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SRI LANKA

September 2014

FIRST POST-PROGRAM MONITORING DISCUSSION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

The following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 27, 2013, following discussions that ended on September 25, 2013, with the officials of Sri Lanka. Based on information available at the time of these discussions, the staff report was completed on November 11, 2013.
- A **Staff Supplement** of November 25, 2013 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board, as expressed during its November 27, 2013 discussion of the Ex-Post Assessment of Exceptional Access Under the 2009 Stand-By Arrangement and First Post-Program Monitoring Discussion.
- A **Statement by the Executive Director** for Sri Lanka.

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SRI LANKA

FIRST POST-PROGRAM MONITORING DISCUSSION

November 11, 2013

EXECUTIVE SUMMARY

Context. Sri Lanka's economy has navigated recent market turbulence relatively well. Growth has remained solid, inflation is in mid-single digits, and the current account deficit has narrowed. From mid-May, the exchange rate came under pressure as market expectations of U.S. Federal Reserve tapering shifted, but Sri Lanka's experience was in line with that of other emerging markets. Since September, market pressures have eased. By some metrics, reserves remain on the low side, but were boosted in late-September by an external debt issue of a large state-owned bank.

Monetary policy. Monetary policy has eased progressively since end-2012 as growth slowed, inflation fell, and private sector credit weakened. At the time of the mission, staff recommended keeping monetary policy on hold for the near term. However, policy rates were subsequently reduced, with the central bank citing continued low inflation and the opportunity to stimulate growth to a higher level in 2014.

Fiscal policy. The authorities remain committed to fiscal consolidation and intend to meet their 2013 deficit target. However, the steady real decline in government revenue collection poses risks to needed medium-term fiscal consolidation. The 2014 budget offers an opportunity to address the steady slide in revenues, including by further expanding the tax base.

External debt. Alongside Sri Lanka's graduation to middle-income status has come a shift away from concessional, bilateral debt and towards external debt issuance on commercial terms by state owned and commercial banks. While this is a natural progression of financial development, it also raises risks. It is essential that the proceeds of such external borrowing are invested so as to enhance productivity, add to economic resilience, and generate the foreign exchange needed to service future obligations.

Approved By
Nigel Chalk and Dhaneshwar Ghura

Discussions were held in Colombo, September 17–25, 2013. The mission met with Senior Minister for International Monetary Cooperation Dr. Sarath Amunugama, Central Bank of Sri Lanka Governor Cabraal, Secretary to the Treasury Jayasundera, other senior officials, and private sector and civil society representatives. The staff team comprised Mr. Schneider (head), Mr. Jonas, Mr. Ghazanchyan (all APD), Ms. Lundgren (SPR), and Mr. Mathai (resident representative). Mr. Ranasinghe (OED) participated in some of the policy discussions.

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RECENT DEVELOPMENTS AND OUTLOOK

Sri Lanka negotiated recent market turbulence well—moving broadly in line with other frontier and emerging market economies. Growth has moderated over the past two years, but inflation is low, the current account deficit is declining, and the government is committed to achieving its 2013 fiscal deficit target (although this may entail significant expenditure cuts). Underlying vulnerabilities related to public debt and the external position remain a concern.

1. Growth. National accounts data indicate real GDP growth of 6.8 percent in Q2, bringing economic growth in the first half of the year to 6.3 percent. Most of the increase has been in retail and wholesale trade and continued strong construction activity. Base effects will support growth in the third and fourth quarters, but recent indicators point to softness in some areas: trade activity has been tepid, tax revenues and public spending (including capital expenditures) are relatively low, and private sector credit growth has been in decline. Staff project real GDP growth of 6.5 percent for 2013 as a whole, somewhat below the authorities' forecast of 7 to 7.5 percent.

2. Inflation. Headline and core inflation fell to 6.2 and 3.0 percent, respectively, in September 2013 (from 9.2 and 7.5 percent at end-2012). Base effects have been an important factor, but pressures appear to be easing, consistent with more moderate economic growth and lower food prices. Staff has revised year-end inflation down to 7 percent, compared with 7.9 percent in the staff report for the 2013 Article IV Consultation. Risks to the inflation outlook stem mainly from potential upward shocks to world commodity prices and there appears to be little domestic pressure from wages or money growth.

3. External sector. Balance of payments data present a mixed picture. Exports decreased by 1 percent during the first eight months of the year, reflecting weak external demand. Imports were also subdued, falling by 3.3 percent in dollar terms in line with slowing growth and lower oil shipments. The net result was a small decline in the trade deficit to $6 billion in January–August 2013 (compared with $6.4 billion in January–August 2012). The external position was further strengthened by a sizable (11 percent) increase in inward remittances, robust tourism earnings, and a moderate increase in foreign direct investment. Trade will likely strengthen as a trend for the remainder of the year. Staff projects a current account deficit of 5.2 percent of GDP in 2013, which should allow the Central Bank of Sri Lanka (CBSL) to maintain gross foreign exchange reserves at about $6.7 billion (3.2 months of imports).

4. Exchange rate, reserves, and external debt. Sri Lanka was not immune to the change in market sentiment that accompanied signals from the U.S. Federal Reserve of a coming exit from unconventional monetary policies (UMP). However, the effects have been moderate.

- Between mid-May and end-August, the rupee depreciated 5.3 percent versus the U.S. dollar—recovering about 2 percent in value by mid-October. The CBSL shifted to net sales of $485 million during July–September, after accumulating reserves in the first six months of 2013. Total loss in reserves (inclusive of considerable valuation losses) were of a somewhat higher relative

magnitude than in comparable economies in the region (Figure 3). However, since September, reserves have recovered and at mid-October were $280 million higher than at end-2012. The relative stability of the rupee implies a modest real effective appreciation so far this year.

- Foreign holding of government securities changed little during 2013, staying close to or above the limit of 12.5 percent of the outstanding stock. Nonresidents remain active in the Colombo Stock Exchange, accounting for about 40 percent of market capitalization.
- While there has been no new sovereign issue this year, $750 million in external debt was issued by National Savings Bank in mid-September.

5. Fiscal performance. Fiscal outturns for the first six months of 2013 showed the government's commitment to fiscal consolidation—mainly through tight expenditure control as revenues continued to decline. Tax revenues in January–June fell by over 5 percent relative to the same period of 2012, and preliminary data through August suggest the first eight months of 2013 saw basically zero nominal increase in tax revenue. This compares to an annual increase of 22.8 percent envisioned in the budget. Part of the revenue shortfall stems from lower imports—particularly vehicles —but also reflects numerous tax exemptions. Despite clearing most of the 2012 arrears, the government has reacted to weak revenues by compressing both current and capital expenditures. As a result, the H1 2013 deficit reached 4.4 percent of GDP—moderately higher than the H1 2012 deficit. Public debt is expected to decline to around 77 percent of GDP by year end, still high compared to other countries in the region.

6. Monetary policy. The monetary policy stance has eased throughout the course of the year through successive cuts in policy rates and a reduction in the statutory reserve ratio.[1] The net effect has been to provide significant liquidity to the banking system and more than unwind the monetary tightening that was implemented in 2011–12 to address overheating and balance of payment pressures. However, these actions have been slow to feed through to bank lending. Treasury-bill yields have declined by over 200 bps, and short-term prime rates have fallen by slightly less. However, longer term (six months) prime rates have declined by only 111 bps, while the average weighted lending rate for all loans remained virtually flat between end-November 2012 and end-August 2013. Private credit growth declined to 8.4 percent year-on-year in July (compared to 31.6 percent in January–July 2012).

7. Financial sector. Financial soundness indicators suggest that, while the system is well capitalized, some stress is becoming evident on banks' balance sheets. The system-wide capital adequacy ratio rose by 1 percentage point from end 2012 to 16.1 percent in June 2013—well above the 10 percent regulatory minimum. However, gross nonperforming loans (NPLs) have increased from 3.6 percent at end-2012 to 4.7 percent in Q2 2013. In addition, recent fraud and balance sheet stress at one finance company have prompted the establishment of a liquidity support system for nonbank financial institutions, financed by the deposit insurance fund.

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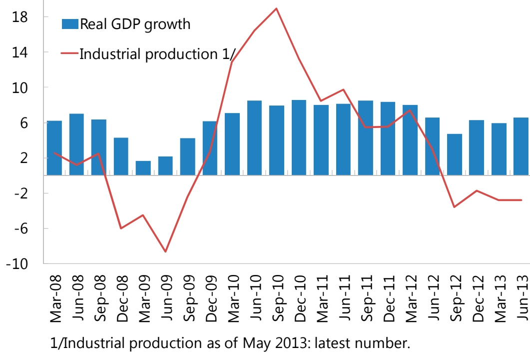
[1] The CBSL cut policy rates by 25 bps in December 2012, 50 bps in May 2013, and 50 bps in October. This was accompanied by a 2 percentage point cut in the statutory reserve requirement in June. In the meantime, inflation fell by 3 percentage points, from 9.2 in end-December 2012 to 6.2 percent in end-September 2013.

Figure 1. Macroeconomic Developments

Growth has moderated in recent quarters.

Economic Activity

(y/y percent change)

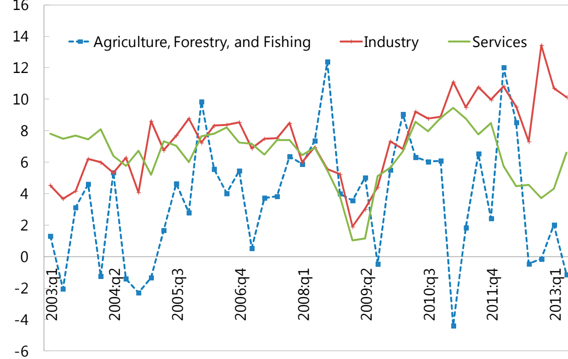


1/Industrial production as of May 2013: latest number.

Industrial production has been contracting with services industry filling the bill.

Economic Activity by Sector

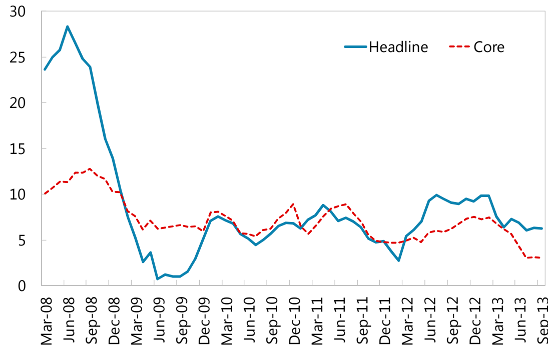
(y/y percent change



Headline and core inflation have declined.

Consumer Price Index

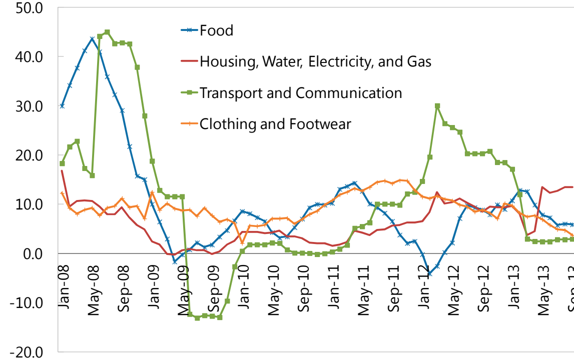
(y/y percent change)



Fuel and utility prices are on the rise with declining food prices.

Consumer Price Index Components

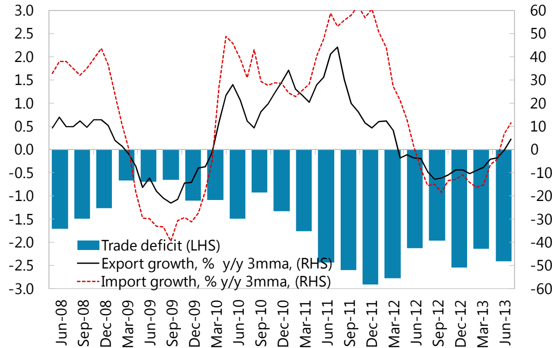
(y/y percent change)



Imports and exports have bottomed out, and trade balance has improved.

Trade Deficit

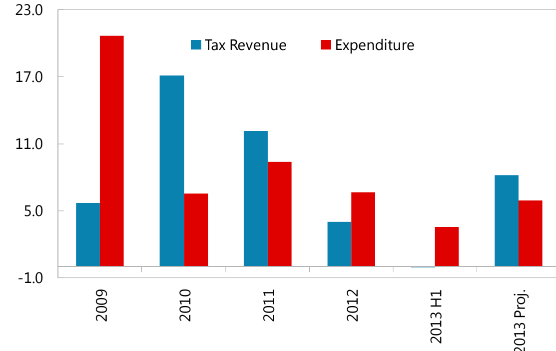
(In billions of U.S. dollars, per quarter)



Revenues are falling short of projections.

Annual Growth in Expenditure and Tax Revenue

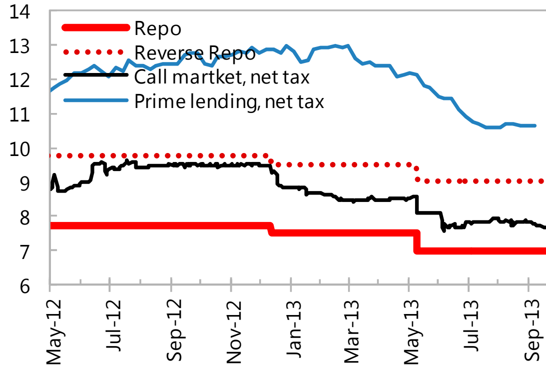
(In percent)



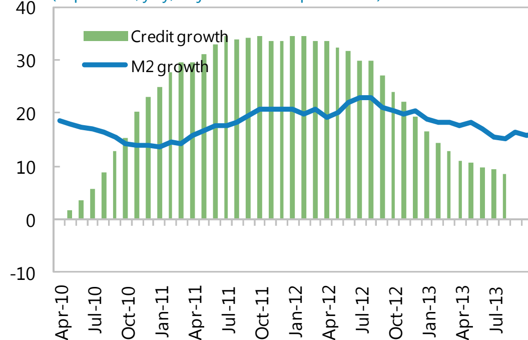
Sources: Central Bank of Sri Lanka; CEIC; Bloomberg LP.

Figure 2. Monetary and Exchange Rate Developments

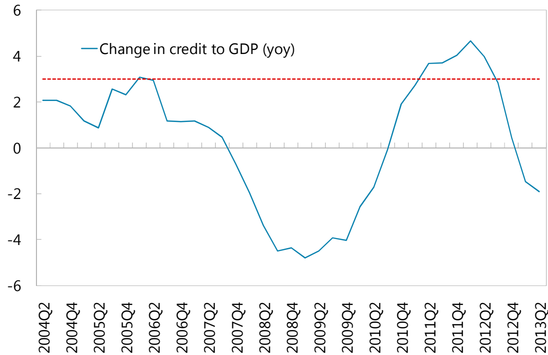
Monetary policy has been eased...



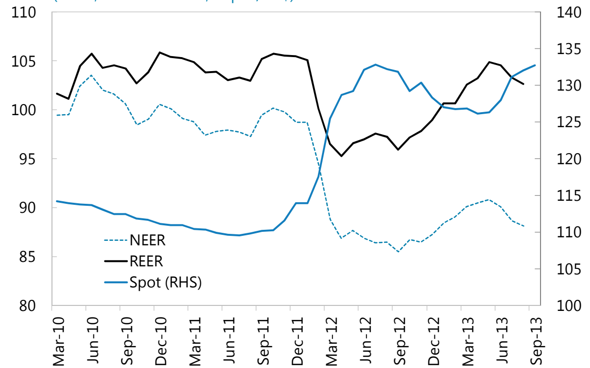
...growth of credit to private sector is slowing...



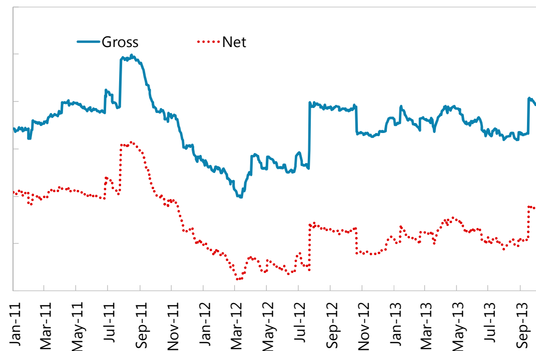
...and credit as percent of GDP has declined.



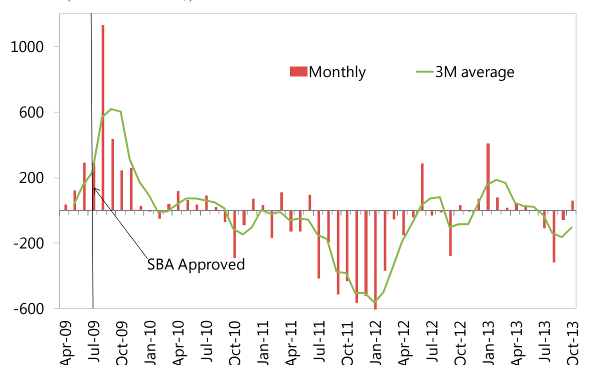
Nominal exchange rate has fallen, but the REER has been appreciating until recently.



Central bank reserves have been under pressure partly due to valuation changes...



...and partly due to CBSL provision of forex to the market.

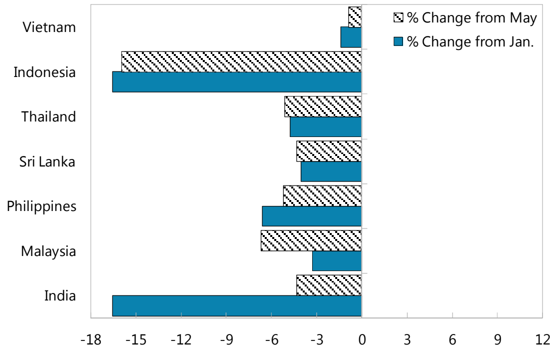


Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; Bloomberg LP; and IMF staff estimates.

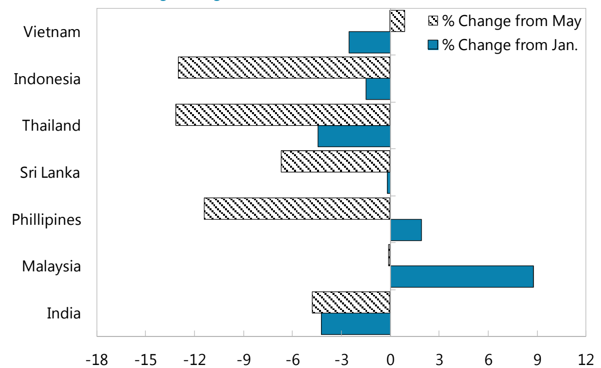
1/ The horizontal line shows a 3 percent "warning threshold" (September 2011 *GFSR*).

Figure 3. Performance Following Market Turbulence on Global Financial Markets

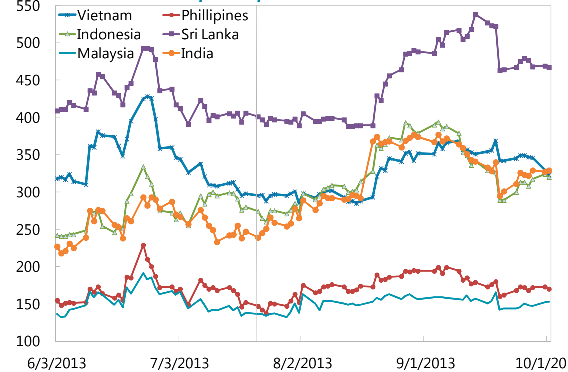
Currency depreciation has been relatively modest.



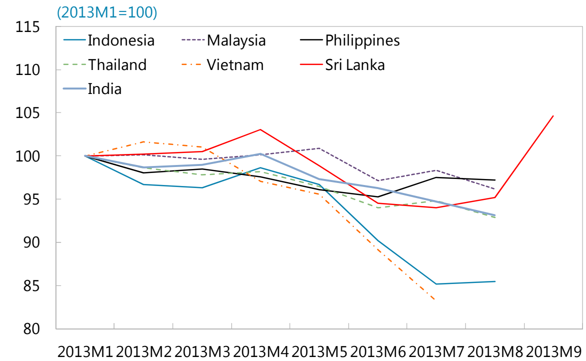
Equity prices did change much since end-2012.



EMBI spread widening has been partly reversed…



…and recent borrowing boosted foreign reserves.

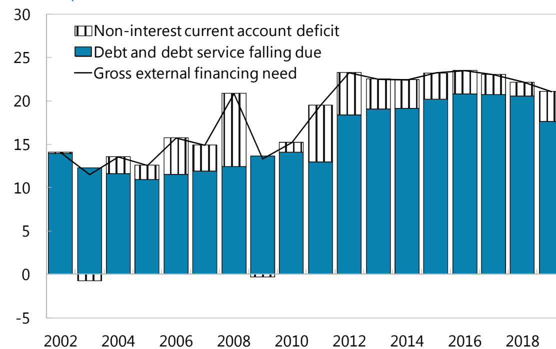


Sources: Central Bank of Sri Lanka; CEIC; Bloomberg LP; and IMF staff estimates.

POLICY DISCUSSIONS

A. Maintaining External Sustainability

8. Sri Lanka has weathered the recent bout of market turbulence well, but further challenges may be lurking down the road. Market volatility following U.S. Federal Reserve announcements in May highlighted potential risks from a broader downturn in investor sentiment and increased pressure on the exchange rate and CBSL foreign exchange reserves. The authorities responded with a mix of exchange rate flexibility, some loss of reserves, and efforts to assure investors through direct communication. This was largely successful. However, the eventual



Source: IMF staff estimates.

withdrawal of exceptional U.S. monetary stimulus could cause a renewed period of tighter financial conditions for emerging and frontier markets, resulting in a slowdown or even reversal of capital flows. A renewed slowdown in global growth also remains a vulnerability for Sri Lanka, given that advanced economies remain key export markets. Either of these risks could create balance of payments and financing challenges for Sri Lanka.

9. Sri Lanka was resilient to shifts in market sentiment, albeit with some loss of central bank reserves. Staff argued that the exchange rate should shoulder a significant part of the adjustment to any renewed pressure on the balance of payments. Given the recent real effective appreciation of the rupee and the need to preserve the CBSL's limited cushion of foreign exchange reserves, intervention should be market-based and limited to dealing with excessive short-term volatility. Contingency plans—involving exchange rate flexibility complemented by a tightening of fiscal and monetary policies and some use of reserves—should be designed to prepare for a potential sudden stop or significant change in market conditions that might endanger Sri Lanka's ability to roll over existing external debt (Box 1). While exchange rate flexibility should be viewed as the first line of defense, there could also be scope to support adjustment by monetary tightening, a tighter fiscal stance[2] and a judicious use of foreign reserves to counter excessive currency volatility. The mission cautioned against using one-off measures (such as import restrictions) as they are distortionary and could undermine confidence.[3]

10. The shift from concessional/bilateral loans to external borrowing by banks and private entities raises risks to external sustainability. To a large extent, this is a natural evolution of financial intermediation, given a limited domestic savings base from which to finance investment and could prove positive for growth and development. However, the staff emphasized two points:

- Careful consideration should be given to external borrowing by state and commercial banks, particularly with regard to the nature and rates of return on the investments financed by these resources, and the impact on debt dynamics and rollover requirements. While external borrowing provides a temporary boost to the balance of payments, it is critical to ensure that these funds are used for projects that lead to productivity gains and help build the future foreign currency generating capacity needed to support debt service. This is a particular concern given the relative decline in Sri Lanka's exports and nondebt related receipts over the past decade.
- Guarantees by the government or CBSL of banks' external borrowings or assumption of the foreign exchange risk should be avoided so as to ensure that financial institutions internalize these risks and build the capacity to hedge them.[4]

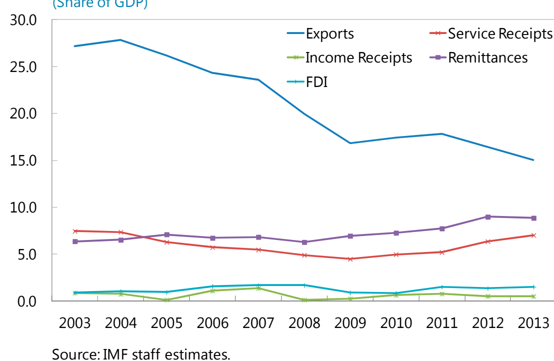
[2] Fiscal tightening would likely be the last step, given the extent to which low revenues have already forced spending cuts to meet Sri Lanka's fiscal consolidation objectives.

[3] In August 2013, the CBSL imposed a 100 percent margin on banks for Letters of Credit issued to car importers—in response to the sharp depreciation in the currency value of several trading partner-countries and concern over a surge in imports. This followed a sizable increase in import taxes on cars in March 2012. Staff is currently assessing the jurisdictional implications of the new regulation.

[4] Currently, the funds raised by National Savings Bank have been allocated between: (i) investment in dollar-denominated Sri Lanka Development Bonds for which the government bears the foreign exchange risk; (ii) a swap (at

(continued)

Sri Lanka: Selected Non-Debt-Creating Flows
(Share of GDP)



Source: IMF staff estimates.

Sri Lanka: Non-Debt Related Foreign Exchange Receipts/GDP, 2003–13

Source: IMF staff estimates.

Box 1. Refinancing Risks and Policy Options

In the coming years, Sri Lanka faces large external refinancing needs. During 2014–16, it will need to finance a projected $11 billion current account deficit, and about $5.3 billion of maturing medium- and long-term external debt. On top of that, it needs to continue rolling over more than $10 billion short-term external debt per year. If access to market financing is lost or reduced, these relatively large external financing needs could quickly erode foreign exchange reserves. Maintaining market access and attracting foreign direct investments are essential, but could become more challenging in the face of continued market volatility and capital outflows associated with the prospect of a U.S. exit from UMP.

An illustrative scenario highlights this rollover risk. The scenario assumes that during 2014-15, short-term capital inflows and the long-term private sector inflows are only 50 percent of those in the baseline scenario (only 25 percent in 2014 for short-term inflows to the banking sector, which would be more vulnerable to external shocks due to creditors' failure to roll over their exposure). With an unchanged current account balance, this would result in the balance of payments weakening by $1.6 billion in 2014 and $3.3 billion in 2015. With the exchange rate at current levels, reserve coverage would fall to less than two months of imports by 2015. Even a sizable monetary and fiscal tightening (assumed to consist of a 1 percent of GDP fiscal tightening and a 4 percent reduction in domestic credit in 2014 relative to baseline) would be insufficient to offset the reduction in capital inflows, and currency depreciation would be required to maintain reserve coverage at three months of imports.

Sri Lanka: Gross Reserves under Different Scenarios
In millions of U.S. dollars (unless otherwise specified)

		2013	2014	2015	2016	2017	2018
Baseline	Gross reserves	6,661	6,750	7,036	7,913	9,238	10,596
	(In months of imports)	3.2	3.1	3.0	3.1	3.3	3.6
Shock	Gross reserves	6,661	5,165	3,777	4,597	5,588	6,237
	(In months of imports)	3.2	2.4	1.6	1.8	2.0	2.1
Tighter policies	Gross reserves	6,661	5,669	4,738	5,628	6,619	7,268
	(In months of imports)	3.2	2.6	2.0	2.2	2.4	2.5

Source: IMF staff estimates.

prevailing market exchange rates) with the CBSL, which is renewed periodically; and (iii) a dollar-denominated loan to the Sri Lankan armed forces for a defense university.

Authorities' views

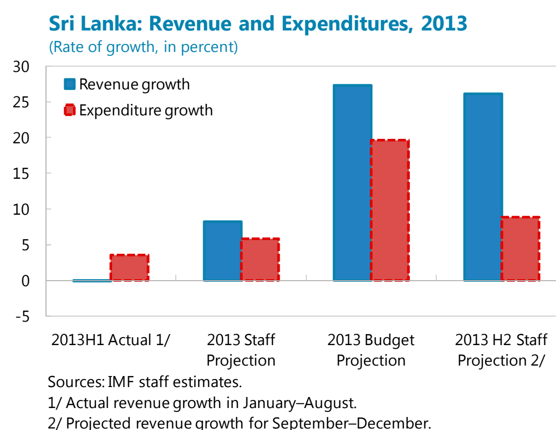
11. The authorities were confident that Sri Lanka would weather well future shifts in market sentiment. CBSL officials believed that the prospect of Fed tapering had already largely been priced into the market and, as such, further shocks are unlikely. They explained that past inflows into Sri Lanka had not been a result of global liquidity or previous rounds of U.S. quantitative easing and, unlike a number of emerging markets, Sri Lanka had not experienced a significant influx of foreign money. They also emphasized that preemptive actions had been taken to limit potential damage from shifting capital flows. In particular, a cap had been maintained on nonresidents' holding of government securities (to 12.5 percent of the outstanding stock). The authorities also highlighted their ongoing efforts to attract investors from the Middle East and Asia to diversify the investor base. Should pressures emerge, however, the authorities reiterated their commitment to a flexible exchange rate regime (with occasional interventions to smooth excessive foreign exchange market volatilities or meet foreign exchange needs related to oil purchases or other large transactions) and noted moves earlier in the year to ease restrictions on banks' net open forward positions. They emphasized that their policy mix would naturally respond to changing market conditions, as needed.

B. Creating Fiscal Space

12. The authorities remain committed to continuing fiscal consolidation and reducing public debt. In this regard, they have taken a number of important fiscal measures in recent months. In line with IMF technical assistance recommendations, the VAT was extended to the retail and wholesale sectors as part of the 2013 budget. Electricity prices were adjusted by a significant margin in April 2013 which, together with favorable rains and hydropower generation, have reduced the losses of Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) to zero (or to small surpluses)—an objective that proved elusive during the three years of the Stand-By Arrangement. The authorities have also moved to systematically lengthen the maturity of the domestic debt portfolio with a view to reducing rollover risk. Ongoing work is focused on enhancing the financial management framework for SOEs, introducing new and streamlined financial regulations, strengthening budget preparation, and developing a medium-term budget framework (some of these initiatives are supported by IMF technical assistance).

13. In the near term, weak revenues will mean that meeting the original 2013 deficit target will require a compression of expenditures. Even with a recovery in revenues in the second half of the year, sizable spending cuts (principally capital expenditures) or accumulation of arrears will be necessary to meet the deficit target of 5.8 percent of GDP, adding to downward pressure on growth. Assuming the same seasonal pattern of revenue collection of the past three years (which due to the base effect would imply a sharp pickup in

Sri Lanka: Revenue and Expenditures, 2013
(Rate of growth, in percent)



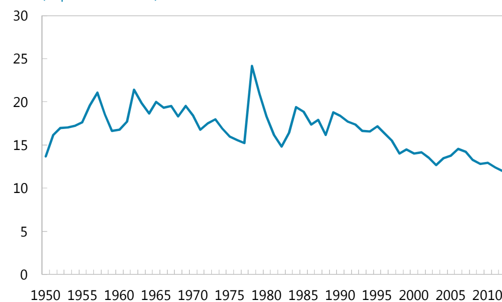
Sources: IMF staff estimates.
1/ Actual revenue growth in January–August.
2/ Projected revenue growth for September–December.

growth in September–December, see chart), and with little scope for additional cuts in current spending, capital spending will have to be kept to only 4 percent of GDP—a sharp drop from 5.3 percent of GDP in 2012 and the 6 percent of GDP planned in the 2013 budget (Box 2). Staff suggested that a modestly higher deficit in 2013, possibly in the range of 6–6.5 percent of GDP, would be preferable to arrears and large compression of capital spending, but that this would have to be followed by concrete measures to reduce the deficit in 2014 and beyond.

Box 2. Sri Lanka's Falling Tax Revenues

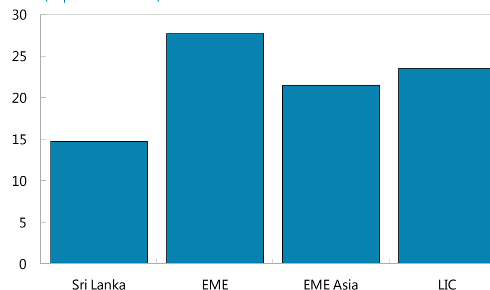
Sri Lanka's tax revenues have seen a steady real decline. By 2012, the tax-to-GDP ratio had fallen to below 12 percent of GDP—the lowest level since 1950 and half the peak level seen in 1978. Sri Lanka's tax collection and overall general government revenues are well below the average for the emerging market economies and low-income countries.

Sri Lanka: Tax Revenue
(In percent of GDP)



Source: Ministry of Finance and Planning.

General Government Revenues, 2012
(In percent of GDP)



Sources: IMF Fiscal Monitor, April 2012; Sri Lanka Ministry of Finance and Planning, Annual Report, 2012.

The need to arrest and reverse falling tax revenues is well-recognized by staff and the authorities. Increasing tax revenues (from 13.3 percent of GDP in 2008 to 15.1 percent of GDP in 2012) was one of the key objectives of the latest program. However, despite several initiatives, including extensive work by the Tax Commission and IMF technical assistance, improving revenue collection has been elusive.

Multiple factors are behind the falling tax revenue. First, trade liberalization and a gradual reduction of external trade taxation have lowered tax revenues from international trade. This effect was exacerbated by measures introduced in 2012 to curb imports. Second, to boost foreign investment or support specific activities, the authorities have introduced numerous tax exemptions and holidays, resulting in an erosion of the tax base. Third, the tax exemptions have made tax administration more difficult, discouraged tax compliance, and created demand for new exemptions.

Increasing tax revenues will require broadening the tax base and strengthening administration and compliance. Some encouraging steps were taken in recent years to broaden the tax base: the Board of Investment incentive regime was revisited to harmonize it with the Inland Revenue Act and rely less on new tax incentives, the salaries of public sector employees were subjected to income tax, and the VAT was extended to retail and wholesale sectors. However, new exemptions are still being introduced and a more concerted effort to limit the number of VAT and income tax exemptions is needed. At the same time, further strengthening of tax administration and compliance, in line with the IMF technical assistance recommendations, is needed to complement the base broadening (including through a reorganization of the Inland Revenue Department). Finally, there is scope to increase some tax rates, including the VAT.

14. A durable fiscal consolidation cannot be achieved without significantly boosting tax revenue. Given the need for high and sustained infrastructure spending and a steady reduction in public debt, putting tax revenues back on an upward path is essential and would generate

confidence in broader macroeconomic management.[5] The 2014 budget provides an opportunity to decisively address weaknesses in the tax system. Measures should be taken to: (i) eliminate exemptions and special rates (which appear to be spreading); (ii) further reduce the VAT threshold for the retail and wholesale sectors; (iii) tighten the registration criteria for simplified VAT (S-VAT) eligibility that allows VAT free supply purchases; and (iv) limit the use of corporate tax holidays and avoid the renewal of expiring holidays.[6] Remaining incentives should be confined to accelerated depreciation or tax credits linked to new investments.

Authorities' views

15. The authorities reiterated their strong commitment to fiscal consolidation. Despite a weak revenue performance thus far, the authorities expressed their determination to keep the deficit at 5.8 percent of GDP, and to continue fiscal consolidation in the medium term to bring the deficit to below 5 percent of GDP and the debt-to-GDP ratio to around 70 percent of GDP by 2015. The authorities remained optimistic that improved tax administration and better enforcement, together with the effects of the recent extension of VAT coverage, would boost tax collection in the second half of 2013. They highlighted signs of improving tax collection in August–September and indicated that no further revenue measures would be taken in 2013. Looking ahead, they believed that the planned reduction of the deficit in 2014 and beyond would be achieved through a reduction in tax exemptions (a number of companies will be graduating from tax holidays), but that tax rates would be left unchanged. The authorities attached considerable importance to the stability of the tax system rather than resorting to ad hoc tax changes.

C. Monetary Policy

16. From a forward-looking perspective, and in light of potential exchange rate and external risks, staff believes it would be prudent to keep monetary policy on hold in the near term. Weaker activity, falling inflation, and slowing private sector credit growth argue for further monetary policy loosening. Further, analysis based on a historical Taylor rule suggests room for easing. However, activity is close to staff estimates of potential growth, recent rupee depreciation could add to inflation pressures, policy rates are at historical lows, and there is a potential for further market volatility arising from future actions by the U.S. Federal Reserve. In addition, the lags between lower policy rates and private credit growth mean that, while significant monetary support is in the pipeline, it may not yet be visible in the data. On balance, staff felt that there was scope to hold off from further policy easing for a few months to gauge the impact of past policy moves. If inflation continued to decline, growth slowed, and the external environment remained benign, staff believed there could be room for further, gradual monetary loosening in 2014.

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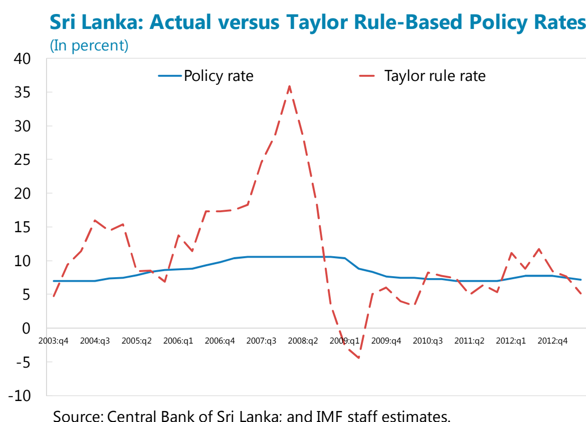
[5] The staff's GDP growth projections for the medium term reflect, in part, the low level of public capital expenditure implied by slow revenue growth in the context of ongoing fiscal consolidation.

[6] VAT exemptions should be reduced to minimum and confined to few items such as health, education, and basic food stuffs.

Authorities' views

17. The authorities agreed on the need to carefully weigh risks, but believed that there was more immediate room to ease policies. They emphasized that growth momentum would continue in the second half of the year, and that Sri Lanka was on its way to growth of 7 to 7.5 percent by year-end, but that there were risks from an uncertain external environment. They were more sanguine on the risks of capital outflows, emphasizing the stability of investment to Sri Lanka, and highlighted the strong performance of inflation in the past several months. As such, the central bank believed that a further easing of monetary policy would be beneficial and, subsequent to the mission, lowered policy rates by a further 50 bps.



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

D. Financial Sector Policies

18. Nonperforming loans have been rising and concerns have recently emerged surrounding the situation of one nonbank financial institution. Staff noted the steady increase in NPLs since the beginning of the year, with system-wide NPLs rising from 3.6 percent of gross loans at end-2012 to 4.7 percent by end-June 2013. The mission also expressed concern over the recent balance sheet stress in one nonbank financial institution and the decision to place that institution under new management.[7] While this appears to have been an isolated event linked to mismanagement, the mission questioned the efficacy of using a liquidity support scheme financed from the deposit insurance fund, rather than a separate line through the CBSL (which would be more in line with international practice, particularly given the limited resources of the deposit insurance fund).[8] The mission suggested that this issue be revisited to shift, over time, financing to a backstop mechanism outside of the deposit insurance fund.

Authorities' views

19. The authorities highlighted the role of gold pawning (Box 3) in explaining the rise in bank NPLs, and emphasized the need to quickly address any contagion risk from the troubled finance company. The use of gold as collateral for loans has been behind a growing segment of banks' and nonbank financial institutions' portfolios (Box 3). As gold prices have fallen, delinquencies have increased. Anecdotal evidence from banking sector representatives suggests

[7] One finance company encountered balance sheet and liquidity stress in August 2013 due to mishandling of funds by management. The CEO was removed and another finance company was appointed as managing agent.

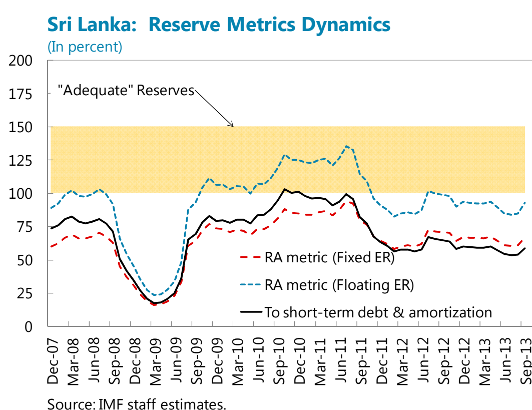
[8] Given the nascent stage of the deposit insurance scheme, the availability of deposit insurance funds for emergency liquidity assistance to nonbanks limits the funds available for payout of insured deposits and thus weakens the confidence-enhancing objectives of the deposit insurance scheme.

that corporate clients continue to do well and that the rise in nonperforming assets is linked largely to retail lending, including pawning advances. The authorities argued that providing CBSL liquidity support to nonbank financial institutions would have required parliamentary approval causing unacceptable delay in containing the problem. The authorities recalled the experience of 2008–09, when failures in the nonbank financial sector had contagion effects to one large bank and to smaller finance companies. They also highlighted the progress that has been made to date in improving regulation and supervision in this area.[9]

CAPACITY TO REPAY

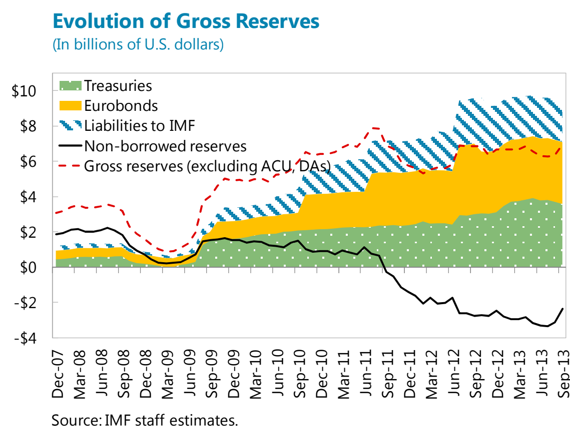
20. Sri Lanka's capacity to repay the IMF remains broadly adequate (Table 5). However, low (and until recently, declining) reserve coverage, high rollover requirements, and an uncertain external environment pose clear risks. Exposure to the IMF currently stands at SDR 1.5 billion (about $2.3 billion—3.5 percent of GDP and 33 percent of gross international reserves). Debt to the IMF is scheduled to be repaid mostly in 2014–16. External debt remains broadly sustainable, but significant debt maturities are coming up in the short term, and the reliance on nonconcessional debt flows to finance investment (and reserves) is a concern over the medium term. Close monitoring of the external debt burden and maturity structure would help to contain potential rollover risks.

Sri Lanka: Reserve Metrics Dynamics
(In percent)



Source: IMF staff estimates.

Evolution of Gross Reserves
(In billions of U.S. dollars)



Source: IMF staff estimates.

[9] In 2008, six finance companies suffered major stress that had their origin in governance issues in a major holding company. Appropriate crisis mitigation measures and a subsequent strengthening of the regulatory framework restored confidence in the sector. The minimum capital requirement for finance companies was doubled to SL Re 400 million (about $3 million). More stringent fitness and propriety requirements were introduced, and the new Finance Business Act provided enhanced regulatory power and more stringent penalties for unauthorized transactions.

Box 3. Sri Lanka—Gold Pawning Activity

Pawning—a form of collateralized lending based on gold jewelry or biscuits—is a significant lending product in many Sri Lankan banks and nonbank financial institutions (NBFIs). Based on the weight and purity of the gold at hand, a loan amount is determined derived from the current market price for gold and the financial institution's loan-to-value (LTV) ratio. Some banks and NBFI's lend up to 90 percent of value, while the average is in the 75–80 percent range.

Pawning advances typically serve two financing needs: (i) for households to meet extra cash needs (largely consumption) or unexpected events; and (ii) for farming communities to purchase agricultural inputs during the planting season. Banks and NBFI's typically lend against jewelry for 12 months, involving a bullet repayment at the end of the period (with interest). As such, delinquencies are recognized only at the end of the loan period. Typical bank interest rates for pawning advances are in the 18–21 percent range while NBFIs are a bit higher, in the 24–26 percent range.

Pawning has grown rapidly in recent years—at an average rate of about 45 percent over 2010–12—outpacing overall credit growth. Several factors have contributed to the rapid growth in pawning advances. For the banks pawning is a lucrative line of business with minimal regulations. There are no statutory limits on LTV ratios. Since the advance involves a bullet repayment at the end of the period (typically 12-months) no recognition of a non-performing asset is made until the end of the loan. On the consumer side pawning has proven to be a convenient and easy means of borrowing given its simplicity and the lack of need for a credit assessment of the borrower—which is routine for other types of advances.

Delinquencies on pawning have historically been low—less than 1 percent for banks and 1–2 percent for NBFIs. Many of the pawned items comprise 'family silver' that hold a high sentimental value and are typically redeemed. Also, with the steady rise in gold prices over the past few years, borrowers seldom resorted to default on their obligations.

However, the sharp fall in the price of gold in the past year has taken a heavy toll on pawning advances—contributing to the overall rise in banks' NPLs. Recent estimates suggest that NPLs related to pawning rose to over 4 percent by the end of the first half of 2013, and to over 6 percent by end-August. Against this backdrop, several banks have started to make both specific and general provisions for pawning NPAs. More generally, financial institutions appear to have slowed their pawning activity significantly, and some have lowered their LTV ratios.

STAFF APPRAISAL

21. Sri Lanka passed through the recent period of market turbulence reasonably well. The economy continues to grow at a solid pace, inflation has gradually declined to the mid-single digits, and (after a tepid first half) exports now appear to be gaining ground. Financial markets received a jolt following signs of U.S. monetary tightening starting in mid-May. While there was a negative impact initially, including a loss of central bank reserves, indicators of financial confidence in Sri Lanka (foreign holdings of public debt and equity, EMBI spreads, and the exchange rate) have now largely recovered.

22. Short-term resilience notwithstanding, there remain a number of vulnerabilities that are of concern. These include the level of public debt, the potential implications of rising private external borrowing, a declining level of nondebt related foreign exchange inflows, a low level of

international reserves (by the commonly used reserve adequacy metrics), lumpy rollover requirements, and a steadily shrinking level of government revenues. Most of these issues are not new—and have been highlighted in program reviews and Article IV discussions.

23. Monetary policy should not be loosened further for the time being. Given Sri Lanka's history of relatively volatile inflation and the lags in monetary policy transmission, the current monetary policy stance is sufficiently accommodative—particularly given the additional 50 bps cut in policy rates in mid-October. Some further easing in the second or third quarter of 2014 may be warranted if growth weakens and inflation and private credit growth are declining. However, this should be weighed against the potential impact on capital flows and the currency.

24. In the event of renewed market turbulence and pressure on the balance of payments, the exchange rate should shoulder a significant part of the adjustment burden. Sri Lanka's reserves have climbed since the balance of payments crisis in 2009, but are still low and predominantly debt-financed (including through exceptional access to IMF resources). Preserving this limited cushion and adjusting to new shocks through additional exchange rate flexibility is recommended—particularly given the likelihood (as indicated in the 2013 Article IV Consultation) that the rupee remains moderately overvalued. The increase in banks' permitted net open position is welcome in this regard, as is the CBSL's stated policy of only using reserves to address large foreign exchange needs related to oil and other lumpy current account transactions and otherwise allowing markets to clear on their own.

25. Higher revenues are needed to generate a durable fiscal consolidation and create space for more capital spending. The authorities' continued commitment to fiscal consolidation and debt reduction is a cornerstone of sound macroeconomic management and has bolstered public and investor confidence. The recent extension of the VAT to the retail and wholesale sectors, as well as the authorities' intention to "graduate" firms as their tax holidays expire, are positive developments. The difficult step of raising electricity prices—together with an increase in hydroelectric power production—has helped to eliminate the losses of the CEB and CPC, and to generate small profits for these state-owned enterprises thus far in 2013. However, a growth-friendly path of fiscal consolidation requires additional revenues. Revenue is being lost to holes in the tax net and new tax exemptions are still being introduced. A more concerted effort to limit the number of VAT and income tax exemptions and to raise tax rates is needed; the 2014 budget is an opportunity for such reform.

26. The increase in state and commercial banks' recourse to international markets for debt issuance opens opportunities to finance needed investments, but carries potential risks. Given the limited domestic savings base, external debt issuance offers new avenues to finance productive investment and development projects. However, these external debts need to be deployed in such a way as to enhance growth prospects and generate the future foreign exchange receipts needed to service these obligations—particularly given the risk that depreciation of the currency will raise the debt servicing burden. Close monitoring of these debts and their rollover cycle, as well as periodic analysis of their impact on Sri Lanka's external debt dynamics, will be essential.

Table 1. Sri Lanka: Selected Economic Indicators, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Prel.			Proj.			
GDP and inflation (in percent)									
Real GDP growth	8.0	8.2	6.4	6.5	6.5	6.5	6.5	6.5	6.5
Inflation (average)	6.2	6.7	7.5	7.2	6.6	6.4	5.8	5.5	5.5
Inflation (end-of-period)	6.8	4.9	9.2	7.0	6.3	6.2	5.5	5.5	5.5
Core inflation (end-of-period)	8.9	4.7	7.5	6.1	6.3	6.2	5.5	5.5	5.5
Public finances (in percent of GDP)									
Revenue	14.6	14.3	13.0	12.5	13.0	13.3	13.4	13.6	13.5
Grants	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Expenditure	22.8	21.4	19.7	18.5	18.4	18.4	18.3	18.1	17.9
Central government balance	-8.0	-6.9	-6.4	-5.8	-5.3	-4.9	-4.8	-4.4	-4.2
Consolidated government balance 1/	-8.4	-8.6	-8.4	-5.8	-5.5	-5.4	-5.1	-4.6	-4.3
Central government domestic financing	4.5	3.5	4.1	4.4	3.5	4.0	2.8	2.2	3.0
Government debt (domestic and external)	81.9	78.4	79.1	76.6	75.8	74.7	72.9	70.6	68.3
Money and credit (percent change, end of period)									
Reserve money	18.8	21.9	10.2	-3.3	17.6	15.2	13.7	13.7	13.4
Broad money	15.8	19.1	17.6	13.1	16.4	15.0	13.6	13.6	13.6
Domestic credit	18.6	34.3	21.7	17.0	16.5	15.9	13.1	13.2	14.4
Private sector credit	24.9	34.5	17.6	17.0	22.7	20.0	17.8	18.0	16.3
Public sector credit	8.2	33.7	29.6	17.0	5.6	7.6	2.3	0.6	8.5
Balance of payments (in millions of U.S. dollars)									
Exports	8,626	10,559	9,774	9,826	10,686	11,164	12,062	13,297	14,458
Imports	-13,451	-20,269	-19,183	-19,406	-21,463	-22,784	-24,581	-26,753	-28,749
Current account balance	-1,075	-4,615	-3,915	-3,384	-3,502	-3,670	-3,810	-4,059	-4,032
Current account balance (in percent of GDP)	-2.2	-7.8	-6.6	-5.2	-5.0	-4.8	-4.6	-4.4	-4.0
Export value growth (percent)	21.7	22.4	-7.4	0.5	8.8	4.5	8.0	10.2	8.7
Import value growth (percent)	31.8	50.7	-5.4	1.2	10.6	6.2	7.9	8.8	7.5
Gross official reserves (end of period) 2/									
In millions of U.S. dollars	6,410	5,758	6,677	6,661	6,750	7,036	7,913	9,023	9,853
In months of imports	3.5	3.2	3.6	3.2	3.1	3.0	3.1	3.2	3.2
External debt (public and private)									
In billions of U.S. dollars	24.8	29.4	33.7	35.5	37.6	40.1	43.1	46.5	49.5
As a percent of GDP	50.1	49.8	56.7	54.3	53.5	52.3	51.5	50.9	49.6

Sources: Data provided by the Sri Lankan authorities; CEIC Data Company Ltd.; Bloomberg L.P.; and IMF staff estimates and projections.

1/ The consolidated government balance includes the Ceylon Electricity Board and the Ceylon Petroleum Corporation.

2/ Excluding central bank Asian Clearing Union (ACU) balances.

Table 2. Sri Lanka: Summary of Central Government Operations, 2010–18

(In percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Prel.	Proj.					
Total revenue (including grants)	14.9	14.5	13.2	12.8	13.1	13.4	13.5	13.7	13.6
Total revenue	14.6	14.3	13.0	12.5	13.0	13.3	13.4	13.6	13.5
Tax revenue	12.9	12.4	11.1	11.3	11.6	11.9	12.0	12.2	12.2
Income taxes	2.4	2.4	2.3	2.4	2.2	2.2	2.3	2.3	2.3
VAT	3.9	3.3	2.7	2.9	3.3	3.5	3.6	3.6	3.6
Excise taxes	2.3	2.8	2.5	2.6	2.7	2.7	2.7	2.7	2.8
Other trade taxes	1.3	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5
Other	2.9	2.5	2.2	1.9	2.0	2.0	2.0	2.0	2.0
Nontax revenue	1.7	1.9	1.9	1.3	1.4	1.4	1.4	1.4	1.4
Grants	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending	22.8	21.4	19.7	18.5	18.4	18.4	18.3	18.1	17.9
Current expenditure	16.7	15.4	14.4	14.5	14.2	14.0	13.8	13.5	13.2
Civil service wages and salaries	2.8	2.7	2.4	2.7	2.7	2.7	2.7	2.7	2.7
Other civilian goods and services	0.7	0.9	0.8	0.7	0.8	0.8	0.8	0.8	0.8
Security expenditure (including contingency)	3.4	3.1	2.7	2.9	2.9	2.9	2.9	2.8	2.7
Subsidies and transfers	3.5	3.3	3.1	2.9	2.8	2.8	2.7	2.7	2.7
Interest payments	6.3	5.5	5.4	5.2	4.9	4.8	4.8	4.6	4.4
Capital expenditure and net lending	6.1	6.0	5.3	4.0	4.2	4.3	4.5	4.6	4.7
Overall balance of the central government	-8.0	-6.9	-6.4	-5.8	-5.3	-4.9	-4.8	-4.4	-4.2
Financing	8.0	6.9	6.4	5.8	5.3	4.9	4.8	4.4	4.2
Net external financing	3.4	3.4	2.4	1.4	1.8	0.9	2.0	2.2	1.2
Net domestic financing	4.5	3.5	4.1	4.4	3.5	4.0	2.8	2.2	3.0
Memorandum items:									
Primary balance (excluding grants)	-2.0	-1.7	-1.3	-0.8	-0.5	-0.3	-0.1	0.1	0.1
Total public debt	81.9	78.4	79.1	76.6	75.8	74.7	72.9	70.6	68.3
Domestic debt	45.8	42.8	42.6	39.5	38.3	37.9	36.4	34.6	33.7
Foreign debt	36.1	35.6	36.5	37.1	37.5	36.8	36.5	36.0	34.6
Nominal GDP (in billion of rupees)	5,604	6,544	7,582	8,532	9,686	10,940	12,327	13,861	15,585

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

Table 3. Sri Lanka: Monetary Accounts, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Prel.	Proj.					
Monetary authorities	(Stocks, in billions of Sri Lankan rupees)								
Net foreign assets	505	340	396	476	614	756	985	1,223	1,390
Net domestic assets	-145	99	88	-8	-64	-122	-263	-402	-460
Of which : Net credit to government	77	263	279	194	210	219	147	83	109
Of which : Other items net	-224	-165	-192	-202	-275	-341	-412	-487	-569
Reserve money	361	440	484	469	551	634	721	821	931
	(Contribution to reserve money growth, in percent)								
Net foreign assets	30.7	-45.9	12.8	16.5	29.5	25.7	36.1	33.0	20.4
Net domestic assets	-12.0	67.8	-2.6	-19.7	-11.9	-10.6	-22.3	-19.3	-7.0
Reserve money (percent change)	18.8	21.9	10.2	-3.3	17.6	15.2	13.7	13.7	13.4
Monetary survey	(Stocks, in billions of Sri Lankan rupees)								
Net foreign assets	377	98	-25	-163	-185	-257	-259	-270	-377
Monetary authorities	505	340	396	476	614	756	985	1,223	1,390
Deposit money banks	-128	-242	-422	-639	-799	-1,013	-1,244	-1,493	-1,768
Net domestic assets	1,714	2,394	2,954	3,475	4,041	4,692	5,295	5,990	6,873
Domestic credit	2,263	3,038	3,696	4,323	5,036	5,839	6,601	7,470	8,547
Public sector (net)	772	1,032	1,338	1,565	1,652	1,778	1,818	1,829	1,984
Private sector	1,491	2,006	2,358	2,758	3,385	4,061	4,783	5,642	6,564
Other items (net)	-549	-644	-742	-849	-996	-1,147	-1,306	-1,480	-1,674
Broad money	2,091	2,492	2,929	3,312	3,856	4,435	5,036	5,720	6,496
	(Annual percent change)								
Net foreign assets	-6.1	-74.0	-125.6	546.9	13.9	38.9	0.8	4.3	39.6
Monetary authorities	22.6	-32.7	16.6	20.1	29.0	23.1	30.3	24.2	13.7
Deposit money banks	1,140	89.1	74.2	51.5	25.2	26.7	22.8	20.0	18.4
Net domestic assets	22.1	39.7	23.4	17.6	16.3	16.1	12.9	13.1	14.7
Domestic credit	18.6	34.3	21.7	17.0	16.5	15.9	13.1	13.2	14.4
Public sector (net)	8.2	33.7	29.6	17.0	5.6	7.6	2.3	0.6	8.5
Private sector	24.9	34.5	17.6	17.0	22.7	20.0	17.8	18.0	16.3
Broad money	15.8	19.1	17.6	13.1	16.4	15.0	13.6	13.6	13.6
	(Contribution to broad money growth, in percent)								
Net foreign assets	-1.4	-13.4	-4.9	-4.7	-0.7	-1.9	0.0	-0.2	-1.9
Net domestic assets	17.1	32.5	22.5	17.8	17.1	16.9	13.6	13.8	15.4
Domestic credit	19.7	37.1	26.4	21.4	21.5	20.8	17.2	17.3	18.8
Public sector (net)	3.2	12.4	12.3	7.8	2.6	3.3	0.9	0.2	2.7
Private sector	16.4	24.6	14.1	13.7	18.9	17.6	16.3	17.1	16.1
Memorandum items:									
Broad money multiplier	5.8	5.7	6.0	7.1	7.0	7.0	7.0	7.0	7.0
Velocity of broad money	2.7	2.6	2.6	2.6	2.5	2.5	2.4	2.4	2.4

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

Table 4. Sri Lanka: Balance of Payments, 2010–18

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

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Prel.			Proj.			
Current account	-1,075	-4,615	-3,915	-3,384	-3,502	-3,670	-3,810	-3,844	-3,505
Trade balance	-4,825	-9,710	-9,409	-9,580	-10,777	-11,620	-12,519	-13,240	-13,764
Exports	8,626	10,559	9,774	9,826	10,686	11,164	12,062	13,366	14,641
Imports	13,451	20,269	19,183	19,406	21,463	22,784	24,581	26,606	28,405
Non-oil imports	10,410	15,474	14,138	14,607	16,176	17,411	19,198	21,055	22,593
Oil imports	3,041	4,795	5,045	4,799	5,288	5,373	5,383	5,552	5,812
Services	707	1,099	1,250	1,634	2,201	2,516	2,908	3,217	3,564
Income	-617	-647	-1,148	-1,259	-1,350	-1,508	-1,675	-1,899	-2,034
Transfers	3,660	4,643	5,392	5,822	6,424	6,941	7,476	8,078	8,730
Private (net)	3,608	4,583	5,339	5,795	6,396	6,912	7,445	8,046	8,696
Remittances	4,116	5,145	5,985	6,650	7,315	7,900	8,532	9,215	9,952
Official (net)	52	60	53	26	28	29	30	32	34
Capital and financial account	2,877	4,262	4,683	3,819	4,309	4,509	5,186	5,432	4,863
Capital transfers (net)	164	164	130	134	99	112	112	112	112
Financial account	2,713	4,098	4,553	3,685	4,210	4,397	5,074	5,320	4,751
Long-term flows	2,379	3,308	2,872	2,454	2,703	2,235	3,311	3,806	3,101
Direct investment	435	896	813	1,000	1,100	1,210	1,331	1,444	1,567
Private sector borrowing 1/	149	175	562	539	361	322	317	309	299
Official sector borrowing	1,796	2,237	1,497	915	1,242	704	1,664	2,052	1,235
Disbursements	2,460	3,026	2,869	1,800	2,300	2,299	3,009	3,197	2,495
Amortization	665	789	1,372	885	1,058	1,595	1,345	1,145	1,260
Short-term flows	334	790	1,681	1,231	1,507	2,161	1,763	1,514	1,650
Government short-term net	531	233	843	500	900	1,200	700	350	350
Nonbank private sector	-1,032	-243	-663	-769	-493	-444	-399	-359	-288
Banking sector 2/	1,064	971	1,196	1,250	850	1,155	1,213	1,273	1,337
Portfolio investment	-230	-171	305	250	250	250	250	250	250
SDR allocation	0	0	0	0	0	0	0	0	0
Errors and omissions	-881	-708	-617	0	0	0	0	0	0
Overall balance	921	-1,061	151	435	807	838	1,377	1,588	1,358
Financing	-921	1,061	-151	-435	-807	-838	-1,377	-1,588	-1,358
NIR (- = increase)	-921	1,061	-151	-435	-807	-838	-1,377	-1,588	-1,358
Gross reserves	-1,513	653	-920	16	-88	-286	-877	-1,325	-1,358
Reserve liabilities (- is outflow)	592	408	769	-451	-719	-552	-499	-263	0
Memorandum items:									
Current account (in percent of GDP)	-2.2	-7.8	-6.6	-5.2	-5.0	-4.8	-4.6	-4.2	-3.5
Gross official reserves (net of ACU debit balances)	6,410	5,758	6,677	6,661	6,750	7,036	7,913	9,238	10,596
(In months of imports of goods and nonfactor services)	3.5	3.2	3.6	3.2	3.1	3.0	3.1	3.3	3.6
(In percent of composite metric)	129	90	98	91	85	78	81	87	93
Net international reserves	5,072	4,011	4,162	4,597	5,404	6,242	7,619	9,206	10,564
GDP	49,552	59,164	59,408	65,317	70,433	76,629	83,619	91,351	99,791

Sources: Data provided by the Central Bank of Sri Lanka; and IMF staff estimates and projections.
1/ Includes public corporations and specialized financial institutions. In 2013 and 2014, this includes bond issuance by state-owned banks of US$750 million and US$250 million, respectively.
2/ Includes short- and long-term external borrowing by banks.

Table 5. Sri Lanka: Projected Payments to the Fund, 2013–18

(In millions of SDR, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018
Fund repurchases and charges						
In millions of SDR	320.7	487.5	370.0	331.3	173.3	0.3
In millions of U.S. dollars	484.8	739.6	564.4	508.1	267.1	0.5
In percent of exports of goods and NFS	3.4	4.6	3.3	2.7	1.3	0.0
In percent of quota	77.6	117.9	89.5	80.1	41.9	0.1
In percent of gross official reserves	7.3	11.0	8.0	6.4	2.9	0.0
Fund credit outstanding						
In millions of SDR	1,335	861	500	172	0.0	0.0
In millions of U.S. dollars	2,018	1,306	762	264	0.0	0.0
In percent of quota	323	208	121	42	0.0	0.0
In percent of GDP	3.1	1.9	1.0	0.3	0.0	0.0
In percent of gross official reserves	30.3	19.4	10.8	3.3	0.0	0.0
Memorandum items:						
Exports of goods and services (in millions of U.S. dollars)	14,420	16,151	17,210	18,865	20,882	22,952
Quota	413	413	413	413	413	413
Quota (in millions of U.S. dollars)	625	627	631	634	637	640
Gross official reserves (in millions of U.S. dollars)	6,661	6,750	7,036	7,913	9,238	10,596
GDP (in millions of U.S. dollars)	65,317	70,433	76,629	83,619	91,351	99,791

Source: IMF staff estimates.

Table 6. Sri Lanka: Financial Soundness Indicators—All Banks, 2008–13

	2008	2009	2010	2011	2012	2013	2013
					Prel.	Q1	Q2
Capital adequacy							
Regulatory capital to risk weighted assets	14.5	16.1	16.2	16.0	15.0	16.0	16.1
Tier 1 capital/risk weighted assets	12.5	14.1	14.3	14.4	13.1	13.9	13.9
Capital to assets ratio	8.1	8.1	8.3	8.7	8.5	8.4	8.4
Asset quality							
Gross nonperforming loans to total gross loans (without interest in suspense)	6.3	8.5	5.4	3.8	3.6	4.2	4.7
Net nonperforming loans to total gross loans	3.4	5.0	3.0	2.1	2.1	2.3	2.7
Provision coverage ratio (total)	60.9	53.0	58.1	57.1	54.5	45.4	44.9
Earnings and profitability							
Return on equity (after tax)	13.4	11.8	22.2	19.7	20.2	n.a.	24.6
Return on assets (after tax)	1.1	1.0	1.8	1.7	1.7	n.a.	2.1
Interest income to gross income	86.3	86.0	83.1	85.5	86.3	n.a.	69.5
Staff expenses to noninterest expenses	44.5	46.5	45.2	43.7	45.2	45.9	46.5
Personnel expenses to total income	9.9	10.6	12.0	12.2	10.7	n.a.	25.5
Total cost to total income	79.8	78.1	71.9	73.9	75.6	79.1	91.2
Net interest margin	4.4	4.6	4.6	4.2	4.1	3.8	6.8
Liquidity							
Liquid assets to total assets	28.4	35.3	31.4	26.8	26.5	28.0	29.2
Assets/funding structure							
Deposits	69.6	74.1	72.8	72.3	70.5	70.2	n.a
Borrowings	17.0	12.9	14.3	14.9	15.8	11.2	11.6
Capital to external funds	9.4	9.3	9.5	10.0	9.9	8.4	8.4
Credit to deposits	87.0	71.5	76.4	84.7	87.4	85.7	n.a

Source: Central Bank of Sri Lanka.

INTERNATIONAL MONETARY FUND

SRI LANKA

November 25, 2013

FIRST POST-PROGRAM MONITORING DISCUSSION—SUPPLEMENTARY INFORMATION

Prepared By Asia and Pacific Department

1. **This supplement reports on developments since the staff report was issued on November 12, 2013**. This new information does not alter the thrust of the staff appraisal.

2. **Government budget for 2014.** The Government of Sri Lanka on November 21 unveiled the official budget for 2014, targeting an overall deficit of 5.2 percent of GDP. In broad terms, the level of the deficit is in line with the staff's projections and the authorities' continued commitment to fiscal consolidation. The staff welcomes the reduction in the overall deficit, as part of the medium-term strategy to reduce public debt and put public finances on a more sustainable footing.

3. **The policy framework for the budget brings several welcome measures.** Tax rates remain broadly unchanged—reflecting intentions to maintain stability in the tax environment. The lowering of the threshold for VAT at the retail level from Rs 500 million to 250 million in quarterly turnover is in line with staff's recommendations on broadening the tax base. Some steps have also been taken to bring professionals into the tax net. Restraint of current expenditure—which has come down consistently as a share of GDP since 2009—is also evident, as is a relatively high level of capital spending (6.7 percent of GDP). Particularly given the recent discussions in the context of post-program monitoring on medium-term growth prospects and the need for public investment in infrastructure, this ambitious target for capital expenditure is welcome.

4. **The staff also sees several areas of concern which might have an impact on economic prospects and the authorities' capacity to fully deliver on the budget.**

- The projected level of real economic growth—at 7.5 to 8 percent—appears high in light of recent performance and prospects for a gradual global recovery in 2014.

- The budget includes increases in taxes on commodity exports, and also increases import taxes on such items as boats, gauze, steel products, aluminum bars and tubes, padlocks, hinges, and cement. These measures could have a negative effect on trade and competitiveness. The budget also imposes a 15 percent tax on lease of state or private land to foreigners.

- Some steps have been taken to tighten the tax net—signaling moderate progress—but more could be done. While the budget includes the withdrawal of some exemptions, it also introduces a number of new exemptions and tax holidays. However, these appear relatively small compared with previous years. The staff continues to believe that a comprehensive review of exemptions and tax holidays is needed, with a view to assessing the overall fiscal

cost, formulating a broader reform of these holes in the tax net, and ensuring a significant rise in tax revenue and lessening the need for debt-financing.

5. Areas where the staff would recommend further action include: (i) eliminating exemptions and special rates; (ii) tightening the registration criteria for simplified VAT (S-VAT) eligibility; (iii) introduction of a single and simplified small taxpayer regime for businesses under the VAT threshold; and (iv) converting tax and other incentives to accelerated depreciation or tax credits. The staff will discuss the budget in greater detail in the weeks ahead, and include a more substantive analysis as part of the 2014 Article IV consultation.

6. Article VIII restriction. With reference to Footnote 3 in the Staff Report, staff has assessed the measure by the Central Bank of Sri Lanka imposing a 100 percent cash margin requirement on letters of credit for automobile importers to be an exchange restriction inconsistent with Sri Lanka's obligations under Article VIII, Section 2(a). However, as this assessment was reached only recently, the mission team has not had a chance to discuss this finding with the authorities in detail or assess whether the criteria set by the Board under Decision No. 1034-(60/27), dated June 1, 1960 for approval of an exchange restriction are met. Therefore, at this time, the authorities have not requested and staff does not recommend approval of the measure. Staff has alerted the authorities to the assessment, and asked for their views and supplementary information on trade in vehicles prior to implementation of the margin requirement on letters of credit for automobile imports. The staff expects to complete its assessment and to include a recommendation on approval or non-approval of this measure in the 2014 Article IV consultation report.

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FOR IMMEDIATE RELEASE
December 3, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes Ex-Post Assessment of Exceptional Access Under the 2009 Stand-By Arrangement and First Post-Program Monitoring Discussion with Sri Lanka

On November 27, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Ex-Post Evaluation of Exceptional Access under the 2009 Stand-By Arrangement (SBA), and the first Post-Program discussion with Sri Lanka.[1]

Sri Lanka's need for IMF support under the 2009 SBA was triggered by the onset of the global financial crisis, and set against a backdrop of rising fiscal and external vulnerabilities. These circumstances also coincided with the end of its decades-long conflict, necessitating international support in order to avert a potential balance of payments crisis. In July 2009, a 20-month SBA was initiated with the IMF. The envisaged access was 400 percent of quota (SDR 1.65 billion). The program was aimed at restoring viability to the balance of payments position, correcting fiscal imbalances that were interlinked to external imbalances, and strengthening the financial sector. Following two extensions, the Stand-By Arrangement was completed in July 2012.

Sri Lanka's economy continues to move forward, and has navigated recent market turbulence well. Overall GDP growth has been solid, but recent indicators underline some areas of concern: trade activity has been slow to pick up, tax revenues and public spending (including capital expenditures) are relatively low, and private sector credit growth has been declining. Staff project real GDP growth of 6.5 percent for 2013 as a whole, somewhat below the authorities' forecast of 7 to 7.5 percent. Headline inflation fell to 6.2 percent in September 2013, from 9.2 percent at end-2012. Base effects have been an important factor, but pressures appear to be easing, consistent with more moderate economic growth and lower food prices. Staff projects end-2013 inflation at 7 percent. Risks to the inflation outlook stem mainly from

[1] Post-Program Monitoring provides for more frequent consultations between the IMF and members whose arrangement has expired but that continue to have IMF credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

potential upward shocks to world commodity prices and lagged effects of the monetary easing. The external position has improved during 2013. Both imports and exports slowed in the first half of 2013, reducing the trade deficit. Exports have since started to pick up, while tourism receipts and inward remittances remain strong. This is expected to contribute to a projected 1½ percent of GDP reduction in the current account deficit in 2013, and broadly stable gross reserves.

Fiscal consolidation is facing headwinds. Despite some important tax reforms introduced in 2012, and the 2013 extension of the VAT to the retail and wholesale sectors, revenue performance has been weak thus far in 2013. To some extent, low revenues reflect the weaker imports, but the numerous tax exemptions and tax administration weaknesses remain the important causes of lower-than-expected revenues. In response to the revenue shortfall, the authorities have kept spending under tight control and are committed not to exceed the 5.8 percent of GDP 2013 deficit target. In the budget for 2014, they are targeting a further deficit reduction, to 5.2 percent, based on continued restraint of current spending and measures to broaden the tax base.

During 2013, monetary policy has been progressively eased. In October 2013, citing benign inflation outlook and the desire to stimulate the economy to reach higher growth in 2014, the Central Bank of Sri Lanka (CBSL) cut the policy rates by 50 basis points. This followed the 50 points cut in May 2013 and a reduction of reserve requirements by 2 percentage points at end-June. The easing of monetary policy throughout the year has been slow to feed through to bank lending, and private credit growth has continued to slow. In addition, as of June 1, 2013, the CBSL increased the reserve maintenance period of commercial banks from one week to two weeks, in order to allow greater flexibility in liquidity management, and announced further relaxation of foreign exchange regulations with effect from June 12, 2013.

The condition of the banking system has improved, and the Financial Sector Assessment Program update last year found that significant progress has been made in strengthening banking supervision. Having said this, vulnerabilities still exist—expressed in the recent rise in nonperforming loans. In addition, the recent shift from concessional/bilateral loans to external borrowing by banks and private entities raises the risks to external sustainability.

Executive Board Assessment

Executive Directors welcomed the opportunity to review macroeconomic and policy developments as part of post-program monitoring and the ex-post evaluation of exceptional access under the 2009 Stand-By Arrangement.

Directors were encouraged by Sri Lanka's strong growth and moderating inflation, and by the economy's resilience in the face of recent market turbulence. They noted, however, that

vulnerabilities remain, stemming from high debt and declining government revenues relative to GDP.

Directors commended the authorities' commitment to fiscal consolidation. They welcomed ongoing expenditure restraint, but cautioned against further cuts in capital expenditure to meet fiscal targets. Instead they underlined the importance of putting tax revenues on an upward trajectory. They emphasized, in particular, the need for further improvements in both tax policy and administration, including elimination or rationalization of exemptions and holidays.

Directors noted that the flexible exchange rate regime has acted as a buffer to external shocks, and welcomed the central bank's move to a less active intervention strategy. In view of the risks of further market turbulence ahead, they emphasized the need to allow time for the effects of monetary policy to feed through to private credit and money growth before considering a further easing.

Directors noted progress in financial sector development, and efforts to strengthen supervision and regulation. However, they saw remaining vulnerabilities, including the recent rise in nonperforming loans, and risks from the increase in external borrowing by banks and private entities on commercial terms. Given Sri Lanka's high level of debt and potential vulnerability to external shocks, they emphasized that close monitoring is warranted.

Directors welcomed the opportunity to review Sri Lanka's experience with the 2009 exceptional access Stand-By Arrangement, and agreed with the thrust of its conclusions. They concurred that the key program objectives of supporting macroeconomic stabilization and averting a balance of payments crisis were achieved. They noted, however, that the wider objectives of the program were only partially achieved as fiscal and external vulnerabilities persist, while durable progress needs to be made in reducing the losses of state-owned enterprises. Directors also highlighted the importance of aligning program design with a careful consideration of structural and implementation capacity.

Sri Lanka: Selected Economic Indicators, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Prel.			Proj.			
GDP and inflation (in percent)									
Real GDP growth	8.0	8.2	6.4	6.5	6.5	6.5	6.5	6.5	6.5
Inflation (average)	6.2	6.7	7.5	7.2	6.6	6.4	5.8	5.5	5.5
Inflation (end-of-period)	6.8	4.9	9.2	7.0	6.3	6.2	5.5	5.5	5.5
Core inflation (end-of-period)	8.9	4.7	7.5	6.1	6.3	6.2	5.5	5.5	5.5
Public finances (in percent of GDP)									
Revenue	14.6	14.3	13.0	12.5	13.0	13.3	13.4	13.6	13.5
Grants	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Expenditure	22.8	21.4	19.7	18.5	18.4	18.4	18.3	18.1	17.9
Central government balance	-8.0	-6.9	-6.4	-5.8	-5.3	-4.9	-4.8	-4.4	-4.2
Consolidated government balance 1/	-8.4	-8.6	-8.4	-5.8	-5.5	-5.4	-5.1	-4.6	-4.3
Central government domestic financing	4.5	3.5	4.1	4.4	3.5	4.0	2.8	2.2	3.0
Government debt (domestic and external)	81.9	78.4	79.1	76.6	75.8	74.7	72.9	70.6	68.3
Money and credit (percent change, end of period)									
Reserve money	18.8	21.9	10.2	-3.3	17.6	15.2	13.7	13.7	13.4
Broad money	15.8	19.1	17.6	13.1	16.4	15.0	13.6	13.6	13.6
Domestic credit	18.6	34.3	21.7	17.0	16.5	15.9	13.1	13.2	14.4
Private sector credit	24.9	34.5	17.6	17.0	22.7	20.0	17.8	18.0	16.3
Public sector credit	8.2	33.7	29.6	17.0	5.6	7.6	2.3	0.6	8.5
Balance of payments (in millions of U.S. dollars)									
Exports	8,626	10,559	9,774	9,826	10,686	11,164	12,062	13,297	14,458
Imports	-13,451	-20,269	-19,183	-19,406	-21,463	-22,784	-24,581	-26,753	-28,749
Current account balance	-1,075	-4,615	-3,915	-3,384	-3,502	-3,670	-3,810	-4,059	-4,032
Current account balance (in percent of GDP)	-2.2	-7.8	-6.6	-5.2	-5.0	-4.8	-4.6	-4.4	-4.0
Export value growth (percent)	21.7	22.4	-7.4	0.5	8.8	4.5	8.0	10.2	8.7
Import value growth (percent)	31.8	50.7	-5.4	1.2	10.6	6.2	7.9	8.8	7.5
Gross official reserves (end of period) 2/									
In millions of U.S. dollars	6,410	5,758	6,677	6,661	6,750	7,036	7,913	9,023	9,853
In months of imports	3.5	3.2	3.6	3.2	3.1	3.0	3.1	3.2	3.2
External debt (public and private)									
In billions of U.S. dollars	24.8	29.4	33.7	35.5	37.6	40.1	43.1	46.5	49.5
As a percent of GDP	50.1	49.8	56.7	54.3	53.5	52.3	51.5	50.9	49.6

Sources: Data provided by the Sri Lankan authorities; CEIC Data Company Ltd.; Bloomberg L.P.; and IMF staff estimates and projections.

1/ The consolidated government balance includes the Ceylon Electricity Board and the Ceylon Petroleum Corporation.

2/ Excluding central bank Asian Clearing Union (ACU) balances.

Statement by Rakesh Mohan, Executive Director for Sri Lanka
and K.D. Ranasinghe, Alternate Executive Director
November 27, 2013

1. Our Sri Lankan authorities thank staff for the useful dialog they had with the Ex-Post Evaluation (EPE) and Post-Program Monitoring (PPM) mission teams, on the 2009 SBA, which was concluded in July 2012. The successful implementation of the SBA supported program, which was commenced soon after the end of the decades long internal conflict in May 2009, helped Sri Lanka to strengthen its macroeconomic stability and build policy spaces in many areas. Our authorities are of the view that the EPE report provides a comprehensive assessment of the SBA, its design, execution and outcomes as well as lessons that could be drawn for both the authorities and staff for future engagements. The PPM report provides a broad assessment of the Sri Lanka's economy and its outlook.

Ex-Post Evaluation (EPE)

2. The IMF Executive Board approved a 20 month SBA for Sri Lanka in July 2009. The key objectives of the SBA, as highlighted in the *Memorandum of Economic and Financial Policies (MEFP),* were to cushion the impact of the global financial crisis, consolidate efforts to bring down inflation, and maintain Sri Lanka's strong economic growth. Accordingly, the SBA had been designed to rebuild the country's international reserves to a comfortable level, strengthen its fiscal position, improve the financial position of key SOEs, strengthen financial system stability and maintain monetary stability. Under a difficult global environment, the SBA provided required assurance and policy support to strengthen the macroeconomic stability, and bolster investor and consumer confidence, fairly quickly, along with the positive sentiment brought about by the ending of the decades-long internal conflict.

3. Sri Lanka's macroeconomic fundamentals have improved significantly in recent years. Economic growth during 2010 – 2012 averaged 7.5 percent. Inflation remained consistently at single digits since beginning 2009. The fiscal deficit has been brought down to 6.4 percent of GDP in 2012, from 9.9 percent in 2009, and the debt to GDP ratio reduced by 7 percentage points from 2009 to 2012. International reserves increased to USD 6.9 billion, equivalent to 4.3 months of imports by end 2012, compared to the 3.5 months envisaged under the program. By end September 2013, the reserves have further increased to USD 7 billion, equivalent to 4.4 months of imports. Although the financial conditions of two key SOEs, namely, Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) got strained during the program period due to volatile oil prices, weather related shocks including sharp reduction in hydropower generation, and delays in price adjustments, their performance has improved robustly in 2013. It is expected that both entities would operate at a breakeven level or even better from 2013 onwards, supported by reductions in cross subsidies, increased low cost power generation capacity, sizable price adjustments and improved financial management.

4. The key financial system stability indicators show significant improvement and resilience in the financial system since 2009. Our authorities share the staff's view that the

initial 20 month period for the SBA was too short to implement deep structural reforms. However, all structural benchmarks, under the SBA, except one, have been implemented and most of them were in relation to financial sector stability. With continued reforms and efficiency improvements, Sri Lanka's ranking under the World Bank's ease of doing business index improved to 81 in 2013, from 102 in 2009. As also highlighted in the staff report, Sri Lanka's EMBI Global spread has narrowed sharply and sovereign ratings of the country have also been upgraded during this period.

5. Notwithstanding the ownership and commitment of our authorities to implement the SBA supported program, recalibration of certain targets was required due to unexpected domestic and global developments, such as sharp changes in world commodity prices, weather related shocks, national elections, surge in post-conflict import demand driven mainly by rehabilitation and reconstruction activities. Our authorities are appreciative of the flexibility shown by staff and the Executive Board to update the targets to reflect real world challenges helping to enhance the effectiveness of the program. However, our authorities consider that the SBA could have generated more benefits to the economy, if there were no extensive delays in the approval process.

6. The authorities' views of the EPE are given in detail in Appendix 1 to the staff report.

Post –Program Monitoring (PPM)
Economic Growth and Outlook

7. The Sri Lankan economy grew by 7.8 percent in the third quarter of 2013 up from 6.8 percent in the second quarter. This growth was driven by the turnaround in the agriculture sector, high growth in factory industry, electricity, trade and port services. The agriculture sector recovered strongly to record a 7.0 percent growth in the third quarter, compared to weather affected negative growth of 0.5 percent in the same quarter of the previous year. Reflecting a gradual recovery in the external demand, the factory industry subsector grew by 6.8 percent, compared to the 3.2 percent in the previous year. Services sector grew by 7.9 percent over the 4.6 percent in the previous year.

8. The growth momentum is expected to continue in the fourth quarter of 2013 and in 2014. The relaxed monetary conditions, gradual recovery in external demand as witnessed since June 2013, and industrial production would largely underpin the higher growth. With the completion of several major infrastructure projects, production capacity of the economy is also undergoing expansion. Growth is estimated to be around 6.9 percent in the first nine months of the year. Overall, our authorities have projected 7.0 – 7.5 percent growth for 2013, and 7.5 per cent growth for 2014.

Fiscal Policy

9. Fiscal consolidation is given utmost priority in our authorities' policy agenda. The fiscal deficit has been steadily reduced over the recent years to record 6.4 percent of GDP in 2012. The government's target is to bring the deficit further down to 5.8 percent of GDP in 2013, and below 5 percent in the medium term. Our authorities recognize that the fiscal

operations in 2013 remain challenging mainly due to a shortfall in the tax revenue. Tax revenue as a percent of GDP has declined to 5.0 percent during the first six months of 2013, from 6.1 percent during the same period of the previous year. Supported by strict control of recurrent expenditure within the budgetary target, prioritizing capital expenditure and turnaround expected in the revenue collection during the second half of the year with the recovery in the external trade and in other economic activities, the government is positive in achieving the targeted fiscal deficit for 2013.

10. The reduction in the government revenue for 2013 was largely reflected in the imports based tax collection. As highlighted during the Article IV discussions in May 2013, this reduction can also be partly attributable to the tax reforms introduced in 2011, which sought to simplify the tax structure, broaden the base and lower the tax rates. Going forward, however, they are expected to have a significant positive impact. The government continued to take measures to strengthen the revenue base. It has streamlined granting of tax exemptions, specially focusing on strategically important large scale investments. At the same time, those companies which enjoy tax exemptions at present will come under the tax net within the next few years when the tax exemption agreements expire. The wholesale and retail businesses have been brought under the VAT net. Steps have also been taken to improve tax administration and compliance by introducing the Revenue Administration Management Information System (RAMIS), Treasury Management Information System (TMIS) and paying taxes on self assessment basis etc.

11. The 2014 budget was presented in the Parliament on November 21, 2013. The main focus of the budget and revenue enhancing measures proposed are given below:

The main focus of the budget;

- 7.5 - 8.0 percent of economic growth in the medium term
- Support the maintenance of inflation at around mid-single digit levels
- Strengthen fiscal consolidation: reduce budget deficit to 5.2 percent of GDP in 2014; 4.5 percent in 2015 and 3.8 percent in 2016 and reduce public debt to GDP ratio to 65 percent by 2016
- Facilitate the expansion of value creation and import competing industries
- Enhancing export earnings;
  - Diversify products, markets and promote value addition
  - Continue with flexible exchange rate regime and improvement in productivity to boost exports
- Ensuring profitability of State Owned Enterprises (SOEs)
- Strengthening public investment, food security and rural economy

Revenue Enhancing Measures:

- Extension of Nation Building Tax (NBT) covering all banking and financial
- institutions

- Broadening the base for Value Added Tax (VAT) on supermarket retail trade by reducing the threshold to Rs 250 million from Rs 500 million per quarter, while limiting the exemption to 25 percent of the turnover
- Telecommunication levy increased to 25 percent from 20 percent
- Revision of motor vehicle depreciation schedule for Customs Duty to prevent undervaluation
- Revision of cess rates on primary commodity exports and items vulnerable to undervaluation
- Revision in Special Commodity Levy/Customs Duty

The government expects an additional revenue of Rs 41.4 billion from the above measures in 2014. Accordingly, revenue as a percent of GDP is estimated to increase to 14.5 percent in 2014 from 13.6 percent in 2013, and budget deficit to decline to 5.2 percent in 2014 from 5.8 percent.

External Sector

12. The external sector remained resilient in 2013, despite weak external demand during the first six months of the year. Export earnings have gradually picked up since June 2013 and recorded an 11 percent year-on-year growth in September 2013. Overall, export earnings up to September during the year have recorded a marginal positive growth while imports recorded a marginal decline, leading to narrowing of the trade deficit by 2 percent. The current account deficit declined by 27 percent during the first half of 2013 with increased remittances, and services exports, including increased earnings from tourism. Our authorities have projected that the current account deficit would improve to 4.3 percent of GDP in 2013 compared with 6.6 percent in 2012. Reflecting relaxation of foreign exchange regulations and improved investor confidence, the capital and financial account also has strengthened with increased FDI, portfolio investment and other inflows to the private sector and to the banks. The Balance of Payments recorded a surplus of US dollars 585 million by end September 2013. Despite significant valuation losses due to depreciation of some major currencies against the US dollar, and sharp decline in the price of gold, the gross official reserves increased to US dollars 7.0 billion, equivalent to 4.4 months of imports by end September 2013.

13. As highlighted in the staff report, Sri Lanka remained largely resilient to the recent financial market volatility. Our authorities have prudently managed short-term capital flows and taken timely measures to address volatility that arose due to global uncertainties. Sri Lanka has opened only 12.5 percent of outstanding stock of Government Securities for nonresident investors, and a larger part of that constitutes investments in long term bonds by major investors. The exchange rate policy continued to focus on maintaining flexibility with cautious intervention to smoothen high volatility. From the second week of June through end August the Rupee depreciated by 5.01 per cent and gained value thereafter. Overall the rupee depreciated by 2.94 per cent against the US Dollar by end October 2013. On net basis the Central Bank had purchased US Dollars 239 million up to end October 2013.

14. Banks are allowed to raise funds abroad with prudent limitations to strengthen their

Tier II capital and to provide long term funding for the SME sector and plantations, construction, industry and manufacturing sectors.

Monetary Policy

15. Inflation continues to remain well anchored despite various supply-side shocks. The year-on-year inflation, which remained at single digit levels for nearly 5 years, moderated to 6.7 percent by October 2013, from 9.2 percent at end 2012. Core inflation has come down sharply to a lowest level of 2.6 percent in October from 7.5 percent at end 2012.

16. Private sector credit growth remained subdued since mid 2012, following tight policy measures introduced during early 2012, and the money supply growth remained well within the targeted level. Administered prices, mainly energy prices, have been substantially adjusted in 2012 and 2013 to reflect the cost and therefore, significant upward adjustments in the near term is unlikely. The pressure on the Balance of Payments has also been contained with a mix of policy measures introduced since early 2012. The benign inflation expectations and still negative output gap provided ample space for the authorities to loosen the monetary policy by reducing policy rates by 100 basis points in two stages in May and in October 2013 and reducing SRR to 6 percent from 8 percent, in July 2013.

Financial Sector Policies

17. The financial sector remains sound and resilient with strong CAR, and healthy profitability and liquidity. In the context of slow credit growth, asset quality of the banking sector slightly weakened with NPL ratio rising from 3.6 percent at end 2012 to 4.7 percent at end June 2013. The increase in the NPL ratio was largely attributable to the increased NPLs relating to gold pawning, as delinquencies increased with the sharp drop in the market price of gold. The share of advances granted against gold has been about 15 percent of the total bank lending. The provision coverage ratio also declined to 44.9 percent by end June, largely due to the increase in pawning related NPLs which did not require provisioning as the value of gold collateral covered the loan value. Banks have however, now started to make provisions for uncovered exposures and lowered their internal LTV ratios in relation to gold pawning.

18. As highlighted in the staff report, one small finance company, representing less than 0.06 percent of the total financial sector assets, faced liquidity problems due to mismanagement. The Central Bank immediately removed the CEO of the company and brought its management under a managing agent, which is an experienced and leading licensed finance company. The managing agent has prepared a restructuring plan, which has been approved by the Monetary Board of the Central Bank. Under the general guidelines issued by the Central Bank, liquidity could be provided to such finance companies with liquidity problems through the Deposit Insurance Fund (DIF), backed by 100 percent resalable assets. However, no such liquidity has been provided so far through the DIF.