



SRI LANKA

December 2016

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION — PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

In the context of the First Review Under Extended Fund Facility, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 18, 2016, following discussions that ended on September 23, 2016 with the officials of Sri Lanka on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on November 4, 2016.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Sri Lanka.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Sri Lanka*
Technical Memorandum of Understanding*
*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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November 18, 2016

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IMF Completes First Review of the Extended Arrangement Under the EFF with Sri Lanka and Approves US\$162.6 Million Disbursement

On November 18, 2016, the Executive Board of the International Monetary Fund (IMF) completed the first review of Sri Lanka's economic performance under the program supported by a three-year extended arrangement under the [Extended Fund Facility \(EFF\)](#) arrangement. Completion of the review enables the disbursement of the equivalent of SDR 119.894 million (about US\$162.6 million), bringing total disbursements under the arrangement to the equivalent of SDR 239.788 million (about US\$ 325.1 million).

Sri Lanka's three-year extended arrangement was approved on June 3, 2016 in the amount of about SDR 1.1 billion (US\$1.5 billion, or 185 percent of quota in the IMF at that time. See [Press Release No. 16/262](#)). The government's reform program, supported by the IMF, aims to reduce the fiscal deficit, rebuild foreign exchange reserves, and introduce a simpler, more equitable tax system to restore macroeconomic stability and promote inclusive growth.

Following the Executive Board's discussion of the review, Mr. Tao Zhang, Acting Chair and Deputy Managing Director, said:

“Sri Lanka's performance under the Fund-supported program has been broadly satisfactory despite challenging circumstances. Macroeconomic and financial conditions have begun to stabilize, inflation has trended down, and the balance of payments has improved. Meanwhile, international reserves remain below comfortable levels.

“Fiscal performance has been encouraging. The reinstatement of the amendments to the value added tax will help boost revenues. The 2017 budget proposal aims to strengthen government finances through revenue mobilization, while guarding against revenue shortfalls by aligning spending with revenue on a quarterly basis. The new Inland Revenue Act scheduled for early next year should result in a more efficient, transparent, and broad-based tax system. Complementary structural reforms in tax administration, public financial management, and the governance and oversight of state-owned enterprises are critical for durable fiscal consolidation.

“While inflation has abated, credit growth remains strong. The central bank indicates its readiness to tighten the monetary policy stance further if inflationary pressures resurge or credit

growth persists. The authorities intend to continue building up reserves through outright purchases while allowing for greater exchange rate flexibility.

“The banking sector is currently well capitalized. Steps are being taken to find a resolution mechanism for the distressed financial institutions. Going forward, there is a need to strengthen the supervisory and regulatory framework, and identify and mitigate vulnerabilities in the financial sector, particularly with regard to non-banks and state-owned banks.”



SRI LANKA

November 4, 2016

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION

EXECUTIVE SUMMARY

Since the start of the three-year Extended Arrangement in June 2016, the economy has begun to stabilize, supported by appropriate monetary and fiscal policies. Progress was made in structural reforms aimed at revenue mobilization and expenditure management, albeit with some delays. The completion of the first review will make available the second purchase equivalent to SDR 119.894 million.

Program Performance and Risks: Performance under the program has been largely satisfactory. All end-June quantitative performance criteria were met, together with all indicative targets for June. The structural benchmarks due in July–September were not met, but the authorities have been making progress toward their completion which is now scheduled for December 2016. Program risks emanate from the political challenges of maintaining momentum for sweeping tax reforms and implementing related fiscal and structural reforms.

Key Policy Issues: The authorities reaffirmed their commitment to fiscal consolidation in 2017 and over the medium term, anchored on revenue mobilization to expand resources for the government's social and development objectives. The suspended VAT amendments were resubmitted to parliament (meeting a prior action) in early October and have now been legislated. Consistent with the program, the authorities pledged that the 2017 budget would aim at a primary balance. Complementary reforms in the income tax system, public financial management, tax administration, and oversight on state-owned enterprises are critical for durable fiscal consolidation. Monetary policy tightening this year has helped contain inflation pressures. While inflation has shown early signs of abating, credit growth remains robust and warrants further monitoring. Given the large external liabilities, the authorities should further accumulate international reserves mainly through direct purchases of foreign exchanges, while maintaining a firm commitment to greater exchange rate flexibility.

Approved By
**Kenneth Kang and
Bob Traa**

Discussions were held in Colombo during September 13–23, 2016. The mission met with Prime Minister Wickremesinghe, Finance Minister Karunanayake, Central Bank of Sri Lanka Governor Coomaraswamy, Secretary to the Treasury Samarathunga, other senior officials and private sector and civil society representatives. The mission comprised Mr. Lee (Head), Ms. Jahan, Mr. Nozaki (all APD), Mr. Danforth (FAD), Ms. Tambunlertchai (SPR), Ms. Kvintradze (resident representative), and Mr. Wijeweera (local economist). Messrs. Kang and Schneider (APD) also joined for part of the mission, and Ms. Gunaratne (OED) participated in the policy discussions. Messrs. George and Sullivan also assisted in the preparation of this report.

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CONTEXT

1. Sri Lanka has embarked on a multi-year reform program to enhance economic stability and resilience. To address persistent macroeconomic imbalances and a deterioration in the balance of payments, the coalition government¹ requested IMF support for a multi-year reform program centered around revenue-based fiscal consolidation. The Board approved in June 2016 Sri Lanka's request for a 36-month extended arrangement under the Extended Fund Facility (EFF) for an amount equivalent to SDR 1.1 billion (185 percent of quota and about US\$ 1.5 billion).

2. The authorities have made important progress under the program but continue to face many challenges in implementing their ambitious reform agenda. With external balances beginning to stabilize, the macroeconomic adjustment envisaged under the program appears achievable as long as the reform momentum is maintained. However, the political challenge of tax reforms—VAT and income taxes—has been and will remain a policy risk. An early example was the July suspension of the VAT amendments, which have since been reinstated by a submission to parliament in early October (meeting a prior action for the first review) and the subsequent parliamentary approval.² Going forward, concerted efforts of the coalition government to continue with the reform program will be critical for the successful implementation of the program.

RECENT DEVELOPMENTS AND OUTLOOK

3. Following the floods in May, the economy has begun to stabilize. After recording 5.2 percent (y/y) in 2016Q1, GDP growth slowed to 2.6 percent in Q2, reflecting the impact of floods on agriculture and manufacturing, as well as decline in construction. Purchasing Manager's Index for August 2016 points to a gradual recovery in the second half of the year, with credit growth remaining robust at 27 percent (y/y) in August. Headline inflation decreased to 3.9 percent (y/y) in September, after picking up to 6 percent in June. Inflation has been volatile, buffeted by the temporary food shortages due to the floods in May and the suspension of the VAT rate increase in July.

4. The balance of payments and external market conditions have improved. The current account deficit in the first half of the year narrowed marginally to 1 percent of annual GDP (from 1.2 percent of GDP in the same period last year), helped by higher inflows in remittances and tourism. Weak earnings from agricultural exports, driven by tea and spices, were offset by declines in imports of fuel, vehicles, and rice. Despite anemic foreign direct investment, the financial account also improved, with the government successfully issuing US\$1.5 billion in international sovereign bonds at favorable yields in July. Net outflows from foreign holdings of government securities

¹ The two largest political parties—Sri Lanka Freedom Party (SLFP) led by President Sirisena and the United National Party (UNP) led by Prime Minister Wickremesinghe—have formed a coalition government since January 2015.

² Sri Lanka introduced VAT amendments in May, which included: (i) a VAT rate increase from 11 to 15 percent, (ii) elimination of exemptions on telecoms and healthcare, and (iii) a lower threshold for the wholesale and retail sectors. These amendments were suspended by the Supreme Court in response to a petition launched by opposition parliamentarians (on the procedural grounds that the bill was not endorsed by the Cabinet).

bottomed out in April and reversed to net inflows of US\$613 million during May–September. Sri Lanka’s EMBI spread tightened by 150 basis points over May–September and the exchange rate has been stable, depreciating by about 2 percent from the beginning of May to end-October.

5. The central bank has tightened monetary policy and shifted to net foreign exchange purchases to rebuild reserves. The Central Bank of Sri Lanka (CBSL) raised policy rates by 50 basis points (bps) in both February and July to contain credit growth and to pre-empt demand-driven price pressures. The average lending rate increased by about 150 basis points between December 2015 and September 2016. The CBSL also shifted from monthly net sales to net purchase of foreign exchange (FX), purchasing about US\$500 million on a net basis during May–September 2016, compared with monthly average net sales of US\$280 million during January 2015–April 2016.

6. On the expectation that steady policy implementation will preserve these incipient gains in stability, the economy is projected to regain momentum through 2016 and 2017. Staff projects GDP growth at 4.5 percent for 2016, with recovery expected in the second half owing to stronger service sector activities mainly in tourism and construction. On the downside, growth in agriculture is expected to be muted due to emerging drought in some parts of the country and low export demand. Compared to the June assessment (CR/16/150), staff has revised down growth to 4.8 percent in 2017 and to 5.3 percent over the medium term in light of the weaker external environment. Given the monetary tightening and stable commodity prices, inflation is projected to remain broadly stable at around 5 percent over 2016 and 2017. The current account deficit is projected to remain modest at around 2 percent of GDP over 2016–21, with more modest FDI prospects and, accordingly, lower investment imports over the medium term. Remittances and tourism inflows are expected to continue to offset a large part of the deficit in the merchandise trade balance.

7. Risks to the outlook remain significant on both domestic and external fronts. Domestically, key risks include the lack of progress in revenue-based consolidation, a further decline in growth, and additional losses from state-owned enterprises (SOEs), which would call for more difficult adjustments. These would further increase the risk to debt sustainability, given the already high level of central government debt (Annex I). Externally, balance of payment risks remain significant, including a shift in investor sentiment on emerging and frontier market economies and slower-than-anticipated growth in the US and the EU that would constrain Sri Lankan exports. A slowdown in China would negatively affect tourism and FDI inflows, adding pressure on external balances.

PERFORMANCE UNDER THE PROGRAM AND POLICY DISCUSSIONS

All end-June quantitative performance criteria were met, and the authorities remain committed to their reform program, including: the VAT amendments, the new income tax law, a robust 2017 budget, a steady international reserves buildup, and a transition to flexible inflation targeting. Uneven progress in fiscal and structural reforms calls for strong political commitment and persistent efforts.

A. Program Performance

8. Program performance so far has been broadly on track, despite delays with all July-September structural benchmarks (SBs). All end-June quantitative performance criteria (QPC) and indicative targets (IT) were met. The monetary policy consultation clause was not triggered as inflation stayed inside the inner consultation band on the test dates. Structural benchmarks due in July and September were not met, but the authorities have taken corrective action and have requested to recalibrate the completion dates (¶13). The end-June target (QPC) for net international reserves was met by a comfortable margin, although this was partly due to active use of FX swaps with domestic banks in June, which boosted net reserves by US\$270 million in the month. The indicative NIR target for September, which was adjusted upward due to capital inflows, was missed by US\$426 million, as the CBSL's FX purchase fell short of meeting the adjusted target (¶17).

9. End-June fiscal targets have been met, as the policy has been tightened in line with the program. The central government recorded an overall deficit of 2.7 percent of annual GDP for the first half of 2016, with the primary deficit slightly below the program ceiling and thus satisfying an end-June QPC. Tax revenue, which satisfied an end-June IT, rose by 20 percent during January–August 2016 over the same period last year, on account of higher collections of corporate income tax and import-related taxes. On the other hand, total spending for the first half of the year was higher than envisaged by 0.4 percentage points of GDP, reflecting heavy frontloading of capital budget execution (up by 39 percent y/y) and larger-than-expected interest payments (¶10).

Sri Lanka: Fiscal Monitoring						
(Cumulative from beginning of the year, unless otherwise indicated)						
	Jun-16		Dec-15	Jun-16		Dec-16
	Prog.	Est.	Est.	Prog.	Est.	Prog.
	CR/16/150			CR/16/150		CR/16/150
	(In billions of rupee)			(In percent of annual GDP)		
Total revenue and grants	701	742	13.1	5.8	6.1	13.0
Total revenue	699	742	13.0	5.8	6.1	12.9
Tax revenue	652	685	12.1	5.4	5.6	11.8
Of which: income taxes	85	105	2.3	0.7	0.9	1.9
VAT	138	131	2.0	1.1	1.1	2.6
Excise	218	221	4.4	1.8	1.8	3.7
Non tax revenue	47	57	0.9	0.4	0.5	1.1
Grants	2	0	0.1	0.0	0.0	0.1
Total Expenditure and net lending	1,019	1,071	19.9	8.4	8.8	18.4
Current expenditure	803	836	15.2	6.6	6.9	13.9
Of which: interest payments	272	290	4.7	2.2	2.4	4.6
Capital expenditure and net lending	216	235	4.7	1.8	1.9	4.5
Overall balance	-318	-328	-6.9	-2.6	-2.7	-5.4
Primary balance	-46	-39	-2.2	-0.4	-0.3	-0.8
Memorandum items:						
(Year on year % change, cumulative from beginning of the year)						
Tax revenue	13.3	19.1	...	...	...	...
Current expenditure	3.9	8.2	...	...	...	...
Capital expenditure and net lending	26.6	37.6	...	...	...	...

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.

B. Fiscal Policy

10. The 2016 fiscal targets are within reach, despite the delay in implementing the VAT amendments. The newly approved VAT amendments will be in effect on November 1. Revenue losses from the interim suspension are estimated to be offset by stronger-than-envisaged collections of income taxes and import duties as well as the rationalization of spending on goods and services and public investment. The 2016 primary deficit will likely fall below the end-December ceiling of Rs 97 billion (0.8 percent of GDP), with tax revenue likely exceeding the full year target of Rs 1,428 billion (11.8 percent of GDP). Interest payments are expected to be larger than estimated by 0.4 percentage points of GDP mainly due to the upward shift in the government bond yields by around 200 basis points since March, and would raise the overall deficit to around Rs 700 billion (5.7 percent of GDP).

11. The authorities should submit to parliament the 2017 budget in line with the program targets (SB for end-November 2016). The 2017 appropriation bill—with a spending ceiling consistent with the program—was presented to parliament in October, ahead of the presentation of the full budget on November 10. The authorities are aiming for a primary balance in 2017, with total revenues and expenditures broadly in line with the original program targets, and pledged that the budget would be underpinned by a well-crafted and high-quality tax policy package (LOI, ¶4). The authorities will unveil the tax package in the November 10 budget speech. Staff has recommended a tax package equivalent to $\frac{3}{4}$ percent of GDP, which is built on income tax reform that includes the rationalization of corporate tax exemptions, removal of preferential corporate tax rates, and a uniform withholding tax rate for interest income (Annex II).

12. The medium-term fiscal consolidation plan envisaged under the program remains appropriate for reducing the risk of debt distress. The authorities' commitment to reduce the overall deficit to 3.5 percent of GDP by 2020 (LOI, ¶4) would require improving the primary balance to a surplus of $1\frac{1}{2}$ percent of GDP by 2020.³ The targeted primary balance path would reduce the public debt to GDP ratio by 8 percentage points over 2015–20. This would be necessary in view of a high level of risk to medium-term debt sustainability (see debt sustainability analysis in Annex I).

C. Fiscal and Structural Reforms

13. By spring 2017, the authorities plan to implement critical fiscal reforms that will lay the foundation for medium-term fiscal consolidation (see Table 2 attached to the LOI). Progress has been uneven, although efforts are being made on all fronts including for past-due structural benchmarks. Fiscal reforms are designed to provide the means for achieving fiscal consolidation on a durable basis. Progress on meeting the structural benchmarks on fiscal policy, public financial management, and SOEs without undue delays is critical for keeping the program on track. Strong political commitment and sustained actions will be instrumental in advancing reforms.

³Projected interest payments over 2016–20 have been revised upward by 0.5–0.7 percentage points of GDP in light of higher-than-envisaged interest payments in 2016 (by 0.4 percentage points of GDP) as discussed above and a concomitant increase in the assumed interest rates for new debt issuance in 2017 and beyond.

- **Tax policy.** Preparation for a new Inland Revenue Act (IRA), the program's flagship reform toward revenue mobilization, is underway, with a view to submitting the bill to the parliament by March 2017. IMF technical assistance (TA) has supported the preparation of the bill, and further TA, including for public consultation and implementation phases, can be provided as necessary. The new IRA will support the planned revenue mobilization under the 2017 budget, in combination with a tax expenditure statement and a strategy to rationalize tax expenditures (Box 1).

Box 1. Inland Revenue Act

The existing Inland Revenue Act (IRA: Inland Revenue Act, No. 10 of 2006) reflects a tax system that many view as too inefficient to support sustained growth. Its higher complexity hinders investors' ability to understand the income tax system and local tax official's ability to administrate, and is a contributing factor to Sri Lanka's low tax-to-GDP ratio. In its current form, the IRA does not adequately deal with modern business structures and commercial transactions (especially cross-border transactions); creates distortions in investment through ineffective and inefficient tax incentives; targets a narrow tax base; limits collection and assessment powers, and encourages taxpayer challenges; and is inconsistent with international best practices.

To address these concerns, the Sri Lankan government, through the approval of cabinet in May 2016, has committed to simplifying and modernizing the IRA, with the aim of improving administrative efficiency and increasing revenue. Under the new IRA, the government should: broaden the tax base by removing excess tax incentives and expanding the sources of income; modernize rules related to cross-border transactions to address base erosion and combat tax avoidance; reduce complexity through an improved principles-based drafting style; and strengthen and clarify existing powers of the IRD to improve enforcement.

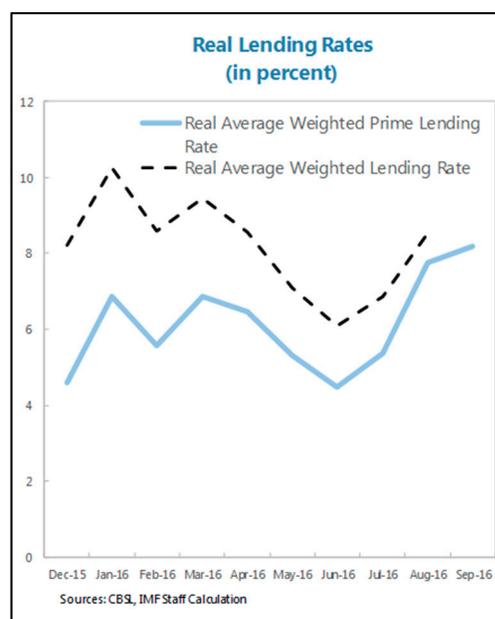
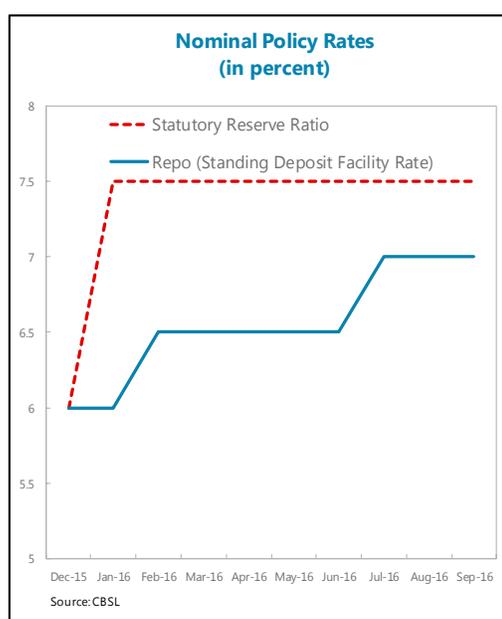
- **Tax administration.** Tax administration reforms centered on VAT, including adoption of a risk-based VAT compliance strategy, have been delayed due to the suspension of the VAT amendments, but rescheduled for completion by December. Full rollout of the new revenue administration IT system (RAMIS) is expected by December as originally planned. These will improve tax collection and increase the revenue impact of new tax policy measures, including the VAT and the new IRA.
- **Public financial management.** As an instrumental tool to avoid the recurrence of arrears, the program envisages establishment of a commitment record and control system. Although commitments have been recorded up to June 2016, creation of a system that can produce quarterly reports and commitment ceilings has been delayed until December as more time is needed to make the necessary changes to the IT infrastructure. Pilot rollout of the new IT system (ITMIS) with an automatic commitment control module, at the Ministries of Finance and Health, will take place simultaneously in January 2017 (with a delay for Finance Ministry and an advance in the date for Health Ministry).
- **State-owned enterprise reform.** SOEs' outstanding financial obligations remain large (11.4 percent of GDP at end-2015), calling for a proactive management of their fiscal risks. To enhance oversight and financial discipline on SOEs and clarify their relationship to the government, preparation is underway to publish Statements of Corporate Intent (SCIs) for

each of the six largest SOEs. Introducing automatic pricing formulas for fuel and electricity requires government action to reduce the discretionary aspects of the price-setting process, while models to estimate cost-recovery fuel and electricity prices have already been developed. A resolution strategy for Sri Lankan Airlines is to be adopted by December 2016 (with delay), including finding a strategic partner and a comprehensive cost-cutting.

14. While immediate external pressures have subsided, medium-term structural reforms are needed to boost competitiveness, in line with staff's external assessment in June (CR/16/150). Such reforms include removing protectionist para-tariffs and non-tariff barriers to trade, improving efficiency in trade facilitation (e.g., electronic customs documentation), and strengthening access to finance. Tax reforms—including the simplification of the IRA—would also go a long way towards attracting further FDI. The authorities in late October announced their intention to foster FDIs and accelerate growth, including by linking to global supply chains. Future program reviews will discuss ways to facilitate structural reforms to help meet these objectives and boost competitiveness, which in turn will strengthen economic resilience.

D. Monetary, Exchange Rate, and Financial Sector Policies

15. The central bank increased policy rates by 50 bps both in February and in July to rein in inflation and credit growth. Inflation has since shown signs of abating, and the CBSL expects inflation to remain around 5 percent over 2016–17 after accounting for the effect of VAT amendments, as envisaged in the program's monetary policy consultation clause. Nonetheless, the impact of monetary tightening on private credit growth has yet to be seen, and there are signs that housing and land prices have risen sharply: the CBSL's land price index for Colombo District



increased by 12.5 percent (y-o-y) in June 2016. Given the lag in monetary transmission, the CBSL expects private credit growth to slow from 27 percent in August (y-o-y) to around 18–20 percent by end 2016 and further in 2017. While agreeing with the adequacy of the current policy stance in terms of inflation and growth outlook, staff viewed that credit growth warranted continued monitoring. If credit growth does not abate as expected or inflationary pressures resurge, the authorities should tighten further the monetary stance. In addition, macro-prudential tools can be applied if needed, including a maximum loan-to-value ratio regulation to curb credit growth.

16. The authorities and staff discussed plans for enhancing exchange rate flexibility, combined with a migration to flexible inflation targeting as the monetary policy framework.

Staff noted that necessary institutional and technical prerequisites include: gradual further liberalization of financial account transactions and foreign exchange markets; clarification and relaxation of the CBSL's intervention policy; development and organizational change in the monetary policy analysis; and adjustments in the Monetary Law Act. With support from the IMF, the CBSL has been developing econometric models for macroeconomic forecasting. Building on the progress made so far, staff urged the authorities to develop a roadmap to transition towards a more flexible exchange rate regime and inflation targeting. Staff also noted availability of IMF TA, including on legal issues to address the transition as well as issues highlighted in a safeguards assessment (¶121). The authorities shared the view that further exchange rate flexibility could take place as the country transitions towards flexible inflation targeting and continues to make progress in fiscal consolidation.

17. The authorities and staff reached understandings on the need to modify the international reserves target, reflecting changes in capital flows environment. The original target for the net international reserves (NIR) accumulation had assumed that foreign investors would continue to repatriate their holdings of government securities; but such repatriation bottomed out in April and net capital inflows turned positive. Meeting the original NIR target for September and December would have required the CBSL to make very sizeable foreign exchange (FX) purchases (monthly purchase exceeding a half of average monthly turnover) that could have destabilized the market.⁴ The authorities and staff also agreed to reduce the reliance on borrowed reserves through a gradual but steady wind-down of FX swaps with domestic commercial banks (US\$2.5 billion outstanding as of end-September 2016). Against this background, the authorities proposed, and staff supports, a new target path that both builds up international reserves and improves its composition. Achieving the target will require continued effort to increase outright FX purchases from the market, supported by a deepening of the FX market and a firm commitment to greater exchange rate flexibility. Greater exchange rate flexibility in turn should strengthen the external position, by easing pressures from the persistent trade deficit and enhancing the economy's ability to absorb shocks. Greater exchange rate flexibility would also facilitate a transition to flexible

⁴ The original end-2016 NIR target was built on an assumption of outflows from government securities around US\$450 million in the second half of the year, with a program adjustor put in place. If outflows were less than the assumed amount, the NIR target would be pushed up by the difference. Going forward, the authorities proposed removing the adjustor on net foreign inflows to treasury bonds and treasury bills to avoid large swings in the target beyond their control.

inflation targeting. Nonetheless, gross international reserves are projected to remain well below the recommended range of 100–150 percent of the ARA metric throughout the program. Staff has encouraged the authorities to further close this gap as opportunities arise.

18. While the banking system is currently well capitalized, there is a need to strengthen supervisory and regulatory framework to identify and mitigate vulnerabilities. Financial soundness indicators are generally adequate for the banking system as a whole, with the capital adequacy ratio (CAR) well above the minimum requirements. However, the recent increase in credit growth has resulted in a slightly lower CAR as risk-weighted assets have grown. The authorities noted that if necessary, the loan-to-value ratio (LTV) can be tightened in sectors with rapid credit growth, following a successful experience for vehicle loans in 2015.⁵ The authorities are also moving towards adopting the Basel III capital standard and in the process of estimating possible implications for the capital position of state owned banks. Staff highlighted the need to monitor the impact of ongoing SOE reforms on financial soundness of these banks. In addition, the authorities are preparing a resolution plan of some 15 distressed non-bank finance companies using a special-purpose vehicle, and CBSL's Monetary Board approved in mid-October a resolution mechanism for the repayment to depositors of 4 insolvent non-bank financial institutions.⁶ The authorities welcomed IMF TA on financial supervision and regulation and asked for further coordination with other TA donors.

PROGRAM MONITORING

19. The attached Letter of Intent (LOI) describes the authorities' progress in implementing their economic program and sets out their commitments (Appendix I). The end-December 2016 QPCs, monetary policy consultation clause, and the end-December 2017 ITs were set at the time of the approval of the arrangement and are proposed to be recalibrated at this review, with respect to the targets on net international reserves, tax revenue, and reserve money, as well as the inflation target bands under the monetary policy consultation clause (Table 1 attached to the LOI and the TMU). End-June 2017 QPCs, along with ITs for end-March 2017, end-June 2017, and end-September 2017 are proposed to be set for this review, together with the continuation of the monetary policy consultation clause. A prior action to submit the bill to the parliament to reinstate the VAT amendments was met. The list of structural benchmarks remains unchanged and completion dates of past-due benchmarks have been reset to December 2016, and two SBs envisaged for December 2016 and April 2017 have been proposed both to be completed in January 2017 (Table 2 attached to the LOI). In view of the Board meeting calendar, it is also proposed to bring forward by 2 days the availability date for the disbursement of the first review.

⁵ In 2006, the authorities had increased risk weights on housing loans to address excessive credit growth.

⁶ Of the 46 licensed financial companies in Sri Lanka, 15 are facing liquidity issues, with 6 at a high level of distress with NPLs ranging from 50 to 90 percent. In addition to the mismanagement and irregular practices, the rapid growth of the non-bank financial sector has often led to excessive risk taking which has led to the deterioration of the financial position of these companies. The cost of resolution is expected to be minimal as the total assets of the distressed companies are about 1 percent of GDP.

20. The program is fully financed for the next 12 months, but risks remain significant. Firm financing assurances from the World Bank, Asian Development Bank, and key bilateral donors, are in place for the sum of \$650 million during 2016–18. Capacity to repay the Fund remains adequate under the baseline scenario (Table 7), while the balance of payment risks discussed above (¶17) may necessitate further adjustment or additional financing. Key risks to the program are still present: (i) revenue slippage or failure to implement key revenue-related reforms; (ii) weaker than expected capital inflows or a reversal of capital flows; (iii) lower than expected growth and/or new pressures on the trade account; and (iv) larger than expected losses at SOEs and lack of progress in SOE reforms. In particular, slippages with the VAT amendments or the new IRA legislation and implementation would undermine the targeted increase in the tax-to-GDP ratio. While a short delay could be accommodated by adjusting or delaying expenditures within the current program framework, a prolonged delay or failure could require a reconfiguration of the fiscal consolidation plan.

21. An updated safeguards assessment has been completed. The assessment found that the CBSL continued to strengthen its safeguards framework in a number of areas, including its audit and financial reporting functions. However, the CBSL Monetary Law Act (MLA) falls short of leading international practices, especially in the areas of the bank’s autonomy and aspects of its governance arrangements (e.g., the government’s voting representation in the Monetary Board, absence of recapitalization provisions, and inadequate limits on credit to government). These issues are to be addressed in the near future with TA from the IMF. Legal reforms would also provide an opportunity to review the CBSL’s mandate in non-core operations (e.g., agent for public debt management and manager of the National Employees’ Provident Fund) that pose reputational risks to the bank. The assessment also noted a need to clarify the treatment of FX swaps with domestic banks in the compilation of program data on NIR, which has since been addressed (¶17 and LOI ¶18).

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22. The Sri Lankan economy and financial markets have shown signs of stabilizing since the summer, following implementation of the authorities’ reform program. Sovereign spreads fell in the second quarter as market confidence strengthened, and inflation began to stabilize. Looking ahead, the economic outlook will depend on to what extent these hard-won gains in stability can be preserved by keeping macroeconomic policies and the reform agenda on track.

23. The end-June quantitative targets were met, but challenges remain in the reform agenda. Besides meeting quantitative policy targets, steadfast implementation of wide ranging fiscal and structural reforms is urgently needed to keep the program on track through 2017.

24. Staff welcomes the authorities’ firm commitment to medium-term fiscal consolidation, which envisages an overall deficit of 3.5 percent of GDP by 2020. This would require a primary surplus of 1½ percent of GDP by 2020, reinforcing the need to make steady progress in revenue-based fiscal consolidation. Two key immediate steps will be VAT amendments and income tax reforms based on the new IRA.

25. The 2017 budget should be consistent with the program and reaffirm the government's commitment to the reform agenda and prudent fiscal policy. Consistent with the program objective of medium-term fiscal consolidation, staff welcomes the authorities' decision to aim at a primary balance in 2017, underpinned by a well-crafted and high-quality tax policy package. The budget with quality revenue measures and strong commitment to reform agenda should strengthen market confidence which has declined recently following the delays in implementing the VAT amendments.

26. Delays in fiscal and structural reforms need to be resolved as soon as possible, building on progresses made so far. Several PFM and tax administration reforms are making slow progress, and the new IRA is being drafted with a view to legislation in 2017. These reforms will provide the wherewithal to put government finances on a sustainable footing, and should be implemented in a timely manner. Strong political commitment will help advance further fiscal and structural reforms.

27. Monetary tightening in July, the second in 2016, was appropriate for containing inflation and credit growth. While inflation shows early signs of abating, credit growth remains robust, warranting continued monitoring. No further monetary tightening is currently recommended, given abating inflation and rising loan interest rates, while credit growth is expected to slow with a lag in response to earlier monetary tightening. Nevertheless, the authorities should stand ready to adjust policy rates if inflation or credit growth were to stay elevated or accelerate. If needed, macro-prudential tools can be applied to sectors with rapid credit growth.

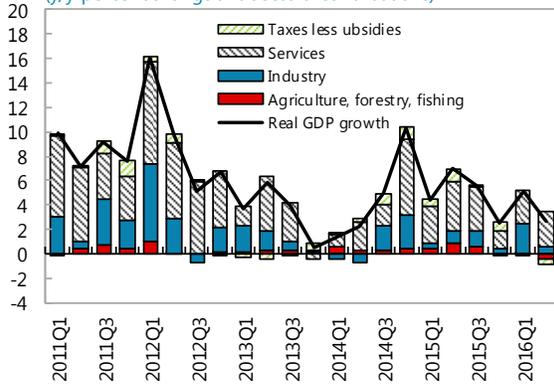
28. Given the large external liabilities and vulnerability to external debt pressure, the authorities should accumulate official international reserves mainly through direct purchases from the FX market, eschewing the reliance on foreign exchange swaps with commercial banks. While the reprogrammed reserve targets reflect an improved composition of reserves, the authorities should opportunistically go beyond the targets (floor) whenever possible. Exchange rate flexibility should be enhanced, in tandem with transition toward a flexible inflation targeting framework.

29. In light of the progress so far and the authorities' policy commitments going forward, staff supports the completion of the First Review under the Extended Fund Facility. Staff also supports the authorities' request for changes to the first-review availability date and modification of performance criterion and the TMU.

Figure 1. Sri Lanka: Real Sector

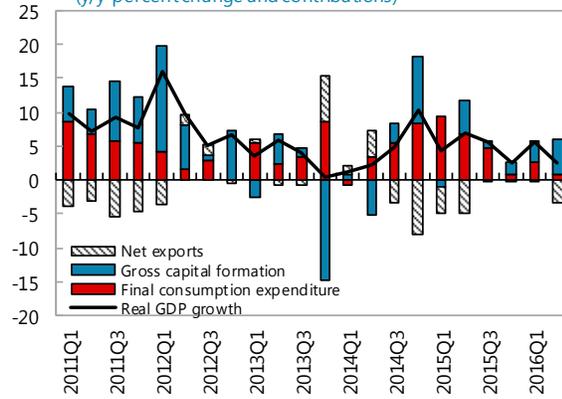
Sri Lanka: Real GDP Growth

(y/y percent change and sectoral contributions)



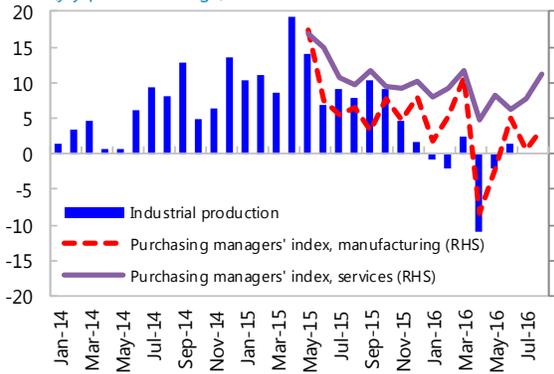
Sri Lanka: Real GDP Growth

(y/y percent change and contributions)



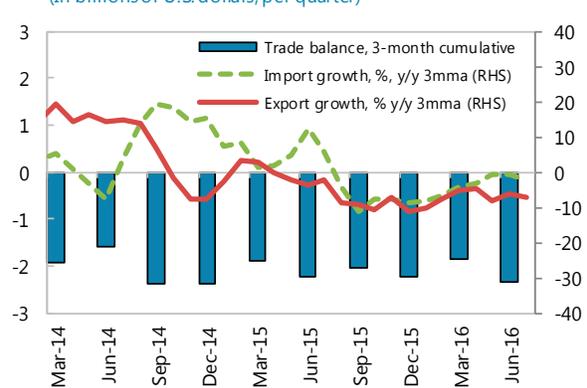
Economic Activity

(y/y percent change)



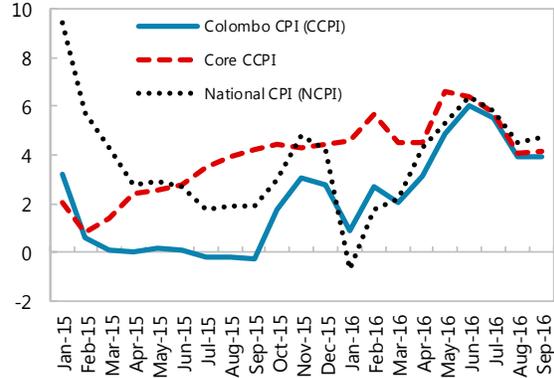
Trade

(In billions of U.S. dollars, per quarter)



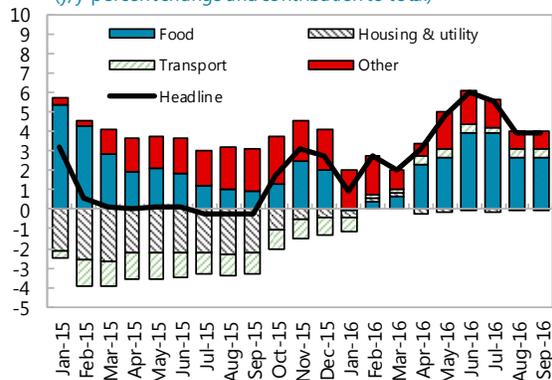
Consumer Price Index

(y/y percent change)



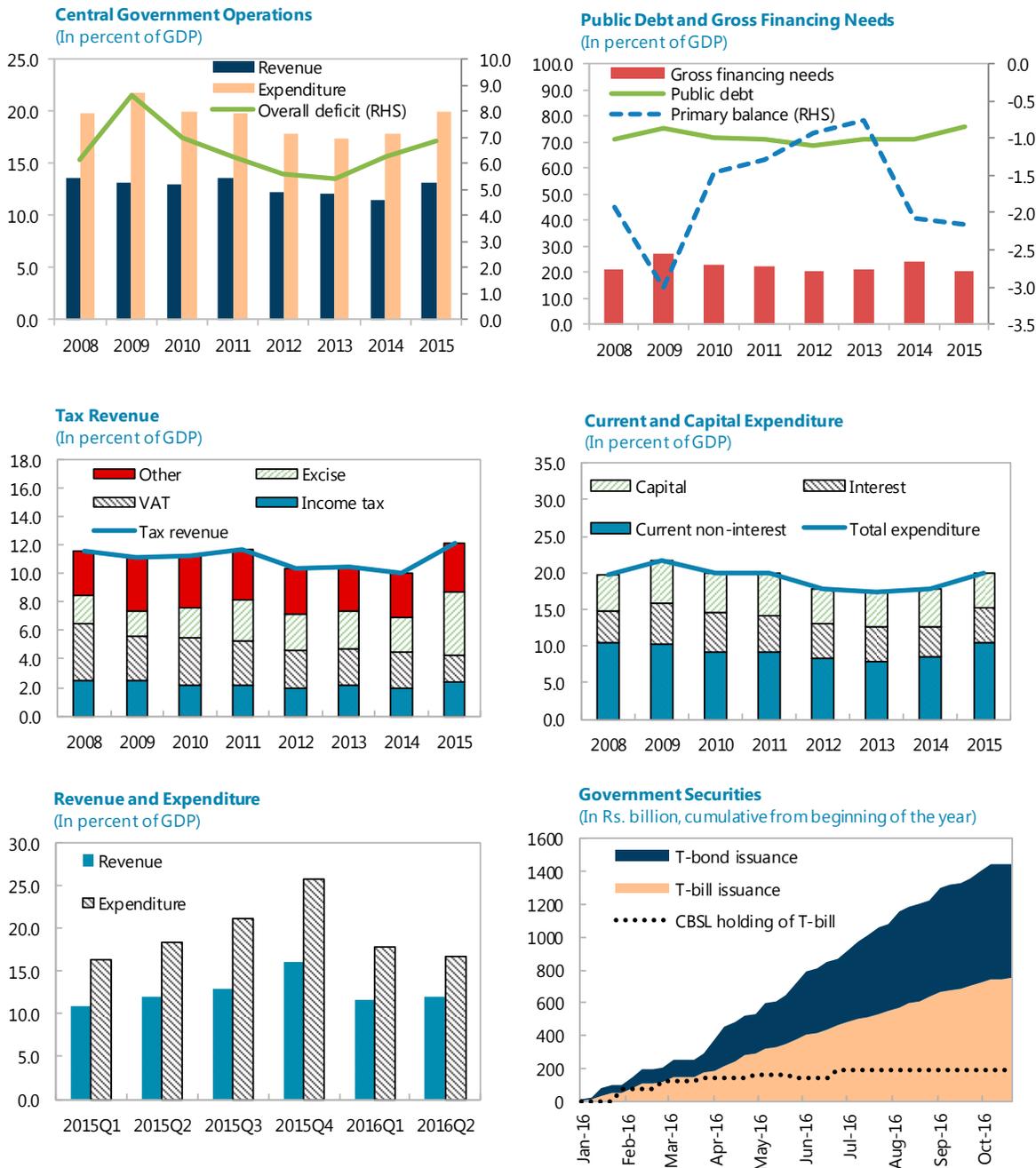
Colombo Consumer Price Index

(y/y percent change and contribution to total)



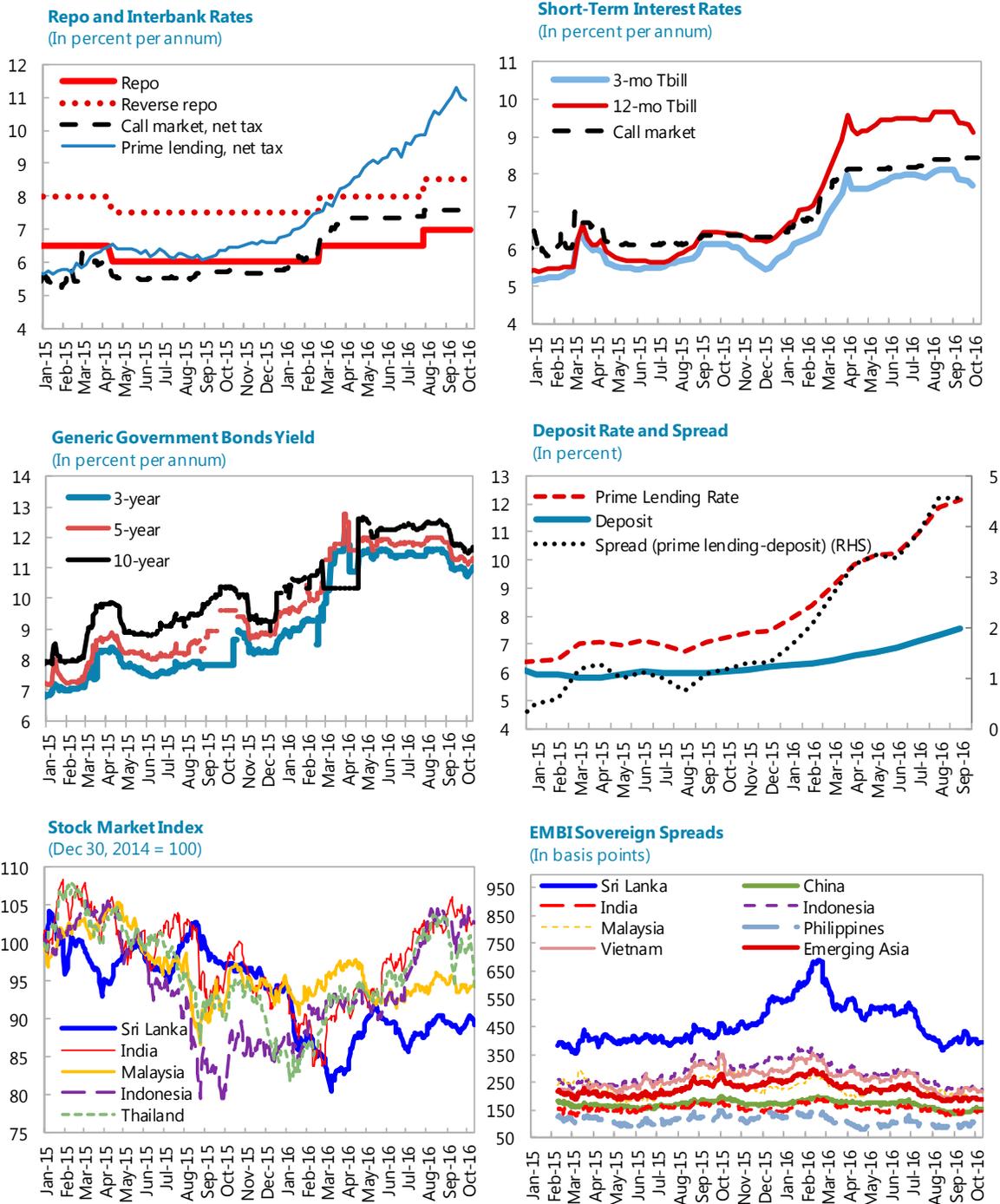
Sources: Central Bank of Sri Lanka; and IMF staff calculations.

Figure 2. Sri Lanka: Fiscal Sector



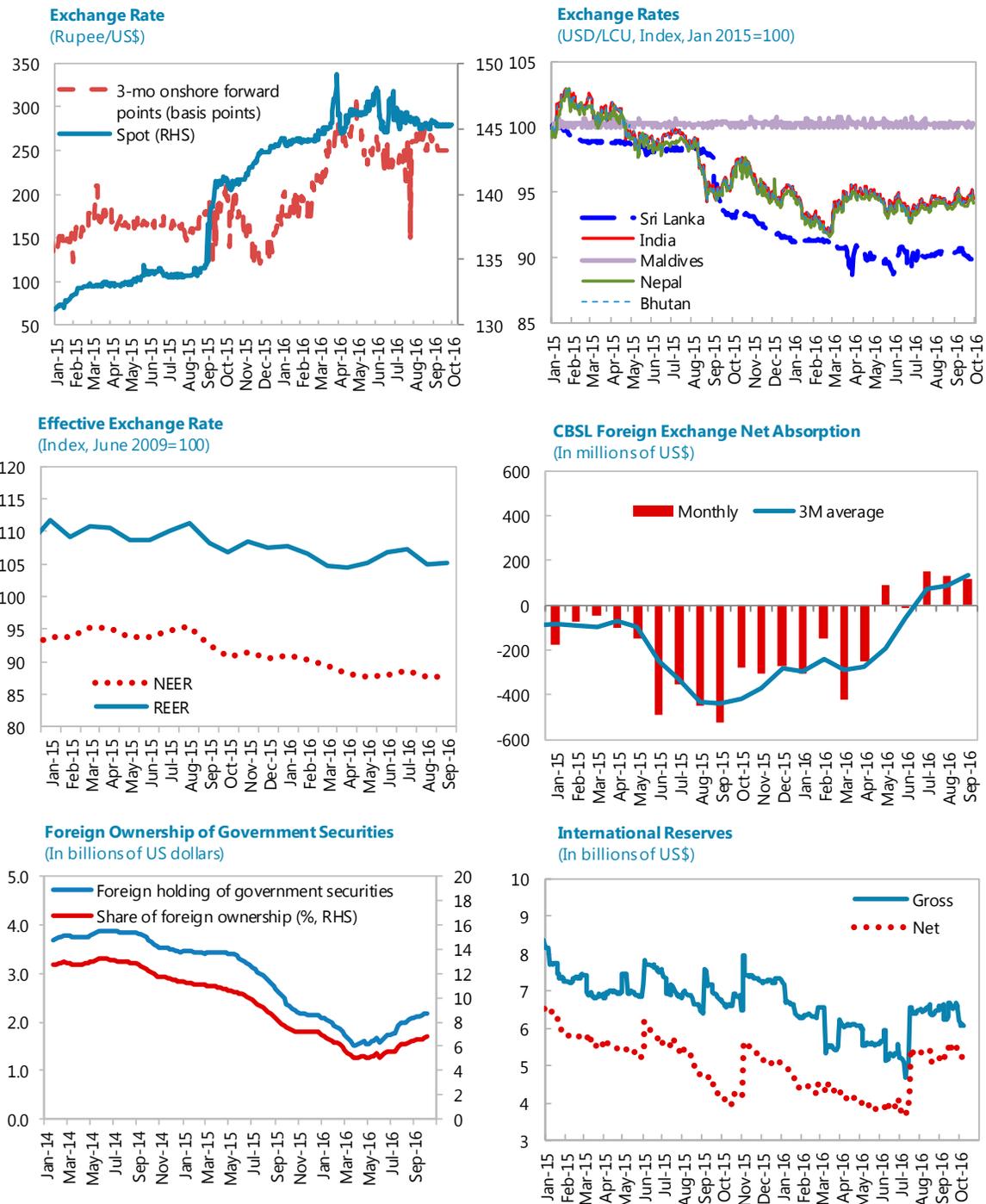
Sources: Central Bank of Sri Lanka; Ministry of Finance; and IMF staff calculations.

Figure 3. Sri Lanka: Financial Market



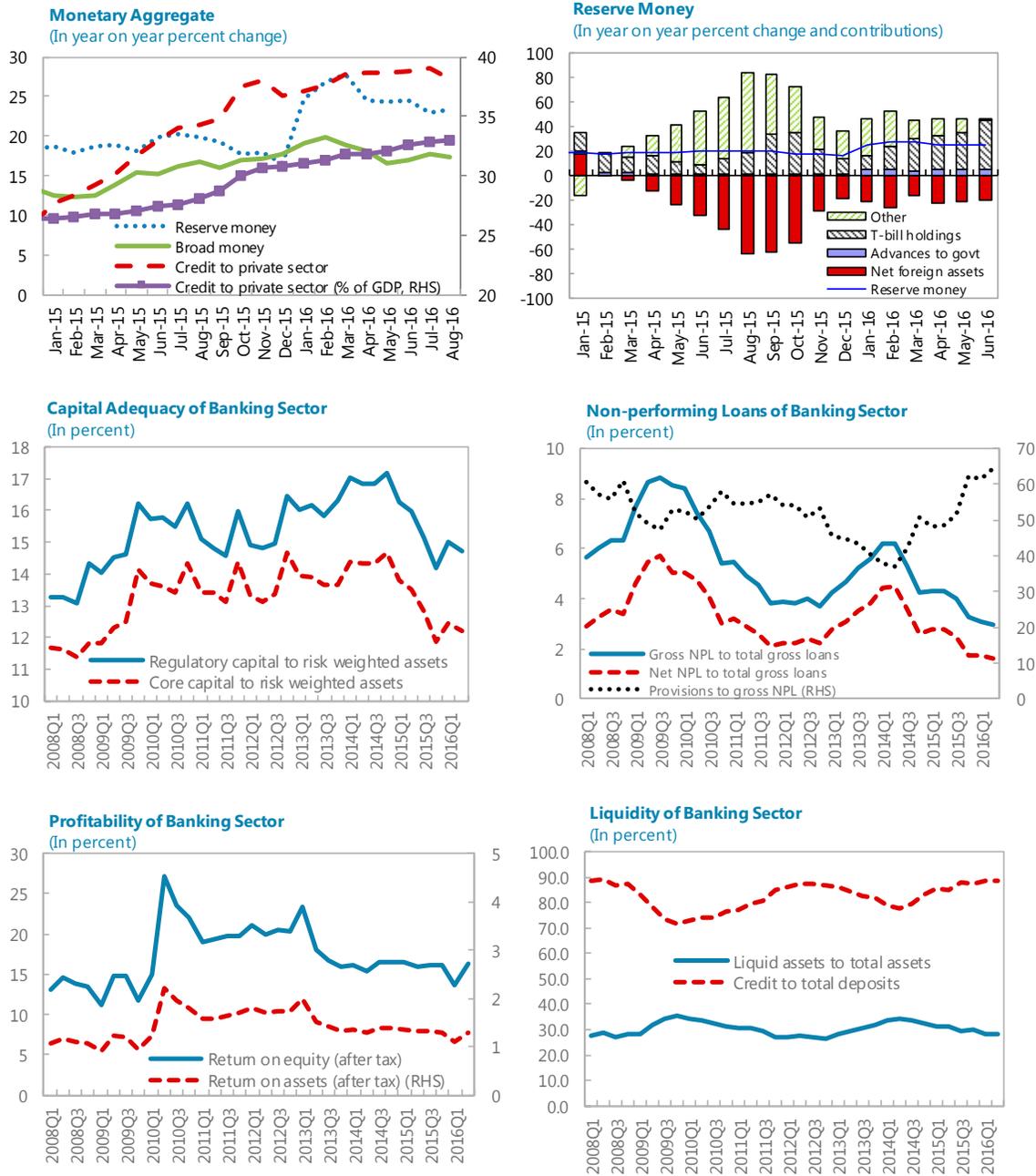
Sources: Central Bank of Sri Lanka; CEIC Daily Database; Bloomberg Data LP; and IMF staff calculations.

Figure 4. Sri Lanka: Foreign Exchange and Reserves



Sources: Central Bank of Sri Lanka; APDCORE Database; Bloomberg Data LP; and IMF staff calculations.

Figure 5. Sri Lanka: Monetary and Financial Sector



Sources: Central Bank of Sri Lanka; and IMF staff calculations.

Table 1. Sri Lanka: Selected Economic Indicators, 2014–21

	2014	2015	2016		2017		2018	2019	2020	2021
			CR/16/150	Proj.	CR/16/150	Proj.				
GDP and inflation (in percent)										
Real GDP growth	4.9	4.8	5.0	4.5	5.0	4.8	4.9	5.1	5.2	5.3
Inflation (average)	3.3	0.9	4.1	4.0	5.3	5.1	5.0	5.0	5.0	5.0
Inflation (end-of-period)	2.1	2.8	5.4	5.1	5.2	5.1	5.0	5.0	5.0	5.0
Core inflation (end-of-period)	3.2	4.5	4.5	4.2	4.3	4.2	4.1	4.1	4.1	4.1
Savings and investment (in percent of GDP)										
National savings	29.5	27.6	26.9	27.3	26.0	28.6	29.6	30.2	31.0	31.2
Government	-1.1	-2.2	-0.9	-1.4	0.2	-0.4	0.6	1.2	2.0	2.0
Private	30.6	29.7	27.8	28.7	25.9	29.0	29.0	29.0	29.0	29.2
National Investment	32.0	30.1	28.3	29.4	28.8	30.8	31.7	32.3	33.0	33.2
Government	4.9	4.7	6.5	4.4	6.9	4.8	5.3	5.4	5.5	5.5
Private	27.1	25.3	21.9	25.0	21.9	26.0	26.4	26.9	27.5	27.7
Savings-Investment balance	-2.5	-2.5	-1.5	-2.1	-2.8	-2.2	-2.1	-2.1	-2.0	-2.1
Government	-6.0	-6.8	-7.4	-5.7	-6.8	-5.2	-4.7	-4.2	-3.5	-3.5
Private	3.6	4.4	6.0	3.7	4.0	3.0	2.6	2.1	1.5	1.5
Public finances (in percent of GDP)										
Revenue and grants	11.5	13.1	13.0	13.1	14.0	13.9	15.2	15.8	16.3	16.1
Expenditure	17.7	19.9	18.4	18.9	18.8	19.2	19.9	19.9	19.9	19.6
Primary balance	-2.0	-2.2	-0.8	-0.8	0.0	0.0	0.8	1.2	1.6	1.4
Central government balance	-6.2	-6.9	-5.4	-5.7	-4.7	-5.2	-4.7	-4.2	-3.5	-3.5
Central government net domestic financing	3.7	4.3	2.3	2.9	3.0	3.5	3.5	2.9	2.4	2.4
Central government debt	70.7	76.0	77.2	77.0	75.5	76.4	74.2	71.9	69.3	66.9
Money and credit (percent change, end of period)										
Reserve money	18.3	16.5	18.4	20.3	12.0	17.0	16.3	15.6	13.0	11.5
Broad money	13.4	17.8	10.8	20.0	15.4	18.2	16.4	13.3	11.6	11.2
Domestic credit	10.5	23.5	8.5	15.4	11.7	12.9	12.0	10.4	9.6	9.4
Credit to private sector	8.8	25.1	10.0	20.1	14.3	15.5	13.8	11.9	11.0	10.4
Credit to government	12.9	21.3	6.2	8.4	7.7	8.6	8.9	7.7	6.9	7.2
Balance of payments (in millions of U.S. dollars)										
Exports	11,131	10,506	10,456	10,530	10,942	10,983	11,714	12,383	13,060	13,681
Imports	-19,417	-18,935	-18,392	-19,013	-20,763	-20,051	-21,196	-22,415	-23,715	-25,094
Current account balance	-1,986	-2,008	-1,202	-1,738	-2,419	-1,953	-2,007	-2,144	-2,247	-2,453
Current account balance (in percent of GDP)	-2.5	-2.5	-1.5	-2.1	-2.8	-2.2	-2.1	-2.1	-2.0	-2.1
Export value growth (percent)	7.1	-5.6	-0.5	0.2	4.6	4.3	6.7	5.7	5.5	4.7
Import value growth (percent)	7.9	-2.5	-2.9	0.4	12.9	5.5	5.7	5.8	5.8	5.8
Gross official reserves (end of period)										
In millions of U.S. dollars	8,208	7,304	7,853	6,542	9,372	7,118	7,913	8,755	9,618	10,262
In months of imports	4.3	3.8	3.7	3.2	4.1	3.3	3.5	3.6	3.8	4.1
External debt (public and private)										
In billions of U.S. dollars	43.0	44.8	45.9	45.1	49.0	47.0	49.0	53.1	56.1	59.0
As a percent of GDP	53.8	55.1	55.8	54.3	55.9	53.3	51.8	52.0	50.8	49.4
Memorandum items:										
Nominal GDP (in billions of rupees)	10,448	11,183	12,147	12,166	13,374	13,342	14,699	16,221	17,918	19,811

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.

Table 2a. Sri Lanka: Summary of Central Government Operations, 2014–21
(In billions of rupees)

	2014	2015	2016		2017		2018	2019	2020	2021
			CR/16/150	Proj.	CR/16/150	Proj.				
Total revenue and grants	1,205	1,461	1,574	1,598	1,878	1,860	2,235	2,559	2,926	3,190
Total revenue	1,195	1,455	1,562	1,587	1,868	1,850	2,227	2,551	2,919	3,182
Tax revenue	1,050	1,356	1,428	1,453	1,721	1,703	2,066	2,373	2,721	2,964
Income taxes	198	263	226	243	344	358	472	595	735	813
VAT	275	220	311	271	384	354	530	636	756	827
Excise taxes	257	498	452	466	499	497	532	572	614	661
Other trade taxes	129	184	199	205	227	214	230	248	268	289
Other	191	191	240	267	267	280	301	323	348	374
Nontax revenue	145	99	134	134	148	147	162	179	197	218
Grants	9	6	12	12	10	10	8	8	7	8
Total expenditure and net lending	1,850	2,229	2,233	2,298	2,510	2,558	2,922	3,233	3,559	3,881
Current expenditure	1,323	1,702	1,688	1,770	1,856	1,919	2,148	2,366	2,572	2,790
Civil service wages and salaries	255	323	335	335	369	348	383	423	467	517
Other civilian goods and services	55	135	71	91	78	96	106	117	129	143
Security expenditure	258	297	301	317	331	335	369	407	450	497
Subsidies and transfers	318	419	419	424	449	446	491	542	599	662
Interest payments	436	527	562	603	629	694	799	876	927	971
Capital expenditure and net lending	527	527	545	528	654	638	774	867	987	1,091
Overall balance	-646	-768	-659	-699	-632	-697	-687	-674	-633	-691
Financing	646	768	659	699	632	697	687	674	633	691
Net external financing	260	292	376	345	234	224	172	200	210	207
Net domestic financing	386	476	283	354	399	473	515	473	423	484
Memorandum items:										
Primary balance	-209	-241	-97	-97	-3	-3	111	203	294	280
Central government debt	7,391	8,503	9,376	9,372	10,092	10,199	10,913	11,662	12,409	13,257
Domestic currency	4,344	4,595	4,975	5,066	5,312	5,427	5,979	6,433	6,855	7,198
Foreign currency	3,047	3,909	4,401	4,306	4,780	4,772	4,933	5,229	5,554	6,059
Publicly guaranteed debt	440	382	...	...	...	...	...	...	...	...
Fund credit outstanding	164	107	85	85	115	114	194	238	242	235
Financial obligations of nonfinancial SOEs 1/	...	1,280	...	...	...	...	...	...	...	...
Nominal GDP (in billion of rupees)	10,448	11,183	12,147	12,166	13,374	13,342	14,699	16,221	17,918	19,811

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.

1/ The figure does not cover all nonfinancial SOEs. It covers financial obligations of Ceylon Electricity Board, Ceylon Petroleum Corporation, Sri Lanka Port Authorities, Sri Lankan Airlines, and other SOEs.

Table 2b. Sri Lanka: Summary of Central Government Operations, 2014–21
(In percent of GDP)

	2014	2015	2016		2017		2018	2019	2020	2021
			CR/16/150	Proj.	CR/16/150	Proj.				
Total revenue and grants	11.5	13.1	13.0	13.1	14.0	13.9	15.2	15.8	16.3	16.1
Total revenue	11.4	13.0	12.9	13.0	14.0	13.9	15.2	15.7	16.3	16.1
Tax revenue	10.1	12.1	11.8	11.9	12.9	12.8	14.1	14.6	15.2	15.0
Income taxes	1.9	2.3	1.9	2.0	2.6	2.7	3.2	3.7	4.1	4.1
VAT	2.6	2.0	2.6	2.2	2.9	2.7	3.6	3.9	4.2	4.2
Excise taxes	2.5	4.4	3.7	3.8	3.7	3.7	3.6	3.5	3.4	3.3
Other trade taxes	1.2	1.6	1.6	1.7	1.7	1.6	1.6	1.5	1.5	1.5
Other	1.8	1.7	2.0	2.2	2.0	2.1	2.0	2.0	1.9	1.9
Nontax revenue	1.4	0.9	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Total expenditure and net lending	17.7	19.9	18.4	18.9	18.8	19.2	19.9	19.9	19.9	19.6
Current expenditure	12.7	15.2	13.9	14.5	13.9	14.4	14.6	14.6	14.4	14.1
Civil service wages and salaries	2.4	2.9	2.8	2.8	2.8	2.6	2.6	2.6	2.6	2.6
Other civilian goods and services	0.5	1.2	0.6	0.7	0.6	0.7	0.7	0.7	0.7	0.7
Security expenditure	2.5	2.7	2.5	2.6	2.5	2.5	2.5	2.5	2.5	2.5
Subsidies and transfers	3.0	3.8	3.4	3.5	3.4	3.3	3.3	3.3	3.3	3.3
Interest payments	4.2	4.7	4.6	5.0	4.7	5.2	5.4	5.4	5.2	4.9
Capital expenditure and net lending	5.0	4.7	4.5	4.3	4.9	4.8	5.3	5.3	5.5	5.5
Overall balance	-6.2	-6.9	-5.4	-5.7	-4.7	-5.2	-4.7	-4.2	-3.5	-3.5
Financing	6.2	6.9	5.4	5.7	4.7	5.2	4.7	4.2	3.5	3.5
Net external financing	2.5	2.6	3.1	2.8	1.7	1.7	1.2	1.2	1.2	1.0
Net domestic financing	3.7	4.3	2.3	2.9	3.0	3.5	3.5	2.9	2.4	2.4
Memorandum items:										
Primary balance	-2.0	-2.2	-0.8	-0.8	0.0	0.0	0.8	1.2	1.6	1.4
Central government debt	70.7	76.0	77.2	77.0	75.5	76.4	74.2	71.9	69.3	66.9
Domestic currency	41.6	41.1	41.0	41.6	39.7	40.7	40.7	39.7	38.3	36.3
Foreign currency	29.2	35.0	36.2	35.4	35.7	35.8	33.6	32.2	31.0	30.6
Publicly guaranteed debt	4.2	3.4	...	...	...	...	...	...	...	...
Fund credit outstanding	1.6	1.0	0.7	0.7	0.9	0.9	1.3	1.5	1.4	1.2
Financial obligations of nonfinancial SOEs 1/	...	11.4	...	...	...	...	...	...	...	...
Nominal GDP (in billion of rupees)	10,448	11,183	12,147	12,166	13,374	13,342	14,699	16,221	17,918	19,811

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.

1/ The figure does not cover all nonfinancial SOEs. It covers financial obligations of Ceylon Electricity Board, Ceylon Petroleum Corporation, Sri Lanka Port Authorities, Sri Lankan Airlines, and other SOEs.

Table 2c. Sri Lanka: Summary of Central Government Operations, 2016–17
(In billions of rupees)

	2016Q1	2016Q2		2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
	Est.	CR/16/150	Est.			Proj.			
Total revenue and grants	346	356	397	392	464	415	446	468	532
Total revenue	346	353	396	387	458	412	443	465	530
Tax revenue	325	326	360	354	414	383	411	436	474
Income taxes	47	38	58	70	68	60	90	99	110
VAT	57	81	74	57	83	83	83	94	94
Excise taxes	111	107	110	118	127	117	124	122	134
Other trade taxes	54	45	54	43	55	54	49	52	59
Other	56	56	64	67	80	69	65	70	77
Nontax revenue	20	27	37	33	44	30	32	29	56
Grants	0	2	0	5	6	3	3	3	3
Total expenditure and net lending	526	493	544	618	609	598	604	670	686
Current expenditure	427	376	409	472	462	474	454	521	470
Civil service wages and salaries	81	84	90	77	87	86	86	89	89
Other civilian goods and services	22	13	9	32	28	22	23	25	27
Security expenditure	70	71	70	87	90	80	83	86	87
Subsidies and transfers	99	91	105	97	124	110	107	116	114
Interest payments	154	117	135	179	134	178	156	206	154
Capital expenditure and net lending	100	116	135	147	147	124	150	150	215
Capital expenditure	95	113	140	148	148	121	150	148	224
Net lending	5	4	-5	-2	-2	3	0	2	-8
Overall balance	-181	-137	-148	-226	-145	-183	-158	-202	-153
Primary balance	-26	-20	-12	-47	-11	-5	-2	4	1

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.

Table 2d. Sri Lanka: Central Government Financing Needs, 2015–18
(In billions of rupees)

	2015	2016	2017	2018	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
	Est.	Proj.	Proj.	Proj.	Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Gross inflow	2,566	2,376	2,408	2,545	517	645	893	322	852	578	492	491
Primary surplus	0	0	0	111	0	0	0	0	0	0	4	1
Rupee-denominated debt disbursement	1,747	1,609	1,689	1,850	289	580	532	207	422	422	422	422
US-dollar denominated debt disbursement	829	759	719	584	163	121	360	115	430	155	66	68
Asset sales (net)	0	0	0	0	0	0	0	0	0	0	0	0
Other	-11	8	0	0	64	-56	0	0	0	0	0	0
Gross outflow	2,562	2,376	2,408	2,545	526	658	709	484	698	623	589	501
Primary deficit	241	97	3	0	26	12	47	11	5	2	0	0
Interest payment	527	603	694	799	154	135	179	134	178	156	206	154
Rupee-denominated debt amortization	1,490	1,204	1,236	1,298	204	397	344	258	309	309	309	309
US-dollar denominated debt amortization	304	473	474	449	141	113	139	80	206	156	74	38
Other	0	0	0	0	0	0	0	0	0	0	0	0
Net cash inflow	4	0	0	0	-9	-12	183	-162	154	-46	-98	-10
Government deposits, end of period	74	74	74	74	65	53	236	74	227	182	84	74
Memorandum items:												
Overall deficit	768	699	697	687	181	148	226	145	183	158	202	153
US\$ denominated debt disbursement (in US\$ millions)	5,984	5,232	4,781	3,753	1,140	838	2,474	780	2,873	1,030	434	444
US\$ denominated debt amortization (in US\$ millions)	2,208	3,267	3,151	2,887	985	779	958	546	1,377	1,036	488	249
Government deposits, end of period (percent of GDP)	0.7	0.6	0.6	0.5	...	...	...	...	...	...	...	...

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.

Table 3a. Sri Lanka: Monetary Accounts, 2014–17
(In billions of rupees, unless otherwise indicated, end of period)

	2014	2015	2016		2017	
			CR/16/150	Proj.	CR/16/150	Proj.
(Stocks, in billions of Sri Lankan rupees)						
Central Bank of Sri Lanka						
Net foreign assets	688	576	707	664	926	748
Net domestic assets	-110	97	91	146	-33	200
Net claims on central government	150	230	267	273	297	238
Net claims on banks	17	-3	-3	-3	-3	-3
Other items, net	-277	-130	-173	-124	-327	-35
Reserve Money	578	673	797	810	893	948
Monetary survey						
Net foreign assets	15	-298	-216	-244	-13	-190
Monetary authorities	688	576	707	664	926	748
Deposit money banks	-673	-874	-922	-908	-939	-938
Net domestic assets	3,861	4,864	5,277	5,724	5,853	6,667
Net claims on central government	1,436	1,759	1,854	1,878	1,987	2,035
Credit to corporations	3,204	3,973	4,364	4,738	4,961	5,435
Public corporations	446	523	570	596	623	651
Private corporations	2,758	3,450	3,793	4,142	4,337	4,784
Other items (net)	-779	-868	-941	-892	-1,095	-802
Broad money	3,876	4,566	5,061	5,480	5,840	6,477
Memorandum Items						
Gross international reserves (in millions of U.S. dollars)	8,208	7,304	7,853	6,542	9,372	7,118
Net international reserves (in millions of U.S. dollars)	6,517	5,029	5,700	5,490	7,043	5,890
Net Foreign Assets (in millions of U.S. dollars)	5,244	3,999	4,670	4,459	6,013	4,859
Private credit (in percent of GDP)	26.4	30.8	31.2	34.0	32.4	35.9
Money multiplier	6.7	6.8	6.3	6.8	6.5	6.8
Broad money velocity 1/	2.7	2.4	2.4	2.2	2.3	2.1
Money and credit (percent change, end of period)						
Broad money	13.4	17.8	10.8	20.0	15.4	18.2
Reserve money	18.3	16.5	18.4	20.3	12.0	17.0
Credit to public corporations	22.2	17.2	9.1	13.9	9.3	9.2
Credit to private sector	8.8	25.1	10.0	20.1	14.3	15.5

Sources: Central Bank of Sri Lanka; and IMF staff projections.

1/ Calculated using end-period quarterly GDP, annualized.

Table 3b. Sri Lanka: Monetary Accounts, 2015–17
(In billions of rupees, unless otherwise indicated, end of period)

	2015	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
		Est.	Est.			Proj.			
Central Bank of Sri Lanka									
Net foreign assets	576	474	414	605	664	779	751	704	748
Net domestic assets	97	318	344	189	146	71	148	232	200
Net claims on central government	230	407	456	262	273	264	256	247	238
Net claims on banks	-3	4	1	-3	-3	-61	57	162	153
Other items, net	-130	-93	-114	-71	-124	-132	-164	-177	-190
Reserve Money	673	792	757	794	810	851	899	935	948
Monetary survey									
Net foreign assets	-298	-440	-492	-230	-244	-132	-164	-177	-190
Monetary authorities	576	474	414	605	664	779	751	704	748
Deposit money banks	-874	-914	-905	-835	-908	-912	-915	-881	-938
Net domestic assets	4,864	5,172	5,336	5,600	5,724	5,944	6,310	6,569	6,667
Net claims on central government	1,759	1,954	2,005	1,862	1,878	1,903	1,956	2,018	2,035
Credit to corporations	3,973	4,149	4,283	4,469	4,738	4,825	4,935	5,126	5,435
Public corporations	523	515	485	550	596	559	577	600	651
Private corporations	3,450	3,635	3,798	3,919	4,142	4,266	4,358	4,526	4,784
Other items (net)	-868	-932	-953	-730	-892	-785	-580	-575	-802
Broad money	4,566	4,732	4,844	5,370	5,480	5,812	6,146	6,392	6,477
Memorandum Items									
Gross international reserves (in millions of U.S. dollars)	7,304	6,221	5,292	6,631	6,542	7,400	7,238	6,797	7,118
Net international reserves (in millions of U.S. dollars)	5,029	4,309	3,843	5,277	5,490	6,446	6,212	5,819	5,890
Money and credit (percent change, end of period)									
Broad money	17.8	18.9	17.0	24.7	20.0	22.8	26.9	19.0	18.2
Reserve money	16.5	27.8	24.5	23.9	20.3	7.4	18.8	17.9	17.0
Credit to private sector	25.1	27.7	28.2	24.2	20.1	17.4	14.7	15.5	15.5

Sources: Central Bank of Sri Lanka; and IMF staff projections.

Table 4a. Sri Lanka: Balance of Payments, 2014–21
(In millions of U.S. dollars, unless otherwise indicated)

	2014	2015	2016		2017		2018	2019	2020	2021
			CR/16/150	Proj.	CR/16/150	Proj.				
Current account	-1,986	-2,008	-1,202	-1,738	-2,419	-1,953	-2,007	-2,144	-2,247	-2,453
Balance on goods	-8,286	-8,429	-7,936	-8,484	-9,820	-9,067	-9,482	-10,032	-10,655	-11,414
Credit (exports)	11,131	10,506	10,456	10,530	10,942	10,983	11,714	12,383	13,060	13,681
Debit (imports)	-19,417	-18,935	-18,392	-19,013	-20,763	-20,051	-21,196	-22,415	-23,715	-25,094
Balance on services	1,880	2,324	2,760	2,796	3,251	2,963	3,339	3,751	4,356	5,015
Credit (exports)	5,605	6,396	7,133	7,141	7,905	7,570	8,176	8,830	9,536	10,299
Debit (imports)	-3,725	-4,072	-4,373	-4,346	-4,654	-4,607	-4,837	-5,079	-5,180	-5,284
Primary income, net 1/	-1,807	-2,097	-2,376	-2,400	-2,315	-2,276	-2,368	-2,514	-2,671	-2,845
Secondary income, net 2/	6,227	6,193	6,350	6,350	6,464	6,427	6,504	6,651	6,723	6,791
Of which: workers' remittances (net)	6,199	6,167	6,322	6,322	6,435	6,398	6,473	6,620	6,691	6,759
Capital account (+ surplus / - deficit)	58	46	43	13	27	12	10	7	2	2
Balance from current account and capital account	-1,928	-1,962	-1,159	-1,725	-2,392	-1,941	-1,998	-2,137	-2,245	-2,451
Financial account (+ net lending / - net borrowing) 3/	-3,802	-3,128	-1,505	-761	-3,536	-2,140	-2,168	-2,728	-3,122	-3,165
Direct investments	-827	-628	-662	-570	-852	-685	-788	-815	-999	-1,148
Portfolio investments	-2,064	-689	-793	-1,237	-808	-1,182	-651	-825	-1,102	-1,102
Equity and investment Fund shares	-1878	58	0	-10	-178	-150	-220	-242	-250	-250
Debt instruments	-1,886	-747	-793	-1,227	-630	-1,032	-431	-583	-852	-852
Of which: deposit taking corporations	-250	0	-200	324	-230	558	689	537	268	268
Of which: general government	-1,461	-747	-593	-1,551	-400	-1,590	-1,120	-1,120	-1,120	-1,120
T-bills, T-bonds, and SLDBs	39	903	1,407	635	-100	-90	-120	-120	-120	-120
Sovereign bonds	-1,500	-1,650	-2,000	-2,186	-300	-1,500	-1,000	-1,000	-1,000	-1,000
Other investments 4/	-911	-1,811	-50	1,046	-1,876	-273	-729	-1,087	-1,022	-916
Of which:										
Currency and deposits	568	-1,314	1,000	751	-250	-150	-250	-280	-275	-270
Central bank 5/	-1	-1,098	1,100	1,101	0	0	0	0	0	0
Deposit taking corporations	569	-216	-100	-350	-250	-150	-250	-280	-275	-270
Loans 4/	-2,432	-1,241	-1,050	-212	-1,626	-473	-854	-1,212	-1,147	-1,046
Central bank 4/	0	0	0	0	0	0	0	0	0	0
Deposit taking corporations	-1,358	-787	-200	-40	-200	-420	-550	-650	-550	-500
General government	-646	-470	-550	-172	-1,231	17	-109	-262	-297	-246
Disbursements	-1,439	-1,268	-1,500	-1,200	-2,300	-1,200	-1,300	-1,500	-1,700	-1,700
Amortizations	793	798	950	1,028	1,070	1,217	1,191	1,238	1,403	1,454
Other sectors	-429	16	-300	0	-195	-70	-195	-300	-300	-300
Errors and omissions	395	-308	0	0	0	0	0	0	0	0
Overall balance (- = need of inflow) 3/	2,270	857	346	-964	1,143	200	170	591	877	715
Total financing (- = inflow)	2,268	857	346	-964	1,143	200	170	591	877	715
Financing (- = inflow)	2,268	857	1,006	-304	1,760	817	795	842	877	715
Change in reserve assets	1,549	350	549	-762	1,519	576	795	842	863	644
Use of Fund credit, net	719	507	456	458	241	242	0	0	14	71
Purchases/Disbursements	0	0	0	0	0	0	0	0	0	0
Repurchases/repayments	719	507	456	458	241	242	0	0	14	71
Financing gap (- = inflow)	0	0	-659	-660	-617	-618	-625	-251	0	0
IMF	0	0	-334	-335	-417	-418	-500	-251	0	0
Other IFIs	0	0	-325	-325	-200	-200	-125	0	0	0
Memorandum items:										
Current account (in percent of GDP)	-2.5	-2.5	-1.5	-2.1	-2.8	-2.2	-2.1	-2.1	-2.0	-2.1
Gross official reserves	8,208	7,304	7,853	6,542	9,372	7,118	7,913	8,755	9,618	10,262
In months of prospective imports of goods and nonfactor services	4.3	3.8	3.7	3.2	4.1	3.3	3.5	3.6	3.8	4.1
In percent of ARA composite metric	86.6	76.0	79.1	65.7	86.9	67.1	68.3	69.3	71.2	75.3
Net international reserves	6,517	5,029	5,700	5,490	7,043	5,890	6,184	6,775	7,652	8,367
In percent of ARA composite metric	68.8	52.4	57.4	55.1	65.3	55.6	53.4	53.7	56.7	61.4
GDP	80,007	81,247	82,239	83,044	87,626	88,137	94,548	102,143	110,498	119,513

Sources: Data provided by the Central Bank of Sri Lanka; and IMF staff estimates and projections.

1/ Under BPM5 known as Income.

2/ Under BPM5 known as Transfers.

3/ Excluding changes in reserves assets and credit and loans with the IMF.

4/ Excluding credits and loans with the IMF, other than reserves (net purchases and repurchases).

5/ Projections in 2016 include repayment of a \$1.1 billion swap line with the Reserve Bank of India.

Table 4b. Sri Lanka: Balance of Payments, 2016–17
(In millions of U.S. dollars, unless otherwise indicated)

	2016					2017				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
	Act.	Est.	Proj.				Proj.			
Current account	-81	-715	-289	-653	-1,738	-562	-439	-348	-604	-1,953
Balance on goods	-1,866	-2,347	-2,042	-2,228	-8,484	-2,354	-2,218	-2,184	-2,312	-9,067
Credit (exports)	2,728	2,380	2,652	2,769	10,530	2,794	2,570	2,767	2,852	10,983
Debit (imports)	-4,594	-4,727	-4,695	-4,998	-19,013	-5,148	-4,788	-4,951	-5,164	-20,051
Balance on services	765	463	767	801	2,796	797	587	813	767	2,963
Primary income, net 1/	-536	-422	-615	-827	-2,400	-611	-415	-584	-666	-2,276
Secondary income, net 2/	1,556	1,590	1,602	1,602	6,350	1,607	1,607	1,607	1,607	6,427
Capital account (+ surplus / - deficit)	1	-2	3	12	13	2	5	3	3	12
Balance from current account and capital account	-81	-717	-287	-641	-1,725	-560	-434	-346	-601	-1,941
Financial account (+ net lending / - net borrowing) 3/	574	515	-1,721	-129	-761	-1,515	-201	48	-472	-2,140
Direct investments	-89	-97	-121	-263	-570	-135	-121	-146	-284	-685
Portfolio investments	351	223	-1,955	144	-1,237	-1,355	138	-23	58	-1,182
Of which: general government	348	181	-2,133	53	-1,551	-1,523	-23	-23	-23	-1,590
T-bills, T-bonds, and SLDBs	348	181	53	53	635	-23	-23	-23	-23	-90
Sovereign bonds	0	0	-2,186	0	-2,186	-1,500	0	0	0	-1,500
Other investments 4/	312	389	354	-10	1,046	-25	-217	216	-246	-273
Of which: currency and deposits, central bank 5/	0	701	0	400	1,101	0	0	0	0	0
Errors and omissions	-186	18	84	84	0	0	0	0	0	0
Overall balance (- = need of inflow) 3/	-654	-1,233	1,435	-512	-964	955	-233	-393	-129	200
Total financing (- = inflow)	-654	-1,233	1,435	-512	-964	955	-233	-393	-129	200
Financing (- = inflow)	-654	-1,065	1,435	-19	-304	955	-65	-393	320	817
Change in reserve assets	-799	-1,185	1,338	-116	-762	858	-162	-442	320	576
Use of Fund credit, net	145	120	96	96	458	97	97	48	0	242
Purchases/Disbursements	0	0	0	0	0	0	0	0	0	0
Repurchases/repayments	145	120	96	96	458	97	97	48	0	242
Financing gap (- = inflow)	0	-168	0	-493	-660	0	-168	0	-449	-618
IMF	0	-168	0	-168	-335	0	-168	0	-249	-418
Other IFIs	0	0	0	-325	-325	0	0	0	-200	-200
Memorandum items:										
Gross official reserves	6,221	5,292	6,631	6,542	6,542	7,400	7,238	6,797	7,118	7,118
In months of prospective imports of goods and nonfactor services	3.7	3.2	4.0	3.9	3.9	4.4	4.3	4.1	4.3	3.3
In percent of ARA composite metric	62.4	53.1	66.5	65.6	65.6	74.2	72.6	68.2	71.4	67.2
Net international reserves	4,309	3,843	5,277	5,490	5,490	6,446	6,212	5,819	5,890	5,890
In percent of ARA composite metric	43.2	38.5	52.9	55.1	55.1	64.7	62.3	58.4	59.1	55.6

Sources: Data provided by the Central Bank of Sri Lanka; and IMF staff estimates and projections.

1/ Under BPM5 known as Income.

2/ Under BPM5 known as Transfers.

3/ Excluding changes in reserves assets and credit and loans with the IMF.

4/ Excluding credits and loans with the IMF, other than reserves (net purchases and repurchases).

5/ Projections in 2016 include repayment of a \$1.1 billion swap line with the Reserve Bank of India.

Table 4c. Sri Lanka: Gross External Financing, 2014–21
(In millions of U.S. dollars, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021
				Proj.				
Current account	-1,986	-2,008	-1,738	-1,953	-2,007	-2,144	-2,247	-2,453
Balance on goods	-8,286	-8,429	-8,484	-9,067	-9,482	-10,032	-10,655	-11,414
Credit (exports)	11,131	10,506	10,530	10,983	11,714	12,383	13,060	13,681
Debit (imports)	-19,417	-18,935	-19,013	-20,051	-21,196	-22,415	-23,715	-25,094
Balance on services	1,880	2,324	2,796	2,963	3,339	3,751	4,356	5,015
Primary and secondary income, net	4,420	4,096	3,950	4,151	4,136	4,137	4,052	3,946
Amortization	-1,860	-934	-2,687	-1,559	-1,566	-3,338	-3,017	-1,925
General government	-793	-1,298	-1,028	-1,217	-1,191	-2,738	-2,403	-2,454
Sovereign bonds	0	-500	0	0	0	-1,500	-1,000	-1,000
Bilateral and multilateral	-793	-798	-1,028	-1,217	-1,191	-1,238	-1,403	-1,454
Central bank	-718	592	-1,559	-242	0	0	-14	-71
IMF repurchases/repayments	-719	-507	-458	-242	0	0	-14	-71
Other central bank liabilities, net	1	1,098	-1,101	0	0	0	0	0
Private sector loans	-348	-227	-100	-100	-375	-600	-600	600
Gross external financing needs	-3,846	-2,942	-4,425	-3,511	-3,573	-5,481	-5,265	-4,378
Sources of financing	3,846	2,942	4,425	3,511	3,573	5,481	5,265	4,378
Borrowing	5,001	3,601	3,003	3,469	3,744	6,072	6,128	5,022
General government	2,952	2,564	2,771	2,810	2,438	4,135	3,830	3,830
T-bills, Tbonds, and SLDBs, net	-39	-903	-635	90	120	120	120	120
Sovereign bonds	1,500	2,150	2,186	1,500	1,000	2,500	2,000	2,000
Bilateral and multilateral 1/	1,439	1,268	1,200	1,200	1,300	1,500	1,700	1,700
Official capital transfers	52	50	20	20	18	15	10	10
Other capital inflows, net	2,049	1,037	232	659	1,306	1,937	2,298	1,192
Deposit-taking corporations, excl. central bank, net	717	789	-186	-238	-164	118	257	202
FDI inflows, net	827	628	570	685	788	815	999	1,148
Private sector loans	777	211	200	170	570	900	900	900
Other capital inflows, net	-272	-591	-352	42	112	104	142	-1,058
Change in reserve assets	-1,549	-350	762	-576	-795	-842	-863	-644
External financing gap	0	0	660	618	625	251	0	0
Financing	0	0	660	618	625	251	0	0
IMF	0	0	335	418	500	251	0	0
Other IFIs	0	0	325	200	125	0	0	0

Sources: Central Bank of Sri Lanka; and IMF staff estimates and projections.

1/ Based on existing and expected commitments (incl. ADB, China, and Japan).

Table 5. Sri Lanka: Financial Soundness Indicators—All Banks, 2012–16

	2012	2013	2014	2015	2015	2015	2015	2016	2016
				Q1	Q2	Q3	Q4	Q1	Q2
Capital adequacy									
Regulatory capital to risk weighted assets	16.4	16.3	15.6	16.3	16.0	15.2	14.2	15.0	14.7
Tier 1 capital/risk weighted assets	14.7	13.7	13.1	13.8	13.5	12.8	11.9	12.4	12.2
Capital to assets ratio	8.6	8.2	8.2	8.2	8.2	8.1	7.9	7.8	7.9
Asset quality									
Gross nonperforming loans to total gross loans (without interest in suspense)	3.7	5.6	4.2	4.3	4.3	4.0	3.2	3.1	3.0
Net nonperforming loans to total gross loans	2.2	3.8	2.6	2.7	2.7	2.4	1.7	1.7	1.6
Provision coverage ratio (total)	53.4	40.4	50.7	48.1	48.4	51.6	62.3	61.2	64.3
Earnings and profitability									
Return on equity (after tax)	20.3	16.0	16.6	16.7	16.0	16.2	16.1	13.5	16.4
Return on assets (after tax)	1.7	1.3	1.4	1.4	1.3	1.3	1.3	1.1	1.3
Interest income to gross income	86.3	69.7	69.3	74.6	74.5	73.0	73.2	75.0	75.4
Staff expenses to noninterest expenses	45.8	44.9	43.5	46.0	46.6	45.6	45.6	39.9	44.8
Total cost to total income	75.2	79.3	75.8	73.7	73.9	73.8	73.1	78.4	76.0
Net interest margin	4.1	3.5	3.5	3.9	3.7	3.6	3.5	3.6	3.6
Liquidity									
Liquid assets to total assets	26.6	31.9	32.2	31.0	31.3	29.4	30.0	28.5	28.3
Assets/funding structure									
Deposits	70.3	70.7	67.6	66.6	67.4	66.5	66.9	66.7	67.5
Borrowings	16.7	16.4	20.2	21.4	20.6	21.7	21.8	21.9	21.0
Credit to deposits	87.4	82.2	83.1	85.5	85.0	87.7	87.3	88.4	88.5

Source: Central Bank of Sri Lanka.

Table 6. Sri Lanka: Reviews and Purchases under the Three-year Extended Arrangement

Date	Amount (SDR millions)	Percent of Quota (%)	Conditions
June 3, 2016	119.894	20.714	Board Approval of the Extended Arrangement
November 18, 2016 1/	119.894	20.714	Completion of the first review based on end-June 2016 and continuous performance criteria
April 20, 2017	119.894	20.714	Completion of the second review based on end-December 2016 and continuous performance criteria
November 20, 2017	177.774	30.714	Completion of the third review based on end-June 2017 and continuous performance criteria
April 20, 2018	177.774	30.714	Completion of the fourth review based on end-December 2017 and continuous performance criteria
November 20, 2018	177.774	30.714	Completion of the fifth review based on end-June 2018 and continuous performance criteria
April 20, 2019	177.776	30.715	Completion of the sixth review based on end-December 2018 and continuous performance criteria
Total	1070.780	185.000	

Source: IMF staff.

1/ This replaces the original date of November 20, 2016, as proposed in the Staff Report.

Table 7. Sri Lanka: Projected Payments to the Fund, 2016–2029 1/
(In millions of SDR, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Fund repurchases and charges														
In millions of SDR	36.1	178.5	9.5	12.6	22.8	62.5	116.3	174.2	187.0	185.0	173.0	131.2	75.4	15.5
In millions of U.S. dollars	50.4	250.4	13.3	17.8	32.3	88.5	164.5	246.4	264.6	261.8	244.7	185.6	106.7	21.9
In percent of exports of goods and NFS	0.3	1.3	0.1	0.1	0.1	0.4	0.7	0.9	1.0	0.9	0.8	0.6	0.3	0.1
In percent of quota	6.2	30.8	1.6	2.2	3.9	10.8	20.1	30.1	32.3	32.0	29.9	22.7	13.0	2.7
In percent of gross official reserves	0.8	3.5	0.2	0.2	0.3	0.9	1.5	2.2	2.3	2.1	1.9	1.4	0.8	0.2
Fund credit outstanding 2/														
In millions of SDR	412.0	537.5	893.0	1,070.8	1,060.8	1,010.8	906.4	742.8	564.3	385.9	217.4	88.9	14.8	0.0
In millions of U.S. dollars	577	755	1,258	1,515	1,502	1,430	1,282	1,051	798	546	307	126	21	0
In percent of quota	71	92.9	154.3	185.0	183.3	174.6	156.6	128.3	97.5	66.7	37.6	15.4	2.6	0.0
In percent of GDP	0.7	0.9	1.3	1.5	1.4	1.2	1.0	0.8	0.5	0.3	0.2	0.1	0.0	0.0
In percent of gross official reserves	8.8	10.6	15.9	17.3	15.6	13.9	11.9	9.3	6.8	4.5	2.4	0.9	0.2	0.0
Memorandum items:														
Exports of goods and services (in millions of U.S. dollars)	17,671	18,553	19,890	21,213	22,596	23,980	25,178	26,437	27,759	29,147	30,605	32,135	33,742	35,429
Quota 2/	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8
Quota (in millions of U.S. dollars) 2/	810	813	816	819	820	819	819	819	819	819	819	819	819	819
Gross official reserves (in millions of U.S. dollars) 2/	6,542	7,118	7,913	8,755	9,618	10,262	10,762	11,262	11,762	12,262	12,762	13,262	13,762	14,262
GDP (in millions of U.S. dollars)	83,044	88,137	94,548	102,143	110,498	119,513	129,074	139,400	150,552	162,596	175,604	189,652	204,825	221,211
U.S. dollars per SDR (eop)	1.40	1.40	1.41	1.41	1.42	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41
U.S. dollars per SDR (avg.)	1.40	1.40	1.41	1.41	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42

Source: IMF staff estimates.

1/ As of October 28, 2016 using the new quota (effective in February 17, 2016).

2/ As of the end of the year.

Annex I. Debt Sustainability Analysis

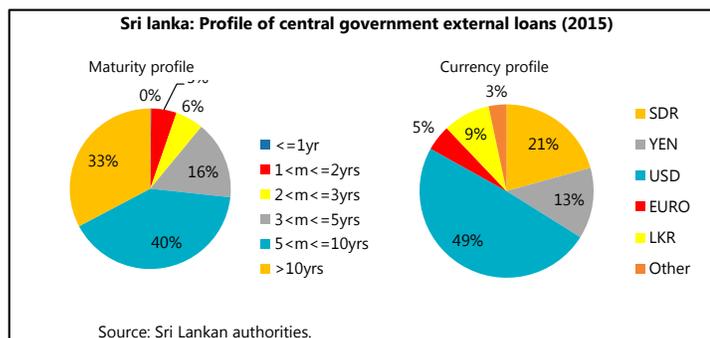
Sri Lanka's public debt and gross funding needs stand high compared with peers, with the ratio of gross financing needs to GDP being the fifth largest among emerging economies. Fiscal consolidation envisaged under the EFF-supported program would steadily reduce them. However, there are significant downside risks including those related to contingent liabilities, with stress tests indicating a high risk to public debt sustainability. External debt remains sustainable, though with high currency risks. Risks to external debt sustainability are mitigated by long maturities and Sri Lanka's access to international financial markets.

A. Background and Key Assumptions

1. Public debt reached 80.4 percent of GDP at end-2015. Public debt in this DSA covers debt owed by the central government (76 percent of GDP), outstanding amount of loans guaranteed by the central government (3.4 percent of GDP), and outstanding Fund credit (1 percent of GDP). SOEs' financial obligations identified by recent FAD TA (11 percent of GDP at end-2015) are not included in the public debt outstanding. Nevertheless, the impact from possible realization of the contingent liabilities is assessed under a shock scenario. Foreign-currency denominated debt accounted for 47 percent of total, while debt owed to official and multilateral creditors accounted for about a quarter of the total. Gross financing needs are projected at 17.6 percent of GDP in 2016, comprising short-term debt repayment of 5.2 percent of GDP, medium-and long-term debt amortization of 6.6 percent of GDP, and projected overall deficit of 5.7 percent of GDP. Sri Lanka's debt to GDP ratio remains higher than the median for emerging economies (57 percent; excluding major oil exporters), and gross funding needs are the fifth largest among them.

Sri Lanka: Public Debt, 2015		
	Rs. billion	% of GDP
Public debt	8,992	80.4
Central government debt	8,503	76.0
Domestic	4,959	44.3
Treasury Bills	658	5.9
Treasury Bonds	3,305	29.6
Other	996	8.9
External	3,544	31.7
Multilateral and bilateral	2,237	20.0
International sovereign bonds	958	8.6
Nonresident holdings of T-Bills and T-Bonds	304	2.7
Other	45	0.4
Publicly guaranteed debt	382	3.4
Fund credit outstanding	107	1.0
Memorandum items:		
SOE debt	1,280	11.4
Ceylon Electricity Board	237	2.1
Ceylon Petroleum Corporation	424	3.8
Sri Lanka Ports Authority	240	2.2
Sri Lankan Airlines	309	2.8
Other	69	0.6
Sources: Sri Lankan authorities and IMF staff estimates.		
1/ IMF staff estimates.		

2. External debt is estimated at 55.1 percent of GDP at end-2015. It is predominantly owed by the public sector (55 percent held by the general government and 6 percent by the central bank). However, private external debt has risen over the last years, in particular with debt of deposit-taking financial institutions rising from 13 percent of total in 2011 to 20 percent in 2015. The ratio of debt to exports is also high, at 265 percent in 2015. However, rollover risks are low as 83 percent of total debt (i.e., public and private) is medium or long term and the next sovereign bond repayment is not due until 2019 (US\$1.5 billion). About half of the central government's external debt stock is denominated in dollars.



3. The baseline scenario of the DSA reflects the macroeconomic framework and the proposed policies under the EFF-supported program. Real GDP growth is projected to recover from 4.5 percent in 2016 to 5.3 percent by 2021. Inflation is projected to stay around 5 percent over the medium term. Fiscal deficit is programmed to decrease from 5.7 percent of GDP in 2016 to the authorities' target of 3.5 percent of GDP in 2020. This implies that primary balance improves from deficit of 2.2 percent of GDP in 2015 to surplus of 0.8 percent of GDP in 2018 and 1.6 percent of GDP in 2020. Interest payments are projected on the basis of the projected interest payments for existing debt, and the interest rates in the secondary government security markets prevailing in July–September 2016 for the newly issued debt in 2016. Interest rates for newly issued debts are assumed to decrease gradually from these levels over the medium term. This resulted in an upward revision of the effective interest rate path by ½–1 percentage point over 2016–21 from the previous debt sustainability analysis (IMF Country Report No. 16/150, Annex III), worsening the debt dynamics. As a result, interest payments are about ½ percentage point of GDP higher than previously projected, and the primary surplus that is compatible with the authorities' medium-term fiscal target—an overall deficit of 3.5 percent of GDP by 2020—has become 1½ percent of GDP in 2020, ½ percent of GDP higher than previously projected. Publicly guaranteed debt is projected to remain broadly unchanged at the 2015 level in nominal terms. External debt projections are based on a stable path of the projected current account deficit at around 2 percent of GDP over 2016–21, and incorporate planned purchases under the Fund's Extended Arrangement and disbursements of program loans by multilateral and bilateral creditors.

B. Public Debt Sustainability

4. Fiscal consolidation envisaged under the EFF-supported program would steadily reduce public debt. The consolidation path envisaged under the program scenario is projected to bring down the ratio of public debt to GDP steadily from 80.4 percent in 2015 to 70.1 percent in 2021. It will reduce the debt to GDP ratio by about 2–3 percent annually from 2018 onwards,

supported by favorable debt dynamics with a negative interest-rate-and-growth differential. Gross financing needs are projected to decrease from 17.6 percent of GDP in 2016 to 12 percent of GDP in 2021.

5. Nevertheless, there are significant downside risks to the program scenario. If fiscal consolidation stalls and primary balance remains unchanged at the 2016 level (-0.8 percent of GDP), the reduction in the debt-to-GDP ratio over 2015–21 would be only 1½ percentage points, much lower than in the program scenario (10 percentage points). Debt reductions would become less significant under individual shock scenarios on primary balance (lower primary surplus by 0.4 percentage points of GDP for 2017–18), GDP growth (2 percentage points lower than in the program scenario for 2017–18), the exchange rate (15 percent real depreciation in 2017 vis-à-vis the program scenario), and the interest rate (an increase by 300 basis points for new borrowings during 2017–20 vis-à-vis the program scenario). When these shocks are combined, the debt to GDP ratio would reach 86 percent in 2021. Similarly, in a contingent liability shock scenario (the central government becomes liable for additional debt of 10 percent of GDP in 2017), the debt to GDP ratio would reach 83 percent of GDP in 2021. In the combined shock scenario and the contingent liability shock scenario, gross funding needs would remain elevated at 15–16 percent of GDP in 2021.

6. Heat map analysis indicates a high risk to debt sustainability. The debt burden benchmark of 70 percent of GDP and gross financing need benchmark of 15 percent of GDP are exceeded in the program and the shock scenarios during the projection period, reflecting the initial conditions (under the program scenario, the debt to GDP ratio and gross financing needs as a percent of GDP were 81 percent and 18 percent in 2016, respectively). Debt profile analysis indicates moderate degree of vulnerabilities related to market perception, external financing requirement, debt held by non-residents, and debt denominated in foreign currency.

C. External Debt Sustainability

7. The ratio of external debt to GDP is projected to gradually decline over the medium term. Under the program scenario, external debt is projected to decrease by 6 percentage points of GDP to 49 percent in 2021. The decline is driven by robust GDP growth, gradual current account adjustments, and subdued FDI loans and other debt-creating private capital inflows.

8. Nevertheless, vulnerabilities linked to inadequate reserve coverage, exchange rate depreciation, and deleveraging could pose a risk for debt servicing. Currency risk, notably related to the dollar, is high. Large rupee depreciation could pose a significant risk, if sustained; as stress tests show that a 30 percent real depreciation would raise the external debt to GDP ratio to about 72 percent. In the short run, tighter global liquidity and shifts in investor confidence could raise rollover vulnerabilities and costs. Although rollover risks are generally low due to the high share of medium- to long-term debt, there are lumpy repayments starting in 2019, and external financing at non concessional terms gradually substitutes concessional financing, pointing to a need to build up buffers. Lower than expected GDP or export growth would also deteriorate debt dynamics.

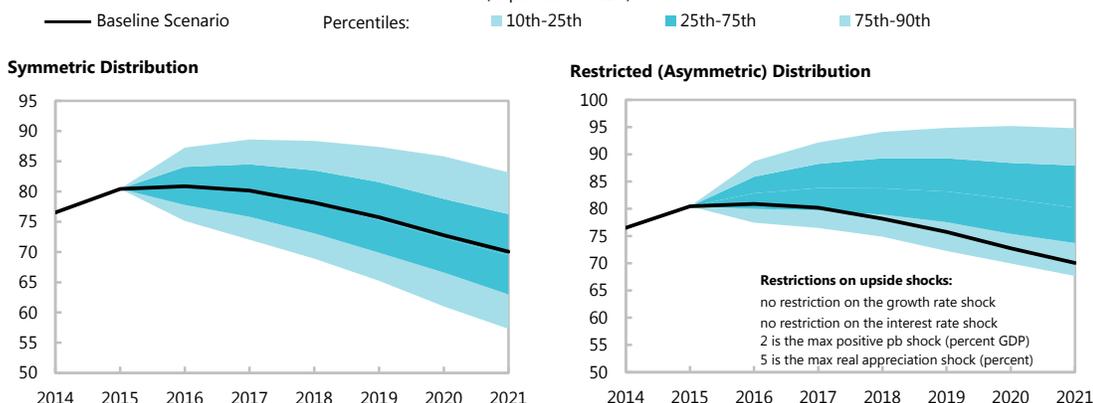
Sri Lanka Public DSA Risk Assessment

Heat Map

Debt level ^{1/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs ^{2/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile ^{3/}	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

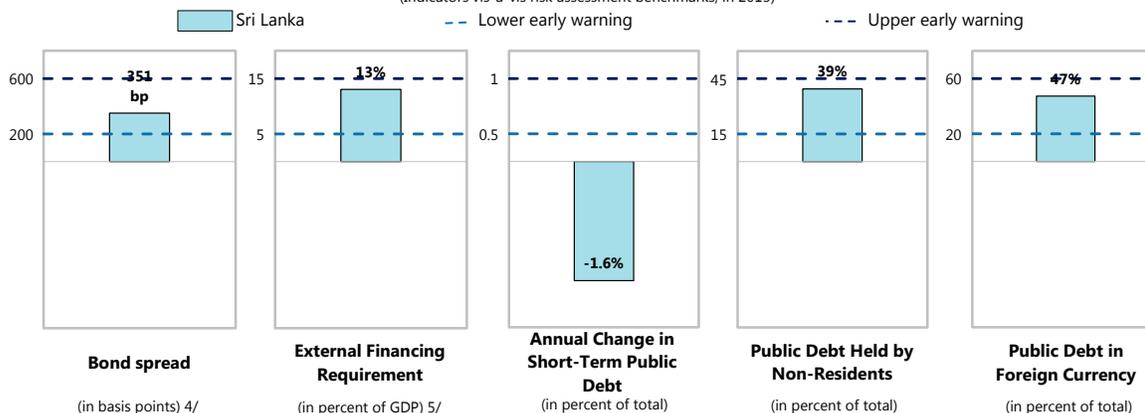
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

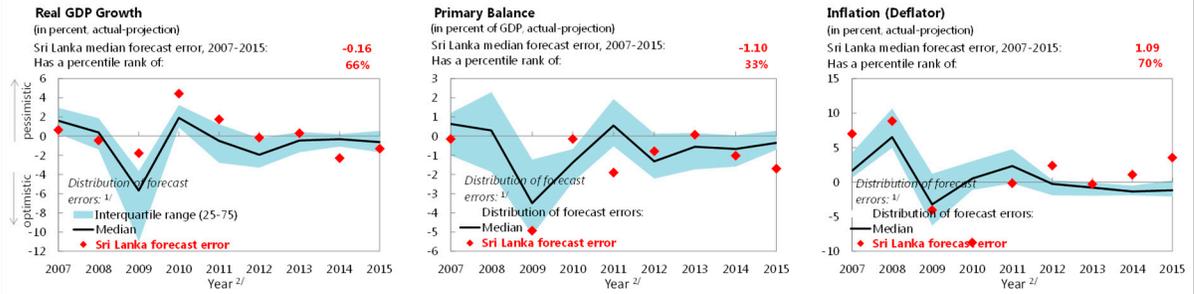
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 20-Jul-16 through 18-Oct-16.

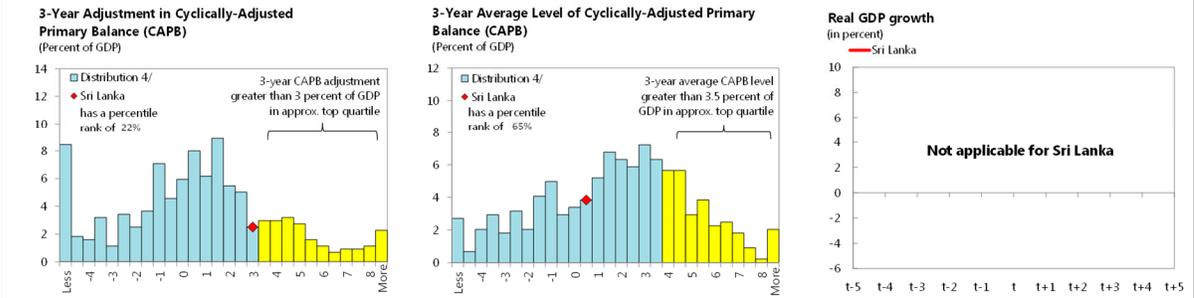
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Sri Lanka Public DSA - Realism of Baseline Scenario Assumptions

Forecast Track Record, versus program countries



Assessing the Realism of Projected Fiscal Adjustment



Source : IMF Staff.
1/ Plotted distribution includes program countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Sri Lanka, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Sri Lanka Public Sector Debt Sustainability Analysis (DSA)

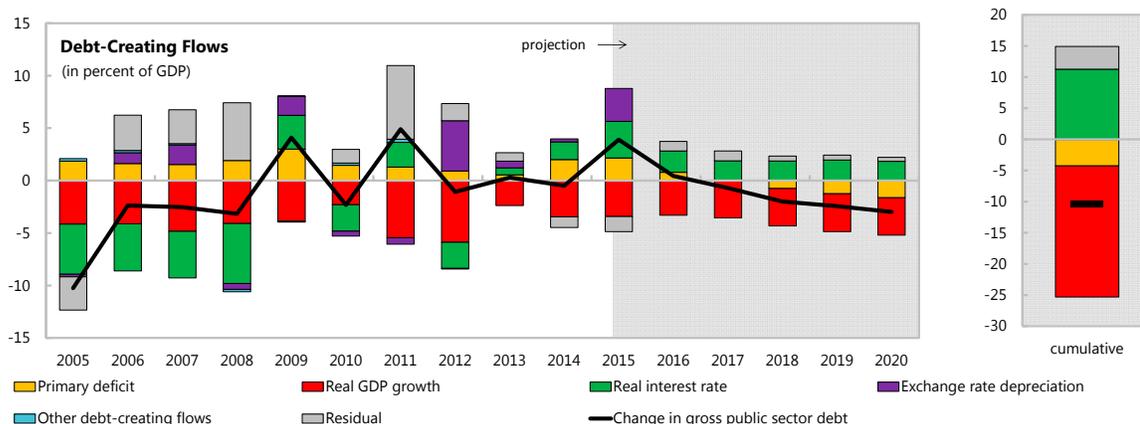
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of October 18, 2016		
	2005-2013 ^{2/}	2014	2015	2016	2017	2018	2019	2020	2021			
Nominal gross public debt	75.7	76.5	80.4	80.9	80.2	78.2	75.7	72.8	70.1	Sovereign Spreads ^{3/}	399.3	
o/w: guarantees and Fund credit outstanding	2.5	5.8	4.4	3.8	3.7	3.9	3.9	3.5	3.1	EMBIG (bp) ^{3/}	356	
Public gross financing needs	21.5	24.2	20.7	17.6	17.0	16.6	15.4	12.8	12.0	5Y CDS (bp)	n.a.	
Real GDP growth (in percent)	6.3	4.9	4.8	4.5	4.8	4.9	5.1	5.2	5.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	9.9	3.9	2.1	4.2	4.6	5.0	5.0	5.0	5.0	Moody's	B1	B1
Nominal GDP growth (in percent)	16.8	8.9	7.0	8.8	9.7	10.2	10.4	10.5	10.6	S&Ps	B+	B+
Effective interest rate (in percent) ^{4/}	7.4	6.4	7.1	7.1	7.4	7.8	8.0	8.0	7.8	Fitch	B+	B+

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021		
Change in gross public sector debt	-1.4	-0.5	3.9	0.4	-0.7	-2.0	-2.4	-3.0	-2.7	-10.4	
Identified debt-creating flows	-3.6	0.5	5.4	-0.5	-1.6	-2.5	-2.9	-3.4	-3.2	-14.0	
Primary deficit	1.6	2.0	2.2	0.8	0.0	-0.8	-1.2	-1.6	-1.4	-4.2	
Primary (noninterest) revenue and grants	13.5	11.5	13.1	13.1	13.9	15.2	15.8	16.3	16.1	90.5	
Primary (noninterest) expenditure	15.1	13.5	15.2	13.9	14.0	14.4	14.5	14.7	14.7	86.2	
Automatic debt dynamics ^{5/}	-5.2	-1.5	3.2	-1.3	-1.7	-1.7	-1.6	-1.7	-1.8	-9.8	
Interest rate/growth differential ^{6/}	-6.1	-1.8	0.1	-1.3	-1.7	-1.7	-1.6	-1.7	-1.8	-9.8	
Of which: real interest rate	-2.0	1.7	3.5	2.0	1.9	1.9	2.0	1.8	1.7	11.3	
Of which: real GDP growth	-4.1	-3.4	-3.4	-3.3	-3.5	-3.6	-3.6	-3.6	-3.5	-21.1	
Exchange rate depreciation ^{7/}	0.9	0.3	3.1	...	...	...	...	...	...	...
Other identified debt-creating flows	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits (negative)	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	2.2	-1.0	-1.5	0.9	0.9	0.5	0.5	0.4	0.5	3.7	



Source: IMF staff.

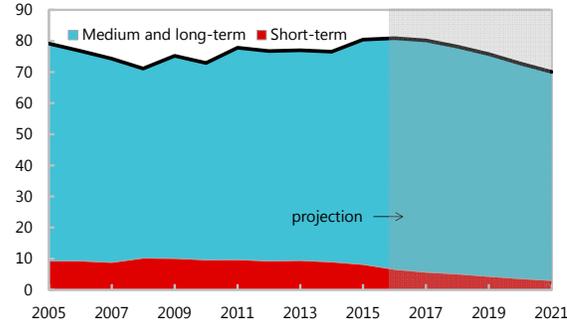
^{1/} Public sector is defined as central government and includes public guarantees, defined as outstanding amount of loans guaranteed by the central government and Fund credit outstanding.^{2/} Based on available data.^{3/} Long-term bond spread over U.S. bonds.^{4/} Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.^{5/} Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).^{6/} The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.^{7/} The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.^{8/} Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.^{9/} Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Sri Lanka Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

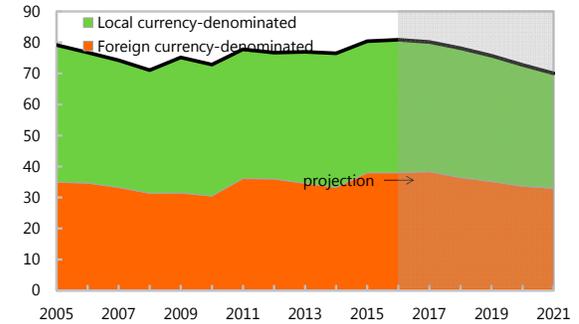
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



Alternative Scenarios

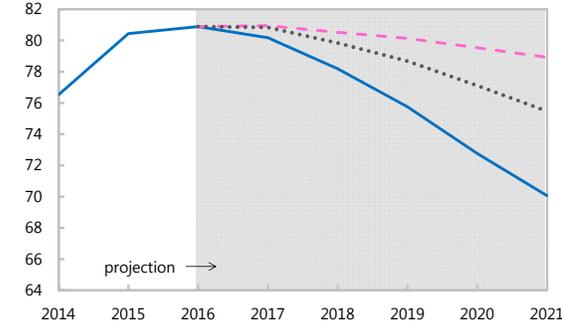
— Baseline

..... Historical

- - - Constant Primary Balance

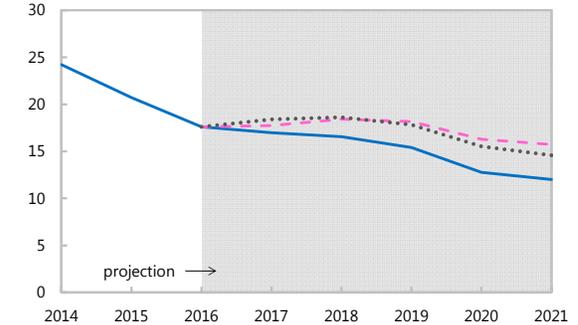
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario

	2016	2017	2018	2019	2020	2021
Real GDP growth	4.5	4.8	4.9	5.1	5.2	5.3
Inflation	4.2	4.6	5.0	5.0	5.0	5.0
Primary Balance	-0.8	0.0	0.8	1.2	1.6	1.4
Effective interest rate	7.1	7.4	7.8	8.0	8.0	7.8

Constant Primary Balance Scenario

Real GDP growth	4.5	4.8	4.9	5.1	5.2	5.3
Inflation	4.2	4.6	5.0	5.0	5.0	5.0
Primary Balance	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Effective interest rate	7.1	7.4	7.9	8.1	8.0	7.8

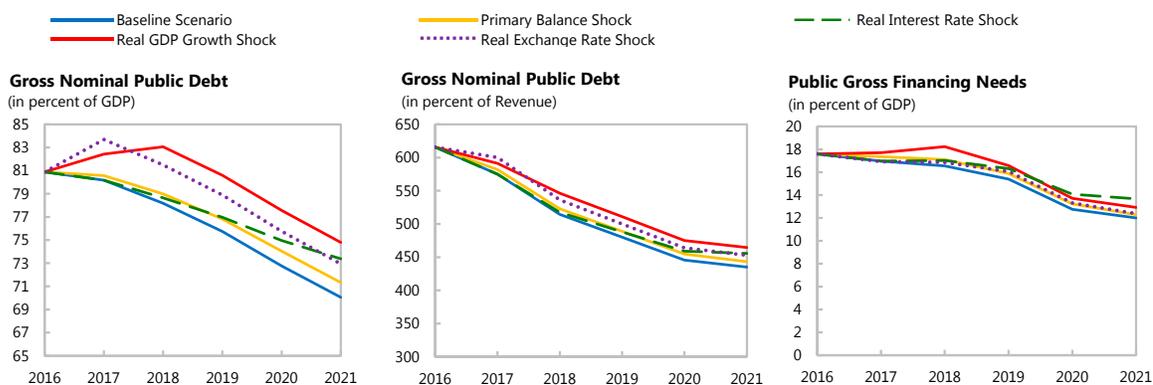
Historical Scenario

	2016	2017	2018	2019	2020	2021
Real GDP growth	4.5	6.1	6.1	6.1	6.1	6.1
Inflation	4.2	4.6	5.0	5.0	5.0	5.0
Primary Balance	-0.8	-1.6	-1.6	-1.6	-1.6	-1.6
Effective interest rate	7.1	7.4	7.1	6.7	6.2	5.7

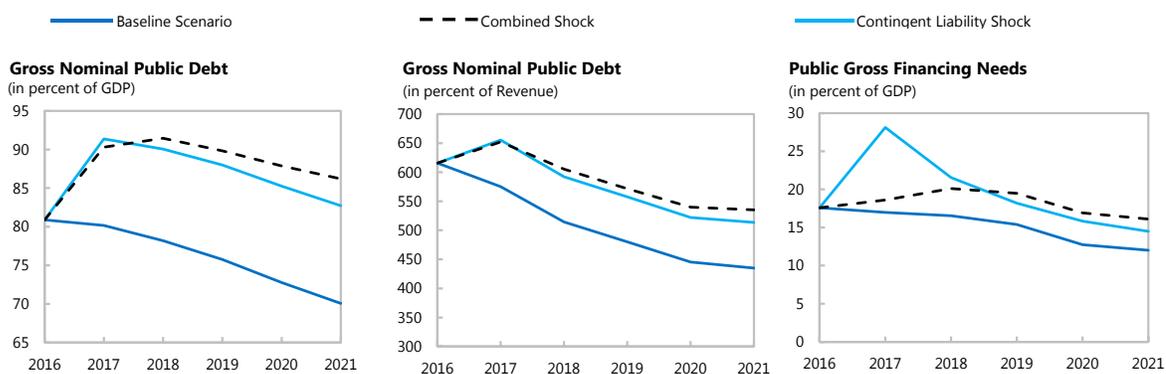
Source: IMF staff.

Sri Lanka Public DSA - Stress Tests

Macro-Fiscal Stress Tests



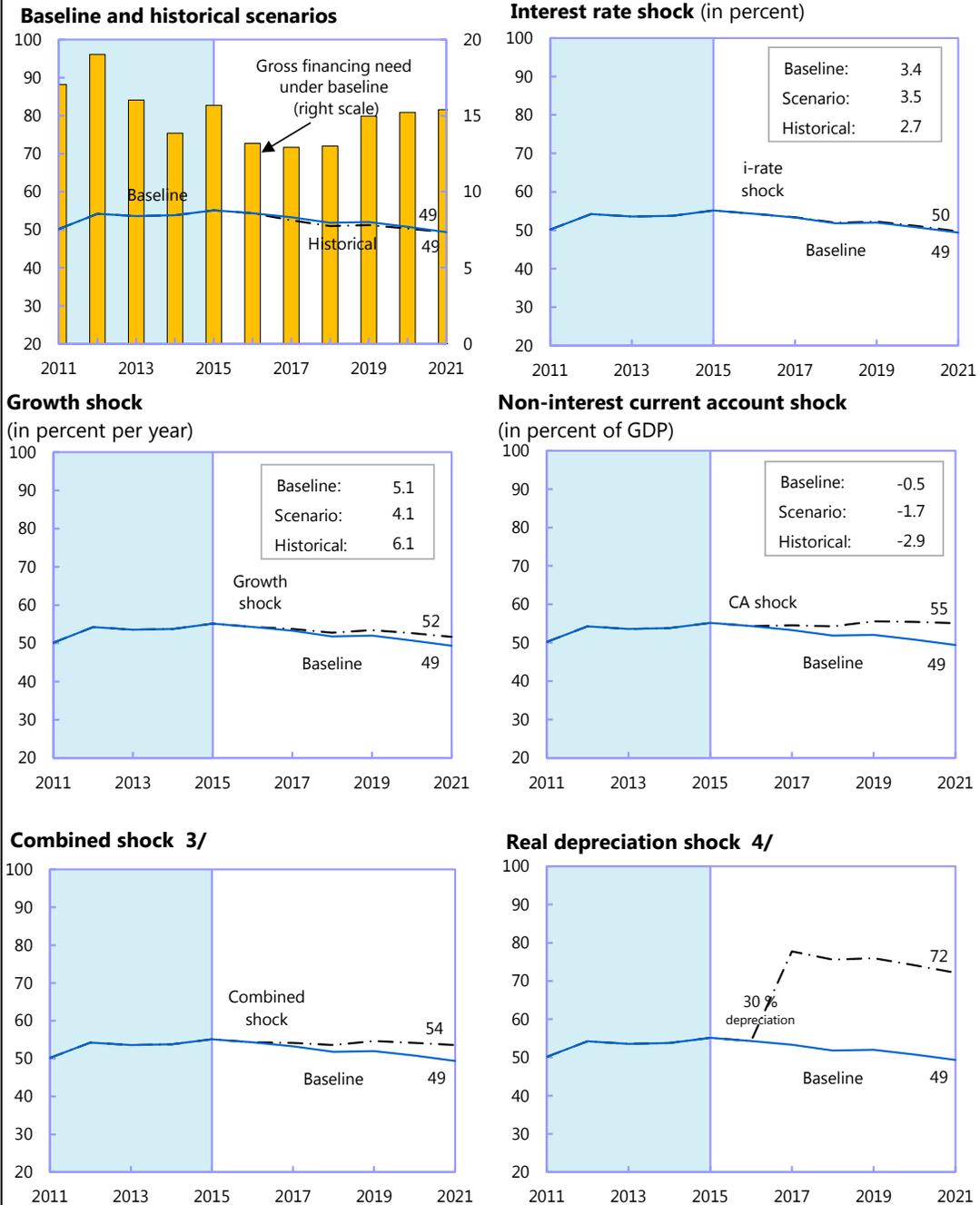
Additional Stress Tests

Underlying Assumptions
(in percent)

	2016	2017	2018	2019	2020	2021
Primary Balance Shock						
Real GDP growth	4.5	4.8	4.9	5.1	5.2	5.3
Inflation	4.2	4.6	5.0	5.0	5.0	5.0
Primary balance	-0.8	-0.4	0.4	1.0	1.4	1.4
Effective interest rate	7.1	7.4	7.9	8.1	8.0	7.9
Real Interest Rate Shock						
Real GDP growth	4.5	4.8	4.9	5.1	5.2	5.3
Inflation	4.2	4.6	5.0	5.0	5.0	5.0
Primary balance	-0.8	0.0	0.8	1.2	1.6	1.4
Effective interest rate	7.1	7.4	8.5	9.1	9.5	9.6
Combined Shock						
Real GDP growth	4.5	2.8	2.9	5.1	5.2	5.3
Inflation	4.2	4.2	4.5	5.0	5.0	5.0
Primary balance	-0.8	-0.5	0.0	1.0	1.4	1.4
Effective interest rate	7.1	7.8	8.2	8.9	9.3	9.4
Real GDP Growth Shock						
Real GDP growth	4.5	2.8	2.9	5.1	5.2	5.3
Inflation	4.2	4.2	4.5	5.0	5.0	5.0
Primary balance	-0.8	-0.4	0.1	1.2	1.6	1.4
Effective interest rate	7.1	7.4	7.9	8.1	8.0	7.9
Real Exchange Rate Shock						
Real GDP growth	4.5	4.8	4.9	5.1	5.2	5.3
Inflation	4.2	9.8	5.0	5.0	5.0	5.0
Primary balance	-0.8	0.0	0.8	1.2	1.6	1.4
Effective interest rate	7.1	7.8	7.6	7.8	7.8	7.7

Source: IMF staff.

Sri Lanka: External Debt Sustainability: Bound Tests 1/2/ (External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
 4/ One-time real depreciation of 30 percent occurs in 2017.

Sri Lanka: External Debt Sustainability Framework, 2011-2021
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -3.3	
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021		
1 Baseline: External debt	50.2	54.2	53.6	53.8	55.1	54.3	53.3	51.8	52.0	50.8	49.4		
2 Change in external debt	6.4	4.0	-0.6	0.2	1.3	-0.8	-1.0	-1.5	0.2	-1.2	-1.4		
3 Identified external debt-creating flows (4+8+9)	0.0	1.3	-2.5	-2.5	0.8	-1.0	-1.2	-1.4	-1.4	-1.6	-1.6		
4 Current account deficit, excluding interest payments	6.0	4.5	2.0	1.0	1.0	0.5	0.6	0.5	0.4	0.3	0.4		
5 Deficit in balance of goods and services	13.2	11.9	8.6	8.0	7.5	6.8	6.9	6.5	6.1	5.7	5.4		
6 Exports	20.9	19.8	20.3	20.9	20.8	21.3	21.1	21.0	20.8	20.4	20.1		
7 Imports	34.1	31.7	28.9	28.9	28.3	28.1	28.0	27.5	26.9	26.2	25.4		
8 Net non-debt creating capital inflows (negative)	-1.4	-1.7	-1.5	-1.3	-0.7	-0.7	-0.9	-1.1	-1.0	-1.1	-1.2		
9 Automatic debt dynamics 1/	-4.6	-1.5	-3.0	-2.3	0.5	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8		
10 Contribution from nominal interest rate	1.1	1.3	1.4	1.4	1.5	1.6	1.6	1.6	1.7	1.7	1.6		
11 Contribution from real GDP growth	-3.2	-4.4	-1.7	-2.4	-2.5	-2.4	-2.5	-2.4	-2.4	-2.5	-2.5		
12 Contribution from price and exchange rate changes 2/	-2.5	1.6	-2.7	-1.3	1.5	...	...	...	...	...	...
13 Residual, incl. change in gross foreign assets (2-3) 3/	6.4	2.7	1.9	2.7	0.6	0.2	0.2	-0.1	1.6	0.4	0.2		
External debt-to-exports ratio (in percent)	240.0	273.3	264.6	257.1	265.0	255.3	253.1	246.3	250.5	248.3	246.1		
Gross external financing need (in billions of US dollars) 4/	11.1	13.0	11.9	11.1	12.7	10.9	11.4	12.3	15.3	16.8	18.4		
in percent of GDP	17.0	19.0	16.0	13.8	15.7	10-Year	10-Year	13.2	12.9	13.0	15.0	15.2	15.4
Scenario with key variables at their historical averages 5/						54.3	52.5	50.9	51.2	50.3	49.3	-5.2	
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						
Real GDP growth (in percent)	8.4	9.1	3.4	4.9	4.8	6.1	2.0	4.5	4.8	4.9	5.1	5.2	5.3
GDP deflator in US dollars (change in percent)	6.2	-4.0	5.3	2.4	-3.1	5.1	7.2	-2.1	1.3	2.3	2.8	2.8	2.7
Nominal external interest rate (in percent)	2.8	2.7	2.9	2.9	2.8	2.7	0.3	2.9	3.1	3.3	3.5	3.5	3.5
Growth of exports (US dollar terms, in percent)	22.9	-0.5	11.1	11.0	1.0	8.3	10.5	4.6	5.0	7.2	6.7	6.5	6.1
Growth of imports (US dollar terms, in percent)	46.2	-2.4	-1.0	7.6	-0.6	10.3	19.9	1.5	5.6	5.6	5.6	5.1	5.1
Current account balance, excluding interest payments	-6.0	-4.5	-2.0	-1.0	-1.0	-2.9	2.5	-0.5	-0.6	-0.5	-0.4	-0.3	-0.4
Net non-debt creating capital inflows	1.4	1.7	1.5	1.3	0.7	1.2	0.4	0.7	0.9	1.1	1.0	1.1	1.2

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex II. Tax Policy Options

The authorities have committed to a primary balance target for 2017 underpinned by a well-crafted and high-quality tax policy package in the upcoming budget (LOI). To aid the process of generating a tax policy package, staff presented a set of policy options that have the potential to generate around 1.4 percent of GDP in revenue (see table below).

- Options for increasing corporate income tax (CIT) include taxing profit that is currently exempt from tax at the standard rate (28 percent), eliminating sector-specific reduced rates, removing qualifying payments, and taxing remittances at the standard rate of 28 percent rather than the current rate of 10 percent. The extent to which existing exemptions and reduced rates are grandfathered will impact the potential revenue yield from removing them.
- There is scope to raise revenue from financial income by taxing interest at a uniform 10 percent rather than allowing a reduced rate (currently 2.5 percent) on interest income accrued to individuals. The introduction of a new Capital Gains Tax, expected by April 1, 2017 should also generate revenue.
- Although not yet quantified owing to data limitations, revenues could also be boosted by personal income tax reforms, including rationalizing deductions and the rate structure, as well as expanding the coverage for withholding tax on labor income.

Sri Lanka: Income Tax Reform Options for 2017 Budget		
(In percent of GDP, on an annual basis)		
	Tax collection in 2015	Potential Revenue yield 1/
Corporate income tax	1.50	0.96
Tax exempt profits at standard rate of 28 percent	...	0.52
Eliminate reduced rates and tax at standard rate	...	0.36
Eliminate qualifying payments	...	0.06
Tax remittances at standard rate	...	0.02
Personal income tax	0.34	...
Rationalize tax rate structure	...	...
Rationalize tax deductions	...	...
Expand coverage of withholding tax on labor income	...	...
Financial income tax	0.56	0.24
Introduce uniform withholding tax rate for interest income	...	0.24
Implement capital gains tax	...	...

1/ Revenue yield is estimated from FY2014/15 tax return data. This would be an underestimate to the extent that the database does not cover firms that did not file tax returns. On the other hand, arrangements to grandfather existing preferential tax treatment would result in lower revenue yield.

Appendix I. Letter of Intent

Colombo, November 3, 2016

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

Dear Ms. Lagarde:

This letter serves as a supplement to our Letter of Intent dated May 12, 2016 and the associated Memorandum of Economic and Financial Policies (MEFP).

1. The Sri Lankan economy is showing signs of stabilizing. Since June, sovereign spreads have fallen and the exchange rate has stabilized, reflecting improved market confidence. Real GDP growth surprisingly slowed in the second quarter, not least due to floods, but is expected to rebound in the second half of the year. Headline inflation is expected to remain broadly stable around 5 percent for the remainder of the year.
2. Program performance has been broadly on track. All end-June 2016 quantitative targets have been met. The Central Bank of Sri Lanka (CBSL) has appropriately tightened monetary policy stance by way of raising policy interest rates in two occasions, while adjusting the statutory reserve ratio to absorb a part of excess liquidity. Fiscal policy remained on track, thanks to improvement in tax revenue. Overall, the policy adjustment has contributed to improving market confidence and thereby easing pressures on external balances.
3. We expect the 2016 fiscal targets on tax revenues and the primary balance to be met. Since the Supreme Court's suspension of the VAT amendments in July, the government has reinstated the amendments, with an amendment bill approved by the Cabinet in September and by the Parliament in October, to become effective on November 1. Revenue losses are being compensated by stronger-than-envisaged collection of income taxes and import duties as well as rationalization on goods and services spending and public investment. While the primary deficit will be contained to less than Rs 97 billion (0.8 percent of GDP) in 2016 as originally planned, a larger-than-envisaged interest bill will raise the overall deficit to around Rs 700 billion (5.7 percent of GDP).
4. We remain committed to the medium-term fiscal consolidation plan, which envisages an overall deficit of 3.5 percent of GDP by 2020. Fiscal consolidation will be achieved mainly through revenue measures to broaden the tax base and improve the efficiency of collection. As envisaged in the program, the 2017 budget will accordingly target a primary balance, underpinned by a well-crafted and high-quality tax policy package. The appropriation bill for the 2017 budget that is in line with the program target was gazetted in early October, to be submitted to the

parliament in due course. The tax policy package will be announced in the upcoming budget speech to the parliament in November. The new Inland Revenue Act is being drafted for parliamentary submission in March 2017, with a view to widening the tax net and creating a transparent legislation on par with international best practices.

5. We will continue to make progress on our ambitious structural reform agenda. While structural benchmarks for July and September have been delayed, preparatory work is well underway and we have reset their target completion dates to December 2016. Regarding the establishment of a commitment record and control system, we plan to modify our existing public financial management system (CIGAS) by end-December to handle commitment management for capital expenditures at the six largest ministries, departments and agencies (MDAs) and use this system to establish quarterly expenditure commitment ceilings for 2017. The adoption of key performance indicators (KPIs) on the number of risk-based VAT audits and the VAT compliance strategy will be completed by end-December, as will the submission and approval from Cabinet of a resolution strategy for Sri Lankan Airlines.

6. Regarding structural benchmarks to be implemented by the end of the year, we are on track to include a tax expenditure statement and the fiscal cost of non-commercial obligations for state-owned enterprises (SOEs) as part of the official government budget, to prepare a strategy to rationalize tax expenditures, to produce statements of corporate intent for the six largest SOEs, and to fully roll out the new revenue administration IT system (RAMIS). Regarding the new public financial management IT system (ITMIS), we expect the rollout of automated commitment control modules to occur simultaneously at the Ministries of Health and Finance in January, rather than staggering them as originally planned. This will delay the rollout for the Ministry of Finance (previously expected in December) but advance it for Ministry of Health (previously expected in April). We also plan to introduce automatic fuel and electricity pricing mechanisms by the end of the year.

7. The CBSL will continue to target keeping inflation in the mid-single digits. While the two rate hikes in 2016 so far have provided adequate monetary tightening, the CBSL will stand ready to adjust policies further if needed.

8. The CBSL has made progress in rebuilding international reserves. Following the sizable drain on reserves due to capital outflows in the first half of 2016, the CBSL raised its net official international reserves (NIR) back to US\$ 5.26 billion in end-August 2016. Going forward, the CBSL aims to keep building reserves through outright purchase of foreign exchange, and improve the quality of its reserve composition. In the same context, the CBSL will gradually wind down the stock of foreign exchange (FX) swaps with commercial banks by only partially rolling over maturing swaps. This policy is consistent with our medium-term plan to put in place a flexible inflation targeting framework and transition to a more market-oriented exchange rate policy. In this light, we have made the corresponding amendments to the TMU: (i) introduce a new "program NIR" that excludes foreign exchange swaps with commercial banks from the reserve asset, and adopt targeted improvements in the program NIR as the quantitative performance

criterion on international reserves going forward; (ii) remove the adjuster on net capital flows into treasury bills and bonds, while keeping in place the adjuster to account for net government borrowings in Sri Lankan Development Bonds from both residents and non-residents; and (iii) add a framework to wind down the CBSL's outstanding liabilities in foreign exchange swaps with domestic commercial banks.

9. Beyond these changes, our policy agenda remains as described in the May 2016 MEFP. Table 1 and Technical Memorandum Understanding attached to this letter set out the quantitative targets through 2017. Table 2 attached to this letter sets out a proposed prior action for approval of the First Review and amended target dates for several delayed structural benchmarks. We request that the second purchase be made available a few days before November 20, the original availability date. The second and third reviews under this arrangement are expected to be completed on or after April 20, 2017, and November 20, 2017, respectively.

10. We believe that the policies set forth in this and previous Letters of Intent are adequate to achieve the objectives of our economic program, but the Government stands ready to take additional measures as appropriate to ensure achievement of its objectives. We will continue to consult in advance with Fund staff on adoptions of measures or revisions of the policies contained in the MEFP and in this letter, in accordance with the Fund's policies on such consultations. We will provide the Fund with the information it requests for monitoring program implementation.

11. Against the background of our performance to date and our strong commitment going forward, we request completion of the First Review of the Extended Arrangement under the EFF, following which we intend to draw one tranche amounting to SDR 119.894 million.

12. 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/

Indrajit Coomaraswamy
Governor
Central Bank of Sri Lanka

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

	2015		2016						2017				
	Dec.	Mar.	Jun.		Sep. 1/		Dec.	Mar. 1/	Jun.	Sep. 1/	Dec. 1/		
	Act.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Prog.	Prog.	Prog.	
Quantitative performance criteria													
Central government primary balance (floor, cumulative from the beginning of the year, in billion rupees)	-241	-26	-46	-46	-39	-85	-85	...	-97	-5	-8	-4	-3
Net official international reserves (CBSL's conventional definition, floor, cumulative change from the beginning of the year, in million US\$) 2/ 3/ 4/ 5/	-1,489	-720	390	-1,297	-1,186	330	675	249	...	...	...	...	...
Program net official international reserves (floor, cumulative change from the beginning of the year, in million US\$) 2/ 3/ 4/ 5/	...	...	...	...	...	...	...	...	262	1,161	1,125	769	958
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	0	0	0	0	0	0	0
Monetary policy consultation clause 6/													
Year-on-year inflation in Colombo Consumers Price Index (in percent) 6/													
Outer band (upper limit)	...	...	6.4	6.4	...	7.5	7.5	...	7.9	8.2	7.9	8.1	8.1
Inner band (upper limit)	...	...	4.9	4.9	...	6.0	6.0	...	6.4	6.7	6.4	6.6	6.6
Actual / Center point	2.5	1.9	3.4	3.4	4.7	4.5	4.5	4.5	4.9	5.2	4.9	5.1	5.1
Inner band (lower limit)	...	...	1.9	1.9	...	3.0	3.0	...	3.4	3.7	3.4	3.6	3.6
Outer band (lower limit)	...	...	0.4	0.4	...	1.5	1.5	...	1.9	2.2	1.9	2.1	2.1
Indicative targets													
Central government tax revenue (floor, cumulative from the beginning of the year, in billion rupees)	1,356	325	652	652	685	1,021	1,021	...	1,428	383	793	1,230	1,703
Reserve money of the CBSL (ceiling, end of period stock, in billion rupees)	673	792	791	791	757	794	794	794	810	851	899	935	948
Memorandum items:													
Foreign program financing by the central government assumed under the program (cumulative from the beginning of the year, in million US\$) 3/	0	0	0	...	0	200	...	0	325	0	0	0	200
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\$) 3/	1,650	0	2,000	...	0	2,000	...	2,186	2,186	1,500	1,500	1,500	1,500
The cumulative net change in the amount of SLDBs and foreign holdings of Treasury Bills, Treasury Bonds assumed under the program (cumulative from the beginning of the year, in million US\$) 4/	-903	-348	-842	...	-511	-1,124	...	-621	...	...	...	...	...
Net borrowings from Sri Lankan Development Bonds (cumulative from the beginning of the year, in million US\$) 4/	...	...	...	...	...	...	...	...	-669	0	0	0	0
Amortization of official external debt by the central government assumed under the program (cumulative from the beginning of the year, in million US\$) 5/	798	328	475	...	493	713	...	858	1,015	352	586	969	1,217
Net official international reserves (CBSL's conventional definition, end of period stock, in millions of US\$) 2/	5,029	4,309	5,419	...	3,843	5,359	...	5,277	5,490	6,446	6,212	5,819	5,890

1/ Indicative target.

2/ Under the CBSL's conventional definition of net official international reserves (NIR), outstanding liabilities in foreign exchange swaps with domestic commercial banks are not part of the CBSL's foreign liabilities. The Program NIR is measured as the difference between the CBSL's conventional definition of NIR and outstanding liabilities in foreign exchange swaps with domestic commercial banks. See the TMU on details.

3/ If (i) the amount of foreign program financing by the central government and (ii) 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 international reserves will be adjusted upward/downward by the cumulative differences on the test date.

4/ For end-June and end-September 2016, if the cumulative net change in the amount of SLDBs and foreign holdings of Treasury Bills and Treasury Bonds 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. For end-December 2016 and thereafter, if the cumulative net borrowings of the government from SLDBs is higher/lower in U.S. dollar terms than assumed under the program, the floor on net program international reserves will be adjusted upward/downward by the cumulative differences on the test date.

5/ 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 international reserves will be adjusted downward/upward by the cumulative differences on the test date.

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

Table 2. Sri Lanka: Prior Action and Structural Benchmarks

Prior action			Status
Submission of a VAT amendment bill to parliament, following cabinet approval and review by legal draftsmen and broadly in line with staff's recommendations.			Met (October 4, 2016)
Structural Benchmark	Target Completion Date	Status	Proposed Revised Date
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 broadening 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	Not Met Process was delayed due to legislative changes to the VAT Act.	December 2016
Adopt by MOF Inland Revenue Department a VAT compliance strategy that includes a time-bound plan to implement risk-based audit.	September 2016	Not Met Process was delayed due to legislative changes to the VAT Act.	December 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	Not Met Government modifying existing system (CIGAS) to handle commitment management for capital spending at 6 key ministries (Higher Education & Highways; Health, Nutrition and Indigenous Medicine; Agriculture; Finance; Defense; Transport and Civil Aviation)	December 2016
MOF to roll out ITMIS with an automated commitment control module for Ministry of Finance.	December 2016	Rollout for both Health and Finance is expected to take place simultaneously in January.	January 2017
MOF to roll out ITMIS with an automated commitment control module for Ministry of Health.	April 2017	Rollout for both Health and Finance is expected to take place simultaneously in January.	January 2017
State Enterprise Reform			
Cabinet to approve a resolution strategy for Sri Lankan Airlines.	September 2016	Not Met Strategic partner is being sought and expressions of interest have been received but progress is slower than originally envisioned.	December 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,	December 2016		

National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authorities).			
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 I. 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.
2. The quantitative performance criteria and indicative targets specified in Table 1 attached to the Letter of Intent are listed as follows.
 - a) a quantitative performance criterion on central government primary balance (floor);
 - b) a quantitative performance criterion on net official international reserves (floor);
 - c) a continuous quantitative performance criterion on new external payment arrears by the nonfinancial public sector and the CBSL (ceiling);
 - d) a monetary policy consultation clause;
 - e) an indicative target on central government tax revenue (floor); and
 - f) 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).

- a) 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.
- b) 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.
- c) 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).
- d) 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.
- e) 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).
- f) 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. For the purpose of program monitoring, net official international reserves (NIR) will be measured as the difference between (a) and (b) below, and will be called the “Program NIR.” At end-2015, the Program NIR stood at US\$ 2,893.1 million.

a) The CBSL’s conventional definition of the NIR, that is, (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 (including currency swap arrangements with foreign central banks); the use of Fund credit; and Asian Clearing Union debit balance. Commitments to sell foreign exchange to residents arising from derivatives such as futures, forwards, swaps, and options, such as commitments arising from currency swaps with domestic commercial banks, are not included in the gross foreign liabilities. 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, the NIR as per the CBSL’s conventional definition stood at US\$ 5,028.8 million.

b) The CBSL’s outstanding liabilities (i.e., net short positions) in foreign exchange swaps with domestic commercial banks, which stood at US\$ 2,135.7 million at end-December 2015.

8. The framework to wind down outstanding liabilities in foreign exchange swaps with domestic commercial banks will include discontinuing the provision of FX swaps on concessional terms and gradually reducing outstanding net short positions of FX swaps with commercial banks to below 20 percent of gross international reserves.

9. 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 July 1, 2016, as specified in Table 1. Monetary gold will be valued at US\$1,327.90 per troy ounce, which was the price prevailed on July 1, 2016.

Table 1. Sri Lanka: Exchange Rates (Rates as of July 1, 2016)	
Currency	Sri Lankan Rupee per currency unit
U.S. dollar	145.250
British pound	193.705
Japanese yen	1.411
Canadian dollar	112.084
Euro	161.249
Chinese yuan	21.829
SDR	202.763
Source: CBSL and IMF.	

The following adjustment will apply:

10. If (i) the amount of foreign program financing by the central government (ii) the amount of net borrowings from SLDB by the central government, 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 the program NIR will be adjusted upward/downward by the cumulative differences on the test date. These adjustors will apply to the NIR floor for end-December 2016 and thereafter.

11. 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 program 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*. These adjustors will apply to the NIR floor for end-December 2016 and thereafter.

Table 2. Program Assumptions (cumulative from the beginning of the year, in million US\$)					
	Dec. 2016	Mar. 2017	Jun. 2017	Sep. 2017	Dec. 2017
Foreign program financing by the central government	325	0	0	0	200
Net borrowings from Sri Lankan Development Bonds (SLDBs)	-669	0	0	0	0
External commercial loans (including Eurobonds and syndicated loans) by the central government	2,186	1,500	1,500	1,500	1,500
Amortization of official external debt by the central government	1,015	352	586	969	1,217

II. CONTINUOUS PERFORMANCE CRITERIA

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

12. 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 13 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

13. 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 Letter of Intent. For this purpose, the year-on-year inflation for each test date is measured as follows:

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

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-December 2016 or end-June 2017 falls outside the outer bands specified in Table 1 attached to the Letter of Intent, 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 Letter of Intent for the test date of end-December 2016, end-March 2017, end-June 2017, or end-September 2017, 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

14. 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

15. 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:

16. 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.

17. 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

18. 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 dated May 12, 2016, and Letters of Intent. 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.

19. 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
Receivables (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	Memorandum Items -				
	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	Swaps with Commercial Banks		
	Foreign Assets (FA) (with ACU & Without DA)	Domestic Assets (DA) (BOC & PB)																1st Leg (New)	2nd Leg (Maturity)	Outstanding stock (Short position)
	1	2	3	4	5	6	7	8	9	10	11	12	13			14	15	16	17	18
			(1)+(2)				(4)+(5)+(6)	(8) - (10)	(3)+(7)											

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

Statement by the Staff Representative on Sri Lanka
November 14, 2016

The information below has become available following the issuance of the staff report on November 4. It does not alter the thrust of the staff appraisal.

Fiscal performance through end-September. According to preliminary data, the primary balance and tax revenues have outperformed the end-September indicative targets. Over January-September this year, the primary deficit was Rs 35 billion, exceeding the target by Rs 50 billion (0.4 percent of GDP). Tax revenue collection was Rs 46 billion higher than the target, despite the suspension of the VAT amendments during July-October. The revenue outperformance largely came from collections of income tax and import duties.

Budget for 2017. The 2017 budget, presented to parliament on November 10, looks to outperform the programmed quantitative fiscal targets mainly through higher revenue collection than under the program. The budget envisages a primary surplus of 0.4 percent of GDP, higher than the program target of a primary balance. The revenue projection incorporates a full-year effect of the VAT amendments as well as revenue measures that include simplification of the corporate tax structure and base-broadening of financial income taxes. While the revenue target is ambitious compared with the program's revenue floor, it could be achieved if the revenue measures are implemented promptly and the buoyant tax collection so far this year continues in 2017. The risk to the fiscal program from revenue shortfalls is mitigated by the authorities' commitment to adjust spending in line with revenue collection. The budget contains an explicit statement that any revenue shortfalls will warrant the government to realign expenditures with parliamentary approval. The introduction of quarterly expenditure commitment ceilings—a structural benchmark for December 2016—will also facilitate regular monitoring and adjustment. Meeting the ambitious revenue goal will depend on implementing quality revenue measures, including the new Inland Revenue Act scheduled to take effect in April 2017.

Monetary policy and foreign exchange flows. At its meeting on October 31, 2016, the Monetary Board of the Central Bank of Sri Lanka decided to maintain the current monetary policy stance by keeping policy rates unchanged. Headline inflation slightly increased to 4.2 percent in October on a year-on-year basis while core inflation remained unchanged at 4.2 percent. After having picked up during May–September, foreign holdings of government securities declined by about US\$ 200 million in October and through early November. During this period, the rupee depreciated against the US dollar by about $\frac{2}{3}$ percent but remained stable following the U.S. presidential election. Gross international reserves fell from US\$ 6.4 billion in end-September to US\$ 6.1 billion in end-October.

**Statement by Mr. Subir Vithal Gokarn, Executive Director and
Mrs. Swarna Gunaratne, Alternate Executive Director on Sri Lanka
November 18, 2016**

1. On behalf of our Sri Lankan authorities, we thank staff and management for the productive policy dialogue held in Colombo during 13 – 26 September and during the Annual meetings in Washington D.C. in October on the First Review of 3-year Extended Arrangement under the Extended Fund Facility (EFF). Sri Lanka's performance under the program has been strong, with all end June quantitative performance criteria and indicative targets been met. The VAT amendment, a prior action for the program, which was introduced in May was suspended subsequently by the Supreme Court on the procedural grounds. However, it was reinstated with the approval of the Parliament in early October and implemented with effect from 1st November 2016. Meeting the structural benchmarks on VAT compliance strategy that includes a time bound action plan to implement risk-based audit and preparation of key performance indicators on the number of risk based VAT audit have been delayed due to legislative changes to VAT Act. However, these are expected to be met by December 2016. A significant progress has been made on several other structural benchmarks viz. obtain Cabinet approval for a resolution strategy for SriLankan Airlines, establish a commitment record system and quarterly expenditure commitment ceilings for the 2016 and 2017 budgets and roll out the Integrated Treasury Management Information System (ITMIS) with an automated commitment control module for Ministry of Finance (MOF) and Ministry of Health. These are expected to be completed by end December. In sum, our authorities are strongly committed to achieving the program objectives and request completion of the First Review of the Extended Arrangement under the EFF.

Economic Growth and Outlook

2. The Sri Lankan economy achieved moderate growth of 3.9 per cent during the first half of 2016, compared to 4.8 per cent annual growth recorded in 2015. Unemployment remained low at 4.4 per cent. The growth was mainly supported by continuous expansion in services and industrial activities despite the contraction recorded in agricultural activities due to devastating flood during the second quarter. Inflation increased to around 6 per cent during the second quarter due to domestic supply disturbances and the impact of tax adjustments by the government, but declined to 4.2 per cent by end October. The increase in VAT from 11 to 15 per cent and the removal of certain exemptions applicable on VAT and the Nation Building Tax (NBT) with effect from November 2016 are expected to have a one-off impact on inflation. However, in spite of these transitory developments, prudent monetary policy measures and the fiscal policy adjustments are expected to help maintain inflation within the ranges specified in the program's monetary policy consultation clause.

3. The implementation of sound macroeconomic policies by the government consistent with the EFF program is expected to strengthen macroeconomic stability and improve investor confidence, thereby facilitating a notable expansion in economic activities. With the expected recovery in agriculture and continued expansion in services, manufacturing and construction activity, the economy is expected to grow by 5.0-5.5 per cent in 2016 while a further recovery is expected in 2017 to realize the projected growth of 6.3 per cent for 2017.

4. The economic policy statement which was presented to the Parliament by the Hon. Prime Minister in October 2016 was mainly focused on facilitating a private sector led growth strategy through necessary policy reforms. Improving doing business environment and opening up of avenues for export expansion through entering into economic partnership agreements with India, China and Singapore and establishing two development corridors are key areas highlighted in the policy statement. In line with the objectives of the policy statement, strong pro-business policies have been proposed in 2017 budget which was presented to the Parliament on 10th November 2016. These together with the already planned Colombo International Financial City, new opportunities under the Megapolis project and proposed establishment of Special Economic Zones, with the support of foreign investments are expected to facilitate a higher growth momentum of about 7 per cent in the medium term.

Monetary Policy

5. The Central Bank of Sri Lanka (CBSL) having identified the risks of future demand-driven inflationary pressures due to high money and credit growth as well as market excess liquidity conditions, adopted several macro prudential and monetary policy measures since the last quarter of 2015. In terms of macro-prudential measures, cash margin requirements (subsequently removed) and maximum Loan to Value (LTV) ratio were imposed on selected types of lending during the last quarter of 2015. Also, the Central Bank commenced tightening its monetary policy stance by raising Statutory Reserve Requirements by 1.50 percentage points with effect from January 2016. Further, the CBSL's Standing Deposit Facility (SDFR) and Standing Lending Facility Rates (SLFR) were raised in two steps in February and July 2016 by a total of 100 basis points. These policy measures, coupled with decline in market excess liquidity resulted in an increase in short term interest rates immediately and long term market rates gradually.

6. Responding to the tight monetary policy measures and the increase in market interest rates, some moderation in credit growth to around 27 per cent and broad money growth to around 17.3 per cent was observed by end of August 2016. Nevertheless, these are still higher than the desirable levels and a further moderation is expected by end December 2016 or early 2017. The policy measures taken so far are considered adequate given the considerable time lag of policy transmission. The CBSL is closely monitoring any signs of buildup of demand and inflationary pressures and stands ready to take any

further monetary tightening and/or macro prudential measures should it be required. In fact, it has been proposed to limit LTV in the 2017 budget for certain vehicle categories viz: three wheelers 25 per cent, motor cars and vans 50 per cent and commercial vehicles 90 per cent.

7. Our authorities expect to move to a flexible inflation targeting monetary policy framework in the medium term. In this regard, the CBSL and the government have fulfilled a number of prerequisites in the recent past. A comprehensive model for macroeconomic forecasting is being developed by the CBSL with the assistance of the IMF. Also, technical support from the IMF will be obtained to fulfill the remaining institutional and technical prerequisites. Meanwhile, continued flexibility in the exchange rate will be maintained to facilitate the move towards flexible inflation targeting framework.

Fiscal Policy

8. The fiscal sector showed significant improvement during the first nine months of the year. The primary deficit target (PC) under EFF was met comfortably at end June 2016 while the primary balance and the tax revenue have outperformed the end September indicative targets (IT). These developments indicate that end-December targets are within reach. The total government revenue increased with a higher contribution from tax revenue driven by VAT, income taxes, import duties, Port and Airport Development Levy (PAL) and some other import related taxes. Meanwhile, the total expenditure declined compared to 2015, mainly due to decline in capital expenditure. Accordingly, it is expected that the end- December PC on primary deficit of Rs.97 billion (-0.8 per cent of GDP) will be met. Our authorities believe that these favorable developments, would help to maintain the overall fiscal deficit of around 5.4 per cent of GDP as envisaged in the program. Meanwhile, public debt to GDP ratio is expected to be around 76 per cent in 2016.

9. The theme of the 2017 national budget which was presented to the Parliament on 10th November is “Accelerating growth with Social Inclusion”. To achieve this objective, the budget proposals focus on creating a conducive environment for promoting exports, developing labor skills and productivity, improving digitalization across the country, improving basic requirements for people such as land, housing, education and health, de-bureaucratization of public services and uplifting living standards of the people consistent with the UN Sustainable Development Goals (SDGs) 2030.

10. The 2017 budget is well within the program targets of achieving primary fiscal balance (PC) and reducing the overall fiscal deficit further to 4.6 per cent. In achieving these targets, the total revenue is expected to rise to 15.5 per cent of GDP in 2017 from 13.4 per cent in 2016 and the total expenditure is expected to be maintained at 20 per cent of GDP compared to 19 per cent in 2016. The realization of the revenue target is not

without risks, given the challenging domestic and external environments, and therefore our authorities will present the quarterly expenditure and income outcomes to the Parliament within a month after any quarter. This would be achievable under the Integrated Treasury Management Information System (ITMIS) which is being set up at the MOF to automate the key departments of MOF. For any revenue shortfall, expenditure will be realigned ensuring our authorities' strong commitment to achieve the envisaged fiscal consolidation path to reduce the overall budget deficit to 3.5 per cent of GDP and public debt to GDP ratio to 65 per cent by 2020.

11. Several major changes have been proposed in 2017 budget to simplify the tax structure and to put in place a more efficient and equitable tax system. For corporates, a three tier tax structure of 14 per cent, 28 per cent and 40 per cent has been proposed and the standard rate will be 28 per cent. The exemptions applicable on the income from the investment on listed securities, dividends, unit trusts and other instruments and the notional tax credit applicable on the secondary market transactions will be removed. Also, a Capital Gains Tax of 10 per cent will be imposed while Withholding Tax on interest income will be increased to 5 per cent from the current rate of 2.5 per cent. It has also been proposed to remove Cess on 100 items. Meanwhile, the income tax structure for individuals will be revised with a progressive rate structure with a maximum tax rate of 24 per cent. These measures, together with number of other tax revisions, are expected to support to meet the projected revenue target. Also, in complying with a program requirement, a tax expenditure statement has been provided in the budget and it indicates that the total tax expenditure will be around 1.6 per cent of GDP under the proposed tax structure. A time bound strategy to reduce tax expenditure will be completed by end 2016.

12. With respect to tax administration reforms, re-drafting of the Inland Revenue Act with the technical assistance from the IMF has made a significant progress and will be completed in 2017 incorporating policies for higher compliance and broadening the tax base. It has been proposed in the budget to decentralize the Inland Revenue Department (IRD) for the tax payers' convenience, while a revenue monitoring unit will be established in the General Treasury of MOF. Also, steps will be taken to consolidate the VAT Act incorporating amendments up to date for the convenience of the users. The automation of the revenue agencies under the Revenue Administration Management Information System (RAMIS) at IRD will be fully implemented by end of 2016.

13. Measures are being taken to reduce losses of State Owned Enterprises (SOEs) and improve their balance sheets through a credible restructuring process. A strategic partner for Sri Lankan Airlines is being sought from expressions of interest already received and the process is expected to be completed by end 2016. For the six largest SOEs, statements of corporate intent will be signed by MOF, line ministries and SOEs and will be published by end 2016. Also, the financial position of Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) has been improved significantly and further improvements are expected with the introduction of cost reflective pricing mechanisms.

External Sector Policies

14. The weak recovery of the global economy and the resultant lower global demand for exports, slowdown in remittances, tepid foreign direct investments, and a steady outflow of capital from the government securities market gave rise to an imbalance in the country's external balance, leading to a reduction in official reserves. However, Sri Lanka's entry into a three year EFF with the IMF helped to restore the investor confidence and this, together with the delay in further rate hikes in the USA led to a reversal of the outflows from the government securities market. Accordingly, the CBSL was able to build up foreign reserves through direct foreign exchange purchases from the market and met the end June Net International Reserves (NIR) target comfortably. The foreign exchange purchases, together with the proceeds of the international sovereign bond issue and a syndicated foreign currency loan, helped to improve the gross foreign reserves position to US dollars 6.5 billion, equivalent to 4.1 months of imports by end September 2016.

15. Our authorities observed that the original NIR targets set for September and December were too ambitious as it required a sizable purchases of foreign exchange from the market that could have destabilized the market. Also, as per the recommendations in the recent safeguard assessment report, it was agreed to exclude foreign exchange swaps with commercial banks from reserve assets. Further, our authorities agreed with the staff to gradual wind-down of FX swaps which has an outstanding amount of around US \$2.4 billion. As our authorities observed large fluctuations in foreign investments in government securities market, they requested a removal of the adjuster on net foreign inflows to the government treasury bills and bonds to avoid large swings in the target. By taking into consideration these developments, our authorities requested a more realistic NIR path and accordingly, NIR path has been revised.

16. Nevertheless, there has been a considerable pressure in the FX market due to unexpectedly high capital outflows from the government securities market since the beginning of October given the volatile global economic conditions. This has compelled the CBSL to intervene in the foreign exchange market by supplying foreign exchange. The total net supply of foreign exchange from the beginning of October to 14th November amounted to US dollar 141.5 million. In the meantime, the Rupee depreciated by 2.2 per cent from May to October as the CBSL allowed adequate flexibility to depreciate the exchange rate to improve country's external competitiveness. Our authorities are of the view that the developments in the external sector (especially in the government securities market) after signing of Letter of Intent had posed a significant risk of meeting the end December NIR target.

Financial Sector

17. The financial sector remained stable with higher asset growth in the banking sector and capital and liquidity levels well above the statutory minimum requirements. The total

assets of the banking sector increased by 6.8 per cent, reflecting increased loans and advances during the first eight months of 2016. Asset quality improved with NPL ratio decreasing to a historically low level of 3.0 per cent by end of August from 3.2 per cent at end December 2015, attributed to the better recovery of NPLs and increased loan growth during the period. Meanwhile, the provision coverage ratio increased from 36 per cent to 46.6 per cent on a year on year basis, by end August 2016. The liquid assets to total assets ratio stood at 29 per cent at end August which was well above the minimum statutory requirement of 20 per cent. The bank branch network was expanded further, with new branches being added to the system thereby increasing financial inclusion in the country. Meanwhile, the non-bank financial sector showed a positive momentum in terms of asset growth while preserving asset quality, overall liquidity, capital position and profitability. With respect to a few finance companies which are in financial difficulties, actions are being taken by the government and the CBSL to restructure them through establishment of a Financial Asset Management Company (FAMA).

Technical Assistance

18. Our authorities are grateful to the Fund for its continued support through technical assistance in many areas such as tax administration reforms, public financial management, monetary statistics and macro-economic modeling, national accounts and prices which have been very effective in improving systems, operations and data quality. They expect continued technical assistance by the Fund throughout the EFF which is instrumental in achieving program objectives.

Conclusion

19. Despite the challenging global environment, a significant progress has been achieved in maintaining macroeconomic stability in Sri Lanka since entering into the Fund supported program. Going forward, our authorities are strongly committed to achieving program objectives through implementing appropriate policies in close association with the Fund staff and with the help of their continued technical assistance. Against the background of the progress that has been made to date and our authorities' strong commitment to successful completion of the program, they are requesting completion of the first review under the EFF arrangement.