SRI LANKA

Table 1	2020
Population, million	21.9
GDP, current US$ billion	80.7
GDP per capita, current US$	3685.6
International poverty rate ($1.9)[a]	0.9
Lower middle-income poverty rate ($3.2)[a]	11.0
Upper middle-income poverty rate ($5.5)[a]	42.0
Gini index[a]	39.3
School enrollment, primary (% gross)[b]	100.2
Life expectancy at birth, years[b]	76.8

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2016), 2011 PPPs.
(b) Most recent WDI value (2018).

The COVID-19 pandemic resulted in a sharp economic contraction of 3.6 percent in 2020. With jobs and earnings lost, poverty is projected to have increased. Growth is expected to recover to 3.4 percent in 2021, but the medium-term outlook is clouded by the lasting impact of COVID-19. Economic scarring from the slowdown increased risks to debt sustainability and external stability and macroeconomic vulnerabilities will remain elevated due to large refinancing needs.

Key conditions and challenges

The economy was already showing signs of weakness before the COVID-19 pandemic. Between 2017 and 2019, the average growth rate was only 3.1 percent, well below the levels of the beginning of the decade, when the economy reaped a peace dividend and the benefits of a determined policy thrust toward reconstruction. Modest growth, in recent years, is partly a reflection of (i) limited progress on structural reforms to shift the growth model toward greater private sector participation, export-orientation, and integration into global value chains; (ii) frequent macroeconomic shocks, from inclement weather in 2016 and 2017, a political crisis in late 2018, and the Easter Sunday attacks in 2019; and (iii) low fiscal space to support growth (although a fiscal stimulus package was implemented in 2019, further reducing fiscal space).

Against this backdrop, COVID-19 had a significant impact on the economy and welfare. The government reacted swiftly to control the first large outbreak of COVID-19 in mid-March 2020. Related containment measures, especially in the second quarter of 2020, and a standstill of tourism activity, impacted the economy significantly.

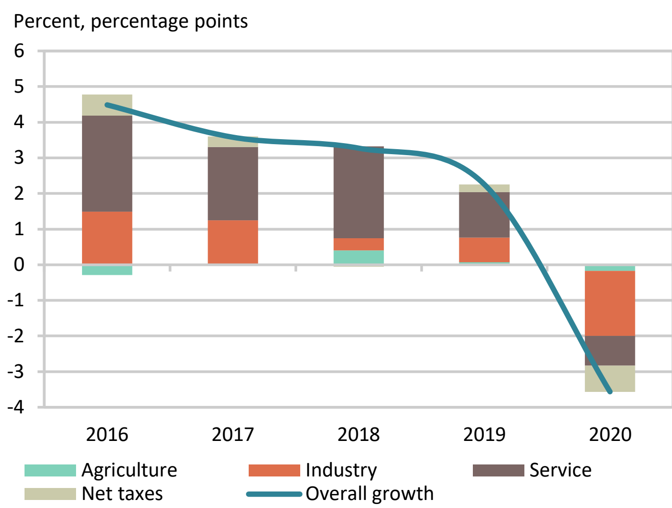
With the slowdown in the economy, fiscal balances were also impacted and particularly so since Sri Lanka is highly exposed to global financial market sentiments (as its debt repayment profile requires accessing financial markets frequently). Further sovereign rating downgrades by major rating agencies could negatively impact market sentiments and constrain market access. Thus, the country will need to strike a balance between supporting the economy and ensuring fiscal and external sustainability.

Recent developments

Real GDP contracted by 3.6 percent in 2020, the worst performance on record. It was caused by contractions in construction, tourism, textile, mining and transport, due to mobility restrictions in the second quarter amid strict lockdowns. Agricultural activities were relatively uninterrupted, but the fishery sector suffered a significant shock. As a result of widespread earnings losses, particularly in industry sectors, poverty using the $3.20 per day poverty line is projected to have increased significantly, from 9.2 percent in 2019 to 11.7 percent in 2020.

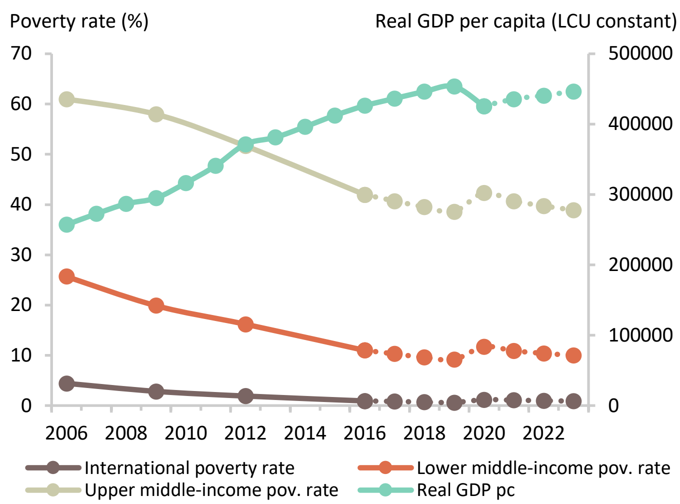
Despite high food inflation, annual average inflation (measured by the Colombo Consumer Price Index) remained low at 4.6 percent in 2020 due to the offsetting effects of weak aggregate demand and low oil prices. This allowed the central bank to reduce policy rates by 250 basis points (Standing Deposit Facility to 4.5 percent and Standing Lending Facility to 5.5 percent) and the reserve ratio by 300 basis points (to 2.0 percent) in 2020.

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



Sources: Department of Census and Statistics, staff calculations.

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



Sources: World Bank. Notes: see Table 2.

The current account deficit is estimated to have narrowed to 0.9 percent of GDP in 2020, as a reduction in imports due to low oil prices and severe import restrictions offset reduced receipts from exports. However, official reserves declined to an 11-year low of US$ 4.6 billion by February 2021, mainly because reserves were mobilized to service external debt. The US$ 1.5 billion currency swap approved by the People's Bank of China in March 2021 is expected to provide a boost to the reserves. After depreciating by 2.6 percent against the US Dollar in 2020, the LKR further depreciated by 4.1 percent in the first two months of 2021.

The combination of a stimulus package in 2019 (pre-pandemic) and low revenues in the aftermath of the COVID-19 shock resulted in a steep deterioration in fiscal balances. The deficit is believed to have increased to 12.6 percent of GDP in 2020 (after including arrears payments), and public and publicly guaranteed debt to have increased to 109.7 percent of GDP. Citing limited fiscal buffers and external vulnerabilities, Fitch, S&P, and Moody's downgraded the sovereign rating to the substantial risk investment category.

Outlook

The pandemic has further clouded an already challenging outlook. While the economy is expected to grow by 3.4 percent in 2021, output will remain 0.3 percent below its pre-COVID level. With a gradual improvement in labor market conditions, poverty at $3.20 per day is projected to fall to 10.9 percent in 2021, still significantly above the 2019 level. Continued import restrictions and the high debt burden will adversely affect growth and poverty reduction over the medium-term. Inflation is projected to increase gradually, as domestic banking institutions, including the central bank, are contributing to finance the government deficit.

The current account deficit is expected to remain low due to strict import restrictions, which should largely offset a deceleration of export growth. Still, significant additional borrowings will be required to close the external financing gap in 2021 and beyond, as external public debt service requirements are estimated above US$ 4.0 billion each year between 2021 and 2023. External buffers are expected to weaken relative to external liabilities as reserves may need to be used to service the external debt.

The fiscal deficit is expected to be high in the forecast period, despite tightly controlled expenditures, as revenue collection is expected to remain weak. In turn, public and publicly guaranteed debt is expected to reach 115.0 percent of GDP in 2021 and to rise further between 2022-2023. High gross financing requirements will exert pressure on the domestic financial market. This baseline assumes a quick and comprehensive vaccine rollout, in line with the government's aim to vaccinate 60 percent of the population in 2021. Delays in the vaccination process in Sri Lanka and/or major tourist origin countries would extend the horizon and depth of economic disruptions. A longer downturn could push many small and medium enterprises from illiquidity to insolvency, further holding back the recovery process and the return to a path of poverty reduction. Lower growth would also put additional strain on public finances and increase risks to macroeconomic stability. Depleted fiscal buffers, high indebtedness, and constrained market access will continue to pose risks to debt sustainability.

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

	2018	2019	2020 e	2021 f	2022 f	2023 f
Real GDP growth, at constant market prices	3.3	2.3	-3.6	3.4	2.0	2.1
Private Consumption	3.7	2.9	-3.7	3.3	1.9	2.2
Government Consumption	-5.1	9.6	6.0	-1.0	-1.0	-1.0
Gross Fixed Capital Investment	-1.4	4.0	-6.7	3.7	2.0	1.8
Exports, Goods and Services	0.5	7.1	-16.8	5.8	5.3	4.7
Imports, Goods and Services	1.8	-5.8	-12.4	3.1	2.7	2.5
Real GDP growth, at constant factor prices	3.7	2.2	-3.1	3.4	2.0	2.1
Agriculture	5.8	1.0	-2.4	2.0	2.0	2.0
Industry	1.3	2.6	-6.9	3.9	1.8	1.9
Services	4.6	2.2	-1.5	3.3	2.1	2.2
Inflation (Consumer Price Index)	4.3	4.3	4.6	5.2	6.0	6.0
Current Account Balance (% of GDP)	-3.2	-2.2	-0.9	-1.2	-1.3	-1.4
Net Foreign Direct Investment (% of GDP)	1.8	0.7	0.6	0.8	1.0	1.2
Fiscal Balance (% of GDP)[a]	-5.4	-6.8	-12.6	-9.4	-8.9	-8.3
Debt (% of GDP)[a]	92.2	94.3	109.7	115.0	117.7	119.6
Primary Balance (% of GDP)[a]	0.6	-0.8	-6.0	-2.7	-2.2	-1.7
International poverty rate ($1.9 in 2011 PPP)[b,c]	0.7	0.6	1.2	1.1	1.0	0.9
Lower middle-income poverty rate ($3.2 in 2011 PPP)[b,c]	9.6	9.2	11.7	10.9	10.4	10.0
Upper middle-income poverty rate ($5.5 in 2011 PPP)[b,c]	39.5	38.6	42.3	40.7	39.7	38.9

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate. f = forecast.
(a) Fiscal balance in 2020 includes arrears payments pertaining to 2019 and foreign funded project related expenditures not included in the audited financial statements in 2019.
(b) Calculations based on SAR-POV harmonization, using 2016-HIES.Actual data: 2016. Nowcast: 2017-2020. Forecast are from 2021to 2023.
(c) Projection using neutral distribution (2016) with pass-through = 0.87 based on GDP per capita in constant LCU.