourism increased to US$2.2 billion in the first eight months of 2024 (or 66.1 percent, y-o-y), driven by tourist arrivals, which were up 50.7 percent (y-o-y). Remittances also continued to increase (by 11 percent, y-o-y), reflecting the high levels of emigration in recent years (Figure 14).[13] As external interest payments remained low, in line with the debt service suspension, the current account is estimated to have remained in surplus in the first seven months of 2024.

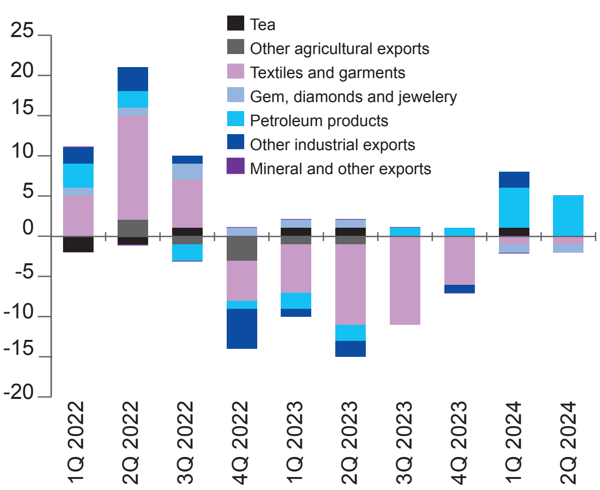
[10] The suspension of *parate* was introduced through amendments to the Recovery of Loans by Banks (Special Provisions) Act in May 2024 to provide relief to MSMEs.

[11] https://www.spglobal.com/commodityinsights/en/market-insights/latest-news/oil/032824-bunker-demand-rises-across-sri-lankan-ports-india-continues-to-grapple-with-supply-shortages

[12] Sri Lanka imposed restrictions on vehicle imports in 2020 due to COVID-19, and these measures were extended amid the economic crisis. Although exceptions were recently granted, such as allowing the tourism industry to import 1000 one-year-old vehicles and permitting expatriates to import electric vehicles, overall vehicle imports have largely remained restricted.

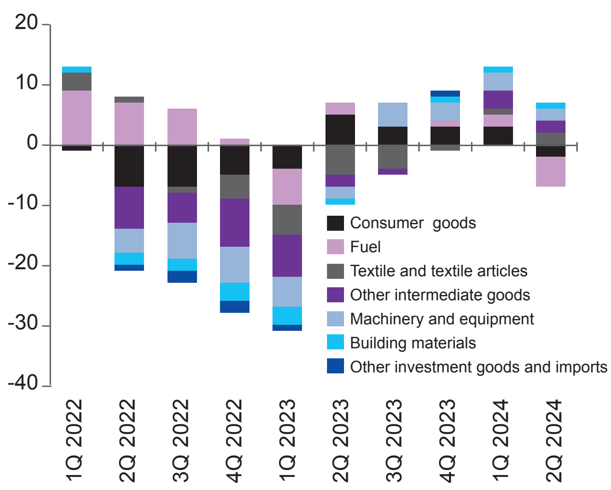
[13] A total of close to 1.2 million people departed for foreign employment between January 2019 and July 2024, of which 780,060 emigrated since January 2022.

Figure 12: The rise in petroleum product exports has been driving export growth
(Percent y-o-y/percentage point contribution)



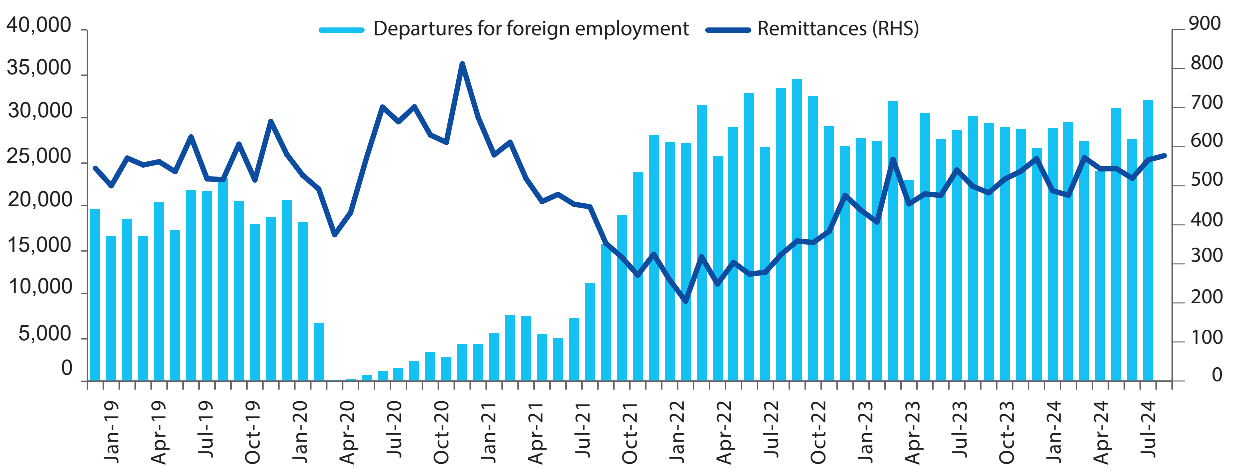
Source: Central Bank of Sri Lanka, World Bank calculations

Figure 13: Intermediate and investment goods have been driving the growth of imports
(Percent y-o-y/percentage point contribution)



Source: Central Bank of Sri Lanka, World Bank calculations

Figure 14: Remittances have been increasing in line with increased migration
(Departures, LHS) *(US$ million, RHS)*

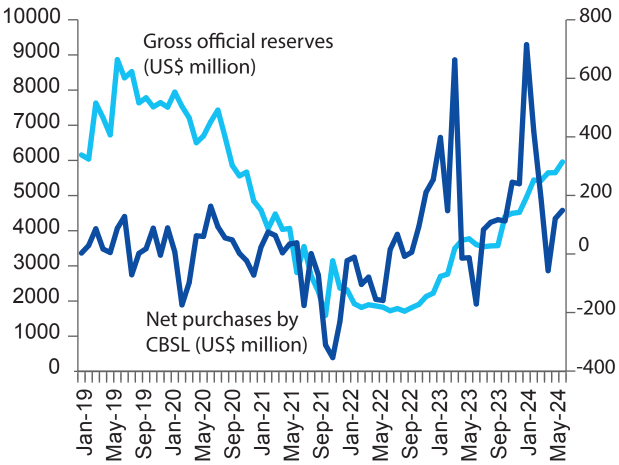


Source: Central Bank of Sri Lanka, Sri Lanka Bureau of Foreign Employment

12. **Inflows on the financial account, amid continued debt service suspension, contributed to an estimated balance of payments surplus and strengthened FX liquidity.** With the current account already in surplus, and most external amortization payments suspended, inflows from development partners, including the International Monetary Fund (IMF) and Asian Development Bank (ADB), are estimated to have contributed to a balance of payment surplus in the first half of 2024. Along with CBSL's net purchases of FX from the market (approximately US$2 billion in January-August 2024), usable gross official reserves (that exclude a currency swap equivalent to US$1.4 billion with China) increased to US$4.5 billion by end-August 2024, compared to US$500 million in December 2022 (Figure 15). This level of reserves is equivalent to three months of imports of goods and services. NFA in the overall banking system turned positive in May 2024 for the first time in four years, increasing from US$-6.4 billion in April 2022 to US$0.7 billion in July 2024 (Figure

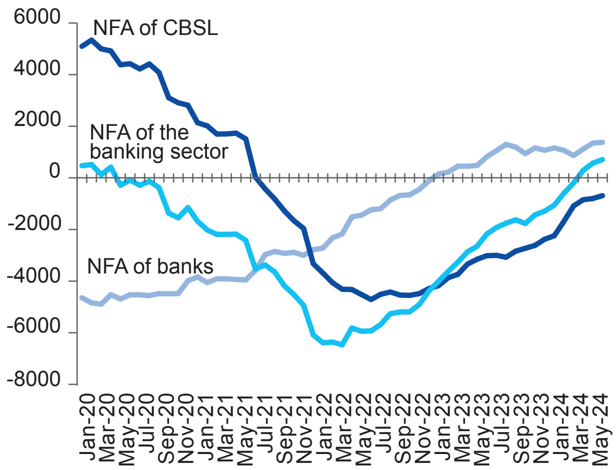
16). With improved FX liquidity, the rupee further appreciated by 7.3 percent between January and August 2024. The real effective exchange rate has stayed broadly stable.

Figure 15: CBSL continued to purchase FX
(US$ million, reserves) *(US$ million, net purchases)*



Source: Central Bank of Sri Lanka
Note: Sharp spikes in net purchases were driven by appreciations in the rupee.

Figure 16: NFA in the banking sector turned positive
(US$ million)



Source: Central Bank of Sri Lanka, World Bank calculations

The primary surplus increased as revenue performance was strong

13. **Increased revenues and careful management of expenditures strengthened the primary balance and led to a reduction in the fiscal deficit in the first half of 2024.** Tax revenue increased by 42.6 percent (y-o-y) in the first six months of the year, driven by higher VAT collection (from the rate increase, reduction in VAT registration threshold, and removal of VAT exemptions), revision of excise duty rates, an increase in collections from the Social Security Contribution Levy (from the threshold reduction), and as imports recovered (Figure 17). Primary expenditures (expenditures minus interest payments) only increased by 2.7 percent (y-o-y) – driven by elevated welfare costs and pension payments (as arrears were cleared) – and were offset by limiting capital spending and recruitment into the public sector (Table 1). While the interest bill declined (10.3 percent y-o-y reduction) in the first half of the year due to lower interest rates, it continued to absorb 66.8 percent of tax revenue. As a result of these measures the overall fiscal deficit declined by 51.8 percent (y-o-y) in H1 2024. With limited access to external sources, the deficit was primarily financed through domestic sources. The stock of public and publicly guaranteed debt increased 4.6 percent in the first six months of the year; however, the debt-to-GDP ratio is expected to have stayed broadly stable thus far, amid an economic recovery and exchange rate appreciation (Figure 18).

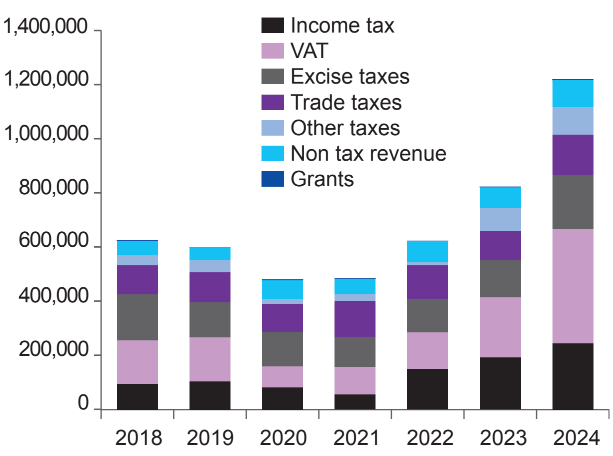
Table 1: Fiscal Operations Table, January–June 2024 *(Actuals)*

LKR billion	2023	2024	Change (percent)
Revenue and Grants	1,317	1,865	41.6
Revenue	1,315	1,861	41.5
Tax Revenue	1,199	1,709	42.6
Non Tax Revenue	116	151	30.4
Grants	2	4	83.4
Expenditure and Lending minus Repayments	2,560	2,463	-3.8
Recurrent Expenditure	2,326	2,218	-4.6
Capital and Lending minus Repayments	234	245	4.6
Primary Balance	31	543	1,668.9
Overall Budget Balance	-1,243	-599	-51.8
Memorandum items			
Public and Publicly Guaranteed Debt (US$ million)	91,460	100,646	10.0

Source: Ministry of Finance, Central Bank of Sri Lanka, World Bank calculations

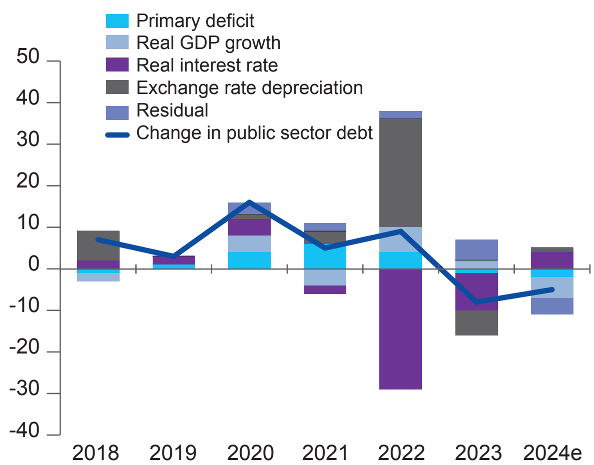
14. **Debt restructuring, essential to restore debt sustainability and regain market access, is making good progress.** In June 2024, the government signed agreements with the Official Creditor Committee (OCC, co-chaired by Japan, India, and France), and Exim Bank of China to restructure US$10 billion of debt. Progress was also made in negotiations with international bondholders. In September 2024, Sri Lanka and the Ad-Hoc Group of Bondholders (controlling approximately 50 percent of the aggregate outstanding amount of bonds) agreed on a 'joint working framework' proposal to restructure US$12.5 billion worth of International Sovereign Bonds. This proposal includes the use of a macro-linked bond (where debt service is contingent on Sri Lanka's macroeconomic performance). Domestic debt restructuring was completed in September 2023, and is expected to reduce annual GFN by 1.5 percent of GDP in 2027–2032, on average.

Figure 17: The revenue increase in the first four months of 2024 was driven by VAT
(LKR million, January-April)



Source: Ministry of Finance Mid-Year Fiscal Position Reports, World Bank calculations

Figure 18: Primary surplus and real GDP growth are expected to reduce debt-to-GDP in 2024
(Percent of GDP)

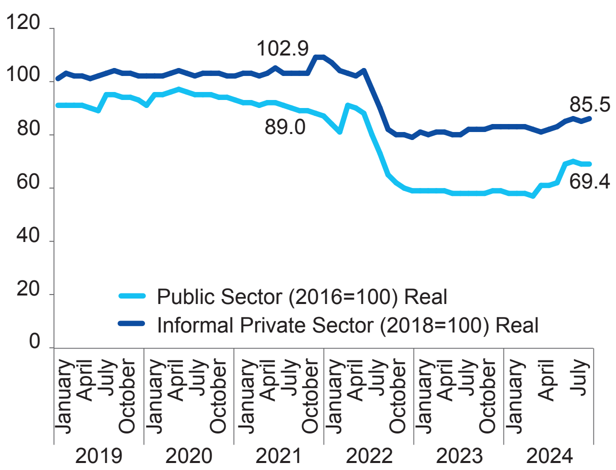


Source: Central Bank of Sri Lanka, World Bank calculations
Note: 2024 estimates are World Bank projections

Human development outcomes have deteriorated in the face of high poverty and falling LFP

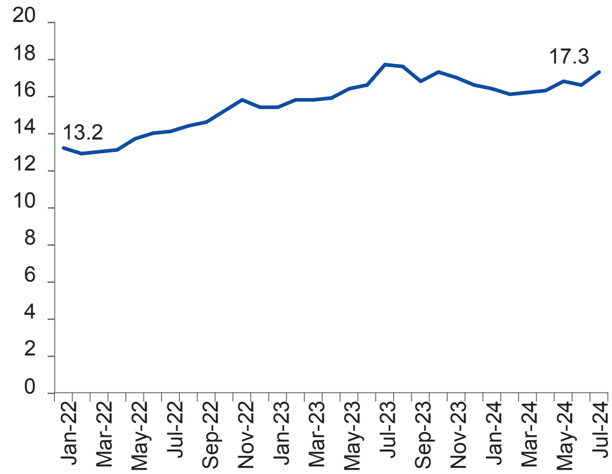
15. **Households' budgets have shrunk since 2019, leading to increases in malnutrition and child mortality.** While inflation has eased since its peak in 2022, prices remain high and moderate food insecurity remains elevated at 23.7 percent in 2023.[14] The effects of the crisis have been felt across the country and affected households not considered vulnerable before 2019. Poverty is projected to have tripled in urban areas. Notwithstanding a timid improvement in the first half of 2024, wages have contracted by 16.9 and 22 percent in the informal private and public sector, respectively, between July 2021 and 2024 (Figure 19). Together with job losses, this has resulted in generalized worsening of living conditions, including deteriorating health outcomes. 17.3 percent of children under five years of age were underweight in July 2024 (Figure 20), with rates as high as 24.7 percent in poorer districts like Nuwara Eliya (Figure 21) posing concerns over persisting structural inequalities. Stunting increased for children at all education levels (grade 1 through 10) between 2022 and 2023 and child mortality continued to increase in 2023.

Figure 19: Notwithstanding an improvement in recent months, real wages remain considerably below pre-crisis standards.
(Index)



Source: Central Bank of Sri Lanka

Figure 20: The share of children who are underweight continued to increase in H2 2024.
(Percent)

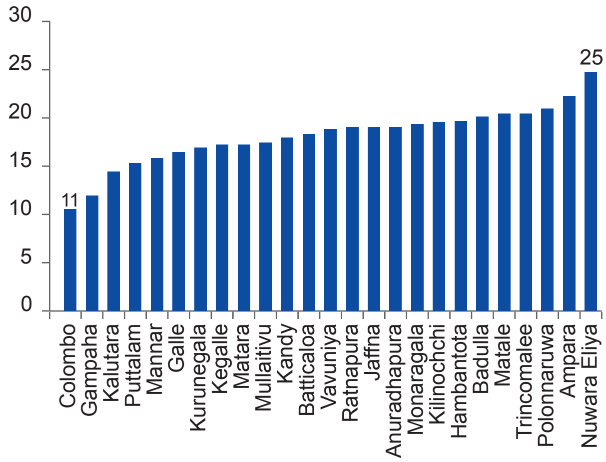


Source: Family Health Bureau Sri Lanka

16. **The labor market has not recovered.** LFP continued to decline from 49.9 percent in Q1 2023 to 47.1 percent in Q1 2024 nationally (down from 52.3 percent in 2019) and from 32.7 percent to 29.6 percent among women (Figure 22). Improvements in the tourism sector drove a marginal improvement in the share of the population employed in services (from 47.8 percent in Q1 2023 to 49.5 percent in Q1 2024). However, employment declined in agriculture (26.5 percent to 25.8 percent) and industry (25.3 percent to 24.7 percent) in Q1 2024 (y-o-y), exerting pressure on household income and domestic consumption.

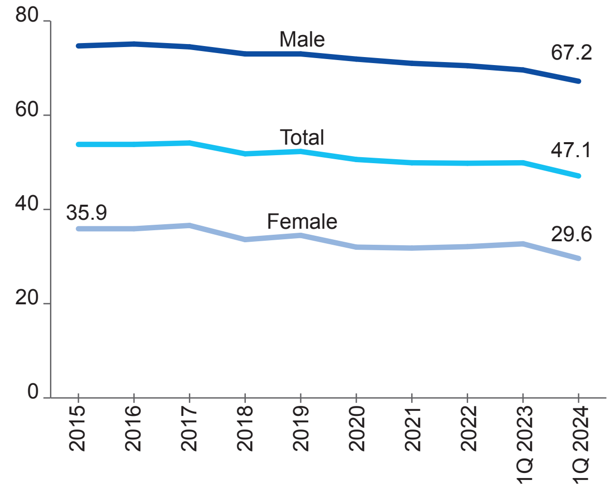
[14]https://docs.wfp.org/api/documents/WFP-0000158905/download/?_ga=2.78790292.109577589.1726807512476840235.1726807512

Figure 21: Share of children who are underweight is higher in poorer districts
(Percent)



Source: Family Health Bureau Sri Lanka

Figure 22: Female labor force participation is at the lowest level in a decade
(Percent)



Source: Department of Census and Statistics

17. **While key reforms - including utility pricing adjustments, new revenue measures, and debt restructuring - restored macroeconomic stability, they imposed additional burdens on the poor.** Although social protection reforms helped mitigate some of the regressive impacts, crisis-induced welfare losses exceeded what social assistance could cover, and crisis-induced poverty increased by 9.6 percentage points between 2019 and 2023 (Table 2). Of this, fiscal reforms related to indirect taxes, including the VAT, were particularly regressive, and contributed to a poverty increase of 3.9 percentage points. Social protection mechanisms are expected to have offset this increase, but data to assess their poverty-targeting performance is unavailable.

Table 2: Drivers of Poverty, 2019-2023

LKR million	Change in Poverty (percentage points)
Baseline: Poverty and Inequality in 2019	11.3
Impacts (cumulative)	11.3
COVID-19, 2020	1.4
COVID-19 aftermath, 2021	0.4
Economic crisis, 2022	9.6
Total fiscal reforms, mid 2022-mid 2023	-0.1
Direct taxes + Direct transfers	-4
Indirect taxes + Indirect subsidies	3.9

Source: Protecting Poor and Vulnerable Sri Lankans During an Economic Crisis: A Tough Balancing Act for Fiscal Policy (2024), World Bank

3. Outlook and Policy Priorities

The outlook for 2024 has improved but is subject to considerable policy uncertainty and downside risks, given limited buffers. Prospects for growth and poverty reduction depend on progress with debt restructuring, continued macro stability, and the sustained implementation of structural reforms.

Sri Lanka's path towards stability and sustainable economic growth remains narrow

18. **The short-term growth outlook has improved, but structural reform is needed to raise the medium-to long-term growth potential.** Faster than expected macroeconomic stabilization has improved the growth outlook to 4.4 percent (y-o-y) in 2024, as the economy continues to expand amid the rebound in industry and tourism, increased private credit, and improved supply conditions. However, scarring from the crisis is likely to drag on medium-term growth. Key issues are the departure of skilled workers overseas and limited external financing. Continued implementation of structural reforms will be key to raising the medium-to long-term growth potential. Poverty (below $3.65 per person per day, 2017 PPP) is expected to decline gradually as growth recovers but remain above 20 percent until 2026. Inflation is projected to remain in single digits, and well below CBSL's target of 5 percent in 2024, reflecting weak aggregate demand, improving supply conditions, lower global commodity prices, and discontinued monetization of deficits. It will gradually increase towards the target as demand conditions improve. However, faster than expected depreciation could raise inflation. Demand for credit and deposit growth are expected to continue to increase, though demand may be impacted by business uncertainty linked to the electoral cycle.

19. **The current account is projected to remain in surplus in 2024, but face pressures as imports pick up and external debt servicing resumes.** The current account surplus will be driven by rising tourism and remittance flows, with the restriction on importing personal vehicles only being phased out from 2025. Over the medium-term, pressures on the current account are expected to rise with the liberalization of vehicle imports, increase in consumption goods and other imports as economic activity picks up, and resumption of full external debt servicing (post-restructuring). Reserve accumulation is expected to continue, supported by sustained inflows from tourism, remittances and development partners.

20. **Fiscal consolidation is expected to continue, although the financing needs will remain high in the medium-term.** The primary balance is projected to strengthen further to 1.6 percent of GDP in 2024 and move towards the IMF Extended Fund Facility (EFF) target of 2.3 percent of GDP in 2025. The overall fiscal deficit will decline through 2024 and beyond, as the interest bill falls. However, interest payments will continue to take up half of the revenues collected in the 2024-27 period. Post-restructuring, debt is expected to decline to 106.2 percent of GDP in 2024, 102 percent by 2027, and gradually decline towards 95 percent in the outer years – in line with the targets set by the IMF EFF program. The GFN will remain high in the medium-term (approximately 20.8 percent of GDP on average between 2024 and 2027), with reductions in the outer years, and is projected to stay below the IMF EFF target (an average of 13 percent of GDP in 2027–32). However, this reduction in the GFN hinges on government's ability to replace maturing T-bills (currently 13.2 percent of GDP)[15] with longer-term Treasury-bonds, which is subject to the absorptive capacity of the domestic market.

21. **Given limited fiscal and external buffers, downside risks remain high.** Policy uncertainty (including the direction and pace of policy reform, as well as the potential fiscal impact of electoral promises), reform reversals, inadequate domestic revenue mobilization, and limited external financing support are key risks to maintaining stability, regaining a sustainable growth path, and bringing Sri Lanka back to pre-crisis rates of poverty reduction. A protracted or insufficiently deep debt restructuring could also exert continued pressure on GFN targets. Adverse weather conditions from the expected La Niña event in late 2024 could affect agricultural production and food prices, and hence food security. Medium-term scarring effects of the crisis are potentially high due to the loss of jobs, ongoing depletion of human capital, and the impact of food insecurity and lower spending on health and education on future human capital. On the upside, a strong and sustained implementation of structural reforms could boost confidence and attract fresh, non-debt-creating capital inflows. Potential earnings from tourism remain high, as current levels are well below those at the peak of the tourist boom in 2018-19.[16] Finally, underutilization of the amounts included for bank recapitalization in the 2024 budget may provide further upside to the primary balance.

Continued reform implementation is central to preserving macroeconomic stability and economic gains

22. **Policy consistency and continued implementation of the current fiscal measures are critical to ensure a sustainable fiscal adjustment.** *First*, the gains in domestic revenue mobilization need to be preserved to sustain the improved fiscal balances and safeguard fiscal resilience, while improving progressivity. In-year policy consistency of tax policy is needed to support the recovery in investment. Deviations from the agreed fiscal consolidation path (including through the potential fiscal impact of any tax and public sector wage changes) need to be carefully assessed. *Second*, continued tax administration reforms to strengthen tax compliance and enforcement are critical to support the revenue-based fiscal adjustment and, ultimately, broaden the tax base and shifting revenue collections from indirect to direct taxes which are more progressive. *Third*, improved transparency, through the regular publication of criteria for providing tax incentives and the amount of foregone revenue, will improve accountability and tax progressivity.[17] *Fourth*, with the enactment of the new Public Debt Management Law and the establishment of the Public Debt Management Office (expected by end-December 2024), improved debt management and transparency practices – including passage of relevant regulations for the granting of sovereign guarantees and on-lending – will contribute to better borrowing decisions and ensure that debt remains sustainable over the medium to long-term. *Finally*, addressing fiscal risks associated with SOEs remains critical for stability. The introduction of cost-reflective utility pricing, including for electricity, fuel and water in 2022, curbed the recurrent losses of SOEs. Continued enforcement of cost-reflective utility pricing is needed to further improve the financial position of SOEs.

[15] End-August 2024

[16] Subject to the swift resolution of visa issues.

[17] The one-off tax expenditure statement published by the government suggests that approximately 50 percent of 2022 tax revenue was foregone as a result of tax incentives.

23. **Monetary and financial sector policies need to continue to support macroeconomic stability.** While the elimination of monetary financing and enactment of a new Central Bank Law will contribute to monetary stability, consistent monetary policy is essential for continued macroeconomic stability. Monetary policy needs to be managed carefully to ensure that additional monetary loosening does not lead to inflationary pressures. Financial sector risks need to be carefully monitored as NPLs and exposure to the sovereign remain high and continue to hinder financial sector stability. Continued implementation of key reforms, including the Central Bank of Sri Lanka Act that came into force in September 2023, and the amended Banking Act that came into force in June 2024, will be crucial for further stabilization of the banking sector. Further structural financial sector reforms, including reinforcing adequacy of bank capital and strengthening the governance and oversight of state-owned banks, will be critical to deepen financial intermediation to the private sector and ensure the sustainable recovery of the sector and broader economy. Exchange rate flexibility needs to be the first line of defense to facilitate external adjustments and continue to rebuild international reserves.

24. **Poverty outcomes will hinge on reform design and sequencing, and the adequacy and targeting of compensating transfers.** A strong economic recovery and more equitable fiscal consolidation are needed to revert the welfare losses experienced during the crisis. Future reforms aimed at restoring pre-crisis poverty reduction rates need to focus on three areas: (i) more progressive revenue mobilization measures, (ii) improved targeting of cash transfers and fertilizer subsidies programs, and (iii) structural reforms aimed at job creation and increasing LFP. More equitable fiscal reforms could include measures aimed at increasing revenue mobilization via direct rather than indirect taxation. While cash transfers helped offset some of these effects, continued improvements to the targeting formula are needed. Better income-based targeting of fertilizer subsidies would help reach those farmers who are most in need of support. Finally, reforms that support private sector growth and ease constraints to female labor force participation (FLFP, see Box 2) will contribute to more equitable growth. Restoring income growth at the bottom of the distribution will be key for long-term growth and sustained poverty reduction.

Structural reforms are needed to address long-standing weaknesses and the root causes of the crisis

25. **Enhancing competitiveness is critical to return to a sustainable growth path.** Continued implementation of reforms that support trade and investment are necessary to enhance competitiveness and enable private sector-led growth (see Special Topic). Further implementation of SOE reforms is needed to address the fiscal, financial stability and governance-related risks posed by SOEs, as well improve the country's competitiveness. This includes measures to restructure the balance sheets of selected key SOEs; strengthen regulatory and institutional frameworks and introduce competition into key sectors, leading to better pricing and services to consumers; improve governance frameworks, accountability and transparency mechanisms; and explore opportunities to increase private participation in SOEs engaged in commercial activities. Measures to develop the financial sector more broadly, as well as strengthen the digital economy, including mobilizing private capital and competition in the broadband market, will also help enhance productivity and competitiveness, and improve service delivery.

Box 2: Increased FLFP can contribute to more inclusive growth

Like other countries in the region,[18] Sri Lanka exhibits large FLFP gaps (32 percent compared to 71 percent for men in 2022). Women have higher unemployment rates, lower wages, and their work is concentrated in the informal sector. Furthermore, FLFP has declined over time. The *South Asia Development Update* (October 2024) suggests that raising women's labor force participation rate to parity with men would increase regional GDP by 13-51 percent, with larger impacts if capital and labor markets are more flexible. While the reasons for these gender gaps are complex, Sri Lanka's current legal framework, which includes many explicit restrictions on women's employment, is likely a contributing factor. For example, the Shop and Office Employees Act (1954) restricts the number of working hours for female employees and their ability to work at night in specific sectors.

There are current efforts underway to address these challenges. The Ministry of Labor is working to overhaul labor legislation to address, among other issues, barriers to women's employment through the proposed Sri Lanka Unified Labor Law (ULL or Employment Act). These changes span across three dimensions specifically to address: relaxing restrictions on overtime work, enabling women to work at night, and allowing part-time work to be recognized as formal. This legislation would likely have a positive impact on gender equality and women's participation in the workforce. Empirical evidence from other Asian countries shows that relaxing regulations on overtime and nighttime work can increase women's participation in the labor force, and that better options for job flexibility reduce the probability of women leaving the labor force.

In July 2024, Parliament enacted the Women Empowerment (WE) Act, No. 37 of 2024, which aims to reduce legal discrimination on the grounds of gender in several key areas of social, economic, and political participation. It complements the labor legislation reforms being pursued through the ULL by establishing a framework to enforce the implementation in Sri Lanka of the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW). The WE Act includes specific clauses to address inequalities in women's economic participation and discrimination in the workforce. This includes ensuring women's equal rights to the same employment opportunities and remuneration as men. For example, the WE Act allows the government to adopt regulations necessary to reduce gender-based discrimination in the workplace. The WE Act also directly prohibits discrimination based on gender in employment and promotes revision of laws and procedures to ensure equal salaries between men and women engaged in employment with equal value.

Other ongoing reforms include the establishment of the National Commission on Women (NCW). The NCW will monitor the implementation of anti-discriminatory measures in state institutions, non-state entities, and the private sector. Importantly, the WE Act includes a provision to allow the NCW to investigate reported discriminatory employment practices, enabling women to obtain redress against such practices. Both the new (WE) Act and establishment of the NCW constitute critical intermediate steps to the prospective passage of the Employment Act.

[18] See South Asia Development Update, October 2024

Table 3: Key Economic Indicators (annual percent change unless indicated otherwise)

LKR million	2021	2022	2023	2024f	2025f	2026f
Real GDP growth, at constant market prices	4.2	-7.3	-2.3	4.4	3.5	3.1
Private consumption	2.7	-0.5	-1.6	2.2	2.6	2.9
Government consumption	-2.8	1.4	-5.4	-0.1	2.4	1.8
Gross fixed capital investment	6.5	-24.5	-8.4	14.0	7.0	4.6
Exports, goods and services	10.1	10.2	12.0	4.3	3.6	3.4
Imports, goods and services	4.1	-19.9	6.5	4.7	3.9	3.7
Real GDP growth, at constant factor prices	3.9	-7.0	-2.6	4.4	3.5	3.1
Agriculture	1.0	-4.2	2.6	1.5	1.5	1.5
Industry	5.7	-16.0	-9.2	10.4	6.4	4.1
Services	3.4	-2.6	-0.2	2.3	2.5	2.9
Inflation (consumer price index)	6.0	46.4	17.4	3.0	4.5	5.1
Current account balance (% of GDP)	-3.7	-2.0	1.8	..	..	..
Net foreign direct investment inflow (% of GDP)	0.7	1.2	0.8	-0.9	-1.0	-1.0
International poverty rate ($2.15 in 2017 PPP)[a]	1.5	4.1	5.2	4.3	3.5	3.3
Lower middle-income poverty rate ($3.65 in 2017 PPP)[a]	13.1	22.7	25.9	23.4	21.3	20.1
Upper middle-income poverty rate ($6.85 in 2017 PPP)[a]	51.2	64.4	66.6	64.3	63.3	62.0
GHG emissions growth (mtCO2e)	1.2	-5.8	-2.4	6.2	6.1	5.9
Energy related GHG emissions (% of total)	59.7	57.8	56.2	58.5	60.7	62.7

Source: Central Bank of Sri Lanka, Department of Census and Statistics, OECD, Climate Analysis Indicators Tool, World Bank calculations
Note: e = estimate, f = forecast.
a/ Calculations based on SAR-POV harmonization, using 2019-HIES. Actual data: 2019. Nowcast: 2020-2023. Forecasts are from 2024 to 2026.

B. Opening Up to the Future

Key Messages

- Sri Lanka's inward turn over the past two decades has led to a sharp fall in the role of trade in GDP, as the country erected trade barriers that raised effective rates of protection, reduced incentives for exports, and led to an appreciated real exchange rate.
- Sri Lanka could miss opportunities created by shifting GVCs due to low performing exports and the inability to attract export-oriented domestic and foreign investment.
- To take advantage of these opportunities, trade and investment policy must:
  - Reduce and sustain low trade tariffs to incentivize export activities
  - Implement an NSW to reduce the time and costs of engaging in international trade
  - Adopt a modern investment regime focused on attracting export-oriented investments
  - Develop complementary labor market policies, and
  - Address governance challenges including the prevalence of discretionary tax exemptions.

1. Introduction

26. **Sustained medium- to long-term growth requires greater private investment, higher exports, and productivity growth.** High rates of total investment that drove Sri Lanka's economic growth over the previous decade have proved difficult to sustain as they led to high current account deficits and rising external debt. Years of low export growth and limited diversification, due to inward-oriented policies, also contributed to this. The declining growth rate of the working age population has lowered employment growth, and with depleted national savings and ongoing fiscal consolidation limiting public investment, greater private investment and better export and productivity growth are needed for improving growth prospects. Higher FDI inflows can help revive private investment and diversify and expand exports.

27. **Achieving Sri Lanka's untapped merchandise export potential of US$10 billion annually would create jobs and help contain macroeconomic imbalances.** Missing exports are estimated by comparing actual merchandise export levels with export potential.[19] Engaging further with the global economy to tap into regional and GVCs could help speed up economic recovery, create an additional 142,500 jobs and generate US$8.5 billion net inflows of FX.[20] To reach this untapped export potential, Sri Lanka would need to liberalize trade, attract more and better investments, improve trade facilitation, and increase the competitiveness of domestic firms.

28. **The external sector underperformed over the last decade with stagnant export values, lack of product diversification, and little FDI.** Growth of goods exports was negligible – 2.2 percent per year on average over the last decade – and total goods exports averaged around US$11.4 billion through that period. Five products (textiles, tea, coconut, spices, and rubber products) accounted for two thirds of exports – a share that has barely changed since 2013. Attracting FDI, a key enabler of export performance, has been a challenge for Sri Lanka. As exports and FDI are a platform for productivity growth, Sri Lanka has missed out on new technologies and know-how typically associated with FDI.

29. **Sri Lanka has an opportunity to capitalize on shifts in GVCs precipitated by ongoing geopolitical shifts, supply chain disruptions, and geopolitical instability.** Global trade is rebounding, with a projected 2.6 percent growth in 2024 and expected growth of 3.3 percent in 2025. Heightened perceptions of geopolitical risks, labor cost increases in China, and disruptions of social unrest in the region have prompted companies to diversify their sourcing strategies in some labor-intensive manufacturing sectors in which Sri Lanka has a comparative advantage (see Box 3). To make the most of these new opportunities, however, the country's trade policy should: (i) reduce and sustain low tariffs to incentivize export activities to reduce input costs for exporters; (ii) implement a NSW to reduce the time and costs of engaging in international trade; (iii) adopt a modern FDI regime focused on attracting export-oriented investments; and (iv) establish complementary labor market policies, and (v) address governance challenges (e.g., the prevalence of discretionary tax exemptions).

[19] Sri Lanka's export potential is estimated using a gravity model, with data for 105 countries over the 2000-2017 period. The gravity model can be used to assess how much each country pair is expected to be trading based on their observable characteristics. Using information on actual exports and comparing them to predicted flows obtained from a gravity regression can be used to evaluate a country's export performance and quantify the missing exports. However, results need to be carefully interpreted as countries' performances depend on which variables are included in the gravity regression.

[20] Varela 2021

Box 3: Implications of geoeconomic fragmentation for South Asia

The global economy is fragmenting along geopolitical lines. Over the past decade, the share of trade and FDI between countries with similar geopolitical stances has been growing (Gopinath et al. 2024; IMF 2023).[21] Simultaneously, restrictions on international trade and financial transactions *between* geopolitical blocs have been rising (IMF 2023). Geopolitical concerns are creating incentives for firms to reorganize and diversify their supply chains.

For most South Asia region (SAR) countries, exposure to geopolitical shocks is limited by their generally low openness to global trade and investment. Except for Maldives, they have limited portfolio investment liabilities and are among the least open EMDEs to global trade, FDI, and lending from global banks. Partly this reflects policy decisions such as South Asia's above-average FDI-restrictions, capital controls, tariffs, and customs delays.

Trade and investment outcomes were further limited by below-average growth in SAR countries' main export markets and FDI sources. Most SAR countries exported little to China (one of the fastest growing economies) over the past decade. For Sri Lanka, exposure of FDI to China is higher than in other EMDEs, yet its export exposure is lower than elsewhere. The relatively higher exposure to the US and Europe means that Sri Lanka faces slower export growth than the average EMDE. SAR countries also face geoeconomic risks from services exports, which account for an above-average share of GDP, and are particularly vulnerable to geopolitical tensions as they are closely linked to buyers' trust.[22] Sri Lanka's reliance on tourism, and potential for service exports (see Section 3), exposes it to these risks.

While the lack of openness limits vulnerabilities, it also limits SAR countries' abilities to take advantage of the reshaping of GVCs that is underway. Despite low levels of trade and FDI, most SAR countries are in or near the quartile of EMDEs with the most geopolitically *diverse* export markets, FDI sources, and portfolio investment sources.[23,24] Further, since 2016, India, Pakistan, Sri Lanka, and Bhutan have widened the geopolitical spectrum of their export markets and FDI sources. With above-average export concentration towards the US and Europe, and above-average concentration of FDI from China, Sri Lanka shares characteristics of 'connector countries' that are able to navigate and benefit from relationships across different geopolitical blocs.[25] Removing obstacles to trade and foreign investment, improving infrastructure and logistics, and increasing institutional effectiveness can help Sri Lanka and other SAR countries integrate further into global supply chains.

Source: World Bank 2024a. South Asia Development Update, October 2024.

2. Missing Merchandise Exports and the Untapped Trade Potential

30. **Sri Lanka's 'missing' merchandise exports stand at US$10 billion.** Given Sri Lanka's observable characteristics (economic size, level of development, remoteness, factor endowments) potential exports are estimated at about US$20.1 billion (about twice the current level).

31. **At destination level, the largest portion of untapped export potential lies in Asia.** In 2020, 70 percent of missing exports for Sri Lanka were accounted for by five destinations: China (US$3.5 billion), India (US$1.5 billion), Japan (US$1 billion), Indonesia (US$0.7 billion) and South Korea (US$0.5 billion). This points to a lack of active trade diplomacy in the region. Sri Lanka is exporting at potential to the USA, UK and Germany.

32. **At sector level, except for clothing, plastics, and rubber, most sectors show missing exports.** It is estimated that the missing exports are mostly in manufacturing, particularly in machinery and equipment,

[21] The geopolitical distance between two countries is measured using UN voting patterns (Bailey et al 2017). See World Bank 2024a.
[22] Bhattacharya, Patnaik, and Shah 2012; Wagner 2014
[23] Using the geoeconomics connectedness index, which measures the standard deviation of partner countries geopolitical stances.
[24] Official statistics may exaggerate the diversity of South Asia's FDI sources in case FDI is indirectly channeled via certain countries.
[25] Gopinath et al. 2024; Freund et al. 2023

and to a lesser extent in minerals, metals, and chemicals. Clothing exports are substantially above potential, consistent with the historic pattern of specialization of the economy.

33. **The export sector in Sri Lanka could potentially create an additional 142,500 jobs if potential is tapped.** Of these, 19,000 jobs could be created in agriculture exports, and 123,500 in manufacturing exports.[26] While some of these jobs could be newly created, others may involve the reallocation of labor from lower productivity, domestic-oriented firms, to higher productivity, export-oriented firms.[27] This also suggests a positive revenue impact once the impact of the additional exports on corporate profits is accounted for.

Myth 1: Sri Lanka has always been inward-oriented

Sri Lanka's missing exports are a recent phenomenon, as the country has become more inward-looking over the past two decades. In fact, actual and potential exports were aligned in the early 2000s. Since then, exports performed poorly, even as other Asian countries became highly successful exporters. The ratio of trade to GDP fell from 88.6 percent in 2000 to 42.8 percent in 2023, and exports as a share of GDP fell from 39 to 20.5 percent (Figure 23). The share of Sri Lanka's exports of goods and services in world exports also fell precipitously (Figure 24).

Figure 23: Trade as a share of GDP has fallen by more than half since 2000

(Percent of GDP)

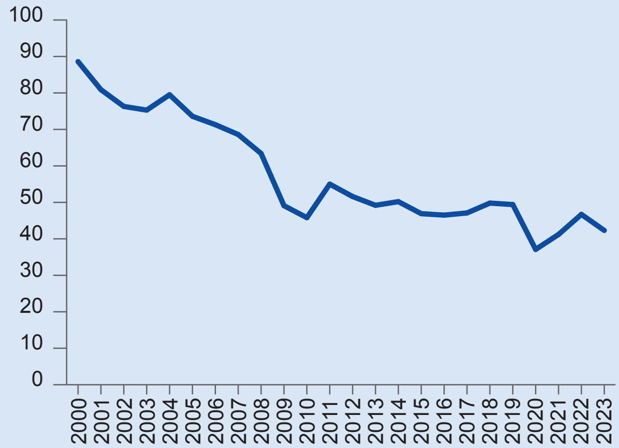
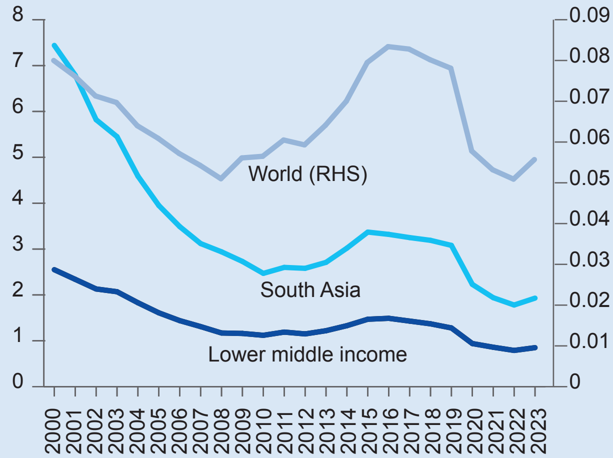


Figure 24: The share of Sri Lanka in global and regional exports has declined

(Percent)



This poor export performance is largely due to the country becoming more inward orientated and adopting a more restrictive FDI policy. In 1978, Sri Lanka was one of the first countries in the region to adopt policies that led to liberalization and opening of the national economy – including, for example, by establishing the Greater Colombo Economic Commission. However, following years of conflict, persistent savings deficits, the erosion of a domestic revenue base,[28] and lobbying for protectionism by influential groups, there was pressure by the early 2000s to collect additional revenue from tariffs.[29] Increasingly higher para-tariffs were imposed on top of existing customs duties,[30] appreciating the real exchange rate, and making exports relatively less profitable than import substitutes and/or non-tradables. New laws nationalized several foreign-owned firms and restricted the extent of foreign ownership.

Source: World Development Indicators, World Bank calculations

Source: World Development Indicators, World Bank calculations

[26] This estimate draws on the elasticity of jobs creation to exports derived from the "Jobs Content of Exports" (JOCEX) dataset (Cali, M. et al 2016).

[27] Export oriented firms in Sri Lanka are likely substantially more productive than comparable domestic-oriented firms. This is a pattern observed across the world.

[28] Moore 2017

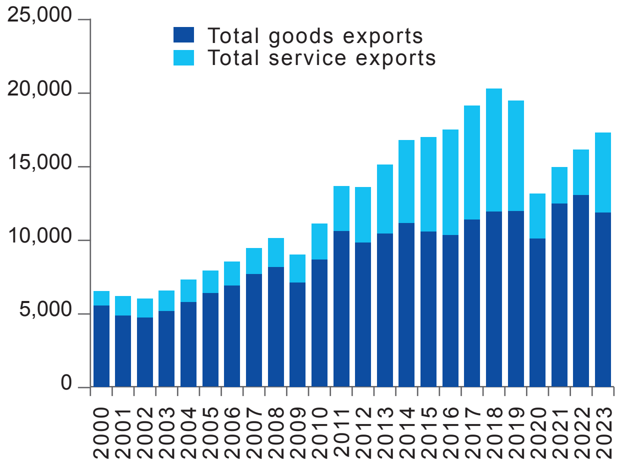
[29] Athukorala 2024

[30] Total nominal protection rate (customs duty + para-tariff) went up slightly between 2002 and early 2004, driven ostensibly by revenue considerations, but then more than doubled soon after. After 2009, additional tariffs were imposed on manufactures on a case-by-case basis driven most likely by domestic producers' interests where imports competed with domestic production (Pursell and Ahsan 2011; Athukorala 2017).

3. Key Export Sectors Face Considerable Challenges

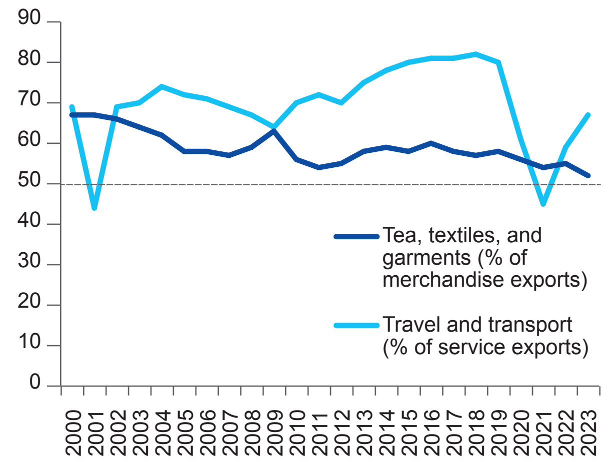
34. **Between 2010 and 2023, total exports of goods and services grew at an average annual rate of around 5.8 percent a year.** Of this, merchandise exports grew at an annual average of only 4.4 percent (to US$11.9 billion in 2023), compared to service exports, which grew at an annual average of 12.6 percent (to US$5.4 billion in 2023) (Figure 25). Agricultural exports virtually stagnated and industrial exports grew at a moderate 5 percent a year. There has also been little export diversification. Clothing and tea still accounted for two-thirds of goods exports, while transport and travel account for four-fifths of service exports before the COVID-19 shock and economic crisis (Figure 26).

Figure 25: Exports of services have on average grown faster than goods
(US$ million)



Source: Central Bank of Sri Lanka, World Bank calculations

Figure 26: Exports of goods and services have seen little diversification since 2000
(Percent y-o-y)



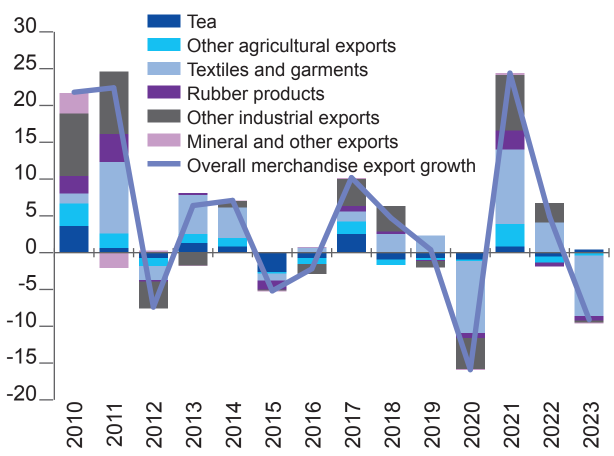
Source: Central Bank of Sri Lanka, World Bank calculations

35. **None of the key agricultural exports experienced much export growth in 2010–24.** Tea exports – the single largest item, amounting to slightly over half of agricultural exports on average during the period – declined, which is surprising given Sri Lanka's intrinsic advantages and rising world tea exports in which some Asian and African countries increased their share. Furthermore, tea production was affected by the fertilizer ban in 2021, and productivity challenges remain high. As a result, the industry has struggled to maintain its competitiveness in the global tea market.[31] The remaining agricultural exports were comprised mainly of coconuts, spices, and seafood – each of which grew only modestly. There is potential for greater value chain development across various product categories in agriculture, including for coconuts and cinnamon. Further, increasing the quality of agricultural exports and their compliance with international standards is critical since most agricultural exports fetch low prices in international markets. Increasing export quality and standards compliance would demand investments in technology, development of the national quality infrastructure, employee training, and traceability systems to comply with new environmental requirements like the EU regulation on deforestation-free products (EUDR).

36. **Industrial exports have grown slowly and diversified little.** On average, during 2010–23, slow growth in industrial exports accounted for the weak performance of exports overall, as it comprised three-quarters of goods exports (Figure 27). Clothing – the most successful manufactured export – grew at only 3.7 percent a year during 2010–23, and lost world market share in 2010–19 (Annex 3). Furthermore, the share of sophisticated manufactured products in the export basket is low, as indicated by Sri Lanka's ranking of around 80 (in recent years) among 133 countries based on the Economic Complexity Index (ECI).[32] Sophisticated goods provide more opportunities to upgrade vertically within a sub-sector (e.g., machinery versus clothing) and generate more inter-industry spillovers and faster export and productivity growth.[33]

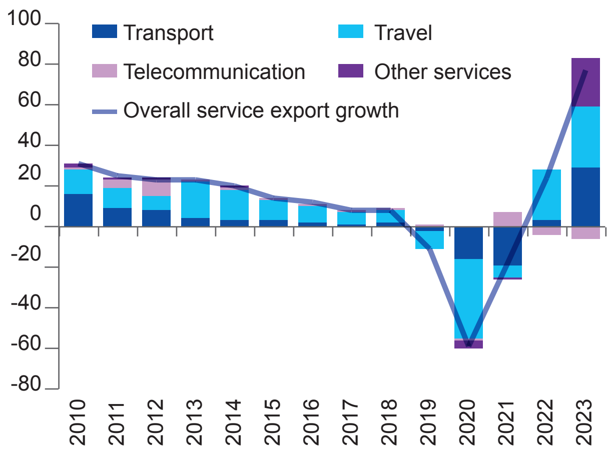
[31] Ariyaratne, S. 2023.
[32] The ECI captures the idea that more complex export products require highly specific inputs (such as knowledge, trained labor, infrastructure, intermediate goods, property rights, regulatory framework, etc.), which are also linked to moving up global value chains.
[33] Hidalgo et al 2007.

Figure 27: Growth of goods exports has been volatile
(Percent and percentage point contribution, y-o-y)



Source: Central Bank of Sri Lanka, World Bank calculations

Figure 28: The over-reliance on a few services has made service export growth more sensitive to shocks
(Percent and percentage point contribution, y-o-y)



Source: Central Bank of Sri Lanka, World Bank calculations
Note: Other services include construction, insurance and pension services, and financial services, among others.

37. **Service exports remain below potential.** Sri Lanka's exports of services grew faster than those of goods, driven by travel and transport. During 2010–2023, transport and logistics exports grew at an annual average of 10.8 percent (to US$1.5 billion in 2023) and computer, telecom, and information service exports at 8.8 percent a year (to US$0.9 billion in 2023). In 2023, traditional exports (travel and transport services) comprised about 80 percent of total service exports, and modern services accounted for 20 percent, similar to the shares in 2010 (Figure 28).[34] Potential for higer value addition, for example, in tourism (through destination development, and creating linkages with local communities and SMEs) is high. Addressing the constraints faced by key sub-sectors (see Annex 3) can help boost service exports.

Cross-Cutting Challenges

38. **The growth and diversification of Sri Lanka's exports, particularly manufactured goods, was restricted by protection.** High import tariffs made import substitutes relatively more profitable than exports, creating an anti-export bias. Protection was mostly driven by the imposition of para-tariffs on top of the existing custom duties. The manufacturing sector was the most protected, with an effective rate of protection (ERP) of 63 percent (2015).[35] Estimates of ERP for 105 disaggregated subsectors show that the top ten most protected subsectors in manufacturing (with ERPs ranging between 170 and 524 percent) did not represent strategic developments or high employment activities (Table 4). More than likely, they reflect the subsector's ability to lobby for protection to increase profits.

Table 4: Top Ten Most Protected Subsectors in Manufacturing

Ranking	Sector
1	Processing and preserving fruit and vegetables
2	Manufacture of bakery products
3	Manufacture of macaroni, noodles, couscous, and similar products
4	Manufacture of refined petroleum products
5	Manufacture of refractory products
6	Distilling, rectifying, and blending of spirits & manufacture of wines
7	Manufacture of other porcelain and ceramic products
8	Manufacture of articles of concrete, cement, and plaster
9	Manufacture of soft drinks, mineral water, and bottled waters
10	Manufacture of dairy products

Source: IMF 2018

[34] Modern services consist mainly of computer and telecom (ICT) services, finance, insurance, and real estate services, as well as other business and professional services.
[35] Athukorala 2017

39. **The export sector in general was also challenged by an appreciated real exchange rate.** High import tariffs and high domestic spending on infrastructure contributed to the rupee remaining at appreciated levels between 2006 and 2015, despite low productivity growth. This trend in the exchange rate has continued in recent years, and discouraged exports.[36]

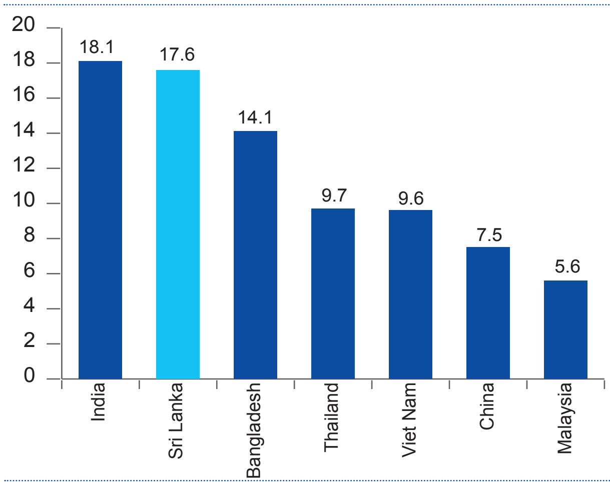
40. **Lack of capacity in export processing zones (EPZs) and restrictions on FDI discouraged investments in the manufacturing sector.** Only a small share of the reduced FDI inflows in the post-conflict (2010–19) period went into manufactured exports, as most were ploughed into real estate and telecommunication infrastructure. The government's acquisition of several foreign investments under a new 2011 law weakened investor confidence. Fully foreign owned investments were subject to various restrictions, and in several subsectors – such as logistics, tea, rubber processing and fishing – only minority foreign ownership was permitted. This deprived the country of FDI that could boost its ability to upgrade exports and increase the share of sophisticated items in its export basket. Furthermore, the land and infrastructure capacity in existing EPZs, especially those in favorable location, remains a constraint.

4. Addressing Key Challenges through Reforms

4.1. Lower tariffs will increase incentives to export and improve exporters' access to imported inputs

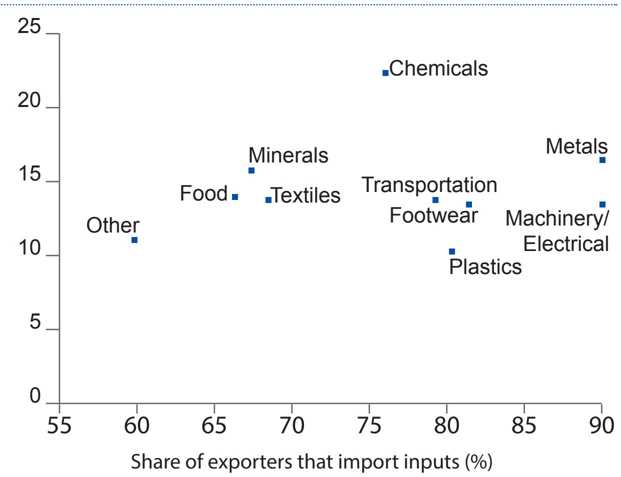
41. **High tariffs create anti-export bias and make it harder for exporters to access inputs at competitive prices.** Sri Lanka has one of the most protective and complex tariff systems in the world with an average tariff of 17.6 percent in 2022 (Figure 29). Ad-hoc introduction of para-tariffs and frequent revisions to their rates have made the tariff structure complex and unpredictable. Consistency in tariff policy reduces uncertainty for businesses and improves their capacity to plan long-term investments. High tariffs are a powerful incentive to focus on the internal market to the detriment of exports ("anti-export bias"), but also increase production costs and constrain productivity upgrading for exporters by limiting access to technology embodied in imported inputs. Most export sectors face double digit tariffs on their imported inputs – with the average tariff for exporters close to 15 percent (Figure 30). Furthermore, reduced tariffs can promote increased foreign competition and create a competitive business environment that can boost productivity and innovation. Committing to increase the incentives to export by consistently reducing the anti-export bias of tariffs is a necessary condition to tap into Sri Lanka's export potential.

Figure 29: Sri Lanka has one of the highest average tariffs
(Simple average that includes para-tariffs – PAL and Cess, 2022)



Source: World Trade Organization

Figure 30: Most export sectors face double digit tariffs on their imported inputs
(Average tariffs on inputs, percent)



Source: Panjiva data (www.panjiva.com)
Note: Tariffs (including para-tariffs) for exporters assuming no access to duty remission schemes or BOI incentives

[36] Despite a sharp nominal depreciation (81.2 percent in 2022) during the crisis, the real effective exchange rate remained stable.

42. **Government schemes to reduce the tariff burden of exporters need to be revamped to increase coverage – especially of Small and Medium Enterprises (SMEs).** Less than half of exporters can avail of tariff-free inputs through Board of Investment (BOI) incentives or duty remission schemes (e.g., TIEP, INFAC and MUB),[37] which are predominantly used by larger firms that can absorb the fixed costs of applying and fulfilling their documentation requirements. Similarly, elimination of the cashless *simplified VAT* (SVAT) system for VAT rebates on domestic purchases will create a problem for exporters' cash flows if a fully digitized and automated system is not implemented to replace it. In the short run, focusing on improving duty remission schemes to ensure that exporters have unrestricted access to imported inputs and capital equipment will facilitate their integration and performance in international markets. Other measures that ensure exporters have access to credit and liquidity to source necessary inputs and fulfil their orders would also benefit export expansion.

43. **Implementation of the new National Tariff Policy (NTP) can help reduce Sri Lanka's untapped export potential by gradually cutting tariffs and para-tariffs and reducing trade policy complexity and uncertainty.** A gradual reduction of tariffs focusing on key inputs for exporters can improve their competitiveness in the short term. Phasing out para-tariffs would reduce trade policy complexity and uncertainty as well as anti-export bias. Rationalizing tariff exemptions, especially those granted to inward-oriented firms, would result in additional tax revenues and level the playing field for domestic firms.

Myth 2: There is a trade-off between efficiency and revenue gains

Para-tariffs make the trade regime more complex and uncertain. In addition to customs duties, Sri Lanka charges two para-tariffs – the Export Development Board Cess and Ports and Airport Levy (PAL) – on imports. These keep effective rates of protection high.[38] Frequent revisions to their rates have made the tax structure complex and unpredictable, reversing efforts taken to simplify and reduce custom duties. Both taxes do, however, generate considerable tax revenues (Figures 31 and 32).[39]

Figure 31: Taxes on imports contribute significantly to government revenue
(Percent of overall revenue)

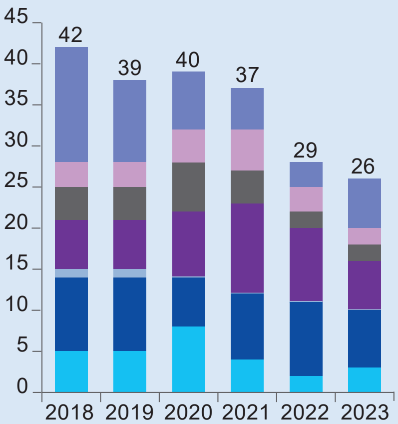


Figure 32: The share of PAL and Cess in the overall import tariff mix is large
(Percent)

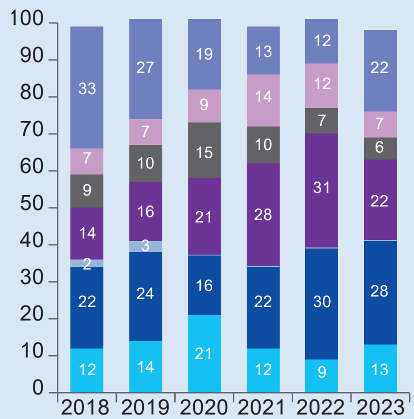
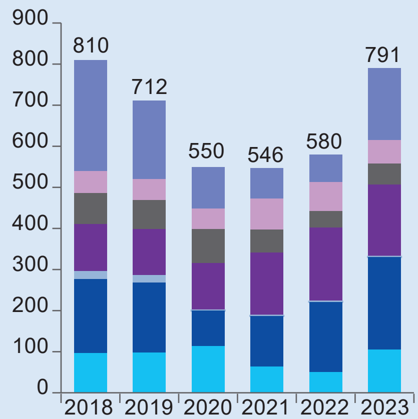


Figure 33: Revenue from PAL and Cess declined as overall revenue from imports rose in 2023
(LKR Billion)



Note: CID – Customs Import Duty; VAT – Value Added Tax; NBT – Nation Building Tax; PAL – Port and Airport Development Levy; SCL – Special Commodity Levy; Cess– Export Development Board Cess; XID – Excise (Special Provisions) Duty

Source: Ministry of Finance, Central Bank of Sri Lanka, and World Bank calculations

[37] Duty remission schemes for exporters suspend payment of customs tariffs for inputs that go into exports. INFAC=Investor Facilitation Centre; MUB=Manufacturing under Bond, TIEP=Temporary Import for Export Processing.

[38] In 2022, PAL affected 75.7 percent of tariff lines and 63.4 percent of import value, while Cess affected 31 percent of tariff lines and 27.4 percent of import value.

[39] While PAL has a broader tax base (75 percent of tariff lines) and a lower and flatter rate structure (2.5%, 5%, 7.5%, and 10% rates), Cess has a narrower tax base (31 percent of tariff lines) and more than 250 tax rates that are higher (25 percent average rate) and more complex than PAL.

The gradual phase-out of PAL and Cess, accompanied by compensatory increase in customs duty rates, increased efficiency. In March 2023, Sri Lanka began streamlining para-tariffs, reducing them while increasing customs duties to maintain revenue neutrality amid fiscal consolidation needs.[40] Analysis shows that revenues from affected tariff lines *increased* by 14 percent (y-o-y) between April and September of 2023, despite a 15.6 percent *decline* in overall import value. Revenue losses from PAL (LKR 0.3 billion, a 1.5 percent fall) and Cess (LKR 2.7 billion, a 10.7 percent fall) were offset by a significant rise in customs duties (LKR 11.9 billion, a 72.3 percent rise) (Figure 33). Most losses were compensated by increases in custom duty revenues from the *same* tariff line, resulting in minimal change in protection for domestic sectors.

Eliminating para-tariffs over time can simplify trade policy, reduce complexity and uncertainty, and enhance Sri Lanka's export competitiveness. Although the reform did not alter protection levels, it increased efficiency by reducing distortionary tariff protections. While revenue losses are certainly likely without compensating adjustments, a less distortionary and long-term fiscal policy should take the planned phase-out of tariffs into account and shift towards direct, more progressive taxation.

4.2 Implementation of a NSW and other soft infrastructure will reduce barriers to exporting, especially for SMEs

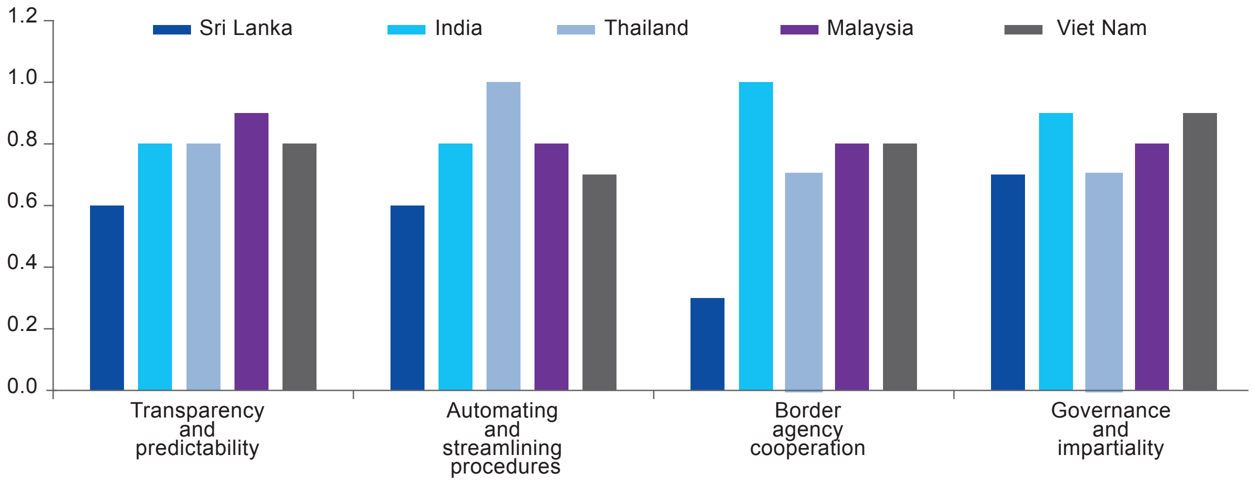
44. **Sri Lanka needs to streamline and automate cross-border procedures and improve border agency cooperation to boost exports and capitalize on opportunities created by shifting GVCs.** Participation in GVCs relies on a fast and predictable movement of goods across borders, as firms need to constantly source inputs and ship goods to many locations. Recent global supply chain disruptions have prompted companies to diversify their sourcing strategies and look for locations with enhanced trade facilitation that can increase their supply chain resilience. Sri Lanka lags its comparators in terms of automating and streamlining procedures and internal border agency co-operation (Figure 34). Most processes are paper based and there is little integration of government agencies systems, leading to multiple submissions of the same information to different regulatory bodies, and multiple cargo inspections by different agencies. These inefficiencies in cross-border procedures significantly affect export competitiveness as two thirds of Sri Lanka's exporters directly import their inputs.

45. **Implementation of a NSW will reduce the time and costs of international trade transactions, lowering barriers to exporting, especially for SMEs.** A single window is an electronic platform that provides a single-entry point to submit documentation and obtain regulatory clearances needed for international trade transactions. It acts as a centralized system that connects various government agencies responsible for regulating trade activities, such as customs, quarantine, and other inspection bodies.[41] It does this by streamlining and sequencing business-to-government and government activities in real time to simplify the clearance processes, reducing the cost of doing business and increasing competitiveness. These benefits are especially large for SMEs because they open new market opportunities by lowering barriers to entry into exporting and facilitating easier access to international supply chains.

[40] The simple average PAL rate went from 6.7 to 4.7 percent, the average Cess rate (ad-valorem part) went from 25.1 to 19.1 percent. To compensate for the revenue loss, the simple average CID rate went from 15.3 to 20.3 percent.

[41] Ceylon Chamber of Commerce 2024.

Figure 34: Sri Lanka performs poorly on trade facilitation indicators
(Normalized trade facilitation scores, Singapore = 1)



Source: OECD Trade Facilitation Indicators
Note: Scores are shown as percentage of regional best practice (Singapore) scores. A lower score implies poorer performance compared with best practice.

46. **A NSW can bring significant cost and time reductions in a relatively short time.** Single windows have demonstrated significant progress in improving trade facilitation and reducing costs in the region. In Singapore, the NSW reduced the processing time of trade documents from 2–4 days to as short as 15 minutes while reducing trade documentation processing costs by 20 percent.[42] Pakistan's NSW has streamlined 65 percent of regulated trade, reduced filing times by a third, and reduced cost by nearly 20 percent, while online payments jumped to 91 percent in less than three years.

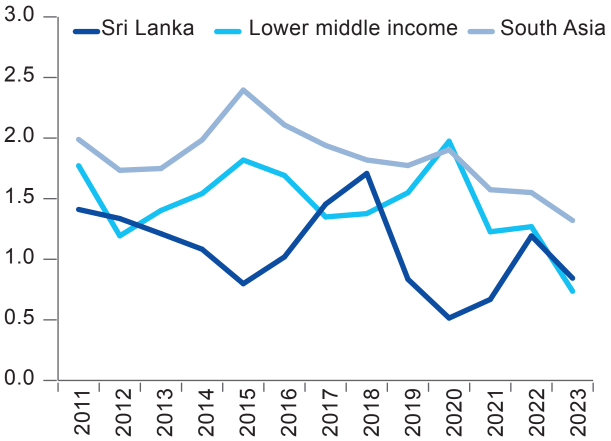
47. **Additional investments in soft infrastructure are needed to complement ongoing port investments and take full advantage of Sri Lanka's strategic location.** Recent infrastructure investments have positioned the Port of Colombo as one the best performing ports in the region and 40th globally. Ongoing expansions in the port's capacity and inland transport connectivity may miss the full potential to improve port operations unless all port, vessel and shipping operations are digitized and interconnected through a Port Community System – a digital collaborative platform that enables seamless exchange of information among port stakeholders (e.g., customs agencies, port management, shipping and logistics companies, and freight forwarders).

4.3 An enabling regime to attract FDI would result in a focus on export-oriented investments

48. **Sri Lanka has struggled to attract export-oriented FDI over the last decade.** FDI serves as a crucial mechanism to boost investment, introduce new technologies and production processes that enhance productivity, generate positive spillover effects by improving skills and introducing new management practices, and improve access to global production networks and GVCs (Box 4). Sri Lanka's FDI as a share of GDP on average amounted to 1.1 percent over the 2011–21 period, which is lower than the average (4.8 percent) among comparator countries (Figure 35). Most FDI inflows are concentrated in the services sector (Figure 36). Approximately 27 percent of all FDI inflow between 2017–21 was into real estate – and only 36 percent of greenfield FDI announcements classified as export-oriented efficiency-seeking FDI. Sub-sectors that received the highest number of FDI projects were financial services, followed by business and transport services. Sri Lanka's FDI inflows are also predominantly comprised of intra-company loans, representing short-term capital. Only about 10 percent of FDI inflows in the past decade constituted new investments (i.e., equity), and this share has been decreasing since 2018.

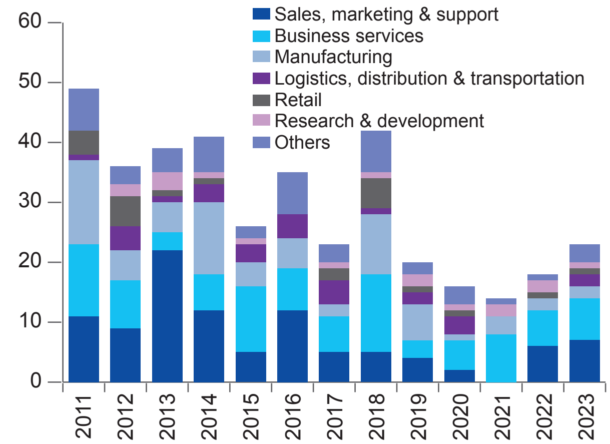
[42] ADB 2012.

Figure 35: FDI inflows have been below peers
(Percent of GDP)



Source: Central Bank of Sri Lanka, United Nations Trade and Development, FDI markets, and World Development Indicators

Figure 36: FDI inflows are concentrated in the services sector
(Number of projects, 2011–2023)



Source: Central Bank of Sri Lanka, United Nations Trade and Development, FDI markets, and World Development Indicators

Box 4: Rethinking Sri Lanka's Growth Strategy

Sri Lanka faces the challenge of overcoming the 'middle-income trap' to reach high-income status in the next two to three decades. In order for this to happen, the World Development Report (WDR), 2024, suggests that middle-income countries need to increase the 'sophistication' of their economic structure, primarily by enhancing the economic complexity of their export basket. This requires lower-middle income countries to increase *investment* and *infusion* to reach Upper Middle Income (UMI) status, and UMI counties to enhance *innovation* to reach higher income status.

The first transition is particularly relevant to Sri Lanka today. It involves gradually increasing private domestic and foreign investment (especially in strategic industries), and the infusion (or diffusion) of technological and operational expertise from abroad into local production. This process necessitates improvements in human capital and market competition. Upskilling the labor force through vocational training and promoting science-tech-engineering-medicine fields in secondary education will create a pool of specialized workers connected to global knowledge flows. Increased competition, driven by openness and appropriate regulation, will boost local firms' productivity and global competitiveness. Both established firms, which can scale and enhance capabilities, and new entrants, which drive innovation and equitable growth, are essential for this transition.

Source: World Bank 2024b.

49. **Sri Lanka's ability to attract and retain FDI faces several obstacles.** These include an outdated legal and regulatory framework, policy uncertainty, and institutional and governance weaknesses. This has resulted in a fragmented, outdated, and time-consuming investment entry process, insufficient investor protection rights,[43] frequent changes to the investment regime, and red tape. Further, capacity limitations in the institutions tasked with investment promotion have led to uncoordinated and incoherent investment promotions. For example, only 1 percent of staff in the BOI work on investment promotion while 60 percent work on regulatory issues or EPZs.

50. **There are substantive restrictions on FDI in services that support international trade, such as transport and logistics.** These include caps on foreign equity, minimum investment requirements, and investment approval restrictions. For example, foreign investment up to only 40 percent can be approved by the BOI in the freight forwarding and shipping sectors, without seeking a special approval.[44]

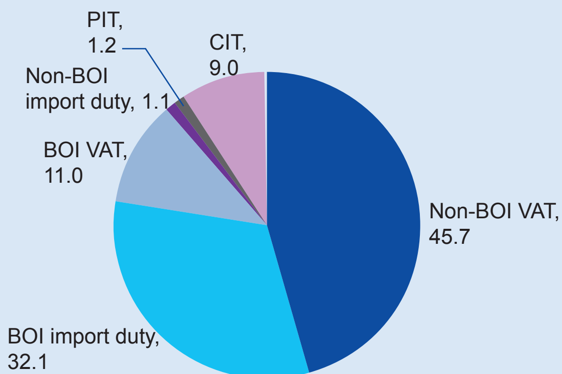
Myth 3: Tax incentives lead to greater investment

Sri Lanka provides an extensive set of discretionary tax exemptions, but still attracts relatively limited FDI. Foregone revenue amounted to 56 percent of total tax revenue collected in 2022, well above the regional average.[45] At the same time, FDI investment as a share of GDP remained below the regional average. Tax incentives under SDP and BOI projects are sizable (1.7 percent of GDP in 2022) (Figure 37). Foreign investors benefit from at least 50 percent of tax expenditures, with the biggest share of BOI tax expenditure coming from Customs Duties and VAT.

Sri Lanka's extensive use of discretionary incentives contrasts with international good practice where policy certainty and predictability are key to countries' success in attracting FDI. The provision of incentives and exemptions with limited transparency, no cost-benefit analysis, and lack of sunset clauses likely introduces significant distortions to economic activity, imposes a higher tax burden on non-exempt taxpayers, and may, ultimately, not be that effective in attracting investments. Investor perception of Sri Lanka's business enabling environment suggests that investment incentives play a marginal role in investor decisions. At the sector level, coverage is uneven, and about a third of incentives go to non-export sectors, such as infrastructure and power (Figure 38). At the firm level, performance of tax-exempt firms is not publicly available. A systematic evaluation of incentives provided needs to be undertaken to improve their targeting and effectiveness going forward.

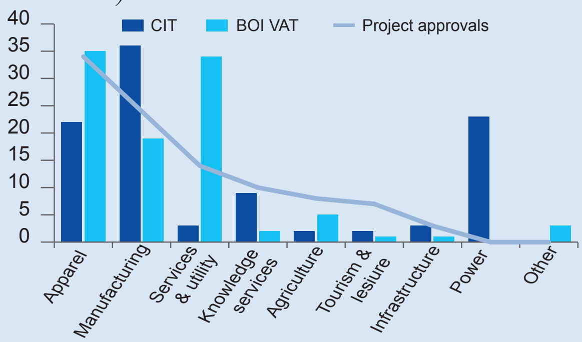
Source: World Bank analysis based on Tax Expenditure Statement, Ministry of Finance

Figure 37: Tax incentives under BOI are significant
(Share of overall tax incentives, 2022)



Source: IMF 2024
Note: PIT - Personal Income Tax; CIT - Corporate Income Tax

Figure 38: Sectoral coverage of tax expenditures is uneven
(Sectoral share of tax expenditure and invesment approvals, 2022–2023)



Source: Economynext.com, 13 March 2024; BOI 2022; MoF 2024.
Note: Investment approvals include new projects approved and expansion of existing projects. Information on CIT expenditures use sectoral breakdown of CIT expenditures for BOI companies for 2022–23. Information on VAT expenditure estimates look at VAT expenditures for BOI companies by sector for 2022–23.

[43] Sri Lanka has five investor-state dispute cases in international arbitration (out of 1,190 publicly known cases), which is high relative to its total FDI stock.
[44] A special approval for a higher percentage may be granted by the BOI.
[45] Ministry of Finance 2024.

51. **Operationalization of Sri Lanka's new investment institutional framework can enhance Sri Lanka's investment regime, bolster investor confidence, and attract more FDI.** The Economic Commission chapter of the recently enacted ETA provides the foundation to strengthen the institutional framework, provide clear rules for investment entry, and safeguard investor protection. It establishes a more streamlined investment promotion agency (Invest Sri Lanka), aligned with good practices, including simpler registration of FDI. It also increases transparency by proposing a negative list that consolidates specific restrictions on foreign entry. Additionally, it provides balanced and strong investor protections, which are anchored in international investment law. Steps to operationalize this new institutional framework include the development of detailed regulations and guidelines that clarify the law's provisions and provide guidance on the law's application, and the establishment of entities responsible for overseeing compliance such as the Economic Commission, Invest Sri Lanka, and an Investment Facilitation Center.

52. **Deep trade agreements that go beyond tariff reductions and into investment, services, and facilitation provisions help attract investment and secure market access.** One option for deepening global trade and investment integration is to initiate or join deep trade agreements with other countries, which go beyond tariff reductions to include provisions that facilitate investment and trade. Deep trade agreements, which have become common, offer an opportunity to ease FDI restrictions.

4.4 Other Priorities

53. **Complementary policies will be needed to achieve the full benefits of trade integration.** Although trade integration initiatives will provide significant benefits, some less competitive sectors could be negatively affected and might need support whilst transitioning to a more open and free trade regime. To facilitate a smooth and inclusive transition, the government should support flexible labor markets, improve connectivity, and maintain sound macroeconomic policies, as well as a business environment that is friendly to domestic and foreign investors. Monitoring the distributional impacts of trade reforms will enable policymakers to reduce the costs of job switching and provide effective safety nets. Policies that facilitate upskilling and reallocation of agriculture workers to sectors with increasing trade openness (like textiles, food processing, and business services) will help accelerate gains.

54. **In addition, there is a strong need to address challenges arising from poor governance and discretionary approaches prevailing in important areas of the economy.** These issues manifest in complex and inconsistent trade and investment policies; lack of transparency in tax advantages provided to certain industries, firms, or interest groups; conflicts of interest and opaque decision making within government, including SOEs. Addressing these issues through improved governance across all key economic sectors will contribute to higher economic efficiency, reduce the scope for corruption, improve government's credibility and prevent future crises. Minimizing face to face interactions through digitization of government processes and increasing transparency by establishing a beneficial ownership register for firms receiving tax advantages are among the measures that would help improve business confidence.

5. Next Steps

55. **Announcing a consistent program of priority structural reforms aimed at spurring exports, FDI, and productivity growth is critical to ensure credibility and enhance the initial confidence of the private sector.** Table 5 provides a sequence of key recommendations and their potential impact in boosting trade and investment.

Table 5: Key Recommendations and Potential Impact

	Timeline	Impact
	S= <6 months (m) M=6–18m	M=Medium H=High
Tariffs		
Reduce tariffs and para-tariffs as part of the new NTP, prioritizing inputs for exports	S	H
Implement a digital VAT refund system to replace the SVAT system	S	H
Simplify and digitize duty remission schemes for exporters (TIEP, INFAC, MUB)	M	M
Trade Facilitation		
Implement the fully electronic submission and processing of Customs Declarations	S	M
Implement the NSW to simplify and digitize trade processes	S	H
Implement a Port Community System to interconnect all port and shipping operations	M	H
FDI		
Operationalization of the ETA	S	H
Remove foreign investment restrictions on trade-enhancing services (transport, logistics)	M	M
Negotiate “deep” Free Trade Agreements with investment provisions to attract FDI	M	M

Annex 1: Balance of Payments, 2020-2023 *(Actuals)*

Percent of GDP	2020	2021	2022	2023
Current account balance	(1.5)	(3.7)	(1.3)	2.0
Merchandise trade balance	(7.1)	(9.2)	(6.2)	(5.8)
Exports	11.9	14.1	17.6	14.1
o/w articles of apparel and clothing accessories	5.1	6.1	7.8	5.6
Imports	19.0	23.3	23.8	19.9
o/w petroleum, petroleum products and related materials	2.4	3.5	5.7	4.7
Services trade balance	1.0	1.8	2.7	4.1
Exports	3.6	2.8	4.0	6.4
o/w travel	0.3	0.3	1.1	2.3
Imports	2.6	1.0	1.3	2.3
o/w transport	1.3	0.3	0.4	0.9
Primary income, net	(2.7)	(2.2)	(2.6)	(3.0)
o/w investment income	(2.6)	(2.2)	(2.5)	(3.0)
Secondary income, net	7.4	5.9	4.8	6.6
o/w worker's remittances	8.4	6.2	5.2	7.1
Capital account balance	0.0	0.0	0.0	0.1
Net borrowing (balance from current and capital a/c)	(1.5)	(3.7)	(1.3)	2.1
Financial account balance	(0.5)	(4.8)	(1.9)	1.4
Portfolio investments, net	(0.5)	(0.6)	(1.2)	(0.8)
Direct investments, net	2.8	1.7	(0.7)	(1.1)
Other investments, net	(0.4)	(3.1)	1.2	0.6
Reserve assets	(2.4)	(2.8)	(1.1)	2.6
Errors and omisions	1.0	(1.1)	(0.6)	(0.7)
Overall balance	(1.0)	(9.6)	(3.8)	2.8

Annex 2: Fiscal Operations Table, 2020-2023 *(Actuals)*

Percent of GDP unless otherwise stated	2020	2021	2022	2023
Total Revenue and Grants	8.8	8.3	8.4	11.1
Tax revenue	7.8	7.4	7.3	9.8
Income taxes	1.7	1.7	2.2	3.3
VAT	1.5	1.7	1.9	2.5
Excise taxes	2.1	1.7	1.4	1.7
Trade taxes	2.3	2.0	1.4	1.4
Others	0.2	0.2	0.3	0.9
Non-tax revenue	1.0	0.9	0.9	1.2
Grants	0.0	0.0	0.1	0.1
Total expenditure	19.4	20.0	18.6	19.4
Current expenditure	16.3	15.6	14.6	17.0
Salaries and wages	5.1	4.8	4.0	3.4
Transfer payments	4.6	3.9	3.4	3.6
Purchases of goods and services	1.2	1.0	0.8	1.1
Interest	6.3	6.0	6.5	8.9
Capital and net lending	3.1	4.4	4.0	2.4
Bank recapitalization				
Primary balance	(4.4)	(5.7)	(3.7)	0.6
Overall balance	(10.7)	(11.7)	(10.2)	(8.3)
Net foreign financing	(0.5)	(0.1)	1.8	1.8
Net domestic financing	11.2	11.8	8.4	6.5
Total PPG debt	105.0	110.3	119.2	110.8
Interest (share of revenue)	71.7	72.0	77.8	79.9
Interest (share of expenditure)	32.2	29.8	35.0	45.8

Annex 3: Trends and Challenges in Key Export Sectors

Sector	Challenges
Garments	• Clothing exporters have been unable to leverage their success in women's fashion (which dominates Sri Lanka's clothing exports) to expand into other high-fashion segments. • With more favorable policies, such as faster border clearances and logistics shorten lead times, the prospect of expanding into high-fashion segments of the world clothing market is good. • Sri Lanka already has well-developed textile and clothing export capacity that uses domestic innovations,[46] a satisfied customer base of reputed international brands, and largely domestically produced inputs.
Travel and Tourism	• Although travel and tourism exports expanded significantly over the last decade, they remain below potential. Sri Lanka's per capita tourism arrivals were only half of those in Viet Nam and one-fifth of those in Thailand. • Constraints to growth in this sector include: (i) the stretched capacity of the main airport in Colombo; (ii) constraints related to airline connectivity and access; (iii) limited use of digital booking platforms; (iv) relatively higher pricing than in the region; [47] and (v) dearth of a skilled and service-oriented workforce. More recently, uncertainty caused by the changes in visa processing has contributed to the industry's issues. • There is considerable scope to tap into the large regional tourist traffic by addressing these constraints, including through additional investments and financing, a shift towards a more 'open skies' policy, and greater digitization of travel and accommodation that would improve efficiency.[48]
Transport and Logistics Services	• Despite Colombo's position as the largest deep-sea container port in South Asia,[49] with high liner-shipping connectivity to major world markets, as well as an extensive feeder network in the region, transport and logistics services face policy and infrastructure constraints. • These include restrictions on foreign ownership that limit the improvement of value-added logistics services; significant levies and administrative restrictions on entrepot trade and multi-country consolidation (MCC) of cargo; and deficiencies in transport infrastructure that are worsened by insufficient coordination among agencies. As a result, Sri Lanka ranks poorly on logistics performance, relative to its comparators. • Nevertheless, with three deep-sea ports – Colombo, Hambantota, and Trincomalee – located near major east-west shipping routes, there is potential for improving and increasing transport and logistics service exports in the medium-term, creating the opportunity for Sri Lanka to potentially become an international shipping and logistics hub in the long-term, along the lines of Panama, Dubai, and Singapore.
IT and Professional Services	• Several Sri Lankan firms are leaders in IT, engineering, and analytics services. • The potential for growth of IT as well as other business and professional services is considerable – as their global exports have grown rapidly between 2008 and 2019. The share of these service export categories in total service exports has exceeded 60 percent in countries such as India and the Philippines.[50] • The expansion of these subsectors depends on access to quality digital infrastructure, a favorable regulatory environment, and the availability of skilled workers.

[46] Many of the large apparel export firms have established design centers that work closely with design teams of brand owners. They have invested in computer-aided design and manufacturing, as well as electronic fitting which enables design decisions by visualizing the garment digitally and skipping fitting sessions with models.

[47] Star-graded accommodation in Colombo costs 10-15 percent more as compared to competing countries in the region.

[48] Such widespread digitization of travel and tourist services would require a significant improvement in coverage and access to internet and broadband and thus a more rapid adoption of digital technology in the country.

[49] A string of islands blocks large ships from passing through the Palk Bay, thereby preventing India's southern coast from becoming a major international shipping hub in the region, giving Colombo a natural advantage (Ministry of Foreign Affairs 2016).

[50] Nayyar, Hallward-Driemeier, and Davies (2021).

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