

Sri Lanka: 2005 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 2005 Article IV consultation with Sri Lanka, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 12, 2005, 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 June 30, 2005. 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 July 15, 2005 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 15, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

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

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SRI LANKA

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Sri Lanka

Approved by Wanda Tseng and Donal Donovan

June 30, 2005

- A mission visited Colombo during April 28–May 12, 2005 to conduct discussions for the 2005 Article IV consultation and met with Prime Minister Rajapaksa, Treasury Secretary Jayasundera, Central Bank Governor Mendis, and other senior government officials, as well as representatives from opposition parties, the private sector, NGOs, and labor unions.
- The staff team comprised Messrs. Rumbaugh (Head), Fernandez, and Lueth (all APD), Davies (FAD), and Kock (PDR). Ms. Olin Liu (APD) joined the mission during May 9–12. Mr. Valdivieso (Senior Resident Representative) assisted the mission, and Mr. Herat (Alternate Executive Director) also participated in the discussions.
- The last Article IV consultation was concluded by the Executive Board on March 5, 2004 (IMF Country Report No. 04/68). The Executive Board approved in April 2003 three-year PRGF and EFF arrangements for SDR 413 million (100 percent of quota). Only the first disbursements (SDR 59 million), upon approval, have taken place thus far. The first reviews of the program were initially delayed because of lack of progress with key structural reforms. During 2004, however, macroeconomic policies also deteriorated.
- On January 13, 2005, the Executive Board approved the extension of repayment expectations arising in the remainder of 2005 in the amount of SDR 74 million, and on March 4, 2005 approved Sri Lanka's request for a purchase under the Fund's Emergency Assistance Policy for Natural Disasters in the amount of SDR 103 million.
- 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.
- This report was prepared by a team led by Thomas Rumbaugh.

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Executive Summary

Expansionary monetary and fiscal policies in 2004 helped support growth but added to inflationary pressures. The fiscal deficit exceeded budget targets, and with a significant amount of government financing provided by the central bank, the growth in monetary aggregates increased, contributing to higher inflation. The external current account deficit increased to 3 percent of GDP and official international reserves declined by \$313 million to 2 months of import coverage.

The December 26 tsunami led to extensive loss of life and damaged nearly two thirds of Sri Lanka's coastline. The near-term economic outlook is to a large extent shaped by the post-tsunami reconstruction effort. Reconstruction and a quick rebound in tourism should maintain growth momentum, but demand pressures and fuel price adjustments are expected to keep inflation in double digits. A significant increase in imports of oil and construction materials are projected to increase the external current account deficit to 5½ percent of GDP, but this is expected to be financed by international assistance on concessional terms.

Managing the economy in the near term will be a challenge. The policy slippages experienced in 2004 need to be avoided. Monitoring aid flows and ensuring accountability in their use will be a key priority in mobilizing external financing for tsunami reconstruction. At the same time, fiscal policy will have to be implemented carefully to reduce demand pressures by taking steps to enhance revenue, reduce subsidies, and cut back on development spending in lower priority areas. The authorities have taken steps to tighten monetary policy and more will be needed to keep inflationary pressures in check.

The medium-term outlook depends on Sri Lanka's ability to move toward fiscal consolidation, implement structural reforms, and revive the peace process. High levels of public debt constrain growth prospects and affect expectations of macroeconomic stability. Thus far, progress toward a meaningful path of consolidation has been elusive, and debt sustainability is a concern. Addressing this problem will require stronger efforts to improve revenue, rationalize expenditure, and improve overall debt management. Inefficiencies in labor and capital markets and poor infrastructure will also need to be addressed.

Structural reforms have been advanced in some key areas, but restructuring of public enterprises remains an important priority. Noticeable improvements have been made in the overall regulation and supervision of the financial system. Tariff adjustments and restructuring are needed to reduce the fiscal burden of the Ceylon Petroleum Corporation and the Ceylon Electricity Board.

Sri Lanka's commitment to an open trade regime needs to be maintained to benefit from strong global and regional growth.

I. INTRODUCTION AND POLITICAL BACKGROUND

1. **Since the last Article IV consultation, political constraints and uncertainties have affected policy implementation** (Box 1). In concluding the 2003 Article IV consultation, Executive Directors noted that uncertainties in the political situation and the peace process posed a risk to the implementation of essential reforms. Uncertainties have not abated since then, and while the ceasefire continues to hold, peace talks have been stalled for two years. The April 2004 elections turned power over to a coalition led by the President's party together with several other smaller parties, including the Marxist People's Liberation Front (JVP). However, difficulties in building a consensus for key reforms have been a constraint on policy implementation. The December 2004 tsunami, which took close to 40,000 lives and caused extensive damage to over two thirds of the Sri Lankan coastline, has added to the political frictions. As a result, a parliamentary majority that was established five months into the government's term only lasted until June 2005 when the JVP withdrew from the government coalition because of their opposition to a coordination mechanism with the LTTE to distribute tsunami aid to the North and East. On June 24, the government signed the Post-Tsunami Operational Management Structure (P-TOMS) with the LTTE.

Ceasefire accord	February 2002
LTTE pullout from peace talks	April 2003
Tokyo declaration	June 2003
LTTE proposal for interim administration	October 2003
President suspends Parliament for two weeks	November 2003
Alliance between President's party and JVP	January 2004
Split in LTTE leadership	March 2004
Parliamentary elections	April 2004
Parliamentary majority established	September 2004
JVP resigns from the government	June 2005
P-TOMS agreement signed	June 2005

2. **The economic strategy of the current government differs in significant ways from its predecessor's.** Greater emphasis is placed on rural development as the means to achieve poverty reduction. At the same time, the focus on the public sector as a driver of growth has increased, as evidenced by the expansion of the civil service and the halt of privatization plans for several strategic enterprises in favor of a restructuring under the newly created Strategic Enterprise Management Agency (SEMA). The government's broad economic strategy, which was outlined in an election manifesto and the 2005 budget, was further elaborated in the context of a development forum on tsunami reconstruction held in Sri Lanka during May 16–17 (donors pledged on the order of \$3 billion in assistance over the next 3–4 years). In addition to the immediate task of tsunami reconstruction, the announced strategy is based on enhancing public sector financial management and public service delivery, and promoting small and medium enterprises and rural development. The government's strategy was welcomed as a first step toward a more comprehensive poverty reduction strategy. Several donors emphasized that, while strengthening the role of the state and provision of public services was useful, attention needs to be equally directed at incentives for private sector development. It was also noted that the development strategy

Box 1. Sri Lanka: Previous Policy Recommendations

Over the past few years, Fund advice on several macroeconomic and structural reforms played a key role in policy development—for instance, in floating the exchange rate, introducing a VAT, and implementing financial sector reforms. These issues were summarized in the 2003 Article IV consultation report (IMF Country Report No. 04/68).

More recently, the authorities' implementation of staff's recommendations has been more mixed. The following is the status of the Board's main recommendations in the 2003 Article IV consultation:

- **Continue process of fiscal consolidation.** The overall fiscal deficit in 2004 remained at the same level as in 2003, while the primary deficit worsened by about 1 percent of GDP. Overruns in subsidies reached 1¼ percent of GDP.
- **Improve tax administration.** The creation of an independent Revenue Authority was envisaged under the PRGF/EFF-supported program. However, the authorities opted for the creation of a Revenue Board within the existing civil service. The establishment of the Revenue Board, together with recent staff changes within revenue agencies, provides scope for improved inter-agency coordination similar to what was anticipated under the proposed Revenue Authority. Establishment of a second large taxpayers unit has also resulted in some improvements in tax administration.
- **Broaden tax base and simplify tax regime.** The introduction of the Economic Service Charge, a broad-based business tax, was a positive step as was bringing civil service income into the tax net. Some measures in the 2005 budget, however, made the tax system more complex, such as the introduction of two new VAT bands and surcharges on a broad range of consumption goods.
- **Stand ready to tighten monetary policy if the political situation deteriorates or severe budget pressures materialize.** The end-2004 reserve money growth target was missed by more than 5 percentage points. Lax monetary policy was supportive of growth and contained the government's debt service costs but also contributed to the sharp increase in inflation and the loss of reserves. Since late 2004, policy rates have been increased three times and open market operations intensified.
- **Restructure state-owned banks.** Financial performance of state-owned banks has improved significantly reflecting continued operational autonomy. Although privatization plans have been abandoned, restructuring continues under the supervision of the Strategic Enterprise Management Agency.
- **Tighten prudential norms and enhance supervision.** Changes to provisioning rules and firmer enforcement of regulations have contributed to improvements in financial indicators in the banking system.
- **Implement automatic compensation formula for layoffs.** Formula has been specified but implementation remains pending. The level of compensation in the formula, which was originally very high by international standards, was increased further in March 2005.

remained unclear in several key areas such as agricultural policies and labor market regulations.

II. ECONOMIC DEVELOPMENTS IN 2004

3. **Accommodative fiscal and monetary policies helped support growth above 5 percent in 2004, but added to inflationary pressures.** These policies helped offset the adverse impact on growth of rising oil prices and a drought. Export performance was also strong in 2004, aided by textiles and tourism arrivals, but domestic demand (especially strong private investment) contributed to rapid growth in imports. Annual inflation reached 16.8 percent (SLCPI; end-of-period), reflecting demand pressures as well as higher food and oil prices (Table 1).

4. **The fiscal deficit reached 8.2 percent of GDP in 2004, or 1½ percent higher than budgeted.** Revenues fell short of the budget target owing to the late enactment of income tax amendments and lower than expected profit transfers from the central bank. Expenditure overruns were due to higher subsidies (mostly for fuel). The impact of these slippages on net domestic financing, which reached 6 percent of GDP, was exacerbated by lower privatization proceeds and shortfalls in program financing (Table 2). To bridge this gap, the government issued \$250 million (1¼ percent of GDP) in dollar denominated bonds in the domestic market. As a result, government debt remained at 105 percent of GDP, underscoring concerns about overall debt sustainability.

5. **With the central bank purchasing large amounts of treasury bills, ample liquidity was available for private credit, and money growth increased significantly.** Broad money increased by 20 percent, compared with 15 percent in 2003 and 14 percent envisaged under the authorities' monetary program (Table 3). The purchases of treasury bills aimed to offset the liquidity impact of foreign exchange intervention (which was undertaken to slow the depreciation of the rupee) and keep the cost of public and private credit low. Indeed, with the increase in inflation, and despite a modest increase in policy rates by 50 basis points in November, real interest rates remained negative contributing to private credit growth of 22 percent. In contrast to the previous year, monetary expansion in 2004 was accounted for by an expansion of net domestic assets (Figure 1).

6. **The balance of payments shifted to a deficit of \$205 million in 2004, from a surplus of \$502 million in 2003.** Despite robust export performance, the current account moved from near balance to a deficit of 3 percent of GDP (Table 4), reflecting the effects of both oil price increases and strong demand for investment goods. Official external financing—especially program loans—dried up significantly, with donors waiting for an articulation of the government's policy agenda. By end-2004, the rupee had lost 8 percent of its value against the dollar (y/y), despite central bank intervention, and gross official reserves had fallen to \$1.8 billion (equivalent to 2.1 months of imports) (Figure 2).

7. **The 2005 budget, approved in December 2004, envisaged a reduction in the deficit to 7½ percent of GDP.** The budget aimed to improve economic conditions for the rural poor, increase spending on health and education, phase out numerous subsidies,

including on petrol and diesel, and reaffirmed the government's commitment to meet the targets of the Fiscal Management (Responsibility) Act, albeit on a delayed timetable (Box 2).¹ While the 2005 budget targets represent a welcome step toward putting government debt on a declining path relative to GDP, budget estimates appeared overly optimistic, particularly for revenue. At the time, staff estimated that additional measures equivalent to 1¼ percent of GDP would be needed to meet budget targets.

8. **While some progress was being made on structural reforms by the end of 2004, financial costs in key public enterprises increased significantly.** On revenue administration, the cabinet approved in June 2004 the creation of a revenue board to coordinate the activities of various revenue departments. However, much remains to be done on the concurrently approved restructuring of the Inland Revenue Department. In the financial sector, the ADB approved a program loan in support of the restructuring of People's Bank, whose performance indicators have improved. In the energy sector, however, large fiscal and quasi-fiscal costs arising from the operations of the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) were incurred in 2004–05. Direct subsidies from the budget amounting to 1 percent of GDP in 2004, and ½ percent of GDP so far in 2005, have been paid to CPC to cover their losses. While electricity charges are among the highest in the region, operational inefficiencies in CEB have led to substantial losses estimated at ¾ percent of GDP in 2004, and accumulated debt and arrears amount to about 4 percent of GDP. Deadlines for reforming CEB have been postponed repeatedly.

9. **While macroeconomic conditions have stabilized somewhat since the tsunami, the situation remains vulnerable.** The rupee ended its downward slide on the expectation of aid inflows and has appreciated 5 percent against the U.S. dollar through end-May, and gross reserves increased by about \$240 million reflecting the Fund's emergency assistance and other donor disbursements. However, weaknesses in fiscal policy remain and, despite efforts by the central bank to absorb excess liquidity, monetary aggregates continued to exceed official targets and inflation remained in double digits (15 percent y/y in the SLCPI as of April). Fuel prices have been adjusted twice so far in 2005, but they remain below cost recovery levels. Stock prices, after a dip in the immediate aftermath of the disaster, have continued their rising trend from 2004 and are up by about 25 percent so far this year.

¹ The FMRA sets targets to reduce the overall fiscal deficit and government debt to 5 percent of GDP and 85 percent of GDP, respectively, by 2006. The target date in the Act is not binding, but the government is required to explain why the target is not met and announce a new time path.

Box 2. Sri Lanka: The 2005 Budget—Excluding Tsunami

The budget targeted a deficit of 7½ percent of GDP, a contraction of some 0.7 percentage points over the previous year. Since the budget was approved, official projections have been revised to forecast a deficit of around 8 percent of GDP. This revised estimate takes into account the impact of higher oil prices on subsidies and a lower revenue projection.

Revenue was projected in the budget to increase by 1¼ percentage point of GDP to slightly above 17 percent of GDP. The main measures on the revenue side were as follows:

- The unified VAT rate of 15 percent introduced in 2004 was supplemented with rates of 5 percent on essential food items and 18 percent on luxury goods. A 5 percent surcharge was introduced on the value of imported goods for VAT purposes, and imported capital goods exempted from VAT. A number of measures aimed at limiting refunds were also introduced.
- The excise tax base was broadened to include several household appliances, while excise rates were raised to prohibitive levels on betting and cars. The taxes on cars were raised from 30 percent to a maximum of 115 percent, depending on engine capacity.
- A broadening of the corporate income tax base was coupled with a reduction in personal income tax (PIT) rates. The deductibility of business expenses (e.g., for advertising, travel, entertainment) under the corporate income tax was restricted.
- Custom duty bands were reduced from 6 to 5 with the top rate broadly unchanged. However, a cess (surcharge) of 10–20 percent was imposed on more than 300 items ranging from fruits to footwear.

The authorities have lowered their revenue projection to 16¼ percent of GDP, but staff estimates that revenue is still likely to fall short of this target by about ½ percent of GDP. The impact of improvements in revenue administration appear unlikely to materialize to the extent expected by the authorities, and the sharp decline in vehicle imports in response to the imposition of prohibitive excises has had an adverse impact on revenue performance. Moreover, privatization receipts are also likely to fall short of budget estimates.

Expenditure was budgeted to increase by 1 percent of GDP. A steep increase in public investment more than offset cuts in current outlays. Spending on health and education was budgeted to increase by 30 percent. Subsidies were projected to decline by more than 1 percentage point of GDP, following adjustments in the prices of oil, wheat, and public services. Provisions for fuel subsidies were limited to kerosene. The budget also incorporated the 2005 effects of the two-year 40 percent wage increase for civil servants and new hiring equivalent to 7 percent of existing personnel.

Expenditure increases will now be limited to around ½ percent of GDP. Higher than expected subsidy payments will be more than compensated for by reductions in domestically and externally financed capital expenditure (excluding tsunami reconstruction). Continued high world oil prices, contrary to budget forecasts, mean that the maintenance of administered oil prices requires substantial ongoing subsidy payments, particularly on diesel.

III. POLICY DISCUSSIONS

A. Outlook and Risks

10. **The near-term outlook is to a large extent influenced by the post-tsunami reconstruction effort, which will have a significant financial impact on the government's budget and the balance of payments (see Annex I).**

- The devastation of the fisheries sector will adversely affect growth, but a rebound in tourist arrivals has been quicker than expected. After declining sharply in January and February, tourist arrivals rebounded and for the first five months of the year, arrivals and earnings increased by 8 percent compared with the previous year. Moreover, reconstruction activity and a bumper crop earlier this year are expected to support growth at about 5¼ percent in 2005, broadly in line with last year. Demand pressures arising from tsunami reconstruction and fuel price adjustments are likely to keep inflation in double digits.
- While the tsunami's impact on revenues is projected to be minor, government spending on reconstruction and relief will amount to 1½ percentage points of GDP. The authorities' intention is to finance additional tsunami-related spending through international support. Overruns on oil subsidies are projected to amount to ½ percent of GDP (even after assuming further price adjustments are made), and the authorities plan to reduce locally-financed development projects (compared with budget estimates) to keep domestic financing of the 2005 budget at 4½ percent of GDP.
- The external current account deficit is expected to increase by 2½ percentage points to 5½ percent of GDP in 2005, reflecting higher imports for tsunami reconstruction, slow growth in garment exports, and a steep oil price increase.² Total exports increased by 12 percent in the first five months of the year, and remittances by 24 percent. Coming off strong growth of 9 percent in 2004, garment exports increased by 6 percent in the first quarter of 2005. While the industry remains concerned about weaker orders for coming months, the overall adverse impact should be contained (Box 3).
- The authorities' monetary program envisages broad money growth of 15 percent in 2005. Given a modest increase in net international reserves, and provided the government meets its domestic financing target, the expansion of private sector credit would remain at about 20 percent.

² Oil prices are projected at \$51 per barrel in 2005 compared with \$38 per barrel in 2004 and \$29 per barrel in 2003. As a result, oil imports have increased in value terms by about \$900 million since 2003.

Box 3. Sri Lanka: Vulnerability to the Removal of Quotas on World Textile Trade

Sri Lanka is one of many nations affected by the removal of quotas under the WTO Agreement on Textiles and Clothing on January 1, 2005. Producers have shifted production to China and India to take advantage of low cost labor in these countries. The extent and timing of the impact, on Sri Lanka's and other nations, is difficult to determine, and depends on importer's policy responses, producer strategies, and price effects.

Sri Lanka has adopted policies to mitigate the impact of the quota removal. Large companies in particular are expected to remain competitive as most of them restructured their businesses, diversified their production to out-of-quota, high value-added goods, and expanded into new export markets. Although only 12 percent of the total, these companies generate more than 70 percent of the total value of textile exports. Medium sized exporters, with an export share of roughly 25 percent, have been and will go through further restructuring and consolidation to remain competitive. Small companies are likely to close down, but they account for only 5 percent of exports. However, small- and medium-sized companies employ 38 percent of the workers in the sector. The recent Comprehensive Economic Partnership Agreement with India and FTA negotiations with the United States and other countries will also help improve market access.

Government policies and changing business strategies have prepared the textile sector for the liberalization. The gradual shift to out-of-quota goods led to a decline in the quota utilization rate of the U.S. market from 85 percent in 2000 to about 67 percent in 2003. Exports to the European Union have been quota free for some years now, also suggesting they are competitive. Overall, Sri Lanka's quota-based exports have declined from more than 60 percent in the 1990s to about 50 percent in 2003.

Staff assesses the impact of quota removal on Sri Lanka's external position to be limited. The global price effect of quota removal is estimated at negative 10 percent over a three-year period. Although producer margins are likely to be squeezed, some of the price effect could be compensated by an increase in output. In the medium term, the volume of textile exports is projected to rise by a modest 2 percent per year.

11. **There are several downside risks to this outlook.** As noted above, the authorities will need to be prepared to take additional measures to meet fiscal objectives, including further adjustments in domestic fuel prices, which may prove politically difficult. Capacity constraints in the construction sector could also negatively affect inflation, while limiting the effectiveness of aid inflows. Shortfalls or delays in mobilizing external assistance could potentially lead to the same effects as in 2004: inflationary budget financing, recourse to nonconcessional foreign currency bonds, and pressures on the exchange rate. Further increases in international oil prices would also cloud growth and inflation prospects and amplify external vulnerabilities.

12. **The staff and the authorities agreed that the medium-term outlook hinges critically on Sri Lanka's ability to move toward fiscal consolidation, revive the peace process, and raise investment to levels comparable to its East-Asian peers.** To support poverty reduction, the authorities are targeting growth at 6–7 percent annually. Economic strategies would focus on effective implementation of tsunami reconstruction and providing more room for private investment by reducing the overall fiscal deficit to 4½ percent of GDP by 2008, with adjustment predicated on improving revenue performance. In addition, a sound monetary policy would lower inflation to single digits, and exports would be promoted through further rationalization of tariff and trade policies, enhanced trade facilitation, and investment arrangements with partner countries.

13. **Achieving growth and poverty reduction objectives will depend on the implementation of a sound and credible economic program.** In this regard, further work will be needed to develop the government's strategy unveiled during the May 16–17 Development Forum into a comprehensive Poverty Reduction Strategy. Looking forward, there is scope for significant gains in agriculture productivity and further development of tourism and telecommunication services, and significant untapped growth potential exists in the North and East of the country.³ There are also good reasons to believe that private investment will respond strongly if political stability and an improved investment climate can be established: literacy rates are among the highest in the region, administrative corruption is moderate, and preferential trade access to the European Union, India, and other regional partners should help counterweigh any adverse effects from the removal of textile quotas. However, land and labor market rigidities, poor road infrastructure, and unreliable and expensive electricity are major obstacles that need to be eased for private investment to flourish. Credible progress toward fiscal consolidation is also needed to improve investors confidence and provide a means for ending the financial repression that constrains capital market development.

³ Sri Lanka's recent growth experience and some comparisons with other similar countries are analyzed in Chapter I of the selected issues paper.

14. Sri Lanka has traditionally had strong social indicators, and progress towards many of the Millennium

Development Goals has been recorded. For example, Sri Lanka is on track to meet the targets on primary enrollment, and infant and maternal mortality (Table 8).

However, reductions in income poverty have been limited and mask wide disparities within the country. Despite per capita GDP growth of 3.5 percent during the 1990s, the incidence of poverty fell by a modest 3 percentage points to 22.7 percent in 2002 (excluding the North and East), compared with the MDG target to reduce poverty to 13 percent

by 2015. The reduction was much larger in urban than in rural areas, with the incidence of poverty in the seven poorest districts increasing from 30 percent to 37 percent. Persistent poverty in rural areas, and in the North and East, underscores the need to upgrade infrastructure and improve performance in the agricultural sector, as well as finding a durable solution to the civil conflict. The tsunami disaster, which hit hardest in the north, east and south, has also reportedly aggravated the unequal poverty trend.

	1990	1995	2002	2004
Poverty headcount ratio				
National average	26	29	23	...
Colombo area	16	12	6	...
Kandy	36	37	25	...
Monaragala (poorest district)	34	56	37	...
Difference between richest and poorest district				
Urban areas	16	14	8	...
Rural areas	29	31	25	...
GDP per capita (U.S. dollar)	473	719	870	1,031
Gini coefficient	0.47	0.46	0.48	...

Sources: Central Bank of Sri Lanka, *Annual Report*; and Development Forum discussion paper by the Ministry of Finance and Planning (May 2004), Department of Census and Statistics.

1/ Excludes the North and East, for which data are not yet available.

B. Fiscal Consolidation and Debt Sustainability

15. Fiscal developments thus far in 2005 reflect departures from budget estimates in several areas. While many aspects of the improved revenue performance evident in the fourth quarter of 2004 have carried over into 2005, collections in several areas have fallen short of expectations, including excise tax and import duties (as discussed in Box 2). On the expenditure side, subsidies for fuel have been considerably higher than budget provisions (despite price increases in May and June), and Rs. 20 billion has already been spent on tsunami relief. Domestic financing of the budget in the first five months reached Rs. 50 billion, compared with the budget estimate of Rs. 105 billion for the year. The authorities explained that, to remain within the budget target for domestic financing, cash flow relief provided by debt moratoria/cancellation will offset the tsunami relief expenses incurred earlier in the year and the implementation of locally-financed investment projects will be paced according to the availability of financing.

16. Staff indicated that careful implementation of fiscal policy was critical for maintaining macroeconomic stability, especially in view of demand pressures likely to be associated with tsunami reconstruction. Staff argued for consideration of additional near-term

revenue measures. These could include reducing the prohibitive excise duty on vehicle imports, streamlining tax exemptions, or increasing the number of items subject to the top VAT rate of 18 percent. For expenditure, there is no feasible alternative to further adjustment in domestic prices to end subsidies for diesel and, while there is a public policy role for maintaining subsidies on kerosene to protect the poor, there is scope for cutting back on the size of the subsidy. The authorities' plans to reduce spending on lower priority locally-financed development projects would also be desirable in view of significant spending on tsunami reconstruction expected in the second half of the year.

17. **The authorities agreed with this overall approach, but remain somewhat more optimistic on revenue prospects.** They expect to achieve the revised revenue estimate of 16¼ percent of GDP and believe that performance would improve significantly by midyear reflecting the extension of the Economic Service Charge (ESC)—a minimum corporate tax—to Board of Investment (BOI) companies, and an expected increase in dutiable imports. On this basis, they would review revenue developments in the first six months and take additional measures if needed to meet the revised target. Following the fuel price increases in May and June, they plan to implement further adjustments over the next several months to eliminate the subsidy for diesel. Price adjustments are also expected to be implemented for electricity, railways, and buses.

18. **Staff agreed with the authorities that the key priority for fiscal adjustment, and for meeting medium-term objectives, was revenue enhancement.** However, the authorities' medium-term framework relies on revenue projections that are very ambitious (rising from 15 percent of GDP in 2004 to 19½ percent in 2008). The authorities explained that they were committed to improving revenue but had not yet decided on specific policies, while they were also more optimistic than staff on the gains from improved tax administration. The staff emphasized that, until significant progress in improving revenue has been demonstrated, the medium-term fiscal framework should be based on lower revenue targets and more adjustment on the expenditure side to meet FMRA targets (Table 5). In addition to the near-term revenue measures noted above, extension of the VAT to the wholesale and retail sectors, continued improvements in tax and customs administration, and other base-broadening measures should be the priorities over the medium term.

19. **Persistent problems in improving revenue performance underscore the importance of rationalizing and improving the efficiency of government spending.** Expenditure reforms would need to include elimination of most subsidies, improved administration and targeting of welfare benefits, and better debt management. Increasing public employment levels and significant pay increases aggravate the problems caused by an overstaffed civil service and provide yet another factor that complicates medium-term consolidation. A comprehensive plan for civil service reform needs to be developed that takes into account the objectives to increase average pay levels, decompress the wage structure, and improve the efficiency of the civil service.

20. **With public debt over 100 percent of GDP, debt sustainability is a serious concern.** This underscores the importance of having the FMRA in place, and in taking

credible steps to get on a path consistent with meeting the legislative targets by 2008, as envisaged by the government. The scenarios depicted in Annex II indicate that if this is done, the debt outlook would be sustainable. However, if fiscal performance does not improve or failure to address structural problems undermines future growth, the outlook quickly deteriorates. The staff also expressed concern about debt management, especially since recent developments such as the terms of the Paris Club debt moratorium and issuance of domestic bonds at high coupon rates will increase debt service costs in the future.^{4 5} While the authorities have expressed interest in an extension of the Paris Club debt service moratorium to help finance tsunami reconstruction, they also want to maintain their future access to commercial credit and are considering requesting an international sovereign rating.

21. **Some welcome improvements in tax administration over the last six months are evident.** The new Revenue Board has created the potential for improved inter-agency coordination, the scope of the Large Taxpayers Unit has been expanded, civil servants have been brought into the tax net, and the introduction of the Economic Service Charge has improved income tax collections. While this is a good start, much more will be needed to underpin improved revenue performance in the future. Consistency in tax policy by avoiding ad hoc adjustments in rates and charges would help improve administration. Efforts should also be focused on upgrading technology, introducing a uniform taxpayer ID number and risk-based audit procedures, and strengthening collection and enforcement efforts.

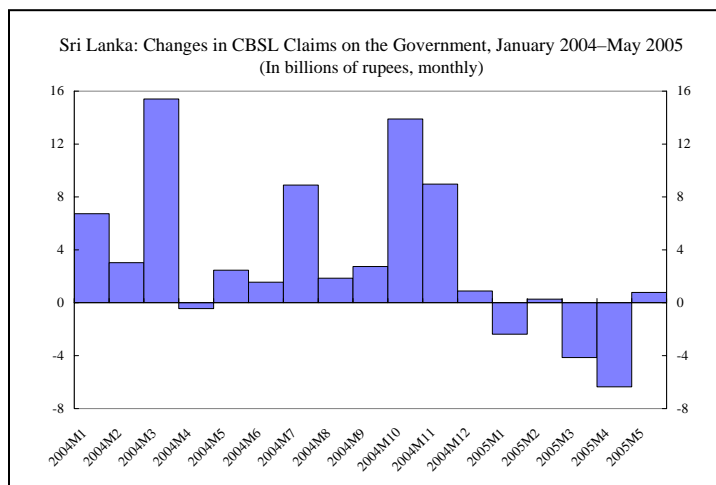
22. **Since the 2002 fiscal ROSC, some progress has been made in improving budgetary procedures, but many of the weaknesses still remain.** There has been progress with respect to the quality of budget documentation and in the reporting of intra-year fiscal data. Problems remain, however, in the coverage of fiscal data. Priority should also be given to a more comprehensive monitoring of fiscal risks—such as those posed by the losses of CEB—in particular by systematically accounting for implicit and contingent liabilities in both the short and medium-term and through analysis of the overall public sector debt burden.

⁴ Because of the high interest rates, purchasers are willing to pay more than face value for the bonds with receipts above face value recorded as negative interest payments in the current year (amounting to ½ percent of GDP in 2005). While this is a proper statistical treatment, it holds down interest payments (and the overall deficit) in the current year at the expense of higher interest payments in future years.

⁵ Paris Club creditors have granted a one-year moratorium on debt service payments due in 2005, which are now to be repaid in the period 2006–2009. Interest accrued during the moratorium period will be capitalized and repaid along with the rescheduled payments.

C. Monetary and Exchange Rate Policy

23. **The staff welcomed recent central bank efforts to reduce liquidity and recommended a more aggressive tightening of monetary policy.** Outstanding credit to the government by the central bank declined by about ½ percent of GDP from December to May—a reversal from the experience of 2004. Noting that monetary growth is still above target, and that the CBSL quarterly targets leave a considerable amount of adjustment to take place at the end of the year, the staff argued that a faster tightening would reduce the risk of a sharper and potentially disruptive correction in interest rates later



on. Delays in tightening the monetary policy stance risk entrenching current inflation pressures, especially since tsunami reconstruction is expected to place considerable pressure on wages and prices in the second half of the year. The authorities indicated that they would continue to gradually tighten monetary policy, reflecting their desire for policy to remain supportive of growth. In late May and June, the repo/reverse repo policy corridor was increased by 25 basis points and 50 basis points, respectively, raising expectations of future adjustments in coming months. The staff also stressed the importance of reducing fiscal dominance, granting more autonomy to the CBSL to strengthen its credibility, and to increase the transparency of monetary policy by, for example, publishing the minutes of the meetings of the Monetary Board.

24. **The authorities reiterated their commitment to the flexible exchange rate regime.** Staff emphasized that interventions in the foreign exchange market should be limited to moderating short-term fluctuations in the rate, or increasing reserves to targeted levels when market conditions are conducive. The authorities maintained that interventions undertaken in 2004 and 2005 were meant to stabilize and smooth the transition in the rate in response to market pressures. While there has been some appreciation in the nominal and real effective rates thus far in 2005, overall competitiveness was not an immediate concern as the real effective exchange rate has depreciated slightly over the last three years. Staff agreed with the authorities that, given possible differences in the timing of tsunami-related aid flows and the corresponding import needs, exchange rate volatility could pick up, and the central bank could intervene during the time of inflows to provide scope for selling foreign exchange to the market later, if necessary, to finance imports that are the counterpart to tsunami-related aid. However, a sustained drop in foreign reserves (as happened in 2004) below current low levels should be avoided at a time of downward pressure on the rate. Staff also advised

against using protectionist trade policies or exchange control measures in an attempt to stem downward pressures on the currency.

D. Priority Structural Reforms

25. **The financial performance of some large public enterprises has deteriorated to the point where they could threaten economic and financial stability.** Fuel price adjustments will reduce government subsidies to the CPC, and once prices have been adjusted to reflect prevailing international levels, reinstatement of the automatic pricing formula would prevent the problem from recurring in the future. For CEB, there is a more urgent need for fundamental restructuring. There appears to be no option but to move forward as quickly as possible with the long-delayed unbundling of production, transmission, and distribution being supported by the ADB and Japan Bank for International Cooperation (JBIC), while securing the necessary investments to reduce the reliance on expensive sources of power. More independent regulation of public utilities would also be important for avoiding political interference. There are similar fiscal risks (but on a much smaller scale) in the operations of railways, buses, and other utilities that need to be addressed. In addition to adjusting fuel prices, the authorities stressed their commitment to bring in another foreign investor to increase competition in the distribution of oil products, and to press forward with CEB reforms. At the time this report is being issued, the government was still negotiating with labor unions on CEB restructuring.

26. **There are several examples where the performance of enterprises has been enhanced through privatization or improved management.** These include Sri Lanka Telecom, Air Lanka, the Ports Authority, Bank of Ceylon, and even People's Bank (although much more remains to be done). These examples show that strong management teams and increased commercial autonomy can contribute to significant improvements in performance, and staff noted that these positive experiences could be better leveraged to build public consensus for reform.

27. **There have been improvements in the overall regulation and supervision of the financial system.** Commendable progress has been made since the completion of the FSAP in 2002. NPAs have come down, provisioning increased, and capital positions improved across the entire banking system (Table 6). Among other things, this should help reduce banks spreads between deposit and lending rates which at about 4 percent are relatively high.⁶ This progress has been largely due to changes in prudential regulations that reduced the value of collateral consistent with more realistic recovery rates, enhanced supervisory efforts, and improved procedures for collection and recovery of bad debts. However, by not requiring provisioning against loans overdue between 3–6 months, capital remains somewhat overstated. Staff is also concerned that the current rapid growth in lending—in a context of

⁶ Recent developments in Sri Lanka's banking sector are discussed in Chapter III of the selected issues paper.

negative real interest rates—could lead to a deterioration of asset quality in the future. In response to the authorities' plans to implement a system of mandatory deposit insurance, staff noted the need to ensure that necessary preconditions are satisfied, including the need to strengthen legal and financial institutions. The CBSL has addressed all of the recommendations of the full Safeguards Assessment of June 2003, including through revisions in the Central Bank Act that are expected to be approved in 2006.

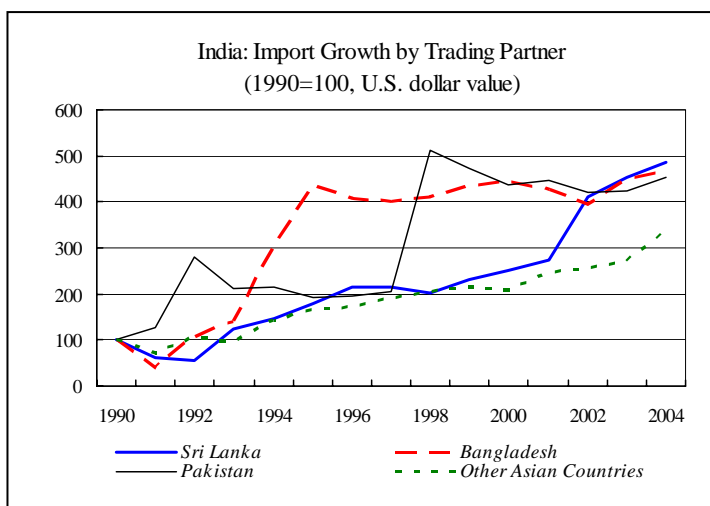
28. **Significant improvements have also been made in the financial position and operation of the two large state-owned banks.** Bad loans have been written off and/or recovered, provisioning increased, government interference declined, and better credit risk practices were installed. People's Bank, however, still has a long way to go before it could be considered a financially sound entity. While progress has been made in disposing and provisioning for the stock of NPAs on the books, it is too early to tell whether new lending policies are significantly increasing the quality of the loan portfolio. To avoid repeating the mistakes with previous recapitalizations, capital injections should be directly linked with performance indicators as envisaged under the restructuring plan agreed with SEMA.

29. **Sri Lanka's commitment to an open trade regime needs to be maintained to benefit from strong global and regional growth.** Recent ad hoc changes in import surcharges and fees have complicated the system and send mixed signals to the private sector. Staff argued that this system should be rationalized into the current tariff structure and the remaining 10 percent surcharge on imports removed once revenue improvements have been secured. The authorities responded that they remain fully committed to an open trade regime. The various fees placed on a number of consumer imports (cesses) are specific charges earmarked to fund export promotion and development activities. They indicated their intention to further rationalize the tariff structure in the future.

30. **There are large trade opportunities within the region, especially with respect to the fast growing Indian economy.**

Sri Lanka was slow to pick up on the large trade potential that its fast growing neighbor provides, but since 2001 the pace of export growth to India has picked up substantially.

The Comprehensive Economic Partnership Agreement with India and other regional trade initiatives provide the basis for further expansion.⁷ Staff stressed that, to fully



⁷ See Chapter IV of the selected issues paper for a further discussion of Sri Lanka's trade and regional integration.

capture the benefits of regional trade integration, progress should also be made in moving to a low uniform tariff structure to minimize distortions and inefficiencies than can result from preferential agreements.

31. **Lack of capital market development threatens to constrain future growth performance.** While capitalization in the stock market has continued to grow, the corporate bond market remains underdeveloped. The Employee Provident Fund (EPF) and National Savings Bank (NSB), with assets amounting to about 30 percent of GDP, remain important captive sources of government financing. While these institutions plan to seek alternative investments in the future, very little movement in this direction has yet taken place. These captive sources have enabled the government to access financing at rates that are below the prevailing inflation rate, but this financial repression is also acting as a constraint on broader banking and capital market development.

32. **High redundancy payments for private sector workers continue to undermine the efficiency of the labor market.** At a maximum of four years of salary, Sri Lanka has one of the most generous schemes in the world. Moreover, the private sector is concerned with a recent government initiative to mandate specific wage increases. Staff noted that

such interference in wage setting was unwarranted and could damage competitiveness of some sectors. The authorities, however, felt that the strength of labor unions and the protections provided to workers were a positive feature and stressed the need for strategic partnerships between the government, the private sector, and unions.

	Difficulty of Firing Index (0-100)	Firing Costs (Weeks of wages) 1/
Sri Lanka	80	152
Indonesia	70	157
Pakistan	30	90
Nepal	90	90
India	90	79
Malaysia	10	74
China	40	53
Thailand	20	47
Bangladesh	20	47
Cambodia	30	39
Hong Kong, SAR	0	13
Singapore	0	4

Sources: 2005 *Doing Business* database, World Bank; and staff estimates.

1/ Estimated firing costs for a 20-year tenure worker. The figure for Sri Lanka reflects recent legal changes while the figures for other countries refers to January 2004.

E. PRGF and Extended Arrangements

33. **The authorities indicated their desire to resume discussions on a Fund-supported program in the near future and requested that the Fund continue to provide policy advice and focused technical assistance.** The authorities recognized the usefulness of a formal financial framework with the Fund in underpinning macroeconomic discipline, providing a framework for donor coordination, and supporting domestic reform efforts. However, they also stressed the importance of ownership for program success and felt that more time was needed to generate domestic consensus for key reforms. Staff agreed

that establishing credibility of the reform program was essential, especially in view of the slippages experienced in the implementation of the current program (Table 9). The authorities expressed interest in further technical assistance from the Fund in key areas, including deposit insurance, revenue administration, and debt management. A staff visit is envisaged in September to review progress and discuss the framework for the 2006 budget.⁸

F. Tsunami Reconstruction

34. **Coordinating tsunami reconstruction and the use of aid resources will be a considerable challenge for the government.** Staff advised that spending priorities and final decisions on distributing aid should be determined by the government who should coordinate official assistance and oversee arrangements to manage and monitor private aid flows. While all official aid should ideally be recorded in the budget, the government intends to have a significant portion of reconstruction—especially for schools and hospitals—executed directly by donors (outside of the central government’s budget). Given the extra burden these additional projects would exert on the government’s administrative capacity, this approach can be justified. Coordination mechanisms have been set up in the form of the Task Force for Reconstruction of the Nation (TAFREN) to manage the relationship between the government and donors, and memoranda of understanding (MOUs) have been signed to monitor and coordinate implementation. An external auditor has also been hired and a database for monitoring aid is being established. The government has indicated its commitment to implement the reconstruction strategy with full transparency and accountability and improve its communication and community participation to involve every stakeholder in the process. Periodic comprehensive reports are expected to be prepared on these activities and provided to the public and the donor community.

G. Economic Statistics

35. **Improvements in economic statistics have been made in a number of areas, but weaknesses remain.** While full adoption of the GFSM 2001 methodology will take substantial time, there are several improvements in fiscal statistics that can be made a priority, including reducing the lag in producing monthly expenditure details, improving reporting on extra budgetary funds and provincial councils, and revising budgetary classifications and the accounting structure. Staff also encouraged the authorities to address the remaining issues needed to meet SDDS requirements, which include compiling and disseminating prescribed data on general government operations, international reserves and foreign currency liquidity, and the international investment position.

⁸ For illustrative purposes, the balance of payments scenario presented in Table 4 assumes a one-year extension of the current PRGF/EFF arrangements until April 2007.

IV. STAFF APPRAISAL

36. **The Sri Lankan authorities, supported by the international community, have provided the initial stages of tsunami relief relatively efficiently.** However, implementation of the more difficult reconstruction phase will affect economic performance going forward. While near-term prospects for economic growth remain positive, inflation pressures are likely to be sustained. Growth could suffer as a result of the impact of the tsunami on fisheries, as well as the removal of global textile quotas. These factors, however, will be compensated by the good performance of the agricultural sector, and the impact of tsunami reconstruction activity. While some decline in agricultural prices is expected, fuel price adjustments, and the high growth in monetary aggregates are expected to keep inflation in double digits. As reconstruction efforts proceed, pressure on domestic wages and prices are likely to perpetuate inflation pressures into 2006.

37. **To help support reconstruction efforts, the staff continues to emphasize the importance of closely monitoring the disbursement and use of aid flows to ensure accountability and transparency.** The monitoring mechanisms for tsunami aid that have been established are a good start, but need to be supplemented by frequent reports directly to the public and the donor community on the use of aid flows, and specific audit procedures to ensure adequate accountability in the use of aid should be established.

38. **The high level of public debt exerts a toll on sustainable growth and adversely affects expectations of macroeconomic stability.** Insufficient fiscal adjustment could very well lead to adverse debt dynamics, undermine economic sustainability, and significantly compromise the ability of the government to further reduce poverty and meet the MDGs. Thus far, meaningful progress toward the path of fiscal consolidation envisaged under the Fiscal Management (Responsibility) Act has remained elusive, and government debt at end-2004 remained above 105 percent of GDP. Improvements in overall debt management in the context of a medium-term budget framework geared toward consolidation will be needed to manage this situation.

39. **A recent improvement in revenue performance is welcomed, but much more needs to be done.** After declining for several years, tax revenue increased by one percentage point of GDP in 2004, and a number of measures taken in the second half of 2004 helped limit the increase in the central government deficit and set the stage for improved revenue in 2005. However, despite this improvement, the 2005 budget targets for revenue are unlikely to be achieved. Additional near-term policy measures should be considered to strengthen tax collections, especially given the uncertain outlook for privatization receipts. Over the medium term, extending the VAT to the wholesale and retail sectors, continued improvements in tax and customs administration, and broadening the tax base would be important priorities.

40. **Expenditure reforms will also be needed to support fiscal adjustment.** In the short term, there is no feasible alternative to price adjustments to end fuel subsidies for petrol and diesel while reducing the subsidies for kerosene. Careful prioritization of locally-financed

investment projects will be needed to limit pressure on domestic resources while using available foreign financing to advance tsunami reconstruction. Expenditure reforms will also need to include improved administration and targeting of welfare benefits. Beyond tsunami reconstruction, transportation infrastructure needs to be improved to enhance the environment for private sector investment. Controlling the wage bill and promoting better public services will require a comprehensive plan for civil service reform that takes into account the objectives to increase average pay levels, decompress the wage structure, and improve efficiency.

41. **In view of the prevailing high inflation, and continued high growth in monetary and credit aggregates, monetary policy should be tightened further.** The central bank is to be commended for recent efforts to intensify open market operations, but stronger efforts are needed to reduce the rate of reserve money growth, and interest rates will need to be free to adjust as necessary to meet monetary targets. A further increase in the interest rate policy corridor would signal the government's determination to reduce inflation, and help reduce inflationary expectations. More central bank autonomy is also needed to enhance the credibility of monetary policy.

42. **The flexible exchange rate regime has an important role to play in economic adjustment**—especially in view of the external and domestic macroeconomic shocks experienced in 2004–05. The loss of official reserves in 2004 underscores the risks of trying to avoid an exchange rate depreciation through protracted intervention. Given the prospects for large aid inflows and import needs in the coming months, exchange rate volatility could pick up, and some intervention to smooth short-run adjustments is justified. However, a drop in foreign exchange reserves below current levels should be avoided, and the exchange rate allowed to depreciate if downward pressures on the rate were to emerge. Any attempts to use protectionist trade policies or reverse long-standing liberal exchange policies in an attempt to temporarily reduce pressures on the exchange rate would be counterproductive and should be avoided. Over the medium term, international reserves should be increased to a more comfortable level.

43. **The medium-term outlook hinges critically on Sri Lanka's ability to move toward fiscal consolidation, implement structural reforms, and revive the peace process.** Significant untapped growth potential remains in the North and East, and the country has a good opportunity to take advantage of rapid growth in the subregion through increased cooperation and trade. However, a complex tax system, labor market rigidities, unreliable and expensive electricity, and poor infrastructure threaten to undermine growth potential. Moreover, capital market development will also be necessary to support future growth.

44. **Restructuring of public enterprises remains an important priority.** The creation of the Strategic Enterprise Management Agency (SEMA) is an important step in monitoring the performance of those large enterprises expected to remain in the public sector. While improvements have been made in the financial position of some enterprises, fiscal and quasi-fiscal costs incurred by the Ceylon Electricity Board (CEB) and Ceylon Petroleum

Corporation (CPC) threaten to undermine economic performance and the need for reforms has become increasingly urgent. Further tariff adjustments and restructuring are needed to improve the financial position and reduce the fiscal burden of these enterprises. A more comprehensive monitoring of fiscal risks posed by public enterprises should be a priority.

45. Noticeable improvements have been made in the overall regulation and supervision of the financial system since the completion of the FSAP in 2002.

Nonperforming loans have come down, provisioning increased, and capital positions improved across the entire banking system, including in the two large state-owned banks. While constrained by limited resources, the benefits of improved regulatory and supervisory practices are clearly evident. Continued vigilance will be needed, however, as the recent rapid growth in lending could lead to a deterioration of asset quality. It will be important to closely monitor the large state banks to ensure that restructuring continues and that any capital injections are directly linked with performance indicators. Reforms in the banking system will also contribute to reduce interest rate spreads and improve the monetary transmission mechanism. Improving the functioning of the government debt market, including by liberalizing investment options for captive sources of government financing (e.g., the EPF), will lead to more market-determined interest rates, improve returns to pensioners, and, by reducing financial repression, contribute to the development of capital markets and higher economic growth.

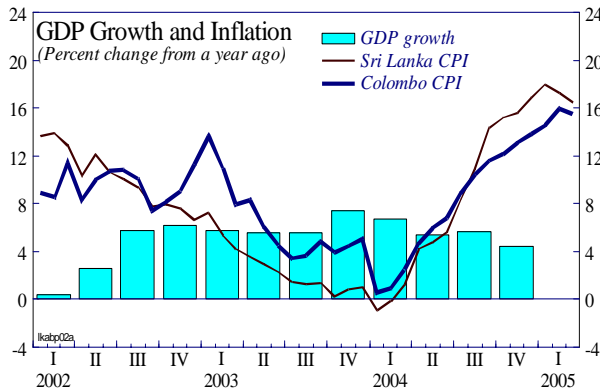
46. Sri Lanka's commitment to an open trade regime needs to be maintained to benefit from strong global and regional growth. In conjunction with efforts to promote regional trade, progress also should be made in moving to a low uniform tariff structure to minimize distortions and inefficiencies than can result from preferential agreements.

47. Staff urges the authorities to re-establish the credibility of their reform program to provide a basis for the resumption of Fund program support. The authorities are also encouraged to improve the quality and coverage of fiscal statistics and address the remaining issues needed to meet SDDS requirements.

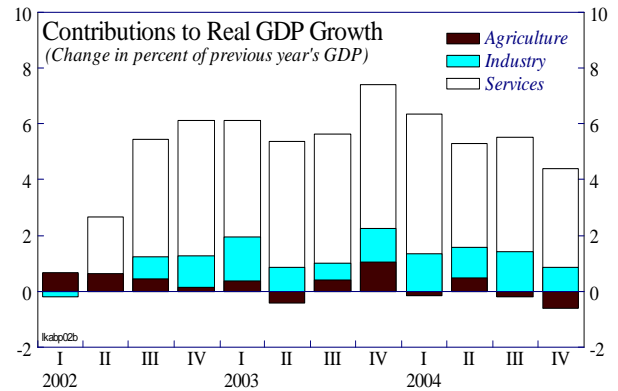
48. It is recommended that the next Article IV consultation with Sri Lanka be held in accordance with the provisions of Board Decision No. 12794-(02/76) approved on July 15, 2002.

Figure 1. Sri Lanka: Real, Fiscal, and Monetary Sector Developments 1/

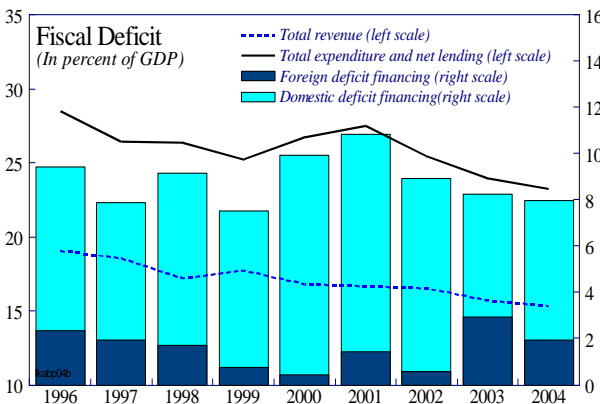
While GDP growth eased in early 2004, inflation has picked up sharply.



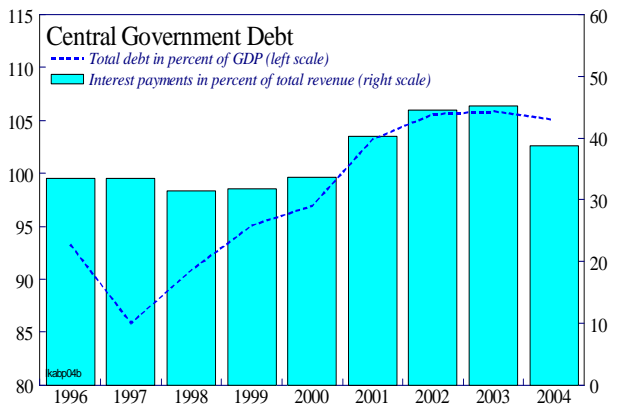
Poor agricultural performance, due to drought, contributed to the slowdown in growth.



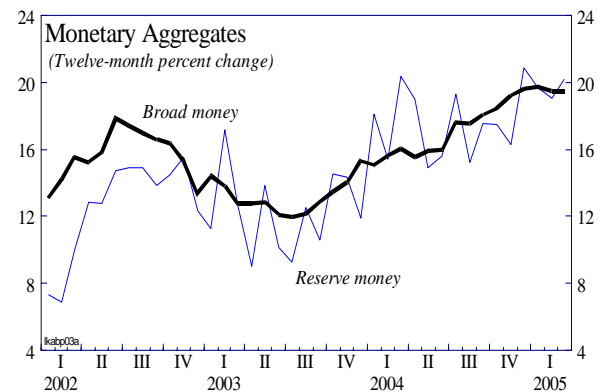
Fiscal adjustment remained elusive, and domestic deficit financing increased in 2004.



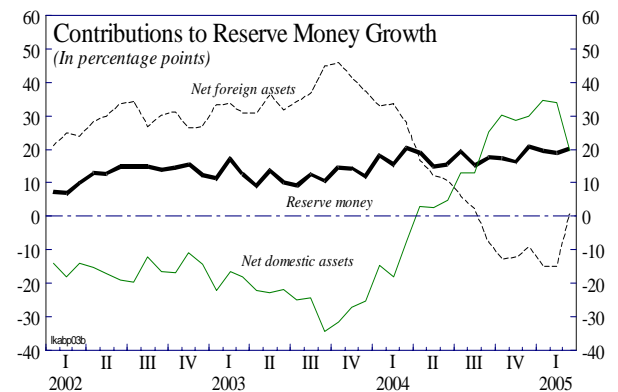
While interest payments decreased somewhat, the debt stock remains very high.



Monetary growth has accelerated...



...reflecting a substantial increase in NDA

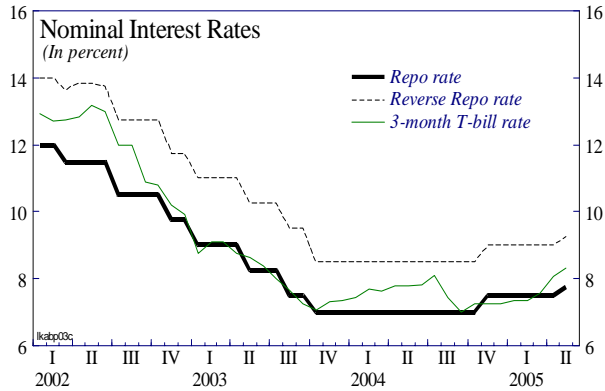


Sources: Data provided by the Sri Lankan authorities; and CEIC Data Company Ltd.

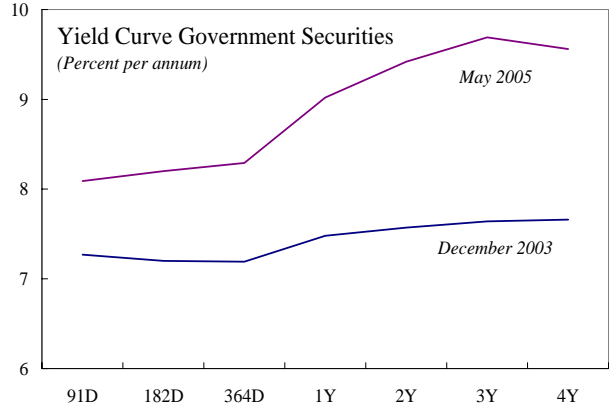
1/ GDP for FY2004 is a staff estimate.

Figure 2. Sri Lanka: Financial and External Sector Developments

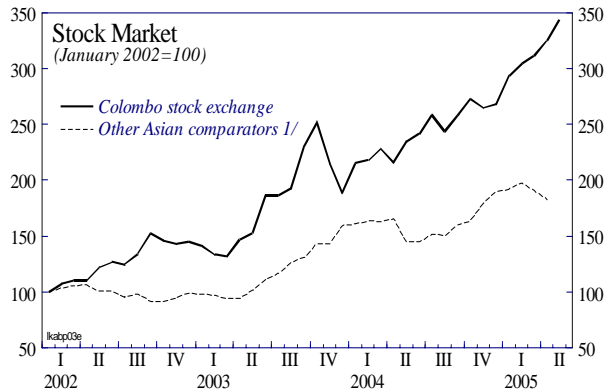
Short-term interest rates have risen by much less than the increase in inflation...



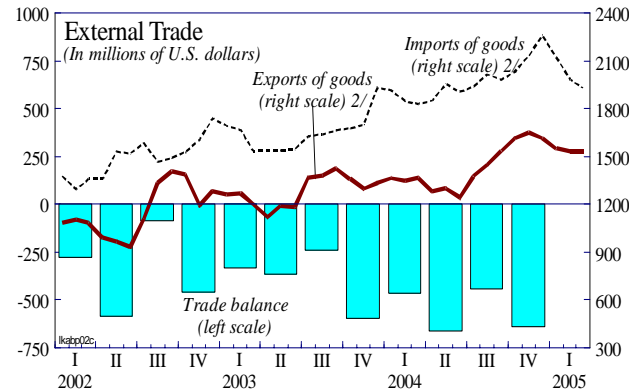
...but the steepening of the yield curve suggests that inflation expectations have increased.



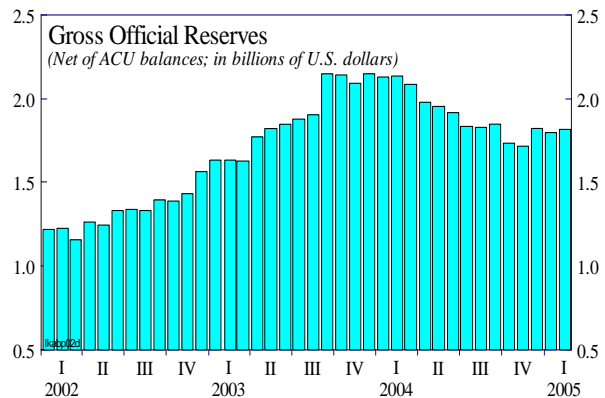
The stock market has recovered dramatically since late 2003, due to strong corporate earnings and dearth of investment opportunities.



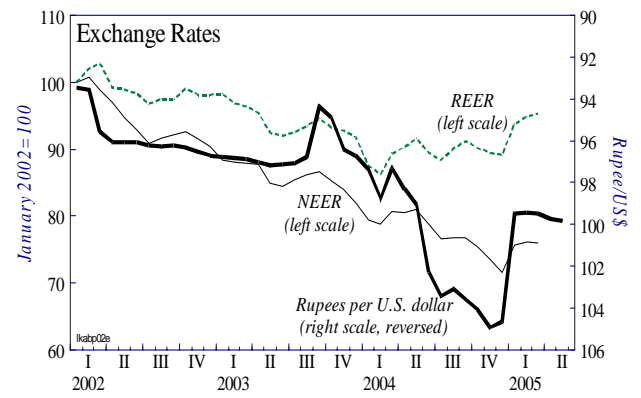
Higher oil prices and robust demand for non-oil imports have caused the trade deficit to widen.



Despite heavy intervention by the central bank...



...the rupee depreciated considerably vis-à-vis the U.S. dollar in 2004 before appreciating on the expectations of post-Tsunami aid flows.



Sources: Data provided by the Sri Lankan authorities; and CEIC Data Company Ltd.
 1/ Weighted average of indices of India, Malaysia, Indonesia, Pakistan, and Philippines.
 2/ Three-month moving average.

Table 1. Sri Lanka: Selected Economic Indicators, 2001–2005

Nominal GDP (2004): US\$20.0 billion

Population (2004): 19.3 million

GDP per capita (2004): US\$1,029

Quota: SDR 413 million

	2001	2002	2003	2004 Est.	2005 Proj.
GDP and inflation (in percent)					
Real GDP growth	-1.5	4.0	6.0	5.4	5.3
Inflation (Sri Lanka CPI; average)	12.1	10.2	2.6	7.9	14.0
Inflation (Sri Lanka CPI; end-of-period)	13.4	6.6	1.0	16.8	10.5
Public finances (in percent of GDP)					
Revenue	16.6	16.5	15.7	15.3	15.7
Expenditure	27.5	25.4	24.0	23.5	23.9
Primary balance (excluding grants)	-4.1	-1.6	-1.2	-2.2	-3.1
Overall balance (excluding grants)	-10.8	-8.9	-8.3	-8.2	-8.2
Overall balance (including grants)	-10.4	-8.5	-7.8	-7.7	-7.4
Domestic financing	8.8	8.0	4.8	5.8	4.4
Government debt (domestic and external)	103.2	105.6	105.8	105.4	100.7
Money and credit (percent change, end of period)					
Reserve money	7.0	12.3	11.9	20.9	15.0
Broad money	13.6	13.4	15.3	19.6	15.0
Domestic credit	16.2	6.5	7.6	22.4	13.2
Private sector credit	8.9	12.0	16.9	22.1	21.0
Public sector credit	30.6	-2.6	-10.0	23.2	-5.7
91-day T-bill rate (in percent, end of period)	12.9	9.9	7.4	7.3	10.0
Balance of payments (in millions of U.S. dollars)					
Exports	4,817	4,699	5,133	5,757	6,098
Imports	5,974	6,105	6,673	8,000	9,171
Trade balance	-1,157	-1,406	-1,540	-2,242	-3,073
Current account balance	-179	-236	-74	-648	-1,257
Current account balance (in percent of GDP)	-1.1	-1.4	-0.4	-3.2	-5.6
Overall balance	229	339	502	-205	-126
Export value growth (percent)	-12.8	-2.4	9.2	12.2	5.9
Import value growth (percent)	-18.4	2.2	9.3	19.9	14.6
Gross official reserves (end of period)					
In millions of U.S. dollars 1/	1,183	1,560	2,146	1,833	2,083
In months of imports	2.0	2.4	2.8	2.1	2.2
As a percent of short-term debt 2/	57	80	109	81	93
External debt (public and private)					
In billions of U.S. dollars	9.5	10.3	11.7	12.6	13.3
As a percent of GDP	60.8	62.6	64.1	62.8	58.9
Memorandum item:					
Nominal GDP (in billions of rupees)	1,407	1,582	1,761	2,029	2,345

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

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

2/ As reserves exclude ACU balances, they are also excluded from short-term debt to compute this ratio.

Table 2. Sri Lanka: Summary of Central Government Operations, 2001–2005
(In percent of GDP, unless otherwise indicated)

	2001 Act.	2002 Act.	2003 Act.	2004		2005			
				Budget	Est.	Budget	Excl.	Incl.	Incl.
						tsunami IMF 1/	tsunami	tsunami	tsunami
Total revenue	16.6	16.5	15.7	16.4	15.3	17.1	16.0	16.3	15.7
Tax revenue	14.6	14.0	13.2	14.5	13.9	15.4	14.3	14.6	14.1
Income taxes	2.5	2.4	2.2	3.0	2.0	2.4	2.3	2.3	2.3
Value added tax/GST	3.3	4.2	5.5	6.0	5.9	6.3	6.0	6.0	5.8
Excise taxes	3.2	3.3	2.9	2.8	3.2	3.4	3.1	3.2	3.1
National security levy	3.1	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on international trade	1.9	1.8	1.9	2.1	2.0	2.4	2.1	2.3	2.0
Other	0.7	0.5	0.6	0.7	0.6	0.9	0.9	0.9	0.9
Nontax revenue	2.0	2.5	2.5	1.8	1.5	1.7	1.7	1.7	1.7
Total expenditure and net lending	27.5	25.4	24.0	23.2	23.5	24.6	23.8	24.5	23.9
Current expenditure	21.6	20.9	19.0	17.6	19.2	18.5	18.5	18.3	18.6
Civil service wages and salaries	3.4	3.4	3.2	3.2	3.2	3.9	3.8	3.8	3.8
Other civilian goods and services	2.0	1.3	1.2	1.1	1.3	1.2	1.2	1.2	1.2
Security related expenditure	4.9	4.1	3.5	3.5	3.6	3.6	3.5	3.5	3.5
Subsidies and transfers	4.6	4.7	4.0	3.9	5.2	4.1	4.5	4.7	5.0
Households	3.8	3.4	3.0	3.0	4.1	3.1	3.6	3.8	4.1
<i>Of which: Samurdhi</i>	0.9	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4
<i>Of which: pensions</i>	1.9	2.0	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Institutions, corporations, other government agencies	0.9	1.4	1.0	0.9	1.1	0.9	0.9	0.9	0.9
Interest payments	6.7	7.4	7.1	6.0	5.9	5.6	5.5	5.1	5.1
Foreign	0.7	0.7	0.7	0.8	0.7	0.8	0.8	0.3	0.3
Domestic	6.0	6.7	6.4	5.2	5.2	4.8	4.7	4.7	4.7
Capital expenditure and net lending	5.9	4.6	5.0	5.5	4.3	6.2	5.3	6.2	5.3
<i>Of which: tsunami</i>	...	...	...	...	...	...	...	0.9	0.9
Overall balance	-10.8	-8.9	-8.3	-6.8	-8.2	-7.5	-7.9	-8.2	-8.2
Overall balance (including grants)	-10.4	-8.5	-7.8	-6.3	-7.7	-7.1	-7.4	-7.4	-7.4
Financing	10.8	8.9	8.3	6.8	8.2	7.5	7.9	8.2	8.2
Net external financing	1.0	0.1	2.4	2.5	1.8	2.1	1.2	2.6	2.6
Net domestic financing	8.8	8.0	4.8	3.2	5.8	4.6	5.9	4.4	4.4
Privatization	0.6	0.4	0.6	0.6	0.1	0.3	0.3	0.3	0.3
Grants	0.4	0.4	0.5	0.5	0.4	0.4	0.4	0.8	0.8
Memorandum items:									
Current account balance (excluding grants)	-4.9	-4.4	-3.3	-1.3	-3.9	-1.3	-2.6	-1.9	-2.8
Primary balance (excluding grants)	-4.1	-1.6	-1.2	-0.8	-2.2	-1.9	0.0	-3.1	-3.1
Paris Club debt moratorium	...	...	...	...	...	...	...	1.1	1.1
Nominal GDP (in billions of rupees)	1,407	1,582	1,761	2,026	2,029	2,276	2,345	2,345	2,345
Total debt	103.2	105.6	105.8	94.8	105.4	103.0	100.5	100.4	100.7
<i>Of which: domestic debt</i>	58.0	60.0	57.9	54.0	56.3	54.9	54.7	53.2	53.2

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

1/ IMF projections.

Table 3. Sri Lanka: Monetary Accounts, 2003–2005

	2003	2004				2004 1/	2005	2005				2005 2/
	Dec. Act.	Mar. Act.	Jun. Act.	Sep. Act.	Dec. Act.	Dec. Target	Mar. Act.	Mar. Target	Jun. Target	Sept. Target	Dec. Target	Dec. Staff Proj.
(In billions of Sri Lankan rupees)												
Monetary authorities												
Net foreign assets	165	161	152	151	152	184	162	157	159	159	176	166
Net domestic assets	-23	-2	-1	7	19	-21	29	23	25	30	20	31
<i>Of which</i> : net credit to government	42	67	71	84	108	45	101	101	106	115	104	115
Reserve money	141	159	151	158	171	163	191	179	183	189	197	197
(Contribution to reserve money growth, in percent)												
Net foreign assets	37.4	27.9	10.8	-7.6	-9.1	14.0	0.7	-2.7	4.4	4.8	14.5	8.1
Net domestic assets	-25.5	-7.5	4.8	25.2	30.0	1.4	19.5	15.7	16.8	14.3	0.5	6.9
Reserve money (percent change)	11.9	20.4	15.6	17.6	20.9	15.4	20.2	12.9	21.2	19.1	15.0	15.0
(In billions of Sri Lankan rupees)												
Monetary survey												
Net foreign assets	167	180	164	167	170	207	185	168	193	194	205	186
Monetary authorities	165	161	152	151	152	184	162	157	159	159	176	166
Deposit money banks	2	19	12	15	19	22	23	12	35	35	29	21
Net domestic assets	551	566	596	635	688	608	706	715	710	738	782	801
Domestic credit	732	757	791	842	896	793	881	914	914	946	995	1,015
Public sector	212	223	228	252	262	191	235	256	237	242	246	247
Government (net)	176	189	190	213	220	161	218	221	214	218	220	221
Public corporations	36	34	38	39	41	30	18	35	23	25	26	26
Private sector	519	534	563	590	634	602	645	657	676	704	749	768
Other items (net)	-181	-191	-196	-208	-208	-185	-174	-198	-203	-208	-213	-213
Broad money	718	746	760	802	859	815	892	884	904	932	987	987
(Annual percent change)												
Net foreign assets	51.0	56.1	23.5	12.7	1.9	23.6	2.8	-6.7	17.6	16.0	20.5	9.3
Monetary authorities	40.2	29.6	10.3	-6.4	-7.8	12.0	0.7	-2.7	4.3	5.0	16.3	9.1
Deposit money banks	-137.1	-323.5	-350.5	-213.7	641.9	786.2	20.4	-40.0	182.5	123.7	54.9	11.3
Net domestic assets	7.6	7.3	14.1	19.6	25.0	10.4	24.8	26.4	19.3	16.3	13.6	16.4
Domestic credit	7.6	10.5	15.3	21.4	22.4	8.3	16.3	20.7	15.4	12.3	11.1	13.2
Public sector	-10.0	-4.8	4.3	22.3	23.2	-9.9	5.7	14.9	4.0	-4.0	-5.8	-5.7
Government (net)	-8.7	-1.3	5.6	28.1	25.1	-8.5	15.4	17.1	12.8	2.0	0.0	0.1
Public corporations	-15.9	-20.4	-1.5	-2.1	13.8	-16.6	-47.9	2.9	-39.5	-36.9	-37.1	-36.4
Private sector	16.9	18.4	20.4	21.0	22.1	15.8	20.8	23.1	20.1	19.3	18.1	21.0
Broad money	15.3	16.0	16.0	18.1	19.6	13.5	19.5	18.4	18.9	16.2	15.0	15.0
(Contribution to broad money growth, in percentage points)												
Net foreign assets	9.1	10.1	4.8	2.8	0.4	5.5	0.7	-1.6	3.8	3.3	4.1	1.9
Net domestic assets	6.3	6.0	11.2	15.3	19.2	8.0	18.8	20.0	15.1	12.9	10.9	13.1
Domestic credit	8.3	11.2	16.0	21.8	22.9	8.5	16.6	21.0	16.1	12.9	11.6	13.8
Public sector	-3.8	-1.8	1.4	6.8	6.9	-2.9	1.7	4.5	1.2	-1.3	-1.8	-1.7
Government (net)	-2.7	-0.4	1.5	6.9	6.2	-2.1	3.9	4.3	3.2	0.5	0.0	0.0
Public corporations	-1.1	-1.4	-0.1	-0.1	0.7	-0.8	-2.2	0.1	-2.0	-1.8	-1.8	-1.7
Private sector	12.1	12.9	14.6	15.1	16.0	11.4	14.9	16.5	14.9	14.2	13.3	15.5
Memorandum items:												
Broad money multiplier	5.1	4.7	5.0	5.1	5.0	5.0	4.7	4.9	4.9	4.9	5.0	5.0
Velocity of broad money	2.65	...	...	...	2.61	2.61	...	...	...	...	2.55	2.55
Private sector credit (in percent of GDP)	29.5	...	...	...	31.3	29.6	...	...	...	...	31.9	32.7

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

1/ Original projections, as reflected in IMF Country Report No. 04/68.

2/ Projections for 2005 are at end-2004 exchange rates.

Table 4. Sri Lanka: Balance of Payments, 2003–2009 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2003	2004 Est.	2005		2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
			Excl. tsunami 2/	Incl. tsunami				
Current account	-74	-648	-968	-1,257	-1,327	-1,181	-926	-693
Trade balance	-1,540	-2,242	-2,673	-3,073	-3,308	-3,361	-3,162	-2,982
Exports	5,133	5,757	6,098	6,098	6,386	6,587	6,908	7,258
<i>Of which:</i> textiles and garments	2,576	2,811	2,857	2,857	2,883	2,868	2,925	2,983
Imports	6,673	8,000	8,771	9,171	9,694	9,948	10,070	10,240
Non-oil imports	5,835	6,790	7,057	7,457	7,796	7,983	8,048	8,129
<i>Of which:</i> oil imports	838	1,209	1,714	1,714	1,898	1,964	2,022	2,111
Services	399	419	474	324	473	504	590	682
Receipts	1,410	1,526	1,719	1,609	1,866	2,015	2,177	2,351
Income	-172	-204	-225	-225	-296	-255	-273	-296
Transfers	1,240	1,380	1,456	1,717	1,804	1,930	1,919	1,903
Private (net)	1,205	1,350	1,421	1,617	1,700	1,825	1,841	1,863
Official (net)	36	30	35	100	103	105	78	41
Capital and financial account	722	635	765	1,132	1,237	1,191	1,072	941
Capital transfers (net)	74	64	62	174	192	193	144	64
Financial account	648	572	703	958	1,044	998	928	877
Long-term flows	723	684	704	879	958	914	881	827
Direct investment	201	227	261	276	227	237	370	370
Private sector borrowing 3/	-32	18	63	103	116	102	82	90
Official sector borrowing	554	439	380	500	615	575	429	367
Disbursements	913	771	783	903	1,064	1,093	990	900
Program	225	30	104	104	160	165	160	150
Project	618	603	679	799	904	928	830	750
Amortization	359	332	403	403	449	518	561	533
Short-term flows	-75	-112	-1	79	86	84	47	50
Errors and omissions	-146	-192	0	0	0	0	0	0
Overall balance	502	-205	-204	-126	-91	10	146	248
Financing	-502	205	204	126	91	-10	-146	-248
Debt service moratorium	...	...	...	258	...	...	...	...
<i>Of which:</i> moratorium on interest due	...	...	...	77	...	...	...	...
NIR (- = increase)	-502	205	204	-132	91	-10	-146	-248
Gross reserves	-586	313	243	-250	-65	-229	-76	-154
Reserve liabilities	-84	108	-40	117	155	219	-69	-95
Memorandum items:								
Current account (in percent of GDP)	-0.4	-3.2	-4.5	-5.6	-5.4	-4.5	-3.2	-2.2
Export growth (in percent)	9.2	12.2	5.9	5.9	4.7	3.1	4.9	5.1
Textiles and garments	6.3	9.1	1.6	1.7	0.9	-0.5	2.0	2.0
Other	12.4	15.2	10.0	10.0	8.1	6.2	7.1	7.3
Import growth (in percent)	9.3	19.9	9.6	14.6	5.7	2.6	1.2	1.7
Non-oil	9.8	16.4	3.9	9.8	4.5	2.4	0.8	1.0
Gross official reserves 4/ 5/	2,146	1,833	1,590	2,083	2,147	2,376	2,453	2,606
(In months of imports of goods and nonfactor services)	2.8	2.1	1.7	2.2	2.2	2.4	2.5	2.5
(In percent of short-term debt)	109	81	82	93	91	95	99	109
Net international reserves	1,779	1,574	1,369	1,705	1,615	1,624	1,770	2,019
GDP (US\$ millions)	18,250	20,020	21,695	22,530	24,399	26,512	28,811	31,321
Oil price (US\$ per barrel)	28.9	37.8	50.7	50.7	53.0	51.8	50.3	49.5
Short-term debt (US\$ million, residual maturity)	1,966	2,253	1,935	2,230	2,366	2,507	2,482	2,389

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

1/ For illustrative purposes, a one-year extension of the current PRGF/EFF arrangements until April 2007 is assumed.

2/ Reflects economic conditions prior to the tsunami, but updated to reflect latest oil price projections.

3/ Includes public corporations.

4/ Net of ACU debit balances.

5/ Valued at historical cost through 2002, and at market cost since then.

Table 5. Sri Lanka: Medium-Term Macroeconomic Framework, 2004–2009

	2004 Prov.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Real sector (percent change)						
Real GDP	5.4	5.3	6.0	6.0	6.0	6.0
Contribution of domestic demand	7.5	7.7	7.0	6.1	4.8	4.8
Contribution of external demand	-2.1	-2.3	-0.9	-0.2	1.1	1.2
Inflation (Sri Lanka CPI; average)	7.9	14.0	9.5	7.5	6.0	5.0
Inflation (Sri Lanka CPI; end-of-period)	16.8	10.5	8.5	6.5	5.0	4.5
Savings-investment balance (in percent of GDP)						
Gross national saving	21.6	22.1	22.9	24.0	25.0	25.3
Private	25.0	24.2	24.0	24.1	24.2	23.7
Public	-3.4	-2.1	-1.1	-0.1	0.7	1.5
Gross domestic investment	25.0	27.7	28.3	28.5	28.2	27.5
Private	22.8	24.9	25.2	25.3	25.1	24.5
Public	2.2	2.8	3.1	3.2	3.1	3.0
Public finances (in percent of GDP)						
Total revenue	15.3	15.7	16.4	16.9	17.4	17.8
Total expenditure and net lending	23.5	23.9	24.1	23.7	23.1	22.4
Current expenditure	19.2	18.6	18.1	17.5	17.2	16.7
<i>Of which</i> : interest payments	5.9	5.1	6.1	5.5	5.3	5.2
Capital expenditure and net lending	4.3	5.3	6.0	6.1	5.9	5.7
Overall balance (excluding grants)	-8.2	-8.2	-7.8	-6.8	-5.7	-4.6
Primary balance (excluding grants)	-2.2	-3.1	-1.7	-1.3	-0.4	0.5
Net external financing (including grants)	2.2	3.4	3.9	3.5	2.9	2.3
Net domestic financing	5.8	4.4	3.6	3.0	2.5	2.0
Assets sales	0.1	0.3	0.3	0.3	0.3	0.3
Total government debt	105.4	100.7	95.3	91.2	87.1	83.0
Domestic	56.3	53.2	49.2	46.0	43.2	40.7
Foreign	49.1	47.6	46.1	45.2	43.9	42.3
Balance of payments (in percent of GDP) 1/						
Trade balance	-11.2	-13.6	-13.6	-12.7	-11.0	-9.5
Current account balance	-3.2	-5.6	-5.4	-4.5	-3.2	-2.2
Overall balance	-1.1	-0.6	-0.4	0.0	0.5	0.8
Gross official reserves (in millions of U.S. dollars) 2/	1,833	2,083	2,147	2,376	2,453	2,606
(in months of imports of goods and services)	2.1	2.2	2.2	2.4	2.5	2.5
Total external debt	62.8	58.9	58.2	57.1	54.1	50.9
Money and credit (in percent of GDP)						
Reserve money	8.4	8.4	8.6	8.6	8.7	8.7
Broad money	42.3	42.1	43.1	43.3	43.4	43.6
Domestic credit	44.1	43.3	44.0	44.5	44.1	43.8
Private sector credit	31.3	32.7	34.6	36.3	37.4	39.4
Public sector credit	12.9	10.5	9.4	8.2	6.7	4.4
Memorandum item:						
Oil price (U.S. dollar per barrel)	37.8	50.7	53.0	51.8	50.3	49.5

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

1/ Medium-term projections assume disbursements under the PRGF-EFF arrangements, which were approved in 2003, and continued program financing from multilateral agencies. Tsunami-related reconstruction is projected to take place over 2005–2007.

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

Table 6. Sri Lanka: Vulnerability Indicators, 2000–2004

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

	2000	2001	2002	2003	2004
Banking sector indicators 1/					
Nonperforming loans (as percent of total loans)					
State-owned commercial banks	22.2	21.8	22.9	21.0	14.2
Domestic private banks 2/	14.5	18.1	17.6	14.7	10.5
Foreign banks 2/	14.3	12.8	7.6	5.2	3.3
Risk-based capital asset ratio (total capital over risk-weighted assets)					
State-owned commercial banks	4.3	2.9	4.2	4.5	5.5
Domestic private banks 2/	11.4	10.5	11.0	12.5	11.1
Foreign banks 2/	12.2	14.2	21.6	14.8	12.4
Financial indicators					
Broad money (percent change, 12-month basis) 3/	12.9	13.6	13.4	15.3	19.6
Private sector credit (percent change, 12 month basis) 3/	11.8	8.9	12.0	16.9	22.1
Share of deposits in broad money 3/	87.0	88.1	87.9	88.1	88.4
Share of foreign currency deposits in total deposits 3/	21.1	21.8	22.1	21.7	23.8
Stock market index (ASPI; 1985=100)	448	621	815	1,062	1,507
External indicators					
Exports (annual percent change)	19.8	-12.8	-2.4	9.2	12.2
Imports (annual percent change)	22.4	-18.4	2.2	9.3	19.9
Current account balance (excluding official transfers)	-6.7	-1.3	-1.6	-0.6	-3.4
Capital and financial account balance	2.7	3.4	2.7	4.0	3.2
<i>Of which</i> : portfolio investment	-0.3	-0.1	0.2	0.0	0.1
Medium- and long-term inflows, net	1.9	1.0	2.0	4.0	3.4
Foreign direct investment	1.1	0.5	1.1	0.9	1.1
Exchange rate (rupee per U.S. dollar, period average)	77.0	90.2	95.8	96.5	101.2
Reserves indicators					
Gross official reserves (millions of US\$; excl. ACU balance)	911	1,183	1,560	2,146	1,833
As percent of broad money	15.6	20.1	24.2	28.9	22.3
As percent of short-term debt 4/ 5/	42.5	57.4	79.6	109.2	81.4
Debt indicators					
Government debt (domestic and external)	96.9	103.2	105.6	105.8	105.4
Total external debt (public and private)	62.0	60.8	62.6	64.1	62.8
Debt service (as percent of exports goods & services)	13.2	14.3	12.3	10.9	9.9
Short-term debt (in percent of GDP) 4/ 5/	10.1	10.6	9.7	9.1	10.4

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

1/ Excludes foreign currency banking units prior to 2002. Indicators are weighted averages of individual bank data.

2/ Indicators for 2004 are estimates based on unaudited accounts.

3/ Including foreign currency banking units (FCBUs).

4/ Includes CPC acceptance credits, other trade credits, central bank ACU balances, and commercial bank liabilities.

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

Table 7. Sri Lanka: Projected Payments to the Fund, 2005–2009

(In millions of SDRs, unless otherwise indicated)

	2005	2006	2007	2008	2009
Disbursements 1/	103.4	177.2	177.2	0.0	0.0
Repayments 2/	25.8	74.2	31.9	46.0	62.8
Charges/interest 2/	5.3	9.1	7.1	6.2	4.3
Stock of outstanding use of Fund resources	266.8	369.8	515.1	469.0	406.2
Memorandum items:					
Debt service					
Payments to the Fund/exports GNFS	0.6	1.5	0.7	0.9	1.1
Payments to the Fund/Quota	7.5	20.1	9.4	12.6	16.2
Payments to the Fund/GDP	0.2	0.5	0.2	0.3	0.3
Payments to the Fund/reserves	2.3	5.9	2.5	3.2	3.9
Outstanding use of Fund resources					
Outstanding UFR/exports GNFS	5.2	6.8	9.0	7.8	6.4
Outstanding UFR/quota	64.5	89.5	124.6	113.5	98.3
Outstanding UFR/GDP	1.8	2.3	2.9	2.5	2.0
Outstanding UFR/reserves	19.4	26.1	32.8	29.0	23.6

Source: Fund staff estimates.

1/ Taking into account emergency assistance of 25 percent of quota in 2005. For illustrative purposes, a one-year extension of the current PRGF/EFF arrangements until April 2007 is assumed.

2/ On an obligation basis.

Table 8. Sri Lanka: Millennium Development Goals 1/

	1990	1994	1997	2000	2003
Eradicate extreme poverty and hunger 2/	(2015 target = halve 1990 \$1 a day poverty and malnutrition rates)				
Poverty headcount, national (in percent of population)	20.0	...	25.0	...	...
Population below \$1 per day (in percent)	3.8	6.6	...	7.6	...
Poverty gap at \$1 per day (in percent)	0.7	1.0	...	1.5	...
Percentage share of income or consumption held by poorest 20 percent	...	...	...	8.3	...
Prevalence of child malnutrition (in percent of children under 5)	...	32.9	...	...	...
Population below minimum level of dietary energy consumption (in percent)	...	...	26.0	...	22.0
Achieve universal primary education 3/	(2015 target = net enrollment to 100)				
Net primary enrollment ratio (in percent of relevant age group)	89.9	...	...	97.0	...
Percentage of cohort reaching grade 5 (in percent)	94.4	...	...	...	...
Youth literacy rate (in percent of ages 15-24)	95.1	95.8	96.3	96.8	97.0
Primary completion rate, total (in percent of relevant age group)	103.0	...	98.0	...	...
Promote gender equality 4/	(2005 target = education rate to 100)				
Ratio of girls to boys in primary and secondary education (in percent)	102.2	...	...	...	102.8
Ratio of young literate females to males (in percent of ages 15-24)	98.3	98.9	99.2	99.6	99.7
Share of women employed in the nonagricultural sector (in percent)	39.1	45.4	41.2	46.0	44.6
Proportion of seats held by women in national parliament (in percent)	5.0	...	5.0	5.0	4.0
Reduce child mortality 5/	(2015 target = reduce 1990 under 5 mortality by two thirds)				
Under 5 mortality rate (per 1,000)	32.0	25.0	...	20.0	15.0
Infant mortality rate (per 1,000 live births)	26.0	21.0	...	16.0	13.0
Immunization, measles (in percent of children under 12 months)	80.0	84.0	94.0	99.0	99.0
Improved maternal health 6/	(2015 target = reduce 1990 maternal mortality by three fourths)				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	92.0	...
Births attended by skilled health staff (in percent of total)	...	94.1	...	96.6	87.1
Combat HIV/AIDS, malaria, and other diseases 7/	(2015 target = halt, and begin to reverse, AIDS, etc.)				
Prevalence of HIV, female (in percent of ages 15-24)	...	...	...	0.1	0.1
Contraceptive prevalence rate (in percent of women ages 15-49)	...	...	...	...	...
Number of children orphaned by HIV/AIDS	...	...	...	70.0	...
Incidence of tuberculosis (per 100,000 people)	60.5	60.5	60.5	60.5	60.5
Tuberculosis cases detected under DOTS (in percent)	...	63.0	71.1	67.8	70.4
Ensure environmental sustainability 8/	(2015 target = various /1)				
Forest area (in percent of total land area)	35.4	...	...	30.0	...
Nationally protected areas (in percent of total land area)	...	...	...	...	13.5
GDP per unit of energy use (PPPS per kg. oil equivalent)	7.0	8.1	7.9	7.9	8.0
CO2 emissions (metric tons per capita)	0.2	0.3	0.4	0.6	...
Access to an improved water source (in percent of population)	68.0	...	...	...	78.0
Access to improved sanitation (in percent of population)	70.0	...	...	...	91.0
Access to secure tenure (in percent of population)	...	...	...	...	...
Develop a global partnership for development 9/	(2015 target = various /2)				
Youth unemployment rate (in percent of total labor force ages 15-24)	33.3	36.4	28.2	23.6	...
Fixed line and mobile telephones (per 1,000 people)	7.4	12.2	25.5	64.9	121.7
Personal computers (per 1,000 people)	0.2	1.0	4.2	7.3	13.2
Debt service (in percent of exports)	...	...	...	...	...
Internet users (per 1,000 people)	...	0.0	1.7	6.6	11.7
Aid per capita (current US\$)	44.9	35.2	18.7	15.0	34.9
General indicators					
Population (in billions)	16.3	17.1	17.7	18.5	19.2
Gross national income (in billions of U.S. dollars)	7.9	11.4	14.7	16.4	17.8
GNI per capita (in U.S. dollars)	490.0	670.0	830.0	890.0	930.0
Adult literacy rate (in percent of people ages 15 and over)	88.7	89.9	90.8	91.6	92.1
Total fertility rate (births per woman)	2.5	...	2.2	...	2.0
Life expectancy at birth (in years)	70.2	...	71.8	...	74.0
Gross capital formation (in percent of GDP)	22.6	27.0	24.4	27.9	22.3
Trade (in percent of GDP)	67.2	79.4	80.1	88.6	78.1

Source: *World Development Indicators* database, April 2004.

1/ In some cases the data are for earlier or later years than those stated.

2/ Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

3/ Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

4/ Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

5/ Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

6/ Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

7/ Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.

8/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water.

9/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states.

Table 9. Sri Lanka: Structural Policy Actions Under the First Year of the PRGF-EFF Arrangements

Policy Area	Policy Action	Timing	Status
I. Fiscal measures			
1. Budget	1. Extension of the VAT to the wholesale and retail sectors	January 31, 2004	Not met. Plan abandoned by new government
	2. Rationalization/streamlining of tax incentives 1/	January 31, 2004	No progress made. 2/
	3. Reduce import surcharge to 10 percent from 20 percent	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	June 30, 2003	Not met. Plans for Revenue Authority were abandoned by new government.
II. Nonfiscal measures			
3. Financial sector reform	1. Presentation to parliament of the Asset Management Company (AMC) law	June 30, 2003	Met with delay (November 2003). The law, however, has not been approved.
	2. Presentation to parliament of the amended banking laws and the new Exchange Management Act	June 30, 2003	Partly met with delay (November 2003). Banking Laws were approved in December 2004; but Exchange Management Act has been dropped from the legislative agenda.
4. Public enterprise reform	3. External evaluation of assets and liabilities of People's Bank	September 15, 2003	Not met. External consultants have not been re-engaged.
	4. Complete the restructuring of People's Bank 1/	March 31, 2004	Not met. New government has abandoned privatization strategy, but has approved business development plan, including public recapitalization.
5. Labor market 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/	December 31, 2003	Not met. Government open in principle to share sales of non-strategic SOEs. Decisions on SLT and Hilton are still pending.
	1. Implementation of the binding redundancy compensation formula	April 30, 2003	Not met. While the formula was gazetted in March 2005, implementation is contingent on the creation of an unemployment insurance scheme.

1/ Was to be given more specificity in the context of the first review.

2/ Most measures planned for 2004 were never enacted after the change in government. In the 2005 budget, new incentives outnumber the elimination of existing incentives.

Sri Lanka—Social and Economic Impact of the Tsunami

1. **The immediate humanitarian impact of the tsunami disaster was huge.** The tsunami struck a relatively thin but long coastal area stretching over 625 miles, or two thirds of the country’s coastline. Close to 40,000 people are dead or missing, 1,000 children are left without parents, and about 1 million people have been affected (5 percent of the population). The tidal waves hit some of the most vulnerable segments of society, including fishermen and small enterprises, and the ADB estimates that an additional 250,000 people may fall into poverty. Some 60 percent of the damage was sustained by the war-ravaged North-East.

2. **Reconstruction of the severely damaged physical capital stock is likely to mitigate the tsunami’s negative effect on growth.** The hardest hit sectors were fishing and tourism, while other export sectors remained intact. The fishing industry which accounts for about 2 percent of GDP and exports very little, has been devastated—thousands of fishermen died, 65 percent of the boat fleet was either damaged or destroyed, and 11 fisheries harbors sustained severe damage. Tourism and related services account for an estimated 2 percent of GDP and more than 8 percent of exports of goods and services. However, the affected areas account for only 25 percent of Sri Lanka’s hotel room capacity. The construction sector, which accounts for 7 percent of GDP, is likely to offset most of the contraction in the fishing and tourism sectors. Tsunami reconstruction and financing will have a significant impact on the medium-term outlook leading to higher import and financing needs compared with the previous baseline.

3. **The authorities’ currently estimate total post-tsunami relief and reconstruction costs to be around \$2.1 billion.**¹ The government has moved swiftly to mobilize the domestic, official and private resources required to meet this financing challenge. An additional \$250 million of debt rescheduling/relief has been secured in 2005 from the Paris Club and other bilateral creditors, which eased the immediate cash

Table I.1. Sri Lanka: Financing of Tsunami Relief and Reconstruction Spending
(In millions of U.S. dollars)

	2005	2006	2007	2008	Total
Total reconstruction spending	600	600	600	300	2,100
Financing	746	518	501	224	1,990
Private/NGO financing	196	180	198	100	674
Donors	297	380	380	200	1,257
Grants	177	200	200	120	697
Loans	120	180	180	80	560
Debt rescheduling (net)	253	-42	-77	-76	59
Financing surplus/gap	146	-82	-99	-76	-110
Memorandum item:					
Government spending plan	510	500	500	250	1,760

Sources: Ministry of Finance and Planning; Central Bank of Sri Lanka; Asian Development Bank; World Bank; bilateral donors; and Fund staff estimates and calculations.

¹ *Post-Tsunami Recovery and Reconstruction Strategy* presented to the Development Forum, May 2005.

flow constraints of tsunami relief and the early stages of reconstruction. The composition of expected external financing is shown in Table I.1.²

4. **A four-year recovery and reconstruction strategy is currently being finalized by the government.** Preliminary estimates suggest total expenditure under this plan will be around \$1.75 billion. Not all expenditure will be executed through the government budget. The government intends, wherever possible, to delegate procurement and construction to donors outside of normal budgetary procedures. It may be required to contribute up to Rs. 17 billion (\$170 million) of domestic financing to the plan. The expenditure profile of the strategy, however, remains to be defined. Additional private donations will also contribute to the reconstruction effort.

5. **The central government budget is expected to contribute about Rs. 32 billion in 2005.** Much of this expenditure has already been incurred through transfer schemes to support affected households immediately following the disaster. Additional budgetary expenditure is expected to be directed to the housing sector and the Susahana credit scheme. Budget contributions will be financed by grants, loans, and domestic funds in broadly equal proportions.

6. **The amount of off-budget expenditure in 2005, and beyond, is uncertain.**

In 2005, the main items of off-budget expenditure are expected to be grant-financed health, education and transport infrastructure construction. Table I.2 presents an illustrative expenditure profile based on available financing data. The estimate of off-budget expenditure in 2005 is broadly consistent with the levels of construction expenditure in health, education, and transport envisaged in the authorities sectoral plan.

	2005	2006	2007	2008	Total
Total Expenditure	51	50	50	25	176
Central government budget	33	28	26	14	101
Loans	12	18	18	8	56
Grants	10	6	6	6	28
Debt rescheduling (net)	25	-4	-8	-8	6
Domestic financing	-14	8	10	8	11
Off-budget grants	18	22	24	11	75

Sources: Ministry of Finance and Planning; Central Bank of Sri Lanka; Asian Development Bank; World Bank; bilateral donors; and Fund staff estimates and calculations.

² As of end-May 2005, it is estimated that Sri Lanka has received \$158 million in emergency assistance from the IMF and about \$200–250 million in other financial aid from official donors, NGOs/private sources, and the year-to-date impact of the debt moratorium.

7. **Post-tsunami activities are expected to significantly increase the external current account deficit** (Table I.3). While the import content of tsunami relief is very high, to the extent that a portion of tsunami reconstruction will be spent on domestic goods and services, the net impact on the balance of payments of foreign financing is somewhat larger than on the fiscal position. Tsunami-related import spending of \$440 million in 2005 pushes the current account deficit up by about 1 percent of GDP. The financing gap arising is, however, more than compensated for by debt rescheduling and relief in 2005. As discussed above, however, the proceeds of this debt relief allowed the government to swiftly address the relief and reconstruction effort through the budget. Imports for tsunami-related spending increase to \$475 million in 2006 and decline thereafter while the accumulation of net international reserves declines with the expiry of debt relief and the need to repay the rescheduled debt.

Table I.3. Sri Lanka: Tsunami Inflows and Outflows in the Balance of Payments
(In millions of U.S. dollars)

	2005	2006	2007	2008	Total
Impact on current account					
Total outflows	550	475	470	240	1,735
Imports of goods	400	430	430	220	1,480
Imports of services	40	45	40	20	145
Tourism	110	0	0	0	110
Financing					
Total	548	590	578	300	2,016
Official sector	297	380	380	200	1,257
Grants	177	200	200	120	697
Project loans	120	180	180	80	560
Private sector	251	210	198	100	759
NGO grants	196	180	198	100	674
Loans	40	20	0	0	60
FDI	15	10	0	0	25
Tsunami related financing gap	2	-115	-108	-60	-281
Debt rescheduling	253	-42	-77	-76	59
Tsunami related change in NIR (- = increase)	-251	-73	-31	16	-340

8. **Effective and transparent management of tsunami-related expenditure requires a comprehensive database of all expenditures and financing.** This information will be crucial in managing the fiscal and macroeconomic implications of the reconstruction effort. Clear coordination structures, such as TAFREN, will assist in this task. When the authorities seek necessary approvals for expenditure through the central government budget, they should provide information to parliament on all planned expenditure under the recovery and reconstruction plan.

9. **The government is making efforts to ensure the effective use of aid.** It has hired an international auditor, imposed information and registration requirements on NGOs, and is establishing a database for monitoring aid. However, the government, donors, and the LTTE have yet to agree on a framework for allocating aid across projects and regions. A multi-donor-trust fund and the tracking matrix—currently under discussion with donors—would also help prevent the duplication of aid as well as reduce the government’s transaction costs in dealing with a huge number of donors.

Sri Lanka—Debt Sustainability Analysis¹

Central Government Debt Sustainability

The baseline fiscal scenario of sustained fiscal consolidation yields a favorable path for Sri Lankan public debt. Under this scenario, central government debt falls linearly from 105 percent of GDP in 2004 to 78 percent of GDP in 2010 and 48 percent in 2025 (Table II.1). NPV indicators of debt and debt-to-revenue and the debt-service to revenue ratio perform similarly. However, the debt service-to-revenue ratio will continue to exceed the indicative threshold (40 percent) through 2010. The main driver of the relatively favorable debt dynamics is a continued interest rate/growth differential. The real growth projection of 6 percent through the period (compared to an average of 4½ percent over the last 10 years) exceeds the projected real interest rates on domestic and foreign debt.

There are substantial downside risks to this outlook. If growth and primary balances continue at historic averages over the period (Table II.2, alternative scenario A1), the NPV of the debt-to-GDP ratio would fall to only 78 percent of GDP in 2010 as compared to 62 percent in the baseline and would eventually begin to increase to a level of 104 percent of GDP in 2025. The significance of growth is underlined by the fact that the most extreme stress test is of continued lower-than-average growth.

An even greater risk exists if the authorities fail to engineer a turnaround in current fiscal policies. This is illustrated in the alternative scenario A2, which assumes a continuation of recent (2002–2004) economic policies throughout the period. This entails a primary deficit of 1.2 percent of GDP, an average real interest rate of 2.6 percent, asset changes and off-budget activities equal to 3.2 percent of GDP (similar to historic residuals), and real growth of 5 percent. Under these relatively plausible assumptions, the NPV of debt-to-GDP would increase from 87 percent in 2005 to 89 percent of GDP in 2010 and 113 percent of GDP in 2025.

External Debt Sustainability

The key assumption underlying the external debt sustainability analysis is that over the medium term Sri Lanka will graduate from low-income country status. With GDP per capita already above \$1,000 in 2004, the country is assumed to continue to move towards middle-income status over the next two decades. This process will be supported by less concessional public financing and more international capital market financing. Private sector external financing, at this stage still small, is also set to increase. Export growth is assumed

¹ This DSA has been shared with the World Bank staff, and no differences of view have been expressed. As the new procedures for DSAs were established by the Executive Board around the time of the Article IV discussions, there was not sufficient time for this DSA to be undertaken jointly with the World Bank.

to continue at 6 percent per year, based on diversification of the export portfolio, and a competitive tourism sector. In the long term, a higher standard of living is expected to increase the demand for imported consumer goods.

Under the baseline, the medium term debt ratio is on a sustainable path. Sri Lanka's external debt declines from 63 percent of GDP in 2004 to just under 50 percent of GDP in 2010 (Table II.3). In NPV terms the debt ratio declines from about 40 percent to 30 percent of GDP (Table II.4). This keeps Sri Lanka well below the debt thresholds for a country classified as having a strong policy framework according to the World Bank's Country Policy and Institutional Assessment (CPIA) index. The pace of medium-term debt reduction is comparable to the baseline of the previous Article IV staff report, but the starting point is less favorable. In 2004, external debt is about 10 percentage points above what was expected at the time of the last Article IV consultation. This is due to a stronger reserve buildup in 2003 as well as a higher current account deficit and a weaker rupee in 2004 than initially projected. Over the medium term, the tsunami-induced increase in the current account deficit combined with a slower reserve buildup, leads to comparable debt slopes across the two baseline scenarios. As the country develops and external financing shifts from concessional to commercial terms, the debt service ratio increases to about 12 percent for public debt, and 17 percent for total external debt.

While none of the standard stress tests leads to an explosive trajectory for external debt, they illustrate Sri Lanka's vulnerability to exchange rate changes (see B3 and B6 in Table II.4). A one-time 30 percent depreciation would bring the NPV of external debt to about 50 percent of GDP, and it would take about eight years to bring it back to its current level.

Table II.1. Sri Lanka: Public Sector Debt Sustainability Framework, Baseline Scenario, 2002–2025
(In percent of GDP, unless otherwise indicated)

	Actual					Historical Average 5/ Deviation 5/	Standard Deviation 5/	Estimate 2005	Projections							
	2002	2003	2004	2006	2007				2008	2009	2010	2005–10 Average		2015	2025	2011–25 Average
	2002	2003	2004	2006	2007				2008	2009	2010	2005–10 Average		2015	2025	2011–25 Average
Public sector debt 1/ <i>Of which:</i> foreign-currency denominated	105.5	105.8	105.4	100.7	95.3	87.1	83.0	78.3	61.9	47.9	...	...	...	...
Change in public sector debt	2.3	0.3	-0.4	-4.7	-5.4	-4.1	-4.1	-4.7	-2.5	-0.9	...	...	...	...
Identified debt-creating flows	-1.5	-3.5	-2.4	-4.3	-5.2	-3.9	-4.1	-4.7	-2.8	-1.8	...	...	...	...
Primary deficit	1.1	0.7	1.8	2.3	1.0	0.7	-0.1	-1.0	-0.9	-0.7	...	...	...	...
Revenue and grants	17.0	16.2	15.8	16.5	17.0	17.5	17.9	18.2	18.7	19.0	...	...	...	...
<i>Of which:</i> grants	0.4	0.5	0.4	0.8	0.7	0.6	0.5	0.4	0.3	0.0	...	...	...	...
Primary (noninterest) expenditure	18.1	16.9	17.6	18.8	18.0	18.1	17.8	17.2	17.8	18.3	...	...	...	...
Automatic debt dynamics	-2.2	-3.6	-4.1	-6.7	-6.1	-4.4	-3.7	-2.8	-1.9	-1.1	...	...	...	...
Contribution from interest rate/growth differential	-1.0	-2.1	-4.6	-5.6	-4.6	-3.9	-3.2	-2.6	-1.7	-1.0	...	...	...	...
<i>Of which:</i> contribution from average real interest rate	2.9	3.9	0.8	-0.3	1.1	1.5	2.0	2.3	1.9	1.7	...	...	...	...
<i>Of which:</i> contribution from real GDP growth	-3.9	-6.0	-5.4	-5.3	-5.7	-5.4	-5.2	-4.9	-3.6	-2.8	...	...	...	...
Contribution from real exchange rate depreciation	-1.2	-1.6	0.5	-1.0	-1.5	-0.6	-0.5	-0.2	...	...	...	...	...	...
Other identified debt-creating flows	-0.4	-0.6	-0.1	0.0	-0.1	-0.1	-0.2	-0.2	...	...	...	...	...	...
Privatization receipts (negative)	-0.4	-0.6	-0.1	-0.3	-0.3	-0.3	-0.3	-0.3	...	...	...	...	...	...
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.3	0.2	0.2	0.1	0.1	...	...	...	...	...	...
Residual, including asset changes	3.8	3.8	2.0	-0.3	-0.3	-0.2	-0.1	0.0	0.3	0.9	...	...	...	...
NPV of public sector debt	...	...	...	87.3	80.0	74.1	70.2	66.6	62.1	47.9	37.6	...	...	...
<i>Of which:</i> foreign-currency denominated	3.4	2.2	2.8	39.9	35.4	32.4	29.7	27.4	25.1	17.0	8.3	...	...	...
<i>Of which:</i> external	...	...	...	36.8	33.0	30.2	27.6	25.4	23.3	15.4	6.8	...	...	...
NPV of contingent liabilities (not included in public sector debt)	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Gross financing need 2/	36.5	32.2	28.5	28.7	26.8	25.1	23.4	21.4	19.2	16.2	15.1	...	...	...
NPV of public sector debt-to-revenue ratio (in percent) 3/	...	...	...	528.6	469.2	423.8	393.0	365.3	335.2	256.4	197.7	...	...	...
<i>Of which:</i> external	...	...	...	223.0	193.8	172.6	154.6	139.5	125.9	82.7	35.7	...	...	...
Debt service-to-revenue ratio (in percent) 3/ 4/	104.9	104.1	91.2	90.1	87.3	79.8	74.3	69.2	61.7	50.5	48.9	...	...	...
Primary deficit that stabilizes the debt-to-GDP ratio	-1.2	0.4	2.2	7.0	6.4	4.8	4.0	3.2	3.0	1.6	0.2	...	...	...
Key macroeconomic and fiscal assumptions	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real GDP growth (in percent)	4.0	6.0	5.4	5.3	6.0	6.0	6.0	6.0	5.9	6.0	6.0	6.0	6.0	6.0		
Average nominal interest rate on forex debt (in percent)	1.4	1.3	1.4	0.7	1.4	1.5	1.4	1.5	1.5	1.3	1.5	2.9	2.1	2.1		
Average real interest rate on domestic currency debt (in percent)	6.4	8.8	2.3	1.0	3.1	4.2	5.6	6.7	6.8	4.6	7.0	5.7	6.3	6.3		
Inflation rate (GDP deflator, in percent)	8.2	5.0	9.4	9.7	10.0	8.0	6.5	5.5	5.0	7.5	5.0	5.0	5.0	5.0		
Growth of real primary spending (deflated by GDP deflator, in percent)	-9.6	-1.1	10.0	12.7	1.4	6.7	4.1	2.6	3.7	5.2	6.5	6.2	6.6	6.6		
Grant element of new external borrowing (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...

Sources: Sri Lankan authorities; and Fund staff estimates and projections.

1/ Gross central government debt.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table II.2. Sri Lanka: Sensitivity Analysis for Key Indicators of Public Debt 2005–2025

	Estimate		Projections										
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2025	
NPV of debt-to-GDP ratio													
Baseline	87	80	74	70	67	62	58	55	52	50	48	38	
A. Alternative scenarios													
A.1. Real GDP growth and primary balance are at historical averages	87	82	79	78	78	78	79	79	80	81	83	100	
A.2. Key indicators at 2002–2004 averages ^{3/}	87	86	85	86	88	89	90	92	94	95	98	113	
A.3. Permanently lower GDP growth ^{1/}	87	80	75	72	69	65	62	59	57	55	55	57	
B. Bound tests													
B.1. Real GDP growth is at historical average minus one standard deviations in 2006–2007	87	84	82	79	76	73	70	67	65	64	63	60	
B.2. Primary balance is at historical average minus one standard deviations in 2006–2007	87	82	79	75	71	67	63	59	56	54	52	39	
B.3. Combination of B1-B2 using one half standard deviation shocks	87	84	82	78	74	69	65	61	58	55	54	40	
B.4. One-time 30 percent real depreciation in 2006	87	95	87	82	77	72	67	63	59	56	54	40	
B.5. 10 percent of GDP increase in other debt-creating flows in 2006	87	90	84	80	76	71	67	63	60	57	55	42	
NPV of Debt-to-Revenue Ratio ^{2/}													
Baseline	529	469	424	393	365	335	313	294	277	266	256	198	
A. Alternative scenarios													
A.1. Real GDP growth and primary balance are at historical averages	529	483	451	437	430	423	423	424	427	435	443	527	
A.2. Key indicators at 2002–2004 averages ^{3/}	529	510	498	500	506	510	521	533	545	563	579	709	
A.3. Permanently lower GDP growth ^{1/}	529	472	429	401	377	350	331	316	304	298	293	298	
B. Bound tests													
B.1. Real GDP growth is at historical average minus one standard deviations in 2006–2007	529	490	466	440	417	391	374	359	348	342	337	316	
B.2. Primary balance is at historical average minus one standard deviations in 2006–2007	529	483	452	420	391	360	337	317	299	288	277	204	
B.3. Combination of B1-B2 using one half standard deviation shocks	529	491	467	433	404	371	348	327	309	297	287	213	
B.4. One-time 30 percent real depreciation in 2006	529	560	499	459	425	388	361	337	317	303	292	212	
B.5. 10 percent of GDP increase in other debt-creating flows in 2006	529	526	478	445	415	383	359	338	320	308	297	219	
Debt service-to-revenue ratio ^{2/}													
Baseline	90	87	80	74	69	62	58	55	53	52	51	49	
A. Alternative scenarios													
A.1. Real GDP growth and primary balance are at historical averages	90	88	83	80	77	73	73	74	75	77	79	103	
A.2. Key indicators at 2002–2004 averages ^{3/}	90	88	82	78	76	71	71	71	72	73	74	91	
A.3. Permanently lower GDP growth ^{1/}	90	88	81	76	71	64	61	59	57	56	56	62	
B. Bound tests													
B.1. Real GDP growth is at historical average minus one standard deviations in 2006–2007	90	90	86	82	77	70	67	65	64	63	63	65	
B.2. Primary balance is at historical average minus one standard deviations in 2006–2007	90	87	82	79	74	66	62	59	56	55	54	47	
B.3. Combination of B1-B2 using one half standard deviation shocks	90	89	85	81	76	68	64	61	58	57	55	49	
B.4. One-time 30 percent real depreciation in 2006	90	88	82	76	71	64	61	58	56	54	53	48	
B.5. 10 percent of GDP increase in other debt-creating flows in 2006	90	87	89	83	78	69	65	62	60	58	57	49	

Sources: Sri Lankan authorities; and Fund staff estimates and projections.

^{1/} Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

^{2/} Revenues are defined inclusive of grants.

^{3/} Real growth, primary balance, real interest rate and residual.

Table II.3. Sri Lanka: External Debt Sustainability Framework, Baseline Scenario, 2002–2025 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/ Standard Deviation 6/	Estimate 2005	Projections						2011-25 Average	
	2002	2003	2004			2006	2007	2008	2009	2010	2005-10 Average		2015	2025
External debt (nominal) 1/	62.6	64.1	62.8		58.9	57.2	54.2	51.0	48.3	48.3	36.9	26.7	
Of which: public and publicly guaranteed (PPG)	60.8	62.3	60.7		56.7	54.4	51.3	48.1	45.4	45.4	34.5	21.1	
Change in external debt	1.9	1.5	-1.3		-3.8	-0.7	-3.0	-3.2	-2.7	-2.7	-2.4	-0.2	
Identified net debt-creating flows	-3.1	-6.4	-3.5		1.7	1.2	0.3	-1.2	-2.0	-2.3	-1.9	-0.6	
Non-interest current account deficit	0.1	-0.8	2.1	0.9	4.5	4.4	2.2	1.3	0.7	0.7	0.3	0.4	0.2
Deficit in balance of goods and services	6.7	6.3	9.1		12.2	11.6	10.8	8.9	7.3	6.7	5.2	3.7	
Exports	36.1	35.9	36.4		34.2	33.8	32.4	31.5	30.7	29.9	26.3	22.0	
Imports	42.8	42.1	45.5		46.4	45.4	43.2	40.5	38.0	36.6	31.5	25.7	
Net current transfers (negative = inflow)				0.6	-7.6	-7.4	-7.3	-6.7	-6.1	-6.0	-5.0	-3.6	-4.6
Other current account flows (negative = net inflow)	0.2	-0.2	-0.2		-0.1	0.1	-0.1	0.0	0.0	0.0	0.1	0.2	
Net FDI (negative = inflow)	-1.1	-0.9	-1.1	0.3	-0.9	-0.9	-0.9	-1.3	-1.2	-1.1	-0.8	-0.5	-0.7
Endogenous debt dynamics 2/	-2.1	-4.7	-4.5		-1.9	-2.2	-2.2	-2.1	-2.0	-1.9	-1.4	-0.5	
Contribution from nominal interest rate	1.3	1.2	1.2		1.1	1.1	1.1	1.0	1.0	0.9	0.8	0.9	
Contribution from real GDP growth	-2.3	-3.4	-3.1		-3.0	-3.3	-3.2	-3.2	-3.0	-2.8	-2.2	-1.5	
Contribution from price and exchange rate changes	-1.2	-2.5	-2.5		...	...	...	...	...	...	...	...
Residual (3-4) 3/	5.0	7.9	2.2		-5.5	-1.9	-1.4	-1.8	-1.2	-0.4	-0.5	0.5	
Of which: exceptional financing	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
NPV of external debt 4/	...	...	38.4		37.1	37.0	35.7	34.4	32.7	32.7	22.2	16.4	
In percent of exports	...	...	105.7		108.5	113.9	113.3	112.0	109.4	109.4	84.3	74.6	
NPV of PPG external debt	...	...	36.4		34.8	34.2	32.9	31.5	29.7	29.7	19.8	10.8	
In percent of exports	...	...	100.0		101.8	105.4	104.3	102.6	99.6	99.6	75.3	49.3	
Debt service-to-exports ratio (in percent)	12.3	10.9	9.9		10.2	9.8	10.6	11.2	10.4	9.0	9.6	16.7	
PPG debt service-to-exports ratio (in percent)	10.0	8.8	7.8		8.4	8.7	9.3	9.4	8.7	7.3	6.9	11.6	
Total gross financing need (billions of U.S. dollars)	1,651.6	1,602.4	1,665.9		2,077.6	2,051.6	2,099.6	2,142.3	2,142.0	2,141.8	2,603.4	4,664.4	
Non-interest current account deficit that stabilizes debt ratio	-1.7	-2.3	3.4		8.3	5.0	4.5	5.2	4.4	3.4	2.7	0.5	
Key macroeconomic assumptions													
Real GDP growth (in percent)	4.0	6.0	5.4	4.3	5.3	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
GDP deflator in U.S. dollar terms (change in percent)	1.9	4.1	4.1	0.6	6.9	2.2	2.5	2.6	2.6	2.6	2.4	2.4	2.4
Effective interest rate (percent) 5/	2.3	2.1	2.0	2.8	2.0	2.0	2.0	1.9	1.9	2.0	2.1	3.8	2.6
Growth of exports of goods and services (U.S. dollar terms, in percent)	-3.6	9.6	11.3	5.4	5.8	7.1	4.2	5.6	5.8	5.9	6.2	7.0	6.4
Growth of imports of goods and services (U.S. dollar terms, in percent)	-0.4	8.5	18.5	5.3	14.8	6.0	3.4	1.7	2.2	4.5	5.7	7.2	6.1
Grant element of new public sector borrowing (in percent)	...	...	...	...	17.9	22.7	21.8	20.7	21.0	21.0	15.1	-6.2	7.5
Memorandum item:													
Nominal GDP (billions of U.S. dollars)	16.5	18.2	20.0		22.5	24.4	26.5	28.8	31.3	34.1	51.4	117.2	

Source: Staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - \rho(1+g)] / (1+g+\rho+g\rho)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that NPV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table II.4. Sri Lanka: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005–25
(In percent)

	Estimate			Projections									
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2025	
NPV of debt-to-GDP ratio													
Baseline	35	35	34	33	31	30	28	26	24	22	20	11	
A. Alternative scenarios													
A1. Key variables at their historical averages in 2006–25 1/	35	32	31	30	29	29	29	28	28	27	27	22	
A2. New public sector loans on less favorable terms in 2006–25 2/	35	35	36	35	34	33	32	30	28	27	25	17	
B. Bound tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	35	36	37	36	34	32	30	28	26	24	21	12	
B2. Export value growth at historical average minus one standard deviation in 2006–07 3/	35	37	42	40	38	36	34	31	28	26	23	11	
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2006–07	35	36	38	36	35	33	31	28	26	24	22	12	
B4. Net nondebt creating flows at historical average minus one standard deviation in 2006–07 4/	35	37	38	37	35	33	31	29	26	24	22	11	
B5. Combination of B1–B4 using one-half standard deviation shocks	35	40	47	46	44	41	38	35	32	29	26	13	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	35	49	48	47	45	42	39	37	34	31	28	15	
NPV of debt-to-exports ratio													
Baseline	102	102	105	104	103	100	96	91	86	81	75	49	
A. Alternative scenarios													
A1. Key variables at their historical averages in 2006–25 1/	102	95	94	94	95	97	99	100	101	101	101	101	
A2. New public sector loans on less favorable terms in 2006–25 2/	102	105	111	112	112	111	109	106	103	100	95	78	
B. Bound tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	102	102	105	104	103	100	96	91	86	81	75	49	
B2. Export value growth at historical average minus one standard deviation in 2006–07 3/	102	121	150	148	146	142	135	127	119	111	103	60	
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2006–07	102	102	105	104	103	100	96	91	86	81	75	49	
B4. Net nondebt creating flows at historical average minus one standard deviation in 2006–07 4/	102	109	118	117	115	112	107	101	95	89	82	50	
B5. Combination of B1–B4 using one-half standard deviation shocks	102	119	140	139	137	132	126	119	112	104	96	55	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	102	102	105	104	103	100	96	91	86	81	75	49	
Debt service ratio 6/													
Baseline	8	9	9	9	9	7	7	7	7	7	7	12	
A. Alternative scenarios													
A1. Key variables at their historical averages in 2006–25 1/	8	9	8	8	8	9	9	10	11	11	11	23	
A2. New public sector loans on less favorable terms in 2006–25 2/	8	9	8	8	8	8	8	9	9	9	9	16	
B. Bound tests													
B1. Real GDP growth at historical average minus one standard deviation in 2006–07	8	9	8	8	8	9	10	10	10	10	9	11	
B2. Export value growth at historical average minus one standard deviation in 2006–07 3/	8	10	10	11	11	12	14	15	15	14	14	13	
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2006–07	8	9	8	8	8	9	10	10	10	10	9	11	
B4. Net nondebt creating flows at historical average minus one standard deviation in 2006–07 4/	8	9	8	8	9	10	11	12	11	11	11	11	
B5. Combination of B1–B4 using one-half standard deviation shocks	8	9	9	10	10	12	13	14	14	13	13	12	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	8	9	8	8	8	9	10	10	10	10	9	11	
Memorandum item:													
Grant element assumed on residual financing (i.e., financing required above baseline) 7/	2	2	2	2	2	2	2	2	2	2	2	2	

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and nondebt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

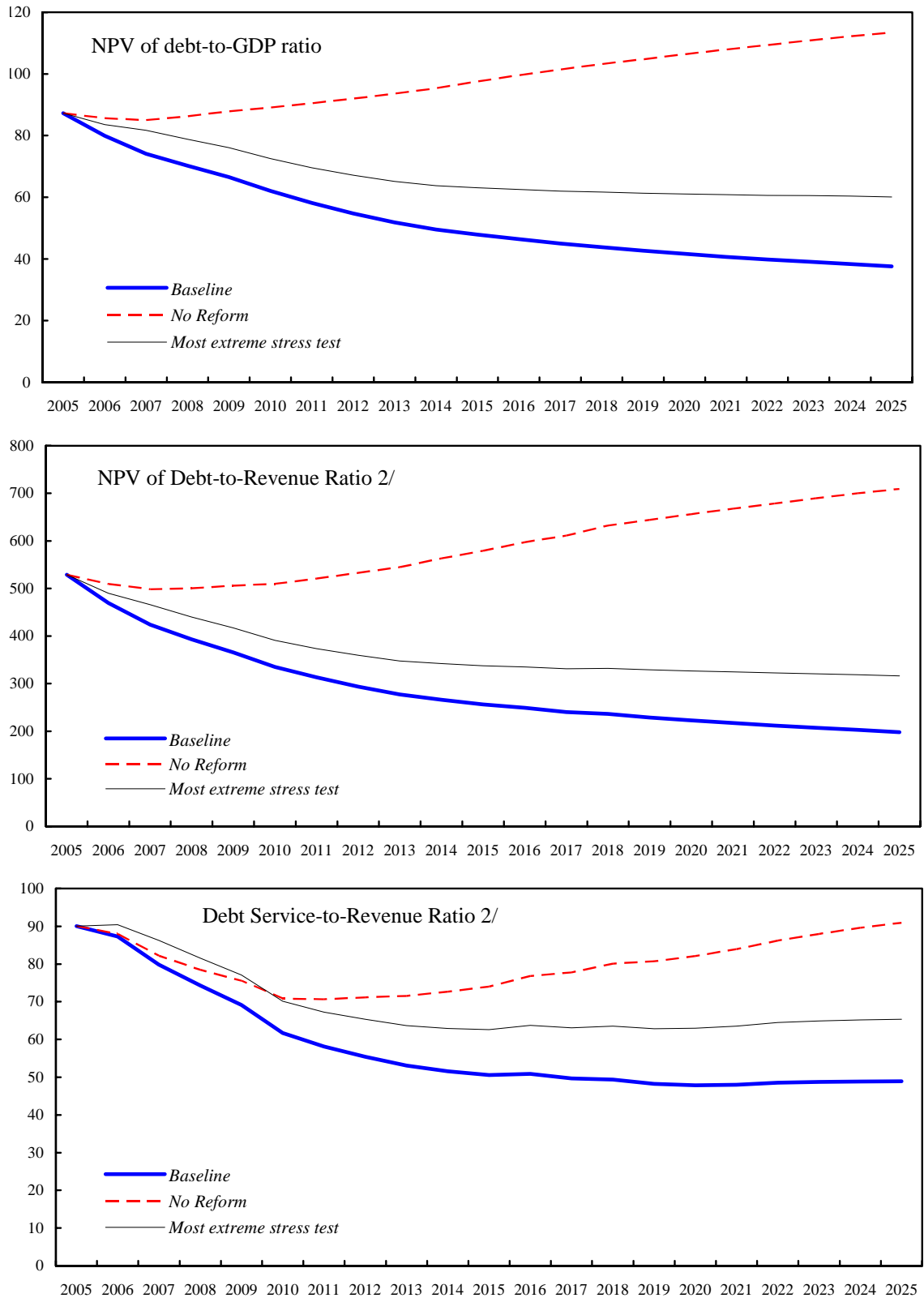
4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ A one-year moratorium by Paris Club's creditors as part of tsunami relief is included. Repayment of these obligations takes place in 2006–09.

7/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure II.1. Sri Lanka: Indicators of Public Debt Under Alternative Scenarios, 2005–2025 1/

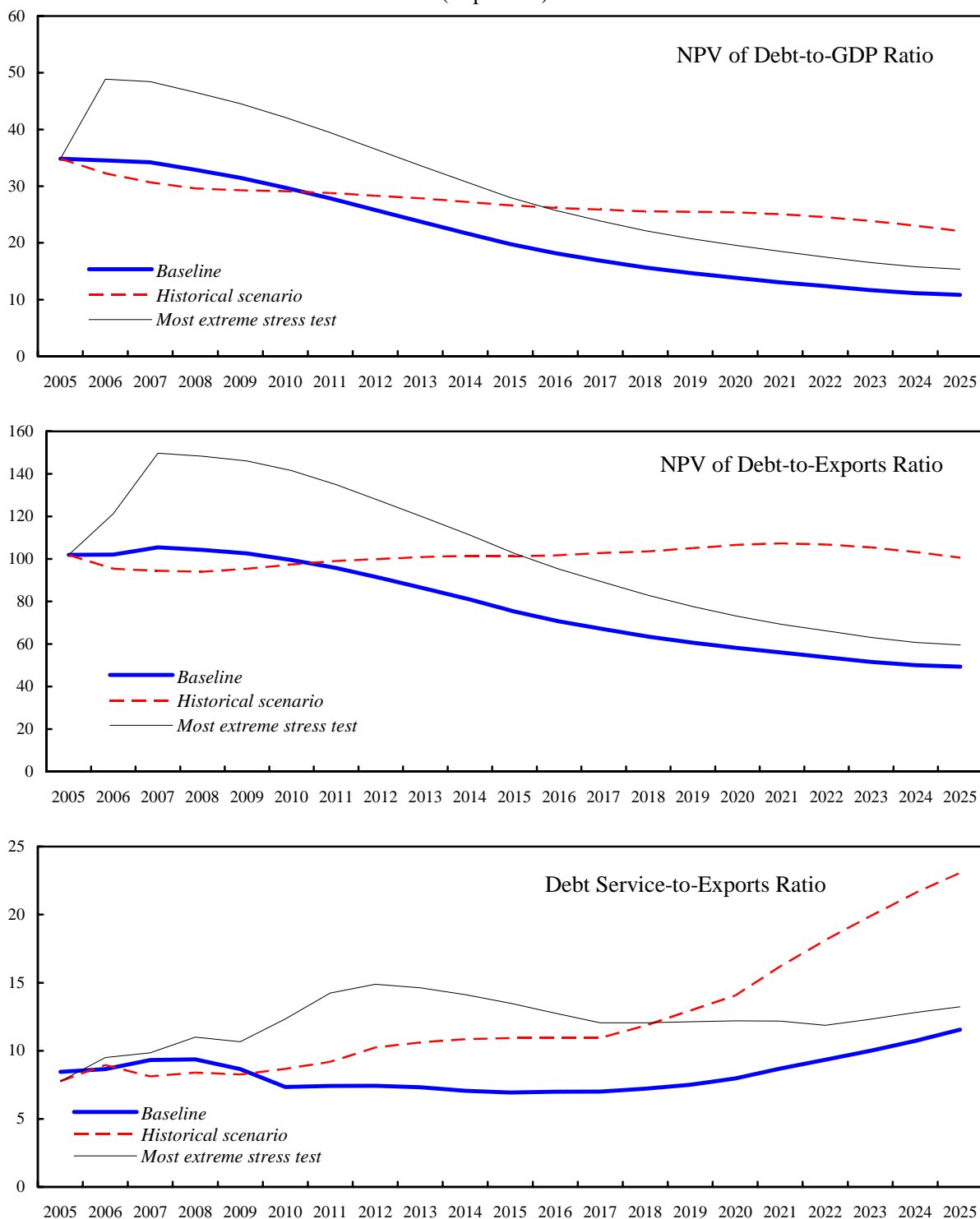


Source: Staff projections and simulations.

1/ Most extreme stress test is test that yields highest ratio in 2015.

2/ Revenue including grants.

Figure II.2. Sri Lanka: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2005–2025 (In percent)



Source: Staff projections and simulations.

Sri Lanka—Fund Relations

(As of May 31, 2005)

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	593.95	143.67
Reserve position in Fund	47.86	11.58

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	70.87	100.00
Holdings	0.95	1.34

IV. Outstanding Purchases and Loans:	SDR Million	Percent Quota
Stand-by arrangements	104.37	25.25
Extended arrangements	20.67	5.00
PRGF arrangements	38.39	9.29
Emergency Assistance	103.35	25.00

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):

	2005	2006	2007	2008	2009
Principal		74.16	31.93	46.04	62.80
Charges/interest	5.31	9.10	7.08	6.16	4.30
Total	5.31	83.27	39.01	52.20	67.09

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.

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. The authorities have already implemented most of the proposed measures, including the full implementation of International Accounting Standards, and committed to implementation of the outstanding ones, including in the context of the new Central Banking Act.

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 2003 Article IV consultation on March 5, 2004.

X. FSAP and ROSC Participation:

- MFD: Both the FSSA and the FSAP reports were completed in 2002.
- STA: A data ROSC was completed and the report published in 2002.
- FAD: A fiscal transparency ROSC was completed and the report published in 2002. A ROSC update will be issued to the Board in July 2005.

XI. Resident Representative:

Mr. Valdivieso replaced Mr. Carter as Senior Resident Representative in February 2005. A resident representative has been stationed in Sri Lanka since 1977.

Sri Lanka—Relations with the World Bank Group¹

(As of June 20, 2005)

A. Partnership in Sri Lanka's Development Strategy

In mid-2004, the coalition government that was formed after the April 2004 elections released its economic policy framework, “*Creating our Future, Building our Nation.*” This document placed strong emphasis on reducing poverty and laid out the Government’s broad areas of focus—developing the rural economy, promoting SMEs, restructuring strategic state-owned enterprises, reinvigorating the civil service and cutting the budget deficit. In the second half of 2004, the Government was in the midst of translating the broad framework into specific programs and action plans in the form of an update of the Poverty Reduction Strategy Paper (PRSP) when a powerful tsunami struck the country on December 26, 2004. This catastrophe led to the loss of some 31,000 lives as well as damage to over 110,000 homes, the natural ecosystems and coastal infrastructure. Total asset loss is estimated at around \$1 billion (4.5 percent of GDP), but the cost of reconstruction is higher due to the need for upgrades. The Government presented the much awaited draft of the PRSP update at the Development Forum held in Sri Lanka on May 16–17, 2005. The draft is an expansion of the 2004 economic policy framework, more specifically on the Government’s “pro-poor pro-growth” stance. Consultations on the draft document with stakeholders are expected to take place in the course of updating and finalizing the strategy.

B. IMF-World Bank Collaboration in Specific Areas

A summary of IMF-World Bank collaboration in Sri Lanka is provided in Table IV.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 long led the analytical work on the nature and root causes of poverty in Sri Lanka. The *Poverty Assessment* with specific focus on lagging regions and sectors (e.g., rural, estate, and North East) will be completed in FY06. The Bank has been assisting the Department of Census and Statistics with the latter’s update of poverty line data and helping to strengthen the country’s capacity for conducting poverty and social impact analyses.

The Bank has also led the dialogue in the health sector. The ongoing *National HIV/AIDS Prevention* project is assisting in curbing the spread of HIV infection by: (i) expanding prevention programs for highly vulnerable groups and the general population; (ii) developing

¹ Prepared by the World Bank staff.

programs to sustain political and societal commitment to HIV/AIDS prevention; and (iii) strengthening multi-sectoral involvement and capacity. The Bank worked closely with the authorities in developing a health sector strategy/program. This has resulted in the financing of the **Health Sector Development** operation which supports the implementation of the strategy to: (i) strengthen health programs delivered by district authorities; (ii) improve the Ministry of Health’s capacity at central and provincial levels for policy-making and supporting budget formulation process to reflect priority objectives; and (iii) strengthen orientation of public health system towards outputs and results.

Table IV.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 and financial sector	<i>IMF</i> : PRGF performance criteria and benchmarks on monetary and fiscal targets, benchmark on labor market reform <i>Bank</i> : Economic and sector work (DPR, Rural-Urban ICA); project support (Central Bank Strengthening) <i>Jointly</i> : PRSP progress report
Budget	Medium-term budget framework, tax policy and administration, tariff reform, budget classification and compilation	Public expenditure analysis	<i>IMF</i> : PRGF performance criteria on fiscal targets, benchmark on tax policy and creation of Revenue Authority; TA on fiscal statistics <i>Bank</i> : Public expenditure review
Public Sector Reform	Restructuring/ privatization of public enterprises	Welfare system, capacity building in financial management and accountability, reform of environmental management	<i>IMF</i> : PRGF benchmarks on government holdings in specified companies <i>Bank</i> : CFAA and CPAR; technical assistance; project support (ERTA)
Social/Poverty		Capacity building for monitoring and evaluation of the PRSP; Poverty Assessment	<i>IMF</i> : PRGF <i>Bank</i> : Economic and sector work (Poverty Assessment, PSIA); project support (health, education, community driven development including in the North East) <i>Jointly</i> : PRSP progress report
Private Sector Development	Financial sector reform	Reforms in banking sector, insurance industry, pension/provident funds, power sector regulatory framework	<i>IMF</i> : PRGF benchmarks on Asset Management Company Law, amendments of banking and exchange management laws, restructuring of Peoples Bank <i>Bank</i> : Project support (Central Bank Strengthening, ERTA); capacity building (IDF grant)
Rural Development		Reforms to enhance productivity and competitiveness of agriculture and rural nonfarm sector, water management	<i>Bank</i> : Project support (rural water and sanitation, water management, rural electrification and community driven development including in the North East) <i>Jointly</i> : 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 objectives of GEP II are 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 complement GEP II, TETD has been supporting the strengthening of teacher training institutions and the upgrading of teacher education programs. These two projects were restructured in November 2002 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. Furthermore, 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.

The Bank's recent report, "*Treasures of the Education System in Sri Lanka: Restoring Performance, Expanding Opportunities and Enhancing Prospects*," provides a comprehensive analysis of the education system and assisted the Government in developing the sector strategy. Subsequently, preparation of the **Education Sector Operation** is proceeding with a view to supporting the implementation of the strategy which comprises: (i) strengthening basic and secondary education system through promotion of equitable access to basic education; (ii) increasing learning levels and upgrading the curriculum; (iii) enhancing the efficiency and equity of resource allocation and distribution; and (iv) strengthening the quality of service delivery.

Given the 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.

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 current **Legal and Judicial Reform 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 led the dialogue on structural reforms supported by the first **Poverty Reduction Support Credit (PRSC I)** approved by the Board in June 2003. PRSC I aimed at enhancing the effectiveness of the overall strategy of the 2003 PRSP by: (i) accelerating economic growth and supporting private sector development; and (ii) strengthening governance in the public sector and improving the welfare system. Complementing PRSC I, the Bank led the dialogue with the public expenditure review, primarily to assist the Government in its efforts for preparing a medium term budget framework (MTBF). The Bank's FY05 report, "*Development Policy Review*" (DPR), focused on the unusual pattern of development in

Sri Lanka—i.e., sustained economic growth accompanied by rising income disparities—and partially attributed it to the country’s unfinished reform agenda.

With regard to reforms in the factor markets, 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 through a ***Land Titling and Related Services*** project. A number of other operations are supporting the implementation of reforms in public administration and institutional dimensions of public expenditure management, and they include: (i) the ***Economic Reform Technical Assistance*** credit (discussed below); (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 with the establishment and operation of a Distance Learning Center (DLC); and (iii) the ***e-Sri Lanka Development Project*** that aims to enhance growth, employment and equity by promoting affordable access to and wide use of on-line public information and services by citizens and businesses and private sector competitiveness, particularly of knowledge industries and small and medium enterprises (SMEs).

Recognizing the importance of a sound investment climate for generating growth and poverty reduction, the Bank and ADB jointly conducted a comprehensive investment climate assessment (ICA) of the urban formal sector and entrepreneurship in the rural areas. A key finding of the report, “*Sri Lanka: Improving the Rural and Urban Investment Climate*,” is that despite differences in the urban and rural investment climate, the poor quality of infrastructure (especially energy and transport) and finance represent major obstacles to both urban manufacturing and rural enterprises.

In taking the lead in the area of rural development, the Bank completed a major study, “*Sri Lanka: Promoting Agricultural and Rural Non-Farm Sector Growth*” which identified key constraints, including poor access to critical infrastructure and services, ineffective public sector expenditure programs, poor flow of information on technology transfer and dominance of public sector as a service provider and underutilization of private sector initiatives. To support the focus on poverty reduction and reinvigoration of the rural economy, the Bank is financing the ***Community Development and Livelihood “Gemi Diriya”*** project by: (i) providing the rural poor with better access to basic infrastructure and services; and (ii) developing policies, systems, procedures and institutional arrangements allowing for the transfer of funds directly to communities to provide the latter with technical and other support on a demand-driven basis.

In the area of peace and reconstruction of the North East (NE), the Bank has played a leading role. Soon after the signing of the ceasefire agreement, approximately \$15 million was made available from four projects to provide urgently needed assistance to the reconstruction. Another \$31 million to support the reconstruction was subsequently identified through the restructuring of three operations. A follow-on project, ***North East Irrigated Agriculture Project II***, continues to help conflict-affected communities in the NE and adjoining areas in restoring livelihoods, enhancing agricultural and other production and incomes, and building

capacity for sustainable, social and economic reintegration. To address housing needs, the ***North East Housing Reconstruction Project*** is providing the poorest conflict-affected families in the NE (that meet accepted vulnerability criteria) with improved and affordable housing units. Under the project, cash grants are being offered on an installment basis to vulnerable families to help reconstruct their homes.

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 the implementation of reforms in priority sub-sectors: transport, telecommunications, petroleum, power, port and airport services and urban water supply and sanitation services. 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 ***Second Community Water*** project, the Bank is supporting the implementation of demand-responsive and sustainable rural water and sanitation services, including in the NE.

The Bank—in collaboration with ADB, Japan Bank for International Cooperation (JBIC)—conducted a preliminary damage and needs assessment and released a joint report in early February 2005. The assessment forms the basis for a Tsunami Emergency Recovery Program covering roads, rail, power, water, housing, health, education and livelihoods. To support the first phase of the program, the Bank restructured its portfolio to release an immediate \$75 million for emergency reconstruction. In support of the second phase of the emergency recovery program, the Bank has made available \$75 million (of which \$30 million is in grant form) through an emergency credit/grant to support urgent recovery efforts over a two to three year period. The objectives of this operation are to: (i) reduce the immediate suffering resulting from the effects of the tsunami and restore livelihoods destroyed by the tsunami; (ii) restore basic services to the population; and (iii) start the recovery and reconstruction process. The areas of support include livelihood support, housing reconstruction, roads and implementation support to The Authority for Rebuilding the Nation (TAFREN).

Areas of shared responsibility

As described above, although the Bank has taken the lead in certain structural areas, the IMF has a strong interest from both a macroeconomic viewpoint and from the perspective of supporting reforms. As such, there is close coordination on all aspects of support to ongoing structural reforms.

As one example of an area of joint responsibility, the Bank and the IMF are working closely together on financial sector issues. 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. The IMF has been providing technical advice to the CBSL in a number of reform areas, including with regard to drafting/implementing key new legislation and in conducting active open market operations.

Sri Lanka has long been known for its comprehensive social protection programs. 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. With regard to pension reform, the Bank has long been conducting a dialogue on the topic and support is being provided under ERTA and an Institutional Development Fund (IDF) grant. The implementation of these reforms will partly depend on 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. The Bank carried out a trade policy analysis as part of the recent DPR. Specifically, it identified areas of the existing external sector policies—e.g., preferential trade arrangements as well as trade and tariff and foreign investment policies—where there may be scope for improvement in order to contribute to Sri Lanka's development and ability to cope with a changing external economic environment, especially the abolition of the Multi-Fiber Arrangement (MFA) in January 2005. 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 the 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.

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 reorienting 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

Country Assistance Strategy. The Country Assistance Strategy (CAS) for Sri Lanka was considered by the Bank's Board on April 1, 2003. The CAS was designed to support the 2003 PRSP, which focused on three core themes: peace, growth and equity. The rationale

for these themes is: (i) 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; (ii) growth is the key to prosperity and to creating a bigger cake for distribution; and (iii) 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.

At the present time, the Bank's program continues to support the peace and equity themes of the 2003 PRSP. More recently, the tsunami-related reconstruction and recovery program has been added to the program of assistance. However, Bank support with respect to the growth theme—possibly through budget support credits to follow PRSC I—awaits the development of a reform agenda that is expected to emerge out of the PRSP update and consultations. The CAS will be updated to reflect the revised agenda. The CAS also envisioned a key role for the International Finance Corporation (IFC), especially in helping achieve the growth objectives.

The Base Case Lending Program. The FY03–FY06 base case lending program presented in the CAS consisted of about four projects per year for a total of \$800 million in IDA resources. In each year, the lending program was anchored in a budget support credit (such as PRSC I) linked to the implementation of the PRSP and complemented by two to four investment/sectoral operations per year to support key programs in the focus areas.

Bank Assistance Program in Sri Lanka. The Bank's active portfolio as of June 20, 2005 comprises 20 IDA credits/grants and one Global Environmental Facility (GEF) grant for a total commitment (net of cancellation) of \$904 million (Table IV.2). During FY05, the following projects were approved: (i) e-Sri Lanka Development project in September 2004; (ii) North East Housing Reconstruction Project in December 2004; and (iii) Tsunami Emergency Recovery Program, Phase II in February 2005.

Economic and Sector Work. The Bank's leading economic report is the "*Development Policy Review*" (DPR) (Report No. 29396-LK, December 8, 2004). Three important sector reports/policy notes were completed in FY04 and FY05—"*Treasures of the Education System in Sri Lanka: Restoring Performance, Expanding Opportunities and Enhancing Prospects*," "*Sri Lanka: Improving the Rural and Urban Investment Climate*" and the "*Post-Tsunami Recovery Program: Preliminary Damage and Needs Assessment*." Other recent diagnostic work includes the Country Procurement Assessment Review, Country Financial Accountability Assessment, ROSC Accounting and Auditing Assessment, "*Promoting Agricultural and Rural Non-Farm Sector Growth*" (Report No. 25387-CE, February 26, 2003), Health Sector Policy Note and Roads Policy Note. The following economic and sector work will be completed shortly—MDG Assessment Report, Decentralization and Delivery of Services Policy Note and Social Protection Policy Note. The Poverty and Social Impact Assessment (PSIA) will be carried out on a continuous basis. The Bank's recent and ongoing analytical work helped shape its latest report, "*Sri Lanka*

Development Forum: The Economy, The Tsunami and Poverty Reduction (Report No 32221-LK April 28, 2005) that aimed to contribute to the national debate on the primary issues and to serve as an input to the update of the PRSP, the draft of which was presented at the Forum.

IFC's Activities in Sri Lanka. As of February 28, 2005, IFC's held portfolio in Sri Lanka consisted of investments in 10 companies, with a total committed exposure of \$104 million. The portfolio is spread over financial institutions, power, health care, manufacturing, ports and telecommunications. In FY04, IFC approved an SME development program for Sri Lanka and the Maldives. IFC would provide \$2 million of the \$10 million total funding requirement for the five-year program along with other donors. The program's focus will be on financial services, and the business enabling environment, as well as specific sub-sectors, such as, tourism, construction and agribusiness. In light of the tsunami, IFC plans to accelerate the launch of this program to assist the rehabilitation and creation of sustainable private enterprises. As part of IFC's immediate response to the tsunami, it approved a \$2.5 million Matching Grant Program to match the costs incurred in relief work by selected partner companies in the affected countries in order to enable such companies to step up their participation in the relief effort. Total approved sub-projects under this program amount to \$319,000, as of April 2005, covering airport and port logistics, relief camps and emergency telecommunications. In addition, IFC provided \$150,000 to the Fishermen's Relief Trust Fund—established by the National Development Bank (NDB)—to help finance the repair or replacement of fishing boats and equipment damaged by the tsunami.

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

Table IV.2. Summary of World Bank Operations
(As of June 20, 2005)

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	6.1
2881	1996	Teacher Education and Teacher Deployment	64.1			2.0
3014	1998	General Education II	70.3		0.9	7.5
3058	1998	Mahaweli Restructuring	57.0			0.8
3301	2000	North-East Irrigated Agricultural Project	27.0			2.4
3384	2001	Legal and Judicial Reforms	18.2			8.0
3469	2001	Distance Learning Initiative (LIL) ^{3/}	2.0			0.7
3496	2001	Land Titling and Related Services (LIL) ^{3/}	5.0			1.6
3525	2001	Central Bank Strengthening	30.3			4.1
3673	2002	Renewable Energy for Rural Economic Development	75.0			45.9
3722	2003	Economic Reform Technical Assistance	15.0			5.7
H013	2003	National HIV/AIDS Prevention	12.6			12.0
H035	2003	Second Community Water	39.8			38.1
3781	2003	Improving Relevance and Quality of Undergraduate Education	40.3			30.7
H078	2004	Community Development and Livelihood	51.0			49.5
H095	2004	Health Sector Development	60.0			58.2
3935	2004	North-East Irrigated Agricultural Project II	64.7			64.1
4014	2005	North East Housing Reconstruction Program	75.0			73.5
3986	2005	E-Sri Lanka Development	53.0			44.8
4039/ H147	2005	Tsunami Emergency Reconstruction Program Phase II	75.0			60.3
<i>GEF Projects^{4/}</i>						
51248	2002	Renewal Energy for Rural Economic Development ^{5/}		8.0		2.8
Total			912.3	8.0	15.9	519.0

^{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 Bank¹

(As of May 31, 2005)

The Asian Development Bank (ADB) started its operation in Sri Lanka in 1969 and has provided 128 public sector loans totaling about \$3.4 billion and 213 technical assistance projects totaling about \$88.5 million.

In April 2005, ADB approved a \$197 million grant and loan package for two projects that will help rebuild tsunami- and conflict-affected areas of Sri Lanka. External funding for the projects will total \$256 million including grant cofinancing by the European Commission and Sweden. A \$150 million grant and a \$7 million loan for the Tsunami-affected Areas Rebuilding Project (TAARP) will help to rapidly improve the living conditions of people in tsunami-affected areas by restoring basic social infrastructure, community and public services, and livelihoods. The grant comes from ADB's Asian Tsunami Fund, set up in February with an initial ADB contribution of \$600 million to deliver prompt emergency grant funding to tsunami-affected countries. The loan comes from reallocated surplus loan funds from other ADB projects in Sri Lanka. An additional \$14 million grant and a \$26 million loan for the North East Community Restoration and Development Project II (NECORD II) will continue the Government's rehabilitation program in conflict-affected areas of the Northern and Eastern provinces.

During 2004, ADB approved eight projects to Sri Lanka totaling \$195 million and \$3.9 million in technical assistance grants, to support development and reforms in key areas of the economy. The ADB assistance includes road sector development, wastewater management, and assistance to Sri Lankan debt market and for psycho-social health in conflict affected areas.

In 2004, the ADB's Board of Directors endorsed the Country Strategy and Program Update (CSPU) for 2005–2006, which envisages assistance of about \$570 million over the next two years. The CSPU 2005–2006 supports the government's efforts in rehabilitating and reconstructing the conflict-affected areas. ADB operations over this period will also be based on the Tsunami Needs Assessment carried out in January 2005, which identifies and emphasizes the importance of key guiding principles—such as conflict sensitivity, subsidiarity, community empowerment, transparency, multi-hazard risk management, and coordination between stakeholders—during the development of a comprehensive tsunami recovery strategy.

ADB'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, \$330 million will come

¹ Prepared by ADB staff.

from ADB's Asian Development Fund (ADF), which supports the sustainable social and economic development of poor countries in the Asian and Pacific region, and \$240 million will be from ordinary capital resources (OCR). The timing and magnitude of the assistance program will be responsive to the developing peace process and the country performance.

Reflecting ADB's country-wide focus, ADB'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 technical assistance program will support project preparation, institutional development, and economic, thematic and sector work.

As of December 31, 2004, the sectoral distribution of the loan portfolio is agriculture and natural resources, 21.8 percent; social infrastructure, 13.2 percent; energy, 8.4 percent; education, 10.9 percent; finance and industry, 17.2 percent; transport and communications, 21.1 percent; and relief and rehabilitation, 7.4 percent.

Lending by the Asian Development Bank, 1997–2004

(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003	2004
Commitment	166	190	184	209	100	157	315	184
Net resource transfer	71	93	72	47	65	125	166	n.a.
Disbursement	96	126	99	76	91	171	225	186

Source: Asian Development Bank.

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. Quarterly national accounts and monthly monetary and fiscal revenue data are published regularly. The authorities have expressed their intention to subscribe to the Special Data Dissemination Standard (SDDS) and have appointed an SDDS coordinator in February 2003. However, substantial work is still needed in terms of meeting all SDDS requirements and preparing the necessary metadata before Sri Lanka is ready for subscription.

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.

A 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. The national accounts suffer from lack of

sufficient data sources and undeveloped statistical techniques. Sri Lanka does not have periodic comprehensive benchmarks and a system for conducting regular annual surveys of establishments. A statistical business register, which would serve as the main basis for conducting sample surveys, is not available. As a result, the few surveys that are conducted do not have good sample frames. Most of the data used for regular compilation are obtained on a timely basis. However, detailed data needed to measure both output and intermediate consumption are mostly unavailable or not collected. As a result, the estimates of gross value added are prepared directly relying on outdated fixed ratios established from the base year 1996, often with outdated studies or ad hoc assumptions. Quarterly indicators are used for compiling quarterly value added estimates. The methodology for deriving GDP at constant prices is not satisfactory. Expenditures estimates are available only annually and rely mostly on commodity flow techniques. Whenever possible, estimates are validated and checked with other sources.

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 eventually match the *GFSM 2001* classifications of all stocks and flows and to apply that chart of accounts to all general government units.

Data regularly provided for publication in the *GFS Yearbook* cover only the budgetary accounts of central government. No data on the four extra-budgetary funds or 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 framework of *GFSM 2001*. They have also begun a process to compile current and historical data on the budgetary operations of Provincial Councils. Full adoption of the *GFSM 2001* system is expected to take a substantial period of time.

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

A STA mission visited Colombo in December 2004. The highest priority issues identified by the mission included dealing with some shortcomings in the international transactions reporting system (ITRS), which is the primary data source for the balance of payments. The recommended improvements included addressing the large values of unclassified transactions, inclusion of FCBUs in the data, and providing an instruction book to assist ITRS reporters to apply classifications and coding more accurately. The mission advised the authorities on the development of a comprehensive survey to implement their medium-term plan to introduce 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—Common Indicators Required for Surveillance

As of June 20, 2005

	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶	Memorandum Items:	
						Data Quality—Methodological Soundness ⁷	Data Quality Accuracy and Reliability ⁸
Exchange rates	6/20/2005	6/20/2005	D	D	D		
International reserve assets and reserve liabilities of the Monetary Authorities ¹	6/17/2005	6/20/2005	D	W	W		
Reserve/base money	6/16/2005	6/17/2005	W	W	W	LO, LO, LO, LO	LO, O, O, NA
Broad money	4/29/2005	6/15/2005	M	M	M		
Central bank balance sheet	5/31/2005	6/15/2005	M	M	M		
Consolidated balance sheet of the banking system	4/29/2005	6/15/2005	M	M	M		
Interest rates ²	6/17/2005	6/17/2005	W	W	W		
Consumer price index (SLCPI)	4/2005	6/1/2005	M	M	M	O, LNO, LO, O	O, LO, O, NA
Revenue, expenditure, balance and composition of financing ³ —general government ⁴							
Revenue, expenditure, balance and composition of financing ³ —central government	4/2005	6/15/2005	M	M	M	O, O, O, O	LO, NA, LO, LO
Stocks of central government and central government-guaranteed debt ⁵	3/2005	6/1/2005	M	M	M		
External current account balance	Q4/2004	3/31/2005	Q	Q	Q		
Exports and imports of goods and services	Q4/2004	3/31/2005	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, LO
GDP/GNP	Q4/2004	3/31/2005	Q	Q	Q	LO, LO, LNO, LNO	LNO, LNO, LO, O
Gross external debt	12/2004	4/29/2005	A	A	A		

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

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

³Foreign, domestic bank, and domestic nonbank financing.

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

⁵Including currency and maturity composition.

⁶Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

⁷Reflects the assessment provided in the data ROSC published in May 2002 and based on the findings of the mission that took place during June 2001 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO), not applicable (NA).

⁸Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Sri Lanka—Technical Assistance

Fiscal Sector

Consistent with the continued prominence given to improving revenue performance in both the PRSP and in the surveillance and program context, recent FAD technical assistance (TA) has focused on tax policy and administration. A report in 2001 proposed a wide-ranging agenda for policy and administrative reform. It recommended in particular the introduction of a single-rate VAT, the repeal of a number of ad hoc taxes, the limiting of tax exemptions and incentives, and a number of measures to broaden the base of existing taxes. Subsequent TA focused on improving administration with missions in 2002 and 2003 providing advice on the design of a revenue authority and strategies for modernizing revenue departments. In early 2004, as the prospects for the establishment of a revenue authority diminished, FAD focused on operational support to the Large Taxpayer Unit (LTU) through a five-month assignment of a resident expert.

The implementation of FAD recommendations has, however, been patchy. In line with the key recommendations of the 2001 report, many ad hoc taxes have been repealed, a VAT has been established and the Economic Service Charge implemented. However, fundamental aspects of these recommendations, such as the coverage and rate of the VAT and the limiting of tax exemptions were not implemented with the possible result that policy reforms have not achieved their potential. While there have been some successes, notably in the LTU, overall progress in revenue administration has been disappointing particularly in key areas such as establishing a single Taxpayer Identification Number and modernizing the structure and processes of the Inland Revenue Department.

Monetary and Financial Sector

MFD and LEG have provided extensive TA on financial sector reform consistent with Sri Lanka's FSAP, PRSP, and the new government's development strategy recently presented to the Development Forum. The PRSP, issued in late 2002, identifies insufficient access to finance and high financial intermediation costs as a prime impediment to growth and poverty reduction. The poor intermediation is commonly attributed to a combination of inefficient state banks, insufficient competition, and a weak regulatory framework. Accordingly, MFD TA has focused on state bank restructuring, bank supervision, capital market development (to increase competition in the banking sector), and—in cooperation with LEG—legal reform.

The implementation record of MFD/LEG recommendations has been affected by political uncertainties related to the 2004 elections and, subsequently, the tsunami. On the positive side, the performance of the two state-owned banks continues to improve, provisioning requirements have been strengthened, actual provisioning increased across the banking sector, and short selling of government securities has been permitted to enhance capital markets. However, the new central bank law and banking law have been delayed, and approval by Parliament is not expected before end-2006. The laws aim to strengthen the

CBSL regulatory power and the drafting has been assisted by MFD and LEG since September 2002.

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
	▪ Large taxpayers unit	February–June 2004
MFD	▪ Deposit Insurance	May 2005
	▪ Financial sector regulation and supervision	February, June, May, September, November 2003, February, April, May 2004,
	▪ Monetary operations	May, October 2002, Feb 2003
	▪ Bank restructuring	May 2002, January 2003
	▪ Banking and Central Banking Laws	June 2003
MFD/LEG	▪ AML/CFT Legislation	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

**Statement by the IMF Staff Representative
July 15, 2005**

This statement reports on recent developments since the issuance of the staff report. The information presented does not materially change the economic outlook or the staff appraisal.

The political situation remains difficult. Despite the government's lack of majority in parliament, the President has ruled out calling for parliamentary elections at this time. Meanwhile, the main opposition party has stepped up its demand that a Presidential election be held this year.

The Post-Tsunami Operations Management Structure (P-TOMS), which was discussed in Parliament earlier this month, is taking shape. The P-TOMS will have representatives from the government, the LTTE and the Muslim community, and will be in charge of approving reconstruction projects for tsunami-affected areas in the North and East parts of the country. Funding will be channeled through a Trust Fund for which the World Bank has been asked to be the custodian and to which about \$100 million has been pledged so far. Out of total tsunami pledges, staff estimates that Sri Lanka has now received \$300–350 million in aid for reconstruction from official donors, NGOs/private sources, and the year-to-date impact of the debt moratorium. This is in addition to \$158 million in emergency assistance from the IMF and about \$65 million in humanitarian assistance by UN agencies.

Notwithstanding the political uncertainty, financial markets have remained stable. The exchange rate has hovered around Rs. 100/US\$ since end-May and, despite some central bank intervention when the JVP quit the government, reserves remained at \$2.1 billion (about 2.4 months of imports) as of July 6. Equity prices remain at about the same level as in May. The yields on the 3-month treasury bill have risen somewhat to about 9 percent, close to 200 basis points above their level at end-2004, as a result of the increases in policy rates and open market operations by the central bank.

GDP growth in the first quarter reached 4.8 percent (y/y), in line with expectations. The tsunami contributed to a slowdown in services, especially trade- and tourism-related, and had a devastating impact on fisheries, which contracted by 65 percent. Tourism, however, contracted by less than expected in the first quarter (arrivals decreased by 5 percent y/y) and arrivals in April-May were well above last year's levels. A good paddy harvest and a rebound in value added in the electricity sector (which was affected by a drought last year) helped offset the negative impact of the tsunami on GDP. The apparel sector also performed reasonably well and posted a growth rate of 7 percent.

Inflation moderated slightly in May, thanks to a decline in food prices, with the Sri Lanka CPI falling to about 13 percent (y/y). Although inflation measured by the Colombo CPI also fell in June, to below 10 percent, inflationary pressures remain a concern

for the second half of the year, when reconstruction activity will pick up and adjustments in administered prices are expected to take place.

In accordance with the Fiscal Management (Responsibility) Act, the government presented to Parliament the Mid-Year Fiscal Position Report. In it, the overall fiscal deficit in the first four months of the year is estimated at about 3 percent of annual GDP. The latest revenue figures (20 percent growth y/y through May) are broadly in line with the staff revenue projections but high oil prices, which are currently above the assumptions used in the staff report, represent a risk to expenditure projections. Staff estimates that at current oil prices, additional subsidies of around $\frac{1}{3}$ percent of GDP would be required unless fuel and diesel prices are adjusted by more than envisaged in the staff report.

On monetary policy, the CBSL appears to have been successful at moderating somewhat the pace of money creation. Thus, at end-June, reserve money growth stood at about 19 percent (y/y), compared to 21 percent at end-2004. Further tightening, however, will be necessary to rein in inflationary pressures. At its monthly meeting earlier this week, the Monetary Board left interest rates unchanged.

As regards the Ceylon Electricity Board (CEB), negotiations between the authorities and the unions have continued since the staff report was issued, but the main issues remain unresolved. The sticking point continues to be the unbundling of CEB, which the unions fear could facilitate privatization in the future. In the meantime, an increase in fixed charges for electricity has been announced.



INTERNATIONAL MONETARY FUND

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

IMF Executive Board Concludes 2005 Article IV Consultation with Sri Lanka

On July 15, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sri Lanka.¹

Background

Since the last Article IV consultation, economic growth momentum has largely been sustained, but accommodating monetary and fiscal policies have added to inflationary pressures. The Sri Lankan authorities, supported by the international community, have provided the initial stages of tsunami relief relatively efficiently. However, implementation of the more difficult reconstruction phase will affect economic performance going forward.

Export performance was strong in 2004, aided by textiles and tourism arrivals, but rising oil prices and a drought were a drag on growth. Real GDP increased by 5.4 percent, compared with 6.0 percent in 2003. Growth was led by domestic demand, especially strong private investment, which contributed to rapid growth in imports. Annual inflation reached 16.8 percent (end-of-period), reflecting demand pressures as well as higher food and oil prices.

The fiscal deficit reached 8¼ percent of GDP in 2004, or 1½ percentage points higher than budgeted. Revenues fell short of the budget target owing to the late enactment of income tax amendments and lower than expected profit transfers from the central bank. Expenditure overruns were due to higher subsidies (mostly for oil). The impact on net domestic financing, which reached 6 percent of GDP, was exacerbated by lower privatization proceeds and

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.

shortfalls in program financing. To help bridge this gap, the government issued \$250 million (1¼ percent of GDP) in dollar denominated bonds in the domestic market.

With the central bank purchasing large amounts of treasury bills, ample liquidity was available for private credit, and money growth increased significantly. Broad money increased by 20 percent, compared with 15 percent in 2003. With the increase in inflation, and despite a modest increase in policy rates by 50 basis points in November, real interest rates remained negative contributing to private credit growth of 22 percent. In contrast to the previous year, monetary expansion in 2004 was accounted for by an expansion of private and public credit rather than an increase in international reserves.

The balance of payments shifted to a deficit of \$205 million in 2004, from a surplus of \$502 million in 2003. Despite robust export performance, the current account moved from near balance to a deficit of 3 percent of GDP, reflecting the effects of both oil price increases and strong demand for investment goods. Official external financing—especially program loans—dried up significantly, with donors waiting for an articulation of the government’s policy agenda. By end-2004, the rupee had lost 8 percent of its value against the dollar (y/y), despite central bank intervention, and gross official reserves had fallen to \$1.8 billion (equivalent to 2.1 months of imports).

The 2005 budget, approved in December 2004, envisaged a reduction in the deficit to 7½ percent of GDP. The budget aimed to improve economic conditions for the rural poor, increase spending on health and education, phase out numerous subsidies, including on petrol and diesel, and reaffirmed the government’s commitment to meet the targets of the Fiscal Management (Responsibility) Act, albeit on a delayed timetable. While the 2005 budget targets represent a welcome step toward putting government debt on a declining path relative to GDP, budget estimates appeared overly optimistic, particularly for revenue.

Progress has been made on some structural reforms, but problems remain, especially for some key public enterprises. On revenue administration, the cabinet approved in June 2004 the listing of various revenue departments under a revenue board. However, much remains to be done on the concurrently approved restructuring of the Inland Revenue Department. In the financial sector, the ADB approved a program loan in support of the restructuring of People’s Bank, whose performance indicators have improved. In the energy sector, however, large fiscal and quasi-fiscal costs arising from the operations of the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) have taken place in 2004-05. Direct subsidies from the budget amounting to 1 percent of GDP in 2004, and ½ percent of GDP so far in 2005, have been paid to CPC to cover their losses. While electricity charges are among the highest in the region, operational inefficiencies in CEB have led to significant losses and accumulated debt (including arrears) amounts to about 4 percent of GDP. Deadlines for reforming CEB have been postponed repeatedly.

While still vulnerable, the macroeconomic situation has stabilized somewhat since the tsunami. The rupee ended its downward slide on the expectation of aid inflows and has appreciated 5 percent against the U.S. dollar through mid-July, and gross reserves increased by more than \$300 million reflecting the IMF’s emergency assistance and other donor disbursements. However, monetary aggregates have continued to grow rapidly and inflation has remained high, despite efforts by the central bank to absorb excess liquidity, and increases in policy interest rates in May and June of 25 and 50 basis points, respectively. Fuel prices have been adjusted

twice so far in 2005, but fuel subsidies continue to be a drag on the budget. Stock prices, after a dip in the immediate aftermath of the Tsunami disaster, have continued their rising trend from 2004 and are up by about 25 percent so far this year.

Executive Board Assessment

Executive Directors commended the Sri Lankan government for its prompt and effective implementation of relief work to cope with the loss of life, suffering, and destruction caused by the December 2004 tsunami. A key ongoing challenge will be to manage the reconstruction activity in an efficient and transparent manner by mobilizing donor assistance effectively and maintaining macroeconomic stability. The longer-term challenges facing Sri Lanka include moving toward fiscal consolidation, implementing structural reforms that enhance the investment climate, and reviving the peace process, in order to establish a solid foundation for sustainable growth and reduction of poverty.

Directors observed that near-term prospects for economic growth remain positive, with reconstruction activity and a strong performance of the agricultural sector expected to offset the tsunami's adverse impact on fisheries and tourism. They cautioned, however, that inflationary pressures could be exacerbated if reconstruction faces bottlenecks. Accordingly, Directors emphasized the importance of effective management of the reconstruction, with the government continuing to coordinate official tsunami assistance and oversee arrangements to monitor private aid flows. They welcomed the establishment of the Task Force for Reconstruction of the Nation and the appointment of an external auditor, and called for periodic reports on the use of aid directly to the public and the donor community, as well as implementation of audit procedures to ensure transparency and accountability.

With the reconstruction plans in place, Directors considered that emphasis should now be placed on Sri Lanka's longer-term challenges. Positive factors behind the growth outlook include the significant untapped potential in the North and East of the country, the country's open trade policies, and increased commercial links with its fast growing neighbors. At the same time, Directors noted that a complex tax system, labor market rigidities, poor infrastructure, and an underdeveloped capital market constrain private investment and impede growth.

Directors cautioned that the recent large fiscal deficits and the high level of public debt constitute a potential source of macroeconomic instability. Noting that meaningful progress toward the path of fiscal consolidation envisaged under the Fiscal Management (Responsibility) Act has been elusive, Directors called for stronger efforts at fiscal consolidation. Improvements in debt management, and curtailment of central bank financing of the budget in the context of a medium-term budget framework, remain essential.

Directors welcomed the recent improvement in revenue performance, noting, in particular, that several measures had helped increase tax revenue relative to GDP in 2004. However, the authorities were encouraged to consider additional measures if needed to ensure that the revised 2005 budget targets for revenue are achieved. In addition, Directors encouraged the authorities to give priority to a comprehensive tax reform, including improvements in tax and customs administration as well as broadening of the tax base.

Directors considered that fiscal adjustment will also need to focus on the expenditure side, with the aim of shifting expenditure to priority infrastructure and poverty-related projects.

The authorities were urged to cut fuel subsidies, particularly for petrol and diesel, by raising prices to cost-recovery levels. Directors also reiterated the need for civil service reform to contain the wage bill and decompress the wage structure. To protect the poor from the effects of these measures, Directors encouraged the authorities to proceed with earlier plans to improve the targeting of welfare benefits.

Directors commended the central bank's recent actions to tighten monetary policy and increase transparency. Nevertheless, inflation remains high and monetary and credit aggregates continue to grow rapidly. Accordingly, Directors recommended appropriately paced additional monetary tightening in order to signal the central bank's determination to curb inflation and reduce inflationary expectations. Some Directors also felt that greater independence of the central bank would contribute toward these objectives.

Directors reiterated their support for the flexible exchange rate regime, which has helped cushion the external and domestic shocks of 2004–2005. They concurred that some smoothing of the exchange rate path is appropriate, especially given the large aid inflows and import needs over the coming months. However, Directors underscored the risks of trying to avoid an exchange rate depreciation through protracted intervention. They also advised that reserves be increased to more comfortable levels over the medium term. Directors urged the authorities to maintain their long-standing commitment to an open trade regime, which will play an important role in ensuring that Sri Lanka benefits from strong global and regional growth.

Directors encouraged the authorities to move forward with the restructuring of key public enterprises. They welcomed the creation of the Strategic Enterprise Management Agency (SEMA) to monitor those enterprises expected to remain in the public sector. Directors expressed concern that the fiscal and quasi-fiscal costs incurred by the Ceylon Electricity Board (CEB) and Ceylon Petroleum Corporation (CPC) threaten to undermine fiscal sustainability and economic performance, and urged the authorities to make further tariff adjustments and proceed with their restructuring. More broadly, Directors suggested a more comprehensive monitoring of public enterprises' fiscal risks.

Directors commended the authorities for the progress made in the regulation and supervision of the financial system since the completion of the Financial Sector Assessment Program (FSAP) in 2002. As a result, financial indicators have improved across the entire banking system, including in the two state-owned commercial banks. However, Directors warned that the recent rapid growth in lending could lead to a deterioration of asset quality. They emphasized that the planned recapitalization of People's Bank should proceed on the basis of the achievement of agreed performance targets. Looking ahead, Directors encouraged efforts to promote greater competition in the banking system, and some called for the increased commercialization of the state-owned banks.

Directors considered that Sri Lanka's statistical information is adequate for surveillance purposes and encouraged the authorities to improve the quality and coverage of fiscal statistics and address the remaining issues needed to meet Special Data Dissemination Standard (SDDS) requirements. They commended the authorities for successfully addressing the recommendations of the Safeguards Assessment.

Directors expressed regret about the delays in completing the reviews under the Poverty Reduction and Growth Facility and Extended Arrangements. They looked forward to continued

progress in the near future toward the development of a credible and sustainable economic reform program based on a broad domestic consensus.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Sri Lanka: Selected Economic Indicators

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

	2001	2002	2003	2004 Est.	2005 Proj.
Domestic economy					
Real GDP growth (percent)	-1.5	4.0	6.0	5.4	5.3
Inflation (percent, 12-month average) 1/	12.1	10.2	2.6	7.9	14.0
National savings (percent of GDP)	20.3	19.5	21.6	21.6	22.1
Gross investment (percent of GDP)	22.0	21.2	22.1	25.0	27.7
Fiscal position					
Revenue (percent of GDP)	16.6	16.5	15.7	15.3	15.7
Expenditure (percent of GDP)	27.5	25.4	24.0	23.5	23.9
Overall deficit (percent of GDP) 2/	-10.8	-8.9	-8.3	-8.2	-8.2
Total government debt (percent of GDP)	103.2	105.6	105.8	105.4	100.7
External economy					
Exports	4,817	4,699	5,133	5,757	6,098
Imports	5,974	6,105	6,673	8,000	9,171
Current account balance (in percent of GDP)	-179 -1.1	-236 -1.4	-74 -0.4	-648 -3.2	-1,257 -5.6
Capital and financial account balance	535	444	722	635	1,132
<i>Of which: direct investment</i> 3/	172	186	201	227	276
Gross official reserves (excluding ACU balances)	1,183	1,560	2,146	1,833	2,083
(in months of prospective imports)	2.0	2.4	2.8	2.1	2.2
Real effective exchange rate (percent change, period average) 4/	1.7	0.1	-4.9	-4.7	...
External debt (in percent of GDP)	60.8	62.6	64.1	62.8	58.9
Debt service (in percent of goods and services exports)	14.3	12.3	10.9	9.9	10.2
Financial variables					
Broad money growth (annual percent change) 5/	13.6	13.4	15.3	19.6	15.0
<i>Of which: net credit to government</i>	36.8	-4.2	-8.7	25.1	0.1
<i>Of which: credit to the private sector</i>	8.9	12.0	16.9	22.1	21.0
Interest rate (percent, end of period) 6/	12.9	9.9	7.4	7.3	10.0

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

1/ Sri Lanka consumer price index.

2/ Excluding grants and privatization receipts.

3/ Includes privatization.

4/ (-) = depreciation.

5/ Including foreign currency banking units.

6/ Three-month treasury bill rate.