International Monetary Fund

Sri Lanka and the IMF

Press Release:
IMF Executive Board Approves Three-Year US$1.5 Billion Extended Arrangement under EFF for Sri Lanka

June 3, 2016

Country's Policy Intentions Documents

E-Mail Notification
Subscribe or Modify your subscription

Sri Lanka: Letter of Intent, Memorandum of Economic Financial Policies, and Technical Memorandum of Understanding

May 12, 2016

Letter of Intent

Colombo, May 12, 2016

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Lagarde:

Sri Lanka is experiencing serious economic challenges against the backdrop of an increasingly volatile global economic environment. To tackle these challenges, we are proposing a strong and ambitious reform program, aimed at reducing macroeconomic vulnerabilities, strengthening public finance and financial management, and promoting sustained high levels of inclusive economic growth.

While Sri Lanka's economic fundamentals have remained strong, domestic imbalances and a deteriorating external environment pose risks. Our revenue base has deteriorated over the past two decades, creating an over-reliance on debt financing. Downside risks to the balance of payments have materialized in 2015 and 2016 as the end of unconventional monetary policy in the United States, regional rebalancing, and heightened global market volatility have created significantly tighter financing conditions. We have also seen our position in world trade deteriorate reflecting some decline in competitiveness. We are of the view that a decisive change in the direction of macroeconomic policies is needed to ensure continued growth and prosperity.

The attached Memorandum of Economic and Financial Policies (MEFP) presents the plans and policies of the authorities of Sri Lanka for 2016−2019. In support of the policies in the attached MEFP, the Government requests that the Executive Board of the IMF approve a 3-year Extended Arrangement under the Extended Fund Facility (EFF) with access equivalent to SDR 1,070.78 million (185 percent of quota). Table 1 and Technical Memorandum of Understanding attached to the MEFP set out quantitative targets that are to be observed under the Extended Arrangement. Table 2 attached to the MEFP sets out proposed prior actions for approval of the Extended Arrangement and structural benchmarks under the Extended Arrangement.

We believe the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but we will take any further measures that may become appropriate for this purpose. The Government will consult with the Fund on the implementation of the policies contained in the MEFP, and in advance of revisions to these policies, in accordance with the Fund's policies on such consultation.

In keeping with its policy of transparency, the Government has authorized the publication of this letter and its attachments as well as the associated staff report.

Sincerely yours,

/s/

Sandresh Ravindra Karunanayake
Minister of Finance

/s/

Lakshman Arjuna Mahendran
Governor
Central Bank of Sri Lanka

Attachment I. Memorandum of Economic and Financial Policies

May 12, 2016

Sri Lanka has recorded significant economic achievements. Growth has been strong since the beginning of the new century, inflation has recently been brought down to the low single digits, and substantial progress has been made with respect to reducing poverty and improving social indicators.

In some important ways, Sri Lanka needs a new phase of economic transformation to keep pace with the major changes in global and regional growth. Further, macroeconomic management in the past few years was at times uneven. While growth has been high, it has not yet reached full potential. Our foreign exchange and fiscal buffers are lower than desirable given an increasingly uncertain global environment. Public debt is a continued burden on both government finances and development, and more needs to be done to ensure that both the gains from economic growth and the cost of public services are distributed more equally.

In this context of the need for a new phase of economic management, heightened vulnerability, and a significantly more challenging external environment, we aim to make progress in the economic transformation under a 3-year program supported by an IMF Extended Arrangement under the Extended Fund Facility (EFF). Our main objectives are to achieve high and sustained levels of economic growth, create a more inclusive economic environment where the gains are spread more equally across the population, restore discipline to macroeconomic and financial policies, and rebuild fiscal and external buffers to better weather adverse shocks. The government supports a decisive strengthening of the nation's outward orientation, based on a more open trade regime and a welcoming environment for investment. We expect economic growth to come close to 5½ percent over the medium term, inflation to remain contained to low single digits, and international reserves to reach over 4 months of imports by the end of the program.

We have an extensive structural reform agenda in support of these goals. Fiscal reforms are critical and include: (i) improvements in revenue administration and tax policy to raise domestic revenues to levels commensurate with dynamic emerging markets in the region and reduce reliance on borrowing; (ii) public financial management reforms to strengthen budget planning and execution, as well as eliminate arrears; (iii) comprehensive measures to restructure and put on a more rigorous commercial footing our state enterprises—thereby reducing both fiscal risk and economic distortions. We plan to review and reform out external tariff structure to reduce effective rates of protection while we simultaneously pursue new trade agreements and find other ways to support productivity growth and bolster competitiveness. In the monetary policy area, we plan steps to shift toward flexible inflation targeting and measures to help deepen foreign exchange markets and a more flexible exchange rate regime. Strengthening financial sector supervision and increasing the role of private credit and financial intermediation in the economy will remain an important objective.

MACROECONOMIC OUTLOOK

1. **The economic outlook is stable and underlying momentum and positive prospects for new investments should balance the impact of tighter fiscal and monetary policies.** Over the short run, real GDP growth is likely to improve to 5 percent in 2016, with sound macroeconomic policy and restoration of market confidence, supported by recovery in investment. There is a clear need to re-start fiscal consolidation in 2016 as part of the government's objective of macroeconomic stabilization and restoration of investor confidence. Given expansive credit growth and rising core inflation in the second half of 2015, there has already been some tightening of the monetary policy stance. While inflation has moderated to 2.7 percent in February 2016, we stand ready to tighten monetary policy further should inflationary pressure emerge. A renewed commitment to exchange rate flexibility, low oil prices, and the impact of measures to curb the rapid increase in credit and imports seen in 2015 should lead to further improvement in the external sector. The current account deficit is projected to fall from 2.5 percent of GDP in 2015 to 1.5 percent in 2016 allowing for accumulation of international reserves by the central bank.

2. **Notwithstanding short-term challenges, we see ample room for more vibrant economic growth going forward.** Sri Lanka's economic pillars are strong. Economic activity should increase over the medium-term and be sustained near the estimate rate of potential (non-inflationary) growth. This positive outlook is supported by the strength of Sri Lanka's economic foundation and the resilience shown during previous periods of economic and financial stress. Sri Lanka has a strong base of human capital and reliable infrastructure—especially compared with other South Asian economies. It also occupies a strategic position in a fast growing and dynamic region, and infrastructure investments over the last decade (particularly on port and other transport-related facilities) have taken advantage of this opportunity. Services growth has been strong, particularly in such relatively new areas as tourism, IT, and accounting—all of which hold potential for further expansion. However, we recognize that stronger macroeconomic management, a decisive strengthening of Sri Lanka's outward orientation, a stronger role for the private sector and market forces in the economy, and further investment in physical infrastructure and human capital are needed to achieve high, inclusive, and sustained growth.

FISCAL POLICY

3. **A durable reduction of the fiscal deficit and public debt through a growth-friendly emphasis on revenue generation is the main priority for fiscal policy**. Fiscal consolidation achieved over the last decade was heavily skewed toward cutting expenditure in the face of a secular decline in revenue. Sri Lanka's tax-to-GDP ratio is now one of the lowest in the world, is unsuitable from a developmental level (as we approach middle income status), creates an unsustainable reliance on debt financing, and limits our ability to lower the overall level of public debt and debt vulnerability. The lack of fiscal space also hampers our ability to mitigate the impact of adverse shocks, which is a key consideration in an increasingly volatile economic environment.

4. In line with these considerations, the government will move quickly to implement greater financial discipline. The government aims to reduce the overall fiscal deficit to no more than 5.4 percent of GDP in 2016, compared with a deficit of 6.9 percent in 2014. This reduction in the deficit is to be accomplished through steps to durably bolster tax revenues—rather than one-off measures—and close attention to recurrent, discretionary, and capital spending. It is vital that fiscal consolidation continue over the medium-term, as we see a steady decline in budget deficits and public debt as a linchpin to reducing Sri Lanka's vulnerability, making room for private investment, and restoring confidence in macroeconomic policies. We are committed to a steady path of lower fiscal deficits—bringing the primary balance to surplus within three years to ensure a steady reduction in the ratio of public debt to GDP and, as indicated in the Prime Minister's November 2015 speech to parliament, we aim to bring the overall central government deficit down to at least 3.5 percent of GDP by 2020. This will bring a corresponding reduction in the level of government debt. Specifically, we will target a primary balance to be achieved in 2017 and a primary surplus of 0.7 percent of GDP in 2018. These targets will be anchored by an increase in the tax to GDP ratio by about 1.2 percent of GDP annually in 2017–18. Annual budget proposals to be submitted to Parliaments for 2017–19 will be in line with the program targets (structural benchmark). Fiscal consolidation beyond 2019 will be ensured through revision of the Financial Responsibility Act to include binding targets for the government deficit and level of overall public debt.

5. Fiscal consolidation will be achieved mainly through measures to broaden the tax base and improve the efficiency of collection rather than slashing expenditure. Sri Lanka's fiscal deficits stem not from exceptionally high expenditures, but rather, from a steady erosion of the tax base over the last two decades. Sri Lanka's tax-to-GDP ratio is among the lowest in the world, and the nation's tax efficiency ratio is also now below that of comparator countries—particularly for the VAT. This was not always the case. In the not too distant past, Sri Lanka's tax-to-GDP was at or above levels in comparator countries, and the VAT—which is used successfully by some 140 countries worldwide—was a major source of government revenue. Rebuilding the tax base is thus not an impossible task, but will require a fundamental re-set of tax policies and a concerted effort to bolster tax administration. Our strategy in this regard will focus on (i) broadening the tax base; (ii) rationalizing the tax system and removing the many exemptions, holidays, and special rates that have undermined fair and effective tax administration; (iii) strengthening capacity for risk-based revenue administration to improve tax compliance; and (iv) bolstering public financial management, in particular on commitment control, and financial planning and discipline.

6. The fiscal framework for 2016 includes a number of measures to improve revenue performance. To broaden the tax base, the VAT will continue to apply to wholesale and retail trade (at a lower threshold), and has also been extended to telecommunication and private health. The VAT rate will remain unified to make administration simple, and increased to 15 percent, while initial plans to raise the NBT rate to 4 percent have been scaled back given the cascading nature of this turnover tax. Thresholds for personal income tax will be maintained at levels that capture a sufficient portion of the tax base.

7. **Further measures to broaden the tax base are envisaged for the medium-term**. Past administrations have offered various forms of tax incentives to encourage export-oriented industrialization, and to provide benefits to selected groups. The proliferation of exemptions, tax holidays, and special tax rates has not only been ineffective in boosting investment, they have also resulted in a tax system that is largely inefficient, non-transparent, and unfair. It is now the case that a relatively narrow share of the population provides the bulk of tax revenues. As an initial step towards rationalizing tax incentives, the Cabinet suspended the Board of Investment Act, precluding that body from the capacity to grant tax exemptions and other forms of preferential treatment (these powers will henceforth be concentrated in the Ministry of Finance, which has ultimate oversight of tax policy). Further, within the current year, we will redraft the Inland Revenue Act, with a view to creating new income tax legislation that is both in line with international best practices, but also clear, transparent, and aimed at widening the tax net such that over time, tax rates may be reduced. We will submit the draft act to Parliament by March 2017 (structural benchmark). We will also conduct a diagnostic review of the VAT by June 2017 (structural benchmark), and implement amendments to simplify and strengthen this essential pillar of our tax framework. To monitor our progress in reducing distortions, annual budgets will henceforth include a catalogue of tax expenditures (tax exemptions, holidays, and other incentives), along with an estimate of their cost such that their merits can be debated openly (structural benchmark by December 2016). By December 2016, the Cabinet will adopt a time-bound strategy to reduce or eliminate these tax expenditures, as agreed with IMF staff (structural benchmark).

8. **Improvements to tax administration will complement tax policy reforms**. Changes to tax policy will be ineffective in raising revenue unless accompanied by a concerted effort to strengthen capacity on revenue administration. We see it as vital to build a tax authority that is not only efficient and effective, but that enjoys public trust. Laudable efforts have been underway at the Inland Revenue Department (IRD) for some time—including essential steps toward automation and the use of information technologies that are already standard in many middle income economies. To bolster these efforts and raise our tax administration to the highest standard, our structural reform agenda will consist of: (i) adoption by IRD of Key Performance Indicators (KPIs) on the number of risk-based VAT audit by September 2016 (structural benchmark); (ii) adoption by IRD of a VAT compliance strategy that includes a time-bound plan to implement risk-based audits by September 2016 (structural benchmark); (iii) adoption by IRD of compliance strategies for corporate and personal income taxes by June 2017 (structural benchmark); and (iv) fully rolling out new IT systems (RAMIS and ASYCUDA) for domestic tax and customs administration (full roll out of RAMIS by December 2016, including web-based tax filings, is a structural benchmark). Organizational and business procedure reform for the Inland Revenue Department will also be pursued, including restructuring IRD along functional lines, creating a design and monitoring unit, making management structure more efficient to speed up interaction with taxpayers, strengthening the Large Taxpayer Unit, introducing mandatory e-filing, and enhancing the use of taxpayer identification numbers.

9. A disciplined approach to government spending and prioritization of public investment (both in physical and human capital) will be a second pillar of fiscal consolidation. We intend to keep the overall spending envelope under control, while reallocating spending within this envelope to areas that will bolster our medium-term prospects for high and inclusive rates of economic growth. We intend to review spending patterns and identify areas of savings in government purchase of goods and services, and government subsidies and transfers, with a view to making more resources available for critical spending on public infrastructure, health, education, and social assistance. With the assistance of the World Bank, we will also upgrade our procurement processes, produce a national policy statement for public investment management, and strengthen our capacity in the area of debt management.

PUBLIC FINANCIAL MANAGEMENT

10. Further improvements in fiscal management and transparency are also planned to address past irregularities and prevent future occurrences. With technical assistance from the IMF we have identified outstanding obligations of the central government and SOEs totaling Rs 1.36 trillion. This includes (i) outstanding obligations of the central government, totaling Rs 58 billion, which are to be settled during 2016; and (ii) those of 4 SOEs (CPC, CEB, Sri Lankan Airlines, and the Sri Lanka Port Authority), totaling Rs 1.2 trillion. These SOEs currently have no arrears in their financial obligations. The government will devise plans for each SOE to resolve and repay the obligations through a resolution strategy for Sri Lankan Airlines, establishment of Statement of Corporate Intent, and reform of utility subsidies (see paragraph 12).

11. For both credibility and to fully meet our financial commitments, we see careful monitoring of government spending commitments as a pillar of good management. By July 2016, the government will implement a commitment control system based on a commitment record system (with quarterly reports produced no later than one month after the end of each quarter) and quarterly expenditure commitment ceilings for the 2016 budget and the 2017 budget (structural benchmark). The rollout of the new Integrated Treasury Management Information System (ITMIS) should significantly expand PFM capabilities, including commitment control, budget preparation, treasury, accounting, and procurement, among others. As an initial stage, the introduction of the ITMIS, including the commitment control module to implement a formal commitment record system and quarterly expenditure ceilings, will be completed for the Ministry of Finance by December 2016 and for the Ministry of Health by April 2017 (structural benchmarks). This will be followed by full roll-out to all ministries, agencies, and spending sub-units by end-2017. To boost transparency, the MOF will begin publishing quarterly financial bulletins summarizing government fiscal operations; ensure that annual budgets explicitly cost out tax expenditures and adhere to Government Financial Statistics Manual (GFSM) standards. Budgets will also include an analysis of fiscal risks, including those related to SOEs and public-private partnerships (PPPs).

STATE ENTERPRISES

12. The financial condition of some of our state enterprises and ultimate responsibility for their existing obligations is a challenge we seek to address and resolve as part of the program. Sri Lanka currently has more than 200 public enterprises representing a substantial share of the nation's economic activity. Although some SOEs are profitable and performing well, collectively they represent a risk to public finances (either directly or through the state banks, which fund the largest SOEs). The Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) have incurred financial losses in fulfilling non-commercial obligations because of implicit energy subsidies—retail fuel and electricity prices have been set below cost-recovery levels. Sri Lankan Airlines has been poorly managed, and continues to incur significant losses on a monthly basis. The government recognizes the need to decisively address the issue of SOE performance and minimize fiscal risk. A comprehensive strategy for SOE reform and a more rules-based approach to financial management is being developed. In the near-term, however, our strategy encompasses the following elements:

- A resolution strategy for Sri Lankan Airlines will be completed and approved by Cabinet by September 2016, effectively removing this company from the government's accounts (structural benchmark).

- To enhance oversight and financial discipline, the six largest SOEs (CPC, CEB, Sri Lankan Airlines, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authorities) will agree with MOF and the relevant line ministry and publish a statement of corporate intent (SCI) which encompasses the SOE's mission, high level objectives, and multiyear corporate plan; capital expenditure and financing plans; explicit financial and non-financial targets; and description and cost of non-commercial obligations (structural benchmark by December 2016). We will also look at strengthening the legal framework for the governance and oversight of SOEs, including through establishment of coherent financial regulations for SOEs on governance, accountability, and funds management.

- Reform of energy and other utility subsidies. This would entail implementation of a formula-based automatic pricing mechanism for petroleum products, so as to reduce the possibility of future financial losses by the CPC and avoid large adjustments in retail prices. We will also enact legislative reforms to ensure that the Public Utilities Commission (PUC) will have sole authority to set electricity tariffs in a cost-reflective manner. Automatic fuel and electricity pricing mechanisms that ensure retail prices above cost-recovery levels and a financial position of CPC and CEB capable of covering debt service will be introduced by December 2016 (structural benchmark). We will extend this strategy for water tariff settings when the PUC starts regulating the water sector. To support these objectives, the government will record the fiscal cost of non-commercial obligations (such as utility subsidies) for SOEs in the central government budget, starting from the 2017 budget (structural benchmark by November 2016).

MONETARY AND EXCHANGE RATE POLICY

13. **The focus of monetary policy will remain at keeping inflation in the mid-single digits**. For most of 2015, the CBSL maintained an accommodative policy stance given continued low inflation and anemic credit growth in 2014. However, private credit accelerated in the second quarter of 2015 and into 2016, and together with steadily increasing core inflation signaled a turning point in the policy cycle. The CBSL increased the statutory reserve ratio of commercial banks from 6 percent to 7.5 percent in January 2016, followed by an increase in the standing deposit facility rate and lending facility rate by 50 basis points to 6.5 and 8 percent, respectively, in February 2016. Going forward, headline inflation is expected to gradually increase to about 5 percent by end-2016, reflecting the VAT increase in May 2016, the depreciation of rupee, and an anticipated increase in international food prices. The CBSL aims at maintaining headline inflation within a range of 3 percent from the projected path. This objective will be monitored through a monetary policy consultation clause (see the Technical Memorandum of Understanding), supported by monitoring of reserve money developments. The CBSL stands ready to further adjust its policy stance to achieve its inflation objective.

14. **The CBSL has been making steady progress toward a more effective monetary policy framework**. We will continue to improve liquidity management so as to avoid extended periods of excess liquidity in the financial system and to maintain good control of interest rates. This should enhance the effectiveness of the monetary transmission mechanism.

15. **Over the medium-term, we intend to finish putting place conditions for gradually moving toward a flexible inflation targeting framework**. In such a framework, more weight will be given to inflation as a nominal anchor, while also considering policy's impact on growth and the foreign exchange market. As a first step, we plan to formulate and make public a well-articulated plan spelling out actions already taken and milestones for moving gradually to a flexible inflation-targeting framework. The plan would lay out in detail the elements of a successful inflation targeting regime, and how and when these will be developed. We will address (i) the legal framework, including central bank independence from fiscal and/or political pressures that would conflict with an inflation objective; (ii) a sound financial system that would reduce the risk of conflict between monetary and financial system stability objectives; (iii) well developed technical infrastructure, including improved forecasting and modeling capabilities; (iv) the choice of targets and how unanticipated shocks would be dealt with; and (v) the policy decision making process.

16. **We aim to transition over the life of the program to a market-oriented approach to exchange rate policy.** Sri Lanka's approach to exchange rate flexibility has at times been uneven—reflecting both the realities of a thin foreign exchange market, as well as a desire to avoid turbulence in currency markets spilling over into inflation and external debt and debt service. Historically, however, this has at times of stress resulted in a delayed adjustment and loss of reserves. It is our attention to move forward with a durable transition to a more flexible exchange rate regime. In this context, we will take steps toward meeting the essential-preconditions for a truly flexible exchange rate regime, including (i) a deeper and more liquid

foreign exchange market; (ii) adequate systems to review and manage exchange rate risks; and (iii) a transparent intervention policy, consistent with a flexible inflation targeting framework.

17. A strengthening of reserve coverage (guided by the level of net reserves as a percentage of the ARA reserve metric) will be programmed, supported by purchases under the Extended Arrangement. Further, because the supply and demand for foreign exchange will be uncertain over the program period, the program includes a clause whereby the authorities would consult with the Fund staff on the appropriate policy response in the event that the gap between supply and demand of foreign exchange results in a more sudden and disruptive depreciation of the exchange rate than anticipated by the staff and authorities.

18. During the program we will not impose or intensify restrictions on the making of payments and transfers for current international transactions; introduce or modify multiple currency practices; conclude bilateral payments agreements that are inconsistent with Article VIII; or impose or intensify import restrictions for balance of payments reasons. The CBSL and the Government will also abstain from providing exchange guarantees for foreign currency borrowing.

POLICIES TO STRENGTHEN TRADE AND INVESTMENT

19. Achieving medium-term macroeconomic objectives will require a renewed effort toward greater integration into regional and global supply chains, higher levels of FDI, and enhancing prospects for private sector investment. In addition to better infrastructure, this will entail improvements in the trade regime and investment climate. Immediate steps toward this end have been the establishment of a Development Agency (which will seek to prioritize infrastructure development), as well as a Trade Agency (responsible for trade promotion and negotiation of trade and investment agreements). The EU ban on fishery imports will be removed in the next few months, which will also help facilitate resumption of GSP plus trade status.

20. To boost trade and private sector development, we will seek to reduce costs and bolster competitiveness. A key element in this work would be a review of Sri Lanka's trade regime including an evaluation of para-tariffs and other nontariff barriers that have led to a high level of effective protection and hampered exports. In addition, we are negotiating a Development Policy Credit with the World Bank to enhance competitiveness. It aims to increase the efficiency of trade facilitation, remove barriers to foreign investment entry and establishment (including access to land), enhance access to finance, and strengthen financial market infrastructure. These steps should help to attract FDI and complement public investment.

RISKS AND CONTINGENCIES

21. In light of the high degree of uncertainty with respect to the global economic environment, there are elevated economic and financial risks to the program. The main risks include (i) a slowdown in the economic recovery of key external trade partners and continued volatility in global financial markets; (ii) weaker than projected revenues; (iii) weaker than expected capital inflows, which would widen the projected financing gap given already substantial gross fiscal financing needs of close to 19 percent of GDP in 2016 ; (iv) lower than expected growth and/or new pressures on the trade account; and (v) weaker than expected performance at state owned enterprises. These risks could further challenge public debt sustainability. Should such risks materialize, the government stands ready to adjust promptly its policies, in close consultation with IMF staff, to ensure the achievement of a sustainable external position at the end of the program.

PROGRAM MONITORING

22. Our program will be subject to semiannual reviews with performance criteria and indicative targets set out in Table 1 attached to this MEFP and Technical Memorandum of Understanding (TMU). Completion of the first and second reviews will require observance of the quantitative performance criteria for end-June 2016 and end-December 2016, respectively, as well as continuous performance criteria, as specified in Table 1 attached to this MEFP. The reviews will also assess progress toward observance of the structural benchmarks specified in Table 2 attached to this MEFP. The first two reviews of the program will take place on or after November 20, 2016 and April 20, 2017, respectively.

Table 1. Sri Lanka: Quantitative Performance Criteria (PC) and Indicative Targets (IT)

	Dec. 2015 Act.	Mar.2016 Est.	Jun. 2016 PC	Sep. 2016 IT	Dec. 2016 PC	Dec. 2017 IT
Quantitative performance criteria						
Central government primary balance (floor, cumulative from the beginning of the year, in billion rupees)	-241	-26	-46	-85	-97	-3
Net official international reserves (floor, cumulative change from the beginning of the year, in million US$) 1/ 2/	-1,489	-720	390	330	671	1,343
Continuous performance criteria						
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	0	0	0	0
Monetary policy consultation clause 3/						
Year-on-year inflation in Colombo Consumers Price Index (in percent) 3/						
Outer band (upper limit)	…	…	6.4	7.5	8.2	8.1
Inner band (upper limit)	…	…	4.9	6.0	6.7	6.6
Actual / Center point	2.5	1.9	3.4	4.5	5.2	5.1
Inner band (lower limit)	…	…	1.9	3.0	3.7	3.6
Outer band (lower limit)	…	…	0.4	1.5	2.2	2.1
Indicative targets						
Central government tax revenue (floor, cumulative from the beginning of the year, in billion rupees)	1,356	325	652	1,021	1,428	1,721
Reserve money of the CBSL (ceiling, end of period stock, in billion rupees)	673	792	791	794	797	893
Memorandum items:						
Foreign program financing by the central government assumed under the program (cumulative from the beginning of the year, in million US$) 1/	0	0	0	200	325	200
The cumulative net change in the amount of foreign holdings of Treasury Bills, Treasury Bonds, and SLDBs assumed under the program (cumulative from the beginning of the year, in million US$) 1/	-903	-560	-842	-1,124	-1,407	100
External commercial loans (including Eurobonds and syndicated loans) by the central government assumed under the program (cumulative from the beginning of the year, in million US$) 1/	1,650	0	2,000	2,000	2,000	300
Amortization of official external debt by the central government assumed under the program (cumulative from the beginning of the year, in million US$) 2/	798	238	475	713	950	1,070
Net official international reserves (end of period stock, in millions of US$)	5,029	4,309	5,419	5,359	5,700	7,043

1/ If (i) the amount of foreign program financing by the central government, (ii) the cumulative net change in the amount of foreign holdings of Treasury Bills, Treasury Bonds, and SLDBs, and (iii) the amount of external commercial loans (including Eurobonds and syndicated loans) by the central government is higher/lower in U.S. dollar terms than assumed under the program, the floor on net official international reserves will be adjusted upward/downward by the cumulative differences on the test date.

2/ If the amount of amortization of official external debt by the central government in U.S. dollar terms is higher/lower than assumed under the program, the floor on net official international reserves will be adjusted downward/upward by the cumulative differences on the test date.

3/ See the TMU for how to measure year-on-year inflation.

Table 2. Sri Lanka: Prior Actions and Structural Benchmarks

Prior Actions	Date	Status
Cabinet to issue a Memorandum requiring the Ministry of Finance to complete by end-October 2016 a time-bound strategy to address the issue of outstanding arrears of the central government and obligations of state enterprises. The Memorandum will specify that the strategy include: (i) completion (by end-2016) of a comprehensive database of SOE's financial obligations, including a breakdown of arrears and non-arrears to be certified by the Auditor General, for use in creating a registry of such obligations; (ii) clarification of the government's responsibility over existing obligations related to subsidies and other non-commercial obligations of the SOEs.	Prior action	[Met]
Ministry of Finance to issue circulars to (i) formally implement tax policy and other revenue measures outlined in the Cabinet Memorandum of March 4, 2016; (ii) detail revised expenditure ceilings for government ministries and agencies consistent with the overall budget deficit target for 2016.	Prior action	[Met]
Cabinet to issue a resolution to adopt a framework note (agreed with IMF staff) for a new Inland Revenue Act, which embodies key tax policy drivers, overarching legal design framework, and the tax law reform roadmap as outlined in the March 2016 IMF Legal Department technical assistance mission Aide Memoire.	Prior action	[Met]
Formally suspend by Cabinet order the Board of Investment's capacity to grant tax exemptions, tax holidays, and special tax rates until such time as the BOI Act can be formally amended.	Prior action	[Met]

Structural Benchmarks	Date	Status
Fiscal Policy Management		
Submit to Parliament the 2017 budget in line with the program targets.	November 2016	
Submit to Parliament the 2018 budget in line with the program targets.	November 2017	
Submit to Parliament the 2019 budget in line with the program targets.	November 2018	
Tax Policy Reform		
Publish a tax expenditure statement as part of the official government budget.	December 2016	
Approve by cabinet a time-bound strategy (agreed with IMF staff) to reduce or eliminate tax expenditures.	December 2016	
Submit to Parliament a new Inland Revenue Act with a view to simplifying and broad-basing the income tax.	March 2017	
Complete by Ministry of Finance (MOF) a diagnostic review of the VAT system.	June 2017	

Tax Administration Reform	
Adopt by MOF Inland Revenue Department Key Performance Indicators on the number of risk-based VAT audit.	September 2016
Adopt by MOF Inland Revenue Department a VAT compliance strategy that includes a time-bound plan to implement risk-based audit.	September 2016
Fully roll out by MOF Inland Revenue Department new IT systems (RAMIS) for major domestic taxes (including income tax and VAT), including web-based tax filings for income tax and VAT.	December 2016
Adopt by MOF Inland Revenue Department compliance strategies for corporate and personal income taxes.	June 2017
Public Financial Management	
Establish by MOF a commitment record system (with quarterly reports produced no later than one month after the end of each quarter) and quarterly expenditure commitment ceilings for the 2016 budget and the 2017 budget.	July 2016
MOF to roll out ITMIS with an automated commitment control module for Ministry of Finance.	December 2016
MOF to roll out ITMIS with an automated commitment control module for Ministry of Health.	April 2017
State Enterprise Reform	
Cabinet to approve a resolution strategy for Sri Lankan Airlines.	September 2016
Record the fiscal cost of non-commercial obligations (including subsidies) for SOEs in the central government budget, starting in 2017.	November 2016
MOF, line ministries, and SOEs to sign and publish Statements of Corporate Intent for the six largest SOEs (Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lankan Airlines, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authorities).	December 2016
MOF to introduce automatic fuel pricing mechanism that ensures retail prices above cost-recovery levels and a financial position of Ceylon Petroleum Corporation capable of covering debt service.	December 2016
Cabinet to introduce automatic electricity pricing mechanisms that ensure retail prices above cost-recovery levels and a financial position of Ceylon Electricity Board capable of covering debt service.	December 2016

Attachment II. Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out a framework for monitoring the performance of Sri Lanka under the program supported by the Extended Arrangement under the Extended Fund Facility (EFF). It specifies the performance criteria and indicative targets (including adjustors) under which Sri Lanka's performance will be assessed through semiannual reviews. Monitoring procedures and reporting requirements are also specified. The first review will take place on or after November 20, 2016, and the second review on or after April 20, 2017.

2. The quantitative performance criteria and indicative targets specified in Table 1 attached to the Memorandum of Economic and Financial Policies (MEFP) are listed as follows.

- a quantitative performance criterion on central government primary balance (floor);
- a quantitative performance criterion on net official international reserves (floor);
- a continuous quantitative performance criterion on new external payment arrears by the nonfinancial public sector and the CBSL (ceiling);
- a monetary policy consultation clause;
- an indicative target on central government tax revenue (floor); and
- an indicative target on reserve money of the CBSL (ceiling).

3. Throughout this TMU, the central government is defined to include line ministries, departments, and other public institutions. The Central Bank of Sri Lanka (CBSL), state-owned enterprise, parastatals and other agencies that do not receive subventions from the central government are excluded from the definition of central government. Debt is defined in accordance with paragraph 8 of the Guidelines on Public Debt Conditionality in Fund Arrangements attached to Executive Board Decision No. 15688-(14/107), adopted December 5, 2014.

I. PERFORMANCE CRITERIA

A. Performance Criterion on Central Government Primary Balance

4. The primary balance of the central government on cash basis is defined as central government revenues and grants minus expenditures and net lending, plus interest payments. Spending will be recorded in the period during which cash disbursements are made.

5. For the purpose of program monitoring, the primary balance of the central government on cash basis will be measured as the overall balance of the central government plus the interest payment of the central government. The overall balance of the central government is measured from the financing side, as the negative of the sum of the items listed below. Here, net borrowings refer to gross disbursements minus principal repayments. For 2015, the primary balance of the central government on cash basis measured in this manner was Rs –241 billion (the overall balance was Rs –768 billion and the interest payment was Rs 527 billion).

- Net borrowings from issuances of Treasury Bills, Treasury Bonds, and Rupee Loans.[1] In 2015, the total amount of such net borrowings was Rs 257.6 billion.
- Net borrowings from Sri Lankan Development Bonds (SLDBs) and commercial borrowings including international sovereign bonds and syndicated loans. In 2015, the total amount was Rs 455.7 billion.
- Net borrowings from project and program loans. In 2015, the total amount was Rs 69.7 billion, after adjustment for program loans that were contracted and disbursed during 2014 but were recorded in the 2015 fiscal account (Rs 61.6 billion).
- Net increases in non-market borrowings, CBSL advances, government import bills, government overdraft from the banking system, cash items in process of collection, and borrowings from offshore banking units of domestic commercial banks. In 2015, the total amount was Rs –10.1 billion.
- Net decreases in the deposit of the central government in the banking system. In 2015, the total amount was Rs –4.4 billion (an increase in deposit).
- Net borrowings from all other bonds, loans, and advances contracted by the central government. In 2015, the total amount was Rs –0.5 billion (net repayment).

The following adjustment will apply:

6. If the actual amount of gross cash disbursement of project loans in 2016 is higher than US$1.5 billion in U.S. dollar terms, the floor on the primary balance of the central government for end-December 2016 will be adjusted downward by the difference between the actual amount and US$1.5 billion. The difference will be converted to the amount in Rupee terms by using the exchange rates as indicated in Table 1 below. The downward adjustment of the primary balance target will be capped at Rs 20 billion. If the actual amount of gross cash disbursement of project loans in 2016 is lower than US$1.5 billion in U.S. dollar terms, the floor on the primary balance of the central government for end-December 2016 will not be adjusted.

[1] Rupee Loans are a medium to long-term debt instrument issued with maturities more than two years on tap basis or as private placements by the CBSL on behalf of the government under the Registered Stock and Securities Ordinance.

B. Performance Criterion on Net Official International Reserves

7. Net official international reserves (NIR) is defined as (i) the difference between the gross foreign assets and liabilities of the CBSL and (ii) the balance of State Treasury's (DSTs) Special Dollar, Japanese Yen, and Chinese Yuan Revolving accounts, both expressed in terms of market values. Gross foreign assets of the CBSL consists of monetary gold; foreign exchange balances held outside Sri Lanka; foreign securities (valued in market prices); foreign bills purchased and discounted; the reserve position at the IMF and SDR holdings; and the Crown Agent's credit balance. Foreign exchange balances, securities, and bills denominated in Chinese Yuan are part of the gross foreign assets of the CBSL. Excluded from gross foreign assets will be participation in international financial institutions; holdings of nonconvertible currencies; holdings of precious metals other than monetary gold; claims on residents (e.g., statutory reserves on foreign currency deposits of commercial banks and central bank foreign currency deposits with resident commercial banks); pledged, non-liquid, collateralized or otherwise encumbered foreign assets (such as the government's war risk insurance deposit with Lloyds during 2001/02); and claims in foreign exchange arising from derivative transactions (such as futures, forwards, swaps and options). Gross foreign liabilities are all foreign currency denominated liabilities of the CBSL to non-residents; the use of Fund credit; Asian Clearing Union debit balance and commitments to sell foreign exchange arising from derivatives such as futures, forwards, swaps, and options. In addition, NIR will include the balance of the DSTs' Special Dollar, Japanese Yen, and Chinese Yuan Revolving accounts. DST accounts are foreign currency accounts held by the Treasury and managed by the CBSL as an agent of the government. At end-December 2015, NIR defined in this manner stood at US$ 5,028.8 million.

8. For the purpose of the program, all foreign-currency related assets and liabilities will be converted into U.S. dollar terms at the exchange rates prevailed on April 29, 2016, as specified in Table 1. Monetary gold will be valued at US$1,274.1 per troy ounce, which was the price prevailed on April 29, 2016.

Table 1. Sri Lanka: Exchange Rates
(Rates as of April 29, 2016)

Currency	Sri Lankan Rupee per currency unit
U.S. dollar	143.900
British pound	210.698
Japanese yen	1.341
Canadian dollar	114.776
Euro	163.801
Chinese yuan	22.229
SDR	203.954

Source: CBSL and IMF.

The following adjustment will apply:

9. If (i) the amount of foreign program financing by the central government, (ii) the cumulative net change in the amount of foreign holdings of Treasury Bills, Treasury Bonds, and SLDBs, and (iii) the amount of external commercial loans (including international sovereign bonds and syndicated loans) by the central government—as set out in Table 2—are higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative differences on the test date.

10. If the amount of amortization of official external debt by the central government in U.S. dollar terms—as set out in Table 2—is higher/lower than assumed under the program, the floor on the NIR will be adjusted downward/upward by the cumulative differences on the test date. Official external debt refers to external debt owed to multilateral and official bilateral creditors, as defined in the *2013 External Debt Statistics: Guide for Compilers and Users*.

Table 2. Program Assumptions
(cumulative from the beginning of the year, in million US$)

	Dec. 2015	Mar.2016	Jun. 2016	Sep. 2016	Dec. 2016	Dec. 2017
Foreign program financing by the central government	0	0	0	200	325	200
Cumulative net change in the amount of foreign holdings of Treasury Bills, Treasury Bonds, and SLDBs	-903	-560	-842	-1,124	-1,407	100
External commercial loans (including Eurobonds and syndicated loans) by the central government	1,650	0	2,000	2,000	2,000	300
Amortization of official external debt by the central government	798	238	475	713	950	1,070

II. CONTINUOUS PERFORMANCE CRITERIA

A. Performance Criterion on New External Payment Arrears by the Nonfinancial Public Sector and the CBSL

11. A continuous performance criterion applies to the non accumulation of new external payments arrears on external debt contracted or guaranteed by the nonfinancial public sector and the CBSL. The nonfinancial public sector is defined following the 2001 Government Financial Statistics Manual and the 1993 System of National Accounts. It includes (but is not limited to) the central government as defined in ¶3 and nonfinancial public enterprises, i.e., boards, enterprises, and agencies in which the government holds a controlling stake. External payments arrears consist of debt-service obligations (principal and interest) to nonresidents that have not been paid at the time they are due, as specified in the contractual agreements, subject to any applicable grace period. However, overdue debt and debt service obligations that are in dispute will not be considered as external payments arrears for the purposes of program monitoring.

III. MONETARY POLICY CONSULTATION CLAUSE

12. The inflation target bands around the projected 12-month rate of inflation in consumer prices, as measured by the headline Colombo Consumers Price Index (CCPI) published by the Department of Census and Statistics of Sri Lanka, are specified in Table 1 attached to the MEFP. For this purpose, the year-on-year inflation for each test date is measured as follows:

$$\{ CCPI^*(t) - CCPI^*(t-12) \} / CCPI^*(t-12)$$

where

t = the month within which the test date is included

CCPI(t) = CCPI index (all items) for month t

CCPI(t-k) = CCPI index (all items) as of k months before t

$CCPI^*(t) = \{ CCPI(t-2) + CCPI(t-1) + CCPI(t) \} / 3$

$CCPI^*(t-12) = \{ CCPI(t-14) + CCPI(t-13) + CCPI(t-12) \} / 3$

If the observed year-on-year inflation for the test date of end-June 2016 or end-December 2016 falls outside the outer bands specified in Table 1 attached to the MEFP, the authorities will complete a consultation with the IMF Executive Board which would focus on: (i) the stance of monetary policy and whether the Fund-supported program remains on track; (ii) the reasons for the deviation; and (iii) on proposed policy response. When the consultation with the IMF Executive Board is triggered, access to Fund resources would be interrupted until the consultation takes place and the relevant program review is completed. In addition, if the observed year-on-year inflation falls outside the inner bands specified in Table 1 attached to the MEFP for the test date of end-June 2016, end-September 2016, or end-December 2016, the authorities will complete a consultation with IMF staff on the reasons for the deviation and the proposed policy response.

IV. INDICATIVE TARGETS

A. Indicative Target on Central Government Tax Revenue

13. Central government tax revenue refers to revenues from taxes collected by the central government. It excludes all revenues from asset sales, grants, and non tax revenues. The revenue target is calculated as the cumulative flow from the beginning of the year. For 2015, central government tax revenue defined in this manner was Rs. 1,356 billion.

B. Indicative Target on Reserve Money of the CBSL

14. Reserve money of the CBSL consists of currency in circulation (with banks and with the rest of the public), financial institutions' domestic currency deposits at the CBSL, and the deposits of following government agencies: the National Defence Fund (General Ledger Acc. No. 4278), the Buddha Sasana Fund A/C (General Ledger Acc. No. 4279); and the Road Maintenance Trust Fund (General Ledger Acc. No. 4281). At end-December 2015, reserve money defined in this manner stood at Rs. 673.4 billion.

The following adjustment will apply:

15. If any bank fails to meet its legal reserve requirement, the ceiling on reserve money will be adjusted downward to the extent of any shortfall in compliance with the requirement.

16. Changes in required reserve regulations will modify the reserve money ceiling according to the formula:

$$\Delta M = \Delta r B_0 + r_0 \Delta B + \Delta r \Delta B$$

where ΔM denotes the change in reserve money, r_0 denotes the reserve requirement ratio prior to any change; B_0 denotes the reservable base in the period prior to any change; Δr is the change in the reserve requirement ratio; and ΔB denotes the immediate change in the reservable base as a result of changes to its definition.

V. DATA REPORTING REQUIREMENTS

17. Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the Memorandum of Economic and Financial Policies. All the program monitoring data will be provided by the Ministry of Finance and the CBSL. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 3 and 4. For the purpose of monitoring the monetary targets under the program, data will be provided in the format shown in Table 5. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 6 and 7.

18. Data relating to the fiscal targets (Table 3 and Table 4) will be furnished within no more than five weeks after the end of each month, except for the data on salaries and wages, goods and services, subsidies and transfers (and its subcomponents) that will be furnished within no more than seven weeks after the end of each month (the data on total recurrent expenditure and interest payments will be furnished within no more than five weeks after the end of each month). Data relating to the external and monetary targets (Tables 5, Table 6, and Table 7) will be furnished within no more than three weeks after the end of each month.

Table 3. Sri Lanka: Central Government Operations 1/
(In millions of rupees)

Total Revenue & Grants
Total Revenue
Tax revenue
Income Tax
Personal & Corporate
Corporate & non-corporate
PAYE
Economic Service Charge
Tax on interest income
Taxes on goods & services
VAT
Excise Taxation
Liquor
Cigarettes
Motor vehicles
Petroleum
Other
Other Taxes & Levies
NBT
Stamp duties
Telecommunication Levy
Motor vehicles Taxes & Other
Sales tax
Debit tax
Telephone Subscriber Levy
National Security Levy
Tax on treasury bills
Taxes on External Trade
Imports
Cess
Special Commodity Levy
PAL
Non-Tax Revenue
Property income
Fines,Fees & Charges
Other
Grants
Total Expenditure
Recurrent Expenditure
Salaries & wages
Goods & Services
Interest Payments
Subsidies & Transfers
Public Corporations
Public Institutions
Households
Capital Expenditure
Net lending
Primary Balance
Overall balance
Total Financing
Total Foreign Financing (Net)
Total Domestic Financing (Net)
Privatization

1/ As agreed for the purpose of monitoring the program.

Table 4. Sri Lanka: Central Government Financing 1/
(In millions of rupees)

1. Domestic instrument borrowings
T-Bills (net)
T-Bonds
Rupee Loans
Other
2. Domestic non-instrumental borrowings
Sri Lankan Development Bonds (SLDB)
Non market borrowings
CBSL advances
Government deposit at CBSL
Government import bills
Cash items in process of collection (CIPC)
Overdraft to government
Short term loans
Deposit with commercial banks
Oversee Banking Units
Other
3. Net foreign financing
Net T-Bill purchase by nonresidents
Net T-Bond purchase by nonresidents
International sovereign bonds
Project loans
Other
Total financing (1+2+3)
Memorandum items:
T-Bonds
Gross borrowings
Repayments
Net borrowings
SLDBs
Gross borrowings
Repayments
Net borrowings
ISBs
Gross borrowings
Repayments
Net borrowings
Project loans
Gross borrowings
Repayments
Net borrowings

1/ As agreed for the purpose of monitoring the program.

Table 5. Sri Lanka: Balance Sheet of the Central Bank of Sri Lanka 1/
(In millions of rupees)

Net foreign assets
Foreign assets
Cash and balances abroad
Foreign securities
Claims on ACU
IMF Related Assets
SDRs
RR on FCDs of banks
Recievables (Accrued Interest)
Derivative Financial Instruments
Foreign liabilities
IMF & nonresident a/c
SDRs
Liabilities to ACU
Payables
Derivative Financial Instruments
Net domestic assets
Claims on Government
Advances
Treasury bills & Treasury Bonds
Treasury Bonds
Cash items in collection
Government deposits
Claims on commercial banks
Medium and long-term
Short-term
Other assets (net)
Reserve money
Currency in circulation
Commercial bank deposits
Government agencies deposits

1/ As agreed for the purpose of monitoring the program.

Table 6. Sri Lanka: Foreign Exchange Cashflows of the Central Bank and the Government 1/
(In millions of U.S. dollars)

1. Total inflows
Loans
Program
IMF
Project (cash component only)
Commercial borrowing (incl. new and rolled over SLDBs)
Interest earnings, forex trading profits, cap gains
Purchases of foreign exchange
Change in balances in DST's A/Cs
Other inflows
Borrowing from SLDBs
Loans from FCBUs
Syndicated Loans
International Swaps/Commercial Loans/Sovereign Bonds
OMO FX swap transactions
2. Total outflows
Public Debt Service Payments
Amortization
Principal (foreign loans)
Settlement SLDBs
Settlement FCBU
Settlement of syndicated loans
Interest
Foreign loans
Domestic foreign currency loans
SWAP/Loan interest
ISB interest
Payments to the IMF/ change in valuation of liabilities
Foreign exchange sales to commercial banks
OMO FX swap transactions
3. SWAP
Inflow
Outflow Including Interest
3. Net flow at current rates (1-2)
Net International Reserves
Gross International Reserves

1/ As agreed for the purpose of monitoring the program.

Table 7. Sri Lanka: Gross Official Reserve Position 1/

(In millions of U.S. dollars)

Date	Central Bank				Government				Gross Official Reserves		Liabilities					Net International Reserves	Overall balance
	Reserves managed by IOD		Reserve Position at I.M.F. & SDR hol.	Total	Crown Agent's Credit Balance	D S T's Special Dollar Revolving Cr.balance	DST's Yen Accounts	Total	(without ACU & DA & with Swap)	(with ACU & SWAP & without DA)	Other Deposits	Asian Clearing Union	Drawings from the IMF	International Currency Swap	Total		
	Foreign Assets (FA) (with ACU & Without DA)	Domestic Assets (DA) (BOC & PB)		(1)+(2)				(4)+(5)+(6)	(8) - (10)	(3)+(7)							
	1		2	3	4	5	6	7		8							

1/ As agreed for the purpose of monitoring the program.