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SRI LANKA

September 2014

2014 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSION—STAFF REPORT; PRESS RELEASE

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 2014 Article IV consultation with Sri Lanka, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on May 30, 2014, 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 July 9, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Press Release** summarizing the staff report.

The following document has been or will be separately released.

Selected Issues Paper

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

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STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSION

July 9, 2014

KEY ISSUES

Context. Macroeconomic performance has generally exceeded expectations. Real GDP grew 7.3 percent for 2013, up from 6.3 percent in 2012. Inflation declined to below 5 percent, and the external current account balance has improved. Private credit growth has been slow, however, a number of financial sector indicators have deteriorated.

Outlook and Risks. Growth is expected to remain robust at 7 percent and inflation to remain in the mid-single digits. The external current account should improve marginally, allowing for further accumulation of foreign exchange reserves. Near-term risks appear moderate, although there may be some bumps in the road from market turbulence and climatic events. Medium-term risks relate to the potential for tighter external liquidity, the challenge of further fiscal and debt consolidation while maintaining high levels of investment in infrastructure and human capital, maintaining a balanced monetary policy, and staying competitive in a shifting economic landscape.

Key Policy Recommendations.

- Fiscal consolidation and debt reduction need to continue, but the burden of adjustment needs to shift decisively to revenue generation. Debt targets could potentially be recast to achieve deeper reduction over a longer period.

- Monetary policy needs to maintain a balance between supporting growth and containing inflation. A continued forward-looking approach is needed given long lags in monetary transmission.

- Financial sector consolidation could lead to economies of scale, greater resilience, and more effective supervision, but corporate governance needs to continue to improve, and careful supervision in the post-consolidation period will be key.

- Maintaining competitiveness and achieving a more sustainable external position will require a mix of continued innovation, sustained investment in infrastructure and human capital, a predictable business environment, and ideally a heavier emphasis on direct investment and equity portfolio flows than debt.

Approved By
Jerald Schiff and Dhaneshwar Ghura

Discussions took place in Colombo May 20–30, 2014. The staff team comprised T. Schneider (Head), J. Jonas, M. Ghazanchyan (all APD), C. Lundgren (SPR), and E. Kvintradze (Resident Representative), and R. Wijeweera (local economist). M. Inoue, S. Boyce, and Q. Zhang also assisted in preparation of this report.

CONTENTS

CONTEXT

1. **Sri Lanka has made notable advances in recent years, and appears to be on its way to joining the ranks of upper middle income countries**. Per capita GDP has increased from US$869 in 2000 to US$3,256 in 2013, and there appears to be an ongoing shift toward higher value added industrial production, as well as rapid expansion of services. The years following the end of civil conflict in 2009 have seen an acceleration of activity. Overall real GDP growth has risen (albeit sometimes on the back of unsustainable booms in credit and consumption), and new areas of economic activity (tourism and transport, IT, and other services) have emerged. Inflation has also come down—from an average of 12.6 percent during 2001–08, to mid-single digits. Infrastructure has also visibly improved. Vulnerabilities have generally moderated with stronger economic performance and a commitment to fiscal consolidation. Nonetheless, public debt and debt service remain high by international comparison, reserves are limited, tax revenues are low, and medium-term sustainability depends heavily on continued growth and a positive external environment.

2. **Notable gains have been made in poverty reduction, and the government has made a public commitment to inclusive growth and development**. The national poverty headcount ratio declined from 8.9 percent in 2009/10 to 6.7 percent in 2012/13. Also, poverty headcount has significantly declined on a $2 and $1.25 scale from 29.1 (7.0) to 23.9 (4.1) percent, respectively within the last two surveys. Regionally, poverty headcount ratios were lower in 18 districts and higher in 4 districts in 2012/13 compared with 2009/10. Available data suggest a gradual decrease in inequality at national and most provincial levels with the Gini coefficient decreasing from 0.49 in 2009/10 to 0.47 in 2012/13. The lowest ratio is in the North-Central and Sabaragamuwa provinces of Sri Lanka and highest in the North and North-Western provinces of the country. The government espouses an inclusive development strategy[1] that focuses on six pillars: (i) macroeconomic stability; (ii) spatial transformation (creating economic links through improved infrastructure; (iii) human resources development; (iv) rural-centric development; (v) resilience to climate and external shocks; and (vi) five hubs of development (knowledge, shipping, energy, aviation and commercial hubs.

Sri Lanka. Poverty and Social Indicators

	1996	2002	2006	2010	2012
Poverty headcount ratios (% of population)					
At $2 a day (PPP)	46.7	39.7	29.1	23.9	n.a
At $1.25 a day (PPP)	16.3	14.0	7.0	4.1	n.a
At national poverty line	5.3	4.3	3.0	1.8	n.a
GDP per capita, current US$	758	904	1,614	2,400	2,923
At national poverty line	28.8	22.7	15.2	8.9	6.7
Population	18.3	18.9	19.9	20.7	20.3
Employment in industry (% of total employment)	22.4	22.4	26.6	24.2	26.3
Unemployment' total (% of total labor force)	11.3	8.8	6.5	4.9	4.0

Source: World Bank; HIES.

Sri Lanka. Income Inequality by Province, 2006/07, 2009/10 and 2012/13

	Gini coefficient, per capita		
Province	2006/07	2009/10	2012/13
Sri Lanka, national	0.49	0.49	0.47
Western	0.49	0.48	0.47
Southern	0.43	0.42	0.45
Sabaragamuwa	0.47	0.51	0.39
Central	0.48	0.48	0.40
Uva	0.47	0.46	0.50
Eastern	0.42	0.41	0.40
North-Western	0.47	0.54	0.52
North-Central	0.44	0.44	0.39
Northern	n.a.	0.41	0.52
Sri Lanka, national, expenditure	0.40	0.38	0.39

Source: HIES, 2006/07 2009/10, 2012/13.

[1] The government's development strategy is published in the Annual Report of the 2013 Ministry of Finance and Planning, released in May 2014.

3. Political context and medium-term vision. President Rajapaksa is in his second term of office, having been first elected to the presidency in 2005. Presidential elections are expected in 2015. The President's second five-year plan (from 2010–15) aims to raise per capita income to US$4,000 by 2016 and to reach real GDP growth of 8 percent or more. Sustaining the current momentum of development and growth will require a continued focus on macroeconomic stability, high and sustained investment in infrastructure and human capital, and continued progress in fiscal consolidation and debt reduction.

4. Policy consistency with staff advice. The direction of the authorities' macroeconomic policies since the 2013 Article IV Consultation has been broadly in line with past staff advice. Progress was made on fiscal policy but in some areas more gradually than advocated by staff. The government has implemented a number of recommendations made by the Presidential Tax Commission (which was complemented by IMF technical assistance). Importantly, fuel and electricity tariffs were adjusted in 2013, and measures taken to put the state-owned Ceylon Electricity Board (CEB), and the Ceylon Petroleum Corporation (CPC) on a more commercial footing and eliminate their financial losses. Also in 2013, the VAT was extended to the wholesale and retail level. In line with staff advice and the authorities' medium-term objectives, the 2014 budget targeted a further reduction of the deficit. The VAT threshold at the retail level was also lowered from Rs 500 million to 250 million in quarterly turnover to broaden the tax base. Ongoing work, with support of IMF TA, focuses on introducing a formal system for the collection, analyzing, and reporting of commitment data. Reform of tax holidays and exemptions remains a key objective. On monetary policy, the authorities moved to a more aggressive easing than recommended by staff, but with no adverse affects given low private credit growth.

RECENT DEVELOPMENTS AND OUTLOOK

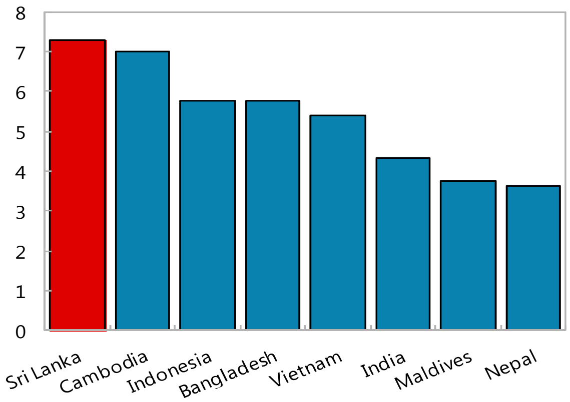
A. Recent Economic Performance

5. Growth and inflation. Sri Lanka's economic growth has been among the fastest in Asia's frontier and developing economies in recent years, albeit somewhat volatile. After falling to 6.3 percent in 2012, real GDP growth accelerated to 7.3 percent in 2013—driven primarily by a pickup in services activity, and supported by manufacturing and construction, but also benefiting from an increase in net exports. Price pressures meanwhile remained moderate, with headline and core inflation reaching 4.7 and 2.1 percent, respectively—the fifth consecutive year of single digit inflation and a marked contrast to the average of 12 percent headline inflation in 2001–08. Lower food prices played a key role in lowering the overall CPI to below 5 percent in 2013, but demand side pressures were also contained.[2] Headline inflation declined further to 3.2 percent year-on-year in May 2014, even while first quarter growth came in at a robust 7.6 percent.

[2] The mission questioned the consistency of high levels of growth with low inflation, weak credit demand, and reduced import of investment goods. The authorities saw the picture as broadly coherent, but reflecting structural change. Lower food prices reflect, inter alia, improved transport infrastructure. Moderate private credit growth partly

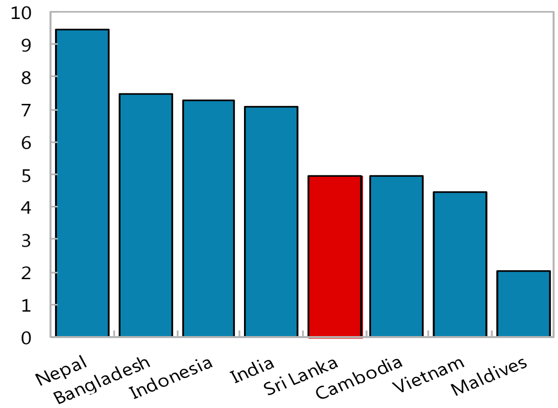
(continued)

2013 Real GDP Growth
(In percent)



Sources: IMF staff calculations (WEO)

April 2014: Headline Inflation
(In yoy percent change)



Sources: APDCORE Database

6. External Accounts. Sri Lanka's external position strengthened in 2013 and into 2014, as exports gained ground and imports remained subdued. The current account deficit improved from 6.7 percent of GDP in 2012 to 3.9 percent in 2013. On the export side, recovery in advanced economies (Sri Lanka's main export markets) helped boost exports in the second half of 2013 and into 2014. Foreign exchange receipts from services (particularly tourism) have also risen steadily, and net remittances are now equivalent to 8.4 percent of GDP, compared with 6.4 percent a decade earlier. At the same time, imports decreased by 6.2 percent. A fall in oil and fuel shipments (reflecting a favorable monsoon and increased hydropower production) contributed over half of the overall decline in 2013, but intermediate and investment goods also dropped.[3] The stronger external position and issuance of new external debt enabled the Central Bank of Sri Lanka to accumulate additional foreign exchange reserves, and the rupee has been virtually stable in nominal terms vis-à-vis the U.S. dollar since the end of October 2013.

7. Fiscal Position. During 2013, tax revenue fell almost 1.5 percent of GDP short of the budget target. However, as in previous years, tight spending control allowed fiscal consolidation to continue. With current and capital spending cuts, the government came close to meeting its budget deficit target of 5.8 percent of GDP. First quarter revenue data suggest that reforms implemented in 2013-14 (extending VAT coverage, lowering the threshold, broadening the base) and aided by a pick-up in imports, may finally be yielding some results. However, achieving the FY 2014 deficit

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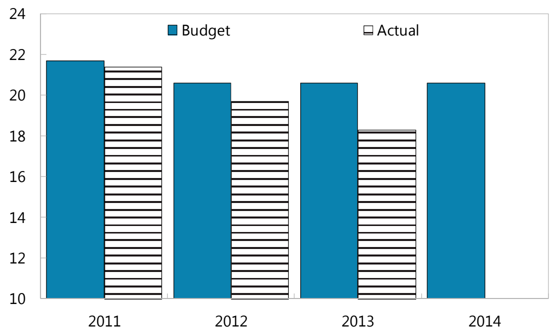
reflects the aftermath of a credit boom, as well as increased use of corporate debentures; and the fall in import of intermediate and investment goods captures rising domestic production of such products and backward linkages.

[3] The mission followed up on a cash margin requirement for letters of credit for vehicles, which was identified (at the time of the first Post Program Monitoring consultation in November 2013) as an exchange restriction inconsistent with Sri Lanka's obligations under Article VIII, Section 2a of the Fund's Articles. The authorities provided staff with a copy of the Circular withdrawing the cash margin requirement effective January 2, 2014 and, based on this, staff has found that the exchange restriction has been eliminated. No other changes have been introduced to the foreign exchange system that could give rise to restrictions on the making of payments and transfers for current international transactions or multiple currency practices.

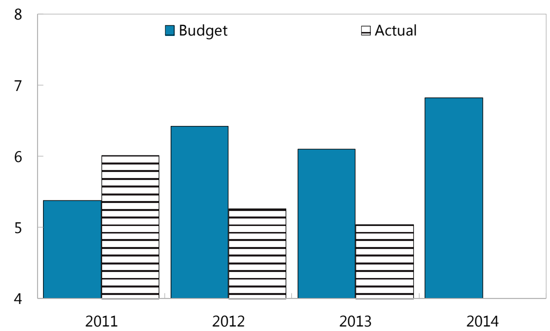
target of 5.2 percent of GDP will be challenging given the ambitious year-end target for revenues (an increase of 26 percent— a significant acceleration compared to previous years), and continued tight spending control will likely be needed.

Total Government Expenditures, 2011-2014
(Percent of GDP)



Sources: Ministry of Finance and Planning, staff calculations

Government Capital Expenditures, 2011-2014
(Percent of GDP)



Sources: Ministry of Finance and Planning, staff calculations

8. The banking system remains well capitalized, but a number of financial soundness indicators have deteriorated. Nonperforming loans (NPLs) rose from 3.7 percent of total loans at end-2012 to 5.6 percent by end-2013, and the sector saw profits decline by 10 percent. Net interest margins have declined, reflecting high-cost term deposits, slow credit growth, and an increase in low yielding assets. The rise in nonperforming assets appears most closely linked to gold pawning activity (which accounts for a significant share of assets in most banks) and the sharp drop in gold prices in 2013.[4] In this context, the CBSL has announced a credit guarantee scheme to foster a resumption of credit growth.[5] The CBSL announced in January 2014 a financial sector consolidation plan to reduce the number of nonbank financial institutions and create larger banks.

B. Outlook and Risks

9. The short-term outlook appears broadly positive, as Sri Lanka is well positioned to benefit from the global economic recovery and particularly stronger growth in advanced economies. Staff's medium-term projections, which are anchored around a potential output level of 6.5 percent, a modest level of inflation, continued public and private investment, and a maintenance of sound macroeconomic policies, suggest gradual improvement in incomes and a reduction of key vulnerabilities (most notably, a lower budget deficit, a reduction in public debt, and a shrinking external current account deficit). The framework is sensitive to assumptions on growth, however, and the authorities' medium-term outlook (which targets real GDP growth of more than 8 percent) projects a more rapid improvement in key macroeconomic balances. The mission discussed with the

[4] Total NPLs increased by Rs74 billion in 2013, of which Rs 56 billion (76 percent) were linked to gold pawning. For additional information on gold pawning activity, see EBS/13/140).

[5] The CBSL aims to increase loan-to-value ratios to a maximum of 80 percent (from 65 percent) and cap interest rates at 16 percent per year. This is part of a broader goal to support economic activity in agriculture and small and medium enterprises (SMEs)—the primary sectors that have historically taken advantage of pawning advances.

authorities differing views on the medium-term framework, which rest in large part on estimates of potential output (which in turn rely on key assumptions regarding the economic gain from reintegration of Northern and Eastern provinces, and the effects of structural transformation and development). It was agreed that IMF and CBSL staff would collaborate on potential output, with a view to reconciling estimates.

10. Near-term risks appear moderate given the ongoing recovery of advanced economies and a relatively benign outlook for international commodity prices. Adverse climatic events (such as the recent drought) remain a constant source of vulnerability, but the impact of such events on power generation and the balance of payments may be lessened by the introduction of coal-based electricity generation. Medium-term risks remain centered on the potential for slower-than-projected growth in the advanced economies, tighter external liquidity conditions and chronic turbulence in international capital markets (negatively affecting rollovers and borrowing costs), and continued weakness in government revenues (which would threaten fiscal and debt consolidation objectives and potentially undermine confidence).

Sri Lanka Risk Assessment Matrix[6]

Source of Risk	Likelihood	Expected Impact on Economy	Policy Response
		Potential Domestic Shocks	
Continued drought	*Medium*	**M-L**: Adverse impact on agriculture output, increased costs of energy production, higher oil imports.	Raise electricity tariffs, increase efficiency and lower electricity generation costs, allow exchange rate flexibility, and ensure open market for food imports.
Tax revenues fail to strengthen as planned	*High*	**H**: Pressure to cut spending to reach deficit target, including capital spending, with possible adverse impact on growth.	Accelerate reforms on revenue administration and broadening tax base, reduce tax exemptions.
GDP growth momentum fades	*Medium*	**H**: Could induce excessively stimulative macro policies and risk higher inflation and external imbalances.	Avoid loose macro policies; concentrate on structural reforms to promote domestic and foreign investment.
Increased private and quasi private debt, without parallel increase in foreign exchange earnings.	*Medium*	**M**: Increased external indebtness and vulnerability to external shocks.	Monitor closely the volume and terms of external borrowing by private and quasi private entities.
		Potential External Shocks	
Surges in global financial market volatility	*High*	**M**: Increased borrowing costs and more difficult rollover of maturing debt, with adverse impact on fiscal consolidation and external position.	Strengthen macro fiscal fundamentals and allow exchange rate flexibility.
Protracted period of slower growth in advanced and emerging markets	*High*	**H**: Slower-than-projected pickup in exports to the EU and the United States, weaker trade balance and growth.	Limited room for fiscal stimulus. Diversify exports markets, support increased value added production.

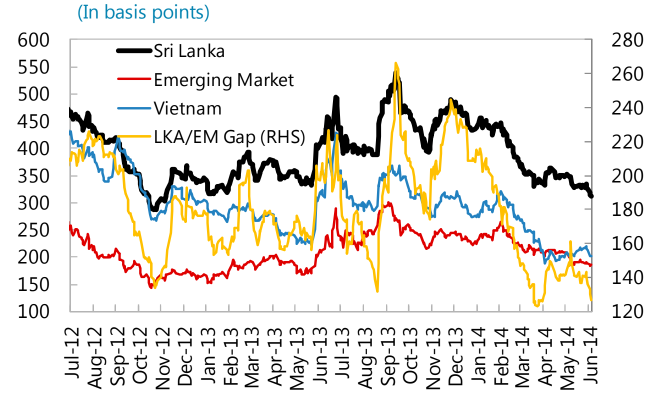
[6] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

11. The authorities recognized potential vulnerabilities as highlighted by staff, but noted that such risks had been part of the backdrop in planning macroeconomic and structural reform strategies. On external risks, they highlighted measures (such as the cap on non-resident holdings of government securities) that had limited foreign exchange inflows during the boom period in international capital markets—limiting Sri Lanka's exposure to market turbulence over the past year. Slower growth in advanced economies is a chronic risk, but Sri Lanka is seeking to diversify economic ties (a free trade agreement with China is being examined). With respect to domestic risks, climatic shocks remain a potential source of vulnerability. However, the impact of drought on power generation has, in the authorities' view, at least been mitigated by new coal-powered thermal energy stations. Sri Lanka has also agreed on a $110 million development policy credit with the World Bank to bolster resilience to climatic shocks. The authorities were confident, that ongoing reforms would bring a recovery in revenues, and that growth momentum would continue. The authorities also reassured staff that new external borrowings by commercial banks and other entities will add to Sri Lanka's growth capacity, but agreed that such exposure should be limited.

C. Debt Sustainability

12. Sri Lanka's public debt sustainability assessment indicates high risks but a sustainable debt trajectory (see DSA supplement). The debt burden benchmark of 70 percent of GDP and gross financing need benchmark of 15 percent of GDP are exceeded in the baseline and in all shock scenarios. This contrasts with a benign market assessment (bond spreads are within the 200–600 point range of lower and upper risk benchmark). Positive market sentiment reflects: (i) sustained fiscal adjustment and falling debt ratio; (ii) favorable global environment (iii) credible commitment to further deficit and debt reduction in the future; (iv) lengthening of average debt maturity; and (v) limited nonresident holding of government debt in domestic currency which contributed to Sri Lanka's resilience during market turbulence. The DSA also illustrates the critical contribution of growth to recent and projected declines in the debt ratio. Slower-than-projected growth (alone or combined with a higher primary deficit and higher borrowing costs) could stop or reverse the fall in the public debt ratio. The high share of foreign currency denominated debt also creates a vulnerability to currency depreciation.

EMBI Global Sovereign Spreads
(In basis points)



Source: APDCORE Database.

POLICY DISCUSSIONS

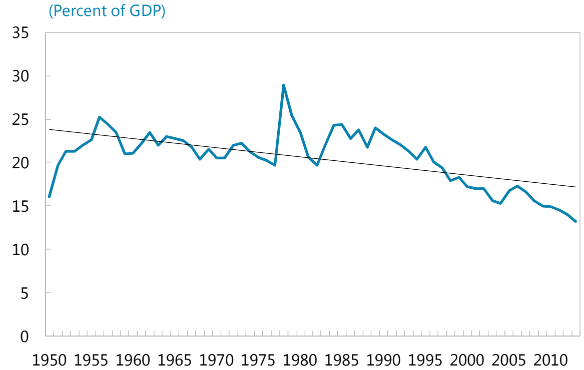
With the above risks in mind, staff discussed with the authorities ways to enhance resilience and further reduce macroeconomic and financial risks. In this context, the mission discussed with the authorities ways to put fiscal consolidation on a more stable long-term trend; issues affecting *monetary transmission and the implications for monetary policy; developments with respect to external competitiveness and sustainability; and ongoing consolidation of the financial sector.*

A. Fiscal Consolidation: How Fast and How Deep

13. Staff welcomed the commitment to fiscal consolidation and debt reduction evident in the 2013 fiscal outturn and the 2014 budget. After peaking at close to 10 percent of GDP in 2009, the fiscal deficit has been reduced to 5.9 percent of GDP in 2013, and the debt-to-GDP ratio fell from 86 percent to 78.3 percent during the same period. The steady decline in the fiscal deficit and public debt as a share of GDP is a linchpin of macroeconomic stability and a critical factor in maintaining credibility and investor confidence.

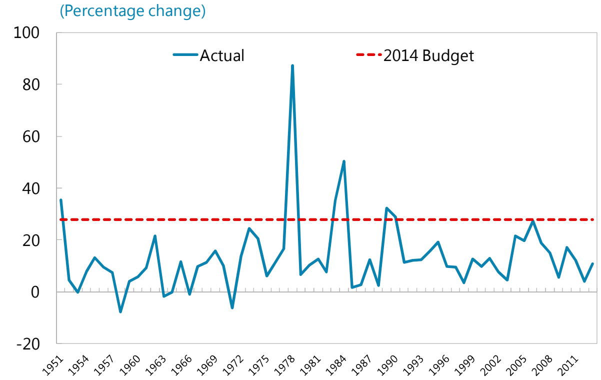
14. At the same time, the continued decline in the tax revenue-to-GDP ratio remains a concern. Repeated revenue underperformance places a heavy burden on expenditure compression to meet budget targets, and limits the government's ability to use counter-cyclical fiscal policy in the event of shocks. In addition, resorting to repeated cuts in public investment could delay the development of infrastructure and human capital required to meet ambitious growth targets. In turn, weaker growth would worsen debt dynamics and make the ambitious debt reduction plans (essential to reducing vulnerability) more difficult to achieve.

Sri Lanka - Tax Revenue, 1950-2013
(Percent of GDP)



Sources: Central Bank of Sri Lanka, staff calculation

Sri Lanka: Tax Revenue, 1950-2014
(Percentage change)



Sources: Ministry of Finance and Planning; staff estimates

15. Fiscal reforms are generally moving in the right direction, but key steps on tax exemptions and holidays should be accelerated. The authorities have taken some important steps to broaden the tax base: in 2013, they extended the VAT to the retail and wholesale level, and in 2014, they reduced by one half the threshold for imposition of VAT on wholesale and retail activities, and restricted exemptions applicable to national building tax (NBT). In addition, excise duties on tobacco, alcohol and motor vehicles were increased. While welcoming these steps, staff highlighted that numerous tax exemptions and concessions play a key role in undermining potential revenue gains. In addition to narrowing the tax base, these exemptions complicate tax administration and weaken tax compliance. The granting of new exemptions also mitigates potential progress toward broadening the tax base and perpetuates business expectations for special treatment. In staff's view there is significant scope for further extension of the tax base.[7] The mission argued that a more systematic effort to broaden the tax base is needed to improve revenue collection. In this context, the mission suggested IMF technical assistance to quantify the costs of tax expenditures—as an input to the government's own medium-term reform plan.

16. The authorities agreed that the weakening revenue position needs to be addressed. However, they were more sanguine about the impact of measures already implemented to boost future revenue collection. In addition to the tax broadening, they observed that a recovery of imports should result in improved collection of border taxes (which performed particularly poorly in the recent period). The authorities also noted that a number of tax holidays granted for a fixed period need to be phased out gradually. Finally, the authorities highlighted tax administration reforms, including the implementation of the Revenue Administration Management Information System (RAMIS) at the Inland Revenue Department expected to become operational by September 2015, and the upgrade of the Customs Department to ASYCUDA WORLD system. At the same time, the authorities noted the tax administration challenges arising due to the shift from an agriculture-based to a more industry- and service-oriented economy.

17. Staff welcomed the authorities' commitment to strengthen public financial management. With the help of IMF and Asian Development Bank (ADB) technical assistance (TA), Sri Lanka is moving ahead to strengthen public financial management systems. TA is focused on improving the oversight of state-owned enterprises (SOEs), strengthening budget preparation and improving the commitment control system. The authorities expect that these reforms will allow them to further improve expenditure control and limit the occurrence of payment arrears.[8]

18. The authorities are also using the current favorable market environment to improve the public debt structure. With the yield on government securities falling in response to lower inflation, a supportive global environment and increased market confidence, the authorities succeeded in lengthening the average maturity of public debt from 3.2 years in 2012 to 4.8 years in 2013, while at the same time reducing the overall borrowing costs. In 2014, they also successfully placed two five-year international sovereign bonds in total amount of US$ 1.5 billion at yields of 5-6 percent. A diversified funding base and longer maturities should help reduce fiscal vulnerability and rollover risk.

19. The government's commitment to medium-term fiscal consolidation is clear, but staff suggested some modifications. In the 2014 Budget and the revision of the Fiscal Management Responsibility Act of 2003, the authorities announced plans to reduce the fiscal deficit to 3.8 percent

[7] VAT collection is particularly weak: at 2.5 percent of GDP in 2013, the C-efficiency of VAT collection in Sri Lanka is 0.25, about one half of the C-efficiency for lower-middle income countries and Asia/Pacific countries. See M. Keen, 2013, The Anatomy of the VAT. IMF Working Paper 13/111.

[8] At the end of 2012, recurrent and capital payment arrears reached about 1 percent of GDP, and were cleared in 2013. Data for end-2013 payment arrears are being collected.

of GDP by 2016, while the debt to GDP ratio is expected to fall to below 65 percent. Staff argued that current targets for debt reduction were ambitious relative to recent revenue performance, and also highly sensitive to assumptions on economic growth. Drawing on cross-country experience and empirical work on debt sustainability, staff suggested the option of re-casting fiscal and debt consolidation objectives in a longer-term context—targeting a debt ratio of 50 percent (deemed significant from an vulnerability perspective) over a longer time horizon (see Selected Issues Paper). The authorities shared staff's view that long-term plans are necessary and did not disagree with the potential debt target, but did not consider a need to reformulate their current fiscal consolidation strategy as spelled out in the 2014 budget and the 2013 amendment of the Fiscal Responsibility Act.

20. Tariff adjustments and favorable weather conditions all but eliminated the losses of the energy and petroleum companies. In 2012, the Ceylon Electricity Board (CEB) and Ceylon petroleum Company (CPC) incurred total loss of almost 2 percent of GDP. However, large electricity tariff adjustments for clients using more than 60 units and moderate fuel price adjustment in 2013, together with ample rains that allowed increased reliance on cheaper hydro power, brought the combined financial outcome of the two companies to a small surplus. Staff raised concerns about renewed losses in 2014 as a result of drought during the first quarter. However, the authorities argued that with new coal power plants now operating, there is less need for more expensive fuel power plants and that the financial position of CEB and CPC is projected to remain solid.

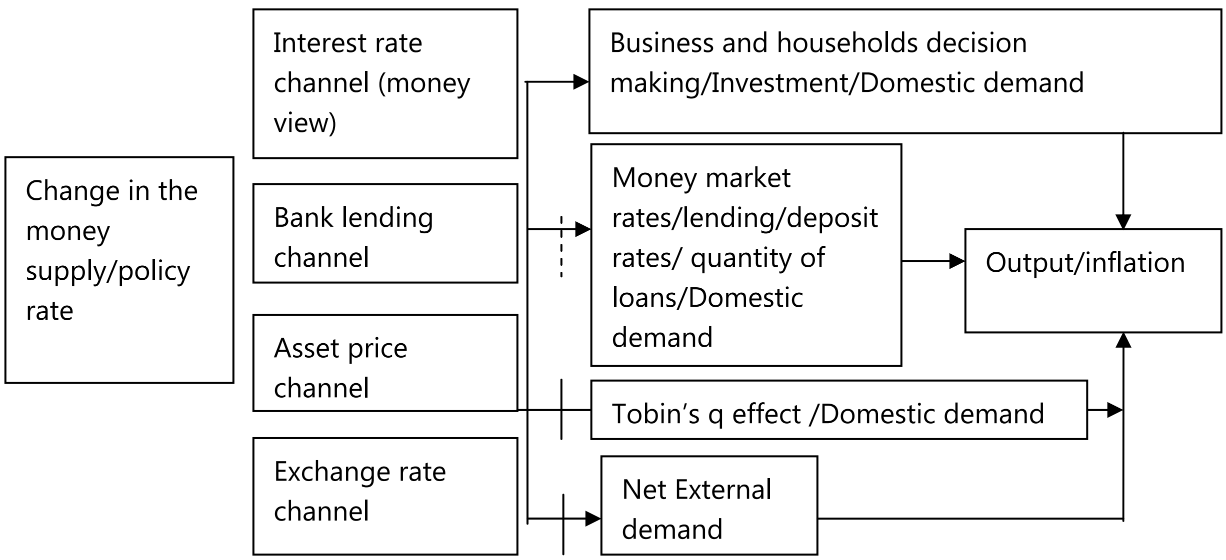
B. Monetary Policy: Timing Matters

21. Monetary policy has eased but the impact on monetary aggregates has been minimal. Following a tightening of policies to address overheating and rapid credit growth in 2011–12, the CBSL began reducing policy rates in December 2012. Between December 2012 and October 2013, the CBSL reduced the repurchase and reverse repurchase rates by 125 basis points and reduced banks' reserve requirement by 2 percentage points. In addition, the standing rate corridor was compressed from 200 basis points down to 150 basis points, resulting in the recent reduction of the bank interest rate spread, leaving its lower bound (the deposit rate) intact. The policy easing has fed through to a reduction in lending and deposit rates over time, although the effect has been more noticeable with respect to short-term rates. Aggregate private sector credit was seemingly unaffected, with year-on-year private credit growth falling to 7.5 percent in 2013, compared to 17.6 percent in 2012 and 34.5 percent in 2011.

22. The mission discussed with the authorities the dynamics of monetary transmission in Sri Lanka (Box 1 and Selected Issues Paper). Research by the staff in collaboration with the CBSL suggests several important findings. First, there is a weak correlation between central bank policy actions and money market and bank retail rates in Sri Lanka. Second, from a cross-country perspective, the contemporaneous effects of policy rate changes in Sri Lanka are also very weak. Short-term impact on money market and bank retail rates is limited compared with ASEAN countries and Vietnam. Third, the contribution of the bank lending channel to the interest rate channel in affecting output is operational, but with a significant lag—on the order of five quarters. The staff suggested that some obstacles to a more effective monetary transmission might include a strong presence of state banks in the financial system, a shift in banks' portfolios from lending to government securities, and less-than-optimal levels of bank competition.

Box 1. Dynamics of Monetary Transmission in Sri Lanka

The efficacy of monetary transmission channels has been a key question given a slow pass-through of policy changes to lending rates and private credit growth. The mission looked in particular at: (i) how effective are adjustments to monetary policy instruments in effecting changes to output and prices and (ii) what is the timing and magnitude of the effects of policy changes. A Vector Autoregressive (VAR) model was used to analyze: (i) interest rate channel; (ii) bank lending channel; (iii) exchange rate channel; and, (iv) asset price channel. Standard methodology proposed by Sims (1972) in using Granger causality is followed to describe the relationship between monetary policy variables and output and prices. The baseline VAR model is estimated using five variables from 2000q1 and 2013q3: output, prices, money supply, interest rates, and exchange rates. The results are summarized below—with vertical lines showing that the channel is inoperative:



Other key findings include: (i) the policy rate has significant predictive value for output and money supply has weak Granger effects for prices. Output declines by about 0.6 percent in the second quarter and by about 0.5 percent during the entire period of nearly 3 years after innovations to the repo rate; (ii) the bank lending channel contributes to policy innovations that affect output—weakly and with a significant lag. Private credit contributes to the interest rate channel by about 0.2 percent starting in quarter two but only in the model with exchange rates. The prime lending rate has a significant Granger effect on output--reducing it by about 0.1 percent more after 5 quarters; and (iii) exchange rate and asset price channels are not significant in affecting output and prices.

23. **Given continued growth momentum and the long lags in monetary transmission, staff argued for keeping the current monetary stance unchanged**. The slow response of private credit to successive reductions in policy rates mitigated the risk of upward pressure on prices through more rapid growth in money supply. However, recent data on GDP growth (first quarter GDP growth was 7.6 percent year-on-year), and rising private credit growth in areas not linked to gold pawning

suggest some risk of demand side pressures emerging later in the year. In this context, staff noted the risk of monetary policy becoming pro-cyclical if further cuts were made and suggested that rates remain unchanged for now.

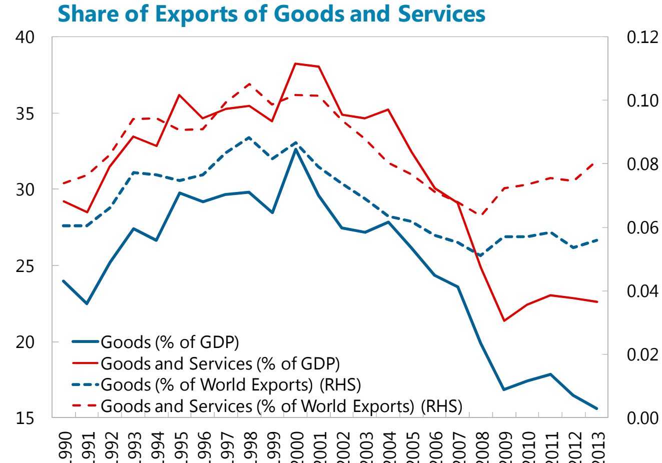
24. On monetary policy, the authorities highlighted several structural innovations. They noted that five years of single digit and declining inflation have altered inflation expectations—affording an opportunity to lower policy rates. For the time being, they did not envisage any further easing, but would be ready to reduce rates further if growth falters or inflation remains low. However, they also noted a constraint with respect to how low deposit rates could fall given the lack of social safety nets for a significant part of the retired population, and a reliance on high rates of return on deposits for income support (an issue they are seeking to rectify through the banking system via introduction of annuities and longer-term instruments).

25. The authorities agreed that monetary transmission was not working as effectively as it might. However, in reviewing the mission's findings, they suggested that (i) there is sufficient competition among banks; (ii) the shift in bank assets from lending to government securities was partly a result of a lack of credit demand, reflecting greater use of corporate debentures; and (iii) low credit growth is partly a supply side issue (banks' reluctance to lend given the rise in non-performing assets a result of gold pawning) which would eventually be resolved, sharpening the transmission response from policy rates to bank lending.

C. Competitiveness and External Sustainability

26. Previous staff reports have highlighted concerns about Sri Lanka's medium-term external sustainability. Recent improvement in the external current account is encouraging, but may be short-lived given the heavy role played by import compression. Longer-term trends signaling potential vulnerabilities include (i) a chronic current account deficit and relatively low reserve adequacy metrics; (ii) a gradual but steady decline in goods exports as a share of GDP; (iii) a similar decline in Sri Lanka's share of world exports; (iv) an already high external debt burden and a rising cost for external financing as Sri Lanka shifts to middle-income status and bilateral concessional debt is replaced with borrowing on commercial terms; and (v) modest increases in foreign direct investment, which would otherwise alleviate the need for debt financing.

Share of Exports of Goods and Services



27. While the current account deficit has decreased in recent years, it remains financed largely by debt-creating inflows and central bank foreign exchange reserves are at the lower end of what is considered adequate by standard metrics. The predominance of debt-creating inflows is reflected in a high debt component in gross reserves—which is slowly improving along with the gradual decline in external debt. While gross reserves are now within the “adequate” band of the composite metric, they are still on the low side relative to short-term debt and upcoming amortizations. To raise the reserve cushion, the authorities have absorbed foreign exchange inflows. While generally supporting the accumulation of additional reserves, the staff emphasized the need to maintain a flexible exchange rate regime, as the CBSL’s interventions had effectively stabilized the exchange rate.[9]

28. Exchange rate analysis does not signal an obvious problem of competitiveness, and the exchange rate appears broadly in line with fundamentals. The External Balance Assessment (the current account approach) points to a slight overvaluation of the rupee. By contrast, analysis based on the CGER indicate that the underlying current account deficit is slightly smaller than the level predicted by panel regressions on advanced and emerging markets, suggesting a slight undervaluation while staying in line with the estimated current account norm. According to the external sustainability approach, only a smaller adjustment would be compatible with a stabilization of the external debt/GDP position. Overall, however, the relatively small degree of estimated misalignment in either direction suggests that the exchange rate is broadly in line with fundamentals.

Sri Lanka - External Balance Assessment

Approach:	Macrobalance (CGER)	External Sustainability	Current Account (Current Account)
Underlying Current Account Balance	-4.0	-4.0	-2.5
Current Account Norm	-4.5	-4.3	-1.3
Required Improvement in the Current Account	-0.5	-0.3	1.1
Implied over (+) / under (-) valuation	**-3.5**	**-2.3**	**8.0**

29. Sri Lanka fares relatively well with respect to qualitative indicators of competitiveness, although there remains room for improvement. Sri Lanka ranks well in the World Economic Forum Competeviteness Index as well as the overall World Bank Doing Business Index (ranking 85 out of 189 countries and well ahead of the rest of South Asia, although areas for improvement include tax rates and administration, enforcing contracts, and registering property). Several sectors also report problems hiring and retaining labor at different skill levels. The garment industry (40 percent of exports) has also shown considerable flexibility to shocks—such as the end of the Multifibre Agreement in 2005 and discontinuation of preferential access under the EU’s Generalized System of Preferences (GSP+) in 2010—by moving up the value chain (Box 2).

[9] The rupee has been virtually stable vis-à-vis the U.S. dollar since the beginning of October 2013. As a result, the IMF classification of Sri Lanka’s de facto exchange rate has been changed from “managed float” to “stabilized” (Informational Annex).

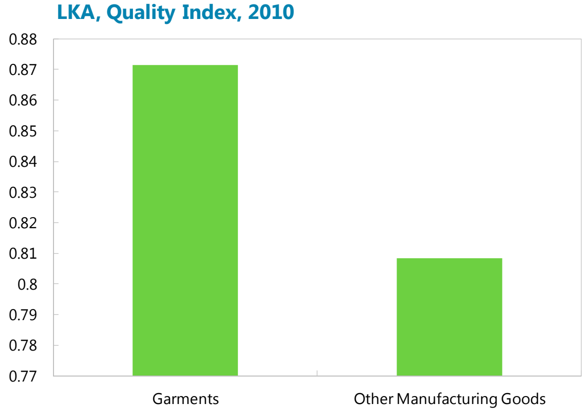
Box 2. Sri Lanka's Garment Industry

After trade liberalization in the late 1970's and with the support of the Multi-Fibre Agreement (MFA), the garment industry emerged as Sri Lanka's key export engine and source of employment. After peaking at 55 percent in 2000 garments still account for over 40 percent of total exports. The sector employs around 280,000 people—with significantly more indirectly dependent on the industry. FDI and joint ventures were initial catalysts, but the industry is today dominated by local firms.

The Sri Lankan garment industry has gone through rapid structural change in the past 15 years in response to a shifting competitive landscape—notably the phasing out of the MFA in 2005 and of China safeguard in 2008, followed by discontinuation of the EU Generalized System of Preferences (GSP+) in 2010. The industry responded by moving up the quality ladder, with leading companies progressing towards becoming total service providers by designing and developing products. The structural changes implied a decline in the number of firms, and a drop in employment from at most 340,000 in 2003. The decline in employment also reflects difficulties hiring due to perceived low wages, as well as being a side effect of a comparatively better educated labor force (labor costs are also higher than in most other Asian garment producing countries).

The garment sector's strategy to move even higher up the quality ladder is well placed and its track record indicates that the sector will remain an important source of exports for Sri Lanka. However, critical to future garment export earnings will be how volumes develop in a higher price segment. In this respect, further diversification to markets beyond the E.U. and U.S. will be important. Given limited backward linkages and largely imported input material, the contribution to the trade balance will also depend on how firms decide to set up their future production chains and to what extent they will keep lower value production segments in Sri Lanka.

LKA, Quality Index, 2010



Importantly, even if garment exports growth continues to average 6 percent as during the past decade, this will not be enough to alone reverse the negative long-term trend in Sri Lanka's overall goods exports. Diversification to other export sectors will be necessary and there is significant room for existing non-garment exports to move up the quality ladder.

Source: Diversification Toolkit; IMF Policy Paper, March 2014

30. **Structural transformation may ameliorate some medium-term pressures on the external accounts**. While goods exports have decreased as a share of GDP, services receipts have increased and now rival the garment industry as a source of foreign exchange earnings. The most visible aspect of this is growth in tourism—which more than doubled in dollar terms between 2011 and 2013—in tandem with transportation services, supported by significant investment in port

facilities. Rapid growth (albeit from a small base) is also visible in information technology and accounting services. Inward remittances have also risen as a comparatively well educated Sri Lankan work force increases its overseas presence. Net remittances as a share of GDP have increased to about 8.4 percent of GDP in 2013, compared with 6.4 percent a decade earlier—equivalent to a rise from about one-quarter the value of total goods exports in 2003 to nearly two-thirds by 2013.

31. The mission highlighted that sustained improvement in the current account would likely require further diversification of exports, and that cross-country experience demonstrated greater gains from equity and direct investment relative to debt flows. The mission noted that there appears room for further growth in the garment industry and higher value added, but that rising competition and labor scarcity might also give rise to shifting some operations to lower-cost locations. Further diversification of goods and services exports would rest on continued macroeconomic stability, improvements to the investment environment (including the tax structure, enforcement of contracts and property rights) and a predictable policy environment. In this context, staff noted that FDI flows might also gain from such structural improvements, and that available evidence suggest greater gains to productivity and growth from equity and FDI flows than from debt financed investment.[10]

32. The authorities had confidence that the external accounts would continue to improve, and that the current development strategy (the Five Hubs) would facilitate diversification. They highlighted the competitiveness of the garment industry as an example of innovation and productivity gain despite a highly competitive environment and loss of preferential trading arrangements. They also noted the rise in services, and that in addition to tourism and emerging sectors such as IT, transport and logistics services were expected to increase as a result of continued investment in port facilities. With respect to financing, they highlighted the focus on attracting FDI and creating an enabling investment environment, but noted that a small domestic market would likely constrain the amount of foreign investment compared to other emerging markets.

D. Financial Sector Consolidation

33. The mission discussed ongoing consolidation of the financial sector (Box 3)—highlighting potential gains and pitfalls. On the positive side, the mission noted that consolidation could potentially increase resilience and contribute to more effective oversight. The strong focus on consolidating nonbank financial institutions (NBFIs) sector seems warranted given expected gains from economies of scale and enhanced efficiency of operations. While not large, the NBFI sector has been more prone to weakness. Consolidating NBFIs with a view to building a stronger capital base may add some resilience to shocks, potentially generate cost efficiencies, and should also allow for closer oversight. With respect to the banking sector, consolidation could provide sufficient scale to invest in technology and management systems to enhance efficiency and profitability. Over the longer term, sufficient scale could also facilitate introduction of new products and services. A larger capital base would also increase resilience to shocks.

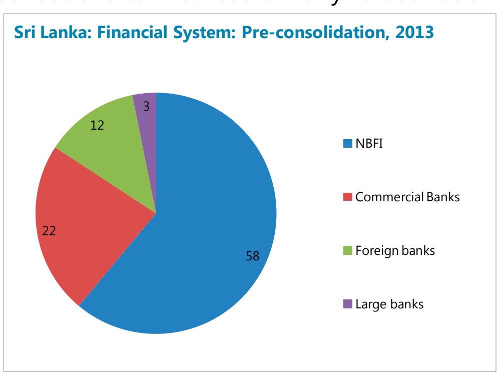
[10] Kose, et al (2006 and 2008); Bosworth and Collins (1999); and Borensztein et al (1998).

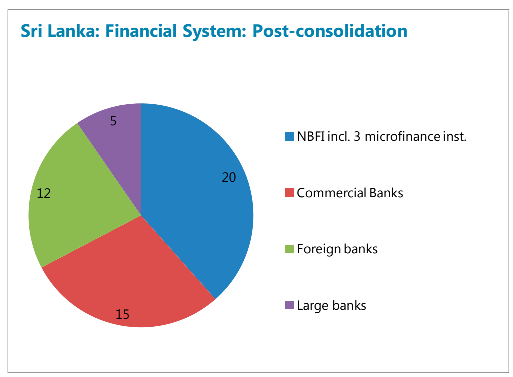
Box 3. Sri Lanka's Master Plan for Financial Sector Consolidation

There are 24 commercial banks in Sri Lanka and nine specialized banks. In the NBFI sector, there are 58 firms—47 finance companies and 11 specialized leasing companies. Together banks and NBFI's control 64 percent of total financial system assets (banks control 57 percent). The financial sector is dominated by the state. The top three banks (the Bank of Ceylon, People's Bank, and the National Savings Bank) are state-owned and together account for about half of total assets of the 33 commercial and specialized banks. Twelve foreign banks account for 10 percent of market share.

Sri Lanka's financial sector consolidation master plan seeks to reduce the number of NBFIs, create a set of larger banks able to compete regionally, and to bolster the strength and resilience of the financial system. Comprehensive plans for all mergers were required at end-May 2014, with a view to completing most mergers (or consolidations) by end-year. Key pillars of the strategy include:

- Creating a stronger banking sector comprising 5 strategically important banks with assets in excess of LKR 1 trillion; merging two development banks (DFCC and NDB—now operating as commercial banks) to a single large development/universal banking entity; and consolidating (or absorbing) smaller state banks into larger state banking units.
- Consolidating the NBFI sector—reducing the number of institutions from the current 58 firms down to 20, with three specialized in microfinance. CBSL will make available funds through its deposit insurance window for any merger that may need capital infusion. If there remain any of the weakest NBFIs by March 2015, the CBSL can direct a consolidation.
- Higher minimum capital thresholds starting in 2016. Minimum capital requirements for commercial banks will be raised to LKR 10 billion, and LKR 5 billion for specialized banks. For NBFI's minimum core capital requirement will be raised to LKR 1bn by 1 January 2016, then LKR 1.5 billion by 1 January 2018 (compared to LKR 200-300 million now for finance and leasing companies respectively).
- Consolidations cannot result in any forced redundancies of staff, or in reduced salaries of staff.





The plan shares some common elements with consolidation efforts in other EMs, but also some differences. First, for most EMs, cross-border mergers and acquisitions have typically accounted for a large share of consolidation activity—this is unlikely for Sri Lanka. Second, consolidations in EM markets have often been a way of resolving financial crises, whereas in Sri Lanka the effort is more pre-emptive. Third, market forces have played a dominant role in mature markets, whereas in EMs (and Sri Lanka), country authorities typically had a more major role. Finally, ownership structures and concern over job losses have been key issues in EMs, and appear to be in Sri Lanka as well.

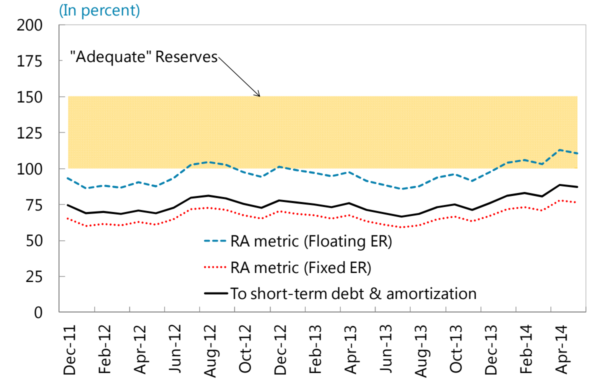
34. The mission highlighted some aspects that might limit potential gains from consolidation. Since the plan restricts merged financial institutions from restructuring employment or reducing salaries, gains from economies of scale may be limited. Further, as small NBFIs as a group represent less than two percent of the financial system and are not systemically important, the requirement to consolidate small NBFIs could provide at best marginal improvements in financial system stability. Consolidation can also bring new risks. For example, larger financial institutions can pose greater systemic risks. In this context, the CBSL's intention to implement regulatory reforms in line with Basel is move in the right direction, but additional buffer requirements for systemically important banks/NBFIs might also be considered. A post-consolidation push to improve profitability can also trigger aggressive credit expansion and higher risk-taking. Increased concentration can also, in some cases, hinder competition.

35. The authorities noted staff's concerns, but also highlighted that consolidation will be an evolving process. In their view, it was important for stability to signal that no mandatory restructuring of employment would be required, but rather, that the process could be voluntary and done over time as institutions merged and operations were adjusted organically. They also argued that systemic risks would be limited, as the currently largest banks in the banking system are very close in terms of the levels of required post-consolidation capital and asset bases. Having said this, the authorities agreed that risks exist regarding the ultimate capital structure of consolidated companies, limited options for self-organizing staff related retentions, potential IT problems and lags in installing effective management systems and corporate governance.

POST PROGRAM MONITORING

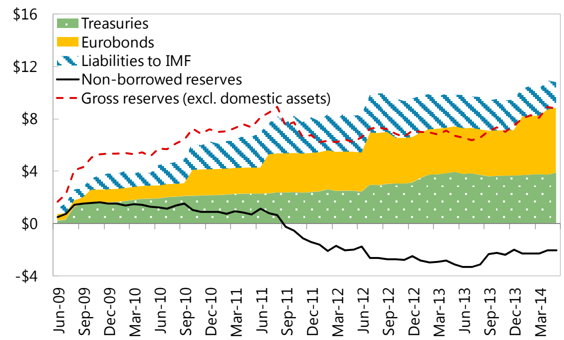
36. Sri Lanka's capacity to repay the IMF remains broadly adequate and slightly improved since the first post-program monitoring discussion in September 2013. Exposure to the IMF currently stands at SDR 1.16 billion (about US$1.8 billion—2.4 percent of projected 2014 GDP and 20.5 percent of current gross central bank foreign exchange reserves). Repayments to the IMF stretch into mid-2017, although Sri Lanka is expected to fall below 200 percent of quota (the threshold for post-program monitoring) in early 2015. External debt remains broadly sustainable, but as highlighted by the debt sustainability analysis, significant vulnerabilities remain with respect to exchange rate risk and baseline assumptions on growth and the course of fiscal consolidation. The cost of external debt has also risen sharply in recent years as Sri Lanka continues to shift from concessional, bilateral debt into new external loans on commercial terms. External borrowing by commercial banks also remains a concern, but has been relatively limited thus far.

Sri Lanka: Reserve Metrics Dynamics
(In percent)



Source: IMF staff estimates.

Evolution of Gross Reserves
(In billions of U.S. dollars)



Source: IMF staff estimates.

STAFF APPRAISAL

37. Outlook and risks. Sri Lanka's recent economic performance has been better than expected—particularly given some headwinds from chronic market turbulence and climatic shocks. While there remain weak spots in economic activity (such as agriculture, which has been negatively affected by recent drought), strong activity in traditional sectors such as garment manufacture, and new sectors such as tourism and services bode well for the near and medium-term outlook. This is complemented by a sustained reduction in headline and core inflation—bringing a new and welcome level of stability which has hopefully fed into a new set of public expectations regarding inflation.

38. Fiscal policy. The government has remained solidly committed to fiscal consolidation and reduction of public debt as a mainstay of macroeconomic stability. In this context, and given rising economic growth, the mission saw the fiscal stance for 2014 as appropriate, but raised concern about the composition of further consolidation. Capacity in expenditure and commitment control has increased, enhancing the government's ability to curtail spending to meet fiscal objectives. However, given sizeable investment needs, the staff was of the view that spending cuts may have reached their effective limit, and that the burden of adjustment needed to fall more squarely on increasing revenue. Particularly if Sri Lanka is to maintain current growth momentum and foster economic development and diversification, high and sustained levels of public spending on infrastructure and human capital will be essential. Tackling the issue of tax expenditures and broadening the tax base will be essential. The mission appreciated the steps taken thus far, but was of the view that the pace of reform in this area could reasonably be accelerated. There is also room, in the mission's view, to take another look at the medium- and long-term strategy for debt reduction, and consider a more ambitious debt target (more strongly associated with reduced vulnerability) over a longer time horizon.

39. Monetary policy. The current, supportive stance of monetary policy is appropriate given the decline in inflation and weak private credit growth. However, the overall picture is complex and requires close monitoring. On the one hand, with economic activity apparently on the rise and private credit (outside of pawning activity) beginning to show signs of recovery, the authorities should be ready to adjust rates as needed to ensure price stability—particularly given the long lags involved in monetary transmission. On the other hand, the current low inflation environment and the apparent change in inflation expectations offers an opportunity for a downward shift in the interest rate structure that might benefit the investment environment (and borrowing costs) over the medium term. Given the mix of signals, a cautious approach is warranted and the staff believes policy rates should remain on hold for the near term.

40. Exchange rate. Exchange rate policy remains broadly appropriate, but should be monitored in light of developments in the balance of payments and inflation, and the commitment to flexibility maintained. Staff's analysis indicates that the exchange rate is broadly in line with fundamentals, and staff saw merit in central banks' purchases to build its reserves, which remain on the lower end of most reserve adequacy metrics. However, staff also cautioned that the persistent stability of the rupee (vis-à-vis the US dollar) that has arisen as a side effect of foreign exchange absorption by the central bank since the fourth quarter of 2013 carries risks. First, it may create the perception that the rupee is implicitly fixed—a point supported by the shift in exchange rate classification from "managed float" to "stabilized" under the IMF's Annual Report on Exchange Rate Arrangements. This perception could lead market participants and firms to hold un-hedged foreign exchange risk on their balance sheets. Second, should external balance continue to improve and inflation stay low, it could gradually lead to increasing currency misalignment. The central bank should thus be prepared to allow sufficient exchange rate flexibility to adjust to fundamental pressures, while limiting intervention to accumulation of reserves and smoothing short-term volatility.

41. External sustainability. Recent improvements in the trade and current account balances notwithstanding, Sri Lanka remains vulnerable to external shocks. Medium-term sustainability will depend on maintaining an outward orientation, diversification of the export structure, and a judicious use of foreign borrowing—particularly given the rapid increase in debt servicing costs that have accompanied the shift from bilateral concessional debt to new loans on commercial terms. The Market Access Debt Sustainability Analysis (MAC-DSA) highlights the sensitivity of Sri Lanka's debt sustainability to growth and foreign exchange shocks. The staff urges caution with respect to external borrowing through the banking system.

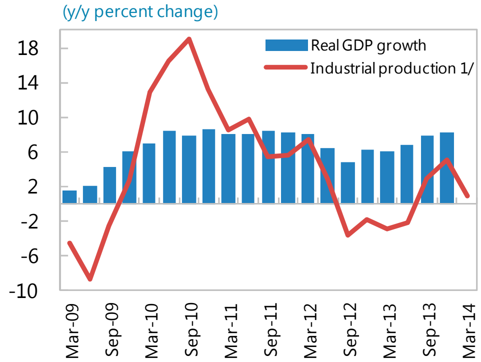
42. Financial sector reform. Financial sector consolidation has potential benefits in the form of economies of scale, new products and services, and a greater resilience (via a stronger capital base) to shocks. The benefits of consolidation would likely be more rapid if fewer restrictions were placed on restructuring operations. Continued progress on corporate governance is also key. Close supervision during and after the consolidation process could also help avoid some of the pitfalls encountered by other countries in episodes of financial sector restructuring, such as excessive credit growth. Consolidation may also result in increased concentration and hinder effective competition if larger and state-owned banks continue to grow and dominate the banking sector.

43. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Sri Lanka: Macroeconomic Developments

GDP growth has picked up in recent quarters.

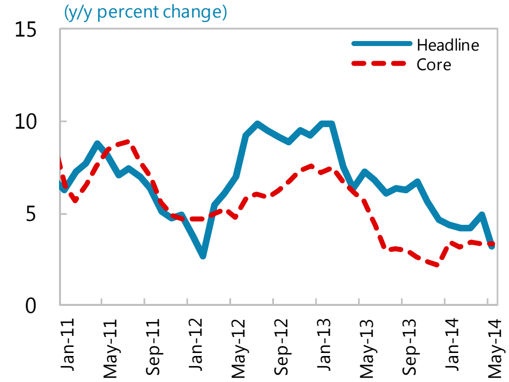
Economic Activity
(y/y percent change)



1/Industrial production as of Sep 2013: latest number.

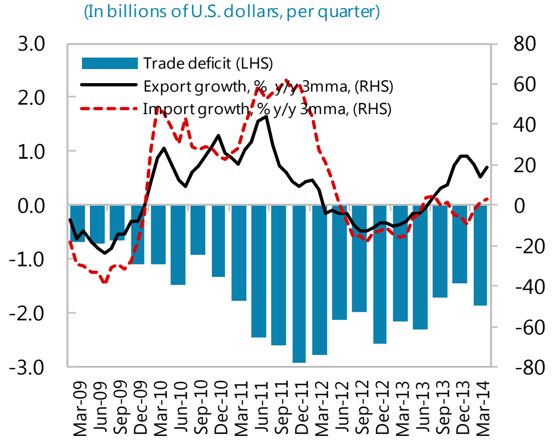
Headline and core inflation have declined.

Consumer Price Index
(y/y percent change)



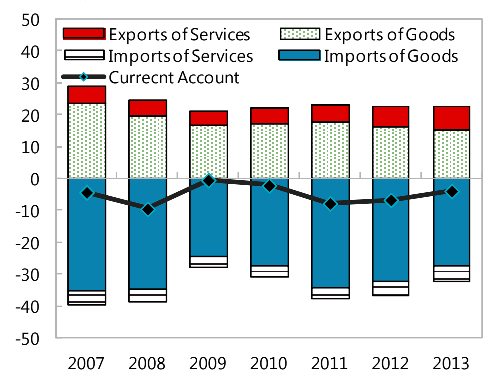
Imports fell, exports have picked up and trade balance has improved ...

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



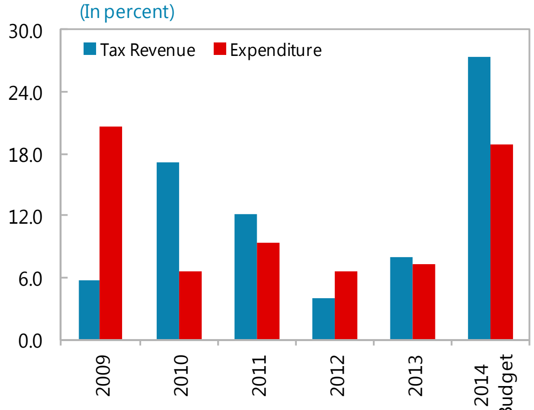
... as did the current account balance, supported by stronger export of services.

Current Account Balance and Imports, Exports
(In percent of GDP)



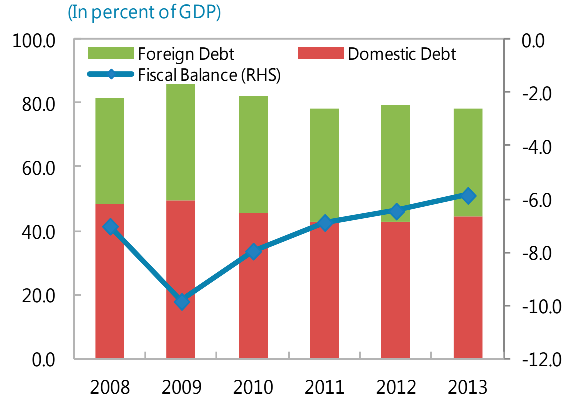
Tax revenues rose moderately in 2013 but 2014 budget targets strong growth

Annual Growth in Expenditure and Tax Revenue
(In percent)



Fiscal deficit has been falling, contributing to a gradual decline in the debt to GDP ratio

Fiscal Balance and Public Debt
(In percent of GDP)

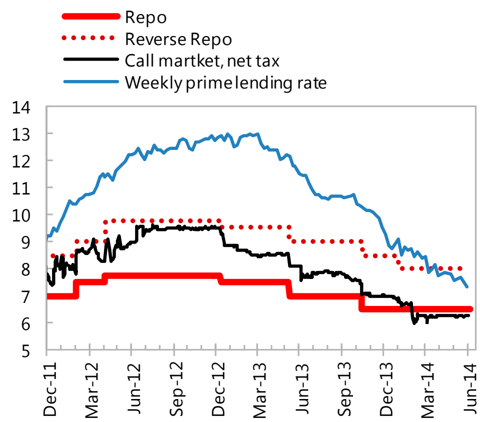


Sources: Central Bank of Sri Lanka; CEIC; Bloomberg LP; and IMF staff estimates.

Figure 2. Sri Lanka: Monetary and Exchange Rate Developments

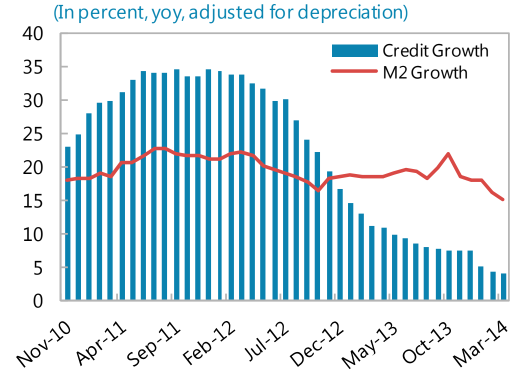
Monetary policy has been eased...

Repo and Interbank Rates
(In percent per annum)



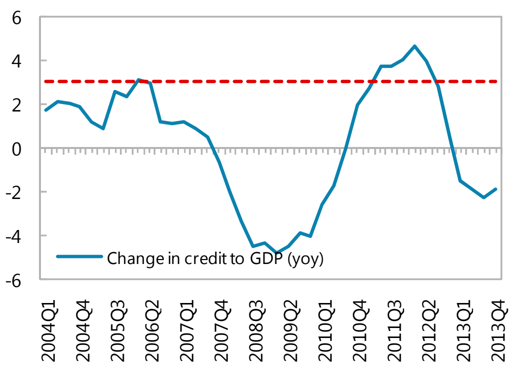
... Growth of credit to private sector has slowed sharply...

Credit and M2 Growth
(In percent, yoy, adjusted for depreciation)



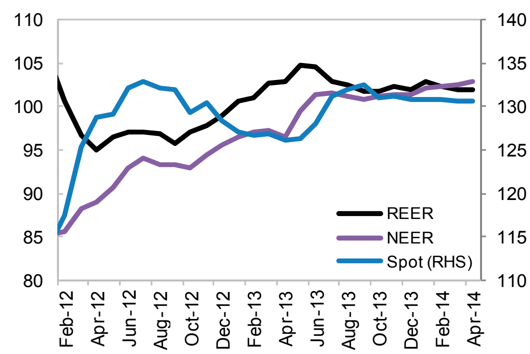
... and credit as percent of GDP has declined.

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



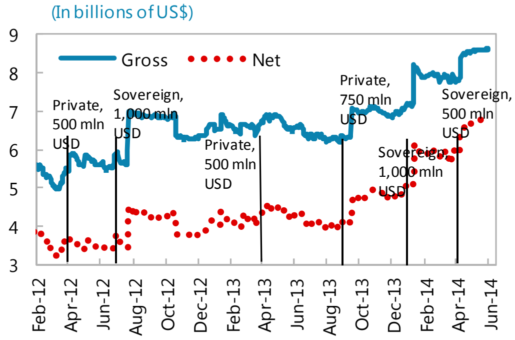
Spot exchange rate has been recently stable.

Exchange Rate
(Index, June 2009=100; Rupee/US$)



Central bank reserves have been increasing partly as a result of new borrowing ...

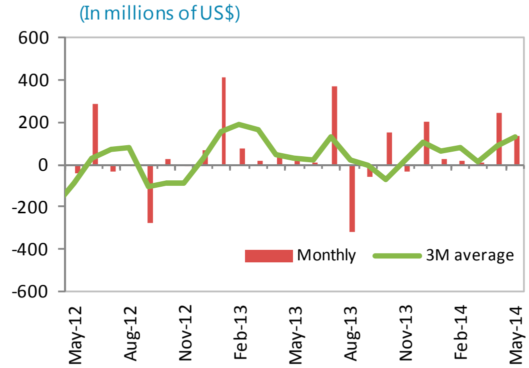
International Reserves
(In billions of US$)



Note: the vertical lines mark the dates and amount of which sovereign or private debt were issued

... and partly due to CBSL absorption of forex from the market.

CBSL Foreign Exchange Net Absorption
(In millions of US$)



Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; Bloomberg LP; and IMF staff estimates.
1/ The horizontal line shows a 3 percent "warning threshold" (September 2011 GFSR)

Table 1. Sri Lanka: Selected Economic Indicators, 2011–19

	2011	2012	2013	2014	2015	2016	2017	2018	2019
			Prel.			Proj.			
GDP and inflation (in percent)									
Real GDP growth	8.2	6.3	7.3	7.0	6.5	6.5	6.5	6.5	6.5
Inflation (average)	6.7	7.5	6.9	3.8	5.4	5.5	5.5	5.5	5.5
Inflation (end-of-period)	4.9	9.2	4.7	5.2	5.5	5.5	5.5	5.5	5.5
Core inflation (end-of-period)	4.7	7.5	2.1	4.3	4.6	4.6	4.6	4.6	4.6
Savings and investment (in percent of GDP)									
National savings	22.2	23.9	27.7	28.6	28.8	29.4	29.7	30.0	30.1
Government	-0.9	-1.2	-0.8	0.4	0.9	1.6	1.8	1.9	2.5
Private	23.0	25.1	28.6	28.2	27.8	27.8	27.9	28.1	27.6
National Investment	30.0	30.6	31.6	32.0	32.2	32.6	32.6	32.7	32.8
Government	6.3	2.3	2.9	3.1	3.0	3.1	3.2	3.2	3.4
Private	23.6	28.4	28.8	29.0	29.2	29.5	29.5	29.5	29.5
Savings-Investment balance	-7.8	-6.7	-3.9	-3.5	-3.4	-3.2	-3.0	-2.7	-2.7
Government	-7.3	-3.6	-3.9	-3.0	-2.1	-1.6	-1.4	-1.4	-0.9
Private	-0.4	-3.0	0.0	-0.4	-1.2	-1.6	-1.5	-1.3	-1.8
Public finances (in percent of GDP) 1/									
Revenue	14.3	13.0	12.2	13.1	13.7	13.9	14.1	14.3	14.5
Grants	0.2	0.2	0.2	0.3	0.1	0.1	0.1	0.1	0.1
Expenditure	21.4	19.7	18.3	18.7	18.3	18.1	18.2	18.5	18.3
Central government balance	-6.9	-6.5	-5.9	-5.2	-4.5	-4.2	-4.0	-4.1	-3.7
Central government domestic financing	3.5	2.7	4.6	1.8	2.7	3.0	2.9	2.4	3.1
Government debt (domestic and external)	78.5	79.2	78.3	76.8	74.2	71.4	68.8	66.3	63.6
Money and credit (percent change, end of period)									
Reserve money	21.9	10.2	0.9	15.0	14.3	14.9	14.4	14.7	13.3
Broad money	19.1	17.6	16.7	15.1	14.1	14.7	14.3	14.8	13.3
Domestic credit	34.3	21.7	13.9	11.9	12.3	12.7	12.4	11.3	11.9
Credit to private corporations	34.5	17.6	7.5	14.9	14.9	15.2	14.5	14.0	13.7
Credit to government	33.7	29.6	24.6	8.0	8.2	8.4	8.5	6.0	8.0
Balance of payments (in millions of U.S. dollars)									
Exports	10,559	9,773	10,394	11,822	12,774	13,845	15,006	16,509	17,822
Imports	-20,269	-19,190	-18,003	-21,399	-23,322	-25,240	-27,217	-29,422	-31,696
Current account balance	-4,615	-3,983	-2,606	-2,491	-2,663	-2,748	-2,759	-2,771	-2,996
Current account balance (in percent of GDP)	-7.8	-6.7	-3.9	-3.5	-3.4	-3.2	-3.0	-2.7	-2.7
Export value growth (percent)	22.4	-7.4	6.4	13.7	8.1	8.4	8.4	10.0	7.9
Import value growth (percent)	50.7	-5.3	-6.2	18.9	9.0	8.2	7.8	8.1	7.7
Gross official reserves (end of period) 2/									
In millions of U.S. dollars	6,749	7,106	7,495	8,380	9,096	9,345	10,044	11,826	12,815
In months of imports	3.2	4.0	3.5	3.6	3.6	3.4	3.3	3.6	3.6
External debt (public and private)									
In billions of U.S. dollars	32.7	37.1	39.7	42.4	45.5	47.7	50.3	53.9	58.2
As a percent of GDP	55.4	62.5	59.6	59.2	58.3	55.9	54.0	53.0	52.4
Memorandum items:									
Nominal GDP (in billions of U.S. dollars)	59.2	59.4	66.7	71.6	78.2	85.3	93.1	101.7	111.0

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

1/ Revenue and expenditure from 2011 to 2013 may be different from numbers published by Sri Lankan authorities due to different accounting methodology.

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

Table 2. Sri Lanka: Summary of Government Operations, 2011–19

(In percent of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
			Prel.			Proj.			
Total revenue (including grants) 1/	14.5	13.2	12.4	13.5	13.8	14.0	14.2	14.4	14.6
Total revenue	14.3	13.0	12.2	13.1	13.7	13.9	14.1	14.3	14.5
Tax revenue	12.4	11.2	10.6	11.5	12.0	12.2	12.4	12.7	12.8
Income taxes	2.4	2.3	2.4	2.5	2.6	2.6	2.8	2.9	2.9
VAT	3.3	2.7	2.5	2.8	3.1	3.2	3.3	3.4	3.5
Excise taxes	2.8	2.5	2.4	2.5	2.5	2.5	2.5	2.6	2.6
Other trade taxes	1.4	1.4	1.4	1.5	1.6	1.6	1.6	1.6	1.6
Other	2.5	2.2	1.9	2.1	2.2	2.3	2.3	2.3	2.2
Nontax revenue	1.9	1.9	1.5	1.7	1.7	1.7	1.7	1.7	1.7
Grants	0.2	0.2	0.2	0.3	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending 1/	21.4	19.7	18.3	18.7	18.3	18.1	18.2	18.5	18.3
Current expenditure	15.4	14.4	13.2	13.1	12.9	12.4	12.4	12.5	12.0
Civil service wages and salaries	2.7	2.4	2.2	2.3	2.4	2.4	2.4	2.4	2.4
Other civilian goods and services	0.9	0.8	0.7	0.7	0.7	0.7	0.8	0.8	0.8
Security expenditure (including contingency)	3.1	2.7	2.4	2.5	2.4	2.4	2.3	2.3	2.2
Subsidies and transfers	3.3	3.1	2.8	2.9	2.9	2.8	2.8	2.8	2.8
Interest payments	5.5	5.4	5.1	4.8	4.5	4.2	4.1	4.3	3.8
Capital expenditure and net lending	6.0	5.3	5.0	5.6	5.5	5.7	5.8	6.0	6.3
Overall balance of the central government	-6.9	-6.5	-5.9	-5.2	-4.5	-4.2	-4.0	-4.1	-3.7
Financing	6.9	6.5	5.9	5.2	4.5	4.2	4.0	4.1	3.7
Net external financing	3.4	3.8	1.2	3.3	1.9	1.2	1.2	1.6	0.7
Net domestic financing	3.5	2.7	4.6	1.9	2.7	3.0	2.9	2.4	3.1
Memorandum items:									
Primary balance (excluding grants)	-1.66	-1.27	-0.97	-0.8	-0.2	-0.1	0.0	0.1	0.0
Total public debt	78.5	79.2	78.3	76.8	74.2	71.4	68.8	66.3	63.6
Domestic currency	42.9	42.7	44.2	42.0	38.7	37.2	36.5	35.8	36.4
Foreign currency	35.6	36.5	34.1	34.7	35.5	34.2	32.3	30.5	27.2
Nominal GDP (in billion of rupees)	6,543	7,579	8,674	9,638	10,819	12,154	13,654	15,338	17,231

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.
1/ Revenue and expenditure from 2011 to 2013 may be different from numbers published by Sri Lankan authorities since it excludes the tax exemptions granted for specific projects and the amounts of tax concessions granted on importatiton of motor vehicles by public servants from revenue and corresponding expenditures

Table 3. Sri Lanka: Monetary Accounts, 2011–14

(in millions of rupee, unless otherwise indicated, end of period)

	2011	2012	2013				2014
			Mar.	Jun.	Sept.	Dec.	
	(Stocks, in billions of Sri Lankan rupees)						
Central Bank of Sri Lanka							
Net foreign assets	340	396	394	366	479	529	551
Net domestic assets	99	88	118	134	-14	-41	11
Net claims on central government	263	279	265	233	134	114	49
Other items, net	-165	-192	-151	-94	-143	-170	-53
Reserve Money	440	484	512	500	466	489	562
Monetary survey							
Net foreign assets	98	-26	-106	-169	-88	-76	-133
Monetary authorities	340	396	394	366	479	529	551
Deposit money banks	-242	-422	-499	-535	-567	-605	-684
Net domestic assets	2,394	2,955	3,195	3,339	3,377	3,494	4,067
Net claims on central government	834	1,045	1,180	1,264	1,292	1,301	1,356
Credit to corporations	2,204	2,651	2,731	2,767	2,809	2,899	3,356
Public corporations	198	292	336	334	339	365	444
Private corporations	2,006	2,358	2,396	2,433	2,470	2,534	2,912
Other items (net)	-644	-742	-716	-692	-724	-707	-645
Broad money	2,492	2,929	3,090	3,170	3,289	3,418	3,934
Memorandum Items							
Gross international reserves (US $millions)	5,758	6,878	6,806	6,541	7,071	7,495	8,091
Net international reserves (US $millions)	4,011	4,162	4,317	3,994	4,748	5,149	6,640
Money multiplier	5.7	6.0	6.0	6.3	7.1	7.0	7.0
Broad money velocity 1/	2.6	2.6	2.8	2.7	2.6	2.5	2.5
	(Annual percentage change)						
Broad money	19.1	17.6	15.6	15.8	16.3	16.7	15.1
Reserve money	21.9	10.2	8.8	9.3	-1.6	0.9	15.0
Credit to corporations	47.8	20.3	13.4	10.2	9.4	9.4	15.7
Credit to private corporations	34.5	17.6	10.9	8.9	7.6	7.5	14.9

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

1/ Calculated using end-period quarterly GDP, annualized.

Table 4. Sri Lanka: Balance of Payments, 2012–19, BPM6

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

	2012	2013	2014	2015	2016	2017	2018	2019
		Prel.			Proj.			
Current account	-3,983	-2,606	-2,491	-2,663	-2,748	-2,759	-2,771	-2,996
Balance on goods	-9,417	-7,608	-9,577	-10,547	-11,395	-12,211	-12,913	-13,875
Goods credit (exports)	9,773	10,394	11,822	12,774	13,845	15,006	16,509	17,822
Goods debit (imports)	-19,190	-18,003	-21,399	-23,322	-25,240	-27,217	-29,422	-31,697
Non-oil imports	-14,145	-13,695	-16,186	-18,478	-20,445	-22,191	-24,189	-26,187
Oil imports	-5,045	-4,308	-5,213	-4,844	-4,794	-5,026	-5,233	-5,510
Services	1,260	1,180	1,705	2,007	2,294	2,559	2,931	3,336
Credit (exports)	3,799	4,685	5,886	6,823	7,747	8,671	9,783	10,962
Debit (imports)	-2,539	-3,505	-4,180	-4,816	-5,453	-6,112	-6,852	-7,626
Primary income, net 1/	-1,219	-1,817	-841	-881	-925	-971	-1,020	-1,070
Secondary income, net 2/	5,392	5,639	6,222	6,759	7,278	7,865	8,231	8,613
Workers' remittances (net)	5,339	5,619	6,200	6,736	7,254	7,839	8,204	8,586
Capital account (+ surplus / - deficit)	130	71	100	73	101	102	102	103
Balance from current account and capital account	-3,853	-2,536	-2,391	-2,590	-2,646	-2,657	-2,669	-2,893
Financial account (+ net lending / - net borrowing)	-4,275	-3,120	-2,391	-2,590	-2,646	-2,657	-2,669	-2,893
Of which : Short term liabilities /3	-649	108	150	200	200	200	200	200
Direct investments	-877	-850	-964	-1,067	-1,183	-1,311	-1,452	-1,780
Portfolio investments	-2,126	-2,106	-1,968	-1,424	-779	-785	-1,290	-296
Other investments	-2,031	-1,276	-343	-815	-933	-1,260	-1,708	-1,806
Of which : Loans	-3,081	-942	-163	-635	-753	-1,080	-1,528	-1,626
Central bank 4/	-791	459	733	565	517	274	0	0
Deposit taking corporations	-579	-124	-180	-400	-400	-400	-500	-500
General government	-992	-821	-890	-953	-1,016	-1,093	-1,156	-1,244
Other sectors	-719	-456	174	153	146	138	129	117
Change in reserve assets	760	1,112	885	716	249	699	1,782	989
Errors and omissions	-422	-585	0	0	0	0	0	0
Memorandum items:								
Current account (in percent of GDP)	-6.7	-3.9	-3.5	-3.4	-3.2	-3.0	-2.7	-2.7
Gross official reserves /5	7,106	7,495	8,380	9,096	9,345	10,044	11,826	12,815
(In months of imports of goods and nonfactor services)	4.0	3.5	3.6	3.6	3.4	3.3	3.6	3.6
(In percent of composite metric)	101	97	101	104	101	101	109	109
Net international reserves	4,162	5,149	6,766	8,048	8,813	9,787	11,568	12,558
GDP	59,378	66,696	71,608	78,169	85,331	93,150	101,685	111,002

Sources: Data provided by the Central Bank of Sri Lanka; and IMF staff estimates and projections.
1/ Under BPM5 known as Income.
2/ Under BPM5 known as Transfers.
3/ Net incurrence of short term liabilities (portfolio debt securities and loans).
4/ Credits and loans with the IMF (other than reserves).
5/ Gross reserves data in previous staff reports were adjusted for Sri Lanka's net balance with the Asian Clearance Union.

Table 5. Sri Lanka: Projected Payments to the Fund, 2014–18

(In millions of SDR, unless otherwise indicated)

	2014	2015	2016	2017	2018
Fund repurchases and charges					
In millions of SDR	488.4	370.4	331.5	173.4	0.3
In millions of U.S. dollars	755.9	578.5	523.2	276.3	0.5
In percent of exports of goods and NFS	4.3	3.0	2.4	1.2	0.0
In percent of quota	118.1	89.6	80.2	41.9	0.1
In percent of gross official reserves	9.0	6.4	5.6	2.8	0.0
Fund credit outstanding					
In millions of SDR	861	500	172	0.0	0.0
In millions of U.S. dollars	1,333	780	272	0.0	0.0
In percent of quota	208	121	42	0.0	0.0
In percent of GDP	1.9	1.0	0.3	0.0	0.0
In percent of gross official reserves	15.9	8.6	2.9	0.0	0.0
Memorandum items:					
Exports of goods and services (in millions of U.S. dollars)	17,707	19,597	21,592	23,677	26,292
Quota	413	413	413	413	413
Quota (in millions of U.S. dollars)	640	646	652	659	663
Gross official reserves (in millions of U.S. dollars)	8,380	9,096	9,345	10,044	11,826
GDP (in millions of U.S. dollars)	71,608	78,169	85,331	93,150	101,685

Source: IMF staff estimates.

Table 6. Sri Lanka: Financial Soundness Indicators—All Banks, 2008–13

	2010	2011	2012 Sept.	2012	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Capital adequacy								
Regulatory capital to risk weighted assets	16.2	16.0	15.0	15.0	16.0	16.1	15.8	16.3
Tier 1 capital/risk weighted assets	14.3	14.4	13.3	13.1	13.9	13.9	13.6	13.7
Capital to assets ratio	8.3	8.7	8.6	8.5	8.4	8.4	8.2	8.2
Asset quality								
Gross nonperforming loans to total gross loans (without interest in suspense)	5.4	3.8	4.0	3.6	4.2	4.7	5.2	5.6
Net nonperforming loans to total gross loans	3.0	2.1	2.4	2.1	2.3	2.7	2.0	3.3
Provision coverage ratio (total) 1/	58.1	57.1	50.9	54.5	45.4	44.9	50.9	40.4
Earnings and profitability								
Return on equity (after tax)	22.2	19.7	20.5	20.2	7.3	24.6	23.2	22.5
Return on assets (after tax)	1.8	1.7	1.7	1.7	0.6	2.1	2.0	1.9
Interest income to gross income	83.1	85.5	85.3	86.3	66.4	69.5	70.5	69.7
Staff expenses to noninterest expenses	45.2	43.7	45.7	45.2	45.9	46.5	46.1	44.9
Personnel expenses to total income	12.0	12.2	10.9	10.7	n.a.	25.5	25.0	25.0
Total cost to total income	71.9	73.9	74.3	75.6	79.1	91.2	n.a	56.8
Net interest margin	4.6	4.2	4.1	4.1	3.8	6.8	5.8	5.7
Liquidity								
Liquid assets to total assets	31.4	26.8	27.1	26.5	28.0	29.2	30.6	31.9
Assets/funding structure								
Deposits	72.8	72.3	70.5	70.5	70.2	n.a	n.a	n.a
Borrowings	14.3	14.9	16.2	15.8	11.2	11.6	n.a	n.a
Capital to external funds	9.5	10.0	9.9	9.9	8.4	8.4	n.a	8.2
Credit to deposits	76.4	84.7	87.6	87.4	85.7	n.a	n.a	n.a

Source: Central Bank of Sri Lanka.

1/ The drop in the provisioning ratio reflects an increase in NPLs (loans categorized as substandard or below—the denominator), with the bulk of new NPLs at the low end of provisioning requirements. For the given stock of NPLs, this ratio is expected to increase as the stock of new NPLs migrates from substandard to lower categories (doubtful and loss) and provisioning requirements increase.

INTERNATIONAL MONETARY FUND

SRI LANKA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSION—INFORMATIONAL ANNEX

July 10, 2014

Prepared By: Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of May 31, 2014)

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)	1528.25	369.68
Reserve Tranche Position	47.86	11.58

SDR Department	**SDR Million**	**% Allocation**
Net cumulative allocation	395.46	100.00
Holdings	5.75	1.45

Outstanding Purchases and Loans	**SDR Million**	**% Quota**
Stand-by Arrangements	1162.69	281.25

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				
	2014	**2015**	**2016**	**2017**	**2018**
Principal	301.44	361.73	327.28	172.25	
Charges/interest	6.16	8.64	4.20	1.16	0.39
Total	307.60	370.36	331.47	173.41	0.39

[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. Since October 2013, the Sri Lanka rupee has stabilized within a 2 percent band against the U.S. dollar. Accordingly, the de facto exchange rate arrangement has been reclassified from floating to a stabilized arrangement, effective October 1, 2013. 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 implemented majority recommendations of the report. However, staff has not received 2012-2013 Management Letters issued by the CBSL's external auditor. Delivery of this monitoring information by the CBSL is required under the safeguards policy.

Article IV Consultation

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

FSAP and ROSC Participation

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

Resident Representative

Mrs. Eteri Kvintradze has been the resident representative since March 2014.

Technical Assistance

- ***FAD.*** A number of TA missions in tax policy and administration took place during the 2000s. A series of TA missions in revenue administration were conducted in 2003. Tax policy missions took place in 2001 and 2009, to provide advice on the reform of the tax system. In 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 taxpayers compliance. In addition, a number of missions took place during 2012–2014 to strengthen Public Financial Management, improving oversight of the State-Owned Enterprises, strengthening budget preparation and improving the commitment control system.

- ***MCM.*** In August 2001, a TA mission to develop a strategy for strengthening the framework and implementation of monetary and foreign exchange cooperation 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, TA mission on financial sector issues and financial sector reforms took place, followed by 2005 mission to provide advice on the introduction of new deposit insurance scheme.

- ***STA.*** In November 2012, a mission visited Sri Lanka to report on data dissemination practices with respect to the requirements of the Special Data Dissemination Standards (SDDS). During 2013–2014, Sri Lanka has received TA provided by the IMF/STA as part of the Asia module of the JSA Project on the Improvement of statistics in the Asia and Pacific Region. This TA focused on improving data collection and compilation of ESS including balance of payments, IIP, EDS, and Reserves Data Template (RDT), and supporting the authorities in their transition to the *BPM6* format. In 2013, TA missions also took place to review work on methodological improvements to the consumer price index and the development of the new producer price index, and to provide guidance on rebasing of GDP estimates and quarterly national accounts. In 2014, a mission took place to review the Government Financial Statistics (GFS) compilation system and make recommendations on the implementation of the GFSM 2001 and its 2014 update (GFSM 2014).

RELATIONS WITH THE WORLD BANK GROUP

(As of May 30, 2014)

As set out in the Country Partnership Strategy (CPS) for FY13–16, the World Bank Group is supporting Sri Lanka in addressing its long-term strategic and structural development challenges as it transitions to middle-income country (MIC) status. Key elements of this transition include boosting investment, including in human capital, realigning public spending and policy with the needs of a middle income country, enhancing the role of the private sector, including the provision of an appropriate environment for increasing productivity and exports, and ensuring inclusive growth. The CPS set out to contribute to achieving these goals through three areas of engagement: (i) facilitating sustained private and public investment; (ii) supporting structural shifts in the economy; and (iii) improving living standards and social inclusion.

A CPS Progress Report prepared this fiscal year provided an opportunity to review the country program and strategy together with the government, taking stock both of progress to date and the government's evolving development needs and agenda. While the strategic objectives of the CPS remain relevant through FY16, the Progress Report proposed a refocusing of some activities as well as the addition of a fourth strategic area of engagement, namely increasing resilience to disasters and climate change, deemed central to Sri Lanka's current development agenda and poverty reduction efforts. As the country shifts from reconstruction to addressing the challenges of development on a middle income trajectory greater emphasis has been placed on facilitating and creating the enabling environment for increased foreign and domestic investment. At the same time, continued pockets of poverty highlight the need for renewed efforts to target development to the poor.

The World Bank has been supporting Sri Lanka's development for close to six decades, having accompanied the country as it has grown to join the ranks of middle-income countries. Sri Lanka re-emerged as a blend IDA-IBRD country in FY12, regaining access to IBRD resources after a 26-year hiatus. It will remain a blend IDA-IBRD country through the IDA17 cycle. The current active World Bank portfolio in Sri Lanka comprises the following 15 projects, with a total net commitment value of $1.77 billion:

Summary of World Bank IDA Operations

	Board Approval	Revised Closing Date	Net Comm Amount ($mil)
Dam Safety & Water Resource Planning	03/27/2008	05/15/2018	148.3
Improving Climate Resilience	04/22/2014	05/30/2019	110.0
Catastrophe DDO	04/22/2014	05/31/2017	102.0
Comm Livelihoods in Conflict Areas	06/22/2004	12/31/2014	124.7
2nd Com Dev & Livelihood improvement	09/10/2009	09/30/2014	75.0
N&E Local Services Improvement	05/13/2010	12/31/2015	50.0
LK – Road Sector Assistance	12/15/2005	09/30/2014	298.1
Provincial Roads Project	12/17/2009	03/31/2015	105.0
Metro Colombo Urban Development	03/15/2012	12/31/2017	213.0
Sri Lanka Strategic Cities Development	05/05/2014	12/31/2019	147.0
SME Development Facility	09/07/2010	03/31/2014	57.4
Warehouse Receipts Financing	06/01/2012	05/31/2015	6.5
Higher Education for 21st Century	05/13/2010	06/30/2016	40.0
Transforming School Education	11/29/2011	06/30/2017	100.0
Second Health Sector Development	03/27/2013	09/30/2018	200.0

Source: World Bank.

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of June 26, 2014)

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 enhancing the effectiveness of public investment, and (iii) human resource and knowledge development, as the focus of operations over the period 2012–16. ADB continues to focus on transport, energy, water supply and waste water management, and irrigation sectors in infrastructure development, and education sector.

- **Indicative Resources:** The allocation for 2014-2016 consists of $562 million from ordinary capital resources (OCR) and $437 million from the Asian Development Fund (ADF).

Indicative Pipeline for 2014-16

- Country Operations Business Plan (COBP) for the period 2014–16 indicates that the indicative project pipeline for 2014-2016 addresses the priority agendas of middle-income countries, such as skills development, integrated transport network development, sustainable energy, and integrated water resource management. 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 lending (RBL) programs, and additional financing. To the extent possible, thematic priorities such as gender, governance, climate change, and regional cooperation will be included in each project. Co-financing and private sector operation opportunities will be explored.

The Skills Sector Enhancement Program (RBL) approved in 2014 develops skills relevant to Sri Lanka's economy by supporting priority sectors where large skills gaps exist. The program focuses on increasing employability of the Sri Lankan workforce, particularly the youth by transforming Sri Lanka's technical and vocational education training (TVET) system into a more market responsive, inclusive, and quality-oriented one. The program will strengthen the engagement of private sector employers and bodies in TVET planning and delivery through (i) industry sector skills councils to validate skills gap analysis, training plans, competency standards, and curricula; and (ii) introduction of an employment-linked training agreement model where employer can deliver training to bridge the skills gaps.

The Integrated Road Operation and Development Investment Program (MFF) is being processed in 2014 to support the Government's program to connect 1,000 villages to city centers. It includes rehabilitation and upgrading of rural, provincial and national roads in 6 provinces. The Expressway Connectivity Investment Program (MFF) for 2015 will optimize the connectivity of highways and expressways. This includes providing the access to the expressway network from Colombo City to limit congestion. The most priority expressways to be constructed under the project will be (i) elevated expressway from Kelani Bridge to Colombo Port (port access road) and (ii) elevated expressway from Kelani Bridge to Kirulapone (baseline road).

The Green Power Development and Energy Efficiency Improvement Investment Program (MFF) to be approved in 2014 addresses the energy sector focus 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 Greater Colombo Water and Wastewater Management Improvement Investment Program (MFF) focuses on reducing nonrevenue water (NRW) and improving wastewater management in the greater Colombo area. It targets NRW reduction in Colombo City from 60 percent to about 18 percent in critical areas and to about 20 percent elsewhere after project completion. The Program will be a platform to mobilize co-financing and to introduce public–private partnerships (PPPs). The first two tranches focus on water supply, while the third and fourth tranches (planned in 2015 and 2016) primarily address wastewater management.

The Water Resources Development Investment Program (MFF) will assist the government complete outstanding water conveyance investments under the Mahaweli Development Program (MDP). Completion of MDP is a key priority of the government and will maximize the productivity of Mahaweli River Basin water resources by transferring available water to Sri Lanka's northern dry zone areas for irrigation, drinking and commercial purposes. This will accelerate local and national economic growth. The first tranche scheduled for 2015.

In the absence of a PPP framework, ADB will adopt a project-based approach to promote PPP in Sri Lanka. Performance-based contracts can be structured as part of regular sovereign projects, such as in water and wastewater management and road maintenance. ADB's Private Sector Operations supports 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 2013:** During 2013, ADB approved 3 new projects for a total of $363 million as follows:

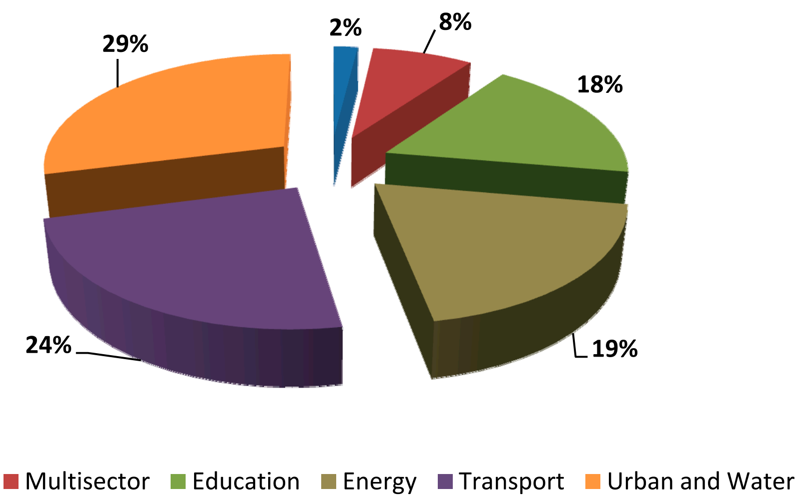
  - Education Sector Development Program ($100 million from OCR and $100 million from ADF)
  - Southern Road Connectivity Project ($70 million from OCR and $5 million from ADF)

- Greater Colombo Water And Wastewater Management Improvement Investment Program - Tranche 1 ($70 million from OCR and $18 million from ADF)

- **Portfolio Performance:** As of 31 December 2013, ADB has approved a total of 166 loans, with cumulative lending of $5.8 billion to Sri Lanka. In addition, ADB has provided $358 million grant assistance (including ADB-administered co-financed grants) for projects and $123 million through 259 technical assistance grants.

The current portfolio includes 49 ongoing loans and grants for 29 projects with a net loan amount of $2.1 billion. Cumulative contract awards reaches $1.0 billion, and disbursements $0.7 billion. 80% of the ongoing portfolio are in transport, urban and water, and energy sectors. The sector composition of the ongoing loan portfolio is in Figure 1.

Figure 1 : Sectoral Distribution



Source: Asian Development Bank

STATISTICAL ISSUES

Macroeconomic statistics are broadly adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series. Sri Lanka is a participant in the General Data Dissemination System (GDDS) since July 2000.

Price statistics. The Department of Census and Statistics (DCS) released a new Consumer Price Index for Colombo in 2007, based on the spending pattern reflected in the Household Income and Expenditure Survey. It is based on the spending patterns of all urban households in the Colombo district. A core inflation index is also compiled by the DCS to provide a measure of underlying inflation. The Central Bank of Sri Lanka (CBSL) produces a Wholesale cum-Producer Price Index (WPI/PPI).

National accounts. The national accounts suffer from insufficient data sources and undeveloped statistical techniques. Most of the data used for national accounts 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, some of the estimates of gross value added are prepared directly relying on fixed ratios, 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 relies on expenditure estimates which are available only annually and rely mostly on commodity flow techniques. Whenever possible, estimates are validated and checked with other sources.

Government finance. 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. In April 2014, a STA mission took place in the context of the Japan-funded IMF project on implementing GFSM 2001 and its update (GFSM 2014), for compiling, analyzing and reporting fiscal data.

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 (NRFC), 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.

External Sector Statistics (ESS). Since April 2014, the CBSL publishes its International Investment Position (IIP) and balance of payments statistics on an annual basis following the sixth edition of the *Balance of Payments Manual* (BPM6). Quarterly data are available three months after the end of the quarter and the CBSL plans to start publishing these data following the BPM6 in June 2014. For Quarterly external debt statistics (QEDS) for GDDS participants, Sri Lanka disseminated data up to 2013 Q1. During 2013 and 2014, Sri Lanka received TA provided by the IMF as part of the Asia module of the JSA Project on the Improvement of ESS in the Asia and Pacific Region. This TA focused on improving data collection and compilation of ESS, including balance of payments, IIP, EDS, and Reserves Data Template (RDT), and supporting the authorities in their transition to the BPM6 format.

Dissemination System/Standards (GDDS/SDDS). Sri Lanka is 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) and have since made substantial progress. However, additional work is still needed for meeting all SDDS requirements, including quarterly IIP and monthly central government operations.

General

A data ROSC mission visited Sri Lanka in 2001, followed by BCP, CPSS, IOSCO, MFPT, RSSS and Fiscal ROSC missions in 2002. A fiscal ROSC update was conducted in 2005 and reassessments of the BCP in 2007 and 2012 and of CPSS in 2007. [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 June 17, 2014

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memorandum Items:	
						Data Quality—Methodological Soundness[8]	Data Quality Accuracy and Reliability[9]
Exchange rates	Today	Today	D	D	D		
International reserve assets and reserve liabilities of the Monetary Authorities[1]	6/13/2013	Today	D	D	D		
Reserve/base money	12/2013	3/2013	M	M	M	LO, LO, LO, LO	LO, O, O, NA, NA
Broad money	12/2013	5/2014	M	M	M		
Central bank balance sheet	12/2013	5/2014	M	M	M		
Consolidated balance sheet of the banking system	12/2013	5/2014	M	M	M		
Interest rates[2]	Today	Today	D	D	D		
Consumer price index (New Colombo CPI)	5/2014	5/2014	M	M	M	O, LNO, LO, O	O, LO, O, NA, NA
Revenue, expenditure, balance and composition of financing[3]—general government[4]							
Revenue, expenditure, balance and composition of financing[3]—central government	12/2013	4/2014	M	M	M	O, O, O, O	LO, NA, LO, NA, LO
Stocks of central government and central government-guaranteed debt[5]	12/2013	4/2014	M	M	M		
External current account balance	2013Q4	4/2014	Q	Q	Q		
Exports and imports of goods and services	3/2014	5/2014	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, NA, LO
GDP/GNP	2013Q4	3/2014	Q	Q	Q	LO, LO, LNO, LNO	LNO, LNO, LO, NA, O
Gross external debt	2013Q4	6/2012	A	A	A		
International Investment Position[6]	2013	4/2014	A	A	A		

[1] 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

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

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

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

[5] Including currency and maturity composition.

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

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

[8] 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).

[9] 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.

SRI LANKA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSION—DEBT SUSTAINABILITY ANALYSIS

July 10, 2014

Approved By
Jerald Schiff and Dhaneshwar Ghura

Prepared by the Staff Representatives for the 2014 Consultation with Sri Lanka

Sri Lanka's public debt sustainability assessment remains broadly unchanged from the assessment in 2013 Article IV report. While still relatively elevated, public and external debt remains on a sustainable trajectory.

Macroeconomic assumptions:

- **Growth** in the medium-term is projected at 6.5 percent, broadly in line with the estimated potential output growth, and below the authorities' projection of 8 percent.
- After falling sharply in the second half of 2013 and early 2014 to below 4 percent, CPI **inflation** is projected to settle at 5.5 percent in the medium term. This projection is based on relatively benign external conditions, and absence of domestic supply shocks.
- The 2014 central government **budget deficit** is projected to decline to 5.2 percent of GDP, in line with the authorities' target. This implies a 0.7 percent of GDP deficit reduction relative to 2013. Tax revenues are projected to improve moderately as a percent of GDP, though less than envisaged in the authorities' budget. Revenue improvements reflects the pickup in imports, some limited tax measures, and the efforts to improve tax administration and compliance. In line with the experience of previous years, lower-than-budgeted revenues are assumed to be offset by lower-than-budgeted expenditures, keeping the deficit on target.
- **The current account** is expected to continue a gradual consolidation, mainly driven by a further strengthening of the services balance, coupled with only a modest increase in **FDI.**

Public Debt Sustainability

Background: During the last decade, central government debt fell from over 90 percent of GDP to below 80 percent of GDP, reflecting relatively low borrowing costs and strong growth, supported by gradually improving primary balance. However, with the reduced role of concessional financing and increased role of commercial borrowing, the average borrowing costs of foreign debt have been recently increasing. The share of local and foreign currency-denominated debt has remained broadly constant, but the average maturity of the debt has been increasing, reflecting the authorities' effort to rely less on issuance of short-term debt. Following the launch of international sovereign bond issuance in 2007 and pickup in non-concessional bilateral and multilateral loans, the share of non-concessional debt in total foreign debt increased from about one fourth in 2009 to one half in 2013. Nonresidents' holdings of government securities in local currency are capped at 12.5 percent of total domestic currency denominated debt, and the authorities are not currently envisaging increasing that ceiling.

Baseline: Under the baseline scenario, the ratio of public debt-to-GDP is projected to decline by about 15 percentage points, to 63 percent GDP by 2019. The primary balance is projected to remain close to zero, about 3 percent of GDP stronger than the debt-stabilizing primary balance. Baseline scenario is based on a conservative growth projection - somewhat lower than other international financial institutions' projections, and 1 ½ percentage point lower than the authorities' target. The projected strengthening in Sri Lanka's cyclically adjusted primary balance is relatively modest, placing it broadly in the middle of distribution of adjustment size among the comparator countries.

Heat map analysis suggests high risks to debt sustainability. The debt burden benchmark of 70 percent of GDP and gross financing need benchmark of 15 percent of GDP are exceeded in all shock scenarios. This contrasts with a benign market assessment (bond spreads are well within the 200–600 point range of lower and upper risk benchmark). Favorable market sentiment reflects: (i) strong economic growth; (ii) favorable global environment; (iii) sustained fiscal adjustment and falling debt ratio; (iv)credible commitment to further deficit and debt reduction in the future; and (v) limited nonresident holding of government debt in domestic currency which contributed to Sri Lanka's resilience during market turbulence.

Risks. The DSA illustrates the critical contribution of growth to recent and projected reduction in the debt ratio. Slower-than-projected growth (alone or combined with a higher primary deficit and higher borrowing costs) could stop or reverse the decline in debt ratio (see macro-fiscal and slow adjustment shocks). The high share of foreign currency-denominated debt also creates a vulnerability to currency depreciation. Sri Lanka's debt is also high as a percent of government revenue—a moderate increase in borrowing costs could eat up a large share of revenues. Looking ahead, increasing reliance on nonconcessional financing, together with the normalization of global financial conditions will push up borrowing costs. Further reduction of the deficit and debt (via revenue gains) is crucial for maintaining market confidence and solid growth.

The authorities' views. There were no major disagreements about the conclusions of debt sustainability analysis. However, the authorities have somewhat more sanguine view, and project a faster reduction of the debt ratio, to 65 percent of GDP by 2016, compared to 71 percent of GDP projected by staff. The main reason for their more favorable debt trajectory is higher projected real GDP growth, averaging 8.1 percent in 2014–1016, compared to staff's average projected growth 6 2/3 percent. In addition, the authorities project a somewhat faster fiscal deficit reduction, reflecting more optimistic revenue projection.

External Debt Sustainability

Structure of debt: While the majority of the external debt, 56.1 percent at end-2013, is still owed by the government, this relationship is quickly changing. The recent increase in private debt has, however, been primarily long term debt. 96.8 percent of public external debt is long term with still a large share of that being contracted on concessional terms, which limits the rollover risks. Outstanding Eurobonds end-April 2014 total US$5 billion, with US$0.5 billion maturing in January 2015 and US$1.5 billion in 2019.

Baseline: as of end-2013 total external debt is estimated to 59.6 percent of GDP, down from 62.5 percent of GDP at end-2012 driven by strong GDP growth and price and exchange rate dynamics. With relatively modest FDI inflows, total external debt as share of GDP is expected to decrease only gradually to just over 50 percent in 2019, GDP growth continuing being the main contributor to this decline.

Other scenarios: the standard alternative scenarios point to a depreciation shock as the main vulnerability, with a real depreciation of 30 percent leading to external debt increasing to nearly 80 percent at the end of the period. Meanwhile, if the current account deficit were to be on average 1.4 percent of GDP larger over the period, this would leave external debt virtually unchanged at the current level.

Risks: this assessment is based on the assumption of continued strong growth and an improvement in the current account, and weaker than expected external demand and lower tourism receipts pose obvious risks. On the positive side, a stronger inflow of FDI would not only have beneficial growth effects, but also decrease the need for debt-creating inflows to finance the current account deficit. Overall, the future external debt levels and vulnerabilities will also depend on the authorities' policies in terms of opening up the capital account from its current relatively tight capital controls. The authorities' ambition to reduce public debt is very welcome, but if it comes with an equivalent increase in private sector external borrowing to fill the financing of the current account deficit, external vulnerabilities for the economy as a whole will not be reduced.

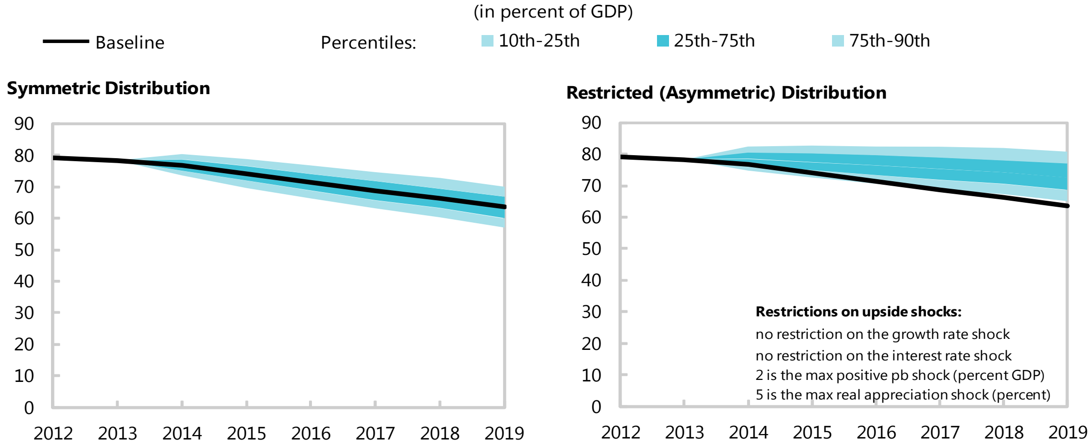
Sri Lanka Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

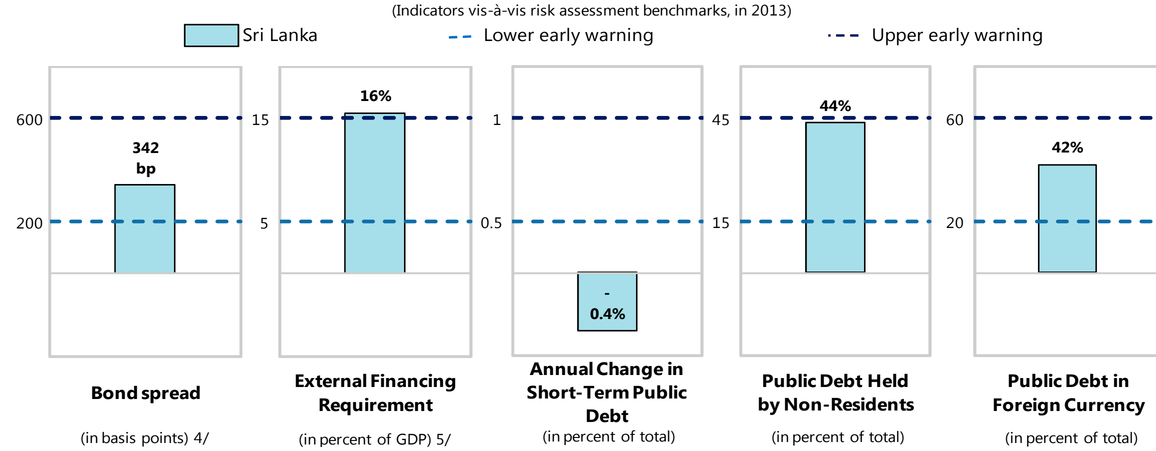
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

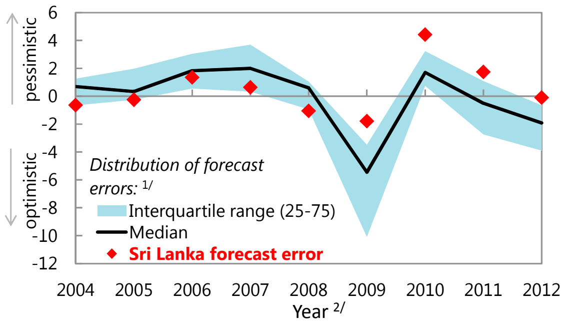
4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 06-Mar-14 through 04-Jun-14.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

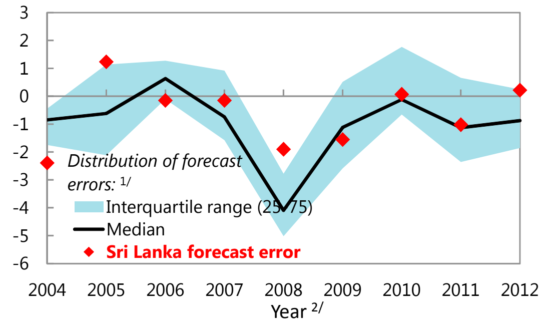
Sri Lanka Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus program countries

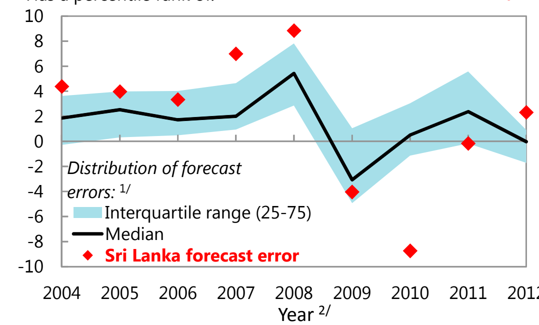
Real GDP Growth
(in percent, actual-projection)
Sri Lanka median forecast error, 2004-2012: **-0.09**
Has a percentile rank of: **38%**



Primary Balance
(in percent of GDP, actual-projection)
Sri Lanka median forecast error, 2004-2012: **-0.15**
Has a percentile rank of: **52%**

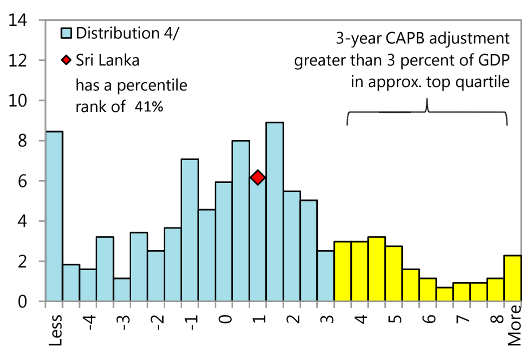


Inflation (Deflator)
(in percent, actual-projection)
Sri Lanka median forecast error, 2004-2012: **3.33**
Has a percentile rank of: **72%**

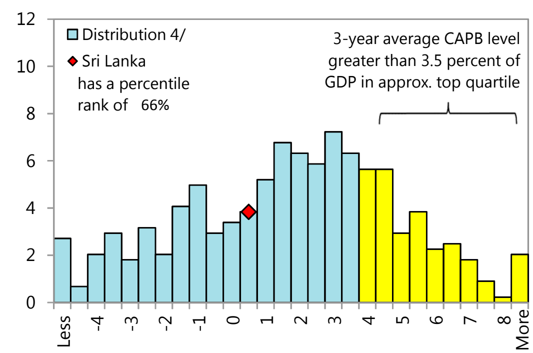


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

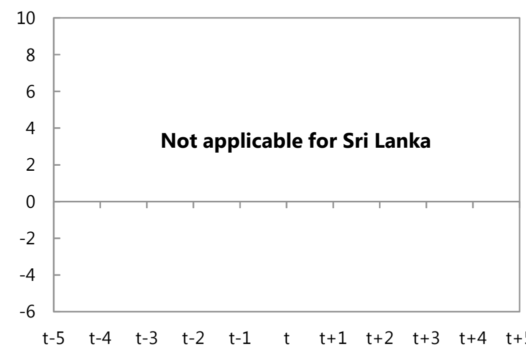


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes program countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Sri Lanka, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Sri Lanka Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

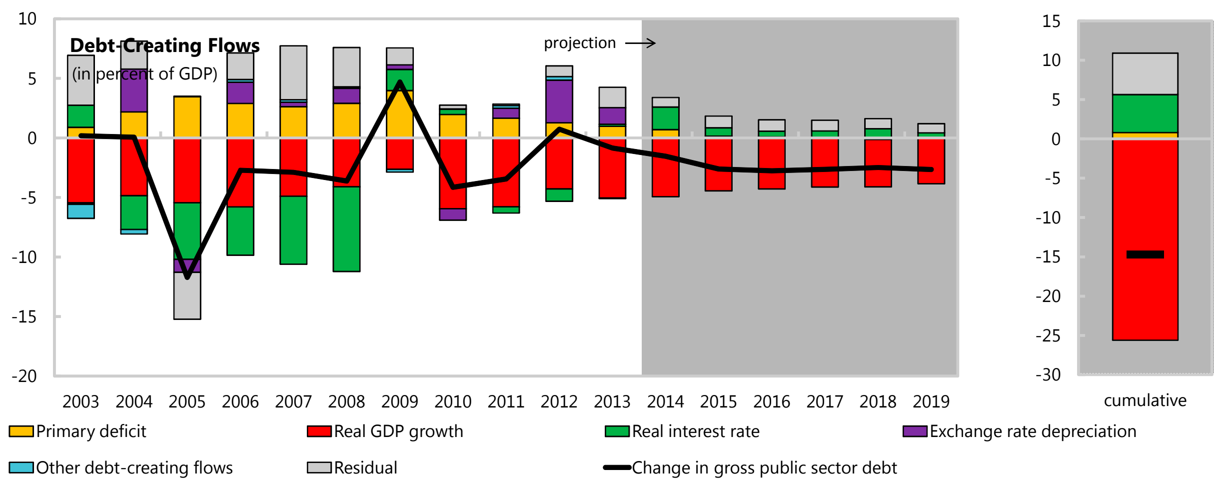
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2003-2011 [2]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	88.4	79.2	78.3	76.8	74.2	71.4	68.8	66.3	63.6
Public gross financing needs	28.1	24.8	23.5	19.4	18.5	15.3	14.5	15.6	15.2
Real GDP growth (in percent)	6.4	6.3	7.3	7.0	6.5	6.5	6.5	6.5	6.5
Inflation (GDP deflator, in percent)	9.7	8.9	6.7	3.8	5.4	5.5	5.5	5.5	5.5
Nominal GDP growth (in percent)	16.7	15.8	14.5	11.1	12.3	12.3	12.3	12.3	12.3
Effective interest rate (in percent) [4]	7.2	8.0	7.4	6.8	6.8	6.6	6.7	7.1	6.6

As of June 04, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		312
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	B+	B+
Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	-2.6	0.7	-0.9	-1.5	-2.6	-2.8	-2.6	-2.5	-2.6	-14.7	-3.4
Identified debt-creating flows	-4.2	-0.2	-2.6	-2.3	-3.6	-3.7	-3.5	-3.3	-3.4	-20.0	
Primary deficit	2.5	1.3	1.0	0.7	0.2	0.1	0.0	-0.1	0.0	0.8	
Primary (noninterest) revenue and grants	15.1	13.0	12.2	13.1	13.7	13.9	14.1	14.3	14.5	83.6	
Primary (noninterest) expenditure	17.6	14.3	13.1	13.8	13.9	14.0	14.1	14.2	14.5	84.5	
Automatic debt dynamics [5]	-6.6	-1.7	-3.5	-3.0	-3.7	-3.8	-3.6	-3.2	-3.4	-20.8	
Interest rate/growth differential [6]	-7.3	-5.3	-4.9	-3.0	-3.7	-3.8	-3.6	-3.2	-3.4	-20.8	
Of which: real interest rate	-2.3	-1.0	0.2	1.9	0.7	0.5	0.6	0.8	0.4	4.8	
Of which: real GDP growth	-5.0	-4.3	-5.0	-4.9	-4.4	-4.3	-4.1	-4.0	-3.8	-25.6	
Exchange rate depreciation [7]	0.7	3.6	1.4	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits (ne	-0.1	0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroare	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	1.6	0.9	1.7	0.8	1.0	1.0	0.9	0.8	0.8	5.3	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as -g.

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

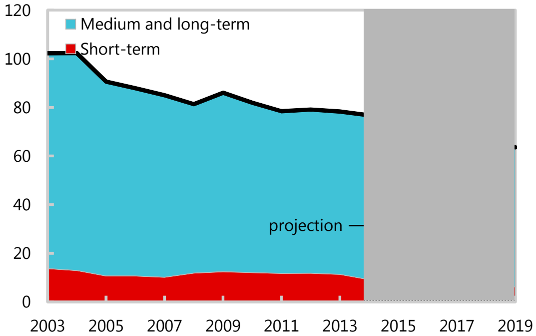
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ 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.

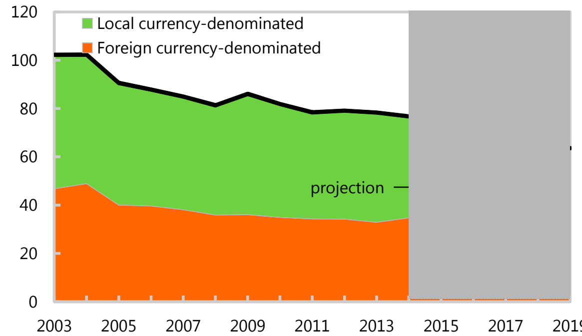
Sri Lanka Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



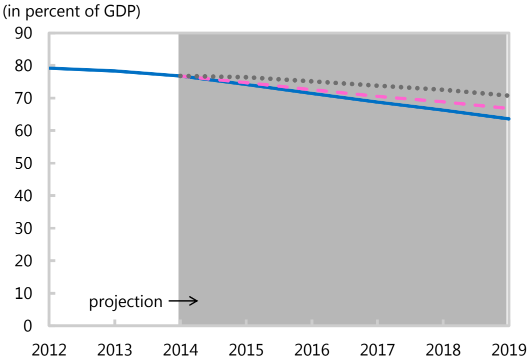
By Currency
(in percent of GDP)



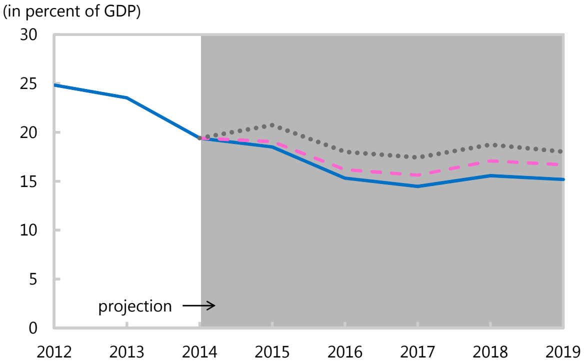
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

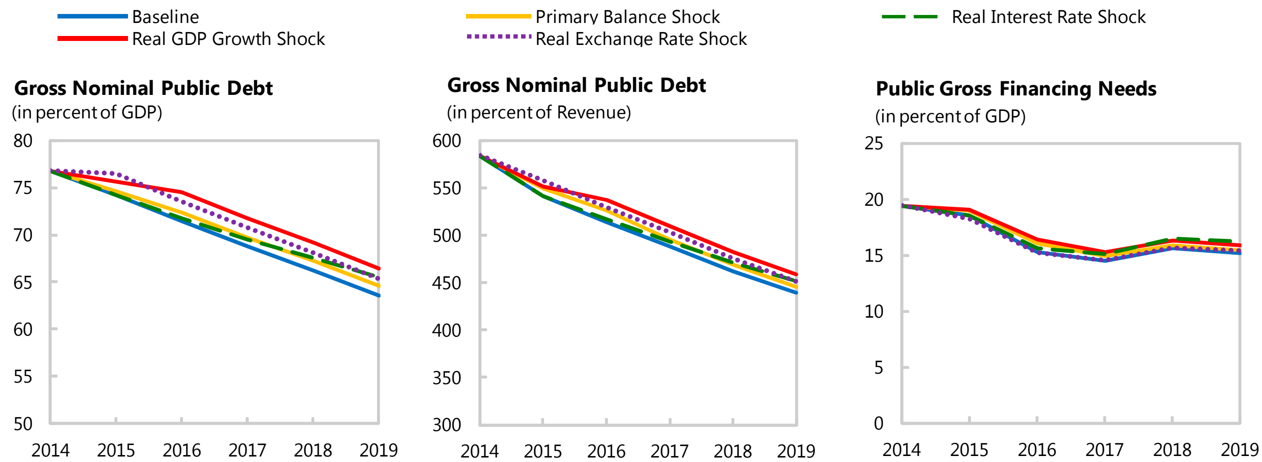
Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	7.0	6.5	6.5	6.5	6.5	6.5
Inflation	3.8	5.4	5.5	5.5	5.5	5.5
Primary Balance	-0.7	-0.2	-0.1	0.0	0.1	0.0
Effective interest rate	6.8	6.8	6.6	6.7	7.1	6.6
Constant Primary Balance Scenario						
Real GDP growth	7.0	6.5	6.5	6.5	6.5	6.5
Inflation	3.8	5.4	5.5	5.5	5.5	5.5
Primary Balance	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	6.8	6.8	6.6	6.7	7.1	6.6

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	7.0	6.6	6.6	6.6	6.6	6.6
Inflation	3.8	5.4	5.5	5.5	5.5	5.5
Primary Balance	-0.7	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	6.8	6.8	5.6	5.4	5.5	4.6

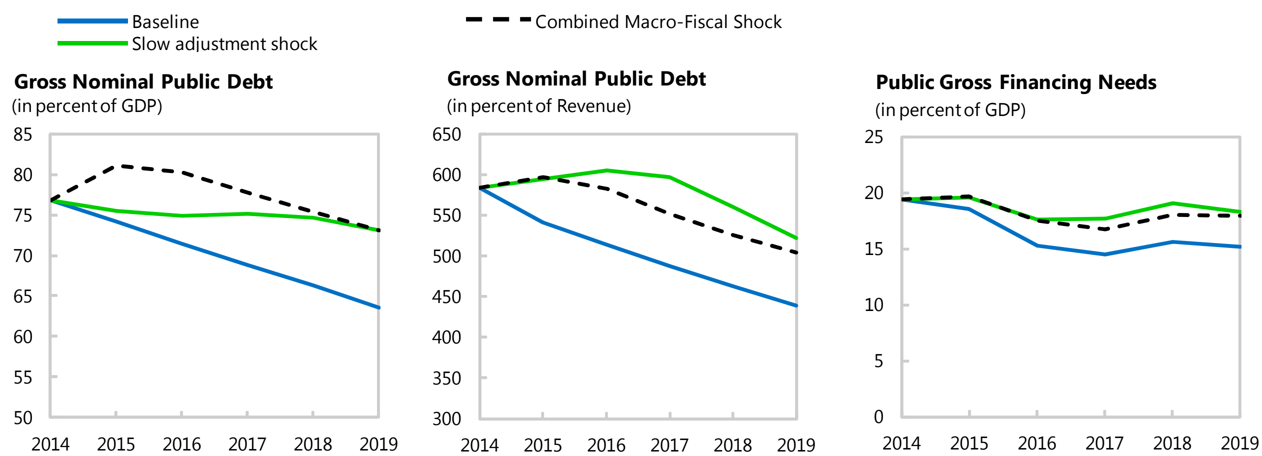
Source: IMF staff.

Sri Lanka Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

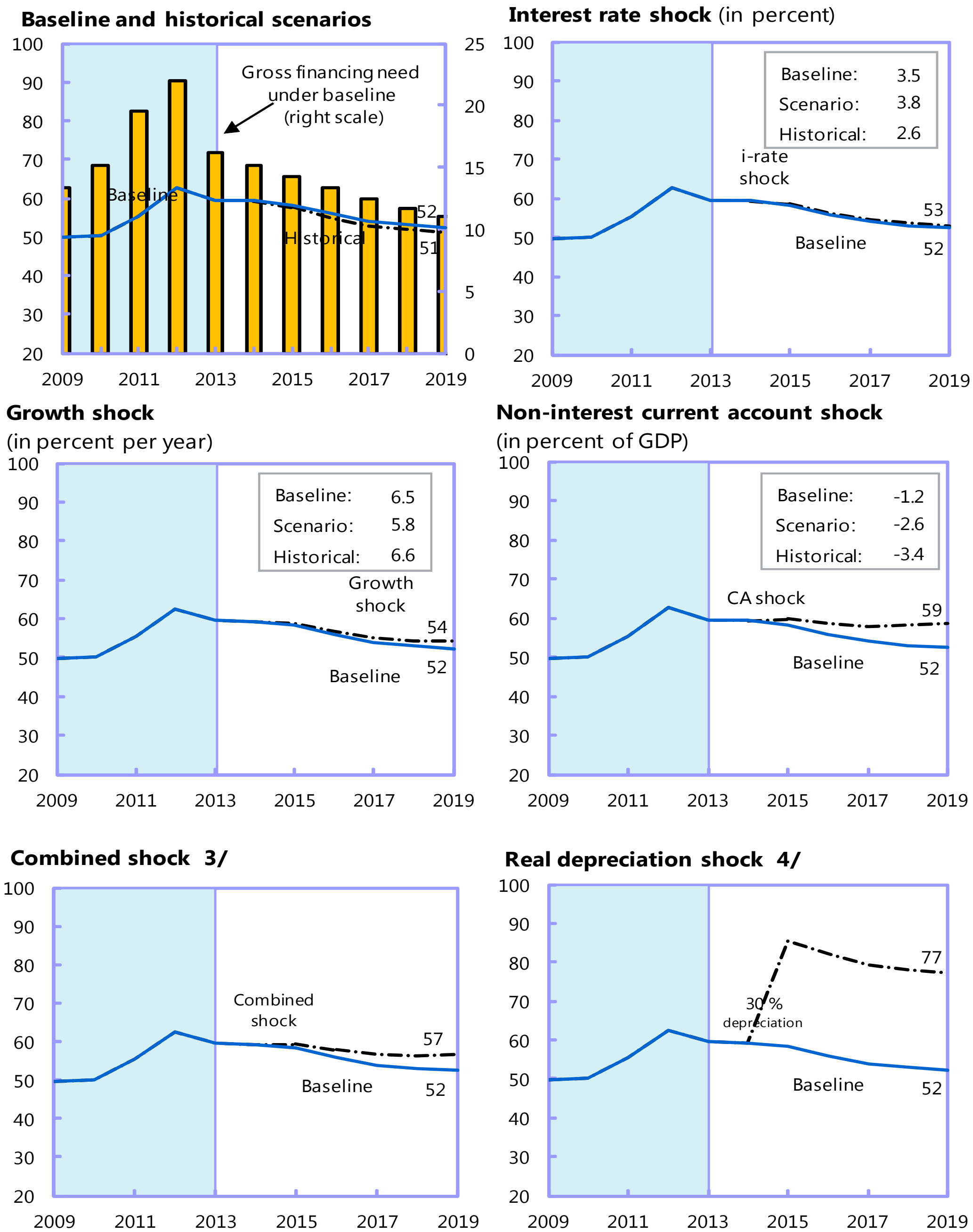
	2014	2015	2016	2017	2018	2019
Primary Balance Shock						
Real GDP growth	7.0	6.5	6.5	6.5	6.5	6.5
Inflation	3.8	5.4	5.5	5.5	5.5	5.5
Primary balance	-0.7	-0.6	-0.6	0.0	0.1	0.0
Effective interest rate	6.8	6.8	6.6	6.8	7.1	6.6
Real Interest Rate Shock						
Real GDP growth	7.0	6.5	6.5	6.5	6.5	6.5
Inflation	3.8	5.4	5.5	5.5	5.5	5.5
Primary balance	-0.7	-0.2	-0.1	0.0	0.1	0.0
Effective interest rate	6.8	6.8	7.1	7.4	8.0	7.6
Combined Shock						
Real GDP growth	7.0	5.1	5.1	6.5	6.5	6.5
Inflation	3.8	5.1	5.1	5.5	5.5	5.5
Primary balance	-0.7	-0.6	-0.7	0.0	0.1	0.0
Effective interest rate	6.8	7.1	6.9	7.3	7.8	7.5

	2014	2015	2016	2017	2018	2019
Real GDP Growth Shock						
Real GDP growth	7.0	5.1	5.1	6.5	6.5	6.5
Inflation	3.8	5.1	5.1	5.5	5.5	5.5
Primary balance	-0.7	-0.4	-0.6	0.0	0.1	0.0
Effective interest rate	6.8	6.8	6.6	6.8	7.1	6.6
Real Exchange Rate Shock						
Real GDP growth	7.0	6.5	6.5	6.5	6.5	6.5
Inflation	3.8	9.3	5.5	5.5	5.5	5.5
Primary balance	-0.7	-0.2	-0.1	0.0	0.1	0.0
Effective interest rate	6.8	7.1	6.4	6.6	6.9	6.4

Source: IMF staff.

Sri Lanka: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half 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.

Sri Lanka: External Debt Sustainability Framework, 2011-2019
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2011	2012	2013			2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	55.4	62.5	59.6			**59.2**	**58.3**	**55.9**	**54.0**	**53.0**	**52.4**	**-4.3**
2 Change in external debt	5.2	7.1	-2.9			-0.4	-1.0	-2.3	-1.9	-1.0	-0.6	
3 Identified external debt-creating flows (4+8+9)	-1.8	4.1	-4.7			-2.1	-1.8	-1.9	-2.1	-2.2	-2.1	
4 Current account deficit, excluding interest payments	6.6	5.2	2.2			1.8	1.7	1.5	1.2	0.9	0.8	
5 Deficit in balance of goods and services	14.6	13.7	9.6			11.0	10.9	10.7	10.4	9.8	9.5	
6 Exports	23.1	22.9	22.6			24.7	25.1	25.3	25.4	25.9	25.9	
7 Imports	37.6	36.6	32.2			35.7	36.0	36.0	35.8	35.7	35.4	
8 Net non-debt creating capital inflows (negative)	-1.5	-1.9	-1.7			-1.7	-1.7	-1.7	-1.7	-1.7	-1.7	
9 Automatic debt dynamics 1/	-6.9	0.8	-5.2			-2.2	-1.8	-1.7	-1.6	-1.4	-1.3	
10 Contribution from nominal interest rate	1.2	1.5	1.7			1.7	1.7	1.8	1.8	1.8	1.9	
11 Contribution from real GDP growth	-3.5	-3.5	-4.1			-3.9	-3.5	-3.5	-3.3	-3.2	-3.2	
12 Contribution from price and exchange rate changes 2/	-4.6	2.8	-2.9			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	7.0	3.0	1.8			1.7	0.9	-0.4	0.1	1.2	1.6	
External debt-to-exports ratio (in percent)	240.0	273.3	263.6			239.5	232.4	221.0	212.4	205.0	202.2	
Gross external financing need (in billions of US dollars) 4/	11.5	13.0	10.8			10.8	11.1	11.4	11.6	11.9	12.3	
in percent of GDP	19.5	21.9	16.2	10-Year	10-Year	15.1	14.3	13.4	12.5	11.7	11.1	
Scenario with key variables at their historical averages 5/						**59.2**	**57.6**	**54.9**	**52.9**	**51.8**	**51.1**	**-6.5**
Key Macroeconomic Assumptions Underlying Baseline				Historical Average	Standard Deviation							
Real GDP growth (in percent)	8.2	6.3	7.3	6.6	1.4	7.0	6.5	6.5	6.5	6.5	6.5	
GDP deflator in US dollars (change in percent)	10.3	-5.6	4.7	6.7	6.7	0.3	2.5	2.5	2.5	2.5	2.5	
Nominal external interest rate (in percent)	2.8	2.7	3.0	2.6	0.5	3.0	3.2	3.3	3.5	3.7	3.9	
Growth of exports (US dollar terms, in percent)	22.9	-0.5	11.1	9.1	10.2	17.4	10.7	10.2	9.7	11.0	9.5	
Growth of imports (US dollar terms, in percent)	46.2	-2.4	-1.0	12.5	19.6	18.9	10.0	9.1	8.6	8.8	8.4	
Current account balance, excluding interest payments	-6.6	-5.2	-2.2	-3.4	2.7	-1.8	-1.7	-1.5	-1.2	-0.9	-0.8	
Net non-debt creating capital inflows	1.5	1.9	1.7	1.4	0.4	1.7	1.7	1.7	1.7	1.7	1.7	

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

2/ 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).

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

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

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

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

Press Release No. 14/371
FOR IMMEDIATE RELEASE
July 29, 2014

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

IMF Executive Board Concludes 2014 Article IV Consultation and Second Post Program Monitoring Discussion with Sri Lanka

On July 23, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] and second Post-Program Monitoring discussion with Sri Lanka and considered and endorsed the staff appraisal without a meeting.[2]

Sri Lanka's economic growth has been one of the fastest among Asia's developing economies in recent years. After falling to 6.3 percent in 2012, real GDP growth accelerated to 7.3 percent in 2013—driven primarily by a pickup in services activity, and supported by manufacturing and construction, but also benefiting from an increase in net exports. Inflation has remained low, falling to 4.7 percent at the end of 2013 and to 3.2 percent year-on-year in May 2014. Fiscal consolidation has continued, with the overall fiscal deficit falling to 5.9 percent of GDP in 2013. A strong recovery in exports in the second half of 2013 and into 2014, combined with declining imports and continued inflow of remittances and services receipts, has bolstered the balance of payments. Together with issuance of external debt, this has allowed the Central Bank of Sri Lanka to accumulate international reserves. Monetary policy has been accommodative, but private credit growth has been slow.

The short-term outlook appears broadly positive, as Sri Lanka is well positioned to benefit from the global economic recovery and particularly stronger growth in advanced economies. Real GDP growth is expected to remain robust at about 7 percent in 2014, while inflation is likely to remain in the mid-single digits. The government has targeted a further reduction of the fiscal deficit to 5.2 percent of GDP, which should allow for even more reduction of public debt. With a continued robust export performance, the current account deficit is expected to narrow further and allow for some additional accumulation of international reserves.

[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal canbe considered without convening formal discussions.

Near-term risks appear moderate given the ongoing recovery of advanced economies and a relatively benign outlook for international commodity prices. Adverse climatic events (such as the recent drought) remain a chronic source of vulnerability. Medium-term risks center on the potential for slower-than-projected growth in the advanced economies, tighter external liquidity conditions and chronic turbulence in international capital markets (negatively affecting rollovers and borrowing costs), and continued weakness in government revenues, which could threaten fiscal and debt consolidation objectives.

Executive Board Assessment

In concluding the 2014 Article IV consultation with Sri Lanka, Executive Directors endorsed the staff's appraisal as follows:

Sri Lanka's recent economic performance has been better than expected—particularly given some headwinds from chronic market turbulence and climatic shocks. While there remain weak spots in economic activity (such as agriculture, which has been negatively affected by recent drought), strong activity in traditional sectors such as garment manufacture, and new sectors such as tourism and services bode well for the near and medium-term outlook. This is complemented by a sustained reduction in headline and core inflation—bringing a new and welcome level of stability which has hopefully fed into a new set of public expectations regarding inflation.

The government has remained solidly committed to fiscal consolidation and reduction of public debt as a mainstay of macroeconomic stability. In this context, and given rising economic growth, the mission saw the fiscal stance for 2014 as appropriate, but raised concern about the composition of further consolidation. Capacity in expenditure and commitment control has increased, enhancing the government's ability to curtail spending to meet fiscal objectives. However, given sizeable investment needs, the staff was of the view that spending cuts may have reached their effective limit, and that the burden of adjustment needed to fall more squarely on increasing revenue. Particularly if Sri Lanka is to maintain current growth momentum and foster economic development and diversification, high and sustained levels of public spending on infrastructure and human capital will be essential. Tackling the issue of tax expenditures and broadening the tax base will be essential. The mission appreciated the steps taken thus far, but was of the view that the pace of reform in this area could reasonably be accelerated. There is also room, in the mission's view, to take another look at the medium- and long-term strategy for debt reduction, and consider a more ambitious debt target (more strongly associated with reduced vulnerability) over a longer time horizon.

The current, supportive stance of monetary policy is appropriate given the decline in inflation and weak private credit growth. However, the overall picture is complex and requires close monitoring. On the one hand, with economic activity apparently on the rise and private credit (outside of pawning activity) beginning to show signs of recovery, the authorities should be ready to adjust rates as needed to ensure price stability—particularly given the long lags involved in monetary transmission. On the other hand, the current low inflation environment and the apparent change in inflation expectations offers an opportunity for a downward shift in the interest rate structure that might benefit the investment environment (and borrowing costs) over the medium term. Given the mix of signals, a cautious approach is warranted and the staff believes policy rates should remain on hold for the near term.

Exchange rate policy remains broadly appropriate, but should be monitored in light of developments in the balance of payments and inflation, and the commitment to flexibility maintained. Staff's analysis indicates that the exchange rate is broadly in line with fundamentals, and staff saw merit in central banks' purchases to build its reserves, which remain on the lower end of most reserve adequacy metrics. However, staff also cautioned that the persistent stability of the rupee (vis-à-vis the US dollar) that has arisen as a side effect of foreign exchange absorption by the central bank since the fourth quarter of 2013 carries risks. First, it may create the perception that the rupee is implicitly fixed—a point supported by the shift in exchange rate classification from "managed float" to "stabilized" under the IMF's Annual Report on Exchange Rate Arrangements. This perception could lead market participants and firms to hold un-hedged foreign exchange risk on their balance sheets. Second, should external balance continue to improve and inflation stay low, it could gradually lead to increasing currency misalignment. The central bank should thus be prepared to allow sufficient exchange rate flexibility to adjust to fundamental pressures, while limiting intervention to accumulation of reserves and smoothing short-term volatility.

Recent improvements in the trade and current account balances notwithstanding, Sri Lanka remains vulnerable to external shocks. Medium-term sustainability will depend on maintaining an outward orientation, diversification of the export structure, and a judicious use of foreign borrowing—particularly given the rapid increase in debt servicing costs that have accompanied the shift from bilateral concessional debt to new loans on commercial terms. The Market Access Debt Sustainability Analysis (MAC-DSA) highlights the sensitivity of Sri Lanka's debt sustainability to growth and foreign exchange shocks. The staff urges caution with respect to external borrowing through the banking system.

Financial sector consolidation has potential benefits in the form of economies of scale, new products and services, and a greater resilience (via a stronger capital base) to shocks. The benefits of consolidation would likely be more rapid if fewer restrictions were placed on restructuring operations. Continued progress on corporate governance is also key. Close supervision during and after the consolidation process could also help avoid some of the pitfalls encountered by other countries in episodes of financial sector restructuring, such as excessive credit growth. Consolidation may also result in increased concentration and hinder effective competition if larger and state-owned banks continue to grow and dominate the banking sector.

Sri Lanka: Selected Economic Indicators, 2011–14

	2011	2012	2013	2014
			Prel.	Proj.
GDP and inflation (in percent)				
Real GDP growth	8.2	6.3	7.3	7.0
Inflation (average)	6.7	7.5	6.9	3.8
Inflation (end-of-period)	4.9	9.2	4.7	5.2
Core inflation (end-of-period)	4.7	7.5	2.1	4.3
Savings and investment (in percent of GDP)				
National savings	22.2	23.9	27.7	28.6
Government	-0.9	-1.2	-0.8	0.4
Private	23.0	25.1	28.6	28.2
National Investment	30.0	30.6	31.6	32.0
Government	6.3	2.3	2.9	3.1
Private	23.6	28.4	28.8	29.0
Savings-Investment balance	-7.8	-6.7	-3.9	-3.5
Government	-7.3	-3.6	-3.9	-3.0
Private	-0.4	-3.0	0.0	-0.4
Public finances (in percent of GDP) 1/				
Revenue	14.3	13.0	12.2	13.1
Grants	0.2	0.2	0.2	0.3
Expenditure	21.4	19.7	18.3	18.7
Central government balance	-6.9	-6.5	-5.9	-5.2
Central government domestic financing	3.5	2.7	4.6	1.8
Government debt (domestic and external)	78.5	79.2	78.3	76.8
Money and credit (percent change, end of period)				
Reserve money	21.9	10.2	0.9	15.0
Broad money	19.1	17.6	16.7	15.1
Domestic credit	34.3	21.7	13.9	11.9
Credit to private corporations	34.5	17.6	7.5	14.9
Credit to government	33.7	29.6	24.6	8.0
Balance of payments (in millions of U.S. dollars)				
Exports	10,559	9,773	10,394	11,822
Imports	-20,269	-19,190	-18,003	-21,399
Current account balance	-4,615	-3,983	-2,606	-2,491
Current account balance (in percent of GDP)	-7.8	-6.7	-3.9	-3.5
Export value growth (percent)	22.4	-7.4	6.4	13.7
Import value growth (percent)	50.7	-5.3	-6.2	18.9
Gross official reserves (end of period) 2/				
In millions of U.S. dollars	6,749	7,106	7,495	8,380
In months of imports	3.2	4.0	3.5	3.6
External debt (public and private)				
In billions of U.S. dollars	32.7	37.1	39.7	42.4
As a percent of GDP	55.4	62.5	59.6	59.2
Memorandum items:				
Nominal GDP (in billions of U.S. dollars)	59.2	59.4	66.7	71.6

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

1/ Revenue and expenditure from 2011 to 2013 may be different from numbers published by Sri Lankan authorities due to different accounting methodology.

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