

STATEMENT | MAY 10, 2023

Economic Reforms Critical for Sri Lanka's Recovery and Sustainability - World Bank Country Director for Sri Lanka



Q: Sri Lankans have begun to feel some relief in terms of somewhat reduced prices of essential commodities, availability of domestic gas and absence of petrol lines. The World Bank says it is a challenging time ahead. How can Sri Lanka sustain the present momentum and get Sri Lanka back on the growth path without burdening people anymore?

The current crisis is not a temporary liquidity shock that can be resolved by external financing support from outside. It is a result of longstanding structural weaknesses, which were elevated by a series of exogenous shocks. Poor governance, fiscal indiscipline, a restrictive trade regime, a weak investment climate, and episodes of loose monetary policy and an administered exchange rate, contributed to macroeconomic imbalances in the last two decades. Resolving a deep crisis of this nature will be difficult.

A strong and credible structural reform program is critical to avoid a prolonged crisis and address the (above) root causes of the current economic difficulties. Meaningful

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may initially adversely affect growth and poverty, but will correct overall imbalances, help regain access to international financial markets, and build the foundation for sustainable growth. Mitigating the impacts on the poor and vulnerable remains critical during the adjustment through better-targeted social assistance.

Q: How important is it to fast-track debt restructuring?

Sri Lanka's public debt is unsustainable, and as a result, the country lost international financial market access in 2022. As of end 2022, Public and Publicly Guaranteed (PPG) debt is estimated to have increased to 122.5 percent of GDP, while the government's gross financing needs (GFN) were about 26 percent of GDP. Restoring a sustainable debt path, therefore, entails reducing the unsustainable level of debt and high GFN through debt restructuring and supported by a broader fiscal adjustment. Speedy and successful debt restructuring is critically important to bring Sri Lanka back to a sustainable path, build confidence among investors and development partners, and regain international financial market access that Sri Lanka lost in 2022, all of which will contribute to raising much needed foreign exchange inflows.

Q: The Sri Lankan government is increasingly under pressure from the trade unions that stand in the way of reforms in the institutions such as the Ceylon Electricity Board and the Ceylon Petroleum Corporation. In economic terms, can Sri Lanka afford to abandon these reforms due to such pressure emanating from various quarters ?

A key factor in Sri Lanka's poor productivity and competitiveness in domestic and international markets is the dominance of SOEs in the economy. Many have monopoly or dominant market positions, receive public subsidies, and compete directly with the private sector. Misallocation of resources in favour of SOEs, along with market advantages and weak governance and management, has resulted in labour and capital inefficiencies, and financial losses. By crowding out the private sector, SOEs diminish the scope for new investment and innovation that can drive productivity and service delivery improvements. SOEs have also been a major source of fiscal risks. Reforming

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other countries with similar experiences suggest that unless root causes of the crisis are addressed, such crises tend to reoccur.

Q: Sri Lanka has been a country that remained resilient in the face of crises such as the tsunami disaster in 2004 and the civil war. How optimistic are you about Sri Lanka this time?

The Sri Lankan people have indeed remained resilient in the face of multiple challenges in past years. There are currently two key factors critical for the recovery and rebound of the Sri Lankan economy – the public debt restructuring process and implementation of government's ambitious reform programme.

Firstly, it's important for the debt restructuring negotiations and an agreement to be reached as soon as possible, but certainly by the time of the first review of the IMF's EFF (in about September/October 2023). Reaching this agreement will be a positive boost to the economy and provide greater clarity on Sri Lanka's path back to fiscal sustainability.

Secondly, the authorities have committed to a wide array of important structural reforms. These include reforms to stabilize the current crisis, such as enhancing revenue mobilization, improving tax administration, cost-recovery based energy pricing, safeguarding financial sector stability, and a stronger social safety net to protect the most vulnerable. They also include reforms to enhance productivity and competitiveness, streamline Sri Lanka's trade and investment environment, unlock the country's growth potential, and address governance and corruption issues.

As a result, our optimism for Sri Lanka revolves around whether the country can stay the course of these reforms and also reach a debt restructuring agreement as soon as possible.

Q: Sri Lankan Cabinet decided to liberalize fuel trading, opening it up to three main global suppliers. What is your view in this regard?

Liberalizing fuel trading can increase competition in the sector and improve service.

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Q: There is a school of thought that liberalization of fuel and electricity sectors will have a bearing on the country's energy security. But reforms in these sectors and liberalization of them are stressed upon to put the country back on the growth trajectory. What kind of insights can be derived from elsewhere in the world to prove that such steps won't lead to any such problem ?

The most important thing Sri Lanka can do to improve energy security is to further increase the share of renewable energy, improve energy efficiency, and otherwise diversify sources of energy to reduce dependency on imported fuels. Fuel and electricity sector reforms can support these objectives. International experience on sector reforms is varied and the outcomes of sector reforms – including on energy security – are influenced by a wide range of complex factors. To the extent that such sector reforms increase the number of market actors, including suppliers of fuels and electricity, and help diversify the energy mix, energy security can be enhanced.

Q: What kind of an impact does corruption have on development in Sri Lanka?

We know from experience around the world that corruption can be damaging in many ways. It impacts people directly through unofficial payments that they make, through services they are denied due to corruption, and indirectly as when the economy becomes skewed to favor well-connected firms and individuals. In countries where corruption is rife, the impact is not just a waste of resources, although this is also important. The real cost of corruption lies in sub-standard infrastructure or medicines, often bringing both health and economic consequences. When building inspections, occupational safety regulations, and environmental protections are subverted by corruption, the impact can be tragic for people and the environment. Corruption dissuades investment, and when corruption allows certain firms or interest groups to control the economy, rather than market efficiency and fairness, the result is weakened competition and sluggish growth. Corruption rots the social contract between the people and the government, and this can lead to loss of trust and instability.

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Discretionary approaches to decision making are rife in many important areas in Sri Lanka. For example, there are complex and discretionary trade policies; tax advantages provided to certain industries, firms or interest groups; and conflicts of interest and opaque decision making regarding the oversight of state enterprises.

As a result, the Bank recommends that government fully implements the proposed *Anti-Corruption Bill*, by ensuring independence of investigations and prosecutions, and adequate budget for the *Commission to Investigate Allegations of Bribery or Corruption* (CIABOC), as commensurate with its expanded mandate.

The Bank welcomes the plans to strengthen the assets and liabilities declarations system, and the new power to access complementary databases, both of which require investments and training. The Bank urges the government to use this crisis as opportunity to make serious strides toward asset recovery related to corruption. In the past the World Bank, working through the Stolen Asset Recovery initiative (StAR), its joint partnership with the UN Office on Drugs and Crime (UNODC), has provided extensive support on the legal framework governing income and asset declarations by public officials, including on e-filing such declarations, and on the *Proceeds of Crime bill* which governs the process for investigating, seizing and confiscating the proceeds of corruption.

StAR stands ready to provide further assistance on both the legal framework and any further capacity building required to implement it. The crisis is also a chance to shore up other important institutions, such as the *Right to Information Law*, which is well designed and has been effective, but requires renewed commitment to the ideals outlined in the law.

The Bank urges the government to reassert the primacy of transparency by ensuring that new legislation does not explicitly or implicitly reduce the power of the *Right to Information Law*. Finally, the Bank emphasizes the importance of an independent and vibrant civil society for the fight against corruption.

Q: How long will it take for the World Bank to resume its projects in Sri Lanka

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The World Bank Group (WBG) has been working closely with the Government, development partners and civil society since the start of the crisis. WBG was the first institution that immediately restructured existing projects to respond to urgent needs. The World Bank repurposed \$325 million from existing projects to address the people's most pressing needs, including medicines, cash transfers, liquid petroleum gas, and fertilizer. Beyond ensuring the well-being of the people, the assistance was targeted to ensure that key institutions for public services and food security, as well as small and medium enterprises, survived the crisis. In doing this, the Bank created a crisis response framework that brought in the ADB, AIIB and other bilateral partners to provide additional funding to these sectors.

WBG is also preparing its new partnership framework with Sri Lanka for the 2023–2026 period. The World Bank remains conscious of Sri Lanka's challenging context and the [limited financial resources](#) available. The upcoming partnership framework is selective – it focuses on specific objectives to support the country's greatest development needs, where the government sees a catalytic role for the WBG's support, and where the World Bank Group can add distinct value. The upcoming CPF aims to assist Sri Lanka in restoring economic stability and building a stronger foundation for green, resilient, and inclusive development and recovery, while protecting poor and vulnerable populations.

Q: Does the current appreciation of the Sri Lankan rupee, though slightly, a healthy sign? Or is it a phenomenon triggered mainly by the low demand for imports?

In the absence of large debt service payments, the authorities have been able to manage the outflows (mainly the import bill) with inflows such as exports, tourism and remittances since the second half of 2022, leading to balance of payment surpluses (please see the latest Sri Lanka Development Update for more details). These surpluses helped an accumulation of official reserves (US\$700 million by January 2023, excluding the currency swap with China), and an improvement in net foreign assets in the banking system (US\$-4.3 billion in January 2023, up from US\$-6.4 billion in April

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above factors have led to an appreciation of the LKR against the US Dollar from February 27, 2023, somewhat easing inflationary pressures. Amid the currency appreciation, the central bank announced that it will transition back to a flexible exchange rate. A flexible exchange rate is the first line of defense against external imbalances. As such, a flexible exchange rate and trade liberalization would be needed to help Sri Lanka avoid stagnation at a below-potential equilibrium.

This interview originally appeared on Daily Mirror on 20 April 2023 and is re-published with permission. The original article can be viewed at [this link](#).

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