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SRI LANKA

June 8, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE-YEAR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—PRESS RELEASE; STAFF REPORT; STAFF STATEMENT, AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

In the context of the third Post-Program Monitoring discussions, 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 June 3, 2016, following discussions that ended on April 11, 2016, with the officials of Sri Lanka on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 20.
- 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*
Memorandum of Economic and Financial Policies 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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Washington, D.C.

Press Release No. 16/262
FOR IMMEDIATE RELEASE
June 3, 2016

International Monetary Fund
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) today approved a 36-month extended arrangement under the Extended Fund Facility (EFF) with Sri Lanka for an amount equivalent to SDR 1.1 billion (about US$1.5 billion, or 185 percent of quota) to support the country's economic reform agenda.

The IMF arrangement aims to meet balance of payments needs arising from a deteriorating external environment and pressures that may persist until macroeconomic policies can be adjusted. It is also expected to catalyze an additional US$650 million in other multilateral and bilateral loans, bringing total support to about $2.2 billion (over and above existing financing arrangements).

The Executive Board's decision will enable an immediate disbursement of SDR 119.894 million (about US$ 168.1 million), and the remainder will be available in 6 installments subject to quarterly reviews.

During the same meeting, the Board also concluded the 2016 Article IV consultation. A separate press release will be issued shortly.

Following the Executive Board discussion on Sri Lanka, Mr. Min Zhu, Deputy Managing Director and Acting Chair, issued the following statement:

"Despite positive growth momentum, Sri Lanka's economy is beginning to show signs of strain from an increasingly difficult external environment and challenging policy adjustments. The new government's economic agenda, supported by the Extended Fund Facility, provides an important opportunity to re-set macroeconomic policies, address key vulnerabilities, boost reserves, and support stability and resilience.

"A return to fiscal consolidation, targeting a reduction in the overall fiscal deficit to 3.5 percent of GDP by 2020, is the linchpin of the reform program. Rebuilding tax revenues through a comprehensive reform of both tax policy and administration will be key in this regard, supplemented by steps toward more effective control over expenditures and putting state enterprise operations on a more commercial footing.

"Medium-term growth prospects also need to be supported through a greater role for market forces and a decisive shift toward an outward orientation. A clear commitment to exchange rate flexibility will enable adjustment to a shifting external environment while allowing the central bank to rebuild foreign exchange reserves and focus more closely on its key mandate of price stability. The economic program also supports the government's objective of boosting competitiveness and greater integration with regional and global markets through comprehensive trade reform and improvements to the investment environment. Steadfast implementation of these reforms should strengthen Sri Lanka's ability to attract investment, improve prospects for sustained medium-term growth, and reduce fiscal risks."

ANNEX

Recent Economic Developments

Macroeconomic performance in 2015 reflected a positive underlying growth momentum mitigated by the negative impact of unbalanced domestic policies and an increasingly difficult external environment. Real GDP growth was 4.8 percent in 2015 (broadly unchanged from 2014), on the basis of strong growth in services (particularly tourism), continued growth in agriculture, and a positive (albeit declining) contribution from manufacturing. The negative growth in construction and weaker growth in manufacturing were indicative of a slowdown in public and private investment, as well as the negative effects of slowing world trade. The economy is currently estimated to be operating slightly below its potential, while the unemployment rate remains at 4.3 percent in end 2015, close to the historical norm.

The government fiscal deficit expanded to 6.9 percent of GDP in 2015. While revenue increased by 1.5 percentage points to 13.1 percent of GDP, this mostly reflected one-off measures and tax collections from a temporary surge in vehicle imports. Expenditures rose by 2.1 percentage points to 19.9 percent of GDP, on account of a post-election wage hike, a higher interest bill, additional spending on goods and services, and an increase in income transfer programs.

The overall balance of payments deteriorated significantly in 2015 despite an improvement in the terms of trade. The current account deficit was contained at 2.5 percent of GDP in 2015—the same level as in 2014. Capital flows have also been a key driving force behind the deterioration in the balance of payments. The capital and financial account position has weakened due to foreign exit from government securities, lower FDI inflows, and slow implementation of externally financed public and private projects. Investor sentiment has worsened, reflecting global market volatility and concern over domestic policies.

Tougher external conditions in the wake of China rebalancing and unwinding of unconventional monetary policies were not outside Sri Lanka's past experience. However, spillovers were magnified by domestic imbalances, as evidenced by higher volatility around the two elections (January and August 2015), and the official budget passed in November 2015. The rupee continues to face downward pressure—largely reflecting capital flow developments. The foreign exchange and government bond markets were volatile in March 2016. highlighting rigidities in both systems.

Program Summary

The proposed new IMF-supported program aims to provide a policy anchor for macroeconomic stability and structural reforms, while strengthening external resiliency in a challenging global environment.

The key objectives of the program relate to fiscal policy and the balance of payments, and measures to: (a) implement a structural increase in revenues, facilitating a reduction in the fiscal deficit; (b) reverse the decline in central bank foreign exchange reserves; (c) reduce public debt relative to GDP and lower Sri Lanka's risk of debt distress; and (d) enhance public financial management and improve the operations of state owned enterprises. The program also aims to transition toward inflation targeting with a flexible exchange rate regime and to promote sustainable and inclusive economic growth.

To achieve these objectives, the program would envisage implementation of a set of reforms under six pillars:

- (i) fiscal consolidation;
- (ii) revenue mobilization;
- (iii) public financial management reform;
- (iv) state enterprise reform;
- (v) transition to flexible inflation targeting under a flexible exchange rate regime; and
- (vi) reforms in the trade and investment regime.

Background

Sri Lanka, which became a member of the IMF on August 29, 1950, has an IMF quota of SDR 578.8 million.

For additional information on the IMF and Sri Lanka, see:
http://www.imf.org/external/country/LKA/index.htm

Sri Lanka: Selected Economic Indicators, 2014–20

	2014	2015	2016	2017	2018	2019	2020
				Proj.			
GDP and inflation (in percent)							
Real GDP growth	4.9	4.8	5.0	5.0	5.0	5.2	5.4
Inflation (average)	3.3	0.9	4.1	5.3	5.1	5.0	5.0
Inflation (end-of-period)	2.1	2.8	5.4	5.2	5.0	5.0	5.0
Core inflation (end-of-period)	3.2	4.5	4.5	4.3	4.1	4.1	4.1
Savings and investment (in percent of GDP)							
National savings	24.5	25.9	26.9	26.0	26.2	25.9	25.7
Government	-1.1	-2.1	-0.9	0.2	1.4	1.7	2.2
Private	25.6	28.0	27.8	25.9	24.8	24.2	23.6
National Investment	27.0	28.4	28.3	28.8	29.3	29.2	29.2
Government	6.1	6.5	6.5	6.9	7.5	7.3	7.3
Private	20.9	21.9	21.9	21.9	21.9	21.9	21.9
Savings-Investment balance	-2.5	-2.5	-1.5	-2.8	-3.1	-3.3	-3.4
Government	-7.2	-8.6	-7.4	-6.8	-6.0	-5.6	-5.1
Private	4.8	6.2	6.0	4.0	3.0	2.4	1.7
Public finances (in percent of GDP)							
Revenue and grants	11.5	13.1	13.0	14.0	15.3	15.5	15.8
Expenditure	17.8	19.9	18.4	18.8	19.3	19.2	19.3
Primary balance	-2.1	-2.2	-0.8	0.0	0.7	0.8	1.0
Central government balance	-6.2	-6.9	-5.4	-4.7	-4.0	-3.7	-3.5
Central government net domestic financing	3.8	4.3	2.3	3.0	1.3	2.3	2.3
Central government debt	70.7	76.0	77.2	75.5	73.1	70.7	68.2
Money and credit (percent change, end of period)							
Reserve money	18.3	16.5	18.4	12.0	13.5	15.0	15.6
Broad money	13.4	17.8	10.8	15.4	15.1	15.2	15.6
Domestic credit	10.5	23.5	8.5	11.7	11.5	11.8	12.5
Credit to private sector	8.8	25.1	10.0	14.3	15.5	14.5	15.2
Credit to government	12.9	21.3	6.2	7.7	4.9	6.9	7.2
Balance of payments (in millions of U.S. dollars)							
Exports	11,130	10,505	10,456	10,942	11,838	12,664	14,093
Imports	-19,417	-18,935	-18,392	-20,763	-22,606	-24,357	-26,608
Current account balance	-1,989	-2,009	-1,202	-2,419	-2,916	-3,343	-3,812
Current account balance (in percent of GDP)	-2.5	-2.5	-1.5	-2.8	-3.1	-3.3	-3.4
Export value growth (percent)	7.1	-5.6	-0.5	4.6	8.2	7.0	11.3
Import value growth (percent)	7.9	-2.5	-2.9	12.9	8.9	7.7	9.2
Gross official reserves (end of period)							
In millions of U.S. dollars	8,208	7,304	7,853	9,372	11,866	13,033	13,843
In months of imports	4.3	3.8	3.7	4.1	4.8	4.9	5.0
External debt (public and private)							
In billions of U.S. dollars	43.0	44.8	45.9	49.0	53.4	58.4	62.4
As a percent of GDP	53.8	55.1	55.8	55.9	56.3	57.1	56.5
Memorandum items:							
Nominal GDP (in billions of rupees)	10,448	11,183	12,147	13,374	14,787	16,333	18,076

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

INTERNATIONAL MONETARY FUND

SRI LANKA

May 19, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE YEAR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY

KEY ISSUES

Context. The Sri Lankan economy has good underlying momentum but is starting to show signs of strain from a combination of unbalanced macroeconomic policies and an increasingly difficult external environment. A significant political transition has brought a new unity government to the fore. There is now an important window of opportunity to re-set macroeconomic policies to support stability and resilience, as well as undertake structural reforms to help Sri Lanka achieve high and sustained economic growth.

Fiscal Policy. There is a clear need to put tax revenues on an upward path as part of a growth-friendly phase of fiscal consolidation and debt reduction. The significant reduction in the 2016 deficit to 5.4 percent of GDP will need to be followed by further revenue-based fiscal consolidation over the medium-term, guided by the 2020 deficit target of 3.5 percent of GDP (a primary surplus of 1 percent of GDP). Support on tax policy and revenue administration will be essential to successful implementation and creation of a simple, efficient, and equitable tax system.

Monetary and Exchange Rate Policies. The recent tightening of monetary policy was a necessary step given rising core inflation and high private credit growth. Further tightening may be needed in coming months. Over the medium-term, the CBSL will shift to a flexible inflation targeting framework. It is essential that the CBSL begin an exit from the present intervention framework, which has bled reserves over the past 20 months.

Structural Reforms. Reform of state owned enterprises, trade policy, and the investment environment are envisioned. Implementation of automatic pricing mechanisms for fuel and electricity prices will be essential to preventing fiscal risk and enhancing the role of market forces in the economy. Trade policy reform and elimination of para-tariffs is needed for a stronger outward orientation and to build resilience.

Extended Arrangement under the EFF. The authorities have requested a three-year arrangement with proposed access equivalent to SDR 1,070.78 million (185 percent of quota) to meet balance of payments needs arising from a deteriorating external environment and pressures which may persist until macroeconomic policies can be adjusted. Key objectives of the program (related to fiscal policy and the balance of payments) are to: (i) implement a structural increase in revenues to reduce the fiscal deficit; (ii) reverse the decline in central bank foreign exchange reserves; (iii) reduce public debt relative to GDP and lower Sri Lanka's risk of debt distress; and (iv) enhance public financial management and improve the operations of state owned enterprises. The program also aims to transition toward inflation targeting with a flexible exchange rate regime and to promote sustainable and inclusive economic growth by supporting trade and investment. Program risks are substantial given the complexity of reforms and the need for strong political commitment. All prior actions have been completed.

Approved By
Kalpana Kochhar and Bob Traa

Discussions were held in Colombo, March 28 to April 11, 2016. The mission met with Prime Minister Wickremesinghe, Finance Minister Karunanayake, Central Bank of Sri Lanka Governor Mahendran, Secretary to the Treasury Samarathunga, other senior officials and private sector and civil society representatives. The staff team comprised Mr. Schneider (head), Mr. Nozaki, Mr. Washimi (all APD), Ms. Diouf (SPR), Ms. Kvintradze (resident representative), and Mr. Wijeweera (local economist). Ms. Kochhar (APD) also joined for part of the mission, and Ms. Gunaratne (OED) participated in the policy discussions. S. George, M. Inoue, and Q. Zhang also assisted in the preparation of this report.

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ECONOMIC BACKGROUND

Lack of coordination and clarity on policies as the country moved through two elections in less than nine months gave rise to both macroeconomic imbalances and a decline in investor confidence.

1. **Macroeconomic performance in 2015 reflected a mix between positive underlying growth momentum, the negative impact of unbalanced domestic policies, and an increasingly difficult external environment.** Real GDP growth was 4.8 percent in 2015 (broadly unchanged from 2014), on the basis of strong growth in services (particularly tourism), continued growth in agriculture, and positive (albeit declining) contribution from manufacturing. The negative growth in construction and weaker growth in manufacturing were indicative of a slowdown in public and private investment, as well as the negative effects of slowing world trade. The economy is currently estimated to be operating slightly below its potential. The industrial production index grew by 3.9 percent in the fourth quarter of 2015 (somewhat lower than the 2010−15 historical average), while the unemployment rate remains at 4.3 percent in end 2015, close to the historical norm. Headline inflation ended the year at 2.8 percent and dropped marginally to 2 percent as of March 2016, but core inflation continued to rise—reaching 4.5 percent by end 2015 and hitting 5.7 percent in February before dropping back to remaining at 4.5 percent by end-March. Private credit growth (at 25 percent in 2015) was well above both the historical average and the authorities' benchmark of 15–16 percent. Credit growth is expected to slow reflecting lower LTV ratios on vehicle finance (70 percent compared to 100 percent) and the temporary use of a 100 percent cash margin requirement on all Letter of Credits opened for vehicle imports (from October 30 to December 1, 2015).

2. **The government fiscal deficit expanded to 6.9 percent of GDP in 2015.**[1] While revenue increased by 1½ percentage points to 13.1 percent of GDP, this mostly reflected one-off measures and tax collections from a temporary surge in vehicle imports. Expenditures rose by 2.1 percentage points to 19.9 percent of GDP, on account of a post-election wage hike (0.8 percentage points), a higher interest bill (0.5 percentage points), additional spending on goods and services (0.5 percentage points), and an increase in Samurdhi transfers (0.3 percentage points). On the other hand, capital outlays were compressed to 4.7 percent of GDP—about 0.4 percentage points lower than in 2014. Public debt increased from 70.7 percent in 2014 to 76 percent in 2015—partly reflecting debt financing of the fiscal deficit, but also the impact of rupee depreciation on the stock of foreign-currency denominated debt. As of end-2015 there was also an estimated Rs 1.36 trillion (11 percent of GDP) in government and state enterprise liabilities (the latter—Rs. 1.28 trillion—accounting for about 94 percent of the total)—some of which is under a government guarantee (see Box 1). Four SOEs (Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB), the Sri Lanka Ports Authority (SLPA), and Sri Lankan Airlines) account for the bulk of these obligations.

[1] The authorities' official figures for capital spending and the fiscal deficit in 2015 were 5.3 and 7.4 percent of GDP, respectively. This reflects an accounting arrangement whereby cost overruns for capital projects amounting to Rs 62 billion or 0.6 percent of GDP (which were paid but not recorded in 2014) were recorded in the 2015 account, according to an estimate provided by the recent FAD TA mission.

Box 1. Public Debt in Sri Lanka

Sri Lanka records public debt on a central government basis, but there are other quasi-fiscal obligations of significant size. As of end-2015, central government debt was 76 percent of GDP, consisting mainly of treasury bonds (30 percent of GDP), multilateral and bilateral debt (20 percent), and international bonds (9 percent). In addition, state-owned enterprises (SOEs) were estimated to have outstanding financial obligations of 11 percent of GDP, according to government data. The government provides guarantees for part of SOE debt (3.4 percent of GDP). These guarantees are capped at 7 percent of GDP, stipulated by the Fiscal Management Responsibility Act.

Sri Lanka: Public Debt, 2015

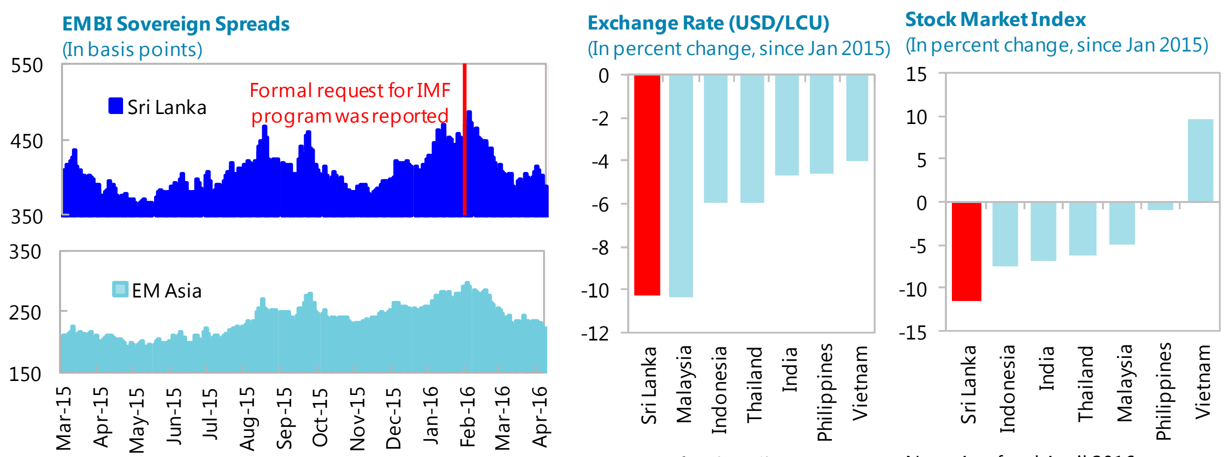
	Rs. billion	% of GDP
Central government debt	8,503	76.0
Domestic	4,959	44.3
Treasury Bills	658	5.9
Treasury Bonds	3,305	29.6
Other	996	8.9
External	3,544	31.7
Multilateral and bilateral	2,237	20.0
International sovereign bonds	958	8.6
Nonresident holdings of T-Bills and T-Bonds	304	2.7
Other	45	0.4
Financial obligations of SOEs 1/	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
Memorandum items:		
Publicly guaranteed debt	382	3.4

Sources: Sri Lankan authorities and IMF staff estimates.
1/ IMF staff estimates.

3. **The overall balance of payments deteriorated significantly in 2015 despite an improvement in the terms of trade.** The current account deficit was contained at 2.5 percent of GDP in 2015—the same level as in 2014. A strong pickup in non-energy imports (notably vehicles), negative export growth[2], and flat growth in remittances more than offset a lower oil bill and robust growth in tourism receipts. Excluding oil, the current account deficit deteriorated from a surplus of $2.6 billion in 2014 to a surplus of only $691 million in 2015. An estimated windfall of some $1.9 billion from lower oil prices (and volumes) was largely consumed by a $1.4 billion in increase in non-oil imports, with consumer goods accounting for about 60 percent of the total. Notwithstanding a boost from a September swap arrangement with the Reserve Bank of India (RBI) for US$1.1 billion and a late-October issuance of a $1.5 billion sovereign bond, gross reserves declined from 87 percent of the ARA reserve metric in 2014 to 76 percent in 2015, with a drop in months of reserve cover (prospective imports of goods and services) from 4.3 to 3.8 months. The RBI swap was repaid in full in early March 2016, but a fresh swap line of $700 million[3] was extended at the same time, and fully drawn by the CBSL at the end of March.

[2] The decline in exports followed lower commodity prices (notably for tea) and lower demand from the EU, Russia, and the Middle East, including for garment and apparel exports.
[3] The duration of the swap is three months, or until an IMF-supported program is approved.

4. Capital flows have also been a key driving force behind the deterioration in the balance of payments. The capital and financial account position has weakened due to foreign exit from government securities, lower FDI inflows, and slow implementation of externally financed public and private projects. Investor sentiment has worsened, reflecting global market volatility and concern over domestic policies. Equity prices on the Colombo All Shares Price Index (ASPI) dropped by about 6 percent in 2015. Sri Lanka's spreads over the 5-year US Treasury have widened relative to other EM Asian countries since the beginning of 2015, reflecting the weakening of macroeconomic fundamentals and investor sentiment. Sri Lanka's spread vis-a-vis the EMBI peaked at 490 bps on February 11, but has since dropped to about 380 bps—compared with 220 bps for emerging Asian economies. Tougher external conditions in the wake of China rebalancing and unwinding of unconventional monetary policies were not outside Sri Lanka's past experience. However, spillovers were magnified by domestic imbalances, as evidenced by higher volatility around the two elections (January and August 2015), and the official budget passed in November 2015.

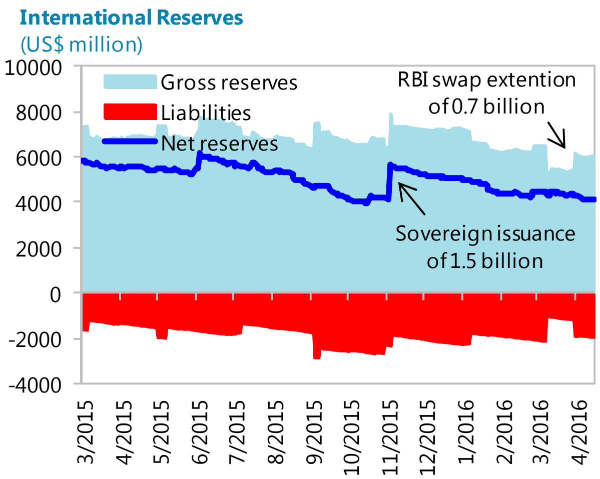


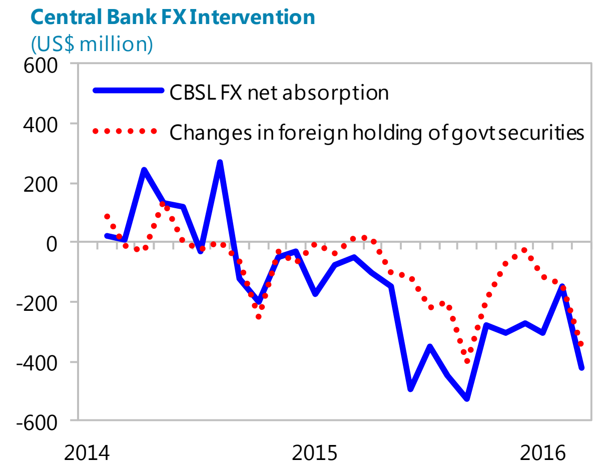
Note: As of end April 2016.

Note: As of end April 2016.

Sources: Country authorities; Bloomberg; and IMF staff calculation.

5. The rupee continues to face downward pressure—largely reflecting capital flow developments. The rupee was held relatively steady during the first eight months of 2015—depreciating by only about 2 percent as the CBSL provided about $1.9 billion to the foreign exchange market. Following the August elections, the CBSL shifted policy to cease giving a daily reference rate, exit from daily intervention and allow the market a greater role in determining the value of the rupee—with the rupee depreciating by some 4 ½ percent in that month despite net intervention of an additional $517 million. Intervention resumed after a short period, with central bank net sales of another $856 million in the remaining months of 2015, and the rupee depreciating slowly by another 2 percent. After some signs of stabilization in February (when net CBSL intervention fell to $190 million compared to a peak of $460 million per month in July−September 2015), market pressures resumed in March. At the beginning of 2016, gross international reserves were short of gross foreign-currency claims coming due in the year.





Sources: Country authorities; and IMF staff calculation.

6. The foreign exchange and government bond markets were volatile in March 2016—highlighting rigidities in both systems. Amid stronger market pressures, CBSL actions (including provision of another $437 million to the foreign exchange market) kept the spot rate virtually unchanged and pushed a greater amount of foreign exchange trading to the forward market. The daily average transaction volume in the spot market declined from US$20 million to US$11 million between January and March, while the total transaction volume in the forward market increased from $58 million to $72 million. This may suggest that moral suasion in the spot market has pushed a greater amount of foreign exchange trading to the forward market. High short-term volatility has also been visible, with the 3-month forward price jumping from Rs 146.5 per US dollar to 151.4 during March 28–30, before settling again close to Rs 145 per dollar. The government bond market also became volatile in late March, as the CBSL initially announced issuance of Rs 40 billion in treasury bonds, but instead issued bonds of Rs 80 billion at a higher rate than that prevailing in the secondary market.

7. Financial soundness indicators for 2015 were generally favorable. Profitability has generally increased on the back of an increase in net interest income, and capital adequacy remains comfortably above regulatory limits. Interest spreads have widened as commercial banks raised their prime lending rates by about 150 bps since December 2015 (reflecting the tightening of monetary policy) while increasing deposit rates by only 25 bps. Vehicle financing accounted for much of banks' loan growth in 2015 followed by other consumer related financing such as housing. The ratio of NPLs to gross loans declined to 3.2 percent in the fourth quarter from 4 percent in the third quarter because of growth in the overall portfolio of loans.

OUTLOOK AND KEY RISKS

8. **Sri Lanka's short-term outlook is challenging, but medium-term prospects are favorable if current macro-financial imbalances can be addressed.** There are significant challenges for 2016 as the government seeks to undertake difficult reforms to re-start fiscal consolidation and tackle high priority structural reforms. Nonetheless, with a solid commitment to reform, clear direction on macroeconomic policies, and restoration of market confidence, there is room for a small uptick in real GDP growth—based on a resumption of investment projects stalled in 2015, continued strong growth in services, and a modest increase in foreign direct investment. Real GDP is projected to rise from 4.8 percent in 2015 to 5 percent in 2016, supported by a recovery in construction from negative growth in 2015 (base effects), regaining of GSP plus status, and sustained momentum in services including tourism, transport, and IT.

9. **Growth is projected to increase to 5½ percent (in line with estimated potential output) by 2020, and inflation to stabilize at 5 percent.** The negative output gap is thus projected to narrow over the medium term and close by 2020. This relatively positive outlook is based on several elements, including Sri Lanka's comparatively buoyant performance during earlier periods of stress (including during the civil war). The outlook is also supported by several macroeconomic pillars. Notwithstanding current challenges, Sri Lanka has a strong base of human capital and reliable infrastructure—especially compared with other South Asian economies. It also occupies a strategic position in a fast growing and dynamic region, and capital investments over the last decade (particularly on port and other transport-related facilities) have been geared to take advantage of this opportunity. Services growth has been strong, particularly in such relatively new areas as tourism (which continues to enjoy double digit growth as part of the peace dividend), IT, and accounting. However, stronger macroeconomic management, a decisive return to an outward orientation, a stronger role for the private sector and market forces, and further investment in physical infrastructure and human capital are needed to achieve high, inclusive, and sustained growth.

10. **The key risks to the outlook (both short- and medium-term) stem from** (i) government inaction on key policies; and (ii) a significant deterioration in the external environment, as highlighted in the Risk Assessment Matrix (RAM, Annex II). Current policies are likely unsustainable. Over the past 1−2 years fiscal consolidation has been reversed, gross financing needs have increased sharply, public debt has risen as a share of GDP, and persistent defense of the exchange rate has reduced net international reserves by over $2.3 billion. Inaction on policies and continued reliance on borrowed resources to fund fiscal deficits and defend the exchange rate is unsustainable over the medium-term, and will undermine prospects for investment and inclusive growth. In this context, the key risks relate to not achieving the envisaged increase in the tax-to-GDP ratio, a further decline in growth, or additional losses from state enterprises—all of which would pose challenges for fiscal consolidation. External risks are also clearly present. Pressure on the balance of payments is expected to continue in the short run given global rebalancing and shifting investor sentiment—with the potential for additional capital outflows beyond what is currently envisaged. Other external risks include a further reduction in export growth in case of a slowdown in demand in key textile/apparel markets (the U.S. and EU); a further drop in inward remittances in the wake of lower oil prices and the negative economic impact on host countries in the Middle East; or a drop in services activity in line with slower

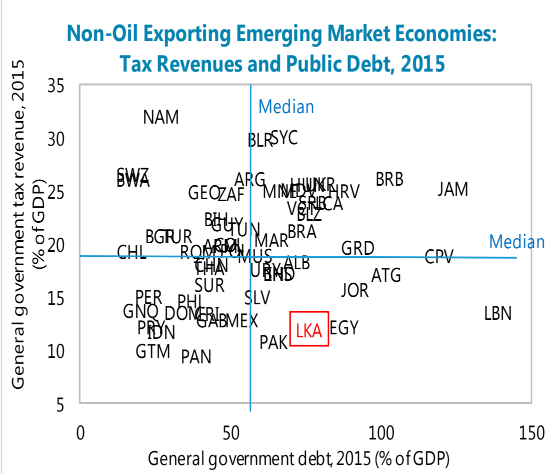
global trade and a downturn in tourism. These shocks can have substantial impact on the balance of payments. Staff estimate that a "worst case" combined shock to the current account (through goods and services exports and remittances) and the capital account (impacting FDI and foreign exit from the government securities market) could widen the financing gap by as much as \$1.8 billion over 2016-17 (assuming no policy adjustment).

ARTICLE IV DISCUSSIONS: NAVIGATING RISK, RESETTING POLICIES, ACHIEVING LIFT-OFF

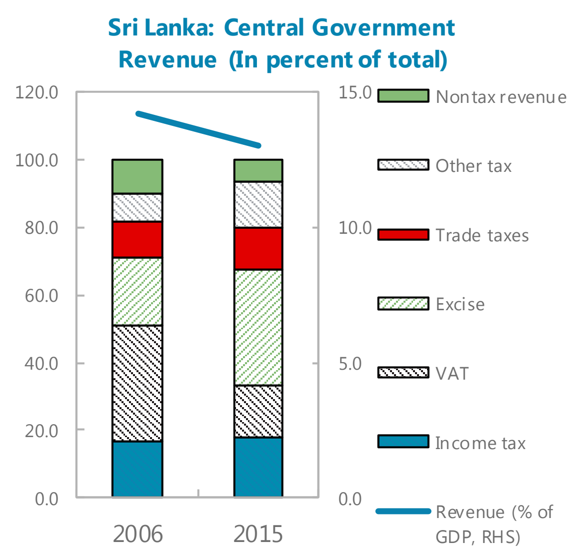
Discussion focused on the authorities' plans to address short-term macroeconomic imbalances, create stronger momentum toward sustainable public finances and economic growth, bolster competitiveness, increase the role of market forces in the economy, and build greater resilience to shocks.

A. Return to Fiscal Sustainability

11. Successive IMF staff reports since the completion of the 2009–12 Stand-By Arrangement have highlighted the fiscal framework and the steady decline in government tax revenue as a key risk. The ratio of tax revenue to GDP has fallen from nearly 13 percent of GDP in 2006 to 10.1 percent in 2014, rebounding to 12.1 percent in 2015 (largely on the basis of one-off tax measures and a short-term surge in import taxes). The composition of tax revenue has changed dramatically. The share of revenue generated by the VAT has fallen by more than half, while the share of excises, trade taxes, and other miscellaneous taxes has increased from about 40 percent of total revenue in 2006 to 60 percent in 2015. A VAT-like indirect tax (Nation Building Tax, NBT) coexists with the VAT, undermining the simplicity of the tax system (Box 2). Income taxes are plagued with an extended list of tax incentives and concessions. The low level of domestic revenues has hampered fiscal and macroeconomic management and magnified reliance on both domestic and external debt.



Sources: World Economic Outlook Database; Sri Lankan authorities; and IMF staff estimates.



Sources: Ministry of Finance and IMF staff estimates.

Box 2. Sri Lanka – the VAT versus the National Building Tax (NBT)

Two similar indirect taxes coexist in Sri Lanka: the VAT and the National Building Tax (NBT).

- Sri Lanka's VAT has such standard features as a credit offset system, a single rate (raised from 11 percent in 2015 to 15 percent in 2016), and zero-rating for exports. However, its effectiveness is hindered by a large number of exemptions. The VAT raised only 2 percent of GDP in 2015.
- The NBT is levied on a company's turnover at a single rate (2 percent), imposed through all production stages and on provision of services. Manufacturers can claim credits for imports and purchases from registered manufacturers, but not for services. Refunds are not allowed, and exports are exempted but not zero-rated. The NBT raised 0.4 percent of GDP in 2015.

Theory and experience suggest the VAT is a clear winner over the NBT as an efficient revenue-raising vehicle. The VAT is more effective in terms of:

- Limiting tax cascading. With its limited offset for tax on inputs, the NBT is a cascading tax that leads to price distortions. This negative effect would be exacerbated if the NBT rate were raised substantially above the current level. On the other hand, a standard VAT avoids tax cascading (up to the minimum level implied by exemptions and the registration threshold).
- Preserving export competitiveness. With exports exempt but not zero-rated under the NBT, exports leave Sri Lanka burdened with the NBT paid on inputs. On the other hand, the VAT is not levied on inputs for exports because they are zero-rated. Thus, the NBT weakens competitiveness of Sri Lanka's exports and provides disincentives for FDI.
- Mobilizing revenue. Keen and Lockwood (2010 1/) find that countries with a VAT raise more revenue than those without, although gains vary with countries' openness and income levels.

The VAT does pose administrative challenges, such as preventing fraudulent VAT refunds. In a standard VAT, the tax authority needs to refund taxpayers whose input taxes exceeds tax receipts on final products (e.g., exporters and start-up enterprises purchasing capital goods). Country experience indicates that the refund process can be the "Achilles heel" of the VAT, as opportunities for fraud often result in tension between tax authorities and taxpayers as well as complex administrative measures (Harisson and Krelove, 2005; Keen and Smith, 2007 2/). Sri Lanka is not an exception: concern over VAT fraud led to introduction of the so-called Simplified VAT (S-VAT) system, under which large exporters are allowed to purchase goods and services free of VAT from registered suppliers, thereby effectively eliminating refund entitlements. The concern has also prompted policymakers to look at the NBT as an alternative to the VAT because refunds do not occur.

Managing VAT refunds would require introducing a risk-based compliance strategy and simplifying the VAT. Country experience suggests no panacea. In Sri Lanka, the S-VAT can increase compliance risk, because it now allows VAT-free purchases for more than 10 percent of VAT taxpayers. Thus, it would be important to establish a VAT compliance plan, encompassing a review of the S-VAT implementation and introduction of risk-based refund audit. The S-VAT should be phased out and replaced by a robust VAT refund system, supported by improvements in administrative capacity. Also, simplifying the VAT system, including through minimizing exemptions and setting an appropriate registration threshold, would help improve VAT compliance.

1/ Keen and Lockwood, 2010, "The Value-Added Tax: Its Causes and Consequences," Journal of Development Economics, Vol. 92, pp. 138–51.
2/ Harisson and Krelove, 2005, "VAT Refunds: A Review of Country Experience," IMF WP 05/218; Keen and Smith, 2007, "VAT Fraud and Evasion: What Do We Know, and What Can be Done?" IMF WP 07/31.

12. As a critical first step toward medium-term fiscal objectives, the authorities revised down the 2016 budget deficit target to 5.4 percent of GDP (0.5 percentage points lower than the original budget target). To offset the impact of the one-off and temporary factors in 2015 and maintain the revenue to GDP ratio at the 2015 level, the authorities introduced tax measures including increasing the VAT rate to 15 percent (from 11 percent) and removing exemptions on telecommunication services, starting from May 2016. They also scaled back initial plans to exempt wholesale and retail sectors from VAT, introduce multiple VAT rates, and raise the NBT rate from 2 percent to 4 percent. On the expenditure side, the authorities plan to control spending within available fiscal space by streamlining non-critical expenditure on goods and services and capital spending.

13. There is a clear need to improve the quality of tax revenues and put them on an upward path as part of a growth-friendly phase of fiscal consolidation and debt reduction. In this context, the staff welcomed the authorities' decision to reduce the 2016 deficit to 5.4 percent of GDP. This is a necessary first step on a path to restructure public finances, and shift from a plethora of fees, excises, and levies to a core revenue base with a stronger emphasis on direct versus indirect taxation. A well designed path of fiscal consolidation should be a cornerstone in addressing current macroeconomic imbalances and restoring investor confidence. Over the medium term, a stronger fiscal position and improved public financial management can also create the space necessary for a reorientation of public expenditure toward levels of infrastructure and social spending needed to ensure high rates of sustained income growth, a steady reduction in poverty, and improvement in Sri Lanka's social development indicators.

14. Lower fiscal deficits, enhanced tax revenues, stronger expenditure management, and mitigated risks from state enterprises are essential to reducing Sri Lanka's macroeconomic and financial vulnerabilities. Sri Lanka's public debt sustainability analysis (DSA) continues to demonstrate a high level of risk to medium-term sustainability (see Annex III). The debt burden benchmark of 70 percent of GDP and gross financing need benchmark of 15 percent of GDP are exceeded in all shock scenarios. Risks are estimated to be particularly high for a potential contingent liability shock (e.g., assuming all or part of the debt of public enterprises).[4] Continuation of the envisioned fiscal stance for 2016 (a primary deficit of 0.8 percent of GDP) would reduce the debt to GDP ratio only by 3½ percentage points over 2015–20, leaving public debt highly vulnerable to downside risks (e.g., negative growth shock). Revenue mobilization will be essential to create fiscal space for higher expenditure and deficit reduction, and reducing key vulnerabilities. Moreover, very low efficiency of income tax and VAT collection suggest ample room to increase the tax-to-GDP ratio through base-broadening tax reforms (see panel chart below). These efforts should be supported by improving the quality and effectiveness of public expenditure and reducing fiscal risks from state enterprises. In that context, the following elements should be emphasized:

[4] Under a contingent liability shock scenario in the public DSA (the central government becomes liable for additional debt of 10 percent of GDP in 2017), public debt and gross funding needs would reach 80 percent of GDP and 15 percent of GDP in 2020, respectively.

- **A medium-term commitment to revenue mobilization and fiscal consolidation**, as outlined in the fiscal framework under the proposed Extended Arrangement and following the principles highlighted in Box 3. To the extent that contingent liabilities come onto the government books, the additional interest cost will need to be absorbed while adhering to the envisioned fiscal path.

- **Tax policy reform to create a simple, efficient, equitable tax regime aimed at collecting revenue rather than distributing benefits and incentives.** Rationalization of income tax expenditures and a new Inland Revenue Act will be critical steps, and should be followed by VAT and customs reform.

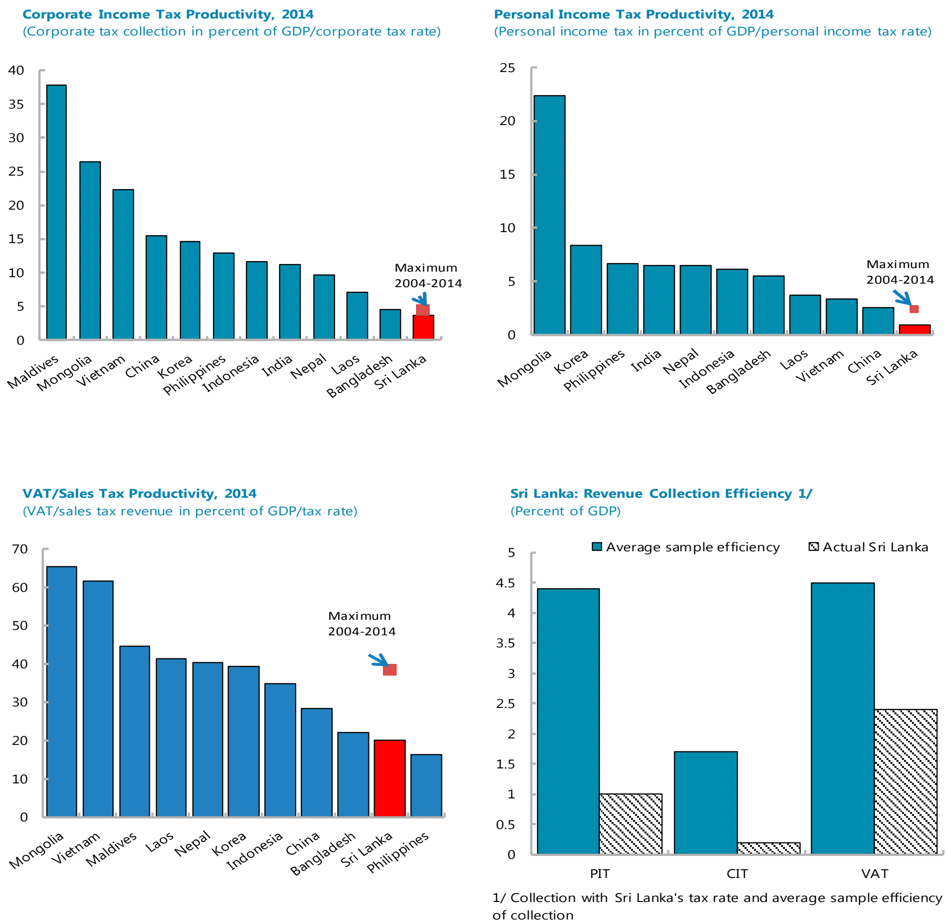
- **Building capacity in revenue administration.** Government ownership of this reform is essential. Staff recommends establishment of performance benchmarks for efficient and effective tax administration, a shift toward risk-based audit, and efficiency-enhancing organizational reform of IRD operations. To achieve these objectives, full and expedited rollout of the IT systems for tax and customs administration (RAMIS and ASYCUDA) is critical, including linkages between the two systems.

- **Stronger expenditure management.** This should be supported by measures to rationalize ineffective public spending (e.g., replacing ill-targeted subsidies with cash transfers targeted for the poor). At the same time, improvements in public expenditure management, in particular in the area of commitment control, are necessary. Spending arrears have recurred because of overly optimistic revenue projections and heavy reliance on cash releases to control expenditure. While the ministry of finance should start to implement commitment record and quarterly commitment ceilings using the current IT system, the expected roll out of the new ITMIS system should be implemented without delay for fully automated commitment control.

- **Decisive reform of state enterprise operations.** Loss-making enterprises such as Sri Lankan Airlines need to be restructured or resolved to stop the hemorrhage of public finances. Other enterprises need to operate on a commercial footing—with the essential first step being market-based pricing of fuel, electricity, and other utilities. A clear commercial relationship, based on annual statements of corporate intent (SCI[5]) signed by the Ministry of Finance, the line ministry, and the SOE, will help ensure viable commercial operations, and clarify government's obligations with respect to non-commercial operations (e.g., subsidies).

[5] Statements of corporate intent are important public accountability documents. They typically include a description of the entity's core purpose, operating environment, key objectives, financial targets (commonly for the medium-term), and important accounting or policy rules.

Sri Lanka: Comparative Tax Productivity



Source: Ministry of Finance, WEO database; FAD tax rate database, country staff reports, staff calculations

15. The authorities agreed with the need for revenue-based fiscal consolidation and further improvements in fiscal transparency and public financial management. Starting from a significant reduction in the 2016 deficit to 5.4 percent of GDP, the authorities aim to steadily reduce the deficit further to 3.5 percent of GDP or less by 2020 (equivalent to a primary surplus of 1 percent of GDP to ensure continued debt reduction). In light of substantial needs for social and infrastructure spending, the authorities agreed that fiscal consolidation needs to be revenue based. The planned introduction of the new Inland Revenue Act will help to simplify the income tax system. Reforming the current regime of corporate income tax incentives toward a targeted, transparent, and rule-based system would be also important. The authorities also highlighted the benefits of digitalization, and that tax administration should also improve with support from newly developed IT systems. On the expenditure side, the authorities have already started to streamline untargeted subsidies and introduced zero-based budgeting to prioritize high-quality government projects. They plan to further strengthen capacity to identify and execute efficiently infrastructure projects, improve commitment control including by expediting roll-out of a new IT system, and move swiftly on the issue of outstanding obligations of SOEs.

Box 3. Tax Reform Strategy in Sri Lanka

Future tax reform should be geared toward a simple, efficient, and equitable system tailored to Sri Lanka. Low tax efficiency in Sri Lanka suggests large potential revenue gains from base-broadening and tax administration reforms. Basic principles that should guide year-to-year reforms (as emphasized in IMF policy papers and TA reports) are as follows:

- ***Direct taxes***. A simple and broad-based corporate income tax regime would preserve revenue collection while facilitating competitive statutory rates. Corporate tax incentives should be limited to those linked to strategic investment. The personal income tax regime should treat individuals equally regardless of occupation, with a tax rate scale appropriately set to alleviate income inequality. Income from capital can be taxed at a low flat rate and collected at source. In Sri Lanka, numerous tax expenditures have been granted against these principles, including corporate tax holidays, low tax rates for professionals, and exemptions for debt securities issued by listed companies. Rationalizing these expenditures could significantly increase tax revenue. Estimated revenue foregone due to corporate profit exemptions was in the range of 1 1/3 percent of GDP in 2012–13, roughly equal to corporate tax collections.

- ***Indirect taxes***. Sri Lanka's single-rate VAT should have minimal exemptions and an appropriate registration threshold. The degree of base erosion (including from recent measures to exempt excisable goods such as petroleum products, cars, tobacco, and alcohol and replace with increases in excise rates), should be reviewed. The Nation Building Tax should be abolished (see Box 2). Levying excises on a few key items at appropriate rates can support revenue needs while addressing externalities.

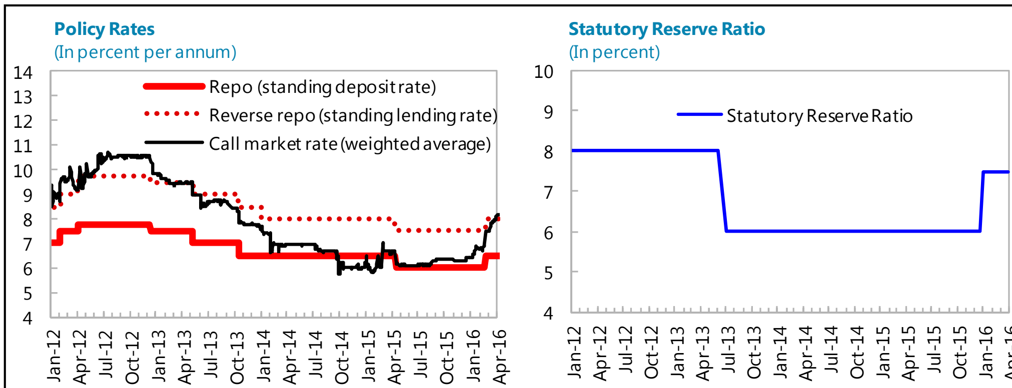
- ***Other taxes***. Reform areas would include strengthening property taxes, streamlining import tariffs and para-tariffs, and establishing simple and coherent regimes for taxing SMEs.

- ***Tax administration reform***. Effective tax administration makes proper use of tax withholding and third-party information to increase voluntary compliance, and uses resources efficiently through risk management and taxpayer segmentation. In Sri Lanka, there is a need to set up risk-based compliance strategies by tax type, taking advantage of a new IT system. Simplification of tax legislation will also contribute to improved tax administration.

Reforms should take account of lessons from the past. Sri Lanka's 2011 tax reform contained measures to improve the efficiency of the tax system: Board of Investment tax incentives were brought into the legal framework; import taxes were streamlined; VAT rates were unified; and some "nuisance" taxes were abolished. However, it also reduced corporate and personal income tax rates without a commensurate broadening of the tax base, and continued the use of the NBT. New tax incentives and exemptions have been added virtually every year since—eroding the tax base and complicating tax administration. The Ex Post Evaluation (EPE) of the 2009 Stand-By Arrangement noted that a more strategic approach to sequencing the reforms—by prioritizing base broadening, carefully calibrating the pace of rate reductions, and carefully aligning revenue targets—might have made a difference. As suggested in the IMF's Ex-Post Evaluation report, annual revenue targets should be supported by clearly-specified, bottom-up measures that are marked by strong ownership.

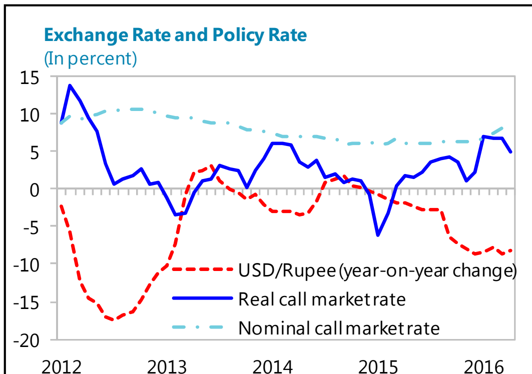
B. Upgrading Monetary and Exchange Rate Policies

16. Steps to tighten monetary policy in late 2015 and early 2016 were appropriate but further tightening may be needed in the months ahead. The central bank uses market based instruments, in particular policy interest rates and open market operations, as the main policy tools along with adjustments to the statutory reserve requirement. The staff welcomed steps already taken to tighten monetary policy given the steady increase in core inflation and high private credit growth (the CBSL increased the statutory reserve ratio from 6 percent to 7.5 percent in January 2016, and then increased the standing deposit facility rate and lending facility rate by 50 basis points to 6.5 and 8 percent, respectively, in February 2016). March data suggest core inflation and private credit growth have begun to moderate. However, staff believes the CBSL should stand ready to further raise policy rates and tighten liquidity should inflationary pressures continue and private credit growth not continue to moderate, or to support adjustment to exchange rate flexibility. Where warranted, the CBSL should be also prepared to strengthen macroprudential measures to mitigate excessive credit growth while carefully assessing the nature of the risks. These actions should also be supported by the planned reduction in the government budget deficit.



Sources: Country authorities: and IMF staff estimates.

17. The central bank has made progress toward upgrading the monetary policy framework by setting out the pre-conditions for a move to flexible inflation targeting. [6]Recognizing the lack of a close relationship between monetary aggregates and inflation, the authorities have made a public commitment to shift toward a flexbile inflation targeting framework. Short-term forecasting tools and medium-term dynamic stochastic general equilibrium (DSGE) techniques are being studied to improve inflation forecasting, and inflation expectations surveys are also conducted.



Sources: Country authorities: and IMF staff estimates.

[6] A flexible inflation targeting framework gives weight to inflation as a normal anchor while also considering the policy's impact on growth.

The staff recommends development of a roadmap to set milestones in the development, testing and making operational a shift to flexible inflation targeting within the next three years, supported by additional IMF technical assistance, as needed.

18. Quantitative analysis of the exchange rate indicates that pressures in the foreign exchange market reflect high policy imbalances (Annex IV). Econometric estimation[7] of the real exchange rate misalignment suggests that Sri Lanka's current account gap is small (-0.2 percent of GDP) with a cyclically-adjusted current account deficit close to the norm predicted by fundamentals. However, the analysis also shows that policy imbalances are high, at 0.8 percent of GDP. Other analysis of the equilibrium real exchange rate point to an overvaluation of about 11 percent. A more qualitative analysis based on central bank intervention in the foreign exchange market suggests that recent intervention has been driven largely by capital account transactions.

19. Sri Lanka's external position is weaker than implied by fundamentals and desirable policies, and there are several concerns with respect to external sustainability (Annex IV). Amid the CBSL's accommodation of foreign exchange demands from non-resident exit of the government securities market, gross international reserves have fallen to a point short of gross foreign currency claims coming due in 2016. Renewed swap arrangements with the RBI ($700 million) and through the South Asian Association for Regional Cooperation (SAARC) line ($400 million) provide additional buffer space, but are likely to be short-lived.[8] The net International Investment Position (IIP) has been increasingly skewed away from equity investments and toward debt and loans. However, on the upside, external debt remains sustainable with low rollover risk (medium and long-term debt represents 83 percent of external debt), although currency risk is elevated (see external DSA in Annex III).

20. With corrective fiscal policies presumed to be coming in to place, and a clear commitment to confidence-boosting reforms, the staff sees it as essential for the CBSL to begin an exit from current intervention policy. The steady, one-sided intervention policies of the past 20 months have drained net reserves by about $3.2 billion and are unsustainable. In the staff's view, foreign exchange intervention is useful to contain volatility, but not to respond to underlying outflows (which require policy strengthening). The staff recommended that the authorities preserve reserve buffers by phasing out intervention in the foreign exchange market, or buying foreign exchange reserves while sterilizing intervention to avoid undermining measures toward monetary tightening. As a second step, the CBSL should start to accumulate foreign exchange reserves to replenish buffers, and limit supply of residual foreign exchange to the market to the minimum, including cases where market imperfections hinder settlement of smaller transactions. Over the medium term, the staff argued that structural reforms to strengthen the monetary policy transmission mechanism and deepen markets could also support a durable transmission to a more

[7] External balance assessment (EBA) current account methodology. Estimates of the other two EBA methodologies are not available.

[8] The bilateral swap with the RBI is due to expire in June 2016, or upon approval of a Fund arrangement. The SAARC swap line is also due to expire in June 2016, but could be rolled over upon approval of a Fund arrangement.

flexible exchange rate regime. Such measures, supported with IMF technical assistance as needed, could include:

- **The functioning of the money markets could be enhanced** through the continued use of term operations, generally with maturities of between 7 and 30 days (longer instruments to be used for managing structural liquidity) and the removal of restrictions on short-selling of securities along with broadening the investor base.

- **The repo markets could also benefit from the adoption of standard repo documentation** across the markets.

- **To deepen foreign exchange markets and reduce volatility, it is recommended that the CBSL undertake a review of foreign exchange laws and regulations** and develop a timeline for rolling back restrictions on banks' net open and forward positions in foreign exchange, as well as phasing out remaining capital account restrictions.

21. The authorities consider that the current monetary policy stance is broadly appropriate, but stand ready to adjust as necessary. They expect inflation to remain at the mid-single digits and private credit growth to decelerate from the current rapid pace to about 15–16 percent for the year. While they are committed to moving toward flexible inflation targeting, they emphasized that the commitment of the government on fiscal consolidation is essential to avoid an expansionary fiscal stance fueling domestic demand and crowding out private credit. The authorities concurred that flexible inflation targeting should accompany greater exchange rate flexibility along with transparent and clear communication with the market. They also expressed an interest in technical assistance to conduct a comprehensive diagnosis on capital market developments, noting that the money markets are shallow and need broadening the investor base.

Box 4. Sri Lanka: Pathway to Greater Exchange Rate Flexibility

The CBSL has shown a tendency to actively manage the rupee in times of stress. In the past year, the CBSL has intervened heavily in the foreign exchange market, announcing daily the rate for spot transactions, and supplying substantial amounts of dollar liquidity ($3.7 billion from January 1, 2015 to February 15, 2016). The CBSL's policy reduced reserves and increased Sri Lanka's vulnerability to shocks. Such policies were not new—it utilized similar operations in 2008 and 2012.

An exit from the "on-again, off-again" approach to exchange rate flexibility would better serve Sri Lanka in times of economic stress or external shocks. Planning such an exit should take into account cross-country experience, which suggests four ingredients for a successful transition to a floating regime: (i) a deep and liquid market; (ii) adequate systems to review and manage exchange rate risks, (iii) a coherent intervention policy consistent with a floating regime; and (iv) an appropriate nominal anchor (IMF Occasional Paper No. 256). Sri Lanka fares variably on these dimensions, and has experimented with periods of greater flexibility. The most binding constraints are a lack of transparency, a shallow market, and large deficit financing requirements.

A coherent and transparent intervention rule would help restore market confidence. Currently, Sri Lanka does not have a publicly announced intervention rule. Given that intervention becomes discretionary under a flexible regime, setting up well-specified principles enhances credibility and signals commitment to a market-determined rate. It is also important in avoiding excessive smoothing, which could also be confusing and send contradictory messages. An intervention rule would also avoid suppressing useful market signals that strengthen market development. It could be calibrated based on a set of objectives, including meeting reserve targets, supply publicly acquired forex, correcting misalignments, or calming disorderly markets.

A successful intervention strategy needs to be realistic, useful, robust, and clear. The strategy should be realistic on the uncertainty around the fair value of the rupee, and help the CBSL gain credibility through a viable monetary policy framework and measurable success in controlling key targets. To maintain credibility, an intervention strategy should be set once, remain fundamentally unchanged, and be robust to shocks, although parameters (e.g. specific intervention thresholds) can evolve as needed. Clarity helps guide markets and provides actionable instructions to traders. A number of countries have used an intervention strategy which consists of five components: (1) the mid-point (the middle of the desired daily trading range for each day), (2) the maximum volatility band (maximum desired within-day movement of the spot rate), (3) the neutral band (the range of the spot rate over which the central bank would not intervene), (4) the daily intervention limit, and (5) the intervention frontier (at what level to intervene and maximum intervention volumes at that rate).

Continued efforts are needed to deepen the forex market to facilitate price discovery. The authorities could reduce constraints on market participants (allowing higher net open positions), develop derivative markets, and increase hedging opportunities to build capacity to manage foreign exchange risk. Although Sri Lanka has spot and forward markets, they are shallow (average daily interbank volumes are about $30 million). A number of official and customary practices foster the lack of depth. Transactions by intermediaries are monitored by the CBSL, which asks for detailed information when a trader's net open position is not consistent with orders—creating moral suasion to limit trading. Traders cannot smooth interventions by building short or long positions to anticipate large orders, which leads to higher market volatility and less depth.

A shift to inflation targeting could facilitate exchange rate flexibility. The monetary framework has been anchored on such quantitative indicators as broad money. While monetary targeting can be an alternative anchor, inflation targeting could enhance credibility by making clear that price stability is the first priority. A flexible inflation targeting framework includes a mandate to pursue an explicit inflation target as the overriding objective of monetary policy; central bank independence and accountability; and a forward-looking procedure that incorporates forecasts into policy and responds to deviations from targets. These would help rule out the "on-again, off-again" approach to exchange rate flexibility by prioritizing policy objectives and eliminating time-inconsistency, together with a transparent intervention rule. In line with recent steps toward the FPAS model, the authorities could lay the ground for inflation targeting as an alternative anchor by increased communication with the public and the markets about the plans and objectives of monetary policymakers.

C. Building Resilience, Competitiveness, and Outward Orientation

Sri Lanka has demonstrated a relatively high degree of resilience to external shocks, but nonetheless faces challenges from stronger economic headwinds, competitiveness issues, and the need for a stronger outward orientation.

22. The Sri Lankan economy has shown considerable resilience during turbulent times, but building greater capacity to weather shocks may be increasingly important in the years ahead. During most of the past two decades, Sri Lanka's growth has been faster than that of the region, and well above the emerging market average despite the dampening effect of civil war. Market turbulence from the "taper tantrums" of 2013 and initial steps toward a reversal of unconventional monetary policies also had comparatively less impact on Sri Lanka than other regional markets. Rebalancing in China and related market disruptions has also had limited spillovers given stronger trade ties with the U.S. and EU, the resilience of tourist inflows from China, and renewed efforts to cement new trade arrangements and investments. However, the period ahead could pose new external risks with a sharper impact:

- ***A sharper than expected global growth slowdown (particularly in European countries), and lower non-oil commodity prices*** could further depress Sri Lankan exports, widen the current account deficit, and reduce economic growth. These effects could be mitigated by a further dampening of oil prices, although lower collection of oil-related fiscal revenue would reduce the mitigating impact.

- ***Slower global and regional growth could also deter new FDI projects*** and potentially slow implementation of new projects—precisely at a time when Sri Lanka is seeking to make a welcome shift from public debt to a greater reliance on private financing.

- ***Tighter external financing conditions***. Sri Lanka's sovereign borrowing spreads have already widened considerably in response to domestic risks and shifting investor confidence. Rebalancing of global portfolio flows and closer scrutiny of emerging markets in the midst of heightened turbulence could further increase spreads, increase public financing costs and public debt rollover risks, and reduce activity in the still-nascent Sri Lankan stock market.

- **Stronger de-risking trends owing to profitability concerns, risk appetites and more stringent AML/CFT regulations could put a dent in remittance inflows**. Anecdotal evidence shows that the ongoing remittances slowdown is not primarily associated to de-risking factors. However, reduced financial services from global and regional banks could exacerbate this factor, adding to CA pressures and slowing down growth through reduced households' consumption and investment.

23. Sound macroeconomic policies and larger fiscal and external cushions (greater fiscal space and higher net international reserves) are the essential elements for maintaining resilience. An ambitious and credible fiscal consolidation path anchored around debt sustainability, while being mindful of growth implications, would help replenish fiscal buffers. Recent interest rate hikes would help attract foreign capital, while monetary policy should remain attuned to domestic conditions. A renewed commitment to exchange rate flexibility with minimal recourse to intervention and capital flows measures would help the exchange rate to absorb new external shocks—reducing balance of payments disequilibria and facilitating reserves buildup. Structural reforms should also be part of the equation. As discussed above, reforms to strengthen the monetary policy framework, deepen the foreign exchange market, and increase transparency in foreign exchange intervention policy would help maintain an internally coherent monetary policy framework and provide a clear operating environment for the market.

24. Renewed efforts to improve competitiveness and integrate into regional and global supply chains will be key to achieving sustained high growth and greater resilience. To boost external trade and private sector development, the staff recommended reducing costs through addressing protectionism. A key element in this work would be a review of Sri Lanka's trade regime including an evaluation of para-tariffs and other nontariff barriers (which have raised Sri Lanka's effective rate of protection to high levels). The staff welcomed ongoing efforts to enhance competitiveness through other means, including removal of the EU fisheries import ban, and the reinstatement of GSP plus status. Further steps are needed to increase the efficiency of trade facilitation (including through full implementation of electronic customs documentation), remove barriers to foreign investment entry and establishment, enhance access to finance, and strengthen financial market infrastructure. A recent IMF Board paper[9] showed that these reforms are among those with the highest productivity payoff for emerging markets.

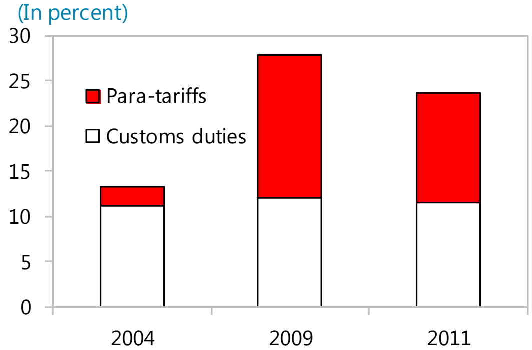
[9] "Structural Reforms and Macroeconomic Performance: Initial Considerations for the Fund", IMF Policy Paper, November 2015.

Box 5. Sri Lanka's Trade Regime and Performance in World Markets

While statutory customs tariffs are relatively low, use of para-tariffs and other trade taxes make the effective rate of protection considerably higher. This partly reflects the revenue problem, as progressive use of border taxes somewhat compensated for weak VAT and income tax. Trade taxes currently in use are the Cess Levy, Special Commodity Levy, and Port and Airport Development Levy, which amounted to 1.4 percent of GDP in 2015 while import duties were 1.2 percent of GDP. World Bank estimates suggested that the average total nominal protection rate as of 2011 was about 24 percent, with para-tariffs amounting to 12 percent. The imposition of these para-tariffs and other trade taxes are often considered as complex and unpredictable, reducing transparency. Cross country comparison suggests Sri Lanka has effectively gone backwards on trade protection—defying both regional and global trends in policies and performance.

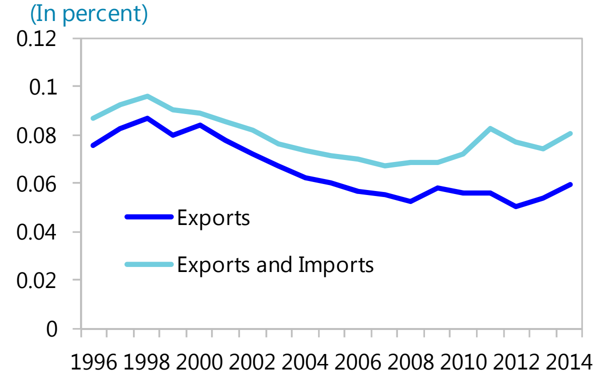
Sri Lanka's weaker trade performance points to the need of reforms. Growth has not been driven by expanding exports and shifting to more processed goods, but by domestic demand fueled by government spending and inward remittances. This reflects in Sri Lanka's trade performance – both exports and total trade as a share of world market declined over the 2000s and stagnated in recent years (albeit with fluctuations). Lack of integration and continued protection will only limit Sri Lanka's growth potential and undermine increased diversification and resilience to external shocks.

Average Protection Rate
(In percent)



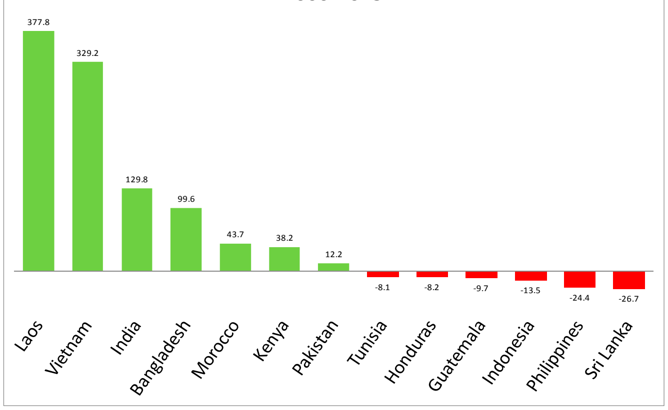
Source: Pursell and Ahsan (2011).

Share in World Trade
(In percent)

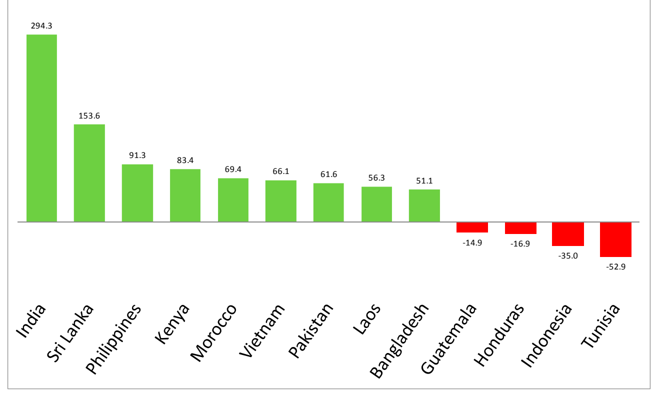


Sources: UNCTAD and IMF staff calculation.

25. Reviving Sri Lanka's outward orientation will also be essential to achieving growth and other macroeconomic objectives. As noted above, Sri Lanka's share in world trade has declined over the years. Some of this was likely linked to increasing isolation and lower productivity during the civil war, but a second component seems to have been a policy of creeping protectionism and import substitution. Several of Sri Lanka's neighbors have performed more strongly in this regard—managing to boost their share of global exports between 2000 and 2015. Notably, the services sector (which has been largely immune from para tariffs, excises, and other forms of non-tariff barriers) has performed much more strongly than goods exports in recent years, mirroring the rise of services in the economy as a whole, and more than keeping up with other lower middle income economies. FDI remains relatively low, however, highlighting the cost of policy uncertainty.

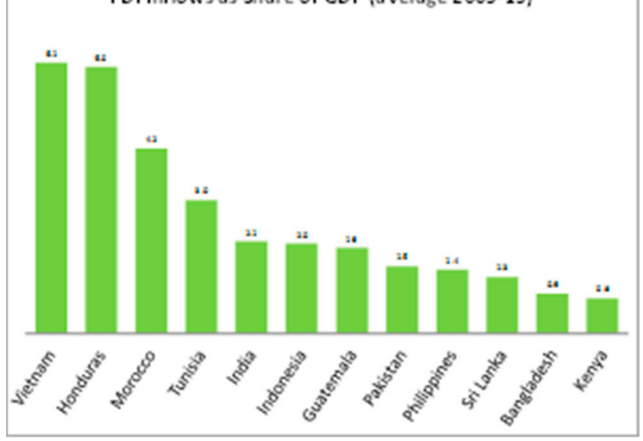


Share of World Goods Exports -- Percentage Change 2000-2015



Share of World Services Exports -- Percentage Change 2000-15

26. The authorities largely agreed with staff's recommendations, and highlighted the initiatives already started in these areas. They noted the steady decline in Sri Lanka's exports as a share of world trade over the past two decades as a sign of fundamental structural bottlenecks and misguided trade policies that had effectively made Sri Lanka more protective. They highlighted the establishment of two new agencies, for trade and development, respectively, charged with taking stock of current impediments and creating strategies for structural reform. They were keenly aware that a clear outward orientation was needed to bolster competitiveness, and move Sri Lanka into higher value chains, as well as the need to foster more equity-related investments to ensure less debt accumulation and greater transfer of technology and management skills.



FDI Inflows as Share of GDP (average 2005-15)

D. Deepening Financial Sector Surveillance

27. While the financial system appears well capitalized and liquid, the authorities should remain vigilant to the risk of a potential rise in non-performing loans (NPL). Financial soundness indicators for the fourth quarter of 2015 were generally favorable with capital adequacy comfortably above regulatory limits. Asset quality of state banks appears broadly sound, with most of the loans to state enterprises guaranteed by the government—these loans amount to 18 percent of total loans of state banks. However, in the absence of a clear and consistent government policy with respect to non-commercial operations of state enterprises (such as subsidies—which frequently end up as SOE debt to state banks), close scrutiny of these banks and stress testing which includes an emphasis on contingent liability risk is recommended.

28. Staff welcomed steps toward supervision on a consolidated basis and shifting to Basel III. The preliminary draft on the amendments to the Banking Act to bring the single borrower limit (SBL) and related party lending definitions in line with international best practices, are welcome, and were assessed by an IMF technical assistance mission in mid-April 2016. The CBSL is also assessing the possibility of introducing fit and proper assessments for owners of finance companies, and requirements on the Basel III capital standard are expected to be introduced in the first half of 2016 in line with the international timeline.

29. Staff concurred with the authorities that continued efforts are needed to strengthen the legal framework for crisis preparedness and resolution. The Fund will work to provide technical assistance in support of ongoing work toward a resolution framework to deal with finance companies which are insolvent or currently operating below the regulatory minimum capital adequacy requirement (which could be done through an establishment of a special purposed vehicle—as suggested in the 2016 Budget).

30. The authorities viewed the financial system as robust and well capitalized. They highlighted that existing weaknesses in the financial system are mostly in the nonbank financial sector. Some finance companies (comprising 16 percent of the non-banking sector) need to replenish capital, although the size of capital injection needs would be limited because the total assets of these companies are about 1 percent of GDP. The authorities reiterated their commitment to finalizing a resolution framework for weak finance companies—through establishment of a special purpose vehicle—by the end of this year, and are seeking support of IMF technical assistance in this area.

PROGRAM DISCUSSIONS

31. The proposed new Fund-supported program aims to provide a policy anchor for macroeconomic stability and structural reforms, while strengthening external resiliency in a challenging global environment. As described in the Letter of Intent (Appendix I) and Memorandum of Economic and Financial Policies (MEFP, Attachment I to LOI), the key objectives of the program relate to fiscal policy and the balance of payments, and measures to: (i) implement a structural increase in revenues, facilitating a reduction in the fiscal deficit; (ii) reverse the decline in central bank foreign exchange reserves; (iii) reduce public debt relative to GDP and lower Sri Lanka's risk of debt distress; and (iv) enhance public financial management and improve the operations of state owned enterprises. The program also aims to transition toward flexible inflation targeting with a flexible exchange rate regime and to promote sustainable and inclusive economic growth. To achieve these objectives, the program would envisage implementation of a set of reforms under six pillars: (i) fiscal consolidation; (ii) revenue mobilization; (iii) public financial management reform; (iv) state enterprise reform; (v) transition to flexible inflation targeting under a flexible exchange rate regime; and (vi) reforms in the trade and investment regime. The program is expected to meet Sri Lanka's BOP needs arising from the legacy of past policies and deterioration in the external environment—providing sufficient reserve cover to buffer against new shocks as macroeconomic policies are adjusted. The structural nature of key reforms and the time required to achieve durable solutions (and an improvement in the BOP) support the use of an extended facility.

Sri Lanka: Extended Arrangement under the EFF–Program Objectives, Policy Pillars, and Key Measures

Objectives

- Structurally increase revenues to facilitate fiscal deficit reduction
- Reverse decline in foreign exchange reserves
- Reduce public debt to GDP ratio and lower Sri Lanka's risk of debt distress
- Enhance public financial management and improve the operations of state owned enterprises
- Transition to flexible inflation targeting and flexible exchange rate regime
- Promote sustainable and inclusive economic growth

Pillars	I. Fiscal consolidation	II. Revenue mobilization	III. Public financial management reform	IV. State enterprise reform	V. Enhancing monetary policy effectiveness	VI. Supporting trade and investment
Measures	1. Improvement in primary balance (PC) 2. Increase in tax to GDP ratio (IT) 3. Annual budget in line with the program target (SB)	1. Tax policy reform - Tax expenditure rationalization (PA, SB) - New income tax law (PA, SB) - VAT diagnostic (SB) and reform 2. Administration reform - Key Performance Indicators for risk-based audit (SB) - Compliance strategies for VAT and income tax (SB) - New IT systems roll-out (SB)	1. Commitment control system (PA, SB) - Commitment record - Quarterly expenditure ceilings 2. New IT system roll-out (SB)	1. Resolution strategy of SOEs' obligations (PA, SB) 2. SOEs' non-commercial obligations in budget (SB) 3. Statement of Corporate Intent for major SOEs (SB) 4. Pricing reform for energy and other ulitility (SB)	1. Prudent monetary policy management - Monetary policy consultation clause - Reserve money monitoring (IT) 2. Buildup of net international reserves (PC) 3. Transition to flexible inflation targeting and flexible exchange rate regime 4. Financial market deepening	1. Trade regime reform - Review of tariffs and para-tariffs - Trade facilitation 2. Enhanced access to finance 3. Improved investment climate

Note: PC = quantitative performance criterion; IT = quantitative indicative target; PA = prior action; SB = structural benchmark.

A. Pillar #1: Fiscal Consolidation

32. The program envisages a return to fiscal consolidation, guided by the authorities' goal of an overall deficit of 3.5 percent in 2020 (MEFP ¶4). To support this, the program sets a deficit reduction path from 5.4 percent of GDP in 2016 to 4.0 percent of GDP in 2018. The corresponding improvement in the primary balance (the program's fiscal anchor) by 0.7–0.8 percentage point each year in 2017–18 would be accomplished primarily by base-broadening tax policy measures, which are envisaged to generate additional revenues of about 1.2 percent of GDP annually in 2017−18 (see text table). The growth impact of this consolidation effort is expected to be limited, given lack of economic slack or financial distress[10], although it will be important for the government to work toward more effective social protection schemes going forward.[11] The revenue-based fiscal consolidation is expected to preserve fiscal space for increasing infrastructure and key social spending,[12] while ensuring (through a path toward steady primary surpluses) a steady reduction in the public debt ratio from 76 percent in 2015 to 68 percent in 2020.[13] At the same time, fiscal consolidation will reduce gross financing needs by 6 percent of GDP over the program period—allowing sufficient room for an orderly expansion of private sector credit.

Sri Lanka: Central Government Operations, 2015-20
(In percent of GDP)

	2015	2016	2017	2018	2019	2020
Revenue and grants	13.1	13.0	14.0	15.3	15.5	15.8
Tax revenue	12.1	11.8	12.9	14.1	14.3	14.6
Witout measures	12.1	11.8	11.8	11.8	11.8	11.7
Measures (cumulative from 2017)	…	…	1.1	2.3	2.5	2.9
Nontax revenue and grants	0.9	1.2	1.2	1.2	1.2	1.2
Expenditure	19.9	18.4	18.8	19.3	19.2	19.3
Current non-interest	10.5	9.3	9.2	9.2	9.2	9.2
Interest	4.7	4.6	4.7	4.7	4.6	4.5
Capital	4.7	4.5	4.9	5.4	5.5	5.6
Overall balance	-6.9	-5.4	-4.7	-4.0	-3.7	-3.5
Primary balance	-2.2	-0.8	0.0	0.7	0.8	1.0
Central government debt	76.0	77.2	75.5	73.1	70.7	68.2
Gross financing needs	20.7	19.2	17.8	16.4	14.7	12.2
Memorandum items:						
Overall balance without measures	…	…	-5.8	-6.3	-6.2	-6.4
Primary balance without measures	…	…	-1.1	-1.6	-1.7	-1.9

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

[10] Under the baseline scenario, the projection assumes fiscal multiplier of about 0.3 based on the evidence for emerging market economies, which would lower growth by about 0.2 percentage points during 2017–18.

[11] The World Bank has committed to deeper analytical work with respect to the potential social implications of the planned fiscal consolidation path, as well as to help the authorities with better targeted social protection schemes.

[12] The programmed level of capital spending is justified given the low base in 2015 (capex fell to 4½ percent of GDP). The World Bank has also cited the need to finance infrastructure needs going forward to meet rising demand; as well as higher spending on health, education and related areas to avoid undercutting Sri Lanka's past gains in human development.

[13] These figures do not account for the outstanding obligations of SOEs, amounting to 11 percent of GDP as of end-2015. If assumed by the government, these obligations will have a material impact on the stock of debt, once assumed by government, and would effectively create a step-change in the path for public debt reduction. Such a scenario is analyzed in the attached DSA.

B. Pillar #2: Revenue Mobilization

33. Revenue mobilization is envisioned as the linchpin of programmed fiscal adjustment, and would be achieved by base-broadening tax policy measures as well as reforms toward efficient, risk-based tax administration. These will be complemented by efforts to simplify the tax system. In line with recommendations made during successive technical assistance missions, the fiscal structural reform agenda includes the following elements:

- ***Tax policy measures (MEFP ¶7)***. In light of low tax efficiency, the program seeks to broaden the base for income tax and VAT. To reduce income tax expenditures, the authorities will publish a statement of tax expenditures, i.e., catalogue and cost all existing tax exemptions, holidays, and special rates, and subsequently rationalize these tax expenditures, for example by limiting corporate tax incentives to expenditure-based ones tied to investment. This is also supported by introduction of a new income tax law with a view to simplifying and broad-basing the tax, supported by Fund TA. The income tax reform will be followed by base-broadening VAT reform including rationalizing VAT exemptions. Further, the authorities plan to streamline the trade tax regime.

- ***Tax administration reform (MEFP ¶8):*** There is ample scope to make tax administration more risk-based, supported by ongoing efforts to upgrade IT systems. In this regard, the program seeks to improve administrative efficiency of the Inland Revenue Department (IRD) through adoption of risk-based compliance strategies for VAT and income tax as well as introduction of Key Performance Indicators on the number of risk-based VAT audit. The program also support timely roll out of the new IT systems for domestic tax and customs administration (RAMIS and ASYCUDA). Further, the authorities will pursue organizational and business procedure reform for the IRD, including creating a design and monitoring unit.

C. Pillar #3: Public Financial Management Reform

34. The program aims to improve expenditure management and fiscal risk monitoring (MEFP ¶11). The recent emphasis on overdue payments and quasi-fiscal obligations related to state enterprises highlights the need for measures to bolster public financial management (PFM), as elaborated below.

- ***Commitment control.*** To control expenditure within fiscal resources and without incurring future arrears, the authorities will establish a commitment control system based on commitment records and quarterly expenditure commitment ceilings, starting from mid-2016. The program also supports timely roll-out of the new Integrated Treasury Management Information System (ITMIS), which will significantly expand PFM capabilities, including commitment control, budget preparation, treasury, accounting, and procurement.

- ***Fiscal reporting and risk.*** To improve fiscal transparency, the authorities plan to publish quarterly financial bulletins summarizing government fiscal operations; ensure that annual budgets explicitly cost out tax expenditures; and adhere to Government Financial Statistics Manual (GFSM) standards. The authorities also plan to include in the annual budget analysis of fiscal risks including those related to SOEs and public-private partnerships (PPPs).

D. Pillar #4: State Enterprise Reform

35. Sri Lanka had some 235 public enterprises representing 17 percent of the nation's economic activity in 2010. Although some SOEs are profitable and performing well, collectively they represent a drag on the private economy and a drain on public finances (both directly, and through the state banks, which fund the largest SOEs). The obligations noted above are largely tied to SOEs, which highlights the need for financial discipline. The Ceylon Petroleum Corporation (CPC, the monopoly in fuel refinery and distribution) and the Ceylon Electricity Board (CEB, the state electricity company) have incurred financial losses in fulfilling non-commercial obligations because of implicit energy subsidies—retail fuel and electricity prices have been set below cost-recovery levels. Sri Lankan Airlines has been a loss-making SOE, reflecting competition with international airlines operating within the region. Against this background, the authorities will introduce far-reaching SOE reforms, as elaborated below (MEFP ¶12).

- **A resolution strategy for Sri Lankan Airlines** will be completed by September 2016, effectively removing this company from the government's accounts.

- ***Enhance oversight and financial discipline of SOEs.*** Drawing on FAD TA recommendations, six major SOEs will establish (with agreement of MOF and the relevant line ministry) a Statement of Corporate Intent (SCI), to include: the SOE's objectives and multiyear corporate plan; capital expenditure and financing plans; explicit financial and non-financial targets; and cost of non-commercial obligations. The authorities will also consider strengthening the legal framework for the governance and oversight of SOEs.

- ***Reform of energy and other utility subsidies.*** The authorities will introduce a formula-based automatic pricing mechanism for petroleum products, so as to ensure that future losses by the CPC and large retail adjustments are avoided. Also, the Public Utilities Commission will be granted enhanced authority to set electricity and water tariffs in a cost-reflective manner. To support these objectives, the fiscal cost of non-commercial obligations for SOEs will be included in the central government budget.

E. Pillar #5. Enhancing monetary policy effectiveness

36. The focus of monetary policy will be to keep inflation in the low single digits, while allowing for a durable transition to a more flexible exchange rate regime. Inflation performance will be monitored through a monetary policy consultation clause, and exchange rate flexibility will be enforced by the programmed accumulation of net international reserves. The program establishes an inflation target band around the projected inflation path, and if inflation falls outside the band, the authorities will consult with the Fund on the reason for the deviation and proposed policy response, which may include adjustment in the CBSL's policy interest rates. The monetary policy consultation clause will be supported by monitoring of reserve money as an indicative target. A strengthening of reserve adequacy (guided by the level of net international reserves (NIR) as a percentage of the ARA reserve metric) will also be programmed, anchored with a PC (floor) on NIR. Further, because the supply and demand for foreign exchange will be uncertain over the program period, the program includes a clause whereby the authorities would consult with the Fund staff on the appropriate policy response in the event that the gap between supply and demand of foreign exchange results in a more sudden and disruptive depreciation of the exchange rate than anticipated by the staff and authorities.

37. The program would support the move toward flexible inflation targeting and financial market deepening. Technical work in support of this objective (focused on developing more sophisticated econometric models for macroeconomic forecasting) has been supported by Fund technical assistance. Further work is needed to develop a working model estimation of the economy to support inflation forecasting. A roadmap would be developed to set milestones in the development, testing and making operational a shift to inflation targeting within the period of the program, supported by additional technical assistance. Such milestones would include adopting an inflation forecasting model, announcing a medium-term numerical inflation objective to serve as a nominal anchor, introducing a policy rate in the middle of the corridor which will serve as an operational target, and establishing an effective communication arrangement. Further, appropriate legal and organizational frameworks need to be put in place to ensure accountability and credibility of inflation targeting.

F. Pillar #6: Supporting Trade and Investment to Strengthen External Sustainability

38. Achieving medium-term growth and reserve objectives will require a renewed effort toward greater integration into regional and global supply chains, higher levels of FDI, and enhancing prospects for private sector investment. In addition to better infrastructure, this will entail improvements in the trade regime and investment climate, and also restoring export profitability. Sri Lanka has been actively promoting further integration to the world economy through Free Trade Agreements (FTAs). It has signed FTAs with India, Pakistan, and Iran, and further strengthened cooperation in technical areas with India through the India Economic and Technical Cooperation Agreement (ETCA) which was signed in early 2016. An FTA with China is under discussion. Sri Lanka has strengthened the economic relationship with the U.S. through the Trade Investment Framework Agreement (TIFA), the primary forum for bilateral trade and investment discussions between the two countries. Notably, the EU announced the lifting of a ban on fisheries imports from Sri Lanka in April 2016. This should facilitate talks toward Sri Lanka regaining the Generalized Scheme of Preferences Plus (GSP Plus) status with the EU, potentially by the end of this year. Sri Lanka is also a member of the South Asia Free Trade Agreement (SAFTA), the Asia-Pacific Trade Agreement (APTA), and the Bay of Bengal Initiative for

Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) which aims to achieve its own free trade area by 2017.

39. To boost trade and private sector development, the program envisages reducing protectionism to enable competitiveness. A key element in this work will be a review of Sri Lanka's trade regime including an evaluation of para-tariffs and other nontariff barriers. The trade regime remains complex, and needs to be simplified by limiting the number of rates, phasing out para-tariffs, and minimizing the number of duty exemptions. The authorities are currently negotiating a program loan with the World Bank to enhance competitiveness. It aims to increase the efficiency of trade facilitation (including through the ratification of the WTO Trade Facilitation Agreement, the establishment of the National Trade Facilitation Committee (NTFC), and full implementation of use of electronic customs documentation), remove barriers to foreign investment entry and establishment (including access to land), enhance access to finance, and strengthen financial market infrastructure. In this context, a one-stop-shop for foreign investors has been created to reduce the processing time for investment approval. These steps should help to attract FDI and complement public investment.

G. Program Modalities

40. Semi-annual program reviews would be undertaken based on quantitative targets and structural benchmarks, with quarterly indicative targets and staff visits between each review. Test dates for the first and second review would be end-June and end-December 2016, respectively. An update safeguards assessment of the CBSL is underway and should be completed no later than the first program review. The last assessment was completed in 2009, and recommendations in audit and controls areas have been implemented. The update assessment will evaluate, inter alia, developments in the legal framework and autonomy against leading practices for central banks.

41. Proposed access is 185 percent of quota (SDR 1,070.780 million). This level of access is based on staff's assessment of the outlook, the strength of the envisaged reforms, and the estimated gross external financing requirement during the program period. Of this, a financing gap of US$1.5 billion would arise in order to keep gross reserves at an adequate and increasing level as measured by the Fund's composite metric. The program also envisages a steady increase in net international reserves to a level commensurate with 75 percent of the ARA metric over the medium term. The choice of a three-year arrangement under the Extended Fund Facility is motivated by the structural and longer-term nature of such key challenges as raising revenue, enacting durable tax reforms, building revenue administration capacity, and bringing state enterprise operations to a commercial footing.

42. Sri Lanka is expected to be able to meet its obligations under the proposed arrangement. With the proposed access, outstanding Fund credit would reach a peak of SDR 1,070.78 million by 2019 (6.7 percent of exports). However, there are significant downside risks related the economic headwinds cited earlier and their potential to combine into a downside scenario that would necessitate either further adjustment or additional financing.

While Sri Lanka has an unblemished repayment history with the IMF (and a strong external repayment history in general), the broader context highlights high debt vulnerability, very low revenue/debt ratio and a high debt service/exports ratio.

43. Support from other donors. Staff has worked in close consultation with the World Bank, Asian Development Bank, and key bilateral donors with respect to program design and timing. There are firm commitments from donors to fill the entire financing gap for the first 12 months of the arrangement, and good prospects that there will be adequate multilateral and bilateral financing for the remainder of the program. Financial support from these partners is expected to reach $650 million during 2016−18, with strong technical assistance also provided.

44. Prior actions. The following prior actions are proposed to be undertaken by the authorities ahead of the Executive Board meeting to underpin the upfront implementation of reforms:

45. Cabinet to issue a Memorandum requiring the Ministry of Finance to complete by end-October 2016 a time-bound strategy to address the issue of outstanding arrears of the central government obligations of state enterprises. The Memorandum will specify that the strategy include: (i) completion (by end-2016) a comprehensive database of SOE’s financial obligations, including a breakdown of arrears and non-arrears to be certified by the Auditor General for use in creating a registry of such obligations; (ii) clarification of the government’s responsibility over existing obligations related to subsidies and other non-commercial obligations of the SOEs (i.e., what proportion of these debts to assume, if any).

- **Ministry of Finance to issue circulars** to (i) formally implement tax policy and other revenue measures outlined in the Cabinet Memorandum of March 4, 2016; (ii) detailing revised expenditure ceilings for government ministries and agencies consistent with the overall budget deficit target for 2016.

- **Cabinet resolution adopting a framework note (agreed with IMF staff) for a new Inland Revenue Act**, which embodies key tax policy drivers, overarching legal design framework, and the tax law reform roadmap as outlined in the March 2016 IMF Legal Department technical assistance mission Aide Memoire.

- **Formally suspend by Cabinet order the Board of Investment's capacity to grant tax exemptions**, tax holidays, and special tax rates until such time as the BOI Act can be formally amended.

46. Quantitative performance criteria and structural benchmarks (Table 1 and Table 2 attached to the MEFP). The program will be monitored with semiannual quantitative performance criteria on the government primary balance and net official international reserves of the CBSL. A monetary policy consultation clause will be applied with respect to inflation. A continuous performance criterion (a zero ceiling) will be applied to new external arrears. There will also be indicative targets on central government tax revenue (floor) and reserve money (ceiling).

Structural benchmarks have been established to gauge progress in key reform measures discussed above. Staff will also monitor the stock of gross debt, consistent with program projections, adjusted for exchange rate changes.

47. Risks. Key program risks include (i) revenue slippage or failure to implement key revenue-related reforms; (ii) weaker than expected capital inflows could widen significantly the projected financing gap given already high gross financing needs of close to 19 percent of GDP in 2016 ; (iii) lower than expected growth and/or new pressures on the trade account; and (iv) larger than expected losses at state owned enterprises and/or inability to carry through with fundamental reforms to bring these firms first to a commercial footing. These risks could challenge public debt sustainability (see DSA in Annex III). Risks would be mitigated by extensive policy dialogue, as well as a steady pipeline of technical assistance from the Fund, the World Bank, and other multilateral and bilateral institutions.

STAFF APPRAISAL

48. Economic growth is showing some signs of strain, consistent with policy-induced macroeconomic imbalances and a more difficult external environment. Despite a substantial boost to consumption from public wage, salary, and transfer increases, real GDP growth has stalled—reflecting a mix of lower public and private investment, as well as slower global trade. Some of these dampening factors have the potential to be quickly reversed through a re-set of fiscal and monetary policies, restoration of confidence, and a boost to trade from resolution of current import bans and resumption of some preferential trading arrangements. However, the risk of strengthening external headwinds also appears more acute than in past periods.

49. The authorities' economic program—supported by the proposed extended arrangement under the EFF—offers a credible plan for correcting underlying imbalances, putting public finances on a path to sustainability, rebuilding foreign exchange reserves, and enabling sustained and inclusive economic growth. The program seeks to (i) implement a structural increase in revenues to reduce the fiscal deficit; (ii) reverse the decline in central bank foreign exchange reserves; (iii) reduce public debt relative to GDP and lower Sri Lanka's risk of debt distress; and (iv) enhance public financial management and improve the operations of state owned enterprises. The program also aims to transition toward flexible inflation targeting with a flexible exchange rate regime and to promote sustainable and inclusive economic growth by supporting trade and investment.

50. Sizeable fiscal adjustment is needed over the medium-term to correct domestic and external balances and put public debt on clear downward path. The fiscal adjustment profile is ambitious and front-loaded, but the projected shift into primary fiscal surpluses over the life of the program through gains in revenue reflect: (i) the very low revenue base, and the need to make decisive progress in reversing the trend decline in the tax-to-GDP ratio through fundamental reform of tax policy and administration; and (ii) the clear need to reduce Sri Lanka's annual financing requirement and public debt. The authorities will need to communicate how basic reforms envisaged in the program will distribute more equitably the burden of taxation, increase transparency, and reduce opportunity for discretion and favoritism.

51. Tax policy and administration reforms will need to be sustained over several years to change the policy dynamic (particularly around exemptions and other tax expenditures) and bring concrete results to higher tax revenues. A new and modernized Inland Revenue Act with minimal deviations from the basic principles outlined in the recent IMF technical assistance mission is a critical first step. This will need to be followed by similar efforts to broaden the base for the VAT and the customs code, and to strengthen significantly their administration. Building capacity toward risk-based tax administration is critical, including setting specific performance indicators, using automation to remove discretion and bolster credibility, and moving to risk-based audit.

52. There is need to expedite public financial management and SOE reforms to avoid recurrence of spending arrears and mitigate fiscal risks. An effective commitment control system needs to be established quickly, based on commitment record and expenditure ceilings, and expedited roll out of the new IT system. Addressing the outstanding obligations of state enterprises as well as their day-to-day operations will be essential to curtailing fiscal risk and strengthening the role of market forces in the economy. The authorities are already taking concrete steps toward a solution for Sri Lankan Airlines, and the eventual fiscal implications will need to be addressed going forward. For other key SOEs, the program lays out a course toward clarifying the financial relationship with the central government, responsibility for non-commercial obligations now and into the future, and establishing market-based pricing for fuel and electricity to minimize subsidies and enable operations on a commercial basis (capable of servicing their current set of obligations).

53. Monetary policy has started on a course of adjustment, but given the absence of buffers must continue to play a role in stemming current imbalances. Initial steps toward monetary tightening should play out over the coming months given the lags in monetary transmission. Given the lags, the CBSL should stand ready to further tighten the monetary policy stance should inflationary pressures continue, private credit growth not moderate, or capital outflows and downward pressure on the exchange rate persist. With time, a durable shift to flexible inflation targeting should both bolster the effectiveness of monetary policy, and enhance the shift to exchange rate flexibility.

54. Exchange rate flexibility is embedded in the programmed accumulation of international reserves, but a clear change in the policy framework is needed over the near-to medium-term. To reach the NIR objectives set under the Fund-supported program, the CBSL will need to disembark from the active intervention policies that have dominated for the past 20 months. While the exchange rate does not appear fundamentally misaligned, there is evidence of a market dysfunction stemming from both a loss of confidence in macroeconomic policies and the one-sided nature of intervention. To ensure a durable shift to a flexible exchange rate regime, there is a need to deepen the foreign exchange market, supported by credible macroeconomic policies, and a clear and coherent framework for monetary and exchange rate policy.

55. Continued vigilance is needed to maintain financial sector stability. The banking system at present does not appear to be a source of vulnerability. However, careful scrutiny of balance sheets is needed with respect to the large stock of state enterprise obligations to public banks, as well as the potential for rising NPLs as the rapid increase in private credit decelerates. Pockets of vulnerability remain in the nonbank sector and should be addressed.

56. Achieving high and sustained rates of economic growth over the medium-term hinges on implementation of an ambitious program of structural reform. Reforms planned for the structure of the tax system, revenue administration, budget management, utility pricing and state enterprise operations, financial market deepening, as well as the trade and investment regime can, if implemented fully, unleash Sri Lanka's considerable economic potential and capacity to fully exploit comparative advantages in geographical position and human capital.

57. Risks to the program are significant. The proposed program will require strong political commitment and implementation by a relatively new government. The key risk is that essential reforms will be delayed, watered down, or abandoned in the face of challenges. External shocks, such as weaker-than-anticipated capital inflows and lower-than-projected growth can challenge the reform effort. The authorities' top level commitment to the reform planned outlined in the Memorandum of Economic and Financial Policies should mitigate this risk, but public outreach should also be bolstered to explain both the short-term costs and the medium-term gains to shareholders and the general public. Contingency planning for the most likely shocks should also be considered.

58. Staff supports the authorities' request for an Extended Arrangement. In view of Sri Lanka's balance of payments need, the policy actions already taken, and the authorities' commitment to implement an ambitious reform package over the duration of the program, staff supports the authorities' request for an Extended Arrangement in an amount equivalent to SDR 1,070.78 million.

59. It is recommended that the next Article IV Consultation with Sri Lanka be held on the 24-month cycle, subject to Decision No. 14747, as amended.

Figure 1. Sri Lanka: Macroeconomic Developments

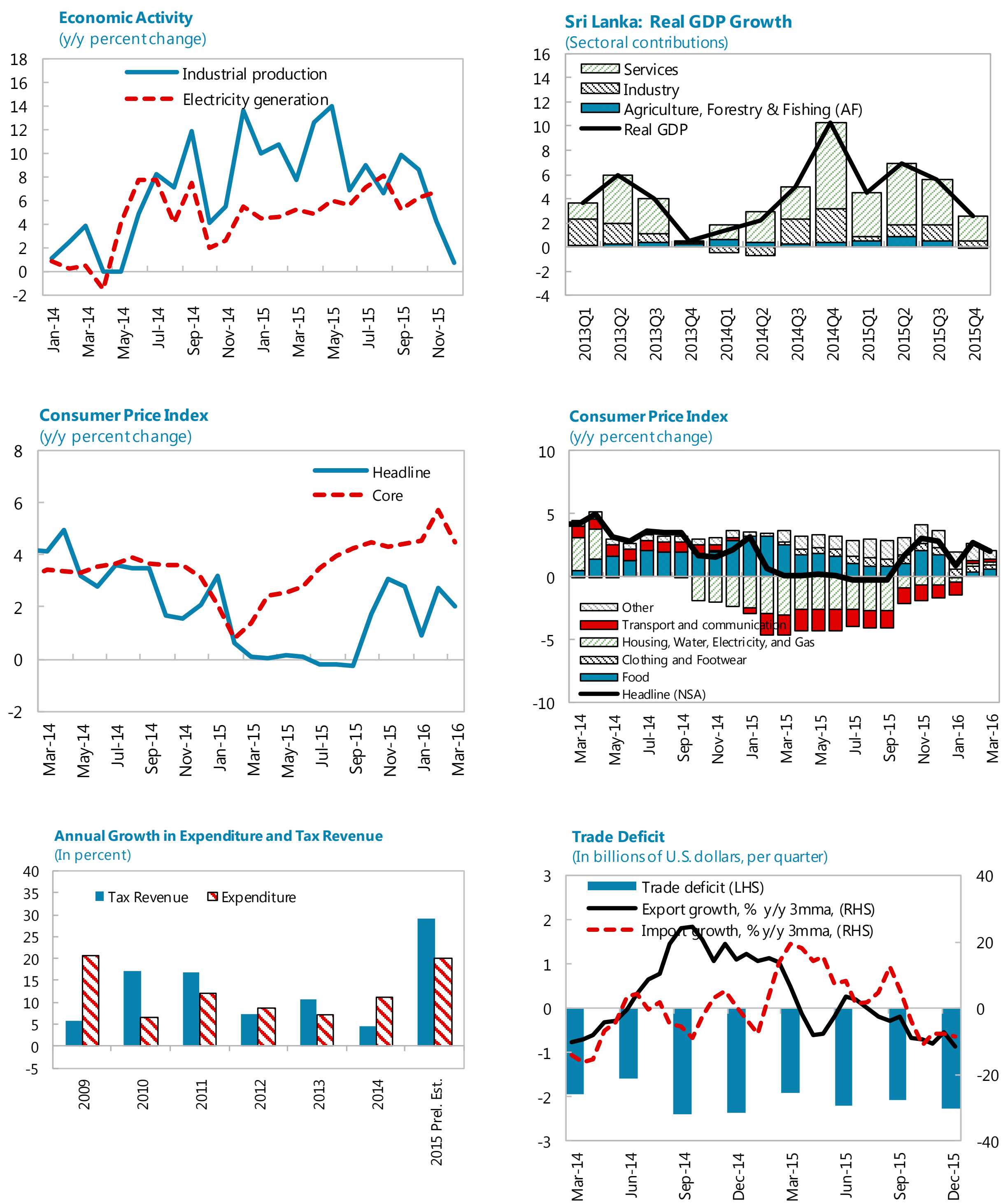


Figure 2. Sri Lanka: Fiscal Sector

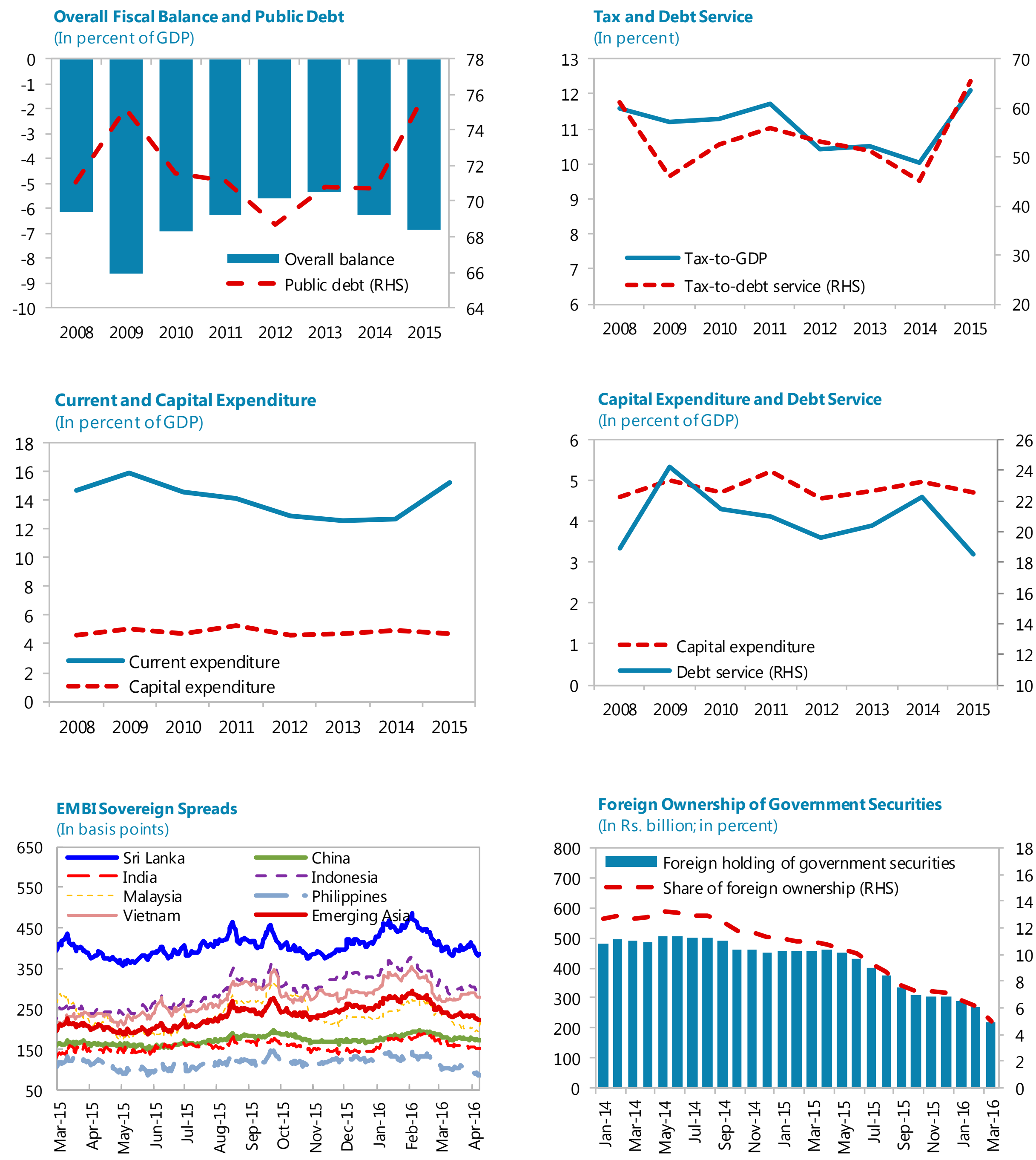


Figure 3. Sri Lanka: Interest Rates

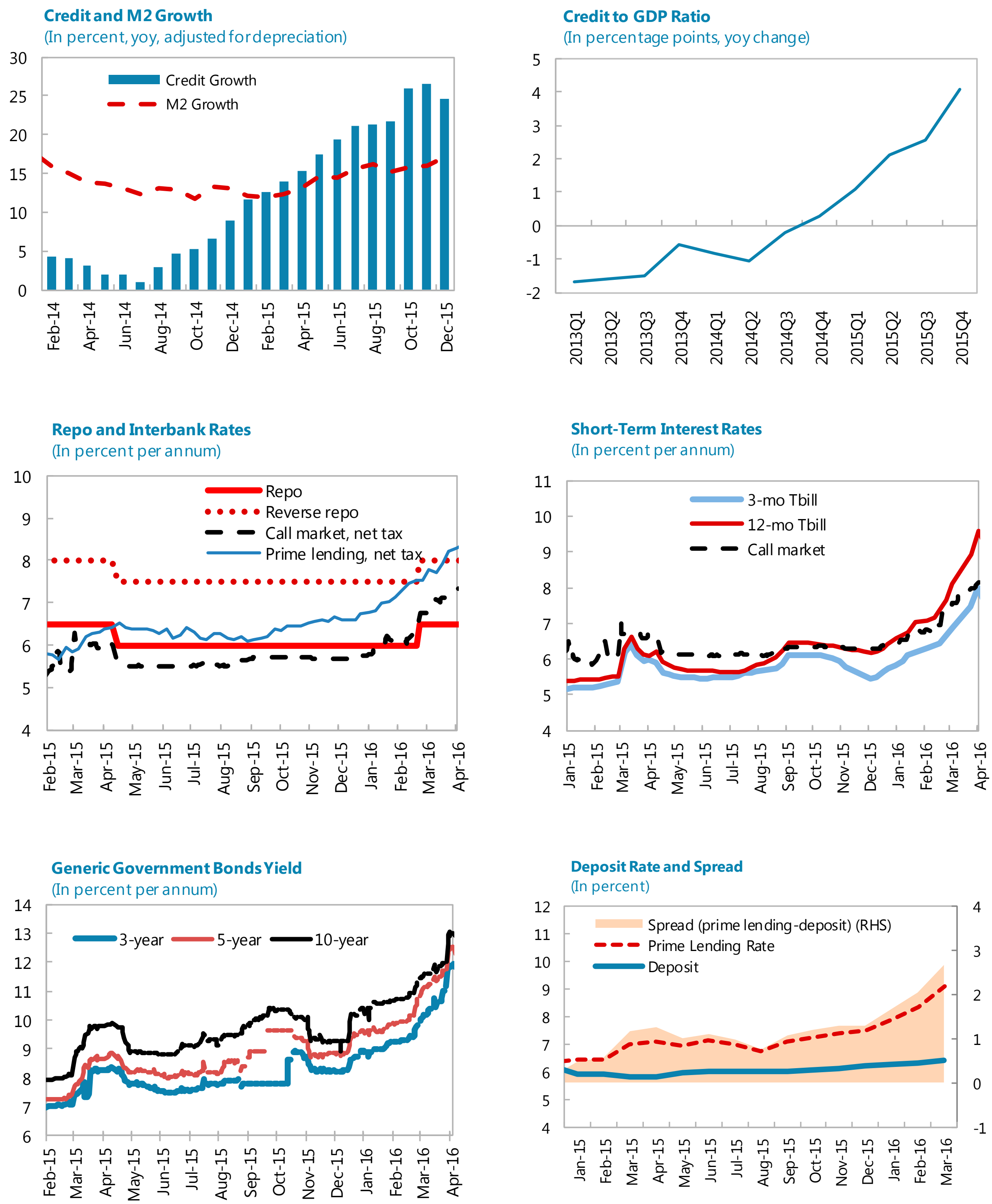


Figure 4. Sri Lanka: Foreign Exchange and Reserves

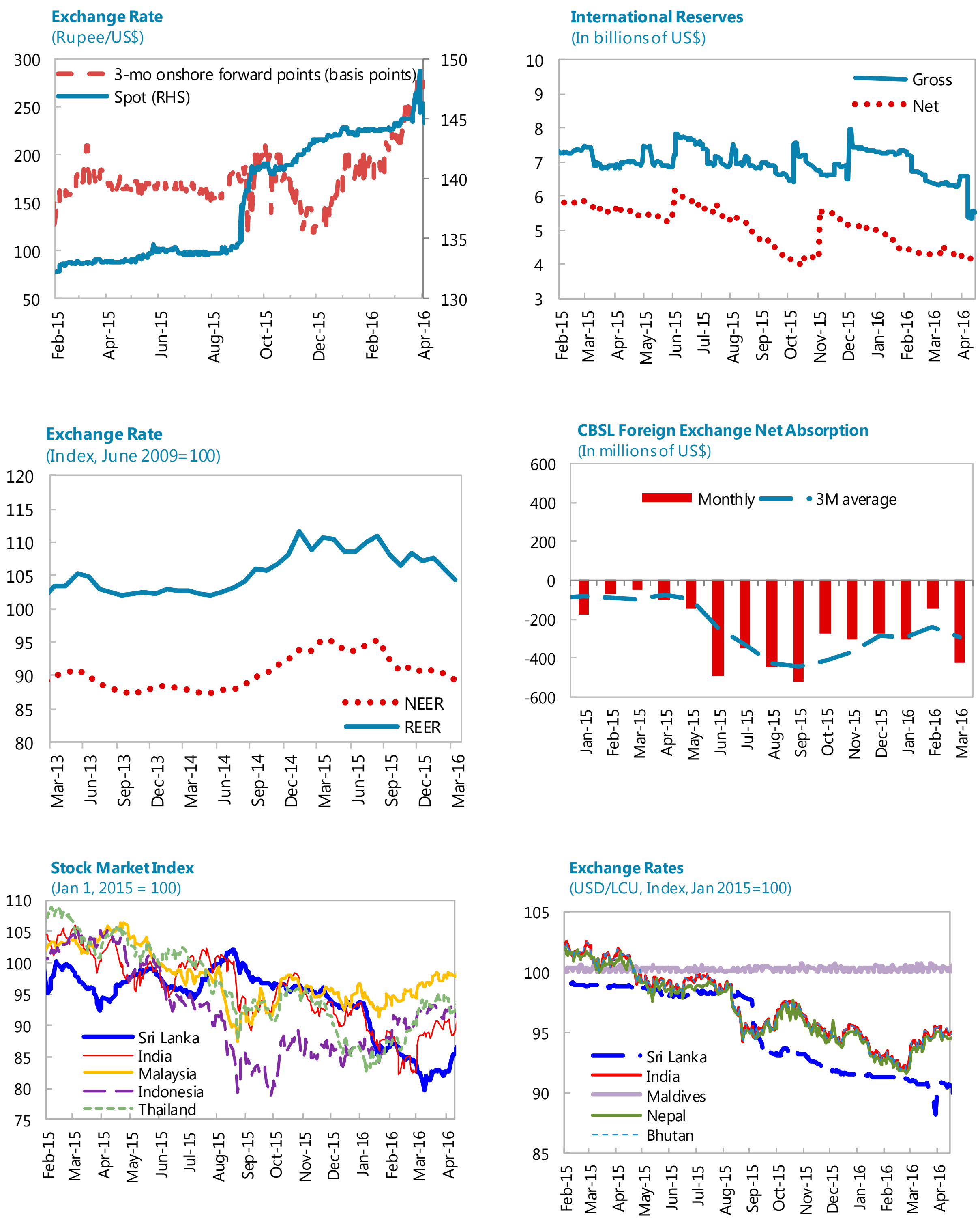


Table 1. Sri Lanka: Selected Economic Indicators, 2014–20

	2014	2015	2016	2017	2018	2019	2020
				Proj.			
GDP and inflation (in percent)							
Real GDP growth	4.9	4.8	5.0	5.0	5.0	5.2	5.4
Inflation (average)	3.3	0.9	4.1	5.3	5.1	5.0	5.0
Inflation (end-of-period)	2.1	2.8	5.4	5.2	5.0	5.0	5.0
Core inflation (end-of-period)	3.2	4.5	4.5	4.3	4.1	4.1	4.1
Savings and investment (in percent of GDP)							
National savings	24.5	25.9	26.9	26.0	26.2	25.9	25.7
Government	-1.1	-2.1	-0.9	0.2	1.4	1.7	2.2
Private	25.6	28.0	27.8	25.9	24.8	24.2	23.6
National Investment	27.0	28.4	28.3	28.8	29.3	29.2	29.2
Government	6.1	6.5	6.5	6.9	7.5	7.3	7.3
Private	20.9	21.9	21.9	21.9	21.9	21.9	21.9
Savings-Investment balance	-2.5	-2.5	-1.5	-2.8	-3.1	-3.3	-3.4
Government	-7.2	-8.6	-7.4	-6.8	-6.0	-5.6	-5.1
Private	4.8	6.2	6.0	4.0	3.0	2.4	1.7
Public finances (in percent of GDP)							
Revenue and grants	11.5	13.1	13.0	14.0	15.3	15.5	15.8
Expenditure	17.8	19.9	18.4	18.8	19.3	19.2	19.3
Primary balance	-2.1	-2.2	-0.8	0.0	0.7	0.8	1.0
Central government balance	-6.2	-6.9	-5.4	-4.7	-4.0	-3.7	-3.5
Central government net domestic financing	3.8	4.3	2.3	3.0	1.3	2.3	2.3
Central government debt	70.7	76.0	77.2	75.5	73.1	70.7	68.2
Money and credit (percent change, end of period)							
Reserve money	18.3	16.5	18.4	12.0	13.5	15.0	15.6
Broad money	13.4	17.8	10.8	15.4	15.1	15.2	15.6
Domestic credit	10.5	23.5	8.5	11.7	11.5	11.8	12.5
Credit to private sector	8.8	25.1	10.0	14.3	15.5	14.5	15.2
Credit to government	12.9	21.3	6.2	7.7	4.9	6.9	7.2
Balance of payments (in millions of U.S. dollars)							
Exports	11,130	10,505	10,456	10,942	11,838	12,664	14,093
Imports	-19,417	-18,935	-18,392	-20,763	-22,606	-24,357	-26,608
Current account balance	-1,989	-2,009	-1,202	-2,419	-2,916	-3,343	-3,812
Current account balance (in percent of GDP)	-2.5	-2.5	-1.5	-2.8	-3.1	-3.3	-3.4
Export value growth (percent)	7.1	-5.6	-0.5	4.6	8.2	7.0	11.3
Import value growth (percent)	7.9	-2.5	-2.9	12.9	8.9	7.7	9.2
Gross official reserves (end of period)							
In millions of U.S. dollars	8,208	7,304	7,853	9,372	11,866	13,033	13,843
In months of imports	4.3	3.8	3.7	4.1	4.8	4.9	5.0
External debt (public and private)							
In billions of U.S. dollars	43.0	44.8	45.9	49.0	53.4	58.4	62.4
As a percent of GDP	53.8	55.1	55.8	55.9	56.3	57.1	56.5
Memorandum items:							
Nominal GDP (in billions of rupees)	10,448	11,183	12,147	13,374	14,787	16,333	18,076

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

Table 2a. Sri Lanka: Summary of Central Government Operations, 2014–20

	2014	2015		2016			2017	2018	2019	2020
		Revised Budget	Prel. Est.	Budget	Revised Budget	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	1,205	1,567	1,461	1,977	1,652	1,574	1,878	2,262	2,525	2,854
Total revenue	1,195	1,532	1,455	1,962	1,640	1,562	1,868	2,253	2,517	2,845
Tax revenue	1,050	1,337	1,356	1,584	...	1,428	1,721	2,090	2,337	2,646
Income taxes	198	302	263	233	...	226	344	515	606	729
VAT	275	292	220	300	...	311	384	476	541	624
Excise taxes	257	333	498	550	...	452	499	556	597	642
Other trade taxes	129	137	184	205	...	199	227	251	276	299
Other	191	273	191	296	...	240	267	292	318	352
Nontax revenue	145	195	99	378	...	134	148	163	180	199
Grants	9	35	6	15	12	12	10	9	8	9
Total expenditure and net lending	1,857	2,061	2,229	2,717	2,308	2,233	2,510	2,848	3,135	3,482
Current expenditure	1,323	1,552	1,700	1,858	1,688	1,688	1,856	2,053	2,243	2,465
Civil service wages and salaries	255	325	321	...	...	335	369	408	450	499
Other civilian goods and services	55	119	127	...	...	71	78	86	95	106
Security expenditure	258	311	300	...	...	301	331	366	405	448
Subsidies and transfers	318	372	425	...	...	419	449	497	548	607
Interest payments	436	425	527	520	...	562	629	695	743	805
Capital expenditure and net lending	535	509	529	859	619	545	654	796	892	1,017
Overall balance	-653	-494	-768	-740	-656	-659	-632	-587	-610	-628
Financing	653	494	768	740	...	659	632	587	610	628
Net external financing	260	251	292	183	...	376	234	391	233	212
Net domestic financing	393	243	476	557	...	283	399	196	376	416
Memorandum items:										
Primary balance	-216	-69	-241	-220	...	-97	-3	109	134	178
Central government debt	7,391	...	8,503	...	...	9,376	10,092	10,805	11,553	12,330
Domestic currency	4,344	...	4,595	...	...	4,975	5,312	5,505	5,807	6,194
Foreign currency	3,047	...	3,909	...	...	4,401	4,780	5,300	5,747	6,136
Publicly guaranteed debt	440	...	382	...	...	...	...	...	...	...

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

Table 2b. Sri Lanka: Summary of Central Government Operations, 2014–20
(In percent of GDP)

	2014	2015		2016			2017	2018	2019	2020
		Revised Budget	Prel. Est.	Budget	Revised Budget	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	11.5	14.0	13.1	16.3	13.6	13.0	14.0	15.3	15.5	15.8
Total revenue	11.4	13.7	13.0	16.2	13.5	12.9	14.0	15.2	15.4	15.7
Tax revenue	10.1	12.0	12.1	13.0	…	11.8	12.9	14.1	14.3	14.6
Income taxes	1.9	2.7	2.3	1.9	…	1.9	2.6	3.5	3.7	4.0
VAT	2.6	2.6	2.0	2.5	…	2.6	2.9	3.2	3.3	3.5
Excise taxes	2.5	3.0	4.4	4.5	…	3.7	3.7	3.8	3.7	3.6
Other trade taxes	1.2	1.2	1.6	1.7	…	1.6	1.7	1.7	1.7	1.7
Other	1.8	2.4	1.7	2.4	…	2.0	2.0	2.0	1.9	1.9
Nontax revenue	1.4	1.7	0.9	3.1	…	1.1	1.1	1.1	1.1	1.1
Grants	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Total expenditure and net lending	17.8	18.4	19.9	22.4	19.0	18.4	18.8	19.3	19.2	19.3
Current expenditure	12.7	13.9	15.2	15.3	13.9	13.9	13.9	13.9	13.7	13.6
Civil service wages and salaries	2.4	2.9	2.9	…	…	2.8	2.8	2.8	2.8	2.8
Other civilian goods and services	0.5	1.1	1.1	…	…	0.6	0.6	0.6	0.6	0.6
Security expenditure	2.5	2.8	2.7	…	…	2.5	2.5	2.5	2.5	2.5
Subsidies and transfers	3.0	3.3	3.8	…	…	3.4	3.4	3.4	3.4	3.4
Interest payments	4.2	3.8	4.7	4.3	…	4.6	4.7	4.7	4.6	4.5
Capital expenditure and net lending	5.1	4.6	4.7	7.1	5.1	4.5	4.9	5.4	5.5	5.6
Overall balance	-6.2	-4.4	-6.9	-6.1	-5.4	-5.4	-4.7	-4.0	-3.7	-3.5
Financing	6.2	4.4	6.9	6.1	5.4	5.4	4.7	4.0	3.7	3.5
Net external financing	2.5	2.2	2.6	1.5	…	3.1	1.7	2.6	1.4	1.2
Net domestic financing	3.8	2.2	4.3	4.6	…	2.3	3.0	1.3	2.3	2.3
Memorandum items:										
Primary balance	-2.1	-0.6	-2.2	-1.8	…	-0.8	0.0	0.7	0.8	1.0
Central government debt	70.7	…	76.0	…	…	77.2	75.5	73.1	70.7	68.2
Domestic currency	41.6	…	41.1	…	…	41.0	39.7	37.2	35.6	34.3
Foreign currency	29.2	…	35.0	…	…	36.2	35.7	35.8	35.2	33.9
Publicly guaranteed debt	4.2	…	3.4	…	…	…	…	…	…	…
Nominal GDP (in billion of rupees)	10,448	11,183	11,183	12,147	12,147	12,147	13,374	14,787	16,333	18,076

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

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

	2016Q1	2016Q2	2016Q3	2016Q4	2016
	Est.		Proj.		
Total revenue and grants	346	356	402	470	1,574
Total revenue	346	353	398	465	1,562
Tax revenue	325	326	369	407	1,428
Income taxes	47	38	60	80	226
VAT	57	81	85	89	311
Excise taxes	111	107	114	120	452
Other trade taxes	54	45	50	50	199
Other	56	56	60	69	240
Nontax revenue	20	27	30	57	134
Grants	0	2	4	6	12
Total expenditure and net lending	526	493	620	594	2,233
Current expenditure	427	376	464	421	1,688
Civil service wages and salaries	81	84	84	86	335
Other civilian goods and services	22	13	19	17	71
Security expenditure	70	71	76	83	301
Subsidies and transfers	99	91	105	124	419
Interest payments	154	117	180	111	562
Capital expenditure and net lending	100	116	156	173	545
Capital expenditure	95	113	138	202	549
Net lending	5	4	18	-30	-4
Overall balance	-181	-137	-218	-124	-659
Primary balance	-26	-20	-38	-12	-97

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 Est.	2016 Proj.	2017 Proj.	2018 Proj.	2016Q1 Proj.	2016Q2 Proj.	2016Q3 Proj.	2016Q4 Proj.
Gross inflow	**2,566**	**2,310**	**2,383**	**2,531**	**563**	**764**	**499**	**484**
Primary surplus	0	0	0	109	0	0	0	0
Rupee-denominated debt disbursement	1,747	1,403	1,692	1,587	351	351	351	351
US-dollar denominated debt disbursement	829	873	658	802	179	413	148	133
Asset sales (net)	0	0	0	0	0	0	0	0
Other	-11	33	33	33	33	0	0	0
Gross outflow	**2,562**	**2,310**	**2,383**	**2,531**	**541**	**615**	**669**	**484**
Primary deficit	241	97	3	0	26	20	38	12
Interest payment	527	562	629	695	154	117	180	111
Rupee-denominated debt amortization	1,490	1,223	1,389	1,426	228	375	353	267
US-dollar denominated debt amortization	304	427	362	409	132	103	98	93
Other	0	0	0	0	0	0	0	0
Net inflow	**4**	**0**	**0**	**0**	**22**	**149**	**-170**	**-1**
Government deposits, end of period	74	74	74	74	96	244	74	74
Memorandum items:								
Overall deficit	768	659	632	695	181	137	218	124
US$ denominated debt disbursement (in US$ millions	5,984	5,993	4,308	5,150	1,255	2,848	1,005	885
US$ denominated debt amortization (in US$ millions)	2,208	2,924	2,370	2,626	924	711	668	622

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

Table 3a. Sri Lanka: Monetary Accounts, 2014–17
(in millions of rupee, unless otherwise indicated, end of period)

	2014	2015	2016	2017
			Proj.	
	(Stocks, in billions of Sri Lankan rupees)			
Central Bank of Sri Lanka				
Net foreign assets	688	576	707	926
Net domestic assets	-110	97	91	-33
Net claims on central government	150	230	267	297
Net claims on banks	17	-3	-3	-3
Other items, net	-277	-130	-173	-327
Reserve Money	578	673	797	893
Monetary survey				
Net foreign assets	15	-298	-216	-13
Monetary authorities	688	576	707	926
Deposit money banks	-673	-874	-922	-939
Net domestic assets	3,861	4,864	5,277	5,853
Net claims on central government	1,436	1,759	1,854	1,987
Credit to corporations	3,204	3,973	4,364	4,961
Public corporations	446	523	570	623
Private corporations	2,758	3,450	3,793	4,337
Other items (net)	-779	-868	-941	-1,095
Broad money	3,876	4,566	5,061	5,840
Memorandum Items				
Gross international reserves (in millions of U.S. dollars)	8,208	7,304	7,853	9,372
Net international reserves (in millions of U.S. dollars)	6,517	5,029	5,700	7,043
Net Foreign Assets (in millions of U.S. dollars)	5,244	3,999	4,670	6,013
Private credit (in percent of GDP)	26.4	30.8	31.2	32.4
Money multiplier	6.7	6.8	6.3	6.5
Broad money velocity 1/	2.7	2.4	2.4	2.3
Money and credit (percent change, end of period)				
Broad money	13.4	17.8	10.8	15.4
Reserve money	18.3	16.5	18.4	12.0
Credit to public corporations	22.2	17.2	9.1	9.3
Credit to private sector	8.8	25.1	10.0	14.3

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

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

Table 3b. Sri Lanka: Monetary Accounts, 2016

(in millions of rupee, unless otherwise indicated, end of period)

	2015	2016Q1	2016Q2	2016Q3	2016Q4
			Proj.		
Central Bank of Sri Lanka					
Net foreign assets	576	494	621	614	707
Net domestic assets	97	298	170	180	91
Net claims on central government	230	239	248	257	267
Net claims on banks	-3	-3	-3	-3	-3
Other items, net	-130	62	-76	-75	-173
Reserve Money	673	792	791	794	797
Monetary survey					
Net foreign assets	-298	-158	-190	-202	-216
Monetary authorities	576	494	621	614	707
Deposit money banks	-874	-651	-810	-816	-922
Net domestic assets	4,864	5,183	5,209	5,243	5,277
Net claims on central government	1,759	1,734	1,781	1,838	1,854
Credit to corporations	3,973	3,873	3,961	4,115	4,364
Public corporations	523	490	506	526	570
Private corporations	3,450	3,383	3,456	3,589	3,793
Other items (net)	-868	-424	-534	-711	-941
Broad money	4,566	5,026	5,019	5,040	5,061
Memorandum Items					
Gross international reserves (in millions of U.S. dollars)	7,304	6,439	7,596	7,440	7,853
Net international reserves (in millions of U.S. dollars)	5,029	4,309	5,419	5,359	5,700
Money and credit (percent change, end of period)					
Broad money	17.8	26.3	21.2	17.1	10.8
Reserve money	16.5	27.8	30.0	24.0	18.4
Credit to private sector	25.1	18.9	16.6	13.7	10.0

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

Table 4a. Sri Lanka: Balance of Payments, 2014–20
(In millions of U.S. dollars, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020
					Proj.		
Current account	**-1,989**	**-2,009**	**-1,202**	**-2,419**	**-2,916**	**-3,343**	**-3,812**
Balance on goods	-8,287	-8,430	-7,936	-9,820	-10,768	-11,693	-12,515
Credit (exports)	11,130	10,505	10,456	10,942	11,838	12,664	14,093
Debit (imports)	-19,417	-18,935	-18,392	-20,763	-22,606	-24,357	-26,608
Balance on services	1,880	2,325	2,760	3,251	3,797	4,405	4,887
Credit (exports)	5,605	6,397	7,133	7,905	8,752	9,646	10,432
Debit (imports)	-3,725	-4,072	-4,373	-4,654	-4,955	-5,241	-5,546
Primary income, net 1/	-1,809	-2,097	-2,376	-2,315	-2,487	-2,669	-2,869
Secondary income, net 2/	6,227	6,193	6,350	6,464	6,541	6,615	6,686
Of which: workers' remittances (net)	6,199	6,167	6,322	6,435	6,510	6,583	6,654
Capital account (+ surplus / - deficit)	**58**	**46**	**43**	**27**	**17**	**12**	**12**
Balance from current account and capital account	**-1,930**	**-1,962**	**-1,159**	**-2,392**	**-2,899**	**-3,331**	**-3,800**
Financial account (+ net lending / - net borrowing) 3/	**-3,803**	**-3,128**	**-1,505**	**-3,536**	**-4,770**	**-4,249**	**-4,624**
Direct investments	-827	-628	-662	-852	-1,137	-1,571	-2,240
Portfolio investments	-2,065	-689	-793	-808	-1,526	-565	-437
Equity and investment Fund shares	-178	58	0	-178	-196	-215	-237
Debt instruments	-1,887	-747	-793	-630	-1,330	-350	-200
Of which: deposit taking corporations	-250	0	-200	-230	-230	-250	-100
Of which: general government	-1,462	-747	-593	-400	-1,100	-100	-100
T-bills, T-bonds, and SLDBs	38	903	1,407	-100	-100	-100	-100
Sovereign bonds	-1,500	-1,650	-2,000	-300	-1,000	0	0
Other investments 4/	-911	-1,811	-50	-1,876	-2,108	-2,112	-1,947
Of which:							
Currency and deposits	568	-1,314	1,000	-250	-250	-250	-250
Central bank 5/	-1	-1,098	1,100	0	0	0	0
Deposit taking corporations	569	-216	-100	-250	-250	-250	-250
Loans 4/	-2,432	-1,241	-1,050	-1,626	-1,858	-1,862	-1,697
Central bank 4/	0	0	0	0	0	0	0
Deposit taking corporations	-1,358	-787	-200	-200	-200	-200	-200
General government	-646	-470	-550	-1,231	-1,508	-1,462	-1,297
Disbursements	-1,439	-1,268	-1,500	-2,300	-2,700	-2,700	-2,700
Amortizations	793	798	950	1,070	1,192	1,238	1,403
Other sectors	-429	16	-300	-195	-150	-200	-200
Errors and omissions	395	-308	0	0	0	0	0
Overall balance (- = need of inflow) 3/	**2,268**	**857**	**346**	**1,143**	**1,871**	**918**	**824**
Total financing (- = inflow)	**2,268**	**857**	**346**	**1,143**	**1,871**	**918**	**824**
Financing (- = inflow)	**2,268**	**857**	**1,006**	**1,760**	**2,494**	**1,168**	**824**
Change in reserve assets	1,549	350	549	1,519	2,494	1,168	810
Use of Fund credit, net	719	507	456	241	0	0	14
Purchases/Disbursements	0	0	0	0	0	0	0
Repurchases/repayments	719	507	456	241	0	0	14
Financing gap (- = inflow)	**0**	**0**	**-659**	**-617**	**-623**	**-250**	**0**
IMF	0	0	-334	-417	-498	-250	0
Other IFIs	0	0	-325	-200	-125	0	0
Memorandum items:							
Current account (in percent of GDP)	-2.5	-2.5	-1.5	-2.8	-3.1	-3.3	-3.4
Gross official reserves	8,208	7,304	7,853	9,372	11,866	13,033	13,843
In months of prospective imports of goods and nonfactor services	4.3	3.8	3.7	4.1	4.8	4.9	5.0
In percent of ARA composite metric	86.6	75.8	79.1	86.9	99.4	99.2	97.3
Net international reserves	6,517	5,029	5,700	7,043	9,040	9,958	10,782
In percent of ARA composite metric	68.8	52.2	57.4	65.3	75.7	75.8	75.8
GDP	80,007	81,247	82,239	87,626	94,898	102,329	110,551

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

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

	2016				
	Q1	Q2	Q3	Q4	Annual
			Proj.		
Current account	-635	-179	-465	77	-1,202
Balance on goods	-2,062	-1,945	-1,907	-2,022	-7,936
Credit (exports)	2,660	2,446	2,634	2,716	10,456
Debit (imports)	-4,722	-4,391	-4,541	-4,738	-18,392
Balance on services	743	545	758	714	2,760
Primary income, net 1/	-638	-433	-609	-696	-2,376
Secondary income, net 2/	1,322	1,654	1,293	2,081	6,350
Capital account (+ surplus / - deficit)	6	17	9	11	43
Balance from current account and capital account	-628	-162	-456	88	-1,159
Financial account (+ net lending / - net borrowing) 3/	92	-1,273	-196	-129	-1,505
Direct investments	-130	-317	-141	-73	-662
Portfolio investments	510	-1,768	232	232	-793
Of which: general government	560	-1,718	282	282	-593
T-bills, T-bonds, and SLDBs	560	282	282	282	1,407
Sovereign bonds	0	-2,000	0	0	-2,000
Other investments 4/	-288	813	-288	-288	-50
Of which: currency and deposits, central bank 5/	0	1,100	0	0	1,100
Of which: general government amortizations	238	238	238	238	950
Errors and omissions	0	0	0	0	0
Overall balance (- = need of inflow) 3/	-720	1,110	-260	216	346
Total financing (- = inflow)	-720	1,110	-260	216	346
Financing (- = inflow)	-720	1,278	-60	508	1,006
Change in reserve assets	-865	1,157	-156	412	549
Use of Fund credit, net	145	120	96	96	456
Purchases/Disbursements	0	0	0	0	0
Repurchases/repayments	145	120	96	96	456
Financing gap (- = inflow)	0	-167	-200	-292	-659
IMF	0	-167	0	-167	-334
Other IFIs	0	0	-200	-125	-325
Memorandum items:					
Gross official reserves	6,439	7,596	7,440	7,853	7,853
In months of prospective imports of goods and nonfactor services	3.0	3.6	3.5	3.7	3.7
In percent of ARA composite metric	64.8	76.5	74.9	79.1	79.1
Net international reserves	4,309	5,419	5,359	5,700	5,700
In percent of ARA composite metric	43.4	54.6	54.0	57.4	57.4

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, 2014–20

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

	2014	2015	2016	2017	2018	2019	2020
				Proj.			
Current account	-1,989	-2,009	-1,202	-2,419	-2,916	-3,343	-3,812
Balance on goods	-8,287	-8,430	-7,936	-9,820	-10,768	-11,693	-12,515
Credit (exports)	11,130	10,505	10,456	10,942	11,838	12,664	14,093
Debit (imports)	-19,417	-18,935	-18,392	-20,763	-22,606	-24,357	-26,608
Balance on services	1,880	2,325	2,760	3,251	3,797	4,405	4,887
Primary and secondary income, net	4,418	4,096	3,974	4,150	4,055	3,946	3,817
Amortization	-1,860	-837	-2,606	-1,416	-1,302	-2,854	-2,537
General government	-793	-1,298	-950	-1,070	-1,192	-2,738	-2,403
Sovereign loans	0	-500	0	0	0	-1,500	-1,000
Bilateral and multilateral	-793	-798	-950	-1,070	-1,192	-1,238	-1,403
Central bank	-718	592	-1,556	-241	0	0	-18
IMF repurchases/repayments	-719	-507	-456	-241	0	0	-18
Other central bank liabilities, net	1	1,098	-1,100	0	0	0	0
Private sector loans	-348	-130	-100	-105	-110	-116	-116
Gross external financing needs	-3,849	-2,845	-3,808	-3,835	-4,218	-6,196	-6,348
Sources of financing	3,849	2,845	3,808	3,835	4,218	6,196	6,348
Borrowing	5,397	3,196	3,698	4,737	6,090	7,114	7,155
General government	2,953	2,564	2,143	2,735	3,825	4,320	3,820
T-bills, Tbonds, and SLDBs, net	-38	-903	-1,407	100	100	100	100
Sovereign bonds	1,500	2,150	2,000	300	1,000	1,500	1,000
Bilateral and multilateral 1/	1,439	1,268	1,500	2,300	2,700	2,700	2,700
Official capital transfers	52	50	50	35	25	20	20
Other capital inflows, net	2,444	632	1,555	2,002	2,265	2,794	3,335
Deposit-taking corporations, excl. central bank, net	717	789	500	680	680	700	550
FDI inflows, net	827	628	662	852	1,137	1,571	2,240
Private sector loans	777	211	400	300	260	316	316
Other capital inflows, net	124	-996	-7	170	188	207	229
Change in reserve assets	-1,549	-350	-549	-1,519	-2,494	-1,168	-806
External financing gap	0	0	659	617	623	250	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, 2012–15

	2012	2013	2014	2015 Q1	2015 Q2	2015 Q3	2015 Q4
Capital adequacy							
Regulatory capital to risk weighted assets	16.4	16.3	15.6	16.3	16.0	15.2	14.2
Tier 1 capital/risk weighted assets	14.7	13.7	13.1	13.8	13.5	12.8	11.9
Capital to assets ratio	8.6	8.2	8.2	8.2	8.2	8.1	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
Net nonperforming loans to total gross loans	2.2	3.8	2.6	2.7	2.7	2.4	1.7
Provision coverage ratio (total)	53.4	40.4	50.7	48.1	48.4	51.6	62.3
Earnings and profitability							
Return on equity (after tax)	20.3	16.0	16.6	16.7	16.0	16.2	16.1
Return on assets (after tax)	1.7	1.3	1.4	1.4	1.3	1.3	1.3
Interest income to gross income	86.3	69.7	69.3	74.6	74.5	73.0	73.2
Staff expenses to noninterest expenses	45.8	44.9	43.5	46.0	46.6	45.6	45.6
Total cost to total income	75.2	79.3	75.8	73.7	73.9	73.8	73.1
Net interest margin	4.1	3.5	3.5	3.9	3.7	3.6	3.5
Liquidity							
Liquid assets to total assets	26.6	31.9	32.2	31.0	31.3	29.4	30.0
Assets/funding structure							
Deposits	70.3	70.7	67.6	66.6	67.4	66.5	66.9
Borrowings	16.7	16.4	20.2	21.4	20.6	21.7	21.8
Credit to deposits	87.4	82.2	83.1	85.5	85.0	87.7	87.3

Source: Central Bank of Sri Lanka.

Table 6. Sri Lanka: Reviews and Purchases under the Proposed 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 20, 2016	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.

Table 7. Sri Lanka: Projected Payments to the Fund, 2016–2020 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	176.5	177.8	8.5	11.4	21.4	61.2	115.0	173.0	186.0	184.2	172.3	130.6	75.0	15.1
In millions of U.S. dollars	246.1	248.9	11.9	16.0	30.2	86.1	161.8	243.4	261.8	259.1	242.4	183.8	105.5	21.2
In percent of exports of goods and NFS	1.4	1.3	0.1	0.1	0.1	0.3	0.6	0.8	0.9	0.8	0.7	0.5	0.3	0.1
In percent of quota	30.5	30.7	1.5	2.0	3.7	10.6	19.9	29.9	32.1	31.8	29.8	22.6	13.0	2.6
In percent of gross official reserves	3.1	2.7	0.1	0.1	0.2	0.6	1.0	1.5	1.5	1.5	1.3	1.0	0.6	0.1
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	576	752	1,252	1,506	1,493	1,422	1,275	1,045	794	543	306	125	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	0.7	0.5	0.3	0.2	0.1	0.0	0.0
In percent of gross official reserves	7.3	8.0	10.5	11.6	10.8	9.1	7.9	6.3	4.6	3.1	1.7	0.7	0.1	0.0
Memorandum items:														
Exports of goods and services (in millions of U.S. dollars)	17,589	18,848	20,590	22,310	24,525	26,218	27,529	28,905	30,350	31,868	33,461	35,134	36,891	38,736
Quota	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)	809	810	811	814	815	814	814	814	814	814	814	814	814	814
Gross official reserves (in millions of U.S. dollars)	7,853	9,372	11,866	13,033	13,843	15,595	16,095	16,595	17,095	17,595	18,095	18,595	19,095	19,595
GDP (in millions of U.S. dollars)	82,239	87,626	94,898	102,329	110,551	119,547	129,111	139,440	150,595	162,642	175,654	189,706	204,882	221,273
U.S. dollars per SDR (end of period)	1.40	1.40	1.40	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41
U.S. dollars per SDR (period average)	1.39	1.40	1.40	1.40	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41

Source: IMF staff estimates.

1/ As of April 22, 2016 using the new quota (effective in February 17, 2016).

2/ As of the end of the year.

Annex I. Response to Past Fund Policy Advice

The authorities have actively engaged in a policy dialogue with the Fund (both before and after elections in January and August 2015). Some IMF recommendations have been implemented, but some policies deviated from previous IMF advice.

Continue fiscal consolidation and debt reduction, but shift the burden of adjustment to revenue generation.	Fiscal consolidation stalled in 2014 and 2015. Revenue gains achieved, but only through one-off measures and higher collection of trade-related taxes (from increase in imports).
Debt targets could potentially be recast to achieve deeper reduction over a longer period.	Fiscal targets have been re-set, but without setting a deeper reduction to the debt target over a longer period.
A more systematic effort to broaden the tax base to improve revenue collection.	Currently underway with redrafting of Inland Revenue Act as first stage in comprehensive reform of tax system.
IMF technical assistance to quantify the costs of tax expenditures—as an input to government's own medium-term reform plan.	Technical assistance on tax policy, tax legislation, and public financial management undertaken (basis for current reform program).
Staff argued for keeping the current monetary stance unchanged.	Monetary policy subsequently loosened.
Maintain a flexible exchange rate regime, as the CBSL's interventions had effectively stabilized the exchange rate.	Central bank intervention continued while the exchange rate was kept virtually steady until September 2015.
The mission highlighted some aspects that might limit potential gains from the government's proposed financial sector consolidation plan.	Financial sector consolidation plan was abandoned following January 2015 elections.

Annex II. Sri Lanka: Risk Assessment Matrix[1]

Source of Risk	Likelihood / time horizon	Expected Impact on Economy	Policy Response
		Potential Domestic Shocks	
Tax-to-GDP ratio fails to increase as planned	*Medium / Medium Term*	**H**: Derails fiscal consolidation or causes capital expenditure cuts. Worsened investor confidence could aggravate capital outflows.	Accelerate tax policy and administration reforms.
Acute slowdown in economic growth	*Low / Short Term*	**H**: Poses challenges against fiscal consolidation, possibly causing capital outflows.	Accelerate structural reforms, such as promoting investment. Scope for fiscal stimulus would be limited, while monetary policy would not be highly effective in supporting growth.
		Potential External Shocks	
Surges in global financial market volatility	*Medium / Short Term*	**M**: Increased borrowing costs and more difficult rollover of maturing debt, with adverse impact on fiscal consolidation and external position.	Strengthen macro fiscal fundamentals and allow exchange rate flexibility.
Surge in the U.S. dollar	*High / Short Term*	**M:** Rises external debt and public debt ratios. Can worsen external position if a portfolio shift toward U.S. dollar assets occurs concomitantly.	Strengthen macro fiscal fundamentals and allow exchange rate flexibility.
Structurally weak growth in advanced economies (AEs) and emerging markets (EMs)	*High for AEs, Medium for EMs / Medium Term*	**M**: Causes a protracted slowdown in goods and services exports to and tourisms from AEs, weakening current account balance and growth.	Diversify exports and tourism markets, support increased value added production.
British voters elect to leave the EU	*High / Short to Medium Term*	**M**: Could lead to higher volatility in the global capital market. Increased borrowing costs and more difficult rollover of maturing debt, with adverse impact on fiscal consolidation and external position.	Strengthen macro fiscal fundamentals and allow exchange rate flexibility.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. Debt Sustainability Analysis

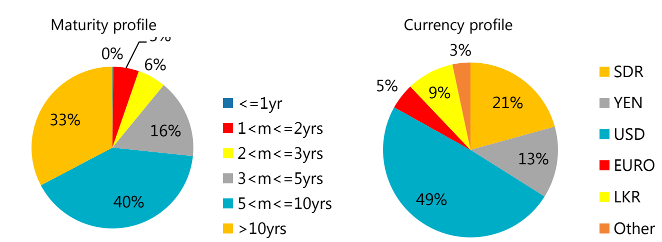
Sri Lanka's public debt and gross funding needs stand high compared with peers, with the ratio of gross financing needs to GDP being the third largest among emerging economies. Fiscal consolidation envisaged under the EFF-supported program would steadily reduce them. However, there are significant downside 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 79.5 percent of GDP at end-2015.** Public debt in this DSA covers debt owed by the central government (76 percent of GDP) and outstanding amount of loans guaranteed by the central government (3.4 percent of GDP). 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 19.2 percent of GDP in 2016, comprising short-term debt repayment of 7.5 percent of GDP, medium-and long-term debt amortization of 6.3 percent of GDP, and projected overall deficit of 5.4 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 third largest among them. 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.

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.

Sri lanka: Profile of central government external loans (2015)



Source: Sri Lankan authorities.

3. **The baseline scenario of the DSA is built on the macroeconomic framework under the EFF-supported program.** Real GDP growth is projected at 5 percent over 2016–18 and thereafter would pick up to 5.4 percent by 2020. Inflation is projected to stay around 5 percent

over the medium term. Fiscal deficit is expected to decrease from 5.4 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 2016 to surplus of 0.7 percent of GDP in 2018 and 1.0 percent of GDP in 2020. Interest payments are projected based on the projected interest payments for existing debt, and the interest rates in the secondary government security markets prevailing in March 2016 for the newly issued debt in 2016. The interest rates for newly issued debt are assumed to decrease gradually by about 2 percentage points over the medium term. Publicly guaranteed debt is projected to remain broadly unchanged at the 2015 level in nominal terms. External debt projections are based on the projected widening of the current account deficit from 1.5 percent of GDP in 2016 to 3.4 percent of GDP in 2020, 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 baseline scenario is projected to bring down the ratio of public debt to GDP steadily from 79.5 percent in 2015 to 70.3 percent in 2020. It will reduce the debt to GDP ratio by about 2½–2¾ percent annually from 2018 onwards, supported by a favorable debt dynamics with a negative interest-rate-and-growth differential. Gross financing needs are projected to decrease from 19 percent of GDP in 2016 to 12 percent of GDP in 2020.

5. Nevertheless, there are significant downside risks to the baseline 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 2015–20 would be only 3½ percentage points, much lower than in the baseline scenario (9 percentage points). Debt reductions would become less significant under individual shock scenarios on primary balance (lower primary surplus by 0.3–0.4 percentage points of GDP for 2017–18), GDP growth (2 percentage points lower than in the baseline for 2017–18), the exchange rate (15 percent real depreciation in 2017 vis-à-vis the baseline), and the interest rate (an increase by 300 basis points for new borrowings during 2017–20 vis-à-vis the baseline). When these shocks are combined, the debt to GDP ratio would reach 85 percent in 2020. 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 82 percent of GDP in 2020. In the combined shock scenario and the contingent liability shock scenario, gross funding needs would remain elevated at 15–16 percent of GDP in 2020.

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 baseline and the shock scenarios during the projection period, reflecting the initial conditions (under the baseline, the debt to GDP ratio and gross financing needs as a percent of GDP were 80 percent and 19 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 remain broadly constant over the medium term. Under the baseline scenario, external debt is projected to increase by 2 percentage points of GDP to 57.1 percent in 2019. It will then start decreasing, driven by strong GDP growth and subdued FDI loans and other debt-creating private capital inflows.

8. Nevertheless, vulnerabilities linked to inadequate reserve coverage, exchange rate depreciation, and early deleveraging could pose a risk for debt servicing. Currency risk, notably related to the dollar, is high. Further 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 82 percent. This is mitigated by low rollover risks with the large share of medium and long term debt, though tighter global financing liquidity and declining investor confidence could raise rollover vulnerabilities and costs—public external financing at non concessional terms substitute gradually for concessional financing to which Sri Lanka does not have access anymore. Lower than expected GDP or exports rebound from their current dip would also deteriorate debt dynamics.

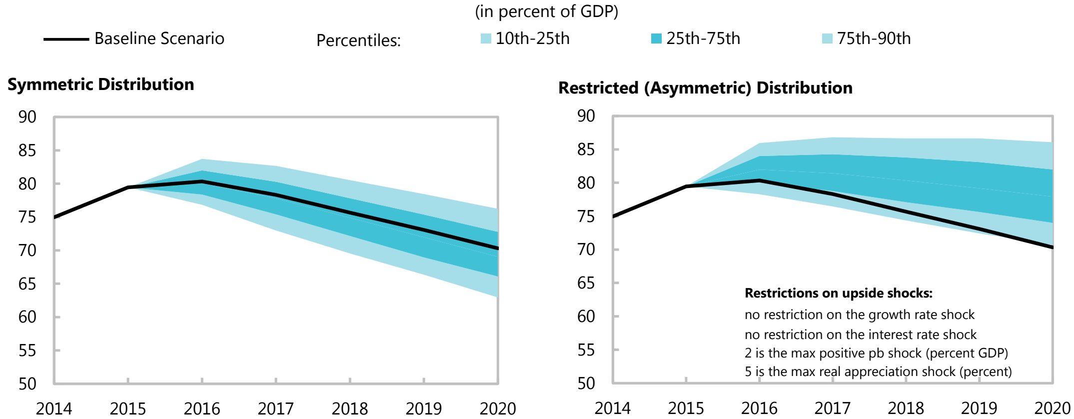
Sri Lanka Public DSA Risk Assessment

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

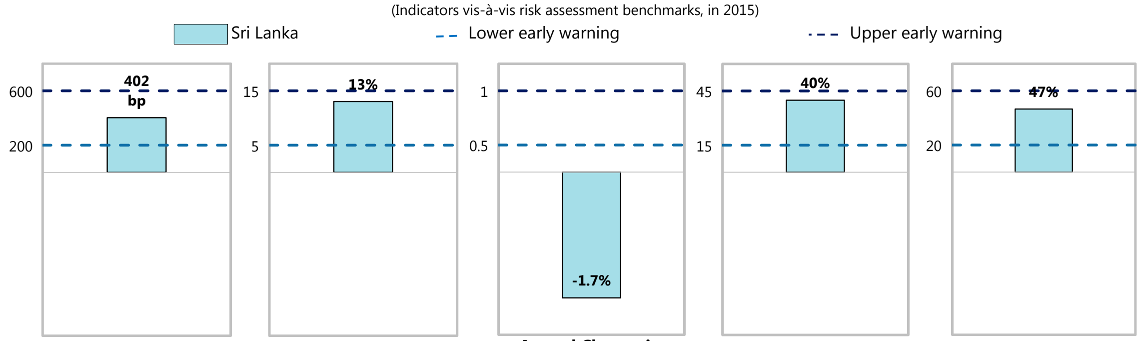
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

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



Bond spread	External Financing Requirement	Annual Change in Short-Term Public Debt	Public Debt Held by Non-Residents	Public Debt in Foreign Currency
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

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.

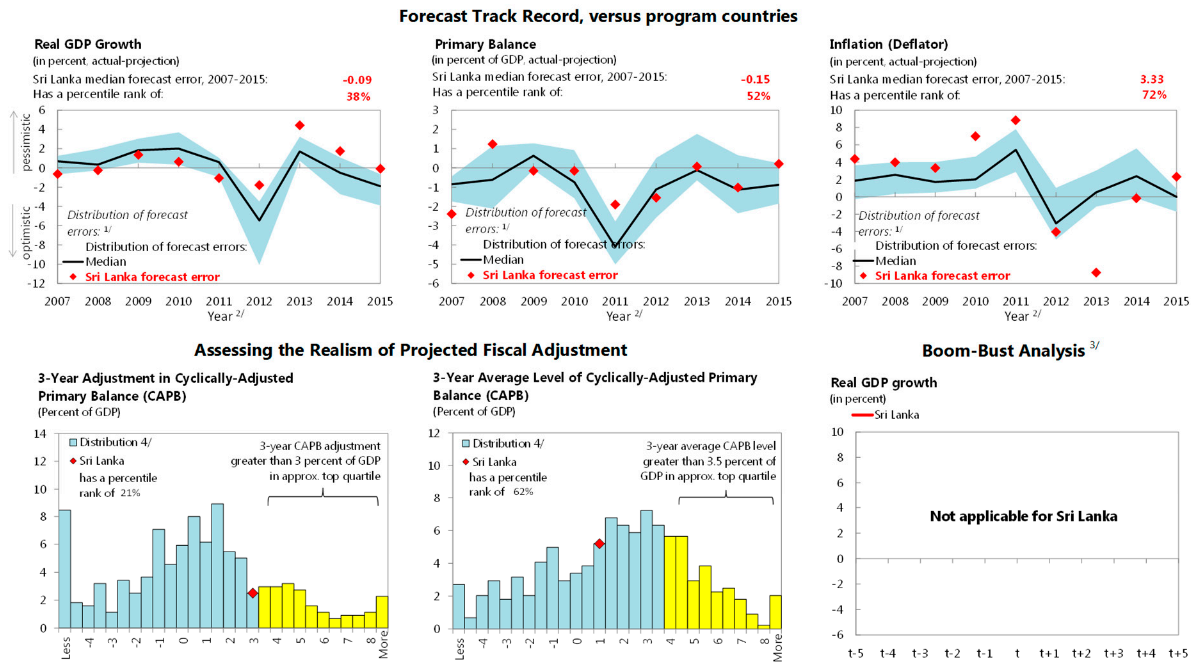
Lower and upper risk-assessment benchmarks are:

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, 06-Feb-16 through 06-May-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



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 obervations 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)

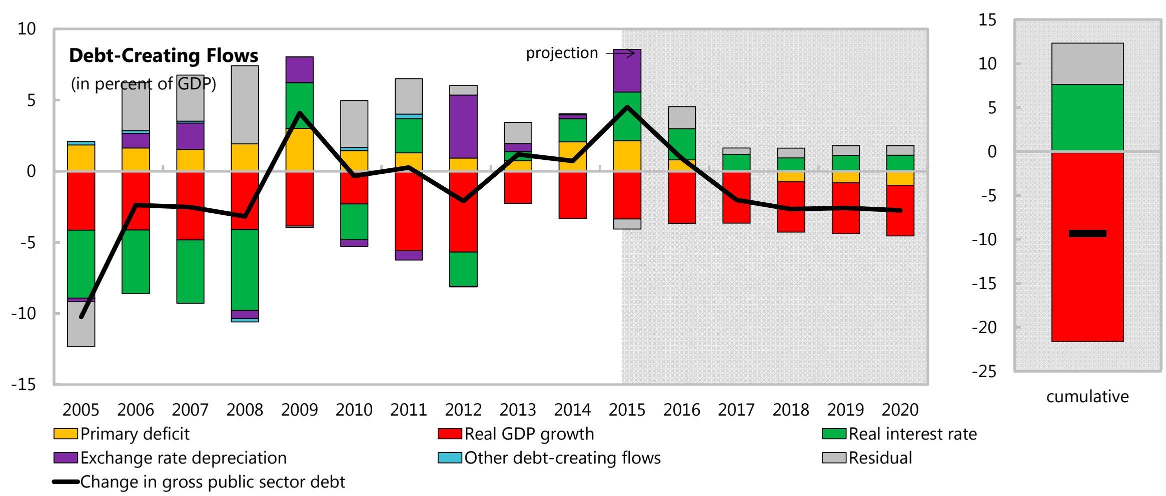
Debt, Economic and Market Indicators 1/

	Actual			Projections				
	2005-2013 2/	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	74.9	75.0	79.5	80.3	78.3	75.7	73.1	70.3
Public gross financing needs	21.5	24.3	20.7	19.2	17.8	16.4	14.7	12.2
Real GDP growth (in percent)	6.3	4.9	4.8	5.0	5.0	5.0	5.2	5.4
Inflation (GDP deflator, in percent)	9.9	3.9	2.1	3.4	4.9	5.3	5.0	5.0
Nominal GDP growth (in percent)	16.8	8.9	7.0	8.6	10.1	10.6	10.5	10.7
Effective interest rate (in percent) 4/	7.4	6.4	7.1	6.6	6.7	6.9	6.9	7.0

As of May 06, 2016		
Sovereign Spreads 3/		399.3
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	B+	B+
Fitch	B+	B+

Contribution to Changes in Public Debt

	Actual			Projections						
	2005-2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance 9/
Change in gross public sector debt	-1.7	0.7	4.5	0.9	-2.0	-2.7	-2.6	-2.8	-9.3	
Identified debt-creating flows	-3.6	0.6	5.2	-0.7	-2.5	-3.3	-3.3	-3.4	-14.0	
Primary deficit	1.6	2.1	2.2	0.8	0.0	-0.7	-0.8	-1.0	-0.2	-2.4
Primary (noninterest) revenue and grants	13.5	11.5	13.1	13.0	14.0	15.3	15.5	15.8	87.3	
Primary (noninterest) expenditure	15.1	13.6	15.2	13.8	14.1	14.6	14.6	14.8	87.2	
Automatic debt dynamics 5/	-5.2	-1.4	3.1	-1.5	-2.5	-2.6	-2.5	-2.4	-13.8	
Interest rate/growth differential 6/	-6.1	-1.7	0.1	-1.5	-2.5	-2.6	-2.5	-2.4	-13.8	
Of which: real interest rate	-2.0	1.6	3.4	2.2	1.2	0.9	1.1	1.1	7.6	
Of which: real GDP growth	-4.1	-3.3	-3.4	-3.7	-3.6	-3.5	-3.6	-3.6	-21.5	
Exchange rate depreciation 7/	0.9	0.3	3.0	…	…	…	…	…	…	
Other identified debt-creating flows	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits (ne	0.1	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	
Please specify (2) (e.g., ESM and Euroare	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 8/	1.9	0.1	-0.7	1.6	0.4	0.7	0.7	0.7	4.7	



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.

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 - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (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).

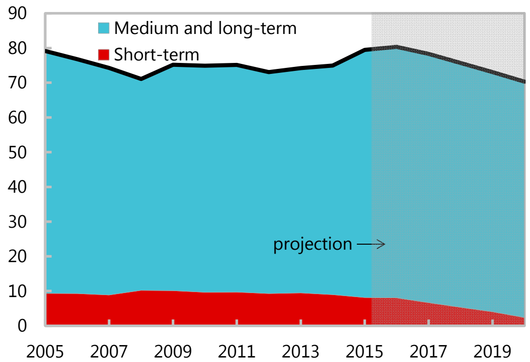
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

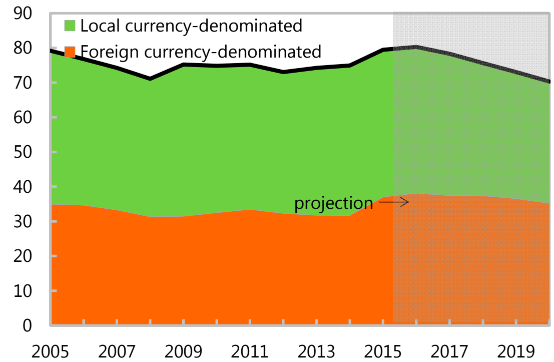
Sri Lanka Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



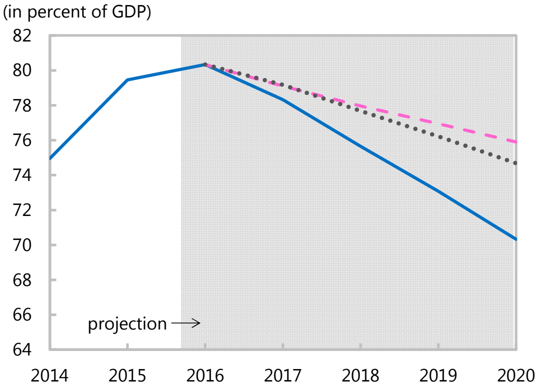
By Currency
(in percent of GDP)



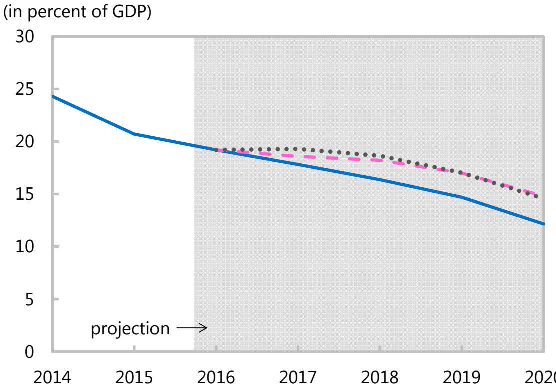
Alternative Scenarios

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)

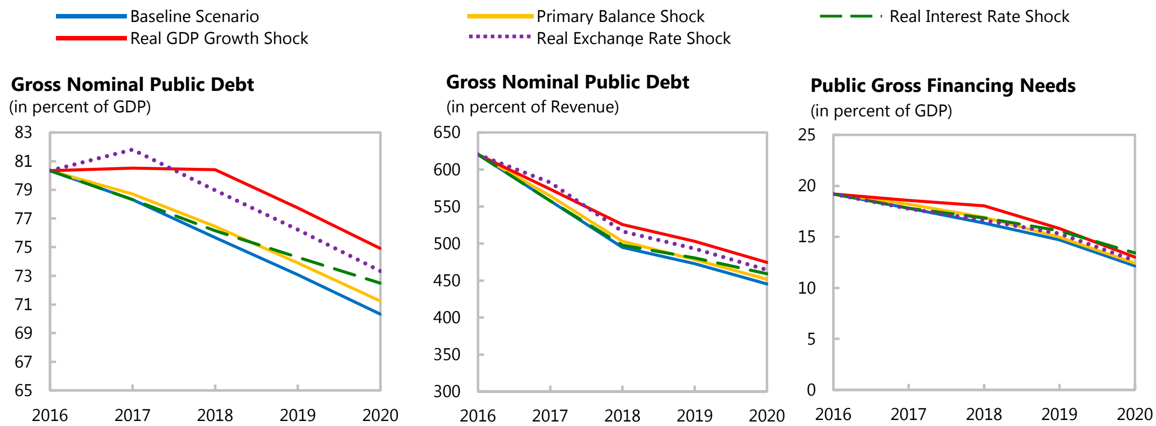
	2016	2017	2018	2019	2020
Baseline Scenario					
Real GDP growth	5.0	5.0	5.0	5.2	5.4
Inflation	3.4	4.9	5.3	5.0	5.0
Primary Balance	-0.8	0.0	0.7	0.8	1.0
Effective interest rate	6.6	6.7	6.9	6.9	7.0
Constant Primary Balance Scenario					
Real GDP growth	5.0	5.0	5.0	5.2	5.4
Inflation	3.4	4.9	5.3	5.0	5.0
Primary Balance	-0.8	-0.8	-0.8	-0.8	-0.8
Effective interest rate	6.6	6.7	6.9	6.9	7.0

	2016	2017	2018	2019	2020
Historical Scenario					
Real GDP growth	5.0	6.1	6.1	6.1	6.1
Inflation	3.4	4.9	5.3	5.0	5.0
Primary Balance	-0.8	-1.7	-1.7	-1.7	-1.7
Effective interest rate	6.6	6.7	6.2	5.8	5.6

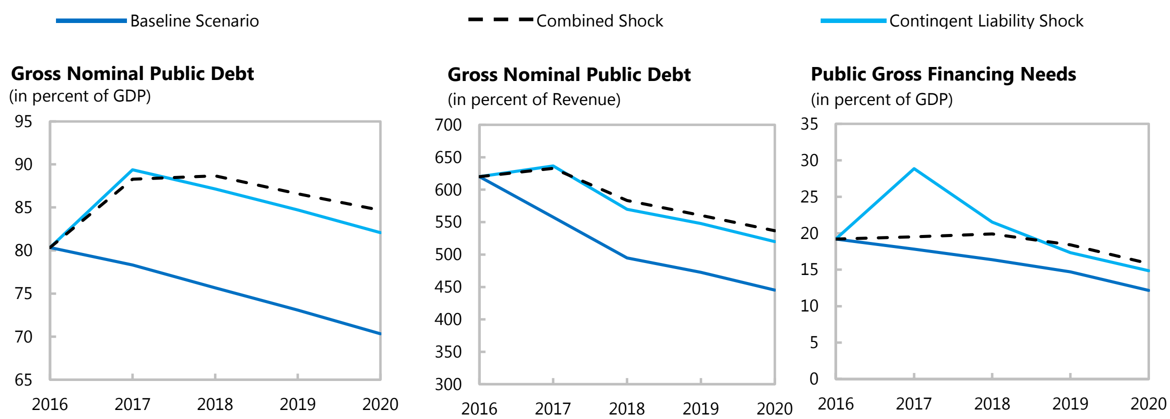
Source: IMF staff.

Sri Lanka Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

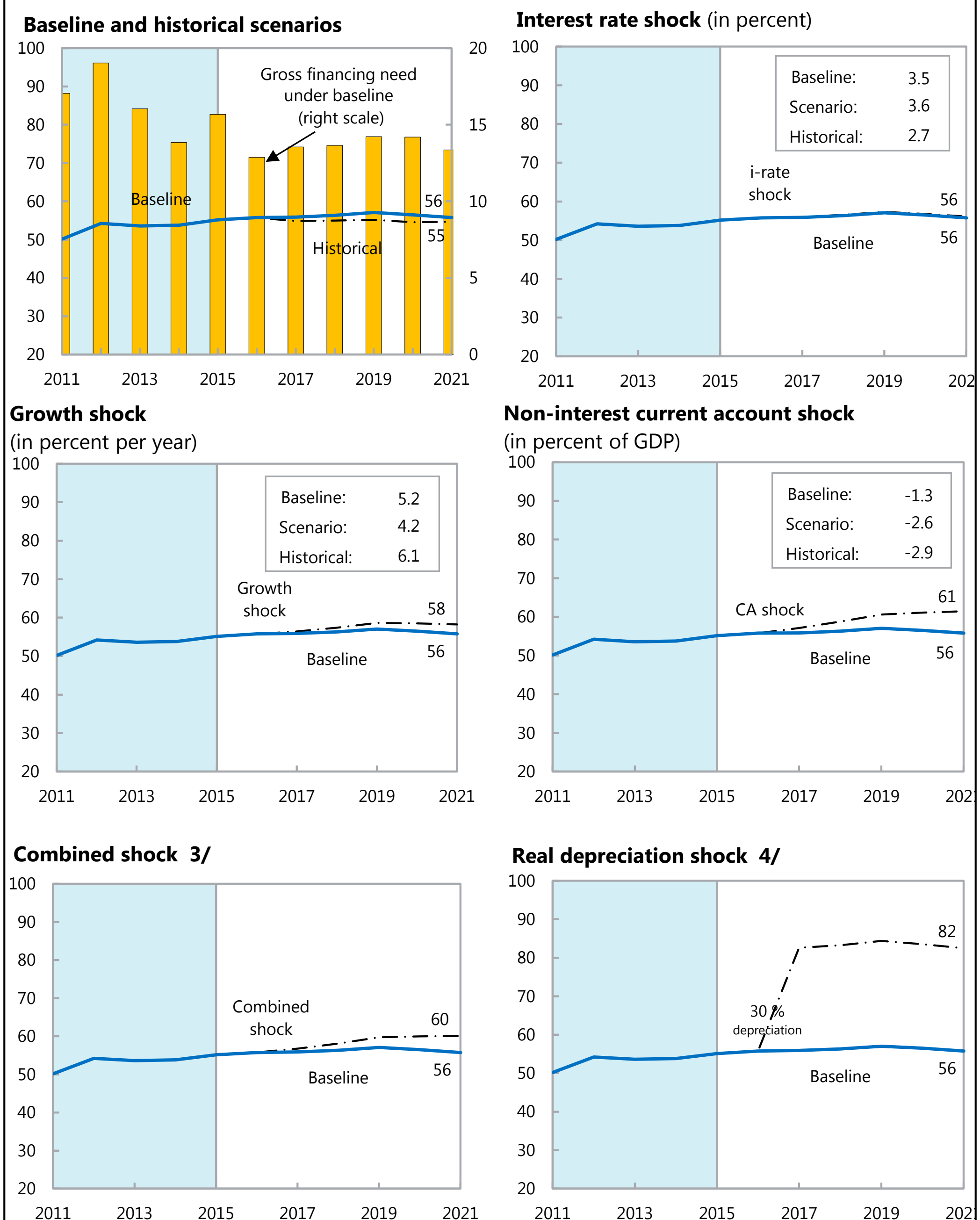
Primary Balance Shock	2016	2017	2018	2019	2020
Real GDP growth	5.0	5.0	5.0	5.2	5.4
Inflation	3.4	4.9	5.3	5.0	5.0
Primary balance	-0.8	-0.4	0.4	0.8	0.9
Effective interest rate	6.6	6.7	6.9	6.9	7.0
Real Interest Rate Shock					
Real GDP growth	5.0	5.0	5.0	5.2	5.4
Inflation	3.4	4.9	5.3	5.0	5.0
Primary balance	-0.8	0.0	0.7	0.8	1.0
Effective interest rate	6.6	6.7	7.6	8.0	8.5
Combined Shock					
Real GDP growth	5.0	3.0	3.0	5.2	5.4
Inflation	3.4	4.4	4.8	5.0	5.0
Primary balance	-0.8	-0.5	-0.1	0.8	0.9
Effective interest rate	6.6	7.1	7.3	7.8	8.3

Real GDP Growth Shock	2016	2017	2018	2019	2020
Real GDP growth	5.0	3.0	3.0	5.2	5.4
Inflation	3.4	4.4	4.8	5.0	5.0
Primary balance	-0.8	-0.4	0.0	0.8	1.0
Effective interest rate	6.6	6.7	6.9	6.9	7.0
Real Exchange Rate Shock					
Real GDP growth	5.0	5.0	5.0	5.2	5.4
Inflation	3.4	10.0	5.3	5.0	5.0
Primary balance	-0.8	0.0	0.7	0.8	1.0
Effective interest rate	6.6	7.1	6.7	6.7	6.8

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 bein 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 i 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						
	2011	2012	2013	2014	2015	10-Year Historical Average	10-Year Standard Deviation	2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	50.2	54.2	53.6	53.8	55.1			**55.8**	**55.9**	**56.3**	**57.1**	**56.5**	**55.8**	**-5.2**
2 Change in external debt	6.4	4.0	-0.6	0.2	1.3			0.6	0.1	0.4	0.7	-0.6	-0.7	
3 Identified external debt-creating flows (4+8+9)	0.0	1.4	-2.5	-2.5	0.8			-2.1	-1.0	-0.9	-1.1	-1.5	-2.7	
4 Current account deficit, excluding interest payments	6.0	4.5	2.0	1.0	1.0			-0.1	1.1	1.3	1.5	1.7	1.2	
5 Deficit in balance of goods and services	13.2	11.9	8.6	8.0	7.5			6.3	7.5	7.3	7.2	7.0	6.1	
6 Exports	20.9	19.8	20.3	20.9	20.8			21.4	21.5	21.7	21.8	22.2	21.9	
7 Imports	34.1	31.8	28.9	28.9	28.3			27.7	29.0	29.0	29.0	29.2	28.0	
8 Net non-debt creating capital inflows (negative)	-1.4	-1.7	-1.5	-1.3	-0.7			-0.8	-1.2	-1.4	-1.7	-2.2	-2.8	
9 Automatic debt dynamics 1/	-4.6	-1.5	-3.0	-2.3	0.5			-1.1	-0.9	-0.8	-0.9	-1.0	-1.0	
10 Contribution from nominal interest rate	1.1	1.3	1.4	1.4	1.5			1.6	1.7	1.8	1.8	1.9	1.9	
11 Contribution from real GDP growth	-3.2	-4.4	-1.7	-2.4	-2.5			-2.7	-2.6	-2.6	-2.7	-2.9	-2.9	
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			2.7	1.1	1.4	1.9	0.9	1.9	
External debt-to-exports ratio (in percent)	240.0	273.3	264.6	257.2	265.0			260.7	259.8	259.6	261.7	254.6	254.3	
Gross external financing need (in billions of US dollars) 4/	11.1	13.0	11.9	11.1	12.7			10.6	11.9	13.0	14.6	15.7	16.0	
in percent of GDP	17.0	19.0	16.0	13.9	15.7			12.9	13.5	13.6	14.2	14.2	13.3	
Scenario with key variables at their historical averages 5/								**55.8**	**54.9**	**55.0**	**55.2**	**54.5**	**54.7**	**-5.6**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	8.4	9.1	3.4	4.9	4.8	6.1	2.0	5.0	5.0	5.0	5.2	5.4	5.5	
GDP deflator in US dollars (change in percent)	6.2	-4.0	5.3	2.4	-3.1	5.1	7.2	-3.6	1.5	3.1	2.5	2.5	2.5	
Nominal external interest rate (in percent)	2.8	2.7	2.9	2.9	2.8	2.7	0.3	2.9	3.2	3.4	3.5	3.6	3.5	
Growth of exports (US dollar terms, in percent)	22.9	-0.5	11.1	11.0	1.0	8.3	10.5	4.1	7.2	9.2	8.4	9.9	6.9	
Growth of imports (US dollar terms, in percent)	46.2	-2.4	-1.0	7.6	-0.6	10.3	19.9	-1.0	11.6	8.4	7.6	8.9	3.6	
Current account balance, excluding interest payments	-6.0	-4.5	-2.0	-1.0	-1.0	-2.9	2.5	0.1	-1.1	-1.3	-1.5	-1.7	-1.2	
Net non-debt creating capital inflows	1.4	1.7	1.5	1.3	0.7	1.2	0.4	0.8	1.2	1.4	1.7	2.2	2.8	

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.

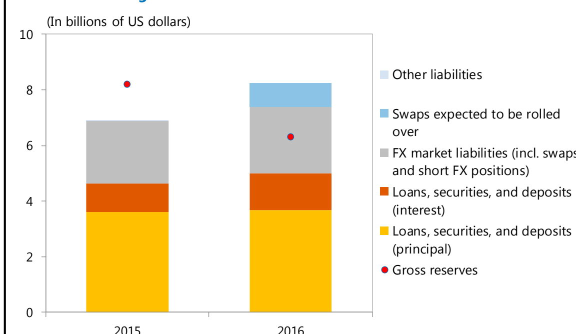
Annex IV. 2016 External Sustainability Assessment External Sustainability Concerns and Mounting Vulnerabilities

Sri Lanka's external position is weaker than implied by fundamentals and desirable policies. The balance of payments is under pressure because of anemic capital inflows and foreign investors' exit from the government securities market. Reserve coverage has deteriorated sharply owing to heavy intervention in the foreign exchange market, and at the beginning of 2016, gross reserves were short of foreign exchange claims coming due in the year. Quantitative estimations of the extent of the rupee overvaluation yield mixed results. External debt remains sustainable. Currency risks are high, but mitigated by long maturities and Sri Lanka's access to international financial markets. Strengthening external sustainability will require addressing domestic policy imbalances, greater exchange rate flexibility, and structural reforms to rebuild buffers, increase investor confidence and improve competitiveness.

1. **External sustainability is a concern—reserve cover has decreased significantly and is short of foreign exchange (FX) claims coming due in 2016**. Gross international reserves decreased by almost $1 billion in 2015—a drop of 11 percentage points of the ARA metric[1] to 76 percent (3.8 months of prospective imports). Reserves fell further to 65 percent of the metric by March 2016—barely 3 months of import cover. Moreover, gross reserves are largely borrowed. FX swaps with domestic banks of $2.1 billion, a swap arrangement with the Reserve Bank of India (RBI) of $700 million, and SAARC arrangement of $400 million provide a temporary buffer to the central bank, but could be short lived.[2] At the beginning of 2016, gross reserves were short of gross foreign-currency claims coming due in the year. Net international reserves were also low, at 43.4 percent of the ARA metric at end-March 2016.

2. **Reserve coverage has been dragged down by pressures on the balance of payments (Figure 1).** The balance of payments deteriorated in 2015 compared to 2014 owing to lower capital inflows. The current account (CA) deficit was contained at 2.5 percent of GDP, similar to the deficit in 2014, but a strong adjustment was expected given a 2.3 percent improvement in terms of trade—thanks to significantly lower oil prices. A large pickup in non-oil imports, notably vehicle imports, triggered by an expansionary budget, and declining exports, due to lower tea and rubber prices and declining demand compensated for the lower oil trade balance and buoyant tourism activity. Remittances were also flat. The financial and capital account was weak. Net foreign direct investment was anemic, at 0.8 percent of GDP, foreign holdings of government securities dropped by 1.1 percent of GDP as foreign investors did not rollover maturing T-bills and T-bonds, and implementation of externally financed public and private projects stalled partly because of the government review of investment projects.

To the contrary of 2015, gross international reserves are lower than claims coming due in 2016. [1]



Source: Central Bank of Sri Lanka.

[1] As of December 31, 2014 for 2015 and February 1, 2016 for 2016.

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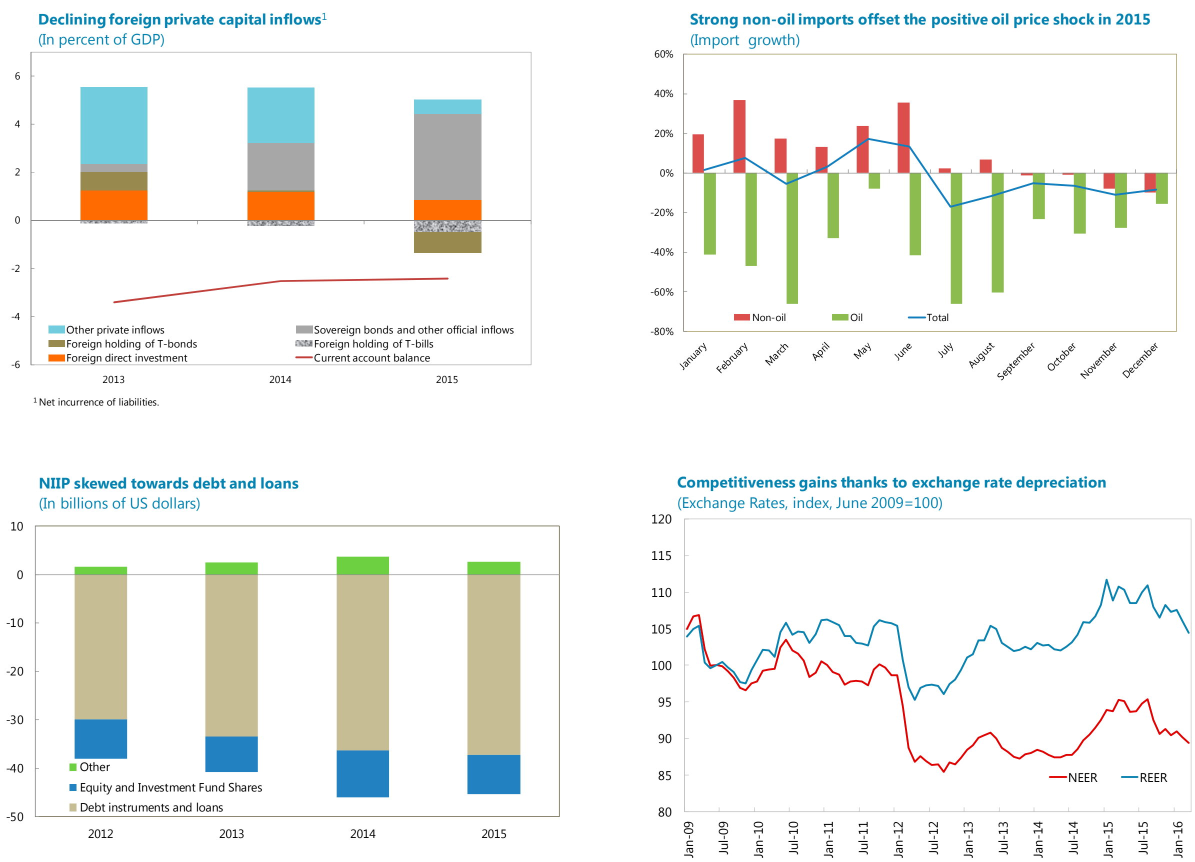
[1] Relative to the ARA metric for floating exchange rate, unadjusted for special circumstances. Reserve cover is even lower when assessed against the ARA metric for fixed exchange rate—which is a good comparator, as the rupee has been heavily managed in 2015.

[2] A large part of the FX swaps with domestic banks are coming due in 2016, including $0.9 billion of long term swaps that are usually rolled over annually. The swap arrangement with RBI is due to expire in June 2016 or upon approval of a Fund arrangement. The SAARC arrangement is also due to expire in June 2016, but could be rolled over upon approval of a Fund arrangement.

Capital inflows were mainly of official sources, mostly from FX swap arrangements and sovereign bond issuances.

Figure 1. Indicators of External Sustainability



Sources: Sri Lankan authorities, IMF World Economic Outlook, and 2016 World Bank's *Doing Business.*

3. In the absence of decisive policy actions to boost investor's confidence, reserve coverage is likely to deteriorate further as the balance of payments remains under pressure, in particular from the financial account. Pressures on the CA are expected to further recede as oil prices are expected to remain on average lower than in 2015 and the peak of high vehicle imports growth has passed (Figure 1), owing to macroprudential measures[3] implemented by the authorities. Efforts to lift the ban on fish exports to the EU and finalize trade arrangements with the United States could help boost exports in the near term, although weak global demand (Figure 2) and commodity prices could generate headwinds. Further exchange rate depreciation could also help further rein in the CA deficit,[4] whereas growth of remittances is likely to remain anemic as almost three fourths of inflows are originated from regions under economic stress (55 percent

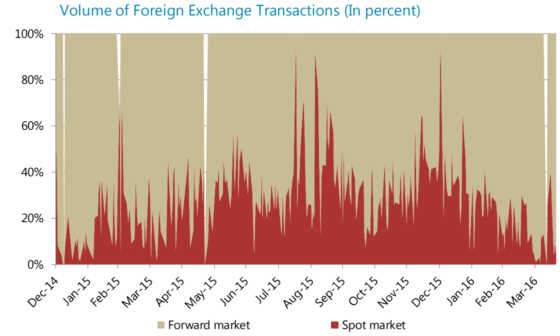
[3] The CBSL introduced a cap of 70 percent on loan-to-value on vehicle leases and loans on September 15, 2015 and imposed temporarily a 100 percent cash margin requirement on letter of credit opened for vehicle imports during the month of November (removed on December 1, 2015). Moreover, additional taxes were imposed on imports of certain motorized vehicles.

[4] Econometric estimations using VAR model and the literature suggest that one percent depreciation of real effective exchange rate could improve the CA balance by 0.1–0.2 percentage points of GDP.

from the Middle East and 18 percent from the European Union). On the contrary, the capital and financial account is expected to remain under pressures in the near term. Investor sentiment has worsened, reflecting concerns over domestic policies, external vulnerabilities, and volatility in global markets. Foreign holdings of government securities have dropped further to 6.1 percent of the stock at March 4, 2016 (from 6.9 percent at end-December 2015). Outflows reached $551 million in the first quarter of 2016, higher than the amount of securities maturing in 2016 ($248 million), reflecting large sales in the secondary market. There is also a risk of further outflows—the remainder stock is $1.5 billion. However, the regulatory ceiling imposed on the share of foreign holdings of T-bills and T-bonds to total stock during periods of inflows (10 percent in 2015) has been helpful in containing the magnitude of spillovers. FDI inflows and project loans are expected to resume only gradually, and the repayment of external liabilities will put a dent on reserves.

4. The CBSL's heavy intervention in the FX market, in response to depreciation pressures on the rupee, also contributed to reserve depletion. Net intervention in the spot market amounted $3.7 billion from January 1, 2015 to February 15, 2016. It reached a peak of $441 million per month in July–September 2015, before receding to US$190 million in February 2016, as part of CBSL's efforts to allow greater rupee flexibility starting in September 2015.[5] Despite the heavy and mostly one-sided intervention, and recourse to moral suasion, the rupee depreciated 9.8 percent from January 1, 2015 to February 15, 2016, though it showed signs of stabilization in February, when the spot rate was flat (Figure 4 of the staff report). Market pressures resumed in March, concomitant to capital outflows. The CBSL depleted FX reserves further, supplying $437 million to the foreign exchange market, which helped keep the spot rate mostly unchanged. However, the CBSL's actions reinforced distortions in the FX market, pushing a greater amount of foreign exchange trading from the spot market to the forward market, which rates are more representative of market forces. The 3-month forward market rate stood at 151 rupees per U.S. dollar for three days at the end of March. It dropped to 146.6 rupees per U.S. dollar at end April, 1.8 percent higher than the spot rate.

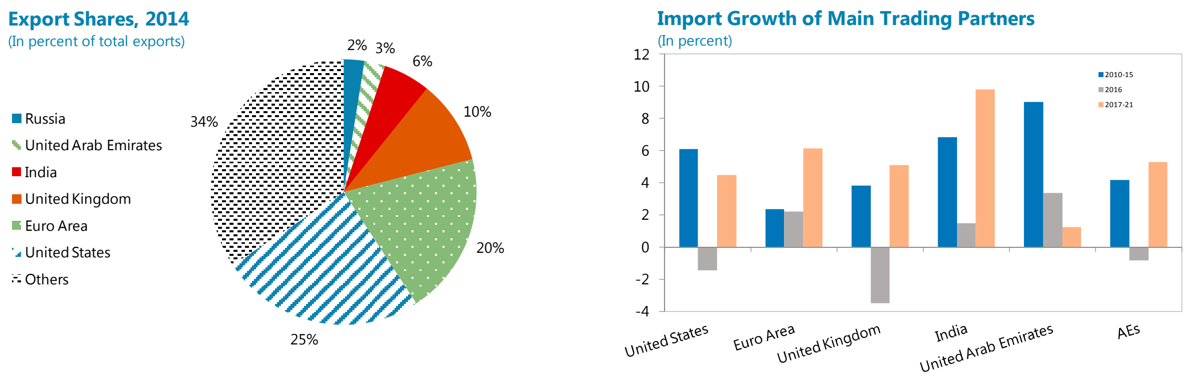
Reduced Volume in the Spot Market
Volume of Foreign Exchange Transactions (In percent)



Source: Central Bank of Sri Lanka.

[5] The CBSL stopped announcing daily the rate at which FX transactions should take place, and stakeholders reported facing less moral suasion in their daily operations.

Figure 2. Lower Demand from Sri Lanka's Main Trading Partners



Sources: IMF *Direction of Trade (DOT)* database and staff calculations.

Source: IMF *World Economic Outlook (WEO)* database.

5. **Econometric analyses confirm that FX market pressures reflect high policy imbalances and suggest that the rupee is overvalued, but yield mixed results on the magnitude of misalignment of the real exchange rate**. The real effective exchange rate depreciated by 4.7 percent in 2015, mainly driven by nominal changes. Estimation of the real exchange rate misalignment using the EBA methodology[6] concludes that Sri Lanka's CA gap is very small, at -0.2 percent, with a CA deficit larger but close to the norm predicted by fundamentals. This indicates that the implied overvaluation of the real exchange rate is within the margin of errors of the model. However, the EBA also shows that policy imbalances are high, at 0.8 percent. Against the backdrop of sustained rupee depreciation, the EBA results could highlight the dysfunction of the FX market due to the adverse effects of domestic policy imbalances on investor confidence and capital flows. Also, the EBA bottom line is based on an estimation of the overall policy gaps whereas investor sentiment reacts to each policy choice and affects mainly capital flows rather than the CA. The EBA may also inadequately capture Sri Lanka's exchange rate dynamics, notably relating to the country's previous episodes of CA adjustments and higher investment needs compared to the other countries in the EBA sample. Notably, estimation of an Equilibrium Real Effective Exchange Rate model suggests an overvaluation of about 11 percent.

Sri Lanka: 2016 Exchange Rate Assessment

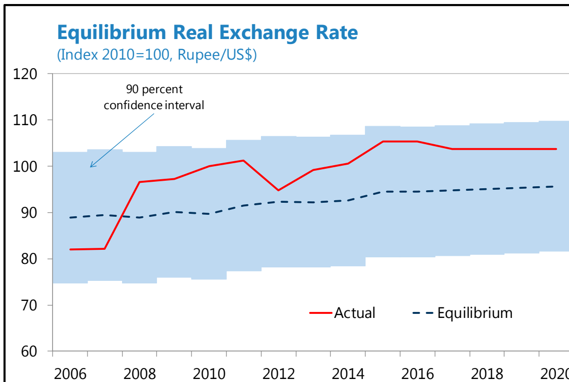
External Balance Assessment *(Current Account Approach)*

Current Account Balance[1] Underlying	Norm	Policy Gaps	Unexplained Residual	Total Gap
-1.7	-1.5	0.8	-0.9	-0.2

Equilibrium Real Exchange Rate

Real Exchange Rate Actual	Equilibrium	Over (+) / under (-) valuation
105.3	94.5	11.4

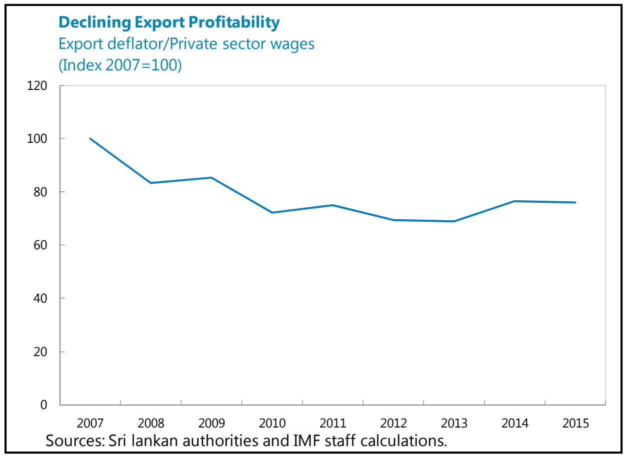
Source: IMF staff calculations.
[1] Cyclically adjusted.



Source: IMF staff calculations.

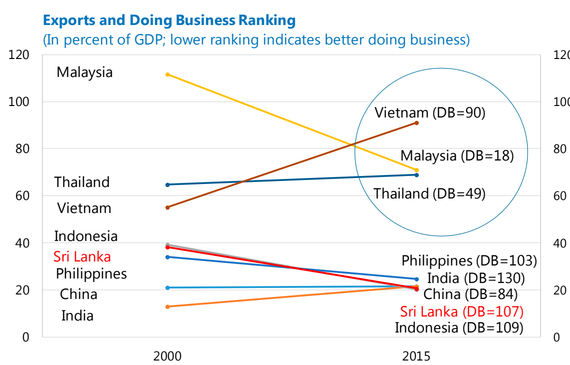
[6] EBA current account methodology. Estimations of the other two EBA methodologies are not available for Sri Lanka.

6. **The real depreciation of 2015 helped further reverse past competitiveness losses; however, structural weaknesses are salient and weigh on external sustainability** (Figure 3). The real exchange rate depreciated 11 percent during 2013–15, and has now come back to pre-2012 levels—the real exchange rate appreciated 6 percent in 2012. However, structural weaknesses still hinder competitiveness. Sri Lanka fared 107 out of 189 countries in the 2016 World Bank's *Doing Business* ranking with significant weaknesses in enforcing contracts, paying taxes, and registering properties, which may deter foreign investment. Ease of starting a business, getting electricity, and dealing with construction permits have improved, but remain comparative bottlenecks. There are also constraints in finding labor, in particular experienced workers, and retaining workers. All these structural hurdles may affect adversely prospects for stronger external sustainability, as evidence show that peer countries with a better *Doing Business* ranking than Sri Lanka have higher export shares and are more integrated into global value chains. Export profitability in Sri Lanka has also been trending down.

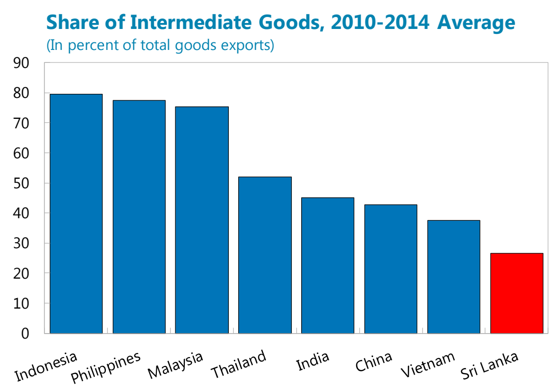


Sources: Sri lankan authorities and IMF staff calculations.

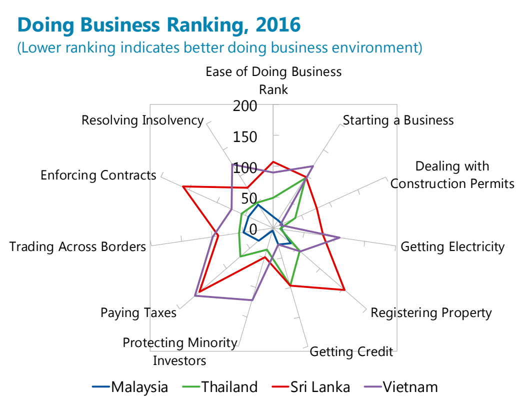
Figure 3. Structural Weaknesses



Sources: IMF *World Economic Outlook* (WEO) and World Bank's 2016 *Doing Business* database.



Sources: UN Comtrade database and IMF staff calculations.



Source: World Bank's *Doing Business* database.

Source: World Bank's 2014 report on *Building the Skills for Economic Growth and Competitiveness*.

7. External debt remains sustainable with low rollover risk, although currency risk is elevated. External debt is estimated at 55.1 percent of GDP at end-2015, and predominantly owned by the public sector (61 percent of total). The ratio of debt to exports is high, at 265 percent. Currency risk, mostly related to the dollar (half of external debt is denominated in dollar), is elevated. Stress tests show that a 30 percent real depreciation would raise the debt to GDP ratio to over 80 percent (see the external debt sustainability analysis). Lower than expected GDP or export growth would also deteriorate debt dynamics. These risks are mitigated by low rollover risks with 83 percent of medium and long term debt, though tighter global financing liquidity and declining investor confidence could raise rollover vulnerabilities and costs. The negative net international investment position reflects high investment needs, but has been skewed toward debt as foreign investment shifted away from equity investments (Figure 1).

8. External sustainability risks are mitigated by access to international capital markets and support of bilateral and multilateral institutions. Sri Lanka has tapped three times international capital markets in 2015, despite the backdrop of domestic policy imbalances and tighter global financial conditions. Several bilateral and multilateral institutions (World Bank, ADB and JICA) renewed their commitment to assist Sri Lanka finance its investment needs—providing a cushion against risks of private capital flight. However, the authorities should be mindful of higher servicing costs from recent spread hikes and risks of losing access to international financial markets if the country's rating is further downgraded[7] and the drag on investors' confidence persists.

9. Reining in balance of payments pressures and strengthening external sustainability will require rebalancing of macroeconomic policies and structural reforms. Improving investor sentiment to contain capital outflows and attract more foreign investment is reliant on government commitment to prudent macro policies. Commitment to exchange rate flexibility, within a strengthened monetary policy framework is needed to deal with short-term volatility (Box 4). Structural reforms to boost competitiveness and exports, which have declined as a share of world trade would also support external sustainability. Current initiatives include ending the EU fishery import ban, regaining GSP plus status, bilateral trade agreements, and a review of current weaknesses in the World Bank's *Doing Business* index. However, against the backdrop of weak global demand and declining non-oil commodity prices, gains of exports shares would require deep structural reforms to improve competitiveness, as well as restoring eroding export profitability.

[7] In end February, Fitch downgraded Sri Lanka's rating from BB- to B+ and revised its outlook to negative. Sri Lanka's spread vis-a-vis the EMBI is about 600 bps—compared with 440 bps for emerging markets in general, and 270 bps for emerging Asian economies.

Appendix I. Letter of Intent

Colombo, May 12, 2016

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

Dear Ms. Lagarde:

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

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

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

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

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

Sincerely yours,

/s/

Sandresh Ravindra Karunanayake
Minister of Finance

/s/

Lakshman Arjuna Mahendran
Governor
Central Bank of Sri Lanka

Attachment I. Memorandum of Economic and Financial Policies

May 12, 2016

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

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

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

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

MACROECONOMIC OUTLOOK

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

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

FISCAL POLICY

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

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

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

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

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

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

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

PUBLIC FINANCIAL MANAGEMENT

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

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

STATE ENTERPRISES

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

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

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

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

MONETARY AND EXCHANGE RATE POLICY

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

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

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

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

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

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

POLICIES TO STRENGTHEN TRADE AND INVESTMENT

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

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

RISKS AND CONTINGENCIES

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

PROGRAM MONITORING

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

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

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

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

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

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

Table 2. Sri Lanka: Prior Actions and Structural Benchmarks

Prior Actions	Date	Status
Cabinet to issue a Memorandum requiring the Ministry of Finance to complete by end-October 2016 a time-bound strategy to address the issue of outstanding arrears of the central government and obligations of state enterprises. The Memorandum will specify that the strategy include: (i) completion (by end-2016) of a comprehensive database of SOE's financial obligations, including a breakdown of arrears and non-arrears to be certified by the Auditor General, for use in creating a registry of such obligations; (ii) clarification of the government's responsibility over existing obligations related to subsidies and other non-commercial obligations of the SOEs.	Prior action	[Met]
Ministry of Finance to issue circulars to (i) formally implement tax policy and other revenue measures outlined in the Cabinet Memorandum of March 4, 2016; (ii) detail revised expenditure ceilings for government ministries and agencies consistent with the overall budget deficit target for 2016.	Prior action	[Met]
Cabinet to issue a resolution to adopt a framework note (agreed with IMF staff) for a new Inland Revenue Act, which embodies key tax policy drivers, overarching legal design framework, and the tax law reform roadmap as outlined in the March 2016 IMF Legal Department technical assistance mission Aide Memoire.	Prior action	[Met]
Formally suspend by Cabinet order the Board of Investment's capacity to grant tax exemptions, tax holidays, and special tax rates until such time as the BOI Act can be formally amended.	Prior action	[Met]
Structural Benchmarks	**Date**	**Status**
Fiscal Policy Management		
Submit to Parliament the 2017 budget in line with the program targets.	November 2016	
Submit to Parliament the 2018 budget in line with the program targets.	November 2017	
Submit to Parliament the 2019 budget in line with the program targets.	November 2018	
Tax Policy Reform		
Publish a tax expenditure statement as part of the official government budget.	December 2016	
Approve by cabinet a time-bound strategy (agreed with IMF staff) to reduce or eliminate tax expenditures.	December 2016	
Submit to Parliament a new Inland Revenue Act with a view to simplifying and broad-basing the income tax.	March 2017	
Complete by Ministry of Finance (MOF) a diagnostic review of the VAT system.	June 2017	

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

Attachment II. Technical Memorandum of Understanding

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

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

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

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

I. PERFORMANCE CRITERIA

A. Performance Criterion on Central Government Primary Balance

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

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

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

The following adjustment will apply:

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

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

B. Performance Criterion on Net Official International Reserves

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

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

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

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

Source: CBSL and IMF.

The following adjustment will apply:

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

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

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

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

II. CONTINUOUS PERFORMANCE CRITERIA

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

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

III. MONETARY POLICY CONSULTATION CLAUSE

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

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

where

t = the month within which the test date is included

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

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

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

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

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

IV. INDICATIVE TARGETS

A. Indicative Target on Central Government Tax Revenue

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

B. Indicative Target on Reserve Money of the CBSL

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

The following adjustment will apply:

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

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

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

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

V. DATA REPORTING REQUIREMENTS

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

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

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

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

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

Table 4. Sri Lanka: Central Government Financing 1/ (In millions of rupees)
1. Domestic instrument borrowings
T-Bills (net)
T-Bonds
Rupee Loans
Other
2. Domestic non-instrumental borrowings
Sri Lankan Development Bonds (SLDB)
Non market borrowings
CBSL advances
Government deposit at CBSL
Government import bills
Cash items in process of collection (CIPC)
Overdraft to government
Short term loans
Deposit with commercial banks
Oversee Banking Units
Other
3. Net foreign financing
Net T-Bill purchase by nonresidents
Net T-Bond purchase by nonresidents
International sovereign bonds
Project loans
Other
Total financing (1+2+3)
Memorandum items:
T-Bonds
Gross borrowings
Repayments
Net borrowings
SLDBs
Gross borrowings
Repayments
Net borrowings
ISBs
Gross borrowings
Repayments
Net borrowings
Project loans
Gross borrowings
Repayments
Net borrowings

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

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

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

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

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

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

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

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

(In millions of U.S. dollars)

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

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

INTERNATIONAL MONETARY FUND

SRI LANKA

May 19, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE YEAR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—INFORMATIONAL ANNEX

Prepared By	Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of May 4, 2016)

Membership Status

Joined 8/29/50; accepted Article VIII, Sections 2, 3, and 4, March 1994.

General Resources Account	**SDR Million**	**% Quota**
Quota	578.80	100.00
Fund holdings of currency (Exchange Rate)	927.14	160.18
Reserve Tranche Position	47.86	8.27

SDR Department	**SDR Million**	**% Allocation**
Net cumulative allocation	395.46	100.00
Holdings	4.94	1.25

Outstanding Purchases and Loans	**SDR Million**	**% Quota**
Stand-by Arrangements	396.18	68.45

Latest Financial Arrangements

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	7/24/09	7/23/12	1,653.60	1,653.60
ECF[1]	4/18/03	4/17/06	269.00	38.39
ECF	4/18/03	4/17/06	144.40	20.67

[1] Formerly PRGF.

Projected Payments to Fund[2]

(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2016	**2017**	**2018**	**2019**	**2020**
Principal	223.93	172.25	0.00	0.00	0.00
Charges/interest	2.51	0.94	0.20	0.20	0.20
Total	226.44	173.19	0.20	0.20	0.20

[2] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

The de jure exchange rate arrangement is free floating since its introduction by the Central Bank of Sri Lanka (CBSL) on January 23, 2001. The CBSL intervenes in the foreign exchange market to limit volatility in the exchange rate. The de facto exchange rate arrangement was classified as a stabilized arrangement as of December 31, 2014, because the Sri Lanka rupee stabilized within a 2 percent band against the U.S. dollar during October 2013–October 2014. While the exchange rate has exhibited a depreciating trend against the U.S. dollar beginning in mid-October 2014, further observation is necessary to determine the new trend. Until then, the de facto exchange rate arrangement remains classified as stabilized. The CBSL publishes intervention data on its website and in its annual report. Sri Lanka maintains an exchange system that is free of restrictions on payments and transfers for current international transactions, except for restrictions maintained solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51).

Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Sri Lanka (CBSL) was subject to an update safeguards assessment with respect to a Stand-by Arrangement approved in July 2009. The assessment found that the CBSL continued to have a relatively strong safeguards framework, especially in the external audit, financial reporting and control areas. An update safeguard assessment would be conducted and completed no later than the first program review of the proposed 3-year arrangement under the Extended Fund Facility.

Article IV Consultation

It is proposed that the next Article IV consultation be held on the 24-month cycle.

FSAP and ROSC Participation

- MCM: Both the FSSA and the FSAP reports were completed in 2002. An FSAP update took place in July 2012.
- 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. A ROSC update was completed and the report published in July 2005.

Resident Representative

Mrs. Eteri Kvintradze has been the resident representative since March 2014.

Technical Assistance

- ***FAD.*** A number of TA missions in tax policy and administration took place during the 2000s. A series of TA missions in revenue administration were conducted in 2003. Tax policy missions took place in 2001 and 2009, to provide advice on the reform of the tax system. In 2012, a mission visited Sri Lanka to evaluate the state of the Inland Revenue Department, with a particular focus on the effectiveness of the administration of the Value Added Tax (VAT) and secondarily the Nation Building Tax to identify measures to staunch and reverse the decline in VAT collections and improve the overall performance of the VAT system and taxpayers compliance. In 2015, a mission reviewed income tax expenditures and recent VAT performance. In addition, a number of missions took place during 2012–2016 to strengthen Public Financial Management, improving oversight of the State-Owned Enterprises, strengthening budget preparation, and improving the commitment control system.

- ***ICD.*** Since August 2015, TA missions provided the CBSL with assistance on macroeconomic forecasting, including developing a Forecasting and Policy Analysis System (FPAS) and a semi-structural Quarterly Projection Model (QPM).

- ***LEG.*** In March 2016, TA missions provided assistance on drafting a new income tax legislation.

- ***MCM.*** In August 2001, a TA mission to develop a strategy for strengthening the framework and implementation of monetary and foreign exchange cooperation took place. In May 2002, an IMF/World Bank mission advised the government of Sri Lanka on options for reform of People's Bank. In 2003, TA mission on financial sector issues and financial sector reforms took place, followed by 2005 mission to provide advice on the introduction of new deposit insurance scheme. Recently, TA missions advised on strengthening the financial stability framework (January 2016) and improving financial regulations, supervision, and the domestic government securities market (May 2016),

- ***STA.*** In November 2012, a mission visited Sri Lanka to report on data dissemination practices with respect to the requirements of the Special Data Dissemination Standards (SDDS). During 2013–2014, Sri Lanka has received TA provided by the IMF/STA as part of the Asia module of the JSA Project on the Improvement of statistics in the Asia and Pacific Region. This TA focused on improving data collection and compilation of ESS including balance of payments, IIP, EDS, and Reserves Data Template (RDT), and supporting the authorities in their transition to the *BPM6* format. In 2013, TA missions also took place to review work on methodological improvements to the consumer price index and the development of the new producer price index, and to provide guidance on rebasing of GDP estimates and quarterly national accounts. In 2014, a mission took place to review the Government Financial Statistics (GFS) compilation system and make recommendations on the implementation of the GFSM 2001 and its 2014 update (GFSM 2014). More recently, STA has been closely engaged with the authorities through TA in various areas, including national accounts, external statistics, GFS, and monetary accounts (see the Statistical Issues Appendix).

RELATIONS WITH THE WORLD BANK GROUP

(As of April 28, 2016)

1. **In the Country Partnership Strategy (CPS) for FY13–16, the World Bank Group supported Sri Lanka to address long-term strategic and structural development challenges as it transitioned to middle-income country (MIC) status.** The CPS FY13-16) focused on: (i) facilitating sustained private and public investment; (ii) supporting structural shifts in the economy; and (iii) improving living standards and social inclusion.

2. **A CPS Progress Report prepared in FY 14 provided an opportunity to review the country program and refocused the activities in line with the government's evolving development needs and agenda.** The Progress Report proposed the inclusion of a fourth strategic area of engagement, namely increasing resilience to disasters and climate change, deemed central to Sri Lanka's development agenda and poverty reduction efforts. As the country shifted from reconstruction to addressing the challenges of development on a middle income trajectory greater emphasis was placed on facilitating and creating the enabling environment for increased foreign and domestic investment. Continued pockets of poverty also highlighted the need for renewed efforts to better target the poor.

3. **The Systematic Country Diagnostic prepared in 2015 identified critical constraints and opportunities that Sri Lanka faced in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner.** The SCD concluded that the challenges of i) fiscal sustainability; (ii) enhancing competitiveness and promoting more and better jobs for the bottom 40 percent, iii) providing for social inclusion for disadvantaged segments of the population; and (iv) longer term sustainability (especially of the environment, political stability, and an aging population) were priority areas. Governance was identified as a cross-cutting challenge.

4. **The Country Partnership Framework (2017- 2020) for the World Bank Group is anchored in the analysis of the SCD and consists of three major pillars.** Interventions under pillar one will seek to improve macroeconomic stability and competitiveness, pillar two will tackle the promotion of inclusion and opportunities, while pillar three will seek to enhance resilience and management of natural assets. The IFC will give priority to sustainable infrastructure (through PPPs), financial inclusion, and access to input/output markets, products, services and jobs. MIGA will where possible support foreign investment projects, across sectors.

5. **The World Bank is supporting the GoSL in a number of macro-critical areas:**

- The Bank is preparing a Development Policy Financing (DPF) operation to support the long-term competitiveness of the Sri Lankan economy through a first package of reforms to eliminate obstacles to private sector competitiveness, enhance transparency and public sector management and improve fiscal sustainability. The actions supported by the proposed DPF represent an important initial set of reforms that are expected to be part of a longer-term policy reform package. In the context of this and possible future operations, the Bank anticipates to give extensive implementation support to help achieve the intended results. The Bank anticipates that some of this support will be carried out jointly with the Fund.

a. The Bank is providing support to increase competitiveness and FDI attraction, to develop a Public Finance Bill and a strategy for its implementation, and to strengthen the public debt management framework and analytical capacity.
b. The Bank is also providing ongoing support for statistical capacity building to better measure poverty and to update the national poverty line, and is updating an analysis of the distributional impact of tax and expenditure.

6. **The World Bank has been supporting Sri Lanka's development for close to six decades, having accompanied the country as it has grown to join the ranks of middle-income countries.** The current active World Bank portfolio comprises 12 projects (10 IDA and two IBRD operations) with a total net commitment value of $1.48 billion. Human development accounts for 33 percent of the overall portfolio followed by urban development (24 percent), water (21 percent) and resilience to climate and disaster risk (14 percent). Trust funds have continued to play an important role with the portfolio currently comprises six recipient-executed trust funds with a total net commitment value of $54.4 million.

	Board Approval	Closing Date	Net Comm. Amt ($mil)
Dam Safety & Water Resource Planning	03/27/2008	05/15/2018	148.3
Improving Climate Resilience	04/22/2014	05/30/2019	152.0
Catastrophe DDO	04/22/2014	05/31/2017	102.0
N&E Local Services Improvement	05/13/2010	12/31/2016	70.0
Metro Colombo Urban Development	03/15/2012	12/31/2017	213.0
Sri Lanka Strategic Cities Development	05/05/2014	12/31/2019	147.0
Higher Education for 21st Century	05/13/2010	06/30/2016	40.0
Transforming School Education	11/29/2011	06/30/2017	100.0
Second Health Sector Development	03/27/2013	09/30/2018	200.0
Skills Development Project	06/20/2014	12/31/2019	101.5
LK Water supply and Sanitation Project	06/24/2015	12/31/2020	165.0
Early Childhood Development Project	06/24/2015	06/30/2021	50.0

Source: World Bank

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of May 2, 2016)

Country Partnership Strategy: ADB's Interim Country Partnership Strategy (ICPS, 2016-2017) for Sri Lanka, approved in 2015 included the agriculture, natural resources, and rural development sectors in ADB's priority sectors for operation in Sri Lanka. The ICPS continued other strategic thrusts and priority sectors as in the CPS 2012–2016 that identified the three pillars: (i) inclusive and sustainable economic growth, (ii) catalyzing private investment and enhancing the effectiveness of public investment, and (iii) human resource and knowledge development. The priority sectors are transport, energy, water supply and wastewater management, irrigation, and education sectors.

Indicative Resources: The allocation for 2016-2018 consists of $741.78 million from ordinary capital resources (OCR) and $468.99 million from the Asian Development Fund (ADF). Co-financing and private sector operation opportunities will be actively explored.

Indicative Pipeline for 2016-18: Country Operations Business Plan (COBP) for the period 2016–18 indicates that the indicative project pipeline addresses the priority agendas of middle-income countries. It emphasizes on human resource development, completes final stage of basic infrastructure development such as rural road connectivity and rural electrification and shifts towards advanced infrastructure such as expressway and railways, and supports inclusive growth through small and medium-sized enterprises (SME) and agriculture assistance. To the extent possible, thematic priorities such as gender, governance, climate change, and regional cooperation will be included in each project.

Lending for education will further strengthen support for human capital development. In addition to continued support for secondary education and support for skills development, opportunity in higher education will be explored. The Science and Technology Human Resource Development Program will focus on science and technology faculties, industry linkages and entrepreneurship. The proposed Skills Sector Enhancement Program (additional financing) will continue support for the government's Skills Sector Development Program for 2017–2020.

The Expressway Connectivity Investment Program (MFF) for 2017 will optimize the connectivity of highways and expressways. This includes providing the access to the expressway network from Colombo City to limit congestion. The priority highways to be constructed under the project will be (i) elevated highway from Kelani Bridge to Colombo Port (port access road) and (ii) highway from Meerigama to Kurunegala (central highway).

The proposed Electricity Supply Reliability Improvement Project will support achieving 100% electrification (currently 98%) in Sri Lanka. It will provide electricity to more than 17,500 rural households, including in the Northern and Eastern provinces. A TA loan for Preparing the Power Development and Interconnection Project will support connectivity and power trade between Sri Lanka and India. The Wind Power Generation Project is proposed to develop renewable energy potential and ensure energy security. The use of a public–private partnership approach will be explored.

In the urban and water supply sector, most of the interventions are continuations from the earlier COBPs and consist of additional financing. The Local Government Enhancement Sector Project (additional financing) will include additional works for areas affected by chronic kidney diseases and expand coverage of the original scope. The Greater Colombo Wastewater Management Project (additional financing) will construct a secondary wastewater treatment plant in the north catchment area of Colombo city. The proposed Jaffna Kilinochchi Water Supply Project (additional financing) will include a desalination plant (as a source of water) and improvement of the water supply system in Jaffna Peninsula. For cities in Eastern Province (Trincomalee, Ampara, and Batticaloa), the Cities Development Initiative of Asia will support development of an integrated strategic master plan.

The SME Credit Line provides funding to SMEs through participating financial institutions. An auction mechanism was introduced to price the additional operating and credit costs of lending to targeted sectors, such as uncollateralized working capital loans, new borrowers, women-led enterprises, and SMEs outside of Colombo. An attached TA will support the enabling environment of a promising export-oriented cluster.

Capital Market Development Program Loan is currently proposed as an additional loan for 2016. It will combine policy reforms with information and communication technology investments and technical assistance to enhance capacity and size of the capital market in Sri Lanka grounded on a strong legal and regulatory framework.

In the absence of a public-private partnership (PPP) framework, ADB adopts a project-based approach to promote PPP in Sri Lanka. Performance-based contracts are structured as part of regular sovereign projects, such as in water and wastewater management and road maintenance. ADB signed a Transaction Advisory Service mandate in February 2016 for the East Container Terminal of Colombo Port. The project will add three deep water berths, increasing its competitiveness. Projected capacity is 2.4 million TEUs (twenty-foot equivalent unit) once the project is complete.

ADB's Private Sector Operations supports finance sector development by providing loans, equity investments, or guarantees for banks or nonbank institutions to enable them to expand activities in targeted areas including housing, small and medium-sized enterprise finance, leasing, renewable energy, and infrastructure lending.

Ongoing Projects:

- **Projects approved in 2015:** During 2015, ADB approved 3 new sovereign projects for a total of $478 million and 1 new non-sovereign loan facility of $100 million as follows:

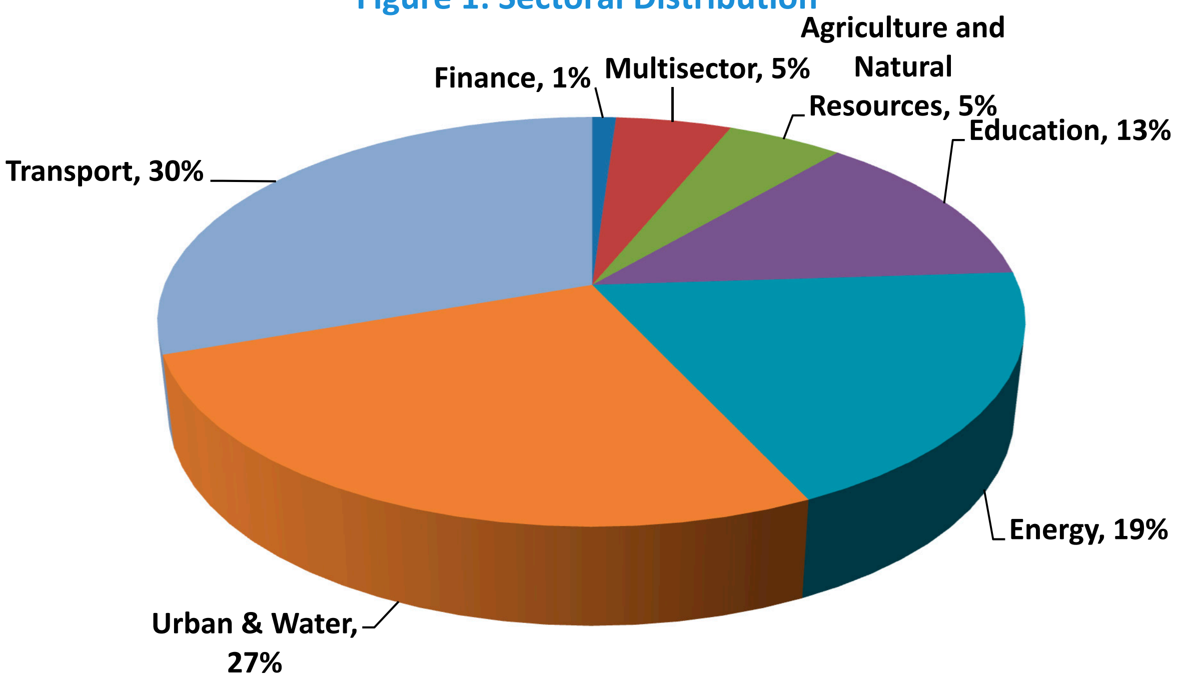
    - Greater Colombo Water and Wastewater Management Improvement Investment Program (tranche 3) ($123 million from OCR and $5 million from ADF)

- Mahaweli Water Security Investment Program (tranche 1) ($76 million from OCR and $74 million from ADF)
- Integrated Road Investment Program (tranche 3) ($175 million from OCR and $25 million from ADF)
- Lanka Orix Leasing Finance Company PLC and Lanka Orix Leasing Company Micro Credit Limited (ADB loan up to $55 million and B loan up to $45 million)

- **Portfolio**: As of 31 December 2015, ADB has approved a total of 179 loans, with cumulative lending of $6.97 billion to Sri Lanka. In addition, ADB has provided $358 million grant assistance (including ADB-administered co-financed grants) for projects and $130 million through 280 technical assistance grants.

  The current portfolio includes 53 ongoing loans and grants for 28 projects with a net loan amount of $2.9 billion. Cumulative contract awards reaches $1.7 billion, and disbursements $1.3 billion. About 76% of the ongoing portfolio are in transport, urban and water, and energy sectors. The sector composition of the ongoing loan portfolio is in Figure 1.

Figure 1: Sectoral Distribution



Source: Asian Development Bank

SRI LANKA—STATISTICAL ISSUES APPENDIX As of May 1, 2016
I. Assessment of Data Adequacy for Surveillance
General: Macroeconomic statistics are broadly adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series.
National Accounts: In 2015, the Department of Census and Statistics (DCS) released a comprehensive revision of the national accounts. The revision included a change of base year from 2002 to 2010; an expanded coverage for the service sector; and several improvements in the compilation methods. An STA mission in September 2015 found that the new annual estimates are robust and better reflect the recent economic developments. The mission suggested a number of improvements to compilation methods and data sources to further improve the quality of the estimates. The DCS also updated its quarterly national accounts methodology and began publishing these estimates in 2015. The new quarterly estimates are now based on quarterly indicators for most economic activities. GDP data by expenditure are only available on an annual basis and rely mostly on commodity flow methods.
Price Statistics: The DCS released a new national Consumer Price Index (CPI) and Producer Price Index (PPI) during 2015. The new indexes reflect international standards and best practices. The national CPI is based on weights from the 2012/13 Household Income and Expenditure Survey. The monthly PPI is currently disseminated on a quarterly basis, with the goal of releasing the index on a monthly basis by the end of 2016. A core inflation index is also compiled by the DCS to provide a measure of underlying inflation. The core index is calculated from the Colombo Consumer Price Index by excluding prices of some food items, energy and transportation services. The Central Bank of Sri Lanka (CBSL) produces a Wholesale Price Index (WPI) based on old weights (from 1974) and methodologies.
Government Finance Statistics: In April 2015, a STA missions took place in the context of the Japan-funded IMF project on implementing GFSM 2001 and its update (GFSM 2014), for compiling, analyzing and reporting fiscal data. As part of this effort, the authorities have incorporated the Chart of Accounts aligned with GFSM2014 into the new IFMIS system. Additional steps are underway to integrate fiscal data of the extra-budgetary central government, the local government and social security funds into the annual general government GFS reporting. The Sri Lankan authorities report budgetary central government debt data to the Public Sector Debt Statistics database on a quarterly basis.
Monetary and Financial Statistics: Monetary data for the central bank and other depository corporations (ODCs) are submitted in a highly summarized format with limitations in the classification of financial instruments and sectorization of the economy. In January 2015, a STA mission started the introduction of the standardized report forms (SRFs) of the central bank and other depository corporations. It is expected that a follow-up mission tentatively scheduled for July 2016 will complete the introduction of the SRFs. **Financial sector surveillance:** The authorities report 11 core and nine encouraged financial soundness indicators (FSIs) for deposit takers and two FSIs on real estate markets to STA.

External sector statistics: Since 2014, the CBSL is reporting to STA its International Investment Position (IIP) and balance of payments statistics (BOP) on a quarterly basis following the sixth edition of the *Balance of Payments Manual* (BPM6). A TA mission in May 2015 observed commendable progress on the implementation of the recommendations of the previous TA missions and a remarkable improvement of the quality of the data.	
II. Data Standards and Quality	
Sri Lanka, graduated to the Special Data Dissemination Standards (SDDS) in November 2015.	A data ROSC mission visited Sri Lanka in 2001 and prepared a comprehensive report on the quality of its statistics.
III. Reporting to STA (Optional)	
The authorities report key data to the Fund on a timely basis. On government finance, annual cash data were regularly reported for publication in the *GFS Yearbook.* These data cover only the budgetary accounts of central government; and no data on the extrabudgetary funds or the provincial and local governments are reported. At the same time, no sub-annual data are reported for publication in *IFS*. The authorities have been encouraged to reduce the time lag for data reporting.	

Sri Lanka: Table of Common Indicators Required for Surveillance

As of March 23, 2016

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memorandum Items:	
						Data Quality—Methodological Soundness[8]	Data Quality Accuracy and Reliability[9]
Exchange rates	Today	Today	D	D	D		
International reserve assets and reserve liabilities of the Monetary Authorities[1]	10/2015	2/2016	D	D	D		
Reserve/base money	11/2015	2/2016	M	M	M	LO, LO, LO, LO	LO, O, O, NA, NA
Broad money	11/2015	2/2016	M	M	M		
Central bank balance sheet	11/2015	2/2016	M	M	M		
Consolidated balance sheet of the banking system	11/2015	2/2016	M	M	M		
Interest rates[2]	Today	Today	D	D	D		
Consumer price index (New Colombo CPI)	1/2016	3/2016	M	M	M	O, LNO, LO, O	O, LO, O, NA, NA
Revenue, expenditure, balance and composition of financing[3]—general government[4]							
Revenue, expenditure, balance and composition of financing[3]—central government	12/2013	4/2014	M	M	M	O, O, O, O	LO, NA, LO, NA, LO
Stocks of central government and central government-guaranteed debt[5]	12/2013	4/2014	M	M	M		
External current account balance	2015Q3	1/2016	Q	Q	Q		
Exports and imports of goods and services	2015Q3	1/2016	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, NA, LO
GDP/GNP	2014Q3	12/2014	Q	Q	Q	LO, LO, LNO, LNO	LNO, LNO, LO, NA, O
Gross external debt	2013Q4	6/2012	A	A	A		
International Investment Position[6]	2015Q3	1/2016	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC published in May 2002 and based on the findings of the mission that took place during June 2001 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), not observed (NO), or not applicable (NA).

[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the Staff Representative on Sri Lanka
Executive Board Meeting
June 3, 2016

The information below has become available following the issuance of the staff report on May 20. It does not alter the thrust of the staff appraisal.

Natural disaster: Heavy rains since mid-May triggered flooding and landslides in a number of regions, including the Colombo district. As of May 29, 294,000 people were estimated to have been affected (about 1.4 percent of population), with Colombo accounting for two thirds of this total. 105 deaths have been confirmed, 116 people remain missing, and about 4,500 houses have been damaged. With weather improving and water levels falling, the government has intensified rescue and rehabilitation efforts, supported by the international community. The economic damage of the flooding has yet to be fully estimated.

Data update. Headline inflation rose to 4.8 percent in May from 3.1 percent in April, largely due to increases in health and communication prices, in addition to the impact of the increase in the VAT rate from 11 to 15 percent. Core inflation rose to 6.6 percent and there is some upside risk given recent flooding. Preliminary fiscal data suggest that the central government recorded an overall deficit of Rs 233 billion (1.9 percent of annual GDP) and a primary deficit of Rs 37 billion (0.3 percent of annual GDP) during January–April.

Monetary policy and foreign exchange management. At its meeting held on 20 May 2016, the Monetary Board of the CBSL decided to maintain the current monetary policy stance by keeping policy rates unchanged. With respect to foreign exchange developments, the CBSL achieved net foreign exchange purchases of US$78 million in the first 30 days of May—breaking the 20-month pattern of net foreign exchange sales. Despite this shift, the rupee remained broadly stable, with the spot and the 3-month forward rates depreciating only 1.3 percent and 1.9 percent, respectively, since end-April.

Statement by Mr. Subir Vithal Gokarn, Executive Director and Mrs. Swarna Gunaratne, Alternate Executive Director on Sri Lanka
Executive Board Meeting
June 3, 2016

1. We wish to express our authorities' deep appreciation to the Fund staff for the candid discussions held in Colombo during 1-5 February, 2016 and 31 March - 11 April, 2016 and during the Spring Meetings in Washington D.C, on the proposed three-year Extended Arrangement under the Extended Fund Facility (EFF). Also, we wish to express our gratitude for the conscientious set of papers that have been produced in connection with 2016 Article IV Consultation and Request for a Three-Year Extended Arrangement under the EFF amounting to USD 1.5 billion (equivalent to185 per cent of Sri Lanka's quota). The economic program supported by EFF is expected to correct underlying imbalances in the fiscal and external sectors, by improving fiscal sustainability and rebuilding foreign exchange reserves while facilitating sustained and inclusive economic growth in Sri Lanka.

2. The conclusion of internal conflict in Sri Lanka in 2009 created a conducive environment for attracting investment and enhancing economic activity including in the conflict affected Northern and Eastern provinces. The rebuilding efforts of the country after the internal conflict were supported by the Stand by Arrangement (SBA) program which was successfully completed in 2012. Accordingly, the economy performed well from 2010-2015, achieving average real GDP growth of 6.4 per cent during the period. Inflation was maintained at single digit level throughout the period. Foreign reserves improved and fiscal deficit declined. However, macro-economic performance in 2015 was affected by the difficult external environment posed by the decline in commodity prices, slowdown in demand for exports and capital outflows, and deterioration in fiscal accounts due to low government revenue and increased debt level, as well as election related uncertainties. The new government is strongly committed to the strengthening of macro-economic and financial stability while reducing vulnerabilities, thereby supporting sustainable high economic growth through the implementation of appropriate macroeconomic policies and structural reforms. Our authorities expect that the extended arrangement under the EFF, together with the support from other International Financial Institutions (IFIs), would help to reinforce investor confidence and correct underlying imbalances through buildup of fiscal and external buffers to better weather adverse shocks.

Economic Growth and Outlook

3. Sri Lanka's economy grew by 4.8 per cent in 2015, compared to 4.9 per cent in 2014, supported by accommodative monetary and fiscal policies and favorable weather conditions. The low and stable inflation and low interest rates facilitated economic activity while credit growth remained high, though it was from a low base. On the fiscal front,

increase in public sector salaries and pensions and downward revision of administratively determined prices contributed to the inducing of domestic demand. All the main sectors - agriculture, industry and services- contributed positively to the growth of the economy. However, the contribution from the industry sector moderated due to slow down in large scale infrastructure construction projects, as a result of the change in new government's policy stance to re-evaluate several large projects with the intention of improving transparency and effective implementation of the projects and to ensure that the associated financial terms were not detrimental to Sri Lanka.

4. The implementation of sound macro-economic policies by the government, in line with the EFF program, is expected to improve market confidence and encourage investment, thereby facilitating the economic growth of around 5 per cent during 2016 and around 6 - 7 per cent annually in the medium term. Improved fiscal consolidation and appropriate monetary policy measures to ensure low inflation are expected to create an investor friendly environment for private sector participation in economic activities. Recovery in the construction sector and the sustained momentum of the services sector, including tourism, transport, communication and IT related activities, are expected to contribute to achieve projected growth. It is also expected that the gradual recovery of the global economy will provide the required impetus to maintain Sri Lanka's external demand at a favorable level. Sri Lanka's strong base of human capital and reliable infrastructure compared with other South Asian economies, along with its strategic location in the Indian Ocean are the country's strengths in achieving sustainable high economic growth.

Recent Devastating Natural Disaster

5. The heaviest rains in a quarter of a century in Sri Lanka, followed by cyclonic conditions in the Indian Ocean during mid-May 2016 caused severe flood and landslides, affecting human lives, destroying houses, other properties and agricultural crops. Official figures show that nearly half a million people have been affected by the flood and landslides, with a large number of them seeking shelter at state-run relief camps. The death toll from landslides currently stands at 101 while about 125 people are reported missing and over 200,000 are displaced. The floods and landslides have completely destroyed close to 30,000 houses while around 128,000 houses have been left partially damaged. This unfortunate incident has incurred a significant burden to the government budget, in terms of providing immediate relief and compensation for the rebuilding of destroyed houses, livelihoods as well as restoring public amenities. The total additional cost due to the floods has been estimated at around USD 2.0 billion. Also, in the short run, there is likely to be some upward pressure on inflation due to the destruction of agricultural crops.

Fiscal Policy

6. Fiscal management in 2015 was extremely difficult given the two key national elections held during the year, the uncertainty that prevailed during the inter-election period and the resultant slowdown in economic activity as well as external sector related issues, including the tightening of international financial market conditions and the slowdown in foreign inflows. These challenges were reflected in the fiscal performance during the year, leading to a notable deviation from fiscal targets announced in January 2015 in the interim budget for 2015, despite the improvement seen in some areas. The overall budget deficit widened to 7.4 per cent of GDP compared to the deficit of 5.7 per cent in 2014 and the targeted deficit of 4.4 per cent in the interim budget for 2015. The deficit was largely financed by domestic sources, given the slowdown in foreign financing during the year. The debt to GDP ratio increased to 76 per cent in 2015 from 70.7 per cent in 2014. This was partly reflective of the debt financing of fiscal deficit as well as the impact of rupee depreciation on the stock of foreign currency denominated debt.

7. The government revenue improved in 2015, in contrast to the declining trend in the revenue to GDP ratio observed since 2011, mainly benefiting from the imposition of several one off taxes and the significant expansion in revenue from excise duties on the increased motor vehicle imports. However, higher government expenditure on salaries and wages, interest payments and subsidies and transfers to households exerted a heavy pressure on government finances, leading to a higher deficit than envisaged.

8. Our authorities have taken a number of measures to address weaknesses in revenue collection and to increase government revenue as well as rationalize and prioritize government expenditure. Redrafting of tax laws with technical assistance from the IMF to simplify the tax laws, improvements in tax administration, including the revenue Administration Management Information System (RAMIS) at the Inland Revenue Department (IRD), introducing single window system at Sri Lanka Customs (ASYCUDA) linking all stake holders, automation of the activities of the Ministry of Finance (MOF) and the setting up of Budget Implementation and Monitoring Unit (BIMU) to ensure close monitoring of expenditure programs are among the important initiatives already taken in this context.

9. The medium term objective of the government is to reduce the budget deficit to 3.5 per cent of GDP by 2020. As a major step toward this objective, the government revised down its originally anticipated budget deficit of 5.9 per cent to 5.4 per cent in 2016. The government expects to reduce its primary deficit to zero level in 2017 and a gradual increase in its primary surplus thereafter. This would enable to reduce debt to GDP ratio to 68 per cent of GDP by 2020. One of the major steps taken by our authorities to achieve revenue target has been the increasing of VAT from 11 per cent to 15 per cent and removing exemptions on telecommunications services, effective from May 2016. Also, VAT will continue to apply to wholesale and retail trade at a lower threshold. On the

expenditure side, measures have been taken to curb spending to within the available fiscal space by streamlining non-critical expenditure on goods and services and capital spending.

10. As the financial condition of some of the State Owned Enterprises (SOE) has deteriorated significantly, a comprehensive strategy is currently being developed by our authorities to decisively address the issues related to SOEs and thereby minimize the associated fiscal risk. The national carrier, Sri Lankan Airlines continues to incur significant losses. A resolution strategy for Sri Lankan Airlines is expected to be completed by September 2016, thus removing the company from government's accounts. Cabinet approval has already been obtained for the government to take over all its liabilities and to identify a suitable partner who can successfully manage the operations of the airline, on the foundation of a clean balance sheet. The Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) have incurred losses due to implicit energy subsidies. Therefore, an automatic fuel and electricity pricing mechanism that ensures retail prices above cost recovery levels will be introduced by end 2016. To enhance oversight and financial discipline, the six largest SOEs are expected to publish Statements of Corporate Intent (SCI) highlighting their mission, objectives, corporate and financing plan to meet future objectives. Also, the legal framework for governance and oversight of SOEs will be strengthened.

Monetary Policy

11. Inflation in Sri Lanka continuously remained at single digit levels for a period of over seven years, due to favorable domestic supply conditions, subdued global commodity prices supported by the demand management policies of the Central Bank. Inflation fell further during the year, with substantial downward revisions to administratively determined prices, including domestic petroleum products. Accordingly, year on year headline inflation (as measured by Colombo Consumers' Price Index) recorded negative rates during July-September 2015 and was at 2.8 per cent by December 2015. Nevertheless, core inflation increased to 4.5 per cent from 3.2 per cent reflecting buildup of some demand pressures in the economy. The recent increase in the Value Added Tax (VAT) rate and the removal of certain exemptions applicable on VAT and the Nation Building Tax (NBT) are expected to have a one-off impact on inflation, while the supply side disruptions due to prevailing adverse weather conditions could exert some upward pressure on inflation in the immediate future. In spite of these temporary disruptions, inflation is expected to remain in mid-single digit levels supported by appropriate demand management policies.

12. The monetary policy stance of the Central Bank of Sri Lanka (CBSL) continued to be accommodative during 2015 with the objective of supporting economic activity. Benefiting from low interest rates and fiscal measures such as reduction in taxes on selected motor vehicle imports, credit growth accelerated from 8.8 per cent in 2014 to 25

per cent by end 2015, while money supply expanded from13.4 per cent at end 2014 to 17.8 per cent by end 2015. As credit and monetary expansion was higher than expected, and excess liquidity in the domestic money market remained persistently high, CBSL commenced tightening of its monetary policy towards end 2015. Accordingly, the CBSL raised the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points to 7.50 per cent in January 2016 and raised its policy interest rates viz; Standing Deposit Facility (SDF) and Standing Lending Facility (SLF) rates by 50 basis points to 6.50 per cent and 8.00 per cent respectively, in February 2016.

13. Several other measures were also taken to contain credit flows to selected sectors. As a significant surge in motor vehicle imports was observed in 2015, a minimum cash margin requirement of 100 per cent was imposed on Letter of Credit (LCs) opened with commercial banks for the importation of motor vehicles with effect from 30 October 2015 as a temporary measure for a period of one month. Subsequently, as a macro-prudential measure, a maximum Loan to Value ratio (LTV) of 70 per cent was imposed in respect of loans and advances granted for the purpose of purchases or utilization of motor vehicles. The CBSL is closely monitoring any signs of buildup of demand and inflationary pressures and stands ready to take any further monetary tightening measures should it be required.

14. Over the past several years, the CBSL and the government have fulfilled a number of prerequisites required to moving towards Inflation Targeting in the medium term. At present, as an interim arrangement, the CBSL conducts its monetary policy within an enhanced monetary policy framework with features of both Monetary Targeting (MT) and Flexible Inflation Targeting frameworks (FIT). Under this framework, CBSL focuses on stabilizing inflation in mid-single digits level over the medium term, while supporting the growth objectives and flexibility in exchange rate management. The CBSL currently uses the average call money rate as its operating target and increasingly relies on market based instruments, namely policy interest rates and open market operations. Over the medium term, as our authorities continue to address the remaining barriers for gradually moving towards FIT regime, the CBSL will continue its current initiatives with the IMF to improve its macroeconomic modelling framework and forecasting capabilities.

External Sector

15. Sri Lanka’s external sector showed a subdued performance in 2015, due to challenging global economic environment and several domestic factors. The decline in external demand for major export commodities due to the slow recovery of the global economy and the withdrawal of foreign investments from the government securities market anticipating normalization of monetary policies in advanced economies and the slowdown in FDIs were major reasons for the lower performance of the external sector. Also, increased consumption demand through excessive fiscal expansion, as well as policy

uncertainties amidst two national elections exerted a pressure from the domestic front on the external sector in 2015. However, foreign investors' appetite for the International Sovereign Bonds remained intact during the year, and two sovereign bond issues amounting to US dollars 2.15 billion were completed successfully.

16. Although the trade deficit continued to widen due to an increase in non-oil imports and slowdown in export earnings, a substantial increase was largely avoided as a result of the low expenditure on oil imports. The current account deficit, at 2.4 per cent of GDP, remained almost unchanged from the previous year's level, benefiting from increased earnings from services exports and the surplus in the secondary income account. Inflows to the financial account of the balance of payments (BOP) was adversely affected by the decline in foreign investments, slowdown in inflows to the government and unwinding of foreign investments from the government securities market. This resulted in the BOP recording an overall deficit of US dollars 1,489 million in 2015. Gross official reserves remained at US dollars 7.3 billion at end 2015 which was equivalent to 4.6 months of goods imports.

17. Promoting Sri Lanka's export sector with greater integration into regional and global supply chains is one of the main priorities of our authorities. For this purpose, a Development Agency for the prioritization of infrastructure investments and Trade Agency for trade promotion and negotiation of trade and investment agreements will be established. On the more positive note, Sri Lanka is now delisted from the EU ban on fishery imports while measures are being taken to regain the GSP+ trade status.

Exchange Rate Policy

18. An increased pressure in the foreign exchange market was witnessed since late 2014. This was largely due to the increased trade deficit, slowdown in net capital inflows, increased debt service payments of the government as a result of the depreciation of Sri Lanka Rupee against the US dollar, repayment of the matured International Sovereign Bond of USD 500 million in early 2015 and the unwinding of foreign investment in government securities market. The CBSL intervened in the foreign exchange market to reduce undue pressure on the exchange rate by supplying about USD 1.9 billion, on net basis, during the first eight months of the year. However, on 03 September 2015 the CBSL decided to limit its intervention in the domestic foreign exchange market and allowed the exchange rate to be largely determined in the market. This resulted in Sri Lankan rupee depreciating at a higher magnitude during the rest of the year. Accordingly, rupee depreciation against the US dollar during the year was 9.03 per cent. The CBSL's net supply of foreign exchange during the year amounted to US dollar 3.2 billion, largely driven by capital account transactions.

19. During the first four months of 2016, some pressure was observed in the foreign exchange market despite the correction in the nominal and real exchange rates, partly

attributable to market uncertainties and delays in repatriation of export proceeds. CBSL intervention during the period was amounted to US dollar 1.16 billion while the rupee depreciated by 0.1per cent. However, the renewed SWAP arrangements with the Reserve Bank of India (RBI) for USD 700 million and the South Asian Association for Regional Cooperation (SAARC) for USD 400 million provided an additional buffer. During May 2016, a turnaround of CBSL intervention was seen with CBSL purchasing about USD 76 million, on net basis, alongside the stabilization of the exchange rate. This could be mainly attributed to improved investor confidence in the wake of the successful negotiations for a program facility with the IMF. Going forward, our authorities will take necessary steps to meet essential preconditions for an increasingly flexible exchange rate regime.

Financial Sector

20. The financial sector stability and soundness improved in 2015, reflecting high capital and liquidity levels and increased profitability. The Capital Adequacy Ratios (CAR) in the banking sector have been maintained well above the regulatory minimum ratio of 10 per cent. As at end 2015, the total CAR and core CAR remained at 14.2 per cent and 11.9 per cent respectively. The banking sector recorded increased level of profits in 2015, largely attributed to the healthy growth in net interest income. Meanwhile, non-performing loans (NPL) ratio declined to 3.2 per cent in 2015 from 4.2 per cent in 2014. However, total loan loss provisions have been increased with an increase in the specific provisions made for NPLs in the loss category. In line with the current regulatory developments, the Liquidity Coverage Ratio under Basel III was implemented in 2015 and the Basel III Capital Standards are expected to be implemented in line with international timelines. Our authorities are committed to the finalization of a resolution framework for weak finance companies (the total assets of which approximately 1 per cent of GDP) through the establishment of a Special Purpose Vehicle and the IMF's technical assistance is currently being sought for this purpose.

Conclusion

21. The Sri Lankan authorities wish to thank the Executive Board for considering their request for financial support under a three-year EFF. They believe that the proposed arrangement by the Fund would support implementation of essential policy reforms to improve external and fiscal buffers and create a conducive environment to achieve high and sustainable economic growth with the support of the international community. Our authorities have already completed required prior actions and are fully committed to implementation of the program. While program ownership will be strengthened, there could be elevated economic and financial risks to the program due to uncertainties with respect to the global economic environment as well as uncertain domestic conditions similar to the recently experienced devastating natural disaster. Such conditions need to be taken into consideration for suitable adjustment.