

Macro Dev

Sri Lanka: After the storm, a promising economic recovery

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Summary: An island nation in the Indian Ocean, since 2019, Sri Lanka has been experiencing the most severe economic crisis in its post-independence history. The country was for a long time held up as an example of success in South Asia, but has suffered from a succession of shocks, coupled with a chaotic management of the economy by the ruling Rajapaksa clan, which has undermined the fundamentals of its development model. In the spring of 2022, and for the first time in its history, it ended up announcing that it was defaulting on its external public debt.

There has recently been a promising upturn in economic activity: inflation is under control, the rupee has appreciated, foreign exchange reserves are slowly being rebuilt, and economic growth reached 5.0% in 2024, well above expectations. This upturn is partly due to the implementation of a series of ambitious measures, in the context of the IMF program (signed in March 2023). At the same time, discussions have been initiated with the country's main creditors with a view to restructuring the public debt, and there has been solid progress in recent months. However, the crisis has left serious social consequences, and the country is not expected to recover its pre-crisis level of GDP per capita before 2028, raising fears of a "lost decade".

At the political level, the victory of the left-wing candidate Anura Kumara Dissanayake in the presidential election of September 2024 marks a real turning point in the history of Sri Lanka. While he was critical during the election campaign, he has finally undertaken to respect the targets and main lines of the IMF program concluded by his predecessor. Boosted by a large majority in Parliament and benefiting from some consensus among the public in terms of the targets of the IMF program, the President's tasks will thus be to implement his electoral priorities (social justice and the fight against corruption, in particular), continue the economic recovery, and focus on more long-term issues, first and foremost, adaptation to climate change.

Thematic area: **Macroeconomics**

Geographical area: **Sri Lanka**

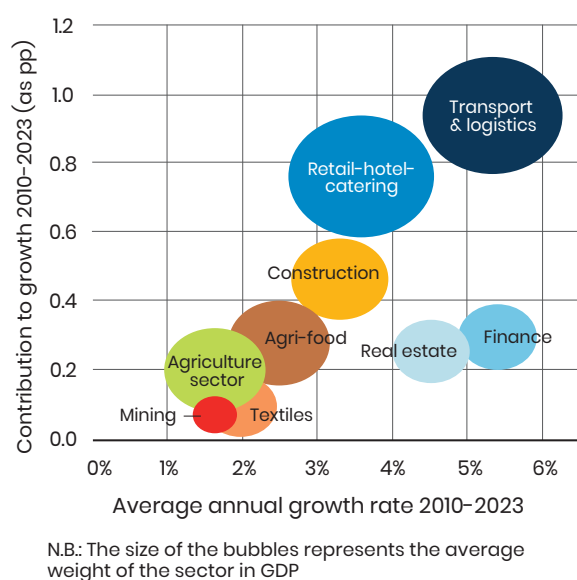
1. From a “development success story” to an economic crisis

1.1. Before the crisis, a “development success story”

Sri Lanka is a small open economy, marked by a relatively high level of diversification. **Services are the prime driver of economic activity** and account for 55% of GDP, a level that has remained stable over the last 20 years. The country enjoys a favorable geographic position and has invested heavily in transport and logistics activities in an effort to become a regional hub (Colombo is one of the three largest ports in South Asia in terms of the volume of containers handled). The health of the tourism industry is also crucial for many segments of the service sector, primarily the retail, hotel and catering industries. The development of financial services has been driven by the slow liberalization

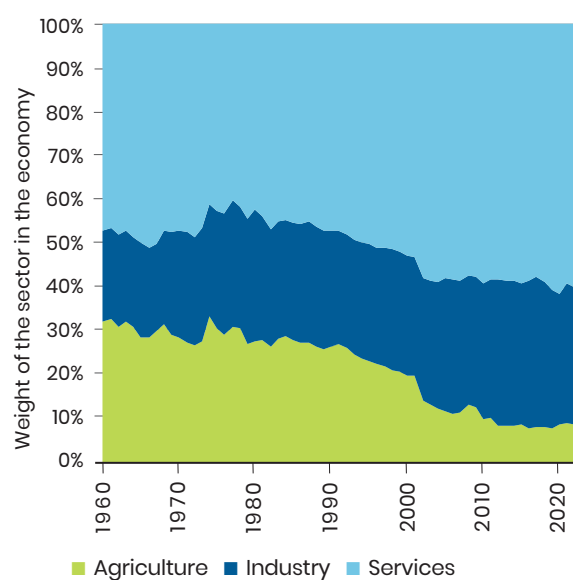
of the sector over the last 50 years. At the same time, **the manufacturing industry is relatively developed**, accounting for 20% of GDP in Sri Lanka (against an average of 14% in South Asia). It is primarily based on the agrifood industry (especially tea processing) and the textile industry. Alongside it, there is the construction industry (7% of GDP), which is largely dependent on public procurement and major projects, as well as a mining sector, which only makes a marginal contribution (2% of GDP) as there are no major metal, mineral and hydrocarbon reserves. Finally, following a decline over the last four decades, **the contribution of the agriculture sector has stabilized over the last ten years**, at just under 10% of GDP. Dominated by the production of rice, tea, spices, rubber, fruits, vegetables and seafood products, it still employs more than a quarter of the labor force.

Graph 1: Dominated by services, the economy is relatively diversified



Source: Department of Census & Statistics, AFD calculations.

Graph 2: Agriculture has declined in favor of industry and services



Source: World Bank, AFD calculations.

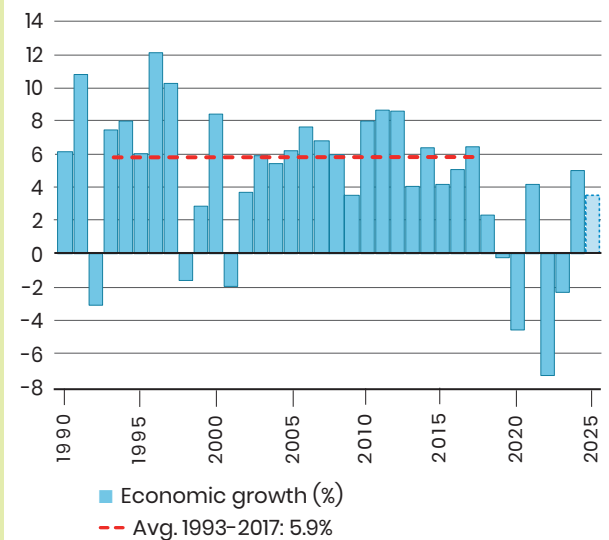
This model initially enabled Sri Lanka to record excellent macroeconomic results. **Annual growth thus averaged almost 6% between 1993 and 2017.** As a result of the liberalization measures initiated in the 1990s,^[1] this growth was fostered by inflows of foreign investment, especially in the textile industry. In the 2000s, further measures to open up the economy,^[2] coupled with extensive public investment programs, contributed to the increase in GDP. This momentum further accelerated from 2009 onwards, with the end of the armed conflict between the central government and the separatist Liberation Tigers of Tamil Eelam (LTTE). After 25 years of civil war, with the loss of almost 100,000 lives, the stabilization of the security situation fostered the take-off of a previously undeveloped tourism sector. Throughout this period, the growing expatriation of Sri Lankan workers to the West, then Gulf countries, largely boosted household consumption through substantial remittances (annual average of over 8% of GDP during the 2010s). Finally, a relatively early demographic transition enabled the country to capitalize on its “demographic dividend”. With a decline in the fertility rate from 5.5 children per woman in 1960 to 2.1 at the end of the 1990s, the UN estimates that the Sri Lankan dependency ratio has dropped considerably since independence in 1947, reaching a low of less than 50% between 2004 and 2011.^[3]

[1] Following the wave of 1977, Sri Lanka introduced a series of economic liberalization measures between 1989 and 1993: tariff cuts, devaluation of the rupee, income and corporate tax reforms, elimination of capital tax, price deregulation (wheat, fertilizer, sugar), increased independence of the Central Bank, reduction of capital controls, privatization of public enterprises, and promotion of special economic zones (SEZs).

[2] The liberalization measures in the 2000s consisted in further tariff cuts, the introduction of VAT, the conclusion of free trade agreements with India and Pakistan (2000 and 2005), the creation of new SEZs, a flexibilization of the labor market, and a liberalization of the financial sector (foreign competition, privatizations, regulatory modernization, development of the stock market).

[3] This dependency ratio has stabilized at around 50% over the last decade, and Sri Lanka is now close to the levels of India (47%) and Bangladesh (53%).

Graph 3: Sri Lanka experienced a period of rapid development between 1993 and 2017



Source: IMF, AFD calculations.

With a threefold increase in GDP per capita in purchasing power parity (PPP) in 25 years, Sri Lanka moved from the classification of low-income country (LIC) to lower-middle-income country (LMIC) in 1997, before reaching the status of upper-middle-income country (UMIC) in 2018. With a much stronger performance than its neighbors, it was rapidly held up as a model country for the region, with the **World Bank describing Sri Lanka's experience as a “development success story”**. Furthermore, the country has managed to virtually eliminate extreme poverty, and there has been significant progress in literacy (92% of adults), life expectancy (76 years), and infant mortality (7‰). Sri Lanka ranked 73rd out of 191 countries in the 2021 UN Human Development Index (HDI). It is today well ahead of its South Asian neighbors: Maldives (90th), Bhutan (127th), Bangladesh (129th), India (132nd), Nepal (143rd), Pakistan (161st) and Afghanistan (180th).

Table 1 – Sri Lanka's Human Development Indicators

	Years				1990–2018	
	1990	2000	2010	2018	Absolute	Relative
GDP per capita (constant USD, PPP)	4,562	6,429	9,832	14,760	+10,198	+224%
Human Development Index	0.64	0.70	0.75	0.78	+0.14	+23%
Extreme poverty rate (%, \$2.15 2017 PPP)	12	12	4	1	-10	-89%
Literacy rate (%)	87	87	91	92	+5	+6%
Life expectancy (years)	69	71	74	76	+7	+10%
Infant mortality rate (‰)	18	13	9	7	-11	-64%

Source: World Bank, UN, AFD calculations.

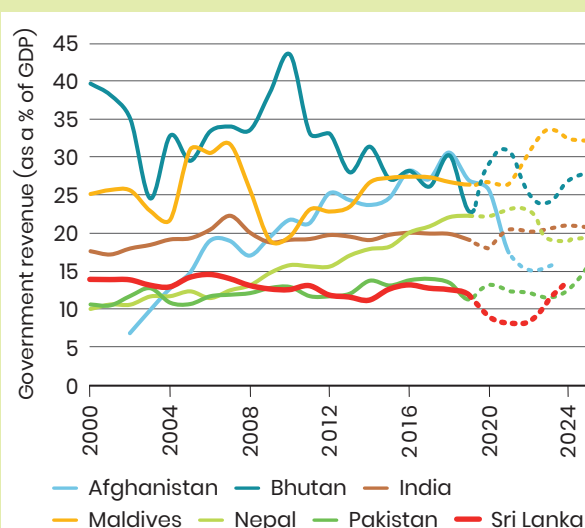
1.2. But the model is fragile, based on significant fiscal and external imbalances

Public accounts the traditional Achilles' heel of the economy

On a downward trend since the 1990s, **Sri Lankan government revenue in relation to GDP is among the lowest in the world**. It only stood at 12% of GDP during the 2010s, far from the South Asian average (21%). This poor performance is primarily due to its narrow tax base (two-thirds of employment is informal according to the International Labour Organization), the application of low rates of taxation, the numerous exemptions, tax evasion, and the lack of productivity of public enterprises. Public spending is higher, reaching 18% of GDP over the same period. The interest burden and the payroll for more than a million public servants (15% of the working population) have alone absorbed three-quarters of government revenue (5% and 4% of GDP, respectively). Both investment expenditure and security expenditure have also been maintained at a substantial level (6% and 2% of GDP, respectively). However, the level of transfers and subsidies is limited for a middle-income country and shows a downward trend (less than 3% of GDP). As a result of the shortfall in revenue to cover expenditure, **public accounts are structurally imbalanced:**

during the 30 years prior to the crisis, the deficit consistently remained above 5% of GDP. In addition, the very structure of revenue and expenditure has not changed substantially over the period: despite six IMF programs since 1991, the consolidation measures taken have regularly been undone and/or offset by the introduction of new expansive measures (especially during pre-election periods).

Graph 4: Sri Lanka's government revenue is among the lowest in South Asia



Source: IMF, World Bank, AFD calculations.

At the same time, between 2008 and 2017, the strong economic growth made it possible to maintain public debt at around 70% of GDP, but **there has been a shift in the type of the country's external creditors.** Historically, Sri Lanka primarily relied on flows from multilateral donors and Paris Club countries. From the late 2000s onwards, these donors were gradually replaced by Chinese loans and international foreign currency bonds (Eurobonds). Several controversial major Chinese loans were given considerable coverage in the media,^[4] but on the eve of the crisis, they “only” accounted for 7% of total public debt, against 16% for Eurobonds. Indeed, in the context of the stabilization of the security situation (end of the conflict with the LTTE) and the abundance of global liquidity, the appetite of international financial actors for Sri Lankan debt suddenly increased at the end of the 2000s. Furthermore, the increase in Sri Lanka's wealth led to a gradual loss of access to concessional debt flows, hence the need to diversify its sources of financing. Previously exceptional in the history of Sri Lanka,^[5] **sovereign Eurobond issuances took place every year between 2009 and 2019, for a total of almost \$20 billion.** These private flows, which are more costly, have also been much more volatile and sensitive to the economic climate. They have thus contributed to weakening the structure of public finances.

Graph 5: Chinese loans and Eurobonds have grown rapidly



Source: World Bank, AFD calculations.

A balance of payments dependent on external financial inflows to ensure its equilibrium

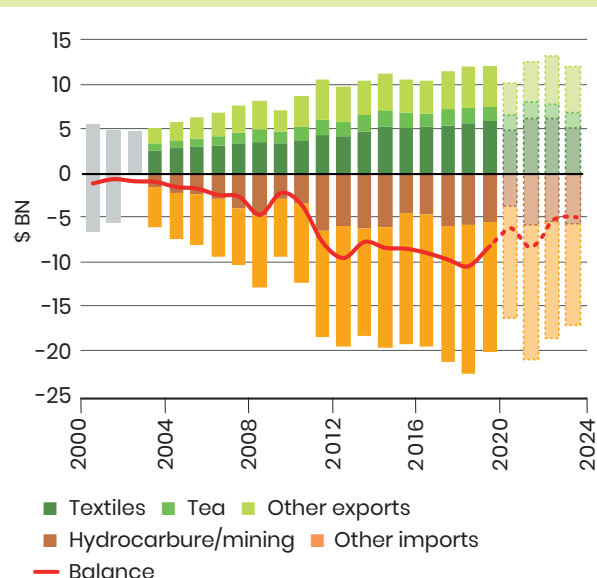
Sri Lanka has a structural imbalance in its trade balance, with the last surplus dating back to 1977. As imports increased much more rapidly than exports, **this deficit gradually widened from the 2000s onwards.** Indeed, imports more than quadrupled between 2001 and 2018 (+\$17 billion) to meet household demand for consumer goods, enable the development of infrastructure, and ensure a supply of raw materials. Over the same period, there was a more moderate increase in exports (+\$7 billion). They are highly concentrated, with about 50% for textiles and 20% for tea, and have suffered from increased international competition,^[6] which explains why they are less buoyant. The trade deficit ultimately peaked at \$10 billion in 2018, or 11% of GDP.

[4] This is the case for the concession for Hambantota Port (stronghold of the Rajapaksa clan) for a period of 99 years granted in 2017 to the China Merchants Port conglomerate, in particular as a result of repayment difficulties.

[5] Before 2009, Sri Lanka had only issued three sovereign Eurobonds in its history, for a total of \$615 million: \$50 million in 1997, \$65 million in 1998 and \$500 million in 2007.

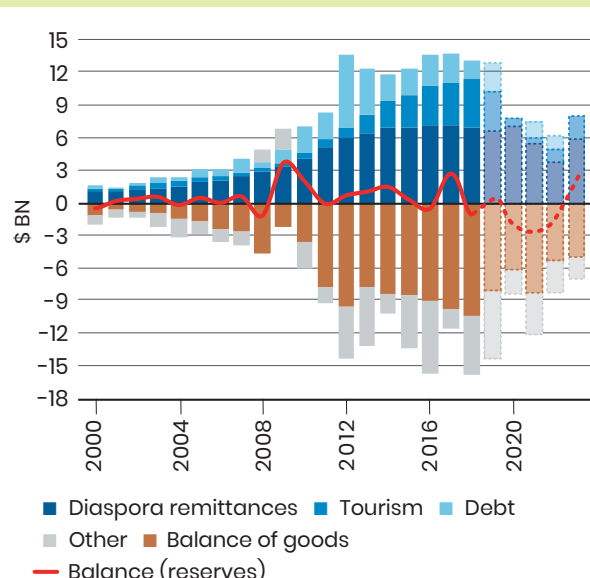
[6] South Asia, Southeast Asia and Türkiye for textiles, and China, Kenya and India for tea.

Graph 6: The deficit in the balance of goods widened from the 2000s onwards...



Source: UN Comtrade, CEPII, Central Bank, AFD calculations.

Graph 7: ...hence the growing dependence on diaspora, tourism and debt flows



Source: IMF, Central Bank, AFD calculations.

However, until the crisis, **balance-of-payments equilibrium was maintained by a combination of external inflows, offsetting the deficit of the balance of goods**. Firstly, diaspora remittances increased rapidly, to such an extent that they became the main source of foreign exchange as of 2010. Between 2014 and 2020, they stood at approximately \$7 billion annually (8% of GDP). Secondly, revenues from the international tourism industry, which had historically been low,^[7] skyrocketed as of 2009 with the end of the civil war and peaked at over \$4 billion in 2018 (5% of GDP). Finally, net external debt flows, both to the public and private sectors in the form of bond issues and bank loans, increased fivefold between the 2000s and 2010s (average flows of approximately 3% of GDP during the 2010s).

Conversely, foreign investment, including foreign direct investment (FDI) which has traditionally been more stable than debt flows, has remained structurally low in Sri Lanka. On the eve of the economic crisis, total FDI stock only accounted for 15% of

GDP in Sri Lanka, far from the average of LMICs and UMICs (22% and 23% of GDP, respectively). This situation is largely attributable to a regulatory framework that has remained relatively restrictive, despite the waves of economic liberalization.

With the gradual widening of the deficit of its balance of goods, **Sri Lanka has put itself in a situation of growing dependence on these remittance, tourism and debt flows**. This dependence has been all the more risky because these flows are highly volatile and sensitive to exogenous shocks (including commodity prices, the economic situation in the countries of residence of the diaspora, the security situation, climate events, investor confidence, and U.S. monetary policy). In addition, the structure of Sri Lanka's balance of payments had already shown signs of weakness during the previous episodes of pressures on the external accounts (2009, 2011-2012, 2015-2016), which had required IMF support to limit capital outflows.

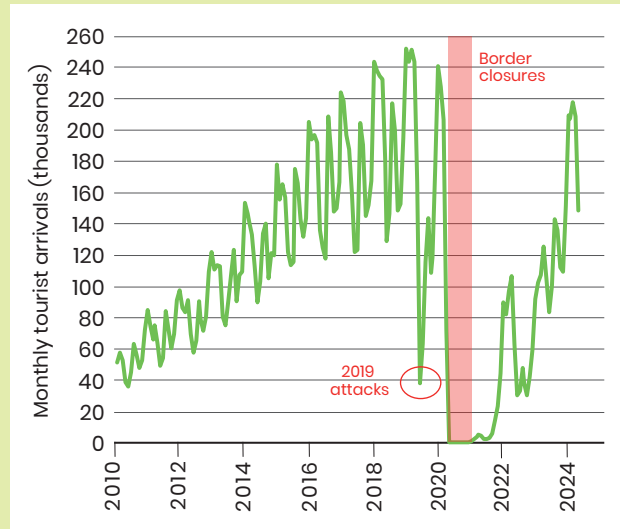
[7] Annual average of \$370 million during the 2000s.

1.3. A series of shocks and the chaotic management of the Rajapaksa clan finally led to default

Starting in 2018, **a succession of shocks destabilized the Sri Lankan economy**. Firstly, the country experienced a serious constitutional crisis at the end of 2018, with the sharing of power between two rival Prime Ministers. While this episode ultimately demonstrated the resilience of the institutions (the Supreme Court ordered the restoration of the Assembly dissolved by the President), it undermined the country's political stability and had an impact on the confidence of economic actors. Secondly, Sri Lanka was the target of a series of Islamist terrorist attacks in April 2019. These attacks targeted hotels and churches (269 people killed) and seriously affected the health of the tourism sector. While the statistics on arrivals were gradually improving, the Covid-19 pandemic and the border closures further hit the tourism sector (508,000 arrivals in 2020, then 195,000 arrivals in 2021, against 2.3 million in 2018), and the economy in general. Finally, the country started to suffer from the collateral effects of the Russia-Ukraine conflict in February 2022, with the increase in its oil bill and a further decline in tourist inflows (Russia and Ukraine accounted for 12% of arrivals in 2021). With this creeping crisis, a wind of panic shook international investors, who increased their risk premium (cessation of sovereign Eurobond issues in particular), exacerbating the deterioration of the macroeconomic indicators.

The recessionary effect of these shocks was compounded by a chaotic management of the economy by the authorities. On the economic front, the Rajapaksa administration introduced huge tax cuts at the end of 2019, notably a reduction of the VAT rate from 15% to 8% and the number of taxpayers subject to income tax by more than one million. As a result of this decision, government revenue, which was already historically low, fell to only 8% of GDP, the third lowest ratio in the world. At the beginning of 2021, the rupee was pegged to the dollar, forcing the

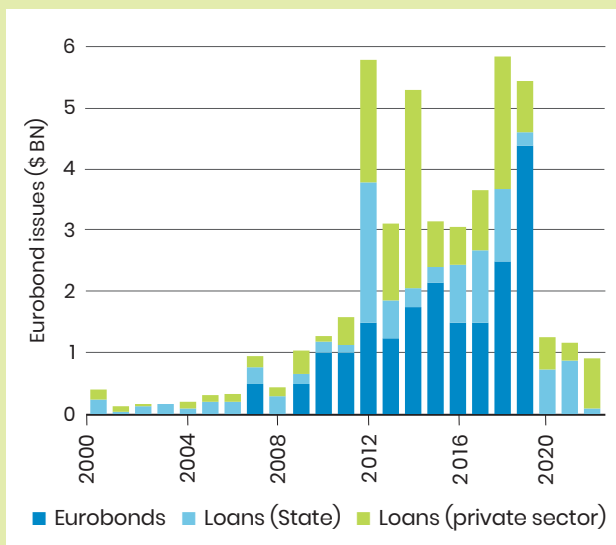
Graph 8:
The attacks of 2019, then the pandemic, brought the tourism sector to a standstill



Source: SLTDA, AFD calculations.

Central Bank to intervene on the foreign exchange market (by selling its foreign exchange reserves) to maintain this parity. Then, in April 2021, the authorities suddenly imposed the conversion of the country to organic farming, whereas this transition was initially supposed to take place according to a ten-year plan. The sudden stop to imports of chemical inputs had devastating effects for the primary sector: imports of rice (whereas there had previously been self-sufficiency), decline in tea production by 18% in a year, and a third of land left fallow. One of the reasons for this conversion to organic farming was to reduce imports and protect foreign exchange reserves, yet it was counterproductive, as it increased Sri Lanka's trade deficit. Finally, while the traditional sources of State financing were drying up, the increasing recourse to money creation to finance the fiscal deficit only bought time and accelerated inflation and depreciation pressures on the rupee.

Graph 9: International commercial debt flows fell suddenly in 2020



Source: World Bank, AFD calculations.

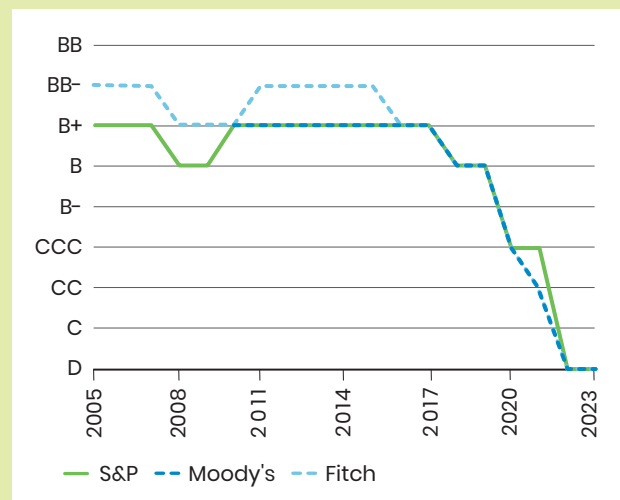
The balance of public accounts, which was already precarious, did not withstand this combination of shocks and economic policy decisions. Revenue dropped due to the slowdown in activity and tax cuts, while expenditure increased due to the rise in social transfers during the pandemic and the automatically higher foreign currency debt maturities (linked to the depreciation). While the fiscal deficit had previously been close to 5% of GDP, it rose to 7.5% of GDP in 2019, 12.2% in 2020, 11.7% in 2021 and 10.2% in 2022. As a result, **the debt dynamics spiraled out of control, with a ratio increasing from 72% to 122% of GDP between 2017 and 2022**. Rated B+ by S&P, Moody's and Fitch until 2017, Sri Lanka's sovereign rating plunged.

The situation is more or less the same for the external accounts. The collapse of tourism, the decline in tea exports and the flight of international investors led to a drop in foreign exchange inflows, while the rise in imports (oil and agricultural goods) and higher external debt maturities led to an increase in foreign exchange outflows. To correct the balance of payments imbalance, **the country had to draw heavily on its foreign exchange reserves**. Despite the multiplication of measures to limit capital outflows, foreign

exchange reserves only amounted to \$1.8 billion in 2022, equivalent to a month of imports of goods and services.^[8]

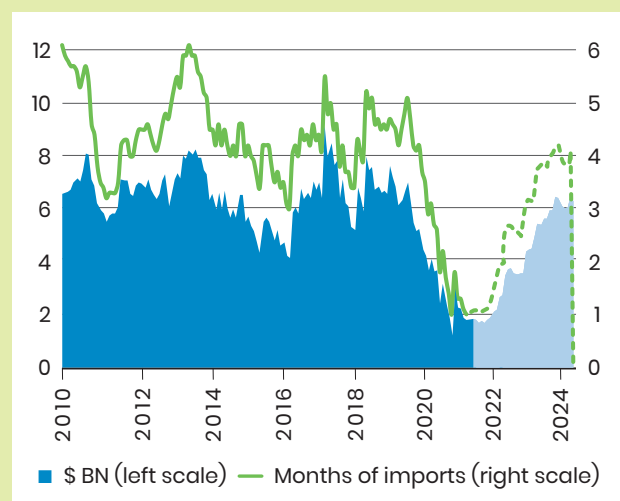
Faced with a public debt that had become unsustainable and the exhaustion of its foreign exchange reserves, **on 12 April 2022, Sri Lanka ended up announcing that it was defaulting on its external public debt, the first default in the country's history**.

Graph 10: Sri Lanka's sovereign rating rapidly deteriorated



Source: S&P, Moody's, Fitch, AFD calculations.

Graph 11: Foreign exchange reserves plummeted as of 2020



Source: Central Bank, AFD calculations.

[8] Moreover, foreign exchange reserves, comprising \$1.4 billion of non-deliverable Chinese swaps as they require a level of reserves above 3 months of imports, had de facto become close to zero.

2. Driven by IMF support and debt relief, a promising upturn in the economy

2.1. To revive a struggling economy, the authorities ended up calling on support from the IMF

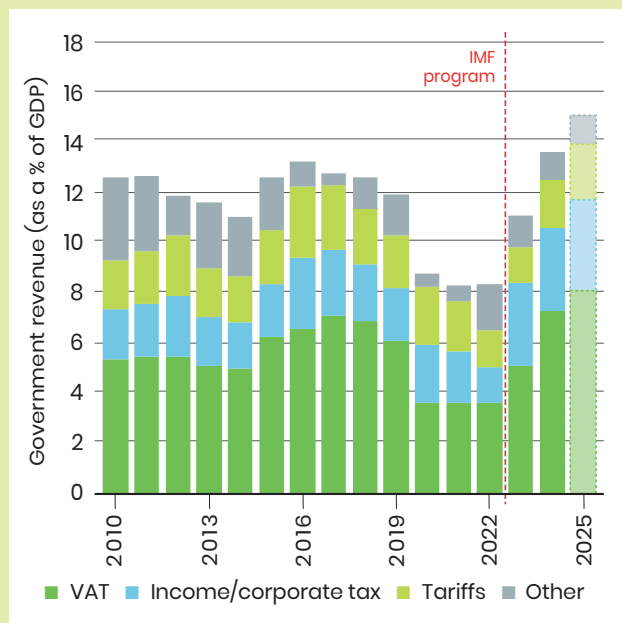
While the authorities declared a “state of economic emergency” in September 2021, the socio-economic situation rapidly deteriorated, with foreign exchange reserves plummeting. The shortages, which had already been triggered by the increasing number of restrictions (milk, sugar, cooking gas, cement, cars, spare part and spices, for example), got worse and inflation surged, reaching a peak at 73% in September 2022. This economic and social crisis was symbolized by the long lines at gas stations, the cancellation of school exams due to the lack of paper, and numerous power cuts. After several weeks of protests (“Aragalaya”), **the Rajapaksa clan was forced to resign between April and July 2022**. Following these departures, the political veteran Ranil Wickremesinghe, who had already been Prime Minister three times in the past (1993–1994, 2001–2004 and 2015–2019), was successively appointed as Prime Minister and elected President of the Republic by Parliament.

In April 2022, the authorities ended up initiating discussions with the IMF with a view to a funding program, an option that the Rajapaksa clan had previously been opposed to. In this respect, **“guarantees” were rapidly given on stabilizing the economy and ensuring the return of a certain financial orthodoxy**. Sharp increases in taxes were introduced in several rounds, largely undoing the reductions granted three years earlier: increase in the rates of VAT (from 8% to 15%) and income and corporate tax, broadening of the tax base, introduction of taxes on imports of non-essential goods, increase in administered prices, restrictions on imports of non-essential goods, for example. On the monetary side, the rupee was placed under a flexible exchange rate regime, resulting in a depreciation in its value of over 40%, and the Central

Bank implemented a stringent tightening of monetary policy. At the same time, to ensure the import of essential goods and social transfers, bridge financing was contracted with the World Bank, the Asian Development Bank, and several bilateral donors.

After several months of negotiations, a staff-level agreement was reached between the different parties in September 2022. **In March 2023, the IMF Board of Directors subsequently approved an Extended Fund Facility of almost \$3 billion for 2023–2027**. The objective at the time was to stabilize the macroeconomic situation and ensure the recovery of economic activity through a series of structural reforms and a substantial provision of financing: IMF disbursements, as well as other external funds catalyzed (World Bank and Asian Development Bank in particular), and the restructuring of public debt (see section 2.2).

Graph 12: The IMF program aims to considerably increase government revenue



Source: IMF, AFD calculations.

The program primarily aimed to **restore the sustainability of public accounts through revenue**, with the target of increasing it to 15% of GDP by the end of 2025 (against 8% in 2022). To this end, under the IMF program, the government mainly focused on permanently establishing the tax increases introduced post-default and supported the adjustments made through the successive Finance Acts (further increase in the VAT rate to 18% in early 2024 in particular). The restructuring of public enterprises was also supported and the automatic adjustment of energy prices (fuel and electricity), but this has not yet been completed (see section 3). However, the program does not provide for sharp cuts in public spending, and even plans to increase it to about 20% of GDP, above its pre-crisis level. Consequently, it has been recommended to strengthen the social safety net and increase investment spending, which is needed to support the economic recovery. The mechanisms governing public finance management and transparency have been revised, and a Public Debt Management Office has been set up. In addition, the program has strictly controlled the financing of the fiscal deficit, in particular by limiting recourse to external financing on commercial terms and Central Bank funding.

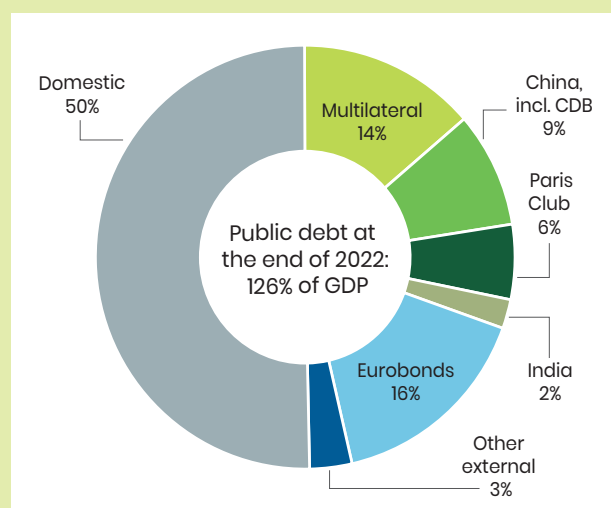
On the monetary and external side, **a reform of the statutes of the Central bank strengthening its independence** was adopted in September 2023 (Central Bank Act). It led to a reorganization of its Board of Directors (of which the Secretary to the Treasury is no longer a member), a restriction on the monetary financing conditions of the deficit, and the introduction of an inflation targeting mechanism (target of $5 \pm 2\%$). A single key interest rate (Overnight Policy Rate) was also introduced in November 2024, strengthening the transmission of the monetary policy of the Central Bank of Sri Lanka (CBSL). Regulations concerning governance practices and solvency ratios in the banking sector were also revised through a reform of the Banking Act in June 2024, and two public banks were recapitalized (see section 2.3). The program also promotes a greater trade and financial openness of the country, including through **an easing of import restrictions** (especially those introduced

from 2020 onwards) and **the removal of restrictions on the convertibility of the rupee**. While the program supports the authorities' efforts to increase the flexibility of the rupee, it also encourages the Central Bank to rebuild its foreign exchange reserves.

Finally, beyond the purely macroeconomic aspects, **the fight against corruption is a central pillar of the program** on the basis, in particular, of the conclusions of the IMF's Governance Diagnostic report published in 2023 (the first Asian country to perform this exercise). The new Anti-Corruption Act which came into force in 2023 strengthens the investigative powers of government agencies (Commission to Investigate Allegations of Bribery or Corruption in particular), and tightens the transparency obligations of public institutions. An Act was also adopted in April 2025 to recover illicitly acquired assets. Finally, several control mechanisms concerning the granting of tax exemptions, the regularity of bid invitations, and appointments in public enterprises have been revised to align them with international standards.

2.2. A long debt restructuring process close to completion

Graph 13: The holders of Sri Lankan public debt are very diverse



Source: IMF, AFD calculations.

The process to restructure Sri Lankan public debt started in September 2022, following a staff-level agreement with the IMF. However, **the diversity of Sri Lanka's creditors** made the restructuring process much more complicated, especially as the country is not eligible for the G20 Common Framework mechanism.^[9] At the end of 2022, Sri Lankan public debt had reached 126% of GDP. It was primarily held (half) by domestic creditors: commercial banks, Central Bank and pension funds. In terms of external creditors, 14% of the debt was held by multilateral donors, 17% by bilateral donors, primarily China (including China Development Bank), Japan and India, and 16% by private creditors in the form of Eurobonds.

Once the scope of the debt to be restructured had been defined (exclusion of the multilateral debt and emergency swap lines in particular), **the process was organized in the form of a multitude of negotiating committees**. Separate committees were set up for the bilateral debt, mainly with the Official Creditors' Committee (OCC, including the Paris Club, India and Hungary) and China EXIM Bank, as well as Iran, Kuwait, Pakistan and Saudi Arabia. The debt towards China Development Bank (CDB) was renegotiated separately from the debt towards China EXIM Bank, as it was considered as a commercial rather than bilateral debt (no explicit guarantee from the Chinese State on CDB loans). In terms of the holders of Eurobonds, most of the international investors came together in an ad hoc committee, while the holders of local Eurobonds formed a separate committee. Finally, there were negotiations with non-bond private creditors, including the banks HSBC and ICBC. The agreements negotiated by these various committees were

required to respect two criteria: i) pave the way for debt relief to restore the sustainability of Sri Lankan public debt (assessed by the IMF) and ii) ensure comparability of treatment between the groups of creditors (assessed by the Paris Club)

Major progress was achieved in 2024, in particular:

- In June 2024, a Memorandum of Understanding was reached with the Official Creditors' Committee, and several bilateral agreements have since been signed in 2025 (including with Japan in March, India in April and France in June);

- At the same time, an agreement was reached with China EXIM Bank and its implementation started in July 2024;

- In September 2024, an agreement was officialized with Eurobond holders (International Sovereign Bonds), including a haircut on the principal of 16 to 40% (contingent instruments). They were also given the option of converting these Eurobonds into instruments in rupees, with priority given to the local holders of these securities. The securities exchanges took place at the end of 2024;

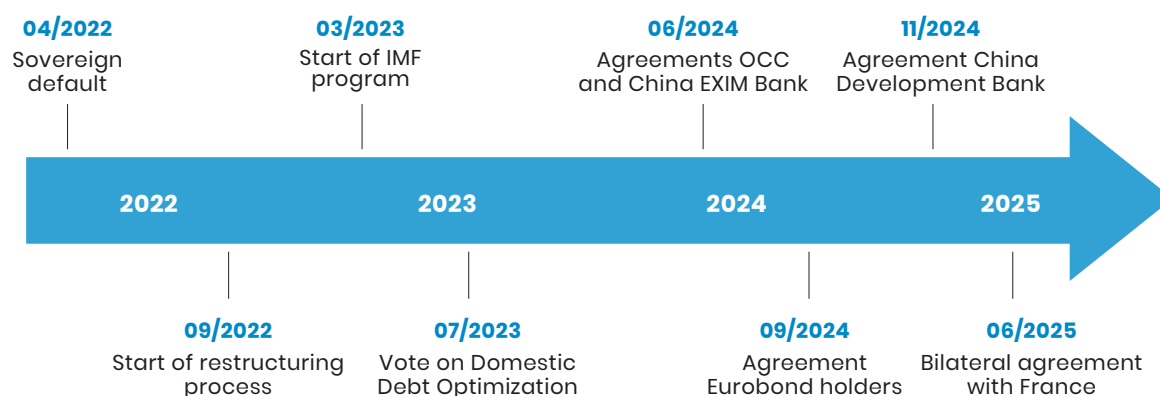
- In November 2024, an agreement was reached with China Development Bank and its implementation started in December;

- Beyond the Eurobonds held by Sri Lankans, the restructuring of the domestic debt was also in the form of a Domestic Debt Operation conducted in 2023, affecting pension funds, holders of currency-denominated securities and the Central Bank.^[10]

[9] The Common Framework for Debt Treatments aims to coordinate debt treatments by bringing Paris Club and G20 creditors together (recent cases include Chad, Ethiopia, Ghana and Zambia). Eligible countries are countries already eligible for the Debt Service Suspension Initiative (DSSI), meaning International Development Association (IDA) borrower countries and all the least-developed countries as defined by the United Nations (provided that they are up-to-date on their debt payments to the IMF and World Bank).

[10] The Domestic Debt Operation includes: i) the extension of the maturity of securities held by pension funds; ii) the conversion of Sri Lanka Development Bonds (distinct from International Sovereign Bonds) into instruments in rupees and the extension of maturities; and iii) the conversion of T-bills (securities with a maturity of less than 12 months) held by the Central Bank into T-bonds.

Diagram 1 – Timeline of the negotiations on Sri Lanka's debt restructuring



Source: Author.

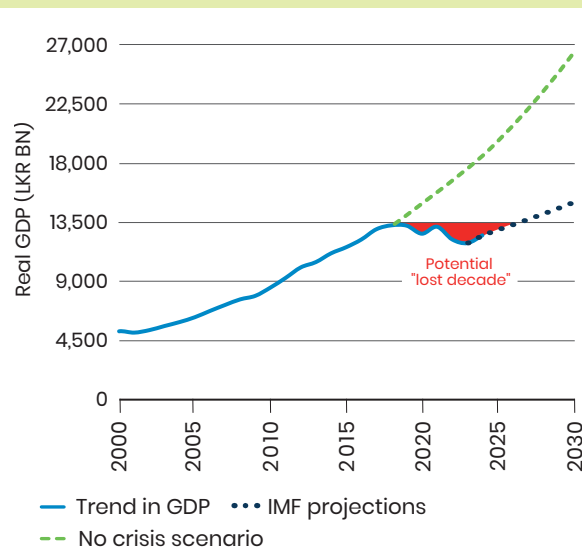
2.3. A promising recovery of the economy, despite serious after-effects

According to IMF projections, the serious impact of the crisis will mean that the country will only return to its pre-crisis level of real GDP in 2026, and its level of per capita GDP of 2018 by 2028, hence **the fear of a “lost decade”**. In addition, due to the economic slowdown, the level of real GDP at the end of 2024 was still about 30% lower than what it would theoretically have reached if the economy had continued on its average growth path of between 2010 and 2018.

This long convalescence of the Sri Lankan economy has serious social implications. While there had been major strides, **the economic crisis has wiped out some 15 years of progress in tackling poverty and inequality**. The share of the population living on less than \$3.65 PPP a day (relevant threshold for LMICs) has thus increased for four consecutive years, reaching a peak at 27% at the end of 2023. While this poverty rate fell slightly in 2024 (to 25%), it remains more than double the pre-crisis level (11% in 2019). It will take a very long time to normalize the level, with the World Bank anticipating that it will still stand at 21% in 2027. Similarly, the World Food Programme estimates that 16% of Sri Lankans were still facing

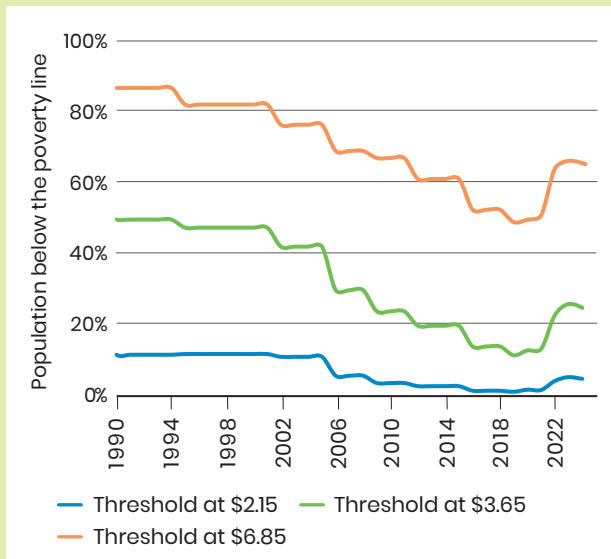
moderate or acute food insecurity at the end of 2024, although the figure has fallen significantly since the peak of the crisis (28% in mid-2022). Consequently, there has been an increase in the emigration of workers in recent years, mainly to Gulf countries. The authorities estimate that 300,000 people left the country each year in 2022, 2023 and 2024, against an average of 218,000 over the previous decade.

Graph 14: Real GDP has still not returned to its 2018 level



Source: IMF, AFD calculations.

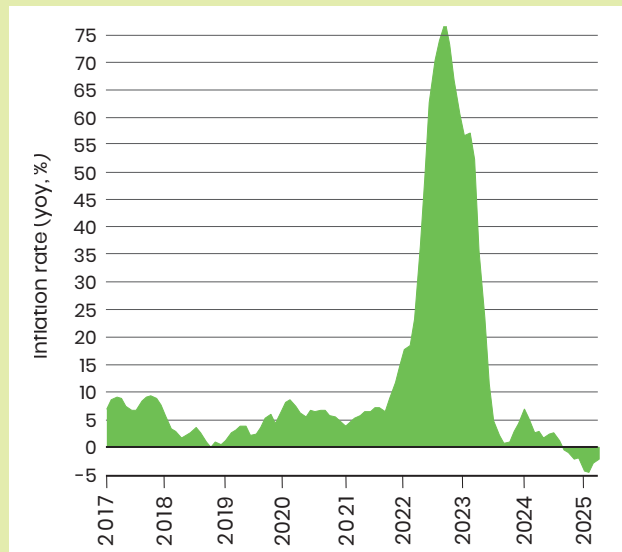
Graph 15: The economic crisis has wiped out 15 years of poverty reduction



Source: World Bank, AFD calculations.

However, **the IMF program and the reforms implemented have had a significant stabilizing effect on the macroeconomic situation**, as illustrated by the sharp decline in inflation (under 5% since July 2023), the appreciation of the foreign exchange rate (over 20% against the USD in 2023–2024), and the fragile replenishment of foreign exchange reserves (close to 4 months of imports since mid-2024). However, as the reforms primarily aim to restore the sustainability of the accounts with structural measures, they will only enable a return to the pre-crisis socio-economic situation in the long term. Furthermore, while several of the reforms implemented have contributed to making the situation of the most vulnerable communities more fragile, the IMF program has incorporated a strong social dimension, especially through support for the introduction of safety nets (Aswesuma transfers in particular),^[11] and the existence of a social spending floor.

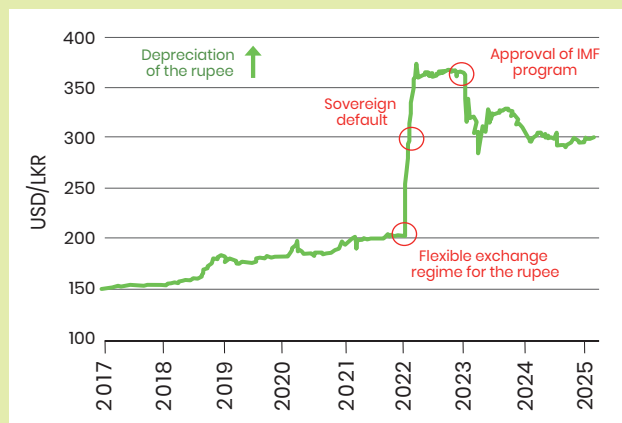
Graph 16: Inflation has fallen below 5% since mid-2023



Source: Central Bank, AFD calculations.

Following a recession in 2019 (–0.2%) and 2020 (–4.6%), then a slight upturn in 2021 (+3.5%), the Sri Lankan economy recorded the strongest contraction in its post-independence history in 2022 (year of the default) to –7.8%. Despite the launch of the IMF program, the country experienced a further year of recession in 2023 (–2.3%). Returning to positive territory in the third quarter of 2023, **economic growth reached 5.0% in 2024, well above forecasts**. Indeed, in June 2024, the IMF still only forecasted Sri Lankan growth at 2.0% for 2023.

Graph 17: The rupee has appreciated since the conclusion of the IMF program



Source: Macrobond, AFD calculations.

[11] Cash transfer program, paid monthly and for vulnerable and low-income households.

Similarly, there has been **a marked improvement in Sri Lanka's banking sector indicators** in recent months. As Sri Lanka has the highest financial inclusion rate in South Asia (89% at the end of 2021, World Bank) and the financial sector is generally well developed (financial assets above 100% of GDP, with two-thirds held by banks), the rebound of the banking sector is an essential requirement for a more general recovery of the economy. In contrast to the Central Bank and pension funds, the country's 30 or so banks have been largely untouched by the sovereign debt restructuring process. They are mainly affected by the conversion of securities denominated in foreign currency into rupees (about 5% of their pre-crisis assets). In addition, two public banks (Bank of Ceylon and People's Bank), which are also the country's two largest banks in terms of assets, benefited from re-

capitalizations in 2024, amounting to 0.5% of GDP, and regulations on governance practices and solvency ratios have been tightened (see section 2.1). Consequently, the banking sector is today more robust (banking solvency ratio of 18.4% at the end of 2024), profitable (return on equity of 15.6%, return on assets of 1.4%) and liquid (liquidity coverage of 314% at the end of 2024). However, it continues to be weighed down by the continually high level of non-performing loans (12.1%, mainly concentrated in the retail, tourism and construction sectors). In addition to its high exposure to sovereign risk and public enterprises (almost half of assets in mid-2024 – much higher for public banks), the sector also continues to have a strong aversion to risk, in particular to the detriment of SMEs.

Table 2 – Banking stability indicators

		Années						
		2018	2019	2020	2021	2022	2023	2024
Capitalization	Risk-adjusted capital (RAC)	16.2	17.2	17.1	16.5	16.2	18.4	18.4
Asset quality	Rate of non-performing loans	3.4	4.7	4.9	4.5	11.6	12.8	12.1
	Unprovisioned NPLs/capital	14.5	19.5	17.2	11.5	44.0	40.9	31.7
Profitability	Return on assets (RoA)	1.1	0.9	1.0	1.2	0.8	1.0	1.4
	Return on equity (RoE)	13.2	10.3	11.4	14.5	10.4	11.5	15.6
Liquidity	Short-term liquid assets/liabilities	37.9	46.1	51.1	44.0	36.8	52.3	51.7
	Liquidity Coverage Ratio (LCR)	/	/	/	/	191.2	288.4	313.8

Source: Central Bank, AFD calculations.

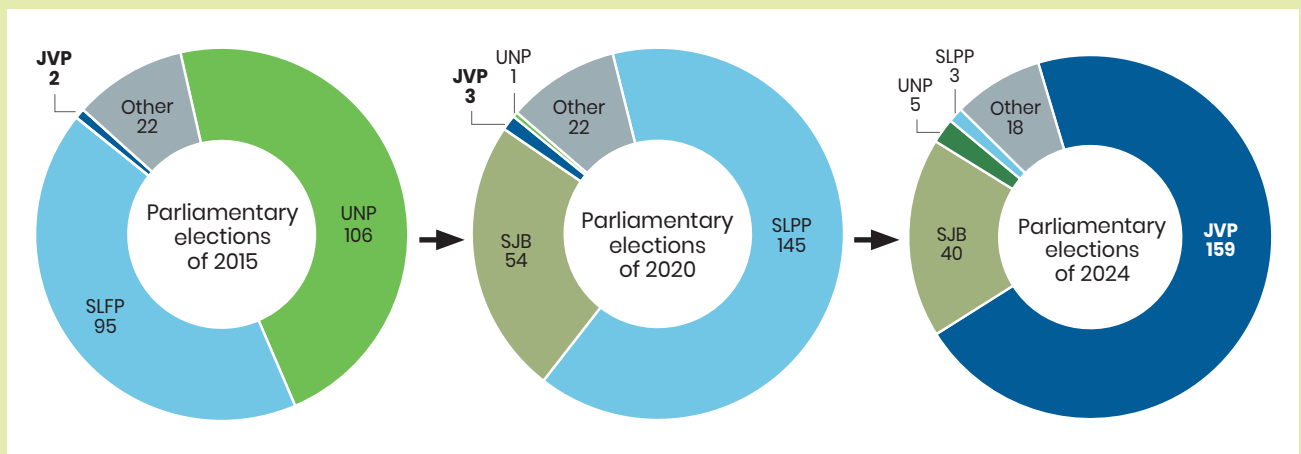
3. The three challenges of democratic consolidation, the continuation of the IMF program and adaptation to climate change

3.1. With the election of Anura Kumara Dissanayake, the need for a consolidation of democracy

The first election since the fall of the Rajapaksa clan, **the presidential election of September 2024 was won by the left-wing candidate Anura Kumara Dissanayake**. Actively involved in the Aragalaya in 2021–2022 and breaking away from the traditional political classes, he is a member of the People's Liberation Front (Janatha Vimukthi Peramuna [JVP]), a Marxist party that has formed a coalition with about 20 parties and organizations within the National People's Power (NPP) alliance. **The coalition led by Anura Kumara Dissanayake subsequently won a**

landslide victory in the parliamentary elections of November 2024, winning 159 seats out of 225 (against only 3 in the elections of 2020 and 2 in the elections of 2015), a majority of over two-thirds, which should enable him to implement his electoral priorities. This result marks a real turning point, as the NPP came out well ahead of the coalitions led by the Sri Lanka People's Front (Sri Lanka Podujana Peramuna [SLPP], associated with the Rajapaksa clan), the Samagi Jana Balawegaya (SJB), and the United National Party (UNP, the party of Ranil Wickremesinghe). Indeed, Sri Lankan political life over the last 50 years had been dominated by the opposition and alternation between the United National Party (which the SJB split from) and the Sri Lanka Freedom Party (SLFP, which the SLPP split from).

Graph 18: Number of seats won by the coalitions and alliances led by the various parties

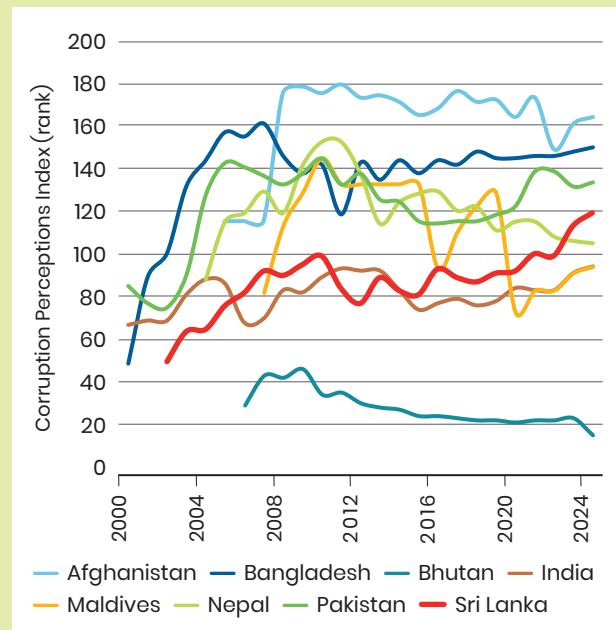


The first months of the presidency have been marked by serious efforts to tackle corruption, a certain pragmatism in terms of economic policy, and continued good relations with international donors. **The President thus benefits, for the time being, from wide public support, which led to a further victory**

for his party in the local elections of May 2025, albeit less of a landslide. The NPP won 43% of votes, ultimately winning 3,927 seats in the local councils (against 434 previously). This election was also marked by a lower turnout (62%, against 79% in the presidential election and 69% in the parliamentary elections).

In a country where governance has deteriorated significantly over the last 20 years, **Anura Kumara Dissanayake will have the daunting task of restoring the public's confidence in their institutions.** Indeed, there has been a serious backsliding in the democratic process since the tenure of Mahinda Rajapaksa (2005–2015), which was marked by an increase in presidential powers and an erosion of civil liberties. While his successor Maithripala Sirisena (2015–2019) initially set out to strengthen checks and balances, this ambition rapidly came up against divisions within his coalition, before being undermined by a constitutional “coup” at the end of 2018. Minister of Defense during the tenure of his brother Mahinda, Gotabaya Rajapaksa was subsequently elected President (2019–2022). During his tenure, presidential prerogatives were strengthened (Amendment to the Constitution of 2020), and nine government portfolios were entrusted to members of his family, covering 75% of the budget. He was forced to leave the country during the Aragalaya and was replaced by the political veteran Ranil Wickremesinghe (2022–2024) who, in turn, was criticized for his authoritarian abuses (repression of protests, failure to hold municipal elections, no clear break with the legacy of Rajapaksa), although his tenure was also marked by a reduction in presidential powers. Consequently, **Sri Lanka's governance indicators are now close to the South Asian average**, whereas they had historically been among the highest ranked countries in the region. The country has thus dropped 38 places in the composite indicator of the World Bank's Worldwide Governance Indicators (WGI). Indeed, between 2016 and 2022, it fell from 89th to 127th place worldwide (moving up to 121st place in 2023). Similarly, the country lost 54 places in the Transparency International Corruption Perceptions Index between 2005 and 2023, and now ranks 121st out of 180 worldwide, surpassed in the region by Bhutan, India, the Maldives and Nepal.

Graph 19: The perception of corruption has deteriorated sharply over the last 15 years



Source: Transparency International, AFD calculations.

At the international level, Anura Kumara Dissanayake was quick to make a visit to India (December 2024) and China (January 2025) to **restore balance in Sri Lanka's geopolitical position.** A small island national with a geostrategic position, it is highly dependent on its two major neighbors which are, at the same time, its largest trading partners, foreign investors and bilateral donors. Following specific moves to establish closer ties with Beijing during the tenures of Mahinda and Gotabaya Rajapaksa, illustrated by the development of major infrastructure projects financed by China (see section 1.2), his aim is to maintain more balanced relations, especially as the assistance from these two countries will be critical in supporting Sri Lanka's economic recovery.

3.2. While initially critical, the President has pledged to respect the terms of the IMF program

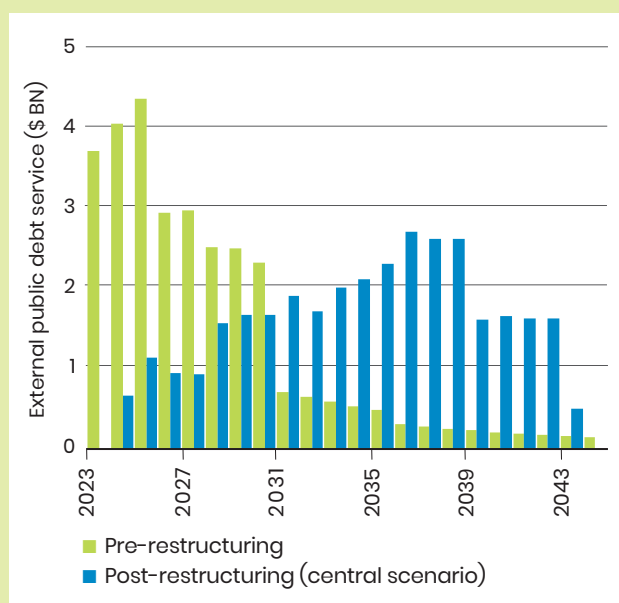
Critical during the election campaign, **President Anura Kumara Dissanayake finally pledged to respect the objectives of the IMF program.** The budget adopted in March 2025 thus provides for a series of expansionary measures, including a revision of income tax rates, a VAT exemption on dairy products, salary increases for public servants, and increased support to the agriculture sector. However, these measures are offset by an increase in revenue, in particular an increase in taxes levied on imports of motor vehicles (after a five-year ban on imports). The objective is to achieve a primary fiscal surplus of 2.3% of GDP in 2025, in line with the target of the IMF program. In this context, the various IMF program reviews have concluded with very positive statements, including those after the election.

While the President's pragmatism in terms of economic policy is lauded, **many reforms are still needed in the short and medium term.** The issues of electricity prices and the financial stability of the Ceylon Electricity Board (CEB) are the first challenges. Indeed, electricity prices have not been aligned with actual costs for a long time, in particular due to three price reductions decided on in 2024-2025 (following four post-default increases), and the CEB recorded losses in the first half of 2025. While there was a 15% price increase in June 2025, a sustainable reform through the effective implementation of an automatic adjustment mechanism is still recommended. The restructuring of public enterprises in difficulty is also a priority, as at least 400 agencies have been identified in Sri Lanka. Many of them also operate in competitive sectors and they are a potential source of fragility for State finances. While the elected President has put a stop to the privatization projects planned by his predecessor, he has pledged to im-

prove the transparency, governance and operational performance of these agencies. However, the privatization of a hotel project (Canwill Holdings) was announced in May 2025. At the same time, the introduction of a Public Financial Management Act (including a fiscal rule and a ceiling on public spending) is expected in the coming months. Finally, **it is necessary to improve the business climate to create new growth drivers**, as several traditional drivers of economic activity have been hard hit by the crisis. The priority measures include removing the barriers to trade and investment (especially those introduced from 2019 onwards), and modernizing labor law, the bankruptcy regime, land law, and the framework for public-private partnerships to improve the country's attractiveness and its integration into the world economy.

More broadly, **the continuation of the economic recovery will require maintaining a certain financial orthodoxy, which could conflict with the government's objectives of maintaining social peace.** With a post-restructuring public debt expected to be above 100% of GDP, the risks surrounding the continuation of the IMF program are far from negligible. Indeed, the elections at the end of 2024 gave rise to major social expectations, and the incentives to keep the reforms on track could disappear once the restructuring has been completed and due to the good macroeconomic results already achieved. In addition to these risks, there are the country's institutional weaknesses and its track record of poor financial governance, which can be seen with the mixed results of the IMF programs in the decades prior to the crisis. 2028 will be a turning point, with the expected increase in the external debt service (approximately +70% over a one-year horizon, resumption of the repayment of the principal to bilateral donors), especially as the IMF program ends in 2027 and it will be a pre-election year.

Graph 20: An increase in debt service expected as of 2028



Source: IMF, AFD calculations.

In addition, while the pick-up in economic activity is encouraging, many of the weaknesses that led to the current crisis remain, and the risk of further shocks cannot be ruled out. Beyond the “traditional” shocks related to the structural vulnerabilities of the economy (such as extreme climate events, a decline in international tourism and a rise in commodity prices), there is a growing risk of a shock related to the deterioration of the international geopolitical situation, in particular through the channel of trade. Indeed, a quarter of Sri Lankan exports of goods goes to the USA, mainly textiles and, to a lesser extent, tires and tea. This windfall amounts to approximately \$3 billion a year (or an average of 3.6% of GDP between 2019 and 2023) and is instrumental in addressing the external account imbalance and rebuilding foreign exchange reserves. In the summer of 2025, the U.S. authorities announced a 20% tariff on Sri Lankan imports (after initially announcing 44% on “Liberation

Day” in April, the sixth highest rate announced). As the flows of U.S. aid to Sri Lanka and those from the Sri Lankan diaspora based in the USA are lower, 0.13% (2023) and 0.25% of GDP (2019), respectively, a potential reduction in them would have a lower impact on the economic recovery. More indirectly, an escalation of geopolitical tensions could affect Sri Lanka through a multitude of other channels, mainly an increase in global interest rates, rising commodities prices, a decline in foreign investment, and a reduction in the financing capacity of international financial institutions. The geostrategic position of Sri Lanka, an island located at the point where the Indian, Chinese and American areas of influence converge, is, more generally, evidently a vulnerability in an increasingly deteriorated international environment.

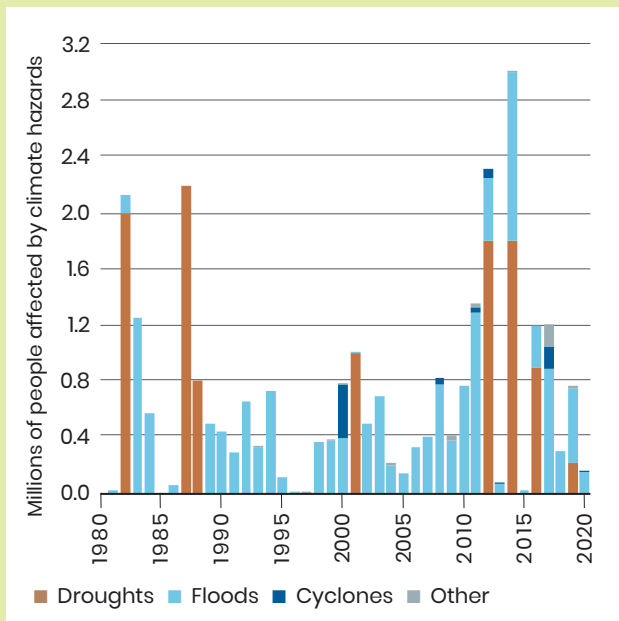
3.3. The need to adapt to climate change

An island nation in the Indian Ocean, Sri Lanka is highly vulnerable to the effects of climate change. Fluvial, pluvial and coastal floods are the biggest threat. In addition to their direct damage, they cause devastating landslides and increase the spread of diseases, such as the dengue epidemics in 2017 and 2019. At the same time, vast areas of the country experience droughts and, more generally, long periods when it is difficult to access water. The World Bank estimates that **floods and droughts have affected 16 and 11 million people, respectively, over the last 40 years** (for a total population of 22 million). On a less frequent basis, Sri Lanka is affected by intense tropical storms, with the last major cyclone dating back to 2017. Because it would cause temperatures to rise and disrupt rainfall patterns, climate change would increase the frequency and intensity of these various extreme climate events. In addition, there is a risk that coastal regions will be seriously affected by rising sea levels, as about one third of the population (World Bank) and a sizeable share of economic activities are concentrated along the 1,340 km coastline.

In addition to the human consequences, climate issues pose serious risks for economic activity. **The agriculture sector is the most exposed to climate risks**, although it accounts for less than 10% of GDP. Indeed, variations in rainfall patterns and temperature increases, in a context where only a third of cropland is irrigated (FAO), are likely to affect agricultural productivity, especially for crops that consume the most water, such as rice (essential to the country's food security). Rising sea levels and soil erosion and salinization also pose a serious risk for crops on coastal plains (primarily rice and coconuts). Fishing activity would be affected by rising temperatures and ocean acidification, which in particular degrade coral reefs and disrupt fish movements. A crucial sector of the economy and a major source of foreign exchange, **tourism is also vulnerable**. With a model based on seaside activities and a large proportion of hotel complexes and restaurants located near the coast, it is vulnerable to rising sea levels, erosion, and the deterioration of marine biodiversity. Finally, **infrastructure (transport, education, health, for example) is exposed to all the physical risks that Sri Lanka may face**. This is compounded by the concentration of the population and economic activities along the coast.

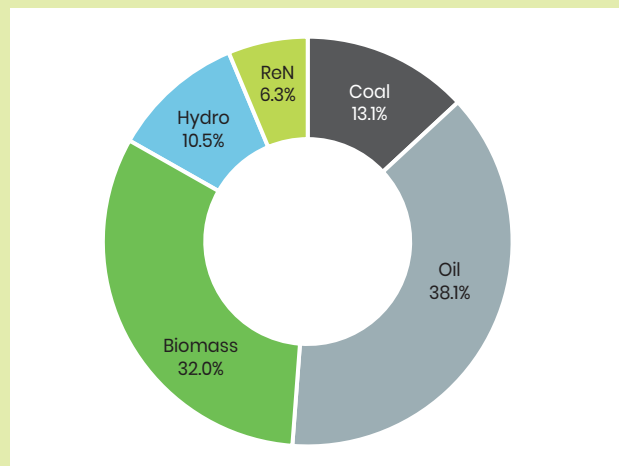
While there are major physical risks associated with climate change, there are fewer risks associated with the low-carbon transition. Indeed, **Sri Lanka has a low level of greenhouse gas (GHG) emissions**, with only 1.6 tons of CO₂ equivalent per capita in 2021, a quarter of the global average (6.2 t eq. CO₂, Climate Watch). This is because economic activity is primarily driven by services (lower emissions than industry), there is a large share of biomass in the energy mix, and 40% of power generation comes from hydroelectric dams. However, it should be noted that the increase in energy demand over the last 15 years has largely been met by coal (consumption nearly zero before 2010). Few sectors would thus appear to be exposed to the risks of the low-carbon transition, although certain key sectors of the economy are indirectly exposed, especially international tourism (air transport), the textile industry (chemical inputs), rice growing (methane emissions), and rubber production (potential deforestation).

Graph 21: Floods and droughts affect 700,000 Sri Lankans a year on average



Source: World Bank, AFD calculations.

Graph 22: Sri Lanka's energy mix is relatively low-carbon



Source: Sri Lanka Sustainable Energy Authority, AFD calculations.

Finally, while there are major macroeconomic risks associated with biodiversity loss, they are also less important than the physical climate risks. Almost half of Sri Lanka is covered by vegetation and its capacity to provide ecosystem services is higher than the world average. However, **the country's natural species have declined by 34% since 1970 due to a change in land use related to human activities**, much higher than the South Asian average (UK Natural History Museum). Similarly, the risk of extinction for endangered species is extremely high, as shown by its Red List Index of 55% (International Union for Conservation of Nature).^[12] The associated macroeconomic risks are far from negligible, as several key sectors for economic activity rely on at least one ecosystem service, especially water-related services (supply, treatment, flow control), soil and sediment retention, and flood control. In addition, several industries contribute to these pressures on the environment, meaning that the biodiversity transition poses a real risk: rice (methane emissions) and tea production (ammonia emissions, pressure on endangered species) and power generation (sulfur dioxide and nitrogen oxide emissions) in particular.

In terms of climate and environmental policies, the Central Environment Authority was established in 1981, a Ministry of Environment was created in 1990, and the country signed the Convention on Biological Diversity in 1992. A series of strategic documents have been prepared, integrating a climate dimension, with priority logically given to adaptation measures. They include the strengthening of infrastructure (dikes, dams, drainage systems) and the restoration of protection ecosystems, the development of monitoring systems, the extension of insurance mechanisms, prevention, improvements in water resources management, and the introduction of more drought-resistant crops. At the same time, and despite the limited GHG emissions, the authorities have gradually integrated mitigation measures, one of the aims being to turn the transition into an opportunity. These policies are based on the development of renewable energies (wind energy in particular), the reduction of coal consumption, the promotion of sustainable transport, and reforesta-

tion. In addition, the authorities have recently largely promoted the Clean Sri Lanka initiative (launched in 2025), which includes a series of concrete measures with a strong environmental dimension.

While an update of the Nationally Determined Contribution is expected soon (NDC 2021: reduction of GHG emissions by 14.5% by 2030), the authorities have set the target of achieving carbon neutrality by 2050. A new biodiversity strategy is also expected, while the last version adopted in 2016 ran until 2022 (National Biodiversity Strategies and Action Plans [NBSAP]). Furthermore, while the authorities have promoted organic farming for several decades, the country's rapid conversion to organic farming in April 2021 was a failure (see section 1.3) and the protected areas only cover 3% of the country (but 30% of the land area), according to the World Bank. Despite the reflection, still in its early stages, on a real shift in the production system towards a more virtuous model in terms of the climate and the environment (blue economy, agriculture, tourism, and so on), **the operationalization of such policies logically comes up against the issue of how to finance them**. For example, to achieve the target of carbon neutrality by 2050 alone, Sri Lanka's Carbon Net Zero 2050 Roadmap and Strategic Plan estimates the investment requirement at \$140 billion between 2023 and 2050 (about 200% of GDP). While the authorities benefit from donor support and aim to give priority to private investment (first Green Bond issuance on the Colombo Stock Exchange in 2024), the scale of the amounts required and the fragility of the public accounts mean that these issues may well become less of a priority.

[12] The Red List Index is an indicator that tracks changes in global biodiversity status. A value of 100% indicates that there is no risk of extinction for any of the endangered species on the IUCN list, a value of 0% means that all the endangered species on the list have become extinct.

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List of acronyms and abbreviations

BN	Billion	NBSAP	National Biodiversity Strategies and Action Plans
CBSL	Central Bank of Sri Lanka	NDC	Nationally Determined Contribution
CDB	China Development Bank	NPP	National People's Power
CEB	Ceylon Electricity Board	OCC	Official Creditors' Committee
DSSI	Debt Service Suspension Initiative	PPP	Purchasing power parity
FDI	Foreign direct investment	SEZ	Special economic zone
GHG	Greenhouse gas	SJB	Samagi Jana Balawegaya
HDI	Human Development Index	SLFP	Sri Lanka Freedom Party
IDA	International Development Association	SLPP	Sri Lanka Podujana Peramuna
JVP	Janatha Vimukthi Peramuna	UMIC	Upper-middle-income country
LIC	Low-income country	UNP	United National Party
LMIC	Lower-middle-income country	USD	American dollar
LTTE	Liberation Tigers of Tamil Eelam	WGI	Worldwide Governance Indicators
M	Million		

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