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SRI LANKA

May 2013

2013 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING

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 2013 Article IV consultation with Sri Lanka, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV Consultation and Proposal for Post-program Monitoring , prepared by a staff team of the IMF, following discussions that ended on February 13, 2013, with the officials of Sri Lanka on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 12, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the staff of the IMF.
- **Staff Statement** of April 26, 2013.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its May 1, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Sri Lanka.

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

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April 12, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING

KEY ISSUES

Context: Notable progress has been achieved in recent years, on both the policy and macroeconomic fronts. Challenges remain, however, including in the near term elevated inflation and slowing, yet resilient, growth. The current account deficit is narrowing, but exports and FDI are lower than expected. Safeguarding macroeconomic stability and launching a new phase of structural reforms would facilitate ambitious medium-term development goals.

Fiscal policy: Reducing high public debt levels requires continued fiscal consolidation. Staff supports the authorities' 5.8 percent of GDP budget deficit target for 2013. A critical issue is strengthening the revenue system to support consolidation while making space for capital investment and key social spending in order to sustain robust and inclusive growth. A second generation of tax reform focused on base broadening and improving administration is needed. Addressing losses at state-owned energy companies requires a comprehensive approach.

Monetary and exchange rate policy: With inflation elevated and growth slowing, monetary policy is facing a challenging task. Policy was eased recently. Further stimulus should remain on hold until inflation pressures decline. Moving toward a flexible inflation targeting framework would provide a nominal anchor for monetary policy in the context of exchange rate flexibility.

Financial stability: The FSAP update recognized progress made in strengthening banking supervision and financial soundness indicators are strong. However, rapid credit expansion in recent years justifies heightened vigilance for systemic vulnerabilities. Annual stress tests and raising capital buffers in banks exposed to notable credit risks, more robust consolidated supervision and macroprudential frameworks, and development of pension and crisis preparedness frameworks would help cement financial stability.

Strengthening trade and broadening growth: Exports have declined significantly as a share of GDP and world exports since 2000. Deeper integration with the world economy, attracting FDI, and a more enabling environment for exports and the private sector would broaden the sources of growth and enhance external resilience. Important measures include reducing policy barriers, continuing to expand infrastructure and improve the business climate, reforming the trade tariff structure, and sustaining exchange rate flexibility.

Approved By
Hoe Ee Khor (APD) and Dhaneshwar Ghura (SPR)

Discussions took place in Colombo January 30–February 13, 2013. Staff team: Messrs. Nelmes (Head), Jonas, Tulin (all APD), Thornton (SPR), and Mathai (resident representative). Mses. Loucks and Inoue and Mr. Dalesio assisted in this report's preparation.

CONTENTS

CONTEXT

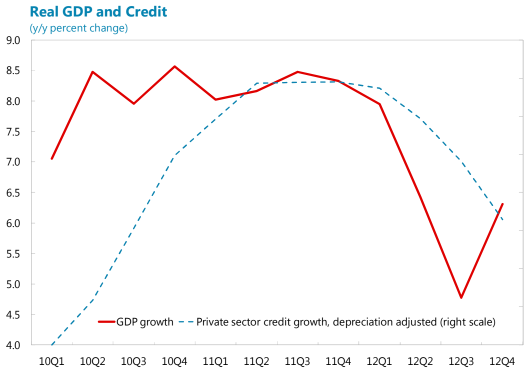
1. **Sri Lanka has achieved notable progress on a number of economic fronts in recent years, although there have also been challenges.** While slowing recently, growth has been generally robust, fiscal consolidation has taken place, and poverty and inequality have declined (Box 1). Other aspects of Sri Lanka's development agenda, however, require ongoing effort. Revenue growth has not responded as envisaged to a first round of tax reforms, undermining capital investment plans; despite recent appropriate price adjustments, state-owned enterprises remain prone to large losses; and the current account deficit remains elevated and financed mainly through debt-creating flows.

2. **The authorities are keen to broaden and deepen economic development, building on the achievements of the recently completed Stand-By Arrangement with the Fund.** The President's second five-year plan aims to raise per capita incomes by a third to US$4,000 in 2016 with real growth of 8 percent per annum. Sustaining robust and inclusive growth will require maintaining macroeconomic stability, with particular near-term attention to inflation risks, as well as structural reforms. Priorities include: a second generation of tax reform to create fiscal space for higher investment and critical social expenditures while supporting fiscal consolidation; re-orienting the monetary policy framework toward achieving low and stable inflation under exchange rate flexibility; broadening and refining frameworks to safeguard financial stability and deepen markets; and addressing structural impediments to trade and private sector growth.

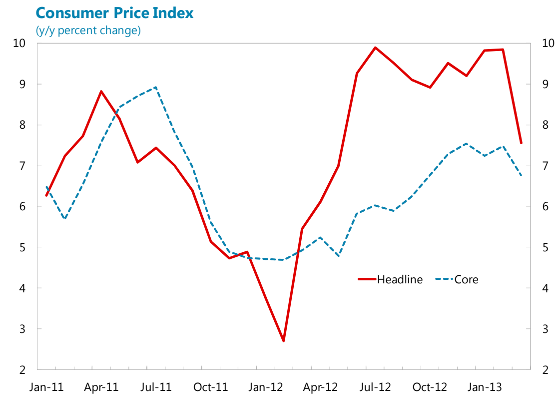
3. **Response to past advice.** The authorities have implemented a range of policies consistent with previous Fund policy advice and meeting program conditionality. They embarked on a challenging fiscal consolidation path with a first round of tax reforms and expenditure containment, including reducing defense spending as a share of GDP. However, the pace and quality of fiscal adjustment fell short of ambitious plans, and tax rate reductions generally took precedence over base broadening, while cost-recovery pricing at state-owned energy companies has yet to emerge. The exchange rate was allowed greater flexibility, albeit after a costly delay. Good progress was made in strengthening bank supervision and regulation, and deposit insurance was introduced, but pension regulation frameworks were not addressed. The investment regime was improved, though exemptions remain prevalent.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

4. **Real GDP growth slowed in 2012, while inflation rose.** Policies were tightened in a bold policy package and the exchange rate was allowed to depreciate in early 2012 to rein in credit and import growth and stabilize international reserves. At the same time, spillovers from weak global growth undermined exports, and drought, followed by floods, adversely affected agriculture. Real growth slowed to 6.4 percent in 2012. Following an upward shift due to exchange rate pass through and higher food and administered prices, headline inflation hovered near double digits for most of the year, before easing to 7½ percent year-on-year in March 2013 due mainly to base effects. Core inflation trended upward, and inflation expectations and private sector wage demands have risen.



Sources: Authorities data; Haver Analytics; and IMF staff estimates.

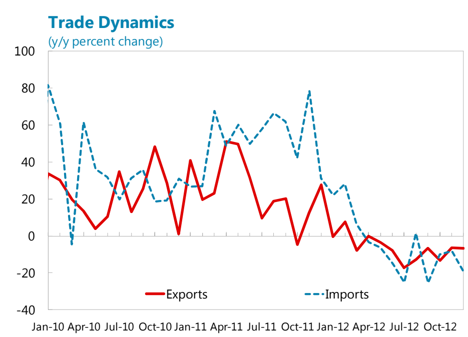


Sources: Haver Analytics; and IMF staff calculations.

5. Fiscal policy remained tight, although less so than budgeted. The government's 2012 budget deficit is estimated to have fallen to about 6½ percent of GDP (above the budget's 6¼ percent target) due to expenditure restraint and payment arrears. Revenues were significantly lower than budgeted, partly reflecting the introduction of new tax exemptions, lower imports that undermined VAT, and weaker-than-expected income taxes. Losses at the state-owned Ceylon Electricity Board (CEB) and Ceylon Petroleum Corporation (CPC) rose to around 2 percent of GDP in 2012 despite significant domestic price increases, as drought induced a shift in electricity generation away from inexpensive hydroelectric to expensive thermal sources.

6. Monetary policy has eased in recent months. With activity and credit growth slowing, the Central Bank of Sri Lanka (CBSL) allowed the credit ceiling to expire and reduced its policy rate corridor in early-December by 25 basis points to 7½–9½ percent. Overnight interest rates have subsequently fallen by about 100 basis points as call money rates were guided down to the middle of the corridor. Treasury bill and bond rates have declined by more, reflecting expectations of further policy easing and healthy foreign demand for rupee-denominated government debt. Sovereign spreads narrowed through late-2012, but have since widened somewhat.

7. The balance of payments has stabilized, and after depreciating sharply early last year, the rupee has rebounded somewhat. The current account deficit declined to around 6½ percent of GDP in 2012 as falling imports—particularly consumer goods—more than offset falling exports, while tourism and remittances remained robust. Foreign direct investment (FDI) was less than half of the authorities' expectations. Gross official international reserves reached around US$6¾ billion (3½ months of imports) in early 2013.



Sources: Haver Analytics; and IMF staff calculations.

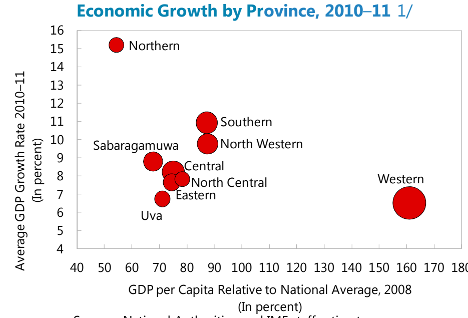
Box 1. Sri Lanka: Growth Inclusiveness and Poverty Reduction

A period of strong economic growth that began in the second half of 2009 has been shared across the country. Moreover, the poorer provinces, the Northern province in particular, experienced relatively stronger overall economic growth after the end of the civil conflict. The country's richest Western province, home to its capital city Colombo, grew a robust 6.5 percent per annum (first chart).

Reflecting robust growth, the national poverty headcount ratio fell to just below 9 percent in 2010 from over 15 percent in 2006/07. Spatially, poverty rates declined across most of the country. Declining inequality has also accompanied poverty reduction (first table). Nevertheless, poverty rates remain relatively high in less-developed provinces, with fewer labor market opportunities and generally higher costs, placing them at a competitive disadvantage (second chart).

Staff estimates suggest that despite generally stronger economic growth, less-developed provinces did not exhibit consistently higher elasticities of poverty reduction (proportional change in poverty per unit growth in GDP per capita). Indeed, the elasticity of poverty reduction during 2007–10 appears to have been strongest in the Western province (second table). To support inclusive growth and poverty reduction going forward, higher poverty-reduction elasticities and continued robust growth in less-developed regions are imperative. For this to occur, inflation must be contained, and economic development policies should provide for a continued expansion of infrastructure, access to health and education services, and improvements in the investment environment to support private sector growth.

Economic Growth by Province, 2010–11 1/



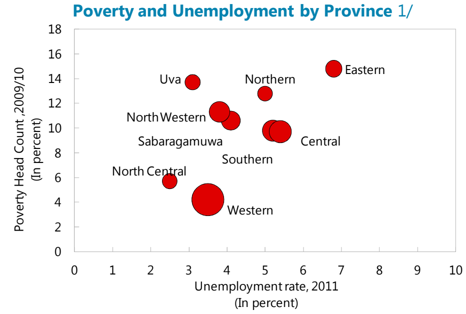
Sources: National Authorities; and IMF staff estimates.
1/ Bubble size is proportional to population.

Inequality by Province, 2006/07 and 2009/10

Province	Gini coefficient 2006/07	2009/10
Sri Lanka, national	0.40	0.36
Western	0.41	0.38
Southern	0.37	0.33
Sabaragamuwa	0.34	0.32
Central	0.38	0.35
Uva	0.35	0.32
Eastern	0.33	0.30
North-Western	0.36	0.34
North-Central	0.40	0.33
Northern	n.a.	0.28

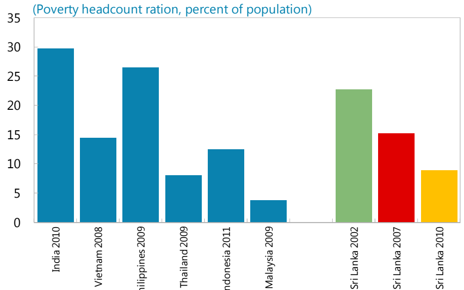
Source: HIES, 2009/10.

Poverty and Unemployment by Province 1/



Sources: HIES Survey; and IMF staff calculations.
1/ Bubble size is proportional to population.

Poverty Headcount: International Comparison 1/
(Poverty headcount ration, percent of population)



Sources: World Bank Development Indicators.
1/ At national poverty line.

Growth Elasticity of Poverty Reduction by Province

Province	2002-2010	2002-2007	2007-2010
Sri Lanka, national	-2.0	-1.7	-2.3
Western	-2.3	-1.0	-4.8
Southern	-1.7	-2.5	-1.1
Sabaragamuwa	-3.1	-3.0	-3.0
Central	-1.8	-0.4	-2.3
Uva	-2.0	-1.2	-2.6
Eastern	n.a.	n.a.	1.0
North-Western	-2.4	-6.8	-0.9
North-Central	-2.0	-1.6	-2.2
Northern	n.a.	n.a.	n.a.

Source: IMF staff estimates.

8. Financial soundness indicators are strong, although some softening is evident. The system-wide capital adequacy ratio declined by 1 percentage point from a year ago to 15 percent in December 2012, but it remains above the 10 percent regulatory minimum. Profitability and liquidity are robust, and gross nonperforming loans (NPLs) eased slightly to 3½ percent of total loans. However, stress tests undertaken during the Financial Sector Assessment Program (FSAP) update indicated that credit risks bear scrutiny.

9. Growth is projected at around 6¼ percent in 2013. A moderately contractionary budget and the lagged impact of tight monetary conditions and real wage compression should restrain domestic demand, while external demand is projected to remain tepid. Recent monetary policy easing should support growth toward the end of the year. Based on this outlook, a small excess supply gap would emerge (Box 2). Inflation pressures would moderate through the year, although headline inflation would be affected if domestic energy prices are increased further. The current account deficit should narrow further reflecting the impact of depreciation and restrained domestic demand, and continued tourism and remittance inflows. Under the staff's baseline scenario, external and public debt dynamics are sustainable, though sensitive to the current account outlook and shocks to contingent liabilities (see debt sustainability analysis supplement).

10. Near-term risks are on the downside. Tax revenue weakness is a key risk to macroeconomic stability. The balance of payments, reserve accumulation, and growth are vulnerable to a weaker-than-anticipated global environment, particularly in Europe and the United States, Sri Lanka's largest export markets. Inflation pressures could fail to moderate if inflation expectations continue to rise, while higher oil prices would worsen CEB-CPC losses. Banks' asset quality may deteriorate.

Sri Lanka: Risk Assessment Matrix

Risk	Up/Down-side	Likelihood	Impact	Policy Response
Tax revenue weakness continues. Larger-than-expected budget deficit.	↓	**H**	**H**	Accelerate revenue administration reforms, broaden base, curtail non-essential spending.
Stalled or incomplete delivery of Euro area policy commitments, protracted period of slow European growth. Fiscal policy shock in the U.S. Emerging markets capital flow reversal, weaker FDI or remittance inflows. Pressure on reserves.	↓	**M**	**H**	Allow exchange rate flexibility. Fiscal space is limited.
Inflation pressures broaden.	↓	**M**	**H**	Tighten monetary policy.
Global oil shock triggered by geopolitical events, causing higher losses at SOEs, inflation, or weaker growth.	↓	**L**	**M**	Adjust domestic energy prices, allow exchange rate flexibility, vigilance for impact on core inflation and banks' asset quality.
Banks' asset quality deteriorates in aftermath of very rapid credit growth.	↓	**M**	**L**	Intensify risk-focused supervision, continue enforcing prudential regulations.

Box 2. Sri Lanka: Potential Growth

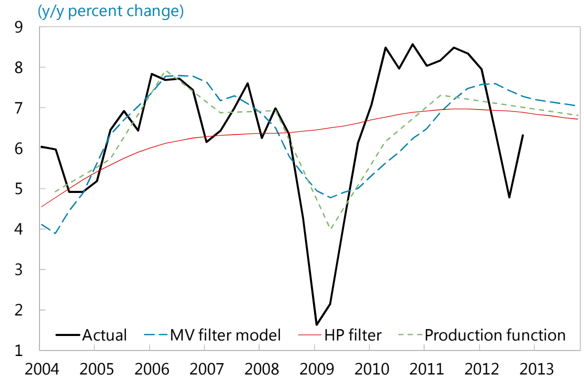
Staff estimates suggest Sri Lanka's potential output growth is about 6¾ percent in the near term. A range of empirical approaches to estimating potential growth suggest that it has risen by almost 1 percentage point in recent years compared to the period 2003–08. This appears to reflect equally capital deepening and improved factor productivity, with labor's contribution broadly unchanged.

Total factor productivity (TFP) growth accounted for about half of Sri Lanka's growth over the last decade contributing on average 3¼ percentage points per year, rising to about 3½ percentage points recently. Going forward, TFP growth and capital deepening are expected to remain key potential growth drivers, in part reflecting public investment, while labor's contribution remains modest, in part reflecting population aging.

The opening of the Eastern and Northern provinces following the end of the conflict likely contributed a marginal boost to potential. Growth in those provinces raised overall real GDP growth by an average of about ¼ of a percentage point per year during 2010–11, with staff estimates suggesting this mostly reflected the service sector and to a lesser extent agriculture. Sustaining a robust medium-term contribution to growth would require rapid productivity gains in those regions.

Excess demand emerged in 2010–11. Real GDP growth was primarily driven by private consumption, while investments' contribution rose to just over 3 percent of GDP from an average of 2½ percent during 2004–08. Estimates based on methodologies that incorporate information regarding cyclical demand factors suggest that the output gap should close around end-2012. An excess supply gap would open with below-potential growth in 2013, helping to reduce inflation pressures and the current account deficit.

GDP Growth: Actual and Potential
(y/y percent change)



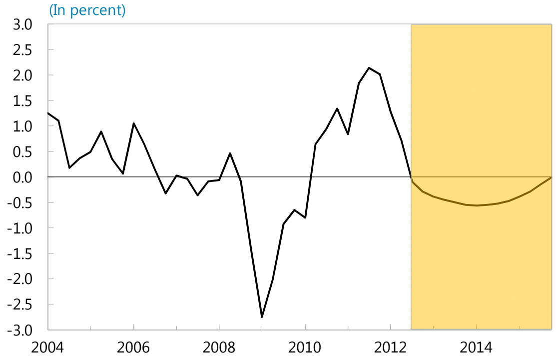
Sources: Haver Analytics; and IMF staff estimates.

Summary of Potential Output Estimates

Potential growth: average of estimates	6.8
Univariate filters	
Hodrick and Prescott	6.8
Baxter and King	6.5
Christiano and Fitzgerald	6.5
Stuctural models	
Multivariate filter (Benes, 2010)	7.0
Production function (Duma, 2007)	6.8
Memorandum item	
Average GDP growth (2002–12)	6.4

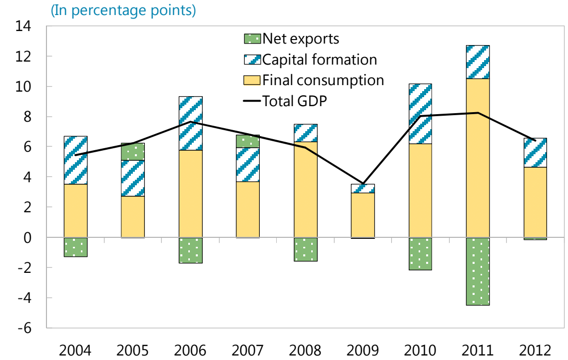
Source: IMF staff estimates.

Output Gap Estimates
(In percent)



Source: IMF staff estimates.

GDP Growth: Contribution by Expenditure
(In percentage points)



Sources: CEIC; and IMF staff estimates.

11. The authorities expect growth of 7½ percent in 2013, supported by monetary easing, the removal of the credit ceiling, and infrastructure investments. They felt confident that such growth would be consistent with inflation falling to mid-single digits toward end-2013. Moreover, they underscored the importance of the peace dividend from the end of the conflict in boosting potential output growth. The authorities agreed there were some downside risks to the outlook, owing to the global environment, however these were seen as manageable.

POLICY DISCUSSIONS

12. Policy discussions focused on the near-term macroeconomic stance; measures to achieve a high-quality fiscal consolidation; strengthening the monetary policy framework under exchange rate flexibility; safeguarding financial stability; and reforms to strengthen the external sector and broaden growth.

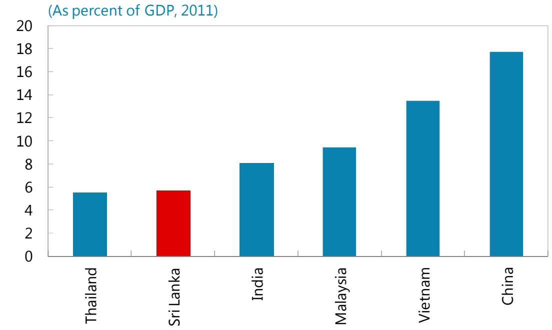
A. Fiscal Policy and State Enterprise Reform

13. Fiscal consolidation remains a key policy priority. Public debt is currently around 80 percent of GDP and over 600 percent of tax revenues, making it one of the highest among emerging market economies. In 2013, the budget targets a 5.8 percent of GDP deficit, the lowest since 1977. The stance is appropriately contractionary, and should help moderate inflation pressures and contribute to external strengthening. However, deficit reduction continues to rely on constraining expenditure growth, to offset a drag from weak revenues (Box 3). Reducing the deficit below 5 percent of GDP over the medium term is central for debt sustainability.

14. Tax revenues have been declining as a percent of GDP for years, and are now low by international standards. In 2011, the authorities implemented a first round of reforms involving rationalizing taxes, rate reductions and some base broadening. Notwithstanding, the tax revenue-to-GDP ratio is estimated to have fallen to just over 11 percent in 2012, lower than most regional peers (Figure 1).

15. Public investment is also low compared to countries that have experienced sustained high growth. Fiscal consolidation in the context of revenue weakness has resulted in low investment plans, and recently shortfalls relative to those plans. Tax holidays and concessions have not delivered the expected increase in FDI inflows (see below). Evidence from emerging Asia points to relatively strong government investment multipliers, indicating that increased infrastructure investment to remove bottlenecks and broaden growth is important if the authorities' ambitious growth objectives are to be realized.

Public Investments
(As percent of GDP, 2011)



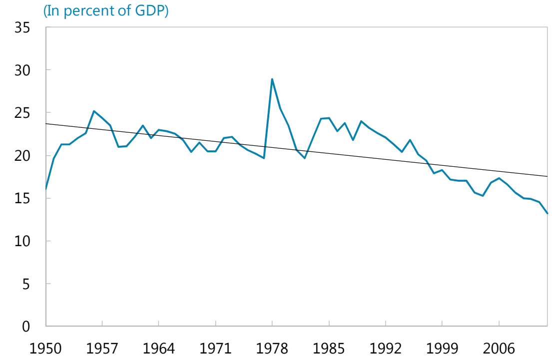
Sources: CEIC; Haver Analytics; and IMF staff estimates.

Figure 1. Sri Lanka: Long-Term Revenue Trends and International Comparison

Government revenue as a percent of GDP has been on a long-run declining trend…

Government Revenue (including grants)

(In percent of GDP)

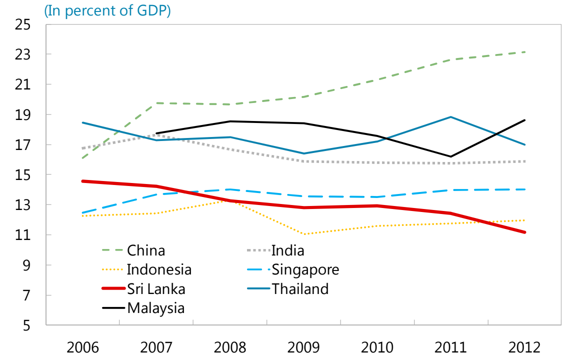


Sources: Ministry of Finance and Planning; Central Bank of Sri Lanka.

…and tax collection has fallen relative to regional peers…

Tax Revenue

(In percent of GDP)

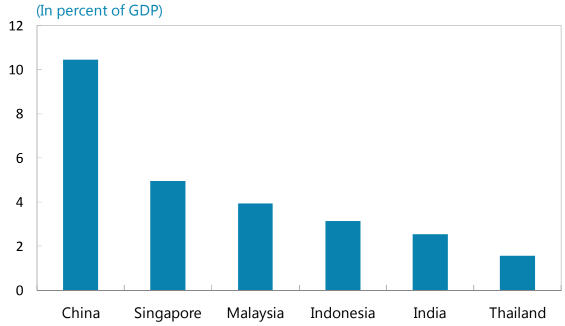


Sources: IMF Fiscal Monitor database; IMF staff estimates.

…in some cases by a significant amount…

Change in Selected Countries' Tax Revenue-to-GDP Ratio Relative to Sri Lanka, 2006–12

(In percent of GDP)

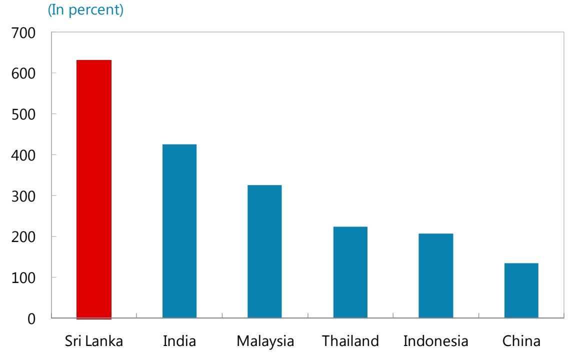


Sources: IMF Fiscal Monitor database; IMF staff calculations.

…leaving government debt very high relative to tax revenue.

Government Debt as Percent of Tax Revenue, 2011

(In percent)

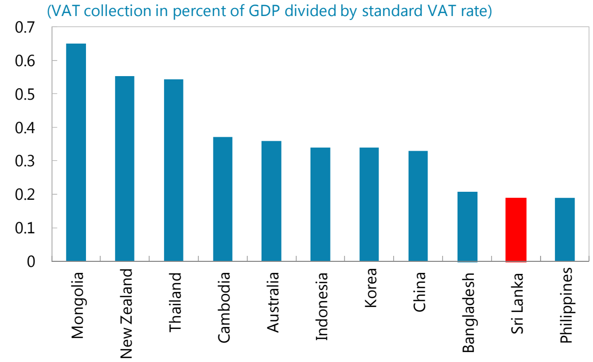


Sources: IMF Fiscal Monitor database; IMF staff estimates.

16. **A high-quality fiscal consolidation that makes space for increased spending on infrastructure while safeguarding critical social expenditures—to support inclusive robust growth and further gains in equality and poverty reduction—will require reversing the decline in tax revenues.** The 2013 budget contained several welcome measures, including the extension of VAT to large retailers and regime simplification. However, these measures are estimated to yield only about half a percent of GDP in new revenue, significantly short of the budget's target. New exemptions were introduced, and profit taxes could underperform with moderate growth. Moreover, revenue efficiency is below comparator countries, particularly for VAT. Broadening the VAT base and increasing its efficiency could raise an additional 2 percentage points of GDP in revenue above the baseline scenario.

VAT Efficiency

(VAT collection in percent of GDP divided by standard VAT rate)



Source: IMF staff estimates.

Box 3. Sri Lanka: Fiscal Stance Analysis

While stronger growth contributed to recent years' deficit reduction, most of the decline reflects structural effort: the cyclically adjusted deficit fell from 9.5 percent of GDP in 2009 to a projected 6.6 percent in 2012.

Deficit reduction was driven exclusively by lower spending, which fell by over 4 percent of GDP. Lower capital spending contributed about one-fourth, while the balance was due to lower current spending. Lower interest payments by over 1 percent of GDP helped, but the biggest contribution came from cuts in primary current spending, which fell by 2 percent of GDP, reflecting cuts in military spending and lower subsidies. At the same time, tax revenues have been declining as percent of GDP, by about 1½ percentage points, creating headwinds to deficit reduction.

As the cyclically adjusted balance strengthened, the fiscal stance shifted from highly expansionary to contractionary in 2012.[1] The 2013 budget targets further deficit reduction and would imply a continued fiscal contraction—an appropriate stance. However, the contractionary fiscal stance has been the result of two opposite developments: an increasingly restrictive expenditure stance, and an increasingly expansionary revenue stance.

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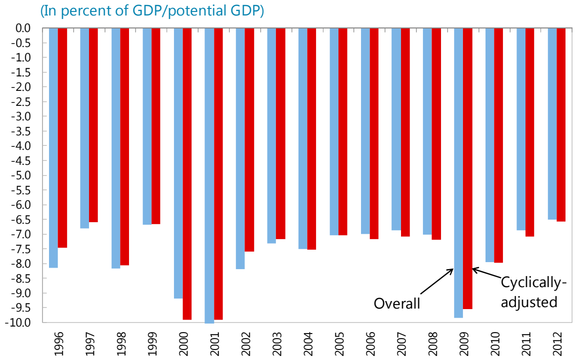
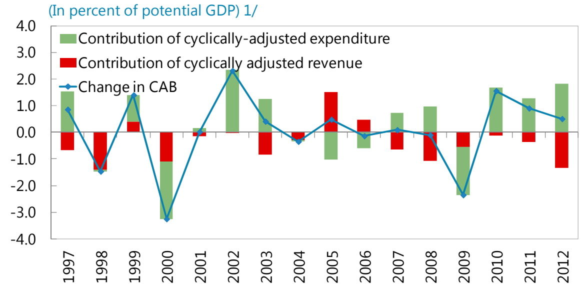
[1] Taking 2005 as the base year with neutral fiscal stance, the year the estimated output gap was smallest.

Sri Lanka: Overall and Cyclically-Adjusted Balance
(In percent of GDP/potential GDP)



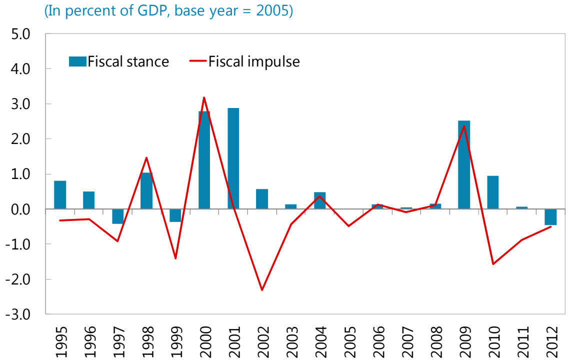
Source: IMF staff estimates.

Sri Lanka: Changes in Cyclically-Adjusted Balance, Revenue, and Expenditures
(In percent of potential GDP) 1/



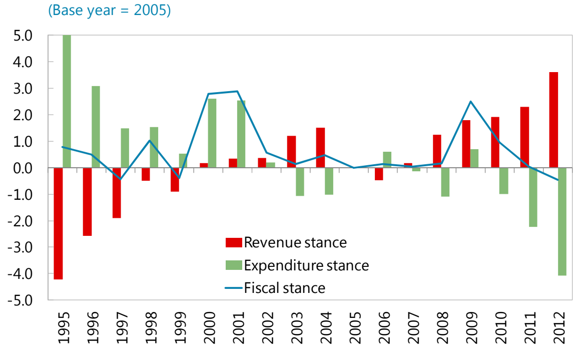
Source: IMF staff estimates.
1/ CAB > 0 means improving balance; a positive number for revenue/expenditure means positive contribution to the CAB.

Overall Fiscal Stance and Fiscal Impulse
(In percent of GDP, base year = 2005)



Source: IMF staff estimates.

Fiscal Stance
(Base year = 2005)



Source: IMF staff estimates.

17. Staff proposed comprehensive reforms to broaden the tax base, simplify the system, and strengthen administration:

- To broaden the base: (i) further expand VAT coverage of the wholesale and retail sectors, with the long-term objective of repealing the Nation Building Tax—a cascading indirect tax using a similar base to the VAT; (ii) value all existing tax holidays and exemptions, and subsequently rationalize costly or ineffective ones, or convert them to accelerated depreciation or investment tax credits linked to investment amounts; and (iii) introduce a single and simplified small taxpayer regime for businesses under the VAT threshold.

- To simplify the system and strengthen administration: (i) implement a comprehensive risk-based VAT refund management system to replace the existing procedure; (ii) streamline and restructure the Inland Revenue Department along functional lines; (iii) strengthen the Large Taxpayer Unit; and (iv) improve audits and compliance risk management.

18. The authorities emphasized their commitment to keep the 2013 deficit at 5.8 percent of GDP, and to reduce it below 5 percent in the medium term, with the aim of reducing public debt to around 60 percent of GDP. Given lower-than-expected tax revenues in 2012, they acknowledged that the budgeted revenue increase in 2013 is likely out of reach. They are determined to meet the deficit target by reducing expenditure. The authorities reported that as there was less scope for lowering current spending, capital spending would be the focus of reductions.

19. The authorities agreed that higher tax revenues hold the key to successful medium-term fiscal consolidation. However, to maintain a stable tax policy regime, they are not prepared to take revenue measures in 2013 beyond those announced in the budget. Any new measures could be implemented in the 2014 budget at the earliest. The authorities argued that, to some extent, poor revenue performance reflected temporary effects of measures to curb imports and strengthen the external position. But they explained that a further refinement of VAT coverage of the wholesale and retail sectors is under consideration, and acknowledged the need to monitor closely and eventually reassess the modalities of the VAT refund system.

20. A more accountable and effective public financial management (PFM) system would complement fiscal consolidation. Core PFM processes are fairly robust; however, more advanced practices are now appropriate, commensurate with Sri Lanka's move to middle-income status. Reforms should be guided by the roadmap developed with IMF technical assistance: building on progress made in updating the legal and regulatory framework; improving budget preparation, including development of a medium-term rolling budget framework; and strengthening budget execution, including recording and reporting of commitments and arrears, oversight and monitoring of public enterprises, and more efficient cash management.

21. The authorities welcomed the PFM recommendations. They are developing an oversight and reporting framework for state-owned enterprises, and are updating financial regulations to modernize the financial administration framework, with IMF technical assistance.

22. Staff emphasized the need to address structural shortcomings undermining the long-term commercial viability of the CPC and CEB. These companies' large losses are unsustainable. At the same time, electricity prices are high by regional standards. A comprehensive approach is required, including better management, lowering electricity generation costs, raising efficiency, and moving toward cost-recovery pricing, followed by adoption of an automatic price adjustment mechanism. Staff also emphasized the need for targeted social protection measures to mitigate the impact of higher prices on the poor.

23. The authorities attach high priority to addressing the losses of CEB and CPC. Diesel and petrol prices were recently increased, and there are plans to increase electricity tariffs and to implement cost-recovery pricing for heavy fuels.

B. Monetary and Exchange Rate Policy

24. A cautious monetary policy stance remains appropriate. The tight stance through most of 2012 was effective in addressing imbalances. Growth slowed, and imports and private sector credit growth have moderated. Nevertheless, headline and core inflation are elevated, private sector wage demands are rising, and with further domestic energy price hikes under consideration, risks of second-round effects exist. Monetary policy should remain on hold until stronger evidence emerges that inflation pressures have begun to dissipate.

25. Flexible inflation targeting would provide a more coherent framework for conducting monetary policy. Economic, price, and financial stability are the CBSL's ultimate objectives. The operational framework employs reserve and broad money targets, although monetary policy had earlier focused on maintaining exchange rate stability, which contributed to imbalances—reflecting both the loss of the exchange rate as a buffer for external shocks and, at times, domestic liquidity conditions inconsistent with external stability. Striving toward a flexible inflation targeting regime that gives weight to inflation as a nominal anchor, while also considering policy's impact on growth, would help clarify objectives and eventually anchor inflation expectations in a more coherent policy framework under continued exchange rate flexibility. Initial steps could embrace developing an overarching strategy and related institutional arrangements, and technical and operational capacity to better understand the inflation process and transmission mechanism.

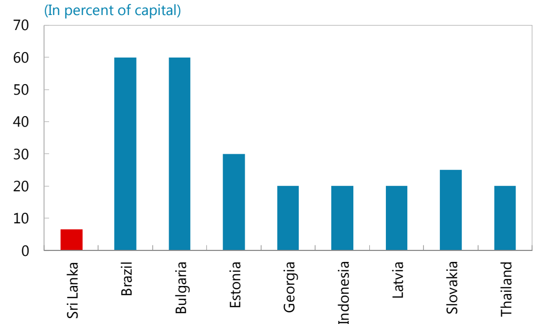
26. The authorities concurred that monetary policy should remain on hold in the near term. They also underscored the need to monitor credit growth closely to avoid an undue credit expansion. At the same time, they indicated that weaker-than-expected economic or credit growth would warrant a further easing of monetary conditions. They indicated their desire to move toward flexible inflation targeting, but expressed concern that it could be difficult to communicate to the public. They are working toward implementing some technical elements, but emphasized the need to develop a nominal anchor that would allow flexibility in ensuring monetary policy would continue to have an important role in supporting growth.

27. Improving monetary operations would strengthen the policy transmission mechanism. Liquidity management has mainly relied on overnight open market operations, which were occasionally suspended in favor of the standing facilities. As a consequence, periods of excess structural liquidity arose, reducing interest rate control and weakening the transmission mechanism. Improved liquidity monitoring and management is needed. Structural liquidity should be monitored and the use of longer-term liquidity operations expanded, with overnight operations used for fine-tuning purposes. Banks' liquidity management could be improved by strengthening the statutory reserve requirement system.

28. The authorities agreed to closely monitor liquidity in the banking system. They also plan to lengthen the statutory reserve maintenance period. However, they were of the view that longer-term operations earned at higher interest rates would not be effective in addressing structural liquidity management issues.

29. Consolidating the shift to exchange rate flexibility is another key building block. The real effective exchange rate has depreciated compared to a year ago, but staff analysis suggests it remains slightly above its equilibrium value, and reserves appear low by a number of metrics (Box 4). Flexibility should be maintained for the real exchange rate to move into line with fundamentals, while the CBSL should seize opportunities to increase reserves further. Moreover, deepening the foreign exchange market would enhance efficiency and support a less active role for the CBSL. Limits introduced in early-2012 on banks' forward transactions were eased and those on net open positions (NOP) were partially rolled back. However, NOP limits remain significantly tighter than in other countries, limiting risk hedging opportunities and market development. Government guarantees under consideration for offshore wholesale bank funding should be avoided, as they raise contingent fiscal liabilities and debt sustainability risks, and incentivize reduced exchange rate flexibility.

Net Open Limits of Selected Countries
(In percent of capital)



Source: IMF staff estimates.

30. The authorities viewed the current exchange rate as broadly in line with fundamentals. They noted that substantial foreign exchange purchases in recent months suggested no overvaluation. Given the thin foreign exchange market, the CBSL would need to stand ready to intervene when necessary to prevent disorderly movements. While reserves were broadly appropriate at this juncture, the CBSL would over the medium term seek opportunities to build them further, but the authorities noted they would not sacrifice macroeconomic fundamentals in order to achieve any particular target. They saw NOP limits as appropriate to prevent excessive speculation.

Box 4. Sri Lanka: External Sector Assessment

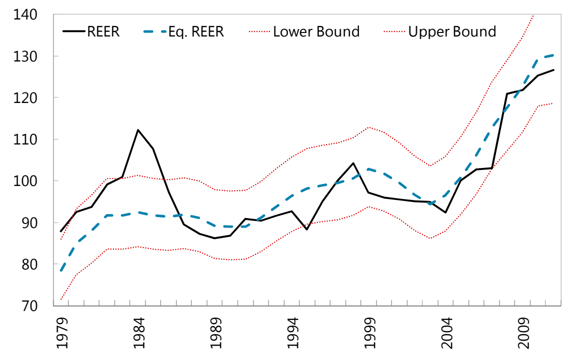
Analysis based on the CGER and the pilot External Balance Assessment indicate that the underlying current account deficit is slightly higher than the level predicted by panel regressions on advanced and emerging markets, with a 5–8 percent real depreciation, ceteris paribus, necessary to bring the deficit down to the current account norm. Similarly, the external sustainability approach finds that around a 4 percent real depreciation would be needed to stabilize the net foreign liability/GDP position.

	Macrobalance	External Sustainability	Current Account (External Balance)
Approach:			
Underlying current account balance	-4.8	-4.8	-4.5
Current account norm	-4.1	-4.3	-3.3
Required improvement in the current account	-0.7	-0.5	-1.2
Implied over (+) / under (-) valuation	**5.2**	**3.7**	**8.2**

Source: IMF staff estimates.

After a strong depreciation in the first half of 2012, the real effective exchange rate has appreciated slightly. In contrast to the current account approach, the results of CGER-style analysis of the equilibrium real effective exchange rate approach point to a slight undervaluation of around 3 percent. However, these results are well within the margin of error, and in staff's view, the broader trends in the trade balance confirm the current account approaches and suggest a continued slight overvaluation.

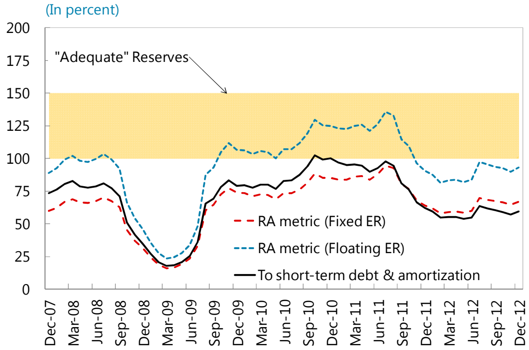
Sri Lanka: Equilibrium Real Exchange Rate



Source: IMF staff estimates.

Capital account flows have been rather disappointing, as the large FDI inflows predicted at the end of the conflict have yet to materialize (see Section D). However, foreign investor interest in government paper has been strong, and official encouragement of external borrowing by the private sector is expected to result in strong inflows over the medium term (see DSA supplement for a discussion of external debt dynamics and risks).

Sri Lanka: Reserve Metrics Dynamics
(In percent)



Source: IMF staff estimates.

While Sri Lanka's foreign exchange reserves have increased in recent months, coverage still appears somewhat low when judged by several commonly used metrics, and compared to other countries in the region. While above three months of prospective imports of goods and services, reserves are low relative to short-term debt and prospective amortization, and just below the IMF's new composite metric adequacy range for countries with a floating exchange rate regime.[1]

Regional Comparison of Reserve Indicators 1/

	Months of Imports of G&S 2/	Percent of Exports of G&S	Percent of Broad Money	Percent of Short-Term Debt 3/	Percent of GDP
China	18.4	154	24	576	44
India	5.7	61	18	279	15
Indonesia	5.8	48	33	230	13
Malaysia	7.0	50	33	253	46
Philippines	10.4	108	49	416	30
Singapore	6.0	44	65	...	91
Thailand	7.1	63	41	366	49
Vietnam	2.0	19	13	219	16
Average 4/	7.5	69	30	302	28
Sri Lanka	3.5	47	31	66	11

Source: IMF staff estimates.
1/ 2012 projections for Sri Lanka, latest WEO data for other countries.
2/ In months of prospective imports of G&S.
3/ Percent of short-term debt and prospective amortization. For Sri Lanka, includes foreign holdings of t-bills and t-bonds.
4/ Excludes Singapore for short-term debt indicator.

Staff's overall assessment is that the external position would benefit from further strengthening. Over the medium term, fiscal consolidation and structural reforms to reduce protectionism, improve productivity, and broaden the export base will be essential to ensure sustainability and limit vulnerabilities stemming from the relatively high public and external debt ratios.

1/ See "Assessing Reserve Adequacy" (SM/11/31).

C. Financial Sector Stability

31. The FSAP update recognized progress in banking supervision. Risk-based supervision guidelines have been issued, and stress testing and early warning systems refined. Nonbank supervision has also improved, although some opportunities for regulatory arbitrage may exist, and capacity should be strengthened. Developing more robust consolidated supervision and macroprudential frameworks would enhance effectiveness (Box 5 summarizes core FSAP recommendations).

32. Recent years' rapid credit growth justifies heightened vigilance for systemic vulnerabilities. International experience indicates that credit booms often presage systemic risk buildup.[1] Some indicators in Sri Lanka flashed warning signals, including rapid growth in the credit-to-GDP ratio and the emergence of an excess credit gap (Figure 2). Macrofinancial indicators provide additional warning signs, but also some comfort. Early during the credit boom, the real exchange rate appreciated and equity prices rose sharply, but both have subsequently eased. Land prices have been subdued, and credit growth is now slowing.

33. FSAP stress tests suggest an overall sound banking sector, but some risks warrant close attention. Most banks are well placed to deal with severe liquidity stress, given relatively large holdings of short-term government securities. Market risk is also broadly contained, except for one bank exposed to re-pricing risk on its large government debt holdings. A very severe credit shock that raises NPLs to around 23 percent, however, would leave 7 of the 12 largest banks undercapitalized, requiring about ½ percent of GDP in fresh capital. Credit concentration risk is also a concern for some banks, although this is mitigated by government loan guarantees. Staff recommended the authorities develop a program of annual stress tests for systemically important banks, raise capital buffers in those banks found to be vulnerable, and increase general and special-mention loan loss provisioning.

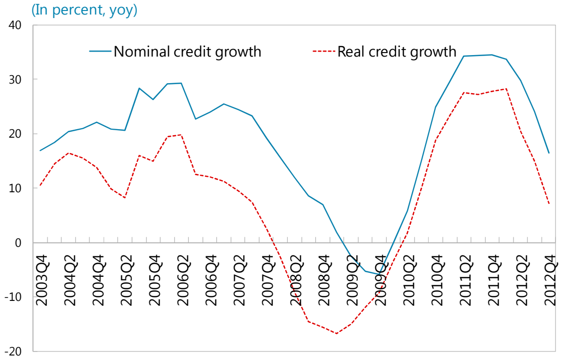
34. Further enhancing frameworks for financial safety nets, pensions, and crisis management would strengthen safeguards. Although the lender-of-last-resort facility and deposit insurance schemes are broadly appropriate, operational arrangements could be further clarified. A target range for deposit insurance reserves should be established, conditions under which the insurance scheme can borrow should be clarified, and its use for emergency liquidity assistance to nonbanks phased out. An overall strategy and robust supervisory framework for pension funds is needed. Formalizing roles and responsibilities for crisis management and placing them in a comprehensive framework as well as clarifying the legal priority of creditor claims would enhance overall preparedness. Requiring systemically important banks to design and submit recovery and resolution plans would mitigate systemic risk.

[1] See "Toward Operationalizing Macroprudential Policies: When To Act?" IMF Global Financial Stability Report (GFSR), September 2011.

Figure 2. Sri Lanka: Macrofinancial Indicators

Private sector credit grew rapidly beginning in 2010, but is now moderating.

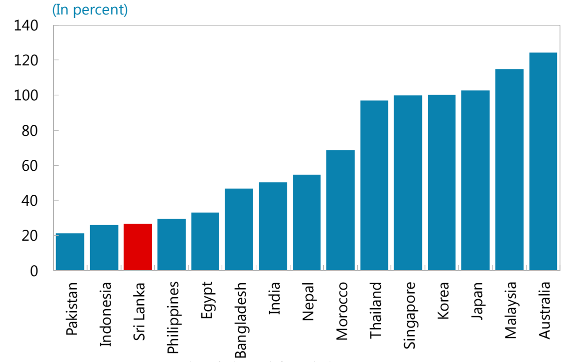
Private Sector Credit Growth
(In percent, yoy)



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

The boom started from a low base....

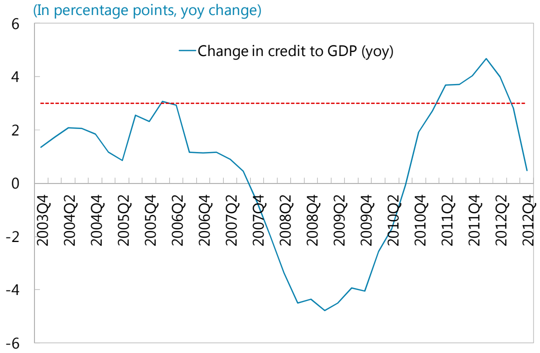
Credit to GDP Ratio (2010)
(In percent)



Source: IMF, International Financial Statistics.

...raising the credit-to-GDP ratio into warning territory...

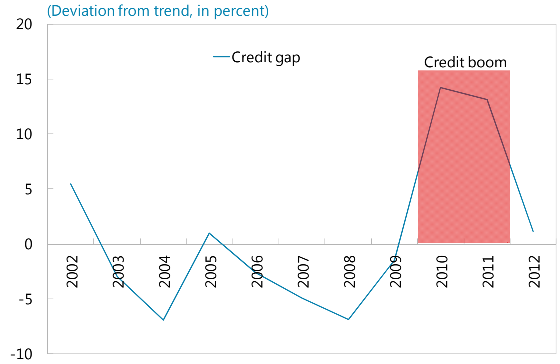
Credit to GDP Ratio 1/
(In percentage points, yoy change)



Source: Central Bank of Sri Lanka.

...and creating a large credit gap, also raising red flags.

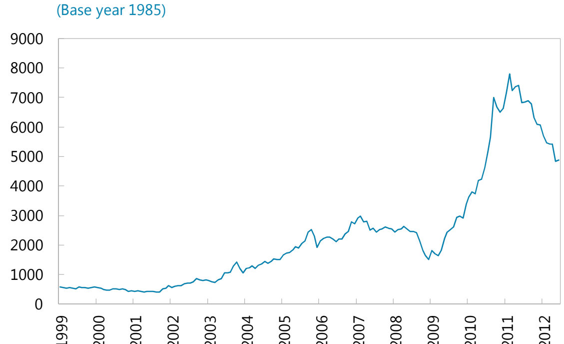
Credit Gap Measure 2/
(Deviation from trend, in percent)



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

Equity prices skyrocketed, but corrected in 2011...

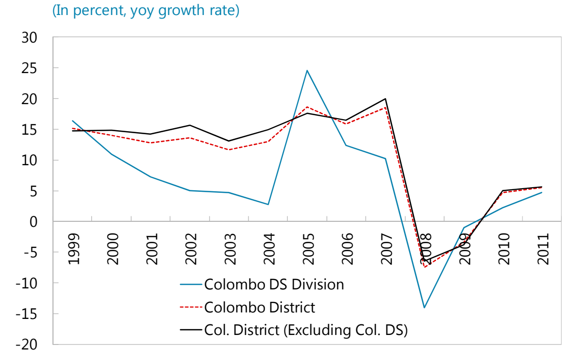
Colombo Stock Exchange Index
(Base year 1985)



Source: Bloomberg.

...while land prices have remained subdued.

Residential Land Prices
(In percent, yoy growth rate)



Source: Central Bank of Sri Lanka.

1/ The horizontal line shows a 3 percent "warning threshold" (September 2011, GFSR).
2/ The credit gap measure is derived as a percentage deviation of credit-to-GDP from a backward looking, rolling, cubic trend estimated over the period between t-10 and t. Following Dell'Ariccia et al (2012), a credit boom occurs when the deviation from trend is greater than 1.5 times its standard deviation and the annual growth rate of credit to GDP ratio exceeds 10 percent.

Box 5. Sri Lanka: Financial Sector Assessment Program—Update on Main Recommendations[1]

Recommendations	Time Frame	Status
Financial Institutions Soundness and Vulnerabilities		
Require bottom-up stress testing by all systemically important banks and increase capital and liquidity buffers in those found to be vulnerable.	Short term	**Progress.** Guidelines are being issued for annual stress tests. A state-owned bank has begun to implement a capital improvement plan.
Continue to enhance corporate governance at state-owned banks.	Continuous	**Work in progress.** Gradual implementation of bank corporate governance standards.
Monetary Policy, Systemic Liquidity Management, and Foreign Exchange Operations		
Manage structural liquidity using longer-term instruments, relying first on market-based instruments to implement monetary policy.	Immediate	**Some progress.** Some term operations have been offered.
Increase net open position limits in foreign exchange to levels commensurate with the customer business needs. Remove restrictions on customer forward transactions.	Immediate	**Progress.** NOP limits partly rolled back and time restrictions on forwards lifted.
Financial Sector Oversight, Supervision, and Regulation		
Complete adoption of Pillars 2 and 3 of the Basel II Accords. Remove impediments to information exchange between domestic and foreign financial sector supervisors.	Short term Medium term	**Progress.** New corporate governance and integrated risk management guidelines have been issued, stress testing and early warning systems refined, and implementation of Basel II pillars is targeted in 2013.
Introduce an updated, fully risk-based examination manual and develop a program of consolidated supervision.	Short term	**Progress.** A risk based supervision manual has been drafted. The legal basis for consolidated supervision is proposed under amendments to the Banking Act.
Harmonize bank and nonbank prudential framework to mitigate regulatory arbitrage possibilities and enhance regulatory framework and supervisory capacity in the insurance sector.	Medium term	**Some progress.** Risk sensitive minimum capital requirements for insurance being developed.
Formalize roles and responsibilities of members of the Inter-Regulatory Institutions Council to strengthen the macroprudential framework.	Medium term	**Some progress.** Information sharing legislation drafted.
Develop an overall pension strategy and introduce a robust supervisory and governance framework for all pension funds, including the EPF.	Medium term	Authorities do not agree with the recommendation.
Have the Secretary of the Treasury serve as a non-voting member of the Monetary Board for budgetary and human resource issues, and for matters related to the supervision of state-owned banks.	Medium term	Authorities do not agree with the recommendation.
Financial Safety Net and Crisis Resolution Framework		
Develop a clearly defined and well documented financial crisis management plan for the entire financial system.	Short term	**Some progress.** Nonbank finance companies crisis management plan being developed.

[1] FSSA (Country Report No. SM/12/253).

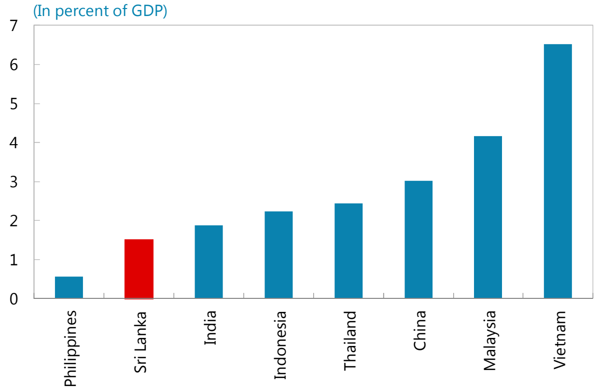
35. The authorities acknowledged the possibility of a modest asset quality deterioration following a period of very strong credit growth. However, they expect NPL ratios to remain low, and are heightening monitoring and supervision. They noted that financial system stability was shored up by prudent regulatory and supervisory frameworks, robust capital buffers, and a state-owned bank is in the process of implementing a capital improvement plan.

36. To strengthen supervision, the authorities have updated the examination manual. Guidelines are being issued for undertaking annual stress tests for systemic banks, and the legal basis for consolidated supervision is expected to be in place by mid-year. However, FSAP recommendations to strengthen crisis preparedness, and pension and macroprudential frameworks have yet to be initiated or are at early stages.

D. Strengthening Trade and Broadening Growth

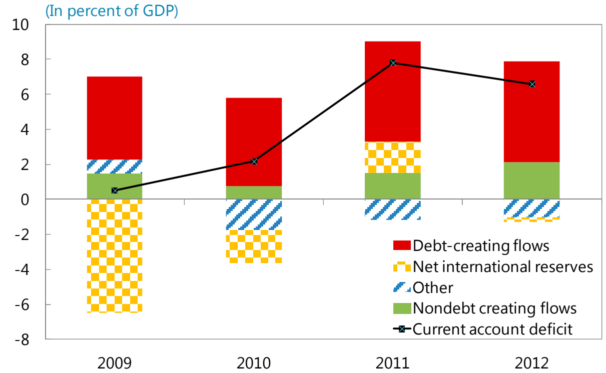
37. During the last decade, gains in trade openness that followed the 1977 liberalization have been largely reversed. After peaking in 2000, exports have declined significantly as a share of GDP and of world exports, returning to the lows of the 1980s. Effective rates of protection have increased and the government has generally emphasized import substitution. Remittances have approximately doubled over the last five years, reflecting high growth of overseas workers, but this has been unable to compensate fully for the poor trade performance. At the same time, FDI inflows have been relatively subdued, and low by regional comparison, and consequently the current account deficit has been financed mainly through debt-creating flows.

FDI Inflow, 2011
(In percent of GDP)



Sources: IMF *World Economic Outlook*; and IMF staff calculations.

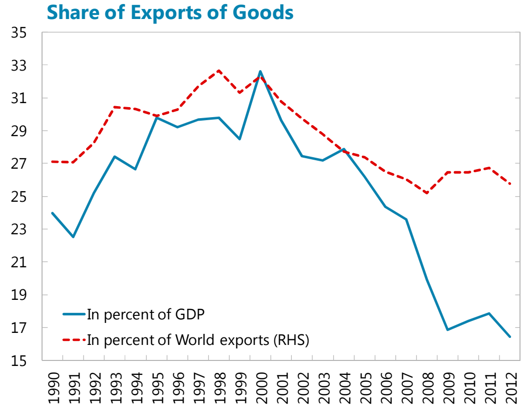
Current Account Financing
(In percent of GDP)



Sources: Sri Lankan authorities; and IMF staff calculations.

Figure 3. Sri Lanka: Export Performance

Share of Exports of Goods



Share of Exports

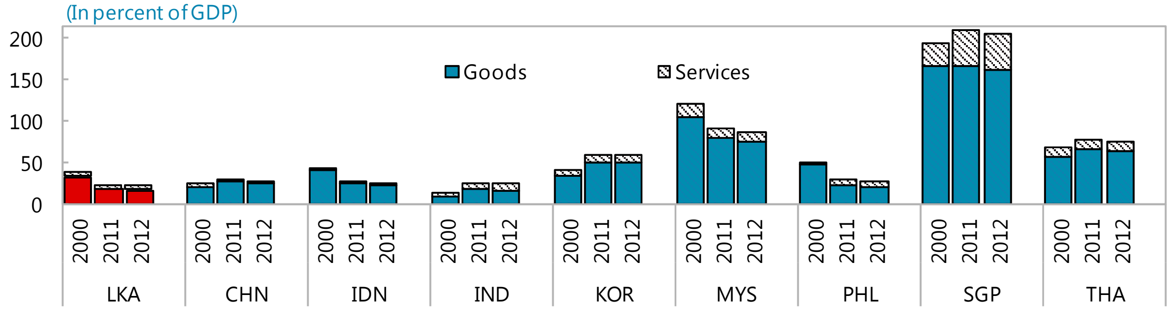
(In percent of total Sri Lankan exports)

Destination	2000	2011
European Union	28.3	36.6
Middle East	6.2	9.4
Latin America	1.5	2.4
United States	40.2	21.5
Asia	9.4	11.4
Rest of the world	14.5	18.8

Source: IMF, Direction of Trade Statistics.

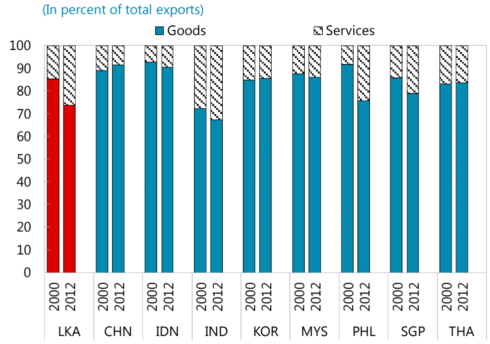
Composition of Exports 1/

(In percent of GDP)



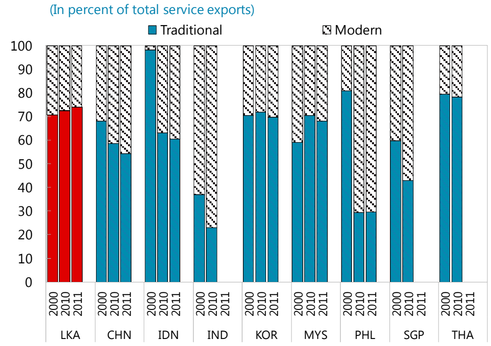
Share of Services 1/

(In percent of total exports)



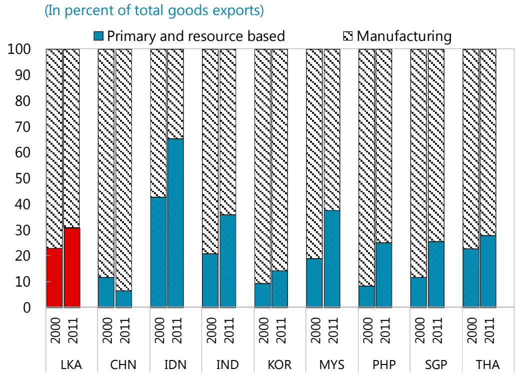
Share of Modern Services Exports

(In percent of total service exports)



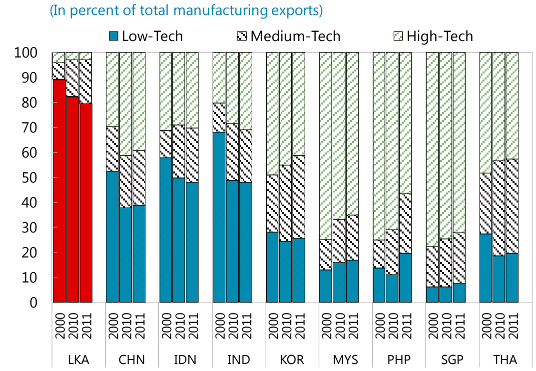
Share of Manufacturing Exports

(In percent of total goods exports)



Share of High-tech Manufacturing Exports

(In percent of total manufacturing exports)



Sources: IMF, *World Economic Outlook;* IMF, *Direction of Trade Statistics*; IMF, *Balance of Payments Statistics*; and UN, *World International Trade Statistics*.

1/ 2012 data reflect staff projections as of IMF October 2012 *World Economic Outlook*.

38. Deeper integration with the world economy would support robust and broad growth. This would help reallocate resources to productive sectors, strengthen competitiveness, and broaden domestic employment opportunities. Achieving this will require greater export diversification product-wise and geographically—India and China account for only 6 percent of exports—moving to high-value, high-tech goods and services, raising export sophistication, and attracting FDI (Figure 3).[2] Reforming the trade tariff structure to reduce protectionism would facilitate increased trade. Exchange rate flexibility will also be critical to buffer external shocks and provide appropriate relative price signals.

39. Productivity must also rise. This would require cutting policy barriers and red tape, improving the business climate, and expanding infrastructure.[3] As well, an educated and productive labor force is key, pointing to the potential benefits of investment in education and health. Developing financial markets and a framework for public private partnerships for investment would help increase private sector involvement.

40. The authorities concurred on the need to strengthen competitiveness. They noted that exchange rate flexibility could only play a limited role in supporting competitiveness over the long term, and their focus is on developing five strategic global hubs (aviation, naval, knowledge, commerce, and energy). As well, infrastructure is being upgraded, the Board of Investment has been revamped to encourage inward investment, and measures are being taken to improve the business climate. Negative perceptions stemming from the time of the conflict are still a handicap, but these are being overcome. The authorities noted the staff's views on the need to address protectionism through tariff reform, but observed that some measures would continue to be needed to support domestic production.

OTHER ISSUES

41. In accordance with Fund policy, the Managing Director recommends the initiation of Post-Program Monitoring (PPM). The last Fund arrangement expired July 2012, Fund credit outstanding will exceed 200 percent of quota (PPM threshold) until 2015, and the external position remains vulnerable. It is recommended that PPM be conducted on a semiannual basis until the external position strengthens significantly, the underlying risks are adequately addressed, and the stock of outstanding obligations to the Fund falls below the PPM threshold. In staff's view, Sri Lanka's capacity to repay the Fund remains adequate, as suggested by the indicators in Table 5. A PPM mission and Board discussion would be envisioned for the second half of 2013.

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[2] Export markets remain concentrated in the European Union and the United States and product diversification is limited. Manufacturing exports dominate goods exports; the basket is comprised mainly of traditional low- and medium-tech exports, and overall product sophistication is low. See Anand et. al. "Structural Transformation and the Sophistication of Production," IMF WP/12/59.

[3] While surveys indicate that the ease of doing business has improved, bureaucratic procedures remain a constraint, and trade costs are high relative to comparator countries.

STAFF APPRAISAL

42. The Sri Lankan economy has enjoyed a broad degree of success in recent years. The authorities' achievements were supported by the Stand-By Arrangement successfully completed last year. Embarking on a second generation of reforms to embed macroeconomic stability and address deeper structural issues would set the stage for a sustained superior economic performance.

43. The near-term macroeconomic picture is challenging. Growth slowed following bold policy measures undertaken early last year, and reflecting weak global growth and weather shocks. However, elevated inflation and inflation expectations risk generating a self-reinforcing cycle and macroeconomic instability, which would undermine medium-term growth and efforts to reduce inequality and poverty further. Under the staff's baseline scenario, a period of moderate, below-potential growth would help reduce inflation pressures and the current account deficit, and calls for continued macroeconomic policy restraint.

44. The commitment to reduce the fiscal deficit to 5.8 percent of GDP in 2013 is welcome. Public debt remains high, and delivering the budget's deficit reduction objective, while clearing arrears, would send an important signal of the authorities' commitment to debt sustainability, and support monetary policy in containing inflation. The authorities' aim to reduce the deficit below 5 percent of GDP over the medium term is also welcome. However, a more ambitious consolidation path based on higher revenues than under the current baseline scenario would generate a higher-quality adjustment by creating space for elevating infrastructure spending to sustain robust inclusive growth, while reducing public debt and external vulnerabilities.

45. Further revenue reform is vital. Tax revenues as a share of GDP have been falling almost continuously since the mid-1980s, leaving Sri Lanka with one of the lowest revenue-to-GDP ratios in the region. As a consequence, deficit reduction has relied on expenditure compression, although this strategy is approaching its limits, as evidenced in 2012 when the deficit exceeded its target despite expenditure cuts and arrears. The main challenges are to broaden the revenue base and improve administration in a second phase of reforms. In particular, the VAT should be extended fully to the wholesale and retail sectors, and its refund management system reformed. Equally important is to reduce and revise tax holidays and exemptions, which have undermined revenues but failed to enhance FDI.

46. Placing the state-owned energy companies on a sound commercial footing and strengthening the PFM system are important for macrofiscal sustainability. Losses at the CEB and CPC crowd out resources for private investment and raise contingent government liabilities. The authorities' steps to increase energy prices are commendable, and should reduce losses in the near term. Adopting cost-recovery pricing and subsequently implementing an automatic price adjustment mechanism with adequate safeguards for targeted social protection would eliminate losses, while initiatives to install cheaper electricity generation capacity take shape. PFM measures to strengthen budget preparation, execution and reporting would improve budget control and efficiency, and are welcome.

47. Monetary policy should remain on hold until firm evidence emerges that inflation pressures will decline. Staff supports the authorities' goal of reducing inflation to mid-single digits, important for strengthening policy credibility and macroeconomic stability. However, elevated inflation, rising wage demands, and prospective energy-price increases tilt inflation risks to the upside. The recent easing of monetary policy should provide some support to growth toward the end of this year, but a further significant easing with the aim of quickly rekindling high growth would jeopardize inflation reduction efforts.

48. Enhancing monetary policy effectiveness and deepening markets would support inflation control in the context of exchange rate flexibility. The authorities' interest in moving toward flexible inflation targeting is welcome, as it should help anchor inflation expectations, while sustaining exchange rate flexibility is important to facilitate external adjustment and buffer shocks. Complementary reforms to deepen the foreign exchange market and improve monetary operations would reduce interest and exchange rate volatility and strengthen the transmission mechanism. Intervention should be limited to countering excessive volatility and opportunistic accumulation of reserves, which appear low by a number of metrics. Staff recommends against providing government guarantees for foreign-currency borrowing by banks.

49. Reinforcing financial system soundness is critical for macrofinancial stability, increasing access to finance, and broadening growth. The authorities have made good progress in strengthening bank supervision and the banking system appears sound. Credit risks require close monitoring and NPLs may increase if recent years' rapid credit expansion masked an underlying deterioration in loan quality. The authorities' plans to enhance supervision and raise capital in a state-owned bank are welcome. Improvements to financial safety nets, more robust provisioning, and developing frameworks for pension supervision and crisis management would further safeguard stability.

50. Expanding trade and broadening the sources of growth would play a key role in achieving the authorities' development objectives and strengthening the external position. A stronger and more consistent business climate, a simplified trade regime, and increased investment in infrastructure and human capital should result in higher FDI and a diversification of the export base, buttressing Sri Lanka's external position and reducing reliance on debt-creating financing flows. Such improvements would also enhance the scope for private sector participation and broaden growth opportunities.

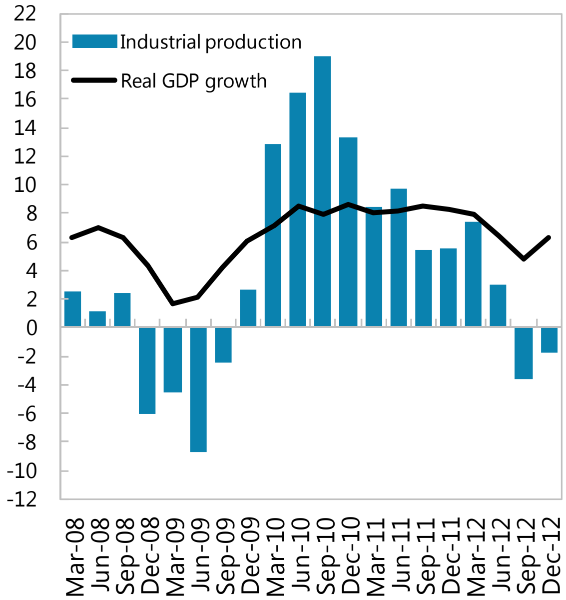
51. It is recommended that PPM takes place on a semiannual basis, and the next Article IV Consultation takes place on the standard 12-month cycle.

Figure 4. Economic Performance

Growth has moderated in recent quarters.

Economic Activity

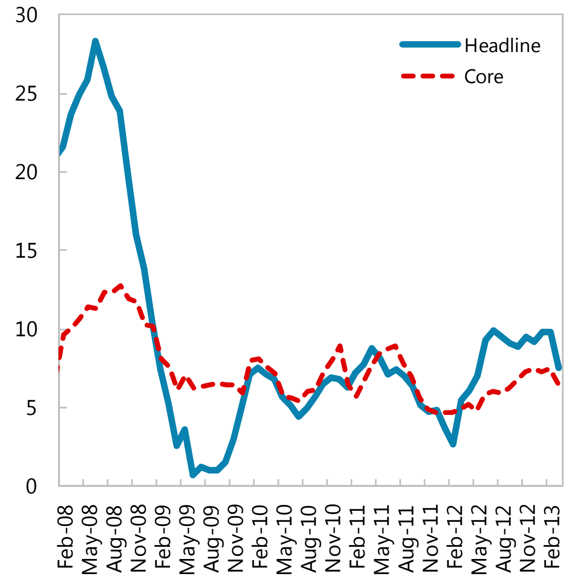
(y/y percent change)



Headline and core inflation remain elevated.

Consumer Price Index

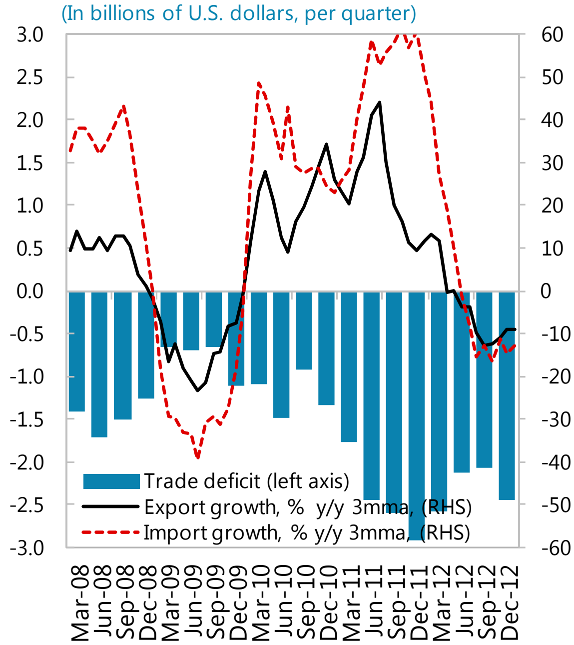
(y/y percent change)



Imports declined sharply, and the trade balance slightly improved...

Trade Deficit

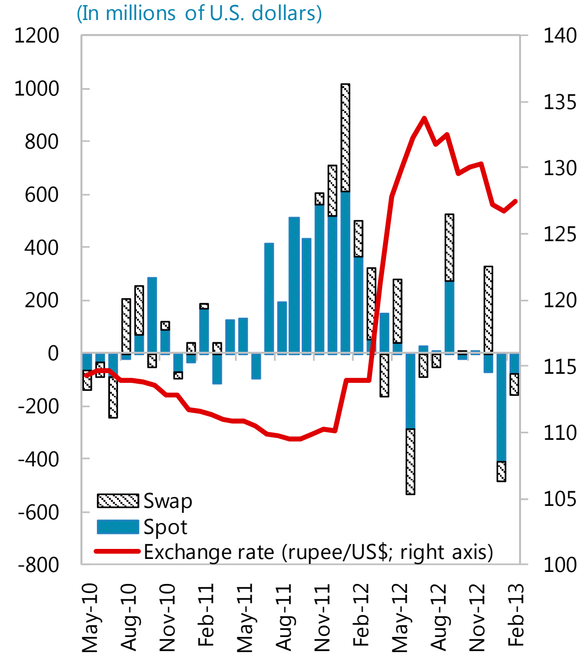
(In billions of U.S. dollars, per quarter)



...reflecting tighter monetary conditions and exchange rate flexibility.

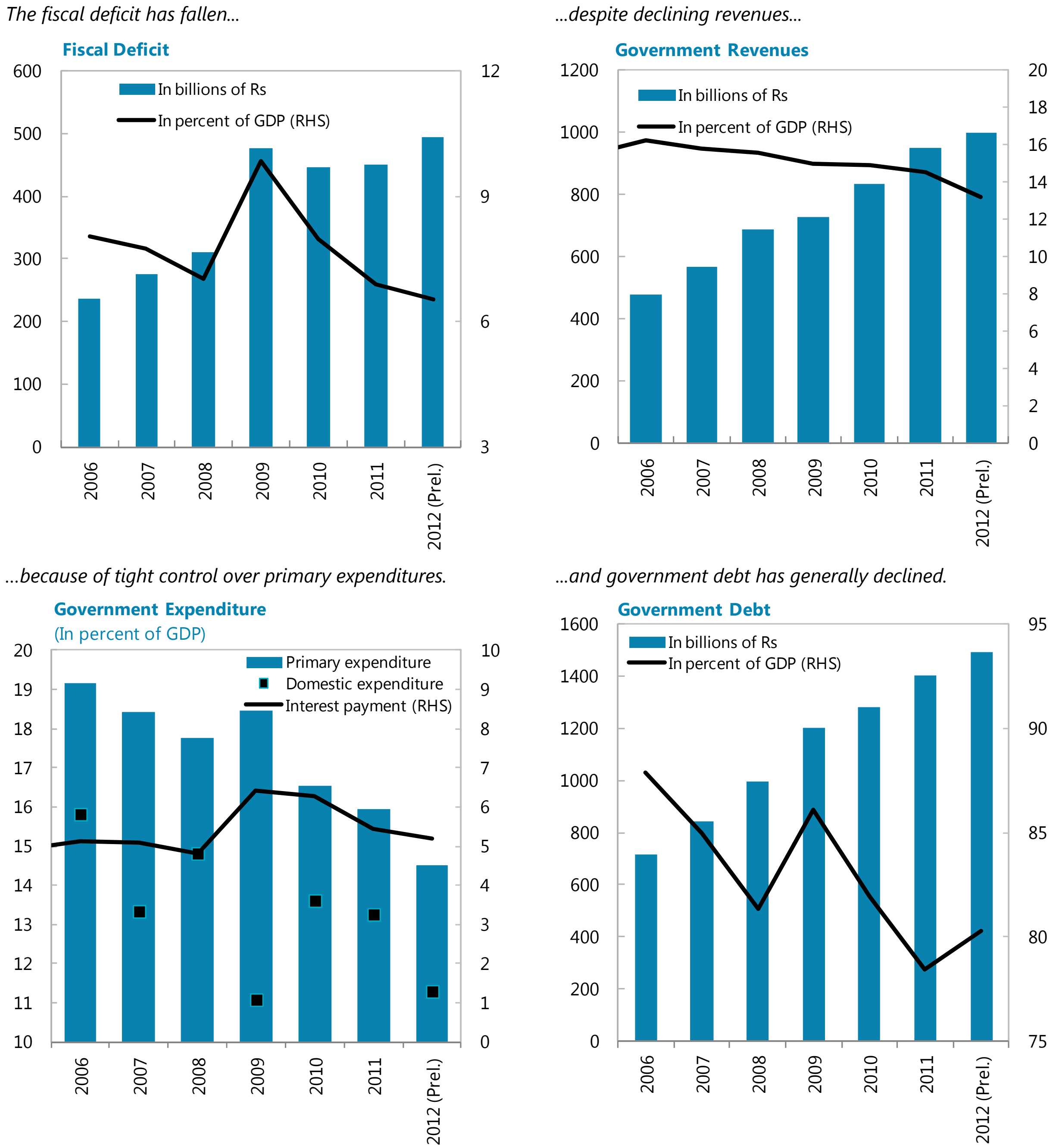
Intervention

(In millions of U.S. dollars)



Sources: CEIC; Haver Analytics; IMF Information Notice System; and IMF staff estimates.

Figure 5. Fiscal Developments

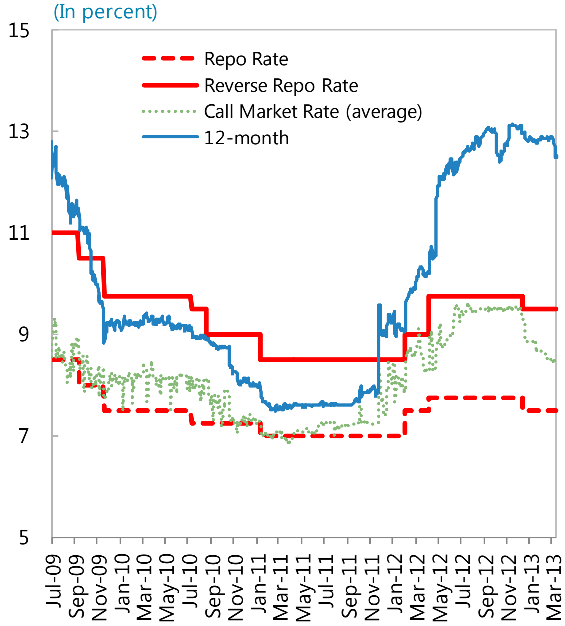


Sources: Central Bank of Sri Lanka; CEIC; Bloomberg LP; and IMF staff estimates.

Figure 6. Monetary and External Developments

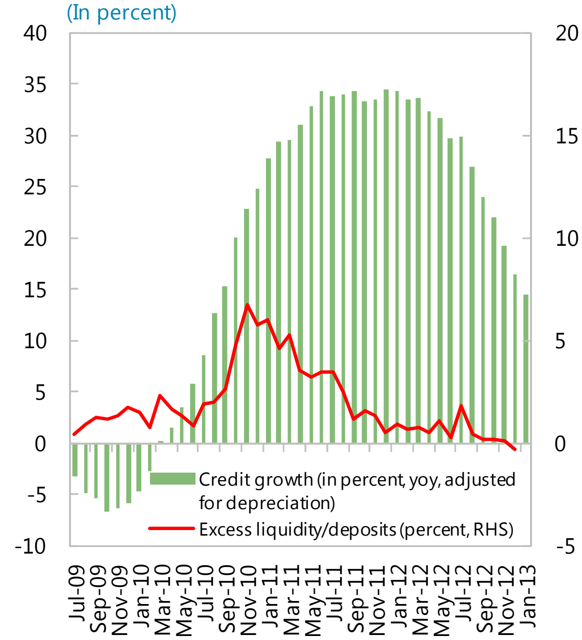
After tightening earlier, monetary conditions have eased recently.

Interest Rates
(In percent)



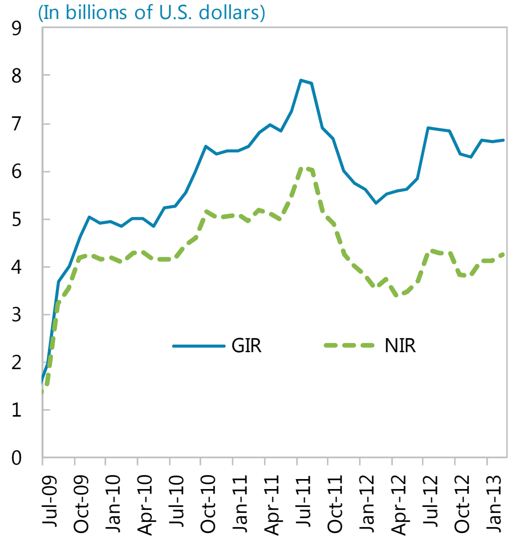
Credit growth and excess liquidity declined.

Credit Growth and Excess Liquidity
(In percent)



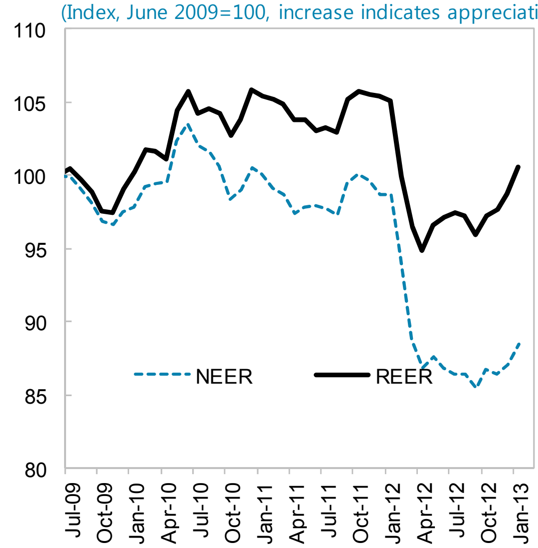
External reserves have stabilized after declining in 2011.

External Reserves
(In billions of U.S. dollars)



The real exchange rate depreciated, though some of this has subsequently reversed.

Real Exchange Rate
(Index, June 2009=100, increase indicates appreciation)

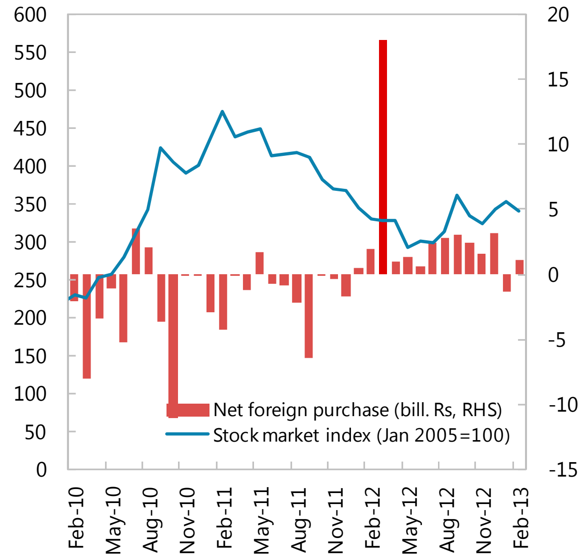


Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; Bloomberg LP; and IMF staff estimates.

Figure 7. Financial Sector Developments

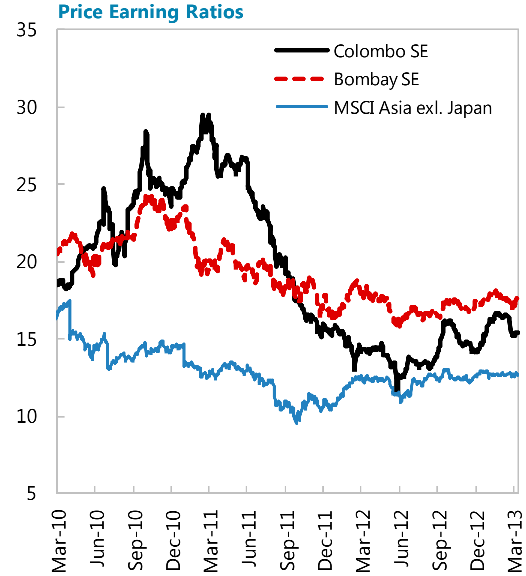
The stock market has rebounded somewhat after declining though 2011.

Stock Market Indicators



The price-to-earnings ratio has declined to around the average for the region.

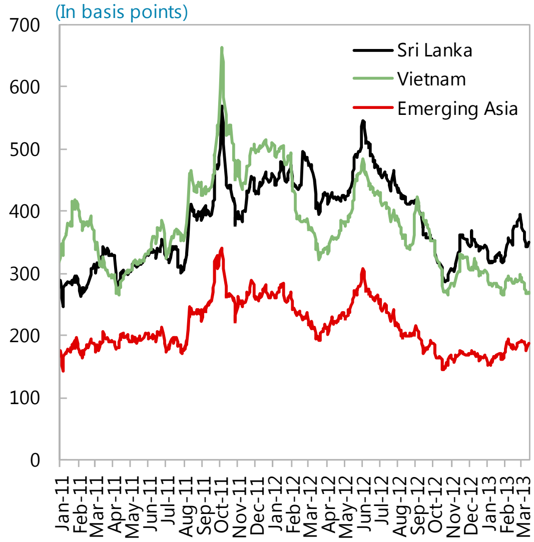
Price Earning Ratios



Sri Lanka's sovereign risk spread remains above emerging Asia.

EMBIG Spreads

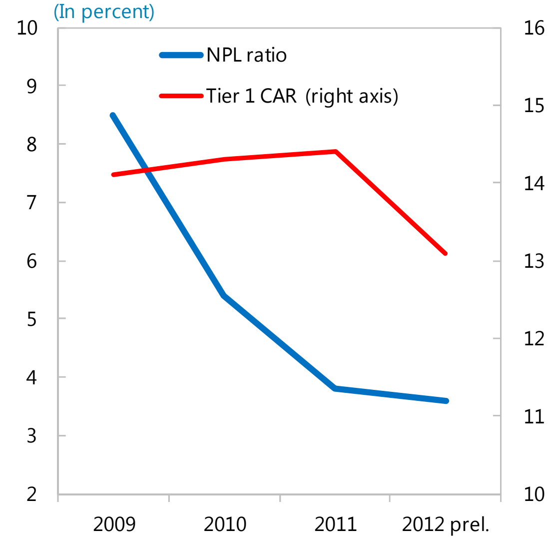
(In basis points)



The NPL ratio of the banking system remains low, but capital adequacy has eased slightly.

NPL and Capital Adequacy Ratios

(In percent)



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

Table 1. Sri Lanka: Selected Economic Indicators, 2009–15

	2009	2010	2011	2012	2013	2014	2015
				Prel.		Proj.	
GDP and inflation (in percent)							
Real GDP growth	3.5	8.0	8.2	6.4	6.3	6.8	6.5
Inflation (average)	3.5	6.2	6.7	7.5	7.9	7.1	6.8
Inflation (end-of-period)	5.0	6.8	4.9	9.2	7.9	6.7	6.5
Core inflation (end-of-period)	5.9	8.9	4.7	7.5	7.0	6.7	6.5
Public finances (in percent of GDP)							
Revenue 1/	14.5	14.6	14.3	13.0	13.2	13.7	14.1
Grants 1/	0.5	0.3	0.2	0.2	0.2	0.2	0.2
Expenditure 1/	24.9	22.8	21.4	19.7	19.3	19.3	19.3
Central government balance 1/	-9.9	-8.0	-6.9	-6.4	-5.8	-5.4	-5.0
Consolidated government balance 1/	-10.3	-8.4	-8.6	-8.6	-7.0	-6.1	-5.4
Central government domestic financing	5.1	4.5	4.0	4.1	4.4	3.6	3.3
Government debt (domestic and external)	86.1	81.9	78.4	80.2	79.9	78.0	75.8
Money and credit (percent change, end of period)							
Reserve money	13.1	18.8	21.9	10.2	16.0	14.8	14.5
Broad money	18.6	15.8	19.1	17.6	15.5	15.5	15.5
Domestic credit	0.5	18.6	34.3	21.7	17.3	15.2	14.8
Private sector credit	-5.8	24.9	34.5	17.6	17.0	18.7	18.6
Public sector credit	13.3	8.2	33.7	29.6	17.8	9.0	7.6
Balance of payments (in millions of U.S. dollars)							
Exports	7,085	8,626	10,559	9,774	10,317	10,995	11,804
Imports	-10,207	-13,451	-20,269	-19,183	-20,269	-21,669	-23,096
Current account balance	-214	-1,075	-4,615	-3,915	-3,700	-3,735	-3,791
Current account balance (in percent of GDP)	-0.5	-2.2	-7.8	-6.6	-5.7	-5.3	-4.9
Export value growth (percent)	-12.6	21.7	22.4	-7.4	5.6	6.6	7.4
Import value growth (percent)	-27.6	31.8	50.7	-5.4	5.7	6.9	6.6
Gross official reserves (end of period) 2/							
In millions of U.S. dollars	4,897	6,410	5,758	6,677	6,964	6,798	7,095
In months of imports	3.9	3.5	3.2	3.5	3.4	3.1	3.0
External debt (public and private)							
In billions of U.S. dollars	20.9	24.8	29.4	33.7	35.7	37.8	40.3
As a percent of GDP	49.7	50.1	49.8	56.7	54.8	53.7	52.5

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

1/ The budget presentation now places grants above the line according to standard practice. Previously grants were classified below the line as a budget deficit financing item. The consolidated government balance includes the Ceylon Electricity Board and the Ceylon Petroleum Corporation. Expenditure arrears in the estimated amount of 0.5 percent of GDP in 2012 are assumed to be cleared in 2013.

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

Table 2a. Sri Lanka: Summary of Central Government Operations, 2009–15

(In percent of GDP)

	2009	2010	2011	2012	2013	2014	2015
				Prel.		Proj.	
Total revenue (including grants)	15.0	14.9	14.5	13.2	13.4	13.9	14.2
Total revenue	14.5	14.6	14.3	13.0	13.2	13.7	14.1
Tax revenue	12.8	12.9	12.4	11.1	11.7	12.1	12.5
Income taxes	2.9	2.4	2.4	2.3	2.4	2.4	2.4
VAT	3.5	3.9	3.3	2.7	3.0	3.4	3.6
Excise taxes	2.0	2.3	2.8	2.5	2.7	2.7	2.7
Other trade taxes	2.0	1.3	1.4	1.4	1.4	1.4	1.4
Other	2.3	2.9	2.5	2.2	2.3	2.3	2.3
Nontax revenue	1.7	1.7	1.9	1.9	1.5	1.6	1.6
Grants	0.5	0.3	0.2	0.2	0.2	0.2	0.2
Total expenditure and net lending 1/	24.9	22.8	21.4	19.7	19.3	19.3	19.3
Current expenditure	18.2	16.7	15.4	14.4	14.4	14.2	14.0
Civil service wages and salaries	3.0	2.8	2.7	2.4	2.7	2.7	2.7
Other civilian goods and services	1.0	0.7	0.9	0.6	0.7	0.8	0.8
Security expenditure (including contingency)	3.9	3.4	3.1	2.7	2.9	2.9	2.9
Subsidies and transfers	3.9	3.5	3.3	3.1	2.9	2.8	2.8
Interest payments	6.4	6.3	5.5	5.4	5.2	5.0	4.8
Capital expenditure and net lending	6.7	6.1	6.0	5.3	4.8	5.0	5.2
Overall balance of the central government	-9.9	-8.0	-6.9	-6.4	-5.8	-5.4	-5.0
Financing	9.9	8.0	6.9	6.4	5.8	5.4	5.0
Net external financing	4.8	3.5	2.9	2.4	1.4	1.8	1.7
Net domestic financing	5.1	4.5	4.0	4.1	4.4	3.6	3.3
Memorandum items:							
Primary balance (excluding grants)	-4.0	-2.0	-1.7	-1.3	-0.9	-0.6	-0.3
Total public debt	86.1	81.9	78.4	80.2	79.9	78.0	75.8
Domestic debt	49.7	45.8	42.8	41.0	40.7	39.2	37.8
Foreign debt	36.4	36.1	35.6	39.2	39.2	38.8	38.0

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

1/ Expenditure arrears in the estimated amount of 0.5 percent of GDP in 2012 are assumed to be cleared in 2013.

Table 2b. Sri Lanka: Central Government Operations, GFSM 2001 Classification, 2010–15

(In percent of GDP)

	2010	2011	2012	2013	2014	2015
			Prel.		Proj.	
Revenue	14.9	14.5	13.2	13.4	13.9	14.2
Taxes	12.9	12.4	11.1	11.7	12.1	12.5
Taxes on income, profits and capital gains	2.4	2.4	2.3	2.4	2.4	2.4
Taxes on goods and services	6.2	6.1	5.2	5.7	6.1	6.3
Taxes on international trade and transactions	1.3	1.4	1.4	1.4	1.4	1.4
Taxes not elsewhere classified	2.9	2.5	2.2	2.3	2.3	2.3
Grants	0.3	0.2	0.2	0.2	0.2	0.2
Other revenues	1.7	1.9	1.9	1.5	1.6	1.6
Total expenditure	22.1	20.9	19.2	18.8	18.8	18.8
Expenses	16.7	15.4	14.2	14.4	14.2	14.0
Compensation of employees	5.4	4.9	4.6	4.8	4.8	4.8
Purchases of goods and services	1.6	1.7	1.1	1.5	1.6	1.6
Interest	6.3	5.5	5.4	5.2	5.0	4.8
Social benefits	1.6	1.5	1.5	1.5	1.5	1.5
Expenses not elsewhere classified	1.9	1.8	1.6	1.4	1.3	1.2
Net acquisition of nonfinancial assets	5.4	5.5	4.9	4.3	4.5	4.7
Net lending/borrowing	-7.2	-6.4	-5.9	-5.3	-4.9	-4.5
Net acquisition of financial assets	0.7	0.5	0.3	0.5	0.5	0.5
Domestic	0.7	0.5	0.3	0.5	0.5	0.5
Foreign	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	8.0	6.9	6.4	5.8	5.4	5.0
Domestic	4.5	4.0	4.1	4.4	3.6	3.3
Foreign	3.5	2.9	2.4	1.4	1.8	1.7

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

Table 3. Sri Lanka: Monetary Accounts, 2009–15

	2009	2010	2011	2012	2013	2014	2015
				Prel.		Proj.	
Monetary authorities	(Stocks, in billions of Sri Lankan rupees)						
Net foreign assets	412	505	340	396	522	629	776
Net domestic assets	-109	-145	99	88	40	16	-38
Of which : Net credit to government	109	77	263	279	312	364	380
Of which : Other items net	-219	-224	-165	-192	-273	-348	-418
Reserve money	304	361	440	484	562	645	739
	(Contribution to reserve money growth, in percent)						
Net foreign assets	98.4	30.7	-45.9	12.7	25.9	19.1	22.9
Net domestic assets	-85.3	-12.0	67.8	-2.5	-9.9	-4.3	-8.4
Reserve money (percent change)	13.1	18.8	21.9	10.2	16.0	14.8	14.5
Monetary survey	(Stocks, in billions of Sri Lankan rupees)						
Net foreign assets	402	377	98	-25	-42	-32	-17
Monetary authorities	412	505	340	396	522	629	776
Deposit money banks	-10	-128	-242	-421	-563	-661	-793
Net domestic assets	1,404	1,714	2,394	2,954	3,426	3,941	4,531
Domestic credit	1,908	2,263	3,038	3,696	4,335	4,993	5,734
Public sector (net)	714	772	1,032	1,338	1,576	1,717	1,848
Private sector	1,194	1,491	2,006	2,358	2,759	3,276	3,886
Other items (net)	-503	-549	-644	-742	-909	-1,052	-1,203
Broad money	1,806	2,091	2,492	2,929	3,384	3,909	4,514
	(Annual percent change)						
Net foreign assets	417.2	-6.1	-74.0	-125.6	66.1	-22.3	-49.0
Monetary authorities	178.2	22.6	-32.7	16.5	31.7	20.5	23.5
Deposit money banks	-85.3	1140.2	89.1	74.0	33.7	17.4	19.9
Net domestic assets	-2.8	22.1	39.7	23.4	16.0	15.0	15.0
Domestic credit	0.5	18.6	34.3	21.7	17.3	15.2	14.8
Public sector (net)	13.3	8.2	33.7	29.6	17.8	9.0	7.6
Private sector	-5.8	24.9	34.5	17.6	17.0	18.7	18.6
Broad money	18.6	15.8	19.1	17.6	15.5	15.5	15.5
	(Contribution to broad money growth, in percent)						
Net foreign assets	21.3	-1.4	-13.4	-4.9	-0.6	0.3	0.4
Net domestic assets	-2.7	17.1	32.5	22.5	16.1	15.2	15.1
Domestic credit	0.7	19.7	37.1	26.4	21.8	19.4	19.0
Public sector (net)	5.5	3.2	12.4	12.3	8.1	4.2	3.4
Private sector	-4.8	16.4	24.6	14.1	13.7	15.3	15.6
Memorandum items:							
Broad money multiplier	6.0	5.8	5.7	6.0	6.0	6.1	6.1
Velocity of broad money	2.7	2.7	2.6	2.6	2.5	2.5	2.5

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

Table 4. Sri Lanka: Balance of Payments, 2009–15

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

	2009	2010	2011	2012	2013	2014	2015
				Prel.		Proj.	
Current account	-214	-1,075	-4,615	-3,915	-3,700	-3,735	-3,791
Trade balance	-3,122	-4,825	-9,710	-9,409	-9,952	-10,673	-11,292
Exports	7,085	8,626	10,559	9,774	10,317	10,995	11,804
Imports	10,207	13,451	20,269	19,183	20,269	21,669	23,096
Services	391	707	1,099	1,250	1,621	2,034	2,406
Income	-488	-617	-647	-1,148	-1,274	-1,474	-1,795
Transfers	3,005	3,660	4,643	5,392	5,905	6,379	6,891
Private (net)	2,927	3,608	4,583	5,339	5,853	6,325	6,834
Official (net)	77	52	60	53	51	54	57
Capital and financial account	3,102	2,877	4,262	4,683	4,440	4,285	4,634
Capital transfers (net)	233	164	164	130	173	115	112
Financial account	2,361	2,713	4,098	4,553	4,267	4,170	4,522
Long-term flows	1,303	2,380	3,308	2,872	3,092	3,252	3,524
Direct investment	384	435	896	813	1,205	1,265	1,391
Private sector borrowing 1/	79	149	175	562	949	742	837
Official sector borrowing	840	1,796	2,237	1,497	939	1,245	1,296
Disbursements	1,780	2,460	3,026	2,869	1,800	2,613	2,222
Amortization	940	665	789	1,372	861	1,368	926
Short-term flows	1,058	334	790	1,681	1,175	918	998
Government short-term net	1,369	531	233	843	500	525	551
Nonbank private sector	228	-1,032	-243	-663	-225	-158	-126
Banking sector	-533	1,064	971	1,196	500	350	373
Portfolio investment	-6	-230	-171	305	400	200	200
SDR allocation	508	0	0	0	0	0	0
Errors and omissions	-162	-881	-708	-617	0	0	0
Overall balance	2,725	921	-1,061	151	740	550	844
Financing	-2725	-921	1061	-151	-740	-550	-844
NIR (- = increase)	-2,725	-921	1,061	-151	-740	-550	-844
Gross reserves	-3,316	-1,513	653	-920	-287	167	-298
Reserve liabilities (- is outflow)	591	592	408	769	-453	-717	-546
Memorandum items:							
Current account (in percent of GDP)	-0.5	-2.2	-7.8	-6.6	-5.7	-5.3	-4.9
Gross official reserves (net of ACU debit balances)	4,897	6,410	5,758	6,677	6,964	6,798	7,095
(In months of imports of goods and nonfactor services)	3.9	3.5	3.2	3.5	3.4	3.1	3.0
(In percent of composite metric)	109	129	91	98	93	89	82
Net international reserves	4,150	5,072	4,011	4,162	4,902	5,452	6,296
GDP	42,040	49,552	59,165	59,408	65,266	70,438	76,636

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

1/ Includes public corporations.

Table 5. Sri Lanka: Projected Payments to the Fund, 2012–17

(In millions of SDR, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017
Fund repurchases and charges						
In millions of SDR	44.8	320.7	486.9	369.6	331.0	173.1
In millions of U.S. dollars	68.7	487.2	736.8	557.9	498.3	260.2
In percent of exports of goods and NFS	0.5	3.3	4.6	3.2	2.6	1.3
In percent of quota	10.8	77.6	117.8	89.4	80.1	41.9
In percent of gross official reserves	1.0	7.0	10.8	7.9	6.1	2.8
Fund credit outstanding						
In millions of SDR	1,633	1,335	861	500	172	0
In millions of U.S. dollars	2,502	2,028	1,303	754	259	0
In percent of quota	395	323	208	121	42	0
In percent of GDP	4.2	3.1	1.9	1.0	0.3	0.0
In percent of gross official reserves	37.5	29.1	19.2	10.6	3.1	0.0
Memorandum items:						
Exports of goods and services (in millions of U.S. dollars)	13,385	14,576	15,921	17,313	19,236	20,727
Quota	413	413	413	413	413	413
Quota (in millions of U.S. dollars)	633	628	626	624	622	621
Gross official reserves (in millions of U.S. dollars)	6,677	6,964	6,798	7,095	8,236	9,443
GDP (in millions of U.S. dollars)	59,408	65,266	70,438	76,636	83,587	91,345

Source: IMF staff estimates.

Table 6. Sri Lanka: Financial Soundness Indicators—All Banks, 2008–12

	2008	2009	2010	2011	2012 Prel.
Capital adequacy					
Regulatory capital to risk weighted assets	14.5	16.1	16.2	16.0	15.0
Tier 1 capital/risk weighted assets	12.5	14.1	14.3	14.4	13.1
Net nonperforming loans to total capital funds	18.5	26.2	15.2	11.5	11.9
Debt to capital funds	209.4	160.1	172.0	171.4	184.6
Capital to assets ratio	8.1	8.1	8.3	8.7	8.5
Asset quality					
Gross nonperforming loans to total gross loans (without interest in suspense)	6.3	8.5	5.4	3.8	3.6
Gross nonperforming loans to total gross loans (with interest in suspense)	8.1	10.7	7.3	6.2	5.6
Net nonperforming loans to total gross loans	3.4	5.0	3.0	2.1	2.1
Provision coverage ratio (total)	60.9	53.0	58.1	57.1	54.5
Earnings and profitability					
Return on equity (after tax)	13.4	11.8	22.2	19.7	20.2
Return on assets (after tax)	1.1	1.0	1.8	1.7	1.7
Interest income to gross income	86.3	86.0	83.1	85.5	86.3
Staff expenses to noninterest expenses	44.5	46.5	45.2	43.7	45.2
Personnel expenses to total income	9.9	10.6	12.0	12.2	10.7
Total cost to total income	79.8	78.1	71.9	73.9	75.6
Interest margin	4.4	4.6	4.6	4.2	4.1
Liquidity					
Liquid assets to total assets	28.4	35.3	31.4	26.8	26.5
Statutory liquid assets ratio-domestic banking units	31.3	39.2	36.6	32.4	31.2
Assets/funding structure					
Deposits	69.6	74.1	72.8	72.3	70.5
Borrowings	17.0	12.9	14.3	14.9	15.8
Capital to external funds	9.4	9.3	9.5	10.0	9.9
Credit to deposits	87.0	71.5	76.4	84.7	87.4

Source: Central Bank of Sri Lanka.

INTERNATIONAL MONETARY FUND

SRI LANKA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING—DEBT SUSTAINABILITY ANALYSIS

April 12, 2013

Approved By
Hoe Ee Khor and Dhaneshwar Ghura

Prepared by the Staff Representatives of the 2013 Consultation with Sri Lanka

Sri Lanka's public and external debt burden, while still relatively elevated, remains on a sustainable trajectory under the baseline assumptions. Continued revenue weaknesses present the main downside risk to public debt sustainability, while the increasing recourse to nonconcessional external borrowing, including by the private sector, point to the need for enhanced monitoring of the external debt burden and maturities to limit rollover risk.

Macroeconomic Assumptions

Growth is projected at 6¼ percent in 2013, reflecting tepid external demand, a moderately contractionary budget, and the lagged impact of tight monetary policy. From 2015 onward growth is projected at 6½ percent, slightly higher than its 10-year average reflecting capital deepening and improved factor productivity.

Inflation is expected to come down from the high to the mid-single digits over the medium term, as the government moves toward a strategy of flexible inflation targeting.

Fiscal assumptions: The 2013 fiscal deficit is assumed to be 5.8 percent, in line with the authorities' target. Despite revenue shortfalls, deficit targets are assumed to be met by constraining spending. Fiscal consolidation is projected to continue in the medium term: the deficit is projected to fall to 5 percent of GDP in 2015, and to 4¾ percent in 2017.

- **Revenues.** Tax revenues are projected to increase only moderately over the medium term, by slightly over 1 percent of GDP, while nontax revenues are assumed to grow broadly in line with nominal GDP. The increase in tax revenue is driven mainly by higher VAT collection, reflecting gradual base broadening and better administration.
- **Expenditure.** Continued expenditure restraint is assumed to help achieve deficit reduction. Current expenditures are projected to fall further moderately, by about ¼ percent of GDP,

reflecting both lower interest payments and lower growth in security spending and subsidies. Capital spending as a share of GDP—already weak—is assumed to remain flat.

- **Financing.** Net external financing of the budget is projected to be below 2 percent of GDP, below the historical average. The government's reliance on external commercial financing is expected to decline, reflecting the authorities' policy of borrowing from domestic sources, which are expected to account for the balance of the government's financing needs.

External assumptions: While the trade deficit is expected to remain relatively elevated at around 14 percent of GDP, the current account is expected to continue consolidating from its peak in 2011 as a result of strong growth in receipts from tourism (reflecting the post-conflict increase in hotel capacity) and remittances (reflecting the increase in emigration, particularly of skilled labor). FDI is expected to increase gradually to around 2 percent of GDP, partly resulting from projects already in the pipeline, as well as additional efforts expected in the context of Sri Lanka's five-hub strategy. As a result of partial financial account liberalization as well as explicit incentives to encourage foreign borrowing by the banking sector, long-term flows to the private sector are expected to be significant over the medium term. Foreign inflows into the domestic bond market and equity markets are also expected to remain relatively robust, though with the former remaining subject to a prudential cap on foreign participation.

Public Debt Sustainability

Baseline: Under the baseline scenario, the ratio of public debt-to-GDP is projected to decline gradually to close to 70 percent by 2017, from around 80 percent in 2012. In 2016 and 2017, the primary balance is projected to move to close to zero. The bulk of the reduction in the debt ratio comes from a favorable interest rate-growth differential.

Other scenarios: A 30 percent real depreciation would push the debt ratio to close to 100 percent of GDP, reflecting a relatively high share of debt in foreign currency, while a contingent liability shock would raise the ratio to around 90 percent of GDP. A no policy change scenario, under which the primary balance does not improve as in the baseline, generates a somewhat slower reduction in debt ratio. However, this scenario, and growth-shock and interest-rate-shock scenarios, still shows a declining debt ratio—though at slower pace and staying well above 70 percent of GDP.

Risks: The projected gradual decline in the public debt ratio is based on two key assumptions: (i) continued deficit reduction; and (ii) continued favorable interest rate-growth differential. Should deficit reduction fail, or growth turn out to be slower or interest rates higher than projected, the decline in the debt ratio could be slowed or even reversed. This could happen if envisaged improvements in tax revenues fail to materialize, and/or continued spending restraint becomes difficult to sustain. Contingent liabilities also pose a risk. Current explicit guarantees are not large, less than 4 percent of GDP, but there is a risk of increased external borrowing by banks that could eventually entail fiscal risk to the government. As illustrated in 2012, the debt ratio is also sensitive to currency movements. On the other hand, implementing a comprehensive tax policy and administration reform could significantly increase revenue, and allow for deficit reduction with higher public infrastructure investment and thus higher growth.

External Debt Sustainability

Structure of debt: With relatively tight capital controls in place, the large majority of Sri Lanka's external debt burden is currently owed by the government and, to a lesser extent, the broader public sector. Rollover risks are limited over the medium term, with around half of the government's foreign debt stock contracted on concessional terms and long amortization schedules. Outstanding Eurobonds total US$3.5 billion, with US$500 million maturing in 2015 and US$1 billion per year in 2020 and the following three years. With the authorities encouraging more external borrowing by the financial sector, the share of private external debt is expected to increase over the medium term.

Baseline: As of end-2012, the external debt-to-GDP ratio is estimated at around 57 percent, up from 50 percent at the end of 2011, with much of the increase reflecting exchange rate depreciation. Under the baseline scenario, the debt ratio is expected to fall gradually over the medium term, supported by robust growth and the relatively low effective interest rate on Sri Lanka's external debt, reaching 51 percent of GDP by 2017.

Other scenarios: A one-time real depreciation of 30 percent in 2013 would see the debt-to-GDP ratio increase to around 80 percent before declining gradually thereafter. A permanent one-half standard deviation shock to the growth rate would still see the debt-to-GDP ratio on a declining trend, with the debt ratio at around 53 percent of GDP at the end of the projection period. A failure of the current account to consolidate over the medium term would have a greater impact on the debt burden: a noninterest deficit in the range of 4.5 percent of GDP would result in the debt-to-GDP ratio increasing slightly over the projection period.

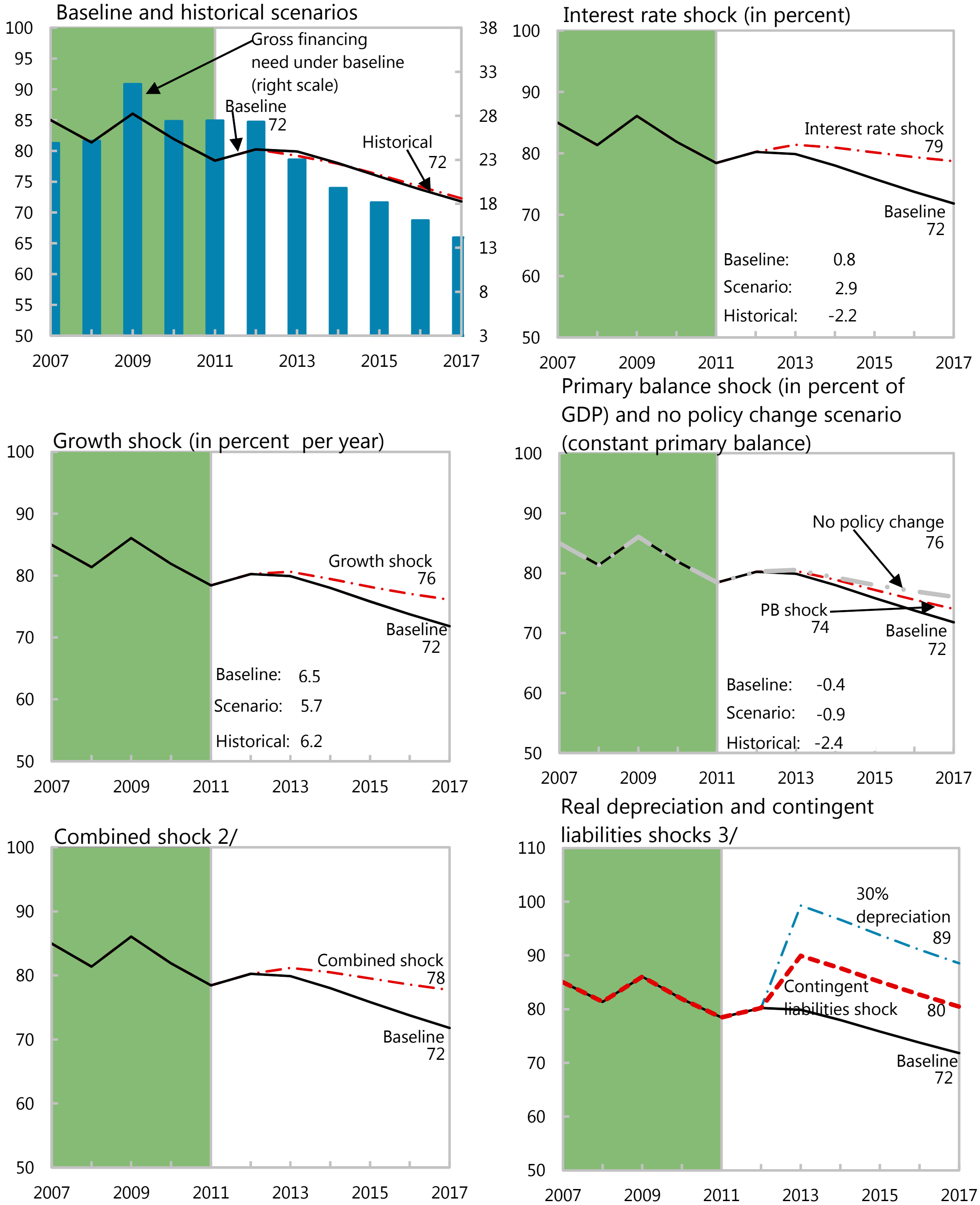
Risks: The envisaged consolidation of the current account is premised on exchange rate flexibility. Failure to allow the exchange rate to move in line with fundamentals could lead to the current account deficit remaining at elevated levels, supported by higher external borrowing. Weaker-than-expected global growth could pose downside risks to tourism and revenue receipts. On the upside, stronger FDI (as projected by the authorities) could enhance the country's productive capacity and lead to faster growth in tourism and the export sector than in the baseline.

While the policy of encouraging the financial sector to borrow abroad directly may serve to reduce the central government's external debt burden, it does not reduce the risks for the economy as a whole. The external debt burden and external debt service profile should be monitored carefully to ensure that external reserves are sufficient, rollover risks limited, and the overall debt burden remains on an appropriate trajectory in line with the country's debt servicing capacity.

Authorities' Views

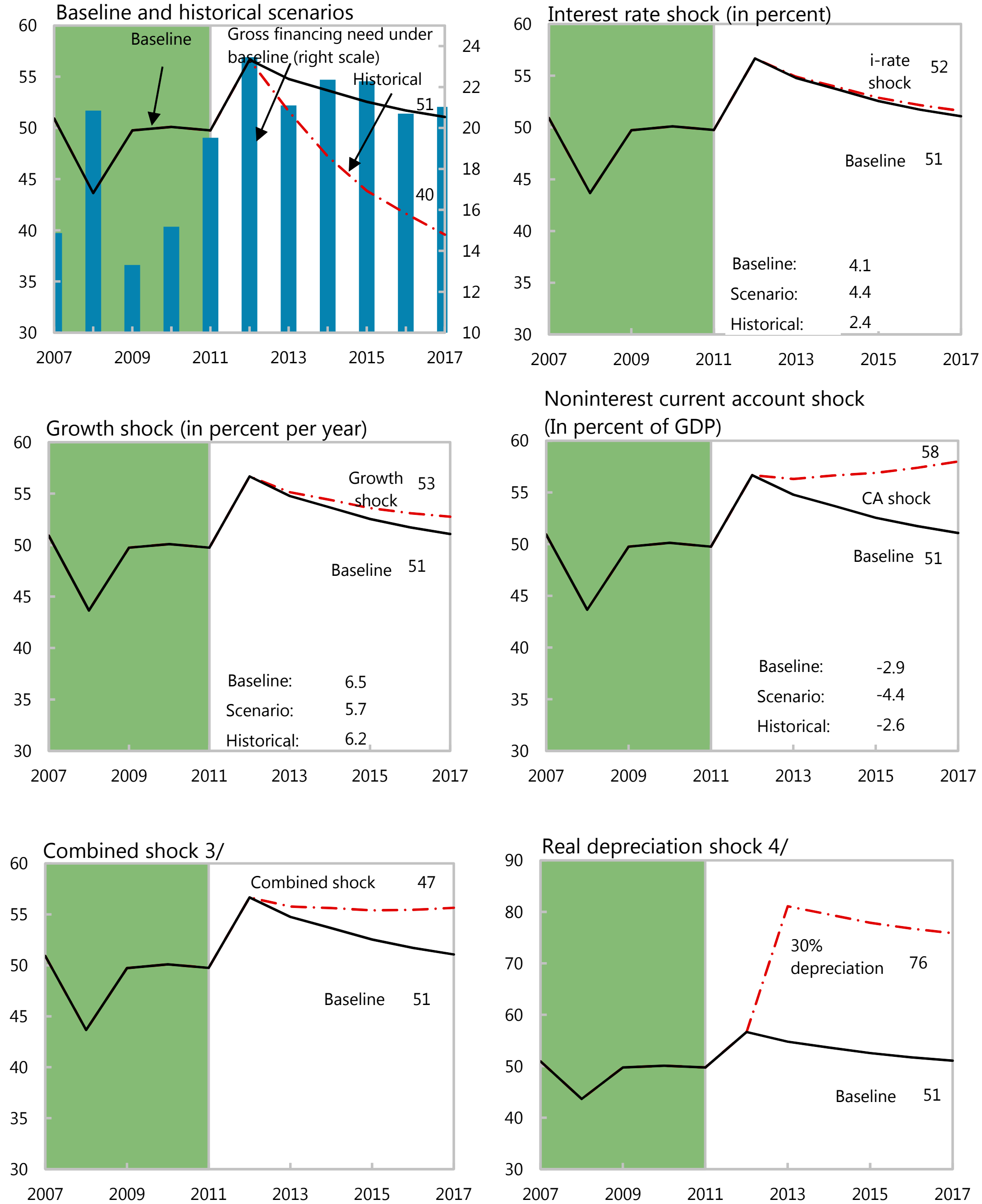
The authorities agreed with the broad thrust of the debt sustainability analysis. They noted that the government had played a major role in intermediating funds for development in the past, and public debt was higher than other countries as a result. Fiscal consolidation would support a decline in the government's debt burden. Increased foreign borrowing by commercial banks would allow for financing of state-owned enterprises' capital spending off budget, though guarantees for such borrowing would be necessary at the early stages of the strategy.

Figure 1. Sri Lanka: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: IMF country desk data and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent 1/2 standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 2. Sri Lanka: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: IMF; country desk data; and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent 1/2 standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2013.

Table 1. Sri Lanka: Public Sector Debt Sustainability Framework, 2009–17

(In percent of GDP, unless otherwise indicated)

	Actual			Projections						Debt-stabilizing
	2009	2010	2011	2012	2013	2014	2015	2016	2017	primary balance 1/
Baseline: public sector debt 2/	86.1	81.9	78.4	**80.2**	**79.9**	**78.0**	**75.8**	**73.8**	**71.8**	**-2.5**
Of which: Foreign-currency denominated	36.4	36.1	35.6	39.2	39.2	38.8	38.0	37.3	36.5	
Change in public sector debt	4.7	-4.2	-3.5	1.8	-0.3	-1.9	-2.2	-2.1	-1.9	
Identified debt-creating flows (4+7+12)	3.6	-4.5	-3.8	0.8	-2.1	-2.4	-2.5	-2.5	-2.4	
Primary deficit	4.0	2.0	1.7	1.3	0.9	0.6	0.3	0.2	0.2	
Revenue and grants	14.5	14.6	14.3	13.0	13.2	13.7	14.1	14.2	14.2	
Primary (noninterest) expenditure	18.5	16.6	15.9	14.3	14.1	14.3	14.4	14.4	14.4	
Automatic debt dynamics 3/	-0.4	-6.5	-5.4	-0.5	-3.0	-2.9	-2.9	-2.7	-2.6	
Contribution from interest rate/growth differential 4/	-0.7	-5.5	-6.3	-5.4	-4.0	-5.0	-4.4	-3.9	-3.6	
Of which: Contribution from real interest rate	1.9	0.4	-0.5	-1.0	0.4	-0.3	0.1	0.5	0.7	
Of which: Contribution from real GDP growth	-2.6	-6.0	-5.8	-4.3	-4.4	-4.7	-4.5	-4.4	-4.3	
Contribution from exchange rate depreciation 5/	0.4	-1.0	0.9	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	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	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2–3) 6/	1.1	0.4	0.3	1.0	1.8	0.4	0.4	0.4	0.5	
Public sector debt-to-revenue ratio 2/	594.8	561.6	549.1	616.0	605.6	567.4	538.5	517.9	505.5	
Gross financing need 7/	31.6	27.4	27.4	27.3	23.0	19.8	18.1	16.1	14.1	
In billions of U.S. dollars	13,284.4	13,570.3	16,237.9	16,214.7	15,018.2	13,940.4	13,899.0	13,466.9	12,914.0	
Scenario with key variables at their historical averages 8/				**80.2**	**79.2**	**77.9**	**76.1**	**74.2**	**72.3**	**-4.7**
Scenario with no policy change (constant primary balance) in 2012–17				**80.2**	**80.6**	**79.3**	**78.0**	**77.0**	**76.0**	**-2.6**
Key macroeconomic and fiscal assumptions underlying baseline										
Real GDP growth (in percent)	3.5	8.0	8.2	6.4	6.3	6.7	6.5	6.5	6.5	
Average nominal interest rate on public debt (in percent) 9/	8.6	8.5	7.8	8.0	7.3	7.1	7.0	7.1	7.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.7	1.2	-0.1	-0.9	1.0	0.0	0.6	1.2	1.4	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-1.2	3.1	-2.6	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.9	7.3	7.9	8.9	6.3	7.1	6.5	6.0	5.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.5	-3.1	4.3	-4.6	4.5	8.8	7.2	6.3	6.4	
Primary deficit	4.0	2.0	1.7	1.3	0.9	0.6	0.3	0.2	0.2	

Sources: IMF; country desk data; and staff estimates.

1/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

2/ Includes central government gross debt.

3/ Derived as $[(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp))$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

4/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as $-g$.

5/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

6/ For projections, this line includes exchange rate changes.

7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ Derived as nominal interest expenditure divided by previous period debt stock.

Table 2. Sri Lanka: External Debt Sustainability Framework, 2009–17

(In percent of GDP, unless otherwise indicated)

	Actual			Projections						Debt-stabilizing Noninterest current account 1/
	2009	2010	2011	2012	2013	2014	2015	2016	2017	
Baseline: external debt	49.7	50.1	49.8	**56.7**	**54.8**	**53.7**	**52.5**	**51.7**	**51.1**	**-4.0**
Change in external debt	6.1	0.4	-0.3	6.9	-1.9	-1.1	-1.1	-0.8	-0.6	
Identified external debt-creating flows (4+8+9)	-1.8	-6.2	-1.8	2.0	0.6	0.1	-0.1	-0.6	-0.4	
Current account deficit, excluding interest payments	-0.3	1.1	6.6	4.5	3.7	3.3	2.9	2.2	2.2	
Deficit in balance of goods and services	14.9	22.5	13.4	16.0	15.3	14.6	14.3	13.2	12.8	
Exports	21.3	22.4	23.1	22.5	22.3	22.6	22.6	23.0	22.7	
Imports	36.2	44.9	36.4	38.6	37.6	37.2	36.9	36.2	35.5	
Net non-debt-creating capital inflows (negative)	-0.9	-0.9	-1.5	-1.4	-1.8	-1.8	-1.8	-1.8	-1.7	
Automatic debt dynamics 2/	-0.6	-6.4	-6.9	-1.1	-1.3	-1.4	-1.2	-1.0	-0.9	
Contribution from nominal interest rate	0.8	1.1	1.2	2.1	2.0	2.0	2.0	2.1	2.2	
Contribution from real GDP growth	-1.5	-3.4	-3.5	-3.2	-3.2	-3.4	-3.2	-3.1	-3.1	
Contribution from price and exchange rate changes 3/	0.1	-4.1	-4.6	...	...	...	...	...	...	
Residual, including change in gross foreign assets (2–3) 4/	7.9	6.6	1.4	4.9	-2.5	-1.2	-1.0	-0.2	-0.3	
External debt-to-exports ratio (in percent)	233.0	223.7	215.8	251.5	245.2	237.4	232.6	224.7	225.1	
Gross external financing need (in billions of U.S. dollars) 5/	5.6	7.5	11.5	13.9	13.8	15.7	17.1	17.3	19.2	
In percent of GDP	13.3	15.2	19.5	23.5	21.1	22.4	22.3	20.7	21.0	
Scenario with key variables at their historical averages 6/				**56.7**	**51.6**	**47.2**	**43.9**	**41.6**	**39.6**	**-5.4**
Key macroeconomic assumptions underlying baseline										
Real GDP growth (in percent)	3.5	8.0	8.2	6.4	6.3	6.8	6.5	6.5	6.5	
GDP deflator in U.S. dollars (change in percent)	-0.3	9.1	10.3	-5.6	3.4	1.1	2.2	2.4	2.6	
Nominal external interest rate (in percent)	2.0	2.6	2.9	4.1	3.8	3.9	4.1	4.3	4.6	
Growth of exports (U.S. dollar terms, in percent)	-11.3	23.7	22.9	-1.9	8.9	9.2	8.7	11.1	7.8	
Growth of imports (U.S. dollar terms, in percent)	30.0	46.2	-3.2	6.3	7.2	6.7	7.9	6.9	7.3	
Current account balance, excluding interest payments	0.3	-1.1	-6.6	-4.5	-3.7	-3.3	-2.9	-2.2	-2.2	
Net non-debt-creating capital inflows	0.9	0.9	1.5	1.4	1.8	1.8	1.8	1.8	1.7	

Sources: IMF; country desk data; and staff estimates.

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

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

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

4/ For projection, line includes the impact of price and exchange rate changes.

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

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

INTERNATIONAL MONETARY FUND

SRI LANKA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND PROPOSAL FOR POST-PROGRAM MONITORING—INFORMATIONAL ANNEX

April 12, 2013

Prepared By: Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of March 31, 2013)

Membership Status

Joined 8/29/50; accepted Article VIII, Sections 2, 3, and 4, March 1994.

General Resources Account	**SDR Million**	**% Quota**
Quota	413.40	100.00
Fund holdings of currency (Exchange Rate)	1,943.37	470.09
Reserve Tranche Position	47.86	11.58

SDR Department	**SDR Million**	**% Allocation**
Net cumulative allocation	395.46	100.00
Holdings	12.59	3.18

Outstanding Purchases and Loans	**SDR Million**	**% Quota**
Stand-By Arrangements	1,576.09	381.25
Extended Arrangements	1.72	0.42
ECF Arrangements	3.84	0.93

Latest Financial Arrangements

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	7/24/09	7/24/12	1,653.60	1,653.60
ECF[1]	4/18/03	4/17/06	269.00	38.39
ECF	4/18/03	4/17/06	144.40	20.67

[1] Formerly PRGF.

Projected Payments to Fund[2]

(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2013	**2014**	**2015**	**2016**	**2017**
Principal	246.71	473.69	361.73	327.28	172.25
Charges/interest	16.87	14.13	8.48	4.08	1.07
Total	263.58	487.81	370.21	331.36	173.32

[2] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

The de jure exchange rate arrangement is free floating since its introduction by the Central Bank of Sri Lanka (CBSL) on January 23, 2001. The CBSL intervenes in the foreign exchange market to limit volatility in the exchange rate. After a period of following a stable path, the authorities have limited their interventions in the foreign exchange market and allowed for increased flexibility against the U.S. dollar since February 2012. As a result, the rupee–U.S. dollar exchange rate departed from the stabilized band and moved more freely. Accordingly, effective February 9, 2012, the de facto exchange rate arrangement has been reclassified to floating from a stabilized arrangement.
Sri Lanka maintains an exchange system free of exchange restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Sri Lanka solely for the preservation of national or international security.

Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Sri Lanka (CBSL) was subject to an update safeguards assessment with respect to a Stand-By Arrangement approved in July 2009. The assessment, completed in July 2009, found that the CBSL continues to have a relatively strong safeguards framework, especially in the external audit, financial reporting and control areas. The assessment recommended measures to improve the process of program data reporting to the Fund and to modernize and strengthen the internal audit function. Also the external audit arrangements were not fully institutionalized. The authorities have already implemented majority recommendations of the report.

Article IV Consultation

It is proposed that the next Article IV consultation take place in 12 months.

FSAP and ROSC Participation

- ***FAD:*** A fiscal transparency ROSC was completed and the report published in 2002. A ROSC update was completed and the report published in July 2005.
- ***MCM:*** An FSAP update took place in July 2012.
- ***MFD:*** Both the FSSA and the FSAP reports were completed in 2002.
- ***STA:*** A data ROSC was completed and the report published in 2002.

Technical Assistance

- ***FAD:*** In June 2001, a TA mission in tax policy and administration took place. A series of TA missions in revenue administration were conducted in 2003. In September 2012, a mission visited Sri Lanka to evaluate the state of the Inland Revenue Department with a particular focus on the effectiveness of the administration of the Value Added Tax (VAT) and secondarily the Nation Building Tax to identify measures to staunch and reverse the decline in VAT collections and improve the overall performance of the VAT system and taxpayer compliance. In November 2012, a mission conducted a diagnostic review of the Public Financial Management Reforms.

- ***MCM:*** In August 2001, a TA mission to develop a strategy for strengthening the framework and implementation of monetary and foreign exchange operations took place. In May 2002, an IMF/World Bank mission advised the government of Sri Lanka on options for reform of People's Bank. In 2003 and 2004, TA missions on financial sector issues and financial sector reforms took place.
- ***STA:*** From May–June 2003, a mission visited to follow up on issues related to monetary data raised by the mission on ROSC and to clear discrepancies between STA and APD data. In December 2004, a mission focused on shortcomings in the International Transactions Reporting System (ITRS). In November 2012, a mission visited Sri Lanka to report on data dissemination practices with respect to the requirements of the Special Data Dissemination Standard (SDDS).

Outreach

The resident representative has speaking engagements that are regularly covered in the media complementing the outreach conducted by APD missions.

Resident Representative

Mr. Koshy Mathai has been the resident representative since October 2009.

RELATIONS WITH THE WORLD BANK GROUP

(As of March 18, 2013)

The Country Partnership Strategy (CPS) for FY13–16 is designed to assist the government of Sri Lanka (GoSL) to address the long-term strategic and structural development challenges, while using the existing portfolio to support ongoing efforts to restore livelihoods of internally displaced persons and others affected by the conflict.

The FY13–16 CPS provides support to address the challenges for achieving the government's vision as laid out in the "Mahinda Chintana—Vision for the Future." For each of the three central goals of the government's vision, the CPS lays out the key areas of engagement in which World Bank Group support can most effectively address the identified challenges. These areas of engagement were developed through a process of 18 thematic consultations with the GoSL, private sector, civil society, development partners, and other stakeholders.

The first goal of the Mahinda Chintana—to increase per capita income to US$4,000 by 2016— will require sustained high economic growth (8 percent per year), driven by a high investment rate. The World Bank Group will support government efforts to improve the investment climate, strengthen governance, and reduce the inefficiencies of the public sector. The IFC plans to catalyze private investment through directly investing in important projects in key sectors. The World Bank will support the government's efforts to maintain a high level of public investment and improved efficiency of public expenditures, and financial management and procurement practices in line with international standards, using both knowledge (e.g., Public Expenditure and Financial Accountability Assessment and Public Expenditure Review) and lending products (e.g., a development policy loan for investment policy and governance reforms and an investment loan for legal and judicial reforms.) The World Bank will also advise government on ways to improve the efficiency of state-owned enterprises.

The second goal is shifting toward a more knowledge-based, globally integrated and competitive, environmentally friendly, internally integrated, and increasingly urban economy. The World Bank Group will deepen its assistance to the knowledge-based economy with investments in skills, research, and innovation. In addition, support for the development of infrastructure projects needed for sustainable urban development and better linkages within Sri Lanka will be enhanced. The Bank Group also stands ready to support government efforts to promote environmental sustainability and climate change adaptation.

The third goal is ensuring improvement in living standards and social inclusion. The World Bank Group will continue to support improvements in living standards and social inclusion in order to ensure that the benefits of rapid growth and higher quality services are broadly shared. Activities in this area already include three ongoing livelihood projects in the conflict-affected North and East regions of the country addressing restoration of basic infrastructures, housing construction, and cash for work, as well as support for starting new businesses. During the CPS period, the program will further include: (i) support to the national health sector program with a focus on supporting emerging service delivery demands resulting from Sri Lanka's aging population, such as work on noncommunicable diseases; (ii) inter-sectoral efforts to address malnutrition, economic integration of women, and a range of other activities to further support the needs of women, youth, and the disabled; (iii) analytical work on allocation of resources and benefits received by various groups; and (iv) IFC's support for inclusive growth.

Sri Lanka is an IDA-IBRD blend country as of FY12. An indicative lending program for IDA and IBRD combined for the first two years of the CPS is US$300 million in FY13 and US$727 million in FY14. Sri Lanka's eligibility for IDA will likely end with the IDA 16 cycle. The government is interested in IBRD lending of up to $500 million annually during FY15 and FY16, which would, however, depend on the macroeconomic environment in Sri Lanka, overall demand for IBRD resources from other clients, IBRD financial capacity and global economic developments.

Summary of World Bank IDA Operations

	Board Approval*	Revised Closing Date	Net Comm Amount	Percent Distribution
Dam Safety	03/27/2008	06/30/2015	65.3	54
Emergency Northern Recovery	12/17/2009	12/31/2013	65.0	90
2nd Comm Devt & Livelihood Imprv	09/10/2009	03/31/2014	75.0	69
Comm Livelihoods in Conflict Areas	06/22/2004	12/31/2014	124.7	84
N&E Local Services Improvement	05/13/2010	12/31/2015	50.0	75
LK – Road Sector Assistance	12/15/2005	09/30/2014	298.1	70
Provincial Roads Project	12/17/2009	03/31/2015	105.0	53
Metro Colombo Urban Development	03/15/2012	12/31/2017	213.0	16
E-Sri Lanka Development	09/21/2004	12/31/2013	53.7	90
SME Development Facility	09/07/2010	03/31/2014	57.4	52
Sustainable Tourism Development	05/13/2010	12/31/2014	18.0	1
Warehouse Receipts Financing	06/01/2012	05/31/2015	6.5	0
SL: Public Sector Capacity Building	06/05/2008	12/31/2013	15.3	87
Higher Education for 21st Century	05/13/2010	06/30/2016	40.0	29
Transforming School Education	11/29/2011	06/30/2017	100.0	10

Source: World Bank.

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of March 18, 2013)

Asian Development Bank (ADB) Country Strategy for Sri Lanka

- ***Country partnership strategy***
  ADB's Country Partnership Strategy (CPS) for Sri Lanka, approved in 2011, identifies three pillars: (i) inclusive and sustainable economic growth; (ii) catalyzing private investment; and (iii) enhancing the effectiveness of public investment and human resource and knowledge development as the focus of operations over the period 2012–16. ADB provides extensive support to infrastructure development, especially in transport, energy, urban, and water supply sectors. Recognizing the magnitude of the needs in the former conflict areas, ADB remains flexible to support critical interventions in these regions depending on the emerging needs.

- ***Indicative resources***
  The annual allocation for 2013–14 consists of $200 million from ordinary capital resources (OCR) and $130.87 million from the Asian Development Fund (ADF).

- ***Country program***
  - As indicated in Country Operations Business Plan (COBP) for the period 2013–15, the country's proposed program addresses the priority agendas of middle-income countries, such as *skills development, transport network optimization, and sustainable energy*. In the finance sector, projects will be identified to support private sector development, for example, in infrastructure financing. To ensure critical mass and continuity, the COBP will take an investment program approach, and financing modalities will include multi-tranche financing facility (MFF), results-based programs, and additional project financing. To the extent possible, thematic priorities such as gender, governance, climate change, and regional cooperation will be included in each project. Cofinancing and private sector operation opportunities will be explored to achieve the target of $2 billion support over a four-year period.
  - The country program focuses on reducing nonrevenue water (NRW) and *improving wastewater management* in the greater Colombo area. The Greater Colombo Water and Wastewater Management Improvement Investment Program (MFF) targets a reduction of NRW in Colombo City from 60 percent to about 18 percent in critical areas, and to about 20 percent elsewhere after project completion. The MFF will be a platform to mobilize cofinancing and to introduce public–private partnerships (PPPs). The first two tranches focus on water supply, while the third and fourth tranches primarily address wastewater management.
  - The program *addresses the issues of high power generation cost and sustainability* in four areas: (i) diversifying energy sources by increasing the share of renewable energy, including wind, hydro, and solar; (ii) strengthening transmission infrastructure to absorb additional capacity from renewable energy sources, and expanding access in post-conflict areas and lagging regions; (iii) improving network efficiency through technical loss reduction; and (iv) enhancing regional cooperation. The first tranche under the Green Power Development and Energy Efficiency Improvement Investment Program (MFF) is programmed for 2014.

A technical assistance (TA) loan to prepare the detailed engineering design for the India–Sri Lanka Power Interconnection Project is programmed for 2015, with a loan project expected in 2016–17.

- The country program supports *the planning, preparation, rehabilitation, and upgrading of national highways and provincial roads*. The National Highways Investment Program (MFF) is expected to be processed in 2014 to optimize the connectivity of highways and expressways currently under development.
- The country program also *strengthens education and develops skills relevant to Sri Lanka's growth by supporting priority sectors linked to the knowledge economy*. To provide long-term financing under a sector-wide approach, the "Human Capital Development: Education Sector Development Program" will cover technical secondary education. Tranches for secondary education will prepare students for higher education to cater to the needs of the labor market. The education sector has a medium-term expenditure framework and sector plan, and the shift toward results-based financing will support government reform and implementation efforts. A tranche to strengthen innovation and research will support second-generation education reforms. The "Human Capital Development: TVET Sector Development Program," programmed for 2014, will cover vocational education and training (TVET), innovation support. Tranches for TVET will improve access, quality, and relevance of vocational education and training to address the skills needs of employers in nine priority industry sectors.
- The nonlending pipeline is restructured to meet the requirements of the lending pipeline. Project preparatory TA will formulate the scope of proposed MFFs and their initial tranches, while the preparation of subsequent tranches will be financed under the MFFs. *Capacity development TA will support project implementation* to ensure effective project outcome and impact.
- In the absence of a PPP framework, *ADB will adopt a project-based approach*. Performance-based contracts can be structured as part of regular sovereign projects, such as the Greater Colombo Water and Wastewater Management Improvement Investment Program. ADB's Private Sector Operations Department will support finance sector development by providing loans, equity investments, or guarantees for banks or nonbank institutions to enable them to expand activities in targeted areas including housing, small- and medium-sized enterprise finance, leasing, renewable energy, and infrastructure lending. ADB may also provide transaction advisory services to structure and procure developers for PPP projects as needed.

Ongoing Projects

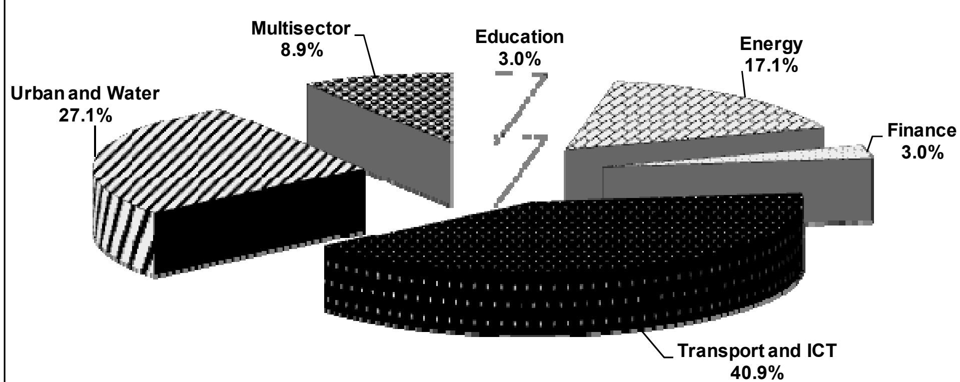
- ***Projects approved in 2012***

  During 2012, ADB approved four new projects for a total of $352 million for urban, water, and energy sectors for the country. The four projects approved during 2012 were the following:
  - Additional financing for Northern Road Connectivity Project ($30 million from OCR and $68 million from ADF).
  - The Clean Energy and Network Efficiency Improvement Project ($100 million from OCR and $30 million from ADF).

- Greater Colombo Water and Wastewater Management Improvement Investment Program—Tranche 1 ($70 million OCR and $10 million from ADF).
- Additional Financing for Dry Zone Urban Water and Sanitation Project ($40 million from ADF).

- ***Portfolio performance***
  - Sri Lanka has received $5.6 billion for 164 public sector loans and $120.6 million for 256 TA projects since joining the ADB in 1966. As of December 31, 2012, there were 40 ongoing public sector loans and 11 grants for a total loan amount of $2.4 billion. Of the 40 loans, 14 loans were financed from OCR, 25 from the ADF, and one cofinance loan from OFID.
  - The ongoing portfolio primarily is for Transport, Urban & Water and Energy Sector and contributes to about 84 percent of the loan amount. ADB has been supporting the government's efforts in post-conflict reconstruction. The sector composition of the ongoing loan portfolio is in Figure 1.

Figure 1: Sectoral Distribution of the Active Loan Portfolio as of 31 December 2012



Source: Asian Development Bank management information systems.

Lending by the Asian Development Bank, 2007–12

(In millions of U.S. dollars)

	2008	2009	2010	2011	2012
Approvals	149.8	330	457	281.6	352
Net resource transfer	127	115	169	103	N/A
Disbursement	249	308	272	246	298

Source: Asian Development Bank.

STATISTICAL ISSUES

Data provision has some shortcomings, but is broadly adequate for surveillance. Most affected areas are national accounts and government finance statistics.

National accounts. The national accounts suffer from insufficient data sources and undeveloped statistical techniques. The country does not have periodic comprehensive benchmarks or a system of 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 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. Expenditure estimates are available only annually and rely mostly on commodity flow techniques. Whenever possible, estimates are validated and checked with other sources.

Price statistics. The Department of Census and Statistics (DCS) collects consumer prices for all of Sri Lanka, but no national index is computed. The DCS compiles the official consumer price index (CPI)—the Colombo Consumer Price Index (CCPI). This is compiled monthly; it covers households of all income groups, but is restricted to Colombo and its suburbs. The February 2013 STA mission discussed and demonstrated how to develop a weighting scheme to support the aggregation of prices collected from the 25 districts into regional indices and an "All Sri Lanka" index. Effective with the new CPI, index coverage will be expanded to include all households in the country. The mission also discussed recommendations to improve index calculation methods and the treatment of missing prices. The authorities welcomed the efforts to update and improve the CPI.

Government finance statistics. In May 2003, a STA mission 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 (beginning in end-2003) the budgetary classifications and the accounting structure to eventually match the *GFSM 2001* classifications of stocks and flows and to apply that chart of accounts to all general government units.

Further technical assistance in 2013, under the Japan Subaccount (JSA) Project, found that areas for improvement in the Sri Lankan fiscal and GFS systems were: (i) upgrading the authorities capacity for compiling GFS through TA and training programs; (ii) establishing sub-annual high frequency reporting of GFS for *International Financial Statistics* (*IFS*) ; (iii) expanding coverage of GFS to provincial and local governments; (iv) the compilation of financing and debt data in line with GFS balance sheet format; (v) sectorization of the public sector needs to be updated to ensure complete coverage of GFS and facilitate consolidation of general government GFS for high frequency reporting; and (vi) a review of the GFS mapping of the chart of accounts is needed to augment a number of steps that have been initiated by the Ministry of Finance and Planning to upgrade government accounting and reporting standards. These issues are to be addressed in a follow up mission in 2013 with additional missions in 2014 and 2015.

Monetary statistics. Foreign Currency Banking Units (FCBUs) are classified as resident institutions in the monetary survey since 1998. To adjust for the proportion of nonresident foreign currency deposits, which are actually held by residents (mainly returning migrant workers), 50 percent of these deposits are reclassified from foreign liabilities to domestic deposits.

In June 2003, a STA mission followed up on issues raised during the 2001 ROSC mission. In particular, the mission clarified the methodology for 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 other shortcomings.

Balance of payments. The CBSL publishes balance of payments statistics on a quarterly and annual basis. Quarterly data are available three months after the end of the quarter. The data largely follow the fifth edition of the *Balance of Payments Manual*.

The STA mission (December 2004) focused on shortcomings in the international transactions reporting system (ITRS)—the primary data source for the balance of payments. The mission recommended resolution of large values of unclassified transactions, inclusion of FCBUs in the data, and circulation of an instruction book to assist ITRS reporters to apply classifications and coding more accurately. The mission advised the authorities on the need to develop comprehensive surveys to implement their medium-term plan to introduce international investment position statistics. Currently, the FCBUs are included in the data, and work on compilation of international investment position has commenced.

Sri Lanka has been a participant in the General Data Dissemination System (GDDS) since July 2000. In February 2003, the authorities appointed a coordinator with the objective of subscribing to the Special Data Dissemination Standard (SDDS). Work is in progress toward meeting all SDDS requirements.

A data ROSC mission visited Sri Lanka in 2001. Most of its recommendations have been implemented, while others are expected to be implemented in the near future.

The authorities report key data to the Fund on a timely basis. On government finance, annual cash data were regularly reported for publication in the *GFS Yearbook.* These data cover only the budgetary accounts of central government; and no data on the extrabudgetary funds or the provincial and local governments are reported. At the same time, no sub-annual data are reported for publication in *IFS*. The authorities have been encouraged to reduce the time lag for data reporting. The authorities have not yet begun reporting data in the format of Standardized Report Forms, which were developed by STA for reporting monetary data and reflect principles for classifying positions by economic sector, financial instrument, and currency of denomination recommended in the *Monetary and Financial Statistics Manual*.

Sri Lanka: Table of Common Indicators Required for Surveillance

As of April 10, 2013

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]	Memorandum Items: Data Quality—Methodological Soundness[2]	Memorandum Items: Data Quality Accuracy and Reliability[3]
Exchange rates	Today	Today	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities[4]	4/8/2013	Today	M	M	M		
Reserve/base money	1/2013	3/2013	M	M	M	LO, LO, LO, LO	LO, O, O, NA, NA
Broad money	12/2012	2/2013	M	M	M		
Central bank balance sheet	12/2012	2/2013	M	M	M		
Consolidated balance sheet of the banking system	12/2012	2/2013	M	M	M		
Interest rates[5]	Today	Today	D	D	D		
Consumer price index (New Colombo CPI)	3/2013	4/2013	M	M	M	O, LNO, LO, O	O, LO, O, NA, NA
Revenue, expenditure, balance, and composition of financing[6]—general government[7]							
Revenue, expenditure, balance, and composition of financing[6]—central government[8]	12/2012	4/2013	M	M	M	O, O, O, O	LO, NA, LO, NA, LO
Stocks of central government and central government-guaranteed debt[9]	12/2012	4/2013	M	M	M		
External current account balance	2012Q4	4/2013	Q	Q	Q		
Exports and imports of goods and services	1/2013	4/2013	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, NA, LO
GDP/GNP	2012Q4	3/2013	Q	Q	Q	LO, LO, LNO, LNO	LNO, LNO, LO, NA, O
Gross external debt	2012Q4	4/2013	A	A	A		
International investment position[10]	NA	NA	NA	NA	Na		

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

[2] Reflects 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), not observed (NO), or not applicable (NA).

[3] Same as footnote 8, 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.

[4] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency, but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

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

[6] Foreign, domestic bank, and domestic nonbank financing.

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

[8] Central government revenue—latest observation: December 2012; date received: February 2013.[9] Including currency and maturity composition.

[10] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
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Public Information Notice (PIN) No. 13/49
FOR IMMEDIATE RELEASE
May 9, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation and Supports Proposal for Post-Program Monitoring with Sri Lanka

On May 1, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sri Lanka.[1]

Background

Sri Lanka has achieved notable progress on a number of economic fronts in recent years, although there have also been challenges. While slowing recently, growth has been generally robust, fiscal consolidation has taken place, and poverty and inequality have declined. Other aspects of Sri Lanka's development agenda, however, require continuing effort. The authorities are keen to broaden and deepen economic development, building on the achievements of the recently completed Stand-By Arrangement with the Fund. Safeguarding macroeconomic stability and launching a new phase of structural reforms would facilitate ambitious medium-term development goals.

Real growth slowed to 6.4 percent in 2012 as macroeconomic policies were tightened, spillovers from weak global growth undermined exports, and drought and subsequent floods adversely affected agriculture. Headline inflation hovered near double digits for most of the year following an upward shift due to exchange rate depreciation and higher food and administered prices, before easing in early 2013 due in large part to base effects. Core inflation trended upward, and inflation expectations and private sector wage demands rose. The current account deficit declined to around 6½ percent of GDP.

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[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The government's 2012 budget deficit is estimated to have fallen to about 6½ percent of GDP, above the budget's 6¼ percent target, due to expenditure restraint and payment arrears, while revenues were significantly lower than budgeted. The 2013 budget targets a 5.8 percent of GDP deficit. Losses at the state-owned energy companies rose to around 2 percent of GDP in 2012 despite significant domestic energy price increases, as drought induced a shift in electricity generation away from inexpensive hydroelectric to expensive thermal sources.

With inflation elevated and growth slowing, monetary policy is facing a challenging task. Policy was eased recently, but further stimulus should be on hold until inflation pressures decline. Financial soundness indicators are robust, and progress has been made in strengthening banking supervision, however rapid credit expansion in recent years justifies heightened vigilance for vulnerabilities.

Growth is projected at around 6¼ percent in 2013. A moderately contractionary budget and the lagged impact of tight monetary conditions and real wage compression should restrain domestic demand, while external demand is projected to remain tepid. Inflation pressures should moderate through the year, although headline inflation would be affected if domestic energy prices are increased further, and the current account deficit should narrow further. Near-term risks to the outlook are on the downside, and include revenue weakness, a weaker-than-anticipated global environment, and continued inflation pressures.

Executive Board Assessment

Executive Directors commended the authorities for prudent policy implementation, which, supported by the Stand-By Arrangement concluded last year, has facilitated the achievement of robust growth and poverty reduction in a difficult environment. The near-term outlook presents challenges, including slower growth and elevated inflation. Directors emphasized that a new phase of reforms is needed to ensure a sustainable fiscal position, achieve low and stable inflation, safeguard financial stability, and support high and inclusive growth over the medium term.

Directors welcomed the authorities' continued efforts toward fiscal consolidation, particularly on recurrent spending, given a high public debt ratio, and supported the goal of reducing the budget deficit while clearing expenditure arrears. However, they noted that revenues have fallen to very low levels, placing the burden of adjustment on expenditure, notably capital spending. To enhance space for infrastructure and critical social spending, Directors stressed the need to broaden the revenue base and improve tax administration, including by extending the VAT fully to the retail and wholesale sectors, reforming the refund system, and revising tax holidays and exemptions. Directors further underscored the need to put state-owned energy enterprises on a sound financial footing. They noted that the recent electricity price hike should help reduce losses, and advised adopting an automatic price adjustment mechanism, complemented by targeted social protection safeguards. Recent efforts to strengthen public financial management will support the overall fiscal consolidation strategy.

With rising wage and cost pressures, Directors cautioned against a further easing of monetary policy in the near term. Exchange rate flexibility should be maintained to cushion external shocks, while deeper markets and a gradual move toward a flexible inflation targeting regime would strengthen inflation control. Directors noted that international reserves are relatively low by most metrics, and encouraged strengthening the reserve position as circumstances permit. They cautioned that government guarantees for foreign currency borrowing by banks, if introduced, could undermine exchange rate flexibility, create contingent liabilities, and raise debt sustainability risks.

Directors concurred that the banking system appears sound and welcomed the progress in strengthening financial sector supervision and regulation. They called for vigilance following recent high credit growth and encouraged the authorities to draw on the recommendations of the updated Financial Stability Assessment Program to bolster financial stability further.

Directors noted the long-term deterioration of the export-to-GDP ratio and growing reliance on debt for current account deficit financing. They encouraged the authorities to boost competitiveness, including through strengthening trade, expanding infrastructure, and further improvements in the business climate to attract foreign direct investment. Directors supported the proposal for post-program monitoring.

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, 2009–15

	2009	2010	2011	2012	2013	2014	2015
				Prel.		Proj.	
GDP and inflation (in percent)							
Real GDP growth	3.5	8.0	8.2	6.4	6.3	6.8	6.5
Inflation (average)	3.5	6.2	6.7	7.5	7.9	7.1	6.8
Inflation (end-of-period)	5.0	6.8	4.9	9.2	7.9	6.7	6.5
Core inflation (end-of-period)	5.9	8.9	4.7	7.5	7.0	6.7	6.5
Public finances (in percent of GDP)							
Revenue 1/	14.5	14.6	14.3	13.0	13.2	13.7	14.1
Grants 1/	0.5	0.3	0.2	0.2	0.2	0.2	0.2
Expenditure 1/	24.9	22.8	21.4	19.7	19.3	19.3	19.3
Central government balance 1/	-9.9	-8.0	-6.9	-6.4	-5.8	-5.4	-5.0
Consolidated government balance 1/	-10.3	-8.4	-8.6	-8.6	-7.0	-6.1	-5.4
Central government domestic financing	5.1	4.5	4.0	4.1	4.4	3.6	3.3
Government debt (domestic and external)	86.1	81.9	78.4	80.2	79.9	78.0	75.8
Money and credit (percent change, end of period)							
Reserve money	13.1	18.8	21.9	10.2	16.0	14.8	14.5
Broad money	18.6	15.8	19.1	17.6	15.5	15.5	15.5
Domestic credit	0.5	18.6	34.3	21.7	17.3	15.2	14.8
Private sector credit	-5.8	24.9	34.5	17.6	17.0	18.7	18.6
Public sector credit	13.3	8.2	33.7	29.6	17.8	9.0	7.6
Balance of payments (in millions of U.S. dollars)							
Exports	7,085	8,626	10,559	9,774	10,317	10,995	11,804
Imports	-10,207	-13,451	-20,269	-19,183	-20,269	-21,669	-23,096
Current account balance	-214	-1,075	-4,615	-3,915	-3,700	-3,735	-3,791
Current account balance (in percent of GDP)	-0.5	-2.2	-7.8	-6.6	-5.7	-5.3	-4.9
Export value growth	-12.6	21.7	22.4	-7.4	5.6	6.6	7.4
Import value growth	-27.6	31.8	50.7	-5.4	5.7	6.9	6.6
Gross official reserves (end of period) 2/							
In millions of U.S. dollars	4,897	6,410	5,758	6,677	6,964	6,798	7,095
In months of imports	3.9	3.5	3.2	3.5	3.4	3.1	3.0
External debt (public and private)							
In billions of U.S. dollars	20.9	24.8	29.4	33.7	35.7	37.8	40.3
As a percent of GDP	49.7	50.1	49.8	56.7	54.8	53.7	52.5

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

1/ The budget presentation now places grants above the line according to standard practice. Previously grants were classified below the line as a budget deficit financing item. The consolidated government balance includes the Ceylon Electricity Board assumed to be cleared in 2013.

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

Statement by the IMF Staff Representative on Sri Lanka
April 26, 2013

This statement contains information that has become available since the staff report was circulated to the Executive Board. This information does not alter the thrust of the staff appraisal.

1. **The Monetary Board of the Central Bank of Sri Lanka kept policy rates unchanged at its April 12 meeting.** The policy rate corridor remains at 7½–9½ percent. Growth of broad money and credit to the private sector continued to moderate to 17 percent and 13¼ percent year-on-year, respectively, in February.

2. **The Bank of Ceylon, a state-owned bank, issued a US$500 million five-year bond with a 5.325 percent coupon.** The issue was six times oversubscribed and upsized from an initially planned offer of US$300 million. There were no government guarantees. Fitch rated the issue at BB-. The yield was substantially lower than a similar bond issued a year ago at 6.875 percent.

3. **The Public Utilities Commission approved a new electricity tariff structure with effect from April 20.** Electricity costs increased on average by around 35 percent and the tariff calculation methodology was revised. The cost structure remains progressive, although the effective increase was greater for small consumers than for large consumers. The increase is estimated to contribute to reducing the combined losses of the state-owned energy companies by around one percentage point of GDP in 2013. The first-round impact on the consumer price index is estimated at around 1¾ percentage points.

Statement by Rakesh Mohan, Executive Director and K.D. Ranasinghe, Alternate Executive Director for Sri Lanka
April 26, 2013

1. Our Sri Lankan authorities are appreciative of the constructive discussions they had in Colombo with the staff mission and of the resulting comprehensive assessment of the economy and reports produced. They would like to thank the Management, Executive Board and staff for the continued productive engagement with Sri Lanka.

2. Despite deepening global uncertainties, a significant economic transformation is taking place in Sri Lanka, benefiting from post-conflict optimism, political stability, infrastructure development and implementation of reforms. These developments have benefitted from the support provided by the IMF-SBA, which was successfully concluded in July 2012.

Recent Economic Developments

3. The Sri Lankan economy grew at a commendable rate of 6.4 percent in 2012, following over 8 percent growth in the preceding two years. This moderation of growth in 2012 was largely attributable to subdued external demand, tightened domestic policies and the adverse weather conditions that impacted on agricultural production and hydropower generation. The severe drought in the second and third quarters of 2012 limited agriculture sector growth to 5.8 percent, while services sector growth moderated to 4.6 percent, mainly due to lower domestic and external demand. The industry sector performed well in 2012 largely supported by the thriving construction sector.

4. The government's development strategy focuses mainly on the development of 5 thrust areas namely, maritime, energy, aviation, knowledge and commercial sectors, in addition to the tourism sector. Significant expansion of productive capacity has been enabled by massive development of infrastructure, accompanied by increased savings and investment. Major infrastructure development projects, which have already been completed or nearing completion include 3 new sea ports, several fishery harbors, a new international airport, power plants, new roads and irrigation schemes. With the enhancement of domestic demand, along with the expected improvement in external demand, our authorities are confident that the economy would return to the high growth trajectory of 7.5 – 8.0 percent in the medium term. In terms of the World Bank's Doing Business Survey 2013, Sri Lanka has ranked at 81, showing a significant improvement from 89 in the previous year. The gross investment /GDP ratio exceeded 30 percent in 2012, after remaining below 30 percent levels for the last 3 decades. Reflecting the greater emphasis placed on regional development and inclusive growth, the disparity between the provinces is gradually narrowing. As a result the overall poverty level has declined from 15.2 percent in 2006/07 to 8.9 percent in 2010, with a rapid decline in rural poverty. With continued economic expansion, the unemployment rate declined further to 4.0 per cent in 2012.

Fiscal Policy

5. As highlighted by the staff report, fiscal consolidation remains challenging, mainly due to some underperformance of revenue, although significant progress has been made in recent years. Our authorities' steadfast efforts towards fiscal consolidation resulted in containing the fiscal deficit to 6.4 percent of GDP in 2012, falling from 9.9 percent in 2009 and 6.9 percent in 2011, but slightly higher than the targeted 6.2 percent for 2012. Comprehensive tax reforms were introduced in 2010 and 2011 to simplify the tax structure and broad base the tax system, under which corporate income tax was brought down from 35 percent to 28 percent; the VAT rate was unified at 12 percent; and certain other taxes were abolished. This reform is, however, yet to generate the desired outcome of enhanced revenues. To some extent, the drop in revenue was offset by the containment of recurrent expenditure, which declined from 18.2 percent in 2009 to 14.4 percent of GDP in 2012. This mainly reflected savings on account of salaries and wages, interest payments, and transfers and subsidies. The government was able to maintain public investment above 6 percent of GDP in recent years, although it declined to below 6 percent in 2012, mainly due to time slicing of capital expenditure in the face of reduction in revenue. Going forward, our authorities have targeted to reduce the fiscal deficit to 5.8 percent of GDP in 2013 and below 5 percent by 2016. Revenue is projected to increase to 15.3 percent of GDP by 2016.

6. Recent tax reforms were mainly focused on creating an enabling environment for investment. Tax incentives were realigned under the Inland Revenue Act and Strategic Investment Law to expedite the approval process and to rationalize tax incentives. Our authorities are aware of the vital need for further broadening the tax base. Steps have already been taken to bringing the wholesale and retail sectors under the VAT system. The government has placed greater emphasis on improving the tax administration to improve compliance and revenue collection. A Tax Appeals Commission and a Tax Interpretation Committee have been set up recently. Paying taxes on a self-assessment basis and making tax payments online have also been introduced with a view to promote tax compliance and timely filing of tax returns.

7. The government debt to GDP ratio, which has consistently declined from 105.6 percent in 2002, increased slightly from 78.5 percent in 2011 to 79.1 percent in 2012, largely reflecting the impact of rupee depreciation. With continued fiscal consolidation, our authorities have projected that the debt to GDP ratio would come down to around 65 percent by 2016.

Monetary and Exchange Rate Policies

8. Inflation has been maintained at single digit levels continuously since 2009, despite adverse domestic and external supply side shocks. The year-on-year headline inflation recorded at 2.7 percent in February 2012 increased to 9.2 percent by end 2012, mainly reflecting the upward adjustments in energy prices, supply disruptions due to adverse weather conditions, the pass-through of the rupee depreciation, as well as demand pressures. Inflation has moderated somewhat to 7.5 percent in March 2013 and

further deceleration is expected in coming months. The Central Bank's "Road Map: Monetary and Financial Sector Policies for 2013 and Beyond" assures the commitment of the authorities to maintain inflation, particularly core inflation, at mid single digit levels.

9. In response to tight policy measures adopted at the beginning of the year, credit growth decelerated rapidly to 17.6 percent by end 2012 from 34.5 percent in the previous year. Reserve money and money supply growth also decelerated to 10.2 percent and 17.6 percent, respectively, in 2012. These developments provided space for the Central Bank to ease monetary policy by reducing policy rates by 25 bps in December 2012. The benign inflationary outlook and existing output gap, if continued, would provide further space to ease the monetary policy.

10. Our authorities have been taking necessary steps to move towards a flexible inflation targeting framework in the medium term. Even under the current monetary targeting framework, inflation is implicitly targeted, and the Central Bank's desire to maintain inflation at mid-single digit level is well communicated to the public. Our authorities have already taken the required steps to lengthen the current one week reserve maintenance period to two weeks commencing June 2013, thereby allowing greater flexibility for banks in managing their day-to-day liquidity. At the same time, among other measures, the Central Bank commenced conducting regular term auctions to address structural liquidity.

11. Greater flexibility has been allowed in the exchange rate since early February 2012, by limiting the Central Bank's intervention in the domestic foreign exchange market. The intervention of the Central Bank during 2012 was limited only to the extent needed to settle a portion of petroleum import bills, mainly during the first few months of the year, while surplus foreign exchange liquidity in the market was absorbed as and when appropriate. The rupee depreciated vis-á-vis the US dollar by 10.4 per cent during 2012. Building on successful completion of the SBA, external buffers were further strengthened in 2012. External reserves increased to US dollars 6.9 billion by end 2012 from US dollars 6 billion at end 2011. In terms of months of imports, gross official reserves were equivalent to 4.3 months by end 2012, a significant improvement from 3.5 months at end 2011.The limits on net open positions (NOP) and forward transactions of commercial banks were relaxed in January 2013. It has been noted that even at the current limits, the utilized amount of NOP is much lower, suggesting that the NOP limit does not constrain forex market activity.

Financial System Stability

12. Despite challenging global and domestic market conditions, overall soundness of the financial sector improved with higher levels of capital, adequate liquidity buffers, and healthy earnings. This has been enabled by enhanced supervisory and regulatory frameworks and integrated risk management arrangements. Further, public confidence in the financial system improved with financial safety net mechanisms, including mandatory deposit insurance and consumer protection measures in place. Obligations of customers and banks were published in the form of a customer charter. The access to finance increased

with the extension of branch networks, in particular in the regional areas. Continuous close supervision and timely guidance helped sustaining the credit quality amidst sharp credit growth. Given the current NPL ratio of 4.2 percent, the stress test scenario in the FSAP report, showing an increase of industry-wide NPL ratio to 23 percent, is a highly improbable extreme event and may lead to erroneous interpretation.

13. The recent FSAP report contains some recommendations, which had already been identified by our authorities for implementation. Our authorities are taking steps to implement such recommendations at an appropriate pace. Steps have been taken to harmonize the regulatory framework of non-banks with banks and several regulations have already been issued in this regard. The Insurance Board of Sri Lanka (IBSL) has already commenced two projects with TA from the World Bank to improve insurance sector supervision, which is scheduled to be commenced in the 2nd quarter of 2013. A draft bill for a supervisory framework for pension funds has been drafted. Our authorities have, however, clearly indicated that certain other impractical recommendations in the FSAP report will not be implemented.

Structural Reforms

14. Our authorities recognize the urgent need of addressing financial difficulties of key state owned enterprises, mainly Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB). While measures are being taken to improve operational efficiency and financial management, the government has already allowed considerable upward adjustment of energy prices both in 2012 and 2013. This politically sensitive and bold decision to make the necessary upward adjustments of energy prices reflects authorities' commitment to improve financial viability of these entities. Accordingly, the prices of petroleum products were raised by 37 – 51 percent in February 2012 and further adjustments were made in December 2012. Moreover, the sale of heavy fuels to CEB at below cost price, a major source of CPC losses, was discontinued from April 2013. With respect to CEB, a substantial tariff increase of around 35 percent was implemented from April 20, 2013, in addition to the fuel adjustment charge (FAC) ranging between 25-40 percent of the monthly bill implemented from February 2012. With the commissioning of the low cost 600 MW coal power plant in 2014, it is expected that these entities will reach breakeven level by end 2014.

Strengthening Trade and Broadening Growth

15. Sri Lanka has one of the most open and least protective trade regimes in the region in terms of tariff and non-tariff barriers as Sri Lanka commenced liberalization of external trade since 1977, well before other countries in the region. Therefore, our authorities do not agree with the staff view that Sri Lanka is moving towards a more protectionist tariff regime. In the recent few years, import duties for very few agricultural products have been changed to maintain stable domestic prices for farmers, especially in the Northern and Eastern Province after the end of the conflict as a large extent of fertile land was opened for cultivation. Hence, import duties on certain agricultural items are increased during the harvesting season and reduced during the off-season, so that prices

remain stable throughout the year for farmers and consumers. This cannot be considered as a protectionism measure and in fact this should be encouraged from food security point of view. Further, the total import value of such items was less than 2 percent of total imports in 2012.

16. The rapid development of infrastructure, improvements to the business climate, fiscal incentives, improved access to finance and relaxation of capital account transactions, will help to increase export oriented investments. At the same time, our authorities have recognized that Sri Lanka has an enormous potential to substantially increase services exports as witnessed in recent years in the areas of tourism, ports, aviation and ICT and BPO. Net services income in the BOP has increased 3 fold since 2008. Actual FDI inflows have also increased to record levels in recent years, although they are below the authorities' ambitious targets, mainly due to current global situation.

Conclusion

17. Our authorities are committed to further strengthening macroeconomic stability and building buffers to improve resilience. Supported by continued post conflict optimism, infrastructure development, improved business climate, political stability and appropriate policy, Sri Lanka's economy is expected to return to a high growth trajectory, though conditional on recovery in external demand. Being committed to fiscal consolidation, the government will take appropriate measures to strengthen the revenue base and improve Public Financial Management Reforms, with help from the Fund's TA programme. The substantial adjustment in energy prices and reforms to enhance operational and financial management of key State Owned Enterprises (SOEs) will help to improve their financial viability and reduce possible burden on the budget and the banking system. A TA team from the Fund is presently in Sri Lanka for consultations on SOE Governance. Our authorities support the proposed PPM and acknowledge the fruitful engagement with the Fund and look forward to strengthening the cooperation.