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# Sri Lanka: 2002 Article IV Consultation and Final Review Under the Stand-By Arrangement—Staff Report; Staff Statement; and Public Information Notice and the News Brief on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2002 Article IV consultation with Sri Lanka and Final Review Under the Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the combined 2002 Article IV consultation and Final Review Under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **June 18, 2002**, 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 August 19, 2002**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **September 3, 2002** updating information on recent economic developments.

- a Public Information Notice (PIN) and a News Brief, **summarizing the views of the Executive Board as expressed during its September 3, 2002, discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

The document(s) listed below will be separately released.

Selected Issues and Statistical Appendix paper

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

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.**

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INTERNATIONAL MONETARY FUND

SRI LANKA

**Staff Report for the 2002 Article IV Consultation and Final Review Under the Stand-By Arrangement**

Prepared by Asia and Pacific Department and Policy Development and Review Department

Approved by Wanda Tseng and Masood Ahmed

August 19, 2002

- **The 2001 Article IV consultation was concluded on April 20, 2001 on which occasion Executive Directors also approved a 14-month Stand-By Arrangement (SBA), amounting to SDR 200 million (48 percent of quota) (EBS/01/41).** In approving the arrangement, Directors noted that the main challenges were to arrest the severe deterioration in the fiscal accounts that took place in 2000 and to press ahead with an ambitious structural reform agenda to enhance private sector driven growth. The Executive Board completed the first and second reviews on April 15, 2002 (EBS/02/59).
- **A staff team visited Colombo during June 7-18, 2002 to conduct the 2002 Article IV consultation discussions and reached understandings on the completion of the final review of the current SBA.** Further discussions were held when the Prime Minister visited Washington in July 2002.
- **Performance under the program was satisfactory during the first six months of 2002.** In particular, all the end-April performance criteria were observed, and the structural benchmarks have been completed.
- **Preliminary PRGF discussions were also held, based on the current draft Poverty Reduction Strategy Paper.** The authorities have initiated the core structural measures that could form the basis for a possible PRGF arrangement later in 2002.
- **The SBA was extended to September 19, 2002 on a lapse-of-time basis to allow the completion of the final review.** A purchase for SDR 48 million will become available upon completion of this review.
- **Sri Lanka accepted the obligations of Article VIII, Sections 2, 3, and 4 in March 1994**, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.
- The staff team consisted of Messrs. Carter (head), Kanda and Leigh (APD), Annett (FAD), Singh (PDR), and Ms. Abraham (Administrative Assistant), and was assisted by Mr. Ul Haque (Senior Resident Representative). Mr. Worrell (MAE) presented the FSAP findings to the authorities. The staff met Prime Minister Wickremesinghe, Finance Minister Choksy, Minister of Economic Reform Moragoda, other cabinet ministers, Governor Jayawardena of the Central Bank (CBSL), officials, businessmen, and NGOs. Mr. Jayatissa, Alternate Executive Director, participated in the discussions.

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## Executive Summary

- **The Article IV consultation discussions focused on the policies required to firmly reestablish fiscal and external sustainability through lasting fiscal consolidation and economic reforms to promote growth.** In addition, this report reviews the results of the recent FSAP and fiscal ROSC studies and the finalization of the data ROSC.

- **The United National Front (UNF) government that came to power in December 2001 is pursuing a two-pronged strategy of macroeconomic stabilization and deeper structural reform**, while at the same time pushing vigorously the peace process.

- **After negative growth and major problems with exports and tourism in 2001, the macroeconomic situation is improving in 2002.** There has been a decline in **inflation** in recent months—notwithstanding sharp increases in administered prices, headline inflation was in the range 8-9 percent for the 12 months to July, on track to meet the year-end target of 7-8 percent. Although economic recovery remains sluggish, **real GDP** bottomed out during the first quarter of 2002—improved rains, an end to power cuts, a stock market rally, improved business confidence, and the global recovery, suggest that reasonable growth is likely in the second half of the year.

- **The external position has stabilized in recent months, and the rupee, which is freely floating, has remained broadly stable during this period.** The trade deficit during the first five months of 2002 was similar to 2001, and reserves continued to rise steadily through early-August. The current account deficit is projected to remain at about 2½ percent of GDP in 2002. Meanwhile, prospects for both portfolio and foreign direct investment flows have improved, following the ceasefire.

- **Performance under the Stand-By Arrangement has been satisfactory, although there are pressures on the budget.** All the quantitative performance criteria for end-April 2002 were met and the structural benchmarks completed, albeit with a small delay. Fiscal revenue performance was reasonable in the first half of the year, and the new VAT was introduced (after some delay) from August. The government has maintained tight control over recurrent expenditure. Moreover, to offset some tax rate concessions granted to reduce the cost of living, the government has identified additional spending cuts. The Central Bank of Sri Lanka (CBSL) continues to maintain a prudent monetary stance. Reserve money and central bank net domestic assets (NDA) remain broadly on track.

- **The authorities have taken several important steps on their structural reform agenda that could be supported by a PRGF later this year.** On privatization, the sale of Lanka Marine has been finalized and shares of Shell Gas Lanka are soon to be listed on the Colombo stock exchange. In the financial sector, the authorities have initiated action to reform the two state banks, while improving the functioning of the central bank. The electricity reform bill will shortly be presented to Parliament, paving the way for the restructuring of the electricity board (CEB) and cabinet has approved draft bills that will initiate the restructuring of the petroleum corporation (CPC) and initiate labor market reforms.

## I. INTRODUCTION AND BACKGROUND

1. **The key challenges facing Sri Lanka in the past twenty years have been inadequate growth and continued dominance of the public sector, with large deficits leading to a high level of government debt and constraints on the private sector**. Despite high indicators of social development, limited economic reform—making the economy insufficiently competitive—and the need to focus on a civil conflict, combined to keep Sri Lanka a low-income country.

2. **In early 2001, Sri Lanka was facing a looming foreign exchange crisis and severe macroeconomic imbalances**—with low reserves, large import bills due, and an exchange rate level and regime (a crawling band) that was no longer credible. With high defense spending, the fiscal deficit was 10 percent of GDP, and public corporations had accumulated significant losses.

3. **In concluding the 2001 Article IV Consultation and approving the SBA on April 20, 2001, Executive Directors stressed that the main challenges ahead were to arrest the severe deterioration in the fiscal accounts and to press ahead with an ambitious structural reform agenda**. Such a reform program was expected to be supported later by a PRGF arrangement.

4. **After making good progress in the first half of 2001, the macroeconomic situation deteriorated as political developments and external shocks slowed the economy and the authorities were not able to take corrective policies to keep the program on track**. Initially, policy adjustments agreed under the SBA led to improvements—the loss of reserves was halted following the float of the rupee and the program met its other fiscal and monetary objectives for June. However, the government lost its parliamentary majority in July leading eventually to December elections. Meanwhile, the global slowdown, a major drought, an attack on Colombo airport in July, and the events of September 11 contributed to a sharp decline in GDP in the second half of the year. Drought-affected food prices also drove up the headline rate of inflation. The balance of payments outcome in 2001 was weaker than programmed due to the delays in external financing (including privatization receipts). The slowing economy and a lack of resolve weakened the budget performance considerably and progress was delayed on structural issues.

5. **Under the new government, performance under the program has been satisfactory since the completion of the first and second reviews of the SBA on April 15, 2002**. All end-April 2002 performance criteria and indicative benchmarks were met and the structural benchmarks were completed, albeit with a small delay. Moreover, recent measures signal the authorities' determination to pursue an ambitious structural agenda. There has been close dialogue between the authorities and the Fund staff and management. Fund technical assistance has generally been put into effect, though in the fiscal area, there have been some delays and adjustments to proposed measures (Annex II).

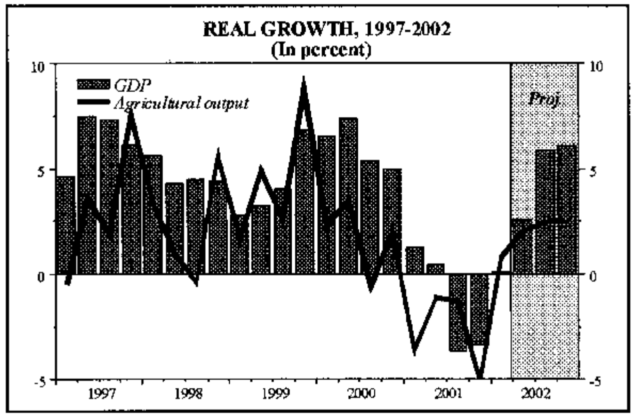
6. **Major initiatives have been taken to resolve the civil conflict during the first half of 2002**. Following the signing of a ceasefire agreement in February 2002, the government is scheduled to commence formal talks with the Tamil Tigers (LTTE) in Bangkok around mid-September. President Kumaratunga, whose Peoples Alliance party lost the December 2001

parliamentary elections, remains in office until 2005. Even though there is considerable ongoing friction with the UNF government, President Kumaratunga continues to express her support for the peace process as well as the economic reform policies of the government.

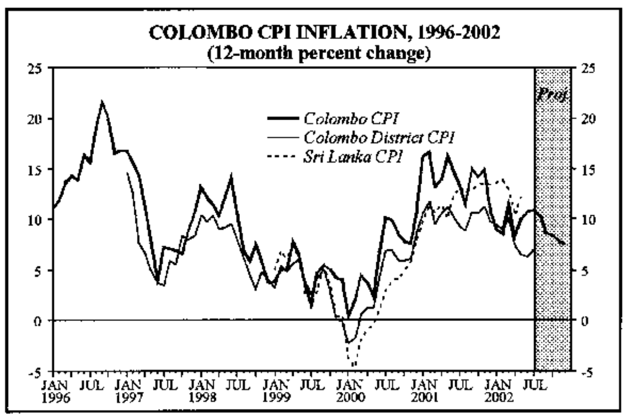
## II. Recent Economic Developments

7. **Economic developments were generally encouraging during the first half of 2002.**

- **The macroeconomic situation has improved.** GDP growth turned positive in 2002 Q1, following two quarters of contraction in 2001. The improvement largely reflected domestic-oriented activity, with robust growth in paddy output (6 percent) and transport and communication (5¾ percent). However, export/tourism performance continued to reflect the impact of the adverse shocks of 2001—weak external demand, and the Colombo airport and September 11 attacks. Moreover, power cuts were required until mid-June, affecting business in general. However, improved rains, the end of power cuts (albeit through the use of expensive temporary thermal power), the recent rally in the stock market, business confidence boosted by progress toward peace, as well the global recovery, suggest that increased growth is likely in the second half of the year. The staff forecast real GDP growth of about 3¾ percent in 2002.

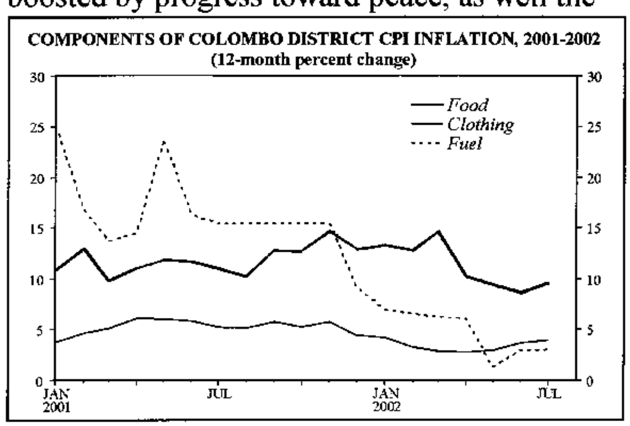


REAL GROWTH, 1997-2002
(In percent)



COLOMBO CPI INFLATION, 1996-2002
(12-month percent change)

- **Trend inflation has declined, albeit at a slow pace.** Headline inflation was in the range 8-9 percent for the 12 months to July, consistent with the annual inflation target for 2002. However

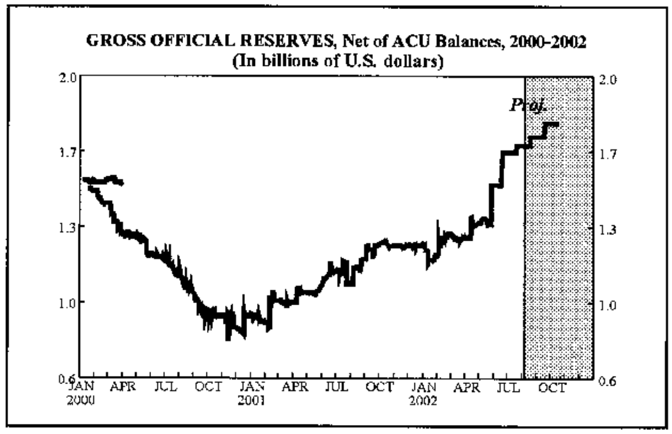


COMPONENTS OF COLOMBO DISTRICT CPI INFLATION, 2001-2002
(12-month percent change)

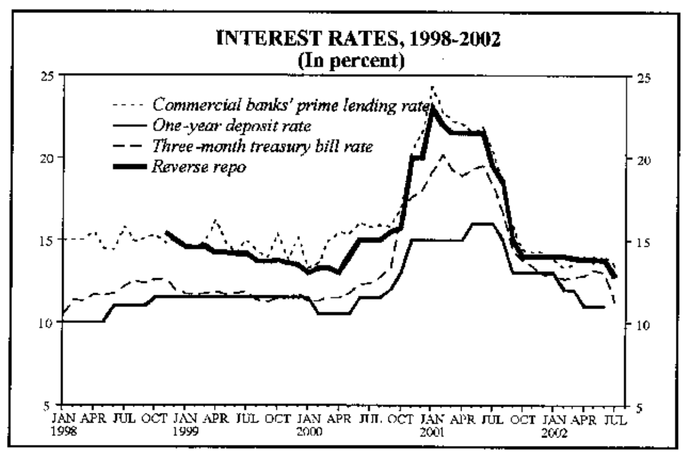
there has been significant variability around this trend, largely reflecting temporary food supply changes and increases in administered prices.

- **The external position has stabilized as expected**. The trade deficit narrowed during the first four months of 2002 before increasing in May, and official reserves continued to rise steadily through early August. Recent progress on the peace front has improved the outlook for both portfolio and FDI flows.

- **Most of the foreign exchange regulations that initially accompanied the float of the exchange rate in early 2001 have been removed**. The rupee has been allowed to respond to market forces, with the Central Bank of Sri Lanka (CBSL) intervening to build up reserves. In nominal effective terms, the rupee depreciated by 9 percent in 2001, and has depreciated a further 6 percent through mid-2002. In real effective terms, the rupee remained roughly constant over the last 18 months, as inflation remained higher than for partner countries. The authorities have been able to remove progressively a number of foreign exchange regulations—low net open position limits, restrictions on forward transactions, prepayment of bills, and the foreign exchange operations of state enterprises—as concerns over reserves and volatility subsided.[1]




- **The CBSL continues to maintain a prudent monetary stance**. Both the reserve money and net domestic assets (NDA) targets have been met, although broad money growth is running slightly ahead of program projections reflecting increased demand for money related to unanticipated liquidity demand coming from the North and East following the ceasefire. The




[1] While liquidity has improved since the float and forward market activity has increased (and risk premia declined) since position and time limits were relaxed in March, the functioning of the foreign exchange market remains weak. Proposed corrective measures were detailed in the report on the Financial Sector Assessment Program (FSAP).

CBSL is generally adjusting policy rates only gradually as inflation eases—the repo and reverse repo rates were reduced by 100 basis points in July, the first significant change since last September.

8. **The fiscal agenda is on track, with a commitment so far to achieve the overall budget deficit target of 8½ percent of GDP for 2002 and reduce state enterprise losses.** However, there have been some delays and departures from the measures announced in the budget.

- **All end-April fiscal targets under the SBA were achieved and prospects look reasonable for the full year.** With expenditure under control, net domestic financing for the first half of the year was Rs 75 billion, close to the program projection (after adjustment for external financing shortfalls). Based on performance through June, the budgeted revenue projection was on course to be met—a shortfall in nontax revenue was expected to be compensated for by higher income taxes and excises.

- **Many of the major tax policy changes announced in the budget have been implemented, including VAT, lowering the import surcharge, simplifying income tax and eliminating stamp duties.** The authorities decided to delay the VAT until July, to avoid taxpayers having to file quarterly returns for both VAT and GST. The VAT was finally introduced on August 1, after a legal challenge was overcome. However, the rate applied to several items was lowered (see paragraph 14).[2] The VAT delay and rate changes cost about ½ percent of GDP, largely offset by higher National Security Levy (NSL) revenue.

- **The large taxpayers unit (LTU) has been extended to GST taxpayers under a single commissioner and the government is planning to harmonize the tax incentive regime under the Inland Revenue Act.** No new Board of Investment (BOI) incentives have been granted this year, although the BOI currently retains its powers to override tax legislation.

- **Based on information through April, most expenditure items are on course to remain within their budgetary allocations.** Expenditure in a small number of areas, including Samurdhi and the fertilizer subsidy, was high through April. Because yields on treasury securities remain high, interest costs could exceed the budget estimates by around ¼ percent of GDP.

- **The financial position of the public corporations stabilized over January-May.** The stock of credit to public corporations averaged Rs 40 billion (2½ percent of annual GDP) over the period, with some reduction for CPC debt reflecting increases in administered prices for petroleum products and profits made by CPC during the first quarter of 2002 (Rs 2½ billion). However, CEB made a loss of Rs 1½ billion during the first quarter

[2] The Supreme Court ruled in mid-July that, with some minor amendments, the VAT legislation was within the constitution. A full description of the changes in the tax regime and rates is included in the accompanying selected issues paper.

of 2002 and the electricity price hike on April 1 only started to improve CEB's finances from June (though losses continue).

9. **Satisfactory progress has also been made on the structural agenda—the authorities have completed the program's structural benchmarks and started further reforms.**

- **The privatization program is on track and state enterprise restructuring has begun**—the government has sold the Pelwatte sugar company and finalized the sale of Lanka Marine (benchmarks), and in August will list on the stock exchange the 49 percent stake in Shell Gas Lanka. Sri Lanka Telecom (SLT) is expected to be listed on the stock exchange in September and 15 percent of the shares sold, while the sale of Sri Lanka Insurance Company should be completed by November. The unbundling of CEB was underway, with the Electricity Reform Act drafted to allow private companies into supply and transmission—approval has been given for a coal plant to be constructed.[3] The authorities have requested financial bids from shortlisted investors interested in a public/private partnership to take over the bus companies. To cover all agencies, a multisector regulatory body is being established.

- **The Prime Minister has set up committees to implement various aspects of financial sector reform**. The initial work included reports on clarifying the relationship between the two state banks, the government, and the public corporations and developing a strategy for recalcitrant debtors. Following a joint Bank-Fund TA mission to discuss the options for the insolvent Peoples Bank (PB), the authorities have chosen to convert PB into a public company and then separate it into a commercial bank, a savings division, and a debt recovery unit. The eventual aim is to privatize the commercial bank part. The Bank of Ceylon has so far met most of its quarterly performance targets and has reached agreement with the World Bank on the targets for 2002 and 2003— Fitch recently rated it AA- (very high credit quality) for long-term debt.

## III. The Macroeconomic Objectives and Policies Through 2003

### A. Overall Objectives

10. **The discussions focused on the need to restore sustainability of government policies in terms of the fiscal stance, while maintaining external competitiveness**. The mission and the authorities agreed on the macroeconomic framework and reached understandings on the key policies for the remainder of 2002. Notwithstanding the risks to the economic recovery and concerns about international oil prices, the macroeconomic framework for 2002 in the last staff report (EBS/02/59) remained broadly appropriate. In line with the trade deficit during the first five months of 2002, the overall surplus is projected to be consistent with the annual gross reserve target of $1.8 billion.

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[3] During discussions with the private sector, reform of CEB was indicated as the first priority.

11. **The government emphasized its determination to continue with the stabilization policies—fiscal consolidation, prudent monetary policy, a competitive exchange rate, and reserve accumulation—while implementing the initial phase of a radical program of structural reform.** They stressed, however, that the challenge was to keep the public support for the difficult measures required. The public was looking for an immediate "peace dividend" to help with the cost of living and boost the economy. They argued for flexibility in implementing details of the program.

## B. Fiscal and Quasi-Fiscal Policies

12. **The mission urged the authorities not to allow the 8½ percent deficit target for 2002 to slip.** Given that public debt was more than 100 percent of GDP, fiscal consolidation and debt reduction remain key priorities. In this context, the mission stressed that fiscal sustainability depended critically on pursuing the agreed policies (Appendix I). The authorities reiterated their intention to keep the primary deficit to about 1 percent of GDP, compared to 4 percent of GDP in 2001.

13. **The mission endorsed the government's tax reform strategy, but was concerned about pressures to narrow the tax base by providing relief measures.** Given the tax regime changes, the revenue projections this year are subject to more than the usual degree of uncertainty. In particular, the introduction of the VAT was a source of fiscal risk; the mission stressed the importance of a smooth transition, with no major revenue shortfalls. The authorities have been facing demands for exemptions from the various new taxes. At the time of the mission, the only major concession had been to lower the Port and Airport development levy rate for exporters.[4] The authorities accepted that they had no room for maneuver in granting further exemptions, without jeopardizing the revenue and overall targets.

14. **In the end, the final VAT rates introduced in August were lower than earlier indicated for several products, but the government took offsetting fiscal measures.** During the mission, the team had stressed the need to minimize the list of goods and services exempt from the VAT, given the existence of a lower rate and the plan to exempt several types of essential goods.[5] However, subsequent to the mission and in an effort to counter fears that the VAT would result in higher prices, the authorities revised the rate structure, shifting selected goods into the lower rate category and exempting a further list of goods (e.g., spices, pharmaceuticals). The estimated revenue loss was Rs 800 million (Rs 2 billion—0.1 percent of GDP—for a full year). After discussions with the Fund, the Cabinet has approved offsetting spending cuts, mainly recurrent items spread over several ministries, totaling nearly Rs 2 billion. The net savings would be used to repay part of CPC debt through transfers from the budget (see

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[4] The 1 percent levy was reduced to ¾ percent. One aim of this levy was to get some revenue from BOI companies, which are exempt from most taxes.

[5] See detailed in the accompanying selected issues paper.

paragraph 17). They also agreed to reconsider this weakening of the tax base when formulating the 2003 budget and the move during 2003 to extend the VAT to the retail sector.

15. **The authorities are keen to undertake a bold tax administration reform, creating a unified revenue authority by 2003**. This envisaged authority would encompass the departments of Inland Revenue, Customs, Excise, and the tax and customs administration components of the BOI. The government has set up an advisory committee to oversee the implementation, and intended to enact some basic enabling legislation by end-August. It regards this project as a reform priority, and FAD and AsDB are providing technical assistance. Although concerned about the timetable for both passing legislation and creating a working organization, the mission supported the plan in principle, especially as it seemed to be a politically feasible way of removing the BOI from tax and customs administration. It would also allow the authorities to hire senior management from outside the civil service and not be bound by the rigid salary and promotion rules. However, noting that, in the meanwhile, the BOI retained its powers to override tax legislation, the mission pressed for a speedy harmonization of tax incentives along the lines set out in the budget. This was expected to be done by end-2002.

16. **Controlling current expenditure was paramount**. Both the staff and authorities recognized that the size of government in Sri Lanka was greater than the politically feasible revenue generating capacity. The authorities saw the need to make expenditure more efficient, and in particular, reverse the growth of government wages and transfers.

- The government has taken measures to reorganize its debt portfolio, problems with which contributed to high interest costs in 2002. As promised, its bank overdrafts have been reduced sharply. These steps will help contain **interest payments**. However, because treasury bill and bond yields fell less than expected in the first half of 2002, interest costs could overshoot the budget by Rs 4 billion (¼ percent of GDP).

- On the **wage bill**, the authorities reiterated their commitment to the civil service hiring freeze. The government also informed the mission that it did not intend to grant the large wage increases recommended by the Salaries Commission—these recommendations had assumed a 30 percent reduction in staffing—desirable but not feasible in the near term.

- The mission endorsed a current government **expenditure review** to weed out inefficiencies, redundancies, and overlapping responsibilities. The mission urged further reforms along the lines of the fiscal ROSC recommendations (see Box 1), encouraging the authorities to be bolder in rationalizing the number of public institutions.

- The newly established **Defense Spending Monitoring Committee** indicated to the mission that the government is holding the line on defense costs—barring a renewal of conflict, the budgeted defense expenditure allocation would not be exceeded. The committee's work focused on reconciling differences between the ministry of defense and the treasury, and making sure there is no deviation from the budget in spending or incurring commitments. The mission was assured that the safeguards in the system were working: no letter of credit could be issued without treasury authorization, and a full schedule of deferred payments on past purchases has been incorporated into the budget. No approval for any deferred payment purchases had been granted in 2002 to date.

## Box 1. Fiscal Review of Standards and Codes (ROSC)

**An FAD mission visited Colombo during May 13–22, 2002 to assess fiscal transparency practices in Sri Lanka**. The ensuing fiscal ROSC forms part of the Article IV consultation.

**Fiscal policy is generally transparent**. The legal and administrative framework is reasonably well developed and appears to be closely observed. The government compiles and publishes detailed fiscal accounts of the central government. All donor inflows are channeled through the budget. Extrabudgetary funds are minimal. Public corporations maintain separate and aggregate accounts.

**A number of pending reforms should further increase transparency**. A proposed new Public Finance Act would rigorously codify the rules for the formulation and execution of the budget. From 2003, the authorities plan to present a budget grounded within a medium-term expenditure framework, which will be used to integrate systematically recurrent and capital spending. A number of proposed reforms—such as establishing a revenue authority, subjecting public corporations to market discipline, and amending regulations and labor laws—will also aid transparency.

**Nonetheless, weaknesses remain—**the following areas could be improved:

- **The distinction between government departments, noncommercial public enterprises, and commercial public enterprises is not always clear**.
- **Tracking arrears is a problem**. The present cash accounting system should be augmented to provide information on both accounts payable and expenditure commitments.
- **There has been a large deviation between the budget projections and fiscal outturns in recent years**. A transparent system for inter-year adjustments to the budget should be developed, with supplementaries based on a thorough mid-session review.
- **Dissemination of fiscal data could improve**. Additional mid-year budget data should be published. A set of consolidated accounts for the central and provincial governments should be compiled and disseminated in a timely manner. The consolidated accounts of the commercial public enterprises should also be published.
- **A systematic accounting of implicit and contingent liabilities should be initiated and published**.
- **Given the intention to reduce the role of the public sector, an overarching privatization strategy should be developed**. This would identify the functions to be transferred to the private sector and including a timetable for divestiture, as well as criteria for determining the residual role of government and transitional regulations.
- **The process of weaning the government from captive sources of financing, especially the Employees Provident Fund (EPF), should be given high priority**. This could take the form of establishing an independent board of directors for the EPF, a transparent link between the rate on rupee securities to marketable securities, explicit recognition of implicit taxes and subsidies, and allowing the EPF to diversify at least a portion of its portfolio internationally.
- **To enhance transparency, the reports of the Auditor General, and recommendations made by parliament in response, should be published in a timely fashion**.

- The **Samurdhi** welfare program was being streamlined to avoid an expenditure overrun. A May circular instructed administrators to cut 25 percent of benefits in all districts, which should allow the subsidy to remain well within the Rs 10 billion budgetary allocation. The new Welfare Benefit Law was presented to parliament in August, setting eligibility criteria and penalties to reduce politicization and mistargeting. The Samurdhi ministry aimed to eliminate from the scheme 200,000 families by the end-2002 (and a further 200,000 in each of the next five years) through further rationalization.

- The new **fertilizer subsidy** that targeted payments only to farmers had not yet been introduced (a revised scheme is now expected to become effective mid-September). The authorities felt confident the envisaged savings could be realized, but accepted the need for strong political will to avoid any expenditure overrun on this item.

- Although no problems had emerged so far, there could be overruns in budget **subsidies to public corporations and institutions** if the pace of reform of these bodies is not accelerated. See Box 2 for details of the government's current strategy for state agencies.

- To limit stifling the early stages of a recovery by raising tax rates, the mission noted that in the event of **revenue shortfalls**, the required fiscal adjustment would need to come from **further current expenditure restraint**. The authorities agreed that they would take the contingency measures outlined in their MEFP (EBS/02/59)—as a last resort domestically financed capital spending might have to be compressed.

17. **Consistent with the 2002 Budget, the authorities maintained their commitment to reduce the debt of public corporations**. The government's strategy for dealing with loss-making state entities had evolved since coming to office. The focus is now on divesting the assets of public corporations and introducing competition, as a way of dealing with the accumulated public corporation debt and of guarding against any further quasi-fiscal losses. The mission supported this approach but expressed concerns about the pace of action.

- **During the mission, the authorities were urged to maintain and publish the details of the automatic petroleum product pricing formula for CPC**, to ensure domestic prices reflect changes in world oil prices. The authorities agreed to full publication.

- **The team also pushed for more concrete plans to deal with bus and railway losses**, and encouraged the authorities to go further in rationalizing noncommercial public institutions.

- **Subsequent to the mission, in July the government abolished the debt recovery charge component of the formula**, reducing the price of gasoline and diesel by 12 and 8 percent, respectively. The staff argued that the change represented a quasi-fiscal slippage (albeit small, under ¼ percent of GDP), and a loss of credibility. Staff further

## Box 2. The New Government Strategy for Public Corporations

**The state sector is pervasive**. Despite recent privatization, 75 commercial public corporations remain in government hands. Other public corporations—including the railways and postal service—are fully integrated into the budget and form their own government departments. There are also around 125 noncommercial public bodies (public institutions), including development authorities, research institutes, and universities.

**The large public sector has exacted a large fiscal and quasi-fiscal cost on the economy**. Public sector entities have a substantial impact on the budget. Total recurrent and capital transfers to public corporations and institutions reached 3 percent of GDP in 2001. Quasi-fiscal losses—with commercial public corporations borrowing from domestic banks—also increased in recent years, as services were not priced to cover costs and overstaffing and weak management were pervasive. Owing mainly to the failure to raise administered prices in the face of world oil price increases, the losses of state-owned enterprises rose to 1½ percent of GDP in 2000. The stock of outstanding public corporation debt stood at around 3 percent of GDP by the end of 2001 (from 1 percent of GDP at end-1999).

**The approach of the last government was based on cost recovery**. With this approach, some progress was made under the Stand-By Arrangement to stem quasi-fiscal losses, although the nominal public corporation debt stock did not change. While higher petroleum prices in 2001 allowed CPC to reduce its debt, this was neutralized by increasing CEB losses despite a 25 percent surcharge, reflecting the drought-induced high cost of thermal power, and higher overdraft charges. An automatic pricing formula for petroleum products was introduced at the end of 2001. By maintaining petroleum prices at their end-2001 levels, when world prices had fallen, the government explicitly mandated a profit for CPC, which would be used to pay down debt. Less progress was made curbing budgetary subsidies. Current transfers to public corporations increased in 2001 owing mainly to large unplanned transfers to the bus companies and no action on railways and posts.

**The UNF government has adopted a new strategy for dealing with troubled public corporations, based on involving the private sector**. Rather than rely solely on cost recovery, the UNF government intends to accelerate structural reform, focusing on private participation in most state enterprises.

- Steps are being taken to hive off the distribution and retail functions of CPC; the cabinet has approved the amendments to the CPC Act, which would open up the import operations to private competition. From July 16, the government removed the debt recovery charge from the petroleum pricing formula, on the grounds that it did not wish to punish consumers for past CPC mistakes. Instead, the government intends to accelerate privatization. CPC reported profits of Rs 2½ billion in the first quarter of 2002; the abolition of the debt recovery charge entails a quasi fiscal slippage (around Rs 2-2½ billion).
- Average electricity tariffs were increased by 35 percent on April 1, 2002. Despite this, CEB still expects to make losses of Rs 5-10 billion, depending on the availability of hydropower, as the government has committed to purchase emergency thermal power to end the daily power cuts. The government plans to unbundle the generation, transmission, and distribution components of CEB; the cabinet has approved the electricity reform bill, which should be enacted by September, removing CEB's legal monopoly.
- The authorities also intend to dispose of CWE, and bolster private sector involvement and corporate governance in public corporations in general.
- To streamline the necessary regulatory regime as the private sector take over much of the utilities and other state functions, a Multisector Regulatory Authority is being introduced in August.
- The 2002 budget took some direct action to reduce subsidies, in particular by increasing postal rates.
- Since then, the authorities have announced plans to have private investment in all the bus companies.
- A private sector/government partnership option is also being considered for the railways.
- In contrast, there has been virtually no attempt to rationalize noncommercial public enterprises (statutory boards); recurrent transfers (mostly wages) remain at close to 1 percent of GDP in 2002.

argued that any relief measures should be targeted to the poorest sections of society. In response, the authorities are taking measures to offset this slippage. The authorities will sell by end-2002 a portion of CPC assets, which include storage facilities, pipelines and depots. They will also use the proceeds of land sales now initiated to reduce CPC debt. Moreover, there may be transfers from the budget, using part of the savings identified on other spending (see paragraph 14).

18. **The authorities agreed that further fiscal consolidation was essential in 2003 to lower the debt burden**. In preliminary discussions on the 2003 budget, expected in November 2002, they accepted the need to reduce further the overall deficit and nonconcessional financing. The mission argued for a deficit target below 7 percent, based on a large reduction in current expenditure and revenue gains from improved administration under the new unified revenue authority. It supported the government's plan to reduce the corporate tax rate from 35 percent to 30 percent and to eliminate the import surcharge from 2003. The authorities agreed to consider a medium-term plan on taxation of civil service salaries as part of the preparatory steps for the 2003 Budget, together with proposals on pensions, recruitment policy and retirement age. A large increase in the capital budget was envisaged, given the need for reconstruction in the north and east—the authorities stressed that the final overall deficit target would depend on the donor-funded programs being formulated. Allowance would also be needed for the fiscal costs of restructuring the public sector. Depending on any changes that could eventually emerge from the peace discussions, the 2003 budget may also reflect some fiscal devolution.

## C. Monetary and External Policies

### Monetary Policy

19. **The CBSL intends to maintain a prudent monetary stance**. Reserve money would continue to be the nominal anchor, although the CBSL's monetary policy committee monitors other indicators of monetary conditions, including forward exchange rates. The mission reiterated that the CBSL should stand ready to tighten reserve money to adhere to the program's broad money target and avoid a buildup in inflationary pressures. **On interest rate policy**, the CBSL noted that they continued to balance the need to avoid inflation and the concerns of the business community to stimulate the economy. The staff supported the recent reduction of repo rates (100 basis points) given the trend decline in inflation, but advised the authorities that further significant easing should be avoided until it is clear that fiscal consolidation has taken hold.

20. **Steps are being taken to implement MAE's recommendations for enhancing the monetary framework and improving the effectiveness of policy instruments**. After publicizing the monetary policy framework and reserve money program targets, the CBSL intended to shift to more active open market operations to increase control over base money.[1] Moving to an inflation targeting regime remained the medium-term objective. The government

[1] The monetary framework is to be posted on the web (http://www.centralbanklanka.org/). A Fund external advisor from Sweden's RiksBank is assisting the authorities.

also intends to expand the Monetary Board (the CBSL's highest decision body) to include more private sector participants to bring greater outside expertise and strengthen accountability. The mission stressed that changes should be carefully designed to avoid conflicts of interest arising from the differing objectives of the private sector and the monetary authorities.

### Exchange Regime

21. **The authorities are committed to the current floating exchange rate regime and have kept the 2002 reserve target unchanged**. The authorities indicated that intervention in the foreign exchange market would continue to be limited to the smoothing of extreme volatilities and the achievement of the international reserve targets. They considered the exchange rate level to be broadly appropriate, but while maintaining the end-year reserve target, they highlighted the risks to achieving reserve accumulation if capital inflows fell short. The mission concurred with the authorities that the rupee remains broadly competitive, and noted that the reserves target was attainable if reforms proceeded. Staff also stressed that the authorities should avoid any moral suasion or increases in the foreign exchange exposure of public corporations. Given evidence of past overvaluation and its impact on the external position, both staff and the authorities saw it was crucial that competitiveness be maintained.[2]

22. **Drawing on the FSAP findings, the authorities are pressing ahead with development of the interbank foreign exchange market**. The prospects were discussed for widening the foreign exchange position limits even further to promote interbank activity, as was the scope for raising these in line with banks' activity and their capacity to participate in the market and manage risk. While the authorities agreed to review existing limits, they noted that these were currently not binding, and expressed concerns over moving from a capital to risk management based system given difficulties in judging banks' capabilities in the market. The authorities noted that they were also considering the other proposals of the FSAP aimed at improving the forex market (Box 3).

### Trade Policy and the Capital Account

23. **Increasing access for Sri Lankan goods into world markets has been the focus of trade policy**. The Indian Free Trade Agreement (ILFTA) is proceeding with Sri Lanka implementing its commitments and preferential margins raised for about half of Sri Lanka's exports in India's 2002 Budget. However, exports under the ILFTA remain a small proportion of total exports—key items such as tea and garments remain well below quota limits. Hence, the authorities are continuing to discuss means to improve trade under the ILFTA. A free trade agreement with Pakistan was signed on August 1, 2002. As the elimination in 2005 of quotas

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[2] See the accompanying selected issues paper on external current account sustainability.

**Box 3. Key Findings of the FSAP Mission**[1]

**The financial sector has been strengthened significantly over the past 20 years.** The legal framework has been upgraded regularly, though some deficiencies remain. The rules governing bank and insurance company entry have been liberalized, and there is now a competitive mix of private and state institutions in these two sectors. However, state ownership in banking and finance continues to be extensive and the state absorbs a large share of financial resources.

**Notwithstanding significant recent progress, a number of weaknesses remain in the banking sector, and the Basel preconditions for effective supervision are not fully met.** Most banks have high levels of NPLs, inadequate provisioning, heavy reliance on collateral security, and high cost/income ratios (at end-March 2002, NPLs for state banks was about 19 percent, 17 percent for private banks, and 13 percent for foreign banks—Table 6). The state-owned Peoples Bank is deeply insolvent, and an effective resolution is needed to stem losses and address operational risks. There has been little disintermediation or flight to quality, partly because of a widespread perception of government backing. However, there is a significant threat of an erosion of public confidence in private financial institutions due to high NPLs and low provisioning for many private banks. Even though the reported average capital adequacy ratio was about 10 percent for all private banks (Table 6), there are several private banks within this category which remain seriously under capitalized. The key policy priority is to restructure the state banks, improve the capital position and management of private domestic banks, and promote a healthy consolidation of the banking system. *The authorities have chosen an option for restructuring the Peoples Bank (see paragraph 9) and are addressing the problems relating to the private banks.*

**Sri Lanka is currently finalizing a draft law on anti money laundering (AML).** However, the draft law had some significant inadequacies, related to its applicability to nonfinancial institutions, customer identification and reporting requirements, the legal powers of the AML authority, and penalties for AML violations. *The authorities have amended their draft AML legislation to incorporate the FSAP mission's recommendations.*

**The overall functioning of the foreign exchange market needs urgent attention.** Tight limits on the net open foreign exchange positions of commercial banks have affected liquidity in the spot and forward interbank markets. Interbank trading, which constituted some 80 percent of total gross transactions, now represents only a tiny fraction of activity, raising concerns about market fragility, the quality of price formation and whether the exchange rate can float freely. A progressive increase of foreign exchange limits in line with the activity and capability of participants should be undertaken. Remaining foreign exchange regulations should be relaxed, and building on the recent widening, the limits on net open positions (NOP) should be set in line with banks' capacity to participate in the foreign exchange market and to manage risk. *The authorities are developing their strategy on NOP limits and are taking into account the FSAP mission's recommendations (see paragraph 22).*

**A more transparent monetary framework and introduction of active market operations are needed to strengthen liquidity management, help bring down risk premiums, and encourage term extension.** A stronger commitment to domestic considerations—through the formal adoption of the base money targeting framework—would assist in stabilizing and reducing term interest rates. The development of active instruments to bring overall banking system liquidity into more consistent balance would serve to encourage greater term extension. *The CBSL has published its reserve money program and is about to implement a new framework for active open market operations with the help of an external advisor from Sweden's Riksbank (see paragraph 20).*

**The authorities also face major long-term challenges.** There is a clear need to reduce the absorption of financial resources by the state, reconsider the extent of state ownership in the financial system, restructure and modernize the provident fund and insurance sectors, and develop a more proficient public debt management approach with a view to stimulating primary market efficiency and secondary market liquidity.

[1] Prepared by the FSAP team headed by Mr. Dimitri Vittas, which visited Colombo in February 2002.

under the Agreement on Textiles and Clothing (ATC) will have an adverse impact on small-scale garment manufacturers, Sri Lanka has lobbied the European Union and the United States for preferential access to their markets (a trade and investment framework agreement with the United States was signed on July 26, 2002). They noted that concessions have been granted to other low income countries.

24. **The authorities were encouraged to make further progress toward a simplified and transparent tariff system under which a two-band tariff structure was established.** Several rates outside the two-band system remain and effective tariff rates are compounded by other levies and charges. Moreover, there is a proliferation of exemptions, and intermittent use of duty waivers and licensing of some imports.[1] The mission noted that high rates of protection of key agricultural products, which keep the prices of some basic foodstuffs well above other regional economies and distort agricultural production, should be reduced. The authorities reiterated their commitment to remove the import duty surcharge from the beginning of next year and consider incorporating other levies and charges into the two band tariff regime as early as possible. They have established a Tariff Commission to review these issues. Nevertheless, in July the Prime Minister publicly reaffirmed the government's determination to keep key agricultural import prices high to safeguard farmers for the immediate future.

25. **The authorities are evaluating the scope for further liberalization of the capital account.** The remaining limits on inward foreign investment—mainly in the financial sector, construction, and utilities—were removed in mid-April. However, an extensive set of capital account restrictions remain covering nonresident investment in domestic securities, foreign borrowing by the private sector and investment abroad by residents. The mission supported the authorities' plans to modernize the Exchange Control Act, and the Fund is reviewing the draft new legislation. While urging further gradual relaxation of controls, the mission concurred with the authorities that full capital account liberalization should proceed only after the financial sector and macroeconomic situation had been strengthened.

### D. External Financing Needs

26. **The program remains fully financed through the end of the arrangement in September. Nevertheless, much of the external financing for 2002 is scheduled for late in the year, reflecting expected program assistance and privatization proceeds.** The AsDB loans are on track, and some progress is being made to finalize the World Bank's credit supporting the Private Sector Development (PSD) program. The second tranche of the AsDB's PSD loan ($25 million) is expected to be disbursed in August. The authorities are finalizing the policy framework for the World Bank's PSD credit, including financial targets for CEB and other enterprises. Once final details are completed, it is expected that the initiating memorandum could

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[1] The simple average tariff is estimated at 11 percent, following the reduction of the surcharge, and nontariff barriers mainly relate to quotas under the ILFTA and items under licensing control for security or health reasons. Exemptions associated with the export zones result in an average import duty rate, i.e., duty collected as a share of total imports, of less than 5 percent.

be approved by the Bank's Operations Committee and an appraisal mission follow shortly thereafter. Nevertheless, only the first tranche of the PSD credit is expected to be released by the fourth quarter of 2002. The authorities were encouraged to ensure that the credit conditions were met to facilitate disbursement. Should loan financing or privatization proceeds be significantly delayed, the mission stressed the need for further adjustment to meet the reserves target.

27. **The maintenance of external repayment capacity requires limiting commercial borrowing.** Sri Lanka faces significant public investment needs associated with modernizing the economy and reconstruction following decades of conflict. Such medium term borrowing should be on concessional terms to preserve creditworthiness and ensure debt sustainability—the net present value of existing public external debt is 40 percent of GDP. In this regard, the mission cautioned against any large sovereign bond issue, and suggested that concessional donor resources, including resources under the PRGF, were more appropriate for meeting external financing needs. To guard against exchange rate shocks and support a free float of the rate, the staff also warned of the risks of any further borrowing in foreign exchange from the domestic market, and reiterated the need for further reduction in the foreign exchange exposure of CPC.

### E. Poverty, the PRSP and Initial PRGF Discussions

28. **The government views its main long-term goal is to increase living standards through achieving a high rate of economic growth, while focusing special attention on the areas, rural and most particularly the North and East, where severe poverty exists.** The authorities are incorporating the comments received at the Development Forum (Colombo, June 5-6) before finalizing the text of the full PRSP and the Bank-Fund staff's joint assessment would be completed soon after. In June, the authorities published their draft, which stressed removing the impediments to private sector growth, rural infrastructure, education, and targeted relief (http://www.erd.gov.lk). During the Development Forum, external donors and civil society supported the poverty reduction strategy. The government's draft contained a frank discussion of the poverty issues and the challenges, and reflected broad participation of civil society and other stakeholders. Notably, the document had a clear agenda for the various objectives consistent with the limited resource envelope. The mission encouraged the authorities to seek World Bank assistance so that they could undertake the necessary poverty and social impact analyses.

29. **Building on the structural measures implemented under the SBA, the mission discussed the key structural measures that would underpin the first year of a PRGF, based on the objectives set out in the PRSP.**[2] The measures focused on measures to promote private sector led growth—further financial sector reform, civil service and pension reforms, tax administration and public enterprise reform, as well as trade and labor market reforms.

[2] PRGF negotiations are scheduled in October. Collaboration with other agencies has been clearly defined with the Fund focusing on its area of responsibility (see Box 4).

### Box 4. Collaboration with IFIs and Other Agencies on Structural Conditionality

#### I. World Bank

**Links in Reform Priorities**

- The Bank's program lending is currently supporting the central bank restructuring exercise and the private sector development program. The former relates to the CBSL's voluntary retirement scheme and latter focuses on land reform (amending legislation), labor reform (introduction of binding compensation formula and time limits for resolution of disputes), public enterprise restructuring (CEB and CPC) and privatization. Privatization receipts constitute a significant part of the SBA's program financing of the state budget.
- The Bank's private sector development program has pushed vigorously the agenda on labor market reform (this has no direct SBA conditionality).
- Bank staff will take the lead on civil service reform, and Fund staff would work closely with the Bank to ensure the longer-term affordability and sustainability of the wage bill.
- The SBA also has a ceiling on total bank borrowing by public corporations. The Bank's PSD loan has a specific conditionality on reduction of CEB losses and a cap on new borrowing by CEB.
- A public expenditure review mission by the Bank is scheduled for October. Fund staff would participate.
- The Bank has other project lending, which covers improvements in education, land titling, and rural infrastructure. The authorities' draft PRSP also covers these areas.

**Progress Report on Disbursement of Program Loans**

- There has been a delay in the Bank's disbursement of the PSD loan. The Bank's Operations Committee is expected to approve the policy framework of the PSD loan shortly. An appraisal mission is expected in September, the first tranche of the PSD credit could be released by the fourth quarter of 2002.

**PRSP Process**

- The Bank is taking the lead in this area, but Fund and Bank staff have coordinated their comments closely on various drafts. While Fund staff focused on the consistency of the PRSP macroeconomic framework, Bank staff advised the authorities in the overall design of poverty reduction strategies (including diagnostic work).

**Mission Participation**

- Bank staff participated in both the February and June 2002 SBA review missions.

#### II. Asian Development Bank (AsDB)

**Links in Reform Priorities**

- The AsDB's PSD loan focuses on labor market reform and public enterprises restructuring, while the SME project finances the development of small and medium-term enterprises. The authorities' PRSP matrix also covers SME development and the forthcoming PRGF plans to address this too.

**Progress Report on Disbursement of Program Loans**

- The first tranche of the SME loan was disbursed on May 7 2002, while the second tranche of the PSD loan ($25 million) is expected to be disbursed in August 2002.

**Mission Participation**

- While AsDB staff do not normally participate in Fund missions, there is extensive consultation and we have had parallel missions to Colombo in which they have participated in Fund mission meetings.

#### III. Others

- The Fund staff regularly meet JBIC staff in Washington and Colombo. Japan is Sri Lanka's biggest bilateral donor and traditionally provides financing for public enterprise restructuring, power sector, and rural development. Fund missions also regularly meet local representatives of all major donors.

- **On financial sector reform**, the key would be to implement the restructuring program for Peoples Bank. The fiscal cost of the restructuring would be included in the 2003 budget.[1] For the Bank of Ceylon, an updated business plan would be required under a PRGF. The CBSL plans to increase the capital requirement of banks and modernize the banking and monetary law acts by early 2003.[2]

- **Tax administration improvements would center on the proposed new revenue authority and on enhancing the role of the LTU**. The newly introduced VAT would be extended to the retail sector while eliminating VAT exemptions.

- **Public enterprise and civil service reform would focus on restructuring CPC and CEB, continuing the privatization program and rationalizing noncommercial public institutions**. Civil service wages would need to allow greater pay differentials, with salaries linked to performance and merit rather than seniority, and other anomalies removed. Given the direct fiscal implications, the program would require further improved targeting of the Samurdhi welfare scheme and reduction of duplication of functions by the central and provincial government civil services. While the World Bank will have primary responsibility in the area of civil service reform, Fund staff will work closely with the Bank to ensure the long-term affordability and sustainability of the wage bill—the Fund will participate in a World Bank public expenditure review mission scheduled for the fall. The authorities also discussed plans to consolidate the public debt management office.

- **The unfunded and generous nature of public service pensions is a major fiscal liability**. With no employee contribution scheme and large benefits, the public pension system is not affordable over the long run. The mission, therefore, supported the government's proposal to develop a contributory pension scheme, along the lines of the private sector Employees' Provident Fund (EPF), for all new recruits to the public service.

- **Trade reform would focus on making further progress toward a simplified and transparent two-band tariff system**, including reducing agricultural protection.

- **The authorities were amending labor market legislation**, crucial to provide greater flexibility. The aim was to provide the framework for a future complete overhaul of the Termination of Employed Workmen Act. They would enact by end-September a law setting a binding redundancy compensation formula and requiring labor disputes to be settled promptly—though the unions and business community told the mission that simplified procedures were needed if the latter was to be achieved.

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[1] Preliminary estimates based on the MAE-World Bank report and work by the staff at the Peoples Bank suggest a total cost of about Rs 9 billion (about ½ percent of GDP).

[2] A joint Bank-Fund TA mission is scheduled for September/October 2002 to help the authorities review their draft financial laws.

### F. Program Monitoring and Capacity to Repay the Fund

30. **Program monitoring focused on the performance vis-à-vis the end-April 2002 quantitative targets** (performance criteria and benchmarks), preliminary estimates for end-June, as well as the structural benchmarks. Preconditions for completion of the final review of the SBA were confined to the introduction of the VAT, delayed actions on privatization and banking sector measures (structural benchmarks for June) and initiating actions needed to maintain the necessary pace of structural reform in preparation for the PRGF. These actions included presentation to parliament of the Welfare Benefit Law, Electricity Reform Act, and labor market reforms.

31. **The Fund's exposure to Sri Lanka will remain limited, relative to the country's capacity to generate resources, even after the purchases made under the SBA**. Sri Lanka's track record of discharging obligations to all creditors, including the Fund, has been consistently good. If the final purchase of SDR 48 million is made under the SBA, total Fund credit outstanding would increase to SDR 228 million by end-2002, or 55 percent of quota. Repurchases and charges to the Fund would average 1 percent of exports of goods and services over 2002-05, equivalent to 1¾ percent of government revenues.

## IV. Other Issues

### A. Medium-Term Outlook and Sustainability Analysis

32. **The baseline medium-term macroeconomic framework remains similar to the scenario presented in the last staff report** (EBS/02/59). The scenario (Table 5) assumes significant structural reforms supported by a PRGF arrangement follow the current SBA-supported program. Under this scenario, GDP growth increases steadily to 6½ percent over the medium term, led by investment, exports, and private consumption (though a massive reconstruction program is not assumed). With restrained monetary policy, normal monsoons, and WEO projections of steadily declining oil prices, inflation is expected to decline to 4½ percent over the medium term. From 2003 onwards, the staff expect a return to strong export volume growth, notwithstanding the elimination in 2005 of quotas under the ATC, as structural reforms and global recovery increase the pace of economic activity and competitiveness is maintained. The external current account deficit is expected to be contained below 3 percent of GDP. With reasonably strong capital inflows, gross official reserves are projected to increase to $3.5 billion (4 months of imports), roughly as previously projected.

33. **Fiscal consolidation takes the form of strong revenue measures and improvements in tax administration**, which increase the revenue-GDP ratio by 2¾ percentage points of GDP from 2001 levels, to those achieved in 1990–95, as well as measures to contain security expenditure, rationalize government departments, and improve expenditure controls. As a result, the fiscal deficit declines from 11 percent of GDP in 2001 to 4 percent of GDP in 2006. Consistent with this, the debt-GDP ratio declines by 20 percentage points by 2006, to 84 percent of GDP.

34. **The mission discussed with the authorities the risks to the baseline scenario and thus developed alternative scenarios.**[3] In the low case scenario, the drought resumes and the power shortages reoccur, there is a return to conflict—stalling structural reform and fiscal consolidation—weaker than expected global recovery, and higher oil prices. Moreover, absent structural reform the end of quotas under the ATC would have a substantial adverse impact on exports. As a result, annual GDP growth is limited to 1 percent over the medium term, with reduced capital inflows, exports, and investment. The fiscal deficit increases to over 11 percent of GDP, causing the government debt-GDP ratio to rise to more than 111 percent by 2006.

35. **For the high case scenario, there is early agreement on a peace deal, a more ambitious structural reform agenda is implemented**, and there is substantial reconstruction and rehabilitation of the north and east financed by aid. GDP growth increases to 8½ percent over the medium term, with strong investment, exports, and external financing inflows. Successful fiscal consolidation efforts considerably increase the revenue-GDP ratio and contain current expenditure. The debt-GDP ratio falls to 84 percent, similar to the baseline.

36. **The staff also reviewed the sustainability of current policies in terms of both the fiscal and external position—that analysis showed that based on the adjustment scenario, both the fiscal and external positions are sustainable**. Nevertheless, significant departures from current adjustment policies and structural reforms would jeopardize sustainability.

- **Prior to the adjustment announced in the 2002 budget, fiscal policy was clearly unsustainable**, leading to a rising debt-GDP ratio. However, with tax policy reform and expenditure restraint, the current policies are sustainable, if economic growth resumes at rates at least similar to the historical average. If growth fails to take off, then fiscal policy will be unsustainable, even in the presence of strong adjustment. This clearly demonstrates the importance of early implementation of the envisaged pro-growth structural reforms that were outlined in the 2002 budget.
- **During 1999–2000, the savings-investment balance was unsustainable and the real exchange rate was overvalued**. Looking forward, if adjustment measures are taken, the external position would be sustainable. The external debt ratios decline significantly into the medium term as a result of strong growth founded on far-reaching structural reforms and renewed peace. However, without adjustment, the external debt ratio will be significantly higher than the baseline by 2006. Thus, this highlights the need for the authorities to pursue prudent debt management strategy and policies that would encourage nondebt creating flows, while maintaining competitive exchange rate through the float.

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[3] See Appendix I, Tables A and B. More detailed work done by the staff on fiscal and external debt sustainability is included in the accompanying selected issues paper.

## B. Safeguards

37. **All the critical recommendations of the Safeguards Assessment report have been implemented, and the CBSL has made significant progress on the remaining suggestions** (Annex I). The external auditor completed the 2001 financial audit of the CBSL on June 25, 2002 and the authorities are addressing the key weaknesses that were identified by the external auditors' report and management letter. The CBSL will publish the fully IAS-compliant accounts from next year. The CBSL has also adopted a new internal audit charter. The work on the review of the high-level internal CBSL control systems, formal risk management procedures, and external review of the management and audit department is expected to be completed by end-September. The mission informed the authorities that a new Safeguards assessment would be required when Sri Lanka moves to a PRGF arrangement.

## C. Financial Sector Assessment Program

38. **The mission reviewed the major findings of the FSAP study with the central bank (Box 3) and confirmed that the CBSL has already begun to implement the FSAP mission's recommendations**. Overall, as reported in the last staff report, the authorities agreed with the analysis and the recommendations, many of which had already been put into practice or were in preparation. The CBSL agreed that the high level of nonperforming loans and low provisioning for private and state domestic banks were worrisome and it is pursuing several efforts to strengthen banking system soundness. The banking supervision department has been strengthened to enable additional off-site and on-site surveillance. Other actions initiated by the CBSL to address banking sector vulnerabilities include: a review of the quality of the loan portfolio, requiring additional provisioning by banks where needed and efforts to promote aggressive loan collection, phasing out of government directed lending, and enforcing better underwriting policies.

## D. Statistical and Data Issues

39. **While data provision to the Fund is broadly adequate for surveillance and program monitoring, there is a need to improve macroeconomic statistics further**. The newly introduced CPI index, which has more current weights, a wider geographic coverage and income deciles, appears reasonably robust. In the area of fiscal transparency, the authorities have improved their presentation of the budget, with much more comprehensive explanation and analysis. Sri Lanka is a participant in the General Data Dissemination System, and following the recent follow-up discussion with the STA ROSC mission, the authorities expect full compliance on Special Data Dissemination Standard (SDDS) by mid-2004.

## E. Other Surveillance Issues

40. **The CBSL remains committed to adopting measures that would guard the financial system against money laundering**. Thus, they are revising the draft anti-money laundering legislation to eliminate the deficiencies identified by the FSAP study (Box 3). They stressed that the integrity of Sri Lanka's banking activity is of paramount importance.

## V. Staff Appraisal

41. **Sri Lanka is at a major crossroads, and despite the promising start made by the new UNF government, the challenges ahead remain enormous.** The macroeconomic situation is still fragile and steering a quick recovery and achieving sustainable high growth will require major adjustments to the economy. The government will need to overcome pressures against reform to pave the way for quick implementation of growth enhancing structural measures, and lay the basis for private sector-led growth, which would ensure fiscal sustainability over the medium term. Resolution of the civil conflict and efforts to generate growth opportunities, so as to raise living standards significantly, are closely connected.

42. **The new government that came to power in December 2001 has improved economic management and initiated important structural measures and remains committed to the reform agenda.** After presenting a strong budget in March 2002 the government maintained tight fiscal and monetary policies during the first half of the year. At the same time, the structural reform agenda focused on tackling financial and operational weaknesses in the public sector.

43. **Overall, notwithstanding some policy delays and adverse external shocks, the SBA has met the key objective of halting reserve losses, while initiating fiscal consolidation and reforms of the tax system and public enterprise operations.** Economic developments during the first half of 2002 met program expectations. The government's observance of all the end-April performance criteria and indicative benchmarks is welcomed. While exports remain weak, the new exchange rate regime is operating smoothly, official reserves have risen steadily, inflation has come down, and there are signs that a recovery is underway. There are good prospects that the overall fiscal deficit will be reduced as targeted, privatization is ongoing, and key enterprises have started to be restructured. The progress on the peace front is also having some favorable economic impact, with lower defense spending and early signs of increased foreign investment.

44. **Nevertheless, the adjustment program has downside risks for the remainder of 2002.** The economic recovery remains fragile, with the long run power situation still largely unresolved and drought fears remaining. Moreover, any delay in the global economic recovery would lower demand for Sri Lanka's exports and affect the ability to build up reserves. Equally important, resumption of political uncertainties could slow the peace momentum. There are clear risks that the fiscal position could be undermined by such shocks, emphasizing the need for tight control.

45. **Fiscal consolidation and reducing government debt are essential to ensuring fiscal sustainability, requiring increased revenue and tightly restricted and monitored spending.** The risks to the 2002 fiscal targets include possible revenue shortfalls, higher interest costs, spending overruns, and pressure for further tax concessions. Thus, on the revenue side, it is vital that the government perseveres with the measures to reform the tax system and administration—the transition to the new VAT is welcome, but the lowering of VAT rates and reduction of petroleum excises weaken the adjustment. Because interest payments will be higher than budgeted, tight control should be maintained on other current spending. Thus, the government needs to enhance its spending monitoring and transparency. It should stand firm on its current

wage and recruitment policies, while lowering subsidies and transfers, targeting the social safety net program, and holding down defense costs. The authorities are also urged to stand ready to take additional adjustment measures, if needed, to ensure that the fiscal goals are broadly achieved.

46. **There will be budgetary costs associated with the economic reforms being undertaken, but general loosening of fiscal policy should be avoided**. The authorities should resist further calls to provide broad cost of living relief measures through tax cuts or administered price adjustments that undermine the financial viability of the budget or public corporations. From 2003 the VAT should be extended to the retail level and exemptions removed. Successfully setting up the unified tax authority will also be a key challenge. Similarly, the 2003 budget will need to continue the path of fiscal consolidation—the overall deficit target will depend on the pace of post-conflict donor-funded capital projects and will need to accommodate the fiscal costs of Peoples Bank restructuring and other public sector reforms.

47. **Fiscal consolidation would help the CBSL to maintain a prudent monetary stance, while balancing the need to provide for sufficient and affordable bank credit for the private sector**. The gradual reduction in policy interest rates this year by the CBSL is supported, given the path of inflation, but further significant easing should await a reduction in the relative size of government debt, releasing resources for private sector credit growth.

48. **The staff support the authorities' current flexible exchange rate policy and commitment to improve the functioning of the interbank foreign exchange market**. CBSL's intervention should continue to aim primarily at achieving the international reserve target, with only limited smoothing of short-term exchange rate volatility. Significant commercial borrowing in foreign currency should be avoided, given the risks to the sustainability of external debt.

49. **The steps taken by the authorities on the structural front are critical for macroeconomic stability and promotion of private sector-led growth**. Most welcome are the measures taken to address the financial position of the CPC and CEB through price adjustments and early steps to break up these enterprises and invite private participation, within an appropriate regulatory framework. Moreover, following the FSAP recommendations, the CBSL has taken steps to strengthen bank supervision and improve banking system soundness. The decision to tackle aggressively the problems of Peoples Bank and improve the performance of the Bank of Ceylon is strongly supported and should benefit from Fund/World Bank technical assistance.

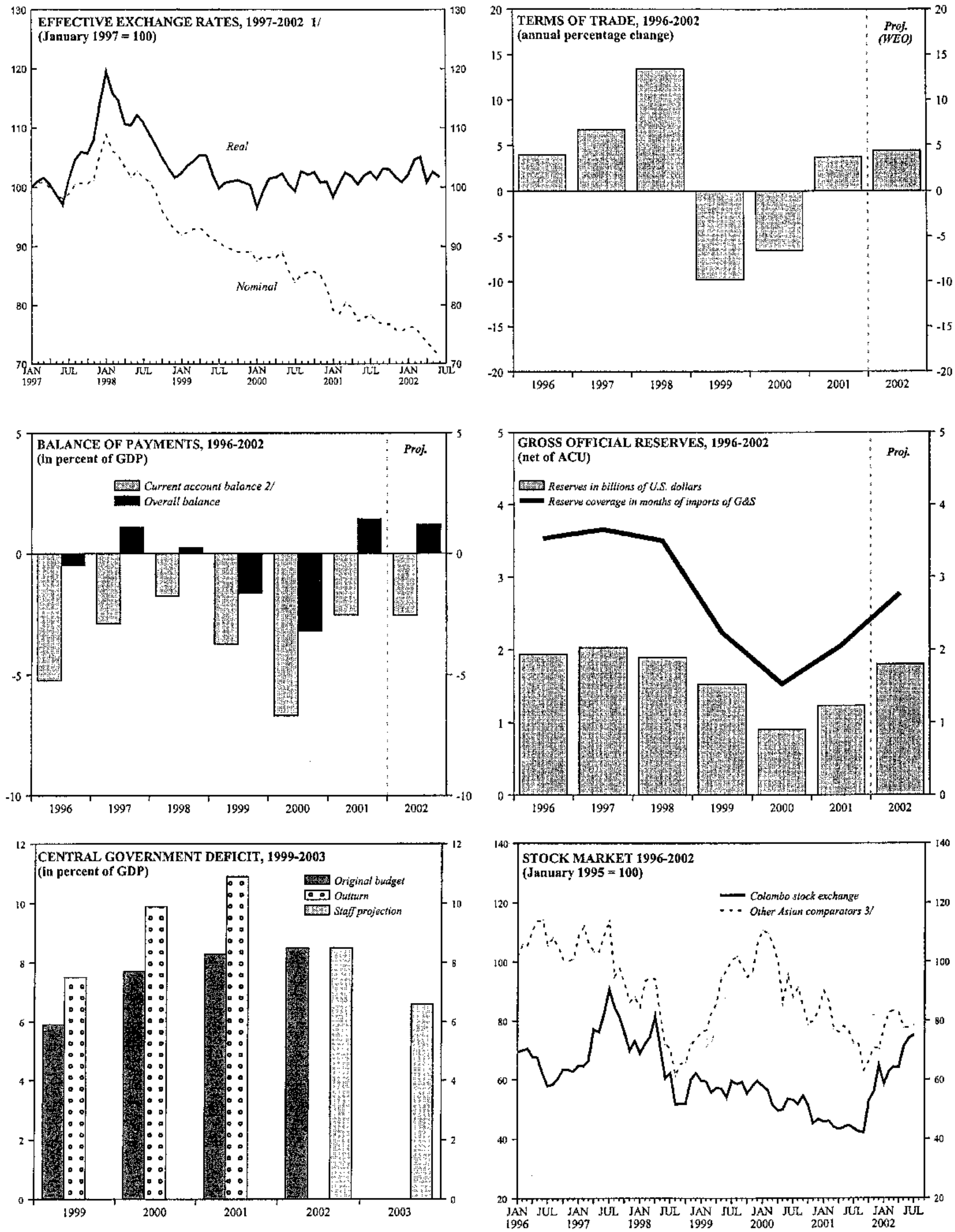
50. **Looking ahead, the government's challenge is to sustain the adjustment effort and press ahead with deeper structural reforms to increase growth and reduce poverty**. Linked closely to the objectives already set out in the PRSP, perseverance with program policies could pave the way for a PRGF arrangement. A medium term program would focus on further reform of the financial sector and restructuring of public enterprises; enhancement of the tax collection agencies and public expenditure reform. At the same time, labor market reform would greatly facilitate improving public sector effectiveness and promote job creation in the private sector.

51. **Despite the risks for the future, the results of the new government's program of adjustment and reform are encouraging and the staff support the completion of the final SBA review**. With the implementation of appropriate policies, Sri Lanka's economic and financial position will continue to strengthen. The successful implementation of the Safeguards Assessment recommendations also illustrates the authorities' determination to demonstrate the security of the Fund's resources, and, more generally, improve the accountability of the central bank.

52. **The quality and timeliness of data are satisfactory for surveillance purposes and for providing the framework for adjusting economic policies**. Nevertheless, as Sri Lanka moves toward SDDS status, the authorities are encouraged to follow up on the outstanding recommendations of the data ROSC.

53. **It is recommended that the next Article IV consultation with Sri Lanka be held on the 24-month cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002**. The authorities have consented to the official publication of the PIN and the Article IV staff report.

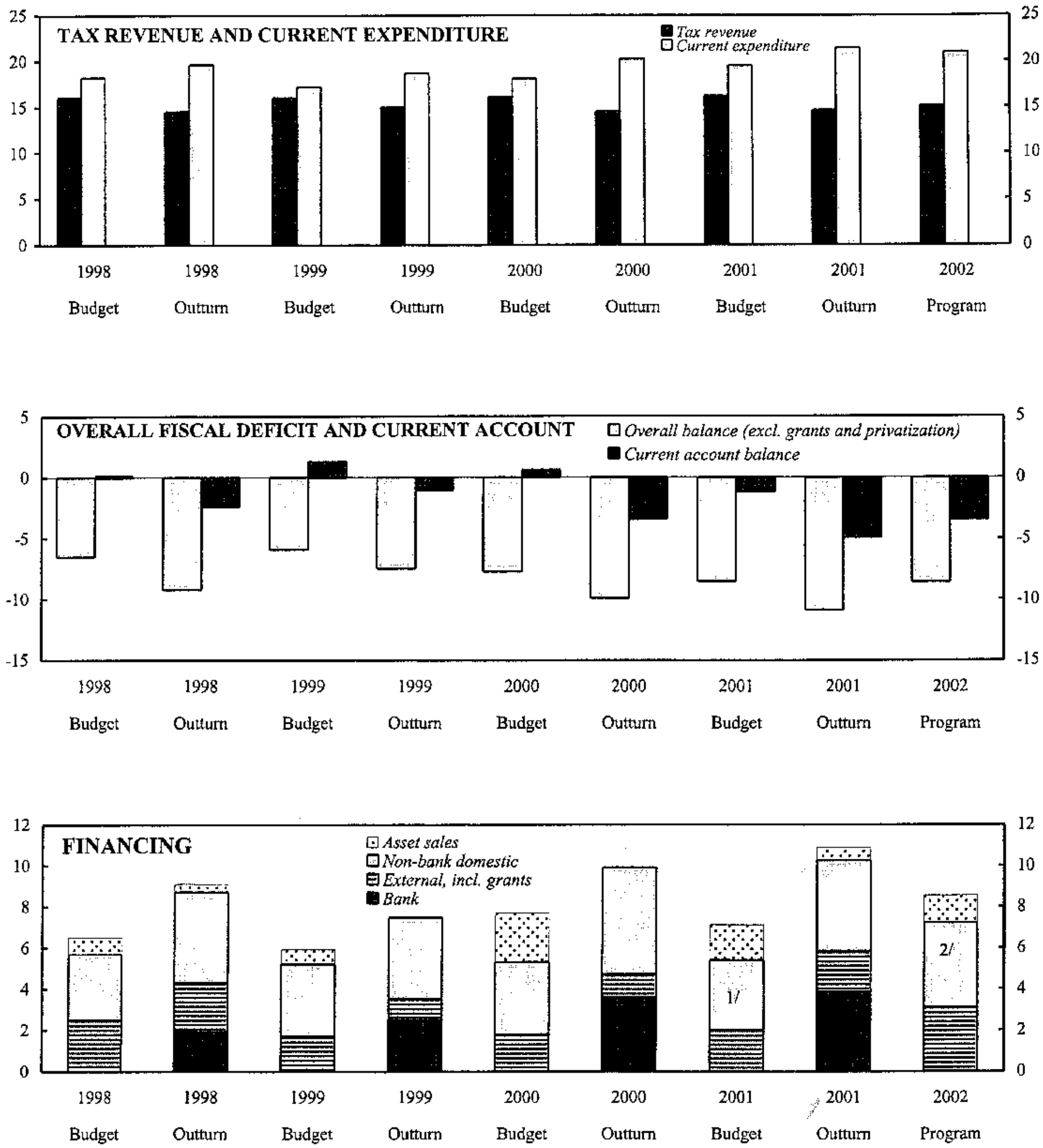
# Figure 1. Sri Lanka: Selected Economic Indicators




Source: Data provided by the Sri Lankan authorities; and staff estimates and projections.

1/ Using 1995 trade weights, and CCPI as the inflation indicator.
2/ Excluding official transfers; from 1999 includes aircraft, ports, and telecom capital imports.
3/ An unweighted average index of the India, Indonesia, Malaysia, Pakistan, Philippines, and Thailand stock exchange indices.

# Figure 2. Sri Lanka: Selected Fiscal Indicators, 1998-2002
**(In percent of GDP)**




Sources: Sri Lanka authorities; and staff estimates and projections.

1/ The 2001 budget projection was 4.5 percent of GDP, shown here offset by bank financing of -1 percent of GDP.
2/ The 2002 program projection is 5.5 percent of GDP, shown here offset by bank financing of -1.3 percent of GDP.

# Table 1. Sri Lanka: Selected Economic Indicators, 1999-2002

Nominal GDP (2001): US$15.7 billion
Population (2001): 18.7 million
GDP per capita (2001): US$836
Quota: SDR 413 million

| | 1999 | 2000 | 2001 | 2002 | |
|---|---|---|---|---|---|
| | | | Prov. | Proj. | Latest Data 1/ |
| | | | (Percent change) | | |
| Real GDP | 4.3 | 6.0 | -1.4 | 3.7 | 0.1 |
| Colombo consumer price index (CCPI, end-of-period) | 4.0 | 10.8 | 10.8 | 7.5 | 10.8 |
| Colombo consumer price index (CCPI, period average) | 4.7 | 6.2 | 14.2 | 9.0 | 11.1 |
| Colombo district consumer price index (CDCPI, end-of-period) | -0.1 | 8.5 | 9.7 | 7.5 | 7.0 |
| | | | (Percent of GDP) | | |
| Saving and investment | | | | | |
| National saving | 23.5 | 21.5 | 19.5 | 22.0 | ... |
| Gross investment | 27.3 | 28.0 | 22.0 | 24.6 | ... |
| | | | (Percent of GDP) | | |
| Government budget | | | | | |
| Revenue | 17.7 | 16.8 | 16.5 | 17.5 | 6.9 |
| Expenditure and net lending | 25.2 | 26.7 | 27.4 | 26.0 | 10.5 |
| Primary balance (including grants) | -1.3 | -3.8 | -3.7 | -0.5 | -0.4 |
| Overall balance (excluding grants and privatization) | -7.5 | -9.9 | -10.9 | -8.5 | -3.6 |
| Overall balance (incl. grants and excl. privatization) | -6.9 | -9.5 | -10.5 | -8.0 | -3.4 |
| Current account surplus (+)/deficit (-) | -1.0 | -3.4 | -4.9 | -3.4 | -1.7 |
| Defense expenditure (excl. pub. order and safety) | 3.4 | 4.6 | 3.8 | 3.0 | 1.4 |
| | | | (Annual percent change; end-of-period) | | |
| Money and credit 2/ | | | | | |
| Reserve money | 8.2 | 4.7 | 7.0 | 12.0 | 14.7 |
| Broad money | 13.4 | 12.9 | 13.6 | 12.5 | 16.2 |
| Domestic credit (percent contribution to M2) | 16.8 | 27.3 | 18.4 | 2.1 | 12.8 |
| Private sector (percent contribution to M2) | 8.2 | 9.0 | 6.7 | 7.2 | 4.3 |
| Public sector (percent contribution to M2) | 8.6 | 18.3 | 11.7 | -5.1 | 8.5 |
| 91-day t-bill rate (percent, end of period) | 11.8 | 18.0 | 12.9 | ... | 12.4 |
| | | | (In millions of U.S. dollars) | | |
| Balance of payments 2/ | | | | | |
| Export volume growth (percent change) | 5.1 | 18.3 | -8.0 | 4.5 | -12.4 |
| Import volume growth (percent change) | 0.2 | 13.0 | -10.7 | 7.0 | 1.3 |
| Trade balance | -1,369 | -1,798 | -1,157 | -1,249 | -734 |
| Current account balance (excl. official transfers) 3/ | -586 | -1,090 | -391 | -419 | ... |
| Current account balance (percent of GDP) 3/ | -3.7 | -6.6 | -2.5 | -2.6 | ... |
| Overall balance | -259 | -522 | 220 | 315 | ... |
| Gross official reserves (end of period, US$ millions) 4/ | 1,530 | 911 | 1,182 | 1,800 | 1,351 |
| Exchange rates | | | | | |
| Rupees per U.S. $ (end of period level) | 72.1 | 82.7 | 93.2 | ... | 96.2 |
| NEER (annual percentage change, e.o.p.) 5/ | -4.0 | -6.8 | -8.9 | -8.1 | -8.4 |
| REER (annual percentage change, e.o.p.) 5/ | -1.2 | 0.6 | -0.1 | -2.8 | 0.4 |
| Vulnerability and reserve adequacy indicators | | | | | |
| Private sector credit (percent of GDP) | 29.5 | 29.0 | 28.3 | 27.5 | 25.6 |
| Gross official reserves (percent of broad money) | 25.8 | 15.6 | 20.0 | 28.7 | 22.4 |
| Gross official reserves (percent of short-term debt) 6/ | 92.4 | 45.7 | 59.3 | 88.7 | 65.6 |
| Gross official reserves (months of imports of g&s) | 2.2 | 1.5 | 2.0 | 2.8 | 2.1 |
| Foreign currency deposits (percent of total deposits) | 20.4 | 21.1 | 21.3 | ... | ... |
| Short-term debt (percent of GDP) 7/ | 8.7 | 9.9 | 10.7 | 10.3 | ... |

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

1/ Latest observations: GDP, first quarter; T-bill, July 12; CPI, end-July; gross reserves, July 31; exchange rate, August 2; effective exchange rates, April; reserve money, end-June; monetary survey, end-May; external trade volumes, January-March; trade balance, January-May; fiscal, January-May.
2/ Includes foreign currency banking units.
3/ Includes aircraft purchases by Sri Lankan Airlines (3 in 1999 valued at $297.5 million, and 3 in 2000 valued at $297.5 million).
4/ At historical cost, and excluding central bank ACU balances.
5/ Projections based on staff estimates of partner country inflation and exchange rates. 1995 trade weights.
6/ Based on residual maturity, including amortization of public and publicy guranteed debt.
As reserves exclude ACU balances, they are also excluded from short-term debt for consistency.
7/ Short-term debt defined as trade credits, Central Bank ACU balances, commercial bank liabilities, CPC acceptance credits, and amortization due.

Table 2a. Sri Lanka: Summary of Central Government Operations, 1999-2002

(In percent of GDP, unless otherwise indicated)

| | 1999 | 2000 | 2001 | | 2002 | | |
|---|---|---|---|---|---|---|---|
| | | | Budget | Outturn | Program | Revised | Prel. Jan.-Apr. 1/ |
| Total revenue | 17.7 | 16.8 | 18.3 | 16.5 | 17.5 | 17.5 | 5.6 |
| Tax revenue | 15.0 | 14.5 | 16.2 | 14.6 | 15.0 | 15.2 | 4.5 |
| Income taxes | 2.6 | 2.2 | 2.4 | 2.5 | 2.5 | 2.7 | 0.5 |
| Value Added Tax/GST | 3.4 | 3.6 | 3.9 | 3.3 | 5.6 | 5.0 | 1.2 |
| Excise taxes | 3.2 | 3.4 | 3.5 | 3.2 | 3.3 | 3.3 | 1.2 |
| National security levy | 2.5 | 2.7 | 3.3 | 3.1 | 1.1 | 1.7 | 1.0 |
| Taxes on international trade | 2.5 | 1.9 | 2.4 | 1.9 | 1.9 | 1.9 | 0.6 |
| Other | 0.8 | 0.7 | 0.8 | 0.7 | 0.7 | 0.6 | 0.1 |
| Nontax revenue | 2.7 | 2.3 | 2.1 | 1.9 | 2.6 | 2.3 | 1.1 |
| Total expenditure and net lending | 25.2 | 26.7 | 26.9 | 27.4 | 26.1 | 26.0 | 8.6 |
| Current expenditure | 18.7 | 20.2 | 19.5 | 21.4 | 21.0 | 20.9 | 7.1 |
| Civil service wages and salaries | 3.0 | 3.2 | 3.3 | 3.4 | 3.5 | 3.4 | 1.1 |
| Other civilian goods and services | 1.4 | 1.6 | 1.6 | 1.7 | 1.5 | 1.3 | 0.7 |
| Security related expenditure | 4.4 | 5.6 | 4.4 | 4.9 | 4.0 | 4.0 | 1.4 |
| *Of which*: Defense | | 4.6 | 3.4 | 3.8 | 3.0 | 3.0 | 1.1 |
| Subsidies and transfers | 4.2 | 4.2 | 4.0 | 4.7 | 4.6 | 4.6 | 1.4 |
| Households | 3.4 | 3.3 | 3.2 | 3.7 | 3.4 | 3.4 | 1.0 |
| *Of which*: Samurdhi | 0.7 | 0.8 | 0.7 | 0.9 | 0.6 | 0.6 | 0.3 |
| *Of which*: Pensions | 1.7 | 1.7 | 1.7 | 1.9 | 2.0 | 2.0 | 0.6 |
| Institutions, corporations, other govt. | 0.9 | 0.9 | 0.8 | 1.0 | 1.2 | 1.2 | 0.4 |
| Interest payments | 5.6 | 5.7 | 6.3 | 6.7 | 7.4 | 7.5 | 2.5 |
| Foreign | 0.8 | 0.8 | 0.9 | 0.8 | 0.8 | 0.8 | 0.2 |
| Domestic | 4.8 | 4.9 | 5.4 | 6.0 | 6.6 | 6.7 | 2.2 |
| Capital expenditure and net lending | 6.5 | 6.5 | 7.4 | 5.9 | 5.1 | 5.1 | 1.5 |
| Capital expenditure | 5.5 | 5.4 | 5.8 | 4.8 | 4.5 | 4.4 | 1.3 |
| Net lending | 1.0 | 1.1 | 1.5 | 1.1 | 0.7 | 0.7 | 0.2 |
| Overall balance (excl. grants and privatization) | -7.5 | -9.9 | -8.5 | -10.9 | -8.5 | -8.5 | -3.1 |
| Overall balance (incl. grants, excl. privatization) | -6.9 | -9.5 | -8.0 | -10.5 | -8.0 | -8.0 | -3.0 |
| Financing | 7.5 | 9.9 | 8.5 | 10.9 | 8.5 | 8.5 | 3.1 |
| Net external financing | 0.1 | 0.7 | 2.8 | 1.6 | 3.2 | 2.6 | 0.4 |
| Net domestic financing | 6.8 | 8.8 | 3.4 | 8.3 | 3.6 | 4.1 | 2.5 |
| Bank | 2.4 | 4.2 | -1.0 | 3.9 | -1.3 | -1.3 | -0.1 |
| Nonbank | 4.4 | 4.5 | 4.5 | 4.4 | 5.0 | 5.5 | 2.6 |
| Asset sales | 0.0 | 0.0 | 1.7 | 0.6 | 1.2 | 1.3 | 0.0 |
| Grants | 0.6 | 0.4 | 0.5 | 0.4 | 0.5 | 0.5 | 0.1 |
| Memorandum items: | | | | | | | |
| Current account balance | -1.0 | -3.4 | -1.2 | -4.9 | -3.4 | -3.4 | -1.5 |
| Primary balance (excl. grants) | -1.9 | -4.2 | -2.2 | -4.1 | -1.2 | -1.0 | -0.6 |
| Health spending | 1.4 | 1.6 | 1.8 | 1.3 | 1.7 | 1.7 | ... |
| Education spending | 2.6 | 2.5 | 2.6 | 2.0 | 2.8 | 2.8 | ... |
| Foreign-financed capital expenditure (in percent) | 40.9 | 39.3 | 53.1 | 68.4 | 86.5 | 86.7 | ... |
| Nominal GDP (in billions of rupees) | 1,106 | 1,258 | 1,443 | 1,400 | 1,586 | 1,586 | 1,586 |
| Real GDP growth | 4.3 | 6.0 | 4.3 | -1.4 | 3.7 | 3.7 | ... |
| Total debt | 95.1 | 96.8 | 97.3 | 103.6 | 101.3 | 101.3 | ... |
| *Of which*: Domestic debt | 49.1 | 53.8 | 48.5 | 58.3 | 55.6 | 55.6 | ... |

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

1/ Actual outturns for revenue, expenditure and domestic financing, although composition of expenditure is preliminary. Grants and external financing are estimated.

Table 2b. Sri Lanka: Summary of Central Government Operations, 1999-2002

(In billions of rupees)

| | 1999 | 2000 | 2001 | | 2002 | | |
|---|---|---|---|---|---|---|---|
| | | | Budget | Outturn | Program | Revised | Prel. Jan.-Apr. 1/ |
| Total revenue | 196 | 211 | 264 | 231 | 278 | 277 | 89 |
| Tax revenue | 166 | 182 | 234 | 205 | 237 | 240 | 71 |
| Income taxes | 28 | 27 | 34 | 35 | 39 | 43 | 8 |
| Value Added Tax/GST | 37 | 46 | 56 | 47 | 88 | 79 | 18 |
| Excise taxes | 36 | 43 | 50 | 45 | 52 | 53 | 18 |
| National security levy | 28 | 34 | 47 | 43 | 17 | 27 | 15 |
| Taxes on international trade | 28 | 24 | 35 | 26 | 30 | 30 | 9 |
| Other | 9 | 9 | 11 | 9 | 10 | 9 | 2 |
| Nontax revenue | 30 | 29 | 30 | 26 | 41 | 37 | 18 |
| Total expenditure and net lending | 279 | 336 | 388 | 383 | 414 | 413 | 137 |
| Current expenditure | 207 | 254 | 281 | 300 | 333 | 332 | 113 |
| Civil service wages and salaries | 34 | 40 | 47 | 48 | 55 | 54 | 17 |
| Other civilian goods and services | 16 | 20 | 23 | 24 | 23 | 21 | 12 |
| Security related expenditure | 49 | 71 | 63 | 68 | 64 | 64 | 23 |
| *of which:* Defense expenditure | 38 | 58 | 48 | 54 | 47 | 47 | 17 |
| Subsidies and transfers | 47 | 52 | 58 | 65 | 73 | 73 | 22 |
| Households | 36 | 42 | 46 | 51 | 55 | 55 | 16 |
| *Of which*: Samurdhi | 8 | 10 | 10 | 13 | 10 | 10 | 4 |
| *Of which*: Pensions | 20 | 22 | 25 | 26 | 32 | 32 | 10 |
| Institutions, corporations, other govt. | 11 | 11 | 12 | 14 | 19 | 19 | 6 |
| Interest payments | 62 | 71 | 91 | 94 | 117 | 119 | 39 |
| Foreign | 9 | 10 | 10 | 11 | 13 | 13 | 4 |
| Domestic | 53 | 62 | 80 | 84 | 104 | 106 | 35 |
| Capital expenditure and net lending | 72 | 82 | 106 | 83 | 81 | 81 | 24 |
| Capital expenditure | 60 | 68 | 84 | 68 | 71 | 70 | 21 |
| Net lending | 12 | 14 | 22 | 15 | 10 | 10 | 3 |
| Overall balance (excl. grants and privatization) | -83 | -125 | -123 | -152 | -135 | -136 | -48 |
| Overall balance (incl. grants, excl. privatization) | -76 | -119 | -115 | -147 | -127 | -127 | -47 |
| Financing | 83 | 125 | 123 | 152 | 135 | 136 | 48 |
| Net external financing | 3 | 8 | 41 | 22 | 51 | 41 | 7 |
| Net domestic financing | 73 | 111 | 50 | 116 | 58 | 65 | 40 |
| Bank | 29 | 53 | -15 | 54 | -21 | -21 | -2 |
| Non-bank | 44 | 57 | 64 | 62 | 79 | 87 | 41 |
| Asset sales | 0 | 0 | 25 | 9 | 19 | 21 | 0 |
| Grants | 7 | 5 | 8 | 6 | 8 | 9 | 1 |
| Memorandum items: | | | | | | | |
| Current account balance | -11 | -43 | -17 | -69 | -54 | -55 | -24 |
| Primary balance (excl. grants) | -21 | -53 | -32 | -58 | -18 | -16 | -9 |
| Health spending | 16 | 21 | 26 | 19 | 27.7 | 19 | ... |
| Education spending | 29 | 31 | 37 | 28 | 43.7 | 28 | ... |
| Foreign-financed capital expenditure | 29 | 32 | 56 | 57 | ... | 70 | ... |
| Nominal GDP | 1,106 | 1,258 | 1,443 | 1,403 | 1,586 | 1,586 | 1,586 |
| Real GDP growth | 4.3 | 6.0 | 4.3 | -1.4 | 3.7 | 3.7 | ... |
| Total debt | 1,051 | 1,219 | 1,405 | 1,451 | 1,607 | 1,607 | ... |
| *Of which*: domestic debt | 543 | 677 | 700 | 816 | 881 | 881 | ... |

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

1/ Actual outturns for revenue, expenditure and domestic financing, although composition of expenditure is preliminary. Grants and external financing are estimated.

Table 3. Sri Lanka: Monetary Program, 1999-2002 1/

| | 1999 | 2000 | 2001 | 2002 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Dec. Act. | Dec. Act. | Dec. Act. | March Act. | April Act. | May Act. | June Rev. Prog. | Sept Rev. Prog. | Dec Rev. Prog. |
| | | | | (In billions of Sri Lankan rupees; end of period) | | | | | |
| Monetary authorities | | | | | | | | | |
| Net foreign assets 2/ | 89 | 58 | 87 | 88 | 94 | 92 | 98 | 119 | 139 |
| Net domestic assets | 11 | 47 | 25 | 29 | 24 | 24 | 20 | 3 | -13 |
| Net credit to government | 47 | 92 | 85 | 76 | 72 | 75 | 85 | 79 | 76 |
| Reserve money | 100 | 105 | 113 | 117 | 118 | 116 | 118 | 121 | 126 |
| | | | | (12-month change in percent of reserve money at start of period) | | | | | |
| Net foreign assets | -13.4 | -31.2 | 27.9 | 20.4 | 28.5 | 30.0 | 32.0 | 41.3 | 46.3 |
| Net domestic assets | 21.6 | 35.9 | -20.9 | -10.4 | -15.6 | -17.2 | -18.1 | -27.7 | -34.2 |
| Reserve money | 8.2 | 4.7 | 7.0 | 10.0 | 12.8 | 12.8 | 12.6 | 16.3 | 12.1 |
| Monetary Survey | | | | | | | | | |
| | | | | (In billions of Sri Lankan rupees; end of period) | | | | | |
| Broad money | 428 | 483 | 549 | 572 | 577 | 579 | 570 | 588 | 618 |
| Net foreign assets | 102 | 70 | 77 | 81 | 87 | 85 | 85 | 112 | 139 |
| Monetary authorities | 89 | 58 | 88 | 88 | 94 | 92 | 98 | 119 | 139 |
| Commercial banks | 13 | 12 | -10 | -7 | -8 | -7 | -13 | -7 | 0 |
| Net domestic assets | 326 | 414 | 472 | 491 | 490 | 494 | 485 | 476 | 478 |
| Domestic credit | 433 | 550 | 639 | 640 | 644 | 652 | 647 | 643 | 650 |
| Public sector | 107 | 186 | 242 | 235 | 241 | 247 | 239 | 229 | 214 |
| Government (net) | 94 | 147 | 201 | 196 | 200 | 203 | 200 | 192 | 180 |
| Public corporations | 13 | 38 | 41 | 39 | 40 | 43 | 39 | 37 | 34 |
| Private sector | 326 | 364 | 397 | 405 | 403 | 405 | 407 | 414 | 436 |
| Other items (net) | -107 | -136 | -167 | -149 | -154 | -159 | -162 | -167 | -172 |
| | | | | (Annual percentage change) | | | | | |
| Broad money | 13.4 | 12.9 | 13.6 | 15.1 | 15.6 | 16.2 | 15.1 | 13.9 | 12.5 |
| Net foreign assets | -3.4 | -31.9 | 10.9 | -0.2 | 11.6 | 20.8 | 17.9 | 47.6 | 80.8 |
| Domestic credit | 17.1 | 27.0 | 16.2 | 11.7 | 10.6 | 10.8 | 10.1 | 7.2 | 1.7 |
| Public sector | 43.3 | 73.5 | 30.5 | 21.4 | 21.2 | 20.6 | 18.9 | 6.6 | -11.5 |
| Government | 45.3 | 56.8 | 36.7 | 26.5 | 27.7 | 27.0 | 29.7 | 11.6 | -10.6 |
| Public corporations | 30.1 | 193.2 | 6.7 | 0.6 | -3.5 | -2.5 | -16.8 | -13.6 | -16.0 |
| Claims on private sector | 10.5 | 11.8 | 8.9 | 6.7 | 5.2 | 5.6 | 5.5 | 7.6 | 9.8 |
| | | | | (Percent contribution to broad money growth 12 months ago) | | | | | |
| Net foreign assets | -0.9 | -7.6 | 1.6 | 0.0 | 1.8 | 2.9 | 2.6 | 7.0 | 11.3 |
| Net domestic assets | 14.3 | 20.5 | 12.0 | 15.1 | 13.8 | 13.7 | 12.5 | 7.0 | 1.2 |
| Domestic credit | 16.8 | 27.3 | 18.4 | 13.5 | 12.4 | 12.8 | 12.0 | 8.4 | 2.0 |
| Public sector credit | 8.6 | 18.3 | 11.7 | 8.3 | 8.4 | 8.5 | 7.7 | 2.7 | -5.1 |
| Government | 7.8 | 12.5 | 11.2 | 8.3 | 8.7 | 8.7 | 9.3 | 3.9 | -3.9 |
| Public corporations | 0.8 | 5.9 | 0.5 | 0.0 | -0.3 | -0.2 | -1.6 | -1.1 | -1.2 |
| Claims on private sector | 8.2 | 9.0 | 6.7 | 5.1 | 4.0 | 4.3 | 4.3 | 5.7 | 7.1 |
| Memorandum items: | | | | | | | | | |
| CPI percent change (c.o.p.) | 4.0 | 10.8 | 10.8 | 11.4 | 8.3 | 10.0 | 10.7 | 8.0 | 7.5 |
| Broad money multiplier | 4.3 | 4.6 | 4.9 | 4.9 | 4.9 | 5.0 | 4.8 | 4.8 | 4.9 |
| Velocity of broad money (e.o.p.) 3/ | 2.8 | 2.8 | 2.8 | 2.8 | 2.8 | 2.8 | 2.9 | 2.7 | 2.8 |

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

1/ Using the program exchange rate of Rs 94/US$ from March 2002 onward. Excludes any recapitalization of commercial banks.
2/ NFA is valued at historical cost as in the original program.
3/ Adjusted by a geometric mean.

Table 4. Sri Lanka: Balance of Payments, 1999-2002

| | 1999 | 2000 | 2001 Prov. | 2002 Rev. Proj. | 2002 Rev. Prog. Jan.-Jun. |
|---|---|---|---|---|---|
| | | | (In millions of U.S. dollars) | | |
| Trade balance | -1,369 | -1,798 | -1,157 | -1,249 | -858 |
| Exports | 4,610 | 5,522 | 4,817 | 5,058 | 2,148 |
| Imports | 5,979 | 7,320 | 5,974 | 6,307 | 3,005 |
| Services, net | 149 | 38 | 109 | 76 | 68 |
| Receipts | 968 | 953 | 1,270 | 970 | 533 |
| Payments | 819 | 915 | 1,161 | 894 | 464 |
| Income, net | -253 | -304 | -280 | -276 | -114 |
| Receipts | 167 | 152 | 94 | 97 | 94 |
| Payments | 420 | 456 | 373 | 373 | 208 |
| Private transfers, net | 887 | 974 | 938 | 1,030 | 546 |
| Current account (excluding grants) | -586 | -1,090 | -391 | -419 | -358 |
| Official transfers | 26 | 25 | 22 | 29 | 20 |
| Current account (including grants) | -560 | -1,065 | -369 | -390 | -338 |
| Capital and financial account | 372 | 445 | 536 | 706 | 397 |
| Capital transfers, (net) | 80 | 50 | 197 | 63 | 44 |
| *of which* Aircraft disposal | | | 148 | | |
| Financial account | 292 | 395 | 339 | 642 | 353 |
| Long-term: | 435 | 307 | 163 | 652 | 266 |
| Direct investment | 177 | 176 | 172 | 350 | 135 |
| Foreign direct investment, net | 177 | 173 | 82 | 225 | 130 |
| Privatization proceeds | 0 | 3 | 90 | 125 | 5 |
| Private, long-term (net) 1/ | 196 | 83 | -257 | 58 | 34 |
| Disbursements | 361 | 301 | 44 | 175 | 88 |
| Amortization | 165 | 217 | 301 | 117 | 54 |
| Government, long-term (net) | 62 | 47 | 248 | 244 | 97 |
| Disbursements | 381 | 355 | 575 | 637 | 280 |
| Amortization | 319 | 308 | 327 | 393 | 182 |
| Short-term, net | -143 | 88 | 176 | -10 | 88 |
| Portfolio investment, net (CSE) | -13 | -45 | -11 | 40 | 14 |
| Private short-term, net | -10 | 100 | -18 | -12 | -6 |
| Commercial banks (net) | -120 | 33 | 254 | -88 | 30 |
| Government short-term, net | 0 | 0 | -50 | 50 | 50 |
| Errors and omissions 2/ | -72 | 99 | 53 | 0 | 25 |
| Overall balance | -259 | -522 | 220 | 315 | 84 |
| Financing requirement | -259 | -522 | -220 | 668 | 177 |
| Net international reserves | 259 | 522 | -220 | -542 | -107 |
| *Of which*: Use of existing Fund credit, net | -99 | -97 | 53 | -49 | -28 |
| Increase in gross official reserves (-) | 340 | 619 | -270 | -619 | -149 |
| Central bank borrowing, net | 18 | 0 | -3 | 0 | 0 |
| Financing gap | | | | 353 | 93 |
| *Of which*: World Bank | | | | 82 | 10 |
| ADB | | | | 35 | 10 |
| IMF | | | | 126 | 63 |
| Bilaterals | | | | 30 | 10 |
| Unidentified 3/ | | | | 80 | 0 |
| | | | (In percent of GDP) | | |
| Memorandum items: | | | | | |
| Current account (excl. official transfers) | -3.7 | -6.6 | -2.5 | -2.6 | -2.2 |
| Current account (incl. official transfers) | -3.6 | -6.4 | -2.4 | -2.4 | -2.1 |
| Overall balance | -1.6 | -3.1 | 1.4 | 1.9 | 0.5 |
| Total external debt (incl IMF) | 63.2 | 60.8 | 61.8 | 62.7 | 61.8 |
| Total debt service (percent of exports of g&s) | 15.2 | 14.7 | 13.3 | 13.4 | 13.3 |
| Gross official reserves (US$ millions) 4/ | 1,530 | 911 | 1,182 | 1,800 | 1,330 |
| (In months of imports) | 2.2 | 1.5 | 2.0 | 2.8 | 2.1 |
| Net official reserves (US$ millions) | 1,272 | 750 | 970 | 1,512 | 1,080 |
| GDP (in millions of U.S. dollars) | 15,712 | 16,596 | 15,669 | 16,433 | 16,433 |

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

1/ Includes public corporations.
2/ Includes valuation gains or losses from 1998 onwards.
3/ Currently assumed to be filled from non-Fund sources, but could be from Fund financing.
4/ For program purposes, gross reserves are shown here net of ACU debit balances.

(In percent of GDP unless otherwise noted)

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|
| Real sector | | | | | | | | |
| GDP at market prices (percent change) | 4.3 | 6.0 | -1.4 | 3.7 | 5.5 | 6.0 | 6.5 | 6.5 |
| GDP deflator (percent change) | 4.2 | 7.3 | 13.0 | 9.2 | 6.2 | 5.0 | 4.6 | 4.4 |
| Gross national saving | 23.5 | 21.5 | 19.5 | 22.0 | 23.6 | 25.1 | 26.4 | 26.8 |
| Gross investment | 27.3 | 28.0 | 22.0 | 24.6 | 26.1 | 27.6 | 28.9 | 29.4 |
| Fiscal sector | | | | | | | | |
| Total revenue | 17.7 | 16.8 | 16.5 | 17.5 | 18.8 | 19.1 | 19.3 | 19.2 |
| Total expenditure and net lending | 25.2 | 26.7 | 27.4 | 26.0 | 25.4 | 24.5 | 23.9 | 23.2 |
| Current expenditure | 18.7 | 20.2 | 21.4 | 20.9 | 18.5 | 17.4 | 16.8 | 16.2 |
| *Of which* : Defense expenditure | 3.4 | 4.6 | 3.8 | 3.0 | 2.4 | 2.0 | 2.0 | 2.0 |
| *Of which* : Interest payments | 5.6 | 5.7 | 6.7 | 7.5 | 6.2 | 5.9 | 5.6 | 5.3 |
| Overall balance | -7.5 | -9.9 | -10.9 | -8.5 | -6.6 | -5.4 | -4.6 | -4.0 |
| Primary balance | -1.9 | -4.2 | -4.1 | -1.0 | -0.4 | 0.5 | 1.0 | 1.3 |
| Net external financing | 0.1 | 0.7 | 1.6 | 2.6 | 1.5 | 1.4 | 1.3 | 1.8 |
| Grants | 0.6 | 0.4 | 0.4 | 0.5 | 0.5 | 0.4 | 0.4 | 0.3 |
| Net domestic financing | 6.8 | 8.8 | 8.3 | 4.1 | 3.8 | 3.3 | 2.7 | 1.7 |
| Total government debt | 95.1 | 96.8 | 103.6 | 101.3 | 97.5 | 93.3 | 88.5 | 83.9 |
| Domestic | 49.1 | 53.8 | 58.3 | 55.6 | 53.4 | 51.3 | 48.7 | 45.5 |
| Foreign | 45.9 | 43.1 | 45.3 | 45.8 | 44.1 | 42.0 | 39.8 | 38.3 |
| External sector | | | | | | | | |
| Trade balance | -8.7 | -10.8 | -7.4 | -7.6 | -7.6 | -7.4 | -7.5 | -7.4 |
| External current account balance (incl. transfers) | -3.6 | -6.4 | -2.4 | -2.4 | -2.4 | -2.4 | -2.5 | -2.5 |
| Overall balance | -1.6 | -3.1 | 1.4 | 1.9 | 1.5 | 1.5 | 1.1 | 1.3 |
| Gross official reserves less ACU balance (US$b) | 1.5 | 0.9 | 1.2 | 1.8 | 2.3 | 2.7 | 3.1 | 3.5 |
| (months of imports of goods and services) | 2.2 | 1.5 | 2.0 | 2.8 | 3.2 | 3.6 | 3.9 | 4.0 |
| External debt | | | | | | | | |
| Total external debt | 63.2 | 60.8 | 61.8 | 62.7 | 60.7 | 58.2 | 55.4 | 53.3 |
| Monetary sector | | | | | | | | |
| Broad money (percent change) | 13.4 | 12.9 | 13.6 | 12.5 | 10.6 | 11.3 | 11.4 | 11.2 |
| Memorandum items: | | | | | | | | |
| Oil price ($ per barrel) | 18.0 | 28.2 | 24.3 | 24.4 | 24.2 | 22.4 | 22.0 | 21.0 |

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

Table 6. Sri Lanka: Vulnerability Indicators, 1999-2002

(In percent of GDP, unless otherwise indicated)

| | 1999 | 2000 | 2001 | 2002 Latest 1/ |
|---|---|---|---|---|
| Official risk indicators 2/ | | | | |
| Share of nonperforming loans (as percent of total loans) | | | | |
| State-owned commercial banks | 18.5 | 15.4 | 18.2 | 19.3 |
| Domestic private banks | 15.9 | 14.9 | 15.7 | 16.8 |
| Foreign banks | 10.7 | 12.7 | 13.2 | 12.8 |
| Risk-based capital asset ratio (capital over risk-weighted assets) 3/ | | | | |
| State-owned commercial banks | 8.4 | 2.2 | 0.1 | -0.1 |
| Domestic private banks | 12.2 | 11.4 | 10.4 | 9.7 |
| Foreign banks | 12.4 | 13.0 | 16.0 | 15.5 |
| Financial sector risk indicators | | | | |
| Public sector debt | 95.1 | 96.8 | 103.6 | ... |
| Broad money (percent change, 12-month basis) 4/ | 13.4 | 12.9 | 13.6 | 16.2 |
| Private sector credit (percent change, 12 month basis) 4/ | 10.5 | 11.8 | 8.9 | 5.6 |
| Share of deposits in broad money 4/ | 86.3 | 87.3 | 88.1 | 88.2 |
| Share of foreign currency deposits in total deposits 4/ | 20.4 | 21.1 | 21.3 | 22.7 |
| Share of private credit collateralized by immovable property, plant, and machinery 5/ | 26.9 | 28.6 | 28.2 | ... |
| Share of housing and property development in private credit 5/ | 13.0 | 13.0 | 14.0 | ... |
| Market assessment indicators | | | | |
| Stock market index (1985=100, e.o.p.) | 573 | 448 | 621 | 711 |
| Share price index of financial institutions (1985=100, e.o.p.) | 1,214 | 870 | 1,356 | 1,743 |
| External indicators | | | | |
| Exports (percent change, 12-month basis in US$) | -3.9 | 19.8 | -12.8 | -16.0 |
| Imports (percent change, 12-month basis in US$) | 1.5 | 22.4 | -18.4 | -10.7 |
| Current account balance (excluding official transfers) | -3.7 | -6.6 | -2.5 | ... |
| Capital and financial account balance | 2.4 | 2.7 | 3.4 | ... |
| *Of which*: Portfolio investment | -0.1 | -0.3 | -0.1 | ... |
| Medium- and long-term inflows, net | 2.8 | 1.8 | 1.0 | ... |
| Foreign direct investment | 1.1 | 1.0 | 0.5 | ... |
| Gross official reserves excl. ACU balance (in millions of US$) | 1,530 | 911 | 1,182 | 1,360 |
| Central Bank short-term foreign liabilities excluding ACU balance (in millions of US$) | 0.0 | 0.0 | 0.0 | 0.0 |
| Short-term foreign assets of commercial banks (in millions of US$) 4/ | 850 | 1,001 | 1,198 | 1,247 |
| Short-term foreign liabilities of commercial banks (in millions of US$) 4/ | 722 | 885 | 948 | ... |
| Foreign currency exposure of commercial banks 4/ 6/ | 100 | 100 | 100 | 100 |
| Gross official international reserves (as percent of imports of goods & services) | 22.5 | 11.1 | 16.6 | ... |
| Gross official international reserves (as percent of broad money) | 25.8 | 15.6 | 20.0 | 22.4 |
| Short-term debt 7/ | 8.7 | 9.9 | 10.7 | ... |
| Gross official international reserves (as percent of short-term debt) 8/ | 92.4 | 45.7 | 59.3 | 65.6 |
| Total external debt | 63.2 | 60.8 | 61.8 | ... |
| External interest payments (as percent of exports goods & services) | 5.3 | 5.1 | 4.2 | ... |
| Debt service (as percent of exports goods & services) | 15.2 | 14.7 | 13.3 | ... |
| Exchange rate (rupee per US$, period average) | 70.4 | 75.8 | 89.4 | 96.1 |

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

1/ Official risk indicators, end-March 2002, Stock market, June; Reserves, July 24; external trade, January-May;exchange rate, July 26; monetary data, end-May. The deterioration in the capital asset ratios of state-owned banks and non-performing loans can be partly explained by compliance to tighter provisioning requirements as well as the impact of high real interest rates on the balance sheets of banks during the past 12 months.

2/ Excluding foreign currency banking units (FCBUs).

3/ Weighted averages of individual bank data.

4/ Including foreign currency banking units (FCBUs).

5/ Based on quarterly survey of loans and advances of commercial banks.

6/ Foreign currency liabilities as a percent of foreign currency assets.

7/ Includes CPC acceptance credits, other trade credits, Central Bank ACU balances, and commercial bank liabilities.

8/ Based on residual maturity, including amortization of public and publicly guaranteed debt.

## Table 7. Sri Lanka: External Financing Needs and Sources, 1999-2002

(In millions of U.S. dollars)

| | 1999 | 2000 | 2001 Prov. | 2002 Proj. | 2002 Proj Jan.-Jun. |
|---|---|---|---|---|---|
| Gross financing needs | 958 | 994 | 1,097 | 1,721 | 759 |
| External current account deficit (excl. official transf | 586 | 1,090 | 391 | 419 | 358 |
| Debt amortization | 614 | 426 | 359 | 633 | 224 |
| Medium and long term debt | 484 | 525 | 628 | 510 | 237 |
| Public sector | 319 | 308 | 327 | 393 | 182 |
| Corporate private sector | 165 | 217 | 301 | 117 | 54 |
| Short-term debt 1/ | 130 | -99 | -269 | 123 | -12 |
| Gross reserves accumulation (- = increase) 2/ | 340 | 619 | -270 | -619 | -149 |
| IMF repurchases and repayments | 99 | 97 | 78 | 49 | 28 |
| Financing sources | 958 | 994 | 1,097 | 1,368 | 666 |
| Foreign direct investment (net) | 177 | 176 | 172 | 350 | 135 |
| Debt financing from private creditors | 361 | 335 | -38 | 249 | 150 |
| Medium- and long-term financing | 361 | 301 | 44 | 175 | 88 |
| Short-term financing | 0 | 35 | -82 | 74 | 62 |
| Official creditors 3/ | 407 | 380 | 728 | 666 | 299 |
| Other flows 4/ | 14 | 104 | 235 | 103 | 82 |
| Financing gap 5/ | 0 | 0 | 0 | 353 | 93 |

1/ Original maturity of less than 1 year. Stock at the end of the previous period. Includes all short term outflows and changes in commercial banks' NFA.
2/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.
3/ Includes both loans and grants. Includes the IMF.
4/ Includes all other net financial flows, and errors and omissions.
5/ Includes prospective IMF disbursements.

Table 8. Sri Lanka: Indicators of Fund Credit, 1999-2006

| | 1999 | 2000 | 2001 | 2002 Proj. | 2003 Proj. | 2004 Proj. | 2005 Proj. | 2006 Proj. |
|---|---|---|---|---|---|---|---|---|
| Outstanding use of Fund credit 1/ | | | | | | | | |
| In millions of SDRs | 188.1 | 123.2 | 170.6 | 228.0 | 205.6 | 174.2 | 104.4 | 30.2 |
| In millions of U.S. dollars | 257.2 | 162.5 | 217.1 | 284.8 | 257.2 | 219.1 | 131.3 | 38.0 |
| In percent of: | | | | | | | | |
| Quota | 45.5 | 29.8 | 41.3 | 55.2 | 49.7 | 42.1 | 25.2 | 7.3 |
| GDP | 1.6 | 1.0 | 1.4 | 1.7 | 1.5 | 1.1 | 0.6 | 0.2 |
| Exports 2/ | 4.6 | 2.5 | 4.5 | 5.6 | 4.6 | 2.3 | 0.9 | 1.9 |
| Public and publicly guaranteed debt | 2.9 | 1.9 | 2.6 | 3.3 | 2.9 | 2.4 | 1.4 | 0.4 |
| Debt service to the Fund 3/ | 73.9 | 65.7 | 61.2 | 45.4 | 30.3 | 39.1 | 76.1 | 78.0 |
| (in millions of SDR) | | | | | | | | |
| o/w Repurchases | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 25.8 | 69.8 | 74.2 |
| PRGF repayments | 72.7 | 64.9 | 56.0 | 39.2 | 22.4 | 5.6 | 0.0 | 0.0 |
| Charges and interest | 1.2 | 0.8 | 5.2 | 6.2 | 7.9 | 7.7 | 6.3 | 3.8 |
| In percent of: | | | | | | | | |
| Quota | 17.9 | 15.9 | 14.8 | 11.0 | 7.3 | 9.5 | 18.4 | 18.9 |
| GDP | 0.6 | 0.5 | 0.5 | 0.3 | 0.2 | 0.3 | 0.5 | 0.4 |
| Exports 2/ | 1.8 | 1.3 | 1.6 | 1.1 | 0.7 | 0.8 | 1.5 | 1.4 |
| Public and publicly guaranteed external debt | 1.2 | 1.0 | 0.9 | 0.7 | 0.4 | 0.5 | 1.0 | 1.0 |
| Central government revenues (excluding grants) | 2.7 | 2.4 | 3.0 | 2.0 | 1.1 | 1.3 | 2.4 | 2.2 |
| Memorandum item: | | | | | | | | |
| Disbursements under the Stand-by Arrangement (SDRs) | 0.0 | 0.0 | 103.4 | 96.7 | 0.0 | 0.0 | 0.0 | 0.0 |

Sources: Treasurer's Department and staff calculations.

1/ End-of-period.
2/ Exports of Goods and Services.
3/ Based on prospective purchases and repurchase obligations.

## Table 9. Sri Lanka: Performance Criteria and Indicative Targets, June 2001-April 2002

(In billions of rupees; unless otherwise indicated)

| | End-June 2001 | | End-September 2001 | | End-December 2001 | | End-April 2002 | End April 2002 | |
|---|---|---|---|---|---|---|---|---|---|
| | Prog. Target | Adjusted Actual | Prog. Target | Adjusted Actual | Prog. Target | Adjusted Actual | Rev. Program | Actuals | Adjusted Actuals |
| Performance Criteria | | | | | | | | | |
| Ceiling on change in net domestic financing of central government deficit 1/ | ... | ... | ... | ... | ... | ... | 40 | 40 | 39 |
| Ceiling on banks' net claims on government 2/ 4/ | 153 | 150 | 158 | 163 | 133 | 178 | ... | ... | ... |
| Ceiling on net domestic assets of the CBSL 2/ | 46 | 37 | 44 | 23 | 12 | 5 | 32 | 24 | 23 |
| Floor on net international reserves of CBSL 3/ - historical cost (In millions of U.S. dollars) | 745 | 795 | 810 | 963 | 1,195 | 1229 | 983 | 1,023 | 1,018 |
| Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the public sector | 350 | 120 | 350 | 144 | 350 | 127 | 400 | 187 | 187 |
| Ceiling on the stock of short-term external debt | 150 | 0 | 150 | 0 | 150 | 3 | 150 | 3 | 3 |
| Accumulation of external payments arrears<br>Continuous performance criterion during the program period | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Indicative Targets | | | | | | | | | |
| Floor on central government revenue | | | | | | | | | |
| Cumulative from January 1, 2001 | 119 | 119 | 190 | 178 | 258 | 231 | | | |
| Cumulative from January 1, 2002 | | | | | | | 83 | 88 | 88 |
| Primary fiscal balance of central government excluding interest payments | | | | | | | | | |
| Cumulative from January 1, 2001 | 15 | -18 | -20 | -30 | -32 | -58 | | | |
| Cumulative from January 1, 2002 | | | | | | | -10 | -10 | -10 |
| Ceiling on Stock of Net Domestic Debt of the Central Government 2/ 4/ | 714 | 706 | 740 | 734 | 729 | 762 | ... | ... | ... |
| Ceiling on banks' net claims on government 2/ 4/ | ... | ... | ... | ... | ... | ... | 208 | 200 | 199 |
| Credit to public corporations by the banking system 5/ | 50 | 46 | 42 | 43 | 31 | 40 | 41 | 40 | 40 |
| Ceiling on reserve money of the CBSL | 113 | 103 | 115 | 107 | 120 | 116 | 119 | 118 | 118 |

1/ Performance criterion on change in net domestic financing of central government is new and is being set for April, 2002.
2/ Adjusted downward by the full amount of excess rupee equivalent of privatization receipts and upward by shortfall of rupee amount of privatization up to quarterly limits as set out in Table 1 of the TMU; adjusted upward/downward by shortfall/excess of rupee equivalent of foreign program assistance as set out in Table 2 of the TMU.
3/ Net International Reserves (NIR) is valued at historical cost adjusted for program exchange rates. Adjusted upward by the full amount of excess privatization receipts and downward by shortfall in privatization receipts up to quarterly limits as set out in Table 1 of the TMU; adjusted upward/downward by excess/shortfall of foreign program assistance as set out in Table 2 of the TMU.
4/ Net claims on government (NCG) was a performance criterion up to December, 2001.
5/ Based on the stock of credit to public corporations by the banking system.

Table 10. Sri Lanka: Revised Schedule of Reviews and Purchases

| Date | Amount of Purchase (In millions of SDRs) | In Percent of Quota | Conditions |
|---|---|---|---|
| Board approval | 103.35 | 25.0 | Disbursed upon Board Approval on April 20, 2001. |
| Revised Schedule April 15, 2002 | 48.33 | 11.7 | Disbursed upon completion of the first and second reviews of the SBA on April 15, 2002. |
| June 30, 2002 | 48.32 | 11.7 | Observance of end-April 2002 performance criteria completion of the third review. |
| Total | 200.0 | 48.4 | |
| Memorandum item: | | | |
| Total quota | 413.4 | 100.0 | |

Table 11. Sri Lanka: Structural Benchmarks for the Remainder of the Stand-By Arrangement (SBA)

| | Structural Benchmarks for End-June 2002 | Status |
|---|---|---|
| 1. | Privatize two state-owned enterprises (Lanka Marine and Pelwatte Sugar). | Pelwatte was done before June. Lanka Marine was done in August 2002. |
| 2. | a. Advertise the sale of shares for Shell Lanka and SLT to the public; | Shell Lanka was done in June 2002. The sale of shares in SLT were announced in July through an IPO. |
| | b. Implementation plan for sale of SLIC agreed with financial advisors. | SLIC was done in June 2002. |
| 3. | a. Develop an action plan for People's Bank and Bank of Ceylon by May based on options developed with assistance of World Bank and Fund TA. | Done in July, 2002. |
| | b. Specific and measurable targets for the two state banks to be identified and agreed by June. | Done in June 2002. |
| 4. | Finalized report of the task forces on the transactions between the state banks, the government and public corporations, and a strategy for recalcitrant debtors. | Done in July 2002. |

## Alternative Macroeconomic Scenarios and Medium-Term Sustainability Analysis[1]

### I. Alternative Macroeconomic Scenarios

#### A. Low Case Scenario

**Given the risks to the baseline scenario described in paragraph 32 of the main text, the mission discussed with the authorities alternative scenarios on that basis.[1] In the low case scenario (Table A below)**, power shortages continue, drought resumes, there is a return to conflict—which stalls the structural reform and fiscal consolidation agenda—weaker than expected global recovery, and higher oil prices. Moreover, absent structural reform the end of the ATC (Agreement on Textiles and Clothing ) in 2005 will have a substantial adverse impact on exports. As a result, GDP growth is held down to 1 percent over the medium term, with reduced capital inflows, exports, and investment, while inflation stays over 10 percent. With lower foreign exchange inflows, the rupee comes under increasing pressure, which we assume compels the central bank to defend the exchange rate using reserves. Thus gross official reserves decline to $¾ billion (1 month of imports). The fiscal deficit increases to over 11 percent of GDP, largely domestically financed, causing the debt-GDP ratio to rise to 111 percent by 2006.

#### B. High Case Scenario

**For the high case scenario (Table B below), there is early agreement on a peace deal, a more ambitious structural reform agenda is implemented, and there is substantial reconstruction and rehabilitation of the north and east financed by aid**. GDP growth increases to 8½ percent over the medium term, with strong investment, exports, and external financing inflows. Successful fiscal consolidation efforts considerably increase the revenue-GDP ratio and contain current expenditure. However, capital expenditure and transfers to households are significantly larger than under the baseline, reflecting reconstruction, rehabilitation and relief efforts in the north and east, and so the deficit is 1½ percentage points of GDP higher in 2006 than under the baseline. The additional expenditure is financed by donor aid, thus keeping domestic debt and interest rates under control. Increased external financing causes official reserves to increase to $4½ billion (4½ months of imports), significantly higher than under the baseline.

### II. Medium-Term Sustainability Analysis

As part of the Article IV surveillance, and in anticipation of a future PRGF, the staff conducted sustainability assessments for Sri Lanka. In assessing sustainability, the staff adopted a multi-dimensional approach given that the range of possible outcomes is vast. Specifically, the staff looked at three aspects of sustainability, namely: **fiscal, external debt, and the external current account**. A summary of the staff's findings is presented below.

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[1] More detailed work done by the staff on fiscal and external sustainability is available in the accompanying selected issues paper.

- **Fiscal sustainability**: Standard fiscal sustainability analysis shows that, prior to the adjustment announced in the 2002 budget, fiscal policy was clearly unsustainable, leading to a rising debt-GDP ratio. If the adjustment, centering on revenue reform—including the creation of a new unified revenue authority—and compression of current expenditure, continues into the medium term, then fiscal policy is sustainable. This conclusion, however, is highly sensitive to assumptions about growth. If growth fails to take off, then fiscal policy will be unsustainable, even in the presence of strong adjustment. Other risks include: a failure of revenue reform to produce results; a fall in external financing; recourse to nonconcessional foreign borrowing; and higher capital spending. Although the analysis shows that none of these scenarios alone endangers sustainability, any combination of them, especially with the failure of growth to rebound in the medium term, could lead to trouble.

- **External debt sustainability**: After a decline from the peaks of the mid-1990s, external debt ratios have begun to increase steadily from 2000. The staff's baseline scenario shows that these ratios decline significantly into the medium term as a result of strong growth founded on renewed peace and political stability, far-reaching structural reforms, and stable macroeconomic conditions. As with work on public debt sustainability, this scenario is highly sensitive to assumptions on growth and, to a lesser extent, non debt creating capital inflows. The main message from the sensitivity analysis is that if there is no radical departure from past outcomes (including on growth, exports and FDI) and the associated policies, the external debt ratio will be significantly higher (by over 17 percentage points of GDP) than the baseline by 2006. Debt ratios are more resilient to temporary shocks to interest rates, growth, and the current account, but a combination of these or large depreciation of the exchange rate could jeopardize sustainability. Even after allowing for the grant element, debt ratios average about 48 percent of GDP into the medium term, a level that empirical work has identified as a cause for concern. This implies caution in the volume of new borrowing, ensuring it is largely on nonconcessional terms or grants.

- **External current account sustainability**: The analysis of the external current account sustainability (based on the savings-investment balance) was conducted using the macroeconomic balance approach (Chinn and Prasad-2000). The results indicate that during 1999-2000, the actual savings-investment balance was out of line with the underlying model-based equilibrium savings-investment balance, reflecting mainly the larger fiscal deficit. However, by end-2001 the imbalance had been eliminated. Extending the savings-investment balance analysis to equilibrium real exchange analysis, shows that the real exchange rate was overvalued during 1999-2000. Looking forward, if adjustment measures continue, the external position would stay on a sustainable path. However, radical departures from the fiscal stance assumed in the staff's medium-term baseline scenario would pose a risk to external sustainability.

Table A. Sri Lanka: Low Case Macroeconomic Scenario, 2001-2006

(In percent of GDP unless otherwise noted)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Real sector | | | | | | |
| GDP at market prices (percent change) | -1.4 | 1.0 | 2.5 | 3.5 | 0.5 | 1.0 |
| GDP deflator (percent change) | 13.0 | 12.0 | 11.0 | 11.0 | 11.0 | 11.0 |
| Gross national saving | 19.5 | 21.5 | 20.6 | 19.8 | 18.5 | 18.4 |
| Gross investment | 22.0 | 24.2 | 23.6 | 22.9 | 22.3 | 21.6 |
| Fiscal sector | | | | | | |
| Total revenue | 16.5 | 17.0 | 17.0 | 17.5 | 17.5 | 17.4 |
| Total expenditure and net lending | 27.4 | 27.8 | 28.0 | 28.5 | 28.6 | 28.5 |
| Overall balance | -10.9 | -10.8 | -11.0 | -11.0 | -11.1 | -11.1 |
| Total government debt | 103.6 | 105.5 | 106.4 | 106.4 | 109.3 | 111.4 |
| External sector | | | | | | |
| External current account balance (incl. transfers) | -2.4 | -2.6 | -2.8 | -2.9 | -3.7 | -3.1 |
| Overall balance | 1.4 | 0.2 | -0.2 | -0.3 | -1.0 | -0.6 |
| Gross official reserves less ACU bal. (US$b) | 1.2 | 1.4 | 1.3 | 1.2 | 0.9 | 0.7 |
| (months of imports of goods and services) | 2.0 | 2.3 | 2.0 | 1.8 | 1.4 | 1.1 |
| Total external debt | 61.8 | 65.0 | 62.4 | 59.2 | 58.3 | 57.4 |
| Memorandum items: | | | | | | |
| Oil price ($ per barrel) | 24.3 | 25.0 | 27.0 | 28.0 | 28.0 | 28.0 |

Table B. Sri Lanka: High Case Macroeconomic Scenario, 2001-2006

(In percent of GDP unless otherwise noted)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Real sector | | | | | | |
| GDP at market prices (percent change) | -1.4 | 3.7 | 7.5 | 8.0 | 8.5 | 8.5 |
| GDP deflator (percent change) | 13.0 | 9.0 | 6.2 | 5.0 | 4.6 | 4.4 |
| Gross national saving | 19.5 | 22.4 | 24.5 | 25.3 | 26.5 | 27.7 |
| Gross investment | 22.0 | 25.2 | 27.6 | 29.3 | 30.4 | 31.6 |
| Fiscal sector | | | | | | |
| Total revenue | 16.5 | 17.5 | 18.8 | 19.1 | 19.3 | 19.3 |
| Total expenditure and net lending | 27.4 | 26.5 | 27.3 | 26.6 | 25.8 | 24.8 |
| Overall balance | -10.9 | -9.0 | -8.5 | -7.5 | -6.5 | -5.5 |
| Total government debt | 103.6 | 101.9 | 97.8 | 93.5 | 88.7 | 83.6 |
| External sector | | | | | | |
| External current account balance (incl. transfers) | -2.4 | -2.6 | -2.5 | -3.3 | -3.3 | -3.3 |
| Overall balance | 1.4 | 1.8 | 2.0 | 1.5 | 1.6 | 1.0 |
| Gross official reserves less ACU bal. (US$b) | 1.2 | 1.9 | 2.6 | 3.2 | 3.8 | 4.4 |
| (months of imports of goods and services) | 2.0 | 2.8 | 3.5 | 3.9 | 4.3 | 4.5 |
| Total external debt | 61.8 | 64.0 | 61.9 | 60.0 | 58.0 | 56.0 |
| Memorandum items: | | | | | | |
| Oil price ($ per barrel) | 24.3 | 23.0 | 22.0 | 21.0 | 21.0 | 21.0 |

## Sri Lanka—Safeguards Assessments—Summary of Conclusions and an Updated Progress Report on the Implementation of Various Remedies

**Safeguards Assessment**: A Stage Two on-site safeguards assessment of the CBSL confirmed critical weaknesses in the bank's external audit mechanism, financial reporting framework, and internal control system. The safeguards assessment proposed recommendations in each of the five safeguards areas, as detailed below. The authorities have accepted the need for the proposed remedies and management has endorsed the recommendations.

***Status**: The staff has integrated the remedies in the ongoing SBA and the CBSL has already implemented most of the recommendations.*

**External Audit Mechanism**: The external audit of the CBSL, which is conducted by the Auditor General of Sri Lanka, is largely related to compliance with rules and regulations, and falls short of international best practices. The safeguards assessment, therefore, proposed that: (i) the CBSL appoint an external audit firm to conduct the financial audit of the bank, beginning in 2001; and (ii) the CBSL establish an audit committee of its Monetary Board to handle relations with internal and external auditors, including the selection of external auditors for the 2001 financial year audit, and to improve overall corporate governance.

***Status**: An audit committee was appointed in August 2001. An external audit firm (Ernst and Young, New Zealand) was appointed in March 2002. The auditor commenced work on April 1,2002 and on June 25, the external auditor submitted its report on the audited accounts to the CBSL management. A month earlier the CBSL had published their accounts in their annual report and thus did not publish the second set of audited accounts by Ernst and Young to avoid confusion. In their report, the external auditors were only able to express an informal opinion which was subject to a number of caveats. This was largely due to their belated appointment—thus, they were not able to conduct a comprehensive IAS type audit. The auditors however identified a few weaknesses including the inappropriate accounting treatment by the CBSL of IMF accounts and contingent liabilities. The CBSL has already corrected both of these and are addressing other weaknesses identified in the Ernst and Young's report. The CBSL has appointed Ernst and Young to conduct the audit of the 2002 accounts.*

**Legal Structure and Independence**: While, in practice, the CBSL enjoys a large degree of independence from the government in the conduct of its monetary and exchange rate operations, the legislation governing CBSL could be amended at some point to bring the provisions concerning auditing, accounting, and credit to government in line with best practices. In the interim, staff recommends that the Monetary Board of the CBSL adopt resolutions in the areas of accounting and auditing.

***Status**: The CBSL's Monetary Board adopted resolutions in the areas of accounting and auditing in September 2001.*

**Financial Reporting**: The CBSL does not apply an internationally recognized set of accounting standards in the preparation of its financial statements. Furthermore, the published financial statements include only a summary balance sheet and income statement. To address these vulnerabilities, staff recommends that the CBSL adopt International Accounting Standards, publish its financial statements in full, and institute a training program for accountants.

***Status**: The CBSL completed the preparation of an IAS-compliant financial reporting template and restated FY 2000 financial statements in accordance with IAS and prepared IAS-compliant financial statements for FY 2001 in January 2002. In addition, monthly balance sheets are now prepared on an accrual basis and are consistent with the IAS-based annual accounts.*

**Internal Audit Mechanism**: The internal audit function at the CBSL focuses on compliance reviews of operational controls and does not have the capacity of perform risk-based, financial, or IT audits of CBSL operations. Bank management has identified the internal audit function as a beneficiary of its current bank-wide restructuring effort, and staff recommends that the CBSL continue to improve internal audit with the assistance of external consultants.

***Status**: A new Chief Accountant has been appointed. The external auditor commenced their work on the review of the management audit department in July and will submit an interim report by mid-August 2002. The external review of the management audit department would be formally completed by end-September, 2002.*

**System of Internal Controls**: The CBSL has a number of low-level controls in the area of reserves management. Nevertheless, there remain significant vulnerabilities related to the valuation of the bank's foreign and domestic assets. In particular, the CBSL records its foreign securities at historical cost, and in so doing, considerably overstates their value. In addition, there are concerns about the concentration of authority for foreign exchange dealing, settlement, and accounting in one department of the bank. Staff therefore recommends that the CBSL develop a formal system of verifying the value of data reported to the Fund and ensure that reported data reflect the market value of the underlying assets. The CBSL should also segregate duties in the area of foreign exchange operations during its current restructuring effort.

***Status**: The CBSL has adopted a formal mechanism of verifying the data reported to the Fund and now regularly reports reserves expressed in terms of both market value and historical costs. With effect from January 2002, as part of its ongoing restructuring exercise, the CBSL has reconstituted the Banking Department into four departments namely the International Operations Department (IOD),Domestic Operations Department (DOD), Payments & Settlements Department (PSD)and the Finance Department (FD). The CBSL has also now allocated foreign exchange dealing to the IOD, settlements to PSD and accounting to FD. The CBSL has resolved small unconfirmed foreign exchange balances with correspondent banks abroad. The work on the review of the high level internal control system and adopting a formal risk management process began in June 2002, and a final report will be completed by end-September, 2002.*

**Safeguards Assessment for the Next PRGF Arrangement**

*In accordance with the guidelines, under a new arrangement, the CBSL will also be subject to subsequent safeguards assessment which will be based on the review of documents submitted by the CBSL to the Fund. On July 16, Treasurer's Department sent a letter to Governor Jayawardena requesting this documentation by August 23, 2002, if possible. The documents required include copies of all reports related to the central bank's organization, audit, control, and financial reporting mechanisms that may have been issued during the past year by parties external to the central bank.*

## Sri Lanka—Implementation of Previous Fund Policy Advice by the Authorities

**In general**, the Sri Lankan authorities have implemented Fund policy advice during the Stand-By Arrangement (SBA). The authorities also regularly consult the Fund staff on policies they initiated.

**In terms of specific areas of policy advice,**

- The authorities have generally followed the staff's advice on **fiscal issues**. However, during the second half of 2001, the authorities departed significantly from the policy agreed with the Fund on revenues and expenditures—the SBA reviews were consequently delayed. Examples include the pre-2001 December election tax cuts and wage and pension increases, and the award of some tax incentives in the 2002 Budget. Nevertheless, even during this period, the authorities made efforts to follow the staff's advice on tax policy regime changes and tax administration. Specifically, in collaboration with FAD's TA mission and AsDB, the authorities organized seminars on tax policy and tax administration and the conclusions from these seminars were subsequently incorporated in the 2002 Budget. At other times, there have been instances where political and other considerations carried the day and the authorities ignored the staff's advice.
- On January 23, 2001, the CBSL floated the rupee in the context of program negotiations for the SBA. In addition, the authorities have implemented most of the recommendations of the MAE TA mission to improve the functioning of the foreign exchange markets. The CBSL removed most of the foreign exchange regulations that were imposed after the float following the staff's advice on this.
- The CBSL has also followed Fund staff's advice on the conduct of **monetary policy**. The CBSL regularly contacts the Fund staff before implementing particular monetary policy decisions. Examples include the various decisions to cut the CBSL's key policy rates—the reverse repo and repo rates—and the decision to cut the statutory reserve requirements (SRR) for commercial banks. The authorities have implemented most of the recommendations of the MAE and FSAP missions in the area of improving the monetary policy framework.
- The authorities have also in general followed the Fund staff's policy advice in the area of **structural reforms**. The long overdue petroleum pricing formula was introduced by the new government as soon as the new government assumed office in late December 2001.[1] The authorities also moved quickly to remove restrictions on FDI flows in various sectors. They have also amended their **draft anti-money laundering legislation** to incorporate the joint Bank-Fund FSAP recommendations.
- The authorities have implemented the recommendations of the Stage II **Safeguards Assessment** report.

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[1] However, the authorities recently removed the debt recovery component of the pricing formula to reduce the cost of petroleum and diesel, against the staff's advice.

## Sri Lanka—Fund Relations

(As of June 30, 2002)

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

| II. **General Resources Account**: | SDR Million | Percent Quota |
|---|---|---|
| Quota | 413.40 | 100.00 |
| Fund holdings of currency | 517.32 | 125.14 |
| Reserve position in Fund | 47.79 | 11.56 |

| III. **SDR Department**: | SDR Million | Percent Allocation |
|---|---|---|
| Net cumulative allocation | 70.87 | 100.00 |
| Holdings | 9.71 | 13.70 |

| IV. **Outstanding Purchases and Loans**: | SDR Million | Percent Quota |
|---|---|---|
| Stand-By Arrangements | 151.68 | 36.69 |
| ESAF arrangements | 44.80 | 10.84 |

V. **Financial Arrangements**:

| Type | Approval Date | Expiration Date | Amount Approved (SDR Million) | Amount Drawn (SDR Million) |
|---|---|---|---|---|
| Stand-By | Apr 20, 2001 | Jun 19, 2002 | 200.00 | 151.68 |
| ESAF | Sep 13, 1991 | Jul 31, 1995 | 336.00 | 280.00 |
| SAF | Mar 09, 1988 | Oct 21, 1991 | 156.17 | 156.17 |

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

| | Overdue (05/31/02) | Forthcoming | | | | |
|---|---|---|---|---|---|---|
| | | 2002 | 2003 | 2004 | 2005 | 2006 |
| Principal | -- | 16.80 | 22.40 | 31.40 | 63.80 | 50.00 |
| Charges/interest | -- | 3.20 | 6.20 | 6.00 | 4.60 | 2.50 |
| Total | -- | 20.00 | 28.60 | 37.40 | 68.40 | 52.50 |

VII. **Exchange Rate Arrangement**:

Independent float. The central bank floated the rupee on January 23, 2001. The CBSL has removed the foreign exchange regulations that were imposed after the float (EBS/02/59).

VIII. **Safeguards Assessment**:

Under the Fund's safeguards assessment policy, a Stage One assessment of the CBSL was completed on June 13, 2001 concluding that high risks may exist in the external audit mechanism, the financial reporting framework, and the system of internal controls. The Stage Two (on-site) assessment was completed on August 30, 2001. A summary of staff's findings and recommendations and actions taken by the authorities is in Annex I.

VIII. **Article IV Consultation**:

Sri Lanka is on the standard 12-month consultation cycle. The Executive Board concluded the 2001 Article IV consultation (EBS/01/41) on April 20, 2001.

IX. **FSAP and ROSC Participation**:

- MAE: Two FSAP missions visited Colombo during November 1-14, 2001 and February 6-20, 2002. The FSAP report is being finalized. The mission identified a number of vulnerabilities which could lead to systemic problems if left unaddressed. A joint Bank-Fund TA mission visited Colombo between May 6-10, 2002 to provide advice on Peoples Bank. The mission also advised the Bank of Ceylon on their restructuring plan. A Joint Bank-Fund TA mission is scheduled for September/October 2002 to help the authorities review their draft financial laws.

- STA: A data ROSC mission visited Colombo during June 7-22, 2001, and the authorities' comments were incorporated in the final report which was approved by the Executive Board and published on the Fund's website. The authorities have requested follow-up technical assistance in the areas of national accounts, government finance statistics, and compiling the international investment position. A follow-up STA ROSC mission visited Colombo during May 22-24 to discuss the implementation of the recommendations of the data module for the ROSC.

- FAD: An FAD ROSC mission is also currently visiting Colombo between May 13-21. The mission's principal task is to help and develop a ROSC fiscal transparency module for the authorities and strengthen the control and monitoring of defense expenditures. An FAD TA mission is scheduled for August 2002 to discuss the issues involved in setting up a new revenue authority.

X. **Technical Assistance, 1997–2001**:

| Department | Purpose | Date |
|---|---|---|
| FAD | ▪ Public expenditure management | March 1998 |
| | ▪ Cash management and expenditure monitoring | February 1997-February 1998 |
| | ▪ Implementing a Goods and Services Tax and tax administration | January-February 1997; March 1997-September 1998 |
| | ▪ GST Seminar | July 1999 |
| | ▪ Government securities market | December 1999 |
| MAE | ▪ Monetary Policy Instruments | May 2001 |
| STA | ▪ General Data Dissemination System | June-July 1997, February-March 2000 |
| | ▪ Price indices | October 1998 |

XI. **Resident Representative**:

A resident representative has been stationed in Sri Lanka since October 1977. Mr. Haque has been the Senior Resident Representative since August 1999 and his term expired in August, 2002. He will be succeeded by Mr. Carter from October 2002.

## Sri Lanka—Relations with the World Bank Group[1]

Sri Lanka has received 12 IBRD loans totaling $211 million and 84 IDA credits totaling $2.43 billion since joining the World Bank group in 1954, and loans of $45 million and equity commitments of $25 million since joining the IFC in 1970. As of May 31, 2002, MIGA's portfolio in Sri Lanka consists of one guarantee contract with a gross exposure of US$1.7 million. During FY 89–02, IDA approved 35 credits totaling $1.3 billion.

The Country Assistance Strategy (CAS) Progress Report of January 1999 featured support for macroeconomic and sector reforms to achieve sustained growth, employment and poverty reduction by promoting private sector-led growth in a manner consistent with the country's concern for social welfare and equity. The proposed lending program included a number of relatively high risk, high return operations to address policy issues in health, poverty and rural development, infrastructure, private sector development and civil service/governance.

In FY 01, IDA approved three projects designed to: (i) help establish distance learning capacity in the country; (ii) pilot the design and initial implementation of land titling reforms; and (iii) support the reorganization and strengthening of the Central Bank. In FY 02, IDA (along with financing from the Global Environmental Facility) approved a renewable energy project designed to improve the quality of rural life by utilizing off-grid renewable energy technologies to bring electricity to remote communities. In the future, the Bank will likely provide IDA credits to help increase agricultural productivity, reduce rural poverty, reform tertiary education, and expand access to rural water and sanitation. Support will also be considered to restructure and promote private investment in various sub-sectors, and in the social sectors to help improve quality, access, financing and management of education and address health issues raised by an aging population, financing constraints, and declining quality, as well as emerging health issues (i.e., HIV/AIDS prevention). Recent pieces of analytical work include a poverty analysis (June 2002), a Country Procurement Assessment Review (CPAR) and a Country Financial Accountability Assessment (CFAA) to be finalized in early FY 03. A Public Expenditure Review (PER) will be initiated in FY 03.

A local Development Forum—chaired by the Government—was held in Colombo on June 5-6, 2002. The meeting broadly endorsed the government's draft Poverty Reduction Strategy Paper (PRSP) and the Framework for Relief, Rehabilitation and Reconciliation (RRR). The Bank/IMF have been working with the government throughout the preparation of the PRSP, which is expected to be presented to the Bank/IMF Boards in the first half of FY 03.

Lending by the World Bank Group, FY 1996-2002[1/]

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|
| | | | (In millions of U.S. dollars) | | | | |
| IBRD (net) | -7 | -6 | -6 | -6 | -6 | -4 | -4 |
| IDA (net) | 101 | 78 | 60 | 73 | 30 | 25 | 39 |
| Disbursements | 109 | 88 | 71 | 87 | 46 | 48 | 69 |
| Amortization | 8 | 10 | 11 | 14 | 16 | 23 | 31 |
| Total loans/credits (net) | 94 | 72 | 54 | 67 | 24 | 21 | 34 |
| Interest and charges | 16 | 15 | 14 | 14 | 14 | 13 | 13 |

Source: Data provided by the World Bank, Controller's Department

[1/] As of June 30, 2002.

[1] Prepared by World Bank staff.

## Sri Lanka—Relations with the Asian Development Bank[1]

The Asian Development Bank (AsDB) started its operation in Sri Lanka in 1969 and has provided 105 public sector loans totaling about $2.6 billion and 189 TAs totaling about $75.2 million. AsDB has also assisted 9 private sector projects (4 loans and 6 equity investments) amounting $83 million (with $72 million in loans and $11 million in equity investments).

In 2001, AsDB approved six loans for four projects to Sri Lanka totaling $146 million and $4 million in technical assistance grants, to support development and reforms in key areas of the economy. The AsDB assistance includes Colombo Port's increased efficiency and expansion, North East community restoration and development, Southern Province rural economic advancement, and SME development.

AsDB also provided (in 2000), through its private sector window, a loan of $26 million without Government guarantee and a political risk guarantee of commercial co-financing of $52 million, to support private sector power supply in Sri Lanka. In 2001, ADB approved an equity investment of $360,000 in Sri Lanka's first private sector housing bank, which will provide loans to low and middle income borrowers. AsDB's strategy to enhance private sector development to contribute to growth and poverty reduction has a two-pronged approach: (i) the promotion of an enabling environment for private sector activities through AsDB's public sector operations, and (ii) direct investment in private sector companies in the form of loan and equity through operations of AsDB's Private Sector Group.

Over the medium term, the AsDB aims to help reduce poverty and achieve sustainable growth by supporting: (i) reforms to promote private sector development and improve public sector management; (ii) human development; (iii) enhancement of infrastructure; (iv) preservation of the natural resource base; and (v) measures to mitigate the social and environmental impact of the transition to a higher growth path.

As of 31 December 2001, the sectoral distribution of the loan portfolio is agriculture, 33.6 percent; social infrastructure, 18.8 percent; energy, 10.6 percent; finance and industry, 19.6 percent; transport and communications, 15.9 percent and others, 1.6 percent.

Lending by the Asian Development Bank, 1996–2002

| | | | | | | Proj. | |
|---|---|---|---|---|---|---|---|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | (In millions of U.S. dollars) | | | | | | |
| Commitment | 44 | 166 | 190 | 184 | 209 | 146 | 216 |
| Net resource transfer | 127 | 71 | 93 | 72 | 47 | 65 | ... |
| Disbursement | 149 | 96 | 126 | 99 | 76 | 91 | 145 |

Source: Data provided by the AsDB; and staff estimates.

[1]Based on material prepared by AsDB staff.

## Sri Lanka—Statistical Issues

**Staff Assessment**

Overall, the coverage and timeliness of available data in Sri Lanka are adequate. The authorities supply key data to the Fund on a timely basis, the Government regularly publishes economic information and data, and daily information on stock, money, and foreign exchange market developments is readily available through electronic media. However, as noted below, there are deficiencies in the statistical base which, if rectified, would improve the ability to monitor developments and formulate appropriate economic policies. Sri Lanka is a participant in the General Data Dissemination System (GDDS) and metadata were posted on the Fund's DSBB in July 2000. The authorities expect full compliance on Special Data Dissemination Standard (SDDS) by mid-2004 (including the data template on reserves, foreign currency liquidity and on external Debt).

**Outstanding Statistical Issues**

Sri Lanka produces several consumer price indices. The official price measure—the Colombo Consumer Price Index (CCPI)—produced by the Department of Census and Statistics (DCS) uses an outdated consumption basket and weighting system and has become increasingly irrelevant as a measure of general inflation. The DCS also publishes a Greater Colombo Price Index (GCPI), including Colombo city and the suburbs. The Central Bank of Sri Lanka (CBSL) produces a Colombo District CPI (CD-CPI) and a Wholesale cum-Producer Price Index (WPI/PPI).

A technical assistance report by STA (October 1998) recommended that authorities should produce a single, high quality official CPI, which should cover all households (rather than just lower-income ones), and include a reliable price indicator for rent and owner-occupied housing. In response, a new nationwide CPI, covering the second to eighth income deciles, the Sri Lanka Consumer Price Index is being published. STA expects to publish this new index in IFS, following an assessment of its quality.

An STA ROSC mission in June 2001 noted that considerable progress has been made in meeting most requirements for the Special Data Dissemination Standard (SDDS). However, the mission identified a number of deficiencies, and follow-up TA is planned to assist the authorities implement the 1993 SNA, compile the IIP, and prepare government finance statistics on an accrual basis.

Quarterly national accounts, and monthly monetary and fiscal revenue data are published regularly.

Consolidated central government data regularly provided for publication in the *GFS Yearbook* cover the budgetary accounts. The authorities are planning to reduce the lag in producing expenditure details to 45 days, and to revise the presentation to conform to GFS standards. They have also begun to compile current and historical data on the budgetary operations of Provincial Councils.

Foreign Currency Banking Units (FCBUs) are now classified as resident institutions in the monetary survey (since 1998). To adjust for the proportion of nonresident foreign currency deposits (NRFC), which are actually held by residents (mainly returning migrant workers), 50 percent of these deposits are reclassified out of foreign liabilities into domestic deposits. The authorities have started reporting to STA the adjusted monetary data from January 1999 onwards for publication in *IFS*.

## Sri Lanka—Core Statistical Indicators

(As of August 5, 2002)

| | Exchange Rates | International Reserves | Reserve/ Base Money | Central Bank Balance Sheet | Broad Money | Interest Rates | Consumer Price Index | Exports/ Imports | Current Account Balance | Overall Government Balance | GDP/GNP | External Debt |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Date of latest observation | August 2 2002 | August 1 2002 | June 30 2002 | June 30 2002 | May 31 2002 | July 12 2002 | July 2002 | April 2002 | March 2002 | April 2002 | Q1 2002 | 2001 |
| Date received | August 5 2002 | August 5 2002 | July 15 2002 | July 15 2002 | July 15 2002 | July 24 2002 | July 2002 | April 2002 | June 2002 | July 15 2002 | June 2002 | Feb 2002 |
| Frequency of data 1/ | D | D | D/M | M | M | D/W | M | M | Q | M | A/Q | A |
| Frequency of reporting 2/ | D | W | M 3/ | M | M | W | M | M | Q | M | Q | A |
| Source of data 4/ | P | A | A | A | A | A | A | A | A | A | A | A |
| Mode of reporting 5/ | E | E | E | E | E | O | E | E | C | E | C | C |
| Confiden-tiality 6/ | C | D | C | C | C | C | C | C | C | D | C | C |
| Frequency of publication | D | W | M | M | M | W | M | M | Q | M | Q | A |

1/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, or O-other.

2/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, V-irregularly in conjunction with staff visits, or O-other irregular basis.

3/ Daily observations available upon request with a one-week time lag; end-month data reported on a routine basis.

4/ A-direct reporting by central bank, Ministry of Finance, or other official agency, N-official publication or press release, P-commercial publication, C-commercial electronic data provider, E-IMF s Economic Information System (EIS), O-other.

5/ E-electronic data transfer, C-cable or facsimile, T-telephone, M-mail, V-staff visits, O-other.

6/ A-for use by the staff only, B-use by the staff and the Executive Board, C-unrestricted use, D-embargoed for a specified period and thereafter for unrestricted use, E-subject to other use restrictions.

## Sri Lanka--Social and Demographic Indicators

| | Units | Sri Lanka: 15-20 Years Ago | Sri Lanka: Most Recent Estimate | Comparator Groups: South Asia | Comparator Groups: Low-Income Countries | Comparator Groups: Lower-Middle-Income Countries |
|---|---|---|---|---|---|---|
| **General** | | | | | | |
| Land Area | 000 km$^2$ | 66 | 66 | 4,781 | 41,383 | 36,096 |
| Arable land | Percent of land area | 36.0 | 36.0 | 42.4 | 12.4 | 9.2 |
| GNP per capita | US Dollars | 370 | 850 | 440 | 410 | 1,130 |
| Income distribution | | | | | | |
| Highest quintile | Percent of income | 43 | 43 | ... | ... | ... |
| Lowest quintile | Percent of income | 7 | 8 | ... | ... | ... |
| **Population characteristics** | | | | | | |
| Population | Millions | 16 | 19 | 1,355 | 2,460 | 2,048 |
| Population density | per km$^2$ | 216 | 300 | 283 | 76 | 47 |
| Population growth rate | Percent per annum | 1.5 | 1.6 | 1.9 | 1.9 | 0.9 |
| Life expectancy at birth | Years | 69 | 73 | 62 | 59 | 69 |
| Age dependency ratio 1/ | Percent | 65 | 48 | 66 | 71 | 52 |
| Urban population | Percent | 22 | 24 | 28 | 32 | 42 |
| **Labor force** | | | | | | |
| Labor force participation rate 2/ | Percent | 39 | 44 | 44 | 45 | 54 |
| Females in labor force | Percent | 30 | 37 | 33 | 38 | 43 |
| Labor force growth | Percent | 2.0 | 2.6 | 2.5 | 2.3 | 1.2 |
| **Health and nutrition** | | | | | | |
| Physicians | Per thousand people | 0.1 | 0.4 | 0.4 | 0.6 | 1.9 |
| Hospital beds | Per thousand people | 2.9 | 2.7 | 0.7 | 1.5 | 3.4 |
| Immunisation from measles | Percent of children under 12 months | 2 | 95 | 53 | 57 | 89 |
| Safe water | Percent of population with access | 37 | 83 | 87 | 76 | 80 |
| Total fertility rate | Births per woman | 3.3 | 2.1 | 3.3 | 3.6 | 2.1 |
| Infant mortality rate | Per thousand live births | 30 | 15 | 73 | 76 | 33 |
| **Education** | | | | | | |
| Male illiteracy | Percent of male population 3/ | 9 | 6 | 34 | 28 | 9 |
| Female illiteracy | Percent of female population 3/ | 21 | 11 | 57 | 47 | 21 |
| Primary school enrollment | Percent of school-age population | 96 | 111 | 101 | 96 | 106 |

Source: *World Bank, World Development Indicators.*

1/ Ratio of dependents (total number of individuals aged less than 15 years and greater than 64 years ) to working age population (number of individuals aged between 15 and 64 years).

2/ Total labor force as a percentage of population.

3/ Fifteen years old or older.

**Statement by the IMF Staff Representative**
**September 3, 2002**

1. **This statement provides an update on recent political and economic developments and policies since the staff report was issued on August 20, 2002** (EBS/02/153). The information contained in this statement does not alter the analysis or the appraisal in the staff report.

2. **The authorities have announced that the formal talks with the rebel Liberation Tigers of Tamil Eelam (LTTE) will take place in Thailand during September 16-18**. In advance of this meeting, the government has said the ban imposed on the LTTE would be removed on September 6.

3. **The authorities have made significant progress on the structural actions that were expected before the completion of the SBA review** (paragraph 30, EBS/02/153).

- The VAT was introduced on August 1.
- The privatization and banking reform benchmarks were completed by mid-August.
- The Welfare Benefit Law was submitted to Parliament, and approved on August 26.
- Cabinet approved the draft electricity reform act, which was gazetted on August 16.
- Cabinet approved amendments and special provisions bills on the Industrial Disputes and the Termination of Employment of Workmen Acts on August 28.

Although the electricity and labor market bills have not yet been presented to Parliament, the Prime Minister has instructed that they be tabled in Parliament by September 6.
On this basis, the staff recommends completion of the SBA review.

4. **Based on data through end-June, the fiscal position is on track (see table) and public corporations' debt has declined**. The overall deficit for the first half of the year was Rs 71 billion (4.5 percent of annual GDP), compared with the annual target is Rs 136 billion. Revenue was somewhat lower than originally projected, with collections through end-June at 45 percent of budget estimates. In particular, this reflects weaker income tax and GST collection. Revenue is expected to be more buoyant in the second half of the year, because of a rebound in economic activity and gains from the introduction of VAT on August 1. Expenditure performance was in line with the budget: total outlays in the first half of the year reached only 48 percent of the budget estimates, with no reported overruns. Total government debt at end-June was Rs 1.6 trillion, equivalent to 100 percent of expected 2002 GDP. Public corporations' debt to the banking system declined by Rs 4 billion in June, largely reflecting a repayment by CPC.

5. **The new fertilizer subsidy scheme, targeting assistance directly to farmers, which was to be put into operation in mid-August, is being revised**. The authorities report that, as originally specified, the new farmers inputs scheme would not realize the cost savings they had envisaged in the budget. To meet the budget limit, they are formulating a revised scheme, further restricting the costs, to be in effect from mid-September. The staff is

concerned about the further delay in introducing a properly targeted scheme, but would expect any total overrun on fertilizer subsidies for 2002 to be small.

6. **In an attempt to clamp down on excessive government spending in the future, on August 21 the Cabinet approved a draft Fiscal Responsibility Act**. The Act seeks to hold state institutions accountable for spending public funds, prompting full accountability from all public offices. The Finance Minister will also have to make a fiscal statement at the beginning of every year and account for any deviation from the budget estimates. The staff has not discussed with the authorities this proposed legislation (which is not referred to in the staff report) but, in principle, welcomes this move to enhance fiscal transparency. Prior to the bill being enacted, the staff will review the specific provisions and advise the authorities, in the context of the September staff visit to Colombo, which will focus on the 2003 budget.

7. **Monetary aggregates remain broadly in line with projected values—both reserve money and central bank net domestic assets are within their targeted path**. However, broad money is running slightly ahead of projected values, reflected in both higher-than-projected credit to the private sector and an improvement in the net foreign assets of the commercial banks.[1] The Central Bank of Sri Lanka (CBSL) has kept its key overnight reverse repo rate at 12.75 percent since the July 24 reduction by 100 bps. Other rates have declined slightly recently—for the week ending August 23, the 3-month treasury bill rate was 10.9 percent, compared with 12 percent at mid-July, while the prime lending rate was 12.2 percent on August 23, compared with 13.5 percent at mid-July 2002.

8. **Preliminary data for June show a trade deficit of $863 million for the first half of 2002—broadly in line with the staff's projections—and gross official reserves of the CBSL have continued to rise steadily through late August**. Both export and general import volumes were low in June 2002, but the recovery in the imports of intermediate goods continued. The decline in textiles and garment exports was largely attributable to a lower demand from the United States, the United Kingdom, Canada, and Germany. As of August 20, gross official reserves were $1,327 million—about two months of imports. The rupee is currently trading at about the same level as end-July—Rs 96/$. In this context, the projected GDP growth (3.7 percent) for 2002 may be difficult to achieve fully, given the disappointing export performance through June and continued concerns about the prospects for global recovery and rising oil prices.

[1] Credit to the private sector grew by 7 percent in the 12 months to June 2002, compared with 5½ percent projected under the program.

## Sri Lanka: Summary of Central Government Operations, 2001-02

(In percent of GDP)

| | 2001 | 2002 | | |
|---|---|---|---|---|
| | | Program | Revised | Prel. Jan-June 1/ |
| Total revenue | 16.5 | 17.5 | 17.5 | 8.0 |
| Tax revenue | 14.6 | 15.0 | 15.2 | 6.6 |
| Income taxes | 2.5 | 2.5 | 2.7 | 0.9 |
| Value Added Tax/GST | 3.3 | 5.6 | 5.0 | 1.6 |
| Excise taxes | 3.2 | 3.3 | 3.3 | 1.7 |
| National security levy | 3.1 | 1.1 | 1.7 | 1.4 |
| Taxes on international trade | 1.9 | 1.9 | 1.9 | 0.8 |
| Other | 0.7 | 0.7 | 0.6 | 0.2 |
| Nontax revenue | 1.9 | 2.6 | 2.3 | 1.3 |
| Total expenditure and net lending | 27.4 | 26.1 | 26.0 | 12.4 |
| Current expenditure | 21.4 | 21.0 | 20.9 | 10.2 |
| Civil service wages and salaries | 3.4 | 3.5 | 3.4 | 1.7 |
| Other civilian goods and services | 1.7 | 1.5 | 1.3 | 0.9 |
| Security related expenditure | 4.9 | 4.0 | 4.0 | 2.0 |
| *Of which:* Defense | 3.8 | 3.0 | 3.0 | 1.5 |
| Subsidies and transfers | 4.7 | 4.6 | 4.6 | 2.2 |
| Households | 3.7 | 3.4 | 3.4 | 1.6 |
| Institutions, corporations, other govt. | 1.0 | 1.2 | 1.2 | 0.6 |
| Interest payments | 6.7 | 7.4 | 7.5 | 3.5 |
| Capital expenditure and net lending | 5.9 | 5.1 | 5.1 | 2.2 |
| Overall balance (excl. grants and privatization) | -10.9 | -8.5 | -8.5 | -4.5 |
| Financing | 10.9 | 8.5 | 8.5 | 4.5 |
| Net external financing | 1.6 | 3.2 | 2.6 | n/a |
| Net domestic financing | 8.3 | 3.6 | 4.1 | 4.2 |
| Bank | 3.9 | -1.3 | -1.3 | 0.2 |
| Nonbank | 4.4 | 5.0 | 5.5 | 4.1 2/ |
| Asset sales | 0.6 | 1.2 | 1.3 | 0.1 |
| Grants | 0.4 | 0.5 | 0.5 | 0.2 |

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

1/ Actual outturns for revenue and expenditure, although composition of expenditure is preliminary. Domestic bank financing, grants and asset sales are actuals, but net external financing data are not available.
2/ Residual.

INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL RELATIONS DEPARTMENT

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

## IMF Concludes 2002 Article IV Consultation with Sri Lanka

On September 3, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sri Lanka.[1]

### Background

Sri Lanka's economy grew steadily during the last two decades, despite the civil conflict, which has been going on for over 19 years. During this period, financial markets were liberalized, the outward orientation of the economy was significantly increased, and a more diversified export base established. However, large fiscal imbalances (which averaged more than 9 percent of GDP during this period) led to prolonged periods of public dissaving. Slow progress in key structural areas, including civil service reform, restructuring of state-owned enterprises, financial and labor market reforms, undermined the economy's growth potential.

Faced with low reserves, large import bills, and an exchange rate level and regime (a crawling band) that was no longer credible, the authorities initiated a program of economic stabilization. The Central Bank of Sri Lanka (CBSL) floated the exchange rate on January 23, 2001 and committed to an ambitious stabilization program, supported by a Stand-By Arrangement, which was approved by the Board on April 20, 2001. As envisaged, the current account deficit narrowed, and the CBSL succeeded in building up net international reserves with a broadly stable exchange rate. At end-June 2001, the program had met all its key objectives. However, political developments complicated economic policymaking during the second half of 2001.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

During this time, the government was not able to take corrective policies to keep the program on track in the face of worsening circumstances.

GDP contracted by about 1½ percent in 2001—the first contraction since independence in 1948. The global recession led to stagnant demand overseas for garments and textiles—which account for half of exports. Due to the drought, agricultural output declined more than 3 percent and low water reservoir levels led to widespread power cuts. The attack on Colombo airport and the events of September 11 also exacerbated the slowdown. While underlying inflation was close to the program target of 8 percent (end-year basis) for 2001, drought-affected food prices drove up the headline rate. The official Colombo Consumer Price Index (food items account for 65 percent of the CCPI basket) increased 10¾ percent in the 12 months to December 2001.

Although, the external reserve losses of 2000 were partly reversed, balance of payments developments in 2001 were weaker than programmed due to the external and domestic shocks and delays in external financing. Private capital flows (including privatization receipts) fell below expectations as structural reforms were delayed and investor confidence was undermined.

After a good start, the envisioned fiscal stabilization in 2001 did not materialize. In the second half of the year, the slowing economy and a lack of resolve weakened the budget performance considerably. Instead of declining as planned, the fiscal deficit rose in 2001 by 1 percentage point to almost 11 percent of GDP. Revenue suffered from slower growth, election-related tax cuts, and a lack of progress on tax administration reform. On the expenditure side, despite tight controls on nonwage recurrent spending, the authorities failed to tackle the politically sensitive spending on Samurdhi and subsidies. Fiscal laxity intensified in the run-up to the December 2001 elections, with the granting of large wage and pension increases. There was also an overrun in defense spending. The program target on borrowing by public corporations was exceeded due to large losses by the Ceylon Electricity Board (CEB).

Monetary policy was constrained by the fiscal situation, requiring high real interest rates to counter exchange rate and inflationary pressures during most of 2000 and the early part of 2001. However, the CBSL progressively reduced rates during the last three quarters of 2001 because of the weak economy. By end-2001, the reverse repo rate was 900 basis points lower than its rate in January 2001. Despite the weak economy and the concomitant compression of credit to the private sector, broad money growth slightly exceeded the 2001 target (13½ percent) reflecting the increased public sector borrowing requirement.

Following victory in the December elections, the United National Front (UNF) government committed to deal with the major economic challenges it faced and move ahead with the program. The new government presented a strong budget in March 2002, which demonstrated their commitment to fiscal consolidation and structural reforms to lay the foundations for private sector led growth in the medium-term.

Substantial progress was made on the macroeconomic stabilization front during the first half of 2002. Inflation showed a trend decline—headline inflation was in the range 8-9 percent for the 12 months to August, consistent with the year end target. GDP growth bottomed out in the first quarter GDP. The external position has stabilized and the rupee remained broadly stable. The CBSL continued to maintain a broadly prudent monetary stance. Fiscal consolidation has began which is a key program objective. The financial position of the public corporations also stabilized over January-June 2002.

In addition, major initiatives have been taken to resolve the civil conflict——a permanent ceasefire is in operation and peace talks are expected to commence in Thailand in September.

**Economic Prospects**

Modest growth of 3½-4 percent is expected in 2002, reflecting in part the gradual pace of recovery in external demand. With improved rainfall, early indications are that agricultural output will rebound during the second half of 2002. Although some recovery is expected in both the garment and tea sectors, which should boost manufacturing activity, significant turnaround in exports is not expected until the latter part of 2002. Headline inflation through August indicates that the annual inflation target of 7-8 percent is achievable. The CBSL continued to maintain a prudent monetary stance and fiscal data through June suggest that the 8½ percent deficit target is achievable. Nominal interest rates are expected to decline during the second half of 2002 as inflation comes down and fiscal consolidation takes hold and confidence begins to strengthen. The rupee, which is freely floating, has remained stable in recent months. The trade deficit narrowed significantly during the first four months of 2002 before increasing in May, and official reserves continued to rise steadily through August. Preliminary data suggest that recent progress on the peace front has improved the outlook for both portfolio and FDI flows. Thus, the external position is expected to strengthen, and gross official reserves are projected to rise to $1¾ billion, about 2¾ months of imports of goods and services.

**Executive Board Assessment**

Executive Directors noted that Sri Lanka is at a critical juncture—despite recent improvements, the macroeconomic situation remains fragile, and achieving sustainable high growth requires major adjustments. Directors also noted that resolution of the civil conflict and the scope for generating growth opportunities are closely intertwined.

Directors welcomed the fact that the cease-fire is already providing an economic boost to the country through lower security spending and renewed economic activity in the country's conflict-affected North and East. Sustained peace would allow budgetary resources to be reallocated to social programs and building or rehabilitating infrastructure, especially in the war-torn parts of the country.

Directors welcomed that the government's key macroeconomic objectives under the Stand-By Arrangement had been achieved, with reserves being rebuilt and fiscal consolidation and several structural reforms initiated, especially in the public sector. Nevertheless, Directors observed that the government's adjustment program has significant downside risks. In particular, there remain risks of drought, and the long-term electricity shortages are still a major concern. Directors were also concerned that any resumption of political uncertainties could slow down the peace momentum, and undermine the fiscal position.

Directors welcomed the authorities' intention to press ahead with fiscal consolidation, which is essential to ensuring fiscal and external sustainability over the medium term. They welcomed the introduction of the new VAT, but stressed that the government should press on with other measures to reform the tax system and administration. To contain current spending, the government should also stand firm on its disciplined approach to wage and recruitment policies and defense spending. In that connection, Directors welcomed the newly formed Defense Spending Monitoring Committee. In addition, they urged the authorities to avoid having subsidies and transfers exceed the budget provisions, and they should resist any further broad cost-of-living relief measures, including tax cuts and administered price adjustments, that would undermine the financial viability of the budget or the public corporations. If needed, the authorities should stand ready to take additional measures to ensure that the broad fiscal goals are achieved.

Directors stressed that the 2003 budget will need to continue the path of fiscal consolidation, with the focus on controlling current expenditures. They urged the authorities to extend the VAT to the retail level and remove exemptions. The proposed unified revenue authority would likely soon contribute to enhancing tax administration.

Directors considered that firm fiscal consolidation would enable the CBSL to maintain a prudent monetary stance, while balancing the need to provide sufficient and affordable bank credit to the private sector. While welcoming the gradual decline in policy interest rates this year, in line with the path of inflation, Directors urged the CBSL to avoid further significant easing until it is clear that fiscal consolidation has taken hold.

Directors endorsed the authorities' current exchange rate policy and their commitment to improve the functioning of the interbank foreign exchange market by implementing the Financial System Stability Assessment (FSSA) recommendations. They agreed that CBSL's intervention should continue to aim primarily at realizing the net foreign asset path of the monetary program, with only limited smoothing of short-term exchange rate volatility.

Directors emphasized the need to strengthen the banking system, which, together with a stable macroeconomic environment, would provide a stronger basis for a gradual and sequenced form of capital account liberalization. They called for further strengthening of the CBSL's supervisory function. They welcomed the authorities' decision to tackle the problems of Peoples Bank and to improve the performance of the Bank of Ceylon, with the help of technical assistance from the Fund and the World Bank. The authorities were encouraged to finalize the draft law on anti-money laundering, in the light of the Financial Sector Assessment Program (FSAP) mission's recommendations.

Looking ahead, Directors noted that a major challenge for the authorities is to press ahead with deeper structural reform measures to promote growth and reduce poverty. They endorsed the authorities' structural reform agenda, and were encouraged by the initial steps taken on the structural front. The measures to restructure the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB), and to invite private participation in those companies under an appropriate regulatory framework, were welcomed. More ambitious privatization was recommended, which could provide resources for government debt reduction, and contribute to long-term economic growth and private sector development. Over the medium term, further reform of public expenditure and the financial sector, restructuring of public sector institutions, strengthening the tax collection agencies, and labor market reforms would serve to improve public sector effectiveness and promote private sector growth.

Directors noted that data quality and timeliness are satisfactory for surveillance. They looked forward to Sri Lanka soon subscribing to the Special Data Dissemination Standard (SDDS).

***Public Information Notices (PINs)*** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

## Sri Lanka: Selected Economic Indicators

(In millions of U.S. dollars, except where otherwise noted)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|
| ***Domestic economy*** | | | | | | | |
| Change in real GDP (percent) | 5.5 | 3.8 | 6.4 | 4.7 | 4.3 | 6.0 | -1.4 |
| Change in CCPI (percent, end of period) | 11.5 | 16.8 | 10.7 | 3.7 | 4.0 | 10.8 | 10.8 |
| Change in CDCPI (percent, end of period) | ... | ... | 8.3 | 4.0 | -0.1 | 8.5 | 9.7 |
| National savings (percent of GDP) | 19.5 | 19.0 | 21.5 | 23.4 | 23.5 | 21.5 | 19.5 |
| Gross investment (percent of GDP) | 25.7 | 24.2 | 24.4 | 25.1 | 27.3 | 28.0 | 22.0 |
| ***Fiscal position*** | | | | | | | |
| Revenue (percent of GDP) | 20.4 | 19.0 | 18.5 | 17.2 | 17.7 | 16.8 | 16.5 |
| Expenditure (percent of GDP) | 30.5 | 28.5 | 26.4 | 26.3 | 25.2 | 26.7 | 27.4 |
| Overall deficit (percent of GDP) 1/ | -10.1 | -9.4 | -7.9 | -9.2 | -7.5 | -9.9 | -10.9 |
| ***External economy*** | | | | | | | |
| Exports | 3,807 | 4,095 | 4,639 | 4,798 | 4,610 | 5,522 | 4,817 |
| Imports | 5,311 | 5,439 | 5,864 | 5,889 | 5,979 | 7,320 | 5,974 |
| Current account balance (excl. official transfers) | -847 | -727 | -437 | -278 | -586 | -1,090 | -391 |
| (in percent of GDP) | -6.5 | -5.2 | -2.9 | -1.8 | -3.7 | -6.6 | -2.5 |
| Capital and financial account balance | 704 | 457 | 600 | 414 | 372 | 445 | 536 |
| Of which, direct investment | 57 | 119 | 430 | 193 | 177 | 176 | 172 |
| Gross official reserves (less ACU balances) | 1,989 | 1,855 | 1,922 | 1,892 | 1,530 | 911 | 1,182 |
| Change in the real effective exchange rate (annual percent change) 2/ | -1.1 | 10.4 | 13.4 | -10.5 | -1.2 | 0.6 | -0.1 |
| External debt (in percent of GDP) | 75.0 | 68.6 | 62.3 | 61.0 | 63.2 | 60.8 | 61.8 |
| Debt service (in percent of goods and services exports) | 16.5 | 15.3 | 13.3 | 13.3 | 15.2 | 14.7 | 13.3 |
| ***Financial variables*** | | | | | | | |
| Broad money growth (annual percent change) 3/ | 21.1 | 11.3 | 15.6 | 13.2 | 13.4 | 12.9 | 13.6 |
| Interest rate (in percent; e.o.p.) 4/ | 19.3 | 17.5 | 10.2 | 12.0 | 11.8 | 18.0 | 12.9 |

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

1/ Excluding grants and privatization receipts.
2/ (-) = depreciation.
3/ Including foreign currency banking units.
4/ Three-month treasury bill rate.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

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September 3, 2002

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

**IMF Completes Review Under Sri Lanka's Stand-By Arrangement and Approves US$64 Million Disbursement**

The Executive Board of the International Monetary Fund (IMF) today completed the third and last review of Sri Lanka's economic performance under a Stand-By Arrangement (SBA), which was approved on April 20, 2001 (see Press Release No. 01/16). The completion of the review enables the immediate release of a further SDR 48.3 million (about US$64 million) from the arrangement, which would bring total disbursements under the IMF-supported program to SDR 200 million (about US$266 million). The current arrangement is to expire on September 19, 2002.

After the Executive Board's discussion on Sri Lanka, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, made the following statement:

"Notwithstanding some policy delays and adverse external shocks, the Sri Lankan authorities have achieved their key goals of halting reserve losses within a flexible exchange rate system, initiating fiscal consolidation and reforms of the tax system and public enterprise operations. The government has improved economic management and initiated important structural reforms under the SBA-supported program despite difficult circumstances.

"Looking ahead, the government's challenge is to sustain the adjustment effort and press ahead with deeper structural reforms. The Fund supports the authorities' two-pronged strategy of macroeconomic stabilization and intensive structural reform. Further fiscal consolidation will enable the release of funds to finance private sector activities and, with prudent public debt management and monetary policy, provide a stable platform for economic growth. The structural reform agenda is linked closely to the poverty reduction strategy already set out in the government's draft poverty reduction strategy document. Perseverance with these measures could pave the way for a Poverty Reduction and Growth Facility arrangement later in 2002.

"The key next steps will be to strengthen the financial sector, restructure public enterprises with private sector participation, improve tax collection, and overhaul the priorities and governance of public expenditure. Initiation of labor market reform would also greatly facilitate the improvement of public sector effectiveness and promote private sector growth.

"Steady progress in the ongoing peace talks would significantly improve business confidence and the willingness of the international community to support reform in Sri Lanka, and thus enhance growth over the medium term. It would also pave the way for much-needed rehabilitation and reconstruction efforts," Mr. Sugisaki said.