March 2004
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Sri Lanka: 2003 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Sri Lanka, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 19, 2004,** 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 February 19, 2004.** 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 **March 5, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 5, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

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

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SRI LANKA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Sri Lanka

Approved by Wanda Tseng and Matthew Fisher
(In consultation with other departments)

February 19, 2004

- Staff missions visited Colombo during August 14-27, 2003, October 17-27, 2003, and January 12–19, 2004 to conduct the 2003 Article IV consultation discussions and the first review under the PRGF and Extended Arrangements. The teams comprised Messrs. Aziz (Head), Leigh and Fernandez, Mss. Fujita and Richter Hume (all APD), Mr. Balakrishnan and Ms. Corbacho (FAD), Ms. Koliadina (PDR), Mr. Worrell (MFD), and Ms. Cormier (administrative assistant, APD). The missions were assisted by Mr. Carter (Senior Resident Representative). Ms. Tseng joined the January 2004 mission. Mr. Jayatissa (Alternate Executive Director) participated in the discussions.
- At the conclusion of the 2002 Article IV consultation and the completion of the Stand-By Arrangement in September 2002, Directors noted that Sri Lanka was at a critical juncture. Despite progress in many areas, the macroeconomic situation remained fragile, and achieving sustainable high growth required major reforms and progress on the peace front.
- Since then, the Executive Board approved in April 2003 three-year PRGF and Extended Arrangements for SDR 413.4 million (100 percent of quota) of which SDR 59 million have been disbursed. In doing so, Directors commended the progress on the peace front and economic reforms, and endorsed the poverty reduction strategy paper (PRSP) as an adequate framework to raise growth and reduce poverty.
- Sri Lanka accepted the obligations of Article VIII, Sections 2, 3, and 4 in March 1994, and maintains an exchange system free of restrictions in making payments and transfers for current international transactions.
- The authorities have communicated that, as before, they will publish the staff report and the selected issues paper.

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EXECUTIVE SUMMARY

- **Since the last Article IV consultation, the Sri Lankan economy has advanced on several fronts:** the ceasefire has held; the economic recovery has taken firmer roots; external vulnerability has declined; and reforms in several areas have progressed. However, the effects of the two-decade long civil conflict are yet to be overcome and many challenges remain. Against this background, the 2003 Article IV consultation discussions focused on how to turn the ongoing recovery into a sustained high growth, raise employment, and alleviate poverty.

- **The economic recovery that began in 2002 is becoming broad based.** In 2003, exports and, during the second half of the year, private investment joined private consumption and tourism as drivers of growth. GDP growth is estimated to have reached 5½ percent in 2003, and is projected at 6 percent in 2004. Disinflation has been faster than expected, though the ongoing drought may exert some price pressure in the near term.

- **The external position has continued to strengthen.** Strong exports, remittances, and tourism receipts helped gross reserves rise by $0.5 billion through December 2003 to over $2 billion (about 2¾ months of imports and 100 percent of short-term debt).

- **Fiscal consolidation has continued, but slower than envisaged.** In 2002, the fiscal deficit declined by about 2 percentage points of GDP, to 9 percent of GDP. Last year, the fiscal deficit is estimated to have narrowed to 8 percent of GDP (½ percentage point above the budget target), reflecting severe revenue shortfalls. The 2004 budget aims at a deficit of 6¾ percent of GDP, but staff estimates that the deficit could reach 7¼ percent of GDP, due to a slower turnaround in revenue and added drought-related expenses. Monetary policy has steered a careful course, balancing support to the recovery and restraint on inflation.

- **While progress has been made in some areas of structural reform, other key reforms have been delayed.** The privatization program has advanced with the divestment of several major public corporations. The restructuring of People's Bank, however, has been delayed. Also, parliamentary presentation of legislation to create a Revenue Authority, a key step in the government's strategy to strengthen revenue collection, has been postponed until after the April elections.

- **Over the last few months, the political situation has become increasingly unsettled, constraining the government's ability to implement critical reforms.** In November, the President dismissed the ministers of defense, interior, and media, citing their mishandling of the peace process. Without control over these ministries, the Prime Minister has expressed difficulties in leading peace negotiations with the Liberation Tigers of Tamil Eelam (LTTE) and the peace talks have remain stalled. Taking advantage over the political impasse interest groups have intensified resistance to the government's reform agenda. In early February, the President dissolved Parliament calling for general elections on April 2. Under these political conditions, the government has found it difficult to push ahead with critical reforms, particularly in tax administration, as anticipated under the PRGF and Extended Arrangements. Accordingly, the first reviews of the PRGF and Extended Arrangements have been temporarily postponed.

I. Introduction and Background

Since the last Article IV consultation, the Sri Lankan economy has advanced on several fronts: the peace process has moved ahead albeit with interruptions; the economic recovery has taken firmer roots; external vulnerability has declined; and reforms in several areas have progressed. However, the economic effects of the two-decade long civil conflict are yet to be overcome, and many challenges remain. In recent months, heightened political uncertainty has constrained the government's ability to push ahead with reforms.

1. **A ceasefire between the government and the LTTE has held since February 2002.** After an initial flurry of peace talks—facilitated by Norway—the LTTE broke off negotiations in late April 2003 alleging insufficient progress on the withdrawal of government troops from agreed areas and the lack of spending for development and social needs in the North and East (the conflict-affected areas). In October 2003, the LTTE presented its plans for an interim administration. The resumption of peace talks now awaits a response from the government to these proposals.

2. **During the past two years, the government initiated wide-ranging reforms to reinvigorate an economy ravaged by 20 years of civil conflict.** These reforms, together with the government's medium-term economic strategy outlined in its poverty reduction strategy paper (*Regaining Sri Lanka*), the rehabilitation and reconstruction plans identified in the Needs Assessment for the North and East, and the peace process, have received strong support from donors. Including the pledges made in the Tokyo conference last June, donors have committed $4½ billion in aid over the medium term (25 percent of 2003 GDP), with Japan ($1 billion) and multilaterals—AsDB ($1 billion), the World Bank ($1 billion), and the IMF ($560 million)—providing the bulk of the funds. Much remains to be done to reverse the economic toll of the conflict, which, in addition to huge loss of human life, disrupted inter-regional commerce, deepened poverty, deteriorated infrastructure, and weakened public finances.

3. **Over the past few years, the Fund has been closely engaged in Sri Lanka under the Stand-By, PRGF, and Extended Arrangements, and through the Article IV consultations.** Fund advice on several macroeconomic and structural reforms—floating the exchange rate, introducing a VAT system, amending banking laws, and restructuring financial markets—played a key role in policy development, although the exact shape of these reforms was determined by the authorities to reflect their social and political concerns (Annex I). In concluding the last Article IV consultation held in September 2002, Directors highlighted the need for continued fiscal consolidation, restructuring public enterprises, reforming the financial sector, improving labor market flexibility, and better targeting social safety programs. These were also the priorities in *Regaining Sri Lanka*, and formed the core of the program under the PRGF and Extended Arrangements, approved in April 2003. Some progress has been achieved on these fronts, but the agenda remains unfinished. At the time when the IMF arrangements were approved, the staff took stock of past reforms and assessed the impact of the civil conflict *(IMF Country Report No. 03/107)*.

II. Recent Developments

4. **In recent months, the already uneasy relationship between the President and the Prime Minister's government has become more strained.** On November 4, President Kumaratunga suspended Parliament for two weeks and took control of the ministries of defense, interior, and media, citing the government's poor handling of the peace process. This created a political impasse as the Prime Minister's government expressed difficulties in leading the peace talks without control over these ministries. In January, ahead of the provincial elections then scheduled for late April, the President's party (SLFP) and the Marxist party (JVP) formed an electoral alliance. Taking advantage of the unsettled political situation, interest groups stepped up resistance to the government's reform agenda. In early February, the President dissolved Parliament, calling for general elections on April 2. (The provincial council elections have been postponed.) These developments have markedly slowed the pace of reform implementation.

5. **Meanwhile, the economic recovery is becoming broad based.** In 2002, private consumption and tourism were the main engines of growth. In 2003, exports were an added force, and private investment picked in the second half of the year. GDP growth for 2003 is estimated to have risen to 5½ percent from 4 percent in 2002, as projected under the program supported by the PRGF and Extended Arrangements. Last year, disinflation was faster than projected, with average inflation (Colombo CPI) declining to 6⅓ percent from 9½ percent in 2002, due to good harvests and the appreciation of the rupee against the dollar. The appreciation was reversed in the last two months of the year reflecting the heightened political instability (Table 1 and Figure 1).

6. **The external position has continued to strengthen.** Improved exports and strong inflows of remittances and tourism receipts kept the current account deficit lower than expected, at an estimated 1 percent of GDP. Gross reserves rose by $500 million to $2 billion through end–December, covering 2¾ months of imports and 105 percent of short-term debt. News reports indicate that some foreign private investment may have been delayed due to the recent political uncertainty, although other projects have moved ahead.

7. **The financial sector performed well in 2003, but has reacted nervously to recent political developments.** Until November last year, the equity market had made significant gains, among the largest in Asian bourses, reflecting rising corporate profits. Since then, the market has weakened and become more volatile as political uncertainties increased. During 2003, bank profitability increased significantly (including in the state-owned banks), though nonperforming loans (NPLs) have remained high.

8. **The monetary program has remained on track.** Despite the political uncertainty, interest rates remain low, following their marked decline in 2003. The Central Bank of Sri Lanka (CBSL) cut repo rates by 275 basis points over the year, but there is still substantial liquidity in the banking sector. Broad money grew in line with expectations, with private sector credit picking up late in the year (Figure 2).

9. **However, the budget remained under pressure in 2003 and fiscal consolidation was slower than envisaged.** In 2002, the deficit was lowered by roughly 2 percentage points of GDP, to 9 percent of GDP. Last year, the deficit is estimated to have reached around 8 percent of GDP (about ½ percentage point above the budget target), reflecting revenue shortfalls of around 1¾ percent of GDP, higher post-conflict capital spending, and some additional restructuring costs. In its first mid-term budget review (mandated by the 2002 Fiscal Management (Responsibility) Act—FMRA), the government had acknowledged that fiscal performance was lagging, and initiated several administrative and tax policy measures to bring the deficit back on track. Unfortunately, some of the key tax measures could not be adopted due to the suspension of the Parliament in November. To limit the deficit, the government resorted to cutting nonpriority capital spending, while protecting PRSP-related projects. Lower-than-expected interest and pension payments also helped to contain expenditure.

10. **Since the last Article IV consultation, significant headway has been made on the structural reform agenda, particularly on the legislative front:**

- On public enterprise reform, the Electricity Reform bill was enacted in December 2002 to begin the unbundling of the state electricity company (CEB). The petroleum sector was opened to private participation with the entry of Indian Oil in the retail market. The government sold a 12 percent stake in Sri Lanka Telecom (SLT) in November 2002, and the telecommunications market has been liberalized. In 2003, the state-owned insurance company (SLIC) was privatized in April, and the sale of a 40 percent stake in the Cooperative Wholesale Establishment's retail network was concluded in November.

- Amendments to the labor laws streamlining the settlement of labor disputes, eliminating restrictions on overtime work by women, and increasing penalties for child labor were implemented in January 2004. Their implementation was delayed by 9 months to allow time to establish additional labor courts and tribunals, a mandatory compensation formula for laid-off workers, and an unemployment insurance scheme.

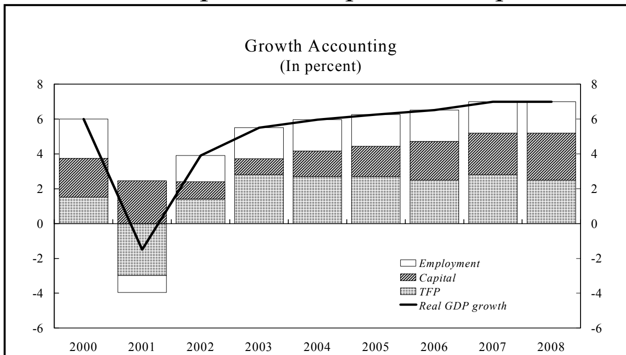
- To strengthen public finances, the FMRA was enacted in December 2002. The FMRA limits borrowing from the CBSL, sets medium-term fiscal deficit targets, and mandates "pre-election budget reports" (before parliamentary elections) to discourage election handouts. The Board of Investment's (BOI) power to grant tax holidays and incentives outside the regular tax code was repealed by Parliament in December 2002 (although the repeal still needs to be enacted). To improve tax administration, a draft Revenue Authority bill—aimed at unifying the Inland Revenue, Customs, and Excise departments—and its implementation plan has been presented to Cabinet.[1]

[1] Presentation of this bill to Parliament, a structural performance criterion under the program for June 2003, has been further delayed due to the political situation.

- In the financial sector, amendments to the Banking Act to enhance the CBSL's supervisory powers and facilitate the entry, exit, and merger of banks, and a Foreign Exchange Management bill (FEM) that relaxes some longer-term capital account restrictions, have been tabled in Parliament. The CBSL has introduced a scripless securities system and a real-time gross settlement system. An Asset Management Company (AMC) bill to aid banks in restructuring their balance sheets has been approved by Cabinet.

III. Outlook and Risks

11. **The authorities expect growth of around 6 percent in 2004.** Increased investment, higher tourism and exports, along with domestic private consumption are likely to be the main drivers of growth. While confident that the growth target could be met, they concurred with the staff that this would require an early resolution of the political impasse. After the rapid decline in 2003, inflation should stabilize at around 6 percent. Imports are expected to rise as investment strengthens, but healthy export growth, tourism, and remittances should contain the current account deficit to 2¼ percent of GDP. Gross reserves should reach \$2¼ billion (covering 3 months of imports and 120 percent of short-term debt).



Source: IMF staff estimates.

12. **Lasting peace and a deepening of reforms are vital to unlock Sri Lanka's medium-term growth potential.** Growth over the medium term is projected to average 6½ percent, predicated on macroeconomic stability. This will be underpinned by continued fiscal consolidation; a rebound in public and private investment, particularly in infrastructure, agro-industries, tourism, and commercial fishing (which were adversely affected by the civil conflict); and a deepening of structural reforms, especially in labor and financial markets, which should contribute to higher productivity. Higher tourism receipts and remittances, as well as sizeable donor commitments made at the Tokyo conference have improved the balance of payments outlook since the last staff report *(IMF Country Report No. 03/107)*. Despite large reconstruction- and investment-related imports, official reserves should rise to \$3 billion (covering 3½ months of imports) by 2006.

13. **Risks to these projections have increased in recent months.** On the upside, a stronger global outlook should assist in strengthening exports, tourism, and remittances. If power and infrastructure bottlenecks are eased, tourism, shipping, and telecommunications could expand faster than anticipated. On the downside, while occasional setbacks are to be expected, a prolonged impasse in the peace talks could hold back private investment. Ahead of the general elections, the reform momentum has already slowed down with several critical legislative initiatives awaiting the reconvening of Parliament to be enacted. If the political uncertainty is not resolved after the elections and the reform agenda is not brought back on track, both donor-supported public and private investment will be seriously delayed. The

ongoing drought could adversely affect agricultural output and power generation. A combination of these factors could depress growth, raise the fiscal deficit and domestic financing, and keep reserves at a vulnerable level if donor financing is also reduced.[2] Thus, in line with the Joint Staff Assessment *(IMF Country Report No. 03/106)*, staff encouraged the government to develop an alternative macroeconomic scenario and discuss plans to mitigate these risks (including from exogenous factors such as the removal of textile quotas in 2005) when the PRSP is updated in 2004.

IV. Policy Discussions

14. **Against the backdrop of a challenging economic and political terrain, the discussions focused on near- and medium-term policy responses and the reform agenda.** For the near term, the discussions concentrated on the appropriate response to the revenue shortfall and the conduct of monetary policy in light of the political uncertainties. For the medium term, the discussions centered around the likely drivers of growth, the structural reforms needed to foster them, and policy challenges posed by the expected large aid inflows (Box 1).

A. Fiscal Policy

15. **The authorities agreed with staff that notwithstanding its immediate causes, the revenue shortfall was symptomatic of chronic weaknesses in Sri Lanka's tax system.** Among the chief causes of the revenue shortfall last year were poor compliance under the dual-band VAT system and a slowdown in collection efforts by tax officers resisting the creation of a Revenue Authority. In the event, tax revenue has fallen by about 4 percentage points of GDP since the mid-1990s, and income tax yields are among the lowest in the region. While lower import tariffs were one of the major factors behind this decline, the import tax base was also narrowed with exemptions and preferential rates. Revenue from direct taxes was also depressed by a proliferation of exemptions and preferential treatment. Indirect taxes carry much of the burden of raising revenue, but the two-band VAT regime (10 percent and 20 percent) coupled with a vast array of exemptions, suffered from significant

Sri Lanka: Corporate and Personal Income Tax Revenues, 2001

(In percent of GDP)

	Corporate	Personal
Sri Lanka	1.3	0.9
Malaysia	6.2	2.8
Singapore	6.2	2.5
Vietnam	5.6	0.4
Thailand	2.9	1.9
Philippines	2.7	2.2
Indonesia	1.6	5.0
India	1.6	1.4

Source: IMF, *Government Finance Statistics* .

[2] A detailed discussion of the sources of growth and the associated risks, together with an alternative scenario of lower growth, was presented in Box 3 of the last staff report (EBS/03/40). While recent developments highlight domestic political risks, the alternative scenario presented there remains valid.

Box 1. Sri Lanka: The Challenges of Large Aid Inflows

Over the medium term, Sri Lanka expects to receive significant foreign aid, which could present an added challenge to macroeconomic policy management.

- **Monetary policy.** To the extent that foreign aid is not used for imports, and is converted into domestic currency, the money supply will increase, exerting inflationary pressure and forcing the central bank to sterilize the inflows. Such sterilization operations will need to be coordinated with fiscal policy, especially regarding the timing of the aid flows, and their likely impact on the monetary base.
- **Fiscal policy.** The volatile nature of aid flows, whose timing can be difficult to predict, can complicate the planning of government expenditure. Thus, spending plans should be based on realistic projections of the aid that is likely to materialize. In addition, given Sri Lanka's high public debt, spending plans will need to remain flexible, so that shortfalls in aid flows do not necessitate higher public borrowing.

Although the significant inflow of foreign aid could raise concerns of a "Dutch disease" impact on the Sri Lankan economy, the risks of such an impact are relatively small.

- **The volume of aid flows should be manageable from a domestic liquidity standpoint.** During 2004-2006, net external financing and grants are expected to average about 3 percent of GDP a year, which is modest compared to receipts by other developing countries and only about 1½ percent of GDP above recent experience in Sri Lanka. Moreover, constraints on project implementation capacity could lengthen the aid disbursement period. In addition, significant external leakage of the aid flows (e.g., on imports needed for investment projects) and sterilization of the inflows by the monetary authorities should minimize their impact on relative prices and the real exchange rate.
- **Most aid will be used to finance projects that should boost productivity across all sectors of the economy, including the export sector.** The PRSP includes projects in agriculture, roads, ports, and energy. However, aid expenditure on housing projects and civil service reform could result in some price pressure on the nontradables sector. Similarly, although the majority of aid flows to the North and East is destined for infrastructure projects, a significant portion is humanitarian aid (to support basic consumption needs), which could therefore also have a Dutch disease effect.

leakages. The continued revenue shortfalls also reflect deep-rooted problems in tax administration, particularly its weak management and poor governance. These problems have prevented the tax agencies from making a successful transition from a tax regime based on high import tariffs and turnover levies to the broad-based income tax and VAT regime introduced in recent years.

16. **In response to the revenue shortfall, the authorities initiated a number of policy and administrative measures in 2003.** Administrative measures undertaken included restarting the audit program after the tax amnesty ended in August and increasing the number of officers in the large taxpayer unit (LTU). Tax policy measures included extending the VAT to nonbank financial services; raising excise taxes and import duties on select items; and increasing the corporate tax rate on foreign banking units to that on domestic banking operations. However, several of the policy measures came into operation only in 2004 (although they have been effective since the second half of 2003), as the suspension of Parliament in November prevented these measures from being enacted.

17. **The 2004 budget takes further steps to strengthen the tax regime (Box 2).** Among the main measures are: unifying the two-band VAT regime (10 and 20 percent) at 15 percent and, beginning in July 2004, extending it to the wholesale and retail sectors;[3] introducing a minimum corporate tax to expand this tax base; curtailing tax incentives; and raising railway and postal charges. In addition, the import surcharge was halved to 10 percent and the number of custom duty bands reduced to 5 from 6, but a simultaneous adjustment of rates and a reduction of exemptions has kept these changes revenue neutral.[4] The authorities estimate that the potential additional revenue from these and the delayed measures undertaken after last year's mid-term budget review could amount to 1½ percent of GDP. However, they have counted on only 1 percent of GDP of the increased revenue towards this year's budget, in light of weak tax administration and possible disruptions in collection in the initial stages of establishing the Revenue Authority.

18. **Based on these revenue measures, the 2004 budget targets a deficit of 6¾ percent of GDP.** Total revenue is estimated to rise by 1 percent of GDP to 16.4 percent of GDP, while overall spending is budgeted to fall by 0.4 percent of GDP, reflecting lower interest payments and current transfers. Priority spending, however, will rise: post-conflict spending is budgeted at close to 1 percent of GDP and capital spending is projected to increase by ½ percent of GDP, balancing reconstruction expenditure across the country.

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[3] The extension was originally planned for January 2004, but additional time is needed to design a revenue sharing arrangement with provincial councils (who currently collect turnover tax) and expand the capacity of the tax authorities to handle the increase in tax files.

[4] Staff noted that to enhance external openness, the import surcharge should be eliminated in 2005 as planned, without offsetting changes in the tariff structure.

Box 2. Sri Lanka: 2004 Budget

The 2004 draft budget continues the process of fiscal consolidation and debt reduction started in 2002. It targets a deficit of 6.8 percent of GDP, 1.3 percentage point lower than the estimated 2003 outcome, and 4 percentage points lower than the 10.8 percent of GDP deficit in 2001. Public debt is expected to decline by over 5 percentage points, reaching 95 percent of GDP at end-2004. However, staff estimates that tax revenue could fall short of target by 0.6 percent of GDP, given the continued weakness in collection. Additional spending of 0.2 percent of GDP would be required to finance drought relief. To limit the impact of a higher deficit on domestic interest rates and remain close to the debt reduction targets set in the FMRA, the overall deficit needs to be contained to 7.2 percent of GDP through expenditures cuts of 0.4 percent of GDP.

The budget proposes several tax policy measures:

- The VAT will be unified at a 15 percent rate, with exemptions reduced to basic food and socially critical items. The retail and wholesale sectors will be included in July. The unification of the VAT rate is expected to be revenue neutral in the short term, but simplifies the tax system considerably, with potentially positive effects on collection. However, the authorities need to strengthen the audit program to address the recent problems with refunds (in particular, VAT refunds should be audited before funds are released). The unified rate of 15 percent balances the authorities' concerns over raising the price of sensitive items with increasing tax efficiency and safeguarding revenue. Staff estimates indicate that the overall effect on the household expenditure of the poor is likely to be moderate.
- The import surcharge will be cut from 20 percent to 10 percent, and the tariff structure will be simplified to a 5-band system, while moving towards the goal of eliminating import surcharges in 2005, and establishing a three-band tariff regime in 2006. These measures could yield about 0.1 percent of GDP.
- A service charge of 1 percent on assets or turnover will be imposed on all companies over two years old, to be offset against income tax obligations. This tax will be phased out as the corporate tax regime is simplified to a single-rate system, and tax administration is strengthened. Companies under the BOI Act will be included in the tax net in 2005, after existing contracts are modified. The revenue gain could be about 0.1 percent of GDP.
- Other corporate tax measures include: capping carry-forward losses at 35 percent of taxable income; taxing partnership income at 10 percent; and withholding interest income on the basis of consolidated accounts. These should yield around 0.1 percent of GDP.
- Other revenue measures include: increasing excises and duties for certain items; raising railway and postal fares; charging a fee on cell phone bills; and streamlining exemptions. These are expected to yield 0.2 percent of GDP.

The budget includes higher post-conflict spending, a wage increase for public employees, a targeted early retirement program, and higher capital expenditures.

- Post-conflict spending will rise to nearly 1 percent of GDP, from 0.7 percent of GDP in 2003.
- Wages and pensions will be increased, keeping their share with respect to GDP roughly constant over 2003 levels.
- Public employment is targeted to decline by 10 percent via a targeted early retirement scheme, which will cost the budget 0.4 percent of GDP.
- Capital expenditures will rise by about 0.5 percent of GDP relative to such spending in 2003 .
- Another 0.2 percent of GDP will be spent on seed money for the unemployment insurance scheme (funded from inactive accounts of the Employee's Provident Fund), support to selected industries, and fertilizer subsidies.

19. **The authorities recognized that attaining these targets required strong collection efforts and full implementation of the proposed tax measures.** The staff pointed out that at least since 2000, actual revenue had fallen short of budget targets by around 1½ percent of GDP each year, largely due to continued deterioration in tax administration. Reversing this trend required fundamental reforms in tax administration, particularly in its leadership, staffing, organization, and incentives structure. The authorities noted that they were planning to introduce several organizational changes over the next few months, aided by technical assistance from the IMF. However, the Revenue Authority was envisaged to provide the legal framework and political space to introduce professional leadership in the tax departments that would oversee the more fundamental reforms in resource allocation and incentives. The authorities argued that the present political impasse precluded presenting a strong Revenue Authority bill to Parliament. Rather than opt for a weak bill that would appease the interest groups who opposed these reforms, they preferred to wait until the political climate was more conducive to moving ahead with a strong and effective Revenue Authority, after the April elections.

20. **The staff noted that there were considerable risks to budget implementation.** The proposed tax policy measures hinge on improvements in collection to yield significant results, and cannot be enacted until the Parliament is reconvened (though they are effective from January). Measures that rely on broadening the tax base, such as the minimum corporate tax, typically take time to yield results. With the Revenue Authority bill being postponed, and in the absence of an alternative comprehensive strategy, it will be difficult to implement the needed fundamental reforms in administration. The tax administrative changes that are being undertaken, such as restarting the audit program, while necessary, will take time to be fully effective. Another risk arises from pre-election spending pressures. In January, the government reduced import duties on several food items in response to public concern about a rise in the cost of living.

21. **Thus, it is likely that tax revenue could fall short of target by ¾ percent of GDP.** In addition, the authorities expected that extra spending of ¼ percent of GDP would be required to finance drought relief (including emergency power supply). Combined, these would increase the budget deficit by 1 percent of GDP above the budget target. Such an outcome would put significant pressure on domestic interest rates (especially if a delay in donor funds increases the domestic financing requirement), damage investor confidence, and undermine the ongoing recovery. To limit domestic financing close to last year's level and remain on track to reach the debt reduction targets set in the FMRA, the staff noted that the overall deficit should be contained to at most 7¼ percent of GDP—½ percent of GDP higher than budgeted. This would require expenditure to be cut by ½ percent of GDP. The authorities took note of staff's concerns, and argued that limiting domestically financed capital spending to only priority projects (those that are ongoing and those that are identified in the PRSP) could provide the spending restraint needed to achieve the deficit target under such circumstances. To guide fiscal policy in the coming months and ensure that remedial measures are taken early, monthly and quarterly targets for tax revenue have been set. If revenue fell below these targets, the authorities assured the staff that contingency measures would be triggered, which could include increases in excises and custom duties, and reductions in tax

exemptions.[5] If these failed to generate sufficient revenue, the staff advised that nonpriority capital expenditures would need to be cut further.

22. **The authorities' medium-term fiscal priorities are to enhance sustainability, while providing adequate resources for post-conflict and reconstruction needs.** The debt-to-GDP ratio is expected to fall to 95 percent in 2004 from 101 percent in 2003. Although debt dynamics will remain on a downward trend, the primary balance in 2005 and 2006 needs to be reduced by about ½ percent of GDP per year more than projected under current policies to reach the PRSP and FMRA target of a debt-to-GDP ratio of 85 percent by 2006. Stress tests indicate that the debt dynamics, while relatively robust to most shocks, turn unstable if policies return to those of the late 1990s (Annex II). Tax policy reforms focus on moving toward a single rate corporate tax regime, further simplifying the tariff structure, and rationalizing tax incentives. The authorities are working on integrating the post-conflict spending outlined in the Needs Assessment, the funds committed by donors in the June donor conference, and the capital projects identified in the PRSP into a consistent medium-term budget framework (MTBF). Aided by the World Bank, sectoral policy papers are being prepared, as part of the larger MTBF exercise, to serve as inputs in preparing budget allocations starting with the 2005 cycle. A new Aid and Development Agency is being planned to streamline selection and improve implementation of donor-financed projects. However, legislation to establish the agency remains pending. A program to restructure domestic debt, including by increasing the term structure and converting old rupee loans into marketable bonds, is underway.[6] The public debt management office is being reformed to strengthen its technical capacity, with assistance from the U.S. Treasury.

B. Monetary and Exchange Rate Policies

23. **The mission considered the monetary policy stance of balancing support to the economic recovery with restraint on inflation appropriate.** During 2003, the CBSL took advantage of higher-than-expected foreign exchange inflows to build up official reserves, while keeping to the programmed reserve money path through sterilization, using government and CBSL securities. The mission agreed with the authorities that the cuts in policy rates had been cautious and broadly in line with the pace of disinflation, with real interest rates remaining low but positive. Staff also welcomed the regular public announcements on monetary policy that began in 2003, which have greatly increased the transparency of the decision-making process.

24. **The authorities noted that monetary policy would need to chart a careful course in the coming months.** In particular, if political uncertainty deepened and fiscal pressures rose, the monetary authorities would need to tighten monetary policy to contain inflation and maintain

[5] The staff strongly advised that changes in custom duties should be undertaken in the context of the authorities' long-term goal of establishing a single-rate duty regime, rather than to meet short-term revenue needs.

[6] The composition of public debt was discussed in detail in Annex 1 of the IMF Country Report No. 03/107.

investor confidence. They stressed that exchange rate interventions would remain confined to smoothing short-term volatility.

25. **The CBSL stressed the need to improve the monetary policy transmission mechanism.** Open market operations, which began in March 2003, have proceeded smoothly. To improve liquidity management the CBSL intends to continue expanding its instrument mix to include longer-term repos, secondary market auctions, and direct sales, which should help deepen the capital market. However, the development of the credit channel of monetary transmission has been slowed by banking sector weaknesses, notably the high level of NPLs and poor risk management.[7]

C. Structural Reforms

26. **Turning the ongoing recovery into sustained high growth to reduce poverty and unemployment is the main challenge facing the government.** If lasting peace was achieved, the business community saw significant opportunities in new outward-oriented services—tourism, communications, transshipment, and financial activities—and agro-industries, building on Sri Lanka's traditional strength of external openness. For such a transformation to take place, they noted that business costs, which remain high by regional standards, needed to be lowered through provision of reliable and affordable electricity, better infrastructure, predictable labor market conditions, deeper financial markets, and a better skilled labor force. The authorities also see these as key requirements for growth, and therefore focus on reconstructing the dilapidated infrastructure; reducing state dominance in the economy; restructuring the power sector; strengthening financial markets; enhancing labor market flexibility; and establishing a rationalized and transparent trade

Sri Lanka: Comparative Indicators of Doing Business, 2002

	Sri Lanka	India	Bangladesh	Pakistan	Thailand	Malaysia	Indonesia	Singapore
Economy characteristics indices								
GNI per capita (in U.S. dollar)	840	480	360	410	1,980	3,540	710	20,690
Informal economy (in percent of GNI)	45	23	36	37	53	31	19	13
Infrastructure indices								
Per capita electricity consumption (kwh)	244	384	81	337	1,345	2,554	320	...
Electricity charge for business purpose (in U.S. dollar)								
Base charge per month	0.31-8.30	4.2	0.0	0.0	5.1	4.6	2.7	5.1
Charge per kwh	0.08	0.08	0.02-0.13	0.09	0.04	0.05	0.04	0.07
Paved road ratio (in percent of all roads)	23	46	10	43	98	76	46	100
Credit market indices								
Public Credit Registry	No	No	Yes	Yes	No	Yes	Yes	No
Public Credit Bureau	Yes	No	No	Yes	Yes	Yes	No	Yes
Public Credit Bureau coverage (per 1000 capita)	8	...	...	...	97	461	...	512
Creditor Rights Index 1/	2	3	2	2	3	2	2	3
Private credit (in percent of GDP)	29	27	24	26	96	100	29	110
Five bank concentration ratio (in percent)	79	43	51	60	74	55	85	60
Labor market and contract enforcement indices								
Hiring index 2/	33	22	33	48	60	33	74	33
Conditions of employment index 2/	55	66	85	71	65	26	52	23
Firing index 2/	42	19	38	18	43	9	43	11
Duration to resolve a dispute (days)	440	106	270	365	210	270	225	50
Procedural complexity index 3/	59	50	51	54	48	47	56	54

Sources: World Bank, JETRO-FILE, ODA Loan Assistance Strategy for Sri Lanka (JBIC); and International Road Federation, *World Road Statistics.*

1/ Scale 0 to 4, with 0 indicating weak creditor rights.
2/ Scored between 0 and 100, with 100 representing the highest level of regulation.
3/ Constructed by averaging the six sub-indices including indices for the level of legal justification, the intervention of other types of adjudicators, control of superior review. It varies between 0 and 100, with higher values indicating more complexity.

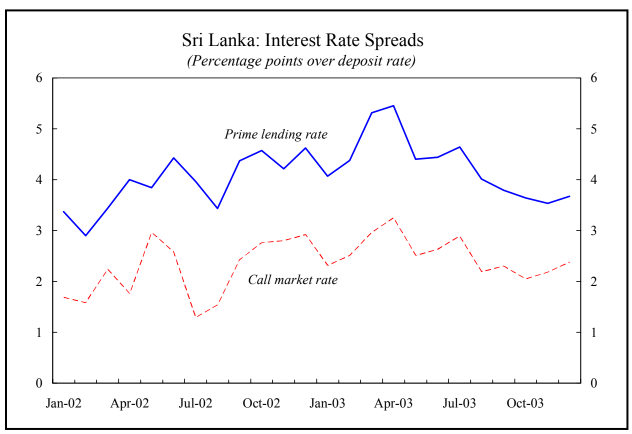
[7] Chapter I of the selected issues paper analyzes the monetary transmission mechanism.

regime. Over the past 18 months, substantial progress has taken place in advancing the reform agenda, particularly on the legislative side. However, implementation remains challenging.

27. **Reforms in public corporations have advanced, although the pace has been slow in some cases.** The government has followed a two-pronged strategy to reform public corporations: divesting or closing down some of the enterprises, while restructuring the remainder to improve their efficiency. The state petroleum company (CPC) has improved its financial position, and negotiations to allow a third party in the retail sector are scheduled for completion in early 2004. The restructuring of the electricity board (CEB), aided by Japan and the AsDB, has been delayed, with its unbundling, which would create a wholesale electricity market, now slated for completion in 2004. A lasting solution to CEB's problems—stemming the continued losses while lowering tariff charges—lies in securing a low cost source of energy. The authorities plan to commission three large generation plants over the next 10 years, but their locations are yet to be determined. Staff stressed the need for an early decision on this matter to avoid power shortages, which beleaguered the economy two years ago. The government also intends to divest a further stake in SLT during 2004, for which there is considerable market interest, and continue to sell its shares in various hotels.

28. **The authorities are modernizing the regulatory framework, which should support private sector growth.** Under the multisector regulatory bill enacted last year, three regulatory bodies covering utilities, transport, and communications have been set up, and another is planned for nonbank financial services. Because a lack of skilled personnel has been a major hurdle to staffing these regulatory bodies, the authorities are expanding training institutes in public-private partnerships.

29. **Poor lending practices and inefficiencies in the banking sector have kept interest rate spreads high and restrained private-sector credit growth.** Reflecting large legacy NPLs and high operating costs, interest margins in the two state banks—People's Bank and Bank of Ceylon, which account for almost half of total deposits—are high. Instead of competing down interest margins, foreign and private domestic banks (many of whom are also beset with high NPLs) have followed the spreads of the market leaders (Table 6). Large public-sector deficits in the past decade provided a ready source of demand for bank funds. However, over the past 18 months public sector borrowing has declined significantly, freeing up substantial liquidity. This has coincided with the CBSL stepping up supervision, raising capital requirements, and implementing other prudential norms.[8] Faced with this new environment, but lacking adequate risk management skills, banks have adopted a cautious



[8] The CBSL raised provisioning requirements and imposed "hair cuts" on the valuation of collateral. The suspension of Pramuka Bank (a small savings bank) has focused the banking sector's attention

(continued)

lending strategy—limiting corporate loans to blue-chip clients, expanding guardedly into highly collateralized consumer lending, and holding their excess liquidity with the CBSL.

30. **However, this situation is likely to change.** Banks have begun to put risk management systems in place and introduce new products and services. The CBSL noted that the continued decline in public borrowing would induce more aggressive competition and increased consolidation, thereby improving efficiency and reducing intermediation costs.[9] In addition, the planned new AMC law would help banks restructure their balance sheets, while the amendments to the Banking Act and envisaged new banking laws (to be introduced by end–2004) would facilitate orderly consolidation. In a recent ruling, the Supreme Court judged a provision of the 1990 Debt Recovery Act, which accords quasi-judicial power to commercial banks to seize assets of noncompliant debtors, to be unconstitutional. Although the Supreme Court has no power to annul the original legislation, the authorities are concerned that the ruling could undermine debt recovery by banks, and hence have a chilling effect on bank lending. The authorities are exploring options to ensure that this does not happen, including by legislative means.

31. **In updating the FSAP, staff pointed out that progress had been made in addressing the key policy priorities identified in 2002.** The capital position and management of private banks had improved, and steps were being taken to promote the healthy consolidation of the banking system. However, NPLs remain high and provisions are too low, especially in private domestic banks. The

Sri Lanka: Financial Soundness Indicators

(In percent)

	1999 Dec.	2000 Dec.	2001 Dec.	2002 Dec.	2003 Mar.	2003 Jun.	2003 Sep.
Nonperforming loans (in percent of total loans)	16.6	15.0	17.0	15.7	16.7	17.3	16.4
State-owned commercial banks	18.5	15.4	18.2	17.8	19.4	20.7	19.3
Domestic private banks	15.9	14.9	15.7	15.0	15.4	15.5	14.9
Foreign banks	10.7	12.7	13.2	8.7	7.8	10.3	10.2
Net nonperforming loans (net of provisions; in percent of total loans	10.7	10.2	10.1	8.5	9.1	9.9	8.9
State-owned commercial banks	9.8	8.3	8.3	6.3	7.4	8.4	6.5
Domestic private banks	13.6	13.5	13.3	11.5	11.7	12.1	11.5
Foreign banks	5.3	7.8	6.3	4.1	3.4	5.3	5.4
Capital adequacy ratio (total capital over risk-weighted assets)	10.6	8.3	7.8	8.1	7.5	7.4	7.9
State-owned commercial banks	8.8	4.3	0.1	1.7	1.2	0.9	1.1
Domestic private banks	12.2	11.4	10.4	10.8	11.6	11.4	12.2
Foreign banks	12.5	12.5	16.0	21.7	18.6	16.7	16.2
After-tax return on average equity	-10.1	13.1	15.5	22.0	23.8	…	…

Source: Central Bank of Sri Lanka.

on prudential requirements. Liquidation proceedings against the bank ran into court challenges, and the CBSL is now in advanced discussions with private investors who wish to recapitalize the bank.

[9] By international standards, Sri Lanka is considered "overbanked," with 39 banks and 25 finance companies vying for a private sector credit base of 30 percent of GDP.

overall NPL ratio for the banking system rose from 15¾ percent in December 2002, to 16½ percent in September 2003, reflecting primarily a tightening of loan classifications, which affected all bank types.[10] An update of stress tests indicate that the banks' balance sheets were sensitive to credit quality, but not to interest rate changes. While data were lacking to test for exchange rate sensitivity, existing limits on net open positions contain these risks. The CBSL is addressing the weaknesses identified in the FSAP, including by implementing risk-based supervision and upgrading risk management skills with technical support from donors, including the IMF.

32. **Restructuring of the state-owned banks is underway.** The external evaluation of the net worth of the insolvent People's Bank is expected to be completed by April, so as to launch its divestment by June. This process is now expected to be completed by end-October.[11] Bank of Ceylon, which is solvent, met most of its 2002 restructuring targets, including on loan recovery and return on assets, but bank branches and staffing need to be rationalized.

33. **Domestic capital markets need to be deepened.** The corporate bond market remains shallow, dominated by a few large firms. Market capitalization of listed companies is only about 15 percent of GDP, with few liquid shares and only a handful of new listings over the past few years. To deepen the corporate bond market, the authorities were issuing more long-term paper so as to establish a meaningful benchmark yield curve (in October the government issued its first 20-year bond). On the demand side, public pension funds are the largest institutional investors—the Employee Provident Fund's (EPF) assets (almost all in Sri Lankan Treasury securities) are around 18 percent of GDP. With the improvement in public finances and decline in interest rates, the EPF will be seeking alternative investments, particularly longer-term instruments, thereby deepening capital markets. Staff advised that the EPF's reference portfolio be broadened, perhaps even selectively easing restrictions on investing funds abroad, and its management outsourced. The authorities noted that, with the help of an investment advisor, a reform strategy was being elaborated, with the aim of starting implementation by late 2004.

34. **Both the authorities and the private sector believe that increased labor market flexibility is key to securing higher long-term growth.** The recent amendments to the labor laws have standardized the mandatory redundancy payments for private sector employees, which in the past had been subject to the discretion of the Ministry of Labor. The proposed compensation formula, which is based on past service and years remaining until retirement, provides 15-30 months of salary. In addition, the proposed unemployment benefit scheme, largely funded by employers, will provide up to nine months of salary. These schemes are generous by regional standards, but employers considered them a reasonable trade-off for greater predictability in the resolution of labor disputes. Staff expressed concern that while the reform represented a step in the

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[10] For state-owned and foreign banks, the increased NPL ratio reflects the reclassification of credit facilities to state-owned enterprises following the withdrawal of government guarantees or letters of comfort. For private domestic banks, the increase reflects classification changes for large loans that were recommended by external auditors.

[11] The NPLs of People's Bank are about ½ percent of GDP, net of provisions, half of which would be eligible for transfer to the future AMC.

right direction, the generosity of the proposed schemes could undermine competitiveness. The authorities took note of these concerns, but pointed out that the compensation package was lower than what was typically being offered under the previous system. Under renewed union pressure, the government has recently indicated that the limit on redundancy benefit to employees might be raised to 50 months.

35. **The government has unveiled a major civil service reform program in the 2004 budget.** The three-year program will award a 25 percent increase in the wage structure phased in over 2004-2006, conditional on a 30 percent reduction in employment. In 2004, the aim is to cut employment by 10 percent through a targeted retirement scheme that will require ⅓ percent of GDP in additional restructuring costs. Notwithstanding the wage increase, the wage and pension bill will remain constant in terms of GDP. Wages in subsequent years will be raised if the previous year's employment reduction target is met. While supporting the authorities' aim of streamlining civil service employment, the mission, along with the World Bank, expressed concern that the scheme could become too costly, both in terms of its expense as well as in terms of loss of required skills, if it is not specifically targeted towards those sections of the cadre where redundancy is largest. An official directive from the government to the line ministries on the details of the scheme, designed with the help of the World Bank, is expected to be circulated by end-February.

36. **To promote external trade, the government has launched several initiatives.** The free-trade agreement with India has benefited both sides and negotiations for arrangements with Egypt, Pakistan, and the United States are underway.[12] A comprehensive economic treaty has been signed with India. Recently, the European Union reduced its tariff for Sri Lankan exports by 5 percent. These measures should help cushion the adverse impact on the textile sector from the removal of export quotas in 2005. Staff analysis suggests that smaller exporters, who are the main quota users, either would close or be merged, but that larger firms, who contribute the bulk of exports, would be able to withstand the impact. An anti-dumping legislation is being drafted. Staff advised that the provisions of the bill restraining the use of anti-dumping measures needed strengthening. Looking forward, the authorities expected workers' remittances and tourism to remain important sources of foreign exchange earnings.[13]

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[12] Sri Lanka's trade regime is moderately restrictive, and frequent changes make it uncertain. Three new tariff bands were introduced in 2003 along with elimination of tariff exemptions on more than 1600 commodities, bringing the simple average overall tariff rate to 12 percent, compared with 11 percent in 2002. The 2004 budget revised the tariff structure further, keeping the average tariff rate broadly unchanged, but widening the dispersion in the rates. Most agricultural imports are subject to specific tariffs, which are frequently adjusted in line with domestic supply. Export licenses are limited to a small number of environmentally sensitive items.

[13] Chapter II of the selected issues paper focuses on the economic role played by workers' remittances and tourism receipts.

37. **Poverty in Sri Lanka is mainly rural or conflict related.** Preliminary results from the 2002 household survey indicate that income poverty may have declined in the latter half of the 1990s, and that it remains concentrated in rural and conflict-affected areas. Analyses suggest that, apart from the two-decade long conflict, inadequate growth in agriculture and lack of opportunity and isolation of the poor have been the main causes of poverty. These studies also point out that the incidence of poverty varies little across ethnic groups or gender. Departing from previous policies of redistributive transfers to alleviate poverty, *Regaining Sri Lanka* focuses on reducing poverty by increasing growth and removing barriers that prevent the poor in rural and conflict areas from benefiting from private-sector led development. This includes improving access of these communities to basic services (education and health) and markets (transport and telecommunications); reforming the land tenure system;[14] liberalizing land-use policy; and reducing the high protection of agricultural goods. A poverty and social impact analysis (PSIA) of the reforms in the PRSP has been initiated, with help from the World Bank and the U.K.'s Department for International Development (DFID). This could be used to adjust the reform agenda. Qualitative assessments indicate that labor and civil service reforms could have a negative impact on certain social groups.[15] Some social safety schemes are being designed to ameliorate these adverse effects (e.g., the early retirement

Sri Lanka: Key Social Indicators, 1980–2001

	1980	1985	1991	1996	2001	Low-Income 1/ 2/
Population						
Total population, midyear (in millions)	14.6	15.5	16.4	17.5	18.7	2,506
Growth rate (in percent annual average for period)	1.3	0.99	1.1	1.2	1.3	1.9
Urban population (in percent of population)	21.6	21.4	21.4	22.0	23.1	30.8
Poverty (in percent of population)						
National headcount index	...	...	20.0	25.0	...	...
Urban	...	...	15.0	15.0	...	...
Rural	...	...	22.0	27.0	...	...
Income						
GNI per capita (in U.S. dollars)	280	380	520	780	880	430
Income distribution						
Gini index (in percent of income)	...	...	...	34.4	...	...
Lowest quintile	...	...	...	8.0	...	...
Highest quintile	...	...	...	42.8	...	...
Net primary school enrollment rate (in percent of age group) 3/						
Total	103	103	107	109	...	...
Female	100	101	106	108	...	...
Ratio of girls to boys in primary and secondary education	...	99	99	99	...	...
Pupil-teacher ratio (primary)	...	...	31	28	...	...
Access to an improved water source (in percent of population)						
Total	...	...	68	n.a.	77	76
Urban	...	...	91	n.a.	98	90
Rural	...	...	62	n.a.	70	70
Immunization rate (in percent under 12 months)						
Measles	...	20	79	89	99	60
DPT	46	70	87	92	99	61
Life expectancy at birth (years)						
Total	68	69	70	71	73	59
Male	66	67	68	69	71	58
Female	70	71	73	74	76	60
Mortality (per 1,000 live births)	35.0	25.0	19	17.3	17.0	...
Physicians (per 1,000 people)	0.14	0.18	...	0.23	0.37	...

Source: *2002 World Development Indicators*, World Bank.

1/ Latest available single year data.
2/ Countries with 2001 gross national income (GNI) per capita of $745 or less.
3/ Net enrollment ratios exceeding 100 indicate discrepancies between the estimates of school-age population and reported enrollment data.

[14] Legal reforms to establish private ownership and clear property rights are being prepared with the help of the World Bank.

[15] Box 5 of the last staff report (IMF Country Report No. 03/107) contains a discussion of the qualitative effects of the PRSP's main reforms.

scheme for government employees and unemployment insurance program for private sector workers), but a more thorough analysis of the impact is warranted, as envisaged by the PSIA.

38. **Samurdhi—Sri Lanka's largest welfare program—is being reformed.** Over the years, the program became mired in inefficiencies due to rampant abuse and politicization. By mid-2001 the program covered more than 40 percent of households, but left out many of the truly needy. Samurdhi is now being reformed under the 2002 Welfare Benefits Act, which sets clear criteria for eligibility and termination of benefits. A means-tested formula has been designed and a pilot project to analyze its efficacy is underway. Samurdhi transfers were tightly controlled in 2003 and are budgeted to remain so this year. However, the program needs to be expanded in the conflict areas, where poverty is deeper. The authorities are designing ways to expand the program into the North and East within the framework of the Welfare Benefits Act, while continuing with the ongoing reforms elsewhere.

D. Discussions on the Reviews of the PRGF and Extended Arrangements

39. **With the current political uncertainty constraining the government's ability to advance the reform agenda, completion of the first reviews of the PRGF and Extended Arrangements, originally scheduled for August 2003, will take some more time.** Except for the end-December performance criterion on net domestic financing, all quantitative performance criteria for June and December under the program are estimated to have been met. However, end-December indicative targets for revenue, the primary balance, banks' net claims on government, and credit to public corporations are likely to have been missed (Table 7). On the structural front, some progress has been made, albeit with delays (Table 8). However, as discussed earlier, the government is not in a position to present the Revenue Authority bill to Parliament—a June 2003 performance criterion—before the elections. Given the urgency of improving tax administration to raise near- and medium-term revenue collection—a core element of the program—it was agreed with the authorities to postpone completing the review until the bill can be presented to Parliament. Another key structural element of the program—restructuring of People's Bank—has been delayed due to prolonged negotiations to appoint an external advisor.

40. **Looking ahead, fiscal and monetary policies over the next few months need to be very prudent to safeguard macroeconomic stability under the uncertain political circumstances.** A financial program has been set, which, as agreed with the authorities, will be used to measure performance for the first review. However, both fiscal and monetary policies may need to be tightened further during the first half of the year if inflationary pressures rise or investor confidence slackens. Implementing the delayed structural measures, particularly those related to the Revenue Authority and People's Bank, are also key to ensure that the objectives of the PRSP are met. In the second half of the year, the government envisages tabling new Banking and Central Bank bills to Parliament, initiating reforms to the EPF, and advancing its divestment program—particularly with regard to SLT and the Hilton Colombo. Preparations to update the PRSP are underway and the progress report is expected later this year.

E. Other Issues

41. **Sri Lanka's statistical information is adequate for surveillance and program monitoring, but reporting weaknesses remain.** Aided by technical assistance from the IMF, a migration plan for reporting fiscal data using the GFSM 2001 methodology is underway, while the compilation of monetary statistics is being improved. Staff advised that quarterly GDP data from the expenditure side and retail sales data be compiled to aid surveillance and inform policymaking. Sri Lanka participates in the GDDS; full compliance with the SDDS is expected by mid–2004. An update of the fiscal ROSC is planned for this year.

42. **Anti-money laundering legislation is being drafted and is planned for parliamentary presentation by mid–2004.** Staff has provided technical assistance on the drafting of the bill.

43. **The CBSL has made progress in implementing the recommendations of the 2001 Safeguards Assessment,** as noted by the full Safeguards Assessment in June 2003 (Annex III). The authorities have committed to implement the staff recommendations.

44. **The staff met with labor unions, NGOs, and parliamentarians, and held discussions on how best to broaden the consultation process in designing reforms**.

V. Staff Appraisal

45. **Over the past year, Sri Lanka has made gains on several fronts.** The economic recovery has taken root and external vulnerability has declined. Seizing the opportunity provided by the ceasefire, the government put in place policies and reforms to begin erasing the economic legacy of the conflict years. The international community has stood firmly behind the peace and reform process, while foreign investors have started to show renewed interest. However, significant challenges remain: the political situation is unsettled, the reform agenda is unfinished, and the peace talks remain stalled.

46. **The ongoing recovery should strengthen in 2004, provided the political uncertainty is resolved early and peace talks resume soon; however, the risks to this outlook are substantial.** While on the upside, a faster global recovery could boost external demand, an extended delay in resolving the political impasse and resuming peace talks could depress growth. A further pickup of growth over the medium term hinges on deepening reforms and securing lasting peace.

47. **Economic management over the next few months will be challenging.** Staff supports the tax policy measures proposed in the 2004 budget, particularly the unification of the VAT rates and the reduction in VAT and import duty exemptions. It is, however, regrettable that the government has reversed some of the proposed reductions in exemptions, which will add to revenue pressures. In addition, the full benefits of the tax policy measures will not be seen until fundamental reforms in tax administration, particularly in its leadership, staffing, and incentives structure, are implemented. Staff also regrets that the establishment of the Revenue Authority, which was envisaged by the authorities to provide the framework to bring about these changes in tax administration, has been delayed due to the political uncertainty. Weak tax administration is a critical bottleneck to improving tax revenue—it fell last year to its lowest level (in percent of GDP) in over a decade—and needs to be addressed urgently. In this regard, the government should be ready to take

corrective revenue and expenditure measures if tax collection falls below the levels required to meet the budget targets. The authorities should be commended for their control over expenditure in the last two years, while making available adequate resources for priority spending. Tight control over spending, particularly ahead of the April elections, continues to be needed.

48. **On monetary policy, the staff commends the CBSL for steering a careful course, judiciously supporting the economic recovery while restraining inflation.** However, if the current drought continues, inflationary pressures could emerge; if the political uncertainty deepens and fiscal pressures rise, these pressures could intensify. The CBSL should stand ready to tighten monetary policy if the need arises. Staff supports the continuation of the flexible exchange rate regime, which helped to absorb some of the pressure from large services receipts and capital inflows last year. While open market operations have so far proceeded smoothly, the monetary transmission mechanism could be made more effective by addressing banking sector weaknesses.

49. **The key medium term challenges remain restoring fiscal sustainability, while making available adequate resources for priority spending and post-conflict needs.** In light of the recent revenue shortfalls, stronger fiscal consolidation than currently envisaged will be needed if the debt reduction targets set in *Regaining Sri Lanka* and the FMRA are to be achieved. This will require streamlining the tax regime, which remains burdened with a vast array of exemptions; these in turn have proved difficult to administer and consequently have encouraged avoidance.[16] Thus in the coming years, the tax regime needs to broaden its base, be further simplified, and made more equitable, including by further reductions in income tax exemptions and incentives. The proposed early retirement scheme for civil servants, if properly designed, should help to improve governance and service delivery. However, care needs to be taken to ensure that the scheme does not become too costly, and that the associated wage increase does not unduly compress the wage structure.

50. **Changing the role of the public sector from a "player" to a "referee" is one of the pillars of the government's economic policy to eradicate poverty through private-sector led growth.** To this end, the authorities have privatized several state-owned entities, but in some of the other larger enterprises, there have been delays in planned divestments. The entry of private firms in the petroleum market will encourage competition. As the supply of uninterrupted and affordable electricity is critical for long-term investment and growth, the unbundling of the state electricity board should be carried out without further delay and locations for the proposed large generation plants identified early. As the state's role in commercial activities diminishes, the importance of efficient regulation is heightened. The staff concurs with the authorities' emphasis on building well-functioning regulatory agencies in line with the multi-sector regulatory bill.

51. **The staff welcomes the implementation of the long needed amendments to the labor laws, which are necessary to increase labor market flexibility.** The authorities should make sure that the predictability these reforms bring to the labor market is not eroded by introducing changes to the mandatory compensation formula that allows, as before, labor commissioners to have the discretion to determine the retrenchment package. Raising the upper limits of the compensation package will also hurt employment by reducing the country's competitiveness.

[16] Chapter III of the selected issues paper assesses Sri Lanka's tax incentives regime.

52. **The ongoing financial sector reforms should help to improve the sector's efficiency.** The restructuring of state-owned banks is critically important, particularly that of People's Bank, where any further delay should be avoided. The staff supports the CBSL's recent initiatives to tighten prudential norms and enhance supervision. The new banking and monetary acts are expected to further strengthen the CBSL's powers and along with the forthcoming AMC law, facilitate mobility and consolidation in the industry. The nonbank financial markets also need to be deepened. In this regard, liberalizing the EPF's reference portfolio and outsourcing its management would help boost demand for corporate bonds and equities.

53. **Staff supports the government's approach to reducing poverty by removing barriers that exclude the poor from the benefits of private-sector led growth as laid out in the PRSP.** Increasing the access of the poor to basic services and markets and liberalizing land policy are needed steps in this direction. The reforms to the social welfare program need to be sped up to ensure that a well-targeted safety net is in place.

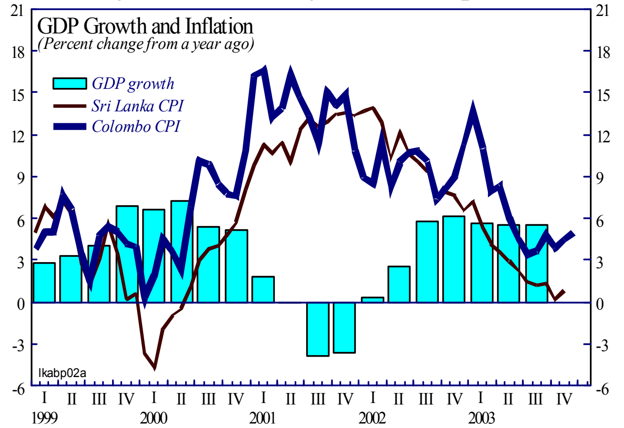
54. **While Sri Lanka's statistical information is adequate for surveillance and program monitoring, some weaknesses remain.** Staff welcomes the authorities' plans to implement the GFSM 2001 methodology for fiscal data and to comply fully with SDDS in 2004. The compilation of quarterly GDP data from the expenditure side and of retail sales data, which would aid surveillance efforts, remains pending.

55. **Sri Lanka has great potential to achieve rapid growth and reduce poverty.** What is needed is a political environment conducive to steadfast implementation of reforms and progress on the peace front. Staff regrets that completion of the first reviews under the PRGF and Extended Arrangements will take more time. The government needs to continue advancing the reform agenda and ensure that macroeconomic policies safeguard the hard-earned improvements in the economy and investor confidence of the last two years. It is hoped that the policies will be in place and sufficient progress made on the reform agenda, including the enactment of the tax measures proposed in the 2004 budget, presentation of the Revenue Authority bill to Parliament, and advances in restructuring People's Bank, to allow for an early completion of the first reviews of the PRGF and Extended Arrangements.

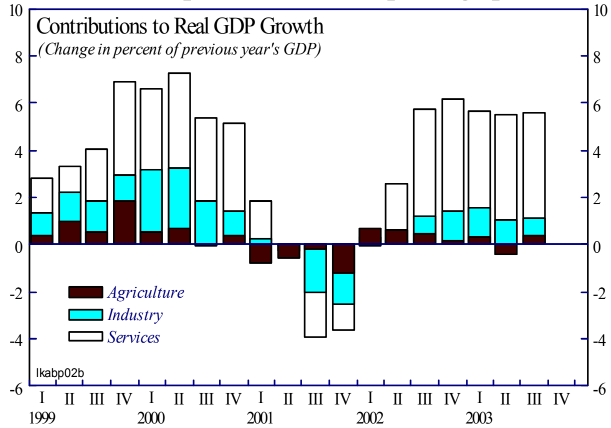
56. **Staff recommends that the next Article IV consultation be held on a 24-month cycle, subject to the provisions on consultation cycles approved on July 15, 2002.**

Figure 1. Sri Lanka: Real and External Sector Developments

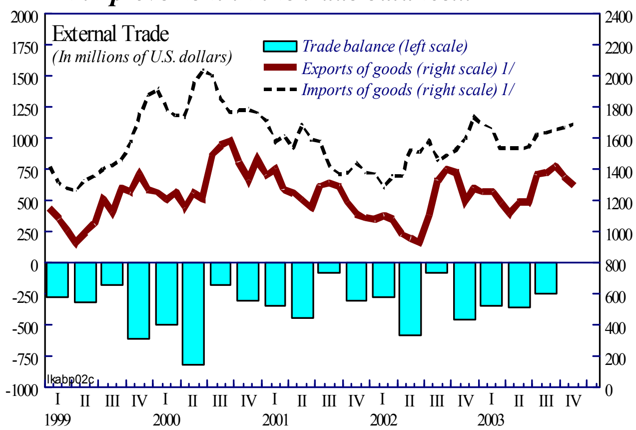
Economic activity continues to recover, while inflation has eased faster than expected.



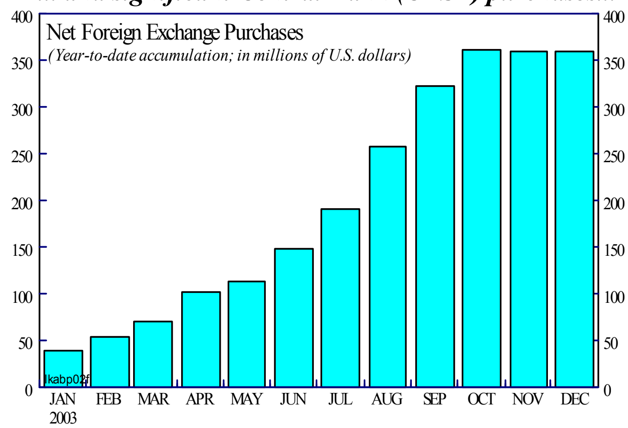
Services have contributed most to the recovery, but industrial production is also picking up.



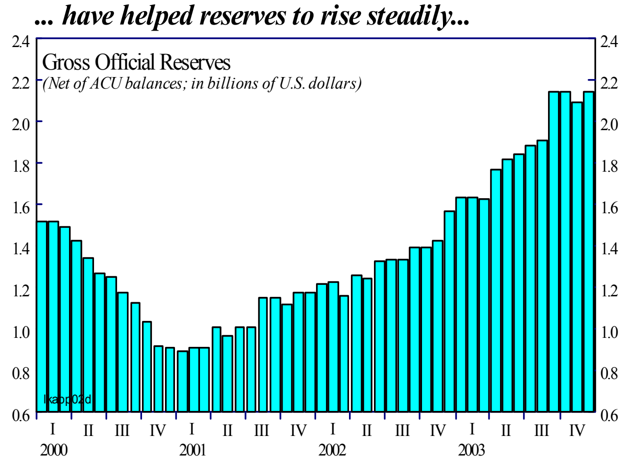
An improvement in the trade balance...



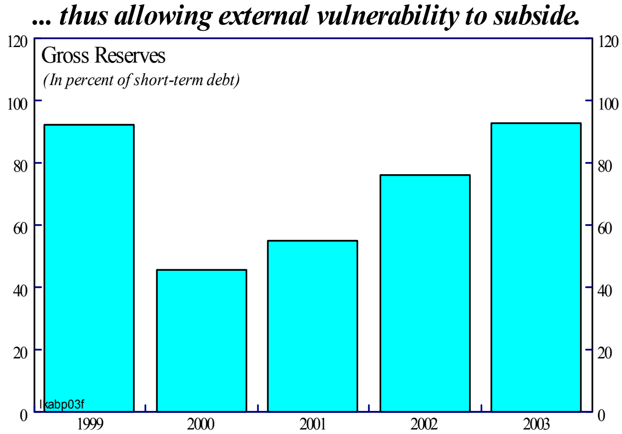
... and significant Central Bank (CBSL) purchases...



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



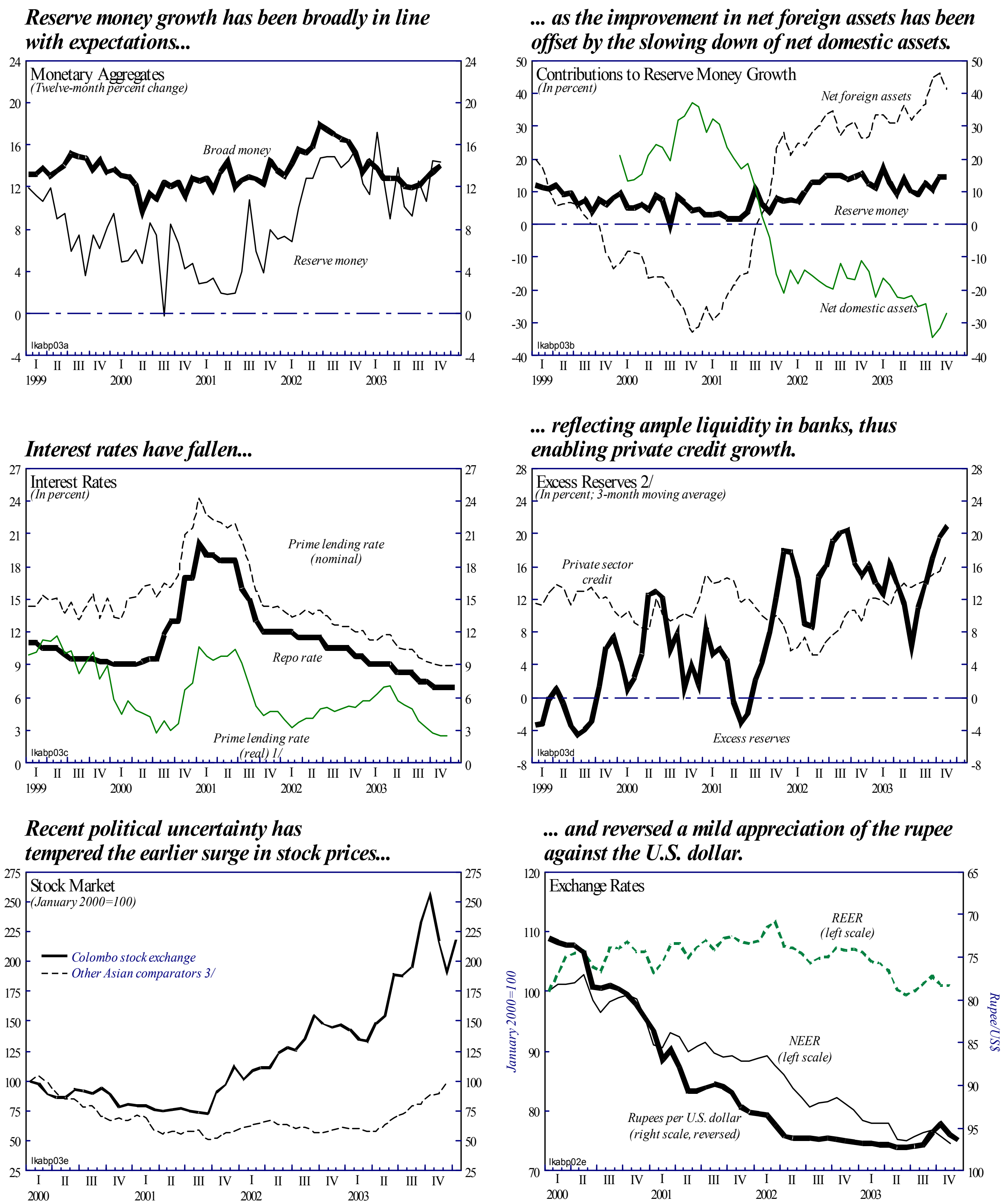
... thus allowing external vulnerability to subside.



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

1/ Three-month moving sum.

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, 2001-2004

Nominal GDP (2002): US$16.5 billion
Population (2002): 19 million
GDP per capita (2002): US$868
Quota: SDR 413 million

	2001	2002	2003 Est.	2004 Proj.
GDP and inflation (in percent)				
Real GDP growth	-1.5	3.9	5.5	6.0
Inflation (period average) 1/	14.2	9.6	6.3	6.0
Savings and investment (in percent of GDP)				
National savings	20.3	19.6	21.9	22.0
Gross investment	22.0	21.3	22.8	24.2
Public finances (in percent of GDP)				
Revenue	16.6	16.5	15.4	15.8
Expenditure	27.5	25.4	23.6	23.0
Primary balance	-4.1	-1.6	-1.2	-1.3
Overall balance	-10.8	-8.9	-8.1	-7.2
Government debt (domestic and external)	103.2	105.5	100.9	95.4
Money and credit (percent change, end of period)				
Reserve money	7.0	12.3	11.9	15.4
Broad money	13.6	13.4	15.3	13.5
Domestic credit (percent contribution to M2 growth)	18.4	7.5	8.3	8.5
Private sector	6.7	8.7	12.1	11.4
Public sector	11.7	-1.1	-3.8	-2.9
91-day T-bill rate (percent, end of period)	12.9	9.9	7.4	…
Balance of payments (in millions of U.S. dollars)				
Trade balance	-1,157	-1,406	-1,446	-1,781
Current account balance	-243	-272	-179	-459
Current account balance (in percent of GDP)	-1.5	-1.6	-1.0	-2.2
Overall balance	220	338	438	180
Export value growth (percent change)	-12.8	-2.5	9.4	8.6
Import value growth (percent change)	-18.4	2.2	7.9	11.8
Gross reserves				
In millions of U.S. dollars (end of period) 2/	1,180	1,595	2,084	2,385
In months of imports	2.0	2.4	2.9	3.1
As a percent of short-term debt 3/	55.2	76.4	104.3	122.7
External debt (public and private)				
In billions of U.S. dollars	9.7	9.9	10.2	11.6
As a percent of GDP	61.8	59.9	55.2	52.1
Exchange rate				
Rupees per U.S. dollar (end of period)	93.2	96.7	96.7	…
NEER (annual percentage change, end of period)	-8.9	-9.2	-8.0	…
REER (annual percentage change, end of period)	-0.1	0.0	-5.8	…
Memorandum items				
Nominal GDP (in billions of rupee)	1,407	1,583	1,787	2,026
Nominal GDP (in billions of U.S. dollars)	15.7	16.5	18.5	20.7

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

1/ Colombo consumer price index.
2/ Excluding central bank ACU balances.
3/ As reserves exclude ACU balances, they are also excluded from short-term debt to compute this ratio.

Table 2a. Sri Lanka: Summary of Central Government Operations, 2001-2004

(In percent of GDP, unless otherwise indicated)

	2001	2002	2003		2004	
			Budget	IMF Est.	Budget	IMF Proj.
Total revenue	16.6	16.5	16.9	15.4	16.4	15.8
Tax revenue	14.6	14.0	14.7	12.9	14.5	13.8
Income taxes	2.5	2.4	2.7	2.3	3.0	2.6
Value added tax/GST	3.3	4.2	6.7	5.4	6.0	5.6
Excise taxes	3.2	3.3	2.7	2.8	2.8	2.9
National security levy	3.1	1.8	0.0	0.0	0.0	0.0
Taxes on international trade	1.9	1.8	1.9	1.9	2.1	2.0
Other	0.7	0.5	0.7	0.6	0.7	0.7
Nontax revenue	2.0	2.5	2.2	2.5	1.8	2.0
Total expenditure and net lending	27.5	25.4	24.4	23.6	23.2	23.0
Current expenditure	21.6	20.9	19.2	18.7	17.6	17.8
Civil service wages and salaries	3.4	3.4	3.1	3.0	3.2	3.2
Other civilian goods and services	2.0	1.3	1.1	1.1	1.1	1.1
Security related expenditure	4.9	4.1	3.5	3.5	3.5	3.5
Of which: Defense	3.9	3.1	2.7	2.6	2.8	2.8
Subsidies and transfers	4.6	4.7	4.3	4.0	3.9	4.1
Households 1/	3.8	3.4	3.2	2.9	3.0	3.2
Of which: Samurdhi	0.9	0.6	0.5	0.5	0.4	0.4
Of which: Pensions	1.9	2.0	1.9	1.7	1.8	1.8
Institutions, corporations, other govt.	0.9	1.4	1.1	1.1	0.9	0.9
Interest payments	6.7	7.4	7.2	7.0	6.0	6.0
Foreign	0.7	0.7	0.8	0.6	0.8	0.8
Domestic	6.0	6.7	6.4	6.3	5.2	5.2
Capital expenditure and net lending	5.9	4.6	5.2	4.9	5.5	5.2
Of which: CWE Operation 2/	...	...	...	0.2	...	...
Overall balance	-10.8	-8.9	-7.5	-8.1	-6.8	-7.2
Overall balance (incl. grants)	-10.4	-8.5	-7.0	-7.6	-6.3	-6.7
Financing	10.8	8.9	7.5	8.1	6.8	7.2
Net external financing	1.0	0.1	2.0	2.4	2.5	1.7
Net domestic financing	8.8	8.0	4.1	4.7	3.2	4.2
Bank	3.4	-0.3	-0.9	-0.9	-1.3	-0.7
Nonbank	5.3	8.3	5.0	5.6	4.5	4.9
Asset sales	0.6	0.4	0.9	0.6	0.6	0.8
Grants	0.4	0.4	0.4	0.5	0.5	0.5
Memorandum items:						
Current account balance	-4.9	-4.4	-2.3	-3.3	-1.3	-2.0
Primary balance	-4.1	-1.6	-0.3	-1.2	-0.8	-1.3
Nominal GDP (in billions of rupees)	1,407	1,583	1,799	1,787	2,026	2,026
Real GDP growth	-1.5	3.9	5.5	5.5	6.0	6.0
Total debt	103.2	105.5	99.6	100.9	94.8	95.4
Of which: Domestic debt	58.0	59.9	56.8	57.7	54.0	55.1

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

1/ Staff projections for 2004 include 0.2 percent of GDP on drought relief.

2/ In December 2003, the government assumed the debt of CWE (a state-owned enterprise) to banks.

Table 2b. Sri Lanka: Summary of Central Government Operations, 2001-2004

(In billions of rupees)

	2001	2002	2003		2004	
			Budget	IMF Est.	Budget	IMF Proj.
Total revenue	234	261	304	275	332	320
Tax revenue	206	222	265	230	294	280
Income taxes	35	38	48	41	60	53
Value Added Tax/GST	47	67	120	96	121	114
Excise taxes	45	52	49	51	58	60
National security levy	43	29	0	0	0	0
Taxes on international trade	26	28	33	33	43	40
Other	10	8	13	10	13	13
Nontax revenue	28	39	39	45	37	40
Total expenditure and net lending	387	402	438	421	469	467
Current expenditure	303	330	345	334	358	362
Civil service wages and salaries	48	54	56	54	65	65
Other civilian goods and services	28	21	20	20	22	22
Security related expenditure	68	64	62	63	71	71
Of which: Defense	...	49	48	47	57	57
Subsidies and transfers	65	75	77	72	78	82
Households 1/	53	53	57	51	60	64
Of which : Samurdhi	13	10	9	9	9	9
Of which : Pensions	26	31	34	31	37	37
Institutions, corporations, other go	12	22	20	20	18	18
Interest payments	94	117	130	124	121	121
Foreign	10	11	15	12	16	16
Domestic	85	106	116	113	105	105
Capital expenditure and net lending	83	72	93	87	112	105
Of which: CWE Operation 2/	...	...	...	4	...	...
Overall balance	-152	-141	-134	-146	-138	-146
Overall balance (incl. grants)	-147	-134	-126	-136	-128	-136
Financing	152	141	134	146	138	146
Net external financing	15	2	36	43	51	35
Net domestic financing	124	126	74	83	65	85
Bank	49	-5	-17	-17	-26	-15
Non-bank	75	131	91	100	91	100
Asset sales	9	6	17	10	13	16
Grants	6	7	8	9	10	10
Memorandum items:						
Current account balance	-69	-69	-41	-58	-26	-41
Primary balance	-58	-25	-4	-21	-17	-25
Nominal GDP (in billions of rupees)	1,407	1,583	1,799	1,787	2,026	2,026
Real GDP growth	-1.5	3.9	5.5	5.5	6.0	6.0
Total debt	1,453	1,669	1,792	1,802	1,920	1,934
Of which : domestic debt	816	948	1,022	1,031	1,094	1,116

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

1/ Staff projections for 2004 include Rs 4 billion on drought relief.

2/ In December 2003, the government assumed the debt of CWE (a state-owned enterprise) to banks.

Table 3. Sri Lanka: Monetary Program, 2002-2004 1/

	2002 Dec. Act.	2003 Mar. Act.	2003 Jun. Act.	2003 Sept. Act.	2003 Dec. Est.	2004 Mar. Proj.	2004 Jun. Proj.	2004 Sept. Proj.	2004 Dec. Proj.
Monetary authorities	(In billions of rupees)								
Net foreign assets	117	124	138	162	165	163	164	172	184
Net domestic assets	9	8	-7	-27	-23	-12	-11	-16	-21
Of which : Net credit to government	71	63	53	35	42	51	53	49	45
Reserve money	126	132	131	135	141	151	153	156	163
	(Contribution to reserve money growth, in percent)								
Net foreign assets	26.7	30.9	31.9	44.9	37.4	29.2	19.9	7.5	14.0
Net domestic assets	-14.4	-18.3	-21.8	-34.3	-25.5	-14.7	-2.7	8.6	1.4
Reserve money (annual percent change)	12.3	12.7	10.1	10.6	11.9	14.5	17.2	16.1	15.4
Monetary survey	(In billions of rupees)								
Net foreign assets	111	116	133	148	167	170	175	191	207
Monetary authorities	117	124	138	162	165	163	164	172	184
Deposit money banks	-7	-9	-5	-14	2	7	11	19	22
Net domestic assets	512	528	522	531	551	567	579	589	608
Domestic credit	680	685	687	694	732	747	760	772	793
Public sector	236	234	219	206	212	216	212	203	191
Government (net) 2/	193	191	180	167	176	182	180	171	161
Public corporations	43	43	39	40	36	34	32	32	30
Private sector	444	451	468	488	519	531	549	569	602
Other items (net)	-169	-158	-165	-163	-181	-180	-181	-183	-185
Broad money	622	643	655	679	718	737	754	780	815
	(Annual percent change)								
Net foreign assets	43.5	41.4	47.3	47.2	51.0	46.8	31.8	29.0	23.6
Monetary authorities	34.5	41.1	37.9	51.0	40.2	31.0	18.9	6.3	12.0
Deposit money banks	-34.1	37.4	-49.6	109.5	-137.1	-180.2	-332.1	-241.0	786.2
Net domestic assets	8.4	8.0	5.7	6.0	7.6	7.6	10.9	10.9	10.4
Domestic credit	6.5	7.0	4.7	4.0	7.6	9.1	10.7	11.1	8.3
Public sector	-2.6	-0.4	-10.0	-15.2	-10.0	-7.8	-3.2	-1.7	-9.9
Government (net) 2/	-4.2	-2.6	-11.8	-16.9	-8.7	-5.0	0.2	2.7	-8.5
Public corporations	5.4	10.8	-0.6	-7.0	-15.9	-20.2	-18.6	-20.2	-16.6
Private sector	12.0	11.3	13.4	15.0	16.9	17.8	17.3	16.6	15.8
Broad money	13.4	12.8	12.1	12.9	15.3	14.6	15.1	14.8	13.5
	(Contribution to broad money growth, in percent)								
Net foreign assets	6.1	5.9	7.3	8.3	9.1	8.4	6.5	6.3	5.5
Net domestic assets	7.2	6.8	4.8	5.5	6.3	6.2	8.7	8.5	8.0
Domestic credit	7.5	7.8	5.3	5.7	8.3	9.6	11.3	11.4	8.5
Public sector	-1.1	-0.2	-4.2	-6.1	-3.8	-2.9	-1.1	-0.5	-2.9
Government (net) 2/	-1.5	-0.9	-4.1	-5.8	-2.7	-1.5	0.1	0.7	-2.1
Public corporations	0.4	0.7	0.0	-0.3	-1.1	-1.4	-1.1	-1.2	-0.8
Private sector	8.7	8.0	9.4	11.8	12.1	12.5	12.3	11.9	11.4
Memorandum items:									
Broad money multiplier	4.9	4.9	5.0	5.0	5.1	4.9	4.9	5.0	5.0
Velocity of broad money	2.7	...	...	...	2.7	...	...	...	2.7
Private sector credit (in percent of GDP)	28.0	...	...	...	29.1	...	...	...	29.7

Sources: Central Bank of Sri Lanka.

1/ Projections are at the program exchange rate of 98 Rs / U.S. dollar for 2004.
2/ In December 2003, this item includes the government's assumption of CWE's bank debt. This differs from the CBSL presentation, which shows an increase in other assets of the banking system.

Table 4. Sri Lanka: Balance of Payments, 2001-2008
(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003 Est.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
Current account	-243	-272	-179	-459	-618	-776	-790	-832
Trade balance	-1,157	-1,406	-1,446	-1,781	-2,039	-2,279	-2,404	-2,614
Exports	4,817	4,699	5,139	5,582	5,819	6,150	6,616	7,046
Imports	5,974	6,105	6,585	7,363	7,858	8,429	9,020	9,660
Of which : non-oil imports	5,243	5,316	5,733	6,434	6,888	7,396	7,957	8,514
Services	175	271	279	293	323	358	419	508
Receipts	1,355	1,270	1,361	1,472	1,564	1,690	1,850	2,025
Payments	1,180	999	1,082	1,179	1,242	1,332	1,431	1,517
Income	-267	-260	-224	-255	-281	-331	-381	-406
Receipts	108	74	95	108	138	154	167	194
Payments	375	334	319	363	419	485	548	600
Transfers	1,006	1,123	1,212	1,284	1,379	1,476	1,576	1,680
Private	984	1,097	1,183	1,248	1,346	1,443	1,546	1,650
Official 1/	22	26	29	36	33	33	30	30
Capital and financial account	514	509	589	639	985	1,015	754	868
Capital transfers	198	55	61	74	71	79	80	80
Financial account	316	454	528	565	914	936	674	788
Long-term flows	164	351	676	755	892	912	648	759
Direct investment	172	235	231	320	288	294	358	400
Foreign direct investment	82	230	201	210	238	264	328	370
Privatization proceeds	90	5	30	110	50	30	30	30
Private sector borrowing 2/	-257	4	-65	-69	-58	-38	-30	19
Disbursements	45	141	79	80	92	130	195	250
Amortization	302	137	144	149	150	168	225	231
Official sector borrowing	249	112	510	504	662	656	320	340
Disbursements	575	492	864	832	975	995	700	700
Program	...	...	244	269	295	295	0	0
World Bank	...	...	128	125	125	125	0	0
ADB	...	...	65	60	70	70	0	0
Bilaterals	...	...	51	84	100	100	0	0
Project	...	...	620	563	680	700	700	700
Amortization	326	380	354	328	313	339	380	360
Short-term flows	152	103	-148	-190	22	24	26	29
Portfolio investment (CSE)	-11	25	10	0	22	24	26	29
Nonbank private sector	-42	68	-33	0	0	0	0	0
Banking sector	254	-40	-125	-190	0	0	0	0
Government	-50	50	0	0	0	0	0	0
Errors and omissions	-51	8	28	0	0	0	0	0
Valuation adjustments	0	93	0	0	0	0	0	0
Overall balance	220	338	438	180	367	239	-35	36
Financing	-220	-338	-438	-180	-367	-239	35	-36
Change in net international reserves	-220	-338	-438	-180	-367	-239	35	-36
Increase in gross official reserves (-)	-270	-415	-489	-300	-435	-301	79	-19
Increase in reserve liabilities (+)	50	77	51	120	68	62	-44	-17
Memorandum items:								
Current account (in percent of GDP)	-1.5	-1.6	-1.0	-2.2	-2.8	-3.2	-3.0	-2.9
Gross official reserves 3/ 4/	1,180	1,595	2,084	2,385	2,819	3,121	3,041	3,060
(In months of imports)	2.0	2.4	2.9	3.1	3.5	3.6	3.3	3.1
Net international reserves 4/	970	1,277	1,715	1,895	2,262	2,501	2,466	2,502
IMF disbursements	131	124	82	164	164	164	0	0
GDP	15,750	16,545	18,510	20,686	22,208	24,034	26,256	28,684

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

1/ Includes only transfers that are chanelled through the budget. Other official transfers are reflected under project disbursements.
2/ Includes public corporations.
3/ Net of ACU debit balances.
4/ Valued at historical cost through 2002, and at market cost since then.

Table 5. Sri Lanka: Macroeconomic Framework, 2001-2008

(In percent of GDP unless otherwise noted)

	2001	2002	2003 Est.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
Real sector								
Real GDP (percent change)	-1.5	3.9	5.5	6.0	6.3	6.5	7.0	7.0
Average inflation (CCPI; percent change)	14.2	9.6	6.3	6.0	5.5	5.0	4.5	4.0
Gross national saving	20.3	19.6	21.9	22.0	21.9	22.1	22.9	23.5
Gross investment	22.0	21.3	22.8	24.2	24.7	25.3	25.9	26.4
Fiscal sector								
Total revenue	16.6	16.5	15.4	15.8	16.4	16.9	17.2	17.5
Total expenditure and net lending	27.5	25.4	23.6	23.0	22.5	22.1	21.5	21.4
Current expenditure	21.6	20.9	18.7	17.8	16.9	16.1	15.1	14.6
Of which : Defense expenditure	3.9	3.1	2.6	2.8	2.5	2.2	1.9	1.9
Of which : Interest payments	6.7	7.4	7.0	6.0	5.4	4.9	4.3	3.8
Capital expenditure	5.9	4.6	4.9	5.2	5.6	6.0	6.4	6.8
Overall balance	-10.8	-8.9	-8.1	-7.2	-6.1	-5.2	-4.3	-3.9
Primary balance	-4.1	-1.6	-1.2	-1.3	-0.7	-0.3	0.0	-0.1
Net external financing (excluding grants and asset sales)	1.0	0.1	2.4	1.7	2.5	2.3	0.8	0.8
Net domestic financing (excluding grants and asset sales)	8.8	8.0	4.7	4.2	2.1	1.5	2.5	2.1
Grants	0.4	0.4	0.5	0.5	0.9	0.9	0.7	0.7
Asset sales	0.6	0.4	0.6	0.8	0.6	0.6	0.3	0.3
Total government debt	103.2	105.5	100.9	95.4	91.1	86.5	81.5	76.8
Domestic	58.0	59.9	57.7	55.1	51.0	47.1	44.6	42.2
Foreign	45.2	45.5	43.1	40.3	40.1	39.4	36.9	34.6
External sector								
Trade balance	-7.3	-8.5	-7.8	-8.6	-9.2	-9.5	-9.2	-9.1
External current account balance (incl. transfers)	-1.5	-1.6	-1.0	-2.2	-2.8	-3.2	-3.0	-2.9
Overall balance of the balance of payments	1.4	2.0	2.4	0.9	1.7	1.0	-0.1	0.1
Gross official reserves less ACU balance (in billions of U.S. dollars)	1.2	1.6	2.1	2.4	2.8	3.1	3.0	3.1
(months of imports of goods and services)	2.0	2.4	2.9	3.1	3.5	3.6	3.3	3.1
Total external debt	61.8	59.9	55.2	52.1	52.8	51.2	49.9	47.9
Monetary sector								
Broad money (end-of-period; percent change)	13.6	13.4	15.3	13.5	12.9	12.1	12.1	11.8
Private sector credit (end-of-period; percent change)	8.9	12.0	16.9	15.8	15.5	15.0	14.5	14.0
Memorandum items:								
Oil price (U.S. dollar per barrel)	24.3	25.0	29.0	25.5	23.0	21.0	21.0	21.0
Post-conflict related spending 1/	...	...	0.7	0.9	1.0	1.0	1.0	1.0
Total social spending (recurrent and capital) 2/	7.3	7.7	7.6	7.6	7.8	8.0	8.0	8.0
Of which: Welfare and community services	3.9	3.7	3.6	3.5	3.3	3.1	2.9	2.9
Of which: Health spending	1.3	1.6	1.5	1.5	1.6	1.7	1.8	1.8
Of which : Education spending	2.0	2.4	2.4	2.4	2.6	2.7	2.7	2.7

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

1/ Preliminary estimates and projections of spending channeled through the central government budget.

2/ 2003 budget; 2004-08 staff estimates.

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

(In percent of GDP, unless otherwise indicated; end-of-period)

	1999	2000	2001	2002	2003 (Latest) 1/
Banking sector indicators 2/					
Nonperforming loans (as percent of total loans)					
State-owned commercial banks	18.5	15.4	18.2	17.8	19.3
Domestic private banks	15.9	14.9	15.7	15.0	14.9
Foreign banks	10.7	12.7	13.2	8.7	10.2
Risk-based capital asset ratio (total capital over risk-weighted assets) 3/					
State-owned commercial banks	8.8	4.3	0.1	1.7	1.1
Domestic private banks	12.2	11.4	10.4	10.8	12.2
Foreign banks	12.5	12.5	16.0	21.7	16.2
Financial indicators					
Broad money (percent change, 12-month basis) 4/	13.4	12.9	13.6	13.4	15.3
Private sector credit (percent change, 12 month basis) 4/	10.5	11.8	8.9	12.0	16.9
Share of deposits in broad money 4/	86.3	87.3	88.1	87.9	88.4
Share of foreign currency deposits in total deposits 4/	18.8	21.1	21.8	22.1	21.7
Stock market index (ASPI; 1985=100)	573	448	621	815	1,062
External indicators					
Exports (annual percent change)	-3.9	19.8	-12.8	-2.5	10.3
Imports (annual percent change)	1.5	22.4	-18.4	2.2	8.0
Current account balance (excluding official transfers)	-3.7	-6.6	-1.7	-1.8	…
Capital and financial account balance	2.4	2.7	3.3	3.4	…
Of which : Portfolio investment	-0.1	-0.3	-0.1	0.2	…
Medium- and long-term inflows, net	2.8	1.8	1.0	2.4	…
Foreign direct investment	1.1	1.0	0.5	1.4	…
Exchange rate (rupee per U.S. dollar, period average)	70.4	75.8	89.4	95.7	96.5
Reserves indicators					
Gross official reserves (millions of US$; excl. ACU balance)	1,530	911	1,180	1,595	2,084
As percent of broad money	25.8	15.6	20.0	26.5	30.0
As percent of short-term debt 5/ 6/	92.4	45.7	55.2	76.4	...
Debt indicators					
Government debt (domestic and external)	95.1	96.8	103.2	105.5	102.8
Total external debt (public and private)	63.2	60.8	61.8	59.9	...
External interest payments (as percent of exports goods & services)	5.3	5.1	4.1	3.5	...
Debt service (as percent of exports goods & services)	15.2	14.7	13.3	13.2	...
Short-term debt (in percent of GDP) 5/ 6/	8.7	9.9	11.1	9.4	...

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

1/ Banking sector risk indicators, end-September; external trade, January-November; Government debt, end-November.
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: Performance Criteria and Indicative Targets, June-December 2003, and Projections, 2004

(In billions of rupees; unless otherwise indicated)

	Program						Projections			
	Jun. 2003 Adj. Prog.	Jun. 2003 Act.	Sept. 2003 Adj. Prog.	Sept. 2003 Act.	Dec. 2003 Adj. Prog.	Dec. 2003 Est. 5/	Mar. 2004 Proj.	Jun. 2004 Proj.	Sept.2004 Proj.	Dec. 2004 Proj.
Performance Criteria 1/										
Ceiling on change in net domestic financing of central government deficit 2/										
Cumulative from January 1, 2003	52	48	61	59	73	83				
Cumulative from January 1, 2004							33	51	69	85
Ceiling on net domestic assets of the CBSL 2/	8	-10	-7	-35	6	-20	-12	-11	-16	-21
Floor on net international reserves of CBSL 3/ (In millions of U.S. dollars)	1,317	1,452	1,449	1,736	1,435	1,650	1,660	1,663	1,824	1,895
Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the public sector										
Cumulative from January 1, 2003 (in millions of U.S. dollars)	510	352	510	466	510	466				
Cumulative from January 1, 2004 (in millions of U.S. dollars)							400	400	400	400
Ceiling on the stock of short-term external debt										
Cumulative from January 1, 2003 (in millions of U.S. dollars)	25	0	50	0	50	0				
Cumulative from January 1, 2004 (in millions of U.S. dollars)							50	50	50	50
Accumulation of external payments arrears	0	0	0	0	0	0	0	0	0	0
Continuous performance criterion during the program period										
Indicative Targets										
Floor on central government revenue										
Cumulative from January 1, 2003	145	137	222	203	304	275				
Cumulative from January 1, 2004							71	148	234	320
Floor on central government tax revenue (added for 2004)										
Cumulative from January 1, 2004	...	110	...	169	...	230	62	131	206	280
Primary fiscal balance of central government (excludes interest payments)										
Cumulative from January 1, 2003	-2	-7	-1	-14	-4	-21				
Cumulative from January 1, 2004							-4	-10	-18	-25
Ceiling on banks' net claims on government 2/ 4/	192	181	176	169	175	177	177	175	166	157
Credit to public corporations by the banking system 4/	44	39	44	41	33	36	34	32	32	30
Ceiling on reserve money of the CBSL	135	131	138	135	143	141	151	153	156	163

1/ End-June and end-December 2003 were performance criteria test dates. End-March and end-September had indicative targets.

2/ Adjusted downward by the excess/shortfall in programmed privatization receipts.

3/ Net International Reserves (NIR) are valued at program exchange rates for 2003. At end-December, NIR at actual exchange rates is estimated at $1,715 million (see table 4). For 2004, NIR projections are based on end-2003 actual exchange rates. Adjusted for the excess/shortfall in programmed privatization receipts and by the excess/shortfall in programmed foreign program assistance.

4/ Foreign currency denominated debt is converted into rupees at program exchange rates.

5/ Estimates as of February 11, 2004.

Table 8. Sri Lanka: Structural Policy Actions Under the First Year of the PRGF-EFF Arrangements

Policy Area	Policy Action	Status	Timing	Status
I. Fiscal Measures				
1. Budget	1. Extension of the VAT to the wholesale and retail sectors	Structural Benchmark	January 31, 2004	Not met. Expected by July 2004.
	2. Rationalization/Streamlining of tax incentives 1/	Structural Benchmark	January 31, 2004	Modest progress made. 2/
	3. Reduce import surcharge to 10 percent from 20 percent	Structural Benchmark	January 31, 2004	Met on time (January 2004).
2. Tax Administration and Tax Policy Reform	1. Presentation to Parliament of a new Revenue Authority act and preparation of detailed implementation plan	Performance Criterion	June 30, 2003	Not met. Expected by mid-May 2004.
II. Nonfiscal Measures				
3. Financial Sector Reform	1. Presentation to Parliament of the Asset Management Company (AMC) law	Structural Benchmark	June 30, 2003	Not met. Pending resumption of Parliament.
	2. Presentation to Parliament of the amended Banking laws and the new Exchange Management Act	Structural Benchmark	June 30, 2003	Met with delay (November 2003).
	3. External evaluation of assets and liabilities of People's Bank	Structural Benchmark	September 15, 2003	Not met. Expected by end-March 2004.
	4. Complete the restructuring of People's Bank 1/	Structural Benchmark	March 31, 2004	Likely to be delayed until end-October 2004.
4. Public Enterprise Reform	1. 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 2/	Structural Benchmark	December 31, 2003	Not met. Expected by end-December and end-September 2004, respectively.
5. Labor Market Reform	1. Implementation of the binding redundancy compensation formula	Structural Benchmark	April 30, 2003	Met with delay (January 2004).

1/ Structural benchmark was to be given more specificity in the context of the first review.

2/ In late 2003, the government announced that the extension of certain tax holidays beyond their expiration date will be curtailed beyond 2004, and that all registered companies, including those registered with the BOI, will be required to file tax returns from 2004 onwards.

Sri Lanka—Implementation of Major Policy Initiatives (2001–04)

Policy Area		Measure Proposed	Assessment and Actions Taken
Fiscal Policy	**Deficit Reduction and Fiscal Responsibility**	• Enhance **fiscal consolidation**, and aim to reduce the deficit by about 1¼ percent of GDP per year. • Legislate a **Fiscal Responsibility Management Act (FRMA)** to ensure fiscal transparency, accountability, and discipline.	• **Significant progress**. Central government fiscal deficit is estimated to have been 8 percent of GDP in 2003, down from 8.9 percent of GDP in 2002 and 11 percent of GDP in 2001. • **Significant progress**. A Fiscal Management (Responsibility) Act (FMRA) was enacted in December 2002, which sets strict limits on borrowing from the Central Bank (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. The FRMA also required a mid-term review of the budget, which was presented to parliament on June 30.
	Tax Reform	Broaden the revenue base by: • Introducing the **VAT**. • Extending the VAT to the **retail sector**. • Rationalizing **exemptions**. • Rationalizing **incentives**. • **Taxing civil servants income**.	• **Significant progress**. NSL was merged into GST with a dual rate VAT (20 percent and 10 percent) in the 2002 Budget. VAT was extended to the financial sector at the 10 percent rate. A unified rate of 15 percent is expected to be introduced by March 2004. • **No progress**. Although this was announced in the 2003 budget, actual extension has been delayed until July 2004. Discussions have been held with provincial councils on revenue sharing. • **Some progress**. Additional exemptions were created with the introduction of the VAT. Some VAT exemptions were lifted in the 2003 Budget and further exemptions will be removed in 2004. • **Some progress**. In December 2002, Parliament adopted a new Board of Investment (BOI) law, eliminating BOI's power to grant tax holidays and incentives outside the regular tax code. However, this law still needs to be enacted. • **Limited progress**. Under the amended Inland Revenue Act, effective April 2003, civil service emoluments count toward statutory income thresholds for tax purposes.
		Improve tax administration by • Establishing a **large taxpayer unit (LTU)**. • Establishing **a unified revenue authority**.	• **Significant progress**. The LTU was restructured in 2002. Subsequently, all the LTU's administrative functions were consolidated under a single commissioner and assigned responsibility for administering all types of taxes owed by large taxpayers. • **Some Progress**. The Revenue Authority bill has been presented to Cabinet, but presentation to Parliament has been delayed (now expected in May 2004). The RA will encompass the departments of Inland Revenue, Customs, Excise and the tax and customs components of the BOI. The selection process for its management is underway.

Sri Lanka—Implementation of Major Policy Initiatives (2001–04)

Policy Area		Measure Proposed	Assessment and Actions Taken
	Expenditure Reform	Promote expenditure rationalization by:	
		• Better debt management to contain the **interest bill** (the largest expenditure item in the budget).	• **Significant progress**. The government has taken measures to reorganize its debt portfolio, problems with which contributed to the high interest cost in 2002. It has improved its instrument mix and reduced significantly the stock of outstanding expensive overdraft at the 2 state banks. A decision has been made to create a new debt office—the World Bank and the U.S. Treasury are giving TA.
		• Containing **defense spending**.	• **Significant progress**—helped by the current ceasefire. A Defense Spending Monitoring Committee was established in 2002 to ensure no deviation from the budget in spending or incurring commitments.
		• Implementing **civil service hiring freeze** to contain the wage bill.	• **Significant progress**. Hiring freeze has been in place since the 2002 budget and salary increases have been deferred.
		• Streamlining the **Samurdhi Welfare Benefits** scheme.	• **Significant progress**. The number of beneficiaries reduced from 1.9 million to 1.5 million. The Welfare Benefits Law that was enacted in September 2002—which sets clear and transparent eligibility criteria, provides guidelines for the termination of the benefits, and penalties to reduce politicization and mistargeting.
		• Establishing a **medium-term expenditure framework** (MTEF) by mid-2003.	• **Little progress**. Delayed, and to be part of the 2005 Budget. As part of its program on public expenditure review (PER), the World Bank is assisting the government in establishing the MTEF.
Exchange Rate and Monetary Policies		• Adopt a **flexible exchange rate arrangement**.	• **Significant progress**. The rupee was floated on January 23, 2001. The foreign exchange regulations that were put in place soon after the float to limit overshooting were eliminated by August 2001.
		• Enhance the **transparency and credibility of the reserve money program**.	• **Significant progress**. Reserve money (RM) is the nominal anchor; the RM program was put in place at the beginning of the SBA and the CBSL introduced active open market operations in March 2003 to strengthen liquidity management, enhance greater control over RM and reduce volatility of short-term rates. The CBSL has also published on its website the basic monetary policy framework, including objectives, targets and instruments; and regularly updates the public on the assessment of the RM program (actuals versus targets) and releases monthly review of monetary policy issues and decisions on its website.
		• Enhance **greater monetary policy instrument independence** for the CBSL.	• **Significant progress**. The CBSL's monetary law act (MLA) was amended in December 2002, which gave powers to the CBSL's Monetary Board to change (by removing statutory limits) and remunerate statutory reserve requirements (SRRs), if necessary.

Sri Lanka—Implementation of Major Policy Initiatives (2001–04)

Policy Area		Measure Proposed	Assessment and Actions Taken
Financial Sector Reform	**Banking Sector**	• Restructure the two state-owned **banks**.	• **Some progress**. The government has laid out a strategy for the restructuring of People's Bank, and an investment consultant (who will conduct the net worth assessment) has been appointed. Key policy actions are yet to be taken. Bank of Ceylon is implementing its own restructuring plan and the World Bank agreed targets are being used to assess performance. BOC has formulated a VRS to reduce staff costs.
		• Improve the mechanism to resolve **NPLs**.	• **Some progress**. An Asset Management Company (AMC) bill has been finalized and is expected to be sent to Parliament by end February. The bill it aims to facilitate bank restructuring, take over large NPLs of some banks and to recover some of the bad loans through enhanced powers of collection and enforcement.
		• Improve the **capital base of banks**.	• **Some progress**. The minimum CAR was raised to 10 percent for all domestic banking units from January 2003 and on a consolidated basis for all domestic and foreign currency banking units effective end-December 2003.
		• Bring **loan classification and provisioning norms** more in line with international best practices.	• **Some progress**. The CBSL has started to enforce its current regulations and has tightened provisioning requirements by discounting the value of the collateral.
		• Modernize the banking act and introduce **greater competition** in the banking system	• **Significant progress**. The amendments to the Banking Act—to enhance CBSL's supervision capacity, and facilitate easier entry and exit into the banking sector—were tabled in Parliament in November 2003. Work has started on new banking and Central Bank laws.
Structural Reform	**Public Enterprise Reform and Divestment**	• Enhance **cost recovery by key public corporations** to stem quasi-fiscal losses.	• **Significant progress**. An automatic petroleum pricing formula linked to international oil prices was established in January 2002. Electricity tariffs were increased by 35 percent in April 2002.
		• Bolster **private sector participation** in key public corporations.	• **Significant progress**. A large portion of CPC's distribution and retail functions have been sold to Indian Oil Company (IOC). Preliminary bids have been made for the divestment of an additional 1/3 of outlets. Following parliamentary passage of the electricity reform bill, the generation, distribution, and transmission components of Ceylon Electricity Board are being unbundled into six small CEBs to be run by private sector management. The sale and transfer of control and partial equity in the retail network of CWE have been agreed.
		• Speed up the general **privatization** program.	• **Significant progress**. Pelwatte sugar company, Lanka Marine and 12½ percent of Sri Lanka Telecom shares were sold in 2002. Sri Lanka Insurance Corporation (SLIC) was sold in April 2003. Government disposed of its holding in NDB in July 2003.

Sri Lanka—Implementation of Major Policy Initiatives (2001–04)

Policy Area		Measure Proposed	Assessment and Actions Taken
	Trade Liberalization	• Eliminate the **import surcharge**.	• **Some progress**. The surcharge was reduced from 40 percent to 20 percent in the 2002 budget, and was reduced further to 10 percent in January 2004. The government has committed to eliminating it by January 2005.
		• **Rationalize the existing tariff structure** to a simplified three-band regime.	• **Some progress**. One band was eliminated in January 2004, leaving five bands in place. However, tariff rates were increased at the same time.
	Capital Account Liberalization	• Ease restrictions on **inward foreign direct investment**.	• **Significant progress**. The restrictions on inward FDI flows have been significantly liberalized, including in the financial sector. The limit on foreign ownership of domestically incorporated commercial banks was raised to 60 percent in 2002.
		• Ease restrictions on other private **capital flows**.	• **Significant progress**. The Foreign Exchange Management bill was tabled in Parliament in November 2003. The bill relaxes restrictions on some longer term capital account transactions such as foreign borrowing by the private sector of over five years' maturity and allows foreigners to invest in government securities, while retaining existing controls over other short term capital movements.
	Labor Markets	• Amend the **Industrial Disputes Act**.	• **Some progress**. An amended Industrial Disputes Act with a time-bound rule for settling labor disputes and a new redundancy compensatory formula to avoid discretionary rulings by the labor commissioner were enacted in January 2003. The bills were gazetted in May, but implementation was delayed to January 2004. Preliminary parameters for the compensation formula have been prepared.
Safeguards		• Strengthen the **external audit mechanism, financial reporting framework and internal controls systems of the CBSL**.	• **Excellent progress**. The CBSL has implemented almost all the recommendations in the 2001 safeguards assessment report and has already initiated the recommendations in the 2003 safeguards assessment report. Most notably, CBSL has appointed an external audit firm (Ernst & Young, NZ), appointed an audit committee, the Monetary Board has adopted resolutions in the areas of accounting and auditing, the CBSL now prepares its accounts on a full IAS basis and has strengthened its internal controls system and its internal audit function.

Sri Lanka—Debt Sustainability Analysis Update

This annex updates the debt sustainability analysis in the last staff report (IMF Country Report No. 03/140). The broad conclusions of the previous exercise—that while debt is sustainable under the adjustment scenario, significant departures from the adjustment scenario jeopardize sustainability—remain valid.

Central Government Debt Sustainability

The updated baseline scenario continues to show a steady decline in central government debt, but at a slower pace than in the baseline scenario presented in March 2003 (Table II.1). By the end of the period (2008), the debt-to-GDP ratio falls to 77 percent, a few percentage points above what had been projected earlier. This reflects a higher fiscal deficit path for 2003-8, reflecting greater difficulties in raising tax revenue than originally envisaged.

Stress tests demonstrate that most shocks increase the debt stock, but keep debt dynamics on a downward trend, mainly because of a significant differential between economic growth and the real interest rate. However, with nearly 50 percent of the debt denominated in foreign currency, the debt dynamics are vulnerable to large external shocks—for example, a 30 percent nominal depreciation in 2004 raises the central government debt-to-GDP ratio to nearly 120 percent, and allows it to fall to only 98 percent by 2008.

The analysis on alternative scenarios shows that a return to pre-SBA policies—proxied by the 1999-2000 averages of key macroeconomic variables being sustained over the forecast period—is clearly unsustainable, with the debt-to-GDP ratio steadily rising to over 110 percent of GDP by 2008.

External Debt Sustainability

Under the baseline scenario, consistent with the macroeconomic framework of the staff report, the external debt-to-GDP ratio would decline to 50 percent in 2008, compared with 60 percent in 2002 (Table II.2). The financing for reconstruction-related needs in the North and East is expected to average 1.3 percent of GDP in 2004-2008, with about half of it to met by grants. The debt-stabilizing noninterest current account deficit is estimated at 3½ percent of GDP, a larger deficit than projected over the medium-term. Estimates of the NPV for total external debt are below their nominal values, reflecting a grant element of approximately 25 percent on public external debt.

Alternative scenarios suggest that a deceleration of the reform process and its temporary reversal (Scenarios A1 and A3) would lead to unsustainable debt dynamics. Scenario A1 simulates the effects of sluggish reforms interrupted by policy reversals, leading to significant variations in economic growth, high inflation and external vulnerability. Scenario A3 simulates potential implications of the pre-SBA policies, with slow economic growth, expansionary fiscal policy, fragile external position, and stalled structural reforms. The debt-to-GDP ratios under Scenarios A1 and A3 would reach 64 percent and 83 percent, respectively, in 2008, compared with expected 55 percent in 2003. The current account deficit would have to be almost half of that under the baseline to stabilize the debt ratio. Scenario A2 simulates the impact of low economic growth brought about by a weaker-than-expected external demand, resulting in the deterioration of the current account and exchange rate depreciation. The economy is assumed to recover from the shock in 2006. The post-shock debt-to GDP ratio would exceed that of the baseline by 4 percentage points, but the effects of the shock would taper off as the economy returns to normal conditions.

Key Macroeconomic Assumptions Underlying the Country-Specific Shock in 2004
(Scenario A2)

	Baseline	Country-Specific Shock
Nominal GDP (change in percent)	11.8	4.5
Real GDP growth (in percent)	6	2.4
GDP deflator in U.S. dollars (change in percent)	5.7	2.3
Nominal external interest rate	2.1	2.1
Growth of exports (U.S. dollar terms, in percent)	8.5	7.2
Growth of imports (U.S. dollar terms, in percent)	11.4	9.5
Current account balance, excluding interest payments	2.2	-3.7
Net non-debt creating capital inflows	1.5	1.4

Temporary shocks illustrate potential costs of deviations from macroeconomic stability and structural reforms. Even if shocks are short-lived, the convergence period is long, with post-shock debt ratios exceeding those under the baseline by about 1–10 percentage points in 2008. Significant currency depreciations result in unsustainable debt levels—a 30 percent nominal exchange rate depreciation leads to an immediate increase in the debt-to-GDP ratio of 20 percentage points, and an increase of 16 percentage points for 2008. The effects of the widening of the external current account or real currency depreciation are less severe, bringing the debt-to-GDP ratio 7–10 percentage points above the baseline, with the gap narrowing only gradually over the medium term. Real GDP and interest rate shocks both increase the debt stock, but keep the debt dynamics sustainable, with the debt ratios exceeding that of the baseline by 1½ percentage points and 5 percentage points, respectively.

Table II.1. Sri Lanka: Public Sector Debt Sustainability Framework, 2003-2008

(In percent of GDP, unless otherwise indicated)

	10-Year Historical Average	1999-2000 Historical Average	2003	2004	2005	2006	2007	2008
				Projections				
				I. Baseline Projections				
1 Central government debt 1/			100.9	95.4	91.2	86.5	81.5	76.8
Of which: foreign-currency denominated			46.8	45.8	44.6	45.1	45.3	44.1
2 Change in central government debt			-4.6	-5.4	-4.3	-4.7	-5.0	-4.7
3 Identified debt-creating flows (4+7+12)			-4.6	-5.4	-4.0	-4.4	-4.8	-4.5
4 Primary deficit (including grants)			0.7	0.8	-0.2	-0.5	-0.7	-0.6
5 Revenue and grants			15.9	16.3	17.3	17.8	17.9	18.2
6 Primary (noninterest) expenditure			16.6	17.1	17.1	17.2	17.2	17.6
7 Automatic debt dynamics 2/			-4.7	-5.3	-3.2	-3.3	-3.8	-3.7
8 Contribution from interest rate/growth differential 3/			-5.1	-6.0	-5.3	-4.7	-4.8	-4.5
9 *Of which:* contribution from real interest rate			0.1	-0.6	0.0	0.6	0.6	0.7
10 *Of which:* contribution from real GDP growth			-5.1	-5.3	-5.3	-5.3	-5.4	-5.1
11 Contribution from exchange rate depreciation 4/			0.4	0.6	2.1	1.4	1.0	0.8
12 Other identified debt-creating flows			-0.6	-0.8	-0.6	-0.6	-0.3	-0.3
13 Privatization receipts (negative)			-0.6	-0.8	-0.6	-0.6	-0.3	-0.3
14 Recognition of implicit or contingent liabilities			0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g., bank recapitalization)			0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)			0.0	-0.1	-0.3	-0.2	-0.2	-0.2
Central government debt-to-revenue ratio 1/			633.5	585.5	526.7	487.0	455.2	421.9
Gross financing need 5/			31.7	29.9	24.5	23.2	20.7	20.3
In billions of U.S. dollars			5.9	6.2	5.4	5.6	5.4	5.8
Key Macroeconomic and Fiscal Assumptions								
Real GDP growth (in percent)	4.6	2.2	5.5	6.0	6.3	6.5	7.0	7.0
Average nominal interest rate on public debt (in percent) 6/	7.4	7.3	7.4	6.7	6.4	6.0	5.6	5.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.7	-3.2	0.4	-0.3	0.4	1.0	1.1	1.2
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-7.0	-12.0	-0.9	-1.5	-4.7	-3.2	-2.3	-1.8
Inflation rate (GDP deflator, in percent)	9.1	10.5	7.0	7.0	6.0	5.0	4.5	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	2.8	5.4	-3.1	9.0	6.7	7.1	7.0	9.5
Primary deficit (including grants)	2.2	3.8	0.7	0.8	-0.2	-0.5	-0.7	-0.6
Revenue to GDP ratio	19.0	17.1	15.9	16.3	17.3	17.8	17.9	18.2
				II. Stress Tests for Public Debt Ratio				
A. Alternative Scenarios								
A1. Key variables are at their 10 year historical averages in 2004-08 7/			100.9	96.9	94.6	91.9	89.2	86.5
A2. Key variables are at their 1999-2000 historical averages in 2004-08, with a 0 percent real interest rate 7/			100.9	102.2	105.1	107.4	109.6	111.5
A3. Primary balance under no revenue policy change in 2004-08, with interest expenditure at 2004 levels			100.9	95.8	93.5	91.5	89.7	88.7
B. Bound Tests								
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005			100.9	98.1	95.7	90.9	85.7	80.8
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005			100.9	102.4	106.4	103.4	99.8	96.6
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005			100.9	99.2	99.5	94.5	89.2	84.1
B4. Combination of B2-B3 using one standard deviation shocks			100.9	102.3	105.3	100.1	94.5	89.1
B5. One time 30 percent real depreciation in 2004 8/			100.9	120.2	115.0	109.5	103.5	97.8
B6. 10 percent of GDP increase in other debt-creating flows in 2004			100.9	105.4	100.8	95.8	90.4	85.3
B7. No new foreign concessional funding, with the gap financed domestically			100.9	95.4	91.2	86.5	81.7	77.2

1/ Central government gross debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = 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 numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
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/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table II.2. Sri Lanka: External Debt Sustainability Framework, 2003-2008

(In percent of GDP, unless otherwise indicated)

	10-Year Historical Average	10-Year Standard Deviation	2003	2004	2005	2006	2007	2008	
						Projections			
					I. Baseline Projections				**Debt-Stabilizing Non-Interest Current Account 6/**
1 **External debt**			**55.2**	**52.1**	**52.8**	**51.2**	**49.9**	**47.9**	**-3.7**
2 Change in external debt			-4.3	-3.0	0.7	-1.6	-1.3	-2.0	
3 Identified external debt-creating flows (4+8+9)			-6.7	-5.2	-3.1	-2.5	-3.0	-3.3	
4 Current account deficit, excluding interest payments			-0.1	1.2	1.7	2.2	2.1	1.7	
5 Deficit in balance of goods and services			6.3	7.2	7.6	7.9	7.4	6.9	
6 Exports			35.1	34.0	32.7	32.1	31.8	31.1	
7 Imports			41.5	41.2	40.4	40.0	39.2	38.0	
8 Net non-debt creating capital inflows (negative)			-1.4	-1.5	-1.6	-1.7	-1.7	-1.5	
9 Automatic debt dynamics 1/			-5.2	-4.9	-3.2	-3.1	-3.5	-3.5	
10 Contribution from nominal interest rate			1.0	1.0	1.0	0.9	0.9	0.8	
11 Contribution from real GDP growth			-2.9	-3.0	-3.0	-3.2	-3.3	-3.2	
12 Contribution from price and exchange rate changes 2/			-3.3	-3.0	-1.2	-0.8	-1.1	-1.1	
13 Residual, incl. change in gross foreign assets (2-3)			2.4	2.2	3.8	1.0	1.7	1.4	
External debt-to-exports ratio (in percent)			156.9	153.1	161.2	159.4	157.1	153.9	
Gross external financing need (in billions of US dollars) 3/			2.2	2.5	2.6	2.9	3.0	3.0	
in percent of GDP			12.0	12.0	11.7	11.7	11.1	10.3	
Key Macroeconomic Assumptions	10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.6	2.4	5.5	6.0	6.3	6.5	7.0	7.0	6.4
Exchange rate appreciation (US dollar value of local currency, change in percent)	-7.4	3.5	-1.0	-1.2	-3.4	-3.2	-2.3	-2.1	-2.2
GDP deflator in US dollars (change in percent)	1.0	3.6	6.0	5.7	2.4	1.6	2.1	2.3	3.4
Nominal external interest rate (in percent)	3.0	0.5	1.9	2.1	2.1	1.9	1.8	1.8	1.9
Growth of exports (US dollar terms, in percent)	7.2	8.5	9.0	8.5	4.6	6.2	8.0	7.3	7.3
Growth of imports (US dollar terms, in percent)	6.4	10.3	8.0	11.4	6.5	7.3	7.1	6.1	7.7
Current account balance, excluding interest payments	-2.1	1.9	0.1	-1.2	-1.7	-2.2	-2.1	-1.7	-1.5
Net non-debt creating capital inflows	1.0	0.7	1.4	1.5	1.6	1.7	1.7	1.5	1.6
					II. Stress Tests for External Debt Ratio				**Debt-Stabilizing Non-Interest Current Account 6/**
A. Alternative Scenarios									
A1. Key variables are at their 10-yr historical averages in 2004-08 4/			**55.2**	**57.2**	**61.0**	**61.7**	**63.3**	**64.4**	**-3.1**
A2. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation 5/			**55.2**	**56.4**	**53.2**	**52.3**	**50.5**	**48.9**	**-4.8**
A3. Key variables are at their 1999-2001 historical averages in 2004-08 4/			**55.1**	**61.6**	**66.4**	**71.1**	**75.8**	**83.1**	**-1.9**
B. Bound Tests									
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005			**55.2**	**53.5**	**55.4**	**53.7**	**52.2**	**49.8**	**-5.2**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005			**55.2**	**55.8**	**60.4**	**58.3**	**56.5**	**54.0**	**-5.5**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005			**55.2**	**58.6**	**64.4**	**62.0**	**60.0**	**57.3**	**-5.9**
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005			**55.2**	**57.4**	**62.4**	**60.3**	**58.3**	**55.6**	**-5.6**
B5. Combination of 2-4 using one standard deviation shocks			**55.2**	**62.2**	**71.3**	**69.1**	**67.0**	**64.2**	**-6.3**
B6. One time 30 percent nominal depreciation in 2004			**55.2**	**73.1**	**73.8**	**70.8**	**68.1**	**64.8**	**-6.7**

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

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

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

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ The implied change in other key variables under this scenario is discussed in the text.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Sri Lanka—Fund Relations

(As of December 31, 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	586.28	141.81
Reserve position in Fund	47.86	11.58

III. **SDR Department:**	SDR Million	Percent Allocation
Net cumulative allocation	70.87	100.00
Holdings	0.42	0.59

IV. **Outstanding Purchases and Loans:**	SDR Million	Percent Quota
Stand-By arrangements	200.0	48.38
Extended arrangements	20.67	5.00
ESAF/PRGF arrangements	43.99	10.64

V. **Financial Arrangements:**

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

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

	2004	2005	2006	2007
Principal	31.44	69.80	74.16	31.93
Charges/interest	6.00	5.01	3.27	2.08
Total	37.44	74.81	77.44	34.00

VII. **Exchange Rate Arrangement:**

Independent float. The central bank floated the rupee on January 23, 2001. The CBSL has removed the foreign exchange regulations that were imposed after the float *(IMF Country Report No. 01/71)*.

VIII. **Safeguards Assessment:**

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

IX. **Article IV Consultation:**

Sri Lanka is on a 24-month consultation cycle, subject to the terms of the decision on consultation cycles (Decision No. 12794-(02/76), of July 15, 2002). The Executive Board concluded the 2002 Article IV consultation (EBS/02/153) on September 3, 2002.

X. **FSAP and ROSC Participation:**

- MFD: Both the FSSA and the FSAP reports have been finalized. A joint Bank-Fund TA mission visited Colombo between May 6-10, 2002 to provide advice on restructuring state-owned banks. A joint World Bank/IMF mission visited Colombo in October 2002 to follow-up on the FSAP and advised the authorities on public debt management and development of government securities markets. A MFD advisor visited Colombo in February 2003 for 2 months and assisted in the introduction of active open market operations. A multisector MFD TA mission visited Colombo February 18–29, 2003 and helped the authorities in a number of areas including drafting of a revised asset management company (AMC) law. This mission also reached agreement with the authorities on TA plans for the second round of legislative amendments for the CBSL and financial sector laws. Subsequently, the MFD mission visited Colombo in June 18-30, 2003 to assist in drafting new banking and central banking laws, and formulate a TA program. A LEG advisor followed-up on this issues during a mission in October.

- STA: A data ROSC mission visited Colombo during June 7–22, 2001, and the report was subsequently approved by the Board and published on the Fund's website. A follow-up STA ROSC mission visited Colombo during May 22–24, 2002 to discuss the implementation of the recommendations of the data module for the ROSC. An STA GFS TA mission visited Colombo during April/May 2003, to help the authorities to develop in detail a feasible migration plan for publication of fiscal data in accordance with the GFSM 2001 methodology. An STA mission on monetary and financial statistics visited Colombo in May/June 2003 to assist the CBSL in improving the compilation of monetary statistics in accordance with Fund methodology as described in MFSM, and follow up on issues raised by the 2001 June

ROSC mission. A mission visited Colombo to assist the authorities on the compilation of the international investment position.

- 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 and AsDB organized a workshop in Ottawa in May 2003 that focused on the action plan for the new unified revenue authority. Building on the conclusions of that workshop, an FAD TA mission subsequently visited Colombo during May 12-20 to provide further advice on the creation of a new 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
	▪ Revenue Authority	May 2003
MFD	▪ Monetary policy instruments	May 2001
	▪ Bank and other financial supervision	March, June, September, November 2003
MFD/LEG	▪ Banking and Central Banking Laws	March, June, October 2003
	▪ AML/CFT Legislation	June, November 2003
STA	▪ General Data Dissemination System	June–July 1997, February–March 2000
	▪ Price indices	October 1998
	▪ Government Finance Statistics	April/May 2003
	▪ Monetary and Financial Statistics	May/June 2003
	▪ International investment position	August 2003

XII. **Resident Representative:**

Mr. Carter has been Senior Resident Representative since October 2002. A resident representative has been stationed in Sri Lanka since October 1977.

Sri Lanka—Relations with the World Bank Group

(As of December 31, 2003)

A. Partnership in Sri Lanka's Development Strategy

The World Bank leads the policy dialogue in structural and institutional reforms aimed 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 ongoing for a number of years and will receive financial support through a series of Poverty Reduction Support Credits (PRSCs) designed to support implementation of some of the structural reforms that are critical for achieving the priority objectives of the country's Poverty Reduction Strategy (PRS). The Bank's Board of Directors approved the first PRSC to Sri Lanka in June 2003.

B. IMF-World Bank Collaboration in Specific Areas

A summary of IMF-World Bank collaboration in Sri Lanka is provided in Table 1.

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. The Bank has led the work to deepen the 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 FY 01 and the Bank is currently assisting the country to update the poverty estimates, as well as undertake a more extensive poverty analysis of the North East. A Poverty Update is envisioned for FY 05 and the Bank will provide assistance to strengthen capacity in monitoring poverty and undertaking social impact analyses.

The Bank has also led the dialogue in the ***health sector***. A recently completed project—***Health Services***—helped 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 noncommunicable diseases of adults; and (iii) key health policy and financing issues. Following up on this work, the ***National HIV/AIDS Prevention*** project will assist 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) strengthening multi-sectoral involvement and capacity. The Bank has also been working closely with the authorities in developing a health sector strategy/program (with financial assistance provided by a PHRD grant). A short sector policy note was completed in FY 03 and the Bank has begun the preparation of a health sector operation.

Table 1. IMF-World Bank Collaboration in Sri Lanka

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Economic Framework/ Management	Monetary policy, exchange rate, fiscal and trade policies, balance of payments, economic statistics	Economic growth, investment environment for private sector activity especially in labor and land markets and financial sector	*IMF*: PRGF performance criteria and benchmarks on monetary and fiscal targets, benchmark on labor market reform *Bank*: PRSC I support to labor and land reforms *Jointly*: PRSP progress report
Budget	Medium-term budget framework, tax policy and administration, tariff reform, budget classification and compilation	Public expenditure analysis	*IMF*: PRGF performance criteria on fiscal targets, benchmark on tax policy and creation of Revenue Authority; TA on fiscal statistics *Bank*: PRSC I support to implementation of PRGF-supported macroeconomic program; Public expenditure reviews
Public Sector Reform	Restructuring/ privatization of public enterprises	Reforms of welfare system, public governance, capacity building in financial management and accountability, reform of environmental management	*IMF*: PRGF benchmarks on government holdings in specified companies *Bank:* PRSC I support to governance strengthening and improving welfare system; CFAA and CPAR
Social/Poverty		Capacity building for monitoring and evaluation of the PRS; Poverty Update; North East poverty analysis	*IMF*: PRGF *Bank*: PRSC I support to improved monitoring and evaluation of PRS outcomes; economic and sector work on poverty and social development issues
Private Sector Development	Financial sector reform	Reforms of banking sector, insurance industry, pension/provident funds, power sector	*IMF*: PRGF benchmarks on Asset Management Company Law, amendments of banking and exchange management laws, restructuring of Peoples Bank *Bank*: PRSC I support to reforms in financial and power sectors
Rural Development		Reforms to enhance productivity and competitiveness of agriculture and rural nonfarm sector, water management	*Bank*: PRSC I support to reforms in rural development; project support (rural water and sanitation, water management, North East, rural electrification *Jointly*: PRSP progress report

In the ***education sector***, the Bank has been leading the dialogue, primarily through two ongoing projects—***Second General Education*** (GEP II) and ***Teachers Education and Teachers Deployment*** (TETD). The objective of GEP II is to: (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. In November 2002, 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 ongoing with regard to reform of the tertiary sector and Bank financial support is being provided through the ***Improving the Relevance and Quality of Undergraduate Education*** project.

Given a large presence of the Asian Development Bank (ADB) in ***environment***, the World Bank's role has been minimal in the sector. 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 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*** with assistance in making 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 first Poverty Reduction Support Credit (PRSC I). As mentioned, the PRSC I—approved by the Board in June 2003—aims to enhance the effectiveness of the overall strategy for poverty reduction and has two principal 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 given to the promotion of private-sector led growth in the economic development and poverty reduction strategy; and the second aims to help address key weaknesses in public administration and public expenditure management.

Within the context of the first component, the PRSC I focuses on supporting ***reforms in the factor markets (labor, land, and financial), power sector and 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 broad consensus, methods, framework and capacity for making sustainable and comprehensive improvements in the land administration system. Under the second component, the key areas of support include ***reforms in public administration and institutional dimensions of public expenditure management and the welfare system***. Accordingly, the PRSC focuses 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 strengthen 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 is leading the dialogue in the area of ***public expenditure review (PER)***, with four major objectives. First, the PER process will assist the government in its efforts for preparing a medium term budget framework (MTBF) for 2005-2007 and more importantly link the Poverty Reduction Strategy (Regaining Sri Lanka) with the budget, so that growth and poverty reduction policies can be translated into government programs. Second, it will deepen government's understanding of the main expenditure policy challenges by jointly undertaking background policy analysis, whose findings can be incorporated in the government's budget policy. Third, it will provide the Bank and the donor community with an external assessment of the government's own budget strategy as summarized in their three year MTBF for 2005-2007. Fourth, provide a framework to the country team for planning future interventions consistent with the CAS.

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 has resulted in policy notes on the size and composition of the civil service and on establishment of control practices. A model will be developed that will allow the Bank to explore the fiscal implications of various "right-sizing" 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 being addressed—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 build consensus on and develop a comprehensive reform agenda, along with some analytic work that would be required prior to initiating 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 completed a policy note titled: "Sri Lanka: Promoting Agricultural and Rural Nonfarm Sector Growth." Following up on this work, policy dialogue is ongoing and 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 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 focused 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 to the tune of US$31 have been restructured to provide additional urgently needed support to the reconstruction efforts. In the third phase, a longer term program to meet the development needs of the NE will be addressed in the context of the current CAS. During the January 2003 round of peace discussions, the World Bank was selected to be the custodian of the North East Reconstruction Fund (NERF) but the Fund will likely not become operational until the peace process is back on track. In addition, as part of the comprehensive needs assessment conducted jointly by the World Bank, ADB and UNDP for the June 2003 Tokyo Conference on Reconstruction and Development of Sri Lanka, the Bank took the lead on the housing assessment and worked closely with UNICEF on the education assessment.

In ***infrastructure,*** the Bank is actively engaged in a dialogue with the authorities and providing support—through the ***Economic Reform Technical Assistance*** (ERTA) 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. Through the ***Renewable Energy for Rural Economic Development*** (RERED) project, the Bank is helping to improve 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 recently approved ***Second Community Water*** project, the Bank is supporting the implementation of demand-responsive and sustainable rural water and sanitation services—including in the NE—in the context of the 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 in 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 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 joint responsibility, the Bank and the IMF are working closely together in financial sector issues identified under the Financial Sector Assessment Program (FSAP) that was finalized in 2002. 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 2002 Welfare Benefit Act—and reforming the welfare system to better target the poor and improve efficiency are important components of both Bank and IMF programs. With regard to ***pension system reform***, the Bank has long been conducting a dialogue on the topic and support is being provided under ERTA. The IMF is working closely with the Government on this issue as they work out a proposal to develop a contributory pension scheme for 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 have 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 include broadening of the revenue base and re-orienting 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. The Country Assistance Strategy (CAS) for Sri Lanka was considered by the Bank's Board on April 1, 2003. The CAS program is designed to support the PRS and focuses on three core PRS themes: peace, growth and equity. The rationales for these themes are:

- 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.

Programmatic Adjustment Lending. As previously mentioned, the Bank's program will 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 a welfare and control mentality towards an empowerment and service provision approach. While the PRSC would review the overall progress in the implementation of the PRS program, there would be annual focus on particular areas of the strategy where deeper progress would be targeted. Close to half of IDA's financial support under the CAS is planned to be in the form of PRSCs.

The first PRSC focuses on factors of production: labor, land, financial and utilities. The reform of the power sector through greater regulatory capacity and a change in the role of the state is part of the operation. Last and by no means least, the first PRSC places a strong emphasis on monitoring and evaluation mechanisms for the PRS itself. The second PRSC is expected to follow in FY 04, 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 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 (FY 05) 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 (FY 06) would be determined on the basis of the outcome of economic and sector work that will be carried out in FY 04/05, but could well focus on the management and efficiency of public expenditure.

The Base Case Lending Program. The FY 03–FY 06 base case lending program presented in the CAS consists of about four projects per year for a total of US$800 million in IDA resources.[17] In each year, the lending program is planned to 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. In June 2003, a 50 percent increase in the IDA allocations for Sri Lanka for FY 04 and FY 05 was approved, so total commitments for the four year period could reach US$1 billion.

Bank Assistance Program in Sri Lanka. The Bank's active portfolio as of December 31, 2003 contains 15 IDA credits/grants and one Global Environmental Facility (GEF) grant for a total commitment (net of cancellation) of US$655.3 million (Table 2). During FY 03,[18] five projects were approved: (i) the Economic Reform Technical Assistance Project in December 2002; (ii) National HIV/AIDS Prevention in December 2002; (iii) Second Community Water in May 2003; (iv) Improving Relevance and Quality of Undergraduate Education in June 2003; and (v) PRSC I in June 2003.

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 include a poverty assessment (Sri Lanka: Poverty Assessment, Report No. 22535-CE, June 26, 2002), the Country Procurement Assessment Review (CPAR) and the Country Financial Accountability Assessment (CFAA). As mentioned, in the coming years public expenditure analysis will be a continuous process, and work currently ongoing is concerned with helping to establish a Medium Term Budget Framework. Going forward, planned economic and sector work includes an Investment Climate Survey (in both rural and urban areas), 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, 2003, IFC's held portfolio in Sri Lanka consisted of investments in 10 companies, with a total committed exposure of US$81.3 million. The latter comprised US$27.6 million in loans, US$31.2 million in equity and $20.4 million in guarantees. The portfolio is spread over financial institutions, power, healthcare, manufacturing, ports and telecommunications.

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[17] Given the intensity of the conflict in Sri Lanka over the last 20 years, a share of the IDA resources in FY 03 were grants. A significant amount of grant resources will also be provided during FY 04.

[18] No new commitments were approved in the first half of FY04.

Contributing to the World Bank Group CAS, IFC's strategy includes: (i) developing 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) supporting the provision of private infrastructure services (including mobilization of financing and assisting with privatization); and (iii) supporting export-oriented manufacturing and service companies. IFC will explore new opportunities to support the growth of SMEs in conjunction with multilateral and bilateral partners.

Questions may be referred to Ms. Bateman (3-1462) or Ms. Dado (3-2545).

Table 2. Summary of World Bank Operations

(As of December 31, 2003)

Credit/ Grant #	FY[1/]	Name of Operation	IDA Amount	GEF Amount	Cancel- lation	Undis- bursed[2/]
			(In millions of U.S. dollars)			
2880	1996	Private Sector Infrastructure Development	77.0		15.0	20.5
2881	1996	Teacher Education and Teacher Deployment	64.1			7.6
3014	1998	General Education II	70.3		0.9	24.5
3058	1998	Mahaweli Restructuring	57.0			6.0
3301	2000	North-East Irrigated Agricultural Project	27.0			10.9
3384	2001	Legal and Judicial Reforms	18.2			13.1
3469	2001	Distance Learning Initiative (LIL)[3/]	2.0			0.9
3496	2001	Land Titling and Related Services (LIL)[3/]	5.0			3.6
3525	2001	Central Bank Strengthening	30.3			11.5
3673	2002	Renewable Energy for Rural Economic Development	75.0			68.7
3722	2003	Economic Reform Technical Assistance	15.0			13.1
H0130	2003	National HIV/AIDS Prevention	12.6			13.0
H0350	2003	Second Community Water	39.8			39.9
3781	2003	Improving Relevance and Quality of Undergraduate Education	40.3			41.8
3785	2003	Poverty Reduction Support Credit I	125.0			0.0
GEF Projects[4/]						
28370	1998	Conservation of Medicinal Plants		4.6		0.3
51248	2002	Renewal Energy for Rural Economic Development[5/]		8.0		6.7
		Total	658.6	12.6	15.9	282.2

1/ FY is the fiscal year of Board approval.

2/ All loan accounting is done in SDR. As these figures are in U.S. dollars, exchange rate fluctuations may result in undisbursed balances that are greater than original principal amounts.

3/ LIL: Learning and Innovation Loan.

4/ Global Environment Facility.

5/ Not counted as a separate project.

Sri Lanka—Relations with the Asian Development Bank[19]

(As of December 31, 2003)

The Asian Development Bank (AsDB) started its operation in Sri Lanka in 1969 and has provided 115 public sector loans totaling about $3.1 billion and 209 TAs totaling about $83.4 million. AsDB has also assisted 9 private sector projects (4 loans and 6 equity investments) amounting $85.7 million.

In 2003, AsDB approved five projects to Sri Lanka totaling $275 million and $4.2 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, AsDB 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.

On September 9, 2003, the AsDB's Board of Directors endorsed the Country Strategy and Program (CSP) for 2004–2008, which envisages assistance of about US$700 million over the next three years. This CSP is closely linked to the Tokyo Conference for Sri Lanka, held in early June this year, at which AsDB played a major role. As one of Sri Lanka's most important development partners, AsDB pledged support at the conference for the country's reconstruction and development of up to $1 billion over the four-year period from 2003 to 2006. The new CSP program provides both lending and grant assistance for the remaining three years of the period.

AsDB's top priorities in Sri Lanka are supporting broad-based economic growth, advancing social development and supporting improved governance. Emphasis will be placed on poorer regions and those encountering particular hardship. Out of the total, $400 million will come from AsDB's Asian Development Fund (ADF), which supports the sustainable social and economic development of poor countries in the Asian and Pacific region, and $300 million will be from ordinary capital resources (OCR). The proposed lending level represents a $100 million increase over the amount allocated for the last planning cycle (2003–2005), to answer the country's reconstruction and development needs as it recovers from the effects of the two-decade long civil conflict. The timing and magnitude of the assistance program will be responsive to the developing peace process and the country performance.

[19]Based on material prepared by AsDB staff.

Reflecting AsDB's country-wide focus, AsDB's support over the three–year duration of the new program cycle will help the country provide quality education, increase access of the poor to social services, develop basic economic infrastructure, rebuild conflict-torn areas and reintegrate them into the national economy, enhance rural livelihoods, remove the barriers to attracting investment, and improve governance.

The lending program will be supported by technical assistance operations of about $13 million. The TA program will support project preparation, institutional development, and economic, thematic and sector work.

As of December 31, 2003, the sectoral distribution of the loan portfolio is agriculture and natural resources, 21.9 percent; social infrastructure, 12.2 percent; energy, 12.8 percent; education, 8.8 percent; finance and industry, 16.2 percent; transport and communications, 20.3 percent and relief and rehabilitation 6.8 percent.

Lending by the Asian Development Bank, 1997–2003

(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003
Commitment	166	190	184	209	100	157	315
Net resource transfer	71	93	72	47	65	125	n.a.
Disbursement	96	126	99	76	91	171	225

Source: AsDB.

Sri Lanka—Statistical Issues

Staff Assessment

Overall, the coverage and timeliness of available data in Sri Lanka are adequate for program monitoring and surveillance purposes. 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 international reserves and foreign currency liquidity, and on external debt). Quarterly national accounts and monthly monetary and fiscal revenue data are published regularly.

Most data ROSC recommendations have been implemented while others are expected to be implemented in the near future. In particular, most data are now being disseminated in the Census and Statistics and Central bank websites; a Census of industries is underway while a Census of Agriculture (including the North and East) has been finalized; a labor force survey is being conducted on a quarterly basis; the CBSL has issued an advance release calendar and designated a contact person to assist data users.

Outstanding Statistical Issues

Real Sector

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 (CDCPI) 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, 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 in 2004.

An STA data 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.

Fiscal Sector

A government finance statistics mission from STA in May 2003 followed up on the ROSC recommendation to develop a migration path to compile data in accordance with the Government Finance Statistics Manual 2001 (GFSM 2001). As part of that plan, the authorities agreed to revise from end–2003 the budgetary classifications and the accounting structure to match directly the GFSM 2001 categories of all stocks and flows and to apply that chart of accounts to all general government units.

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.

Monetary Sector

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 from foreign liabilities to domestic deposits. The authorities started reporting the adjusted monetary data to STA from January 1999.

A monetary statistics mission from STA in June 2003 followed up on issues raised during the 2001 ROSC mission. In particular, the mission clarified the methodology in the treatment of Fund accounts; recommended that repos be treated as collateralized loans (rather than on a change of ownership basis); and resolved discrepancies between the monetary authorities' data reported to STA and to APD, which reflected problems in the valuation of Fund accounts and different methodological treatments.

External Sector

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. An STA mission visited Colombo in late August 2003 to advise the authorities on international investment position statistics. The CBSL provides gross and net official reserves and intervention data in U.S. dollar terms on a weekly basis.

Sri Lanka—Core Statistical Indicators

(As of January 30, 2004)

	Exchange Rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP	External Debt	Debt Service 3/
Date of latest observation	1/30/04	1/23/04	11/31/04	1/29/04	11/31/03	1/30/04	1/04	11/03	2002	10/03	Q3 2003	2002	2002
Date received	1/30/04	1/30/04	1/10/04	1/30/04	1/10/04	1/30/04	2/04	1/04	5/03	12/03	12/27/03	3/03	3/03
Frequency of data	D	D	M	W	M	W	M	M	Q/A	M	A/Q	A	Q
Frequency of reporting	D	W	M	W	M	W	M	M	Q	M	Q	A	Q
Source of data	A	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting	E	E	E	E	E	O	E	E	E/C	E	C	C	C
Confidentiality	C	D	C	C	C	C	C	C	C	D	C	C	C
Frequency of publication	D	W	M	M	M	W	M	M	Q	M	Q	A	A

1/ Refers to net international reserves.
2/ Overall balance refers to central government balance.
3/ Refers to public debt service.

Note: (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 restriction

Statement by the IMF Staff Representative
March 5, 2004

Recent Developments

The political situation has grown more tense in the run-up to the April 2 elections. Several election-related incidents of violence have occurred, and observers remain concerned about the potential for further violence as the elections near.

Financial markets, while still sensitive to political developments, have stabilized in recent weeks. The rupee nearly reached Rs 100 per U.S. dollar in mid-February, but has now returned to a range of Rs 97–98 per U.S. dollar. This reflects a combination of improved market sentiment and export proceeds, as well as some central bank intervention (about $40 million since end–2003). Official reserves have been kept stable, and amounted to $2.1 billion at end–February (equivalent to 2¾ months of imports and about 100 percent of short-term debt). Equity prices have risen by 20 percent since mid-February, when they bottomed out at two-thirds of their late-October 2003 levels. Interest rates, which had risen about 40 basis points between end-October and end-January, have risen a further 20 basis points since then, reaching 7.7 percent in the most recent 3–month T-bill auction.

Indicators for which more recent data are available suggest that economic performance has continued to hold up. Inflation moderated further in February, falling to 4.4 percent on an annualized basis, as food prices remained stable despite the ongoing drought. Tourism hit a record high in December, growing nearly 40 percent year-on-year, although it could have been affected since then by recent political developments. In the banking sector, the nonperforming-to-total loan ratio declined during Q4 2003, from 16½ percent to 14 percent, reflecting in particular the government's assumption of nonperforming bank debt owed by a public sector corporation (Cooperative Wholesale Enterprise).

Policy Implementation

Preliminary data for January indicate that fiscal performance was in line with staff projections. Total tax revenue amounted to Rs 21 billion, roughly 13½ percent higher than one year earlier, thanks to higher import duties and VAT (with the latter perhaps reflecting higher imports as well).

The government recently issued a "Pre-election Budgetary Position Report" for 2004, as mandated by the Fiscal Management (Responsibility) Act. The deficit target has been revised upward to 7.3 percent of GDP, from the budgeted 6.8 percent, and includes the cost of conducting the elections and of recent measures to provide cost of living relief. This compares with the staff projection of 7.2 percent of GDP. With regard to the outstanding revenue measures (planned in 2003 and those proposed in the 2004 budget), some have been implemented (e.g., adjustment in import duties), while others have been adopted through administrative orders (e.g., unification of the VAT rates) but still require formal enactment.

Further delays in the commercialization of People's Bank are likely. In light of the political uncertainties in the run-up to the elections, the government has postponed the start of the World Bank-financed investment advisor's on-site work until May. While off-site work is continuing, this will delay the restructuring timetable set out in the staff report.

Finalization of the Voluntary Retirement Scheme for the civil service has also been postponed until after the elections. This should allow sufficient time for the proposal to be strengthened in line with World Bank recommendations, which aim to limit the budgetary impact of the reform while ensuring that it is targeted effectively.

The Central Bank of Sri Lanka's audited financial statements for 2003 were published last week. They show substantial progress in implementing recommendations made in the safeguards assessment.

INTERNATIONAL MONETARY FUND
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March 12, 2004

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

IMF Concludes 2003 Article IV Consultation with Sri Lanka

On March 5, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sri Lanka.[1]

Background

Over the last 18 months, the Sri Lankan economy has advanced on several fronts: the peace process has moved ahead, albeit with interruptions; the economic recovery has taken firmer roots; external vulnerability has declined; and reforms in several areas have progressed. However, the economic effects of the two-decade long civil conflict are yet to be overcome, and many challenges remain. The government unveiled the needs assessment for the conflict-affected districts in June 2003, which, together with the poverty reduction strategy, *Regaining Sri Lanka,* anchors the policies and reforms to enhance growth and reduce poverty over the medium term. These policies and reforms, as well as the peace process, have received strong support from the international community. In June 2003, at a conference in Tokyo, donors pledged about US$4.5 billion in aid over the medium term. Recently, domestic political uncertainty has increased, reflecting the impasse between the President and the Prime Minister's government over the control of the Ministries of Defense, Interior, and Media.

Meanwhile, the economic recovery that began last year is becoming more broadly based. In 2002, private consumption and tourism were the main engines of growth. In 2003, exports were an added force, with private investment also picking up later in the year. GDP growth for 2003 is estimated to have risen to 5½ percent, up from 4 percent in 2002. Disinflation has

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

been faster than projected, due to increased agricultural production and the appreciation of the rupee against the dollar until late last year, and inflation fell below 6½ percent from 9½ percent in 2002. Improved exports and strong inflows of remittances and tourism receipts likely contained the current account deficit at 1 percent of GDP, which was lower than expected. Gross reserves rose by US$500 million to US$2 billion through end-December 2003, covering roughly 2¾ months of imports and just over 100 percent of short-term debt. The financial sector's performance has improved with the economic recovery. Until early November, the equity market had made significant gains in 2003, among the largest in Asian bourses. However, the market subsequently weakened as political uncertainties increased. While bank profitability has increased markedly, including in the state-owned banks, non performing loans remain high.

With regard to macroeconomic policy, the monetary program remained on track, but the budget came under pressure last year. Broad money grew in line with expectations, with higher reserves accumulation offsetting slower credit growth. Against the background of moderating inflation, the Central Banks of Sri Lanka (CBSL) has cut repo rates by 275 basis points since end-2002. Fiscal performance through mid-2003 was weaker than expected, reflecting revenue shortfalls (particularly in VAT collections) and higher post-conflict capital spending. To bring the budget back on track, several administrative and tax policy measures were initiated in late 2003. However, due to disruptions in the parliamentary schedule related to the political events of early November, not all measures were implemented. Thus, after declining by 2 percentage points of GDP in 2002 to 8¾ percent of GDP, the fiscal deficit narrowed to 8 percent of GDP in 2003, compared with the budget target of 7½ percent of GDP.

On the structural front, significant headway has been made in various areas. Sri Lanka's public finances are being strengthened through several reforms, including the Fiscal Management (Responsibility) Act, passed in December 2002, which limits borrowing from the CBSL, sets medium-term fiscal deficit targets, and mandates "pre-election budget reports" to discourage election handouts. To improve tax administration, a draft Revenue Authority bill—aimed at unifying the Inland Revenue, Customs, and Excise departments—and its implementation plan have been presented to Cabinet.

In the financial sector, several legislative reform initiatives—amendments to the banking law (to enhance the CBSL's supervisory powers and facilitate the entry, exit, and mergers of banks) and a new Foreign Exchange Management bill that relaxes some longer-term capital account restrictions—were tabled in Parliament in November. An Asset Management Company bill to aid banks in restructuring their balance sheets has been recently approved by Cabinet.
In addition to these legislative initiatives, financial sector stability is being enhanced through stepped-up CBSL supervision, higher capital requirements, and other new prudential norms.

Considerable progress has also been made in public enterprise reform, with divestments completed for several key public corporations. In addition, the telecommunications market has been liberalized, the state electricity company is being unbundled, and the retail market for petroleum has been opened to competition. With regard to the labor market framework, amendments to the laws streamlining the settlement of labor disputes, eliminating restrictions on overtime work by women, and increasing penalties for child labor were implemented in

January 2004. At the same time, additional labor courts and tribunals, a mandatory compensation formula for retrenched workers, and an unemployment insurance scheme were introduced.

Economic Prospects

Economic growth in 2004 is expected to reach 6 percent, underpinned by increased investment, higher tourism and exports, and normal monsoon. After the rapid decline during 2003, inflation should stabilize at around 6 percent next year. Imports are expected to rise as investment picks up, but improved export growth, tourism, and remittances should keep the current account deficit around 2¼ percent of GDP. Gross reserves should reach about US$2.25 billion (covering 3 months of imports and 140 percent of short-term debt).

However, the risks to this outlook are considerable. On the upside, if power and infrastructure bottlenecks are reduced, tourism, shipping, and telecommunications could expand much faster than anticipated, thus bolstering economic growth. On the downside, while occasional setbacks were to be expected, a prolonged impasse in the peace process – resulting from the ongoing political instability – could hold back private investment and delay donor financing. Furthermore, it could divert increasingly the government's attention from economic to political issues, thus slowing the reform momentum. These factors could depress growth, raise the fiscal deficit and domestic financing, and keep reserves at a vulnerable level if donor financing is reduced.

With regard to the 2004 policy framework, the government plans to gear its policies towards maintaining macroeconomic stability and advancing key structural reforms. The 2004 budget, which targets a fiscal deficit of 6¾ percent of GDP, aims to improve fiscal sustainability while providing adequate resources for post-conflict and reconstruction needs. A number of tax measures, including the unification of VAT, the introduction of a minimum corporate tax, and a reduction in tax incentives, will boost revenue. On the expenditure front, there will be an increased focus on priority needs, with post-conflict spending budgeted at close to 1 percent of GDP, and capital spending set to increase to 5½ percent of GDP. To improve civil service performance, a three-year reform has been launched, which targets a significant reduction in employment (through a voluntary retirement scheme) and increases public sector wages. Monetary policy is expected to continue to strike a judicious balance between supporting the economic recovery and restraining inflation, while structural reforms will focus on strengthening the financial sector, reducing the state's role in commercial activities, and improving the labor market framework.

Executive Board Assessment

Executive Directors commended the Sri Lankan government's efforts since the ceasefire to put in place policies and reforms to sustain strong economic growth and reduce poverty over the medium term. As a result, investor confidence is returning and exports and tourism are recovering, contributing to strengthened economic growth and reduced external vulnerability in an environment of falling inflation.

Directors observed, however, that the uncertainties in the political situation and the peace process pose a risk to the implementation of essential further reforms. They stressed that, if Sri Lanka is to benefit fully from the broadly positive domestic economic developments and the boost in global demand expected in the period ahead, the authorities will need to make further progress in establishing a political environment that fosters lasting peace and engenders broad-based popular support for their reform efforts.

Directors considered that the key medium-term challenge remains restoring fiscal sustainability, while ensuring that there are adequate resources for priority poverty reduction and post-conflict spending. This will call for improved revenue performance, in particular through simplification of the tax regime and reduction of exemptions, to increase compliance, improve tax system equity, and reverse the declining trend in the tax effort.

In that vein, Directors welcomed the tax reforms proposed in the 2004 budget, particularly the unification of the value-added tax rates and the reduction of exemptions. Over the next few months, the authorities should press forward urgently with fundamental reforms in tax administration, not only to arrest the long-term deterioration in revenues, but also to realize fully the benefits of changes in tax policy. In this regard, several Directors urged that rapid progress be made following the April elections in establishing the Revenue Authority. Tight control over spending should be maintained, and further demands for measures to adjust for the increase in the cost of living should be resisted. Directors emphasized the need to take corrective revenue and expenditure measures if tax collections fall below the level needed to meet the deficit target.

Directors commended the authorities for maintaining a stability-oriented, prudent monetary policy. This, together with the deficit reduction effort, has been key to lowering inflation and inflationary expectations in 2003. As a result, interest rates have declined, supporting higher private sector credit growth, thus helping to strengthen the economic recovery. The authorities should stand ready to tighten monetary policy if the political situation deteriorates or severe budget pressures materialize, to head off a potential rise in inflation and sharp exchange rate adjustment. To facilitate the conduct of monetary policy, the authorities were encouraged to broaden the range of policy instruments. Directors reiterated their support for the flexible exchange rate regime introduced in 2001, which has greatly helped in reducing external vulnerability and absorbing capital inflows.

Directors highlighted the importance of strengthening the banking sector to improve the monetary transmission mechanism and deepen financial intermediation. They viewed the restructuring of state-owned banks as critical to achieving these goals, and encouraged the government to move decisively with the restructuring of People’s Bank. Directors welcomed the recent initiatives to tighten prudential norms and enhance supervision, the Central Bank of Sri Lanka’s plans to further revamp the banking and monetary laws, and the progress made in drafting anti-money laundering legislation.

Directors reiterated their support for the government’s strategy to eradicate poverty through private-sector-led growth. They welcomed the progress made in improving governance and the privatization of several state-owned enterprises, but noted the delays affecting some of the larger enterprises. The restructuring of the power sector—currently a major bottleneck to growth—should be accelerated. Directors concurred with the government's emphasis on establishing high-quality regulatory agencies, as a clear regulatory framework will become increasingly important in strengthening the private sector's role in the economy. They endorsed the government's strategy to improve the access of the poor to basic services and markets, and to strengthen land tenure rights. Directors encouraged the government to speed up the implementation of a well-targeted social safety net, taking into account the results of the poverty and social impact analysis that is being undertaken with respect to key poverty alleviation initiatives.

Directors welcomed the recent labor market reforms, which should enhance the flexibility and predictability of the labor market. However, concern was expressed that the mandated level of redundancy pay, which is high by regional standards, could hurt Sri Lanka's competitiveness. Directors also welcomed the government's plans to streamline the civil service, although they stressed that the proposed voluntary retirement scheme should be targeted carefully, and not unduly burden the budget in coming years.

Directors considered that Sri Lanka's statistical information is adequate for surveillance and program monitoring, and looked forward to full compliance with the Special Data Dissemination Standard in 2004. They commended the authorities for the considerable progress they have made in implementing the recommendations of the Safeguards Assessment.

Directors noted that political circumstances are delaying completion of the first reviews under the Poverty Reduction and Growth Facility and Extended arrangements. They hoped that sufficient progress would be made on the reform agenda, including the enactment of the tax measures proposed in the 2004 budget, presentation of the Revenue Authority bill to Parliament, and advances in restructuring People's Bank, to allow for completion of the first reviews at the earliest possible juncture.

It is expected that the next Article IV consultation with Sri Lanka will be held on the 24-month cycle, subject to the applicable Executive Board decision on Article IV consultation cycles, and discussions with the authorities.

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

Sri Lanka: Selected Economic Indicators

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

	1999	2000	2001	2002	2003 Est.	2004 Proj.
Domestic economy						
Real GDP growth (percent)	4.3	6.0	-1.5	3.9	5.5	6.0
Inflation (percent, 12-month average) 1/	4.7	6.2	14.2	9.6	6.3	6.0
National savings (percent of GDP)	23.5	21.5	20.3	19.6	21.9	22.0
Gross investment (percent of GDP)	27.3	28.0	22.0	21.3	22.8	24.2
Fiscal position						
Revenue (percent of GDP)	17.7	16.8	16.6	16.5	15.4	15.8
Expenditure (percent of GDP)	25.2	26.7	27.5	25.4	23.6	23.0
Overall deficit (percent of GDP) 2/	-7.5	-9.9	-10.8	-8.9	-8.1	-7.2
Total government debt (percent of GDP)	95.1	96.8	103.2	105.5	100.9	95.4
External economy						
Exports	4,610	5,522	4,817	4,699	5,139	5,582
Imports	5,979	7,320	5,974	6,105	6,585	7,363
Current account balance	-560	-1,065	-243	-272	-179	-459
(in percent of GDP)	-3.6	-6.4	-1.5	-1.6	-1.0	-2.2
Capital and financial account balance	372	445	514	509	589	639
Of which: direct investment 3/	177	176	172	235	231	320
Gross official reserves (less ACU balances)	1,530	911	1,180	1,595	2,084	2,385
(in months of prospective imports)	2.2	1.5	2.0	2.4	2.9	3.1
External debt (in percent of GDP)	63.2	60.8	61.8	59.9	55.2	52.1
Real effective exchange rate (percent change, end of period) 4/	-1.2	0.6	-0.1	0.0	-5.8	…
Financial variables						
Broad money growth (annual percent change) 5/	13.4	12.9	13.6	13.4	15.3	13.5
Of which: net credit to government	45.3	56.8	36.8	-4.2	-8.7	-8.5
Of which: credit to the private sector	10.5	11.8	8.9	12.0	16.9	15.8
Interest rate (percent, end of period) 6/	11.8	18.0	12.9	9.9	7.4	…

Sources: Data Provided by the Sri Lankan authorities, and IMF staff estimates and projections.

1/ Colombo consumer price index.
2/ Excluding grants and privatization receipts.
3/ Includes privatization receipts.
4/ (-) = depreciation.
5/ Including foreign currency banking units.
6/ Three-month treasury bill rate.