Sri Lanka Development Update 2021

PHOTO BY: © RUWAN WALPOLA/SHUTTERSTOCK.COM

Economic and Poverty Impact of COVID-19

THE WORLD BANK

Photo Credits: Cover: Ruwan Walpola/Shutterstock.com; Executive Summary: Savani Jayasooriya; Recent Developments: Samitha Senadheera; Outlook, Risks and Policy Options: Deshan Tennekoon; Special Focus: Simone D. McCourtie; Last Page: Lakshman Nadaraja.

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 a longer term and global context, 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 Robert Beyer and Kishan Abeygunawardana (Senior Economists, Macroeconomics, Trade and Investment (MTI)), Yeon Soo Kim (Senior Economist, Poverty), and Nayantara Sarma (Consultant, SARCE) with inputs from Angela Prigozhina (Senior Financial Sector Specialist, Finance, Competitiveness and Innovation (FCI)), Krishnamurti Damodaran (Lead Financial Sector Specialist, FCI), Amila Dahanayake (Economist, FCI) and Tatsiana Kliatskova (Young Professional, FCI). The team thanks Zoubida Allaoua (Director, Equitable Growth, Finance and Institutions (EFI), South Asia Region), Faris Hadad-Zervos (Country Director for Maldives, Nepal and Sri Lanka), Chiyo Kanda (Country Manager, Maldives and Sri Lanka), Manuela Francisco (Practice Manager, MTI), Andrew Dabalen (Practice Manager, Poverty), Tae Hyun Lee (Lead Country Economist, EFI) and Aurélien Kruse (Lead Country Economist, MTI) for their guidance and comments on the report. Alejandro Espinosa at Sonideas was responsible for the layout, design, and typesetting. Sudip Mozumder, Dilinika Peiris and Samitha Senadheera led dissemination efforts. For questions, please contact: infosrilanka@worldbank.org.

The report was prepared based on published data available on or before March 17, 2021. Data sources included the World Bank, Ministry of Finance, Central Bank of Sri Lanka, Department of Census and Statistics, Bloomberg, and press reports. The team thanks the Ministry of Finance and think tank representatives for their comments on the document.

This report, additional material and previous reports can be found at:

www.worldbank.org/sldu

Previous editions:

- February 2019: Demographic Change in Sri Lanka
  https://openknowledge.worldbank.org/handle/10986/31261
- June 2018: More and better jobs for an upper middle-income country,
  https://openknowledge.worldbank.org/handle/10986/29927
- November 2017: Creating opportunities and managing risks for sustained growth, openknowledge.
  worldbank.org/handle/10986/28826
- June 2017: Unleashing Sri Lanka's trade potential,
  openknowledge.worldbank.org/handle/10986/27519
- October 2016: Structural challenges,
  openknowledge.worldbank.org/handle/10986/25351

Stay in touch with the World Bank in Sri Lanka and South Asia via

- www.worldbank.org/en/country/srilanka
- @WorldBank, @WorldBankSAsia, follow hashtag #SLDU2021
- www.facebook.com/worldbanksrilanka
- https://www.instagram.com/worldbank
- www.linkedin.com/company/the-world-bank

Contents

Executive Summary

Recent Economic Developments

Amid the COVID-19 pandemic, Sri Lanka's economy contracted by 3.6 percent in 2020, the worst growth performance on record, as is the case in many countries fighting the pandemic. Swift measures enacted by the government in the second quarter helped contain the first wave of COVID-19 successfully, but these measures hit sectors like tourism, construction, and transport especially hard, while collapsing global demand impacted the textile industry. Job and earning losses disrupted private consumption and uncertainty impeded investment. As a result, the economy contracted by 16.4 percent (y-o-y) in the second quarter. The economy began to recover in the third quarter as the first wave was brought under control and containment measures were relaxed. The momentum continued in the fourth quarter as the economy was broadly kept open despite a second wave of COVID-19 infections.

The government took proactive measures to mitigate the impact of the pandemic. Despite limited fiscal space, resources were allocated (approximately 0.7 percent of GDP) for health measures, cash transfers, and postponed tax payments. While public expenditures increased, revenues declined, resulting in a widening of the fiscal deficit in 2020. Due to the economic contraction and the elevated fiscal deficit amid COVID-19, public and publicly guaranteed debt is estimated to have increased to 109.7 percent of GDP. In line with the government strategy to reduce external debt over the medium-term, debt financing relied increasingly on domestic sources.

The Central Bank of Sri Lanka (CBSL) significantly contributed to the crisis response. It undertook considerable monetary policy easing, for which there was room given benign inflation, and additional measures to increase liquidity in the market and support businesses. It also introduced financial sector regulatory measures, like a debt moratorium for COVID-19 affected businesses and individuals. However, despite these efforts, bank lending to the private sector remained low. By contrast, credit to the government and state-owned enterprises surged and accounted for 80 percent of the total credit in 2020. The pandemic likely exacerbated pre-existing financial sector vulnerabilities, although the full impact of COVID-19 cannot yet be observed.

An improved trade balance and strong remittance inflows narrowed the current account deficit. A sharp drop in imports in 2020 more than offset the decline in exports. However, with financial inflows insufficient to meet external liabilities, reserves declined to an 11-year low in February 2021, before a currency swap worth US$ 1.5 billion with the People's Bank of China was approved in March 2021. Due to a shortage of foreign currency, the exchange rate depreciated by 6.5 percent from January through March 17, 2021. The CBSL took several measures to preserve foreign exchange reserves and reduce pressures on the exchange rate.

Outlook and Medium-term Prospects

Growth is expected to recover to 3.4 percent in 2021, mainly reflecting a base effect and FDI inflows. Gradually normalizing tourism and other economic activities as well as already signed investments will support growth. However, the subdued global recovery may dampen export demand. Over the medium-term, continued trade restrictions, economic scarring from the slowdown, and the high debt burden may weigh on growth prospects. Through an enhanced focus on an export-oriented growth model that taps the full potential of private investment, the country could realize its ambitions to increase its competitiveness and raise growth in a sustainable manner.

The forecast is subject to both upside and downside risks. If the global economy recovers faster than expected and the global tourism industry rebounds more quickly with the progress on vaccination programs, the growth outlook could become more favorable. On the other hand, downward risks persist, pertaining to debt and external sustainability given high debt and low external buffers, especially because the repayment profile requires accessing financial markets frequently. Given large refinancing requirements, constrained market access amid rating downgrades is a challenge. Thus, striking a balance between supporting the economy amid COVID-19 and ensuring fiscal sustainability is key. A reform program to provide a fiscal anchor could help Sri Lanka to reduce debt vulnerabilities and lower sovereign risk.

Special Section: The COVID-19 Impact on Employment and Poverty

The Special Focus section of this edition discusses the impact of COVID-19 on poverty. The economic contraction in the wake of COVID-19 has reversed past progress, at least temporarily. Poverty is expected to have risen since the onset of the pandemic mostly due to widespread job and earning losses. Simulations suggest that job losses were more likely to occur in urban areas and among private sector and own-account workers. Job losses were concentrated in the lower-middle of the income distribution: workers most vulnerable to job loss are located between the 20th and 40th percentiles of the pre-pandemic earnings distribution. Temporary absence from work and job losses occurred less frequently than declines in earnings. While informal workers are more likely to suffer earnings losses, formal workers have been affected as well, for example in the export-oriented apparel industry.

With jobs lost and earnings reduced, the $3.20 poverty rate is projected to have increased from 9.2 percent in 2019 to 11.7 percent in 2020. The poorest experienced the largest proportionate earnings shock while the smallest proportionate income losses were suffered by the richest. The latter tend to have formal, secure jobs and better access to digital technology that allows them to conduct wage work or business operations remotely.

To mitigate the impact of the economic hardship on the poor and vulnerable, the government implemented several livelihood support programs, which helped to soften the labor market shock and the impact on poverty. Further progress in restoring livelihoods and making them more resilient could help Sri Lanka to continue its path of poverty reduction and shared prosperity. The current social protection system could support the reintegration of those who lost their jobs. In the medium term, social safety nets could be better targeted toward the poor and vulnerable, and adjusted to allow for support to be scaled up quickly and effectively in times of crises.

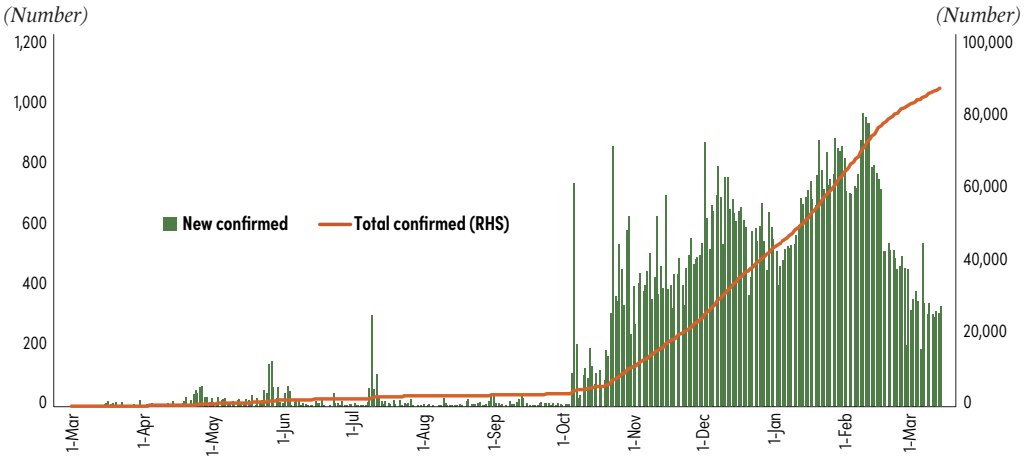
Unequal opportunities to work from home have introduced new economic and spatial divides as working remotely is nearly exclusively an option for high-income earners, and small and medium-sized enterprises were unlikely to adopt digital technologies. In the medium to long-term, digital technologies could become an important engine for job growth. However, despite widescale ownership of cellphones in Sri Lanka, the digital revolution will fall short of expectations without expansion of high-speed networks and accessible data on the whole island. Sri Lanka could provide new opportunities for economic mobility through policies that expand or universalize access to digital infrastructure. Investments in digital literacy are a prerequisite for widely shared benefits from these new opportunities.

1 Recent Economic Developments

Context

The COVID-19 pandemic impacted Sri Lanka profoundly. When the first domestic cases of COVID-19 were reported in March 2020, the government rapidly scaled-up containment measures. Tourist arrivals were suspended, and an island-wide curfew was implemented from mid-March through June 2020. These measures, combined with rigorous case finding, contact tracing, as well as quarantine and isolation, ensured that the first wave was contained successfully. Only 3,380 cases and 13 deaths had been reported by September 30, 2020. However, the country had to contend with a second wave of infections and a rapid increase in cases during the last quarter of 2020. Of the total 88,238 cases reported up to March 15, 2021, approximately 96 percent have been reported since October 2020 (Figure 1). This time, however, the government resorted to targeted lockdowns instead of island wide curfews to minimize the impact on economic activity.

Figure 1: Covid-19 cases in Sri Lanka as of March 15, 2021



Source: Health Promotion Bureau, Our World in Data, and staff calculations.

The COVID-19 shock came against the backdrop of pre-existing weaknesses. Growth averaged only 3.1 percent between 2017 and 2019. Structural reforms to shift the growth model towards wider private sector participation, export-orientation, and integration into global value chains progressed slowly and, in addition, frequent macroeconomic shocks disrupted economic activity. Before the COVID-19 outbreak, the economy started recovering from the Easter Sunday Attacks that caused GDP growth to decelerate to 2.3 percent in 2019, the lowest in two decades. COVID-19 manifested a new economic shock with unparalleled economic consequences.

The pandemic also compounded Sri Lanka's difficult fiscal and debt positions. Low tax revenues (the tax revenue-to-GDP ratio is one of the lowest in the world) combined with high levels of non-discretionary expenditures leave little room for critical development spending, including on health, education, and infrastructure. High fiscal deficits over the last years have resulted in mounting debt. As a share of GDP, Public and Publicly Guaranteed (PPG) debt rose from 78.5 percent in 2015 to 94.3 percent in 2019. Despite a challenging fiscal and debt situation, the government implemented a fiscal stimulus package in November 2019 to support growth over the medium-term.[1] The COVID-19 pandemic made a challenging situation worse, aggravating fiscal sustainability concerns.

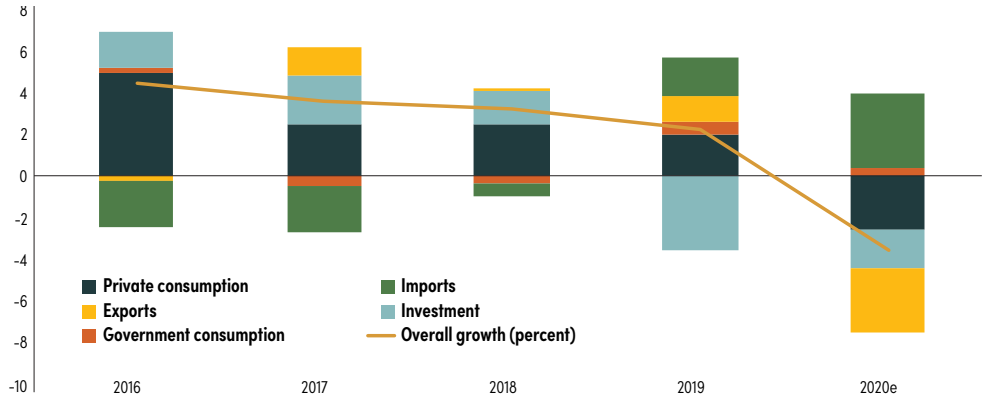
1 This includes a reduction in the VAT rate from 15 to 8 percent, an increase in the VAT registration threshold from LKR 12 million to 300 million per annum, and other concessionary rates and exemptions on Personal Income Tax and Corporate Income Tax.

Real sector

The COVID-19 pandemic led to Sri Lanka's worst growth performance on record, as is the case for many countries around the world . The economy contracted by 3.6 percent in 2020 (y-o-y). In the first quarter, the economy contracted by 1.8 percent. This was followed by an unprecedented decline of 16.4 percent (y-o-y) in the second quarter, with large contractions in construction, manufacturing, tourism, and transport, as a curfew impeded economic activity and global demand collapsed. Growth recovered to 1.3 percent (y-o-y) both in the third and fourth quarter as lockdown measures were relaxed and financial services, manufacturing of food and beverages, and domestic trade drove the rebound.

Figure 2: Growth deceleration (expenditure side)

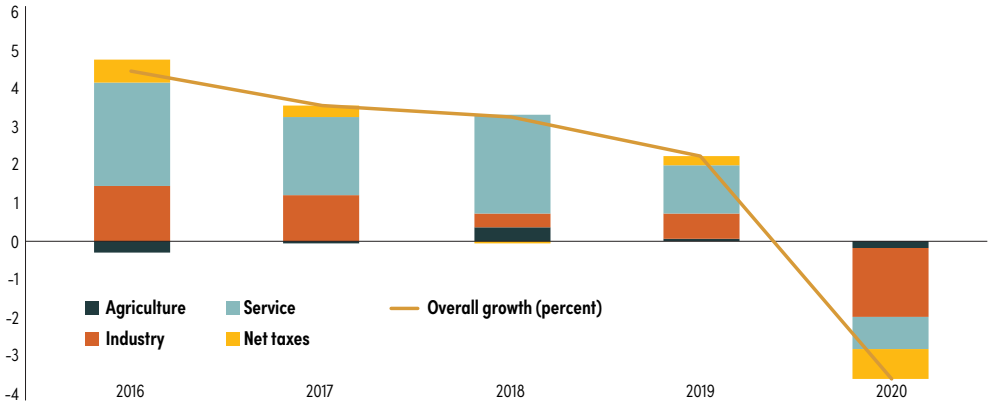
(Percentage point contribution)



Source: Department of Census and Statistics and staff calculations.

Figure 3: Growth deceleration (production side)

(Percentage point contribution)



Source: Department of Census and Statistics and staff calculations.

The pandemic affected most drivers of demand in 2020. Job and earning losses in key sectors (such as construction, manufacturing, and tourism) dampened private consumption despite buoyant remittance inflows.[2] This was only partly mitigated by positive contributions from government consumption. Uncertainty about the medium-term outlook constrained private investment, including FDI. Business outlook surveys of the Central Bank (CBSL) showed weak confidence, even when the economy slightly rebounded in the third and fourth quarter. Merchandise exports such as

2 In the first two quarters of 2020, the labor force participation rate declined below pre-Covid levels and the unemployment rate rose above (Sri Lanka Labour Force Statistics Quarterly Bulletin, Issue 89). The former declined by 2.4 percentage points (y-o-y) and the latter rose by 0.5 percentage points (y-o-y).

textiles and tea suffered from weak demand in Europe and the United States and supply chain disruptions, while the closure of airports between April and December brought tourism to a standstill. Nevertheless, the negative contribution to growth from the reduction in export receipts was largely offset by a reduction in imports amid import restrictions and low domestic demand (Figure 2).

Industrial activity was affected more than services and agriculture. Construction and textile manufacturing, which require workers to be physically present, suffered the largest shocks, leading to an overall contraction of 6.9 percent in industrial activity in 2020. The services sector contracted by 1.5 percent due to weak performances in transport, tourism, and personal services (as mobility remained constrained). Agricultural production suffered from disruptions in supply chains and contracted by 2.4 percent (Figure 3).

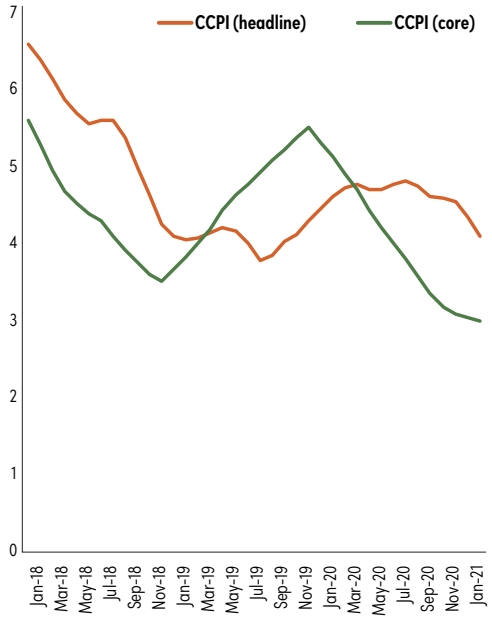
The COVID-19 pandemic led to an increase in poverty through deteriorations in labor market outcomes. Workers engaged in industries were more affected than those working in agriculture and services. Simulations suggest that job losses were concentrated in the lower-middle of the income distribution and more likely to occur in urban areas and among private sector and own-account workers. Poverty is expected to have increased from 9.2 percent in 2019 to 11.7 percent in 2020 (see the Special Focus Section of this report for more details).

Monetary and financial sector

Despite high food inflation, weak demand kept overall inflation in check. Annual average inflation measured by the Colombo Consumer Price Index (CCPI, 2013=100) was 4.1 percent in February 2021 (Figure 4). Food inflation has remained high at around 10 percent since the second half of 2020, reflecting the impact of supply disruptions. However, it was mitigated by low/declining prices in non-food categories amid low demand and administrative price controls, for example on fuel. Core inflation (computed excluding food and energy prices) was 3.0 percent February 2021. The National Consumer Price Index (NCPI, 2013=100) shows a similar trend as the CCPI.

Figure 4: CCPI inflation

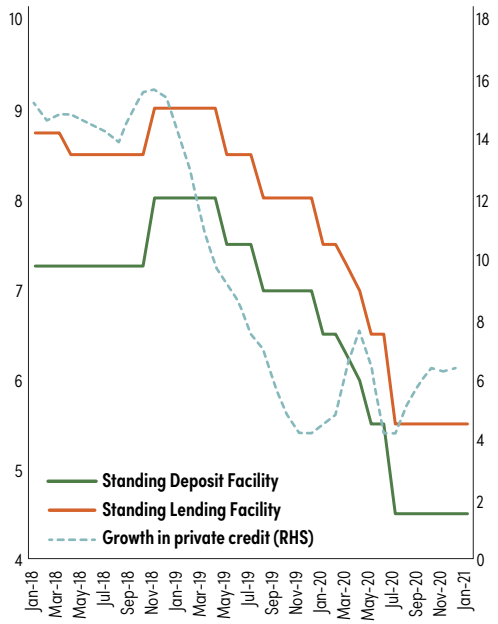
(Percent)



Source: Department of Census and Statistics and staff calculations.

Figure 5: Private credit growth and monetary policy

(Percent) *(Percent)*



Source: Central Bank of Sri Lanka and staff calculations.

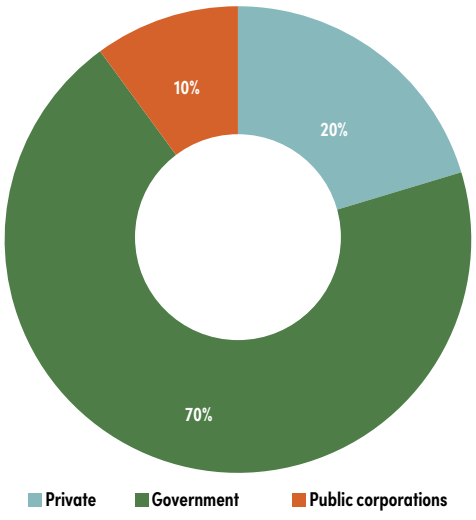
Benign inflation created room for monetary policy support. Monetary conditions were substantially eased in 2020 to reduce market interest rates and increase liquidity. Over the course of the year, the CBSL reduced policy rates by 250 basis points (Standing Deposit Facility to 4.5 percent and Standing Lending Facility to 5.5 percent) and the reserve ratio by 300 basis points (to 2.0 percent). Further, the CBSL aggressively purchased Treasury bills in the primary market to curb upward pressure on interest rates, effectively monetizing the fiscal deficit. Selling government securities to state-managed financial entities at pre-determined rates, following a directive of the President, also helped keeping the interest rates at historically low levels.[3]

The CBSL took various liquidity measures and relaxed financial regulation. In addition to relaxing monetary policy, the CBSL launched an LKR 150 billion concessionary refinancing program (Saubhagya Rennaissance Facility) at a 4 percent interest rate (with a 3 percentage points spread for banks) to support working capital financing for small and medium-sized enterprises (SMEs). It also offered a credit guarantee scheme in support of commercial bank lending to COVID-19 affected businesses. Financial institutions were allowed to reschedule non-performing loans without downgrading the asset classification. The government announced a debt repayment moratorium on bank loans for tourism, garment, plantation, information technology, and SMEs until April 2021. Banks and non-bank financial lenders benefitted from additional regulatory relaxation, including lower capital conservation buffers for systemic and non-systemic banks, relaxation of loan classification and loss provisioning requirements, and postponement of the minimum capital compliance deadline until the end of 2022. Commercial banks were not permitted to declare dividends, to buy back shares, or to increase payments to directors until end-2020.

Despite these measures bank lending to the real sector remained low. Private credit from banks grew by only 6.4 percent (y-o-y) by end-December 2020 (Figure 5). However, over the same period credit growth to the government and state-owned enterprises reached 53.0 and 22.5 percent (y-o-y), respectively. Of the total credit disbursed by the banking sector in 2020, the private sector absorbed 20.3 percent while the government and public corporations received 69.6 percent and 10.1 percent, respectively (Figure 6). State-owned banks (SOBs) played an important part. Based on preliminary estimates, private credit provided by all six SOBs increased by nearly 20 percent in the first nine months of 2020, as compared to a 2.4 percent credit growth by private banks during the same period.

Figure 6: Banking sector credit absorption by agent

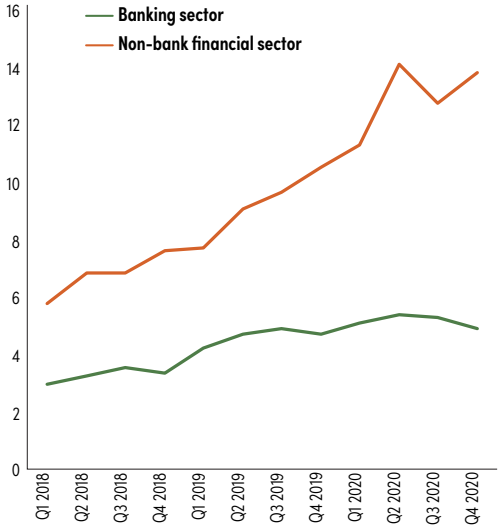
(Percent)



Source: Central Bank of Sri Lanka and staff calculations.

Figure 7: Non-performing loans to total loans and advances

(Percent)



Source: Central Bank of Sri Lanka and staff calculations.

3 In March 2020, the President directed government institutes (Bank of Ceylon, People's Bank, National Savings Bank, Sri Lanka Insurance Corporation, Employees Provident Fund and Employees' Trust Fund) to stabilize the government securities market at an interest rate of 7.0 percent through investments in treasury bonds and bills.

The pandemic likely exacerbated pre-existing financial sector vulnerabilities, although the full impact of COVID-19 cannot yet be observed due to regulatory relaxation. Non-bank financial institutions were already weak before the crisis. Problems of Licensed Finance Companies (LFCs) and Specialized Leasing Companies (SLCs) grew in 2020 with rising Non-performing loans (NPLs) (Figure 7), tighter liquidity, and weak financial performance. To support the sector, CBSL relaxed regulatory requirements further and improved LFCs' access to a special liquidity facility under the deposit insurance, managed by the CBSL. While the aggregate capital adequacy indicators of LFCs seemed to have improved after June 2020, the NPLs and earnings indicators show increased stress, especially for LFCs. The adverse impact of COVID-19 on the financial sector requires policy measures to preserve the sector's stability, while maintaining the flow of credit in the economy (see Box 1 for more detail).

Box 1: The COVID-19 impact on financial sector resilience

Prolonged regulatory forbearance could eventually hurt financial sector resilience. According to CBSL's solvency stress tests,[4] the banking sector is less resilient due to the COVID-19 pandemic, and several banks need to raise capital. A stress testing conducted by the World Bank confirms these results. The analysis is based on the Financial Soundness Indicators published by the CBSL as of end-September 2020. It includes two baseline scenarios and one stress scenario for NPL growth and assesses the potential impact on the capital adequacy of banks and LFCs by Q4-2021 (for different segments): (a) Scenario 1 (low NPL growth) assumes that NPLs will grow at the average NPL growth rate of the past two years (2018 – 2019); (b) Scenario 2 (high NPL growth) assumes that NPLs will grow at a rate equal to the average positive rate of growth during that period; and (c) Scenario 3 (stress scenario) uses a shock of 2 standard deviations to long-term NPL growth since Q1-2008. The results are as follows:

- Banks: Licensed Specialized Banks (LSB) breach the minimum Capital Adequacy Ratio (CAR) (12.5 percent) under Scenarios 1 and 2. Under Scenario 3, Licensed Commercial Banks (LCBs) and Specialized Banks breach their minimum Tier 1 capital ratio (8.5 percent) and minimum CAR (12.5 percent).
- Non-bank financial institutions: Under Scenarios 1 and 2, LFCs breach minimum total CAR (11 percent). The SLCs only breach their minimum total capital adequacy requirements (11 percent) under Scenario 3. In that scenario, LFCs also breach their minimum Tier 1 capital ratio (7 percent).

Given rising vulnerabilities, some measures could be considered to preserve financial sector resilience. Rising NPLs will weaken the lenders' risk appetite and eventually constrain credit growth to the private sector. This is confirmed by the CBSL credit supply and demand survey: banks forecasted a contraction of credit supply in 4Q 2020 in the face of rising NPLs after the expiration of debt moratorium. Higher NPLs and financial losses will place increasing pressure on the profitability and capital of banks in the medium-term. Several mitigating measures could be considered to preserve the resilience of the financial sector, including:

- **Strengthen supervisory readiness and develop a sound exit strategy from the COVID-19 induced regulatory forbearance regime.** As COVID-19 related measures are temporary, an exit strategy is needed, taking into account the economic outlook, expected demand for credit, lenders' credit supply capacity, and the potential impacts of the withdrawal of forbearance measures on the financial position of lenders.
- **Accelerate the modernization of the financial sector related legal framework.** This includes improving key financial sector laws (Banking, Securities, Insurance, Financial Business, Payments and Settlements, Bankruptcy, Secured transactions, Credit Authority) to modernize financial sector infrastructure, enhance financial regulation and supervision, establish a sound crisis and resolution framework, streamline consumer protection, and foster the development of new products and the adoption of modern technologies.

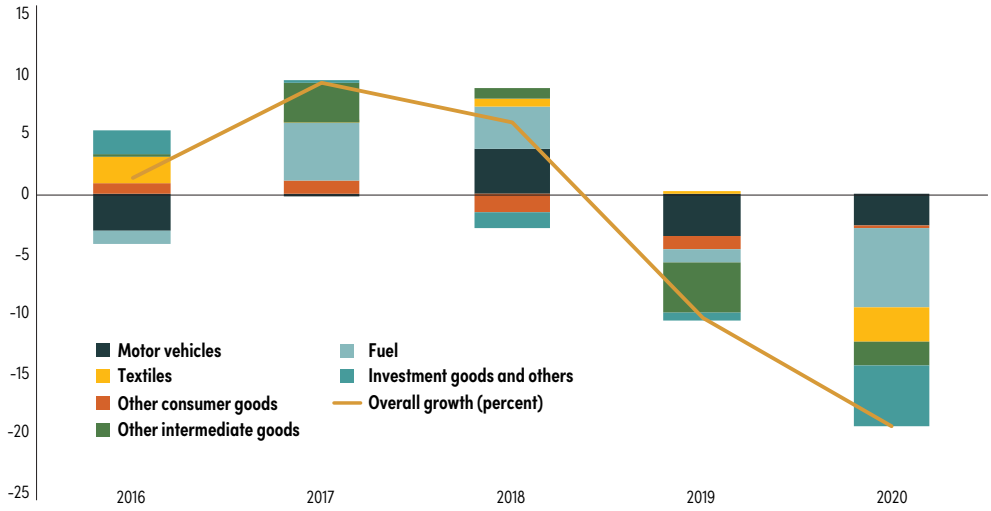
4 Central Bank of Sri Lanka, Financial System Stability Review 2020.

External sector

The current account deficit narrowed in 2020, as the trade balance improved, and remittance inflows remained strong. The goods trade deficit declined by US$ 2.0 billion in 2020 y-o-y, on the back of a large reduction in goods imports (by about US$ 3.9 billion or by 19.5 percent) (Figure 8)[5] which more than offset a decline in goods exports driven by weak performances of textiles, tea and other industrial exports (by US$ 1.9 billion or by 15.6 percent) (Figure 9). Services exports also weakened as tourism receipts collapsed between April and December. However, remittances grew by 5.8 percent (y-o-y), likely reflecting both a repatriation of savings by returning overseas workers and some diversion from informal channels to formal channels. As a result, the current account deficit is estimated to have narrowed to 0.9 percent of GDP in 2020, from 2.2 percent of GDP in 2019.

Figure 8: Goods imports

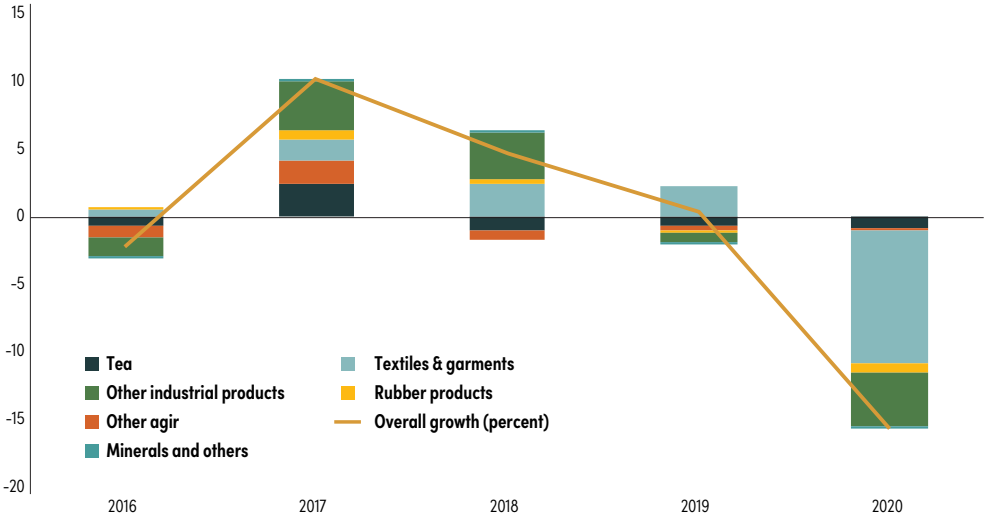
(Percentage point contribution)



Source: Central Bank of Sri Lanka and staff calculations.

Figure 9: Goods exports

(Percentage point contribution)



Source: Central Bank of Sri Lanka and staff calculations.

5 The reduction in imports includes savings of US$ 1.3 billion on fuel due to low oil prices and subdued economic activity. In addition, imports of investment and intermediate goods as well as motor vehicles declined by US$ 2.5 billion in total amid import restrictions and weak demand.

Notwithstanding the improvement in the current account, reserves declined as financial inflows were insufficient to meet liabilities and other outflows. With heightened uncertainty, foreign direct investment (FDI) inflows were sluggish.[6] Key inflows to the financial account included: (i) the proceeds of a US$ 400 million swap facility from the Reserve Bank of India; (ii) a US$ 500 million loan from the China Development Bank, the first tranche of a US$ 1.2 billion facility; and (iii) project loan inflows of US$ 1.4 billion. However, the markets for government securities and listed equity experienced net outflows.[7] Overall, net inflows were insufficient to cover the current account deficit and external debt service payments of approximately US$ 4.2 billion (including the repayment of a US$ 1.0 billion Eurobond in October 2020). As a result, official reserves declined to US$ 5.7 billion in 2020 from US$ 7.6 billion in 2019.[8]

Exchange rate pressures increased, especially during the first wave of COVID-19. The LKR depreciated by 6.0 percent against the US Dollar between March and April 2020. To contain depreciation pressures, the government and CBSL introduced foreign exchange controls in April 2020. Outward remittances were suspended, while inward remittances have been exempted from certain regulations and taxes. Import restrictions were imposed on motor vehicles, agricultural products, and consumer durables. A scheme was introduced to insure investors against foreign exchange risks, by allowing domestic currency proceeds from qualified investments in treasury bonds to be converted at the exchange rate prevailing at the time of initial investment. Further, a special deposit account was introduced for commercial banks with higher rates of interest to attract overseas funds. These measures contributed to a gradual appreciation of the currency in the second half of 2020. Over the year, the LKR depreciated by 2.6 percent against the US Dollar. While the depreciation could improve the competitiveness of Sri Lanka's exports, it increases the foreign-currency denominated debt valuation and related debt service and may raise prices.

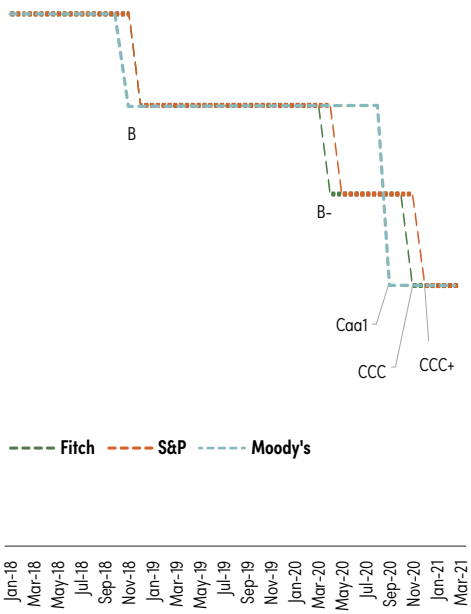
The foreign exchange situation became tighter in early 2021, before a currency swap was approved by the People's Bank of China. In January, a domestic auction to rollover US$ 200 million worth of Sri Lanka Development Bonds (US$ denominated, domestically sold securities) raised only US$ 43.6 million. In addition, debt service payments, including a repayment of the currency swap of US$ 400 million with the Reserve Bank of India, further reduced official reserves to an 11-year low of US$ 4.6 billion in February 2021, equivalent to an estimated 2.9 months of imports of goods and services. The CBSL took several measures to address the shortage of foreign exchange: (i) on January 25, it directed commercial banks to refrain from entering into forward contracts of foreign exchange for three months; and (ii) on January 27, it directed commercial banks to sell 10 percent of the inward worker remittances, which are converted to LKR, to the CBSL; and (iii) on February 19, exporters were ordered to repatriate export proceeds within 180 days from the date of shipment and convert 25 percent of proceeds into domestic currency upon receipt. Commercial banks are expected to sell 50 percent of such converted export proceeds to the CBSL.[9] Nevertheless, the exchange rate depreciated by 6.5 percent from January through March 17, 2021. A currency swap of US$ 1.5 billion, approved by the People's Bank of China in March 2021, could provide a boost to reserves.

Rating downgrades constrained Sri Lanka's market access. In 2020, credit rating agencies downgraded Sri Lanka's sovereign rating to the substantial risk investment category (Figure 10): (i) Moody's by two notches to Caa1 with a stable outlook in September; (ii) S&P to B- in September and to CCC+ with a stable outlook in December; and (iii) Fitch to B- in April and to CCC in November. All three rating agencies flagged heightened external vulnerabilities, limited financing options, and weak fiscal balances. Sri Lanka's credit spreads measured by Emerging Market Bond Index increased from 517 basis points in January 2020 to 1,957 basis points in February 2021 (Figure 11).

6 FDI declined by 30.9 percent in the first nine months of 2020.
7 In 2020, net outflows from the government securities market and listed equity market were approximately US$ 522 million and US$ 276 million, respectively.
8 This level of reserves is low relative to the government foreign exchange debt service obligations estimated at US$ 7.3 billion in 2021.
9 On March 17, the CBSL suspended the latter two (i.e. the measures described under (ii) and (iii)).

Figure 10: Movements in credit rating

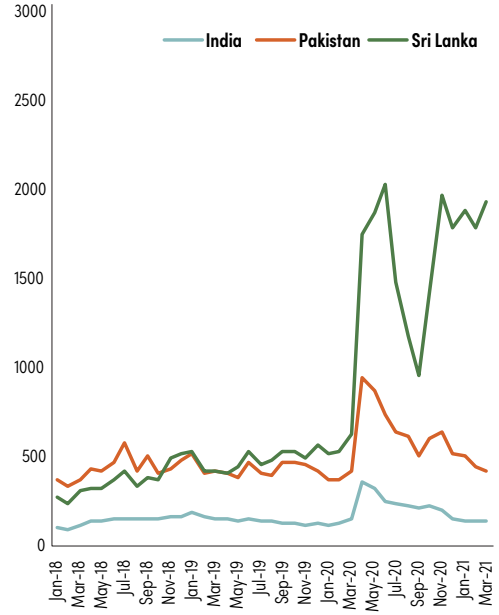
(Rating scale)



Source: Trading Economics and staff scaling.

Figure 11: EMBI spreads

(Basis points)



Source: CEIC.

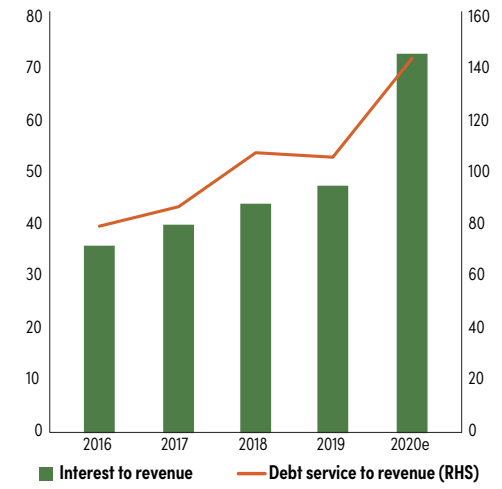
Fiscal developments

Government measures to support the poor and vulnerable amid the pandemic put pressure on public spending. The government spent an estimated 0.7 percent of GDP in cash transfers to displaced daily workers, affected senior citizens, persons with a disability and kidney patients, among others and these measures likely helped soften the impact of the crisis on poverty (see the Focus Section of this report for details). Various tax relief measures were also taken. The payment deadlines for the income tax, the VAT and certain other taxes were extended, income tax arrears of SMEs were partially forgiven, payment terms were relaxed, and legal actions against non-payers were frozen.

The combined effects of the pre-COVID stimulus package and the COVID-19 pandemic led to a deterioration in fiscal balances. Revenue collection is estimated to have declined to 9.1 percent of GDP in 2020 (from 12.6 percent of GDP in 2019). Value-added, income, and import taxes all performed poorly on account of (i) the 2019 fiscal stimulus package, (ii) the economic contraction in 2020, and (iii) declining imports. Meanwhile, non-interest recurrent expenditures increased due to rising public health costs and cash transfers[10], and interest payments are estimated to have absorbed 73.4 percent of total government revenues in 2020 (Figure 12). Public investment was reduced but this was insufficient to prevent a widening of the fiscal deficit to 12.6 percent of GDP in 2020[11] (up from 6.8 percent of GDP in 2019) (Figure 13).

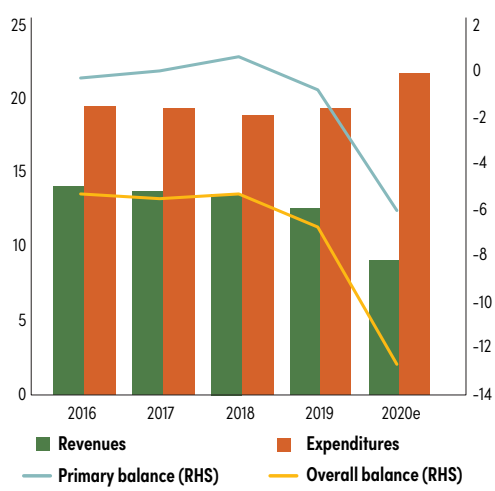
10 As a share of GDP, non-interest recurrent expenditures are estimated to have increased to 9.7 percent of GDP in 2020 from 9.3 percent of GDP in 2019.
11 The fiscal deficit includes arrears from 2019 that were cleared in 2020 and some 2019 expenditures that were not recognized in the audited accounts of 2019 (combined approximately 2.8 percent of GDP).

Figure 12: Debt service indicators to revenue



Source: Ministry of Finance and staff calculations.
Note: Debt service to revenue excludes the Treasury Bill rollover.

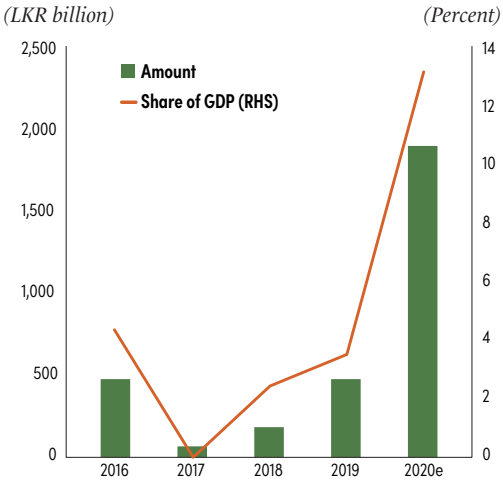
Figure 13: Key fiscal balances



Source: Ministry of Finance and staff calculations.

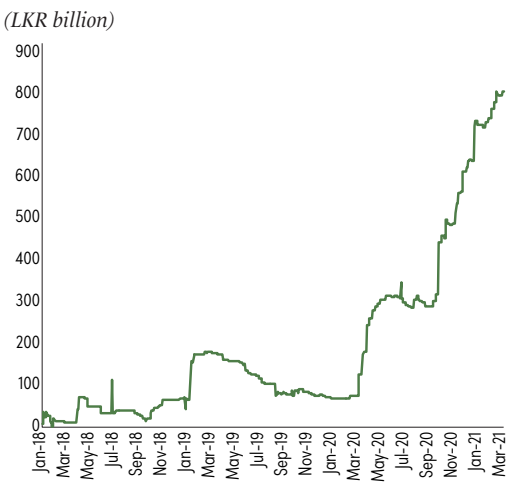
The fiscal deficit was mostly financed by domestic resources amid the tight external liquidity situation (Figure 14). Approximately two thirds of the deficit are estimated to have been financed by non-bank sources such as the Employees' Provident Fund and the Sri Lanka Insurance Corporation, while the remaining third was financed by domestic banks and the CBSL. Holdings of Treasury bills by the CBSL, partly reflecting monetization of the deficit, reached unprecedented levels in 2020 (4.8 percent of GDP at the end of the year) (Figure 15). The financing was in line with the government's proposed medium-term strategy, presented in the medium-term fiscal framework 2021-25, that aims to mobilize domestic sources to reduce the share of foreign financing.[12]

Figure 14: Net change in T bills and bonds outstanding



Source: Central Bank of Sri Lanka and staff calculations.

Figure 15: Central Bank holding of T bills



Source: Central Bank of Sri Lanka and staff calculations.

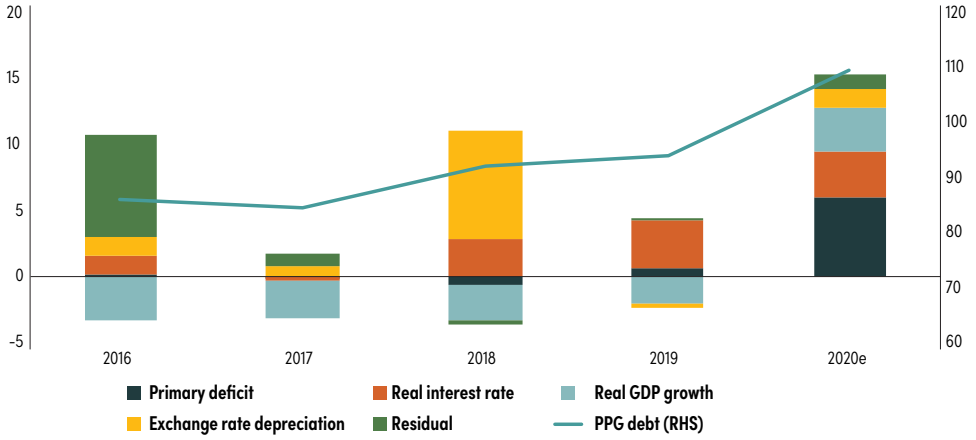
The ratio of public and publicly guaranteed debt to GDP has increased substantially and external debt service will continue to be a major challenge going forward. The high primary deficit and the slow growth drove an estimated 15 percentage points increase in the public and publicly guaranteed debt-to-GDP ratio to 109.7 percent in 2020 (up from 94.3 percent in 2019) (Figure 16). Approximately half of the government debt is denominated in foreign currency. Between 2021-

12 Domestic market capacity constraints and the pre-determined foreign exchange requirements require consideration in implementing this strategy.

2023, around one third of the foreign currency debt is falling due, including four Eurobonds: (i) US$ 1.0 billion in July 2021; (ii) US$ 500 million in January 2022; (iii) USD 1.0 billion in July 2022; and (iii) US$ 1.25 billion in April 2023. The rising debt level and past reliance on foreign-currency denominated commercial debt led to rising foreign exchange refinancing requirements (Figure 15 and Figure 16), a shortening of maturities and an increase in borrowing costs, as well as elevated exchange rate risks.

Figure 16: Drivers of public and publicly guaranteed debt

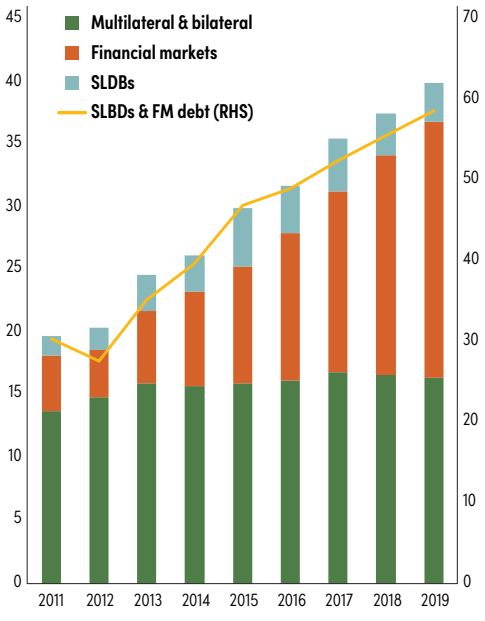
(Percentage point contribution) *(Share of GDP)*



Source: Central Bank of Sri Lanka and staff calculations.

Figure 17: Foreign exchange denominated debt

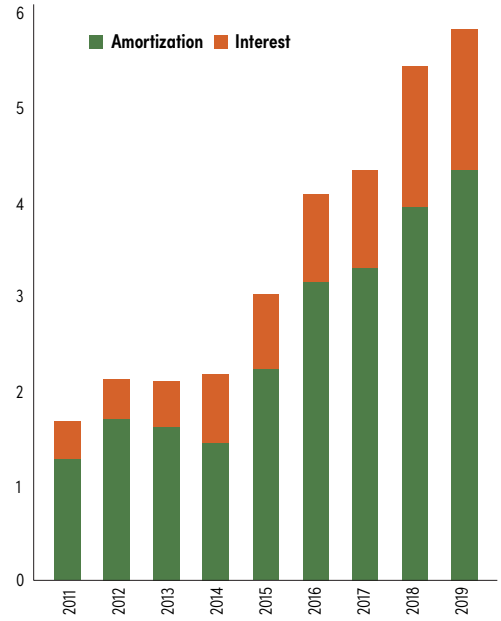
(US$ billion) *(Percent of total)*



Source: Central Bank of Sri Lanka and staff calculations.

Figure 18: Foreign exchange debt service

(US$ billion)



Source: Central Bank of Sri Lanka and staff calculations.

2 Outlook and Medium-term Prospects

Medium-term outlook

Growth should recover gradually in 2021. The economy is expected to grow by 3.4 percent in 2021, from a low base, as vaccination programs progress in Sri Lanka and its major trading partners. Already-signed investments into the Colombo Port City and Hambantota Industrial Zone and gradually normalizing domestic economic activities should provide an impetus to growth. However, the momentum of the recovery is expected to be constrained due to: (i) subdued export demand and tourism, as well as lower remittances growth amidst the sluggish global recovery and (ii) the challenging domestic macroeconomic situation. Continued import restrictions and the high debt burden will adversely affect growth and poverty reduction over the medium-term. Inflationary pressure is expected to materialize in 2021-2023 due to the partial monetization of large fiscal deficits.

External buffers are expected to remain low, with subdued financial inflows and significant financing needs. The current account deficit is projected to remain low in 2021, with strict import restrictions largely offsetting relatively low garment exports and tourism receipts. The currency swap with the People's Bank of China and a remaining tranche of US$ 700 million from the China Development Bank will support reserves in 2021. However, beyond 2021, significant additional borrowing will be required to close the external financing gap, with external public debt service requirements estimated at above US$ 4.0 billion each year between 2021 and 2023. Given high debt service obligations, the ratio of official reserves to short-term external liabilities is expected to deteriorate further. In the medium-term, mobilizing more non-debt creating sources of finance, for example foreign direct investment, will be important.

High fiscal deficits will further weaken debt sustainability. The fiscal deficit is projected to reach 9.4 percent of GDP in 2021 and to remain high in 2022 and 2023 (despite tightly controlled expenditures), as revenue collection is expected to remain weak due sluggish economic activity and the revenue measures enacted in 2019. As a result, PPG debt is expected to reach 115.0 percent of GDP in 2021 and to rise further in 2022 and 2023.

Risks and priorities

Downside risks to the outlook persist. The baseline assumes a quick and comprehensive vaccine rollout, in line with the government's aims 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 SMEs from illiquidity to insolvency. A simple simulation of the impacts of two scenarios on the global recovery, a more positive and a more adverse international recovery compared to the baseline, show a significant impact of global developments on Sri Lanka's growth path, with growth projected at 4.6 percent in the former case, compared to only 2.0 percent in the latter (Figure 19).[13] Lower growth would also put additional strain on public finance and could elevate risks to macroeconomic stability.

The amount of debt and its composition imply significant fiscal risks. Sri Lanka is highly susceptible to market sentiments as its debt repayment profile requires the country to access financial markets frequently. Constrained market access amid rating downgrades remains a key challenge given the large refinancing requirements. A higher than expected deficit or lower than expected GDP growth could further affect market sentiments.[14] A simple simulation of an adverse fiscal scenario

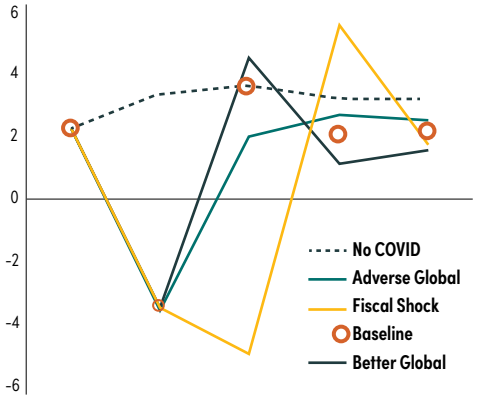
13 The simulations are based on the World Bank's forecasting model MFMod. The former scenario assumes a faster global recovery (with the half the baseline gap compared to a no-Covid baseline in 2021 and full recovery of global demand by 2023) and the latter assumes a delayed recovery (with no growth in 2021 and a slower subsequent recovery). The scenarios are described in more detail in World Bank. 2021. "South Asia Economic Focus – South Asia vaccinates".

14 Moreover, if economic recovery in advanced economies proceeds faster than in others, for example due to more successful mass vaccination programs, and the loose monetary policy is reversed in these economies, external financing conditions for all emerging markets and developing economies could worsen.

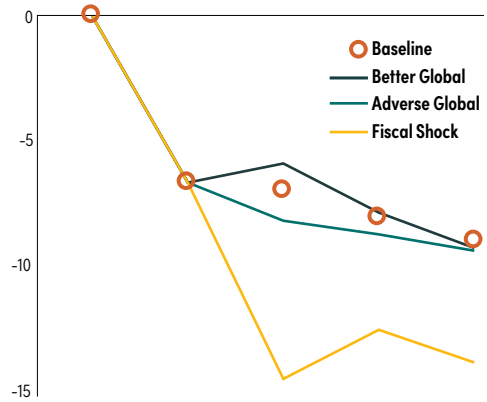
shows that the economy could contract further in 2021 (Figure 19).[15] Thus, striking a balance between supporting the economy amid COVID-19 and ensuring fiscal sustainability is key. A reform program to provide a fiscal anchor could help reduce debt vulnerabilities and lower sovereign risk.

Figure 19: Simple simulations of potential up- and downside risks

a) Real GDP growth simulation
(Percent)



b) Deviation of GDP from no-Covid scenario
(Percent)



Note: The simulations are based on the World Bank's forecasting model MFMod and the scenarios are described in footnotes 16 and 17. For more details on the scenario and estimations see the report cited as the source.
Source: World Bank. 2021. "South Asia Economic Focus – Spring 2021".

In the medium-term, Sri Lanka needs to improve its competitiveness to raise growth. As a relatively small but strategically located country, Sri Lanka could strive to achieve sustainable development by moving towards an export-oriented and private-investment led growth model. This would likely require promoting trade and private investment (including FDI), establishing the necessary conditions for a thriving knowledge economy, facilitating public-private partnerships in key sectors (such as in infrastructure, health, and tourism), investing in tourism infrastructure, allowing productive local companies to integrate into global value chains, and attaining higher value addition in the manufacturing, agribusinesses, and service sectors.

Table 1: Key macroeconomic indicators

	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
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: Ministry of Finance and Planning, Central Bank of Sri Lanka, Department of Census and statistics World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast. The CBSL projects real GDP growth to reach 6.0 percent in 2021.
(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 2021 to 2023.
(c) Projection using neutral distribution (2016) with pass-through = 0.87 based on GDP per capita in constant LCU.

15 The simulations are based on the World Bank's forecasting model MFMod. In this scenario, a limit on deficit financing (calibrated so that net financing is limited to baseline net domestic financing) is introduced. Cuts to expenditures resulting from the loss in available financing are distributed between capital expenditure (60 percent) and good and services (40 percent). The scenarios are described in more detail in World Bank. 2021. "South Asia Economic Focus – South Asia vaccinates".

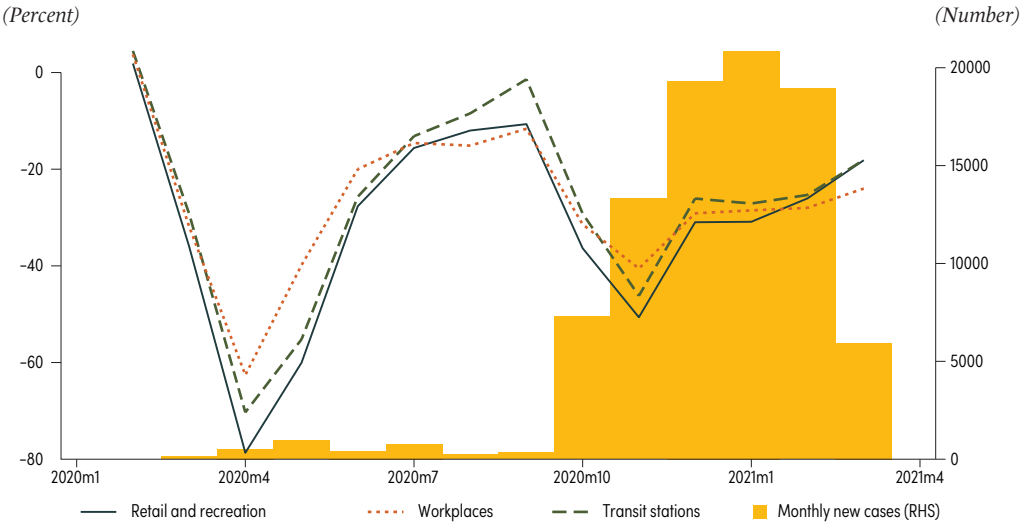
SPECIAL SECTION 2021

3 The COVID-19 Impact on Employment and Poverty

Introduction

The government reacted swiftly to control the first large outbreak of COVID-19 in mid-March 2020, but new infections were high at the end of the year and at the beginning of 2021. At the beginning of the pandemic, as preventive measures, the government closed the airport, halted all inbound and outbound travel, and enacted an island-wide lockdown from March 20 to April 16. The lockdown entailed near-total restrictions to movement, which resulted in a collapse of mobility (figure 20). Restrictions were gradually relaxed, and the lockdown was completely lifted after June 28. COVID-19 infections appeared contained until a breakout in an interconnected cluster that led to an exponential increase in cases during the last quarter of 2020 (figure 20). Localized lockdowns were introduced starting from October 4, primarily in high-risk areas in the highly urbanized and populous Western, Central and North Western provinces. The number of newly confirmed cases started to fall significantly in late February.

Figure 20: Change in mobility and new COVID-19 infections



Source: Google COVID-19 Community Mobility Reports and COVID-19 Data Repository by the Center for Systems Science and Engineering (CSSE) at Johns Hopkins University.
Note: The decline in mobility refers to the change of visits and length of stay, compared to a baseline period. The baseline period is defined as the median value for the corresponding day of the week, during the 5-week period from January 3 to February 6. Holidays and weekends are linearly interpolated.

The pandemic has dealt a significant shock to the economy and has reversed past progress in poverty reduction. Sri Lanka's economy grew at an average 5.3 percent per year since the end of the civil war in 2009. Growth over that period had been inclusive and poverty reduction strong, with the poverty rate at $3.20 per day (in 2011 purchasing power parity) declining from 16.2 percent in 2012/13 to 11.0 percent in 2016. Labor reallocation and growth in nonfarm incomes were the main drivers of poverty reduction in recent years.[16] Prior to the pandemic, Sri Lanka's economy was projected to grow at 3.3 percent in 2020.[17] Instead, the COVID-19 containment measures, especially in the second and fourth quarter of 2020, and a standstill of tourism activity impacted the economy significantly. Real GDP is estimated to have contracted by 3.6 percent in 2020, the worst performance on record, leading to widespread jobs and earnings losses.

Deteriorations in labor market outcomes are the main channels through which the COVID-19 pandemic has increased poverty. Just as improvements in the labor market drove poverty reduction pre-COVID, widespread job and earning losses are the main drivers behind rising poverty since the onset of the pandemic. Sectors such as construction, transport, manufacturing, food, and accommodation created the majority of new jobs in recent years but have been particularly hard hit. On the other hand, jobs that can be done remotely from home have likely been largely insulated from

16 World Bank, forthcoming. "Sri Lanka Poverty Assessment. Accelerating Economic Transformation"
17 World Bank, 2019. "South Asia Economic Focus Fall 2019: Making (De)centralization Work"

the unemployment shock. Since opportunities to work from home tend to benefit mostly high-earning workers, inequalities in digital access have introduced new economic and spatial divides.

Estimates of the pandemic's impact on employment and poverty reveal a profound impact. As is typical for large economic crises, little adequate data based on large surveys are currently available. This makes it difficult to understand the impact of the shock, to devise appropriate mitigation measures, and inform the policy dialogue. In such a situation, microsimulation models can help fill the void, as they can be used to simulate the impact of macroeconomic indicators on the employment status and earnings of individuals. Simulation results suggest that the $3.20 poverty rate increased from 9.2 percent in 2019 to 11.7 percent in 2020 as a result of the crisis. This more than reverses the progress since 2016, implying a significant setback. Several livelihood support programs implemented by the government helped mitigate the labor market shock, but a more targeted approach could have been more effective.[18]

Pre-existing vulnerabilities and the impact of COVID-19 on employment

Pre-existing vulnerabilities

One source of vulnerability is low earnings. Sri Lanka has an economically active population of around 8.6 million, of which roughly 8.2 million were employed in 2019. About a quarter of workers are engaged in agriculture, another 28 percent in industries, and the remainder in services. A large share of workers continues to be engaged in low-productivity jobs, especially in agriculture. Despite ongoing structural transformation, the service sector is still extremely heterogeneous and comprises both high-skilled workers as well as casual low-skilled workers with limited social protection. Thus, workers in services are found all along the earnings distribution, but tend to dominate the richer segment. This is evident in Figure 21, which ranks all workers by their earnings from poorest to richest and plots the share of workers in agriculture, industry, and services within each percentile. The share of agricultural workers, on the other hand, is higher in the lower income percentiles. The agricultural sector is also home to many own-account workers, who make up a third of the employed population.

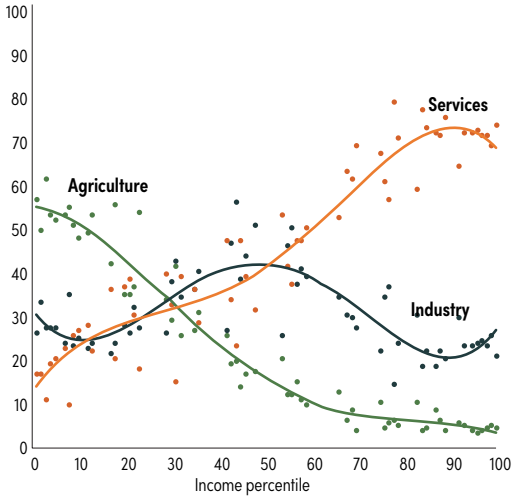
Informal workers, many of whom are low-income earners, often do not benefit from social protection. Informal employment is particularly widespread in agriculture, where 90 percent of workers are informal, and still significant in industry (66 percent) and services (52 percent).[19] Figure 22 depicts the share of formal and informal workers in each percentile of the earnings distribution ordered from poorest to richest. With the rise of earnings, the share of formal workers increases and eventually overtakes that of informal workers. The high level of informality in the lower half of the earnings distribution suggests a high risk of displacement or earnings losses in the event of shocks, like the one from the COVID-19 pandemic.[20] Informal workers are more likely to suffer earnings losses for at least two reasons: firstly, because smaller, informal sector enterprises have been hit harder during the pandemic and, secondly, because even within formal enterprises there are workers that are not protected by written contracts and may be bearing the brunt of the impact. Those who lose their jobs do not have access to job-linked social protection benefits like unemployment insurance.[21]

Formal workers are not immune to shocks, either, as revealed by the COVID-19 crisis. The export-oriented apparel industry, which employs about half a million workers, reportedly cut a significant number of jobs and implemented significant wage cuts. Sri Lanka has a highly protective labor law regime, but it does not include provisions to deal with exceptional situations such as the COVID-19 pandemic, making employment protection challenging even for formal workers.[22]

18 The analysis and discussion presented this section draw heavily on a note on "The COVID-19 Impact on Livelihoods and Poverty" which is part of a forthcoming poverty assessment (World Bank, forthcoming. "Sri Lanka Poverty Assessment. Accelerating Economic Transformation").
19 The concept of informal employment relies on both the individual's employment status and access to social security, as well as the classification of the *enterprise* in which they work, such that informal employment is present even within the formal sector.
20 World Bank, 2020. "South Asia Economic Focus Fall 2020 - Beaten or Broken? Informality and COVID-19"
21 World Bank, 2020. "Informal Employment, Job Quality and Welfare".
22 Department of Labour. 2020. "Covid 19 & Beyond—The Impact on the Labour Market of Sri Lanka." Survey report of the e-survey conducted on private sector establishments. May 2020; World Bank. 2020. "Informal Employment, Job Quality and Welfare".

Figure 21: Sectoral earnings distribution

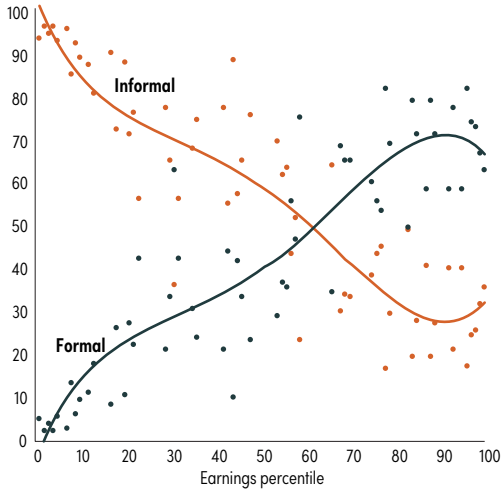
(Percent of workers)



Source: LFS 2018 and staff estimations.
Note: This figure depicts sectoral incidence curves by ranking all workers by their earnings from poorest to richest into equally sized percentiles and plotting the share of workers in agriculture, industry, and services within each percentile.

Figure 22: Earnings distribution for formal and informal workers

(Percent of workers)



Source: LFS 2018 and staff estimations.
Note: This figure depicts formality/informality incidence curves by ranking all workers by their earnings from poorest to richest into equally sized percentiles and plotting the share of workers in formal and informal employment within each percentile.

The impact of COVID-19 on employment

The COVID-19 pandemic did not hit all economic sectors equally. Sectoral GDP data and the discussion in Chapter 1 reveal that industries have been affected more than services and agriculture, but there are large variations across subsectors. Weak external demand impacted export-oriented subsectors. Among industrial subsectors, construction and textile manufacturing, which are sensitive to demand shocks and require workers to be physically present, suffered the largest decline. In the services sector, transport, food and accommodation, and personal services experienced the largest contractions, partly due to extended travel restrictions that shut down all international tourism. Sectoral growth projections and historical employment elasticities suggest that employment in 2020 declined by 1.1 percent in industry and 0.8 percent in services.[23] While agricultural activities continued throughout the pandemic, there were intermittent disruptions in logistics and tea exports slightly declined in 2020. Moreover, the fishery sector suffered a significant shock.

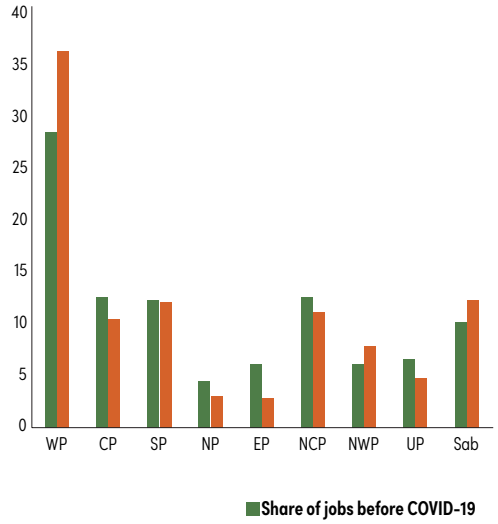
Job loss was more likely to occur in urban areas and among private sector employees and own-account workers.[24] The more urbanized Western Province was home to about 28.6 percent of all workers before the pandemic, but with 36.3 percent accounted for a much higher share of the job losses (figure 23a). This is to be expected given the large contraction in industries that are overrepresented in urban areas. Most job losses occurred among private sector employees, followed by own account workers (figure 23b).

23 Since agriculture was less impacted by the containment measures, the analysis presented in this chapter assumes that no employment in agriculture was lost.
24 We estimate two models using similar assumptions but different data sources. The first data source is the Household Income and Expenditure Survey (HIES) 2016 to estimate poverty impacts and the second data source is the Labour Force Survey (LFS) 2018 to estimate employment impacts by informality. Additional data from a computer literacy module makes it possible to explore potential disparities along the digital divide. The results on labor market impacts are largely consistent between the both models, though the overrepresentation of the Western province is weaker in the results with the LFS data. See Appendix A1 for more details.

Figure 23: Share of jobs lost by province and employment status

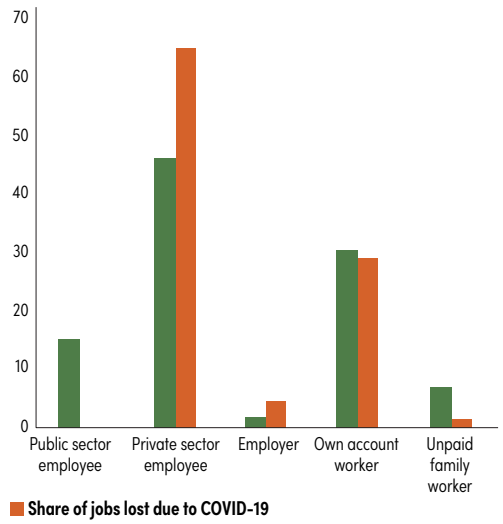
a) by province

(Percent)



b) by employment status

(Percent)

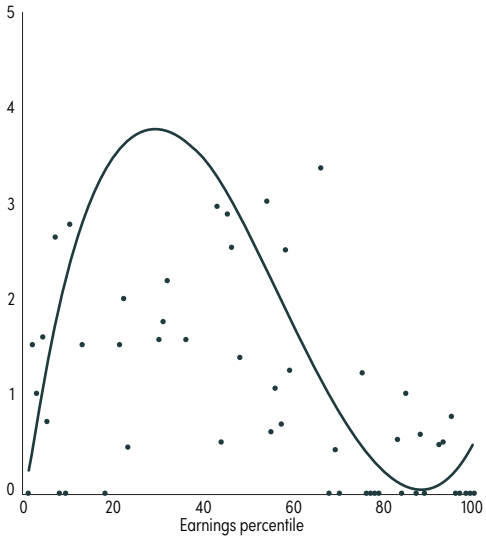


Source: World Bank, forthcoming. "The COVID-19 Impact on Livelihoods and Poverty".

Job losses are concentrated in the lower-middle of the income distribution. Workers most vulnerable to job loss are located between the 20th and 40th percentiles of the pre-pandemic earnings distribution (figure 24). Agriculture dominates the lower part of the earnings distribution but about two thirds of its workers are self-employed or unpaid family workers; job loss is less likely in this context. Further, workers at the higher end of the distribution are more likely to have jobs that are formal and that can be done remotely and, hence, are more protected from unemployment shocks (see below). They are also much more likely to be working in services which has suffered the smallest overall shock. The high share of job losses in the middle of the income distribution could increase both inequality and poverty. Inequality could rise as the shock thins out the middle by shifting workers from the middle into lower percentiles. For some individuals the income loss will imply that they fall into poverty (see next section).

Figure 24: Newly unemployed by earnings

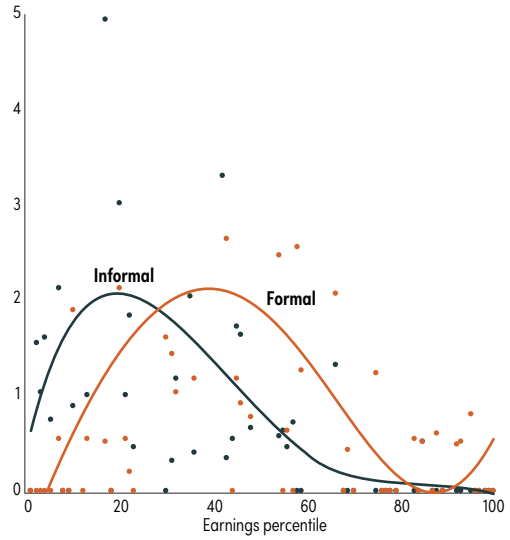
(Percent of all new unemployed)



Source: LFS 2018 and staff estimations.
Note: This figure depicts the share in workers likely to lose their jobs as a percentage of all jobs lost within each equally sized earnings percentile, sorted from poorest to richest.

Figure 25: Share of jobs lost by formality status

(Percent of all new unemployed)



Source: LFS 2018 and staff estimations.
Note: This figure depicts the share of formal and informal workers likely to lose their jobs as a percentage of all jobs lost within each equally sized earnings percentile, sorted from poorest to richest.

The poorest workers vulnerable to unemployment are largely informal. Although the burden of job loss is lower in the poorer percentiles, the workers who are impacted are mostly informal (figure 25). This exposes a dual vulnerability – in terms of their location on the earnings distribution and in the social protection measures they can access. These poorer, informal workers are unlikely to have private coping mechanisms, such as savings to deal with the shock, and do not have recourse to unemployment insurance or severance payments linked to their jobs. The composition of newly unemployed workers, however, shifts when moving towards the right of the distribution. Even formal workers are not immune to the unemployment shock and in fact, face the brunt of impact from the 30th percentile and higher. At the richer end of the distribution, the burden of job losses is much lower, partly because these jobs are in sectors that were less affected. Some of these workers are more likely to have teleworking options (see below). The location of job losses in the distribution has important implications for overall poverty rates, discussed in the next section.

The impact of COVID-19 on poverty and inequality

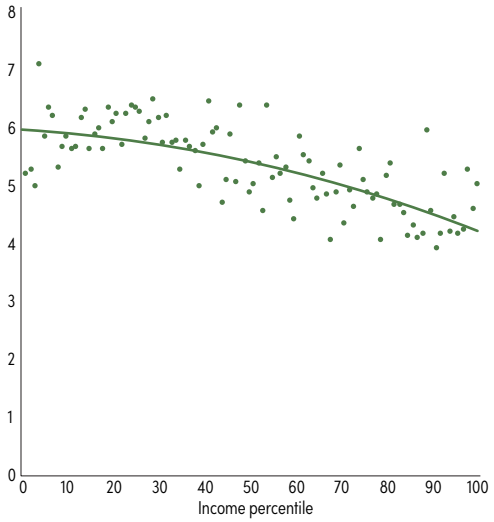
The labor market shock led to an unequal impact along the income distribution.[25] It is important to consider the wider impact on earnings across the distribution that accounts both for the impact of job losses as well as reduced earnings. The need to consider both is also borne out by preliminary findings from a recent World Bank COVID-19 rapid phone survey. According to this survey, among respondents engaged in the labor market prior to the pandemic, more than half suffered a labor market shock, primarily in the form of earnings losses (reported by more than 30 percent) while a more modest impact occurred through temporary absence and job losses.[26] Figure 26 shows the share of income losses across the income distribution. The poorest experienced the largest proportionate earnings shock while the smallest proportionate income losses were suffered by the richest. The latter tend to have formal, secure jobs and better access to digital technology that allows them to conduct wage work or business operations remotely. They are also more likely to be working in the services sector, which suffered the smallest aggregate impact.[27] Consistent with this, the crisis is expected to widen inequalities in the short-term, with the Gini index slightly increasing from 39.3 to 39.8 in 2020. This is concerning given that Sri Lanka had relatively high inequality in comparison to peers even before the crisis.

With jobs lost and earnings reduced, poverty increased significantly in 2020. Over 500,000 people are expected to have fallen into poverty as a result of the crisis, which led to an increase in the $3.20 poverty rate from 9.2 percent in 2019 to 11.7 percent in 2020. This more than reverses the progress made since 2016, when the poverty rate was 11.0 percent. Estimates using the national poverty line suggest a similar trajectory. Extreme poverty (as measured by the $1.90 a day poverty line) is projected to have doubled from 2019 levels (figure 27). Moreover, the poverty gap, which measures the distance to the poverty line, is estimated to have increased from 17.9 percent in 2019 to 20.0 percent in 2020. This implies that not only are there more poor people, but also that the poor have fallen deeper into poverty.

25 The simulations of the income effects rely on GDP projections, sectoral output-employment elasticities and earnings declines that are proportionate to the sectoral output decline (based on sectoral GDP data). See Appendix A2 for more details.
26 The World Bank conducted a rapid phone survey across eight South Asian countries. In Sri Lanka, the survey was implemented between September and December 2020, and primarily aimed to understand changes in the labor market among different groups. Additional questions were included on households' ability to meet basic needs, safety nets, and coping mechanisms. Full survey results with more detailed analysis will become available in the coming months.
27 Sectoral GDP growth rates in 2020 are as follows: agriculture contracted by 2.4 percent, industry by 6.9 percent, and services by 1.5 percent. The aggregate impact on services hides substantial variation between different kind of services. For example, tourism came to a near stand-still, while financial services and telecommunication were affected much less. Several highly productive services sub-sectors, which employ many of the high-income earners, have not been affected much.

Figure 26: Average per capita income loss across the income distribution

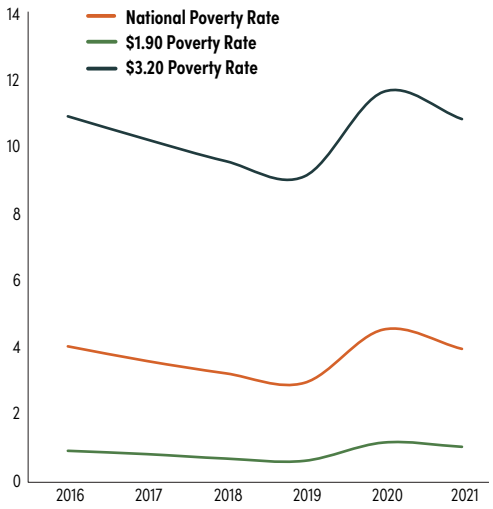
(Percent)



Source: World Bank staff estimation using HIES 2016.
Note: Income centile is based on per capita household income.

Figure 27: Poverty impact of COVID-19

(Percent)



Source: World Bank staff estimation using HIES 2016.

To mitigate the impact of the pandemic on the poor and vulnerable, the government implemented several livelihood support programs. Several mitigation measures were initiated through existing welfare schemes such as Samurdhi, elderly allowance, disability allowance and the chronic kidney disease (CKD) allowance. These programs were implemented in April and May across all 25 districts at a cost of Rs. 47.7 billion (around USD 240 million). The temporary allowance was extended to waitlisted families and one-off top-up payments were made to existing beneficiaries under the Samurdhi and elderly allowance programs. Livelihood support was additionally provided to low-income families not covered under the Samurdhi program, where one or more members had lost their livelihood due to the pandemic. Low-income families that were quarantined or in lockdown areas during the second wave also received relief. An estimated Rs 105.1 billion (around USD 530 million) have been incurred for these programs[28] which covered a large proportion of the population, especially in the Western province. These programs were implemented in addition to regular livelihood support programs, such as Samurdhi and fertilizer subsidies. Public sector training and employment programs were also launched, including the government's Program for Placement of Unemployed Graduates and another program that aims to employ 100,000 individuals from low-income families in the public sector.

These measures likely helped absorb the labor market shock and soften the impact on poverty. Estimates suggest that the share of population living on less than $3.20 a day could have been reduced from 11.7 percent to 10.3 percent in 2020 owing to the livelihood support programs. The results are based on the realistic assumption that the measures were less than perfect at targeting the poorest.[29] If the targeting had been perfect, which is a rather unrealistic scenario in any context, this could have reduced the share of poor even further to 9.7 percent. While a large amount of resources (given limited fiscal space) was mobilized for these measures, they resulted in modest average transfers per household because coverage was very broad.

28 Treasury, Fiscal Management Report 2020-21.
29 The results are likely imperfect given a lack of information on the characteristics of actual beneficiaries. The exercise is aimed at indicating a range of poverty estimates that may have resulted from these mitigation measures.

The new poor are more likely to be urban than the old poor, to work in industry and services, and to be more educated:

- **About 12 percent of the new poor, compared to about 6 percent of the old poor, live in urban areas.** The Western Province, which is highly urbanized, accounted for the largest share of the new poor across provinces (figure 28). While the Western Province has the lowest poverty rate across provinces, at around 4 percent in 2019, an increase to 5.7 percent is expected in 2020.

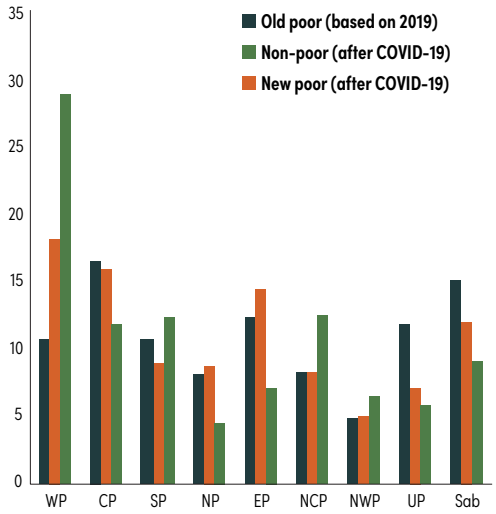
- **Poverty increased the most in sectors that accounted for much of the jobs and earnings lost.** For instance, poverty nearly doubled among households where the head of the household was employed in accommodation and food services and it increased by nearly 50 percent for those in the construction sector (Figure 29).

- **The share of new poor who have completed primary education,** the G.C.E. Ordinary Level (O/L) and the Advanced Level (A/L) is higher than among the old poor, though the new poor are still significantly less educated than the non-poor.

The poverty rate increased the most in places where it was already high before the crisis. Across districts, Kandy and Ratnapura—which are highly rural and before the pandemic had the largest number of pre-pandemic poor—also account for a large share of the new poor (figure 30). This implies that the COVID-19 crisis may have slightly shifted the composition of the poor but did not fundamentally change the nature of poverty in Sri Lanka, as most of the poor continue to live in predominantly rural areas.

Figure 28: Distribution of poor and nonpoor people by province

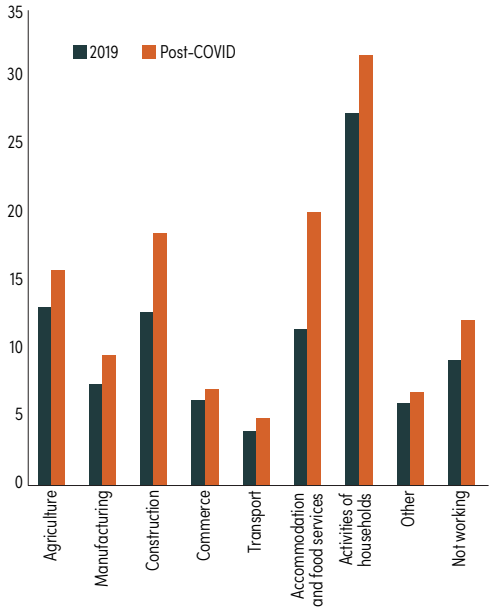
(Percent)



Source: World Bank staff estimation using HIES 2016
Note: WP = Western Province; CP = Central Province; SP = Southern Province; NP = Northern Province; EP = Eastern Province; NCP = North-Central Province; NWP = North-Western Province; UP = Uva Province; Sab = Sabaragamuwa Province.

Figure 29: $3.20 poverty rates by sector of household head

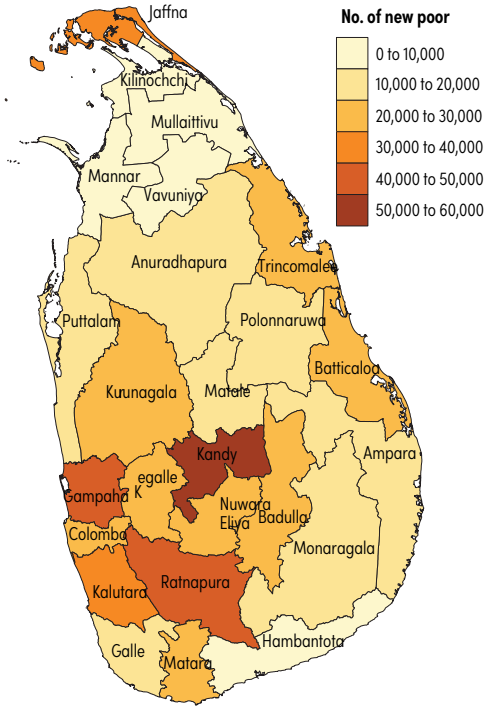
(Percent)



Source: World Bank staff estimation using HIES 2016.

Digital opportunities introduce new divides

Figure 30: The spatial distribution of the new poor



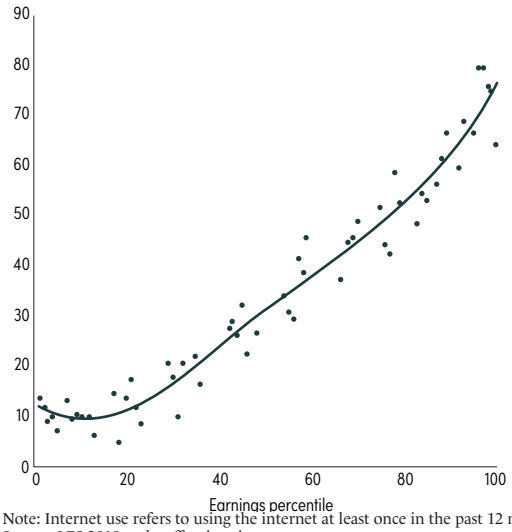
Source: World Bank staff estimation using HIES 2016.

This pandemic has exposed the digital divide. While the findings from the simulations above largely play out along existing economic divides, access to digital technology has become another dimension of inequality. It operates in multiple ways. Firstly, teleworkers who can perform their jobs from home are more protected from the health risks of the pandemic. Data on morbidity and mortality rates related to COVID-19 in other countries show that essential workers, many in healthcare and retail, have been unduly affected. Secondly, these workers are more protected from job losses as many operations can shift online, mitigating losses in earnings. Finally, access to digital technology at the household level has important implications for children's ability to learn remotely. Prolonged school closures and a move to remote learning mean that children in homes without access to computers or tablets may fall behind. These education losses may compound over time leading to diverging trends along the digital divide.

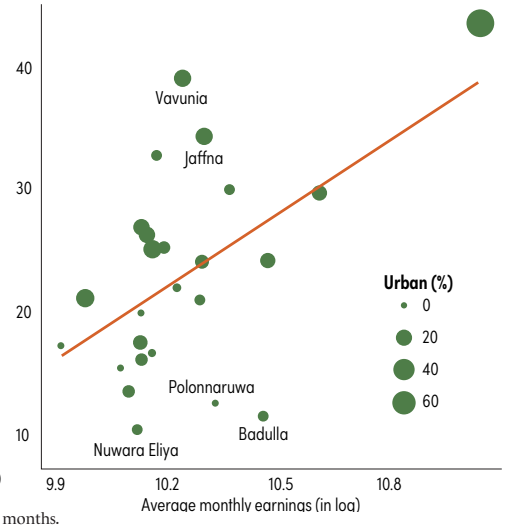
Wide inequalities in digital access could further aggravate economic and spatial inequality. Digital technology and the internet can act as driving forces of income convergence, both across individuals and across districts. However, if access is higher among richer households or in richer districts, digital technologies can compound existing inequalities. Digital access is higher for richer households (Figure 31a), so that it aggravates economic inequality and lowers economic mobility. In addition, the digital divide also has a geographic dimension as richer and more urban districts have higher access to technology (Figure 31b). Internet use is twice as prevalent in urban areas than in rural areas. In the former, four out of ten people used the internet at least once in 2018, relative to only two out of ten in rural areas. The high correlation between the different dimensions of inequality – economic, digital and spatial – make it unlikely that digital opportunities will have an equalizing impact without large policy intervention. One example is the impact of opportunities to work remotely.

Figure 31: Correlation between income and internet use

a) at the individual level
(Percent of workers)



b) at the district level
(Percent on average)

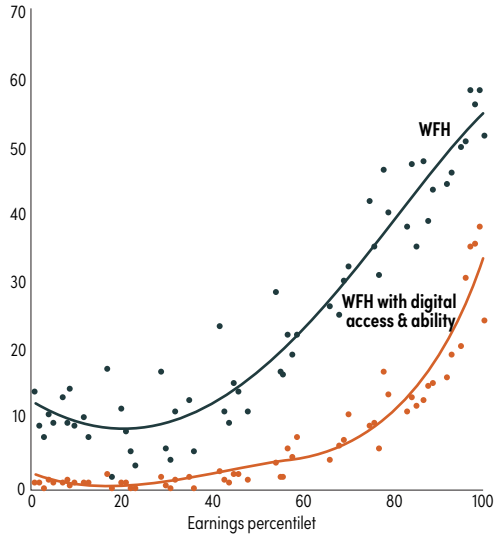


Note: Internet use refers to using the internet at least once in the past 12 months.
Source: LFS 2018 and staff estimations.

Only high-income earners can benefit from working remotely. The share of potential teleworkers in Sri Lanka can be estimated based on an established classification of the feasibility of working from home for different occupations (see Appendix A3). Around 27 percent of workers in Sri Lanka have potentially tele-workable jobs. Figure 32 shows that such job opportunities are much more common among high-income earners. Among the highest 20 percent of income earners, the share of teleworkers is 47 percent. To be able to telework, one does not only need a job that allows for it, but also digital access. Refining the share of teleworkable jobs – by controlling for the ownership of a digital device (desktop, laptop or tablet) and the ability to use it – widens the divide since many poor likely access the internet only through their mobile phones, if at all. Almost no one in the lower half of the income distribution can actually work from home and even among the higher-middle income earners the share is only around 10 percent. It is only among the highest income earners that the share reaches a third. While the share of potential tele-workers is on average only around 24 percent in rural areas, it is around 40 percent in Colombo. The possibility of remote work is also more common in some sectors of the economy than in others and is higher in the public than in the private sector. By offering greater employment opportunities and protections to these richer and more urban teleworkers, the digital divide widens existing economic and spatial inequalities.

Figure 32: Teleworkable occupations for different earning levels

(Percent of workers)



Note: Work from Home (WFH) or tele-workable occupations are those jobs where the majority of daily tasks can be performed away from the workplace. This classification of occupations is based on Dingel and Neiman (2020).
Source: LFS 2018 and staff estimations.

Adoption of telework and digital technology is higher for large private sector firms than for small and medium-sized enterprises.[30] On the labor demand-side, a majority of leading private sector employers reported that flexible work policies were among the most useful for managing human resources during COVID-19. However, challenges in infrastructure and adapting jobs to a fully remote workplace remain. Low phone and internet connectivity were cited as the foremost reason for productivity dips among employees during the pandemic.[12] Just as the amenability for telework varies across workers, the same applies to firms. Small and medium-sized enterprises, were unlikely to adopt digital technology during the lockdowns and women-owned enterprises even less so.[12]

Conclusion

The COVID-19 crisis induced widespread losses in livelihoods, leading to a significant increase in poverty. The sharp economic slowdown is estimated to have increased the $3.20 poverty rate from 9.2 percent in 2019 to 11.7 percent in 2020, leading to more than 500,000 additional poor people. The economic impact of the pandemic is expected to be felt broadly. The impact was disproportionately large among those working in more urbanized areas such as the Western province, likely due to the large impact on industry, and places that had high numbers of poor before the pandemic, such as the Northern, Eastern, Uva and Sabaragamuwa Provinces. Mitigation measures implemented by the government since the onset of the pandemic helped absorb the labor market impact and soften the impact on poverty. A large budget (given limited fiscal space) was expended on these mitigation efforts which, if they were more targeted, could have had an even greater mitigating impact on poverty. Limited fiscal space, however, is a severe constraint to scaling up the public response.

As Sri Lanka's economy gradually recovers from the crisis, efforts to restore livelihoods and to make them more resilient could help Sri Lanka to continue its path of poverty reduction and shared prosperity. Sri Lanka's economy is expected to gradually recover, with a projected GDP

30 World Bank. 2020. Gendered Impacts of COVID-19 on Small and Medium-Sized Enterprises in Sri Lanka. Washington, D.C.: World Bank Group.

growth rate of 3.4 percent in 2021. The share of people living on less than $3.20 per day is hence expected to decline to 10.9 percent. Containing the health crisis with an effective vaccine rollout is a prerequisite to fully resuming economic activities. A labor market that creates more and better jobs can help enhance resilience against future shocks. The current social protection system could support the reintegration of those who lost their jobs into the labor market. In the medium term, social safety nets could be better targeted toward the poor and vulnerable, while a system that allows support to be scaled up quickly and effectively in times of crises could be adopted. In the absence of a strong safety net, households tend to resort to negative coping mechanisms by drawing down savings, selling off assets, or reducing food intake. The lack of an appropriate safety net is highlighted in preliminary results from a World Bank COVID-19 rapid phone survey, which showed that about 44 percent of households did not have any source to help them cover emergency expenses.

In the medium to long term, policies that expand or universalize digital infrastructure could provide new opportunities for economic mobility. Economic activity supported by advanced technologies has proven to be more resilient during this crisis and digital technologies could become an important engine for future job growth. However, despite widescale ownership of cellphones in Sri Lanka, the digital revolution will fall short of expectations without expansion of high-speed networks and accessible data on the whole island. Finally, investments in digital literacy can ensure that everyone can benefit from the new opportunities that digital technologies bring with them.

Appendix

A1 Simulating the impact of the COVID-19 pandemic on employment

This methodology to simulate job-losses due to COVID-19 relies on both characteristics of structural employment, as well as the nature of the shock which hits some sectors harder than others.[31] The following three steps explain the macro-micro simulations used to analyze the labor market impact of COVID-19:

- **The aggregate employment shock is** estimated by translating macroeconomic projections of output at the sectoral into employment projections via historical estimates of GDP-employment elasticities.

- **The aggregate shock is mapped** to specific individuals using a Probit model estimated with the latest available household survey data. This probabilistic model uses characteristics like gender, age, education and household composition to predict an individual-level employment probability score.

- **Workers are then sorted based** on their individual likelihood of employment and classified as 'likely' to be unemployed until the aggregate level of sectoral shock is reached.

The analyses presented in this chapter use data from both the household income and consumption survey (HIES, 2016) and the labor force survey (LFS, 2018). The HIES contains detailed information on household consumption and is used to generate official poverty estimates. This dataset is the basis for all simulations relating to the poverty impact of COVID-19. The LFS, on the other hand, contains information on workers' formality/informality status and detailed occupations. This dataset is used to simulate the impact of COVID-19 related job-losses by formality and for the analysis of the digital divide. Both analyses, thus, complement each other to give a broader picture of the impact.

A2 Simulating the impact of the COVID-19 pandemic on poverty

The impact on poverty employs the simulated job losses and adds ad hoc wage cuts – with the magnitude of the shock varying at the sectoral level – and government mitigation measures. This simulation hence incorporates labor market responses both at the intensive as well as the extensive margin.

- **Individual and household income are** adjusted based on predictions of employment shocks and earnings shocks, including remittances projections.

- **Poverty estimates are derived by** mapping estimates for income into consumption space.[32]

- **The mitigation impacts of policy** responses are simulated using a `realistic' scenario and a `perfect targeting' scenario. The 'realistic' scenario allocates beneficiaries randomly while maintaining the existing distribution of beneficiaries between districts while the second scenario assumes perfect targeting to all poor households. The results are likely imperfect given lack of information on the characteristics of actual beneficiaries. The exercise is aimed at indicating a range of poverty estimates that may have resulted from these mitigation measures.

31 World Bank. 2020. South Asia Economic Focus, Fall 2020: Beaten or Broken? Informality and COVID-19. Washington, DC: World Bank.
32 For a detailed description of the methodology and results, refer to World Bank, forthcoming. "The COVID-19 Impact on Livelihoods and Poverty".

A3 Identifying teleworkers

The classification of workers as "teleworkers" depends on whether regular tasks in the occupations they hold can be performed away from their workplaces. This requires detailed information on the task content of each occupation. The methodology used in this chapter involves the following steps:

- **The Dingel and Neiman (2020)**[33] classification of the feasibility of working from home provides mappings from Standard Occupational Classification (SOC-00) system used by the US federal government to the International Standard Classification of Occupations (ISCO). The Sri Lanka Standard Classification of Occupations is based on ISCO-08 which is mapped to the SOC-00 and each occupation classified according to whether it is "telework-able".

- **The index is then refined** to account for whether the worker actually owns a digital device (desktop, laptop or tablet) and is able to use it based on Labor Force Survey (2018) data.

33 Dingel, J. I., & Neiman, B. (2020). How many jobs can be done at home?. *Journal of Public Economics*, *189*, 104235.

PHOTO BY © RUWAN WALPOLA/SHUTTERSTOCK.COM

THE WORLD BANK