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Sri Lanka: Use of Fund Resources—Request for Emergency Assistance—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion for Sri Lanka

In the context of the use of Fund resources—request for emergency assistance from Sri Lanka, the following documents have been released and are included in this package:

- the staff report for the use of Fund resources—request for emergency assistance, prepared by a staff team of the IMF, in response to the authorities' request on February 8, 2005. Based on information available at the time of these discussions, the staff report was completed on February 11, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- supplementary information issued on March 2, 2005 updating recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its March 4, 2005 discussion of the staff report that completed the request.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

SRI LANKA

Use of Fund Resources—Request for Emergency Assistance

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Wanda Tseng and Donal Donovan

February 11, 2005

- On December 26, 2004, the world's most powerful earthquake in 40 years triggered massive tsunamis that caused extensive damage to over two thirds of Sri Lanka's coastline resulting in extensive loss of life and a cost of replacing damaged infrastructure estimated at about 7½ percent of GDP.
- The authorities have made a request for a purchase under the Fund's policy on emergency assistance for natural disasters on concessional terms. The request was formalized in a letter dated February 8, 2005. This report is based on discussions held with Mr. Burton and Messrs. Valdivieso and Carter (Senior Resident Representatives) (all APD) during the visit of the First Deputy Managing Director on January 18–20, 2005. The report has been prepared by a staff team comprising Messrs. Rumbaugh, Fernandez, and Lueth (all APD).
- The Executive Board approved in April 2003 three-year PRGF and EFF arrangements for SDR 413.4 million (100 percent of quota), of which SDR 59 million have been disbursed. On January 13, 2005, the Executive Board approved the extension of repayment obligations arising in the remainder of 2005 in the amount of SDR 74.2 million.
- The last Article IV consultation was concluded by the Executive Board on March 5, 2004 (IMF Country Report No. 04/68). At that time, Directors considered the key medium-term challenge as restoring fiscal sustainability, while ensuring adequate resources for priority poverty reduction and post-conflict spending. They stressed that to benefit fully from a positive external environment and donor assistance the authorities would need to make further progress in establishing a political environment that fosters lasting peace and engenders broad-based popular support for their reform efforts.
- Sri Lanka has accepted the obligations of Article VIII, Sections 2, 3, and 4 in March 1994 and maintains an exchange system free of restrictions in making payments and transfers for current international transactions (Annex I).

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Executive Summary

- **The tsunamis of December 26, 2004 caused extensive loss of life and physical damage**. Deaths have been estimated in excess of 30,000 with thousands still missing and hundreds of thousands displaced. The cost of replacing damaged infrastructure is estimated at about $1.5-1.6 billion (7½ percent of GDP).

- **The Sri Lankan authorities have requested a purchase in an amount of SDR 103.35 million under the Fund's policy for emergency assistance related to natural disasters**. In line with Fund policy for PRGF-eligible countries, they have also requested the provision of subsidies to reduce the rate of charge to concessional terms.

- **Reconstruction and rehabilitation will support growth momentum in 2005**. While the main commercial areas in the western part of the country were largely unaffected, extensive damage to the fisheries and tourism sectors will adversely affect GDP growth and more than 200,000 have lost their livelihoods. In response, the authorities have implemented several measures to support activity, including plans for extensive reconstruction and rehabilitation. GDP growth for 2005 is projected to be maintained at 5¼ percent.

- **The fiscal and balance of payments impacts will be significant, but reliance on donor support will help contain any impact on domestic financing of the budget or the international reserve position**. Major export sectors have not been seriously affected. While import needs are projected to increase considerably, these are expected to be financed by grants and concessional loans. The authorities have indicated their intention to take appropriate measures to safeguard macroeconomic stability.

- **Managing demand pressures and ensuring accountability and transparency will be important challenges for the authorities**. While the large reconstruction expenditure planned for 2005 is an appropriate response to the devastation that has been experienced, it will be important to manage demand pressures carefully in view of local capacity constraints. To sustain aid flows over time it will also be crucial to closely monitor the disbursement and use of aid flows to ensure accountability and transparency.

- **Rehabilitation and reconstruction will take at least three years and is deserving of support from the international community**. Accordingly, staff supports the authorities' request under the Fund's policy on emergency assistance for natural disasters.

I. Background

1. **On Sunday morning December 26, 2004, the world's most powerful earthquake in more than 40 years struck deep under the Indian Ocean triggering massive tsunamis that obliterated villages and seaside resorts**. In Sri Lanka, the tsunamis struck a long coastal area stretching over 1,000 kilometers, or two thirds of the coastline. The damage stretches from the north, all along the eastern and southern coasts, to part of the western coast. About 31,000 lives are known to have been lost, 6,000 people are still missing, and hundreds of thousands are homeless. The affected areas had a heavy concentration of the poorer segments of society, including fishermen and small enterprises and service providers in the tourism sector.

2. **Beyond the unquantifiable human cost, preliminary assessments place the cost of replacing damaged infrastructure at $1.5–1.6 billion (7½ percent of GDP)**. Overall damage is estimated to be around $1 billion (4½ percent of GDP), but needed upgrades will increase the cost of reconstruction. Extensive damage has been inflicted on fishery harbors and boats, highways and access roads, railways, sanitary facilities, telecommunication networks, schools, private commercial buildings and community resources. Immediate efforts have focused on rescue operations and the humanitarian needs of the survivors. While rehabilitation and reconstruction of the damaged areas will take at least three years, the government intends to make effective use of available and forthcoming donor resources to undertake a significant portion of this work in 2005.[1]

Estimated Reconstruction Costs

Sector	Cost (In millions of U.S. dollars)
Housing	437-487
Roads	200
Water supply and sanitation	117
Railways	130
Education	45
Health	84
Agriculture	4
Fisheries	118
Tourism	130
Power	67-77
Other (private assets, etc.)	168-208
Total (US$ millions)	1,500-1,600

Sources: "Sri Lanka 2005 Post-Tsunami Recovery Program: Preliminary Damage and Needs Assessment" by the AsDB, JBIC and the World Bank, January 2005.

3. **In the attached letter to the Managing Director** dated February 8, 2005 (Attachment I), the Sri Lankan authorities request a purchase in an amount of SDR 103.35 million (25 percent of quota) under the Fund's policy for emergency assistance related to natural disasters. This purchase would support the authorities' international reserve position in the face of the sharp rise in disaster-related imports. The letter sets out the authorities' policy responses to the tsunami and macroeconomic objectives for the period ahead. In line with Fund policy on providing emergency assistance for natural

[1] A preliminary damage and needs assessment was undertaken by the Asian Development Bank, the Japan Bank of International Cooperation (JBIC), and the World Bank. The assessment is expected to be finalized in April 2005.

disasters to PRGF-eligible countries, the authorities have requested the provision of subsidies to reduce the rate of charge on these resources to concessional terms.

4. **The three-year arrangements under the PRGF/EFF facilities, amounting to $567 million for Sri Lanka, were approved in April 2003**. Only the first disbursements, upon approval, have taken place thus far. The first reviews of the program were initially delayed because of lack of progress on key structural reforms—namely, in the areas of tax administration and the restructuring of the state-owned People's Bank. During 2004, however, macroeconomic policies also deteriorated, although toward the end of the year steps were taken to strengthen the macroeconomic policy stance. The new government wanted to flesh out their reform agenda and present the 2005 budget before engaging in further program discussions.

5. **The new government, led by President Kumaratunga's Freedom Alliance, was elected in April 2004** but only secured a Parliamentary majority in September 2004. As a result, virtually no legislation or economic reforms were advanced until the last quarter of the year. While the ceasefire, which has been in place now for three years, continues to hold, the peace process has been stalled for over a year. Efforts by international mediators to restart discussions were intensified in late 2004.

II. Economic Performance in 2004

6. **Economic growth was maintained in 2004, partly reflecting expansionary monetary and fiscal policies**. While tourism and garment exports both increased strongly, the economy was affected by the adverse impacts of a drought and an oil price shock. In response, the government resorted to expansionary fiscal and monetary policies. This helped maintain GDP growth—estimated at 5¼ percent, compared with 6 percent the previous year—but inflation also rose sharply to 13¾ percent (y/y) at end-2004, compared to 5 percent a year earlier, reflecting domestic demand pressures as well as higher food and oil prices (Table 1).

7. **The fiscal deficit is estimated to have reached 8¼ percent of GDP, 1½ percent of GDP higher than the budget target**. As a result, public sector debt increased in 2004 to 108 percent of GDP. The slippage is the result of subsidies for oil, flour and fertilizer and a shortfall in income tax collections. This, together with a shortfall in program loans, caused net domestic financing of the budget to rise to 6 percent of GDP, almost double the budget target (half of this was provided by the central bank) (Table 2). To fill the budget gap in 2004 the authorities made recourse to domestic commercial foreign currency borrowing in the amount of $250 million. While the deficit exceeded budget targets, it was somewhat less than previously projected by staff, reflecting the introduction of some revenue measures in the last quarter of the year.

8. **The 2005 budget, approved in December 2004, envisages a reduction in the overall deficit to 7½ percent of GDP**. On the positive side, the budget focuses on reducing poverty through rural development and higher spending for health, education, and public

infrastructure. However, the budget also includes a significant increase in public sector employment and wages and some revenue measures that will complicate the tax system and revenue administration, such as new VAT rates and special charges on a wide range of consumer imports in addition to maintaining the 10 percent import surcharge. Some of the budget estimates also appear optimistic. Revenue is projected to increase by 1¼ percent of GDP, partly based on uncertain improvements in tax administration, while some expenditure items, such as interest payments, appear to be underestimated. At the time, staff estimated that additional measures of 1¼ percent of GDP would be needed to meet budget targets.

9. **The growth rates of the main monetary aggregates in 2004 were close to 20 percent**, compared with the original central bank targets of around 15 percent, due to higher public and private credit growth (Table 3). During the year, the central bank increased interest rates by 50 basis points in November (repo and reverse repo rates stand at 7½ percent and 9 percent respectively).

10. **Despite a healthy export performance, the external current account deficit widened to about 3 percent of GDP in 2004 from near balance in 2003**. While higher oil prices were partly responsible, there was also a surge in investment-related imports and consumer durables (non-oil imports increased by 16¾ percent). Reflecting the deterioration in the current and capital accounts, the rupee depreciated by more than 8 percent vis-à-vis the U.S. dollar (and considerably more against other currencies) despite heavy intervention by the central bank. During 2004, gross official reserves fell by $320 million to $1.8 billion (about 2 months of imports) (Table 4).

11. **By the end of the year, government plans for key structural reforms were still being finalized**. In general, the current government's economic strategy is to consolidate progress from the previous market-oriented growth strategy while placing more emphasis on regional development, reducing unemployment and poverty, and strengthening the role of the state. In the area of tax administration, plans to create a Revenue Authority, as originally envisaged under the PRGF/EFF-supported program, were abandoned, and a comprehensive alternative is being developed. For the state-owned People's Bank, which was also a key part of the PRGF structural agenda, privatization will no longer be pursued and the government has prepared a restructuring plan that envisages its recapitalization with public funds.

III. Near-Term Outlook and the Authorities' Response

12. **While the main commercial areas in the western part of the country were largely unaffected, there was extensive damage to the fisheries and tourism sectors**. The adverse impact on these sectors would depress GDP growth by about 1–1½ percentage points. However, extensive reconstruction and rehabilitation expenditure planned for 2005 will offset much of the adverse impact on economic growth. The authorities now estimate GDP growth in 2005 at 5¼ percent. However, inflationary momentum from 2004 is expected to continue with inflation projected to remain at double digit levels (y/y) for most of the year before declining to 8½ percent by end-2005. While the stock market lost 5½ percent immediately after the disaster, with tourism stocks hit hardest, it has recovered to record

highs reflecting confidence in recovery efforts. The rupee, after having lost 8 percent of its value against the U.S. dollar in 2004, appreciated by 5 percent so far in 2005, on expectations of aid inflows (Figure 1).

13. **As described in the attached letter, the authorities have introduced several policies in response to the tsunami**. These include the following:

- Providing adequate liquidity to ensure the smooth functioning of financial markets and the payment and settlement systems.

- Setting up a special refinance loan scheme to assist small and medium enterprises affected by the tsunami. The loans will be provided through recognized financial institutions for a period of 3–8 years at a concessionary rate of interest. Resources for the refinance scheme have been obtained from revolving credit guarantee fund accounts maintained by the central bank on behalf of the government.

- Announcing temporary transfers to affected households ($50 per family per month). The duration of these transfers has not been determined but if maintained for the remainder of 2005, the cost is estimated at about 0.2 percent of GDP.

- Developing comprehensive plans for rehabilitation and reconstruction with the expectation that up to 40 percent of planned reconstruction will take place in 2005.

14. **The fiscal impact of these activities will be significant, but reliance on donor support will help contain the impact on domestic financing**. Total domestic revenue is projected by the authorities to be only slightly below (¼ percent of GDP) the budget forecast as major economic sectors were not affected by the tsunami. However, government expenditure is expected to increase by about 2 percent of GDP on account of tsunami-related spending. The authorities expect these expenditures to be financed by additional aid flows both in the form of grants and concessional loans. Accordingly, there are no plans to issue U.S. dollar-denominated bonds at commercial rates to finance the budget as in 2004. Additional post-tsunami aid is estimated at about $500 million, which should allow total domestic financing to be kept within the budgeted figure of 4½ percent of GDP and thereby help to contain inflationary pressures. As indicated above, however, staff's view is that additional measures equivalent to about 1¼ percent of GDP would still be required to meet budget targets. Any debt relief would be additional to the aid flows identified above providing further support to the budget and additional breathing room to the authorities.

15. **Balance of payments developments will be largely driven by substantially higher imports financed by additional aid flows**. Major export sectors have not been affected, although the growth in garment exports will be much smaller than in recent years owing to

the effects of the removal of global textile quotas.[2] The short-term impact on the tourism sector will also keep earnings from this source below 2004 levels. Additional import needs are estimated at $590 million compared with a pre-tsunami scenario. Since some of the aid will be in the form of grants, the increase in the current account deficit (2 percent of GDP) will be somewhat less than in the trade balance. Taking into account projected aid flows, including requested disaster assistance from the Fund, international reserves are projected to increase only marginally to $2.0 billion (2¼ months of imports) by the end of 2005, still well below what had previously been envisaged under the PRGF/EFF-supported program.[3]

16. **Temporary debt relief in line with the January 12–13 Paris Club offer would provide additional protection to the fiscal and external positions and limit near term downside risks** (Box 1). Provided that the authorities meet their reform objectives over the medium term—consistent with the targets set in the Fiscal Management (Responsibility) Act—debt is sustainable but considerable downside risks remain, including uncertainties over oil prices and the impact of the end of the Multi-Fibre Agreement (MFA).[4] Accordingly, staff supports temporary debt relief from those creditors that can provide it. The debt sustainability analysis and near-term outlook will be comprehensively reviewed and updated as part of the forthcoming 2005 Article IV consultation.

17. **The authorities' monetary program for 2005 envisages broad money growth of 15 percent with a view to supporting growth objectives while beginning to bring inflationary pressures under control**. Taking into account a modest projected improvement in international reserves, as well as the domestic financing needs of the government, this would allow room for private sector credit to increase by 18 percent helping to support

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[2] To help Sri Lanka recover from the tsunami, the European Union has decided to bring forward (to April 1, 2005 from July 1) the implementation of the G.S.P. plus scheme, which would allow duty free access to imports from Sri Lanka, including for clothing and textiles.

[3] The balance of payments estimates update those provided in IMF Country Report No. 05/16 (January 2005) to reflect the latest available information on aid flows and preliminary results from the ongoing needs assessment. In addition to the assistance from the Fund, projected aid flows in 2005 in response to the tsunami include $80 million in grants from Japan; $150 million ($30 million in grants) from the World Bank; $35 million ($10 million in grants) from the Asian Development Bank; $23 million in grants from India; and $20 million in grants from the United States. Any debt relief from the Paris Club would be additional to these identified aid flows.

[4] Recent developments have not fundamentally changed the conclusions of the comprehensive debt sustainability analysis presented during the last Article IV consultation (IMF Country Report No. 04/68).

Box 1. Sri Lanka and the Paris Club

Sri Lanka has never gone to the Paris Club for a debt rescheduling. In part, this reflects concerns over implications for their debt rating and access to market financing. This is likely to continue to be a concern of the authorities. Most of Sri Lanka's Paris Club debt is to Japan. Out of total external debt of about $9 billion, $4 billion is bilateral (nearly all to Paris Club countries) with $2.6 billion to Japan.

A temporary moratorium on debt service would help contain fiscal pressures. Sri Lanka has relatively high total debt—over 100 percent of GDP with more than half domestic debt. Total debt service in the 2005 budget (excluding IMF) amounts to 2.8 percent of GDP. Of this, external debt service to the Paris Club is estimated to amount to $323 million (about 1½ percent of GDP).

During the January 12–13 Paris Club meeting, the possibility of temporary relief for debt payments was announced. While the terms of any deferral in debt payments were not announced, the Paris Club indicated that—subject to the national laws of the creditor countries—they would not expect debt payments from affected countries that request such forbearance. The Sri Lankan authorities are seeking more information from creditor countries on the terms of possible debt relief by the Paris Club.

Sri Lanka: Structure of Government Debt, end-2004 1/

	Percent of GDP
Domestic	57.9
External	50.2
Bilateral	23.6
Paris Club	22.2
Of which:	
Japan	15.3
United States	2.9
Germany	2.7
Non-Paris Club	1.4
Multilateral	24.0
ADB	11.8
World Bank	11.5
Other	0.7
Other (commercial banks)	2.6
Total debt	108.1

1/ Excludes debt to the IMF.

Sri Lanka: Estimated Government External Debt Service Payments in 2005 1/

(In millions of U.S. dollars)

Country/Institution	Interest	Amortization	Total
Bilateral	111.9	232.5	344.4
Paris Club	106.1	216.5	322.6
Of which:			
Japan	77.5	147.6	225.1
United States	16.5	26.6	43.0
Germany	9.1	25.5	34.6
Non-Paris Club	5.8	16.0	21.8
Multilateral	45.3	87.3	132.6
Other (Commercial Banks)	12.7	54.1	66.8
Total	169.9	373.9	543.8

1/ Excludes debt service to the IMF.

economic recovery. Staff has advised the authorities to be mindful of the limits to implementation capacity and potential inflationary pressures as reconstruction efforts proceed. In this context, it is likely that the authorities will need to be prepared to increase interest rates in the course of 2005 to meet monetary policy and inflation objectives. It will also be important to closely monitor the impact of recent events on the banking system, including on relevant prudential indicators.

18. **The authorities have indicated their intention to monitor aid flows carefully to ensure their most effective use (Attachment I, paragraph 9)**. The authorities are developing a framework for rehabilitation and reconstruction to operate at both national and local levels based on the needs assessment, and mechanisms for recording, reporting and accounting for assistance are being developed in consultation with donors. The authorities have also indicated that once humanitarian needs have been met and restructuring plans finalized, structural reforms in priority areas and work on an update of the PRSP will be continued with a view to resuming discussions on the PRGF/EFF-supported program in the future.

IV. Ability to Service Obligations to the Fund

19. **In view of the authorities' policy response outlined in the attached letter, and their excellent overall record of payments to the Fund, it is expected that Sri Lanka will be able to discharge its obligations to the Fund in a timely manner**. Gross international reserves, after declining to $1.8 billion in 2004, are being projected at $2.0 billion by end-2005. Based on current information on post-tsunami aid flows, this target is feasible. The authorities have indicated that they would approach donors, including in the context of resuming discussions related to the PRGF/EFF-supported program, to secure necessary support to achieve the medium-term targets. On that basis, international reserves would increase to $2.6 billion (2½ months of imports) by 2009.

V. Staff Appraisal

20. **The impact of the late December tsunamis has caused immense human suffering and physical damage**. Many households have been displaced and urgent action by the government and the international community has been required to avert yet additional deaths from infection and disease. Rehabilitation and reconstruction of the damage will take at least three years and is deserving of extensive support from the international community. Staff hopes that the unity of the Sri Lankan people in responding to this tragedy would contribute positively to advancing the peace process going forward.

21. **Humanitarian relief, efforts to rebuild livelihoods, and reconstruction expenditures planned for 2005 and the succeeding years are appropriate responses to the devastation that has been experienced** and staff supports efforts to mobilize donor assistance. Given the scale of the tragedy, and Sri Lanka's already high debt burden, it would be important for this assistance to be provided on concessional terms. During the reconstruction period, the authorities will need to be mindful of local capacity constraints and

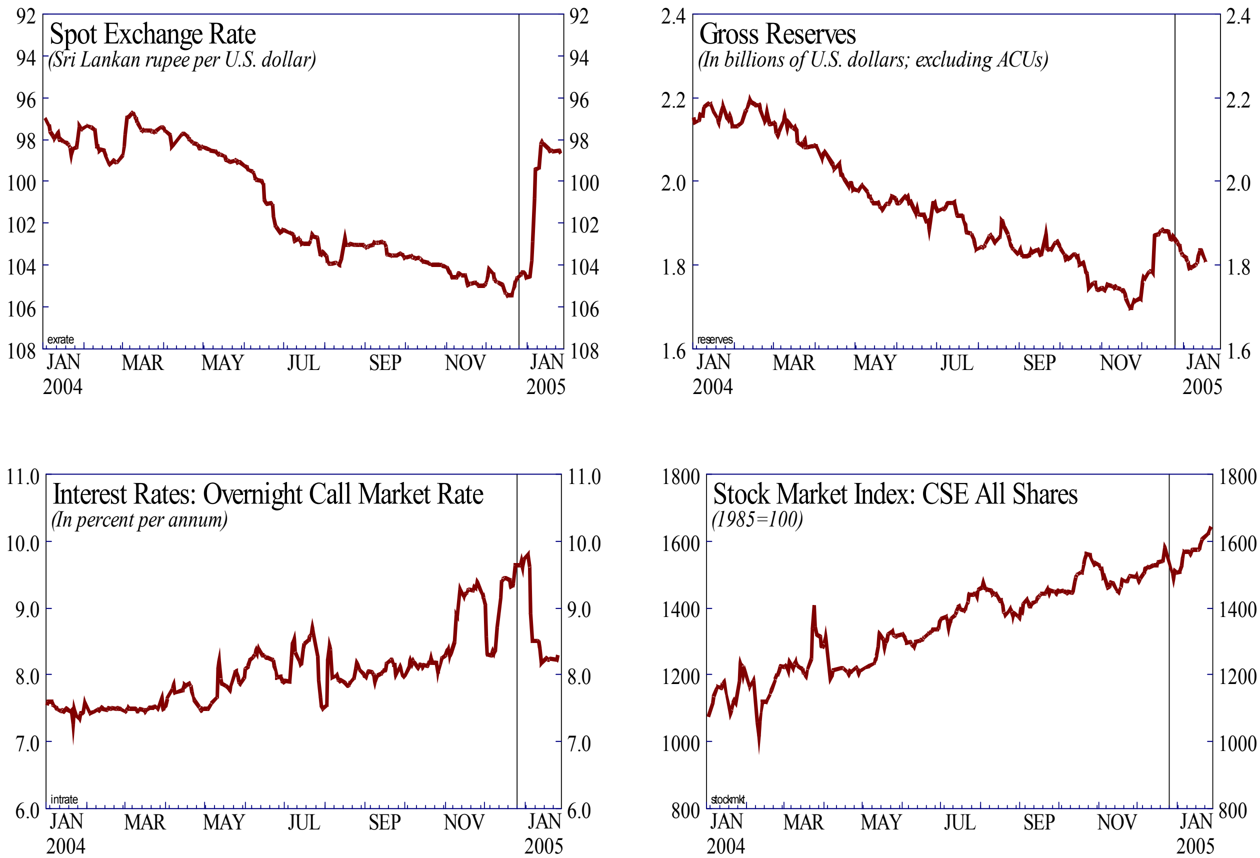
manage demand pressures carefully to keep inflationary pressures in check. In this regard, the staff welcomes the authorities' assurances that appropriate actions will be taken to maintain macroeconomic stability. These will likely need to include taking steps to ensure that budget targets for revenue are achieved, and increasing interest rates from their prevailing low levels when necessary to achieve monetary policy objectives.

22. **The staff also emphasizes the importance of closely monitoring the disbursement and use of aid flows to ensure accountability and transparency**, as well as to minimize temporary fluctuations in the exchange rate. It will be important for sustaining aid flows over the entire reconstruction period, as well as for meeting broader medium-term development objectives, that governance issues in the administration and use of aid flows be avoided. The monitoring mechanisms being established should include, among other things, specific audit arrangements to ensure adequate accountability for the use of donor assistance.

23. **The staff welcomes the authorities' intention to resume discussion on the PRGF/EFF-supported program**. However, it could be some time before the authorities are in a position to resume discussions given the need to focus on disaster relief and reconstruction planning. Also, important issues related to the program will need to be resolved. While there is an obvious need for economic targets in 2005 to accommodate humanitarian assistance as well as spending for rehabilitation and reconstruction, the original medium-term objectives of the PRGF/EFF program—supporting sustained growth and poverty reduction through private sector development, fiscal consolidation, financial sector reform, and improved public sector performance—remain valid. In this context, staff encourages the authorities to pursue a resumption of the PRGF/EFF arrangements as soon as feasible.

24. **Staff supports the request for a purchase under the Fund's policy on emergency assistance for natural disasters** to facilitate the needed imports and avoid depleting Sri Lanka's international reserves, pending the resumption of the PRGF/EFF-supported program. The steps that the authorities have taken and proposed so far and the international support that has been promised are encouraging signs that the recovery efforts can succeed. Accordingly, the staff supports the authorities' request for emergency assistance on concessional terms—subject to the availability of subsidy resources—in the amount of SDR 103.35 million. It also welcomes the authorities' commitment to adhere to a comprehensive medium-term strategy and to cooperate closely with the Fund in developing their reform strategy.

Figure 1. Sri Lanka: Selected Financial Indicators



Sources: CEIC Data Company Ltd; and data provided by the Sri Lankan authorities.

Table 1. Sri Lanka: Selected Economic Indicators, 2001–2005

Nominal GDP (2003): US$18.2 billion
Population (2003): 19.3 million
GDP per capita (2003): US$947
Quota: SDR 413 million

	2001	2002	2003	2004 Est.	2005 Projections Pre-Tsunami	2005 Projections Post-Tsunami
GDP and inflation (in percent)						
Real GDP growth	-1.5	4.0	5.9	5.2	6.0	5.3
Inflation (Colombo CPI; average)	14.2	9.6	6.3	7.6	10.5	12.0
Inflation (Colombo CPI; end-of-period)	10.8	11.3	5.0	13.8	8.0	8.5
Public finances (in percent of GDP)						
Revenue	16.6	16.5	15.7	15.8	16.4	16.2
Expenditure	27.5	25.4	24.0	23.9	25.1	27.0
Savings/revenue measures to be identified	...	...	...	...	1.2	1.2
Primary balance	-4.1	-1.6	-1.2	-2.1	-1.5	-3.6
Overall balance	-10.8	-8.9	-8.3	-8.2	-7.5	-9.6
Government debt (domestic and external)	103.2	105.5	105.9	108.1	102.6	103.1
Money and credit (percent change, end of period)						
Reserve money	7.0	12.3	11.9	20.9	14.5	15.0
Broad money	13.6	13.4	15.3	19.5	14.5	15.0
Domestic credit	16.2	6.5	7.6	23.6	10.6	12.8
Private sector credit	8.9	12.0	16.9	26.1	15.8	18.3
Public sector credit	30.6	-2.6	-10.0	17.2	-2.1	-1.6
Balance of payments (in millions of U.S. dollars)						
Exports	4,817	4,699	5,133	5,787	6,163	6,163
Imports	5,974	6,105	6,673	7,957	8,530	9,120
Trade balance	-1,157	-1,406	-1,540	-2,170	-2,367	-2,957
Current account balance	-179	-236	-76	-626	-689	-1,161
Current account balance (in percent of GDP)	-1.1	-1.4	-0.4	-3.2	-3.2	-5.3
Overall balance	229	339	428	-212	215	33
Export value growth (percent)	-12.8	-2.4	9.2	12.7	6.5	6.5
Import value growth (percent)	-18.4	2.2	9.3	19.2	7.2	14.6
Gross official reserves (end of period)						
In millions of U.S. dollars 1/	1,231	1,566	2,147	1,825	1,886	1,977
In months of imports	2.1	2.4	2.8	2.1	2.1	2.2
As a percent of short-term debt 2/	60	80	110	101	97	109
External debt (public and private)						
In billions of U.S. dollars	9.5	10.3	11.7	12.2	12.9	13.1
As a percent of GDP	60.2	62.5	64.1	62.6	58.9	60.0
Memorandum items:						
Nominal GDP (in billions of rupees)	1,407	1,583	1,760	1,972	2,278	2,297

Sources: Data provided by the Sri Lanka authorities; and staff estimates and projections.

1/ Excluding central bank Asian Clearing Union (ACU) balances.
2/ As reserves exclude ACU balances, they are also excluded from short-term debt to compute this ratio.

Table 2. Sri Lanka: Summary of Central Government Operations, 2001–2005

(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004		2005		
		Actual		Budget	Estimate	Budget	Pre-Tsunami	Post-Tsunami
Total revenue	16.6	16.5	15.7	16.4	15.8	17.1	16.4	16.2
Tax revenue	14.6	14.0	13.2	14.5	14.3	15.4	14.9	14.6
Income taxes	2.5	2.4	2.2	3.0	2.1	2.4	2.2	2.1
Value added tax/GST	3.3	4.2	5.5	6.0	6.0	6.3	6.1	6.0
Excise taxes	3.2	3.3	2.9	2.8	3.4	3.4	3.4	3.4
National security levy	3.1	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on international trade	1.9	1.8	1.9	2.1	2.1	2.4	2.4	2.4
Other	0.7	0.5	0.6	0.7	0.6	0.9	0.8	0.8
Nontax revenue	2.0	2.5	2.5	1.8	1.5	1.7	1.5	1.5
Total expenditure and net lending	27.5	25.4	24.0	23.2	23.9	24.6	25.1	27.0
Current expenditure	21.6	20.9	19.0	17.6	19.4	18.5	18.9	19.2
Civil service wages and salaries	3.4	3.4	3.2	3.2	3.4	3.9	3.9	3.9
Other civilian goods and services	2.0	1.3	1.2	1.1	1.3	1.2	1.2	1.2
Security related expenditure	4.9	4.1	3.5	3.5	3.6	3.6	3.6	3.6
Subsidies and transfers	4.6	4.7	4.0	3.9	5.0	4.1	4.1	4.5
Households	3.8	3.4	3.0	3.0	3.8	3.1	…	…
Of which: Samurdhi	0.9	0.6	0.5	0.4	0.5	0.4	…	…
Of which: Pensions	1.9	2.0	1.8	1.8	1.9	1.8	…	…
Institutions, corporations, other government agencies	0.9	1.4	1.0	0.9	1.2	0.9	…	…
Interest payments	6.7	7.4	7.1	6.0	6.1	5.6	6.0	6.0
Foreign	0.7	0.7	0.7	0.8	0.7	0.8	0.7	0.7
Domestic	6.0	6.7	6.5	5.2	5.4	4.8	5.3	5.3
Capital expenditure and net lending	5.9	4.6	5.0	5.5	4.6	6.2	6.2	7.8
Saving to be identified	…	…	…	…	…	…	1.2	1.2
Overall balance	-10.8	-8.9	-8.3	-6.8	-8.2	-7.5	-7.5	-9.6
Overall balance (including grants)	-10.4	-8.5	-7.8	-6.3	-7.7	-7.1	-7.1	-8.4
Financing	10.8	8.9	8.3	6.8	8.2	7.5	7.5	9.6
Net external financing	1.0	0.1	2.4	2.5	1.5	2.1	2.1	3.5
Net domestic financing	8.8	8.0	4.8	3.2	6.1	4.6	4.6	4.6
Privatization	0.6	0.4	0.6	0.6	0.1	0.3	0.3	0.3
Grants	0.4	0.4	0.5	0.5	0.5	0.4	0.4	1.2
Memorandum items:								
Current account balance	-4.9	-4.4	-3.3	-1.3	-3.6	-1.3	-1.3	-1.8
Primary balance	-4.1	-1.6	-1.2	-0.8	-2.1	-1.9	-1.5	-3.6
Nominal GDP (in billions of rupees)	1,407	1,583	1,760	2,026	1,972	2,276	2,278	2,297
Total debt	103.2	105.5	105.9	94.8	108.1	…	102.6	103.1
Of which: Domestic debt	58.0	59.9	57.9	54.0	57.9	…	54.7	54.3

Sources: Information provided by the Sri Lanka authorities; and staff estimates.

Table 3. Sri Lanka: Monetary Program, 2003–2005

	2003	2004					2005 1/
	Dec.	Mar.	Jun.	Sept.	Dec.	Dec.	Dec.
	Act.	Act.	Act.	Act.	Orig. Proj.	Est.	Proj.
Monetary authorities				(In billions of rupees)			
Net foreign assets	165	161	152	151	184	156	163
Net domestic assets	-23	-2	-1	7	-21	15	34
Of which : Net credit to government	42	67	71	84	45	109	129
Reserve money	141	159	151	158	163	171	197
				(Contribution to reserve money growth, in percent)			
Net foreign assets	37.4	27.9	10.8	-7.6	14.0	-5.5	3.5
Net domestic assets	-25.5	-7.5	4.8	25.2	1.4	25.8	11.5
Reserve money (percent change)	11.9	20.4	15.6	17.6	15.4	20.9	15.0
Monetary survey				(In billions of rupees)			
Net foreign assets	167	180	164	167	207	178	200
Monetary authorities	165	161	152	151	184	156	163
Deposit money banks	2	19	12	15	22	22	38
Net domestic assets	551	566	596	635	608	679	786
Domestic credit	732	757	791	842	793	904	1,020
Public sector	212	223	228	252	191	249	245
Government (net)	176	189	190	213	161	208	219
Public corporations	36	34	38	39	30	41	26
Private sector	519	534	563	590	602	655	775
Other items (net)	-181	-191	-196	-208	-185	-225	-234
Broad money	718	746	760	802	815	858	987
				(Annual percent change)			
Net foreign assets	51.0	56.1	23.5	12.7	23.6	6.7	12.2
Monetary authorities	40.2	29.6	10.3	-6.4	12.0	-4.9	3.9
Deposit money banks	-137.1	-323.5	-350.5	-213.7	786.2	775.3	71.8
Net domestic assets	7.6	7.3	14.1	19.6	10.4	23.4	15.7
Domestic credit	7.6	10.5	15.3	21.4	8.3	23.6	12.8
Public sector	-10.0	-4.8	4.3	22.3	-9.9	17.2	-1.6
Government (net)	-8.7	-1.3	5.6	28.1	-8.5	18.0	5.3
Public corporations	-15.9	-20.4	-1.5	-2.1	-16.6	13.8	-36.4
Private sector	16.9	18.4	20.4	21.0	15.8	26.1	18.3
Broad money	15.3	16.0	16.0	18.1	13.5	19.5	15.0
				(Contribution to broad money growth, in percent)			
Net foreign assets	9.1	10.1	4.8	2.8	5.5	1.6	2.5
Net domestic assets	6.3	6.0	11.2	15.3	8.0	17.9	12.5
Domestic credit	8.3	11.2	16.0	21.8	8.5	24.0	13.5
Public sector	-3.8	-1.8	1.4	6.8	-2.9	5.1	-0.5
Government (net)	-2.7	-0.4	1.5	6.9	-2.1	4.4	1.3
Public corporations	-1.1	-1.4	-0.1	-0.1	-0.8	0.7	-1.7
Private sector	12.1	12.9	14.6	15.1	11.4	18.9	14.0
Memorandum items:							
Broad money multiplier	5.1	4.7	5.0	5.1	5.0	5.0	5.0
Velocity of broad money	2.7	...	...	...	2.7	2.7	2.7
Private sector credit (in percent of GDP)	29.5	...	...	...	30.5	33.2	33.8

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

1/ Projections for 2005 are at end-2004 exchange rates.

Table 4. Sri Lanka: Balance of Payments, 2003–2005

(In millions of U.S. dollars, unless otherwise indicated)

	2003	2004	2005 Projections	
		Est.	Pre-Tsunami	Post-Tsunami
Current account	-76	-626	-689	-1,161
Trade balance	-1,540	-2,170	-2,367	-2,957
Exports	5,133	5,787	6,163	6,163
Of which: Textiles and garments	2,576	2,807	2,906	2,906
Imports	6,673	7,957	8,530	9,120
Non-oil imports	5,835	6,812	7,234	7,824
Of which: Oil imports	838	1,145	1,296	1,296
Services	423	415	474	344
Of which : Receipts from tourism	532	585	655	545
Income	-192	-229	-252	-252
Transfers	1,234	1,358	1,456	1,704
Private (net)	1,205	1,328	1,421	1,506
Official (net)	29	30	35	198
Capital and financial account	603	414	904	1,194
Capital transfers (net)	61	64	63	63
Financial account	542	351	841	1,131
Long-term flows	617	513	821	1,111
Direct investment	201	178	261	276
Private sector borrowing 1/	-33	8	90	90
Official sector borrowing	449	326	470	745
Disbursements	808	655	873	1,148
Program	242	30	74	124
Project	566	625	799	1,024
Amortization	359	328	403	403
Short-term flows	-75	-162	20	20
Errors and omissions	-99	0	0	0
Overall balance	428	-212	215	33
Financing	-428	212	-215	-33
NIR (- = increase)	-428	212	-215	-33
Gross reserves	-581	322	-61	-152
Reserve liabilities 2/	-153	110	-154	119
Memorandum items:				
Current account (in percent of GDP)	-0.4	-3.2	-3.2	-5.3
Export growth (in percent)	9.2	12.7	6.5	6.5
Textiles and garments	6.3	9.0	3.5	3.5
Import growth (in percent)	9.3	19.2	7.2	14.6
Non-oil	9.8	16.7	6.2	14.9
Gross official reserves 3/ 4/	2,147	1,825	1,886	1,977
(In months of imports of goods and nonfactor services)	2.8	2.1	2.1	2.2
(In percent of short-term debt)	110	101	97	109
Net international reserves	1,780	1,568	1,783	1,601
GDP (US$ millions)	18,237	19,450	21,695	21,875
Oil price (US$ per barrel)	28.9	37.8	40.5	40.5
Debt service to the Paris Club	…	…	…	323
Of which: interest payments	…	…	…	106

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

1/ Includes public corporations.
2/ In 2005, it is assumed that Sri Lanka repays the fund on an expectation and obligation basis under the pre-Tsunami and post-Tsunami scenario, respectively. If disbursements under the PRGF/EFF arrangements resume in 2005, this would provide further support to gross official reserves. See also Table 6 for details on Fund disbursements and repayments.
3/ Net of ACU debit balances.
4/ Valued at historical cost through 2002, and at market cost since then.

Table 5. Sri Lanka: Medium-Term Macroeconomic Framework, 2003–2009

	2003	2004 Est.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Real sector (percent change)							
Real GDP	5.9	5.2	5.3	6.0	6.0	6.0	6.0
Contribution of domestic demand	9.6	4.6	10.3	6.1	5.7	4.6	6.3
Contribution of external demand	-3.7	0.6	-5.0	-0.1	0.3	1.4	-0.3
Inflation (Colombo CPI; average)	6.3	7.6	12.0	7.5	5.5	4.8	4.5
Inflation (Colombo CPI; end-of-period)	5.0	13.8	8.5	6.5	5.0	4.8	4.5
Savings-investment balance (in percent of GDP)							
Gross national saving	21.3	21.0	21.5	22.3	22.8	24.5	24.6
Private	24.1	24.2	23.3	22.8	22.3	23.0	22.3
Public	-2.8	-3.1	-1.8	-0.5	0.5	1.5	2.3
Gross domestic investment	22.3	24.2	26.8	26.5	26.1	26.5	26.4
Public finances (in percent of GDP)							
Total revenue	15.7	15.8	16.2	16.9	17.2	17.5	17.8
Total expenditure and net lending	24.0	23.9	27.0	25.6	24.8	23.8	22.8
Current expenditure	19.0	19.4	19.2	18.1	17.3	16.4	16.0
Of which : Interest payments	7.1	6.1	6.0	5.7	5.0	4.5	4.2
Capital expenditure	5.0	4.6	7.8	7.5	7.5	7.4	6.8
Savings/revenue measures to be identified	...	...	1.2	...	...	...	...
Overall balance	-8.3	-8.2	-9.6	-8.7	-7.6	-6.3	-5.0
Primary balance	-1.2	-2.1	-3.6	-3.0	-2.6	-1.8	-0.8
Net external financing (including grants)	2.9	2.0	4.7	4.9	4.3	3.9	3.7
Net domestic financing	4.8	6.1	4.6	3.5	3.0	2.1	1.0
Assets sales	0.6	0.1	0.3	0.3	0.3	0.3	0.3
Total government debt	105.9	108.1	103.1	99.9	97.3	94.2	90.2
Domestic	57.9	57.9	54.3	51.7	49.2	46.4	42.9
Foreign	47.9	50.2	48.8	48.2	48.1	47.8	47.4
Balance of payments (in percent of GDP) 1/							
Trade balance	-8.4	-11.2	-13.5	-12.3	-11.2	-9.7	-9.5
Current account balance	-0.4	-3.2	-5.3	-4.2	-3.3	-1.9	-1.8
Overall balance	2.3	-1.1	0.2	0.7	-0.2	0.7	0.6
Gross official reserves (in millions of U.S. dollars) 2/	2,147	1,825	1,977	2,294	2,466	2,579	2,658
(in months of imports of goods and services)	2.8	2.1	2.2	2.5	2.6	2.6	2.6
Total external debt	64.1	62.6	60.0	60.0	58.1	54.4	50.7
Money and credit (in percent of GDP)							
Reserve money	8.0	8.7	8.6	8.6	8.6	8.7	8.7
Broad money	40.8	43.5	43.0	43.1	43.3	43.4	43.6
Domestic credit	41.6	45.9	44.4	44.0	44.5	44.1	43.8
Private sector credit	29.5	33.2	33.8	34.6	36.3	37.4	39.4
Public sector credit	12.1	12.6	10.7	9.4	8.2	6.7	4.4
Memorandum items:							
Oil price (U.S. dollar per barrel)	28.9	37.8	40.5	38.0	36.0	35.0	34.5

Sources: Data provided by the Sri Lanka authorities; and Fund staff estimates and projections.

1/ Medium-term projections assume disbursements under the PRGF-EFF arrangements and continued program financing from multilateral agencies. Tsunami-related reconstruction is projected to take place over 2005-2007.
2/ Excluding central bank Asian Clearing Union (ACU) balances.

Table 6. Sri Lanka: Projected Payments to the Fund, 2003–2009

(In millions of SDRs, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009
Disbursements 1/	59.1	0.0	103.4	177.2	177.2	0.0	0.0
Repayments 2/	22.4	75.4	25.8	74.2	31.9	46.0	62.8
Charges/interest 2/	5.1	5.6	6.4	4.6	2.9	2.3	2.2
Stock of outstanding use of Fund resources	264.6	189.2	266.7	369.7	515.0	469.0	406.2
Memorandum items:							
Debt service							
Payments to the Fund/exports GNFS	0.6	1.6	0.6	1.5	0.6	0.8	1.0
Payments to the Fund/Quota	6.6	19.6	7.8	19.1	8.4	11.7	15.7
Payments to the Fund/GDP	0.2	0.6	0.2	0.5	0.2	0.3	0.3
Payments to the Fund/reserves	1.8	6.6	2.5	5.3	2.2	2.9	3.8
Outstanding use of Fund resources							
Outstanding UFR/exports GNFS	5.6	3.8	5.3	6.9	9.1	7.9	6.5
Outstanding UFR/quota	64.0	45.8	64.5	89.4	124.6	113.4	98.3
Outstanding UFR/GDP	2.0	1.4	1.9	2.4	3.1	2.6	2.1
Outstanding UFR/reserves	17.3	15.4	20.5	24.8	32.2	28.0	23.6

Source: Fund staff estimates.

1/ Assuming emergency assistance at 25 percent of quota in 2005 and disbursements under the PRGF/EFF arrangements in 2006 and 2007.
2/ On an obligation basis.

Sri Lanka—Fund Relations

(As of December 31, 2004)

I. **Membership Status**: Joined 8/29/50; accepted Article VIII, Sections 2, 3, and 4, March 1994.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	413.40	100.00
Fund holdings of currency	516.44	124.92
Reserve position in Fund	47.86	11.58

III. **SDR Department:**	SDR Million	Percent Allocation
Net cumulative allocation	70.87	100.00
Holdings	0.12	0.17

IV. **Outstanding Purchases and Loans**:	SDR Million	Percent Quota
Stand-By arrangements	130.20	31.50
Extended arrangements	20.67	5.00
PRGF arrangements	38.39	31.50

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	Apr 18, 2003	Apr 17, 2006	144.40	20.67
PRGF	Apr 18, 2003	Apr 17, 2006	269.00	38.39
Stand-By	Apr 20, 2001	Sep 19, 2002	200.00	200.00

VI. **Projected Obligations to Fund—Obligation basis**: (SDR million; based on existing use of resources and present holdings of SDRs):

	2005	2006	2007	2008
Principal	25.84	74.16	31.93	7.28
Charges/interest	6.36	4.61	2.89	2.33
Total	32.19	78.77	34.82	9.62

VII. **Exchange Rate Arrangement**:

Independent float. The central bank floated the rupee on January 23, 2001. The CBSL has removed the foreign exchange regulations that were imposed after the float (IMF Country Report No. 02/86).

VIII. **Safeguards Assessment**:

Under the Fund's safeguards assessment policy, the CBSL is subject to a full safeguards assessment with respect to the PRGF arrangement which was approved on April 18, 2003. The assessment was completed on July 30, 2003 and concluded that the CBSL had made commendable progress in strengthening its safeguards since the 2001 assessment. As a result, the risk ratings have been upgraded in four of the five areas of the safeguards framework. The report found a few remaining vulnerabilities that could be addressed through a series of measures to further strengthen the CBSL's operations. Priority recommendations include (i) completing the full implementation of International Accounting Standards, (ii) establishing an external audit policy vis-à-vis auditor appointments, and (iii) continuing to publish the audited financial statements and opinion of the external audit firm.

IX. **Article IV Consultation**:

Sri Lanka is on a 24-month consultation cycle, subject to the terms of the decision on consultation cycles (Decision No. 12794-(02/76), of July 15, 2002). The Executive Board concluded the 2003 Article IV consultation on March 5, 2004.

X. **FSAP and ROSC Participation**:

- MFD: Both the FSSA and the FSAP reports were completed in 2002.
- STA: A data ROSC was completed and the report published in 2002.
- FAD: A fiscal transparency ROSC was completed and the report published in 2002.

XI. **Technical Assistance, 1997–2003**:

Department	Purpose	Date
FAD	▪ Public expenditure management	March 1998
	▪ Cash management and expenditure monitoring	February 1997–February 1998
	▪ Implementing a Goods and Services Tax and tax administration	January–February 1997; March 1997–September 1998
	▪ GST Seminar	July 1999
	▪ Government securities market	December 1999

	▪ Tax Policy	June 2001
	▪ Revenue Authority	August 2002
	▪ Revenue Authority	May 2003
	▪ Large taxpayers unit	February-June 2004
MFD	▪ Monetary policy instruments	May 2001
	▪ Bank and other financial supervision	Several visits 2003 and 2004
MFD/LEG	▪ Banking and Central Banking Laws	March, June, October 2003
	▪ AML/CFT Legislation	June, November 2003
STA	▪ General Data Dissemination System	June–July 1997, February–March 2000
	▪ Price indices	October 1998
	▪ Government Finance Statistics	April/May 2003
	▪ Monetary and Financial Statistics	May/June 2003
	▪ International investment position	August 2003

XII. **Resident Representative**:

Mr. Valdivieso will replace Mr. Carter as Senior Resident Representative in February 2005. A resident representative has been stationed in Sri Lanka since October 1977.

February 8, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431
United States of America

Dear Mr. de Rato,

Further to our letter of January 6, 2005, we would like to provide you with our latest assessment of the impact on Sri Lanka of the Indian Ocean Tsunami of December 26, 2004 and an update of our plans for relief, rehabilitation and reconstruction, as well as request a purchase under the Fund's policy for emergency assistance to support our efforts. We also want to thank you for the Fund's prompt and favourable response to our request for an extension of repurchase expectations arising in 2005, approved by the Executive Board on January 14.

The human toll of the tsunami has been enormous, with over 31,000 people dead, over 15,000 injured and 5,600 still missing and hundreds of thousands displaced. The asset losses alone is estimated at least around US$900 million (slightly over 4 percent of GDP). Our latest assessment suggests that the total reconstruction expenditure is around US$1.5 billion particularly in view of the fact that the reconstruction process should avoid vulnerabilities to natural hazards in the future. The underlying strategy has been a multi hazard risk approach during the recovery phase to ensure that communities and assets are less vulnerable to impacts of future disasters. The bulk of this expenditure is on housing and townships, transportation infrastructure, including roads, railways, and ports (US$400 million), the fisheries sector infrastructure requirements such as harbours, anchorages and related facilities (US$200 million), water supply and sanitation projects (US$150 million) and schools and hospitals building (US$120 million). In our reconstruction and recovery program which will take around 2–3 years, provisions will also be made to the coast conservation and natural resources affects as well. Substantial work has to be done in these areas.

To meet the urgent needs of those affected, the response of the government has been swift and comprehensive, supported by the assistance of donors and relief agencies. While immediate efforts have focused on the humanitarian needs of the survivors, we also aim to undertake as much as 40 percent of the required rehabilitation and reconstruction in 2005 with particular emphasis on settlements and livelihood support. With the generous support of international donors, including the IMF, we aim to undertake this work without jeopardizing macroeconomic stability or introducing changes to the prevailing trade and payments arrangements as per the provisions of Article VIII of the IMF.

The government's immediate policy response includes several initiatives to meet the humanitarian needs of the people while also safeguarding key macroeconomic objectives.

These include: (i) immediate humanitarian support to affected individuals amounting to an estimated 0.2 percent of GDP this year; (ii) a concessional refinancing scheme to ensure that funding is available for small and medium enterprises, initially set at Rs. 5 billion; and (iii) measures to ensure availability of liquidity and smooth functioning of payments and settlements systems.

The overall negative impact on GDP growth will be limited by the initiation of rehabilitation and reconstruction. However, this will lead to significant additional government expenditure in 2005. We estimate that the total fiscal cost in 2005 to be about 2¼ percent of GDP, with most of this reflected in development expenditure. While there could be some minor revenue shortfalls in some areas, we expect these to be limited to about ¼ percent of GDP. This will push the fiscal deficit this year to about 9¾ percent of GDP compared to the 7½ percent envisaged in the 2005 budget. The government expects to meet the additional expenditure on account of post-Tsunami relief, rehabilitation and reconstruction programme out of donor assistance. Additionally, external debt relief would help the government to provide fiscal space to accommodate reconstruction expenditure while containing domestic financing, making more resources available to the private sector. The government is seeking more information on the terms of possible debt relief consequent to the recent offer by the Paris Club.

At this time, we are hoping to receive enough commitment from donors in the form of grants and concessional loans, to finance this additional expenditure in 2005. As a result, we do not envisage the need to resort to financing on commercial terms. While the fiscal program for the medium term will also have to accommodate additional rehabilitation expenditure, we remain hopeful that most of it will be financed without adding to the already high debt burden of Sri Lanka.

The impact of the disaster on the balance of payments, which was already affected by high oil prices and drought before the tsunami, will also be significant. Lower tourism receipts and the need for substantially higher imports to finance reconstruction will increase the external current account deficit by about 2 percentage points of GDP, despite a likely increase in remittances. Even with an expected increase in external aid, official reserves at end-2005 are likely to be sufficient to finance about 2½ months of imports. Volatile oil prices and any adverse impact of phasing out the MFA are risks to this scenario. In this context, to support the Sri Lanka's effort to meet the immediate financing needs without seriously depleting its external reserves, the government requests a purchase from the Fund for the equivalent of SDR 103.35 million (25 percent of quota) under the Fund's policy on emergency assistance. In line with Fund policy on providing emergency assistance for natural disasters to PRGF-eligible countries, we request the provision of subsidies to reduce the rate of charge on these resources to concessional terms.

The measures taken by the government to help the economy withstand the shock of the recent disaster may temporarily raise the growth rate of the monetary base, our main target in the conduct of monetary policy, but we intend to bring this growth rate down gradually, to contain it at 15 percent at end of the year, in line with our GDP growth and inflation objectives. The CBSL will also continue to maintain exchange rate flexibility.

The government is committed to implementing the reconstruction strategy with full transparency and accountability and improve its communication and community participation to involve every stakeholder in the process. Towards this, the government plans to improve capacity at the District level to ensure effective coordination with donors, including NGOs and civil society. The government will ensure availability of information to all stakeholders regarding policies, aid flows, implementation procedures and outcomes with greatest transparency and accountability. Steps are also being taken to improve donor coordination and harmonise procurement practices to ensure efficient implementation.

While the immediate humanitarian needs are being addressed and major plans for reconstruction are being prepared, the government continues to pursue the policy reform agenda outlined in the 2005 budget, including improving tax administration and restructuring and improving management of public enterprises, and pursuing fiscal reform in line with the policy outlines of the Fiscal Management (Responsibility) Act. The government will continue to work closely with the IMF and looks forward to the Article IV consultation in early May 2005. During the Article IV consultation, we wish to resume discussions on the issues related to the PRGF/EFF supported program as well. The government remains committed to take appropriate action to maintain macroeconomic stability.

Yours sincerely,

/s/

Sarath L. B. Amunugama
Minister of Finance and Planning
and Governor of the Fund

INTERNATIONAL MONETARY FUND

SRI LANKA

Use of Fund Resources—Request for Emergency Assistance—Supplementary Information

Prepared by the Asia and Pacific Department
(In consultation with Policy Development and Review Department)

Approved by Wanda Tseng and Matthew Fisher

March 2, 2005

1. This supplement contains information that has become available since the staff report was circulated to the Executive Board on February 11, 2005. This information does not alter the thrust of the staff appraisal, but highlights the need for international donor assistance to support Sri Lanka's recovery and reconstruction from the devastation caused by the tsunami.

2. Recent data on economic developments are consistent with the trends described in the staff report. At its February meeting, The Monetary Policy Board left interest rates unchanged noting the need to facilitate spending on rehabilitation and reconstruction. The exchange rate has remained stable at around Rs. 99.5 per U.S. dollar and gross official reserves were $1.8 billion as of February 23, about $30 million below the pre-tsunami and end-2004 levels. As expected, tourist arrivals in January fell by 35 percent compared to last year. Inflationary pressures from 2004 have continued with the Colombo CPI increasing by 16 percent (y/y) in February.

3. As reflected in the staff report (Table 4, p. 17), the direct balance of payments impact of the tsunami in 2005 is estimated at $720 million. Of this, $308 million in direct financing from major multilateral and bilateral donors has been identified, including a World Bank credit of $75 million approved on February 24 to finance tsunami reconstruction.[1] The requested emergency assistance from the IMF, together with the impact of the extension in repurchase expectations approved by the Board on January 13, would cover part of the remaining financing needs. In addition, official inflows from donors, inflows from NGOs and other private sources, and/or debt relief from Paris Club creditors could cover the remainder. However, considerable uncertainty remains over the timing and amount of pledged assistance. The request for a purchase under the Fund's policy of emergency assistance for natural disasters will help facilitate needed imports and avoid depletion of reserves from the

[1] The estimated direct balance of payments impact in the text table ($720 million) is the same as that reported in Table 4 of the staff report. Identified financing is consistent with the amounts reported in footnote 3 (page 8) of the staff report. Table 4 of the staff report also includes additional possible aid flows from official and private sources based on preliminary indications as an illustration of how the gap might be filled.

already low levels during the first difficult months. At the same time, it will also be important that donor support and pledges be realized in a timely manner in order to allow reconstruction to be completed without jeopardizing macroeconomic stability.

Sri Lanka: Direct Effects of the Tsunami on the Balance of Payments, 2005

	In millions of U.S. dollars
Additional imports for reconstruction/relief	630
Additional service charges on imports	20
Reduction in service receipts from tourism	110
Less: Lower tourism related imports	40
Total direct impact on the balance of payments	720
Identified financing	308
Grants	163
Multilateral	40
Bilateral	123
Loans	145
Multilateral	145
Bilateral	--
Remaining financing need 1/	412

1/ Expected to be financed by private sector flows, IMF assistance, additional donor funds and/or debt relief.

4. Moreover, as emphasized in the staff report, in addition to uncertainties concerning the magnitude and timing of eventual donor support, considerable downside risks to the economic outlook remain, particularly related to the uncertain impact of the removal of global textile quotas, and uncertainty over oil prices. The balance of payments projections in the staff report are based on an average oil price of $40½ per barrel. Taking into account the latest WEO forecast of an average oil price in 2005 of $46½ per barrel would increase the projected oil import bill by $190 million.

5. At a meeting in early February, G-7 creditors clarified their stance on debt relief for tsunami-affected countries. For countries that request it, they agreed to defer debt payments up to end-2005. We understand that Sri Lanka has contacted individual creditors and suspended debt service payments to G-7 creditors by end-February. If debt payments to all G-7 creditors are suspended from March onwards, the authorities would save about $294 million in debt service in 2005, of which $207 million is to Japan. However, the terms and conditions of this debt deferral are still being discussed with some creditors. A meeting to discuss financing needs, especially for the period beyond 2005, will be held in Sri Lanka during May 16–17.

6. The Government is engaged in discussions with Tamil leaders on a framework for tsunami-related reconstruction in the North and East that would encompass the regional allocation of aid according to need, the delegation of execution to lower levels of government, and broad consultations with affected parties.

7. Discussions between the government and donors concerning modalities for monitoring aid flows have also continued, but an agreed framework has not yet been finalized. In this context, staff underscores the importance of ensuring that donor support is provided on a timely basis in line with commitments.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$157.5 million in Emergency Assistance for Sri Lanka

The Executive Board of the International Monetary Fund (IMF) has approved SDR 103.35 million (about US$157.5 million) in emergency assistance for Sri Lanka. The amount approved is available immediately to help the government deal with the devastating effect of the tsunami that struck the island on December 26, 2004.

The human toll has been tremendous, with 31,000 people dead, 6,000 still missing, and hundreds of thousands displaced. The commercial centers in the western part of the country were largely unaffected, but the fisheries and tourism sectors sustained severe damages. The cost of replacing the damaged infrastructure has been estimated at US$1.5–1.6 billion, or 7½ percent of GDP.

Much of the impact on economic growth will be offset by the reconstruction effort. GDP growth in 2005 is now estimated at 5¼ percent, the same level as in 2004. However, the rehabilitation expenditure will put a great strain on the balance of payment and the budget. The emerging gaps in 2005–2007 will need to be filled, in part, through support from the international community.

The IMF provides emergency assistance to member countries hit by natural disaster to help them meet immediate balance of payments financing needs, and maintain or restore macroeconomic stability. The emergency assistance will be repaid in eight equal quarterly installments over 3¼ to 5 years from the disbursement date. In line with the Executive Board's decision to subsidize emergency assistance for PRGF-eligible countries hit by a natural disaster, the rate of charge on the assistance will be subsidized to 0.5 percent per annum (See Public Information Notice No. 05/8), subject to resource availability.

At the conclusion of the Executive Board's discussion on Sri Lanka, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

"The IMF extends its deepest sympathy to the people of Sri Lanka for the destruction, suffering, and loss of life caused by the tsunami of December 26. The human loss has been incalculable, and the repair and reconstruction effort will require at least three years of sustained effort.

"The government, with the support of the international community, responded swiftly to the catastrophe. Within hours, the President of Sri Lanka launched the national operations center to coordinate the rescue and relief effort by government ministries and other institutions. Follow-up measures include a grant scheme for affected individuals, a concessional loan program to assist small and medium enterprises, and the development of a plan for rehabilitation and reconstruction.

"Infrastructure in the fisheries and tourism sectors was severely damaged, but the reconstruction effort should sustain economic growth around current levels. Imports for relief and reconstruction will put pressure on international reserves. Support from the international community, including emergency assistance from the IMF, will therefore be crucial for financing needed imports. Ensuring that pledged aid commitments from donors are effectively mobilized and efficiently used will be crucial for the success of the reconstruction and recovery program.

"As reconstruction efforts proceed, the authorities continue to be mindful of the limits to implementation capacity and of potential inflationary pressures. In this regard, it is reassuring that the government intends to keep domestic financing of the budget at the pre-tsunami level and contain money growth. The government is also working with stakeholders on a framework to monitor the disbursement and use of aid—an important step towards transparency and accountability.

"The government has indicated its intention to pursue steadfastly the medium-term reform agenda laid out in the 2005 budget. Priority will be given to fiscal sustainability. The authorities' commitment to macroeconomic stability, together with the continued support of the international community, will be essential to help Sri Lanka recover from this tragedy. Timely delivery of international support on appropriate terms will be essential to achieve this objective," Mr. Kato said.