



SRI LANKA

December, 2015

THIRD POST-PROGRAM MONITORING DISCUSSION— STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

In the context of the third Post-Program Monitoring discussions, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its April 29, 2015 consideration of the staff report that concluded third Post-Program Monitoring Discussion with Sri Lanka.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on April 29, 2015, following discussions that ended on March 4, 2015, with the officials of Sri Lanka on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 14.
- A **Supplement to the Staff Report** updating information on recent developments.
- A **Statement by the Executive Director** for Sri Lanka.

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IMF Executive Board Concludes Third Post Program Monitoring Discussion with Sri Lanka

On April 29, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the third Post-Program discussion with Sri Lanka.¹

Recent macroeconomic performance has generally been strong but risks appear to be on the rise. Real GDP growth registered 7.4 percent in 2014. Growth was broad-based, with the exception of agriculture which suffered from drought early in the year and heavy rains and flooding in the fourth quarter. Price pressures have been contained, with headline and core inflation declining to 2.1 and 1.2 percent, respectively, by end-year. Reductions in administered prices for fuels facilitated the record low levels of inflation. Preliminary data indicate the 2014 fiscal deficit exceeded the budget target by about 1 percent of GDP, as spending cuts were unable to compensate for a further decline in the tax revenue-to-GDP ratio. This is the first year since 2009 that the deficit was not reduced as a share of GDP. Monetary policy has been accommodative, with private sector credit showing signs of recovery late in the year. The external current account was broadly stable in 2014, with stronger tourism and remittances partially offsetting a wider trade deficit as goods imports recovered in the second half of the year. For the year as a whole, the Central Bank of Sri Lanka managed to accumulate foreign exchange reserves of \$721 million.

The outlook is broadly stable but set against heightened downside risks. Real GDP growth is projected at 6.5 percent in 2015 and beyond—in line with the staff's estimate of potential output. While there is considerable growth momentum, downward pressure may emerge from such factors as lower public and private investment due to budget cuts and an uncertain policy environment, a crowding out of private sector credit, and the potential for negative spillovers from slower economic recovery in Europe—one of Sri Lanka's two most important export markets.

The fiscal deficit is a key concern for 2015 and the medium-term. The 2015 deficit target will likely be very difficult to reach even with relatively optimistic assumptions regarding revenue gains. Further, in the absence of new measures to create a more durable increase in tax collection, revenues in 2016 will drop as the one-off measures expire, while the permanent

¹ Post-Program Monitoring provides for more frequent consultations between the IMF and members whose arrangement has expired but that continue to have IMF credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

increase to recurrent spending from the revised 2015 budget will likely push the deficit higher—raising the level of risk to debt sustainability.

The external sector outlook for 2015 appears favorable, but there are several risks. The sharp drop in oil prices will likely generate a substantial windfall for Sri Lanka's import bill—equivalent to about \$2 billion for 2015 as a whole. Assuming goods exports remain in the current range, the improvement in the trade balance should provide a cushion to the overall balance of payments and allow for further accumulation of central bank foreign exchange reserves. With capital flows at comparatively normal levels, net inflows should be sufficient to keep central bank foreign exchange reserves in the range of around 4 months of imports. However, risks to this outlook include (i) an eventual reversion of the oil price shock; (ii) a slowdown in goods exports in the event growth in key export markets stalls; and (iii) less optimistic assumptions regarding net capital flows.

Even though outstanding borrowing from the IMF has fallen below 200 percent of quota, the staff recommends continuing post-program monitoring (PPM) until the fiscal and external positions strengthen, and a medium-term package of policies is in place.

Executive Board Assessment

Directors welcomed Sri Lanka's recent favorable economic performance, including robust growth, low inflation, and a narrowing of the current account deficit. At the same time, they noted that fiscal risks and reduced external buffers pose challenges, underscoring the need for greater efforts to strengthen the policy framework and reduce vulnerabilities.

Directors welcomed the authorities' commitment to fiscal consolidation. However, they noted with concern that the deficit target under the revised 2015 budget relies to a large extent on one-off revenue measures. Given the risks associated with the high public debt, Directors urged the authorities to adopt more ambitious measures to contain current expenditure while protecting priority social and high value-added infrastructure spending. They emphasized that a strengthening of the fiscal framework is needed to support consolidation and debt reduction. Comprehensive tax policy and administration reforms, including tax expenditure reductions and simplification of the tax system to broaden the revenue base, will be crucial elements in a medium-term fiscal reform strategy.

Directors noted the resumption of private credit growth following monetary easing in 2013-14. They advised close monitoring of credit and inflation developments, given the potential turn in the credit cycle and long lags in monetary transmission. They stressed that it is important to be prepared to act if signs of overheating emerge.

Directors welcomed the authorities' efforts to address weaknesses in the external sector, including plans to establish new swap lines and rebuild external reserve buffers. In this context, they underscored the importance of exchange rate flexibility in protecting international

reserves and facilitating external adjustment. Further structural reforms will also be needed to raise productivity and improve the business climate and competitiveness.

Directors welcomed the reduction in banks' nonperforming assets and the authorities' efforts to bolster supervision and regulation. They highlighted the need for a strong supervisory and clear crisis management framework to be extended to the nonbank sector. They encouraged the authorities to move expeditiously to provide clarity to markets regarding financial sector consolidation.

Directors agreed to extend post-program monitoring in light of risks and the desirability of maintaining a close policy discussion between the authorities and the Fund. Directors looked forward to the new government's comprehensive economic policy agenda.

Table 1. Sri Lanka: Selected Economic Indicators, 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.				Proj.		
GDP and inflation (in percent)									
Real GDP growth	6.4	7.3	7.4	6.5	6.5	6.5	6.5	6.5	6.5
Inflation (average)	7.5	6.9	3.3	1.7	3.4	4.3	5.0	5.0	5.0
Inflation (end-of-period)	9.2	4.7	2.1	3.2	3.6	5.0	5.0	5.0	5.0
Core inflation (end-of-period)	7.5	2.1	1.2	2.3	2.7	4.1	4.1	4.1	4.1
Savings and investment (in percent of GDP)									
National savings	23.9	26.0	23.9	25.9	25.6	25.6	25.4	25.5	25.7
Government	-1.2	-0.8	-1.4	-1.8	-2.4	-2.1	-1.9	-2.0	-1.9
Private	25.1	26.9	25.3	27.7	28.0	27.7	27.3	27.5	27.6
National Investment	30.6	29.9	27.6	27.9	28.2	28.3	28.4	28.5	28.7
Government	6.9	6.9	4.6	4.9	5.1	5.2	5.3	5.5	5.7
Private	23.7	23.0	23.0	23.0	23.0	23.0	23.0	23.0	23.0
Public finances (in percent of GDP)									
Revenue	13.0	12.2	11.6	13.1	12.3	12.5	12.9	13.1	13.6
Grants	0.2	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Expenditure	19.7	18.3	17.7	20.0	19.8	19.9	20.1	20.5	21.1
Central government balance	-6.5	-5.9	-5.9	-6.7	-7.4	-7.3	-7.2	-7.4	-7.4
Central government domestic financing	4.1	4.6	3.3	5.1	6.7	6.6	6.5	6.7	6.8
Government debt (domestic and external)	79.2	78.3	75.9	77.0	78.1	78.2	78.0	77.9	77.8
Money and credit (percent change, end of period)									
Reserve money	10.2	0.9	18.3	15.1	13.5	13.5	13.4	13.7	13.6
Broad money	17.6	16.7	13.4	13.2	13.5	13.5	13.4	13.7	13.6
Domestic credit	21.7	13.5	10.6	9.8	12.5	12.3	12.2	12.3	12.2
Credit to private sector	17.6	7.5	8.8	2.2	0.2	1.1	2.0	2.0	1.9
Credit to government	29.6	24.6	12.9	20.8	27.8	23.1	20.4	19.3	18.1
Balance of payments (in millions of U.S. dollars)									
Exports	9,773	10,394	11,118	12,042	12,991	14,436	16,078	17,860	19,964
Imports	-19,190	-18,003	-19,417	-19,443	-21,571	-23,782	-26,471	-29,196	-32,038
Current account balance	-3,981	-2,606	-2,790	-1,639	-2,282	-2,557	-3,131	-3,408	-3,682
Current account balance (in percent of GDP)	-6.7	-3.9	-3.7	-2.0	-2.6	-2.7	-3.0	-3.0	-3.0
Export value growth (percent)	-7.4	6.4	7.0	8.3	7.9	11.1	11.4	11.1	11.8
Import value growth (percent)	-5.3	-6.2	7.9	0.1	10.9	10.3	11.3	10.3	9.7
Gross official reserves (end of period) 1/									
In millions of U.S. dollars	7,106	7,495	8,216	9,301	10,164	11,244	11,898	13,234	14,485
In months of imports	4.0	3.8	4.1	4.2	4.1	4.1	4.0	4.0	3.9
External debt (public and private)									
In billions of U.S. dollars	37.1	39.7	42.6	45.1	47.6	50.3	53.2	58.5	63.3
As a percent of GDP	62.5	58.9	57.1	56.0	54.4	52.7	51.0	51.4	51.0
Memorandum items:									
Nominal GDP (in billions of rupees)	7,579	8,674	9,741	10,577	11,651	12,944	14,475	16,186	18,100

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

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



SRI LANKA

THIRD POST-PROGRAM MONITORING DISCUSSION

April 14, 2015

KEY ISSUES

Context: Recent outturns have been favorable but the medium-term outlook is difficult to assess in the midst of an ongoing political transition and associated lack of clarity regarding macroeconomic and financial policies. An extended period of political flux and policy uncertainty could negatively affect confidence and growth.

Fiscal policy: Fiscal consolidation stalled in 2014, as tight expenditure control could not offset a continued decline in the tax/GDP ratio. The new government has issued a revised budget which targets consolidation, but a further rise in the deficit appears more likely. The outlook for 2016 onwards is also a concern given expiration of one-off revenue measures and the lack of an explicit strategy to raise tax collection.

Monetary policy: A sustained period of accommodative monetary policy has helped revive private credit, facilitate a reduction in interest rates, and compress the lending/deposit spread. While inflation is low, the incipient rise in credit, a positive output gap, and recent external pressures argue for a tightening bias.

External sustainability: The sharp decline in oil prices should facilitate an improvement in the external current account, but there are emerging risks with respect to capital flows, external financing, and the sustainability of exports. Exchange rate flexibility will be an important element in maintaining an adequate level of central bank foreign exchange reserves.

Financial sector: Financial sector risks appear to be contained despite a decline in capital adequacy. Nonperforming loans in the banking system appear to have peaked, and should continue to fall. Disputes over some troubled nonbank financial institutions are being resolved on a case-by-case basis, but should be subject to a broader crisis management framework.

Post-program monitoring: Even though outstanding borrowing has fallen below 200 percent of quota, the staff recommends continuing post-program monitoring (PPM) until the fiscal and external positions strengthen, and a medium-term package of policies is in place. The next post-program mission is expected in mid-2015.

Approved By
**Kalpna Kochhar and
 Dhaneshwar Ghura**

Discussions were held in Colombo, February 23 to March 4, 2015. The mission met with Prime Minister Wickremasinghe, Finance Minister Karunanayake, Central Bank of Sri Lanka Governor Mahendran, Secretary to the Treasury Samarathunga, other senior officials, and private sector and civil society representatives. The staff team comprised Mr. Schneider (head), Mr. Jonas, Mr. Ghazanchyan (all APD), Mr. Noah Ndela (SPR), Ms. Kvintradze (resident representative), and Mr. Wijeweera (local economist). Mr. Ranasinghe (OED) participated in some of the policy discussions. S. Boyce and Q. Zhang also assisted in preparation of this report.

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RECENT DEVELOPMENTS AND OUTLOOK

A. Political Transition

1. **January presidential elections brought a new coalition government to power—headed by Maithripala Sirisena.** The Sirisena government is dedicated to a 100 day program of political reform—focused on trimming the powers of the presidency and returning to a Westminster-style system of government where greater power is vested in the prime minister’s office. Other key reform pillars relate to improving governance, increasing transparency, ensuring more inclusive growth, and a firmer reconciliation with the Northern provinces. Externally, the Sirisena government is bolstering regional ties, with recent high-level visits to India and China.
2. **The Sirisena government is seeking to complete promised political reforms and call for fresh parliamentary elections by April 24th, or as soon as possible thereafter.** While the political transition envisioned under the 100-day program is an historic milestone, it has also hampered the government’s ability to set clear medium-term economic and reform objectives. The outcome of the next round of elections will be a key determinant in the pace of economic and structural reform—a roadmap for which will need to be articulated by the new government shortly after taking office.

B. Recent Economic Performance

3. **Macroeconomic performance in 2014 was generally strong.** Real GDP growth registered 7.4 percent in 2014. Growth was broad-based, with the exception of agriculture which suffered from drought early in the year and heavy rains and flooding in the fourth quarter. Particularly notable were contributions from construction, manufacturing, and wholesale/retail trade, which together accounted for about 60 percent of growth. Headline and core inflation declined to 2.1 and 1.2 percent, respectively, by end-year. Reductions in administered prices for fuels facilitated the record low levels of inflation.
4. **Preliminary data indicate the overall fiscal deficit for 2014 exceeded the budget target by about ¾ percent of GDP.** Tax revenues grew by only 6.9 percent—well below the growth rate targeted in the budget but broadly consistent with performance of recent years. Income tax collection was particularly weak, falling by nearly 4 percent in nominal terms. Despite tight spending control, the overall deficit is estimated at 5.9 percent of GDP, compared with a budget target of 5.2 percent. This is the largest deviation between outturn and target of recent years, and the first year since 2009 that the deficit was not reduced as a share of GDP.
5. **Financial performance of state owned enterprises (SOEs) improved in 2014.** According to preliminary data, SOEs recorded an aggregate Rs 70 billion profit (0.7 percent of GDP)—an increase of Rs 25 billion over 2013. This reflected mainly an improvement in banking and insurance sectors, and also the favorable impact of lower oil prices on the Ceylon Petroleum Corporation (CPC). However, Ceylon Electricity Board (CEB) recorded a loss of Rs 13 billion, compared to a 2013 profit of Rs 18 billion, mainly as a result of dry conditions in early 2014 that led to lower

hydropower generation and a 16 percent increase in per unit generation costs. The CPC/CEB financial outlook for 2015 is unclear. Besides the usual uncertainty about rainfall and hydropower generation, the potential for changes in the oil price and a lack of clarity regarding the introduction of an automatic fuel price adjustment mechanism add uncertainty. The authorities are considering introduction of cost-price formula, but no decision has been made.

6. The external current account was broadly stable in 2014, but with significant intra-year volatility. For the year as a whole, stronger tourism and remittances partially offset a wider trade deficit. Exports—led mainly by industrial goods (textiles and garments) and agricultural products—increased 7 percent. This was more than offset by a substantial increase (7.9 percent) in imports (mainly consumer and intermediate goods). The stability of the current account for the year as a whole masks a significant intra-year shift. For the first half of 2014, import growth was tepid—facilitating a half-year current account deficit of only 2 percent of GDP. However, as exports hit a plateau and imports climbed in the second half of the year, the non-oil goods trade deficit increased by some 2½ times.

7. Developments in the financial account were mixed. FDI inflows are estimated to have reached \$763 million in 2014—a 10 percent decline from 2013. Foreign loans to the government and the private sector remained broadly unchanged (in levels). Net inflows into the Colombo stock exchange were \$163 million—lower than the \$270 million net inflow of 2013. The government successfully issued sovereign debt totaling \$1.5 billion in 2014. However, foreign investors' participation in government domestic securities recorded a net outflow of \$113 million for the year, despite net inflows on a cumulative basis through September. The pace of net outflows since the beginning of 2015 has subsided reaching US\$4.9 million by February. Reflecting these developments, CBSL foreign exchange reserves declined from a peak of \$9.3 billion in July 2014 to \$8.2 billion by end year and dropped by an additional \$1.3 billion¹ by mid-March 2015, bringing reserve coverage to about 3.1 months of imports.

8. Monetary policy remained broadly accommodative in 2014, with private credit growth beginning to respond in the fourth quarter. Policy rates were lowered by 150 bps between end-2012 and January 2014, and banks' reserve requirement was reduced by two percentage points. Monetary policy was again loosened in September by limiting banks' access to the standing deposit facility (SDF)—a measure that was eliminated in late March 2015. Policy rates reached record lows, but excess liquidity in the banking system was persistently high during much of 2014. Private credit growth has recently started to rise—reaching 8.8 percent through December 2014 and 11 percent through January 2015. Reserve and broad money growth registered 18.3 and 13.4 percent growth in 2014, respectively.

¹ Reserves declined mostly due to a sovereign bond repayment (\$500 million) and settlement of ACU liabilities (\$400 million).

9. Financial sector indicators are mixed, but reflect a bottoming-out of nonperforming loans largely linked to gold pawning.² As of end-2014, nonperforming loans (NPLs) of the banking system declined to 4.2 percent of total loans, compared with 5.6 percent as of end 2013 and a peak of 6.2 percent in mid-2014. The decline in the NPL ratio reflected the gradual resolution of problem assets related to gold pawning, as well as a reduction in banks' pawning activity in general. Profitability showed modest improvement. Return on equity (ROE) for the banking system rose from 16.0 to 16.5 percent between end-2013 and end-2014, while return on assets (ROA) increased from 1.3 to 1.4 percent. Net interest margins remained broadly unchanged in 2014 from end 2013 at 3.5 percent, despite a compression of interest rates. The new government has decided to suspend and review the financial sector consolidation plan initiated by the CBSL in 2014.

OUTLOOK

10. The outlook is broadly stable but set against heightened downside risks. Real GDP growth is projected at 6.5 percent in 2015 and beyond—in line with the staff's estimate of potential output. While there is considerable growth momentum in a number of sectors, the modest cooling reflects uncertainty regarding a number of supporting pillars of economic activity, including:

- ***The potential impact of lower public investment.*** The revised budget targets a relatively low level of public investment compared to the original budget, and a number of projects are also under review.
- ***A dampening effect in the short run of policy uncertainty on private investment.*** Higher domestic consumption supported by increases in wages and salaries under the new budget may not fully compensate.
- ***The impact of an expanded fiscal deficit on private credit.*** Under status quo policies, the overall deficit could approach 7 percent of GDP in 2015 and higher in subsequent years as one-off tax measures expire—effectively crowding out private credit through a higher domestic borrowing requirement.
- ***Negative spillovers from slower economic recovery in Europe***—one of Sri Lanka's two most important export markets.

11. On the positive side, price pressures are expected to remain contained, with headline and core inflation projected at 3.2 and 2.3 percent, respectively. Externally, the current account deficit is projected to narrow to 2 percent of GDP in 2015, driven by lower international commodity prices, relatively robust exports to the U.S., and continued growth in tourism receipts. Increases in public sector wages together with the wealth effect from lower fuel and electricity prices are expected to induce higher consumer good imports. FDI is projected to remain stable (albeit subject

² Pawning is a form of collateralized lending based on gold jewelry or biscuits, and is a significant lending product in many Sri Lankan banks and nonbank financial institutions (NBFIs). Pawning loans are usually 12 months, with little restriction on their use. The sharp drop in gold prices in 2012 had a significant negative impact on such loans.

to the same risks to investment cited above). Increased sovereign financing and a gradual recovery of private sector inflows (mostly equities and loans to SOEs), are expected to help finance the current account deficit and increase gross reserves. However, extended policy uncertainty could potentially undermine these inflows and negatively affect the balance of payments.

Box 1. Sri Lanka: Key Features of the Revised 2015 Budget

Shortly after taking office, the new coalition government introduced a revised 2015 budget,

The revised budget brought a number of significant changes compared with the budget passed under the previous regime in November 2014. The revised budget targeted further fiscal consolidation within the context of a significant shift in composition of expenditure. Some of the more important changes include the following:

- **Introduction of one-off revenue measures**, including a “super gains tax” on companies and individuals with profits over Rs. 2 billion in 2013/14.
- **Introduction of a “mansion tax”** on homes above Rs 100 million in value.
- **Payment by selected public institutions** of profits, dividends and levies which were not “properly” transferred to the central government as non-tax revenue.
- **An increase in public employee’s monthly wages by Rs 10,000**—an effective 47 percent increase compared to the 2014 average wage. This is to be accompanied by an increase in pension payments (Rs 1,000 per month) for retired public servants; and a 200 percent increase in the monthly payments under the Samurdhi welfare scheme.
- **Reduction of public investment spending** on infrastructure by 30 percent compared to the original budget.

	2014	2015 Budget (% of GDP)	
	Preliminary	Original	Revised
Total Revenue and Grants	11.7	14.9	14.3
Total Expenditures	17.7	19.5	18.7
Current	13.2	13.5	14.2
Interest	4.2	3.8	3.8
Capital	4.5	6.2	4.6
Balance	-5.9	-4.6	-4.4

Fuel and commodity prices were also reduced. The new government lowered LP gas prices by 16 percent, diesel by 14.4 percent, petrol by 22 percent and kerosene by 20 percent. Prices of 13 essential food items were also reduced by lowering the special commodity levy and custom duties.

12. The macroeconomic framework presented herein reflects the authorities’ current policy framework and makes no assumptions regarding reforms which may emerge following the next round of elections. In this sense, the framework presents an incomplete picture for 2016 and the medium-term. While useful to highlight the risks of policy inaction, the framework may

nonetheless be pessimistic in assuming a status quo with respect to current policies. The framework will be updated at the earliest opportunity, based on reform measures that take shape over the remainder of this year.

POLICY DISCUSSIONS

A. Maintaining Fiscal Discipline

13. The revised 2015 budget targets continued fiscal consolidation, but seeks to finance a significant boost to current spending largely through one-off revenue measures. The deficit under the new government's revised budget is targeted to fall to 4.4 percent of GDP, from an estimated 5.9 percent of GDP in 2014. A number of significant changes were made to the original 2015 budget (passed in November 2014). First, it changed considerably the composition of spending: current spending was increased significantly, mainly due to higher wages and transfers, while capital spending was reduced. Second, it introduced a number of mostly one-off revenue measures.³ In total, the combined revenue measures from the original and revised budgets are now estimated by the authorities to yield 1.3 percent of GDP. About two thirds of this is to come from taxation of past excess profits and from bank-financed repayment of tax arrears. The budget also assumes 0.4 percent of GDP of administrative costs savings due to rationalization of wasteful expenditure and lower fuel and electricity prices.

14. Staff welcomed the authorities' commitment to continued fiscal discipline, but argued that the 2015 deficit target would be very difficult to reach and that the current path put medium-term consolidation and debt reduction at risk. Even assuming that one-off measures yield the estimated revenues, underlying revenues (excluding the measures) would still have to grow in excess of 20 percent compared to 2014 to reach the revenue target, which appears unlikely. Further, unlike in previous years when revenue shortfalls were offset by lower capital spending, there is much less room for similar adjustment in 2015 as capital spending has already been compressed in the budget.⁴ The use of one-off measures like the super gains tax is also not, in the staff's view, a move toward a more effective tax system, and creates additional problems for 2016 and beyond. In the absence of new measures to create a more durable increase in tax collection, revenues in 2016 will drop as the one-off measures expire, while the permanent increase to recurrent spending will push the deficit even higher—raising the level of risk to debt sustainability.⁵

³ The most significant of which is a "super gains tax" – a 25 percent retroactive tax on individuals or companies that earned more than Rs 2 billion in profit in 2013/14.

⁴ The new government has stated that it will carefully review all new projects in the pipeline, but continue with existing capital projects. However, anecdotal evidence suggests that the review process has extended to a wider range of investment projects.

⁵ Public debt is estimated at 76 percent of GDP in 2014. The last Debt Sustainability Analysis (DSA) was discussed in July 2014 as part of the Article IV Consultation, and assessed Sri Lanka's public debt as sustainable but subject to relatively high risks. The next DSA is slated for early 2016 in line with plans for the Article IV Consultation.

15. Staff argued that maintaining sound public finances will be a difficult policy challenge, and recommended a two-step strategy. The short-term (2015) objective should be to avoid a large increase in the fiscal deficit. Resorting to further ad hoc revenue measures is not advisable, and thus the main tool should be expenditure management. Specifically, staff recommended the following options: (i) savings within non-wage recurrent expenditure of central government (which, despite the cost savings mentioned above, is still projected to increase by 0.4 percent of GDP); (ii) consider delaying the second wave of increases (the first wave having come into effect in February) to public wage, salary and pension payments; and (iii) some additional reduction in low-impact capital expenditures (i.e., those deemed to have comparatively low social or growth impact). For the medium term, the emphasis should be on strengthening the tax system. Forthcoming technical assistance will address these issues in detail, taking into account the many changes since the last major tax mission in 2009. However, fundamental pillars of a medium-term fiscal reform strategy could include:

- ***The practice of providing new tax exemptions should be terminated.*** The government should also avoid reversing previous measures on centralized control over new tax exemptions (such as giving such control back to the Board of Investment).
- ***A comprehensive review of existing tax expenditures should be conducted*** with a view to evaluating their cost and formulating a strategy for their elimination.
- ***A review of tax expenditures should be accompanied by a diagnostic assessment of the structure of taxation.***⁶ A meaningful simplification of the tax regime is needed, with a view to broadening the base and improving tax administration and collection—ideally to be implemented as part of the 2016 budget.
- ***A medium-term framework for fiscal consolidation and debt reduction remains essential.*** The steady reduction in the fiscal deficit since 2009 and accompanying decline in public debt have been linchpins of macroeconomic stability and confidence. The government should move quickly to reestablish a credible medium-term macro-fiscal framework (as has been done in the past under the Fiscal Management (Responsibility) Act (FMRA) to anchor policies and expectations.⁷

16. The authorities emphasized their commitment to continued fiscal consolidation, while moving to a more progressive tax system. They recognized that meeting the 2015 revenue and deficit targets could be challenging, but were encouraged by a strong excise and customs revenues in early 2015. They expressed determination to address weak revenue performance after the election. While the authorities were not ready to provide specifics, they suggested that the measures

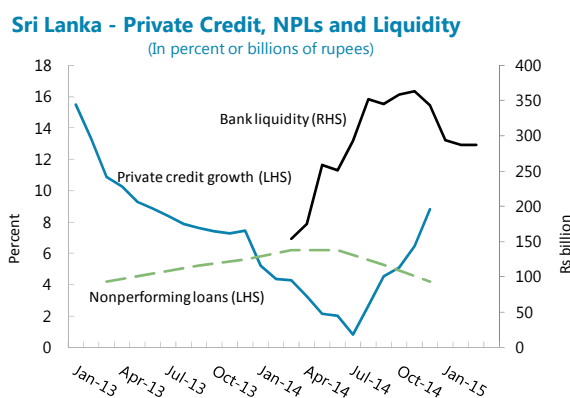
⁶ IMF technical assistance missions on tax expenditures, tax policy, and public financial management were conducted in March-April 2015, with final reports currently under preparation.

⁷ In line with recommendations from the 2014 Article IV Consultation (see ISCR 14/286), staff believe a long-term anchor under this strategy could be a target for public debt to GDP of 50 percent, with appropriate interim (i.e., medium-term) objectives. Staff intends to resume detailed discussion of medium- and long-term fiscal objectives in the next post-program monitoring mission.

should include reduction in tax exemptions and simplification of the tax system. In the meantime, the authorities said that they intend to pursue tight expenditure control to contain the deficit. Specifically, they saw some scope for delaying domestic financed capital projects. They also highlighted ongoing work toward a comprehensive review of government debts and efforts to renegotiate some bilateral loans to lower debt servicing costs. With respect to the medium-term, the authorities reiterated their commitment to financial responsibility. They noted that the FMRA remains in effect and will remain a useful framework for guiding policies.

B. Monetary Policy

17. Monetary policy continued to be accommodative during 2014—facilitating a pick-up of private sector credit late in the year. Although policy rates and reserve requirements remained unchanged in 2014, the CBSL introduced two additional measures in an effort to spur private credit growth. In January, the CBSL compressed the Standing Rate Corridor by 50 basis points. In September, with year-on-year private credit growth at less than 3 percent and substantial excess liquidity in the banking system, the CBSL limited banks' access to its Standing Deposit Facility (SDF) to a maximum of three times per month, with further access available only at a penalty rate. Private credit growth was on a steady upward trend through the remainder of 2014 and into 2015, and banks' excess liquidity has declined. The limited access to the SDF was eliminated in March 2015.



Sources: Central bank of Sri Lanka, staff estimates

18. While the CBSL's accommodative stance helped to facilitate a pickup in private credit in the context of low inflation, there have been side effects. First, while the compression of interest rates does not appear to have adversely affected bank profitability, it seems to have negatively impacted investor appetite for government securities. The steady decline in rates was reportedly a factor behind a non-rollover of a July 2014 maturity by foreign investors—lowering the level of foreign ownership of Sri Lankan securities below 11 percent for the first time since 2012. Second, the removal of the limits on the access to the SDF added some volatility to short-term interest rates—complicating management of liquidity conditions in the interbank money market.

19. The mission advised that monetary policy be kept on hold for the short-term but that the central bank be prepared to tighten if signs of overheating emerge. First, given the long lags in monetary policy transmission, the effects of earlier steps to loosen may yet be emerging. Second, some slowdown in fourth quarter growth argues against any immediate move toward tightening. However, the incipient rise in private credit, combined with the substantial boost to domestic demand likely to come from the interim budget, and a gradual pickup in inflation so far in 2015 suggest that the credit cycle has turned and that the central bank may need to tighten in the

near term to forestall any undue pressures later in the year. The mission also noted support for the resumption of work toward establishing an inflation targeting framework (to be supported by IMF technical assistance).

20. The authorities agreed on the need to remain vigilant given the changing environment. They noted that they are adequately equipped with policy tools to react to a possible fiscal expansion, and similarly ready to adjust to a lower growth scenario. The authorities were not particularly concerned with recent external pressures, and highlighted that the recent firming of rates on the long end of the yield curve might mitigate net outflows.⁸ For the time being, they do not envisage any major policy move in either direction, and expect private credit to grow as high as 18 percent in 2015—which they saw as acceptable given the decline in private credit/GDP over the last two years.

C. External Sustainability

21. Recent balance of payments developments highlight three key trends: (i) a leveling-off of goods exports; (ii) an unwinding of import compression; and (iii) a weakening of capital inflows. On goods trade, the recovery in exports that began in mid-2013 appears to have reached a plateau under current conditions of competitiveness and market structure. With respect to imports, recent data suggest a reversion to the mean, as monthly nonoil imports (particularly consumption and intermediate goods) returned closer to historical norms in the second half of 2014 and into 2015. The shift to a more balanced export/import profile is consistent with recent growth performance, but also adds some pressure on the balance of payments. Market uncertainty regarding the direction of macro policies, and the substantial decline in interest rates may also be dampening net capital inflows.

22. The external sector outlook for 2015 appears favorable, but there are several risks. First, the sharp drop in oil prices produces a substantial windfall for Sri Lanka's import profile—equivalent to about \$2 billion for 2015 as a whole, or roughly 2 percent of GDP. Even assuming a substantial pass-through from higher wages and salaries to imports, there should be a substantial net gain. Assuming goods exports remain in the current range, the improvement in the trade balance should provide a cushion to the overall balance of payments. With capital flows at comparatively normal levels, net inflows should be sufficient to keep central bank foreign exchange reserves in the range of 3.5 to 4 months of imports. Risks to this outlook are not insignificant, however, and include (i) an eventual reversion of the oil price shock; (ii) a slowdown in goods exports in the event growth in key export markets stalls; and (iii) less optimistic assumptions regarding net capital flows.

23. Econometric analysis does not suggest a fundamental misalignment of the exchange rate. In light of significant shifts in the external environment since the 2014 Article IV Consultation, the staff updated the exchange rate analysis to assess the current level of the exchange rate. The

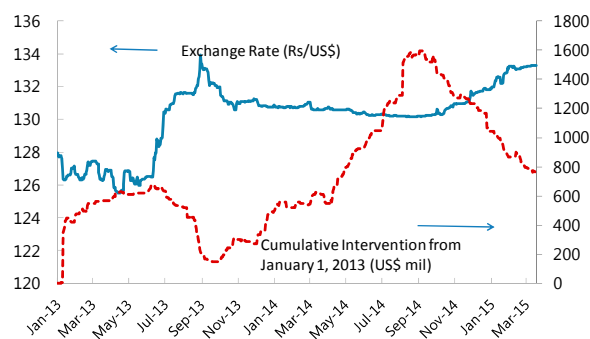
⁸ The authorities were also of the view that reducing exposure to non-resident ownership of government securities was prudent (the limit had been expanded at a time when the need for external financing was more acute).

External Balance Assessment (EBA) methodology points to an overvaluation of about 5 percent, with more than half of policy gaps explained by the fiscal balance to GDP and health expenditures. The CGER approaches suggest mixed results—the macro balance and external sustainability approaches pointing to an undervaluation of 2–4 percent, while the equilibrium exchange rate approach suggested an overvaluation of about 7 percent.

24. Qualitative analysis suggests the rupee has entered a period of downward pressure.

Since September 2014, when imports began to rise, there has been a steady pattern of central bank sales of foreign exchange to the market. Net foreign exchange sales by the CBSL amounted to some US\$812 million in September 2014 to mid-March 2015, compared to a net absorption of about US\$1 billion during January–August 2014. Despite the favorable outlook for the balance of payments with respect to trade in goods and services, market expectations (based on forwards) are leaning toward a depreciation of the rupee.

Sri Lanka: Exchange Rate and Cumulative Foreign Exchange Intervention, 2013-2015



Sources: Central Bank of Sri Lanka, staff calculation

Sri Lanka: Evolution of Gross Reserves, 2013-2015
(In US\$ billions)



Sources: Central Bank of Sri Lanka

25. Staff emphasized that exchange rate flexibility should be allowed to facilitate adjustment and to protect reserves.

While the evidence does not suggest the exchange rate is fundamentally out of alignment, continued intervention appears to be impeding a market adjustment. Particularly given CBSL's foreign exchange reserves falling well below the IMF's standard metrics for adequacy, allowing depreciation is preferable to a continued drain on reserves. Staff further observed that, even if not justified by the underlying fundamentals (projected developments in balance of payments), forward market data indicate expectations of depreciation in the near-term and that volatility has risen from historically low levels and could rise further amid increasing divergence of monetary policy stance among advanced economies. Looking ahead, the staff stressed that, although Sri Lanka is less exposed to volatile capital flows than many EMs given the cap on ownership of government securities, shifts in investor sentiment (given policy uncertainty) could pose additional risks, and that the exchange rate would need to bear some of the adjustment burden should these risks materialize.

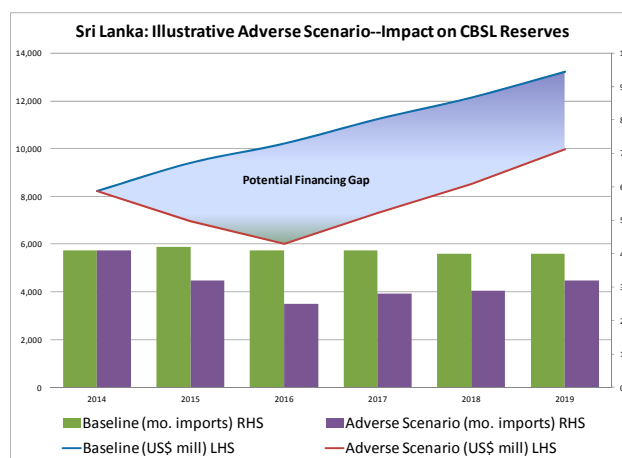
Box 2. Sri Lanka: Potential BOP Impact of Adverse Scenario

An adverse external financing scenario illustrates how a potential slowdown in capital inflows could diminish CBSL foreign exchange reserves. This scenario assumes concurrent shocks to growth and the financial account of the balance of payments in line with downside risks highlighted earlier. It assumes a small policy adjustment (nominal exchange rate depreciation) but no new measures to reduce the fiscal deficit or any increase in policy rates.

The main shock assumptions—drawn from past crises, discussions with the authorities and market participants—include the following:

- **A sharp decrease in non-resident exposure to Sri Lankan T-bills and T-bonds** (T-bill and T-bond rollovers at 25 and 30 percent in 2015, improving to 50 and 55 percent, respectively, in the first half of 2016), and lower rollovers for non-concessional loans.
- **Equity outflows** of about 12.5 percent of total non-resident equity holdings—distributed evenly between the second half of 2015 and in the first half of 2016.

Under a relatively static shock (i.e., minimal adjustment as noted above), the potential drain on central bank foreign exchange reserves could be significant—potentially bringing Sri Lanka’s reserve cover below three months of imports, and well below the IMF’s reserve adequacy metrics.



26. The authorities agreed on the generally positive outlook for the balance of payments, reiterated their commitment to exchange rate flexibility, but underscored the importance of timing. Specifically, the authorities noted that greater flexibility needs to be synchronized with foreign inflows such as sovereign bond issuance. They mentioned that the recent stability of the rupee should not be interpreted as a lack of commitment to greater exchange rate flexibility, but rather, a search for optimal timing. They further noted that developments in the global economy would also affect future actions with respect to intervention and exchange rate policy. Regarding the global context, the authorities argued that positive developments with respect to growth in the U.S. would provide some momentum to the Sri Lankan economy. They also saw potential benefits from a more active approach to building markets—including through a potential new trade agreement with China and existing trade agreement with India and Pakistan, as well as regaining preferential access to the EU market through the Generalized System of Preferences (GSP). In case risks to the balance of payments materialize, the authorities agreed that the exchange rate should

be the one of the first lines of defense. But other measures, including a new swap line with India⁹, are also being used to bolster the external position and prepare for external volatility in the months ahead.

D. Financial Sector

27. Financial sector risks appear manageable, with recent data suggesting improved profitability and lower non-performing loans. For the system as a whole, the capital adequacy ratio edged downward from 16.3 percent in 2013 to 15.6 percent by end-2014. However, the sizeable increase in nonperforming assets that began with the sharp fall in gold prices 2012 appears to have reached its peak. Banks have reduced their exposure to gold pawning activity by some 50 percent, and enforced tighter loan-to-value ratios.¹⁰ Overall profitability, as measured by ROE and ROA, has improved for the system as a whole. The bottoming-out of pawning related provisioning is likely to have a favorable impact on bank bottom lines going forward. Some problematic nonbank financial institutions (NBFIs) are being dealt with on a case by case basis.¹¹

28. The mission welcomed continued improvements in the area of bank supervision (included consolidated supervision) and regulation. In particular, steps have been taken toward adopting the three pillars of the Basel II Accords, with guidelines issued to banks regarding approaches for market and operational risks. An Information Sharing Act (to facilitate information exchange between regulators and supervisors in the country) has received cabinet approval and is being drafted for submission to Parliament. However, progress has been slower with respect to supervision of nonbank financial institutions, and the adoption of a broader crisis management framework that would incorporate the entire financial sector. Forthcoming technical assistance should help to identify key priorities for reform.¹²

29. The financial sector consolidation process has been halted by the new government, and an ongoing review is considering ways forward. At the time of the change of government only five consolidation (merger) transactions had been completed, but with a significant number agreed in principle. The process has been suspended pending both the next round of elections and the findings of a review committee. The committee is comprised of senior representatives from the banking community, and is expected to report on its findings in April. Staff expressed concern about the need for timely decisions on the way forward to reduce uncertainty in the financial system.

⁹ The Reserve Bank of India (RBI) on March 25, 2015 signed a US\$400 million currency swap agreement with the Central Bank of Sri Lanka for three years that will allow the CBSL to draw the amount in dollars or Euros in multiple tranches.

¹⁰ However, with a partial market risk guarantee introduced by the CBSL from June 2014, effective LTV ratios in participating institutions have been raised to around 80 percent—close to pre-crisis levels.

¹¹ The legal foundation for non-bank supervision is provided by the Finance Business Act and the Finance Leasing Act. In general, supervision of NBFIs is similar to that of banks. However, the crisis management framework is not uniform. Current NBFIs under consideration by the CBSL are “legacy” cases from past years.

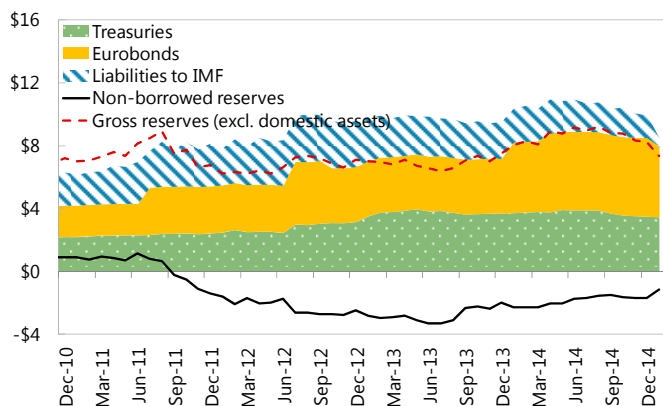
¹² A multi-faceted MCM mission centered on financial sector stability and supervision is expected in the near future.

30. The authorities noted staff’s concerns over consolidation plans, broader supervision and lower capital adequacy ratios. They expressed assurance that the committee selected by the government will consider carefully the pros and cons of consolidation in the bank and nonbank sectors. The CBSL also expressed confidence that completed transactions under the plan will not be reversed. The authorities agreed on the need to conduct regular stress testing of the banking system, adopt a consolidated supervision framework including NFBIs and develop a clearly defined and well documented financial crisis management plan for the entire financial system. They welcomed the Fund’s technical assistance in this area. On capital adequacy, the authorities noted that one large state owned commercial bank has been provided budgetary provisions to support expansion and enhance its resilience to shocks.

POST PROGRAM MONITORING

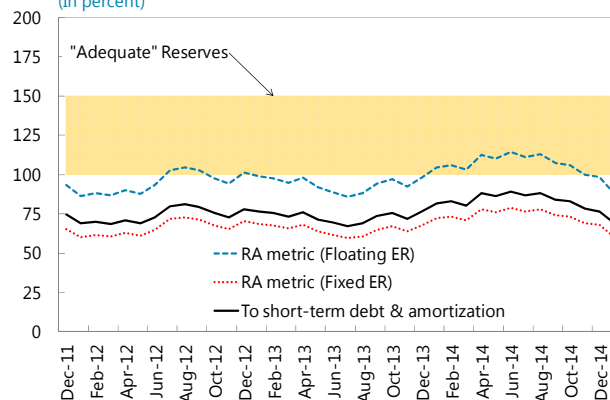
31. Sri Lanka’s capacity to repay the IMF remains broadly adequate. Exposure to the IMF currently stands at SDR 757.9 million (about US\$1.05 billion—1.3 percent of projected 2014 GDP and 16.6 percent of current gross central bank foreign exchange reserves). Repayments to the IMF stretch into mid-2017, but Sri Lanka’s outstanding credit from the Fund has fallen to 183 percent of quota (below the 200 percent threshold for post-program monitoring). External debt remains broadly sustainable, but as highlighted by the most recent 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. The low revenue base also implies limited fiscal maneuvering room and very high debt- and debt service-to-revenue ratios. Reserves have also fallen below the Fund’s standard adequacy metrics in the past few months. Given heightened risks and desirability of maintaining close engagement, the staff recommends an extension of post-program monitoring for one year.

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



Source: IMF staff estimates.

Sri Lanka: Reserve Metrics Dynamics
(In percent)



Source: IMF staff estimates.

STAFF APPRAISAL

32. Sri Lanka's recent performance has been strong in aggregate but a combination of domestic and external factors have significantly raised the level of risk. Externally, Sri Lanka faces the same challenges as other frontier emerging markets, including continued slow global growth and divergence between Sri Lanka's two key export markets (the EU and the U.S.), volatile commodity markets, the prospect of tighter liquidity and potentially less investor appetite for Sri Lankan securities. Domestically, the prospect of higher fiscal deficits is a serious concern given the high level of public debt and lack of fiscal maneuvering room. The external balance of payments is likely to benefit from lower oil prices, but this is not guaranteed, nor is it clear how long oil prices will remain at current low levels. The boost to consumption from the interim budget will spill over into imports and could be larger than expected. The increase in consumption may spur growth, but dampening effects could come from delays in public and private investment, and wavering confidence should policy uncertainty continue.

33. The fiscal situation constitutes Sri Lanka's single biggest macrofinancial vulnerability and should be addressed expeditiously. The reduction in the overall deficit since 2009 is a noteworthy accomplishment. However, the staff remains of the view that reliance on expenditure constraint as a means of reaching fiscal targets has already reached its limit—as evidenced by the outturn for 2014 where continued cuts to current and capital spending were unable to keep pace with the decline in revenue as a share of GDP. The interim budget targets a level of fiscal consolidation which seems unlikely even under optimistic assumptions. The staff strongly urges the authorities to exercise what cost savings are possible (and prudent with respect to high value-added spending on physical and social infrastructure) to keep the deficit under control for 2015.

34. The medium-term fiscal outlook clearly signals the need for a revamping of tax policy. Reform in this area is long overdue, and the staff sees significant risk in the absence of reforms. The staff is cognizant of the constraints imposed by the current political timeline, but emphasizes the need to proceed quickly with the technical work on reform options in the interim—with a view to formulating a set of measures that could be implemented in concert with the 2016 budget (normally presented to parliament in November). Fundamental elements in a reform package should include a comprehensive reduction in exemptions and tax holidays, a streamlining of the tax structure, and continued efforts to boost tax administration and collection capacity. A clear and credible medium-term macro-fiscal framework that supports consolidation and debt reduction is essential.

35. Monetary policy is broadly appropriate but faces a diverse set of risks. Inflation is contained at a comfortably low level, and external push factors appear modest. Private credit has begun to recover, and given the relatively high level of excess liquidity remaining in the banking system and the sharp drop in financial intermediation (private credit/GDP) over the past two years, has room to rise further. However, with credit cycle now appears to be turning a corner. Given the long lags in monetary transmission, and the prospect of higher domestic demand, the CBSL should be prepared to tighten monetary policy should signs of overheating emerge.

36. The overall balance of payments is expected to strengthen, but the authorities should shift focus to exchange rate flexibility as a means of preserving a limited reserve cushion. The sizeable windfall (an estimated \$2 billion or about 2 percent of GDP in 2015) from lower oil prices is likely to ease pressure on the balance of payments from the goods side. Econometric evidence does not suggest the exchange rate is fundamentally misaligned. However, the steady and one-sided nature of central bank intervention, combined with a not insignificant degree of real effective appreciation as a result of low inflation and exchange rate movements among major currencies, suggest the need for exchange rate flexibility. Particularly given Sri Lanka's limited reserve cushion, the central bank should refrain from sustained intervention to support the rupee in the face of strong market pressures.

37. The staff recommends extending the post-program monitoring framework for one year given heightened external vulnerabilities and the need to maintain close engagement for the near future while work on a medium-term set of macroeconomic policies and structural reforms is underway.

Figure 1. Sri Lanka: Macroeconomic Developments

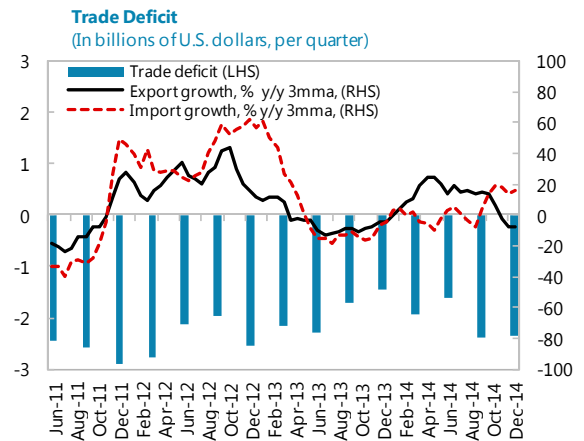
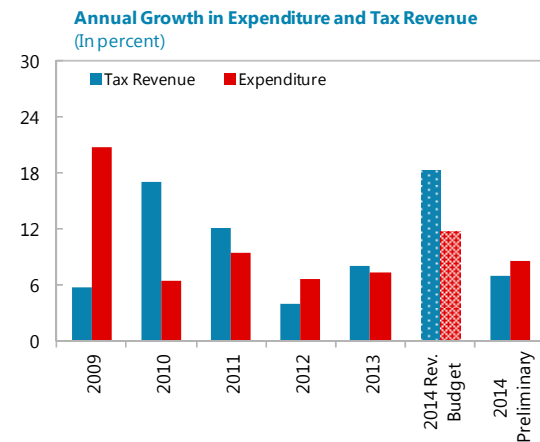
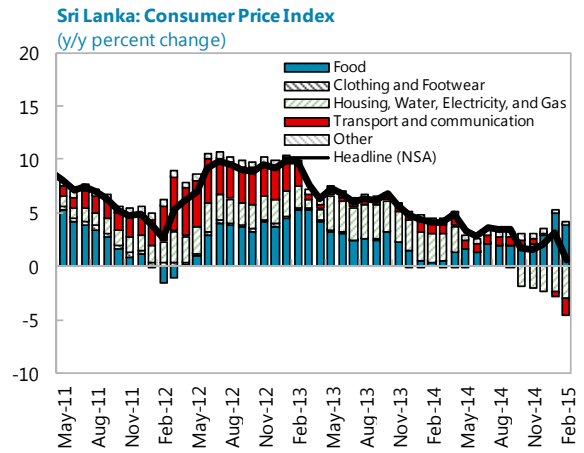
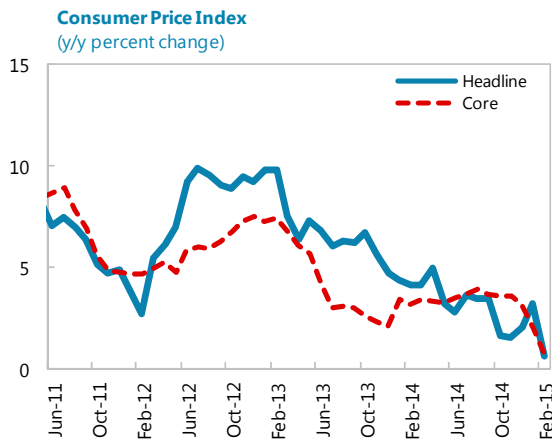
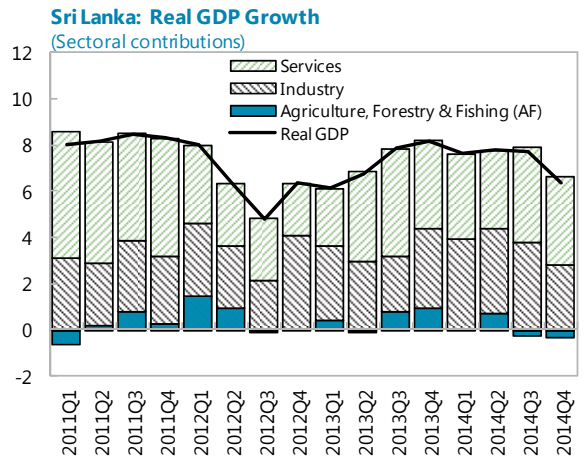
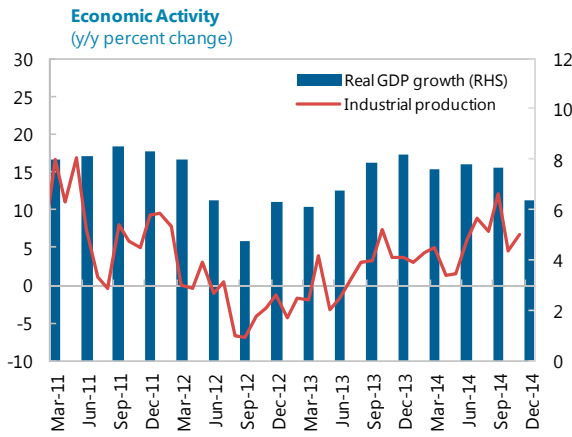
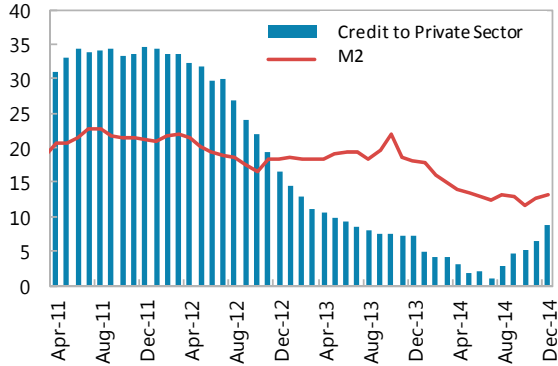


Figure 2. Sri Lanka: Interest Rates

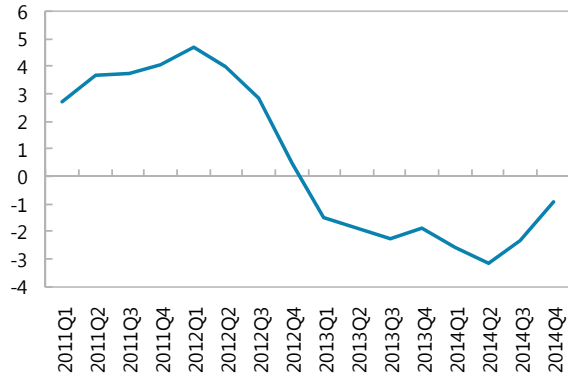
Credit and M2 Growth

(In percent, yoy, adjusted for depreciation)



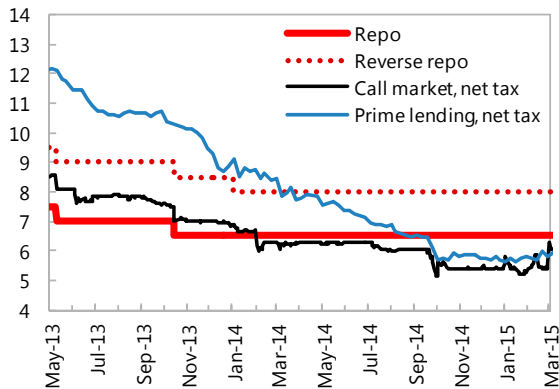
Credit to GDP Ratio 1/

(In percentage points, yoy change)



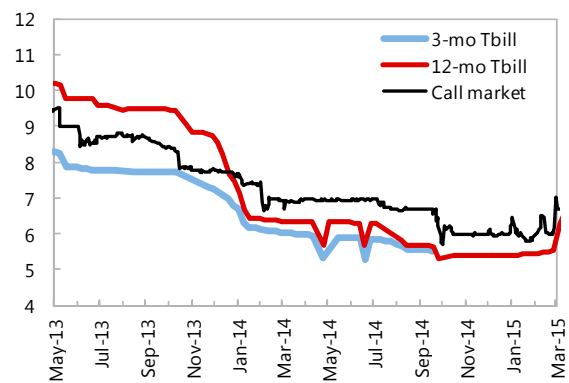
Repo and Interbank Rates

(In percent per annum)



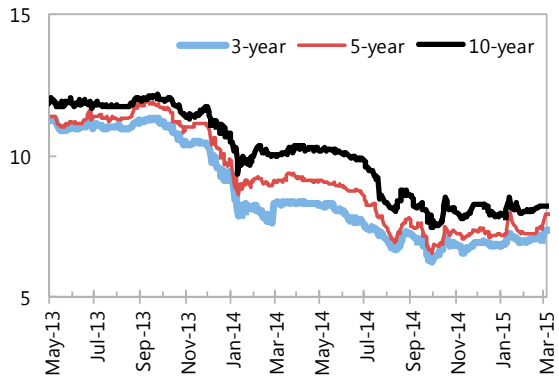
Short-Term Interest Rates

(In percent per annum)



Generic Government Bonds Yield

(In percent per annum)



Deposit Rate and Spread

(In percent)

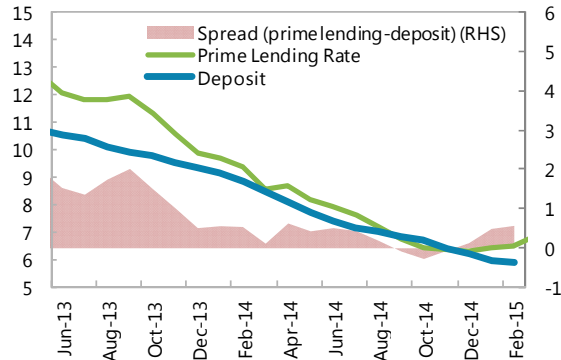
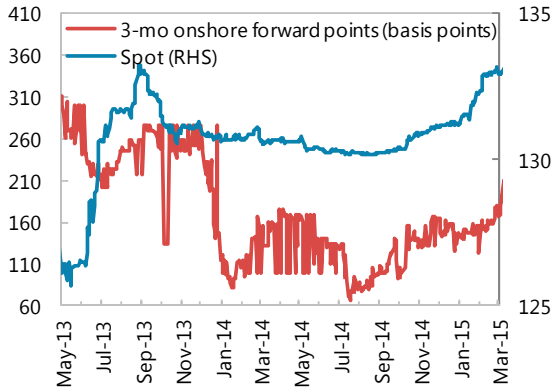
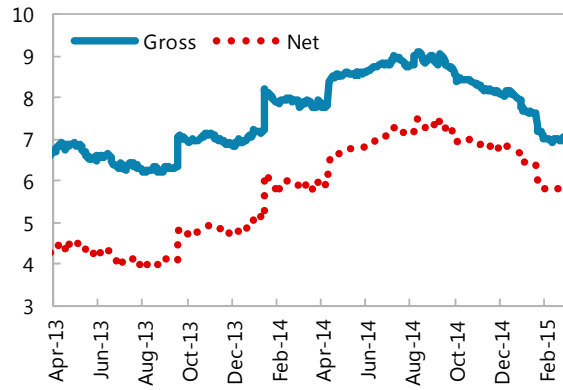


Figure 3. Sri Lanka: Foreign Exchange and Reserves

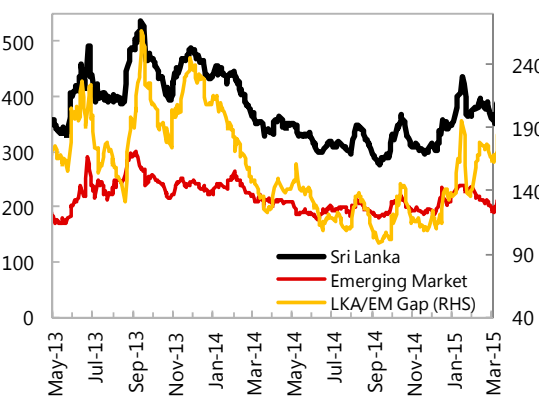
Exchange Rate
(Rupee/US\$)



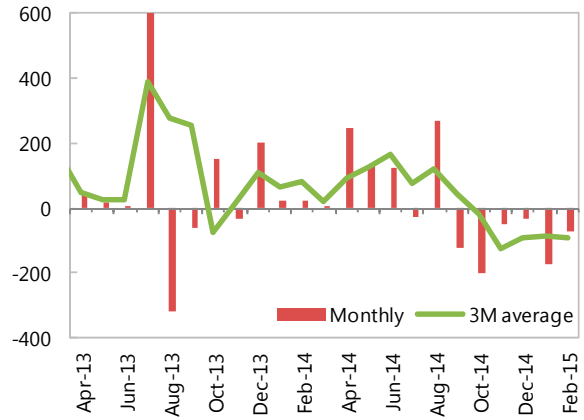
International Reserves
(In billions of US\$)



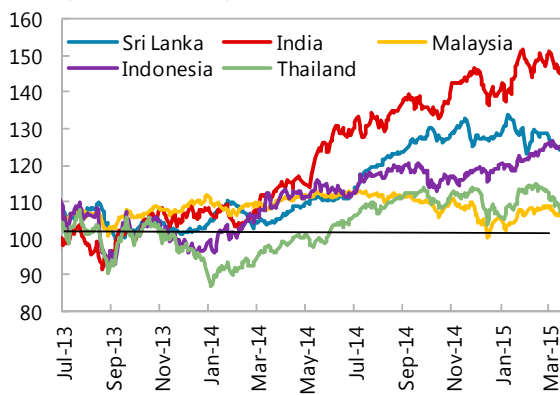
EMBI Global Sovereign Spreads
(In basis points)



CBSL Foreign Exchange Net Absorption



Selective Countries Stock Market Index
(Jan 1, 2013 = 100)



Exchange Rates
(USD/LCU, Index, Jan 2013=100)

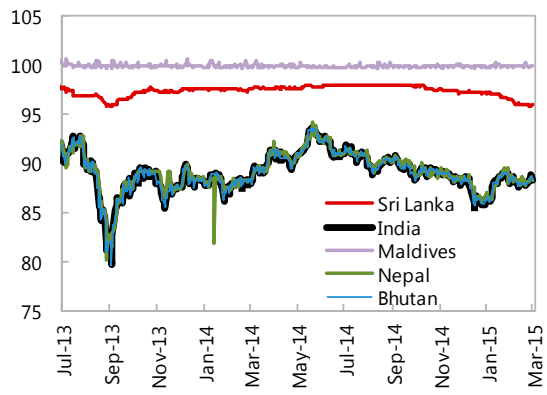


Table 1. Sri Lanka: Selected Economic Indicators, 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.			Proj.			
GDP and inflation (in percent)									
Real GDP growth	6.4	7.3	7.4	6.5	6.5	6.5	6.5	6.5	6.5
Inflation (average)	7.5	6.9	3.3	1.7	3.4	4.3	5.0	5.0	5.0
Inflation (end-of-period)	9.2	4.7	2.1	3.2	3.6	5.0	5.0	5.0	5.0
Core inflation (end-of-period)	7.5	2.1	1.2	2.3	2.7	4.1	4.1	4.1	4.1
Savings and investment (in percent of GDP)									
National savings	23.9	26.0	23.9	25.9	25.6	25.6	25.4	25.5	25.7
Government	-1.2	-0.8	-1.4	-1.8	-2.4	-2.1	-1.9	-2.0	-1.9
Private	25.1	26.9	25.3	27.7	28.0	27.7	27.3	27.5	27.6
National Investment	30.6	29.9	27.6	27.9	28.2	28.3	28.4	28.5	28.7
Government	6.9	6.9	4.6	4.9	5.1	5.2	5.3	5.5	5.7
Private	23.7	23.0	23.0	23.0	23.0	23.0	23.0	23.0	23.0
Public finances (in percent of GDP)									
Revenue	13.0	12.2	11.6	13.1	12.3	12.5	12.9	13.1	13.6
Grants	0.2	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Expenditure	19.7	18.3	17.7	20.0	19.8	19.9	20.1	20.5	21.1
Central government balance	-6.5	-5.9	-5.9	-6.7	-7.4	-7.3	-7.2	-7.4	-7.4
Central government domestic financing	4.1	4.6	3.3	5.1	6.7	6.6	6.5	6.7	6.8
Government debt (domestic and external)	79.2	78.3	75.9	77.0	78.1	78.2	78.0	77.9	77.8
Money and credit (percent change, end of period)									
Reserve money	10.2	0.9	18.3	15.1	13.5	13.5	13.4	13.7	13.6
Broad money	17.6	16.7	13.4	13.2	13.5	13.5	13.4	13.7	13.6
Domestic credit	21.7	13.5	10.6	9.8	12.5	12.3	12.2	12.3	12.2
Credit to private sector	17.6	7.5	8.8	2.2	0.2	1.1	2.0	2.0	1.9
Credit to government	29.6	24.6	12.9	20.8	27.8	23.1	20.4	19.3	18.1
Balance of payments (in millions of U.S. dollars)									
Exports	9,773	10,394	11,118	12,042	12,991	14,436	16,078	17,860	19,964
Imports	-19,190	-18,003	-19,417	-19,443	-21,571	-23,782	-26,471	-29,196	-32,038
Current account balance	-3,981	-2,606	-2,790	-1,639	-2,282	-2,557	-3,131	-3,408	-3,682
Current account balance (in percent of GJ	-6.7	-3.9	-3.7	-2.0	-2.6	-2.7	-3.0	-3.0	-3.0
Export value growth (percent)	-7.4	6.4	7.0	8.3	7.9	11.1	11.4	11.1	11.8
Import value growth (percent)	-5.3	-6.2	7.9	0.1	10.9	10.3	11.3	10.3	9.7
Gross official reserves (end of period) 1/									
In millions of U.S. dollars	7,106	7,495	8,216	9,301	10,164	11,244	11,898	13,234	14,485
In months of imports	4.0	3.8	4.1	4.2	4.1	4.1	4.0	4.0	3.9
External debt (public and private)									
In billions of U.S. dollars	37.1	39.7	42.6	45.1	47.6	50.3	53.2	58.5	63.3
As a percent of GDP	62.5	58.9	57.1	56.0	54.4	52.7	51.0	51.4	51.0
Memorandum items:									
Nominal GDP (in billions of rupees)	7,579	8,674	9,741	10,577	11,651	12,944	14,475	16,186	18,100

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

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

Table 2. Sri Lanka: Summary of Central Government Operations, 2012–20 1/
(In percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.			Proj.			
Total revenue (including grants) 2/	13.2	12.4	11.7	13.3	12.4	12.6	12.9	13.1	13.3
Total revenue	13.0	12.2	11.6	13.1	12.3	12.5	12.9	13.1	13.3
Tax revenue	11.2	10.6	10.1	11.4	10.8	11.0	11.4	11.6	11.7
Income taxes	2.3	2.4	2.0	3.0	2.3	2.4	2.5	2.5	2.6
VAT	2.7	2.5	2.4	2.4	2.4	2.5	2.6	2.7	2.8
Excise taxes	2.5	2.4	2.4	2.7	2.8	2.8	2.9	2.9	2.9
Other trade taxes	1.4	1.4	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Other	2.2	1.9	2.0	2.2	2.1	2.1	2.2	2.2	2.2
Nontax revenue	1.9	1.5	1.5	1.7	1.5	1.5	1.5	1.5	1.5
Grants	0.2	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending 1/	19.7	18.3	17.7	20.0	19.8	19.9	20.1	20.5	20.7
Current expenditure	14.4	13.2	13.2	15.2	14.8	14.7	14.9	15.2	15.2
Civil service wages and salaries	2.4	2.2	2.6	3.1	3.1	3.1	3.1	3.1	3.1
Other civilian goods and services	0.8	0.7	0.7	1.1	1.1	1.1	1.2	1.2	1.2
Security expenditure (including contingency)	2.7	2.4	2.8	2.9	2.9	2.8	2.8	2.7	2.6
Subsidies and transfers	3.1	2.8	2.9	3.5	3.4	3.4	3.4	3.4	3.4
Interest payments	5.4	5.1	4.2	4.5	4.3	4.3	4.5	4.8	4.9
Capital expenditure and net lending	5.3	5.0	4.5	4.8	5.1	5.2	5.3	5.4	5.6
Overall balance of the central government	-6.5	-5.9	-5.9	-6.7	-7.4	-7.3	-7.2	-7.4	-7.4
Financing	6.5	5.9	5.9	6.7	7.4	7.3	7.2	7.4	7.4
Net external financing	2.4	1.2	2.7	1.5	0.8	0.7	0.7	0.7	0.7
Net domestic financing	4.1	4.6	3.3	5.1	6.7	6.6	6.5	6.7	6.7
Memorandum items:									
Primary balance (excluding grants)	-1.3	-1.0	-1.8	-2.3	-3.2	-3.0	-2.8	-2.6	-2.6
Total public debt	79.2	78.3	75.9	77.0	78.1	78.2	78.0	77.9	77.9
Domestic currency	42.7	44.2	43.9	42.4	44.5	46.5	48.5	50.3	52.1
Foreign currency	36.5	34.1	32.0	34.6	33.6	31.7	29.5	27.6	25.9
Nominal GDP (in billion of rupees)	7,579	8,674	9,741	10,577	11,651	12,944	14,475	16,186	18,100

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

1/ Fiscal projection is based on the assumptions of current policies, and does not reflect any new policy measures that could be adopted after the election.

2/ 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 importation of motor vehicles by public servants from revenue and corresponding expenditures.

Table 3. Sri Lanka: Monetary Accounts, 2012–16
(In millions of rupee, unless otherwise indicated, end of period)

	2012	2013	2014	2015	2016
			Est.	Proj.	
	(Stocks, in billions of Sri Lankan rupees)				
Central Bank of Sri Lanka					
Net foreign assets	396	529	690	762	819
Net domestic assets	88	-41	-112	-97	-65
Net claims on central government	279	114	147	108	155
Other items, net	-192	-170	-277	-222	-237
Reserve Money	484	489	578	665	754
Monetary survey					
Net foreign assets	-26	-76	17	76	98
Monetary authorities	396	529	690	762	819
Deposit money banks	-422	-605	-673	-686	-721
Net domestic assets	2,955	3,494	3,858	4,313	4,881
Net claims on central government	1,045	1,301	1,436	1,743	2,301
Credit to corporations	2,651	2,899	3,204	3,351	3,431
Public corporations	292	365	446	531	605
Private corporations	2,358	2,534	2,758	2,820	2,826
Other items (net)	-742	-707	-783	-781	-851
Broad money	2,929	3,418	3,876	4,389	4,979
Memorandum Items					
Gross international reserves (US \$millions)	7,106	7,495	8,216	9,301	10,164
Net international reserves (US \$millions)	4,162	5,149	6,524	8,082	9,419
Private credit/GDP	31.1	29.2	28.3	26.7	24.3
Money multiplier	6.0	7.0	6.7	6.6	6.6
Broad money velocity 1/	2.6	2.5	2.5	2.4	2.3
	(Annual percentage change)				
Broad money	17.6	16.7	13.4	13.2	13.5
Reserve money	10.2	0.9	18.3	15.1	13.5
Credit to public corporations	47.3	24.8	22.2	19.1	13.9
Credit to private sector	17.6	7.5	8.8	2.2	0.2

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, 2012–20, BPM6
(In millions of U.S. dollars, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.	Proj.					
Current account	-3,981	-2,606	-2,790	-1,639	-2,282	-2,557	-3,131	-3,408	-3,682
Balance on goods	-9,417	-7,608	-8,299	-7,401	-8,580	-9,347	-10,394	-11,336	-12,074
Goods credit (exports)	9,773	10,394	11,118	12,042	12,991	14,436	16,078	17,860	19,964
Goods debit (imports)	-19,190	-18,003	-19,417	-19,443	-21,571	-23,782	-26,471	-29,196	-32,038
Non-oil imports	-14,145	-13,695	-14,820	-16,769	-18,298	-19,978	-22,141	-24,342	-26,603
Consumer goods	-2,995	-3,182	-3,853	-4,536	-4,684	-5,242	-5,825	-6,436	-7,164
Intermediate goods	-6,560	-6,259	-6,815	-7,502	-8,397	-9,007	-10,022	-11,012	-12,206
Investment goods	-4,590	-4,253	-4,152	-4,731	-5,217	-5,729	-6,294	-6,893	-7,233
Oil imports	-5,045	-4,308	-4,597	-2,673	-3,273	-3,804	-4,331	-4,854	-5,435
Services	1,262	1,180	1,453	1,442	1,773	2,028	2,423	3,020	3,424
Credit (exports)	3,800	4,685	5,458	6,243	7,080	7,828	8,763	9,895	10,880
Debit (imports)	-2,538	-3,505	-4,005	-4,801	-5,307	-5,800	-6,340	-6,875	-7,456
Primary income, net 1/	-1,218	-1,817	-2,140	-2,236	-2,385	-2,548	-2,724	-2,916	-3,125
Secondary income, net 2/	5,392	5,639	6,196	6,555	6,910	7,309	7,564	7,825	8,094
Capital account (+ surplus / - deficit)	131	71	61	168	101	102	102	102	102
Balance from current account and capital account	-3,850	-2,535	-2,729	-1,471	-2,181	-2,456	-3,029	-3,306	-3,580
Financial account (+ net lending / - net borrow)	-4,273	-3,120	-2,538	-1,471	-2,181	-2,456	-3,029	-3,306	-3,580
Direct investments	-877	-850	-763	-771	-862	-965	-1,078	-1,205	-1,346
Portfolio investments	-2,125	-2,106	-1,943	-1,610	-732	-555	-130	-758	-839
Other investments	-2,031	-1,275	-552	-175	-1,449	-2,016	-2,475	-2,679	-2,645
Of which: Loans	-3,081	-942	-801	-45	-1,319	-1,911	-2,395	-2,599	-2,565
Central bank 3/	-791	459	690	472	475	252	0	0	0
Deposit taking corporations	-579	-124	-680	-200	-250	-450	-450	-450	-350
General government	-992	-821	-485	-248	-658	-690	-748	-833	-833
Other sectors	-719	-456	-326	-69	-886	-1,023	-1,197	-1,316	-1,382
Change in reserve assets	760	1,112	721	1,085	862	1,080	654	1,337	1,250
Errors and omissions	-422	-584	191	0	0	0	0	0	0
Memorandum items:									
Current account (in percent of GDP)	-6.7	-3.9	-3.7	-2.0	-2.6	-2.7	-3.0	-3.0	-3.0
Gross official reserves /4	7,106	7,495	8,216	9,301	10,164	11,244	11,898	13,234	14,485
(In months of imports of goods and nonfact)	4.0	3.8	4.1	4.2	4.1	4.1	4.0	4.0	3.9
(In percent of composite metric)	101	98	98	107	110	113	110	112	114
Net international reserves	4,162	5,149	6,524	8,082	9,419	10,750	11,405	12,741	13,991
GDP	59,378	67,451	74,588	80,591	87,461	95,474	104,222	113,771	124,196

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/ Credits and loans with the IMF (other than reserves).

4/ 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, 2015–20 1/
(In millions of SDR, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020
Fund repurchases and charges						
In millions of SDR	332.9	331.1	173.2	0.2	0.2	0.2
In millions of U.S. dollars	468.6	466.0	243.7	0.3	0.3	0.3
In percent of exports of goods and NFS	2.6	2.3	1.1	0.0	0.0	0.0
In percent of quota	80.5	80.1	41.9	0.0	0.0	0.0
In percent of gross official reserves	5.0	4.6	2.2	0.0	0.0	0.0
Fund credit outstanding						
In millions of SDR	500	172	0.0	0.0	0.0	0.0
In millions of U.S. dollars	703	242	0.0	0.0	0.0	0.0
In percent of quota	121	42	0.0	0.0	0.0	0.0
In percent of GDP	0.9	0.3	0.0	0.0	0.0	0.0
In percent of gross official reserves	7.6	2.4	0.0	0.0	0.0	0.0
Memorandum items:						
Exports of goods and services (in millions of U.S. dollars)	18,285	20,071	22,263	24,841	27,755	30,844
Quota	413	413	413	413	413	413
Quota (in millions of U.S. dollars)	582	600	604	607	613	619
Gross official reserves (in millions of U.S. dollars)	9,301	10,164	11,244	11,898	13,234	14,485
GDP (in millions of U.S. dollars)	80,591	87,461	95,474	104,222	113,771	124,196
Source: IMF staff estimates.						
1/ As of February 28, 2015.						

Table 6. Sri Lanka: Financial Soundness Indicators—All Banks, 2010–14

	2010	2011	2012	2013	2014	2014	2014	2014
					Q1	Q2	Q3	Q4
Capital adequacy								
Regulatory capital to risk weighted assets	16.2	16.0	16.4	16.3	17.0	16.9	16.9	15.6
Tier 1 capital/risk weighted assets	14.3	14.4	14.7	13.7	14.4	14.4	14.3	13.1
Capital to assets ratio	8.3	8.7	8.6	8.2	8.3	8.3	8.4	8.2
Asset quality								
Gross nonperforming loans to total gross loans (without interest in suspense)	5.4	3.8	3.7	5.6	6.2	6.2	5.3	4.2
Net nonperforming loans to total gross loans	3.0	2.1	2.2	3.8	4.4	4.5	3.6	2.6
Provision coverage ratio (total) 1/	58.1	57.1	53.4	40.4	37.7	36.8	41.9	50.7
Earnings and profitability								
Return on equity (after tax)	22.0	19.8	20.3	16.0	16.1	15.3	16.5	16.5
Return on assets (after tax)	1.8	1.7	1.7	1.3	1.3	1.3	1.4	1.4
Interest income to gross income	83.1	85.5	86.3	69.7	85.7	86.0	85.3	85.1
Staff expenses to noninterest expenses	45.2	44.2	45.8	44.9	45.1	44.6	44.2	43.4
Personnel expenses to total income	12.0	12.2	10.7	25.0	10.4	10.8	10.6	10.5
Total cost to total income	72.0	74.1	75.2	79.3	80.4	80.4	77.7	75.8
Net interest margin	4.6	4.2	4.1	3.5	0.8	1.6	2.5	3.5
Liquidity								
Liquid assets to total assets	31.1	26.8	26.6	31.9	33.8	34.1	33.4	32.2
Assets/funding structure								
Deposits	72.4	71.5	70.3	70.7	71.2	70.2	68.9	67.6
Borrowings	15.1	15.8	16.7	16.4	15.9	16.9	18.3	20.2
Capital to external funds	9.5	10.0	9.9	8.2	9.5	9.5	9.6	9.3
Credit to deposits	76.4	84.7	87.4	82.2	79.0	77.9	79.6	83.1

Source: Central Bank of Sri Lanka.



SRI LANKA

THIRD POST-PROGRAM MONITORING DISCUSSION— SUPPLEMENTARY INFORMATION

April 23, 2015

Approved By

Kalpana Kochhar and Dhaneshwar Ghura

This supplement to the staff report summarizes the main developments since the staff report was issued on April 15. Staff projections and the thrust of the staff appraisal remain unchanged.

Revised balance of payments data indicate a stronger current account position in 2014. Due largely to stronger net services receipts, the overall current account deficit is now estimated by the authorities to be 2.7 percent of GDP.

Headline year-on-year inflation declined to 0.1 percent in March 2015, from 0.6 percent in February, but core inflation increased from 0.8 percent to 1.4 percent. The continued decline in headline inflation reflects primarily the impact of downward price revisions of domestic energy prices as well as the administered reduction in prices of a number of consumer items.

The Central Bank of Sri Lanka (CBSL) Monetary Board reduced policy interest rates by 50 basis points, effective April 15. Accordingly, the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the CBSL were reduced to 6 percent and 7.5 per cent, respectively.

**Statement by Rakesh Mohan, Executive Director for Sri Lanka
and Mr. Ranasinghe
April 29, 2015**

1. On behalf of our Sri Lankan authorities, we would like to thank staff for candid discussions and the comprehensive and balanced assessment of the macroeconomic developments and outlook of the Sri Lankan economy under the third Post-Program Monitoring (PPM).

2. The discussions were held in Sri Lanka just after a few weeks of the presidential election held in January 2015, which led to the formation of a new Government. The new administration has placed special emphasis on the implementation of projects identified under its 100-day program, which included far reaching constitutional, institutional and social welfare reforms aimed at strengthening good governance and transparency, promoting equity and reducing poverty. The much awaited constitutional reforms are mainly focused on transferring certain executive powers currently held by the President to the Parliament and establishment of independent judiciary, police, election, public service and anti-corruption commissions. These constitutional amendments have already been forwarded to the Parliament. Although the government formed after the Presidential election has no clear majority in the Parliament, many members are likely to support constitutional reforms irrespective of political differences. The Government is also planning to call for a Parliamentary election early to ensure political stability. This will enable the new government to come up with a firm medium term macroeconomic policy framework to spur growth, strengthen stability and to address emerging imbalances in certain sectors of the economy. Therefore, our authorities share the staff's view that as a firm medium term policy agenda of the new government will be available only after the Parliamentary elections, the medium term analysis presented in the report is incomplete.

3. The SBA supported program, which was successfully completed in 2012, helped Sri Lanka to strengthen its macroeconomic stability and build policy space. Our authorities broadly agree with the thrust of the staff assessment and stand ready to continue the close engagement with the Fund and have indicated their willingness to continue with the PPM, though technically it is not necessary, as outstanding borrowings from the Fund have now fallen below the threshold level that generally calls for PPM.

Economic Growth and Outlook

4. The growth momentum of the Sri Lankan economy continued while inflation remained contained. The economy grew by 7.4 percent in 2014 compared to the growth of 7.2 percent in 2013. The strong performance in the industry and services sectors, supported by recovering external demand, helped maintaining the growth momentum. The industry sector, which grew by 11.4 percent, bolstered by construction and manufacturing activity,

contributed nearly 48 per cent to the GDP growth. The services sector growth of 6.5 percent was largely contributed by trade, tourism, transport, communications and banking and real estate sectors. The agriculture sector, which was affected by adverse weather conditions in 2014, grew only marginally.

5. Our authorities have projected 7 percent growth for 2015. While a low interest rate environment coupled with low inflation, along with improved business conditions, would help to maintain the growth momentum, expected Parliamentary elections and postponement of certain development projects, which are pending a review by the new administration, would slow the growth to some extent. Expected continuation of the global recovery and a growth supportive policy framework which is expected after the Parliamentary elections, would also help sustaining the growth momentum.

Fiscal Policy

6. In terms of the Medium Term Macro Fiscal Framework (MTMFF), the 2014 budget envisaged further strengthening of fiscal consolidation by enhancing revenue collection, containing non-priority expenses and maintaining public investments at a higher level. However, the 2014 fiscal outcome reflected deviation from the original targets, mainly due to weak revenue performance, which declined to 12.2 percent of GDP compared to the targeted 14.5 percent of GDP. As a result, the budget deficit increased to 6.0 percent of GDP in 2014 in comparison to the targeted 5.2 percent, reversing the declining trend observed since 2009.

7. Our authorities recognize that the continued weak revenue mobilization has been the key challenge of fiscal consolidation. Recent efforts to enhance revenue collection including measures to broaden the tax base, improve the tax administration and to rationalize tax exemptions have not produced the expected outcome. The recent IMF TA Mission on Tax Policy has proposed important reform strategies, especially in the area of income taxation, which will be considered by our authorities at the time of preparation of forthcoming budget. In the meantime, measures have been taken to enhance tax compliance, improving tax audit and risk management at revenue authorities. Completion of the Phase I of the Revenue Administration Management Information System (RAMIS) to automate activities of the revenue authorities toward the end of 2015 would help to improve tax administration significantly. Steps are also being taken to improve operations at the Customs and Excise Departments by curtailing undervaluation, strengthening post-clearance audit, and streamlining licensing procedures.

8. Our authorities stand committed for further strengthening of fiscal consolidation. The original budget for 2015 passed in the Parliament in November 2014 targeted a budget deficit of 4.6 per cent of GDP. The Interim Budget presented by the new government in January 2015 has targeted an even lower budget deficit of 4.4 percent of GDP, with several measures to increase direct tax revenue, some of which were one-off as highlighted by the staff. The

interim Budget also included measures to reduce the cost of living by reducing import related taxes on a number of food items, increase of salaries of government employees, and upward adjustment of transfers to low income groups. Given the current political developments, our authorities recognize the challenge of meeting budgetary targets set for 2015. Our authorities would introduce firm measures to enhance revenue mobilization and rationalization of expenditure after the Parliamentary election, which is expected around mid 2015.

Monetary Policy

9. The Central Bank continued to maintain a relaxed monetary policy stance in 2014, and so far in 2015, in the backdrop of well anchored inflation and inflation expectations, and to support growth in private sector credit. The year-on-year inflation declined to 2.1 percent at the end of 2014 from 4.7 percent at the end of the previous year. The inflation rate further declined to very low level of 0.1 percent in March 2015. Reduction of energy prices in line with lower international prices and reduction of import duties on a number of food items under the 100-day program of the new government also largely attributable to this sharp decline in inflation.

10. Private sector credit growth continued to decelerate during the first 8 months of 2014, partly reflecting decline in pawning advances by commercial banks. The Central Bank reduced its Standing Lending Facility Rate (SLF) by 50 basis points in January 2014, and temporarily restricted access to the Standing Deposit Facility (SDF) of the Central Bank in September 2014, which was removed in March 2015. With these measures, private sector credit rebounded during the latter part of 2014 to record 8.8 percent of growth by the end of 2014. By February 2015, private sector credit growth further increased to 12.6 percent, y-o-y. Considering continued outlook for low inflation expectations, relatively high real interest rates in the market and further room for private sector credit growth, the Central Bank reduced its policy interest rates by 50 basis points effective from 15th April 2015.

External Sector

11. Sri Lanka's external sector resilience improved in 2014. The current account deficit declined to 2.7 percent of GDP in 2014 from 3.8 percent in the previous year, supported by slight improvement in the trade account as a percent of GDP and significant improvement in trade in services and workers' remittances.

12. In 2014, export earnings grew at a healthy rate of 7.1 percent, largely supported by industrial exports, mainly textiles and garments. Imports increased by 7.9 percent in 2014, mainly reflecting increased expenditure on imports of petroleum products and textile and textile articles. Despite lower international prices, petroleum import expenditure increased by 6.7 percent during the year due to increased import volume for thermal power generation, as hydropower generation was affected by severe drought conditions. Expenditure on import of

consumer goods, including motor vehicles also increased. With these developments, the trade deficit expanded by 8.9 percent to US \$ 8,287 million in 2014, but as a percent of GDP it declined to 11.1 percent from 11.3 percent in 2013. FDI inflows, including borrowings, increased to US\$ 1,685 million in 2014, while FDI excluding borrowings amounted to US\$ 944 million in 2014 compared to US\$ 933 million in 2013. Major inflows to the financial account in 2014 included issuance of sovereign bonds amounting to US\$ 1.5 billion, and international bond issuances by SriLankan Airlines and National Savings Bank and some commercial banks. There was a net outflow of US\$ 133 million of foreign investments in the government securities in 2014.

13. With these developments, the BOP recorded a surplus of US\$ 1,369 million in 2014. Gross official reserves increased to US\$ 8.2 billion by end 2014 compared to US\$ 7.5 billion at end 2013. Gross official reserves at end 2014 were sufficient to cover 4.3 months of imports of goods and services.

14. An increased pressure in the foreign exchange market was witnessed since late 2014, mainly due to the widened trade deficit and slowdown in net capital inflows, as well as relatively high debt repayments during the first quarter of 2015. As a result, gross official reserves declined to US\$ 6.7 billion at end March 2015, after meeting all short-term debt obligations, including the repayment of matured Sovereign Bond of US\$ 500 million in January, 2015. Our authorities have taken several risk mitigation measures. The government issued dollar denominated Sri Lanka Development Bonds (SLDBs) up to a value of US\$ 800 million. The Central Bank of Sri Lanka entered into a currency swap agreement with the Reserve Bank of India (RBI) for US\$ 400 million. Further, the Government of India has approved enhancing the currency swap arrangement by an additional US\$ 1,100 million. The gross official reserves are estimated to have increased to US\$ 7.0 billion by mid-April 2015 excluding swap arrangements.

15. Our authorities share the staff's view that there is no fundamental misalignment of the exchange rate. Our authorities are committed to maintain flexibility in the exchange rate determination and intervene in the market only to avoid excessive volatility in the exchange rates.

16. As highlighted by the staff, the external sector outlook for 2015 is favorable as the full benefit of sharp drop in oil prices would realize in 2015 with increased level of hydropower generation. In addition, easing of policy uncertainty after the planned Parliamentary elections and measures to address emerging risks also would help to strengthen external sector stability.

Financial Sector

17. The financial sector remains strong and resilient with healthy CAR and high profitability and liquidity. As per provisional data, the total CAR declined to 16.7 percent from 17.6 percent in 2014. However, it is still significantly higher than the regulatory requirement of 10 percent. The banking sector NPL improved to 4.2 percent from 5.6 percent in the previous year, mainly reflecting the recovery of pawning related NPLs. Total provision coverage has also increased to 50.7 percent. The financial sector expanded significantly in recent years benefiting from buoyant economic activity. Strengthened regulatory and supervisory framework in line with international standards and best practices further enhanced the soundness of the financial sector. In 2014, the Central Bank issued guidelines on the computation of risk-mitigated assets for operational risk under the standardized approach of Basel-II capital adequacy framework, baseline security standard for information security management and stress testing.

Conclusion

18. The growth momentum of the Sri Lankan economy is continuing. Inflation and inflation expectations remain well anchored. The authorities' commitment for fiscal consolidation remains high though some slippages of fiscal targets were observed in 2014 mainly due to continuing weak revenue performance. A firm macro-fiscal framework is expected after the proposed Parliamentary elections around mid 2015. The current monetary policy stance remains appropriate. The pressure in the external sector increased in recent months mainly due to widened trade deficit, slowdown in capital inflows and increased debt repayments, but prudent actions by the authorities to mitigate the risks would help to maintain the stability. The financial sector continues to remain sound and resilient.