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Sri Lanka: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Use of Fund Resources—Request for an Extended Arrangement—Staff Report; Staff Statement; News Brief on the Executive Board Discussion

In the context of the request for a Three-Year Arrangement under the Poverty Reduction and Growth Facility, and use of Fund resources—request for an Extended Arrangement, the following documents have been released and are included in this package:

- the staff report for the request for a Three-Year Arrangement under the Poverty Reduction and Growth Facility, and use of Fund resources—request for an Extended Arrangement, prepared by a staff team of the IMF, following discussions that ended on **January 29, 2003,** 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 April 1, 2003**. 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 **April 18, 2003** updating information on recent developments.
- a Press Release summarizing the **views of the Executive Board as expressed during its April 18, 2003 discussion** of the staff report that completed the request.

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

Joint Staff Assessment of the Poverty Reduction Strategy Paper
Letter of Intent sent to the IMF by the authorities of Sri Lanka*
Memorandum of Economic and Financial Policies by the authorities of Sri Lanka*
Poverty Reduction Strategy Paper
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Use of Fund Resources—Request for an Extended Arrangement

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

Approved by Wanda Tseng and Shigeo Kashiwagi

April 1, 2003

- Discussions for a program to be supported by a three-year PRGF arrangement and an extended arrangement took place in Colombo during October 21-31, 2002, and January 17-29, 2003. A staff team comprising Messrs. Aziz (Head), Fernandez, and Leigh (all APD), Mr. Balakrishnan (FAD), Ms. Koliadina (PDR), and Mss. Jupp and Lee (administrative assistants, APD) participated in the missions. Mr. Carter (Senior Resident Representative) assisted the mission. Mr. Jayatissa (Alternate Executive Director) and Mr. Baysan (World Bank) also took part in the discussions.

- The Board completed the final review under the stand-by arrangement (SBA) and concluded the 2002 Article IV consultations on September 3, 2002. All the quantitative performance criteria under the SBA for end-April 2002 (last test date) were observed and the structural benchmarks for end-June completed, albeit with a small delay.

- In the attached Letter of Intent and Memorandum on Economic and Financial Policies (MEFP), the authorities have described the economic program for which they request support under a three-year PRGF arrangement and a three-year EFF arrangement. The MEFP is based on the government's medium-term economic and poverty reduction strategy program (PRSP)—*Regaining Sri Lanka*—that was finalized in January 2003. The Bank-Fund Joint Staff Assessment (JSA) is included for the Executive Board's consideration. They have also requested that repurchase expectations under the SBA arising during July 2003–June 2004 be moved to obligations basis.

- The government has agreed to publish the staff report, the letter of intent, MEFP, and the JSA.

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Executive Summary

1. **Over the last two decades, insufficient growth and economic dominance of the public sector led to high government debt and constraints on the private sector**. Despite strong social development indicators, limited economic reform and the civil conflict combined to undermine infrastructure and institutions across the country and increase poverty.

2. **After declining in 2001, economic activity recovered last year**. Inflation trended down in 2002, although it has picked up recently due to higher world oil and wheat prices. On other recent developments, peace talks between the government and the LTTE have progressed well. Bilateral donors have committed to support immediate post-conflict relief needs. A donors meeting is planned for mid-June in Tokyo.

3. **In line with the PRSP and building on the progress made under the SBA, the PRGF-EFF supported program aims to accelerate economic growth and reduce poverty**. The key elements of the program involve steps to: (i) strengthen public finances; (ii) reform the financial sector, public enterprises, the labor market, and the trade regime; and (iii) strengthen macroeconomic policy instruments and institutions.

4. **Given Sri Lanka's high debt burden, fiscal consolidation is the heart of the macroeconomic program**. The 2002 fiscal deficit is estimated at 9 percent of GDP. For 2003, the PRSP targets a deficit of 7½ percent of GDP, aiming to bring down the deficit to 4⅓ percent of GDP by 2006.

5. **The structural reform agenda for the first year of the arrangements will focus on the following aspects of the PRSP**:

- Financial sector reform—particularly restructuring the insolvent Peoples Bank.
- Improvement in tax administration—including steps to establish a Revenue Authority.
- Restructuring of public corporations—particularly the electricity (CEB) and petroleum (CPC) monopolies.
- Implementing labor market and trade reforms.

6. **There are risks to the program**. Politically, the biggest challenge is to ensure that peace will last. The government's economic agenda is also facing resistance from interest groups, and there is public pressure to stem the rising cost of living. On the economic front, a weakening of external conditions or a protracted conflict in Iraq could slow down the economy. There are implementation risks too, such as delays in tax reforms, which could undermine fiscal consolidation.

I. Introduction and Background

Over the past 20 years, a long civil conflict has beleaguered Sri Lanka. The conflict not only disrupted economic activity, but also hampered the sustained implementation of economic reforms. This resulted in weakened public finances, continued dominance of the state in the economy, and deepened poverty. Nevertheless, the economy's growth potential is evident in the spurts of high growth that have followed intermittent periods of relative calm and reforms, and by Sri Lanka's relatively favorable human development indicators. As the country and the Fund prepare to enter into three-year PRGF-EFF arrangements, this is an opportune juncture to take stock of past reforms and the policy challenges that lie ahead.

1. **In 1983, simmering ethnic tensions erupted into widespread violence, marking the beginning of a 20-year long civil conflict**. The impact of the conflict has been pervasive and severe (Box 1). With the North and East of the country virtually cut off, the inter-regional flows of goods and services dwindled and several key sectors of the economy, including tourism and commercial fishing, collapsed due to security concerns. The country's infrastructure fell into disrepair as public resources became scarce, with mounting defense costs and declining tax revenue. The fiscal deficit rose sharply and the debt stock escalated. By some estimates, the conflict reduced GDP growth by 2–3 percent per year. Poverty also deepened, particularly in the war-torn regions and rural provinces.

2. **Amidst the civil conflict, reforms were implemented in intermittent waves, building on the efforts initiated in the late-1970s**. These changes were aimed at dismantling the economic legacy of the socialist policies of the 1960s and 1970s. Virtually all price controls were removed; most quantitative restrictions were replaced with import tariffs; exchange controls were liberalized; a range of sectors were opened to foreign direct investment; and some state-owned enterprises (SOEs) were privatized. Typically, the reforms took place against the backdrop of economic downturns, and in most instances the reforms paid off—growth increased, private investment picked up, and the balance of payments position improved. However, they remained limited. After an initial spurt of actions, either an intensification of the conflict or domestic political frictions pushed the reform agenda into the background.

3. **Thus, a large reform agenda remains incomplete**. The state dominates the financial and utilities sectors and remains the largest landlord and employer in the economy (around 90 percent of land and 12 percent of the labor force respectively), creating inefficiencies and impairing growth. High defense expenditure, SOE losses, and falling tax revenue have seriously weakened public finances. The banking sector is burdened with a high level of nonperforming loans and low capital adequacy, and one of the country's largest banks—the state-owned Peoples Bank—is insolvent. Invasive and overly restrictive regulations have rendered the labor market inflexible, slowing private sector expansion and employment growth. The welfare system has become bloated and inefficient due to extensive abuse and politicization.

Box 1. Sri Lanka: End of the Conflict—Peace Dividend and Challenges

After 20 years of conflict and several failed attempts to reach a settlement, the progress in the peace talks in the last few months holds promise of finally achieving lasting peace. While it is clear the most important determinant of the future of Sri Lanka's economy is peace, it is difficult to gauge precisely the extent of the peace dividend and the transitional challenges. This box presents a broad assessment of the peace dividend and its challenges.

Effects of the Conflict

Both the humanitarian and economic impact of the 20 year long conflict has been severe. About 1.5 million (8 percent of the population) lived in areas of direct military activity. More than 60,000 have been killed, while 600,000 (3.5 percent of the population) have been internally displaced, including about 170,000 (1 percent of the population) living in refugee camps. With an estimated 1.8 million land mines in the region, the per capita incidence of landmine is comparable to that in Angola. The conflict has also led to low growth and deterioration in the fiscal position. The Central Bank estimates that the conflict has reduced Sri Lanka's growth rate by about 2-3 percentage points per year in the last two decades. Tourism arrivals, which had grown by an average of 22 percent from 1975-82, were still lower in 2001 than in 1982. Defense expenditures rose from around 1 percent of GDP in the early 1980s to a peak of 6.5 percent of GDP in 1995. Central government debt increased by over 20 percent of GDP, during the conflict period, to stand at over 100 percent of GDP by end-2001.

End of the Conflict—The Peace Dividend

An analysis of 22 international episodes of conflict in various countries from 1985-99 shows that in the post conflict year: (i) growth picks up by around 4-5 percent above the conflict period average; (ii) capital expenditure increases substantially, particularly in the private sector; (iii) the fiscal deficit falls, due to increasing revenues and falling expenditures, the latter largely due to a reduction in defense spending, while expenditure is reoriented towards social areas. International experience indicates that lasting peace should result in considerable economic benefits to Sri Lanka:

- Growth should increase, underpinned by an overall increase in business confidence, expansion in tourism; greater inter-regional trade; opening up of new sectors (such as commercial fishing); higher foreign direct investment; improvements in infrastructure; and increases in human capital.
- The reduction in military expenditure and in interest payments should allow more funding for social priorities and capital needs.
- Socio-economic indicators in the conflict-torn regions should improve, particularly as displaced populations are resettled.

The Challenges of Peace

However, the return of peace in the North and the East would entail a rise in public spending. In the immediate future the various spending needs are: (i) aid to begin the process of resettling the internally displaced population; (ii) rebuilding the regions' administrative and institutional capacity; (iii) reconstructing the dilapidated infrastructure; and (iv) demobilizing the LTTE and government forces. Much of the spending in resettling the displaced population and rebuilding capacity would be needed immediately—demining is an obvious high priority—and peak over the next 6-12 months, while expenditure in other areas would be largely required over the medium term. In addition, as parts of the country become fully accessible and the displaced population resettles, there would be additional demands on normal public spending, such as on the welfare benefit scheme (Samurdhi program). A special fund, the North and East Reconstruction Fund (NERF), administered by the World Bank, has been established to process some of the aid directly to the region under the guidance of the joint government/LTTE Subcommittee on Rehabilitation and Development. Other aid will continue to be disbursed through the traditional government/NGO channels.

4. **In April 2001, faced with a looming foreign exchange crisis and severe macroeconomic imbalances, Sri Lanka entered into a Stand-by Arrangement (SBA).** Despite policy delays brought on by adverse external shocks and political instability, the SBA met its key objectives. Reserve losses were stemmed and the deterioration in fiscal accounts was arrested through several policy measures and structural reforms—including floating the currency, reducing defense spending, broadening the tax base, and improving tax administration. The final review of the SBA was completed in September 2002.

5. **To support its continued reform efforts, the government has sought assistance from the Fund through new three-year PRGF-EFF arrangements.** In the attached Letter of Intent and Memorandum on Economic and Financial Policies (MEFP), the authorities describe the economic program for which they request support under a PRGF arrangement with access equivalent to SDR 269 million (65 percent of quota) and a three-year EFF arrangement with access equivalent to SDR 144.4 million (35 percent of quota). The MEFP is based on the government's medium-term economic and poverty reduction strategy program (PRSP)—*Regaining Sri Lanka*—that was finalized in January 2003 (EDB/03/17).

6. **Development partners have demonstrated renewed interest to support Sri Lanka's reform and reconstruction efforts.** Last November, bilateral donors made commitments of $70 million (0.4 percent of GDP), mostly in the form of grants, to support immediate peace-related expenditure in the North and East. An international donors' conference is planned in Tokyo in mid-June—a needs assessment being prepared with the help of the United Nations (U.N.), Asian Development Bank (AsDB), World Bank, and the Fund is to be presented at this meeting. A new World Bank country assistance strategy (CAS) is slated to be considered by its Executive Board in early–April, while discussions on a four–year PRSC arrangement are ongoing. The AsDB is providing assistance through its sectoral programs.

7. **On the political front, several rounds of peace talks with the LTTE—facilitated by Norway—have resulted in significant progress.** The LTTE has dropped its demand for an interim administration and indicated its intentions for early participation in mainstream politics. Both sides have agreed to share power under a federal system of government. On the economic front, the government's reform agenda is facing resistance from interest groups and there is strong public pressure for measures to stem the rising cost of living.

II. Recent Economic Developments

8. **Economic activity recovered in 2002 (Figure 1).**

- After the economy was hit by a series of exogenous shocks in the second half of 2001—the global slowdown, an attack on Colombo airport, and a severe drought, GDP for the year fell by 1½ percent, the first decline in several decades. Growth turned positive from early last year and reached 5½ percent (year-on-year) by Q32002. A robust expansion in domestic demand and tourism underpinned the rebound, as progress toward peace revived business and consumer confidence. However, external demand for goods remains weak, including in the garments sector.

- Inflation fell from 14 percent in 2001 to 9½ percent last year. More recently, inflation has picked up due to higher world oil and wheat prices.[1]

- Strong inflows of remittances and tourism receipts led to an increase in gross official reserves from $1.2 billion (December 2001) to $1.7 billion (February 2003), to a level covering 2½ months of imports and 76 percent of short-term debt. The rupee remained broadly stable in real effective terms in 2002.

- Investor sentiment has strengthened. Since January 2002, equity prices have risen by 30 percent, notwithstanding recent declines due to the tension in the Middle East, and are now at around their 1996 levels. Moreover, the rupee forward premium has declined and foreign direct investment commitments have picked up.

9. **Monetary policy has balanced supporting economic recovery with restraining inflation**. The decline in inflation allowed the Central Bank of Sri Lanka (CBSL) to cut repo rates by 300 basis points since January 2002. Although the associated fall in lending rates raised private-sector credit growth, broad money growth has recently trended down, due to the improvement in the public sector's financial position (Figure 2).

10. **The fiscal deficit for 2002 is estimated at 9 percent of GDP—2 percent of GDP lower than in 2001—but higher than the budget target of 8½ percent of GDP**. This outcome reflected a revenue shortfall of around 1 percent of GDP, partly offset by spending cuts of about ½ percent of GDP. The lower revenue was due to a combination of weaker-than-expected imports, a large number of exemptions granted when the GST was replaced with the VAT, and lower nontax revenue, in part, reflecting a restructuring in payments from the electricity company (CEB) to the budget. The cuts in expenditure reflected reduced capital spending (due to low project-implementation rates) and somewhat lower current spending. Shortfalls in donor financing (the World Bank called off its Private Sector Development loan, preferring to shift to more broad-based lending through the PRSC) and delays in privatization (particularly of the state-owned insurance company, SLIC) led to higher-than-anticipated domestic financing (mainly nonbank).

11. **Structural reforms have advanced, in line with commitments under the SBA**:

- Following the enactment of the Electricity Reform Bill in December 2002, the unbundling of the state electricity company (CEB) is proceeding on schedule, supported by an AsDB power-sector loan. Reforms of the Ceylon Petroleum Corporation (CPC) are progressing in step with the liberalization of the petroleum sector—Indian Oil has entered the market and negotiations with another foreign oil company to take over part of the distribution network are underway.

[1] The Colombo price remains the most used official index, although the Sri Lanka wide index (SLCPI) has broader geographical coverage and more recent weights. The government is planning to shift to the SLCPI in the future.

- The sale of the state-owned bus companies is near completion, while a 12 percent stake in Sri Lanka Telecom (SLT) was sold in December. The privatization of SLIC, which was scheduled for 2002, is expected to be completed in April.

- Amendments to the labor laws—a new redundancy compensation formula, time-bound resolution of labor disputes, elimination of restrictions on overtime work by women, and increased penalties for child labor—were enacted in January 2003.

- A Fiscal Management Responsibility Act (FMRA) was enacted in December 2002, which sets strict limits on borrowing from the CBSL, proposes a medium-term deficit path consistent with reducing the debt stock to 85 percent of GDP by end-2006, and mandates "pre-election budget reports" to discourage pre-election handouts. Parliament enacted a new Board of Investment (BOI) law, eliminating BOI's power to grant tax holidays and incentives outside the regular tax code. To reform the welfare system, a Welfare Benefit Law was enacted in September.

- Amendments to the Monetary Law Act were enacted in December 2002 to provide the CBSL broader supervisory powers and greater independence. To strengthen the integrity of the banking system, the minimum CAR was raised to 10 percent for all domestic banking units from January 2003 and on a consolidated basis on all domestic and foreign banking units effective end-December 2003.

III. The New Program

12. **Poverty remains one of Sri Lanka's most daunting challenges**. The PRSP identifies several factors behind Sri Lanka's poverty—including inadequate growth; unequal opportunities for the poor; impact of the two-decade long conflict; low productivity in agriculture; and governance-related problems (Box 2).

13. **To address these issues, the government has articulated in the PRSP an ambitious economic program and poverty reduction strategy**. The PRSP is the result of four years of extensive consultation with stakeholders, spanning the tenure of the two main political parties. Its main objective is to "regain Sri Lanka" by accelerating growth and eliminating poverty through private sector led development. To meet its aims, the PRSP focuses on: providing a supportive macroeconomic environment; alleviating conflict-related poverty; reducing the role of the public sector in the economy; creating economic opportunities for the poor; investing in human development; empowering the poor and strengthening governance; reconstructing the North and East; and implementing an effective monitoring and evaluation system. Within this broad agenda, the roles of the Fund, World Bank, AsDB, and bilateral partners are clearly demarcated.

14. **Consistent with the PRSP, the authorities' program presented in the MEFP aims to**: (i) strengthen public finances—to restore fiscal sustainability, ensure that adequate funds are available to meet priority spending needs, and release resources for private sector

Box 2. Poverty in Sri Lanka

Poverty in Sri Lanka is high and multi-faceted:

- *The headcount poverty ratio increased from 20 percent in 1990–91 to 25 percent in 1995–96.* Preliminary results from the 2002 Household Survey indicate that poverty rose further in the second half of the 1990's to affect 28 percent of the population.
- *Malnutrition, however, declined during the 1990's*—the prevalence of stunting among children decreased from 23.8 percent to 13.5 percent, and of underweight, from 37.7 percent to less than 30 percent.
- *Poverty rates vary considerably across regions*—ranging from 23 percent in the Western Province to 55 percent in the Uva Province. The surveys do not include the conflict areas of the North and the East, although anecdotal evidence suggests that the incidence of poverty is nearly 50 percent in these regions.
- *Poverty in Sri Lanka is mainly a rural phenomenon*—88 percent of the poor reside in rural areas, some remote and isolated, and lacking basic infrastructure such as electricity and roads.
- *A significant number of the poor (95 percent) are employed.* The poorest tend to work in rice farms or plantations.
- *There is little variation in the incidence of poverty across ethnicity and gender.* However, plantation workers, mostly Indian Tamils, are among the poorest.

The PRSP identifies several factors that have led to Sri Lanka's high poverty rate:

- *Insufficient economic growth*—despite an average growth of more than 5 percent in the 1990s poverty increased mainly due to uneven regional economic performance. While the urban Western Province grew at 7½ percent a year, rural provinces, where the incidence of poverty is the highest, grew at less than 2 percent.
- *Civil conflict*—which increased poverty not only directly, but also through the resulting internal displacement or disabilities from war injuries that affected thousands of people (600,000 people are estimated to have been displaced and 60,000 killed).
- *Geographical isolation*—many of the poor live in remote rural areas that lack access to markets, information or basic infrastructure. These communities are also more vulnerable to shocks, such as drought and floods.
- *Limited access to quality education*—while schools are widely available, the quality of education available to the poor is vastly inferior to that available to wealthier urban households.
- *Limited access to basic social services*—survey evidence indicate that only a small share of government health expenditure reaches the poorest 20 percent of the population; and that in many areas, the poor do not have adequate access to safe drinking water and basic sewage and sanitation facilities.
- *Low agricultural productivity*—agricultural wages and income have remained low owing to limited land market; restrictions on land use; frequent and erratic changes in agricultural trade policies; and the lack of clear land tenure rights.
- *Governance problems*—abuse and politicization of welfare programs, notably of Samurdhi, have resulted in welfare benefits being misused and not reaching the neediest.

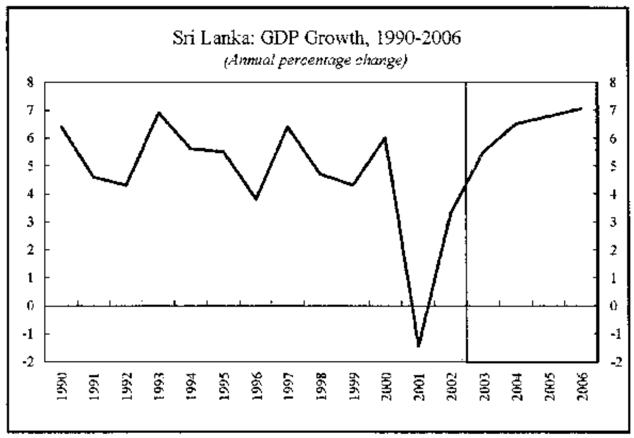
The PRSP envisages a multi-pronged poverty reduction strategy:

- *Enhancing Sri Lanka's growth potential* by pursuing peace; a stable macroeconomic environment, notably through fiscal consolidation; and deep structural reforms that pave the way for private sector led growth.
- *Revitalizing the rural economy*—by establishing clear land tenure rights and liberalizing land use policy. Reducing protection on agriculture goods (as the poor are net consumers of agricultural goods) and providing a stable import tariff regime would aid significantly in reducing rural poverty.
- *Enhancing rural infrastructure*—through extensive investment in roads, electrification, and improving access to safe drinking water, sewage and sanitation services.
- *Improving the quality of education*—by moving to a school base management system, increased stakeholder participation and involvement of the private sector.
- *Prioritizing the health concerns of the poor*—by focusing on public health issues, and better targeting health spending.
- *Depoliticizing social welfare programs*—the recently enacted Welfare Reform Act sets objective criteria for the selection of beneficiaries through strict means testing.

expansion; (ii) reform the financial sector, public enterprises, the labor market, and the trade regime—to increase efficiency and encourage private sector participation; and (iii) strengthen macroeconomic policy instruments and institutions.

A. Macroeconomic Framework, Outlook, and Risks

15. **The ongoing economic recovery is expected to gain further momentum this year, with GDP growth projected to rise to 5½ percent**. A strengthening of consumer confidence, a resumption of delayed private investment projects with the progress toward peace, a substantial increase in public investment, higher tourism, and a return to normal weather from the droughts of the past three years, underpin the higher growth forecast. In the absence of external shocks, inflation is projected to trend down to 7 percent by end-year. The current account deficit is likely to rise to 3¾ percent of GDP, as an export rebound is more than offset by higher imports related to increased activity and reconstruction needs.



16. **There are, however, risks to this outlook**. On the upside, the return of peace could boost activity more than anticipated with increased inter-regional trade and higher private investment. On the downside, a prolonged conflict in Iraq, a slower global recovery, a resumption of drought, and escalation of domestic political frictions are the major risk factors. In case the conflict in Iraq is protracted, higher oil prices, lower tourism, a decline in worker remittances, and lower exports to the Middle East (especially tea) would be the main conduits through which the economy could be affected. Staff analysis indicates that growth could fall by 1 percent, inflation rise by 1½ percent, the current account deficit widen by 1 percent of GDP, and the fiscal deficit worsen by ½ percent of GDP under unchanged policies.[2] With debt reduction being a key priority, much of the adjustment would need to be borne by monetary policy and the exchange rate. However, a prolonged conflict could require some adjustment in the fiscal stance too.

17. **The authorities are confident that with continued peace and deep structural reforms envisaged in the PRSP, growth in the medium-term should average 6½ percent.**[3] The staff views this growth path to be achievable provided fiscal consolidation

[2] This is based on the assumption of oil prices rising to $40 per barrel during the next six months and private capital inflows drying up.

[3] This macroeconomic framework is consistent with that of the PRSP's along all major dimensions, including growth and the fiscal deficit path. However, reflecting more updated

(continued)

is continued, structural reforms are implemented, peace is lasting, and the economy is not hit by large external shocks. The envisaged medium-term growth is 1 percent higher than the average during 1990–2000—a period of intense civil conflict. Also, while the growth rate dipped in 2001–02, the envisaged medium-term rebound in 2003-06 is less than the 4-5 percentage point increase typically witnessed in other post-conflict countries in the period following the end of conflict.[4] The pickup in growth is based on both higher productivity and capital accumulation, reflecting labor market and financial sector reforms, and strong public and private investment growth (Box 3). In the absence of major external shocks, prudent monetary policy, normal monsoons, and a return of oil prices to trend should help inflation fall to 4½ percent by 2006. With higher reconstruction and investment imports, the current account deficit is likely to increase, rising to 4½ percent of GDP in 2004, before falling to 3¾ percent of GDP by 2006. Reasonably strong capital inflows should help gross official reserves to rise to $3 billion (3½ months of imports).

18. **Risks to the medium-term outlook are material, with stronger growth and fiscal sustainability depending critically on continued reforms**. As discussed earlier, over the past two decades, reform efforts have been cut short by a variety of factors. Many of those factors, such as a faltering of the peace process or an escalation of domestic political frictions, are still present in varying degrees of likelihood, while new factors, such as the elimination of textiles quotas in 2005 (Box 4), have emerged. To assess the impact of lower growth on macroeconomic variables, the staff simulated a scenario in which growth remains at 4½ percent a year, the average for 1983-2002. Even under unchanged policies (relative to the program), key variables are adversely affected—inflation rises, interest rates increase, the fiscal deficit rises above baseline levels, and the current account deficit widens. However, the fiscal deficit path and debt dynamics remain on a downward adjustment path. By 2006, government debt declines to 93 percent of GDP, about 10 percentage points lower than at end-2002, but 10 percentage points higher than under the baseline. In addition, debt sustainability analysis (Annex III and ¶19) indicates that the baseline debt dynamics are vulnerable to large external shocks or a return to the policy environment of the late-1990s.

B. Fiscal Policy in 2003 and Beyond

19. **The authorities' fiscal policy program aims to restore sustainability, while making available adequate resources for priority spending and post-conflict needs.**

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information, such as on interest rates, external financing, and commodity prices, there are small differences in the inflation path, the composition of fiscal adjustment, and in the balance of payments.

[4] See, for example, IMF Working Paper WP/02/142.

Box 3. Sri Lanka: Outlook for Growth

While aiming for a growth of 8–10 percent in the long-run, the PRSP's macroeconomic framework projects GDP growth to average 6½ percent in 2003–06. This growth rate is 1¼ percent above that experienced in the 1990–2000, a period of civil conflict, high fiscal deficit, and limited reforms, when growth averaged 5⅓ percent.

- To achieve this growth, total factor productivity (TFP) needs to increase by 2½-2¾ percent a year, slightly higher than the average 2¼-2½ percent TFP growth attained during the 1990's. Capital accumulation should contribute 2 percentage points a year, as investment rates are projected to increase to an average of about 27 percent of GDP in 2002-06 from 25 percent of GDP during the 90's. This reflects substantial public investment (e.g., development of the southern highway and other key roadways to increase market access) and strong private investment, including FDI, reflecting the buildup in confidence as peace returns and delayed projects are brought on line. Employment growth at 3 percent a year, compared to 2¼ percent during the 1990's would contribute the rest. Labor reforms have a crucial role to play, and while the amendments enacted in 2003 should help reach these rates in the near future, further reforms will be necessary to sustain the pace of job creation.
- In terms of sectoral decomposition, the reintegration of the North and East to productive activity; increase in inter-regional commerce; opening up of hitherto restricted areas such as commercial fishing; increase in tourism, particularly in the East; and expansion of agro-industries reflecting easing of regulations on land use and ownership, as planned under the PRSP, are likely to boost GDP growth. The elimination of textiles quota in 2005, is likely to have a negative effect on growth but its impact should be limited given that quota-related exports form only a small fraction of total value-added (Box 4).

There are risks to this scenario:

- In the near-term, a slower than anticipated global recovery and a protracted conflict in Iraq are major downside risks. On the upside, the "rebound" from the contraction of 2001 could be stronger than anticipated—indeed, the current framework implies an annual growth rate of below 5 percent when the average is taken for 2001–06 below the 5.3 percent average growth achieved in 1990-2000.
- Over the medium term, drought, political instability and a stalling of the peace process are plausible downside risks. In addition, slippages in the implementation of the economic program could result in lower growth. On the other hand, the return of peace could boost activity more than anticipated. Although different circumstances make comparisons difficult, in other post-conflict cases growth has increased 4–5 percentage points, on average, in the period following the cessation of conflict.

To assess the robustness of the PRSP framework, staff has simulated a lower growth scenario. This scenario envisages that, despite the peace process and the implementation of structural reforms, growth fails to pick up and remains at 4½ percent, the average during 1982-2002, reflecting lower-than-expected domestic and external demand. As a result, under unchanged policies relative to the baseline, which is predicated on both continued peace and strong reform; higher domestic financing raises inflation and interest rates; the fiscal deficit declines over the medium term, but only to about 6¼ percent of GDP or 2 percent of GDP higher than in the baseline case; and government debt declines to 93 percent of GDP or 9 percent of GDP higher than in the baseline. Thus, to achieve the same reduction in debt-to-GDP ratios as in the baseline requires revisiting plans for total spending. While the external current account balance widens, reserves still increase to cover 3 months of imports. If lower growth were to be caused by a faltering peace process or delays in structural reforms, the fiscal deficit would be even higher relative to the baseline, as a result of further revenue shortfalls and expenditure overruns, particularly in defense. And while the external current account balance would not differ significantly from the baseline case, reserves would remain only slightly above 2 months of imports over the medium term reflecting the lack of official financing.

Sri Lanka: Low Growth Scenario, 2002-2006

(In percent of GDP, unless otherwise noted)

	2002 Est.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.
Real GDP at market prices (percent change)	3.3	4.5	4.5	4.5	4.5
Average inflation (CCPI; percent change)	9.6	9.2	7.4	6.8	6.0
Gross investment	22.3	23.5	24.4	24.9	25.2
Total revenue	16.5	16.9	17.9	18.6	19.1
Total expenditure and net lending	25.4	24.9	25.1	25.3	25.4
Current expenditure	20.8	19.7	18.9	18.4	18.2
Of which: Interest payments	7.4	7.6	7.1	6.8	6.6
Capital expenditure	4.6	5.2	6.2	6.9	7.2
Overall balance	-8.9	-8.0	-7.3	-6.6	-6.3
Net domestic financing	7.9	5.2	3.4	2.5	2.8
Total government debt	104	101	98	95	93
External current account balance (incl. transfers)	-1.8	-3.9	-4.9	-4.8	-4.3
Gross official reserves (US$b)	1.6	1.6	1.8	2.1	2.5
(months of imports of goods and services)	2.4	2.3	2.4	2.7	2.9
Total external debt	60	59	60	59	58

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

Box 4. Sri Lanka: External Competitiveness

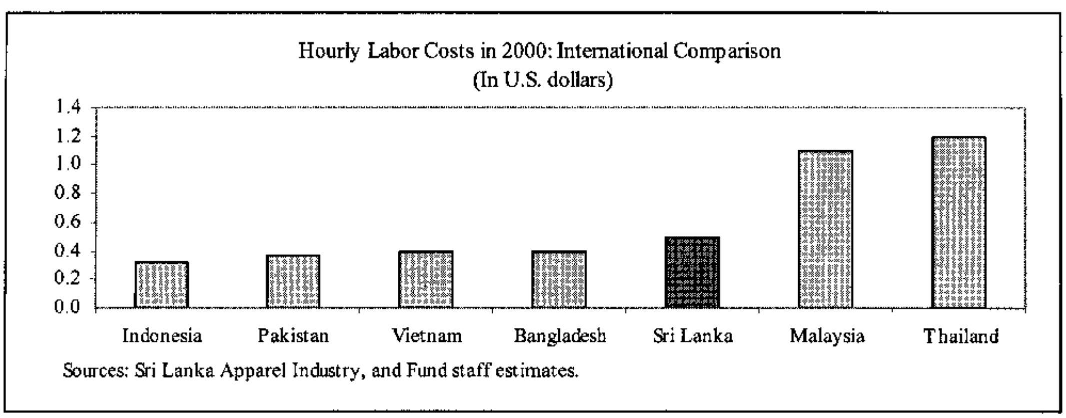
Sri Lanka has maintained its external competitiveness in recent years. The real effective exchange rate remained broadly unchanged in the last two years. However, looking forward, the country faces a number of challenges. In particular, the liberalization of markets to which Sri Lanka has preferential access and insufficient commodity and market diversification could hinder exports.

Sri Lanka's main exports—tea and apparel—rely heavily on the U.S. and EU markets. Sri Lanka accounts for almost one-fifth of global tea exports. The average yield, however, is lower than that of its major competitors, Kenya and India, while the cost of production in Sri Lanka has been increasing, mainly due to an increase in wages, and fuel and electricity charges. The share of textiles, apparel and leather products in merchandise exports has risen to over 50 percent, with almost 95 percent of these exports directed to the United States and the EU. About 60 percent of exports to the United States are subject to quotas, also facing an average 20 percent import tariff rate. While Sri Lanka's exports to the EU are quota-free, they are subject to an average 12.5 percent import duty. The relatively high rate of quota utilization (80 percent) suggests that Sri Lanka's goods have been competitive in the U.S. market.

Sri Lanka's preferential access to developed countries' markets is gradually being diluted by the proliferation of regional arrangements and gradual multilateral liberalization. Free trade arrangements and recent concessions have allowed many of the least developed countries quota- and tariff-free access to the otherwise heavily-protected apparel and textile markets of the United States and the European Union (EU). In addition, after the removal of apparel and textiles quotas by 2005, Sri Lanka would also have to compete with countries currently facing binding quotas, such as China.

The impact of quota removal, however, is likely to be moderate. The share of quota-related exports in total apparel exports is 32 percent. The larger companies, accounting for 85 percent of apparel exports, have been adjusting their operations to the free-market environment, shifting their production to out-of-quota, high value-added goods. Medium-sized companies (10 percent of exports) are expected to consolidate to maintain their competitive edge. Small companies are likely to close down, but they account for only 5 percent of exports and 3 percent of employment in the sector.

However, the industry faces other challenges too. Wages in the apparel sector are somewhat higher than in many of Sri Lanka's competitors, although the lack of data on labor productivity makes it difficult to draw definite conclusions about competitiveness. However, an industry paper[1/] cites infrastructure bottlenecks in the energy sector, transportation, port services, and customs administration, the country's remoteness from its main markets, and reliance on imported inputs as added costs to the sector. In the 2003 budget, the government announced the creation of a Garment Forum (a private-public partnership) to oversee the 2005 transition and committed to contribute to the initial capital of the association.



1/ *Sri Lankan Apparel Industry: Five-year Strategy.*

- *Fiscal sustainability*—public debt now stands at 104 percent of GDP, while interest payments amount to 7½ percent of GDP, raising serious sustainability concerns. With considerable resources being expended to finance the double-digit fiscal deficits of the last decade, private sector development was also crowded out. Thus, to restore sustainability, the PRSP aims to reduce the fiscal deficit, on average, by about 1¼ percent of GDP per year over the medium term, entailing an average increase of ¾ percent of GDP in the primary balance. Thus, by 2006, the deficit is targeted to fall to 4⅓ percent of GDP, the debt-to-GDP ratio to 84 percent, and interest payments to 5½ percent of GDP. Achieving these objectives will require revenue to be raised and expenditure rationalized and reoriented to priority needs.
- *Stress tests*—the program's positive debt dynamics are relatively robust to shocks although they are rendered unsustainable by a return to the policies of the late-1990s (Annex III). For the program path, most shocks—lower growth, higher real interest rate, and weaker revenue—raise the debt-to-GDP ratio, but the debt dynamics remain on a downward trend. For example, if GDP was to remain flat in 2003 and 2004 (compared to growth of 5½ percent and 6½ percent), the debt-to-GDP ratio would rise to 106 percent by 2004, but subsequently decline to 88 percent by 2007. A return to the policy environment of the late 1990s, however, reverses the positive debt dynamics, and the debt-to-GDP ratio keeps rising over the medium term. With around 50 percent of the debt denominated in foreign currency, external shocks play a significant role in the debt dynamics—for example, a 30 percent nominal depreciation in 2003 raises the debt-to-GDP ratio to above 125 percent, before it declines to 101 percent by 2007.
- *Priority spending*—under the program, capital spending rises from 4½ percent of GDP in 2002 to 7 percent of GDP in 2006. Budgeted social spending declines in 2003 compared to 2002, as better targeting of benefits is expected to lower welfare spending and the previous rapid expansion of nonessential staff in education and health is reversed. Social spending, thereafter, remains stable at 7½ percent of GDP, with continued savings in welfare spending allowing a near doubling of capital expenditures in health and education.
- *Post-conflict needs*—while the potential "peace dividend" in the form of higher growth, reduced poverty, and lower defense costs is substantial, it will be some time before it is fully realized. Meanwhile, to support the peace process, additional public spending is needed to aid resettling the internally displaced population, rebuilding the administrative and institutional capacity and dilapidated infrastructure in the North and the East, and cover additional demands on welfare payments. Precisely estimating such needs is difficult at this time, but the program includes ½ percent of GDP each year of post-conflict spending.

20. **In line with the above, the 2003 budget targets a deficit of 7½ percent of GDP**.

- The budget aims to increase revenue by ½ percent of GDP. To achieve this, the VAT was extended to the financial sector at the 10 percent rate; VAT exemptions lifted on some items; the debits tax extended to savings accounts from only current accounts;

and a 2–10 percent duty imposed on all currently exempt imports, except crude oil, pharmaceuticals, wheat and textbooks. The budget also planned to extend VAT to the wholesale and retail sectors in July 2003. However, this has been postponed until January 2004, due to technical complications, including those related to sharing revenue with provincial councils, who currently collect a turnover tax on retail trade. The authorities clarified that resolving these issues would not require constitutional changes, and thus expect to settle them and put in place the required intermediate steps (e.g., taxpayer registration) by end-2003 (MEFP ¶14).[5] The amount of revenue accruing to the budget from this measure will depend, in part, on the specifics of the revenue sharing arrangement. To encourage better tax compliance and investment, the top income tax rate has been cut from 35 percent to 30 percent.

- Expenditure is projected to decline by 1 percent of GDP, despite capital outlays rising by ¾ percent of GDP. The budget includes expenditure rationalizing measures such as a continued general hiring freeze and no increase in the salary structure; closing of redundant cadre positions; a reduction in defense costs; and a refinancing of expensive domestic debt (e.g., outstanding overdrafts) with long-term bonds. The authorities estimate an extra ½ percent of GDP may be needed in 2003 for spending in the North and East, over and above the ½ percent of GDP already budgeted. This extra spending would be included through a supplementary budget later in the year, if foreign financing were available.

21. **The authorities recognize the need to limit nonconcessional borrowing to finance the budget**. Including the SLIC divestment (½ percent of GDP), privatization receipts would be 1 percent of GDP. With grants around ½ percent of GDP and net external financing around 2 percent of GDP, net domestic borrowing would be cut to 4 percent of GDP, from 8 percent of GDP last year, allowing government bank credit to fall by 1 percent of GDP. The program sets \$510 million (medium- and long-term) and \$50 million (short-term) limits on contracting nonconcessional loans. The medium and long term borrowing limit includes \$100 million of commercial borrowing to refinance previously contracted (1999–2000) defense-related debt. The remainder is expected to be made of bilateral donor project loans—related to rehabilitating the children's hospital, rebuilding bridges, restructuring CEB, and rural developments—with an average grant element of 25 percent (reflecting, in part, the current low comparator market interest rates) and are expected to be disbursed over the next 3-4 years. These projects are identified in the PRSP as part of the strategy to reduce poverty and reconstruct the economy. To further reduce debt service, the authorities stressed that they would work closely with donors to substantially lower the use of nonconcessional loans in future years (MEFP ¶16). Also, the government is revamping its public debt office to

[5] To offset the projected revenue loss, earnings from telecommunication licensing fees and charges, which have increased following the recent liberalization of the sector, will be brought under the budget through a levy on Telecommunications Regulatory Commission (TRC).

improve debt management, with technical assistance from the World Bank and the United States.

22. **As required under the Fiscal Management Responsibility Act, the government will conduct a mid-term review of public finances in July 2003**. The authorities recognize that there are pressures on the budget, on both revenue and expenditure. There are still extensive exemptions on various taxes, with pressures from interest groups to grant more. On the expenditure side, demands to increase civil service wages (the last general wage increase was in October 2001) and relief to mitigate some of the effects arising from the conflict in Iraq, such as higher oil prices and the decline in tea exports, are mounting. The government has already taken some steps to allay the impact of the recent spike in oil prices. Since mid-February, the government has subsidized diesel and kerosene prices (the monthly fiscal cost is small and fully offset by spending cuts elsewhere in the budget). The measure is intended to last for at most two months.[6] At the mid-year review, an assessment will be made whether additional revenue (further reduction of corporate tax exemptions) and expenditure (additional cuts in transfers and subsidies to corporations) measures are needed to meet the deficit target. The government does not intend to grant any general wage increase, unless during this review, a determination is made that funds are available to cover the resulting increase in the wage bill (MEFP ¶28).

23. **Over the medium term, to achieve the needed consolidation, the revenue base will need to be broadened**. To this end, the government plans to conduct this year a study of the costs and benefits of the large and varied types of current tax exemptions and incentives. Based on this study, for the 2004 budget the government will consider various options, including extending the VAT to more items; reducing income tax exemptions; cutting down the number and length of tax holidays and the level and duration of the tax concessions; imposing stricter limits on roll over of tax holidays; and limiting tax incentives to strategic sectors (MEFP ¶14). However, the authorities pointed out that VAT exemption on some items, such as basic food items, would need to be sustained for some time.

24. **The authorities plan to set up a medium-term expenditure framework (MTEF) by midyear** (MEFP ¶15). This will allow a more detailed costing of the priorities identified in the PRSP, thus helping to rationalize and reorient expenditure towards priority needs and poverty reduction. To aid in developing the MTEF and better manage public resources, annual public expenditure reviews (PERs) are planned, with help from the World Bank. The government also needs to decide which of the vast number of noncommercial public entities are essential and close down the rest, while privatizing or liquidating commercial SOEs.

25. **The authorities consider the establishment of the revenue authority as key to strengthening tax administration**. The revenue authority is expected to encompass Inland

[6] The authorities plan to pass on the full effect of high oil prices to domestic fuel prices, if from April onwards oil prices continue to remain high.

Revenue, Customs, Excise, and the tax and customs components of the BOI. A workshop, organized by the Fund and AsDB, is planned for late–April in Singapore to help formulate parliamentary acts governing the authority and design a realizable work plan by June (MEFP ¶18). The authorities envisage also using this opportunity to modernize its information system and improve staff recruitment.

26. **Looking ahead, fiscal federalism is likely to surface as a key item on the reform agenda**. Sri Lanka already has devolved some power to the provinces, although, as the PRSP points out, the devolution was incomplete and the system is mired in complex and frequently parallel systems of administration and poor accountability mechanisms, with provinces having very little revenue raising options. The exact nature of the reforms to the federal structure will depend, in part, on the understandings reached between the government and the LTTE on power sharing. The government plans to formulate a new constitution, rather than make piece meal amendments to the existing federal structure.

C. Monetary and Exchange Rate Policies

27. **The flexible exchange rate regime has served the economy well and will be continued**. Thus, market interventions will be limited to smooth short-term volatility or meet the reserves target in line with the monetary program. The authorities agreed that if downward pressures on the currency intensified, reflecting geo-political uncertainties, the exchange rate would have to depreciate to absorb the pressures (MEFP ¶28).

28. **Monetary policy will continue to be guided by the need to support economic recovery, while restraining inflation**. Under the program, supporting anchors for monetary policy will be provided by a ceiling on central bank NDA and a floor on NIR. Broad money is projected to grow at 13½ percent in 2003, broadly in line with nominal GDP growth. If the pace of disinflation and fiscal consolidation picks up in the coming months, then a modest easing of policy rates would be appropriate. The CBSL launched its active open market operations in March 2003, and a short-term IMF advisor has been provided to the CBSL to help in the early stages.

D. Structural Reforms

29. **In line with the PRSP, the program will focus on reforms that help to accelerate growth with the private sector as its main engine**. The main areas of the agenda will be to reduce state dominance in the economy; to strengthen the financial sector; to improve labor market flexibility and the regulatory framework; to implement civil service and pension reforms to raise public sector efficiency and ensure the adequacy and sustainability of the social safety net; to streamline the welfare system by targeting better the truly needy; and to establish a rationalized and transparent tariff system to enhance external competitiveness.

30. **While the financial position of the main public corporations and the two state banks improved in 2002, their ongoing restructuring needs to be continued**. CPC increased its profits, aided by the establishment of an automatic petroleum pricing mechanism in January 2002, and losses of the CEB fell, reflecting a 35 percent increase in

electricity tariffs. The restructuring of both the utilities is progressing as planned, with help from the AsDB and Japan. The two state banks strengthened their financial position, reflecting increased loan recoveries and higher interest margins. Peoples Bank is estimated to have made a profit of Rs1 billion (½ percent of assets), while the Bank of Ceylon profit is projected at Rs 1¼ billion (¾ percent of assets). Bank of Ceylon met most of the World Bank established restructuring targets for end–2002, including loan recovery and return on assets. This year's privatization program includes further sale of shares of the telecom company (SLT) and the state's share in the Colombo Hilton (MEFP ¶22).

31. **With the gradual end of state monopolies and increase in private sector competition, Sri Lanka's regulatory framework needs to be modernized**. To this end, a multisector regulatory bill was enacted last September. Three multisector regulatory bodies covering utilities, transport and communication have been established and a fourth for financial services is envisaged. To enhance competition in telecommunication, access to international gateways was liberalized in January 2003. The Securities and Exchange Commission Act was amended this January to broaden the regulatory scope of the agency.

32. **Restructuring Peoples Bank is an urgent priority**. In line with the PRSP, the authorities have a clear strategy and timetable to restructure Peoples Bank under the direction of a restructuring committee formed in January 2003 (the first-year program includes two related structural benchmarks). A World Bank-financed investment consultant, appointed this March, will assist the authorities in the commercialization of the bank through evaluation of assets and liabilities, and assessment of proposed restructuring arrangements. As its first option, the government will seek a strategic investor to take over Peoples Bank as a single unit. The external evaluation of the bank's assets and liabilities is to be completed by September, along with carving out the loans to be transferred to an asset management company (AMC). At this time, the consultant will seek investor interest (both domestic and international) through an open and transparent process. During the process, the CBSL will conduct "fit and proper" tests of potential investors, in line with the provisions of the amended Banking Law. If by December 2003, the single unit option is found not to be viable, the bank will be separated into a savings and a commercial bank—the former remaining under government control and the latter divested with the help of the consultant. In either case, the government aims to complete the restructuring by March 2004 (MEFP ¶22).[7]

33. **To help improve bank performance, an asset management company (AMC) law is being prepared**. The banking sector, including private banks, remains mired in a high level of nonperforming loans and thus low profitability, despite high lending-deposit rate margins. The aim of the AMC law is to provide troubled banks with a mechanism to effectively deal with their nonperforming assets, while ensuring that perverse incentives are

[7] The budgetary cost of reforming the bank will depend on the precise form of restructuring. Including existing provisioning, estimates indicate that about ¾ percent of GDP would be needed to fully capitalize the bank.

not created for banks to adopt imprudent lending strategies. The draft (AMC) law is expected to be presented to parliament by June 2003. The Fund and the World Bank are providing technical assistance in this area.

34. **Several steps are being taken to strengthen financial sector soundness**. Last December, the CBSL revoked the license of the insolvent Pramuka Bank, signaling the end of its supervisory forbearance. The bank is small, accounting for ½ percent of the sector's assets, and, so far, there has not been any fallout on other banks. Amendments to the Banking Act, which are expected to be presented to parliament in June 2003, aim to enhance CBSL's supervision capacity (including in conducting "fit and proper" tests of new entrants and penal actions for violation of prudential norms) and facilitate mergers and takeovers of banks. In line with FSAP recommendations, the CBSL also plans to raise the rates at which collateral value of impaired assets are discounted. The central bank is closely monitoring time-bound plans of some smaller banks to meet the new CAR requirements. To help deepen the nonbank financial sector, the functioning of the pension funds need to be enhanced by making benefits transferable between the public and private sector and allowing the portfolios of EPF and other pension funds to be managed privately. As part of the government's pension reform plans, a contributory pension scheme for all new public servants was enacted in January 2003. To modernize the exchange market, the Exchange Management Act is being amended—in particular while retaining existing controls over short-term capital movements, the amended act permits some longer term capital accounts transactions such as foreign borrowing by the private sector of over five year maturity. The draft legislation has benefited from Fund technical assistance.

35. **Increasing labor market flexibility is key to securing high long-term growth**. In line with the recent amendments to the labor laws, the government intends to gazette, in April, a new redundancy compensatory formula and a time-bound rule for settling labor disputes (MEFP ¶22). The compensatory formula, the exact parameters of which have not yet been determined, and the time-bound dispute settlement rule, are significant improvements over the current discretionary rulings by the labor commissioner. To provide a cushion against loss of labor income, an unemployment benefits scheme is being designed with assistance from the ILO. To minimize budgetary costs, a combination of provident fund (EPF) resources and contributions from employers and employees is being contemplated to finance the scheme. Over the medium term, a systematic overhaul of the Termination of Employed and Workmen Act (TEWA) is still needed.

36. **Improving governance in the public sector is an important element of the authorities' reform agenda**. To depoliticize the civil service, a new Public Service Commission was constituted in late 2002. Other civil service reforms, including right sizing the service, are planned with the help of the World Bank, working closely with the Fund to ensure that the wage bill is sustainable. In order to reduce duplication of functions and administrative fragmentation, the Expenditure Reform Commission initiated, in 2002, a "zero based review" of various government departments and agencies. A high-level Program Management Committee has been set up to improve the execution rate of planned capital projects, particularly those funded by donors.

37. **To enhance external competitiveness, the authorities plan to implement further trade reforms**. Although Sri Lanka is a relatively open economy, further rationalization of import duty exemptions, waivers, and licensing would improve the transparency of the trade regime and resource allocation. To this end, the government intends to cut the 20 percent import surcharge to 10 percent by January 2004, eliminating it by January 2005. In the 2004 budget, the authorities plan to present a clear timetable, including interim targets, for rationalizing the existing tariff structure to a simplified three-band regime by 2005 (MEFP ¶22). As noted in the PRSP, high protection of agricultural goods has led to high food prices, hurting the poor, who are net consumers of these products.

IV. POVERTY AND SOCIAL PROTECTION

38. **The incidence of poverty rose in the last decade**. Poverty increased significantly in the 1990s, as the headcount ratio (percent of population below the poverty line) rose from 20 percent in 1990 to 28 percent in 2002. However, these figures mask the full extent of poverty in Sri Lanka. The surveys did not cover the conflict-torn North and the East, where poverty is significantly more widespread and intense than the national average. Thus, the authorities are undertaking an updated poverty assessment, based on a specific study of the North and East, integrated to the 2002 household survey.

39. **The PRSP aims to alleviate poverty by widening opportunities for the poor to benefit fully from the private sector-led growth strategy**. Given that 90 percent of the poor live in rural areas, the authorities aim to revitalize rural development by reforming agricultural policies and encouraging the growth of medium and small-scale enterprises. As discussed in the PRSP, limited land tenure rights and restrictions on land use have fostered inefficient production in agriculture. The government has prepared a draft land ownership law, which is likely to be presented to parliament in the first half of 2003. The law provides a framework to establish private ownership and clear land property rights. The World Bank is providing support in this area. In addition, the government considers that improving access of rural communities to markets through better transport and telecommunication infrastructures and increasing access of the poor to better education and health services will play a key role.

40. **Sri Lanka provides support to its poor through extensive and wide-ranging government programs**. Of these programs, Samurdhi is the largest. The program provides cash grants to over 2 million families (about 50 percent of the population), while also operating a range of rural savings schemes, bank societies, and village development projects. Over the years, due to rampant abuse and politicization, the program became mired in inefficiencies. To address these issues, the recently enacted Welfare Benefit Law sets clear and transparent eligibility criteria, and provides guidelines for the termination of the benefits and penalties to reduce politicization and mistargeting. In 2002, around 250,000 families graduated from the program, and over the next three years, the target is to graduate 200,000 beneficiaries each year, through stricter targeting and means testing. Weaknesses in the other functions of Samurdhi are also being addressed. The program currently employs around 25,000 workers and managers. To lower operating costs, the

Ministry of Welfare is marketing the use of Samurdhi's network and officers to other state agencies and NGOs.

41. **The authorities intend to initiate a poverty and social impact analysis (PSIA) of the key policy reforms in 2003, with help of the World Bank and DFID**. Some of the proposed reforms, such as public sector restructuring and the changes to labor laws could impose short-term costs on the poor (Box 5). The government is undertaking counter measures, such as establishing an unemployment benefits scheme, and is discussing options on voluntary retirement schemes with donors. Once the PSIA is completed, the authorities intend to update the PRSP to incorporate specific poverty concerns related to the proposed reforms and policies.

V. Financing Issues, Access, and Phasing

42. **The requested total access of 100 percent of quota over the three years—65 percent of quota under a PRGF arrangement and 35 percent of quota under an EFF arrangement—is appropriate**. The access would yield a total projected disbursement of about \$560 million, phased equally over seven disbursements. Sri Lanka's relatively large medium-term balance of payments needs—averaging about \$400 million a year—reflect the strengthening of the economy and post-conflict reconstruction. The targeted increase in official reserves (to 3½ months of import cover by end-2006) is modest, in light of the large external shocks the economy has been subjected to in the past and the uncertainty surrounding future external developments. The program is strong—containing a broad array of difficult structural reforms and sizeable fiscal adjustment in 2003 and over the medium term, and the government has demonstrated firm commitment to reforms over the past year. Unlike many developing countries, Sri Lanka has access, albeit limited, to international capital markets, given its exemplary debt servicing record, and thus a blend of PRGF-EFF funds is appropriate. Including the new arrangements, Sri Lanka's debt service to the Fund will be around 1¼ percent of exports of goods and services in the medium term, compared to total debt service of 11½ percent. Exposure to the Fund will rise from 1¾ percent of GDP in end–2002 to 2½ percent of GDP by 2006, making up 6 percent of total public external debt.

43. **The 2003 program is fully financed, and a projected remaining financing gap of \$70 million, on average, over 2004–2006, can be met by additional donor support**. The support would depend on making continued progress on the peace and economic reform fronts. Over the program period, the World Bank proposes to disburse \$800 million–\$1 billion (high-case scenario) of IDA funds. Of this amount, half (\$380 million) would be in the form of program financing (PRSC) and around \$120 million in grants. The AsDB's total assistance would be \$400 million over 2003–06, with balance of payments support around \$200 million. If the unidentified gaps are not filled by bilateral funds, market borrowing would be necessary, which, at present, is not envisaged for 2004–06 in the program. In the extreme situation of having to access the market for the entire financing gap, the debt stock would not change discernibly (Annex III), but the debt service ratio would rise, on average,

Box 5. Sri Lanka: How Do Policy Reforms Affect the Poor?

The Sri Lankan authorities plan to undertake a poverty and social impact analysis of key policy reforms in 2003, with the help of the World bank. This box contains a preliminary and qualitative evaluation of the likely impact of some of the key reforms supported by the PRGF-EFF supported program.

Policy Reform	Implication	Impact on Poverty
Fiscal consolidation.	Macroeconomic stability; lower spending on interest; increase in priority spending; lower inflation.	Positive, through growth and higher spending that benefits the poor, and by avoiding high inflation, which disproportionately affects the poor.
Raise fiscal revenues through simplifying tax regime, rationalizing tax exemptions, and improving tax administration.	Increases equity and efficiency of the tax system; allows for lower tax rates on a wider tax base.	Possible negative effects of the eventual removal of VAT exemptions, for instance on some food items and on retail sector (not planned for 2003). However, the poor tend to transact with enterprises that are below the threshold for VAT.
Rationalization and reorientation of government spending.	Contain/reduce wage bill; increase priority spending.	Possible negative effects on workers made redundant; the government, however, intends to make use of attrition and voluntary retirement schemes to the extent possible. Positive, through spending on rural infrastructure and other priorities.
Welfare reform—implement the new Welfare Act	Target beneficiaries through means testing; reduce politicization.	Positive, because of lower exclusion of deserving beneficiaries and room for a higher level of benefits.
Labor reform.	More flexible labor markets, lower procedural and pecuniary firing costs.	Positive, through better incentives for job creation. Negative, owing to more job destruction. Mandatory redundancy payments, however, remain generous and an unemployment assistance scheme is being put in place.
Public enterprise reform, privatization, and liberalization.	Increased efficiency and private sector participation in electricity, petroleum and telecom sectors. Lower quasi-fiscal costs.	Positive, through growth. Short term costs of restructuring ameliorated by the use of voluntary retirement schemes. Employment policies are made part of the bids by potential buyers.
State-bank reform.	Increase efficiency of banking system; lower quasi-fiscal costs.	Positive, through elimination of a large contingent liability that, if unchecked, would have eventually crowded out priority spending. Short term costs of restructuring ameliorated by the use of voluntary retirement schemes and separation payments.
Strengthen bank supervision.	Prevents banking crisis and limits banking system risks.	Positive, as it promotes sustainable growth and protects the savings of the population.

by about 2 percent per year. In light of a continued balance of payments need, including resources from the Fund, the authorities have requested that the SBA repurchase expectations arising during July 2003–June 2004 be moved to obligations basis.

VI. Program Design, Monitoring, and Data Issues

44. **The program's quantitative performance criteria and benchmarks will be based broadly on the specifications that were adopted in the SBA (EBS/02/59).** A ceiling on net domestic financing (NDF) will continue to be the key test on fiscal performance. The first-year program has one prior action—bringing SLIC to a point of sale (MEFP Table 2). There is a structural performance criterion, at the time of the first review, related to the revenue authority, which needs to function efficiently to strengthen tax administration. The program includes structural benchmarks related to Peoples Bank restructuring, which is crucial in maintaining banking sector soundness, in light of the bank's systemic importance. Other benchmarks relate to changes in the tax regime, privatization, labor reforms, and banking and exchange management laws—all of which are closely linked to strengthening macroeconomic performance (Box 6).

45. **Sri Lanka's statistical information is adequate for program monitoring, but weaknesses remain in a number of areas.** A GFS technical assistance mission is planned for Sri Lanka in April–July 2003, focusing on existing classification and compilation issues and the plans for migrating to the publication of fiscal data in accordance with the GFSM 2001 methodology. Sri Lanka is a participant in the GDDS, and the authorities expect full compliance on SDDS by mid–2004. In addition, the government plans to establish a monitoring and control framework to track and protect poverty-reduction expenditures. In this regard, a monitoring system for the Samurdhi program is being implemented to track movement of beneficiaries in and out of the program, with help from the World Bank.

VII. Safeguards

46. **The CBSL has made good progress in implementing the recommendations of the August 2001 Safeguards Assessment Report.** The CBSL has also supplied TRE with the documentation necessary for a follow-up assessment, which is expected to be completed by the first review of the forthcoming PRGF arrangement. The CBSL's 2002 accounts (on full IAS basis) have been audited by Ernst and Young, New Zealand.

VIII. Staff Appraisal

47. **The Sri Lankan economy now stands at a crossroad.** Over the past year, many changes have taken place. There is growing optimism, both within and outside Sri Lanka, that lasting peace may finally be within sight. The ceasefire has held for more than a year and the peace negotiations have progressed well. The economy is recovering, after being hit hard by a series of shocks in 2001. There is renewed interest within the international community to support the reforms and reconstruction of the economy. The government has displayed a

Box 6. Sri Lanka—Structural Conditionality: Collaboration With Other Donor Partners

Coverage of structural conditionality in the current PRGF-EFF arrangements

- The structural conditionality in the PRGF-EFF supported program focuses on: (i) improving tax administration and tax policy (ii) financial sector reform (iii) privatization and (iv) labor market reform (MEFP, Table 2). These reforms which were initiated under the SBA and are critical to the program's macroeconomic objectives.
- The fiscal measures are designed to improve revenue collection and broaden the narrow tax base (see ¶3 and ¶23). Thus, the presentation of the revenue authority law to parliament, which will bring the revenue collecting agencies (Inland Revenue, Customs, Excise, and tax and customs component of BOI) under one body, is a performance criterion under the program. Rationalization of tax incentives and extension of the VAT to the wholesale and retail sectors are structural benchmarks.
- Financial sector reforms aim to strengthen the soundness of the sector and the CBSL's supervisory capabilities (the amendments to the Banking and Exchange Management Acts and an AMC law) and restructure the insolvent Peoples Bank, which is systemically important. Withdrawing the state from commercial activities is a key aim of this program and the PRSP and remains vital to ensure that high quality growth is sustained over the medium term. Thus the privatization of key SOEs is included as prior action and structural benchmarks. Reform of labor laws is critical to encouraging FDI and expanding employment in the formal sector. Thus the implementation of a new compensatory formula and new time-bound redundancy rules feature in the program as a structural benchmark. Also important for medium-term macroeconomic performance is the reduction of policy-induced distortions in the external sector. Hence, liberalizing the trade regime is a major component in the PRSP, and the phasing out the import surcharge is included as a benchmark. This would help to improve allocative efficiency in the economy and improve the transparency of the tariff structure.

Status of structural conditionality from earlier programs

- A SAF (March 1988) and an ESAF (September 1991) aimed at civil service and pension reform as well as the reform of the state banks and implementing tax policy and tax administration reform. The results were mixed and several of the structural objectives were not met, reflecting either an intensification of the conflict or escalation of domestic political frictions, which waned interest for further reforms.
- Under the SBA, the authorities completed all the structural benchmarks albeit with some delays. The measures in the SBA focused on state bank reform, privatization, steps to improve domestic petroleum pricing by CPC and tax reforms. In addition, to promote investment and improvement in the external position, the SBA included measures to liberalize FDI flows as well as critical actions identified by the safeguards assessment report.

Structural areas covered by World Bank and AsDB lending and conditionality

- The World Bank's four-year PRSC program will focus on: factor market reforms—labor, financial, and land—and in the power sector under PRSC-I; the acceleration of rural development and the reform of the welfare system under PRSC-II; and on the public administration/civil service reforms under PRSC-III. Under each PRSC, a number of priority actions aimed at strengthening governance in the public sector in general and public expenditure management in particular will be supported. The specific focus areas to be covered under PRSC-IV will be determined on the basis of the findings of the planned Development Policy Review study to be carried out in 2003/2004. The AsDB's programs focus on public enterprises restructuring and the development of small and medium-term enterprises.
- In terms of the division of labor, while the World Bank's PRSC-I will also address the reform of Peoples Bank, there has been close collaboration with the Fund on the various aspects of the restructuring. The Bank would focus on helping the restructuring committee with investment consultants as well as in the bidding process for the restructuring, and in the design of the AMC law. For labor market reforms, the PRSC will focus on the systematic overhaul of the Termination of Employed and Workmen (TEWA) Act over the medium-term.

Other relevant structural conditions that are not included in the current program

- Areas in which the current program has not set conditionality, and which have macroeconomic relevance, include civil service and pension reforms and public enterprise restructuring. This is in part to streamline the program's structural conditionality, but also because the World Bank programs will cover civil service and pension reforms as well as the restructuring of CPC. Nevertheless, Fund staff would work closely with the Bank to ensure the longer-term affordability and sustainability of the wage and pension bills. The PRGF does not include any conditionality on the restructuring of the state-owned Ceylon Electricity Board (CEB), given that the AsDB is taking the lead in this area. The Japanese Bank for International Corporation (JBIC) also provides financing for public enterprise restructuring, power sector reform and rural development. The ILO is providing advice on the design of the unemployment benefit scheme.

commitment to fiscal consolidation and structural reforms in a difficult economic and political terrain. Thus, the current conjuncture presents a rare opportunity to implement deeper economic reforms and put the economy on a path of sustained high growth.

48. **Seizing this opportunity, the government has articulated an appropriately ambitious strategy to generate sustained growth and reduce poverty**. The staffs of the World Bank and Fund consider the PRSP, which is the result of strong ownership and extensive consultations, to be a good framework to enhance growth and reduce poverty. However, there are some areas that need to be strengthened—including prioritizing policies to reflect a detailed costing of the reform agenda, assessing the impact of policies on the poor and disadvantaged groups, and appraising the extent of poverty and reconstruction needs of the North and East.

49. **The authorities' program for the first year of the requested arrangements provides a sound basis to achieve its medium-term macroeconomic objectives**. However, the economic recovery is not yet broad based, with exports still remaining weak and private investment just beginning to pick up. Strong and steadfast implementation of reforms will be needed to generate growth sufficient to reduce poverty in any significant way.

50. **In view of the large stock of public debt and high interest payments, the program's focus on continued fiscal consolidation is appropriate**. The staff supports the strategy of raising revenue by broadening the tax base, while rationalizing and reorienting expenditure to make available adequate resources for priority social spending and post-conflict needs. In this regard, the recent enactment of the FMRA is a welcome development and will help underpin fiscal integrity. Looking ahead, the authorities need to establish a MTEF to better estimate the cost of the PRSP priorities, and set up a monitoring framework to track and protect poverty-reduction expenditures. The medium-term revenue path needs to be further enhanced, by limiting tax exemptions and incentives to only a few basic items and strategic sectors, and strengthening tax administration by setting up an efficient revenue authority.

51. **The staff supports the maintenance of the flexible exchange rate regime, which has served the economy well over the past year**. The flexibility of the exchange rate is an added policy instrument to respond to exogenous shocks, and the monetary authorities should use it fully, given that fiscal policy is constrained by the large debt burden.

52. **The program's proposed structural reforms should help to accelerate private-sector led growth**. The restructuring of the state-owned CPC, CEB, and CWE, needs to be continued with as planned, while privatization of the many remaining SOEs should be accelerated. The restructuring of Peoples Bank, which is critically important given the bank's systemic importance, needs to be carried out in an open and transparent manner, while ensuring the financial integrity of the restructured entity. The proposed AMC law would help to improve bank performance, but needs to guard against encouraging imprudent lending practices.

53. **The recent amendments to the labor laws are important first steps to improve labor market flexibility, helping to encourage employment growth**. The new redundancy compensation formula, however, should balance workers' concerns with keeping the separation costs low. To ensure that the new time-bound labor dispute rules can be properly adhered to, the government also needs to increase adequately the number of labor tribunals. In addition, the proposed unemployment benefit scheme needs to be designed such that the cost to the budget is minimized and perverse labor market incentives are not created by making the unemployment benefits too generous. To reach the PRSP employment growth targets, it will be necessary to systematically overhaul Sri Lanka's labor laws.

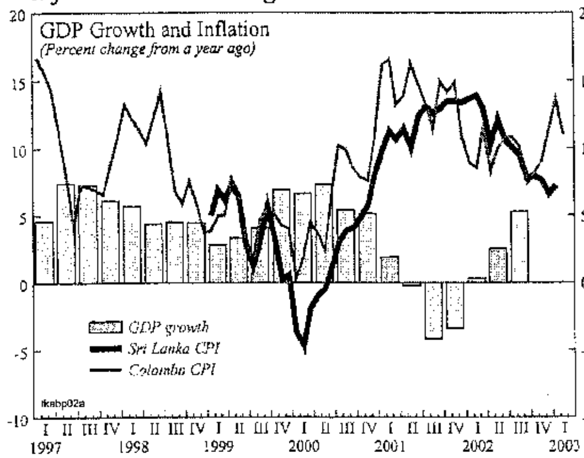
54. **Poverty in Sri Lanka is multi-faceted and remains a daunting challenge**. The government's attention to reducing conflict-related poverty is timely and supported by the staff. More generally, as envisaged in the PRSP, the authorities' plans to strengthen rural infrastructure and improve access of the poor to quality education and health services are necessary steps. With poverty being mainly a rural phenomenon, revitalizing the rural economy, through land tenure reforms and liberalization of land use policy, along with reducing the high protection accorded to agricultural goods, are also needed. In the area of welfare reforms, the new focus on depoliticization and targeting of Samurdhi benefits should be strongly implemented.

55. **There are risks to the program**. Near-term growth could be adversely affected if the global economy slows down or the conflict in Iraq becomes protracted. If the peace process falters or domestic political frictions escalate, the program's medium-term objectives for growth and poverty reduction are unlikely to be realized. In addition, the removal of textile quotas in 2005 could have a larger adverse effect than envisaged. There are also policy implementation risks. The budget could yield to numerous interest group pressures—both on the revenue and expenditure side—and reap the "peace dividend" prematurely. The pace of reforms could also be slowed down if they were seen to threaten public support for peace. The program includes measures that could mitigate some of the risks, but by their nature, many of the risks cannot be fully offset. Nevertheless, the authorities are committed to the program and are taking political risks, by embarking on difficult structural reforms, while making strong efforts to preserve public support for the peace process.

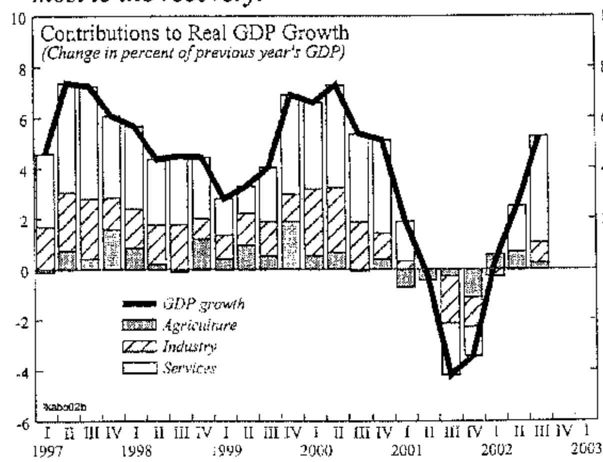
56. In light of these considerations and to join the international partnership to support Sri Lanka's peace and reform process, the staff recommends extension to the obligations schedule of SBA repurchase expectations arising during July 2003–June 2004 and approval of the Sri Lanka's request for the use of Fund resources under the three-year PRGF-EFF arrangements.

Figure 1. Sri Lanka: Real and External Sector Developments

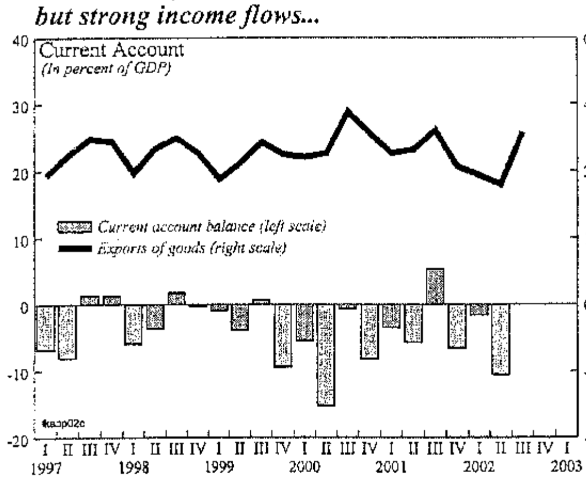
Activity is recovering slowly and, until recently, inflation was trending down.



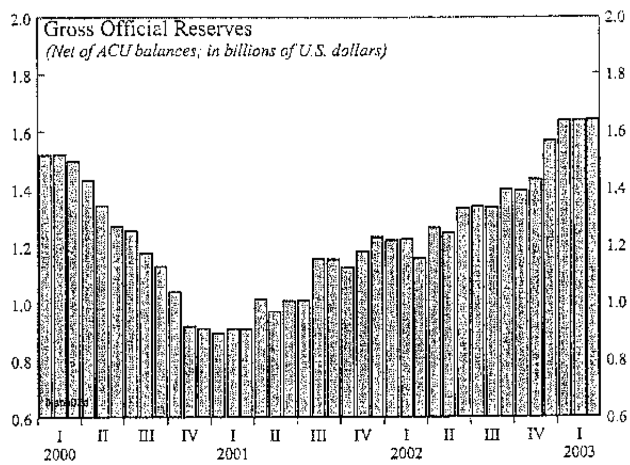
Agriculture and services have contributed most to the recovery.



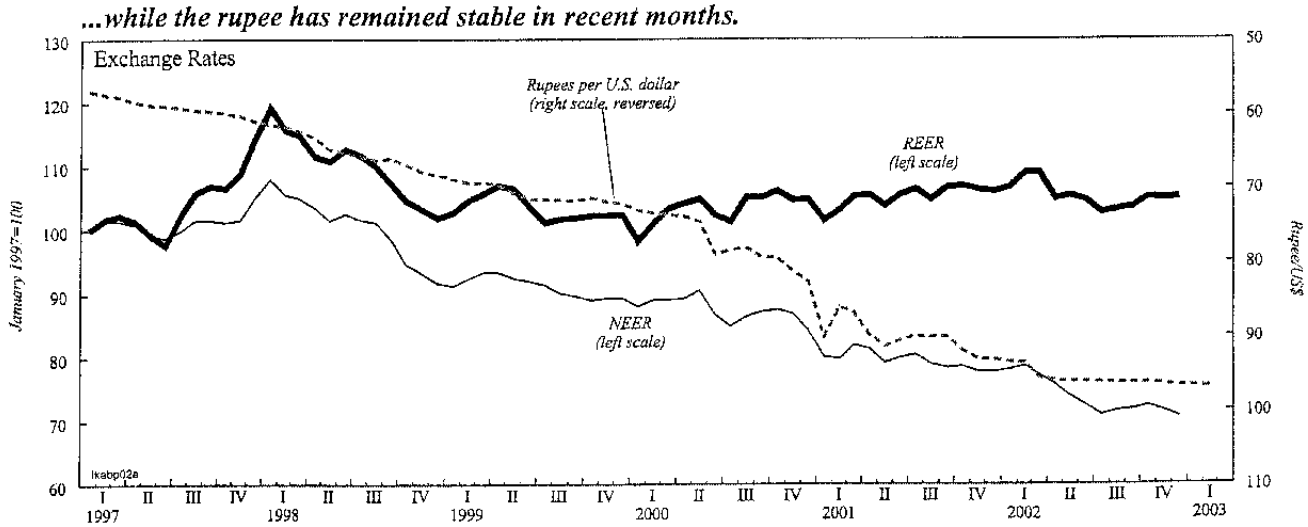
However, exports remain weak, but strong income flows...



... have helped reserves to rise steadily...

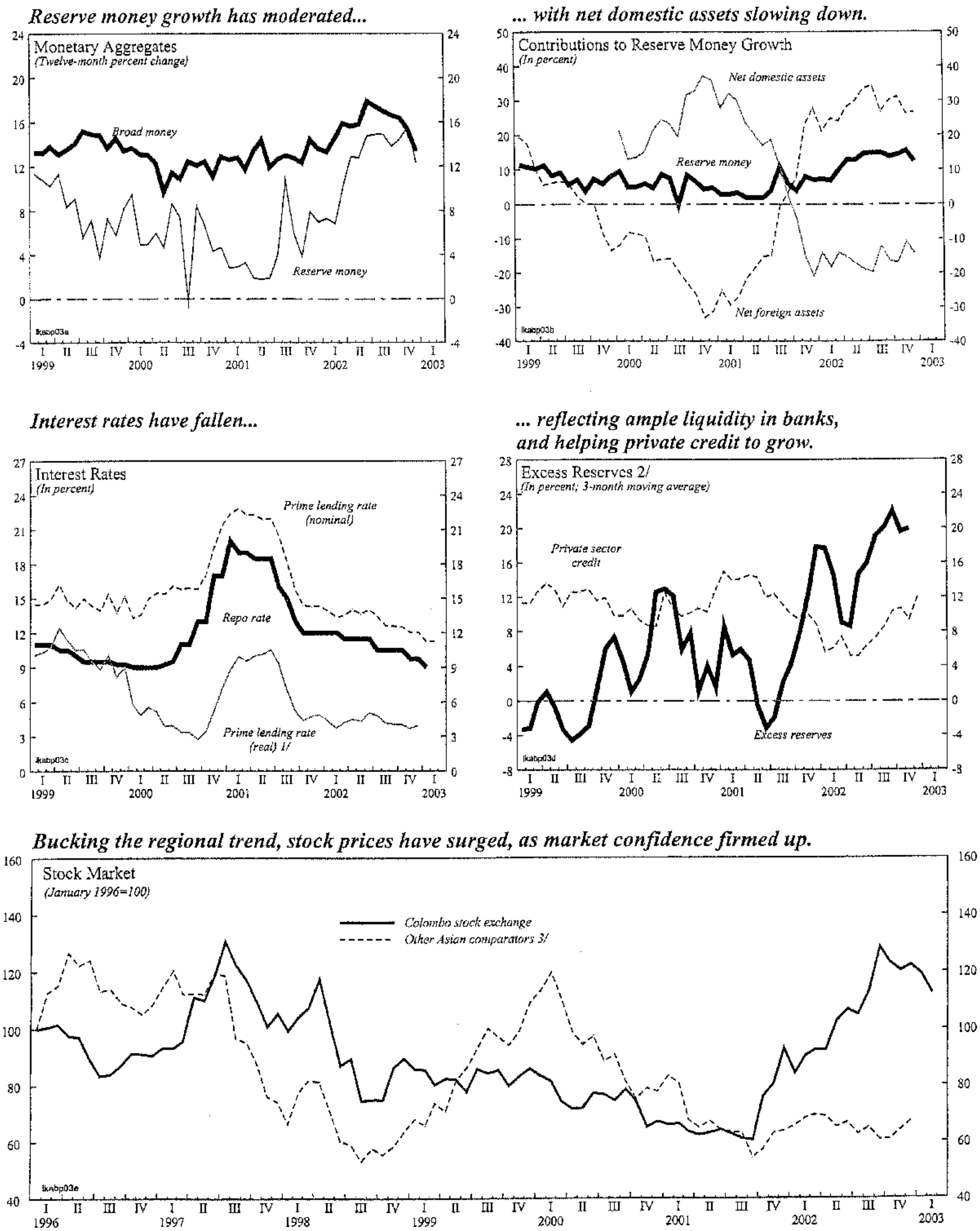


...while the rupee has remained stable in recent months.



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

Figure 2. Sri Lanka: Monetary and Financial Developments



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

1/ Deflated by expected inflation.
2/ Excess reserves and other cash in till in percent of required reserves.
3/ Weighted average of indices of India, Malaysia, Indonesia, Pakistan, and Philippines.

Table 1. Sri Lanka: Selected Economic Indicators, 2000-2003

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

	2000	2001	2002	2003
			Est. 1/	Proj.
		(Percent change)		
Real GDP	6.0	-1.4	3.3	5.5
Colombo consumer price index (end-of-period)	10.8	10.8	11.3	7.0
Colombo consumer price index (period average)	6.2	14.2	9.6	8.9
Sri Lanka consumer price index (end-of-period)	8.1	13.4	6.6	7.0
Sri Lanka consumer price index (period average)	1.5	12.1	10.2	7.6
		(Percent of GDP)		
Saving and investment				
National saving	21.5	19.5	20.3	20.4
Gross investment	28.0	22.0	22.3	24.2
		(Percent of GDP)		
Government budget				
Revenue	16.8	16.5	16.5	16.9
Expenditure and net lending	26.7	27.4	25.4	24.4
Primary balance (excluding grants)	-4.2	-4.1	-1.4	-0.2
Overall balance (excluding grants and privatization)	-9.9	-10.9	-8.9	-7.5
Overall balance (incl. grants and excl. privatization)	-9.5	-10.5	-8.4	-7.0
Current account surplus (+)/deficit (-)	-3.4	-4.9	-4.2	-2.3
Defense expenditure (excl. pub. order and safety)	4.6	3.8	3.0	2.4
		(Annual percent change; end-of-period)		
Money and credit 2/				
Reserve money	4.7	7.0	12.3	13.0
Broad money	12.9	13.6	13.4	13.5
Domestic credit (percent contribution to M2)	27.3	18.4	7.5	7.8
Private sector (percent contribution to M2)	9.0	6.7	8.7	12.2
Public sector (percent contribution to M2)	18.3	11.7	-1.1	-4.4
91-day t-bill rate (percent, end of period)	18.0	12.9	9.9	...
		(In millions of U.S. dollars)		
Balance of payments 3/				
Export value growth (percent change)	19.8	-12.8	-4.1	11.2
Import value growth (percent change)	22.4	-18.4	0.7	14.6
Trade balance	-1,798	-1,157	-1,391	-1,756
Current account balance (excl. official transfers) 3/	-1,090	-294	-321	-672
Current account balance (percent of GDP) 3/	-6.6	-1.9	-1.9	-3.8
Overall balance	-522	220	340	-37
Gross official reserves (end of period, US$ millions) 4/	911	1,181	1,566	1,924
Exchange rates				
Rupees per U.S. $ (end of period level)	82.7	93.2	96.7	...
NEER (annual percentage change, e.o.p.) 5/	-6.8	-8.9	-9.2	...
REER (annual percentage change, e.o.p.) 5/	0.6	-0.1	0.0	...
Vulnerability and reserve adequacy indicators				
Private sector credit (percent of GDP)	29.0	28.3	28.1	28.9
Gross official reserves (percent of broad money)	15.6	20.0	24.3	28.3
Gross official reserves (percent of short-term debt) 6/	45.7	55.2	76.4	99.6
Gross official reserves (months of imports of g&s)	1.5	2.0	2.4	2.7
Foreign currency deposits (percent of total deposits)	21.1	21.8	22.1	...
Short-term debt (percent of GDP) 7/	9.9	11.2	9.4	8.4

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

1/ Actuals for inflation, fiscal sector, monetary sector, exhange rate, and official reserves.
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/ 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.
7/ Short-term debt defined as trade credits, Central Bank ACU balances, commercial bank liabilities, CPC acceptance credits, and amortization due.

Table 2. Sri Lanka: Summary of Central Government Operations, 2001-2003

(In percent of GDP, unless otherwise indicated)

	2001	2002		2003
	Outturn	Program	Provisional	Budget
Total revenue	16.5	17.5	16.5	16.9
Tax revenue	14.6	15.0	14.0	14.7
Income taxes	2.5	2.5	2.4	2.7
Value Added Tax/GST	3.3	5.6	4.3	6.7
Excise taxes	3.2	3.3	3.3	2.7
National security levy	3.1	1.1	1.8	0.0
Taxes on international trade	1.9	1.9	1.8	1.9
Other	0.7	0.7	0.5	0.7
Nontax revenue	1.9	2.6	2.5	2.2
Total expenditure and net lending	27.4	26.1	25.4	24.4
Current expenditure	21.4	21.0	20.8	19.2
Civil service wages and salaries	3.4	3.5	3.3	3.1
Other civilian goods and services	1.7	1.5	1.4	1.1
Security related expenditure	4.9	4.0	4.1	3.5
Of which: Defense	3.8	3.0	3.0	2.4
Subsidies and transfers	4.7	4.6	4.6	4.3
Households	3.7	3.4	3.4	3.2
Of which: Samurdhi	0.9	0.6	0.6	0.5
Of which: Pensions	1.9	2.0	2.0	1.9
Institutions, corporations, other govt.	1.0	1.2	1.2	1.1
Interest payments	6.7	7.4	7.4	7.2
Foreign	0.8	0.8	0.7	0.8
Domestic	6.0	6.6	6.7	6.4
Capital expenditure and net lending	5.9	5.1	4.6	5.2
Overall balance (excl. grants and privatization) 1/	-10.9	-8.5	-8.9	-7.5
Overall balance (incl. grants, excl. privatization)	-10.5	-8.0	-8.4	-7.0
Financing 2/	10.9	8.5	8.9	7.5
Net external financing 2/	1.6	3.2	0.1	2.0
Net domestic financing 2/	8.3	3.6	7.9	4.1
Bank	3.9	-1.3	-0.5	-1.0
Nonbank	4.4	5.0	8.5	5.1
Asset sales	0.6	1.2	0.4	0.9
Grants	0.4	0.5	0.4	0.4
Memorandum items:				
Current account balance	-4.9	-3.4	-4.3	-2.3
Primary balance (excl. grants)	-4.1	-1.2	-1.5	-0.2
Foreign-financed capital expenditure (in percent)	68.4	86.5	...	...
Nominal GDP (in billions of rupees)	1,400	1,586	1,579	1,799
Total debt	103.6	101.3	103.8	99.6
Of which: Domestic debt	58.3	55.6	60.0	56.8

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

1/ The Fiscal Management Responsibility Act prescribes a maximum deficit of 5 percent of GDP by 2006.

2/ Financing mix for 2003 does not correspond to budget due to delayed privatization receipts and market borrowing in 2002.

Table 3. Sri Lanka: Monetary Program, 2001-2003 1/

	2001 Dec.	2002 Dec.	2003 March Proj.	2003 June Proj.	2003 Sept. Proj.	2003 Dec. Proj.
Monetary authorities			(In billions of rupees)			
Net foreign assets	87	117	123	132	138	144
Net domestic assets	25	9	9	2	0	-1
Of which: Net credit to government	85	71	67	64	60	57
Reserve money	113	126	133	135	138	143
			(Contribution to reserve money growth, in percent)			
Net foreign assets	27.9	26.7	30.2	27.2	25.0	21.2
Net domestic assets	-20.9	-14.4	-16.9	-13.7	-11.7	-8.2
Reserve money	7.0	12.3	13.3	13.4	13.3	13.0
Monetary survey			(In billions of rupees)			
Net foreign assets	77	111	117	130	138	147
Monetary authorities	87	117	123	132	138	144
Deposit money banks	-10	-7	-6	-2	0	3
Net domestic assets	472	512	533	535	546	559
Domestic credit	639	680	699	703	715	729
Public sector	242	236	233	228	224	209
Government (net)	201	193	189	184	180	176
Public corporations	41	43	44	44	44	33
Private sector	397	444	466	475	491	520
Other items (net)	-167	-169	-166	-168	-169	-169
Broad money	549	622	650	665	684	707
			(Annual percent change)			
Net foreign assets	10.9	43.5	43.7	44.2	36.9	33.1
Monetary authorities	50.6	34.5	40.1	32.3	28.4	22.8
Deposit money banks	-188.2	-34.1	-6.2	-78.5	-102.8	-145.1
Net domestic assets	14.1	8.4	9.1	8.3	9.0	9.3
Domestic credit	16.2	6.5	9.1	7.2	7.1	7.1
Public sector	30.6	-2.6	-1.0	-6.1	-7.9	-11.6
Government (net)	36.8	-4.2	-3.9	-9.6	-10.2	-9.0
Public corporations	6.7	5.4	13.6	12.0	2.7	-23.2
Private sector	8.9	12.0	15.0	15.1	15.7	17.1
Broad money	13.6	13.4	14.0	13.9	13.7	13.5
			(Contribution to broad money growth, in percent)			
Net foreign assets	1.6	6.1	6.3	6.8	6.2	5.9
Net domestic assets	12.0	7.2	7.8	7.0	7.5	7.6
Domestic credit	18.4	7.5	10.2	8.1	7.9	7.8
Public sector	11.7	-1.1	-0.4	-2.5	-3.2	-4.4
Government (net)	11.2	-1.5	-1.3	-3.3	-3.4	-2.8
Public corporations	0.5	0.4	0.9	0.8	0.2	-1.6
Private sector	6.7	8.7	10.6	10.6	11.1	12.2
Memorandum items:						
Broad money multiplier	4.88	4.92	4.91	4.94	4.96	4.95
Velocity of broad money	2.76	2.69	...	...	...	2.69
Private sector credit (in percent of GDP)	28.3	28.1	...	...	...	28.9

1/ Using the program exchange rate of Rs 100/US$ for 2003.

Table 4. Sri Lanka: Balance of Payments, 2001-2006

	2001	2002 Est.	2003 Rev. Proj.	2004 Rev. Proj.	2005 Rev. Proj.	2006 Rev. Proj.
			(In millions of U.S. dollars)			
Trade balance	-1,157	-1,391	-1,756	-1,923	-2,021	-2,075
Exports	4,817	4,622	5,138	5,677	6,280	6,930
Imports	5,974	6,013	6,893	7,600	8,302	9,005
Services, net	205	275	266	243	249	284
Receipts	1,366	1,178	1,256	1,331	1,438	1,594
Payments	1,161	903	991	1,088	1,189	1,310
Income, net	-280	-246	-243	-288	-317	-327
Receipts	94	84	115	144	177	196
Payments	373	330	359	432	494	523
Private transfers, net	938	1,041	1,061	1,125	1,189	1,252
Current account (excluding grants)	-294	-321	-672	-843	-900	-866
Official transfers	22	26	24	25	24	21
Current account (including grants)	-273	-296	-648	-818	-876	-845
Capital and financial account	536	481	611	863	975	1,029
Capital transfers, (net)	197	57	54	55	67	61
Of which Aircraft disposal	148	0				
Financial account	339	424	557	808	908	968
Long-term:	163	321	687	778	871	942
Direct investment	172	233	350	320	374	393
Foreign direct investment, net	82	228	225	270	324	368
Privatization proceeds	90	5	125	50	50	25
Private, long-term (net) 1/	-257	35	35	164	101	168
Disbursements	44	152	174	327	280	382
Amortization	301	117	138	163	179	214
Government, long-term (net)	248	53	301	294	396	382
Disbursements	575	465	648	632	722	734
Amortization	327	412	347	338	326	353
Short-term, net	176	103	-129	30	37	26
Portfolio investment, net (CSE)	-11	25	31	42	48	49
Private short-term, net	-18	88	-60	-12	-11	-23
Commercial banks (net)	254	-60	-100	0	0	0
Government short-term, net	-50	50	0	0	0	0
Errors and omissions 2/	-43	61	0	0	0	0
Valuation adjustments		94				
Overall balance	220	340	-37	45	99	184
Financing requirement	-220	340	389	486	545	502
Net international reserves	-220	-340	-228	-326	-384	-422
Increase in gross official reserves (-)	-270	-417	-359	-444	-450	-401
Central bank borrowing, net	-3	0	0	0	0	0
Financing gap		0	426	441	446	318
Of which: World Bank			110	110	110	100
ADB			60	50	50	50
IMF, *of which* :			161	161	161	80
PRGF			104	104	104	52
EFF			56	56	56	28
Bilaterals			95	50	50	50
Unidentified 3/			0	70	75	38
			(In percent of GDP)			
Memorandum items:						
Current account (excl. official transfers)	-1.9	-1.9	-3.8	-4.4	-4.3	-3.8
Current account (incl. official transfers)	-1.7	-1.8	-3.7	-4.2	-4.2	-3.7
Reconstruction-related imports		0.0	0.4	0.4	0.4	0.4
Overall balance	1.4	1.5	-0.2	0.2	0.5	0.8
Total external debt (incl IMF)	62.9	59.6	58.7	58.3	57.3	55.6
Total debt service (percent of exports of g&s)	15.5	13.5	11.7	11.7	11.5	11.3
Gross official reserves (US$ millions) 4/ 5/	1,181	1,566	1,924	2,368	2,818	3,219
(In months of imports)	2.0	2.4	2.7	3.0	3.3	3.4
Net official reserves (US$ millions) 5/	970	1,277	1,505	1,831	2,215	2,637
GDP (in millions of U.S. dollars)	15,669	16,503	17,698	19,282	21,067	23,060

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/ Financing gaps in 2003-2006 are assumed to be filled mostly with concessional borrowing from international financial institutions, and donor funds raised during the consultative group meeting slated for May/June 2003.

4/ For program purposes, gross reserves are shown here net of ACU debit balances.

5/ There is a break in the series, as beginning in 2002 the stocks are at a market value, while previously they are at historical cost.

Table 5. Sri Lanka: Program Macroeconomic Framework, 2000-2006

(In percent of GDP unless otherwise noted)

	2000	2001	2002 Est.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.
Real sector							
Real GDP at market prices (percent change)	6.0	-1.4	3.3	5.5	6.5	6.8	7.0
Average inflation (CCPI; percent change)	6.2	14.2	9.6	8.9	7.0	6.0	5.0
Gross national saving	21.5	19.5	20.3	20.4	21.9	23.7	25.3
Gross investment	28.0	22.0	22.3	24.2	26.3	27.9	29.0
Fiscal sector							
Total revenue	16.8	16.5	16.5	16.9	17.9	18.6	19.1
Total expenditure and net lending	26.7	27.4	25.4	24.4	24.1	23.7	23.4
Current expenditure	20.2	21.4	20.8	19.2	17.9	16.8	16.2
Of which : Defense expenditure	4.6	3.8	3.0	2.4	2.0	1.8	1.7
Of which : Interest payments	5.7	6.7	7.4	7.3	6.6	5.9	5.5
Capital expenditure	6.5	5.9	4.6	5.2	6.2	6.9	7.2
Overall balance	-9.9	-10.9	-8.9	-7.5	-6.3	-5.1	-4.3
Primary balance	-4.2	-4.1	-1.4	-0.2	0.3	0.8	1.2
Net external financing	0.7	1.6	0.1	2.0	3.0	3.2	2.7
Grants	0.4	0.4	0.4	0.4	0.6	0.6	0.6
Net domestic financing	8.8	8.3	7.9	4.1	2.4	1.0	0.8
Asset sales	0.0	0.6	0.4	0.9	0.2	0.2	0.2
Total government debt	96.8	103.6	103.8	99.6	94.5	89.1	83.8
Domestic	53.8	58.3	60.0	56.8	52.2	47.2	42.8
Foreign	43.1	45.3	43.8	42.8	42.3	41.9	41.0
External sector							
Trade balance	-10.8	-7.4	-8.4	-9.9	-10.0	-9.6	-9.0
External current account balance (incl. transfers)	-6.4	-1.7	-1.8	-3.7	-4.2	-4.2	-3.7
Overall balance	-3.1	1.4	1.5	-0.2	0.2	0.5	0.8
Gross official reserves less ACU balance (US$b)	0.9	1.2	1.6	1.9	2.4	2.8	3.2
(months of imports of goods and services)	1.5	2.0	2.4	2.7	3.0	3.3	3.4
External debt							
Total external debt	60.8	62.9	59.6	58.7	58.3	57.3	55.6
Monetary sector							
Broad money (percent change)	12.9	13.6	13.4	13.5	14.0	13.2	12.4
Memorandum items:							
Oil price ($ per barrel)	28.2	24.3	25.0	31.0	25.0	22.0	21.0
Conflict related spending 1/	...	...	...	0.5	0.5	0.5	0.5
total social spending (recurrent and capital)	...	7.3	8.1	7.5	7.6	7.6	7.7
Of which: welfare and community services	...	3.8	3.7	3.4	3.2	2.9	2.7
Of which: health spending	...	1.4	1.6	1.5	1.6	1.6	1.8
Of which : education spending	...	2.0	2.6	2.3	2.4	2.6	2.7

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

1/ Preliminary estimates.

Table 6. Sri Lanka: Vulnerability Indicators, 1999-2003

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002 (or latest)	2003 (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	19.0	...
Domestic private banks	15.9	14.9	15.7	15.3	...
Foreign banks	10.7	12.7	13.2	12.1	...
Risk-based capital asset ratio (capital over risk-weighted assets) 3/					
State-owned commercial banks	8.4	2.2	0.1	-0.3	...
Domestic private banks	12.2	11.4	10.4	9.3	...
Foreign banks	12.4	13.0	16.0	36.6	...
Financial sector risk indicators					
Public sector debt	95.1	96.8	103.6	104.4	...
Broad money (percent change, 12-month basis) 4/	13.4	12.9	13.6	13.4	...
Private sector credit (percent change, 12 month basis) 4/	10.5	11.8	8.9	12.0	...
Share of deposits in broad money 4/	86.3	87.3	88.1	87.9	...
Share of foreign currency deposits in total deposits 4/	18.8	21.1	21.8	22.1	...
Market assessment indicators					
Stock market index (1985=100, e.o.p.)	573	448	621	815	737
Share price index of financial institutions (1985=100, e.o.p.)	1,214	870	1,356	1,856	1,734
External indicators					
Exports (annual percent change)	-3.9	19.8	-12.8	-5.0	...
Imports (annual percent change)	1.5	22.4	-18.4	-1.5	...
Current account balance (excluding official transfers)	-3.7	-6.6	-1.9	-0.8	...
Capital and financial account balance	2.4	2.7	3.4	1.5	...
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 (in millions of US$; excl. ACU balance)	1,530	911	1,181	1,566	1,639
Central Bank short-term foreign liabilities (in millions of US$; excl. ACU balance)	0.0	0.0	0.0	0.0	...
Short-term foreign assets of commercial banks (in millions of US$) 4/	850	1,001	1,198	1,247	...
Gross official international reserves (as percent of broad money)	25.8	15.6	20.0	24.3	...
Short-term debt 5/	8.7	9.9	11.2	...	...
Gross official international reserves (as percent of short-term debt) 6/	92.4	45.7	55.2	76.4	...
Total external debt	63.2	60.8	62.9	...	...
External interest payments (as percent of exports goods & services)	5.3	5.1	4.1	...	...
Debt service (as percent of exports goods & services)	15.2	14.7	15.5	...	...
Exchange rate (rupee per US$, period average)	70.4	75.8	89.4	95.7	96.9

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

1/ Official risk indicators,end-September 2002, Stock market, March 6; index for financials, end-February; Reserves, March 5; Public debt, end-October; external trade, January-November; BOP, January-September; exchange rate, March 7; monetary data, end-December.
2/ Excluding foreign currency banking units (FCBUs).
3/ Weighted averages of individual bank data.
4/ Including foreign currency banking units (FCBUs).
5/ Includes CPC acceptance credits, other trade credits, Central Bank ACU balances, and commercial bank liabilities.
6/ Based on residual maturity, including amortization of public and publicly guaranteed debt.

Table 7. Sri Lanka: External Financing Needs and Sources, 2001-2006

(In millions of U.S. dollars)

	2001	2002 Est.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.
Gross financing needs	1,001	1,376	1,646	1,830	1,950	1,935
External current account deficit (excl. official transfer:	294	321	672	843	900	866
Debt amortization	359	589	585	501	505	567
Medium and long term debt	628	529	485	501	505	567
Public sector	327	412	347	338	326	353
Corporate private sector	301	117	138	163	179	214
Short-term debt 1/	-269	60	100	0	0	0
Repayment of arrears	0	0	0	0	0	0
Gross reserves accumulation (- = increase) 2/	-270	-417	-359	-444	-450	-401
IMF repurchases and repayments	78	49	31	43	95	101
Financing sources	1,001	1,376	1,220	1,389	1,504	1,617
Foreign direct investment (net)	172	233	350	320	374	393
Debt financing from private creditors	-38	290	114	315	269	359
Medium- and long-term financing	44	152	174	327	280	382
Short-term financing	-82	138	-60	-12	-11	-23
Official creditors 3/	728	617	672	657	746	755
Other flows 4/	139	237	85	97	115	110
Accumulation of arrears (exceptional)	0	0	0	0	0	0
Financing gap 5/	0	0	426	441	446	318

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	323.7	410.4	458.7	443.6
In millions of U.S. dollars	257.2	162.5	217.1	284.8	440.9	559.0	624.4	603.7
In percent of:								
Quota	45.5	29.8	41.3	55.2	78.3	99.3	111.0	107.3
GDP	1.6	1.0	1.4	1.7	2.5	2.9	3.0	2.6
Exports of goods and services	4.6	2.5	3.5	4.9	6.9	8.0	8.1	7.1
Public and publicly guaranteed debt	2.9	1.9	2.6	3.3	5.0	6.0	6.4	5.9
Debt service to the Fund (in millions of SDRs) 2/	73.9	65.7	61.2	45.4	29.7	40.0	78.7	82.2
Of which: 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	4.2	7.3	8.6	8.9	8.0
In percent of:								
Quota	17.9	15.9	14.8	11.0	7.2	9.7	19.0	19.9
GDP	0.6	0.5	0.5	0.3	0.2	0.3	0.5	0.5
Exports of goods and services	1.8	1.3	1.6	1.2	0.8	1.0	1.7	1.6
Public and publicly guaranteed external debt	1.2	1.0	0.9	0.7	0.5	0.6	1.1	1.1
Central government revenues (excluding grants)	2.7	2.4	3.0	2.1	1.4	1.6	2.7	2.5
Memorandum items:								
Disbursements under the Stand-by Arrangement (SDRs)	0.0	0.0	103.4	96.7	0.0	0.0	0.0	0.0
Disbursements under the PRGF (million of SDRs)					76.8	76.8	76.8	38.7
Disbursements under the EFF (million of SDRs)					41.3	41.3	41.3	20.4

Sources: Treasurer's Department and staff calculations.

1/ End-of-period.
2/ Based on prospective purchases and repurchase obligations.

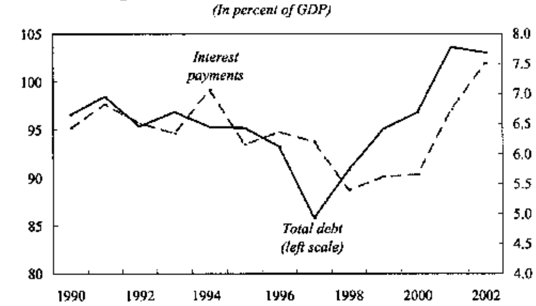
Sri Lanka—Debt Sustainability Analysis

This annex is an overview of Sri Lanka's current public debt situation and analyzes the vulnerability of the program's projected debt path to shocks to key macroeconomic variables. In line with the Fund's standard debt-sustainability guidelines, the shocks are applied as temporary (generally of two year duration) deviations from the baseline. Some analysis of permanent shocks is also reported. These experimental shocks are based on the experience in the last 3-10 years. Overall, the DSA showed that while under the adjustment scenario the debt is sustainable, significant departures from the adjustment scenario would jeopardize sustainability.

I. Introduction

57. Sri Lanka's debt dynamics have worsened considerably since the late–1990s. During the first half of the 1990s (1991-97), the debt-to-GDP ratio declined by over 10 percent, to stand at 86 percent of GDP in 1997, despite an average fiscal deficit of 9½ percent. Much of this decline reflected strong economic growth averaging over 5 percent and low debt servicing costs. However, in the face of expanding fiscal deficit in 2000 and 2001, as the conflict escalated and the economy fell into recession, the debt stock shot up to 104 percent of GDP and interest payments climbed to 7½ percent of GDP. In 2002, under the SBA, the debt-to-GDP ratio was stabilized, as the budget deficit was brought down from 11 percent of GDP in 2001 to 9 percent in 2002 and growth rebounded.

Figure 1. Sri Lanka: Central Government Debt
(In percent of GDP)



Sources: Sri Lankan authorities; and staff estimates.

58. About 60 percent of Sri Lanka's central government debt is held domestically, with 40 percent at longer term maturities. Total debt in the main SOEs (CPC, CEB and CWE) amounted to about 13¼ percent of GDP at end-2002. A public sector debt stock is difficult to construct because of a lack of reliable data for the rest of the public sector, thus the debt stock referred to in this annex only includes central government. However, the external debt stock measure includes both public and private external debt. The government's foreign debt is made up mostly of concessional loans.

Sri Lanka: Outstanding Central Government Debt, end-2002

(In percent of GDP)

		Interest Rate (In percent)	Maturity (In years)
Total domestic debt	60.1		
By instruments and maturity			
Short term	16.5		
Treasury bills	13.4	9.9-14.2	< 1
Provisional advances from Central Bank	2.0	--	0.5
Import bills held by commercial banks	0.8	R-denominated - Repo rate + 0.5 $-denominated - 8	< 1
Overdraft with commerical banks	0.2	Repo rate +0.5	< 1
Other liabilities to the banking sector net of bank deposits	-0.3	--	< 1
Other	0.5	12-month Tbill rate	...
Medium and long term	43.6		
Rupee securities	18.2	11-15.50	2-30
Treasury bonds	22.0	11-13.25	2-6
Sri Lanka Development Bonds	1.5	LIBOR +1.98-2.00	2
FCBUs	1.9	LIBOR +1.92-2.35	2-3.5
Total foreign debt	43.8	1.9	30
Total outstanding govt. debt (Rs. million)	1,640,223		

Source: Data provided by the Sri Lankan authorities.

59. Total external debt—at 60 percent of GDP at end-2002—was mostly at medium- and long-term maturities, with only 16 percent of the stock being short-term. With almost three-quarters of the external debt being held by the government, the share of the concessional part is significant, amounting to more than two-thirds of the total external debt.

II. Debt Sustainability Analysis

A. Assumptions

60. The assumptions underlying the sustainability exercise are based on the medium-term macroeconomic framework under the program and the latest World Economic Outlook (WEO) forecast. In addition, the following assumptions were made regarding the medium-term debt management strategy:

- The government's domestic borrowing would be mainly in the form of one-year treasury bills. The government has dramatically reduced its use of overdraft facilities and stock of military import bills in 2002. To be conservative, interest rates on treasury bills are projected to fall by 50 basis points per year. This is lower than the rate of disinflation, such that the real treasury bill rate rises from 3½ percent in 2002 to 4½ percent in 2006.

- External borrowing is expected to be mainly on nonmarket terms, and predominantly at medium- and long-term maturities. Based on the assumed flow of funds in the balance of payments, about three quarters of the government borrowing is expected to be concessional with a 35 percent grant element or higher, and another 20 percent is expected to be extended on better-than-market terms, with an average grant element of 25 percent. For long-term market loans, an interest rate of 6-month LIBOR+200 basis points, which is the present Sri Lanka risk

Figure 2. Sri Lanka: Debt Dynamics
(In percent of GDP)

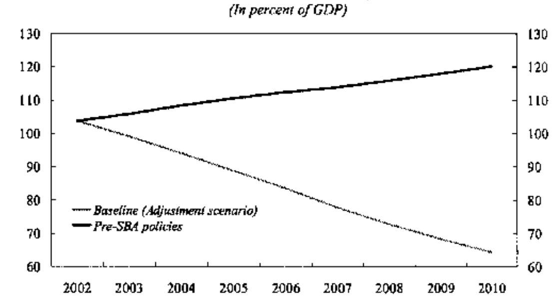


Figure 3. Sri Lanka: Real GDP and Interest Rate Shock Stress Tests
(In percent of GDP)

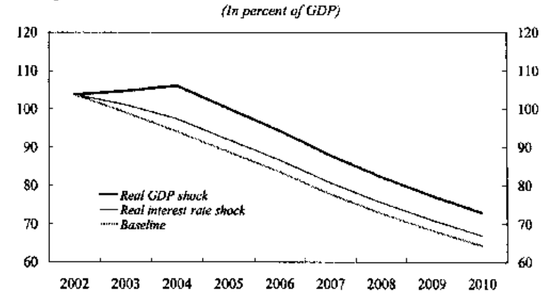
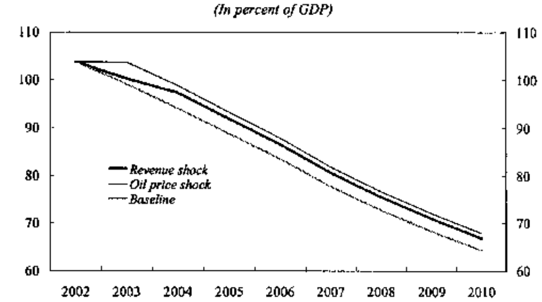


Figure 4. Sri Lanka: Revenue and Oil Price Shock Stress Tests
(In percent of GDP)



premium, is assumed. Thus, the average interest rate on external debt increases by 50 basis points, compared to end-2002, reflecting the latest WEO global interest rate assumptions. As in the case of domestic debt, the real interest rate on foreign debt rises over the medium term.

- Foreign currency denominated domestic debt is assumed to remain stable over the medium term at its end-2002 level, bearing the same interest rate as external market loans.

B. Results and Stress Tests

Debt Sustainability

61. The baseline scenario suggests a steady decline in government debt to below 78 percent of GDP by 2007 (Table III.1). The pace of decline is contingent on the assumed paths for GDP growth and budget deficit being realized. Stress tests demonstrate that, most shocks increase the debt stock but keep the debt dynamics on a down trend. However, the debt dynamics are vulnerable to large external shocks, such as steep depreciation of the rupee. The initial increase in the debt stock is substantial, and although the debt-to-GDP ratio begins to decline subsequently, it remains markedly above the baseline. In addition, a return to pre-SBA policies is clearly unsustainable, as the debt stock continues to rise through the forecast period.

- If GDP growth were to decline to 2 standard deviations below its 10-year average in 2003 and 2004 (-0.1 percent compared to 5½ and 6½ percent), the debt stock would initially increase, but then decline to 10 percent of GDP higher than the baseline by 2007. Similar results hold for higher real interest rates, although the quantitative impact is less.

- If revenue-to-GDP ratio falls from an average of 17½ percent of GDP to 15¾ percent of GDP in 2003-04, the debt ratio rises initially, but subsequently declines to 3 percent of GDP higher than the baseline by 2007.

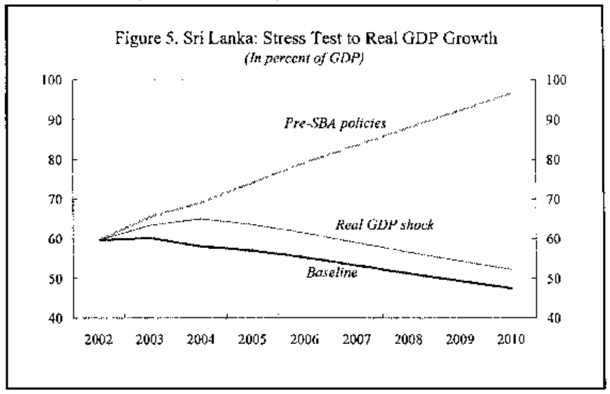
- An increase in oil prices, brought on by a conflict in the Middle East, would raise government debt by 4 percentage points above the baseline in 2003, but continue to decline thereafter. This scenario mimics the assumptions of the worse case situation detailed in the main text.

- In contrast to the program assumptions, if the entire financing need was funded by nonconcessional borrowing, the debt service increases slightly by 1½ percent on average through 2007.

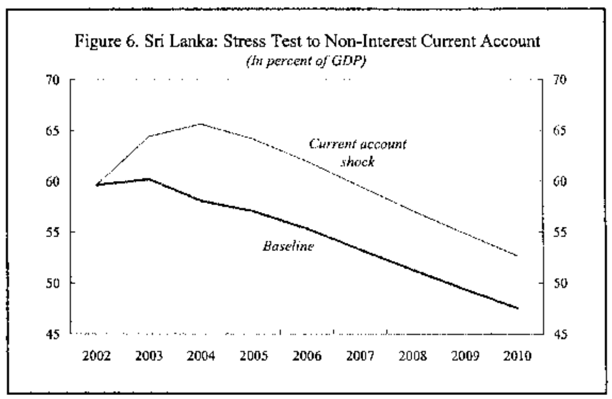
- A return to pre-SBA policies—proxied by the 1999–2001 averages of the key macroeconomic variables being sustained over the forecast period—results in the debt-to-GDP ratio rising steadily to 114 percent of GDP by 2007.

C. External Sustainability

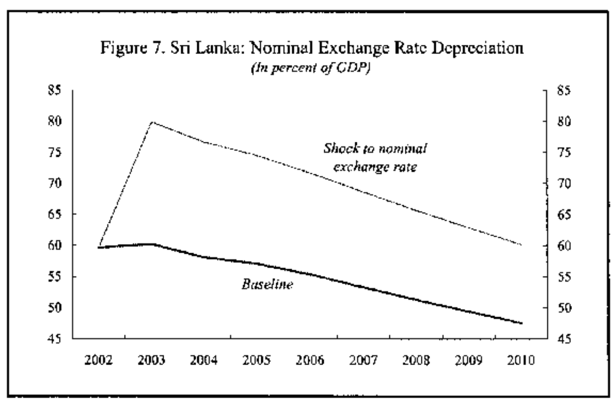
62. Under the baseline scenario the external debt-to-GDP ratio is expected to decline to 53 percent in 2007, compared with 60 percent in 2002 (Table III.2). As in the case of government debt, strong economic growth, substantial concessional borrowing, and nondebt creating inflows are the major contributors to the improved debt dynamics. Similarly, stress tests indicate that the debt dynamics return to a down trend after a shock, but in the case of external shocks, the adjustment is not sufficient to bring down the debt stock reasonably close to the baseline by 2007.



- Real GDP and interest rate shocks both increase the debt stock, but keep the debt dynamics sustainable. Compared to the baseline, the increase in the debt stock in 2007 is 5 percent and 1 percent of GDP higher, respectively.



- The effects of external shocks are qualitatively similar, but the impact is quantitatively larger. A large widening of noninterest current account deficit (e.g., due to sharp decline in exports), or higher real exchange rate, raise the 2003–04 debt-to-GDP ratio by 7-10 percentage points above the baseline, before the gap starts to narrow. Similarly, 30 percent nominal exchange rate depreciation leads to an instantaneous increase in the debt-to-GDP ratio by 20 percentage points above the baseline, although by 2007 this difference is narrowed to 15 percentage points. If the program's financing gap is financed entirely by nonconcessional market borrowing, as in the case of government debt, the stock of debt does not alter much, however debt service ratio would rise—from 12 percent to 14 percent.



III. Conclusion

63. Sri Lanka's debt dynamics are sustainable under the baseline scenario, with debt ratios declining over the medium term, and stress tests suggesting that the adjustment path is fairly robust. However, these tests also clearly demonstrate the importance of strong economic growth for debt dynamics, emphasizing the needs for macroeconomic stability, fiscal consolidation and deep-seated structural reforms. The importance of time-consistency in reforms is illustrated through the effects of temporary shocks on debt dynamics—even if the shocks are short-lived, and the macroeconomic stability is restored, it takes time to bring the debt ratio to its pre-shock level. The return to the pre-SBA policies of late 1990s and early 2000—of runaway fiscal deficits, expensive domestic financing, and little structural reforms—would put the debt on an unsustainable path. Further, given that half of government debt is in foreign currency terms, large depreciation of the exchange rate could jeopardize sustainability. Under the program assumptions, Sri Lanka is expected to have significant financing needs in the medium-term, and the availability of concessional resources is important to maintain debt service at reasonable levels.

Table I.1. Sri Lanka: Central Government Debt Sustainability Framework, 2002-2007
(In percent of GDP, unless otherwise indicated)

		Projections				
	2002	2003	2004	2005	2006	2007
	I. Baseline Medium-Term Projections					
Central government debt 1/	104	99	94	89	84	78
Of which: foreign-currency denominated	53	50	47	45	42	38
Change in central government debt	0.2	-4.7	-5.0	-5.4	-5.2	-5.8
Identified debt-creating flows (4+7+12)	0.1	-3.9	-4.2	-4.7	-4.6	-5.6
Primary deficit	1.4	0.3	-0.3	-0.8	-1.2	-1.8
Revenue and grants	16.5	16.9	17.9	18.7	19.1	19.1
Primary (noninterest) expenditure	18.0	17.1	17.6	17.8	18.0	17.4
Automatic debt dynamics 2/	-0.9	-3.0	-3.7	-3.7	-3.3	-3.6
Contribution from interest rate/growth differential 3/	-4.3	-5.4	-5.6	-5.1	-4.3	-4.1
Of which: contribution from real interest rate	-1.3	-0.4	0.1	0.6	1.2	1.2
Of which: contribution from real GDP growth	-3.0	-5.0	-5.7	-5.7	-5.5	-5.2
Contribution from exchange rate depreciation 4/	3.3	2.4	1.9	1.4	1.0	0.4
Other identified debt-creating flows	-0.4	-1.1	-0.2	-0.2	-0.2	-0.2
Privatization receipts (negative)	-0.4	-1.1	-0.2	-0.2	-0.2	-0.2
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	0.1	-0.7	-0.8	-0.7	-0.6	-0.2
Central government debt in percent of revenues 1/	627	587	527	476	437	407
Gross financing 5/	37	36	38	40	41	40
In billions of U.S. dollars	6	6	7	8	9	10
Key macroeconomic and fiscal assumptions						
Real GDP growth (in percent)	3.2	5.5	6.5	6.8	7.0	7.0
Average nominal interest rate on public debt (in percent) 6/	8.1	8.0	7.6	7.1	6.9	6.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	0.0	0.6	1.1	1.9	1.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.2	-4.7	-3.9	-3.0	-2.3	-1.1
Inflation rate (GDP deflator, in percent)	9.2	8.0	7.0	6.0	5.0	4.5
Growth of real primary spending (deflated by GDP deflator, in percent)	-10.1	0.8	9.0	8.5	7.8	3.4
	II. Stress Tests					
Permanent shocks:						
Real GDP growth, real interest rate, and primary balance are at:						
1. 10 year historical averages in 2003-2007	104	100	97	94	90	87
2. 3 year historical averages in 2003-2007	104	106	108	111	112	114
3. Real interest rate is at 10 year historical average plus two standard deviations in 2003-2007	104	101	97	93	88	82
Temporary shocks in 2003 and 2004:						
4. Real interest rate is at historical average plus two standard deviations in 2003 and 2004	104	101	97	92	87	81
5. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	104	105	106	100	94	88
6. Primary balance is at historical average minus two standard deviations in 2003 and 2004	104	104	104	98	92	86
7. Combination of 3-5 using one standard deviation shocks	104	106	108	101	94	86
8. One time 30 percent real depreciation in 2003 7/	104	127	121	114	108	101
9. 10 percent of GDP increase in other debt-creating flows in 2003	104	109	104	98	92	86
10. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-0	104	100	97	92	87	81
10a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003	627	637	619	493	453	422
11. No new foreign concessional funding, with the gap financed domestically	104	99	94	89	84	79
12. Iraq war oil price shock	104	104	99	93	88	82
Historical statistics for key variables	Past 10 years				Past 3 years	
	Historical Average	Standard Deviation			Historical Average	
Primary deficit	2.1	1.3			2.9	
Real GDP growth (in percent)	4.6	2.4			3.0	
Nominal interest rate (in percent) 6/	7.3	0.4			7.1	
Real interest rate (in percent)	-1.9	2.0			-1.1	
Inflation rate (GDP deflator, in percent)	9.2	2.3			8.1	
Revenue to GDP ratio	19.5	1.9			17.5	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp))$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as $-g$.
4/ The exchange rate contribution is derived from the denominator in footnote 2/ as $ae(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table I.2. Sri Lanka: External Sustainability Framework, 2002-2007 1/

(In percent of GDP, unless otherwise indicated)

		Projections				
	2002	2003	2004	2005	2006	2007
	I. Baseline Medium-Term Projections					
External debt	60	60	58	57	55	53
Change in external debt	-3.3	0.6	-2.1	-1.0	-1.7	-2.1
Identified external debt-creating flows (4+8+11)	-2.9	-2.1	-2.4	-2.5	-3.1	-2.7
Current account deficit, excluding interest payments	0.5	2.0	2.6	2.7	2.3	2.4
Deficit in balance of goods and services	6.8	8.1	8.6	8.4	7.7	8.0
Exports	35.1	36.1	36.3	36.6	37.0	37.3
Imports	41.9	44.2	44.9	45.0	44.7	45.2
Net non-debt creating capital inflows (negative)	-1.5	-1.4	-1.6	-1.8	-1.8	-1.7
Net foreign direct investment, equity	1.4	1.3	1.4	1.5	1.6	1.5
Net portfolio investment,equity	0.2	0.2	0.2	0.2	0.2	0.2
Automatic debt dynamics 2/	-1.9	-2.7	-3.4	-3.5	-3.6	-3.4
Contribution from nominal interest rate	1.3	1.4	1.5	1.4	1.3	1.2
Contribution from real GDP growth	-1.9	-3.1	-3.6	-3.6	-3.6	-3.6
Contribution from price and exchange rate changes 3/	-1.2	-1.0	-1.4	-1.3	-1.3	-1.1
Residual, including change in gross foreign assets (2-3)	-0.4	2.7	0.3	1.5	1.4	0.6
External debt-to-exports ratio (in percent)	169.7	166.9	160.0	155.7	149.8	142.8
Gross external financing need (in billions of US dollars) 4/	2.6	2.6	3.1	2.9	2.9	3.0
In percent of GDP	15.6	14.9	16.1	13.7	12.5	11.8
Memorandum items: Key Macroeconomic and External Assumptions						
Nominal GDP (US dollars)	16.5	17.7	19.3	21.1	23.1	25.2
Real GDP growth (in percent)	3.3	5.5	6.5	6.8	7.0	7.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-6.6	-5.9	-4.4	-3.5	-2.6	-2.9
GDP deflator in US dollars (change in percent)	2.0	1.7	2.3	2.3	2.3	1.9
Nominal external interest rate (in percent)	2.1	2.5	2.8	2.7	2.5	2.4
Growth of exports (US dollar terms, in percent), of which	-6.2	10.1	9.7	10.2	10.4	10.1
textiles and garments	2.4	20.2	13.6	-9.1	0.6	0.0
Growth of imports (US dollar terms, in percent)	-3.1	13.1	10.7	9.7	8.5	10.5
	II. Stress Tests for External Debt Ratio					
Permanent shocks:						
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at 10-yr historical average in 2003-2011	60	62	62	64	65	65
2. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at 3-yr historical average in 2003-2011	60	66	69	74	79	84
Temporary shocks in 2003 and 2004:						
3. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004	60	61	59	58	56	54
4. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	60	63	65	64	61	59
5. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004	60	65	68	67	64	62
6. Non-interest current account deficit is at historical average widened by two standard deviations in 2003 and 2004	60	64	66	64	62	60
7. Combination of 3-6 using one standard deviation shocks	60	67	73	71	68	66
8. One time 30 percent nominal depreciation in 2003	60	80	77	74	72	69

II. Stress Test: Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2010

Historical Statistics for Key Variables	Past 10 years		Past 3 years
	Historic Average	Standard Deviation	Historical Average
Current account deficit, excluding interest payments	2.4	1.9	2.1
Net non-debt creating capital inflows	1.0	...	0.8
Nominal interest rate (in percent)	3.1	0.3	3.0
Real GDP growth (in percent)	4.6	2.4	3.0
GDP deflator in US dollars (change in percent)	1.1	3.8	-3.0

1/ The stock of debt is consistent with the quantitative performance criteria of the Program. The 2003 borrowing assumes the long-term and short-term nonconcessional borrowing in the amount of US\$250 million and US\$150 million, respectively.

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

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

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

Sri Lanka—Fund Relations

(As of February 28, 2003)

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	565.61	136.82
Reserve position in Fund	47.82	11.57

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	70.87	100.00
Holdings	0.59	0.83

IV. **Outstanding Purchases and Loans**:	SDR Million	Percent Quota
Stand-By Arrangements	200.0	48.38
ESAF arrangements	22.4	5.42

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Apr 20, 2001	Sep 19, 2002	200.00	200.00
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 (1/31/03)	2003	2004	2005	2006
Principal	--	16.80	31.44	69.80	74.16
Charges/interest	--	4.65	6.02	4.93	2.99
Total	--	21.45	37.46	74.73	77.15

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**:

A Stage Two (on-site) assessment was completed on August 30, 2001. Under the Fund's safeguard assessment policy, the CBSL was subject to a full safeguards assessment with respect to the standby arrangement, which was approved on April 20, 2001. The assessment of the CBSL was completed on August 30, 2001, and concluded that high risks may exist in the external audit mechanism, the financial reporting framework, and the system of internal controls. A summary of staff's findings and recommendations and actions taken by the authorities is in Annex I of EBS/02/153. Currently the CBSL is subject to a new safeguards assessment with respect to the proposed PRGF arrangement. The documentation has been received from the authorities and an off-site assessment of the CBSL is underway.

IX. **Article IV Consultation**:

Sri Lanka is on the standard 12-month consultation cycle. The Executive Board concluded the 2002 Article IV consultation (EBS/02/153) on September 3, 2002.

X. **FSAP and ROSC Participation**:

- MAE: Both the FSSA and the FSAP reports have been finalized. Two FSAP missions visited Colombo during November 1-14, 2001 and February 6-20, 2002. 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 World Bank/IMF mission visited Colombo in October 2002 to follow-up on the FSAP and advise on public debt management and development of government securities markets. An MAE advisor will visit Colombo in February for 2 months to help the authorities with the initial phase of active open market operations. A multisector MAE TA mission visited Colombo February 18- 29, 2003 and helped the authorities in a number of areas including the initial implementation phase of the new active open market operations and the drafting of a revised asset management company (AMC) law.

- 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. 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. A STA TA mission is scheduled to visit Colombo sometimes during April-July 2003 to help in the authorities in a number of areas, including plans for migrating to the publication of fiscal data in accordance with GFSM 2001 methodology.

- FAD: An FAD ROSC mission visited Colombo between May 13-21, 2002 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 visited

Colombo in August 2002 to discuss the issues involved in setting up a new revenue authority. FAD plans to participate in a workshop in Singapore in late April 2003 which will focus on an action plan for the new unified revenue authority.

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

Department	Purpose	Date
FAD	▪ Public expenditure management	March 1998
	▪ Cash management and expenditure monitoring	February 1997-February 1998
	▪ Implementing a Goods and Services Tax and tax administration	January-February 1997; March 1997-September 1998
	▪ GST Seminar	July 1999
	▪ Government securities market	December 1999
	▪ Tax Policy	June 2001
	▪ Revenue Authority	August 2002
MAE	▪ Monetary Policy Instruments	May 2001
	▪ Active Open Market Operations	February-March 2003
STA	▪ General Data Dissemination System	June-July 1997, February-March 2000
	▪ Price indices	October 1998

XII. **Resident Representative**:

A resident representative has been stationed in Sri Lanka since October 1977. Mr. Haque was the Senior Resident Representative between August 1999 and August 2002. Mr. Carter replaced Mr. Haque as Senior Resident Representative in October 2002.

Sri Lanka—Relations with the World Bank

(As of February 3, 2003)

A. Partnership in Sri Lanka's Development Strategy

After being elected in December 2001, the new Government of Sri Lanka (GOSL) set about the task of defining its own economic program more precisely. This has resulted in the development of *Regaining Sri Lanka: Vision and Strategy for Accelerated Development* (RSL), which is an aggressive proposal to eliminate factors which inhibit the restraints on private sector activity and change the role of the state. The first part of RSL contains the Government's vision for growth and the second part connects growth to the country's Poverty Reduction Strategy (PRS). The PRS reflects a fundamental change in the role of the state with a clear departure away from the unsustainable policies of "redistribution/transfers" to creating an enabling environment for faster economic growth and poverty reduction. Its principal thrusts/objectives are well-identified and include: (i) securing lasting peace; (ii) accelerating economic growth, with macroeconomic stability and the private sector leading the effort; (iii) creating opportunities for the poor to participate in broad-based growth through strengthened human development and by improving the conditions for access to critical means of livelihood—i.e., "investing in people"; and (iv) improving public sector governance to enhance the development impact of publicly-controlled resources. The key target of the PRS is halving the number of poor by 2015. Other targets include: (i) raising GDP growth to around 7 percent within three to four years and to 10 percent in the second half of the decade; and (ii) creating a minimum of two million new jobs during the next few years.

The IMF has been leading in supporting Sri Lanka's medium-term program in maintaining macroeconomic stability. Building on the achievements of Stand-By Arrangement (SBA)—approved on April 20, 2001 and expiring on September 19, 2002—in April 2003 the IMF Executive Board is expected to consider a request by Sri Lanka for a three-year Poverty Reduction and Growth Facility (PRGF) and Extended Fund Facility arrangements. The PRGF's main goal will be to attain a high rate of economic growth to increase living standards and reduce poverty. The PRGF-EFF supported program will focus on: (i) strong fiscal consolidation to lower public debt; and (ii) structural reforms aimed at reducing the dominance of the public sector and promoting private-sector led growth. The structural reform agenda for the first year of the PRGF arrangement will likely focus on a number of aspects of the PRS, including: (i) financial sector reform; (ii) improvement in tax administration; (iii) restructuring of loss-making public corporations; (iv) implementing labor market reforms; and (v) reforming the welfare system to better target the poor and improve efficiency.

The World Bank has been leading the policy dialogue in structural and institutional reforms aiming at: (i) accelerating economic growth and supporting private sector development; and (ii) strengthening governance in the public sector and improving the welfare system. This policy dialogue has been on-going for a number of years and is expected to receive financial support through a number of operations, including a series of Poverty Reduction Support Credits (PRSCs) designed to support the Government in implementing some of the structural reforms that are critical for achieving the priority objectives of its PRS.

B. IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank leads and there is no direct IMF involvement

The policy areas in which the Bank leads and which are not directly incorporated into the IMF program/country dialogue include a range of social and environmental interventions as well as legal and judicial reform. Working together closely with the Government, the Bank has been leading in the work to deepen a joint understanding of the nature and root causes of poverty in Sri Lanka, with a view to reassessing and formulating a policy framework for reducing poverty. A Poverty Assessment was finalized in FY01 and the Bank is currently assisting the Government to update the poverty estimates, as well as undertake a more extensive poverty analysis of the North East. A Poverty Update is envisioned for FY05.

The Bank has also been extremely active and leading in the dialogue in the ***health sector***. A successful recently completed project—***Health Services***—helped to strengthen the Government's ability to address: (i) the remaining major public health problems (malaria, malnutrition and HIV/AIDS); (ii) new challenges raised by the epidemiological transition and the increasing importance of non-communicable diseases of adults; and (iii) key health policy and financing issues. Following up on this work, the recently approved ***National HIV/AIDs Prevention*** project will assist the Government in curbing the spread of HIV infection by: (i) expanding prevention programs for highly vulnerable groups and the general population; (ii) developing programs to sustain political and societal commitment to HIV/AIDs prevention; and (iii) strengthen multi-sectoral involvement and capacity. The Bank has also been working closely with the Government in developing a health sector strategy/program (with financial assistance provided by a PHRD grant). By the end of FY03, it is anticipated that a short sector policy note would be finalized and the Bank would begin preparation of an operation to support the sector-wide program.

In the ***education sector***, the Bank has been leading the dialogue and the main point of entry has been through two on-going projects—***Second General Education*** (GEP II) and ***Teachers Education and Teachers Deployment*** (TETD). The objective of GEP II is: (i) improve quality, access, management and financing of existing education programs; and (ii) increase education's responsiveness to economic needs and reduce poverty. To achieve these objectives, the project has supported curriculum development, improving the content/quality/availability of textbooks, and refurbishing of school facilities, including the provision of quality inputs. Complementing this, TETD has been supporting the strengthening of teacher training institutions (including through construction and refurbishing) and the upgrading of teacher education programs. Recently, these two projects were restructured and their closing dates were extended to support key activities to address three immediate priorities—promoting English education; enhancing the level of information technology in schools; and supporting activities in the North East, including repair of war damaged schools. Finally, a dialogue is also ongoing with regard to reform of the tertiary sector and Bank financial support in this area will likely be forthcoming in the near future.

Given a large presence of the Asian Development Bank (ADB) in ***environment***, the World Bank's role has been minimal in the sector; however, there has been an on-going presence. The Bank's involvement has primarily been through the contributions of staff in the Colombo office who work closely with the ADB team in supervising their existing projects. The objective of the one existing IDA intervention—the ***Environmental Action*** project—is to assist the Government in strengthening the institutional and policy framework for environmental management.

Finally, the Bank has been taking the lead in ***legal and judicial reform*** attempting to assist the Government make the existing legal and judicial framework more efficient, transparent and responsive to the needs of the public at large and of the private sector in particular. The objectives of the ongoing project are to: (i) modernize the legislative framework; (ii) improve the administrative, monitoring and regulatory functions of the Company Registration Act; and (iii) build the capacity of the judiciary and other institutions providing dispute resolution services.

Areas in which the World Bank leads and its analysis serves as input into the IMF program

The Bank is leading the structural reform dialogue through the proposed Poverty Reduction Support Credit (PRSC) and a previously envisioned adjustment credit. As mentioned, the PRSP—anticipated to go to the Bank's Board in May 2003—aims to enhance the effectiveness of the overall strategy for poverty reduction and will have two principle components: (i) **accelerating economic growth and supporting private sector development**; and (ii) **strengthening governance in the public sector and improving the welfare system**. The first component reflects the fundamental importance the Government is giving to the promotion of strong private-sector led growth in its economic development and poverty reduction strategy; and the second aims to help the Government in addressing the key weaknesses in the public administration and public expenditure management.

Within the context of the first component, the PRSC program will focus on supporting ***reforms in the factor markets (labor, land, and financial), the power sector, the enabling business environment, and the rural economy***. Closely linked to the land reform efforts, through a ***Land Titling and Related Services*** project, the Bank has been supporting the development of a broad consensus, methods, framework and capacity for making sustainable and comprehensive improvements in the land administration system. Under the second component, the key areas to be supported include ***reforms in public administration and institutional dimensions of public expenditure management and the welfare system***. Accordingly, the PRSC will focus on the development of the legal foundations of effective public expenditure management. In addition, a number of other operations are supporting the structural reform efforts, including: (i) the ***Economic Reform Technical Assistance*** credit (discussed below); and (ii) the ***Distance Learning Initiative*** that is helping to strengthening the environment for policy reform and build capacity in the public and private sectors through the transfer of the latest global knowledge through the establishment and operation of a Distance Learning Center (DLC).

Closely related to this, the Bank has been leading the dialogue/analysis in the area of ***public expenditure analysis***. Given the importance of public expenditure reform/monitoring in the medium term framework in Sri Lanka and the close linkages to the reform program supported by the PRSC, public expenditure analysis will be an integral part of the Bank's work program during the current CAS period (FY03–FY06). The intention is to carry out public expenditure analysis continuously, selecting relevant themes in each year. In the first stage, complementing and building on the work on the Country Procurement Assessment Review (CPAR) and Country Financial Accountability Assessment (CFAA)—both to be completed before the end of FY03—there will be focus on the institutional and macroeconomic dimensions of public expenditure. This will be followed by an assessment of inter- and intra-sectoral allocations of public expenditures, with a focus on their poverty-orientation. The IMF, as well as the Asian Development Bank (ADB) will be full partners in carrying out this work.

Also complementing the above, the Bank has taken the lead in discussing ***public sector reform issues*** with the Government, initially through a number of governance and public management missions. This work will result in two policy notes on the size and composition of the civil service and on establishment control practices (which are essential to prevent unauthorized recruitment). An initial model will be developed that will allow the Bank to explore the fiscal implications of various rightsizing strategies, which will be further refined as more detailed civil service census data becomes available for 2002. Later—depending on the degree of seriousness with which the issue is addressed by the Government—the Bank could provide financial assistance to a major public sector reform effort, including a voluntary retirement scheme. Currently, the dialogue/assistance is focusing on helping the Government build consensus on and develop a comprehensive reform agenda, along with some analytic work that would be required prior to initiating any comprehensive reform. The work is being undertaken closely with IMF staff to ensure that the civil service wage bill will be affordable and sustainable in the long run.

In taking the lead in the area of ***rural development***, the Bank has recently finalized a policy note entitled: "Sri Lanka: Promoting Agricultural and Rural Non-farm Sector Growth." Following up on this work, a policy dialogue is on-going and the implementation of certain key reforms—including enhancing productivity and competitiveness of the agriculture sector and ensuring the efficient and sustainable use of water resources—will likely be supported through a subsequent PRSC. Related to this, the Bank has long been supporting the ***Mahaweli Restructuring and Rehabilitation*** project, designed to transform the Mahaweli Authority of Sri Lanka into a River Basin Management Agency whose primary mission is to ensure productive and sustainable use and management of the water and land resources of the whole Mahaweli and adjacent related river basins. A secondary objective of this project has been to improve agricultural productivity through rehabilitation, improvement and better operation and maintenance of irrigation facilities.

In the area of ***peace/reconstruction of the North East*** (NE), the Bank has played a leading role since 1999. The ***NE Irrigated Agriculture Project*** (NEIAP) has been active in conflict-affected areas supporting community-driven efforts to rebuild economic activity and the Land Mine Action Project—a US$1 million Post Conflict Fund Grant administered by UNDP—has been providing support to de-mining. More recently, the Bank developed a three-phase strategy for comprehensive reconstruction support to the NE. In the first phase, activities are being redirected, expedited, and scaled in the NE in those projects which focused on the entire country, but activities could not be carried out in the NE because of the conflict. Approximately US$15 million was made available through four projects—Teacher Education/Teacher Deployment, General Education II, Legal/Judicial Reforms and Environmental Action. In the second phase, certain projects—with significant savings and/or where project components will not meet development objectives by closing—have been restructured to provide additional urgently needed support to the reconstruction efforts. US$31 million was identified in three operations and a restructuring package was approved by the Bank's Board on November 14, 2002. In the third phase, a longer term program to meet the development needs of the NE—probably in the form of one or more credits for reconstruction of infrastructure—will be addressed in the context of the new CAS. In addition, the Government has requested that the World Bank, ADB and UNDP conduct a comprehensive needs assessment for the entirety of Sri Lanka in preparation for the Sri Lanka Reconstruction Conference to be held in Tokyo in June 2003. The Bank will take the lead on the housing assessment and work closely with UNICEF on the education assessment. Furthermore, during the January 2003 round of peace discussions, the World Bank was selected to be the custodian of the North East Reconstruction Fund.

In ***infrastructure***, the Bank is actively engaged in a dialogue with the authorities and providing support—through the ***Economic Reform Technical Assistance*** Project—to implement reforms in priority sub-sectors: transport, telecommunications, petroleum, power, port and airport services and urban water supply and sanitation services. The project is also supporting the establishment of a multi-sector regulator that will cover the utilities. The Bank is also supporting increased private sector participation in infrastructure through the ***Private Sector Infrastructure Development*** Project which has been helping to develop a modern and efficient infrastructure system in Sri Lanka by: (i) encouraging significant participation of the private sector in the investment, implementation, operation and maintenance of new infrastructure facilities; and (ii) strengthening the Government's ability to attract and negotiate private sector-sponsored infrastructure projects, including through a Government facility for the placemen of long-term debt. Through the recently approved ***Renewable Energy for Rural Economic Development*** (RERED) project, the Bank will contribute to improving the quality of rural life by utilizing off-grid renewable energy technologies to bring electricity to remote communities and promote private sector power generation from renewable energy resources from the main grid. In addition, through the proposed ***Second Community Water*** project, the Bank will support the implementation of demand-responsive and sustainable rural water and sanitation services in the context of the Government's newly issued National Rural Water Supply and Sanitation Policy. The Bank's involvement in infrastructure is generally restricted to policy and regulatory issues and with the exception of rural water, rural electrification and perhaps reconstruction efforts in the North East, there is limited Bank involvement with regard to infrastructure investments.

Areas of shared responsibility

As described above, although the Bank has taken the lead in the structural reforms, the IMF has a strong interest from both a macroeconomic perspective and from the perspective of supporting the reform program contained within the Government's PRS. As such, there is close coordination on all aspects of support to the structural reform program to implement the PRS.

As one example of an area of truly joint responsibility, the Bank and the IMF are working closely together in the financial sector and a Financial Sector Assessment Program (FSAP) was finalized in 2002. Furthermore, responding to a key policy priority identified in the FSAP—i.e., the need to restructure the state-owned banks, restore the capital position and ensure sound management of private banks and promote a healthy consolidation of the banking system—at the request of the Government, joint follow-up work was undertaken to provide specific recommendations on how to handle one of the state-owned banks. As this is a key issue for both institutions, close coordination is continuing to provide consistent and timely advice in this area that is likely to figure prominently in both the PRSC and PRGF. Complementing this work, through the ***Central Bank Strengthening*** project, the Bank is supporting improvements in: (i) the efficiency and capacity of the Central Bank of Sri Lanka (CBSL); and (ii) financial sector policy and regulatory framework to promote financial sector development. Similarly, the IMF has been providing technical advice (including long-term consultants) to the CBSL in a number of reform areas, including with regard to drafting/implementing key new legislation and in beginning to undertake active open market operations.

Sri Lanka has long been known for its comprehensive ***social protection programs***—most recently, Samurdhi. The Bank and the IMF have shared responsibility for discussing social protection programs with the Government—including the various options under the newly approved Welfare Reform Act—and reforming the welfare system to better target the poor and improve efficiency will likely be important components under both future Bank and IMF programs. With regard to ***pension system reform***, the Bank has long been conducting a dialogue on the topic and future support will likely be provided through a subsequent PRSC. On its part, the IMF is working closely with the Government on this issue as they work out a proposal to develop a contributory pension scheme for all new recruits to the public service. Again, in addition to continuing Government commitment, successful implementation of these reforms will depend upon continued close coordination between the Bank and IMF.

Finally, given the importance of ***trade*** to achieving Sri Lanka's growth and poverty reduction objectives, the Bank and IMF been sharing the responsibility, with each of the institutions taking on a special role. Analysis by both the Bank and IMF have identified the trade-related factors—including high protection of basic foodstuffs—that have hurt Sri Lankan competitiveness. The Bank intends to carry out a comprehensive trade policy analysis that will help to identify key constraints to Sri Lanka's further integration into the multilateral trading system in a manner that is supportive of the PRS. The contribution of the IMF will continue to be on supporting trade reforms focused on making further progress toward a simplified and transparent two-band tariff system, including reducing agricultural protection.

Areas in which the IMF leads and its analysis serves as input into the World Bank program

As is the case in the majority of Bank/IMF countries, the IMF is taking the lead on conducting a dialogue with the Government with regard to maintaining overall sound and flexible macroeconomic policies. Nevertheless, macroeconomic stability remains a foundation for the successful implementation of the Bank program, especially the proposed adjustment lending.

The IMF also leads the dialogue on fiscal matters, setting the overall envelope for public expenditures and other fiscal targets. To achieve the needed consolidation, important medium-term goals will be to broaden the revenue base and re-orient expenditures toward priority spending. The IMF is taking the lead on the revenue side and as mentioned previously, the Bank is taking the lead on the expenditure side.

Areas in which the IMF leads and there is no direct World Bank involvement

The IMF is fully responsible for the dialogue on monetary policy, interest rates, the exchange rate regime, the balance of payments and related statistical and measurement issues.

C. World Bank Group Strategy and Lending Operations

The Country Assistance Strategy: A new Country Assistance Strategy (CAS) for Sri Lanka will be presented to the Bank's Board on April 1, 2003. The proposed CAS program is built on the Government's PRS and focuses on three core PRS themes: peace, growth and equity. The reasons for focus on these three areas are the following:

- Without peace, there is no prospect for development; not only from the difficulty of creating a framework for sustainable poverty reduction and growth in such a situation, but also that the fiscal burden would be likely to become increasingly intolerable and the most vulnerable poor in today's society—the conflict-affected and displaced populations—would not be reached;
- Growth is the key to prosperity and to creating a bigger cake for distribution; and
- Equity concerns will remain high in Sri Lanka, not only to permit the expected attainment of the Millennium Development Goals (MDGs), but more to ensure balance within the society. While education and health have made great strides, access varies sharply across the country and quality is a major concern. Furthermore, the South of Sri Lanka faces many natural disadvantages and growth has lagged behind other parts of the country.

The Bank's strategy also envisions an important role for the International Finance Corporation (IFC), especially through support to the growth agenda as described below.

Programmatic Adjustment Lending: As previously mentioned, the proposed program would heavily use PRSCs to support the implementation of the PRS. At the heart of the PRS is a program to release the private sector from its constraints and to reorient public expenditure away from welfare and control mentality towards an empowerment and service provision approach. It is thus proposed that, while the PRSC would review the overall progress in the implementation of the PRS program, there would be an annual focus on particular areas of the strategy where deeper progress would be targeted. It is anticipated that close to half of the support under the new CAS would be in the form of PRSCs/budget support.

In the first PRSC—planned for FY03—the focus would be on factors of production: labor, land, financial and utilities In addition, the reform of the power and telecommunications sectors calls for greater regulatory capacity and a change in the role of the state, and this too would form a part of the early program to be supported. Last and by no means least, the first year of implementation of the PRS would see a strong emphasis of monitoring and evaluation mechanisms for the PRS itself. The second PRSC would follow in FY04, and in preliminary thinking this might focus on two key areas for the poverty agenda: the *reform of the welfare system* into one which is much more tightly focused on those in need, and *reform of the rural economy*, in particular to raise the productivity of farmers, who remain the poorest sector of the economy. In the third PRSC (FY05) attention would turn to the public sector itself, with a focus on the reform of public sector employment systems and structures, and the related structure of public expenditure, including the issues of decentralization of decision making and revenue-sharing. The specific theme of the fourth PRSC (FY06) would be determined on the basis of the outcome of economic and sector work that will be carried out in FY04/05, but could well focus on the management and efficiency of public expenditure.

The Base Case Lending Program: The proposed FY03–FY06 base case lending program consists of about four projects per year for a total of US$800 million in IDA resources.[8] It is anticipated that in each year the lending program would be anchored in a PRSC providing budget support to the implementation of the PRS. The PRSCs would annually be complemented by two to four investment/sectoral operations to support key programs in the focus areas.

Bank Assistance Program in Sri Lanka: The total Bank program in Sri Lanka to date is comprised of 98 operations for a total original commitment of US$2.668 billion equivalent.

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[8] Given the intensity of the conflict in Sri Lanka over the last 20 years, a portion of the IDA resources in FY03 and FY04 would be in the form of IDA grants. In FY03, in addition to the already approved National HIV/AIDs Prevention Project (US$12.6 million), the IDA grant element would be US$55 million.

This includes 12 loans from IBRD (US$210.7 million equivalent) and 85 credits and 1 grant from IDA (US$2.458 billion equivalent) Of these operations, 85 have been completed and 13 IDA operations—as well as one grant from the Global Environmental Facility (GEF)—are currently under implementation (see Table 1).

Table 1. World Bank Operations

(As of January 31, 2003)

Operation	IDA Amount	GEF Amount	Undisbursed	Board Date
	(In millions of U.S. dollars, net of cancellations)			
Private Sector Infrastructure Development	62.0		34.5	1996
Teacher Education & Teacher Deployment	64.1		14.2	1996
Environmental Action	14.8		2.8	1997
Second General Education	70.3		23.1	1998
Mahaweli Restructuring	57.0		19.8	1998
Conservation of Medicinal Plants		4.6	0.8	1998
Legal and Judicial Reform	18.2		14.1	2000
North East Irrigated Agriculture Project	27.0		15.6	2000
Distance Learning Initiative	2.0		1.0	2001
Land Titling & Related Services	5.0		4.5	2001
Central Bank Strengthening	30.3		17.5	2001
Renewable Energy for Rural Economic Development	75.0	8.0	74.3	2002
Economic Reform Technical Assistance	15.2		15.2	2003
National HIV/AIDs Prevention	12.6		12.6	2003
Total	453.3	12.6	250.0	

Note: The two projects approved in FY03 are not yet effective.
The North East Emergency Reconstruction Program—created by a portfolio restructuring in FY03—received funding from the following projects: Private Sector Infrastructure Development (US$21.0); Mahaweli Restructuring (US$5.0) and Central Bank Strengthening (US$5 million). It is not counted as a separate project.

The active portfolio contains 13 IDA credits/grants and 1 Global Environmental Facility (GEF) grants with a total undisbursed balance of US$250 million. The average project age is 3.2 years and six of the projects (including the stand-alone GEF operation) are scheduled to close in the next eighteen months. After declining for a few years, disbursements increased to nearly US$70 million in FY02 and have registered [US$43.4 million] for the first seven months of FY03. During FY03, two projects have been approved: (i) the Economic Reform Technical Assistance Project on December 10, 2002; and (ii) National HIV/AIDs Prevention on December 17, 2002 (the IDA grant). Three projects are in an advanced stage of preparation—PRSP I, Second Community Water and Improving Relevance And Quality Of Undergraduate Education—and anticipated to be approved during FY03.

Economic and Sector Work: The most recent Country Economic Memorandum (CEM) is titled *Sri Lanka: Recapturing Missed Opportunities* (Report No. 20430-CE, June 16, 2000). Other recently completed core diagnostic work includes a poverty assessment (*Sri Lanka: Poverty Assessment*, Report No. 22535-CE, June 26, 2002). At an advanced stage of preparation are the Country Procurement Assessment Review (CPAR) and the Country Financial Accountability Assessment (CFAA), both of which will be finalized in FY03. As mentioned, in the coming years public expenditure analysis will be a continuous process and work currently on-going is concerned with institutional and macroeconomic dimensions of public expenditure. Going forward, planned economic and sector work includes an Investment Climate Survey (in both rural and urban areas), a Health Sector Strategy, a Development Policy Review emphasizing Growth, work on General Education and Financing of Municipal Services and a Poverty Update.

IFC's Activities in Sri Lanka: As of December 31, 2002, IFC's held portfolio in Sri Lanka consisted of investments in 13 companies, with a total committed exposure of US$75.3 million, of which US$69.8 million is from IFC's own account. This consisted of US$23.4 million in equity and US$46.4 million in loans and guarantees. The portfolio is spread over a number of sectors, including financial institutions, power, healthcare, manufacturing, ports and telecommunications.

As part of the World Bank Group CAS, IFC's strategy is to (i) develop the country's financial markets through domestic debt market development, support to SME and housing finance, by adding value in the ongoing consolidation of financial services, and supporting the growth of privately-managed contractual savings institutions; (ii) support the provision of private infrastructure services (including mobilization of financing and assisting with privatization); and (iii) support export-oriented manufacturing and service companies.

In FY03, IFC is considering further investments in the banking and telecommunications sectors. Other potential areas for future IFC investment include insurance, information technology, power (generation and distribution) and water.

Questions may be referred to Mr. Baysan (3-9745), Ms. Bateman (3-1462), Mr. Fernando (94-1-448070) or Mr. Gregory (IFC, 3-8559).

Sri Lanka—Relations with the Asian Development Bank[9]

The Asian Development Bank (AsDB) started its operation in Sri Lanka in 1969 and has provided 108 public sector loans totaling about $2.6 billion and 189 TAs totaling about $79.17 million. AsDB has also assisted 9 private sector projects (4 loans and 6 equity investments) amounting $85.7 million.

In 2002, AsDB approved four projects to Sri Lanka totaling $237 million and $4.5 million in technical assistance grants, to support development and reforms in key areas of the economy. The AsDB assistance includes Plantation development, aquatic resources development and quality improvement, power sector development and road sector development.

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 December 31, 2002, the sectoral distribution of the loan portfolio is agriculture and natural resources, 22.9 percent; social infrastructure, 12.2 percent; energy, 17.3 percent; education, 7.6 percent; finance and industry, 16.2 percent; transport and communications, 21.7 percent and others, 2.3 percent.

Lending by the Asian Development Bank, 1996–2002

	1996	1997	1998	1999	2000	2001	2002
	(In millions of U.S. dollars)						
Commitment	44	166	190	184	209	100	159
Net resource transfer	127	71	93	72	47	65	76[10]
Disbursement	149	96	126	99	76	91	149

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

[9] Based on material prepared by AsDB staff.

[10] As of 31 October 2002.

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. The authorities plan to make this index official before mid–2003.

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 and prepare government finance statistics on an accrual basis.

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

Central government data regularly provided for publication in the *GFS Yearbook* cover only the budgetary accounts and exclude data for the four extrabudgetary funds, and no data for the provincial and local governments are provided. No sub-annual data are provided for publication in *IFS.*

The authorities are planning to reduce the lag in producing monthly expenditure details on the budgetary central government operations to 45 days, and to revise the presentation of these data 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 started reporting the adjusted monetary data to STA from January 1999. Remaining problems in the data reported to STA are currently being discussed with the authorities.

The authorities have recently adopted most of the recommendations of the fifth edition of the *Balance of Payments Manual,* and a plan to develop data on external debt and international investment position in line with SDDS requirements.

Sri Lanka—Core Statistical Indicators

(As of March 7, 2003)

	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	Mar. 6 2003	Feb. 13 2003	Feb. 28 2003	Dec. 31, 2003	Dec. 31, 2003	Mar. 7 2003	Feb. 2003	Dec. 2002	Q3 2002	Dec. 2002	Q3 2002	2001
Date received	Mar. 7 2003	Feb. 21 2003	Mar. 7 2003	Feb. 10 2003	Feb. 10 2003	Mar. 7 2003	Mar. 1 2003	Feb. 2003	Feb. 2003	Mar.. 2003	Dec. 2002	Mar. 2002
Frequency of data 1/	D	D	W	M	M	W	M	M	Q/A	M	A/Q	A
Frequency of reporting 2/	D	W	W	M	M	W	M	M	Q	M	Q	A
Source of data 3/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting 4/	E	E	E	E	E	O	E	E	E/C	E	C	C
Confiden-tiality 5/	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/ 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.
4/ E-electronic data transfer, C-cable or facsimile, T-telephone, M-mail, V-staff visits, O-other.
5/ 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.

Colombo, Sri Lanka
March 28, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Köhler:

1. The government of Sri Lanka has adopted an economic program for 2003–2006, which aims to reduce poverty through private-sector led growth. This strategy focuses on creating the conditions for a vibrant private sector and a sound fiscal position, and for helping to establish lasting peace by relief, rehabilitation, and reconstruction (RRR) efforts. Our economic program is set out in the attached Memorandum on Economic and Financial Policies (MEFP), and the Poverty Reduction Strategy Paper (PRSP). In support of this program, we are requesting a three–year PRGF arrangement in the amount of SDR 269 million (65 percent of quota) and concurrently a three–year EFF arrangement in the amount of SDR 144.4 million (35 percent of quota).

2. The government believes that the policies set out in the attached MEFP and the Technical Memorandum of Understanding (TMU) are adequate to achieve the objectives of the program. However, it stands ready to take additional measures appropriate for this purpose, and will consult with the Fund in accordance with the policies of the Fund on such consultations. The government will conduct the first review of the PRGF-EFF arrangements with the Fund no later than September 30, 2003.

3. The government will provide the Fund with all the information in a timely manner as might be requested to monitor progress in implementing policies and achieving the objectives of the PRGF-EFF supported program.

4. Given our balance of payments need, at this stage, we also request an extension of repurchase expectations arising in the period July 2003–June 2004 to the obligations schedule.

Sincerely yours,

/s/	/s/
Hon. K.N. Choksy Minister of Finance	Governor A. S. Jayawardena Central Bank of Sri Lanka

Attachments:
Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

SRI LANKA—MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES FOR 2003 UNDER THE THREE YEAR PROGRAM OF THE PRGF-EFF ARRANGEMENTS

I. INTRODUCTION AND BACKGROUND

1. **Sri Lanka today stands at a pivotal point in its history**. After two decades of conflict, the recent progress in the peace process has raised hopes throughout the country that lasting peace may be finally within reach. However, securing lasting peace is inextricably linked with improving economic conditions, and we need to succeed on both fronts if the aspirations of the people of Sri Lanka are to be fulfilled. To this end, we have launched a comprehensive economic reform and poverty reduction strategy (PRS)—Regaining Sri Lanka—with the aim to alleviate poverty by widening opportunities for the poor to benefit fully from accelerated private-sector led growth, eschewing the previous unsustainable policies of "redistribution and transfers."

2. **In late 2001, when the present government took office, the country was in the midst of a serious economic crisis**. A series of shocks—a global slowdown, an attack on Colombo airport, a severe drought, and policy deficiencies had resulted in severe macroeconomic imbalances (including a runaway fiscal deficit and ballooning public debt) and intense pressures on the exchange rate. To stabilize the economy, the previous government entered into a Stand-by Arrangement (SBA). Although, the SBA met some of its key objectives (stemming reserves losses), the program went seriously off-course, particularly with the marked deterioration in the fiscal accounts. Thus, immediately upon taking office, our priority was to bring the SBA-supported program back on track. This was achieved through several policy and structural reforms—including cutting defense spending, broadening the tax base, and improving tax administration. The final review of the SBA was completed in September 2002.

3. **This memorandum describes the medium-term economic program during 2003-2006, in particular the economic and financial policies for 2003**. The economic program builds on the reforms initiated under the SBA, and is guided by the objectives and overall strategy laid out in the PRS paper.

II. MEDIUM-TERM FRAMEWORK AND POLICIES

4. **Regaining Sri Lanka—our poverty reduction strategy program (PRSP)—identifies several factors that underlie Sri Lanka's high poverty**. Chief among these are inadequate growth—reflecting the continued dominance of the public sector in the economy and barriers to productivity growth; unequal opportunities available to the poor—due to geographical isolation and lack of economic integration, limited access to high quality education and basic services, and social exclusion and powerlessness; and the effects of the two-decade long armed conflict. In addition, low labor productivity in agriculture—due to a lack of clear land-tenure rights and continued environmental degradation; barriers to urbanization—particularly due to an over-regulated labor market, which has stifled growth of employment in the formal sector; and problems with governance—especially in the

politicization of poverty reduction programs and incomplete decentralization, have also played their part in keeping poverty high.

5. **To adequately address these issues, the PRSP contains a broad reform agenda.** Within this large agenda, we have reached understandings on the broad areas that will be supported by the Fund, the World Bank, the AsDB, and our bilateral donor partners. Under the PRGF-EFF-supported program, the main focus will be on structural reforms that remove barriers to productivity growth and encourage private-sector led development, restructure the public finances such that scarce resources are freed to redress the lack of opportunities and access of the poor, and provide a stable and enabling macroeconomic environment.

6. **While aiming for sustained growth of 8-10 percent in the long run, our medium-term macroeconomic framework envisages growth to average 6½ percent in 2003-06.** The higher growth rate will depend on both increased private and public sector investment, as well as enhanced productivity growth. In the absence of major external shocks, a prudent monetary policy should help inflation fall to 5 percent by 2006. Despite an increase in export growth as external conditions improve over the medium term, reconstruction-related imports are likely to raise the current account deficit to an average of 4 percent of GDP. Gross official reserves are targeted to rise modestly to 3½ months of import cover by 2006. Given the projected current account deficit, net capital inflows, and reserve accumulation, we envisage substantial financing gaps during 2003–06 (averaging $400 million per year) that are expected to be filled by donor support.

7. **To achieve these objectives, our policies will focus on four areas**:

- *Restoring fiscal sustainability.* Government debt has expanded dramatically in recent years to over 100 percent of GDP, while interest payments have reached 7½ percent of GDP. To bring the level of debt to a manageable level in the medium term, the program aims to reduce the fiscal deficit by 1¼ percent, on average, per year through 2006. To achieve this, revenue will need to be raised by 2½ percent of GDP by 2006, by broadening the tax base mainly by simplifying the tax regime, rationalizing tax exemptions and tax incentives, and improving tax administration. In addition, expenditures will need to be rationalized and reoriented toward priority social and infrastructure spending.

- *Implementing structural reforms that remove barriers to productivity growth and encourage private-sector led development.* In particular, increasing the efficiency of the banking and financial sectors (including by restructuring the state banks and the insurance sector); encouraging competition and private investment by ending state monopoly in various sectors, restructuring public enterprises (including through privatization), increasing labor market flexibility through labor law reforms, and by establishing a light-handed regulatory regime; and further liberalizing the trade regime (including by moving towards a stable, low, uniform tariff rate).

- *Creating opportunities for the poor to share more fully the benefits of higher growth.* Given the strong rural and regional bias in the incidence of poverty in Sri Lanka, revitalizing rural development by reforming agricultural policies and encouraging the growth of medium and small-scale enterprises is vital. In addition, improving access of the poor to markets through better transport and telecommunication infrastructures and access to better education and health services will also play a key role.

- *Garnering resources for reconstruction.* The challenges arising in securing lasting peace are two-fold—immediately, the relief, rehabilitation, and reconciliation (RRR) process will need to be advanced, while in the medium-term, the destroyed infrastructure and institutions in the North and the East have to be reconstructed and the regions reintegrated to the rest of the country. Significant resources will be needed to meet these challenges. The government will seek donor assistance and reorient public expenditures for these purposes, while ensuring that priority needs of the rest of the country continue to be met.

III. The Current Economic Setting

8. **The economy is beginning to recover from the downturn in 2001**. In 2002, GDP grew by an estimated 3-3½ percent, after declining by 1½ percent the previous year. The rebound in activity was led by recovery in domestic demand and exports of services as progress toward peace revived business and consumer confidence and tourism. Inflation trended down (falling to 9½ percent in 2002 from 14¼ percent in 2001), partly due to increased agricultural supplies from the North and the East. Despite soft commodity exports, reflecting weak external demand, the current account deficit remained broadly unchanged from 2001, as inflows of remittances and tourism receipts strengthened. Gross reserves rose to $1.6 billion (2½ months of import cover), while the rupee remained stable in real effective terms.

9. **Fiscal consolidation enabled a steady decline in interest rates**. Despite revenue shortfalls—associated with the teething problems in the changes to the tax system (replacement of the goods and services tax (GST) and the national security levy (NSL) with the value-added tax (VAT)), weak tax administration, and continued losses in the Ceylon Electricity Board (CEB), restraint on expenditures enabled the 2002 fiscal deficit to be limited to 8.9 percent of GDP—2 percent of GDP below the deficit in 2001, although more than the budget target of 8½ percent of GDP. The fiscal adjustment and the decline in inflation allowed policy interest rates to be cut by 300 basis points since January 2002, which has aided private sector credit to begin to recover.

10. **Significant progress has been made on the reform front**:

- *Fiscal, welfare, pension.* A Fiscal Management Responsibility Act (FRA) was enacted in January that sets a medium-term fiscal deficit path, and mandates "pre-election budget reports" to discourage pre-election handouts. A new Board of Investment (BOI) law was passed by Parliament, which eliminated BOI's power to grant tax holidays and incentives outside the regular tax legislation/tax code. A Welfare Benefit Law was enacted in September, which sets clear and transparent eligibility criteria, provides guidelines for the termination of the benefits, and penalties to reduce politicization and mistargeting. A contributory pension scheme for all new public servants was presented to Parliament in January.

- *Public enterprises and privatization.* The electricity reform bill was enacted in December 2002 to pave the way for restructuring the state electricity monopoly (CEB). The restructuring of the Ceylon Petroleum Corporation (CPC) is progressing in step with the liberalization of the petroleum sector. Twelve percent shares of Sri Lanka Telecom (SLT) were sold through an IPO in December 2002, and the privatization of the bus companies is expected to be finalized in March 2003.
- *Banking.* Amendments to the Monetary Law Act were enacted to provide the Central Bank (CBSL) more control over its monetary instruments. To strengthen the integrity of the banking system, the minimum CAR was raised to 10 percent for all domestic banking units from January 1, 2003, and on a consolidated basis on all domestic and foreign banking units effective December 31, 2003.
- *Labor.* Labor reform bills on a new redundancy compensatory formula, time-bound resolution of labor disputes, eliminating restrictions on reasonable overtime work by women, and increasing penalties for child labor were enacted in January 2003.
- *Regulatory.* A multi-sector regulatory bill was enacted in September to establish a single regulatory authority for all public utilities. To enhance competition in the telecom sector, access to international gateways was liberalized this January. Amendments to the Securities Commission Act, which increase the regulatory scope of the agency to a broader range of financial institutions, were passed by Parliament in January 2003.

IV. Macroeconomic Objectives and Policies for 2003

A. Macroeconomic Objectives

11. **We expect growth to reach 5½ percent in 2003**, underpinned by strengthened consumer confidence and a resumption of delayed private investment projects with the progress toward peace, increase in public investment, higher tourism, and a return to normal weather. Inflation is expected to decline to 7 percent by end-year. The current account deficit is likely to rise to 3¾ percent of GDP, as an export rebound is more than offset by higher imports related to increased activity and reconstruction needs. Gross official reserves are targeted to increase to $1.9 billion (over 2½ months of imports).

B. Post-Conflict Challenges

12. **Peace talks with the LTTE have progressed rapidly and the support of the international community has been heartening**. However, securing lasting peace also poses challenges for economic policy. Specifically,

- Resettling our displaced populations; rebuilding the administrative and institutional capacity in the North and East; and reconstructing the dilapidated infrastructure will impose an immediate fiscal cost. There will also be an increased demand on the government's normal programs, including the provision of an adequate social safety net.

- While we have received commitments of US$70 million from donors last November for immediate relief, substantially more funds are needed. To ensure that such funds are properly spent, we have appointed the World Bank to manage the newly created North and East Reconstruction Fund (NERF). With the help of all stakeholders, we are preparing a comprehensive needs-assessment both for reconstruction-related spending as well as in support of the overall reform agenda, ahead of the donor conference slated to be held in Tokyo in June.

C. Fiscal Policy

13. **Continued fiscal consolidation remains key to our macroeconomic program.** The 2003 budget targets a deficit of 7½ percent of GDP in line with the PRSP, of which ½ percent of GDP is related to post-conflict spending in the North and the East. If concessional foreign assistance becomes available for additional post-conflict spending (which we estimate to be ½ percent of GDP), we plan to incorporate the extra spending through a supplementary budget later in the year.

14. **The budget includes several revenue augmenting measures, amounting to ¾ percent of GDP.** Among these, we have already extended the VAT to the financial sector at a rate of 10 percent; extended the debits tax from current accounts to include savings accounts; imposed 2–10 percent duty on currently exempt imports; and lifted VAT exemptions on some items. However, we will not be able to extend VAT to the wholesale and retail sectors this year, due to complications arising from the revenue sharing arrangements with provincial councils, particularly in light of the ongoing peace negotiations. We are committed to extending the VAT to these sectors by January 2004, and will work to resolve the outstanding issues by that time. In addition, we are taking measures to ensure that the bottlenecks and procedures with respect to tax administration are cleared for a smooth implementation. To offset the associated revenue loss in 2003, we will impose a levy on the Telecommunication Regulatory Commission (TRC), which will also raise future government revenue. The top income tax rate has been cut from 35 to 30 percent to encourage better tax compliance and investment.

15. **In light of the pressures on public finances, expenditure rationalizing measures of around ½ percent of GDP are also included in the budget.** These include a continued wage restraint and general hiring freeze of civil servants in 2003 (apart from filling some specific needs for technical, management, education and health personnel), closing of redundant cadre positions; a reduction in defense spending; refinancing (e.g., overdrafts) with long-term bonds; and better targeting Samurdhi program in line with the new Welfare Benefit law. The expenditure measures will not compromise public spending on social priorities. Also, to better track expenditures we will establish a medium-term expenditure framework by July 2003.

16. **The government will carefully manage the financing of the budget and limit the use of nonconcessional funds.** We will use the delayed privatization receipts for SLIC and the bus companies (slated to be completed last year but now expected in March 2003) to reduce net domestic financing from other sources, while keeping to the privatization plans already envisaged for 2003. Thus, with net external financing expected at 2 percent of GDP, net domestic borrowing will be contained to about 4 percent of GDP (compared with 8 percent of GDP in 2002). This will allow reducing outstanding credit from banking system by 1 percent of GDP. The government will also limit its contracting of new medium- and long-term foreign currency nonconcessional loans to $510 million. Most of this borrowing is related to loans from bilateral donors for projects with grant elements ranging from 20-30 percent. These projects are incorporated into the PRSP and are critical to reducing poverty and reconstructing the economy. We are fully committed to substantially reducing reliance on nonconcessional borrowing in future years, by avoiding excessive external commercial borrowing and working closely with donors to increase the concessionality of bilateral loans.

17. **Looking ahead, we plan to continue rationalizing tax exemptions and incentives in the 2004 budget.** The existing exemption and incentive regime is outdated and has hindered the much needed broadening of the tax base. In order to better understand the areas and dimensions along which the tax exemptions and incentives need to be rationalized, we will undertake a comprehensive study of the cost and benefits of the current tax regime, including conducting an international comparison of where Sri Lanka stands in this area. While the specific form of rationalizing and targeting of tax incentives and regime will depend on the conclusion of the study, we will consider various options in the 2004 budget, including reducing the number and length of tax holidays, the level and duration of concessional tax rates, stricter limits on roll over of tax holidays; and limiting incentives to strategic sectors.

18. **As envisaged in the PRSP, we intend to establish a revenue authority to strengthen tax collection, and provide better service.** We have appointed a project manager (the interim chief executive officer) and project team, who are entrusted with setting up of the authority. A workshop is being organized in April in Singapore to provide input to what would be the basis of the Parliamentary Acts governing the operations of the Revenue Authority. By June 2003, we will present to Parliament legislation for establishing the revenue authority and a detailed implementation plan.

19. **With regards to quasi-fiscal policy, the key public enterprises (CPC, CWE, and CEB) will limit their bank borrowing.** In particular, public corporations are expected to reduce their overall outstanding stock of bank debt by Rs 10 billion in 2003. In the case of CPC, petroleum prices will continue to be set by the existing automatic pricing formula, but to compensate for the removal of the debt recovery component in the formula, the corporation's assets will continue to be sold to pay down its bank debt. However, given the recent increase in international oil prices, since mid-February, the government has subsidized diesel and kerosene prices (at an estimated cost of Rs 300 million per month), compensating CPC directly. These temporary measures were taken to ameliorate the impact of the price

increase on the poor, to be fully offset by spending cuts in the Budget. From April onwards, if oil prices continue to remain high, we will protect the budget and pass the full effect of high oil prices on domestic fuel prices. CWE will use proceeds from its asset sales to also draw down its bank debt, while CEB (and its unbundled units) do not intend to increase bank debt during 2003.

D. Exchange Rate and Monetary Policies

20. **Our monetary program will be based on a floating exchange rate regime, which has, thus far, served the economy well.** In this regard, exchange rate interventions will continue to be limited to smoothing extreme short-term volatility or meeting net international reserves (NIR) target in line with the monetary program. The floating of the exchange rate has provided the CBSL an added instrument to absorb shocks. We are committed to make full use of exchange rate flexibility in responding to both short- and long-term exogenous shocks.

21. **Monetary policy will continue to balance the need to support the economic recovery and keep inflation in check.** Reserve money will remain the nominal anchor. In line with the anticipated increase in economic activity, broad money growth will be targeted at 13½ percent in 2003. The current levels of interest rates appear broadly appropriate, but we might consider modest easing of rates if the pace of disinflation and fiscal consolidation picks up in the coming months. The CBSL also stands ready to use the existing stock of treasury bills or issue its own paper to sterilize any excess foreign inflows to adhere to the program targets. The CBSL launched formally its active open market operations in March 2003. To help smooth teething problems at the initial phase of active OMOs, a short-term IMF advisor has been stationed at the CBSL.

E. Structural Issues

22. **The structural reform agenda for the 2003 program under the PRGF-EFF arrangements will focus on**:

Financial Sector Reform

- To enable commercial banks to adequately deal with their nonperforming assets, a draft asset management company (AMC) law is being prepared and will be presented to parliament by June 2003.
- Given the magnitude of Peoples Bank's nonperforming loans (estimated at Rs 23 billion at end–2002—a quarter of the loan portfolio) and poor cost structure, restructuring the bank is an urgent priority. To this end, the government has constituted a restructuring committee and appointed an investment consultant, and will complete an external evaluation of assets and liabilities by September 2003. Since any large recapitalization would impose a substantial burden to the population at large, the government would seek to commercialize the bank. To commercialize the bank as a single entity, an open and transparent process would be initiated by

September 2003. In case this option was not feasible, Peoples Bank would be separated into viable sub-units and commercialized, through an open and transparent process. In any case, it is intended that restructuring of the bank would be completed by March 2004, and would be in full accordance with the amended Banking Act.

- The government will present the revised banking law and exchange management acts to parliament by June 2003. These revisions are designed to enhance CBSL's supervision capacity, facilitate easier entry and exit into the banking sector, and modernize the exchange market. The CBSL will also move expeditiously to resolve the problems of Pramuka Bank, whose license has been revoked.
- To increase market penetration and efficiency in the insurance sector, the state insurance corporation (SLIC) is being privatized.

Public Enterprise Reform

- On the restructuring of loss-making enterprises, we have already initiated the unbundling of CEB, consistent with the timetable agreed with AsDB. The power sector is intended to be unbundled into areas of generation, transmission and distribution by October 2003.
- We have decided on the list of enterprises to be privatized in 2003 (in addition to the sale of SLIC and the bus companies). Key items include the sale of CPC assets and market network, sale of 8½ percent of government shares in Sri Lanka Telecom (SLT), the Hilton Colombo hotel, and CWE's retail business.

Trade and Labor Market Reforms

- Trade reform will focus on phasing out the 20 percent import surcharge and simplifying the tariff structure. In particular, the import surcharge will be cut to 10 percent by January 2004, and then fully eliminated by January 2005. This timetable will be announced in the 2004 budget. In addition, the 2004 budget will include interim targets for rationalizing the existing tariff structure to a simplified three-band regime to be in place in 2005.
- To increase labor market flexibility we will implement the recently enacted time-bound labor dispute settlement law, the redundancy compensatory formula and other laws relating to working conditions by April 2003. To provide a cushion against loss of income, an unemployment protection and retraining scheme is being designed with technical assistance from the ILO. Given the pressures on public finances, the budgetary resources to finance any such scheme will be minimized. The compensatory formula will be designed in line with international practices.

Regulatory Reforms

- In line with the recently enacted multisector regulatory bill, we have established three multisector regulatory bodies covering utilities, transport and communication, and envisage setting up a fourth for all financial services. To this end, we will complete the appointment of the Public Utility Commission by April 2003.

F. Poverty and Social Impact Analysis and Monitoring

23. **We will initiate a poverty and social impact analysis (PSIA) of our key policy reforms in 2003, in collaboration with the World Bank.** We recognize that some of the proposed policies that are committed to in this MEFP, such as public sector restructuring, may have short-term costs for the poor. The government is committed to taking countervailing measures, such as voluntary retirement schemes and a possible unemployment protection plan, to ameliorate the impact of policies on the poor. Moreover, working closely with donors, we will update our poverty reduction strategy, after analyzing the household income and expenditure survey, completed by the Department of the Census and Statistics in February 2003.

24. **As indicated in our PRSP, we will put in place a monitoring and control framework to track and protect poverty-reduction expenditures.** To start with, we have implemented an in-built monitoring system in the Samurdhi program to track improvements in indicators of poverty that will help identify movement of beneficiaries in and out of the program.

G. External Financing

25. **The policies described above and our commitments under the PRGF-EFF supported program would help to galvanize donor financing.** The estimated financing gap of about $426 million in 2003 is expected to be filled by mostly concessional financing from official creditors. The World Bank has committed $110 million of balance of payments support under the PRSC facility, while the AsDB plans to provide about $60 million through their sectoral loans. Bilateral donors are expected to provide $95 million, including $70 million that has already been committed during the Oslo donors meeting in November 2002. The remainder of the gap ($161 million) is expected to be financed by the PRGF/EFF arrangements.

H. Safeguards and Statistical Issues

26. **We remain committed to the financial soundness of the CBSL, adhering to the principles of good governance and best practice as encapsulated in the IMF's safeguards guidelines.** In this regard, we will provide the IMF the requested documentation for the PRGF arrangement. Ernst and Young's (New Zealand) will conduct an audit of CBSL's 2002 accounts on a full IAS basis in March 2003.

27. **On statistical issues,** we plan to migrate our publication of fiscal data in accordance with the GFSM 2001 methodology during 2003 with the help of IMF technical assistance. Sri Lanka is a participant in the GDDS, and we expect full compliance on SDDS by mid-2004.

V. Risks and Contingencies

28. **There are risks to the 2003 program and, thus, a need for designing contingency measures.**

- Among the main risks are a slower global recovery and resumption of drought, which could lower growth, thus requiring revisiting our macroeconomic framework. Disruptions in the Middle East could have a significant negative impact on the economy. With fiscal policy tied down by the need to reduce public debt, the exchange rate and monetary policy will have to bear most of the burden of the needed adjustment. Thus, if there were to be downward pressures on the exchange rate, we would allow the rupee to depreciate, intervening only to limit extreme volatility. However, in case the disruptions are protracted, some adjustment may also be needed in the fiscal stance. We will remain in contact with Fund staff to determine the appropriate policy actions.
- There are also risks to the budget, both on the revenue and expenditure fronts. In line with the requirements of the recently enacted FRA, the government will conduct a mid-term review of the public finances in July 2003. At that time, we will also decide whether additional revenue and expenditure measures are needed to meet the deficit target. We do not intend to grant any general wage increase in 2003, unless during this review, a determination is made that additional resources are available to cover the consequent increase in the wage bill. The government stands ready to take compensatory fiscal measures to keep to the budgeted deficit target, including reducing corporate tax exemptions and further cutting transfers to public corporations.

VI. Program Monitoring and Review

29. **To monitor policy implementation under the program, we have reached understandings on the prior action, a set of quantitative performance criteria for end–June and end–December 2003, and a structural performance criterion and benchmarks (Tables 1 and 2)**. The government intends to bring 90 percent of the shares of SLIC to a point of sale prior to Board consideration of the PRGF-EFF arrangements. There is also a structural performance criterion on the presentation to parliament of the Revenue Authority Act and the preparation of a detailed implementation plan.

30. **The government is aware that the first review under the PRGF-EFF arrangements scheduled to be completed by September 30, 2003, would be conditioned on the observance of end–June, 2003 performance criteria**. Performance criteria, indicative targets, and precise definitions of quantitative variables monitored under the program are set out in the attached updated Technical Memorandum of Understanding (TMU). The standard clauses on overdue financial obligations to the Fund, accumulation of external payments arrears, exchange restrictions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, and import restrictions for balance of payments purposes are also applicable as performance criteria.

Table 1. Sri Lanka Performance Criteria and Indicative Targets, December 2002-December 2003

(In billions of rupees; unless otherwise indicated)

	End-Dec. 2002 Est.	End-March 2003 Prog.	End-June 2003 Prog.	End-Sept. 2003 Prog.	End-Dec. 2003 Prog.
Performance Criteria 1/					
Ceiling on net domestic financing of central government deficit					
Cumulative from January 1, 2002	125				
Cumulative from January 1, 2003		29	44	65	74
Ceiling on net domestic assets of the CBSL 2/	9.0	9.2	2.4	0.4	-1.3
Floor on net international reserves of CBSL 3/ (In millions of U.S. dollars)	1,277	1,286	1,376	1,429	1,505
Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the public sector					
Cumulative from January 1, 2002 (in millions of U.S. dollars)	242				
Cumulative from January 1, 2003 4/ (in millions of U.S. dollars)		450	510	510	510
Ceiling on the stock of short-term external debt					
Cumulative from January 1, 2002 (in millions of U.S. dollars)	0				
Cumulative from January 1, 2003 (in millions of U.S. dollars)		25	25	50	50
Accumulation of external payments arrears Continuous performance criterion during the program period	0	0	0	0	0
Indicative Targets					
Floor on central government revenue					
Cumulative from January 1, 2002	261				
Cumulative from January 1, 2003		73	145	222	304
Primary fiscal balance of central government excluding interest payments					
Cumulative from January 1, 2002	-23				
Cumulative from January 1, 2003		1	-2	-1	-4
Ceiling on banks' net claims on government 2/	193	189	184	180	176
Credit to public corporations by the banking system 5/	43	44	44	44	33
Ceiling on reserve money of the CBSL	126	133	135	138	143

1/ End-June, 2003 and end-December, 2003 will be performance criteria test dates. End-March, 2003 and end-September, 2003 will be indicative targets.
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/ During 2003, Net International Reserves (NIR) will be valued at market prices 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/ The ceiling for 2003 includes $100 million loan from Citibank which is expected to be contracted in March 2003.
5/ Based on the stock of credit to public corporations by the banking system.

Table 2. Sri Lanka: Proposed Policy Actions Under the First Year of a PRGF-EFF Arrangements

Policy Area	Policy Action	Proposed Status	Proposed Timing
I. Fiscal Measures			
1. Tax Policy	1. Extension of the VAT to the wholesale and retail sectors	Structural Benchmark	January 31, 2004 2/
	2. Rationalization/Streamlining of tax incentives	Structural Benchmark	January 31, 2004 2/
	3. Reduce import surcharge to 10 percent from 20 percent	Structural Benchmark	January 31, 2004 2/
2. Tax Administration	1. Presentation to Parliament of a new revenue authority act and prepare a detailed implementation plan	Performance Criterion	June 30, 2003 1/
II. Non-Fiscal Measures			
3. Financial Sector Reform	1. Presentation to Parliament of the Asset Management Company (AMC) law	Structural Benchmark	June 30, 2003 1/
	2. Presentation to Parliament of the amended Banking laws and the new Exchange Management Act	Structural Benchmark	June 30, 2003 1/
	3. External evaluation of assets and liabilities of Peoples Bank	Structural Benchmark	September 15, 2003 1/
	4. Complete the restructuring of Peoples Bank 4/	Structural Benchmark	March 31, 2004 3/
4. Public Enterprise Reform	1. Bring to the point of sale 90 percent of the shares in Sri Lanka Insurance Corporation (SLIC) 5/	Prior Action	April 10, 2003
	2. Complete the sale of 8.5 percent of the government shares in Sri Lanka Telecom (SLT) and bring to a point of sale the shares held by the government in Hilton Colombo.	Structural Benchmark	December 31, 2003 2/
5. Labor Market Reform	1. Implementation of the binding redundancy compensation formula and the revised regulations requiring time bound dispute settlement	Structural Benchmark	April 30, 2003 1/

1/. Structural measure is tied to the first review of the program.
2/. Structural measure is tied to the second review of the program.
3/. Structural measure is tied to the third review of the program.
4/. Additional specifications of the restructuring of Peoples Bank's March 2004 benchmark would be revisited during the first review (TMU, paragraph 21)
5/. The term bringing to the point of sale is defined in the Technical Memorandum of Understanding (TMU, paragraph 20).

Table 3. Sri Lanka: Schedule of PRGF/EFF Program Reviews, Disbursements and Purchases

Availability Date	Amount of PRGF Disbursement (In millions of SDRs)	Amount of EFF Purchases (In millions of SDRs)	Total Disbursements and Purchases (In millions of SDRs)	In Percent of Quota	Conditions
Board Consideration-April 18, 2003	38.39	20.67	59.06	14.29	To be disbursed upon Board Approval.
August 30, 2003	38.39	20.67	59.06	14.29	To be disbursed upon completion of the first review of the PRGF/EFF program and meeting of the end-June, 2003 performance criteria.
February 28, 2004	38.39	20.67	59.06	14.29	To be disbursed upon completion of the second review of the PRGF/EFF program and meeting of the end-December, 2003 performance criteria.
August 30, 2004	38.39	20.67	59.06	14.29	To be disbursed upon completion of the third review of the PRGF/EFF program and meeting of the end-June, 2004 performance criteria.
February 28, 2005	38.39	20.67	59.06	14.29	To be disbursed upon completion of the fourth review of the PRGF/EFF program and meeting of the end-December, 2004 performance criteria.
August 30, 2005	38.39	20.67	59.06	14.29	To be disbursed upon completion of the fifth review of the PRGF/EFF program and meeting of the end-June, 2005 performance criteria.
February 28, 2006	38.68	20.38	59.06	14.29	To be disbursed upon completion of the sixth review of the PRGF/EFF program and meeting of the end-December, 2005 performance criteria.
Total	269.0	144.4	413.4	100.0	
Memorandum item:					
Total quota	413.4	413.4	413.4	100.0	

SRI LANKA

TECHNICAL MEMORANDUM OF UNDERSTANDING FOR THE PROPOSED PROGRAM TO BE SUPPORTED BY THE PRGF-EFF ARRANGEMENTS

March 28, 2003

1. This memorandum sets out a framework for monitoring the proposed program for 2003 to be supported by arrangements under the Poverty Reduction and Growth Facility (PRGF) and Enhanced Fund Facility (EFF). It specifies the proposed quantitative performance criteria and indicative targets and the content and frequency of the data to be provided for monitoring the financial program.

I. FISCAL TARGETS

A. Performance Criterion on Net Domestic Financing of the Central Government Budget

		Ceiling (In billions of rupees)
Flows of net domestic financing at the end of:		
January 1, 2002–December 31, 2002 (actual)		125
Flows of net domestic financing (cumulative balance from January 1, 2003):		
March 31, 2003	(indicative target)	29 [1]
June 30, 2003	(performance criterion)	44
September 30, 2003	(indicative target)	65
December 31, 2003	(performance criterion)	74

2. **Net domestic financing is defined as net credit to the government by the banking system (i.e. CBSL plus deposit money banks) and the net change in holdings of treasury bills and other government securities by the non-bank sector**. For the purpose of program monitoring, the flow of net domestic financing (NDF) of the central government budget would be the sum of the net receipts (in book value terms) of the following government debt instruments (a) Rupee securities, (b) Treasury Bills, (c) Treasury Bonds, (d) Treasury

[1] The NDF target for end-March 2003 assumes that \$60 million of the \$100 million Citibank loan would be used to repay the government's outstanding import bills at the Bank of Ceylon. In the event that this loan is not disbursed by end-March, 2003, the NDF ceiling for end-March would be adjusted upwards by the rupee equivalent of \$60 million using the program exchange rate in Table 4.

Certificates of Deposits, (e) Other rupee-denominated government paper, (f) Provisional advances from the CBSL, (g) and the net change in the stock of debt of other instruments– which consist of overdraft, import bills, syndicated loans with Peoples Bank and Bank of Ceylon *less* government deposits with the CBSL, People's Bank, and Bank of Ceylon. The reporting requirement for NDF appears in Table 6. The data on the instruments (a) through (e) will be provided by the government's public debt office and data on (f) and (g) will be based on the balance sheet data of Central Bank of Sri Lanka (CBSL), People's Bank, and Bank of Ceylon as provided by the CBSL. For program purposes, foreign-currency denominated loans and bonds issued by the government during the program period and held by residents will be excluded from net domestic financing. Central government is defined here to include line ministries, departments and public institutions.

The following adjustments will apply:

3. **The ceiling on net domestic financing** will be adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program financing as set out in Table 2 (memorandum item). However, the upward adjustment for shortfalls in foreign program financing will be limited to the rupee equivalence of $100 million using the program exchange rate in Table 4. Moreover, foreign program financing that increases NIR of the Central Bank of Sri Lanka (CBSL) but does not affect net credit to government (NCG) from the banking system and net domestic financing (NDF) of the budget (such as the DST's Yen Revolving balance), would be excluded from foreign program financing when determining the adjuster for both NCG and NDF.

4. **The ceiling on net domestic financing** will be adjusted downwards by the full amount of any excess privatization receipts beyond the programmed amounts in Table 1. In case of shortfalls in privatization receipts, the upward adjustment in the ceiling would be limited to 50 percent of the shortfall. Privatization receipts in foreign currency will be converted into rupees using the program exchange rates in Table 4. The same adjusters on changes in net domestic financing of central government will also apply to the indicative target on net claims on government in Table D below.

B. Indicative Target on the Primary Fiscal Balance

		Ceiling (In billions of rupees)
Cumulative balance from January 1, 2002 to:		
December 31, 2002	(actual)	-23
Cumulative balance from January 1, 2003 to:		
March 31, 2003	(indicative target)	1
June 30, 2003	(indicative target)	-2
September 30, 2003	(indicative target)	-1
December 31, 2003	(indicative target)	-4

5. **Government primary fiscal balance** is on a cash basis and is defined as the overall central government fiscal deficit minus interest payments. For monitoring purposes, primary fiscal balance excludes grants and privatization receipts. The ceiling on government primary balance is cumulative from the start of the fiscal year. However, the government's primary balance should also broadly equal the sum of net foreign financing (including grants), net bank financing, and nonbank financing and privatization proceeds as recorded by the Public Debt Department and Economic Research Department, Central Bank of Sri Lanka, minus interest payments. For program purposes, interest payments in the Budget will include interest payments on all government debt (including overdraft).

C. Indicative Target on the Central Government Revenue

		Floor (In billions of rupees)
Cumulative balance from January 1, 2002 to:		
December 31, 2002	(actual)	261
Cumulative balance from January 1, 2003 to:		
March 31, 2003	(indicative target)	73
June 30, 2003	(indicative target)	145
September 30, 2003	(indicative target)	222
December 31, 2003	(indicative target)	304

6. **Central government revenue** is defined as the central government revenue as reported in the treasury accounts (economic classification), and excludes foreign grants and privatization receipts. The floor on central government revenue is cumulative from the start of the fiscal year.

D. Indicative Target on Net Claims on the Government by the Banking System

		Ceiling (In billions of rupees)
Outstanding stock as of:		
December 31, 2002	(actual)	193
Cumulative balance from January 1, 2003 to:		
March 31, 2003	(indicative target)	189
June 30, 2003	(indicative target)	184
September 30, 2003	(indicative target)	180
December 31, 2003	(indicative target)	176

7. **Net claims on government by the banking system** is defined as the difference between banks' claims on government, the deposits of government, and the central and provincial governments with the banking system. The ceiling on net claims on government is cumulative from the start of the fiscal year. The adjusters to net domestic financing will also apply to the indicative target net claims on government. In addition, the foreign currency denominated debt component of net claims on government will be converted to rupees at the programmed exchange rate in Table 4. As for net domestic financing, for program purposes, from January 1, 2003, foreign-currency denominated loans and bonds issued by the government during the program and held by resident banks will be excluded from the net claims on government that is reported in the monetary survey.

E. Indicative Target on Credit to Public Corporations by the Banking System

		Ceiling (In billions of rupees)
Outstanding stock as of:		
December 31, 2002	(actual)	43
March 31, 2003	(indicative target)	44
June 30, 2003	(indicative target)	44
September 30, 2003	(indicative target)	44
December 31, 2003	(indicative target)	33

8. **Credit to public corporations by the banking system** is defined as credit of the banking system to public corporations. It comprises both credit from deposit banking units and from foreign currency banking units. The foreign currency denominated debt component of credit to public corporations will be converted to rupees at the programmed exchange rate in Table 4. The list of public corporations refers to those companies that are currently

classified as public corporations under the CBSL's classification in the monetary survey (Table 3).

II. Monetary Targets

A. Performance Criterion on Net Domestic Assets of the CBSL

		Ceiling (In billions of rupees)
Outstanding stock as of :		
December 31, 2002	(actual)	9.0
March 31, 2003	(indicative target)	9.2
June 30, 2003	(performance criterion)	2.4
September 30, 2003	(indicative target)	0.4
December 31, 2003	(performance criterion)	-1.3

9. **Net domestic assets of the CBSL** is defined as the difference between reserve money and net foreign assets of the CBSL valued in rupee. Reserve money is defined below in Section II.B. Net foreign assets of the CBSL are the net claims on nonresidents, in all currency denominations and government (net). For program monitoring purposes, net foreign assets will be calculated using the exchange rate given in Table 4.

The following adjustments will apply:

10. **The NDA ceiling is based on a baseline path of NFA that excludes reserve losses on forwards (III.A)**. The NDA ceiling will be adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program financing as set out in Table 2 using the program exchange rate in Table 4. However, the upward adjustment for shortfalls in foreign program financing will be limited to the rupee equivalence of $100 million using the program exchange rate in Table 4. Foreign program financing is as defined in subsection III (A) below. The NDA ceiling will also be adjusted for DST's Special Dollar and Yen Revolving balance that are kept abroad and are included in the program definition of, NIR (see III. A below).

11. **The NDA ceiling** will be adjusted downward by the full amount of any excess privatization receipts beyond the programmed amounts in Table 1. In case of shortfalls in privatization receipts, the upward adjustment in the ceiling would be limited to 50 percent of the shortfall. Privatization receipts in foreign currency will be converted into rupees using the program exchange rates in Table 4.

12. Changes in required reserve regulations will modify the NDA ceiling according to the formula:

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

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

B. Indicative Target on Reserve Money of the CBSL

		Ceiling (In billions of rupees)
Outstanding stock as of:		
December 31, 2002	(actual)	126
March 31, 2003	(indicative target)	133
June 30, 2003	(indicative target)	135
September 30, 2003	(indicative target)	138
December 31, 2003	(indicative target)	143

13. **Reserve money of the CBSL** consists of currency in circulation (with banks and with the rest of the public), and financial institutions' deposits at the CBSL (only deposits in domestic currency), and government agencies deposits (as defined in CBSL's balance sheet in Table 5). As of end-December 2002, reserve money defined in this manner stood at Rs 126 billion. If any bank fails to meet its legal reserve requirement then reserve money will be adjusted upwards to the extent of any shortfall in compliance with the requirement.

14. The ceiling on reserve money will be adjusted for changes in reserve regulations in line with the adjustment generated to the NDA limit.

III. External Sector Targets

A. Performance Criterion on Net International Reserves of the CBSL

		Floor (In millions of U.S. dollars)
Outstanding stock as of :		
December 31, 2002	(actual)	1,277
March 31, 2003	(indicative target)	1,286
June 30, 2003	(performance criterion)	1,376
September 30, 2003	(indicative target)	1,429
December 31, 2003	(performance criterion)	1,505

15. **For the purpose of monitoring the PRGF-EFF program, net international reserves of the CBSL** is defined as the difference between its gross foreign assets and

liabilities, both expressed in terms of market values. Gross foreign assets of the CBSL consists of monetary gold, foreign exchange balances held outside Sri Lanka, foreign securities (valued in market prices), foreign bills purchased and discounted, net IMF position and SDR holdings, Crown Agent's credit balance, DSTs' Special Dollar and Yen Revolving balance. All foreign currency nondollar denominated reserve balances will be converted into U.S. dollars at programmed exchange rates specified in Table 4 below to reflect valuation adjustment. Excluded from gross foreign assets will be participation in international financial institutions, holdings of nonconvertible currencies, holdings of precious metals other than monetary gold, and claims on residents (e.g., statutory reserves on foreign deposits of commercial banks) pledged, non-liquid, collateralized or otherwise encumbered assets (such as the government's war risk insurance deposit with Lloyds during 2001/02), claims in foreign exchange arising from derivative transactions (such as futures, forwards, swaps and options). Gross foreign liabilities are all foreign currency denominated liabilities, the use of Fund credit, and Asian Clearing Union debit balance and commitments to sell foreign exchange arising from derivatives such as futures, forwards, swaps, and options..

The following adjustments will apply:

16. **The NIR floor will be adjusted** upward by the full amount of excess privatization receipts in foreign currency compared with the programmed amount in Table 1 and downward by shortfall in privatization receipts in foreign currency, but the downward adjustment will be equal to 50 percent of the shortfall; adjusted downward/upward by the shortfall/excess of foreign program financing as set out in Table 2 but the downward adjustment for shortfalls in foreign program financing will be limited to $100 million for each test date. Foreign program financing is defined to include balance of payments support, including adjustment loans from multilateral creditors other than the Fund, balance of payments support from bilateral creditors, loans from private creditors (including commercial banks) and rescheduling of medium- and long-term public and publicly-guaranteed debt. Thus, foreign program financing as defined above, is expected to augment CBSL's reserves without an immediate expected corresponding payment outflow. For program purposes, from January 1, 2003, foreign-currency denominated loans and bonds issued by the government and held by domestic residents will be treated as foreign program financing.

B. Performance Criterion on New Nonconcessional External Debt

	Ceiling (In millions of U.S. dollars)
Cumulative balance from January 1, 2002 to:	
December 31, 2002 (actual)	242
Cumulative balance from January 1, 2003	
March 31, 2003 (indicative target)	450
June 30, 2003 (performance criterion)	510
September 30, 2003 (indicative target)	510
December 31, 2003 (performance criterion)	510

17. **Contracting or guaranteeing of new medium and long-term nonconcessional external debt** is defined as contracting or guaranteeing new nonconcessional external debt by the non-financial public sector (all central and provincial government ministries and departments, public corporations and institutions, and the CBSL) with an original maturity of more than one year (valued at programmed cross exchange rates as defined in Table 4). The program ceiling of $510 million for 2003 includes a Citibank loan of $100 million and another $270 million of loans that Sri Lanka plans to contract with Japan Bank for International Cooperation (JBIC). Both loans are expected to be contracted by end-March 2003. This debt will also include foreign currency denominated loans and bonds contracted with residents. Nonconcessional debt is defined as borrowing containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates. For maturities of less than 15 years, the grant element would be calculated based on six-month CIRR averages, while for maturities longer than this, the grant element would be based on ten-year CIRR averages. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274–(00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are credits extended by the IMF and program financing from IBRD and AsDB, and government counter guarantees on project loans from both IBRD and AsDB, as well as changes in indebtedness resulting from rescheduling operations or rollovers. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time of the contract is entered into, or guarantee issued.

C. Performance Criterion on Stock of Short-Term External Debt

		Ceiling (In millions of U.S. dollars)
December 31, 2002	(actual)	0
March 31, 2003	(indicative target)	25
June 30, 2003	(performance criterion)	25
September 30, 2003	(indicative target)	50
December 31, 2003	(performance criterion)	50

18. **Stock of short-term external debt outstanding** is defined as debt with original maturity of up to one year owed or guaranteed by the non-financial public sector (all central and provincial government ministries and departments, public corporations and institutions, and the CBSL) (valued at programmed cross exchange rates as defined in Table 4). This debt will also include foreign currency denominated loans and bonds contracted by the non-financial public sector with residents. The term debt is defined as set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274–(00/85), August 24, 2000), but excludes normal import-related credits, forward contracts, swaps and other future market contracts. The ceilings also apply to debt instruments with put options that would be triggered within one year after the contracting date.

19. **The program's performance criterion on nonaccumulation of external payment arrears is continuous throughout the program period**. External payments arrears are defined as overdue payments (interest and principal payments) on short-term debt in convertible currencies with an original maturity of up to and including one year (spot, money market, letters of credit) and medium- and long-term debt contracted or guaranteed by the government. As of end-December 2002, there were no reported external payment arrears.

IV. Structural Conditions

20. **The term bringing to the point of sale (MEFP Table 2) means the authorities will have submitted to Cabinet a sale and purchase agreement, including the chosen buyer, final price and other financial and technical understandings by the relevant test date**. That agreement will have been endorsed by the Cabinet Appointed Tender Board and approved by the Attorney General. However, since the condition on Sri Lanka Insurance Corporation (SLIC) is a prior action, this implies that submission to the cabinet would have to be done **five business days** before the Board meeting.

21. Additional specifications of the restructuring of Peoples Bank's March 2004 structural benchmark would be revisited during the first review of the program.

V. Data Reporting Requirements

22. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 6, 7 and 8.

23. For the purpose of external sector performance under the program, data will be provided in the format shown in Tables 9 and 10.

24. Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the letter. All the program monitoring data would be provided by the Ministry of Finance and the Central Bank of Sri Lanka (CBSL). The data on net domestic financing will be reported to Fund both in terms of net receipts of domestic financing (as in I. A above) and the stock of net domestic debt (as earlier reported). Data on gross foreign assets and gross foreign liabilities would be provided at market prices. All the data relating to the above programmed targets will be furnished within six weeks after the end of each month. For the primary balance, preliminary estimates will be available within six weeks and firmer estimates after 10 weeks.

Table 1. Privatization Receipts

	2003 March *Prog.*	2003 June *Prog.*	2003 September *Prog.*	2003 December *Prog.*
Privatization receipts (for NDF and NCG adjuster) Cumulative from January 1, 2003 (in billions of rupees)	0	10	12	17
Privatization receipts (for NIR and NDA adjuster) Cumulative from January 1, 2003 (in millions of US dollars)	0	0	0	125

Table 2. Foreign Program Financing Assumption; Cumulative from January 1, 2003

(In millions of U.S. dollars)

	2003 March *Prog.*	2003 June *Prog.*	2003 September *Prog.*	2003 December *Prog.*
Multilateral creditors	0	110	120	170
World Bank	0	110	110	110
Asian Development Bank	0	0	10	60
Bilateral creditors	0	0	50	95
Private creditors	0	0	0	0
Total	0	110	170	265
Memorandum item:				
Foreign program financing (for NDF and NCG purposes)	0	110	120	200

Table 3. List of Public Corporations as Defined by the Central Bank of Sri Lanka 1/

1. Ceylon Electricity Board
2. Ceylon Petroleum Corporation
3. C.W.E.
4. Ceylon Shipping Corporation
5. State Pharmaceuticals Corporation
6. Building Materials Corporation
7. Ceylon Plywood Corporation
8. National Livestock Development Board

1/ Does not include Sri Lanka Telecom and Sri Lankan Airlines—companies in which the state has large equity shares but which are privately operated.

Table 4. Exchange Rates and Gold Prices to be Used Under the Program 1/

	Rupees per Unit of Foreign Currency
U.S. dollar	100
Japanese yen	0.83
SDR	130
Euro	103
Pound sterling	160
Gold prices (U.S. dollars per ounce)	350

1/ Currencies not shown here will be converted first into U.S. dollars using the official rate used by Fund's Treasury Department on January 28, 2003.

Table 5. Balance Sheet of the Central Bank of Sri Lanka 1/

Net foreign assets
Foreign assets
Cash and balance abroad
Foreign securities
Claims on ACU
SDRs
IMF related assets
Receivables
Foreign currency reserve
Foreign liabilities
IMF and nonresident account
Liabilities to ACU
Government (net)
Net domestic assets
Claims on government
Advances
Treasury bills and bonds
Cash items in collection
Government deposits
Claims on commercial banks
Medium and long term
Short term
Other items net
Reserve money
Currency in circulation
Commercial bank deposits
Government agencies deposit

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

Table 6. Net Domestic Financing of Central Government of Sri Lanka 1/

Net receipts (book value) for domestic financing
Rupee securities
Treasury Bills
Treasury Bonds
Sri Lanka government bonds (held by residents- commercial banks and others)
Treasury Certificates for Central Bank
Provisional Advances for Central Bank
Other liabilities with People's Bank and Bank of Ceylon net of Government deposits
Overdraft with People's Bank
Overdraft with Bank of Ceylon
Government deposits with CBSL
Government deposits with Bank of Ceylon
Government deposits with People's Bank
Import Bills – Bank of Ceylon
Imports Bills – People's Bank
Syndicated Loans with Bank of Ceylon
Syndicated Loans with People's Bank

1/ Expressed in terms of net flows. As agreed for the purpose of monitoring the program.

Table 7. Revenue Collection

(In millions of rupees)

Total Revenue
Tax revenue
Income taxes
Turnover taxes/VAT
Of which: Imports
Excise taxes
Liquor
Tobacco
Other
Debits tax
Taxes on international trade
Stamp duty
License fee/motor vehicles
Nontax revenue
Property income
CB profits
Interest
Profits and dividends
Rents
Fees and charges
Other

Table 8. Expenditures

(In millions of rupees)

Total expenditure and net lending
Current expenditure
Civil service wages and salaries
Security-related wages and salaries
Goods and services
Of which: Military
Subsidies and transfers
Of which: Pensions
Samurdhi
Local and provincial governments
Interest payments
Foreign
Domestic
Capital expenditure and net lending
Rupee funds (incl. counterpart funds)
Foreign financed
Overall balance (excl. grants and privatization)
Overall primary balance (excl. grants and privatization)

Table 9. Net International Reserves

(In millions of U.S. dollars)

Date	Central Bank				Government				Liabilities			
	Foreign Exchange Balance.	Reserve Position with the Fund	Foreign Currency Deposit due to SRR 1/	Total	Crown Agent's Credit Balance	DST's Special Dollar Revenue Balance	Total	Total Gross Official Reserves	Deposits	Asian Clearing Union	PRGF	Total

1/ Foreign currency deposits held by the CBSL on account of statutory reserve requirement on foreign currency deposits by commercial banks.

Table 10. Contracting or Guaranteeing of New Nonconcessional External Debt by Non-Financial Public Sector

(In millions of U.S. dollars)

Creditor	Name of project	Date of agreement	Maturity period	Grace period	Interest rate	Currency	Amount	Disbursement

Press Release No. 03/54
FOR IMMEDIATE RELEASE
April 18, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US$567 Million in PRGF/EFF Credit Arrangements for Sri Lanka

The Executive Board of the International Monetary Fund (IMF) today approved three-year arrangements under the Poverty Reduction and Growth Facility and Extended Fund Facility amounting to SDR 413.4 million (about US$567 million) for Sri Lanka, which will support the government's economic program for 2003–06. Of this amount, SDR 269 million (about US$369 million) is available under the PRGF, and SDR 144.4 million (about US$198 million) is available under the Extended Fund Facility (EFF). The decision will enable Sri Lanka to draw SDR 59.06 million (about US$81 million) from the IMF immediately.

The PRGF is the IMF's concessional facility for low-income countries. It is intended that PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5 ½-year grace period on principal payments. The EFF is an IMF financing facility that supports medium-term programs that seek to overcome balance of payments difficulties stemming from macroeconomic imbalances and structural problems. The repayment terms are 10 years with a 4½-year grace period.

In commenting on the Executive Board's decision, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, made the following statement:

"Sri Lanka today stands at a pivotal point in its history. Over the past 20 years, a long civil conflict has beleaguered the country, which not only disrupted economic activity, but also hampered the sustained implementation of economic reforms. The current environment, in which peace negotiations are progressing well and economic activity is picking up, provides an excellent opportunity for Sri Lanka to implement deeper economic reforms and put the economy on a path of sustained high growth. The PRGF-EFF supported program aims to accelerate economic growth and reduce poverty through private-sector led development, in line with the authorities' Poverty Reduction Strategy Paper and building on steps taken under the IMF's Stand-By Arrangement that was completed in September 2002. Key elements of the program are fiscal consolidation; reforming the financial sector, public enterprises, labor market regulations, and the trade regime; and strengthening macroeconomic policy instruments and institutions. Sri Lanka's PRSP is a satisfactory policy framework to increase growth and reduce poverty.

"The program's focus on fiscal consolidation is appropriate in light of the public debt burden. It is also necessary to ensure that adequate resources are available to meet priority spending needs and to free resources for private sector expansion. Thus, the program emphasizes increasing revenue by broadening the tax base and strengthening tax administration as well as reorienting expenditure towards social, infrastructure, and post-conflict needs.

"Sustaining high growth depends critically on implementing the program's structural reforms. The progress made in reforming the electricity and petroleum sectors, restructuring state-owned enterprises, and strengthening the banking sector is commendable. However, further reforms are needed in financial sector, public enterprises, labor markets, and the trade regime.

"The government's attention to reducing conflict-related and rural poverty is well placed. The implementation of plans to strengthen rural infrastructure and improve access of the poor to quality education and health services are appropriate and necessary steps. In the area of welfare reforms, the new focus on depoliticization and targeting of Samurdhi benefits is commendable and should be strongly implemented.

"To fully realize the program's medium-term objectives for growth and poverty reduction, lasting peace is necessary. The authorities are fully committed to the program and have embarked on difficult reforms, while making strong efforts to preserve public support for the peace process. At the same time, continued donor financing is required to support reforms and reconstruction, as well as the momentum of the peace process", said Mr. Sugisaki.

ANNEX

Recent Economic Developments

After declining in 2001, the economy recovered last year. Following a series of exogenous shocks in the second half of 2001—the global slowdown, an attack on Colombo airport, and a severe drought, GDP for the year fell by 1½ percent, the first decline in several decades. A robust expansion in domestic demand and tourism underpinned the rebound in 2002, as progress toward peace revived business and consumer confidence. GDP growth for 2002 is likely to reach 4 percent. However, the recovery is yet to be broad based, with lingering weaknesses in private investment and exports of goods. Inflation slowed down, due, in part, to better weather conditions, with the 12-month rate dipping below 8 percent in March 2003.

Strong inflows of remittances and tourism receipts helped gross official reserves to rise from \$1.2 billion (December 2001) to \$1.6 billion (March 2003) covering 2½ months of imports. The rupee remained broadly stable in real effective terms.

Monetary policy balanced the need to support the economic recovery with restraining inflation. The decline in inflation allowed the Central Bank of Sri Lanka (CBSL) to cut repo rates by 300 basis points since January 2002. As a result, other lending rates also declined and helped the recovery of private-sector credit.

The fiscal deficit for 2002 is estimated at 9 percent of GDP—2 percent of GDP lower than in 2001—but higher than the budget target of 8½ percent of GDP. This outcome reflected a revenue shortfall of around 1 percent of GDP, partly offset by spending cuts of about ½ percent of GDP. The lower revenue was due to a combination of weaker-than-expected imports, a large number of exemptions granted when the GST was replaced with the VAT, and lower nontax revenue, in part, reflecting a restructuring in payments from the electricity company (CEB) to the budget. The cuts in expenditure reflected reduced capital spending (due to low project-implementation rates) and somewhat lower current spending.

Reforms were advanced in several areas. Following the enactment of the Electricity Reform Bill in December 2002, the unbundling of the state electricity company (CEB) is proceeding on schedule, while Ceylon Petroleum Corporation (CPC) reforms are progressing in step with the liberalization of the petroleum sector. A 12 percent stake in Sri Lanka Telecom (SLT) was sold in December 2002 and the privatization of Sri Lanka Insurance Corporation (SLIC) was completed in early April 2003. Several amendments to the labor laws were passed by Parliament in January 2003. A Fiscal Management Responsibility Act (FMRA) came into force in December 2002, while a Welfare Benefit Law was enacted in September to reform the welfare system.

Program Summary

The government's economic program supported by the combined PRGF-EFF arrangements, is based on their medium-term economic and Poverty Reduction Strategy Paper (PRSP)—Regaining Sri Lanka—that was finalized in January 2003.

Under the PRGF-EFF supported program, the ongoing economic recovery is expected to gain further momentum this year, with GDP growth projected to rise to 5½ percent. A resumption of delayed private investment projects, a substantial increase in public investment, higher tourism, and a return to normal weather underpin the projection. Inflation is expected to slow to 7 percent by end–year. The current account deficit is likely to rise to 3¾ percent of GDP, as an export rebound is more than offset by higher imports related to increased activity and reconstruction needs. Gross reserves are targeted to reach $1.9 billion (2¾ months of imports) by end–2003.

In line with the PRSP, growth is expected to average 6½ percent over the medium term. This reflects both higher productivity and capital accumulation, reflecting labor market and financial sector reforms, and strong public and private investment. In the absence of major external shocks, prudent monetary policy and normal monsoons should help inflation decline to 4½ percent by 2006. With substantial reconstruction and investment imports, the current account deficit is likely to rise to 4½ percent of GDP by 2004, before falling to 3¾ percent of GDP by 2006. Reasonably strong capital inflows should help gross official reserves to rise to $3 billion (3½ months of imports).

The program' fiscal strategy aims to restore fiscal sustainability, while ensuring that adequate resources are available for priority spending and post conflict needs. Public debt now stands at 104 percent of GDP, while interest payments amount to 7½ percent of GDP, raising serious sustainability concerns. To bring the level of debt to a manageable level, the program aims to reduce the fiscal deficit by 1¼ percent of GDP per year, on average, over the medium term, bringing it down to 4⅓ percent of GDP by 2006.

Achieving these objectives will require revenue to be raised and expenditure rationalized and reoriented to priority needs. The aim is to increase revenue by broadening the tax base—through rationalizing tax exemptions and incentives—and by strengthening tax administration—in part, by establishing an efficient revenue authority. The program envisages capital spending to rise over the medium term, while continued savings in welfare, reflecting better targeting of beneficiaries, is expected to allow a near doubling of capital expenditures in health and education. A medium-term expenditure framework (MTEF) is planned to be established by mid–2003 to better reorient expenditure towards social and post-conflict needs. Financing of the budget is programmed to be increasingly shifted away from expensive debt to concessional donor funds.

The flexible exchange rate regime has served the economy well and will be continued. Thus, market interventions will be limited to smooth short-term volatility or meet the reserves target in line with the monetary program. Monetary policy will continue to be guided by the need to support economic recovery, while restraining inflation.

The structural reform agenda of the program will focus on the following aspects of the PRSP:

- Financial sector reform—particularly restructuring the Peoples Bank
- Improvement in tax administration—including steps to establish a Revenue Authority
- Restructuring of public corporations—particularly the electricity and petroleum monopolies.
- Implementing labor market and trade reforms.

Sri Lanka: Selected Economic Indicators

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

	1997	1998	1999	2000	2001	2002 Prov.	2003 Proj.
Domestic economy							
Change in real GDP (percent)	6.4	4.7	4.3	6.0	-1.4	3.3	5.5
Change in Colombo CPI (percent, end of period)	10.7	3.7	4.0	10.8	10.8	11.3	7.0
National savings (percent of GDP)	21.5	23.4	23.5	21.5	19.5	20.3	20.4
Gross investment (percent of GDP)	24.4	25.1	27.3	28.0	22.0	22.3	24.2
Fiscal position							
Revenue (percent of GDP)	18.5	17.2	17.7	16.8	16.5	16.5	16.9
Expenditure (percent of GDP)	26.4	26.3	25.2	26.7	27.4	25.4	24.4
Overall deficit (percent of GDP) 1/	-7.9	-9.2	-7.5	-9.9	-10.9	-8.9	-7.5
Total government debt (percent of GDP)	85.8	90.8	95.1	96.8	103.6	103.8	99.6
External economy							
Exports	4,639	4,798	4,610	5,522	4,817	4,622	5,138
Imports	5,864	5,889	5,979	7,320	5,974	6,013	6,893
Current account balance (excl. official transfers)	-437	-278	-586	-1,090	-294	-321	-672
(in percent of GDP)	-2.9	-1.8	-3.7	-6.6	-1.9	-1.9	-3.8
Capital and financial account balance	601	414	372	445	536	481	611
Of which, direct investment 2/	430	193	177	176	172	233	350
Gross official reserves (less ACU balances)	1,922	1,910	1,530	911	1,181	1,566	1,924
(in months of prospective imports)	3.5	3.4	2.2	1.5	2.0	2.4	2.7
Change in the real effective exchange rate (percent, end of period) 3/	13.4	-10.5	-1.2	0.6	-0.1	0.0	...
External debt (in percent of GDP)	62.3	61.0	63.2	60.8	62.9	59.6	58.7
Debt service (in percent of goods and services exports)	13.3	13.3	15.2	14.7	15.5	13.5	11.7
Financial variables							
Broad money growth (annual percent change) 4/	15.6	13.2	13.4	12.9	13.6	13.4	13.5
Of which, net credit to government	-4.0	42.8	45.3	56.8	36.8	-4.2	-9.0
Of which, credit to the private sector	14.5	12.1	10.5	11.8	8.9	12.0	17.1
Interest rate (percent, end of period) 5/	10.2	12.0	11.8	18.0	12.9	9.9	...

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

1/ Excluding grants and privatization receipts.

2/ Includes privatization receipts.

3/ (-) = depreciation.

4/ Including foreign currency banking units.

5/ Three-month treasury bill rate.

Statement by the IMF Staff Representative
April 18, 2003

1. **This statement provides an update on recent economic and political developments and policies since the staff report was issued on April 2, 2003**. The information contained in this statement does not alter the analysis or the appraisal in the staff report.

2. **The authorities have completed the program's prior action—bringing to a point of sale the state's shares in Sri Lanka Insurance Corporation (SLIC)**. On March 28, the government submitted to the cabinet the final sales and purchase agreement with the chosen buyer—a consortium led by the Distilleries Group—for 90 percent shares in SLIC. Subsequently, on April 3 the cabinet approved the sale. The entire privatization receipts are expected by early–May.

3. **On the economic front, activity has continued to recover, while inflation has moderated**. Provisional data for Q4 2002 shows that the economy grew by 6¼ percent (y/y), reflecting higher export volume and increased agricultural production, bringing growth for the year to 4 percent (higher than the previous estimate of 3⅓ percent). After rising in December–January, inflation declined to below 8 percent in March, reflecting increased agricultural supplies, on track to meet the end–year target of 7 percent.

4. **The trade deficit widened slightly in January—reflecting, in part, the impact of the Iraq war—but the overall external position remained stable**. In January, exports grew by 11 percent (y/y), but were more than offset by increased imports. Tea exports, however, fell by 10 percent (y/y) in value, due to lower prices and weak demand from Iraq—a major importer of Sri Lankan tea. Tourist arrivals appear to have moderated recently, due to the Iraq war and, at least in part, the SARS outbreak. Somewhat surprisingly, continued inflow of remittances and donor funds helped net international reserves to rise to $1.35 billion by end–March—$65 million higher than the program's indicative target. The rupee has remained stable in real effective terms.

5. **The fiscal position appears broadly on track**. Preliminary data indicate net domestic financing (NDF) for February at Rs 19 ½ billion, in line with the Rs 29 billion end–March target. Revenue for January–February has performed well, reflecting increased economic activity and the extension of the VAT to financial services. Public corporations' bank debt declined about Rs 1 billion in January.

6. **Monetary aggregates have evolved broadly as projected**—the end–March 2003 reserve money target was met, and net domestic assets (NDA) of the CBSL and broad money growth are also in line with program expectations.

7. **The Bank's Executive Board approved the Country Assistance Strategy for Sri Lanka and endorsed the joint Bank–Fund Staff Assessment of the PRSP on April 1**. Bank Directors commended the solid progress made on the peace front and considered the PRSP to be a strong vision for regaining the reform momentum and fighting poverty.

8. **Peace talks between the government and the Liberation Tigers of Tamil Eelam (LTTE) continue to progress.** Despite skirmishes, both sides have reiterated their commitment to the peace process during the recent talks in Hakone, Japan. Further rounds of talks are planned for May/June—fiscal federalism, its constitutional implications, and human rights issues are expected to dominate the agenda. Consistent with the LTTE's intentions to participate in mainstream politics, the government and the LTTE have also announced that local government elections will be held in the North and East this year.

9. **The authorities recently completed a needs assessment for the conflict–torn North and the East, with help from the AsDB, World Bank and the United Nations.** The United States Department of State hosted a seminar in Washington on April 14, attended by management, to discuss the progress on the peace talks and the overall development financing needs, including for the North and East. The preliminary financial requirement for post-conflict reconstruction totals about 7 percent of GDP during 2003-08. The program already includes ½ percent of GDP of such expenditure annually, and foreshadowed that additional spending could be needed. In light of the debt burden, the additional spending would need to be financed largely by grants and highly concessional donor funds. The macroeconomic framework will need to be revisited to reflect implementation capacity and the financing details of post-conflict spending after the donors meeting in Tokyo in June.