

**Sri Lanka: Request for Stand-By Arrangement—Staff Report; Staff Supplements; Press Release on the Executive Board Discussion; and Statement by the Executive Director for 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, following discussions that ended on July 11, 2009, 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 17, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement of July 17, 2009, on the joint IMF/World Bank debt sustainability analysis.
- A staff statement of July 20, 2009, on the assessments of the risks to the Fund and the Fund's liquidity position.
- A Press Release summarizing the views of the Executive Board as expressed during its July 24, 2009 discussion of the staff report that completed the review.
- A statement by the Executive Director for Sri Lanka.

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

Letter of Intent sent to the IMF by the authorities of Sri Lanka\*

Memorandum of Economic and Financial Policies by the authorities of Sri Lanka\*

Technical Memorandum of Understanding\*

\*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

SRI LANKA

**Request for Stand-By Arrangement**

Prepared by the Asia and Pacific Department in Consultation with Other Departments

Approved by Kalpana Kochhar and Dominique Desruelle

July 17, 2009

**Motivation:** The global financial crisis has had a serious impact on Sri Lanka. Lax fiscal policies, a reliance on short-term external financing, and an overvalued exchange rate have left the country vulnerable. In the face of a sudden stop in capital flows at the end of 2008 and heavy intervention by the central bank to maintain the de facto peg, foreign exchange reserves fell to low levels at the beginning of 2009. Although the end of the conflict with the LTTE in May 2009 has led to a surge in market optimism and a rebound in capital inflows, international reserves remain at low levels. Without a strong policy response backed by significant balance of payments support, the authorities could face a disruptive devaluation of the exchange rate, with destabilizing social consequences. The program's main goal is to avoid this by allowing for a more orderly exchange rate adjustment, addressing the underlying fiscal weaknesses while ensuring the availability of resources for much needed reconstruction spending, restoring debt sustainability, and safeguarding the stability of the financial system.

**Program:** The proposed Stand-By Arrangement (of 400 percent of quota or SDR1.65 billion) would aim to smooth adjustment to the external shock that has hit the country, restore health to the country's public finances, allow for greater exchange rate flexibility, address weaknesses in the financial system, and protect the most vulnerable from the burden of the needed adjustment. In addition, the Fund program will provide a basis for the authorities to approach donors for supporting a longer-term reconstruction program.

**Discussions:** A staff team consisting of B. Aitken (Head), E. Faal, M. Saxegaard (APD), S. Peiris (MCM), and E. Kvintradze (SPR) visited Colombo during February 26-March 10, March 23-31 and July 6-11, 2009. K. Kochhar (APD) participated in the second and third missions and D. Nyberg (APD) in the third mission. The team held discussions with the President, Senior Advisor to the President, the Deputy Minister of Finance, the Governor of the Central Bank of Sri Lanka, Secretary to the Treasury, the Leader of the Opposition, commercial banks, donors, private sector representatives, and other officials.

Contents	Page
I. Context .....	3
II. Policies .....	4
III. Program Discussions .....	6
IV. Program Modalities .....	15
V. Risks .....	19
VI. Staff Appraisal .....	20
 Boxes	
1. The Post-War Reconstruction Plan for the Northern Province .....	12
2. Developments in Security-Related Spending .....	13
3. Exceptional Access Request .....	16
 Figures	
1. Growth Indicators .....	22
2. Measures of Inflation and Monetary Policy .....	23
3. External Sector Developments .....	24
4. Fiscal Indicators .....	25
5. Financial Market Developments .....	26
 Tables	
1. Selected Economic Indicators, 2006-2011 .....	27
2. Summary of Central Government Operations, 2006-2011 .....	28
3. Monetary Accounts, 2006-2011 .....	29
4. Balance of Payments, 2007-2011 .....	30
5. Medium-Term Macroeconomic Framework, 2006-2014 .....	31
6. Preliminary External Financing Requirements, 2008-2011 .....	32
7. Projected Payments to the Fund, 2006-2012 .....	33
8. Reviews and Disbursements under the Proposed 19-Month Stand-By Arrangement .....	34
9. Financial Soundness Indicators-All Banks .....	35
 Attachment	
I. Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding .....	36

## I. CONTEXT

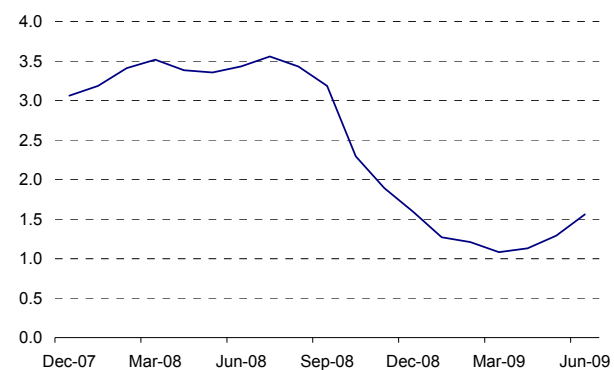
1. **Nature of the shock.** Years of lax fiscal policy forced the government to rely increasingly on short-term financing from international markets. The global financial shock resulted in a sudden stop to this financing and in capital outflows. In an effort to keep the exchange rate from depreciating the central bank had until recently intervened heavily in the foreign exchange market, with reserves reaching dangerously low levels. The loss of competitiveness and a sharp fall in demand for Sri Lankan exports are likely to put additional pressure on reserves, increasing the balance of payments gap further. Despite a rebound in short-term capital inflows following the end of the conflict with the LTTE, reserves remain low and foreign exchange needs significant.

2. **Growth.** The growth outlook has deteriorated markedly since last year. Growth is set to fall from 6 percent in 2008 to 3 percent this year on account of the slowdown in domestic economic activity and weak external demand. The effects of a drought earlier this year hurt the agricultural sector, and growth in tourism and the construction sector slowed sharply. The end of the conflict is projected to result in increased economic activity although the full impact is not likely to be felt until next year.

3. **Inflation.** Inflation peaked at 28 percent in June 2008 driven by high global prices for food and fuel, but the decline in these prices and tight monetary policy have reduced inflation to single digits in 2009.

4. **External sector.** Lower oil prices should reduce the current account deficit significantly to 1¼ percent of GDP from 9½ percent in 2008 despite an expected 13 percent decline in merchandise exports. Nevertheless, the reversal of capital inflows since September 2008 has sharply worsened the overall balance of payments. With the exchange rate effectively pegged to the dollar, the appreciation of the real effective

**Gross Foreign Exchange Reserves**  
(Billions of U.S. Dollars)



exchange rate (since end-2006) peaked at 22 percent in March 2009, before falling to 19 percent in June. Notwithstanding the modest depreciation of the currency since September 2008 and the sharp decline in inflation, competitiveness remains an issues. In May Standard & Poor's downgraded their outlook on Sri Lanka citing the country's weak external position, large fiscal deficit, and uncertainty about a loan agreement with the IMF.

5. **Capital flows.** Project-related inflows, mainly from Japan, China, and multilateral donors remained broadly stable, but short-term private sector inflows had reversed sharply before the recent modest recovery. In the third quarter of 2008, more than \$400 million in

nonresident holdings of government t-bills were redeemed, and since then about \$225 million in syndicated loans were not rolled over. An additional \$550 million of official and private external debt service is falling due in the second half of 2009. These outflows, together with net external payments from the state oil company, sharply reduced central bank foreign exchange reserves from a peak of \$3½ billion in mid-2008 to a low of around \$900 million in March 2009. Reserves have recovered somewhat, partly on account of a rebound in inflows to the Treasury Bill market since the end of the war, and currently stand at \$1½ billion or about 7 weeks of imports.

6. **Financial sector.** Stresses in the financial sector are increasingly apparent. The failure of an unregulated finance company in early 2009 led to deposit withdrawals from Seylan bank, a systemically important bank. Although short-run liquidity conditions have stabilized following the takeover of Seylan Bank by the central bank, the deterioration of system-wide asset quality and contagion effects from weaknesses in smaller finance companies exposed to real estate remain concerns. Non-performing loans for even the larger banks have begun to rise reflecting the slowdown of growth, although the banks are still well capitalized and liquid.

7. **Conflict and political situation.** The government's military campaign against the LTTE is over. Sri Lanka has entered a new post-conflict era faced with numerous challenges relating to humanitarian relief, resettlement of people displaced by the war, and political reconciliation. At the same time the end of the war has opened up the opportunity for the long-term development of the North and a resurgence in economic activity. Partly as a result of its success in ending the 2½ decade long conflict with the LTTE, the ruling party's popularity is very high and the coalition government has achieved victories in recent provincial and local elections. It is expected that democratic institutions and electoral politics can soon be re-established in the Northern province, with local government elections scheduled to take place in August this year.

## II. POLICIES

8. **Fiscal policy.** Sri Lanka has run chronically high budget deficits for the last several years with an average deficit for the central government of around 8 percent of GDP. With no policy adjustment the deficit for 2009 would deteriorate to more than 9 percent of GDP. Expenditures are on a declining trend, reflecting a fall in subsidies and transfers and the civil service wage bill. But revenues have also declined by an average of ¾ percentage points of GDP per year since 2006, in part because of tax exemptions granted under the Board of Investment (BOI) Act and the Inland Revenue Act. The 2009 budget reduced the VAT rate from 15 percent to 12 percent—resulting in an additional revenue loss of ¾ percent of GDP—and included a temporary, targeted, and sector specific stimulus package estimated at about ¼ percent of GDP. Public sector gross debt is now in the range of 80 percent of GDP, and its trajectory—in the absence of corrective steps—is unsustainable. The government has

pledged to reduce the fiscal deficit to 5 percent of GDP by 2011, but sufficient steps to achieve this goal have thus far not been implemented.<sup>1</sup>

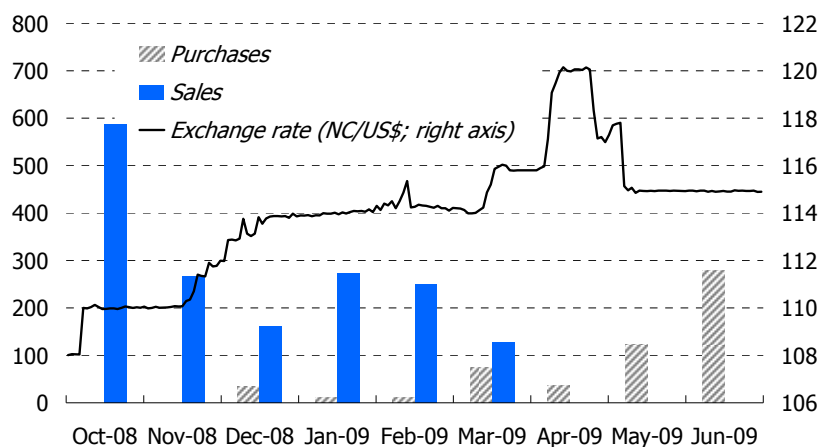
9. **Public enterprises.** Adding to the central government budget outturn, losses in 2008 for the state oil company were significant as high international oil prices were not fully passed through, and the state owned electricity company also experienced losses despite a 35 percent increase in electricity tariffs in March 2008. As a result the deficit for the two largest state enterprises increased to nearly 1¼ percent of GDP.<sup>2</sup>

10. **Monetary policy.** Until recently, large unsterilized foreign exchange intervention has led to a dramatic tightening of monetary conditions, with reserve money growth near zero in 2008. The loss of foreign financing of the budget has further squeezed private sector credit growth and real interest rates remain high. With inflation and domestic demand declining, the central bank has taken steps to loosen monetary policy, lowering reserve requirements from 10 to 7 percent and reducing the policy rates. At the same time the central bank has taken important steps to improve its conduct of monetary policy including eliminating the penal rate and effectively reestablishing the policy rate corridor, thereby significantly reducing the volatility of interbank interest rates.

11. **Exchange rate policy.** After maintaining a de facto exchange rate peg to the U.S. dollar since end-2007, the central bank announced a more flexible exchange rate regime in October 2008. While the exchange rate was allowed to depreciate by more than 6 percent until end-February 2009, the central bank continued to use large amounts of reserves to

#### Sri Lanka: Central Bank Intervention in Forex Market

*In millions of U.S. dollars*



Sources: Bloomberg LP.; and Central Bank of Sri Lanka.

<sup>1</sup> A Fiscal Responsibility Act was passed in 2002 with an original goal of reducing the deficit to 5 percent of GDP in 2006, but this goal has proven elusive.

<sup>2</sup> This deficit excludes the oil company's contingent liability related to losses incurred during 2008 from its oil hedging contracts. These contracts partially hedged upside price risk but left the company exposed to downside price risk. As oil prices fell sharply, losses under these contracts mounted to an estimated \$400-600 million (as much as 1½ percent of GDP). The central bank has suspended payments by the oil company, and the issue is currently in international arbitration. The creditor banks have signaled a willingness to reschedule payments over several years, provided that there is a government guarantee of these payments.

prevent the rate from depreciating further. Moreover, the central bank introduced restrictions in the form of margin requirements on a wide range of consumer goods, while raising existing margin requirements on vehicles, to reduce pressure on reserves. Since the start of program discussions in mid-March, the central bank stopped selling and started purchasing foreign exchange from the market, allowing the exchange rate to depreciate by a further 4 percent. More recently, short-term capital inflows into the treasury bill market and current account inflows following the war's end have put upward pressure on the rate but in line with the program's goals, the authorities have responded by stepping up foreign exchange purchases to prevent further appreciation.

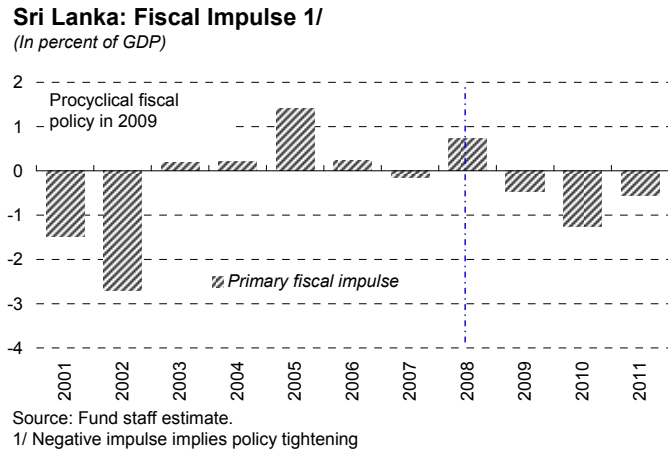
12. **Financial sector policies.** The central bank has replaced the management of Seylan Bank and instructed the bank to issue shares to the public and pre-qualified institutional investors by end-August 2009 sufficient to restore the bank's capital adequacy. Going forward, the central bank plans to address current weaknesses in the bank resolution framework including provisions for mergers and acquisitions and the liquidation of troubled banks. The government has taken steps to address problems faced by regulated finance and leasing companies including by providing temporary liquidity and encouraging consolidation. However, failures in the unregulated finance sector have not yet been addressed.

### III. PROGRAM DISCUSSIONS

13. **Context.** The authorities fully recognize the challenges they face. They realize the need to rebuild reserves and restore the competitiveness of their export sector, take measures to reverse the deterioration of the budget deficit, and head off problems in the financial sector. They view a Fund-supported program as fully consistent with these policy goals. At the same time, they see the end of the conflict as an opportunity to address the substantial reconstruction needs of affected areas, particularly in the North, and recognize that a strong track record under a Fund-supported program could help mobilize donor support to meet these needs. To this end the program aims to bring about credible deficit reduction required for debt sustainability while ensuring the availability of resources for post-war reconstruction, rebuild reserves to prudent levels while also allowing an orderly exchange rate adjustment sufficient to restore external viability, and to put in place a framework to ensure the soundness of the financial sector, resolve problem banks, and rebuild confidence. The authorities believe that this program will enable them to maintain the impressive growth witnessed by Sri Lanka in recent years.

14. **Path for budget deficit reduction.** The authorities are strongly committed to achieving their policy goal of reducing the central government budget deficit to 5 percent of GDP by 2011, setting a target of 7 percent for 2009 (compared to a baseline of 9½ percent and a deficit of 7¾ percent in 2008), and 6 percent for 2010. They are also committed to bringing the accounts of the two largest state enterprises to balance by 2011. To address concerns about debt sustainability and the past over-reliance on short term external financing,

the program's fiscal adjustment—in contrast to most recent Fund-supported programs—is necessarily procyclical with a negative fiscal impulse at a time of a sharp slowdown in growth. While a countercyclical fiscal policy would be desirable to stimulate growth in the current weak economic environment, the program aims to strike a balance between limiting the contractionary fiscal impulse and moving the budget toward a sustainable medium-term path.

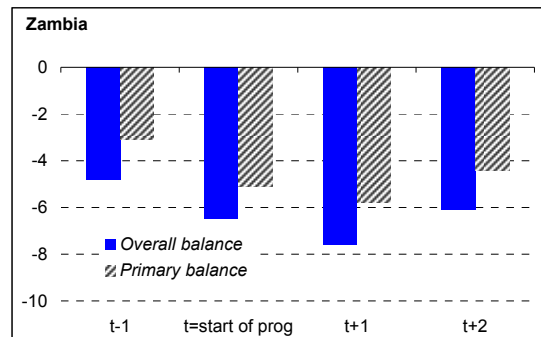
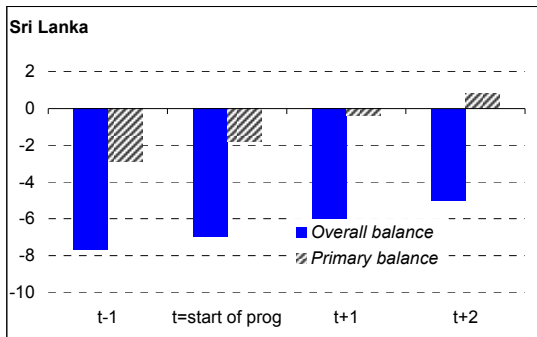
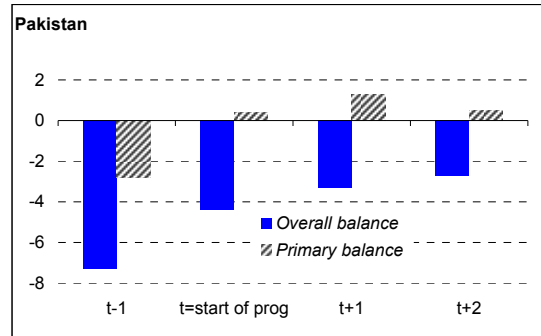
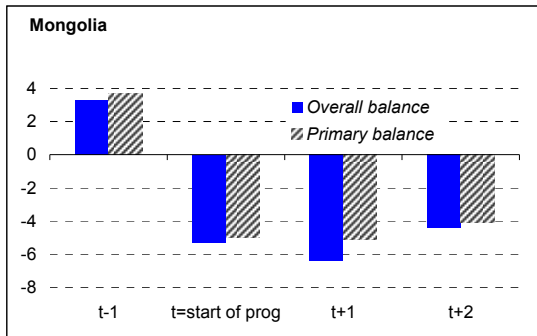
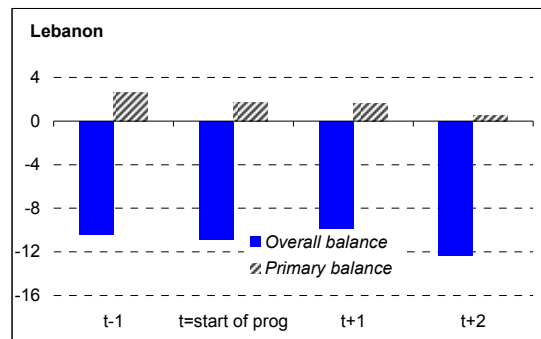
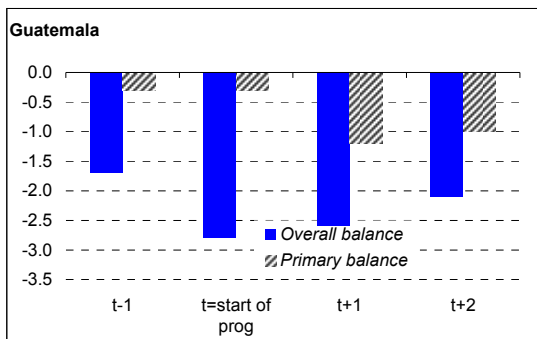
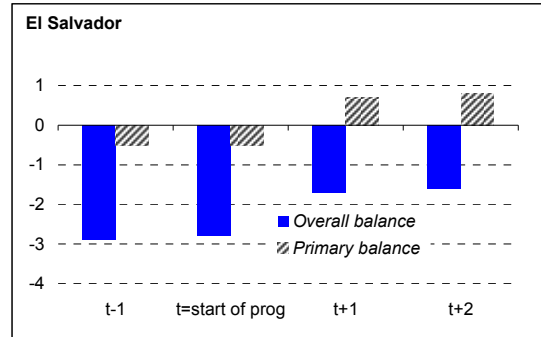
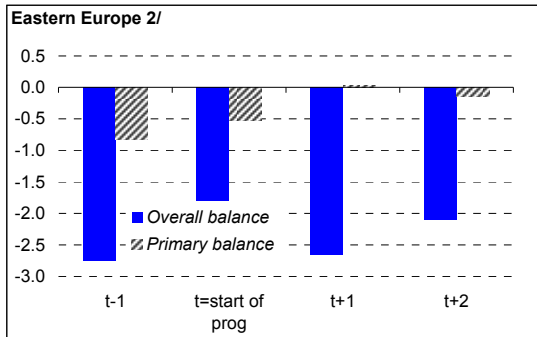


15. **Revenue measures in 2009.** The authorities understand that the most sustainable way to raise revenues is to broaden the base of direct and indirect taxes through reducing the array of exemptions under the Inland Revenue Act and BOI Law. To this end, the Inland Revenue Act was amended in 2008 to limit new tax holidays to a maximum of three years, and to notify that tax holidays already granted under the Inland Revenue Act or the BOI law would not be extended beyond their current period of expiration. Given the need to raise additional revenue this year, the authorities focused on measures that would have an immediate yield, totaling 1¼ percent of GDP for the remainder of the year. Measures include:

- Increasing the nation building tax rate from 1 percent to 3 percent effective May 2009 yielding 2/3 percent of GDP for the remainder of 2009 (Text Table 1). The budget for 2009 introduced this tax at 1 percent, but the authorities have now raised the rate to 3 percent. The base for this tax is largely the same as the VAT. This measure is now fully in place.
- Raising excise taxes on liquor, cigarettes, and selected consumer items effective April 2009. The expected yield from these measures is ¼ percent of GDP for the remainder of 2009. This measure has already been implemented.
- Repealing import margin requirements on consumer goods introduced last fall and the margin requirements already in place prior to that. These requirements sharply reduced imports of high revenue-yielding items. In addition, cesses and other trade taxes have been increased resulting in an expected tax yield of 1/3 percent of GDP. These measures have already been implemented.



Fiscal Adjustment in Recent IMF Programs 1/

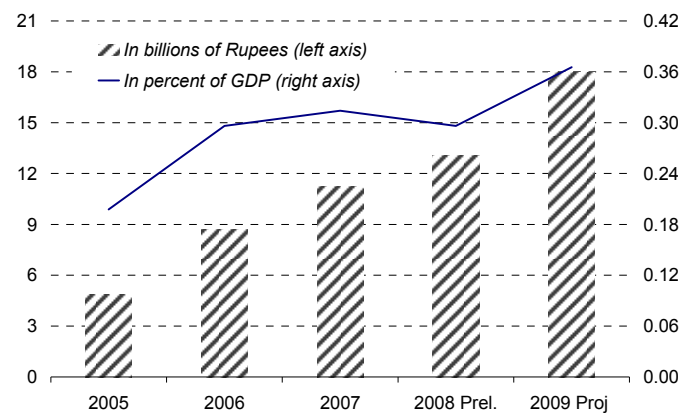


Sources: IMF Program documents.  
 1/ Latest projections.  
 2/ Hungary, Georgia, Kyrgyz Republic, and Ukraine.

16. **Expenditure measures in 2009.** The authorities are committed to cutting spending by ½ percent of GDP relative to the 2008 budget outturn, while maintaining the level of capital spending and preserving expenditure allocations to protect the most vulnerable groups in society. To protect the vulnerable groups in society, social sector spending is targeted to increase to 7 percent of GDP in 2009 from 6.8 percent in 2008.

In addition, the Government also is taking action to provide immediate relief and expand social safety net spending to resettle the displaced persons in the North within the shortest possible time.

**Special Projects for Welfare & Resettlement of IDPs**



17. **Performance in first four months in 2009.** In line with staff projections, revenues in the first four months were about 10 percent below the levels in the same period last year reflecting the collapse in tax yielding imports. At the same time, expenditures have run about 28 percent higher, primarily reflecting repayments of domestic debt contracted at much higher nominal interest rates prevailing during the second half of last year (with annualized treasury bill rates averaging about 20 percent) and the drying up of lower cost external funding. As a result, during this period the central government deficit amounted to around 4 percent of annual GDP. For the remainder of the year, revenues are expected to pick up pace in line with the projected pick up in imports and the yield of the tax measures taking effect beginning in May. The sharp decline in interest rates—from above 17 percent at end-2008 to approximately 11½ percent at end-April—is expected to bring down the domestic interest bill significantly. The pace of goods and services expenditures are projected to slow in line with the authorities’ commitments under the program. Together, these factors are expected to narrow the budget deficit during the remainder of 2009. The authorities have also identified areas where spending on low-priority investment projects could be cut or postponed if necessary, and are committed to making further cuts in spending on civilian goods and services in the event the expected revenue does not materialize and the budget targets come under threat.

18. **Fiscal measures in 2010 and 2011.** Part of the adjustment needed to reach the targets will come from the full-year effect of the new revenue measures introduced in 2009. In addition, the President has formed a tax commission to review current tax policy and to make recommendations on strengthening tax collection, tax auditing and enforcement, and simplifying the tax system, including a review of the tax incentive system administered by the Board of Investment. The authorities anticipate that the commission will also review the VAT with the intention of broadening the base. The interim report of this commission will be discussed during the second program review with a view to identifying base broadening

measures to be included in the 2010 budget. As any new revenue measures yield results, temporary taxes—such as import surcharges—will be gradually phased out. The government has requested technical assistance from FAD to focus and assist the work of the Commission, by assessing the major elements of the tax system and providing advice on tax policy issues. On the expenditure side the authorities understand that additional cuts are needed to reduce the deficit further and make room for reconstruction spending. They envisage that these cuts would come from savings from security related spending and a reduction in transfers. The budget for 2010 is expected to be finalized in November 2009. Ahead of this measures to fill the 2010 budget gap will be discussed during the first review at the time when budget preparations are in the early process.

Table 1: Revenue and Expenditure Measures under the Program, 2008-2011

	2008	2009	2010	2011
	(in percent of GDP)			
Program revenue target	14.9	14.8	15.4	16.0
Total revenue without adjustment	...	13.7	13.8	14.0
Additional revenue needed	...	1.1	1.6	2.0
Revenue measures agreed, of which: 1/	...	1.1	1.3	1.3
Nation building tax	...	0.6	0.8	0.9
Excise taxes	...	0.2	0.2	0.2
Cesses and other surcharges	...	0.3	0.3	0.3
Remaining revenue gap	...	0.0	0.3	0.7
Program expenditure target	22.6	21.9	21.5	21.0
Total expenditure without adjustment	...	23.2	23.2	23.5
Additional expenditure cuts needed	...	1.4	1.7	2.5
Adjustments relative to baseline 2/	...	0.5	...	...
Expenditure measures agreed 1/	...	0.9	0.2	0.1
Remaining expenditure gap	...	0.0	1.5	2.4
Program deficit target	7.7	7.0	6.0	5.0
Deficit without adjustment	...	9.5	9.4	9.5
Adjustment required	...	2.5	3.4	4.5
Identified adjustment	...	2.5	1.5	1.4
Remaining gap	...	0.0	1.9	3.1

1/ The yield of measures in 2009 is on a nine-month basis.

2/ Includes lower domestic interest under the program scenario and adjustments to budget allocation for capital spending.

19. **Public enterprises.** With the fall in oil prices, the combined deficit for the two large public enterprises, the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC), is expected to decline in 2009. Nevertheless additional steps may be needed to ensure that the government achieves its goal of reaching a balanced budget for these enterprises by 2011. As a first step the government established an independent regulator for the electricity sector in March 2009 and are moving toward lower cost electricity generation. Also, retail prices of petrol and diesel were raised by 5-10 percent in

July 2009, broadly consistent with a full pass-through of the recent increase in international oil prices. In addition, the authorities will put in place a mechanism for a regular review of the operational cash flows of these enterprises and have committed to take any adjustments—including to tariffs, management and operations—needed to bring the enterprises to break even by 2011. Any subsidies will be targeted to vulnerable groups and transparently reflected in the government budget. To monitor the operations of the enterprises and to make appropriate recommendations, the government has appointed a Joint Review Mechanism through a committee consisting of high-level representatives from the Ministry of Finance, the CEB, the CPC, and the central bank. The committee is expected to complete its report by mid-August. Progress on these steps will be assessed at the time of program reviews. The authorities have also agreed to develop a plan to address outstanding debts between the key state-owned enterprises by end-December 2009.

20. **Reconstruction.** Addressing the reconstruction needs of areas affected by the conflict will require a substantial effort over the next several years. The government has formed a high-level task force which is in the process of conducting a comprehensive needs assessment. At the same time significant efforts are being made to address the humanitarian needs of those affected by the conflict and to ensure the timely resettlement of internally displaced persons (IDPs) (see Box 1).

21. **Financing the reconstruction.** While reconstruction spending needs in the years ahead will be considerable, they will need to be balanced against the need to preserve debt sustainability. In 2009 the government intends to make room within the existing deficit targets for spending on humanitarian assistance and the resettlement of IDPs using savings in other spending categories and redeploying military personnel for demining and for the provision of basic infrastructure. The broader reconstruction strategy will be based on the needs assessment which is expected to be completed by the end of July. The experience in the Eastern province suggests that reconstruction needs could amount to about 1 percent of GDP per year. Financing for this reconstruction will be through revenue enhancements, savings in military spending of approximately  $\frac{3}{4}$  -1 percent by 2011 (see Box 2) and external financing in the form of concessional loans and grants from development partners. Staff will determine during program reviews the extent to which the deficit target should be adjusted to accommodate externally financed reconstruction spending in order to preserve debt sustainability. Important factors in this assessment will include the productivity of the reconstruction projects and the concessionality of donor financing.

### **Box 1. The post-war reconstruction plan for the Northern province**

**The authorities have moved quickly to provide humanitarian assistance to those affected by the conflict and to develop a post-war reconstruction plan.** Their immediate priorities include satisfying the humanitarian needs of the estimated 300,000 internally displaced persons (IDPs) currently in camps while working to ensure the resettlement of 70-80 percent of IDPs within 180 days. Work is also underway on a broader reconstruction plan for the Northern province.

**The overall reconstruction strategy is built on the experience gained during the reconstruction of the Eastern province which started in 2007.** It is based on four Ds:

(i) demilitarization; (ii) development; (iii) democratization; and (iv) devolution.

Demilitarization includes demining—which is being done by the military with the assistance of local and international NGOs—as well as the restoration of law and order. Development includes the resettlement of IDPs—a process which has already begun—and the restoration of basic services including water, electricity, and education, and the development of economic and social infrastructure in consultation with local officials and communities in the affected areas. Democratization includes conducting local government and provincial council elections, the first of which are scheduled to take place in August, as well as the election of a Chief Minister for the Northern province.

**A newly established Presidential Task Force for Resettlement, Development, and Security in the Northern province is leading the reconstruction effort.** In addition to preparing plans for early resettlement, the task force will also be in charge of planning and monitoring implementation of the rehabilitation and development of economic and social infrastructure in the Northern province. A consultative committee of humanitarian assistance—which includes representatives from the international community—has also been set up to advise on issues relating to humanitarian assistance and the provision of basic services to IDPs.<sup>1</sup>

**Reconstruction spending this year is being accommodated within existing budget limits.**

In particular, the authorities have allocated Rs. 18 billion (2 percent of projected central government spending) in the 2009 budget to reconstruction spending in the North. The majority of this is being used for the provision of humanitarian assistance and the resettlement of IDPs. A needs assessment is currently underway to determine additional funds needed for the broader reconstruction strategy and once completed, the authorities envisage approaching donors for financing assistance, as they did in the case of the tsunami and the Eastern province.

<sup>1</sup>/ The committee—including representatives of various UN agencies, the ICRC and the WHO, and representatives of the governments of the U.S., Sweden and Japan—last met on May 11, 2009.

### Box 2. Sri Lanka: Developments in Security-Related Spending

**Over the past decade, security-related spending in Sri Lanka has fluctuated, broadly reflecting the intensity of conflict with the LTTE.<sup>1</sup>** As the conflict with the LTTE intensified, security-related expenditure rose from 3.3 percent of GDP in 2005 to 3.9 percent in 2008. During this period, defense wages have been relatively stable in a range of 1.5-1.7 percent of GDP, while defense spending on goods and services increased.

**Sri Lanka's military expenditure as a share of GDP is higher than World and regional averages.** The authorities do not expect significant reductions in military spending for 2009, but see some scope for military savings in 2010 and 2011. In the context of reconstruction, a needs assessment is expected to determine additional funds needed, which will be found primarily through revenue enhancement, savings in military spending beginning with the 2010 budget, and additional donor financing (see paragraph 11 of MEFP).

#### Comparative Military Expenditure, 2008

Region	Defense spending (In percent of GDP)
World	2.4
Asia	2.0
SAARC 1/	2.2

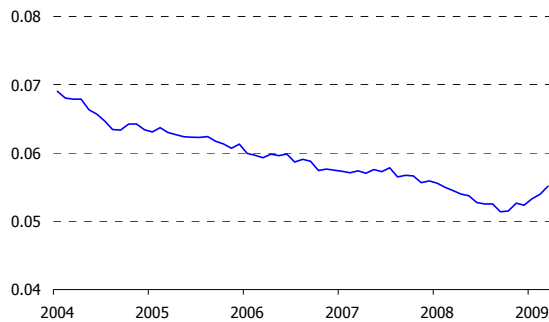
Source: Stockholm International Peace Research Institute.

1/ South Asian Association for Regional Cooperation, including Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

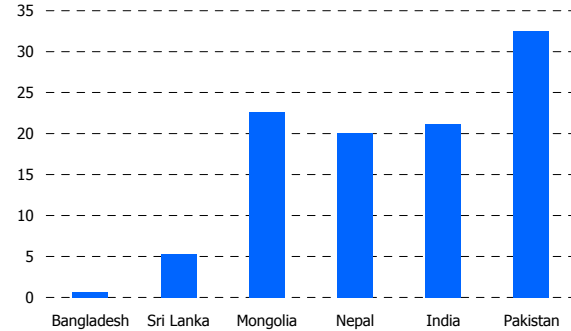
1/ Expenditure on public order and safety (police, immigration, etc) is included in this measure.

22. **Exchange rate policy and reserve targets.** Rebuilding reserves while addressing the loss of competitiveness and restoring external viability are central policy aims of the program. To this end the program targets a reserve buildup to more than 3½ months of imports (\$4 billion) by the end of the program period.

**Sri Lanka: Share of World Exports**  
(In percent, 12mma)



**Exchange Rate Depreciations**  
(In percent since end-2007)



23. **Restoring external competitiveness.** A return to external viability will require addressing the loss of competitiveness, which is evidenced by the steady decline in its export market share. Moreover, Sri Lanka will face stiff competition once a global recovery begins to emerge from other competing countries which have already adjusted, particularly for garments exports. While the program is anchored on reserve targets, the exchange rate would need to be sufficiently flexible to address these circumstances. To ensure that the source of the reserve buildup is through current account adjustment rather than external borrowing as was previously the case, the program is designed to adjust the net international reserve targets upward for short-term capital flows into the domestic bond market. Because the supply and demand for foreign exchange will be uncertain over the program period, the program includes a clause whereby the authorities would consult with the Fund staff on the appropriate policy response in the event that the gap between supply and demand of foreign exchange results in a more sudden and disruptive depreciation of the exchange rate than anticipated by the staff and authorities.

24. **Monetary policy.** Consistent with the floating exchange rate regime—and given the absence of an effective interest rate transmission mechanism—base money will continue to anchor monetary policy. The program’s monetary targets aim to control inflation while ensuring adequate credit to the private sector.

25. **Financial sector reforms.** The program entails a comprehensive and ambitious structural reform agenda for shoring up the financial sector and addressing recent problems. Measures include:

- Resolving the remaining issues from the takeover of the systemically important Seylan Bank. The central bank has already directed Seylan Bank to issue Rs. 3 billion in share capital at the prevailing market price to recapitalize the bank.
- Consolidation of weak finance and leasing companies with the aim of avoiding spillovers to healthy financial institutions.
- Developing a contingency plan to deal with potential stresses in the financial system.

- Implementing a wide range of measures to improve financial sector regulation, focused in part on strengthening capital requirements and banks' integrated risk management frameworks.
- Amending laws and regulations to improve the bank resolution framework and address the major supervisory gaps in the banking, credit card, and finance company sector.

26. **Social policies.** With 15 percent of the population below the poverty line, and large numbers of people in the North and East displaced by the conflict, the economic downturn will undoubtedly have significant social consequences. It is essential therefore that the program protect expenditures on social transfers to Sri Lanka's most vulnerable. The current budget allocation achieves this goal, and the staff will coordinate with the authorities, the World Bank, and other donors to ensure these objectives are met going forward. The safety net system comprises Samurdhi, the main cash transfer program to address chronic poverty and channel disability payments. In addition, the system provides limited social welfare and care services, and disaster relief to displaced persons.

27. **Safeguards.** A safeguards assessment was concluded in May and found that the CBSL had developed a relatively strong safeguards framework. The CBSL is committed to working with IMF staff in the coming months to implement the recommendations outlined in the assessment report with a focus on the priority recommendations in the areas of external audit and data reporting.

#### IV. PROGRAM MODALITIES

28. **Access.** Given the steady depletion of foreign currency reserves, the potential for non-resident deposit outflows, and fragile confidence in the local currency, the program will need to ensure a substantial increase in resources available to the central bank. An excessive depreciation of the currency would be very damaging to the financial system given foreign currency dominated lending to borrowers who lack a natural hedge. Normal access would be insufficient to achieve a reasonable level of reserves while preventing a disorderly exchange rate adjustment. Exceptional access from the Fund of 400 percent of quota (SDR 1.65 billion) during the course of the 20 month Stand-By Arrangement would help reinforce confidence and avert a balance of payments crisis (the four criteria for exceptional access are reviewed in Box 3). Sri Lanka's access during the first year under the proposed SBA would exceed 200 percent of quota. Sri Lanka is therefore subject to the requirements under the current exceptional access policy. With access at this level, the program would be fully financed.

29. **Phasing.** The proposed program envisages a flat purchase schedule. The first purchase would be around \$313 million.

30. **Other donor financing.** The World Bank's Country Assistance Strategy (CAS) includes approximately \$100 million of funds earmarked for existing projects in the Northern



### Box 3. Sri Lanka: Exceptional Access Request

- I. *The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current or capital account resulting in a need for Fund financing that cannot be met within the normal limits.* The balance of payments pressures are predominantly on the capital account. Although there has been a recovery in capital inflows following the end of the conflict, these are mostly of a short-term and speculative nature and could rapidly reverse. Thus the reserve position remains fragile, and there could be a resurgence of pressures in the foreign exchange market. Preventing these pressures from emerging is a key objective of the program, justifying the need for exceptional access to replenish the weak international reserve position and bolster confidence in the currency.
- II. *A rigorous and systemic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term.* The external and public debt sustainability analysis indicates that Sri Lanka has a moderate risk of debt distress. However, the comprehensive package of medium-term policies implemented as part of the proposed SBA-supported program, including bringing the fiscal deficit down to 5 percent of GDP by 2011 and a return to a more flexible exchange rate regime, would substantially reduce the risk of debt distress (including from private sector spillovers) and ensure public debt sustainability going forward.
- III. *The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding.* In the past few years, Sri Lanka has had good access to private markets having floated its \$500 million maiden sovereign bond in October 2007 and raised various syndicated loans amounting to \$100-150 million each over the past few years, the last one being in June 2008. In the first half of 2008, the government of Sri Lanka also sold US\$600 million in domestic-currency denominated Treasury Bills to nonresident investors. There is no reason to believe that as private capital markets normalize, Sri Lanka could not regain similar access.
- IV. *The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.* As always, there are risks to the program. However, the broad policy framework outlined above provides the basis for averting the pending economic and social crisis, and the program entails strong upfront actions to demonstrate ownership. These include spending and revenue measures consistent with achieving the program target for 2009 and a commitment to stem the loss of reserves in the period leading up to the Board meeting. In the event, the authorities have begun rebuilding reserves by purchasing large amounts of foreign exchange from the market in response to the recent rebound of capital inflows. The government's institutional and political capacity to deliver the program's adjustment is strong. The high popularity of the government provides room to take tough measures when needed. Professionals in the civil service, particularly in the Central Bank and the Ministry of Finance, are experienced and skilled. A relatively sophisticated foreign exchange market could rapidly adapt to a return to exchange rate flexibility.

province that have already been committed but not yet disbursed. An additional \$225 million annually is earmarked for sectoral projects it could in theory be used for reconstruction projects if needed and requested by the government. In this context, the World Bank is in preliminary discussions with the authorities on funding community development projects in the Northern province which aim to facilitate the resettlement of IDPs. The AsDB recently concluded a \$160 million loan agreement to fund the development of the power sector in Sri Lanka and has indicated that the government could qualify for up to \$150 million in budget support—with co-financing from Japan—once the Fund-supported program is approved. If this budget support materializes, it would replace more expensive domestic financing and could help reduce the interest bill from levels currently assumed in the program. In addition, Japan has indicated that they intend to continue with the annual lending program of about ¥25-30 billion focused on infrastructure projects in the water, power and road sectors.

31. **Conditionality.** Conditionality is focused on achieving the programmed deficit reduction, building reserves and restoring external viability, and safeguarding financial sector stability. The quantitative and qualitative conditionality is described in Tables 1-3 attached to the government's Memorandum of Economic and Financial Policies. Reviews will be based on quantitative performance criteria assessed quarterly during the program period.

32. **Prior actions.** The authorities have implemented all prior actions (Text Table 2). On the budget side the authorities have taken the necessary steps to implement the agreed revenue measures and eliminate all import margin requirements, including those that were in place prior to the additional requirements introduced October 2008. The central bank has also ceased sales to the foreign exchange market and shown a readiness to allow the exchange rate to be more flexible reflecting the need to rebuild reserves to meet the program targets. Indeed, the central bank has purchased more than \$400 million of foreign exchange since March.

33. **Capacity to repay.** If the government carries out its commitment to maintaining a competitive exchange rate and rebuilding reserves, Sri Lanka's strong export base gives reasonable assurances of the capacity to repay the Fund. If purchases are made as scheduled, there will be a peak in repurchases to the Fund in 2014. The staff's Debt Sustainability Analysis shows that with a floating exchange rate the central bank would accumulate enough reserves to repay the Fund and maintain a level of gross reserves of at least 3½ months of imports. The authorities have expressed their willingness to consider a transition to a concessional arrangement once the immediate crisis has been averted, which would help establish a program for reconstruction and other investment spending and facilitate a steady path of structural reform over a longer horizon.

34. **Debt sustainability analysis.** The external debt sustainability analysis indicates that Sri Lanka has a moderate risk of external debt distress over the medium term. The comprehensive package of medium term policies implemented as part of the program,

**Table 2. Sri Lanka: Prior Actions and Structural Conditionality**

Actions	Type	Date
<b>Removal of import margin requirements imposed in October and November 2008.</b>	Prior Action	Implemented
<b>Amendments to the Nation Building Tax to raise the rate from 1 to 3 per cent.</b>	Prior Action	Implemented
<b>Amendments to the excise taxes on liquor, cigarette and other items.</b>	Prior Action	Implemented
<b>Finalisation of the terms of reference of a tax commission to review tax policy</b>	Prior Action	Implemented
<b>Harmonize the penal rate for commercial bank borrowing from the CBSL and the reverse repo rate.</b>	Prior Action	Implemented
<b>Announcement of a recapitalization plan for Seylan Bank.</b>	Prior Action	Implemented
<b>Recapitalization of Seylan Bank through a public share issuance. <i>This would restore public confidence in the banking system.</i></b>	Structural Benchmark	9/30/09
<b>A contingency plan for orderly workouts of problem banks and financial institutions will be developed by the CBSL. <i>This would help address emerging stresses in the financial sector and strengthen crisis management.</i></b>	Structural Benchmark	9/30/09
<b>Approval by the Monetary Board of a revised Banking Act and other pertinent laws and legislations that: (i) improve the bank resolution framework that more clearly defines the provisions for acquisition, and roles of the conservator and liquidator; and (ii) strengthens the definition of large exposures and related parties to better capture all material risks. <i>This would address weaknesses in the supervisory framework and facilitate orderly workout of problem banks.</i></b>	Structural Benchmark	9/30/09
<b>Submission by the tax review commission of an interim report, including on base broadening measures to be incorporated into the 2010 budget. <i>The recommendations of the tax commission will form the basis for an overhaul of the tax regime in Sri Lanka aimed at boosting revenue on a more efficient and sustainable basis.</i></b>	Structural Benchmark	10/15/09
<b>Develop a plan to address outstanding debts between the CEB, CPC and state-owned banks. <i>This will increase the transparency of these two key state enterprises and help improve their operations.</i></b>	Structural Benchmark	12/31/09
<b>Submission to the parliament of a revised Finance Company Act which includes clarifying the legal authority of the CBSL in enforcing its regulations on all deposit taking finance companies. <i>This would address loopholes in the regulatory framework.</i></b>	Structural Benchmark	12/31/09
<b>Issuance of prudential regulations and guidelines to credit card companies and payment service providers. <i>This would address loopholes in the regulatory framework.</i></b>	Structural Benchmark	12/31/09
<b>Submission to parliament of the 2010 budget consistent with program targets.</b>	Structural Benchmark	12/31/09

especially bringing the fiscal deficit down to 5 percent of GDP by 2011 and a return to a more flexible exchange rate regime, if fully implemented, would bring Sri Lanka to a sustainable path.<sup>3</sup>

## V. RISKS

35. There are substantial risks to the program. While the program's economic goals are consistent with the government's own intentions, achieving these goals will require a great deal of government commitment to implementing necessary measures, particularly for the budget and the exchange rate. At the same time, the end of the war would have a positive economic impact.

- **Exchange rate and reserves.** Prior to entering program discussions the government had shown a willingness to defend a stable exchange rate at the expense of two-thirds of the country's reserves. The program will require however a sharp departure from this policy view. In program discussions the authorities strongly maintained their commitment to the program's reserve targets, and recent actions by the central bank to purchase foreign exchange from the market while allowing the rate to depreciate have demonstrated the credibility of this commitment, but this commitment may be tested going forward.
- **Fiscal risks.** The government has expressed strong ownership of the program's fiscal targets and has taken significant steps to boost revenues while recognizing the need to cut expenditures to meet these targets and create the room for reconstruction spending over the medium term. Nevertheless, the government has had a poor track record of fiscal adjustment. Moreover, the quality of the revenue measures taken so far is less than ideal, while the expenditure cuts will be politically difficult. The program includes steps to develop a more comprehensive revenue reform and to solidify expenditure cuts, and includes a commitment by the authorities to undertake additional expenditure cuts to offset revenue shortfalls. However, there may be a need for further measures to address fiscal shortfalls as the program progresses. There is also a risk that meeting the fiscal targets will result in a second best reliance on cuts in politically sensitive capital spending.
- **Foreign exchange deposits.** A sudden withdrawal of non-resident foreign exchange deposits from the banking sector would put pressure on reserves and could jeopardize the program's reserve targets. However, at this stage this risk appears relatively low. These deposits are related to remittances inflows and are for the most part not

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<sup>3</sup> Sri Lanka does not have any arrears to public (multilateral and bilateral) or private external creditors. As a result, the Fund's policies on arrears have not been applied.

speculative in nature, and an IMF program would help reassure depositors and mitigate the risk of a large outflow.

- **Financial sector.** Weaknesses in the financial sector are likely to increase as the economy slows, and the program is designed to address existing weaknesses and establish an orderly and transparent method for dealing with problems should banks experience a rapid increase in nonperforming loans. While a sudden system-wide withdrawal of deposits is unlikely, there is a risk that problems could emerge in systemically important banks and reduce confidence in the banking sector as a whole.
- **Output growth.** Sri Lanka's trading partners could see a more rapid growth slowdown than currently expected, reducing exports and overall growth. Prolonged real exchange rate overvaluation could also put a drag on export and output growth.
- **Possible peace dividend.** On the upside, the war's end has already led to an increase in remittances and other capital inflows. If these continue the outlook for the balance of payments and for growth could be better than forecasted. On the downside, delays in the authorities' willingness to follow through on commitments to put in place a political solution to ease ethnic tensions may adversely affect donor participation and northern reconstruction.

## VI. STAFF APPRAISAL

36. **Overview.** Sri Lanka has been hit hard by the global financial crisis. Several years of lax fiscal policy, reliance on short-term external financing, and an overvalued exchange rate had left the country particularly vulnerable to this shock. There is now an urgent need for the government to enact policies to shore up the balance of payments, rebuild reserves, reverse the deterioration of the budget deficit, and head off problems in the financial sector.

37. **Program.** The authorities' program aims to bring about credible budget deficit reduction required for debt sustainability, rebuild reserves to prudent levels while also allowing an orderly exchange rate adjustment sufficient to restore external viability, and put in place a framework to ensure the soundness of the financial sector, resolve problem banks, and rebuild confidence.

38. **Reconstruction.** Beyond this, the end of the conflict provides the government with the opportunity to address the substantial reconstruction needs of affected areas, particularly in the North. Financing the reconstruction effort will be a large undertaking, and the credibility of the authorities' reconstruction spending plans will require a strategy for expenditure savings in other areas of the budget. The authorities' commitment to carry out sizeable reductions in defense spending will go a long way toward making room for reconstruction spending while allowing further budget deficit reduction. Greater engagement with bilateral and multilateral donors will also be an important element of the reconstruction

strategy, and a strong track record under a Fund-supported program could help mobilize this donor support.

39. **Fiscal policy.** The authorities are firmly committed to reaching their budget deficit target of 5 percent of GDP and balancing the state enterprises' budgets by 2011. This involves putting in place difficult measures now to address the decline in revenues and reign in spending in order to achieve a targeted deficit of 7 percent this year. The staff would have preferred revenue measures aimed at eliminating exemptions and broadening the tax base, but the need to boost revenues this year requires measures which would provide an immediate yield. The authorities recognize the need for a broader and more durable tax base, and are committed to a comprehensive review of tax policy and administration, making preparations this year to implement high quality revenue reforms as part of next year's budget.

40. **Monetary and exchange rate policy.** To rebuild reserves and reduce external imbalances, it will be essential for the central bank to allow the currency to move flexibly. The adjustment needed under the program will be difficult. However, this adjustment must take place to create the basis for sustained output growth once the global economy recovers, both by ensuring that Sri Lanka's strong underlying export base remains competitive and by creating the room for a recovery in private sector credit growth.

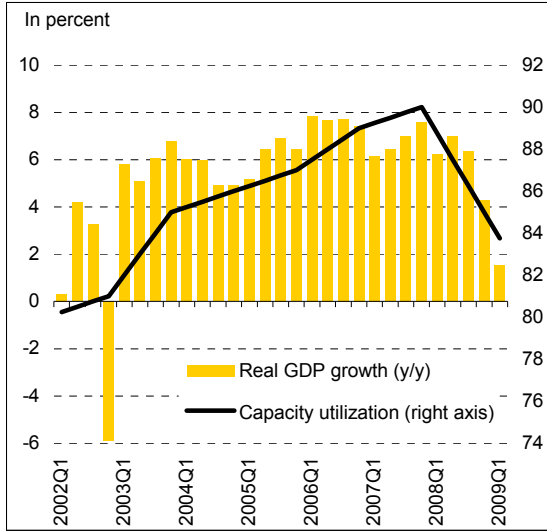
41. **Financial sector policies.** The program's financial sector reform agenda is comprehensive and ambitious, and will go a long way toward addressing the sector's current weaknesses and preparing for any future difficulties associated with a slowdown in output growth. To maintain the health and confidence of sector the central bank will need to act decisively in implementing the program's reform measures, and take prompt action to correct problems when they emerge.

42. **Risks.** As outlined above, there are substantial risks to the program. These needs to be weighed against the risk of not having the framework of a Fund-supported program in place. Given Sri Lanka's acute short-run external financing problems, the country would not be able to avoid a balance of payments crisis without a program involving significant financial resources. The authorities would have few options other than a disruptive devaluation of the exchange rate, with highly destabilizing social consequences. On balance, the Fund-supported program, with all its inherent risks, provides an opportunity to prevent this crisis, offers a guide for needed policies, and a path for bringing the country to fiscal and external solvency.

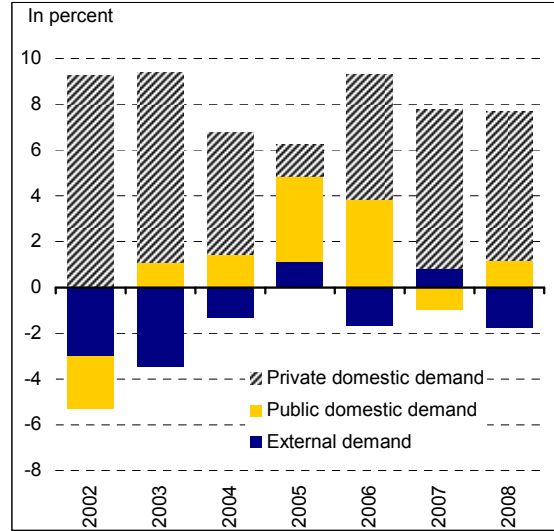
43. While there are risks, the government's program is ambitious and merits Fund support. Staff recommends the approval of the requested Stand-By Arrangement.

**Figure 1. Growth Indicators**

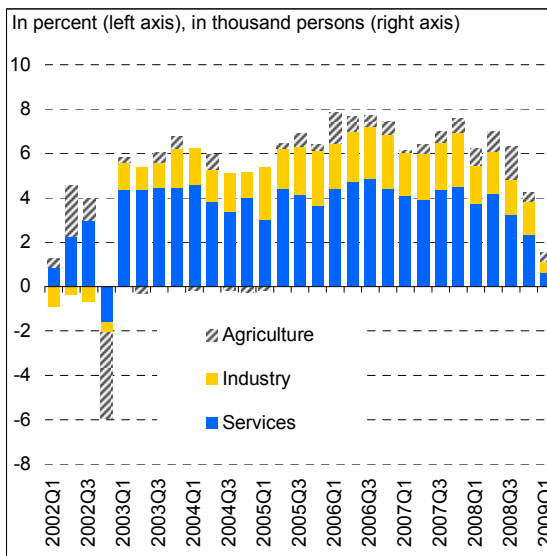
*Real GDP growth decelerated more recently but remained strong in 2008...*



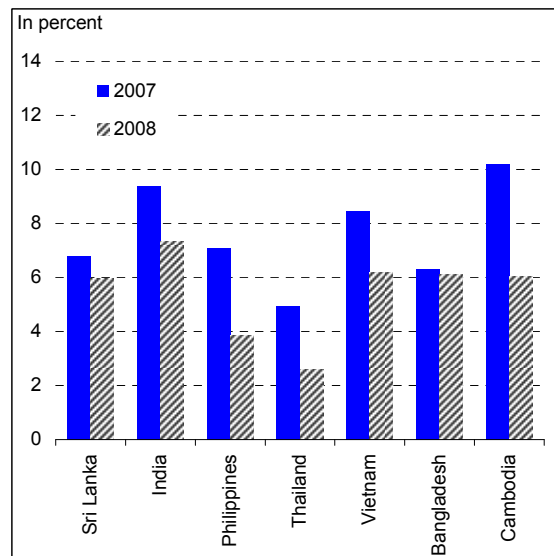
*...driven by strong domestic demand, including higher public expenditure.*



*Growth in 2008 was supported by a rebound in agriculture and robust growth in manufacturing and services, which are showing signs of slowing down.*



*Nevertheless, growth in Sri Lanka continues to compare favorably with other emerging market countries in the region.*

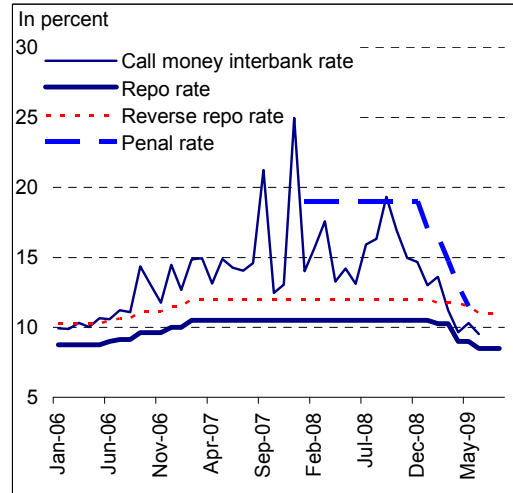
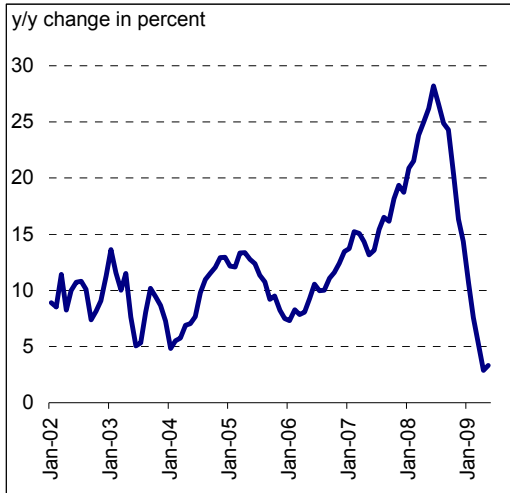


Sources: CEIC Data Company Ltd.; and Fund, World Economic Outlook and staff estimates.

**Figure 2. Measures of Inflation and Monetary Policy**

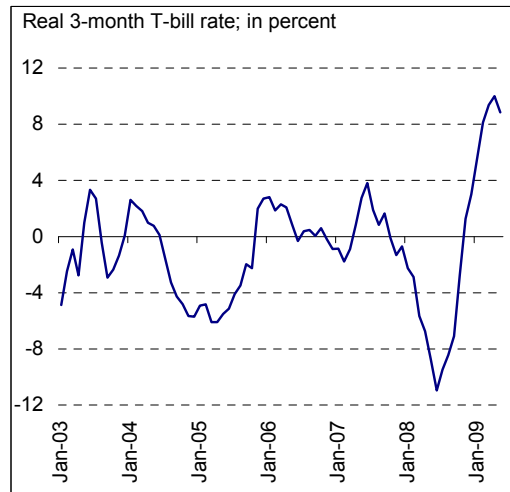
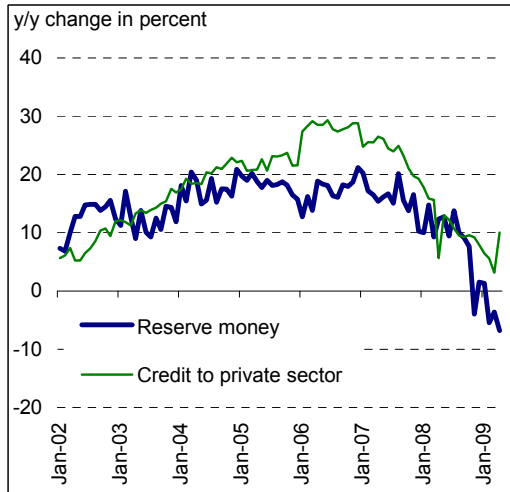
*The decline in commodity prices has led to a sharp fall in inflation...*

*...and the CBSL has recently lowered its policy rates and the statutory reserve requirement.*



*However, the decline in international reserves has led to a sharp tightening of domestic liquidity...*

*...and monetary policy conditions have tightened significantly.*

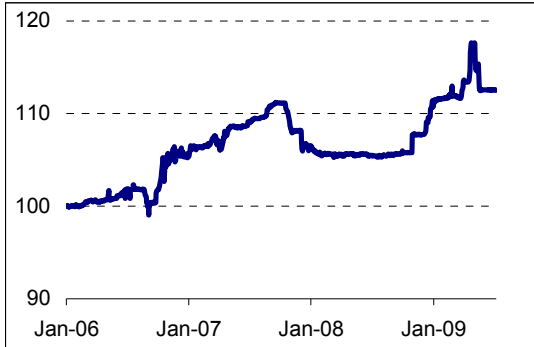


Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; and Fund staff estimates.

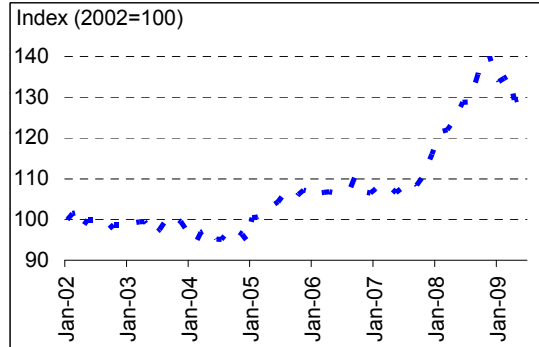


### Figure 3. External Sector Developments

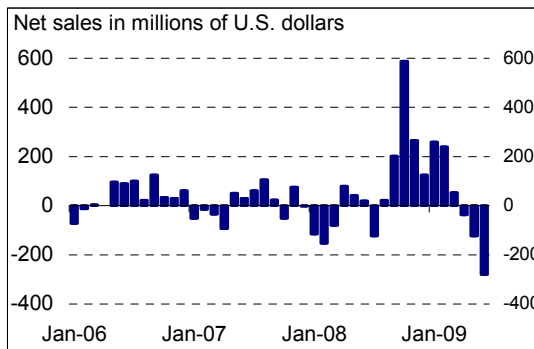
*During 2008, the Rupee - U.S. Dollar rate was fixed...*



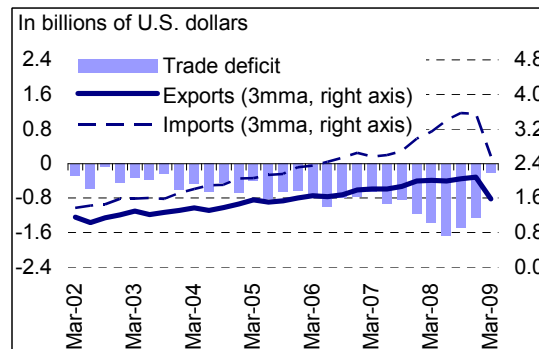
*...causing the REER to appreciate.*



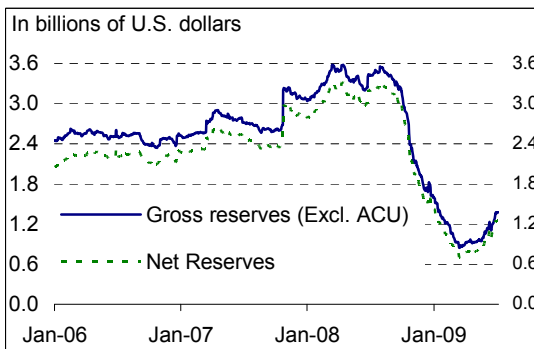
*The central bank's net sales of foreign exchange supported the exchange rate until recently.*



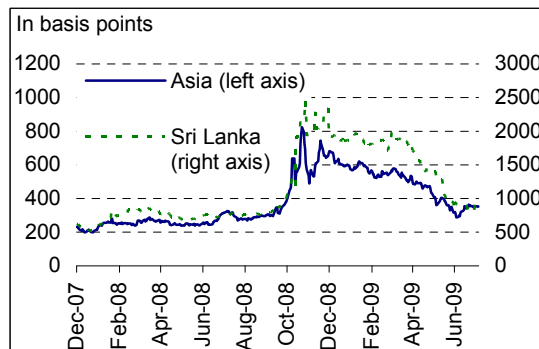
*The trade deficit widened as the oil import bill rose...*



*...leading to a rapid decline in international reserves.*



*The spread on Sri Lankan debt widened sharply after the onset of the global financial crisis but has narrowed more recently.*

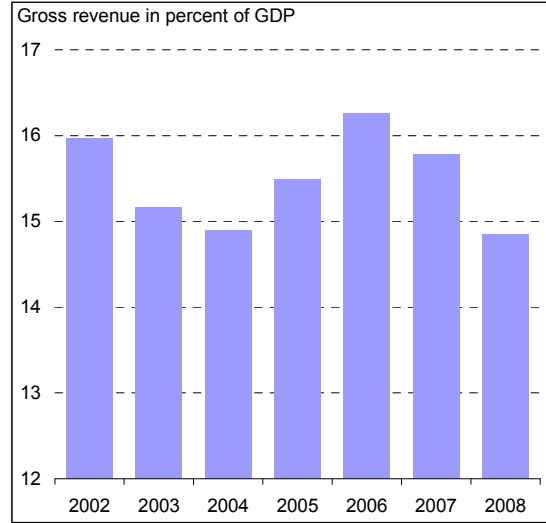
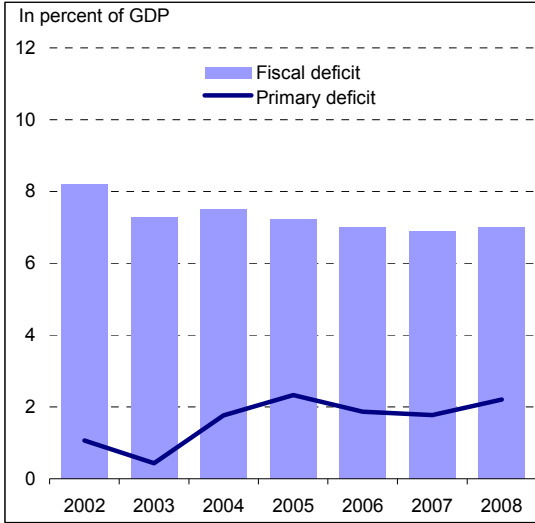


Sources: CEIC Data Company Ltd.; Bloomberg LP.; and Fund staff calculations.

**Figure 4. Fiscal Indicators**

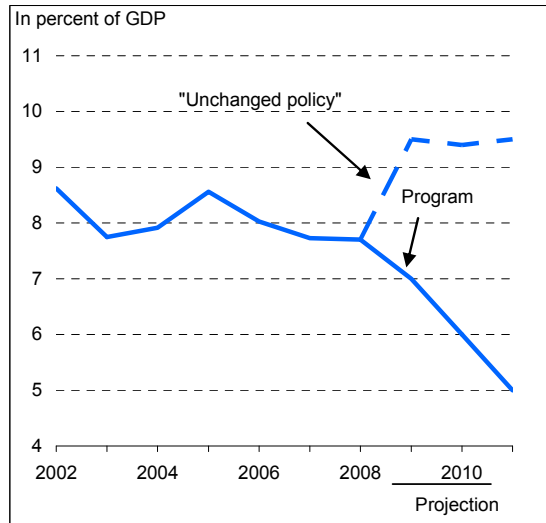
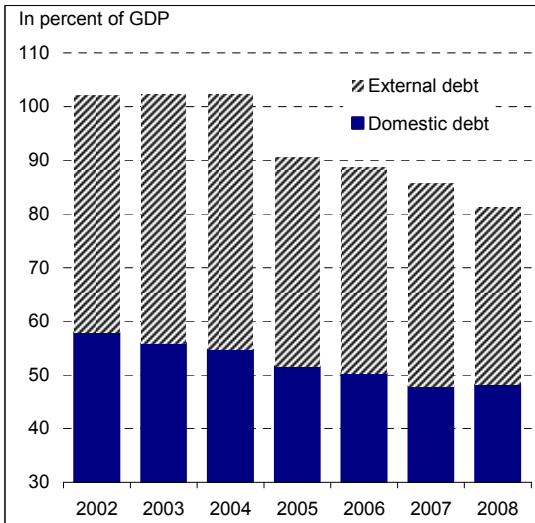
*The overall fiscal deficit remains high...*

*...reflecting a low revenue ratio.*



*As a result, public debt remains high, but has declined as a percent of GDP due to high GDP growth and appreciation of the exchange rate.*

*Achieving the deficit targets under the proposed stand-by arrangement will require significant adjustments.*

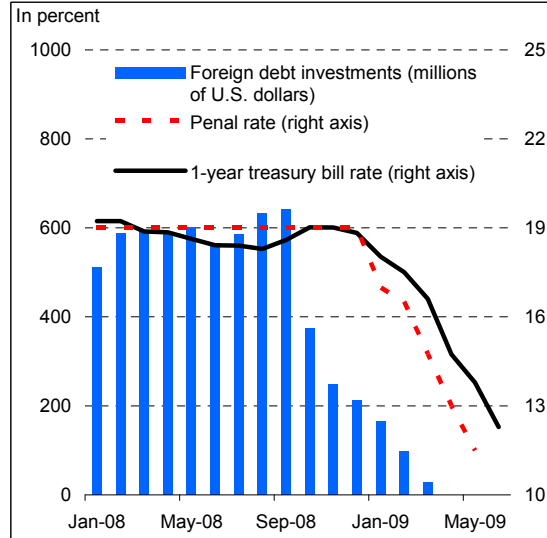
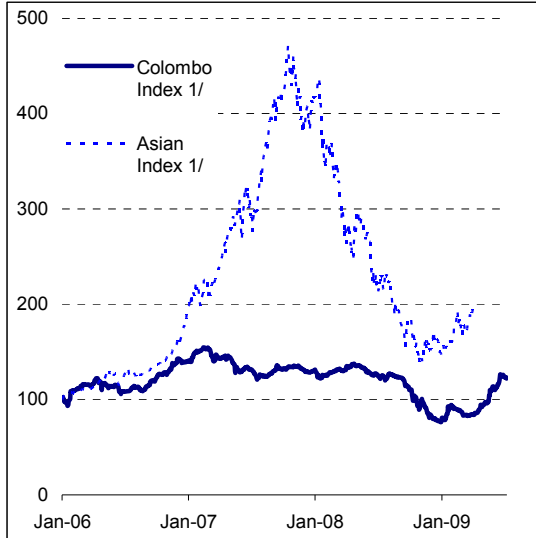


Sources: Country authority; CEIC Data Company Ltd.; and Fund staff estimates.

**Figure 5. Financial Market Developments**

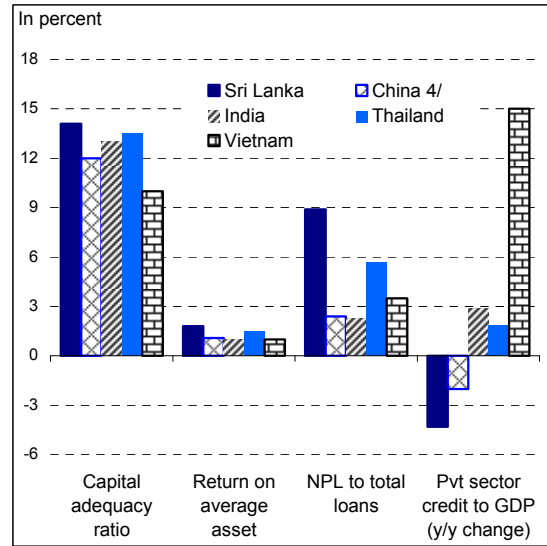
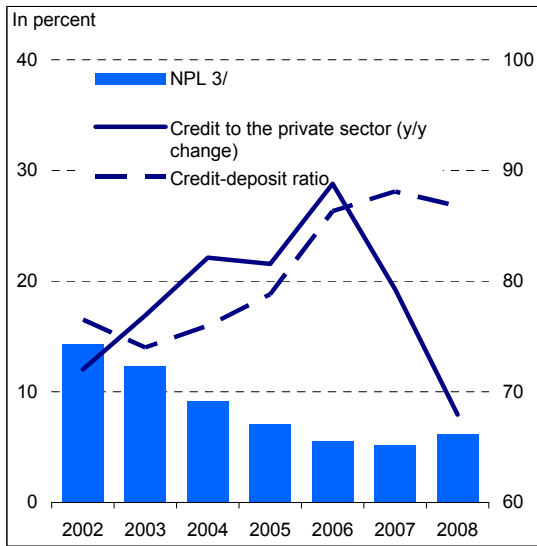
*The stock market has remained relatively immune from recent global shocks...*

*...while market interest rates have mirrored foreign investment flows into the government debt market and changes to the penal rate.*



*Credit growth has slowed, but NPLs may rise as a result of the slowing economy...*

*...although basic financial indicators compare favorably to other countries in the region.*



Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; and Fund staff calculations.

1/ January 2006 =100. Asian index is market capitalization weighted index for India, China, Pakistan and Thailand.

2/ Market capitalization weighted for India, China and Thailand.

3/ Gross non-performing advances ratio.

4/ Refers to 2008 data.

**Table 1. Sri Lanka: Selected Economic Indicators, 2006–2011**

Main exports (percent of total, 2008): garment (43), tea (16)

GDP per capita (2008, est.): US\$1,972

Unemployment rate (2008): 5.4 percent

Poverty rate (2007, incidence): 15.2 percent

FDI (2008, est.): \$691 million

Public debt (2008): 81.1 percent of GDP

	2006	2007	2008	2009	2010	2011
			Est.	Prog.		Proj.
<b>GDP and inflation (in percent)</b>						
Real GDP growth	7.7	6.8	6.0	3.0	5.0	6.5
Inflation (average)	10.0	15.8	22.6	4.6	13.0	9.6
Inflation (end-of-period)	13.5	18.7	14.4	8.0	10.7	8.6
<b>Public finances (in percent of GDP)</b>						
Revenue	16.3	15.8	14.9	14.8	15.4	16.0
Expenditure 1/	24.3	23.5	22.6	21.9	21.5	21.0
Central government balance 1/	-8.0	-7.7	-7.7	-7.0	-6.0	-5.0
Consolidated government balance 1/	-8.2	-8.0	-8.8	-7.7	-6.4	-4.9
Consolidated domestic financing	5.6	4.1	7.1	6.8	4.5	3.6
Government debt (domestic and external)	88.7	85.8	81.1	83.7	84.4	81.0
<b>Money and credit (percent change, end of period)</b>						
Reserve money	21.2	10.2	1.5	12.0	13.8	13.4
Broad money	17.8	16.6	8.5	14.9	20.2	20.8
Domestic credit	29.5	16.3	18.0	13.0	15.2	17.3
Private sector credit	24.0	19.3	7.9	10.5	17.4	21.4
Public sector credit	46.1	8.9	46.2	18.2	10.9	9.1
<b>Balance of payments (in millions of U.S. dollars)</b>						
Exports	6,883	7,640	8,137	7,098	7,559	7,949
Imports	10,254	11,296	14,009	10,015	10,552	11,368
Current account balance	-1,500	-1,401	-3,719	-478	-504	-929
Current account balance (in percent of GDP)	-5.3	-4.3	-9.4	-1.2	-1.3	-2.2
Export value growth (percent)	7.7	11.0	6.5	-12.8	6.5	5.2
Import value growth (percent)	15.7	10.2	24.0	-28.5	5.4	7.7
<b>Gross official reserves (end of period) 2/</b>						
In millions of U.S. dollars	2,515	3,063	1,580	2,492	4,110	4,614
In months of imports	2.4	2.4	1.6	2.4	3.7	4.0
As a percent of short-term debt	71	60	29	45	71	79
<b>External debt (public and private)</b>						
In billions of U.S. dollars	14.2	16.7	17.6	18.0	19.1	19.6
As a percent of GDP	50.2	51.5	44.4	43.5	49.8	47.3
<b>Total stock of public dollar commercial debt 3/</b>						
In millions of U.S. dollars	1,659	2,758	2,658	2,596	2,307	2,275
As a percent of GDP	5.9	8.5	6.7	6.3	6.0	5.5
As percent of gross official reserves	66	90	168	104	56	49
<b>Memorandum items:</b>						
Nominal GDP (in billions of rupees)	2,939	3,578	4,411	4,913	5,905	6,884
Nominal GDP (in billions of U.S. dollars)	28.3	32.3	39.6	41.3	38.3	41.4

Sources: Data provided by the Sri Lankan authorities; CEIC Data Company Ltd.; Bloomberg LP.; and Fund staff estimates and projections.

1/ Staff projections of domestic interest costs are based on a weighted average of yields on government paper. Actual interest payments have, however, averaged about 2 percent points of GDP lower in 2006-08. The consolidated government balance includes the Ceylon Electricity Board and the Ceylon Petroleum Corporation.

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

3/ Staff estimates based on total stock outstanding of foreign exchange commercial debt plus nonresident purchase of rupee-denominated treasury bonds.

Table 2. Sri Lanka: Summary of Central Government Operations, 2006–2011

(In percent of GDP, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011
			Prel.	Prog.		Proj.
Total revenue	16.3	15.8	14.9	14.8	15.4	16.0
Tax revenue	14.6	14.2	13.3	13.4	14.0	14.8
Income taxes	2.7	3.0	2.9	3.0	3.1	3.3
Value added tax/GST	5.6	5.2	4.6	3.8	4.0	4.2
Excise taxes	3.2	2.7	2.3	2.3	2.5	2.5
Taxes on international trade	1.8	1.6	1.8	1.7	2.1	2.5
Other	1.3	1.7	1.7	2.5	2.3	2.2
Nontax revenue	1.7	1.6	1.6	1.4	1.4	1.2
Total expenditure and net lending	24.3	23.5	22.6	21.9	21.5	21.0
Current expenditure	18.6	17.4	16.9	16.5	15.8	15.2
Civil service wages and salaries	3.9	3.7	3.2	3.0	3.0	3.0
Other civilian goods and services	1.0	0.8	1.1	0.8	0.8	0.7
Security related expenditure	3.6	3.8	3.9	3.7	3.1	3.0
Subsidies and transfers	4.9	4.1	3.9	3.6	3.3	2.8
Interest payments	5.1	5.1	4.8	5.5	5.6	5.7
Foreign	0.6	0.6	0.5	0.7	1.2	1.2
Commercial	0.3	0.3	0.2	0.1	0.1	0.2
Domestic	4.2	4.2	4.1	4.7	4.3	4.3
Capital expenditure and net lending	5.6	6.1	5.7	5.3	5.7	5.8
Of which: capital expenditure	5.5	5.8	5.3	4.6	4.9	5.0
Overall balance of central Government	-8.0	-6.9	-7.7	-7.0	-6.0	-5.0
Financing	8.0	7.7	7.7	7.0	6.0	5.0
Net external financing	2.5	3.7	0.6	0.3	1.5	1.4
Net domestic financing	5.6	4.1	7.1	6.8	4.5	3.6
Privatization	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Primary balance (excluding grants)	-2.9	-2.6	-2.9	-1.6	-0.4	0.7
Total public debt	88.7	85.8	81.1	83.7	84.4	81.0
Domestic debt	50.3	47.9	48.3	49.0	46.0	43.3
Foreign debt	38.4	37.9	32.8	34.8	38.4	37.7

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

**Table 3. Sri Lanka: Monetary Accounts, 2006–2011**

	2006	2007	2008	2009	2010	2011
				Prog.		Proj.
Monetary authorities	(Stocks, in billions of Sri Lankan rupees)					
Net foreign assets	230	293	148	200	313	371
Net domestic assets	10	-29	120	100	29	17
<i>Of which</i> : net credit to government	113	101	217	263	227	227
Reserve money	240	264	268	301	342	388
	(Contribution to reserve money growth, in percent)					
Net foreign assets	16.6	26.3	-54.7	19.3	37.5	17.0
Net domestic assets	4.5	-16.1	56.3	-7.4	-23.7	-3.6
Reserve money (percent change)	21.2	10.2	1.5	12.0	13.8	13.4
Monetary survey	(Stocks, in billions of Sri Lankan rupees)					
Net foreign assets	171	228	78	153	254	308
Monetary authorities	230	293	148	200	313	371
Deposit money banks	-59	-65	-70	-47	-59	-63
Net domestic assets	1,033	1,176	1,445	1,597	1,849	2,233
Domestic credit	1,382	1,608	1,897	2,144	2,470	2,898
Public sector (net)	389	423	619	732	812	886
Private sector	993	1,185	1,278	1,413	1,658	2,013
Other items (net)	-349	-432	-452	-547	-621	-665
Broad money	1,205	1,404	1,523	1,750	2,103	2,541
	(Annual percent change)					
Net foreign assets	-16.4	33.2	-65.9	96.6	66.3	21.2
Monetary authorities	16.7	27.4	-49.4	35.0	56.4	18.6
Deposit money banks	-842.6	10.7	8.5	-32.9	24.2	7.5
Net domestic assets	26.4	13.8	22.9	10.5	15.8	20.8
Domestic credit	29.5	16.3	18.0	13.0	15.2	17.3
Public sector (net)	46.1	8.9	46.2	18.2	10.9	9.1
Private sector	24.0	19.3	7.9	10.5	17.4	21.4
Broad money	17.8	16.6	8.5	14.9	20.2	20.8
	(Contribution to broad money growth, in percent)					
Net foreign assets	-3.3	4.7	-10.7	4.9	5.8	2.6
Net domestic assets	21.1	11.8	19.2	10.0	14.4	18.3
Domestic credit	30.8	18.7	20.6	16.2	18.6	20.4
Public sector (net)	12.0	2.9	13.9	7.4	4.6	3.5
Private sector	18.8	15.9	6.7	8.8	14.0	16.8
Memorandum items:						
Broad money multiplier	5.0	5.3	5.7	5.8	6.2	6.5
Velocity of broad money	2.4	2.5	2.9	2.8	2.8	2.7
Private sector credit (in percent of GDP)	33.8	33.1	29.0	28.8	28.1	29.2

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

**Table 4. Sri Lanka: Balance of Payments, 2006–2011**

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

	2006	2007	2008	2009	2010	2011
			Est.	Prog.	Proj.	
Current account	-1,500	-1,401	-3,719	-478	-504	-929
Trade balance	-3,371	-3,656	-5,872	-2,917	-2,993	-3,419
Exports	6,883	7,640	8,137	7,098	7,559	7,949
Imports	10,254	11,296	14,009	10,015	10,552	11,368
Services	255	303	402	450	499	561
Income	-388	-358	-916	-676	-677	-738
Transfers	2,005	2,310	2,667	2,664	2,667	2,667
Private (net)	1,904	2,214	2,566	2,583	2,592	2,597
Official (net)	101	96	101	81	75	70
Capital and financial account	1,808	2,096	1,996	500	905	1,131
Capital transfers (net)	291	268	291	167	125	100
Financial account	1,517	1,828	1,705	333	780	1,031
Long-term flows	907	1,251	1,017	379	710	881
Direct investment	451	548	691	560	450	518
Private sector borrowing 1/	-35	31	74	-306	-194	-93
Disbursements	139	199	265	50	56	150
Amortization	174	168	191	356	250	243
Official sector borrowing	491	672	251	125	454	456
Disbursements	932	1,290	1,059	1,000	1,125	1,318
Amortization	442	618	808	875	671	862
Short-term flows	610	577	688	-96	70	150
Errors and omissions	-104	-166	339	0	0	0
Overall balance	204	530	-1,385	22	401	202
Financing	-204	-530	1,385	-22	-401	-202
NIR (- = increase)	-204	-530	1,385	-22	-401	-202
Gross reserves	-57	-547	1,482	-912	-1,618	-503
Reserve liabilities (- is outflow)	-147	18	-97	890	1,216	302
Memorandum items:						
Current account (in percent of GDP)	-5.3	-4.3	-9.4	-1.2	-1.3	-2.2
Gross official reserves (net of ACU debit balances)	2,515	3,063	1,580	2,492	4,110	4,614
(In months of imports of goods and nonfactor services)	2.4	2.4	1.6	2.4	3.7	4.0
(In percent of short-term debt)	71	60	29	45	71	79
Net international reserves	2,280	2,810	1,425	1,447	1,848	2,050
Total stock of public commercial dollar debt 2/	1,659	2,758	2,658	2,596	2,307	2,275
GDP (US\$ millions)	28,280	32,347	39,604	41,323	38,347	41,399
Oil price (US\$ per barrel)	64.3	71.1	97.0	60.5	74.5	78.0
Short-term debt (US\$ million, residual maturity)	3,524	5,086	5,503	5,480	5,770	5,868

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

1/ Includes public corporations.

2/ Comprises SLDBs, FCBUs, and other commercial loans.

Table 5. Sri Lanka: Medium-Term Macroeconomic Framework, 2006–2014

	2006	2007	2008	2009	2010	2011	2012	2013	2014
			Est.	Prog.			Proj.		
<b>Real sector (percent change)</b>									
Real GDP	7.7	6.8	6.0	3.0	5.0	6.5	6.0	5.5	5.5
Inflation (New Colombo CPI; average)	10.0	15.8	22.6	4.6	13.0	9.6	8.1	7.4	7.0
Inflation (New Colombo CPI; end-of-period)	13.5	18.7	14.4	8.0	10.7	8.6	7.7	7.0	7.0
<b>Savings-investment balance (in percent of GDP)</b>									
Gross national saving	22.7	23.6	18.2	24.1	25.0	25.0	26.6	28.3	28.9
Gross domestic investment	28.0	28.0	27.5	25.3	26.3	27.3	28.4	28.9	29.6
Private	23.9	23.6	24.2	21.3	22.3	23.3	24.3	25.0	25.0
Public	4.0	4.3	3.3	3.9	4.0	3.9	4.1	3.9	4.6
<b>Public finances (in percent of GDP)</b>									
Total revenue	16.3	15.8	14.9	14.8	15.4	16.0	16.4	16.8	17.2
Tax revenue	14.6	14.2	13.3	13.4	14.0	14.8	15.1	15.7	16.1
Nontax revenue	1.7	1.6	1.6	1.4	1.4	1.2	1.3	1.1	1.1
Total expenditure and net lending	24.3	23.5	22.6	21.9	21.5	21.0	20.7	19.9	19.5
Current expenditure	18.6	17.4	16.9	16.5	15.8	15.2	14.5	13.8	12.2
Of which: interest payments	5.1	5.1	4.8	5.5	5.6	5.7	5.5	5.5	4.1
Capital expenditure and net lending	5.6	6.1	5.7	5.3	5.7	5.8	6.2	6.1	7.3
Overall balance	-8.0	-7.7	-7.7	-7.0	-6.0	-5.0	-4.3	-3.1	-2.3
Primary balance	-2.9	-2.6	-2.9	-1.6	-0.4	0.7	1.3	2.4	1.9
Net external financing (including grants)	2.5	3.7	0.6	0.3	1.5	1.4	0.5	1.0	1.0
Net domestic financing	5.6	4.1	7.1	6.8	4.5	3.6	3.7	2.1	1.3
Assets sales	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total government debt	88.7	85.8	81.1	83.7	84.4	81.0	77.9	74.4	70.7
Of which: domestic debt	50.3	47.9	48.3	49.0	46.0	43.3	41.7	39.0	36.1
<b>Balance of payments (in percent of GDP)</b>									
Trade balance	-11.9	-11.3	-14.8	-7.1	-7.8	-8.3	-8.1	-7.9	-8.2
Current account balance	-5.3	-4.3	-9.4	-1.2	-1.3	-2.2	-1.8	-0.6	-0.7
Overall balance	0.7	1.6	-3.5	0.1	1.0	0.5	0.8	2.2	1.7
Gross official reserves (in millions of U.S. dollars) 1/	2,515	3,063	1,580	2,492	4,110	4,614	4,884	5,195	4,906
(in months of imports of goods and services)	2.4	2.4	1.6	2.4	3.7	4.0	4.0	4.0	4.0
Total external debt (public and private)	50.2	51.5	44.4	43.5	49.8	47.3	45.6	44.4	40.2
<b>Money and credit (in percent of GDP)</b>									
Reserve money	8.2	7.4	6.1	6.1	5.8	5.6	5.6	5.5	5.5
Broad money	41.0	39.2	34.5	35.6	35.6	36.9	38.2	39.8	40.7
Domestic credit	47.0	44.9	43.0	43.6	41.8	42.1	42.3	41.5	40.7
Private sector credit	33.8	33.1	29.0	28.8	28.1	29.2	29.9	29.9	30.0
Public sector credit	13.2	11.8	14.0	14.9	13.7	12.9	12.3	11.5	10.6
<b>Memorandum item:</b>									
Oil price (U.S. dollar per barrel)	64.3	71.1	97.0	60.5	74.5	78.0	80.0	81.3	83.3

Sources: Data provided by the Sri Lankan authorities; CEIC Data Company Ltd.; Bloomberg LP.; and Fund staff estimates and projections.

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



**Table 6. Sri Lanka: Preliminary External Financing Requirements, 2008–2011**

(In millions of U.S. dollars)

	2008	2009	2010	2011
	Est.	Prog.		Proj.
Current account, including official transfers	-3,719	-478	-504	-929
(in percent of GDP)	-9.4	-1.2	-1.3	-2.2
Trade Balance	-5,872	-2,917	-2,993	-3,419
Exports	8,137	7,098	7,559	7,949
Imports	14,009	10,015	10,552	11,368
Private transfers	2,566	2,583	2,592	2,597
Other	-413	-144	-103	-107
Amortization	-1,096	-1,278	-954	-1,117
Public sector	-808	-875	-671	-862
Multilateral	-144	-164	-185	-211
Bilateral	-381	-392	-322	-356
Syndicated loans	-283	-319	-164	-295
IMF	-97	-47	-34	-12
Private sector	-191	-356	-250	-243
Change in NFA of commercial banks (- = an increase)	91	-250	0	0
Change in official reserves (- = an increase)	1,482	-912	-1,618	-503
Gross external financing requirement	-3,242	-2,919	-3,076	-2,549
Sources of financing	3,242	1,931	1,826	2,236
Borrowing	1,324	1,050	1,181	1,468
Official Sector Borrowing	1,059	1,000	1,125	1,318
Multilateral	358	395	415	450
Bilateral	551	605	710	718
Syndicated loans	150	0	0	150
Private Sector Borrowing	265	50	56	150
New Official Borrowing	0	0	0	0
Other Capital Account	1,918	881	645	768
Capital transfers	291	167	125	100
FDI inflows	691	560	450	518
Other (including errors and omissions)	936	154	70	150
External financing gap=IMF financing	0	-988	-1,251	-313
Gross official reserves of the Central Bank of Sri Lanka	1,580	2,492	4,110	4,614
(In months of imports of goods and nonfactor services)	1.6	2.4	3.7	4.0

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

**Table 7. Sri Lanka: Projected Payments to the Fund, 2006–2012**

(In millions of SDRs, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012
Disbursements	0.0	0.0	0.0	620.1	826.8	206.7	0.0
Repayments	104.4	3.4	49.5	31.4	22.3	7.7	62.8
Charges/interest	8.8	6.9	7.9	4.7	16.4	22.7	22.8
Stock of outstanding use of Fund resources	162.4	159.0	109.5	698.2	1,502.7	1,701.7	1,638.9
Memorandum items:							
Debt service							
Payments to the Fund/exports GNFS	2.0	0.2	0.9	0.6	0.6	0.4	1.2
Payments to the Fund/Quota	27.4	2.5	13.9	8.7	9.4	7.3	20.6
Payments to the Fund/GDP	0.6	0.0	0.2	0.1	0.2	0.1	0.3
Payments to the Fund/reserves	6.6	0.5	5.7	2.2	1.4	1.0	2.7
Outstanding use of Fund resources							
Outstanding UFR/exports GNFS	2.8	2.6	1.7	11.4	23.1	24.7	22.5
Outstanding UFR/quota	39.3	38.5	26.5	168.9	362.6	409.6	393.6
Outstanding UFR/GDP	0.8	0.8	0.4	2.6	5.9	6.2	5.6
Outstanding UFR/reserves	9.5	7.9	11.0	42.5	55.5	55.9	50.9

Source: Fund staff estimates.

**Table 8. Sri Lanka: Reviews and Disbursements under the Proposed 20-month Stand-By Arrangement**

Date	Amount of Purchase with equal disbursements			Condition
	In percent of quota	In SDRs	in USD	
July 24, 2009	50	206.7	312.5	Approved SBA
September 25, 2009	50	206.7	312.5	Completion of the first review and observance of relevant performance criteria
November 30, 2009	50	206.7	312.5	Completion of the second review and observance of relevant performance criteria
February 28, 2010	50	206.7	312.5	Completion of the third review and observance of relevant performance criteria
May 31, 2010	50	206.7	312.5	Completion of the fourth review and observance of relevant performance criteria
August 31, 2010	50	206.7	312.5	Completion of the fifth review and observance of relevant performance criteria
November 30, 2010	50	206.7	312.5	Completion of the sixth review and observance of relevant performance criteria
March 15, 2011	50	206.7	312.5	Completion of the seventh review and observance of relevant performance criteria
Total	400	1653.6	2500	

**Table 9. Sri Lanka: Financial Soundness Indicators - All Banks**

	2006	2007	2008
<b>Capital Adequacy</b>			
Regulatory Capital to Risk Weighted Assets(RWCAR)	13.3	14.1	13.5
Tier 1 Capital/Risk Weighted Assets(Tier 1 RWCAR)	12.1	12.7	11.5
Net Non - Performing Loans to Total Capital Funds	14.8	14.1	18.4
Debt to Capital Funds	238.5	220.0	210.1
Capital to Assets Ratio	7.6	7.8	8.2
<b>Asset Quality</b>			
Gross Non - Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.6	5.2	6.2
Gross Non - Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	7.4	6.8	8.0
Net Non-Performing Loans to Total Gross Loans	1.9	1.9	2.6
Provision Coverage Ratio (Total)	66.9	64.5	59.3
<b>Earnings &amp; Profitability</b>			
Return on Equity(ROE)-Before Tax	24.7	24.4	24.6
Return on Equity(ROE)-After Tax	15.2	14.0	13.9
Return on Assets(ROA)-Before Tax	1.9	1.9	2.0
Return on Assets(ROA)- After Tax	1.2	1.1	1.1
Interest Income to Gross Income	85.5	87.4	86.2
Staff Expenses to Non Interest Expenses	43.8	44.2	43.2
Personnel Expenses to Total Income	13.0	10.5	9.5
Total Cost to Total Income	77.4	79.2	79.3
Interest Margin	4.4	4.4	4.4
<b>Liquidity</b>			
Liquid Assets to Total Assets	26.7	28.1	28.2
Statutory Liquid Assets Ratio- DBU	30.4	30.4	31.3
<b>Assets/Funding Structure</b>			
Deposits	69.8	69.5	69.2
Borrowings	18.1	17.6	17.3
Capital to External Funds	8.6	9.2	9.5
Credit to Deposits	86.3	88.1	86.8

Source: Central Bank of Sri Lanka.

## ATTACHMENT I

Colombo, July 16, 2009

Mr. Dominique Strauss-Kahn  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The economic fundamentals of Sri Lanka have been improving steadily until the third quarter of 2008. The economy of the country was directed along a national, political and economic framework based on the Government's overall vision documented in the *Mahinda Chintana*. Such policies had already begun to show satisfactory results from 2006 to the later part of 2008, including high output growth, declining inflation and public debt ratios, and a strong buildup of external official reserves. However, the intensification of the global financial crisis in September 2008 has reversed many of these favorable trends, and has had an adverse effect on market confidence. At the same time the end of the decades long conflict with the LTTE in May 2009 provides new opportunities and poses new challenges for Sri Lanka.

The attached Memorandum of Economic and Financial Policies (MEFP) presents the plans and policies of the authorities of Sri Lanka for 2009-2011. In support of the policies in the attached MEFP, the Government requests that the Executive Board of the Fund approve a Stand-By Arrangement with exceptional access in an amount of SDR 1,653.6 million (400 percent of quota).

The Government of Sri Lanka believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. The Government will consult with the Fund on the implementation of the policies contained in the MEFP, and in advance of revisions to these policies, in accordance with the Fund's policies on such consultation.

In keeping with its policy of transparency, the Government has authorized the publication of the attached MEFP.

Sincerely yours,

/s/

Mahinda Rajapaksa  
Minister of Finance

/s/

Ajith Nivard Cabraal  
Governor, Central Bank of Sri Lanka

## MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

*The slowdown in the global economy, coupled with declining export prices and capital outflows, is placing Sri Lanka's recent economic and social progress under strain. The balance of payments outlook has worsened while the continued weak revenue performance is undermining fiscal deficit reduction. As a result, international reserves have declined and the fiscal deficit has exceeded budget targets. In addition, strains are appearing in the financial system. Without significant policy measures, international reserves could decline further while the public debt dynamics could become unfavorable.*

*The objective of our program is to cushion the impact of the global financial crisis on our economy and in particular its effects on the most vulnerable, consolidating our efforts to bring down inflation, and maintaining Sri Lanka's strong record of economic growth over the past few years. The program will be guided by the political and economic framework underpinning the Government's development plans as outlined in the Mahinda Chintana. In particular, the program—which is expected to run through 2011—envisages (i) fiscal adjustment sufficient to reduce the central Government budget deficit to 5 percent of GDP by 2011, consistent with our target under the Fiscal Responsibility Act, and also bringing the CPC and CEB to break even by 2011; (ii) continued flexibility in the exchange rate (as announced in October 2008), while building up reserves to at least 3 ½ months of imports by the end of the program period; and (iii) measures to preserve the soundness of the financial sector. The quantitative targets and structural policies underlying our program are summarized in Tables 1 and 2.*

### I. MACROECONOMIC OUTLOOK

1. **The economic outlook for this year is challenging.** Growth is projected to slow from 6 percent in 2008 to about 3 percent in 2009 on account of the worsening global environment and the fall in domestic demand. At the same time inflation, after reaching a high of 28 percent on a year-on-year basis in June 2008, decelerated sharply to one percent in June 2009 and is expected to remain in single digits in 2009 as a result of recent monetary policy efforts and significantly lower commodity prices. Relatively lower oil prices, a sharp decline in imports, a steady flow of remittances, and continued flexibility in the exchange rate will allow the current account deficit to recover from 9 percent of GDP in 2008 to around 1¼ percent by end-2009.
2. **The economy should begin to recover in 2010 and beyond.** Assuming a recovery in the global economic conditions and gradual normalization of economic activity in the North and the East of the country, we expect growth in 2010 to increase, while inflation is expected to remain low. Over the medium term, the macroeconomic and structural policies set out in the *Mahinda Chintana*—in particular the measures aimed at reducing the cost of living, boosting infrastructure development by attracting foreign direct investment, and increasing competitiveness and productivity—should help accelerate economic growth. While the

unusual uncertainty about global economic prospects poses a downside risk, the rebound in confidence following the end of the war could contribute to a stronger recovery than projected.

## II. FISCAL POLICY

3. **Effective actions will be needed to reverse the declining trend in tax revenues (in percent of GDP) and bring the fiscal deficit in line with the Fiscal Responsibility Act and Government policy.** The Government's fiscal framework targets a reduction in the overall central Government deficit to 5 percent of GDP by 2011 to maintain macroeconomic stability. Deficit reduction will be supported by a strong tax effort, which will allow for higher spending on infrastructure and the social sectors. Specifically, the Government is committed to increasing tax revenue by at least 2 percent of GDP by 2011 with measures to broaden the revenue base, significantly reduce tax exemptions, and further improve tax enforcement. These will be coupled with measures to rationalize expenditure in some areas to allow room for spending on reconstruction over the medium term.

4. **We aim to contain the overall Government deficit to 7 percent of GDP in 2009 compared with 6½ envisaged in the 2009 budget.** Without action, the budget deficit for 2009 would worsen considerably compared to the 7¾ percent outturn in 2008 because of the effects of the global crisis and the stimulus package announced in January 2009. A strong fiscal effort is necessary to achieve the program target of 7 percent of GDP in 2009 and reduce the budget's heavy reliance on domestic borrowing. As revenue measures will take time to put in place and yield results, the Government's adjustment program in 2009 will rely more on expenditure restraint, while ensuring vulnerable groups are protected. In total, revenue enhancing measures are expected to yield about ¼ percent of GDP relative to the 2008 level, while expenditure rationalization will result in savings of about ½ percent of GDP. In the event of a revenue shortfall or expenditure overruns relative to the amounts envisaged for 2009 under the program, we will take prompt action to contain other current expenditure—including on goods and services and transfers—or raise further revenue to safeguard the deficit target. However, any additional expenditure as a result of higher than expected external grants from our development partners will be accommodated within the program.

5. **We have already taken a number of measures that demonstrate our commitment to our fiscal targets.** We have introduced a nation building tax and raised excise taxes on liquor, cigarettes, and other consumer items. Moreover, we have issued directives to Government institutions to maintain strict controls on budget and to justify all cost overruns. Expenditure restraint together with declining international commodity prices will result in expenditure savings of about ½ percent of GDP. The budget will aim to preserve the allocations for capital spending and expenditure to protect the vulnerable groups in society. We have taken steps to limit the length and the scope of tax exemptions granted under the Board of Investment (BOI) Act and the Inland Revenue Act with the intention of broadening

the tax base. In particular, beginning April 2008, current tax holidays for most projects granted under the BOI Act and the Inland Revenue Act are restricted to a maximum of three years from fifteen years previously. Moreover, these tax holidays will not be extended after they expire. This process of limiting exemptions will be reviewed in line with the recommendations of the tax commission (¶8).

**6. Consistent with the Government's objective of substantially increasing tax revenue, a number of tax policy and administration measures are envisaged during the program period to further reduce the budget deficit to 5 percent in 2011.** This effort will be facilitated by the full-year effect of the new revenue measures introduced in 2009 and expenditure rationalization as announced in the 2009 budget. Further, the Government has formed a Tax Commission to review current tax policy and to make recommendations on a comprehensive approach to improve the tax system aimed at the strengthening of tax collection, improve tax auditing and enforcement, and simplifying the tax system. In its proceedings, the Commission will draw on the required tax expertise and submit an interim report by mid-October 2009. The report will contain proposals for base broadening including further rationalization of income tax holidays under the Board of Investment for consideration in preparing the 2010 budget. We also intend to phase out temporary taxes, including import surcharges, as new revenue measures yield results.

**7. Given the difficult external environment, financing of the central Government deficit during 2009 is expected to come mainly from domestic sources.** In addition, we have approached some of our development partners and are in the process of discussing significant budget support. We will continue to explore options for private market external financing to supplement donor resources. However, to keep this financing consistent with the Government's goals of ensuring the public debt sustainability, we will limit such borrowing to less than US\$1,750 million during the course of the program. The CBSL will work with the Ministry of Finance to improve its management of the Government's cash flow.

**8. The Government recognizes that key state owned enterprises need to improve their performance and make a greater contribution to economic growth.** The Government's policy is to ensure that state owned commercial enterprises run efficiently and do not rely on subsidies from the Treasury. Specifically, the aim is to ensure that the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) break even by end-2011. We have already taken measures toward the achievement of this objective. With respect to the CEB, we raised tariffs by 35 percent in March 2008, and passed the Sri Lanka Electricity Act in March 2009 which established an independent regulator for the sector, which should also result in management improvements in this sector. Further improvements to the cost structure of the CEB will be realized by shifting toward lower cost electricity generation. With respect to the CPC, we fully passed through increases in international oil prices by raising the domestic price of petrol. We will continue to monitor developments and take necessary measures to bring these enterprises to break even by 2011. In this regard, continuous assessments will be made of the operational cash flows of these enterprises and



required adjustments will be made including to management and operations. Any subsidies will be targeted to vulnerable groups and transparently reflected in the Government budget. The Government has established a Joint Review Mechanism through a committee consisting of high-level representatives from the Ministry of Finance, the CEB, the CPC, and the CBSL, which will make appropriate recommendations on an ongoing basis, including on cash flow management, to the Government. The committee is expected to submit their report by end-August 2009.

9. **We are also committed to developing a plan to address outstanding debts between the key state-owned enterprises.** The plan, which we intend to finalize by end-December 2009, will clearly identify all elements of circular debt including the identification and reconciliation of debts owed and due among the two largest state owned enterprises and a mechanism and timeframe for settling these debts. The Ministry of Finance will monitor and coordinate this exercise.

10. **Reconstruction of the North and East and the protection of vulnerable groups adversely affected by the conflict will be an integral part of our program.** To this end the government has moved quickly to provide humanitarian assistance to those affected by the conflict and to develop a post-war reconstruction plan. The immediate priority is addressing the humanitarian needs of the estimated 280,000 internally displaced persons (IDPs). The government aims to resettle 70-80 percent of IDPs by the end of the year. The resettlement plan involves restoring basic services including water, electricity, health services, and education, and the development of economic and social infrastructure in consultation with local officials and communities in the affected areas. Work is also underway on a broader reconstruction plan for the Northern province. A newly established Presidential Task Force is leading this effort. A consultative committee of humanitarian assistance—which includes representatives from the international community—has also been set up to advise on issues relating to humanitarian assistance and the provision of basic services to IDPs. Key elements of the reconstruction plan include restoration of law and order, conducting local government and provincial council elections—the first of which are scheduled to take place in August—and the rebuilding of essential infrastructure.

11. **Reconstruction spending needs in the years ahead will be considerable.** In 2009 the government intends to make room within the programmed deficit targets for spending on humanitarian assistance and the resettlement of IDPs using savings in existing budget provisions, redeployment of certain categories of military personnel for demining and for the provision of basic infrastructure, and any external grants from our development partners. About two percent of the projected government spending will be used for the provision of humanitarian assistance and the resettlement of displaced persons. A needs assessment is expected to be completed by end July 2009 to determine additional funds needed for the broader reconstruction strategy. Needed funds will be found both through savings in military spending beginning with the 2010 budget, and external financing in the form of concessional loans and grants from our development partners.

### III. EXCHANGE RATE AND MONETARY POLICY

12. **The Central Bank of Sri Lanka (CBSL) has allowed greater flexibility in the exchange rate** to facilitate the needed adjustment to the global financial and economic crisis while rebuilding its international reserves. Consistent with this objective, the CBSL intends to allow the necessary flexibility in the exchange rate to build up international reserve coverage to at least 3 ½ months of imports by the end of the program, and will limit its intervention to smooth volatility in the foreign exchange market. The Government will continue to pursue other steps to build reserves including bilateral swaps and the sale of diaspora bonds. At the same time, the Government is committed to staying current on all its external debt obligations. Monetary policy will aim to control inflation while ensuring the adequate provision of resources to the private sector.

13. **The CBSL will continue to implement an effective monetary policy framework.** Reserve money will continue to be the nominal anchor and policy interest rates will also be adjusted as appropriate to signal the stance of monetary policy. We have already harmonized the penal rate for commercial bank borrowing from the CBSL and the reverse repo rate and removed restrictions on commercial banks' access to the repo and reverse repo facility. This has established an explicit corridor for money market interest rates and has allowed the CBSL to more effectively maintain stability in short-term interest rates.

14. **During the program period we will not intensify** any existing exchange restrictions or introduce any new restrictions or multiple currency practices. Temporary restrictions imposed by the CBSL in October and November 2008 on margin deposit requirements on importation of vehicles and selected consumer goods and on forward sales and purchases of foreign exchange were removed in March and April 2009.

### IV. STRENGTHENING THE FINANCIAL SYSTEM

15. **We will put in place a comprehensive strategy to strengthen the financial sector, to build confidence, and to address recent problems.** The swift action by the CBSL with respect to Seylan Bank has restored confidence in the bank. As part of the ongoing process to deal with the Seylan Bank issue, the CBSL has directed the Bank to issue an appropriate number of voting shares to generate a capital infusion of around Rs. 3 billion by end-August. This would ensure that the bank meets the minimum capital adequacy requirement by end-December 2009. At the same time, the CBSL will continue to implement the eight point stimulus package for finance and leasing companies with the aim of avoiding spillovers to healthy financial institutions.

16. **The CBSL will continue to improve financial sector regulation.** Prudential regulations have already been strengthened by: adopting Basle II capital adequacy framework; introducing a new share ownership policy for banks; issuing a mandatory direction on corporate governance; issuing a revised direction on loan classification, provisioning and income recognition including imposing a one percent general provision on

outstanding loans; and issuing a direction on maximum amount of accommodation. To further strengthen financial sector regulation, the CBSL aims to ensure banks' compliance with all regulations including capital adequacy, exposure limits and foreign exchange net open position limits by end-2009. Also, given the expected slowdown in economic activity and potential rise in non-performing loans, the CBSL will instruct all banks to have adequate capital to cover future losses in line with international best practice in loss recognition. We have already taken steps to raise the capital requirement of finance companies, and intend to raise capital requirements in the insurance sector as part of the proposed Insurance Companies Act.

17. **The CBSL will also address gaps in the supervisory framework.** To that end, the CBSL intends to issue guidelines to improve banks' integrated risk management frameworks and reinforce the ability of the CBSL to perform consolidated supervision. To broaden the scope of financial sector supervision, greater clarity for the CBSL's legal authority in enforcing regulations on the deposit taking financial institutions will be introduced through an amendment to the Finance Company Act by end-December 2009 and Banking Act by June 2010. With respect to the Banking Act, the Monetary Board will approve a draft amendment by end-September 2009 as an interim measure. The proposed amendment to the Banking Act will also strengthen the definition of large exposures and related party lending to better capture all material risks. The CBSL intends to issue prudential regulations and guidelines to credit card companies and payment service providers during 2009.

18. **The CBSL intends to put in place a framework for the orderly workout of problem banks and finance companies to preserve financial stability.** The proposed amendment to the Banking Act and Finance Company Act will address weaknesses in the current law with regard to the liquidation and acquisition processes to strengthen viable institutions, and introduce measures to encourage the unwinding of unviable ones. We also aim to make the Finance Company Act and the Banking Act compatible with the new Companies Act. Finally, the CBSL will further improve its contingency plan for addressing any future financial sector instability and further strengthen its intervention procedures. The improved plan will also develop an approach to dealing with potential stresses in banks and finance companies.

## V. OTHER POLICIES

19. **A safeguards assessment, which found that the CBSL has developed its safeguards in many respects and has a relatively strong safeguards framework, was concluded in May.** We welcome the findings and conclusions of the safeguards report and the CBSL will work with the IMF staff in the coming months to implement the recommendations outlined in the safeguards assessment report with a focus on the priority recommendations in the areas of external audit and data reporting.

## VI. RISKS AND CONTINGENCIES

20. **The current global economic environment is uncertain, bringing economic and financial risks to the program.** Key risks include a sharper-than-anticipated economic slowdown in trading partner countries which would slow export growth further, a fall in remittances inflows, and capital outflows. If these risks materialize, the Government stands ready to adjust its policies, in close consultation with IMF staff, to ensure the achievement of a sustainable external position by the end of the program period. Finally, in the event of a potentially disruptive movement in the nominal exchange rate against the U.S. dollar in either direction, the authorities will consult with Fund staff on the appropriate policy response.

## VII. PROGRAM MONITORING

21. **The program will be subject to quarterly reviews with quarterly performance criteria as set out in the technical memorandum of understanding (TMU).** Completion of the first two reviews scheduled for September 2009 and November 2009 will require observance of the quantitative performance criteria for end-July 2009 and end-September 2009, respectively, as specified in Table 1. The first two reviews will also assess progress towards observance of the structural benchmarks specified in Table 2.

22. **The Government authorizes the IMF to publish this Letter of Intent and its attachments, Tables 1, 2 and 3.**

**Table 1. Sri Lanka: Quantitative Performance Criteria (PC) and Indicative Targets (IT)**

	12/31/2008 Actual	7/31/2009 PC	9/30/2009 PC	12/31/2009 IT	3/31/2010 IT
<b>Quantitative performance criteria</b>					
Net international Reserves (NIR) of the Central Bank of Sri Lanka (CBSL) (floor, cumulative change from the beginning of the year, in million US\$) 1/ 2/ 3/	-1,385	-109	-13	-7	85
Reserve money of the CBSL (ceiling, eop stock, in million rupees)	268,425	274,130	280,370	300,525	310,886
Net domestic financing (NDF) of the central government from the banking system and the non-bank sector (ceiling, cumulative from the beginning of the year, in million rupees) 4/ 5/ 6/	314,289	282,004	305,001	331,817	82,234
<b>Continous performance criteria</b>					
Contracting and guaranteeing of medium and long-term non-concessional external debt by the government (ceiling, cumulative from end-April 2009, in million US\$)	...	1,750	1,750	1,750	1,750
Accumulation of new external payment arrears (ceiling, eop, in million US\$)	0	0	0	0	0
<b>Indicative targets</b>					
Overall balance of the Ceylon Petroleum Corporation and the Ceylon Electricity Board (floor, cumulative from the beginning of the year, in million rupees)	-49,847	...	...	-35,387	...
<b>Memorandum items:</b>					
External loans assumed under the program (cumulative from the beginning of the year, in million rupees) 4/	80,415	55,928	75,238	109,392	49,896
External grants assumed under the program (cumulative from the beginning of the year, in million rupees) 5/	31,222	5,644	7,825	9,631	3,326
External debt service assumed under the program (cumulative from the beginning of the year, in million rupees) 6/	109,268	72,994	89,735	136,841	42,146
Privatization proceeds to the central government in connection with the sale of central government assets 7/	0	0	0	0	0
Foreign program financing assumed under the program (cumulative from the beginning of the year, in million US\$) 1/	23	0	20	40	0
Cumulative net change in the amount of foreign holdings of Treasury Bills and Treasury Bonds assumed under the program (cumulative from the beginning of the year, in million US\$) 1/	-213	15	15	15	0
Official external debt service assumed under the program (cumulative from the beginning of the year, in million US\$) 2/	802	446	588	837	200
Repayment of foreign currency loan from the CBSL by the Bank of Ceylon and the People's Bank (cumulative from the beginning of the year, in million US\$) 3/	40	261	283	283	0

1/ If the amount of program financing and the cumulative net change in the amount of foreign holdings of Treasury Bills or Treasury Bonds is higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative differences on the test date.

2/ If the amount of official external debt service by the central government in U.S. dollars is higher/lower than assumed under the program, the floor on NIR will be adjusted downward/upward by the cumulative differences on the test date.

3/ The floor on NIR will be adjusted upwards by any repayments for the foreign currency loan from the CBSL by the Bank of Ceylon and the People's Bank in excess of the repayment schedule.

4/ If the amount of external loans is higher/lower in rupee terms than assumed under the program, the cumulative ceiling on net domestic financing of the central government will be adjusted downward/upward by the cumulative difference in external loans on the test date.

5/ If the amount of external grants is lower in rupee terms than assumed under the program, the cumulative ceiling on net domestic financing of the central government will be adjusted upward by the cumulative difference in external grants on the test date.

6/ If the amount of external debt service by the central government in rupee terms is higher/lower than assumed under the program, the ceiling on net domestic financing of the central government will be adjusted upward/downward by the cumulative difference in external debt service payments measured in rupees.

7/ If the amount of privatization proceeds to the central government in connection with the sale of central government assets is higher/lower than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted downward/upward by the cumulative receipt/reimbursement of any privatization proceeds.

**Table 2. Sri Lanka: Structural Benchmarks (SB)**

Actions	Type	Date
Recapitalization of Seylan Bank through a public share issuance.	SB	9/30/2009
A contingency plan for orderly workouts of problem banks and financial institutions will be developed by the CBSL.	SB	9/30/2009
Approval by the Monetary Board of a revised Banking Act and other pertinent laws and legislations that: (i) improve the bank resolution framework that more clearly defines the provisions for acquisition, and roles of the conservator and liquidator; and (ii) strengthens the definition of large exposures and related parties to better capture all material risks.	SB	9/30/2009
Submission by the tax review commission of an interim report, including on base broadening measures to be incorporated into the 2010 budget.	SB	10/15/2009
Develop a plan to address outstanding debts between the CEB, CPC and state-owned banks.	SB	12/31/2009
Submission to the parliament of a revised Finance Company Act which includes clarifying the legal authority of the CBSL in enforcing its regulations on all deposit taking finance companies.	SB	12/31/2009
Issuance of prudential regulations and guidelines to credit card companies and payment service providers.	SB	12/31/2009
Submission to parliament of the 2010 budget consistent with program targets.	SB	12/31/2009

**Table 3. Actions Already Taken by the Government**

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Removal of all import margin requirements.

Amendments to the Nation Building Tax to raise the rate from 1 to 3 per cent.

Amendments to the excise taxes on liquor, cigarette and other items.

Finalization of the terms of reference of a tax commission to review tax policy.

Harmonization of the penal rate for commercial bank borrowing from the CBSL with the reverse repo rate.

Announcement of a recapitalization plan for Seylan Bank.

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## Technical Memorandum of Understanding

1. **This Technical Memorandum of Understanding sets out a framework for monitoring the performance of Sri Lanka under the program supported by the Stand-By Arrangement (SBA).** It specifies the performance criteria and indicative targets (including adjustors) under which Sri Lanka's performance will be assessed through quarterly reviews. Monitoring procedures and reporting requirements are also specified. The first review will take place on or after July 30, 2009, and the second review on or after September 30, 2009.

### I. FISCAL TARGETS

#### A. Performance Criterion on Net Domestic Financing of the Central Government

2. **Net domestic financing (NDF) is defined as the change in net credit to the central government by the domestic banking system and the net change in holdings of treasury bills and other government securities by the domestic non-bank sector.** For the purpose of program monitoring, the central government is defined to include line ministries, departments, and other public institutions. The Central Bank of Sri Lanka (CBSL), state-owned enterprise, parastatals and other agencies that do not receive subventions from the central government are excluded from the definition of central government, NDF of the central government is defined as the sum of (i) net borrowing from the CBSL (ways and means advances, loans, holdings of treasury bills, treasury bonds, and other central government bonds minus deposits) and (ii) net borrowing from domestic commercial banks and the domestic non-bank sector (loans, advances, holdings of restructuring bonds, and holdings of treasury bills and other central government securities minus deposits). In 2008, NDF of the central government defined in this manner amounted to Rs. 314.3 billion. Of this amount, Rs. 195.2 billion was net borrowing from the domestic banking system, Rs. 114.8 billion was net borrowing from the domestic non-bank sector, and Rs. 4.2 billion was net borrowing from other sources.

#### **The following adjustment will apply:**

3. If the amount of external loans to the central government—as set out in Table 1—is higher/lower in rupee terms than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted downward/upward by the cumulative difference in external loans in rupees.

4. If the amount of external grants to the central government—as set out in Table 1—is lower in rupee terms than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted upward by the cumulative difference in external grants in rupees up to a limit of Rs. 5 billion.



5. If the amount of external debt service by the central government in rupee terms—as set out in Table 1—is higher/lower than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted upward/downward by the cumulative difference in external debt service payments measured in rupees.

6. If the amount of privatization proceeds to the central government in connection with the sale of central government assets—as set out in Table 2—is higher/lower than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted downward/upward by the cumulative receipt/reimbursement of any privatization proceeds.

**B. Indicative Target on the Sum of the Overall Balance of the Ceylon Electricity Board and the Ceylon Petroleum Corporation.**

7. The balance of the overall profit or loss position of the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) from their operating income statements is measured from above the line on an accrual basis. At end-December 2008, the sum of that overall position of the CEB and CPC defined in this manner stood at Rs. -50 billion.

**II. MONETARY TARGETS**

**A. Performance Criterion on Reserve Money of the CBSL**

**Reserve money of the CBSL** consists of currency in circulation (with banks and with the rest of the public), financial institutions' domestic currency deposits at the CBSL, and the deposits of following government agencies: the National Defence Fund (General Ledger Acc. No. 4278), the Buddha Sasana Fund A/C (General Ledger Acc. No. 4279); and the Road Maintenance Trust Fund (General Ledger Acc. No. 4281). At end-December 2008, reserve money defined in this manner stood at Rs. 268.4 billion.

The following adjustment will apply:

8. If any bank fails to meet its legal reserve requirement, the ceiling on reserve money will be adjusted downward to the extent of any shortfall in compliance with the requirement.

9. Changes in required reserve regulations will modify the reserve money ceiling according to the formula:

$$\Delta M = \Delta r B_0 + r_0 \Delta B + \Delta r \Delta B$$

where  $\Delta M$  denotes the change in reserve money,  $r_0$  denotes the reserve requirement ratio prior to any change;  $B_0$  denotes the reservable base in the period prior to any change;  $\Delta r$  is the change in the reserve requirement ratio; and  $\Delta B$  denotes the immediate change in the reservable base as a result of changes to its definition.

### III. EXTERNAL SECTOR TARGETS

#### A. Performance Criterion on Net Official International Reserves

10. **Net official international reserves (NIR) is defined as (i) the difference between the gross foreign assets and liabilities of the CBSL and (ii) the balance of State Treasury's (DSTs) Special Dollar and Yen Revolving accounts, both expressed in terms of market values.** Gross foreign assets of the CBSL consists of monetary gold; foreign exchange balances held outside Sri Lanka; foreign securities (valued in market prices); foreign bills purchased and discounted; the reserve position at the IMF and SDR holdings; and the Crown Agent's credit balance. Excluded from gross foreign assets will be participation in international financial institutions; holdings of nonconvertible currencies; holdings of precious metals other than monetary gold; claims on residents (e.g., statutory reserves on foreign currency deposits of commercial banks and central bank foreign currency deposits with resident commercial banks) pledged, non-liquid, collateralized or otherwise encumbered foreign assets (such as the government's war risk insurance deposit with Lloyds during 2001/02); and claims in foreign exchange arising from derivative transactions (such as futures, forwards, swaps and options). Gross foreign liabilities are all foreign currency denominated liabilities of the CBSL to non-residents; the use of Fund credit; Asian Clearing Union debit balance and commitments to sell foreign exchange arising from derivatives such as futures, forwards, swaps, and options. In addition, NIR will include the balance of the DSTs' Special Dollar and Yen Revolving accounts. DST accounts are foreign currency accounts held by the Treasury and managed by the CBSL as an agent of the government. At end-December 2008, NIR defined in this manner stood at U.S. dollars 1,424.9 million.

**The following adjustment will apply:**

11. If the amount of foreign program financing and the cumulative net change in the amount of foreign holdings of Treasury Bills or Treasury Bonds—as set out in Table 3—is higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative differences on the test date.

12. If the amount of official external debt service by the central government in U.S. dollar terms—as defined in Table 3—is higher/lower than assumed under the program, the floor on the NIR will be adjusted downward/upward by the cumulative difference in official external debt service payments.

13. The floor on NIR will be adjusted upwards by any repayments for the foreign currency loan from the CBSL by the Bank of Ceylon's and the People's Bank in excess of the repayment schedule in Table 4.

14. The floor on NIR will be adjusted upward for any increase in Sri Lanka's allocation of Special Drawing Rights (SDR) from the IMF. Sri Lanka's SDR allocation at the time of approval of this arrangement amounted to SDR 70.868 million.

## **B. Performance Criterion on Contracting and Guaranteeing of Medium and Long-Term Non-Concessional External Debt by the Government**

15. **A continuous performance criterion applies to contracting and guaranteeing of medium and long-term non-concessional external debt by the Government.** For the purpose of this performance criterion, the Government is defined as the central government (as defined in ¶2) and the CBSL. The term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

- a. Loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future;
- b. Suppliers credit, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and
- c. Leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of this agreement, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.

Under the definition of debt set forth above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt will not give rise to debt. Medium and long-term debt is debt with a maturity of one year or longer. Excluded from this performance criteria are purchases under the stand-by arrangement of the IMF.

16. **Non-concessional borrowing** is defined as borrowing with a grant element of less than 35 percent, following the methodology set out in SM/96/86. The discount rates used to calculate the grant element will be the six-month and ten-year Commercial Interest Reference Rates (CIRRs) averages, as computed by the Strategy and Policy Review Department of the IMF. Six-month CIRRs are updated mid-February and mid-August (covering the six-month

period preceding the date of update) and the ten-year CIRRs averages are updated mid-December (covering a period of ten years preceding the date of the update). Six-month CIRRs averages are to be used for loans whose maturity is less than 15 years while 10-years CIRRs averages are to be used for loans whose maturity is equal or more than 15 years.

### **C. Performance Criterion on External Payment Arrears**

17. **A continuous performance criterion applies to the nonaccumulation of external payments arrears on external debt contracted or guaranteed by the central government (as defined in ¶2) or the CBSL.** External payments arrears consist of external debt-service obligations (principal and interest) on debt as defined in ¶13 that have not been paid at the time they are due, as specified in the contractual agreements. However, overdue debt and debt service obligations that are in dispute will not be considered as external payments arrears for the purposes of program monitoring.

## **IV. DATA REPORTING REQUIREMENTS**

18. Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the Memorandum of Economic and Financial Policies. All the program monitoring data will be provided by the Ministry of Finance and the Central Bank of Sri Lanka (CBSL). Data relating to the external and monetary targets will be furnished within no more than three weeks after the end of each month. With regards to the fiscal targets, the data in table 5 will be furnished within no more than five weeks after the end of each month and the data in table 6 within no more than nine weeks after the end of each month. For the overall balance of the CEB and the CPC, estimates will be available within four weeks.

19. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 5 and 6.

20. For the purpose of monitoring the monetary targets under the program, data will be provided in the format shown in Table 7.

21. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 8 and 9.

Table 1. Sri Lanka: External Financing Assumptions  
(cumulative from the beginning of the year, in millions of rupees)

	July	2009		2010
		September	December	March
External loans	55,928.3	75,238.2	109,392.4	49,896.0
External grants	5,644.2	7,825.1	9,630.9	3,326.4
External debt service	72,993.9	89,734.9	136,841.0	42,146.4

Table 2. Sri Lanka: Assumptions on Privatization Proceeds  
(cumulative from the beginning of the year, in millions of rupees)

	July	2009		2010
		September	December	March
Privatization proceeds	0.0	0.0	0.0	0.0

Table 3. Sri Lanka: External Financing Assumptions for NIR purposes  
(cumulative from the beginning of the year, in millions of U.S. dollars)

	July	2009		2010
		September	December	March
Program loans	0.0	20.0	40.0	0.0
Treasury Bills/Bonds	15.0	15.0	15.0	0.0
Official External debt service	445.6	587.8	836.5	200.0

Table 4. Repayment Schedule for the Foreign Currency Loan from the CBSL by the Bank of  
Ceylon and the People's Bank  
(cumulative from the beginning of the year, in millions of U.S. dollars)

	July	2009		2010
		September	December	March
Repayments	261.0	283.0	283.0	0.0

<b>Table 5. Sri Lanka: Summary of Central Government Operations 1/</b>	
(In millions of rupees)	
<b>Total revenue</b>	
<b>Tax revenue</b>	
	Income taxes
	Value added tax
	Excise taxes
	Nation Building Tax
	Taxes on international trade
	Other
<b>Nontax revenue</b>	
<b>Total expenditure and net lending</b>	
	<i>of which:</i> Interest payments
	Foreign
	Commercial
	Domestic
<b>Overall balance of central Government (Excluding grants)</b>	
<b>Financing</b>	
	Net domestic financing
	Net external financing
	Privatization

1/ As agreed for the purpose of monitoring the program

<b>Table 6. Sri Lanka: Central Government Expenditure 1/</b>	
(In millions of rupees)	
<b>Total expenditure and net lending</b>	
<b>Current expenditure</b>	
	Civil service wages and salaries
	Other civilian goods and services
	Security related expenditure
	Subsidies and transfers
	Households
	<i>Of which:</i> Samurdhi
	Pensions
	Fertilizer
	Institutions, corporations, other government agencies
	Interest payments
	Foreign
	Commercial
	Domestic
<b>Capital expenditure and net lending</b>	

1/ As agreed for the purpose of monitoring the program

**Table 7. Sri Lanka: Balance Sheet of the Central Bank 1/**

(In millions of rupees)

**Net foreign assets****Foreign assets**

Cash and balances abroad  
 Foreign securities  
 Claims on ACU  
 SDRs  
 IMF related assets  
 Receivables  
 Foreign currency reserve

**Foreign liabilities**

IMF and nonresident account  
 Liabilities to ACU

**Net domestic assets****Claims on government**

Advances  
 Treasury bills and bonds  
 Cash items in collection

**Government deposits****Claims on commercial banks**

Medium and long term  
 Short term

**Other items net****Reserve money**

Currency in circulation  
 Commercial bank deposits  
 Government agencies deposits

1/ As agreed for the purpose of monitoring the program

**Table 8. Sri Lanka: Summary of Central Bank Foreign Exchange Operations 1/**

(In millions of USD)

**1. Total inflows**

Loans  
 Program  
 IMF  
 Project (cash component only)  
 Interest earnings, forex trading profits, cap gains  
 Purchases of foreign exchange  
 Change in balances in DST's A/Cs  
 Other inflows  
 Borrowing from SLDBs  
 Loans from FCBUs  
 Syndicated Loans  
 Commercial loans  
 Repayments of BOC and PB claims

**2. Total outflows**

Public Debt Service Payments  
 Amortization  
 Principal (foreign loans)  
 Settlement SLDBs  
 Settlement FCBU  
 Settlement of syndicated loans  
 Interest  
 Foreign loans  
 Domestic foreign currency loans  
 Payments to the IMF/ change in valuation of liabilities  
 Foreign exchange sales to commercial banks  
 Foreign exchange deposits at BOC and PB

**3. Net flow at current rates (1-2)****Net International Reserves****Gross International Reserves****Cumulative net change in foreign holdings of Treasury Bills/Bonds**

1/ As agreed for the purpose of monitoring the program



Table 9. Sri Lanka: Estimated Gross Official Reserve Position (in US\$ million) 1/

Date	Central Bank		Reserve Position at I.M.F. & SDR hol. 3	Total {2}+{3} 4	Government			Total Gross Official Reserves		Liabilities					Net International Reserves	Overall balance	
	Reserves managed by IOD				Crown Agent's Credit Balance 5	D S T's Special Dollar Revolving Cr.balance 6	DST's Yen Accounts 7	Total (5)+(6) +(7) 8	(without ACU) {1}+{3}+{8} 9	(with ACU) (4)+(8) 10	Other Deposits	Asian Clearing Union	Drawings from the IMF	Currency Swap			Total
	(without ACU) 1	(with ACU) 2															

1/ As agreed for the purpose of monitoring the program

INTERNATIONAL MONETARY FUND

SRI LANKA

**Debt Sustainability Analysis 2009**

Prepared by the Staff Representatives of the International Monetary Fund  
and the World Bank

Approved by Kalpana Kochhar and Dominique Desruelle (IMF)  
Carlos Braga and Ernesto May (World Bank)

July 17, 2009

*The analysis indicates that Sri Lanka has a moderate risk of external debt distress over the medium term. This risk rating assumes that external borrowing is more concessional than it has been in recent years when the government built up a significant amount of short-term commercial debt. All debt indicators are projected to remain below indicative thresholds under the program baseline scenario. This conclusion rests heavily on the satisfactory implementation of the program, especially with regard to the fiscal consolidation measures. Moreover, the significant cost and roll-over risk of domestic debt adds to the total public debt burden and calls for a pro-active medium-term debt management strategy that aims to reduce costs and risks in the overall public debt portfolio.*

**I. THE DEBT PORTFOLIO: BACKGROUND AND CURRENT CONTEXT**

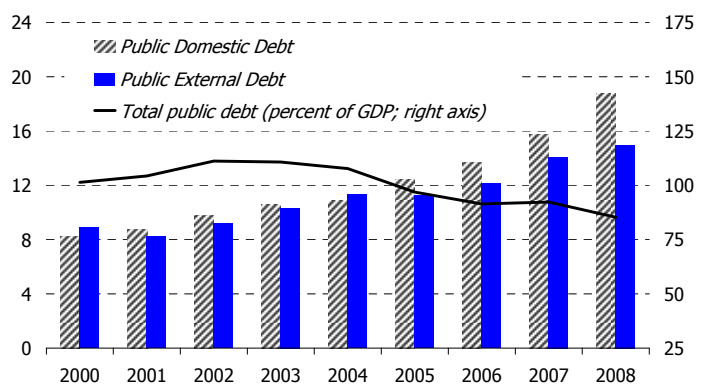
1. Sri Lanka's stock of public debt has nearly doubled since 2000 mainly as a result of financing persistent primary fiscal deficits. The government has relied on both external and domestic sources of financing in roughly equal measure until recently when it has had to rely more heavily on domestic debt issuance, particularly in 2008 when international capital markets were all but closed. Robust GDP growth in recent years has led to decline in the debt to GDP ratio from a recent peak of 98 percent of GDP in 2005 to 87 percent in 2008.

A more systematic look at the debt to GDP ratio decomposition in recent years confirms that GDP growth is the primary factor that drove the debt burden down since 2005. Negative and near zero real interest rates as inflation reached double-digit levels

and real appreciation of the rupee from 2005 also helped the decline. The primary fiscal deficit averaged 2¼ percent over the 2005-08 period and was the key reason for not

**Figure 1. Sri Lanka: Public Debt**

(In billions of U.S. dollars)



observing an otherwise larger decline in the ratio. This year it is expected that the debt burden will increase largely due to a real exchange rate depreciation (Table 1). The expected decline in the primary deficit helps contain an otherwise larger increase underscoring the importance of fiscal adjustment under the program.

Table 1. Factors Explaining the Falling Debt Burden in 2006-09

	2005-06	2006-07	2007-08	2008-09
Change in public sector debt	-3.5	-4.2	-4.2	3.9
Primary deficit	2.2	1.9	2.3	0.8
Real GDP growth	-7.0	-6.0	-5.1	-2.5
Real Interest Rate	-0.2	0.0	0.2	4.5
Real Exchange rate (+depreciation)	-0.8	-4.0	-3.5	2.5
Residual	2.3	4.0	1.9	-1.4

2. While the overall debt burden has decreased in recent years, the structure of the debt portfolio has changed in ways that have increased both its costs and risks. There has been a shift from lower cost external concessional borrowing to higher cost domestic and non-concessional external borrowing (Figure 2). Nominal interest rates on domestic debt increased significantly in recent years reaching almost 19 percent on T-bills and T-Bonds in 2008.<sup>1</sup> Domestic interest costs are estimated to be over 26 percent of government expenditures in 2009. Moreover, more than 40 percent of the domestic debt stock will be maturing in 2009, indicating significant roll-over risk. Recognizing this risk, the government adopted a strategy to extend T-bill maturities from 3 month issues to one year maturities. Additionally, the stock of U.S. dollar denominated domestic debt has increased to about 10 percent of the total portfolio, which adds to exchange rate risk (Figure 3).

Figure 2.

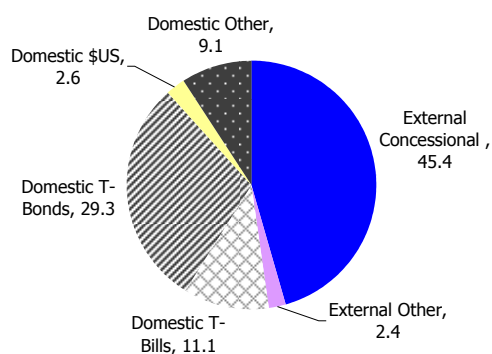
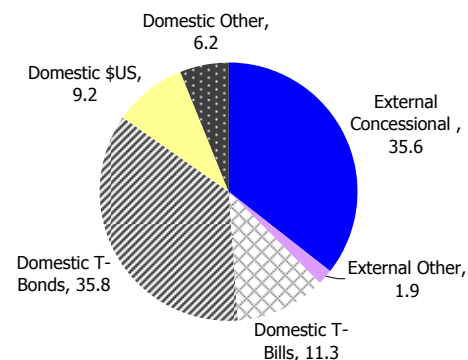
**Public Debt Composition 2004***(In percent of total stock)*

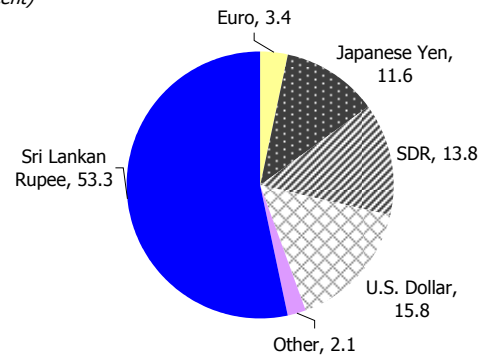
Figure 3.

**Public Debt Composition 2008***(In percent of total stock)*

<sup>1</sup> Weighted average domestic debt interest cost.

3. Concessional external debt still makes up approximately 85 percent of the total public external debt portfolio, but non-concessional sources of financing have grown in recent years. The Eurobond issue in 2007 (\$500 million) is one example, as are the syndicated loans and Sri Lanka development bonds issued in recent years. The opening of the T-bill market to foreign investors in 2008 has also contributed to the change in the external debt portfolio, although, much of the foreign inflows into T-bills flowed out of the country in last quarter of 2008.<sup>2</sup> In addition to increasing the cost of the portfolio, the non-concessional borrowings have been of shorter maturities than concessional funds thereby increasing roll-over risk in the external portfolio as well. Relying less on non-concessional sources of financing, and if the conditions allow, extending domestic debt maturities must be a key feature of the government's medium-term debt management strategy going forward.

**Currency Composition of Total Public Debt Portfolio, 2008**  
(In percent)



## II. MACROECONOMIC ASSUMPTIONS

4. Sri Lanka's debt sustainability analysis (DSA) builds on the program baseline scenario<sup>3</sup>. Macroeconomic assumptions in the previous DSA (SM/08/311) built a baseline scenario where increasing balance of payments gaps were financed with commercial borrowing over the medium and long-term. Under the current baseline program scenario external and fiscal adjustments close the financing gaps during the program period.

- Growth over 2008–2013 is projected at 5.3 percent, which is in line with the 10-year historical average of 5 percent. Growth over 2014–2028 period is projected to remain slightly higher level than the historical average.

<sup>2</sup> Foreign investor holdings of T-bills is subject to a 10 percent of total outstanding T-bill stock limit.

<sup>3</sup> Based on debt and debt service thresholds approved by the Boards of the IMF and the World Bank for use in the assessment of LIC DSA frameworks, Sri Lanka is classified as a medium performing country based on the average of its 2004–07 Country Policy and Institutional Assessment Index (CPIA).

- Export growth is projected at 2.9 percent in 2008-2013. This is 3.7 percentage points lower than 10-year historical average reflecting sharp decline in the global demand in general and tea and garment export prices in particular. Exports will recover in 2014-2028 with higher growth rate than the 10-year historical average.

	Baseline		Historical Average	
			10-year	5-year
	2008-13	2014-28	1998-2007	2003-07
Real GDP growth	5.3	5.5	5.0	6.4
Current account deficit (percent of GDP)	2.7	2.9	2.9	3.1
Growth of exports	2.9	10.0	5.5	10.2
Growth of oil imports	4.0	10.0	21.1	26.6
Growth of non-oil imports	3.2	11.0	5.6	10.7

Source: Fund staff estimates and projections.

- Oil imports are projected to decline to an average growth of 4 percent during 2008-2013, reflecting sharp drop in world oil prices compared with historical averages. Non-oil imports are projected at 3.2 percent in 2008-2013 and are expected to grow at 11 percent over 2014-2028 broadly in line with historical average.
- The current account deficit is projected at average 2.7 of GDP during 2008–2013, which is close to the historical average. Over the longer term current account is projected to remain at historical average. Foreign exchange reserves are projected to increase over 3.7 months of import coverage by end 2010.
- Assumptions on external financing are consistent with the program. The main sources of external financing over the medium term are multilateral and bilateral loans as commercial sources of financing are assumed to have dried out due to global financial crises. Commercial borrowing is projected to gradually increase after 2013 but would remain manageable.
- Revenues and grants would increase from around 14.9 percent of GDP in 2009 to around 16.7 percent of GDP by 2011, as the government is expected to intensify its efforts to broaden the tax base and strengthen tax administration, with a view to mitigating the decline in total revenue. Over the longer-term revenues are projected to raise gradually as the base of direct and indirect taxes is broadened through reducing the array of exemptions.
- Total primary expenditure declines in relation to GDP from 17 percent of GDP in 2008 to about 16 percent of GDP by 2010 as defense spending is reduced and untargeted subsidies are phased out. Primary spending will revert to historical levels over the long run. This trajectory also includes an important compositional change in

expenditures, with the interest component falling relative to other recurrent and capital expenditures.

- Inflation is expected to increase somewhat in 2010 reflecting recovery in growth and impact of the projected exchange rate depreciation. Over the medium- to long term inflation is expected to remain in single digits.

### **III. PUBLIC DEBT SUSTAINABILITY**

5. Short -term public external and domestic debt in Sri Lanka has grown to become a significant share of the total public debt portfolio in recent years. Consequently, debt service payments are heavy this year and next. To better capture short-term debt in the subsequent analysis a modification to the DSF templates is required as the main output produced by the DSF framework considers only medium and long term public debt. e modified the Data-Input sheet in the template to add the stock of short-term debt to the total stock of public debt (according to the DFS guidelines SM/08/317). All charts and tables presented reflect this change.

6. Under the baseline macroeconomic assumptions, the primary deficit would decline from 2.3 percent of GDP in 2008 to a surplus 0.8 percent of GDP by 2011. Public debt burden indicators would remain on a downward trend over the medium term. The debt service to revenue ratio would remain manageable throughout the projection period, underscoring the importance of implementation of the program revenue measures to raise the revenue to GDP ratio. Stress tests suggest that the path of total public debt is particularly sensitive to changes in the assumptions about the extent of fiscal adjustment and a one-time depreciation of the exchange rate. The biggest risks would be posed by a failure to carry out the envisaged adjustment in the primary balance (Figure I.1 and Table I.2). The main conclusion of the analysis is that effective implementation of the program is a precondition for fiscal sustainability.

### **IV. EXTERNAL DEBT SUSTAINABILITY**

7. All debt burden indicators, remain below indicative thresholds under the program baseline scenario (Tables I.3, I.4 and Figure I.2). While the debt burden indicators of this year and next are influenced by a sharp decline of tea and textile exports, a growth slowdown and the IMF financing under the program, they remain below indicative thresholds. PV of external debt to exports, debt to GDP and debt to revenue ratios would remain close to the indicative thresholds in 2009-2010 and would decline thereafter. The grant element in external debt is projected to decline rapidly from 2013 as commercial sources of financing start to increase.

8. Sensitivity analyses show that slower export growth and further depreciation of the rupee could worsen the debt and debt service ratios further. The debt-to-GDP and debt-to-revenue ratios are particularly sensitive to developments in the exchange rate of the rupee.

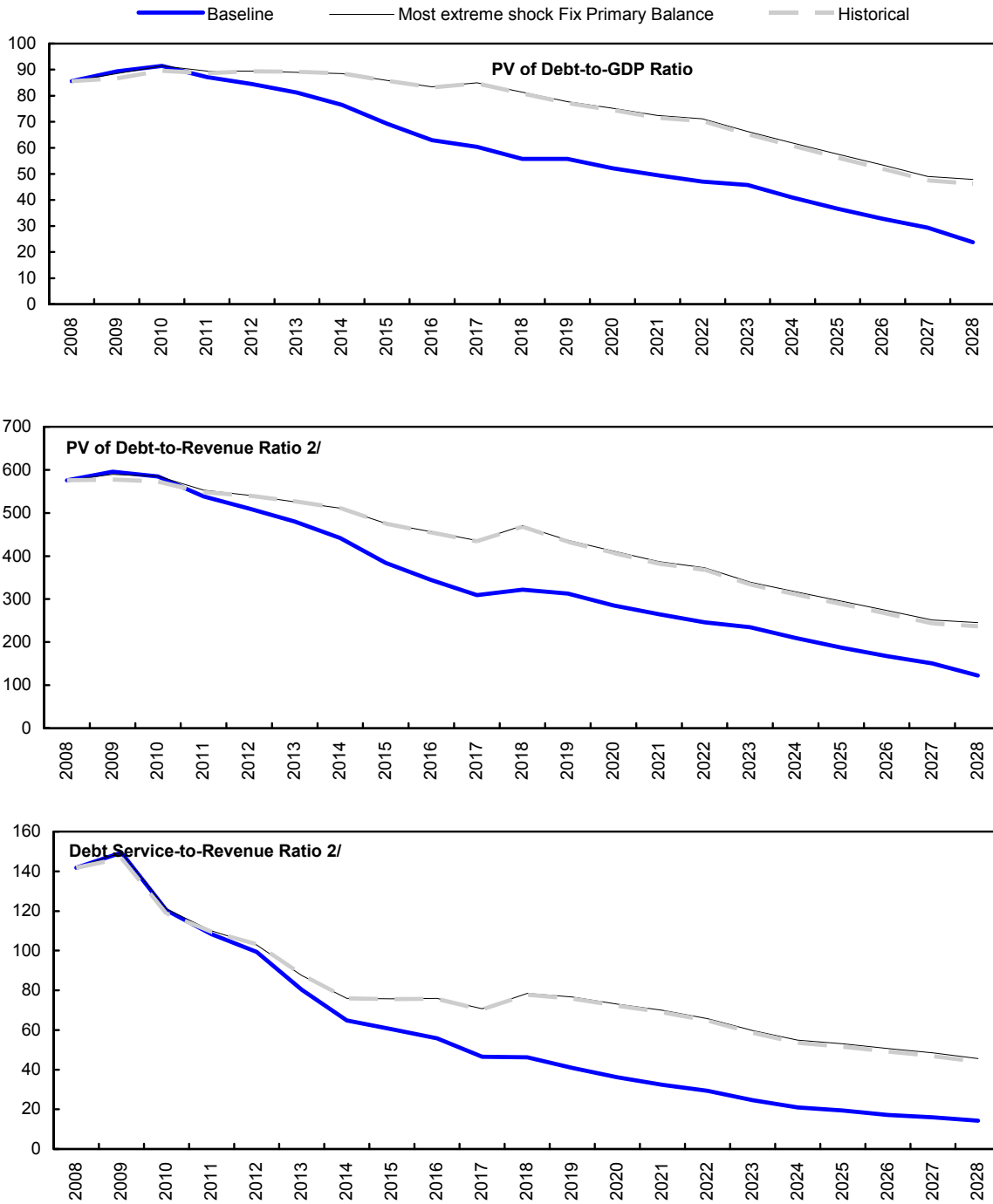
Similarly, the debt service-to-revenue ratio is most sensitive to exchange rate movements and the debt service-to-exports ratio is adversely affected by lower export growth.

9. The moderate level of the debt distress is an improvement from the high risk of the debt distress rating in the previous DSA (SM/08/311). The previous DSA rightly concluded that delay in the external and fiscal adjustment and continues reliance on commercial borrowing to fill the financing gap would lead to high risks of the debt distress. While the current DSA is built on a program scenario with substantial fiscal and external adjustments in combination with large IMF financing that close the financing gaps and bring the debt to a more sustainable path. However, without effective program implementation risks of debt distress are likely to increase.

#### **V. STAFF ASSESSMENT**

10. Staff considers Sri Lanka to be at moderate risk of external debt distress over the period. 2009–14. Both the external and public DSA suggest that debt dynamics will return to a more sustainable path with the credible fiscal consolidation to offset a decline in exports and the unsettled conditions in global financial markets. Sensitivity analyses show that slower export growth and further sharp depreciation of the rupee could worsen the debt and debt service ratios. Stress tests suggest that prolonged maintenance of an expansionary fiscal policy or a permanently lower GDP growth rate could pose risks to long-run fiscal sustainability. These considerations reinforce the need for the adoption of a more restrained fiscal stance over the medium term.

Figure I.1. Sri Lanka: Indicators of Public Debt Under Alternative Scenarios, 2008-2028 1/



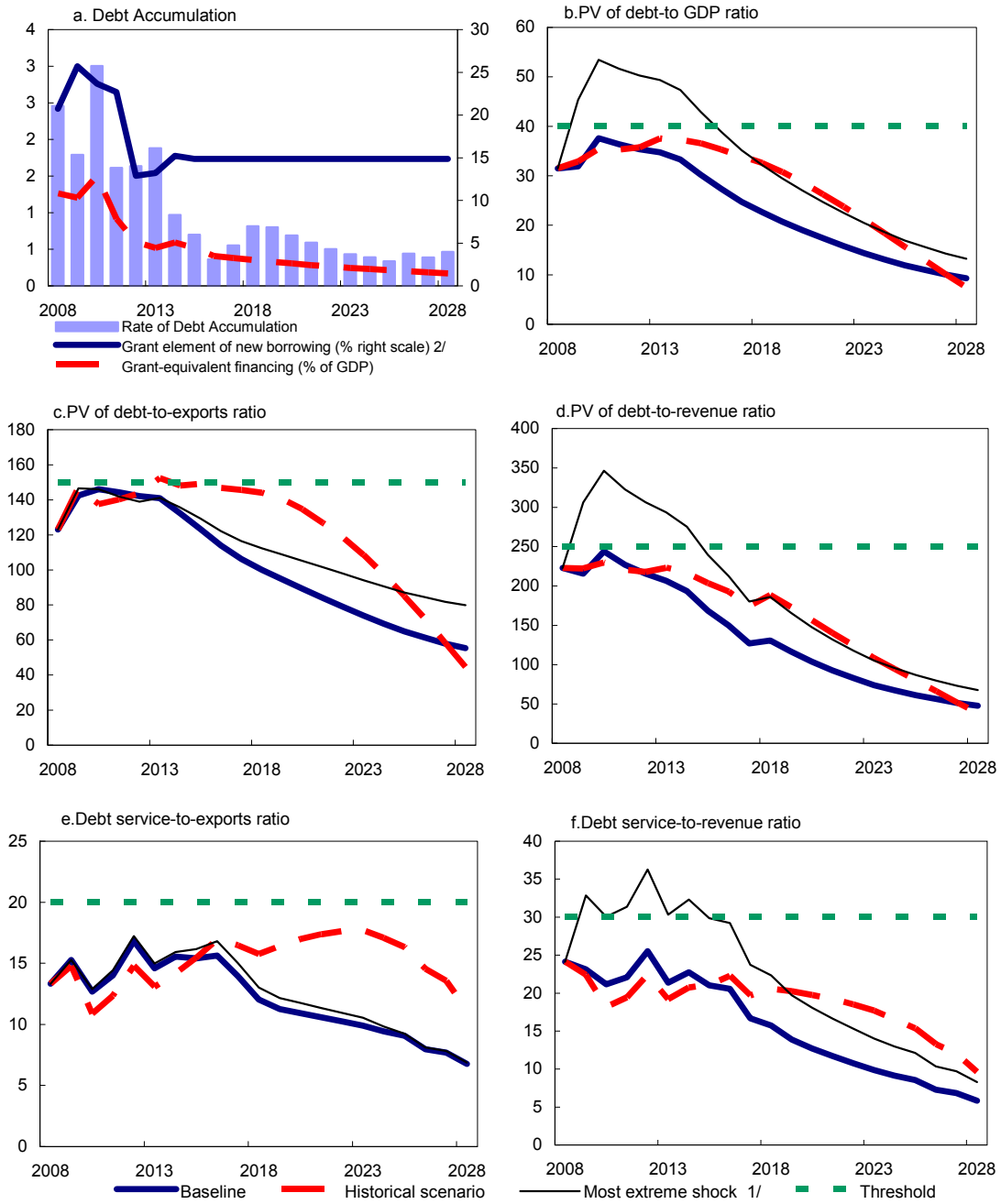
Sources: Country authorities; and Fund staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2018.

2/ Revenues are defined inclusive of grants.



**Figure I.2. Sri Lanka: Indicators of Total External Debt under Alternatives Scenarios, 2008-2028 1/**



Source: Fund staff projections and simulations.

1/ The most extreme stress test is the test that yields the highest ratio in 2018. In figure b. it corresponds to a One-time depreciation shock; in c. to a Terms of trade shock; in d. to a One-time depreciation shock; in e. to a Non-debt flows shock and in picture f. to a One-time depreciation shock.

**Table I.1. Sri Lanka: Public Sector Debt Sustainability Framework, Baseline Scenario, 2005-2028**  
(In percent of GDP, unless otherwise indicated)

	Actual			Average	Standard Deviation	Estimate					Projections				
	2005	2006	2007			2008	2009	2010	2011	2012	2013	2008-13 Average	2018	2028	2014-28 Average
<b>Public sector debt 1/</b>	98.4	94.9	90.7			86.5	90.5	93.0	88.2	84.6	80.5		54.9	23.7	
o/w foreign-currency denominated	42.9	46.8	43.8			38.4	39.4	44.6	42.3	39.9	38.0		24.4	10.4	
Change in public sector debt	4.8	-3.5	-4.2			-4.2	3.9	2.5	-4.8	-3.6	-4.1		-4.6	-2.5	
Identified debt-creating flows	-6.4	-5.5	-8.2			-6.1	5.4	0.4	-4.3	-3.7	-2.8		-2.5	-1.5	
Primary deficit	2.5	2.2	1.9	2.2	1.0	2.3	0.8	0.1	-0.9	-1.2	-1.1	0.0	-0.4	-0.4	
Revenue and grants	16.6	17.3	16.6			14.9	15.0	15.6	16.2	16.5	16.9		17.3	19.5	
of which: grants	1.3	1.0	0.9			0.7	0.2	0.2	0.2	0.1	0.1		0.0	0.0	
Primary (noninterest) expenditure	19.0	19.5	18.6			17.2	15.8	15.7	15.3	15.3	15.8		16.9	19.1	
Automatic debt dynamics	-10.2	-8.0	-10.1			-8.4	4.5	0.3	-3.4	-2.5	-1.6		-2.1	-1.1	
Contribution from interest rate/growth differential	-5.7	-7.2	-6.1			-4.9	2.0	-3.4	-3.1	-2.4	-1.6		-0.2	-0.4	
of which: contribution from average real interest rate	-0.3	-0.2	0.0			0.2	4.5	0.9	2.6	2.6	2.9		2.6	0.9	
of which: contribution from real GDP growth	-5.5	-7.0	-6.0			-5.1	-2.5	-4.3	-5.7	-5.0	-4.4		-2.8	-1.2	
Contribution from real exchange rate depreciation	-4.5	-0.8	-4.0			-3.5	2.5	3.7	-0.3	-0.1	-0.1		...	...	
Other identified debt-creating flows	1.4	0.3	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.3	0.3	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	1.1	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	11.3	2.0	4.0			1.9	-1.4	2.2	-0.5	0.1	-1.3		-2.0	-1.0	
<b>Other Sustainability Indicators</b>															
<b>PV of public sector debt</b>	55.5	53.8	87.9			85.6	89.4	91.4	87.1	84.4	81.2		55.7	23.8	
o/w foreign-currency denominated	0.0	5.8	41.0			37.5	38.3	43.0	41.2	39.7	38.6		25.2	10.5	
o/w external	...	...	35.5			32.1	34.6	39.2	37.7	36.4	35.6		23.2	9.5	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	42.1	39.2	36.4			36.4	34.7	35.4	31.0	25.6	23.9		11.3	7.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	334.6	311.3	528.1			575.9	595.7	585.0	538.7	510.3	479.7		322.2	122.1	
PV of public sector debt-to-revenue ratio (in percent)	363.8	330.9	556.6			604.7	603.5	592.4	544.4	514.5	482.7		322.2	122.1	
o/w external 3/	...	...	224.8			226.6	233.8	253.8	235.3	222.0	211.7		134.0	48.9	
Debt service-to-revenue and grants ratio (in percent) 4/	133.6	134.7	133.3			141.8	149.4	120.3	108.3	99.4	80.2		46.2	14.3	
Debt service-to-revenue ratio (in percent) 4/	31.3	29.4	31.2			38.1	40.7	37.2	35.5	32.5	32.2		23.2	8.4	
Primary deficit that stabilizes the debt-to-GDP ratio	-2.4	5.7	6.1			6.5	-3.1	-2.5	3.9	2.4	3.0		4.1	2.1	
<b>Key macroeconomic and fiscal assumptions</b>															
Real GDP growth (in percent)	6.2	7.7	6.8	5.0	2.5	6.0	3.0	5.0	6.5	6.0	5.5	5.3	5.0	5.0	
Average nominal interest rate on forex debt (in percent)	1.2	2.3	2.5	2.3	0.6	4.2	3.9	3.9	3.9	4.1	4.4	4.1	5.0	4.8	
Average real interest rate on forex debt (in percent)	1.4	3.6	6.6	12.8	7.3	-0.7	14.9	28.9	11.4	10.9	10.4	12.6	4.5	2.6	
Change in GDP deflator (in percent) 6/	11.2	7.6	7.1	2.6	5.1	15.5	1.3	-11.6	1.4	1.3	1.7	1.6	7.5	7.1	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.2	0.1	0.0	0.1	0.1	0.0	-0.1	0.0	0.0	0.1	0.1	0.0	0.2	-0.1	
Grant element of new external borrowing (in percent)	...	...	...	...	...	20.8	25.7	23.7	22.7	12.9	13.2	19.8	14.9	14.9	

Sources: Country authorities; and Fund staff estimates and projections.

1/ Central government and state owned enterprises.

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

3/ Revenues excluding grants.

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

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

6/ From the macro-framework

Table I.2. Sri Lanka: Sensitivity Analysis for Key Indicators of Public Debt 2008-2028

	Projections							
	2008	2009	2010	2011	2012	2013	2018	2028
<b>PV of Debt-to-GDP Ratio</b>								
<b>Baseline</b>	86	89	91	87	84	81	56	24
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	86	87	90	89	89	89	81	46
A2. Primary balance is unchanged from 2008	86	88	91	89	89	89	81	48
A3. Permanently lower GDP growth 1/	86	87	89	84	82	79	56	38
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	86	88	91	86	83	80	55	27
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	86	89	93	88	84	80	53	22
B3. Combination of B1-B2 using one half standard deviation shocks	86	88	93	87	84	80	53	23
B4. One-time 30 percent real depreciation in 2009	86	108	110	104	101	98	68	34
B5. 10 percent of GDP increase in other debt-creating flows in 2009	86	97	98	93	89	85	57	24
<b>PV of Debt-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	576	596	585	539	510	480	322	122
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	576	578	573	548	540	527	468	237
A2. Primary balance is unchanged from 2008	576	590	585	553	541	526	470	245
A3. Permanently lower GDP growth 1/	576	583	568	521	493	464	326	197
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	576	583	581	532	502	470	316	141
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	576	595	596	543	510	475	307	114
B3. Combination of B1-B2 using one half standard deviation shocks	576	588	593	541	508	474	309	119
B4. One-time 30 percent real depreciation in 2009	576	721	704	646	611	577	395	174
B5. 10 percent of GDP increase in other debt-creating flows in 2009	576	646	629	574	539	504	329	124
<b>Debt Service-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	142	149	120	108	99	80	46	14
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	142	147	119	109	103	88	78	44
A2. Primary balance is unchanged from 2008	142	149	121	110	103	87	78	46
A3. Permanently lower GDP growth 1/	142	150	121	109	101	81	51	31
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	142	150	124	111	102	82	50	22
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	142	149	121	111	103	85	50	17
B3. Combination of B1-B2 using one half standard deviation shocks	142	148	122	111	103	85	50	18
B4. One-time 30 percent real depreciation in 2009	142	156	130	121	115	96	71	37
B5. 10 percent of GDP increase in other debt-creating flows in 2009	142	149	125	117	107	95	56	19

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the length of the projection period.

2/ Revenues are defined inclusive of grants.

**Table I.3. Sri Lanka: External Debt Sustainability Framework, Baseline Scenario, 2005-2028 1/**  
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average	Standard Deviation	Projections									
	2005	2006	2007			2008	2009	2010	2011	2012	2013	2008-2013 Average	2018	2028	2014-2028 Average
<b>External debt (nominal) 1/</b>	<b>53.3</b>	<b>50.2</b>	<b>51.5</b>			<b>44.3</b>	<b>43.9</b>	<b>50.8</b>	<b>48.4</b>	<b>46.7</b>	<b>45.3</b>		<b>29.4</b>	<b>12.8</b>	
o/w public and publicly guaranteed (PPG)	51.8	48.8	49.8			42.7	43.2	50.5	48.3	46.3	44.8		28.9	11.9	
Change in external debt	-8.6	-3.1	1.3			-7.2	-0.4	6.9	-2.4	-1.7	-1.3		-2.8	-1.0	
Identified net debt-creating flows	-8.0	-3.6	-3.7			5.1	-1.5	-2.2	-2.1	-2.2	-3.0		-0.1	2.7	
<b>Non-interest current account deficit</b>	<b>1.6</b>	<b>4.2</b>	<b>3.0</b>	<b>1.7</b>	<b>1.9</b>	<b>7.6</b>	<b>-0.4</b>	<b>-0.4</b>	<b>0.5</b>	<b>0.0</b>	<b>-1.2</b>		<b>1.1</b>	<b>3.4</b>	<b>1.8</b>
Deficit in balance of goods and services	8.7	11.0	10.4			13.8	6.0	6.5	6.9	6.6	6.4		7.2	7.5	
Exports	32.5	30.1	29.1			25.6	22.4	25.7	25.2	24.9	24.6		22.6	16.8	
Imports	41.2	41.1	39.5			39.4	28.4	32.3	32.1	31.5	31.0		29.8	24.3	
Net current transfers (negative = inflow)	-7.5	-7.1	-7.1	-6.5	0.7	-6.7	-6.4	-7.0	-6.4	-6.7	-7.5		-6.4	-4.1	-5.7
o/w official	-0.4	-0.4	-0.3			-0.3	-0.2	-0.2	-0.2	-0.1	-0.1		0.0	0.0	
Other current account flows (negative = net inflow)	0.4	0.2	-0.3			0.5	0.1	0.1	0.1	0.1	-0.1		0.3	0.0	
<b>Net FDI (negative = inflow)</b>	<b>-1.0</b>	<b>-1.6</b>	<b>-1.7</b>	<b>-1.1</b>	<b>0.3</b>	<b>-1.7</b>	<b>-1.4</b>	<b>-1.2</b>	<b>-1.3</b>	<b>-1.3</b>	<b>-1.3</b>		<b>-1.1</b>	<b>-0.7</b>	<b>-1.0</b>
<b>Endogenous debt dynamics 2/</b>	<b>-8.7</b>	<b>-6.2</b>	<b>-5.0</b>			<b>-0.7</b>	<b>0.3</b>	<b>-0.7</b>	<b>-1.4</b>	<b>-1.0</b>	<b>-0.6</b>		<b>-0.1</b>	<b>0.0</b>	
Contribution from nominal interest rate	0.8	1.1	1.4			1.8	1.5	1.7	1.7	1.7	1.8		1.3	0.6	
Contribution from real GDP growth	-3.3	-3.5	-3.0			-2.5	-1.3	-2.4	-3.1	-2.7	-2.4		-1.4	-0.6	
Contribution from price and exchange rate changes	-6.2	-3.8	-3.3			...	...	...	...	...	...		...	...	
<b>Residual (3-4) 3/</b>	<b>-0.7</b>	<b>0.5</b>	<b>4.9</b>			<b>-12.3</b>	<b>1.1</b>	<b>9.1</b>	<b>-0.4</b>	<b>0.5</b>	<b>1.7</b>		<b>-2.8</b>	<b>-3.7</b>	
o/w exceptional financing	-1.1	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	37.8			33.1	32.7	37.9	36.4	35.7	35.3		23.1	10.2	
In percent of exports	...	...	129.8			129.1	145.7	147.3	144.5	143.6	143.4		102.3	60.6	
<b>PV of PPG external debt</b>	<b>...</b>	<b>...</b>	<b>36.1</b>			<b>31.5</b>	<b>31.9</b>	<b>37.6</b>	<b>36.3</b>	<b>35.4</b>	<b>34.7</b>		<b>22.6</b>	<b>9.3</b>	
In percent of exports	...	...	124.1			123.1	142.4	146.1	144.3	142.2	141.0		100.1	55.4	
In percent of government revenues	...	...	228.7			222.7	215.5	243.8	227.1	215.6	206.6		130.9	47.7	
<b>Debt service-to-exports ratio (in percent)</b>	<b>7.4</b>	<b>11.0</b>	<b>13.0</b>			<b>16.8</b>	<b>20.2</b>	<b>16.2</b>	<b>17.6</b>	<b>19.9</b>	<b>17.6</b>		<b>15.6</b>	<b>9.2</b>	
<b>PPG debt service-to-exports ratio (in percent)</b>	<b>3.5</b>	<b>6.9</b>	<b>9.0</b>			<b>13.3</b>	<b>15.3</b>	<b>12.7</b>	<b>14.0</b>	<b>16.8</b>	<b>14.6</b>		<b>12.0</b>	<b>6.8</b>	
<b>PPG debt service-to-revenue ratio (in percent)</b>	<b>7.5</b>	<b>12.9</b>	<b>16.6</b>			<b>24.1</b>	<b>23.1</b>	<b>21.2</b>	<b>22.1</b>	<b>25.5</b>	<b>21.4</b>		<b>15.7</b>	<b>5.8</b>	
Total gross financing need (billions of U.S. dollars)	5.4	6.6	7.2			10.9	9.7	8.7	7.8	7.9	7.1		9.5	19.9	
Non-interest current account deficit that stabilizes debt ratio	10.3	7.3	1.7			14.8	0.0	-7.2	3.0	1.8	0.1		4.0	4.4	
<b>Key macroeconomic assumptions</b>															
Real GDP growth (in percent)	6.2	7.7	6.8	5.0	2.5	6.0	3.0	5.0	6.5	6.0	5.5	5.3	5.0	5.0	5.0
GDP deflator in US dollar terms (change in percent)	11.2	7.6	7.1	2.6	5.1	15.5	1.3	-11.6	1.4	1.3	1.7	1.6	7.5	7.5	7.1
Effective interest rate (percent) 5/	1.6	2.5	3.1	2.6	0.6	4.2	3.6	3.6	3.6	3.8	4.1	3.8	4.6	4.8	4.6
Growth of exports of G&S (US dollar terms, in percent)	8.9	7.3	10.7	5.7	7.1	7.7	-8.7	6.6	5.6	6.0	6.2	3.9	9.5	9.6	9.6
Growth of imports of G&S (US dollar terms, in percent)	10.5	15.5	9.9	7.3	10.4	22.3	-24.9	5.5	7.4	5.5	5.6	3.6	10.6	10.6	10.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	20.8	25.7	23.7	22.7	12.9	13.2	19.8	14.9	14.9	14.9
Government revenues (excluding grants, in percent of GDP)	15.3	16.3	15.8	...	...	14.1	14.8	15.4	16.0	16.4	16.8	...	17.3	19.5	18.7
Aid flows (in billions of US dollars) 7/	1.4	1.5	1.6			1.7	1.9	2.5	2.9	3.0	3.1		2.8	4.9	
o/w Grants	0.3	0.3	0.3			0.3	0.1	0.1	0.1	0.1	0.1		0.0	0.0	
o/w Concessional loans	1.1	1.2	1.4			1.4	1.8	2.5	2.8	3.0	3.0		2.8	4.9	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			1.3	1.2	1.5	0.9	0.6	0.5		0.4	0.2	0.3
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			37.3	29.3	26.3	26.5	16.1	16.0		14.9	14.9	15.2
<b>Memorandum items:</b>															
Nominal GDP (billions of US dollars)	24.4	28.3	32.3			39.6	41.3	38.3	41.4	44.4	47.7		81.9	275.0	
Nominal dollar GDP growth	18.1	15.9	14.4			22.4	4.3	-7.2	8.0	7.4	7.3	7.0	12.9	12.9	12.4
PV of PPG external debt (in billions of US dollars)	...	...	11.7			12.5	13.2	14.4	15.0	15.7	16.6		18.5	25.6	
(PVt-PVt-1)/GDPt-1 (in percent)	...	...	...			2.5	1.8	3.0	1.6	1.6	1.9	2.1	0.8	0.5	0.6

Source: Staff simulations.

1/ Includes both public and private sector external debt.

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

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

Price and exchange rate change accounts of 8 percent, while reserve depletion compared to 2007 adds additional 3.2 percent

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

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

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

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

**Table I.4. Sri Lanka: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2008-2028**  
(In percent)

	Projections											
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2028
<b>PV of debt-to GDP ratio</b>												
<b>Baseline</b>	32	32	38	36	35	35	33	30	27	25	<b>23</b>	9
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2008-2028 1/	32	33	35	35	36	38	37	37	35	34	<b>33</b>	7
A2. New public sector loans on less favorable terms in 2008-2028 2	32	33	38	36	35	35	34	32	29	27	<b>25</b>	13
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	32	32	39	37	36	36	34	31	28	26	<b>23</b>	10
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	32	30	36	35	34	33	32	29	26	24	<b>22</b>	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	32	33	35	34	33	33	31	28	26	23	<b>21</b>	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	32	33	40	39	38	37	36	32	29	26	<b>24</b>	9
B5. Combination of B1-B4 using one-half standard deviation shocks	32	30	31	30	29	28	27	25	23	21	<b>19</b>	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	32	45	53	52	50	49	47	43	39	35	<b>32</b>	13
<b>PV of debt-to-exports ratio</b>												
<b>Baseline</b>	123	142	146	144	142	141	132	123	114	106	<b>100</b>	55
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2008-2028 1/	123	147	138	140	144	152	148	149	147	146	<b>144</b>	45
A2. New public sector loans on less favorable terms in 2008-2028 2	123	147	146	142	139	141	136	129	122	116	<b>112</b>	80
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	123	142	146	144	142	141	132	123	114	106	<b>100</b>	55
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	123	125	139	137	135	134	126	118	109	102	<b>97</b>	55
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	123	142	146	144	142	141	132	123	114	106	<b>100</b>	55
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	123	147	157	155	153	151	142	132	122	113	<b>106</b>	56
B5. Combination of B1-B4 using one-half standard deviation shocks	123	121	124	123	121	120	112	105	98	92	<b>87</b>	51
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	123	142	146	144	142	141	132	123	114	106	<b>100</b>	55
<b>PV of debt-to-revenue ratio</b>												
<b>Baseline</b>	223	215	244	227	216	207	194	168	150	127	<b>131</b>	48
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2008-2028 1/	223	222	229	220	218	223	217	204	193	174	<b>188</b>	38
A2. New public sector loans on less favorable terms in 2008-2028 2	223	222	244	223	211	207	199	176	160	139	<b>147</b>	69
<b>Debt service-to-exports ratio</b>												
<b>Baseline</b>	13	15	13	14	17	15	16	15	16	14	<b>12</b>	7
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2008-2028 1/	13	15	11	12	15	13	14	15	17	16	<b>16</b>	11
A2. New public sector loans on less favorable terms in 2008-2028 2	13	15	13	14	17	15	16	15	16	14	<b>12</b>	7
A3. Alternative Scenario (Costumize, enter title)	13	15	10	11	13	11	11	10	9	6	<b>3</b>	-12
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	13	15	13	14	17	15	16	15	16	14	<b>12</b>	7
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	13	14	12	14	17	14	15	15	15	13	<b>11</b>	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	13	15	13	14	17	15	16	15	16	14	<b>12</b>	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	13	15	13	14	17	15	16	16	17	15	<b>13</b>	7
B5. Combination of B1-B4 using one-half standard deviation shocks	13	14	12	13	15	13	14	13	13	12	<b>10</b>	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	13	15	13	14	17	15	16	15	16	14	<b>12</b>	7
<b>Debt service-to-revenue ratio</b>												
<b>Baseline</b>	24	23	21	22	26	21	23	21	21	17	<b>16</b>	6
<b>A. Alternative Scenarios</b>												
A1. Key variables at their historical averages in 2008-2028 1/	24	22	18	19	22	19	21	21	22	20	<b>21</b>	10
A2. New public sector loans on less favorable terms in 2008-2028 2	24	23	21	23	26	19	16	14	13	11	<b>11</b>	4
A3. Alternative Scenario (Costumize, enter title)	24	22	17	17	20	16	16	14	12	7	<b>4</b>	-10
<b>B. Bound Tests</b>												
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	24	23	22	23	26	22	23	22	21	17	<b>16</b>	6
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	24	23	21	22	25	21	22	20	20	16	<b>15</b>	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	24	24	20	21	24	20	21	20	19	16	<b>15</b>	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010 4/	24	23	21	23	26	22	23	22	22	18	<b>17</b>	6
B5. Combination of B1-B4 using one-half standard deviation shocks	24	23	19	19	22	19	20	18	17	14	<b>13</b>	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	24	33	30	31	36	30	32	30	29	24	<b>22</b>	8
<b>Memorandum item:</b>												
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	9	9	9	9	9	9	9	9	9	9	<b>9</b>	9

Source: Fund staff projections and simulations.

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

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

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

4/ Includes official and private transfers and FDI.

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

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

INTERNATIONAL MONETARY FUND

**Sri Lanka—Assessment of the Risks to the Fund and the Fund’s Liquidity Position**

Prepared by the Finance and Strategy, Policy, and Review Departments

(In consultation with other Departments)

Approved by Andrew Tweedie and Dominique Desruelle

July 20, 2009

1. **This note assesses the risks to the Fund arising from the proposed Stand-By Arrangement (SBA) for Sri Lanka and its effects on the Fund’s liquidity, in accordance with the policy on exceptional access.**<sup>1</sup> The authorities are requesting a 20-month SBA with access of SDR 1,653.6 million (400 percent of quota). The arrangement would have a flat purchase schedule with the first purchase of SDR 206.7 million (50 percent of quota) upon approval, followed by seven purchases as shown in Table 1. Access during the first year would reach about 250 percent of quota and the last purchase under the arrangement would be available in March 2011.

**Table 1. Sri Lanka: Proposed SBA—Access and Phasing**

Availability	Date 1/	SDR mn	Percent of quota	
			Purchase	Cumulative
2009	July (approval)	206.7	50.0	50.0
	September	206.7	50.0	100.0
	November	206.7	50.0	150.0
2010	February	206.7	50.0	200.0
	May	206.7	50.0	250.0
	August	206.7	50.0	300.0
	November	206.7	50.0	350.0
2011	March	206.7	50.0	400.0
	Total	1,653.6	400.0	400.0

Source: Finance Department.

1/ Starting in September 2009, purchases will depend on the completion of a review.

<sup>1</sup> See *IMF Concludes Discussion on Access Policy in the Context of Capital Account Crises; and Review of Access Policies in the Credit Tranches and the Extended Fund Facility*. Public Information Notice (PIN) No. 03/37; available via the internet: <http://www.imf.org/external/np/sec/pn/2003/pn0337.htm>.

## I. BACKGROUND

2. **Sri Lanka had several Fund GRA and PRGF arrangements over the last thirty years (Table 2).** Access under these arrangements ranged from SDR 100 million to SDR 413.4 million. The authorities' last program—supported by a blend PRGF/EFF arrangement—aimed to build on the progress made under the previous SBA, by accelerating economic growth while reducing poverty. The key elements of the program involved strengthening public finances, reforming the financial sector, public enterprises, the labor market and the trade regime, and improving macroeconomic policy instruments and institutions. As of end-May 2009, Fund credit outstanding to Sri Lanka under the GRA is about SDR 60.3 million (or 15 percent of quota), and Fund credit outstanding to Sri Lanka under the PRGF is about SDR 30.7 million (or 7 percent of quota) (Figure 1). All obligations to the Fund have been met in a timely manner.

**Table 2. Sri Lanka: IMF Financial Arrangements, 1981–2015**  
(In millions of SDRs)

Year	Type of Arrangement	Date of Arrangement	Date of Expiration or Cancellation	Amount of New Arrangement	Arrangement as a Percent of Quota	Amount Drawn	Purchases	Repurchases	Fund		
									GRA 1/	PRGF	Exposure Total 2/ 3/
1979	EFF	01-Jan-79	31-Dec-81	260.3	218.7	260.3	80.0	27.1	234.5	70.3	304.8
1980							30.0	38.4	211.1	95.4	306.5
1981							175.6	59.1	346.9	95.8	442.6
1982							39.2	49.9	341.5	95.8	437.2
1983	SBA	14-Sep-83	31-Jul-84	100.0	44.8	50.0	35.8	46.2	331.1	94.1	425.2
1984							0.0	24.7	328.3	84.7	413.0
1985							0.0	52.0	292.5	68.6	361.1
1986							0.0	77.5	234.0	49.5	283.6
1987							0.0	88.4	164.7	30.4	195.1
1988	SAF	09-Mar-88	12-Sep-91	156.2	70.0	156.2	153.4	81.4	209.4	57.7	267.1
1989							66.9	55.7	163.4	114.9	278.3
1990							44.6	34.8	131.6	156.5	288.1
1991	PRGF	13-Sep-91	31-Jul-95	336.0	150.6	280.0	56.0	63.9	68.0	212.2	280.2
1992							112.0	54.4	13.6	324.2	337.8
1993							56.0	18.1	0.0	375.7	375.7
1994							56.0	8.9	0.0	422.8	422.8
1995							0.0	22.3	0.0	400.5	400.5
1996							0.0	31.2	0.0	369.2	369.2
1997							0.0	48.0	0.0	321.2	321.2
1998							0.0	60.4	0.0	260.8	260.8
1999							0.0	72.7	0.0	188.1	188.1
2000							0.0	64.9	0.0	123.2	123.2
2001	SBA	20-Apr-01	19-Sep-02	200.0	48.4	200.0	103.4	56.0	103.4	67.2	170.6
2002							96.7	39.2	200.0	28.0	228.0
2003	PRGF/EFF	18-Apr-03	17-Apr-06	413.4	100.0	59.1	59.1	22.4	220.7	44.0	264.7
2004							0.0	75.4	150.9	38.4	189.3
...											
2009 2/	SBA	24-Jul-09	15-Mar-2011	1,653.6	400.0		620.1	55.1	639.9	26.9	666.8
2010 2/							826.8	14.6	1452.1	19.2	1471.3
2011 2/							206.7	0.0	1658.8	11.5	1670.3
2012 2/								55.1	1603.7	3.8	1607.5
2013 2/								466.8	1136.9	0.0	1136.9
2014 2/								749.3	387.6	0.0	387.6
2015 2/								361.7	25.8	0.0	25.8
2016 2/								25.8	0.0	0.0	

Source: Finance Department.

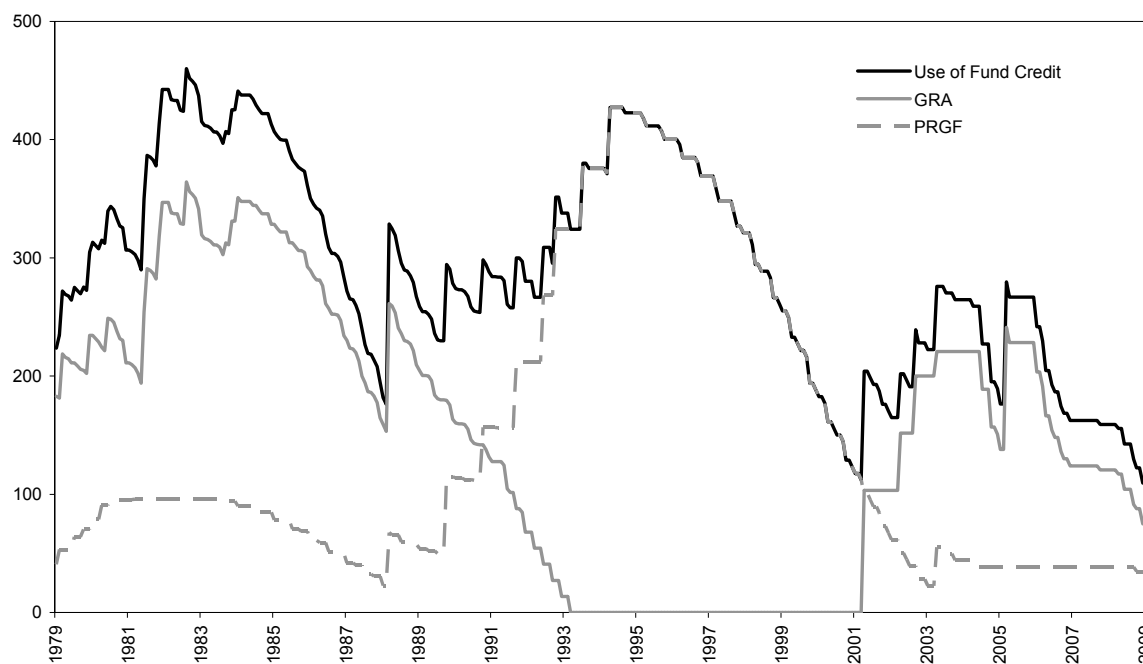
1/ GRA starting from 2009 includes emergency assistance and extended arrangements.

2/ As of end-December.

3/ Figures under the proposed program in italics. Assumes repurchases on an obligations basis.

3. **Sri Lanka's external debt is just above the median across recent exceptional access cases, with public sector debt accounting for the largest share.** At end-2008, Sri Lanka's total external debt stood at 44.2 percent of GDP, of which almost three-quarters was owed by the public sector (Table 3), mainly to bilateral and multilateral institutions (Figure 2). Private sector external debt, at 11.5 percent of GDP in 2008, is mainly short-term. Sri Lanka's public external debt as a ratio of GDP is higher than that in several recent

**Figure 1. Sri Lanka: IMF Credit Outstanding, 1979–2009**  
(In millions of SDRs)



Source: Finance Department.

**Table 3. Sri Lanka: Total External Debt, 2005–2009 1/**

	2005	2006	2007	2008	2009 2/
	(In Millions of U.S. Dollars)				
Total External Debt	13,020	14,209	16,659	17,507	18,141
<i>of which:</i>					
Public	10,303	11,107	12,973	12,933	13,768
Loans	10,303	11,107	12,600	12,773	13,768
Multilateral	4,893	5,206	5,591	5,559	6,797
Bilateral	4,321	4,724	5,196	5,322	5,384
Commercial	1,088	1,177	1,813	1,892	1,586
Bonds	0	0	373	160	0
Private	2,718	3,102	3,686	4,574	4,367
Short-term	2,330	2,709	3,147	3,917	4,074
Long-term	388	393	539	657	293
	(In Percent of GDP)				
Total External Debt	53.3	50.2	51.5	44.2	47.1
<i>of which:</i>					
Public	42.2	39.3	40.1	32.7	35.7
Loans	42.2	39.3	39.0	32.3	35.7
Multilateral	20.0	18.4	17.3	14.0	17.6
Bilateral	17.7	16.7	16.1	13.4	14.0
Commercial	4.5	4.2	5.6	4.8	4.1
Bonds	0.0	0.0	1.2	0.4	0.0
Private	11.1	11.0	11.4	11.5	11.3
Short-term	9.5	9.6	9.7	9.9	10.6
Long-term	1.6	1.4	1.7	1.7	0.8

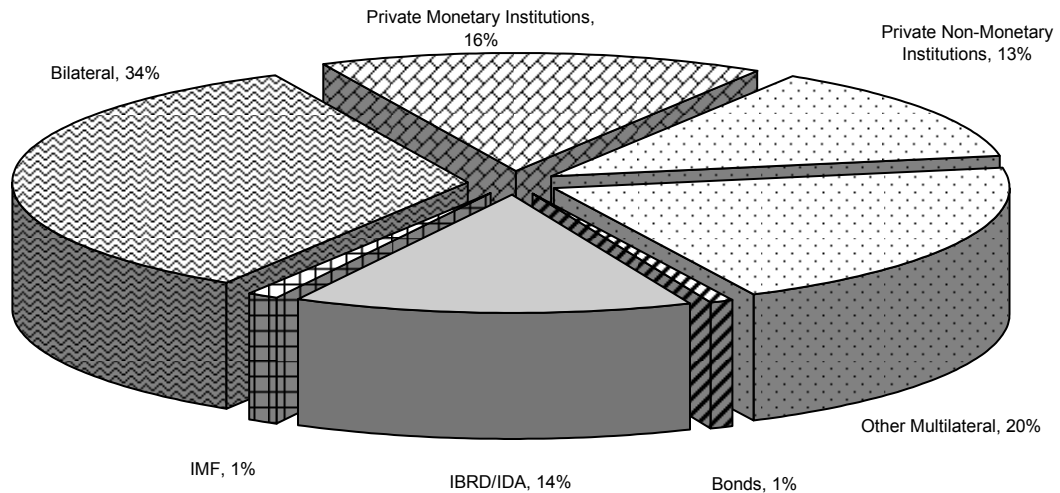
Source: Sri Lankan authorities and IMF staff estimates.

1/ End of year unless otherwise indicated.

2/ Staff projections for end-2009.



**Figure 2. Sri Lanka: Composition of Total External Debt, end-2008**  
(In percent)



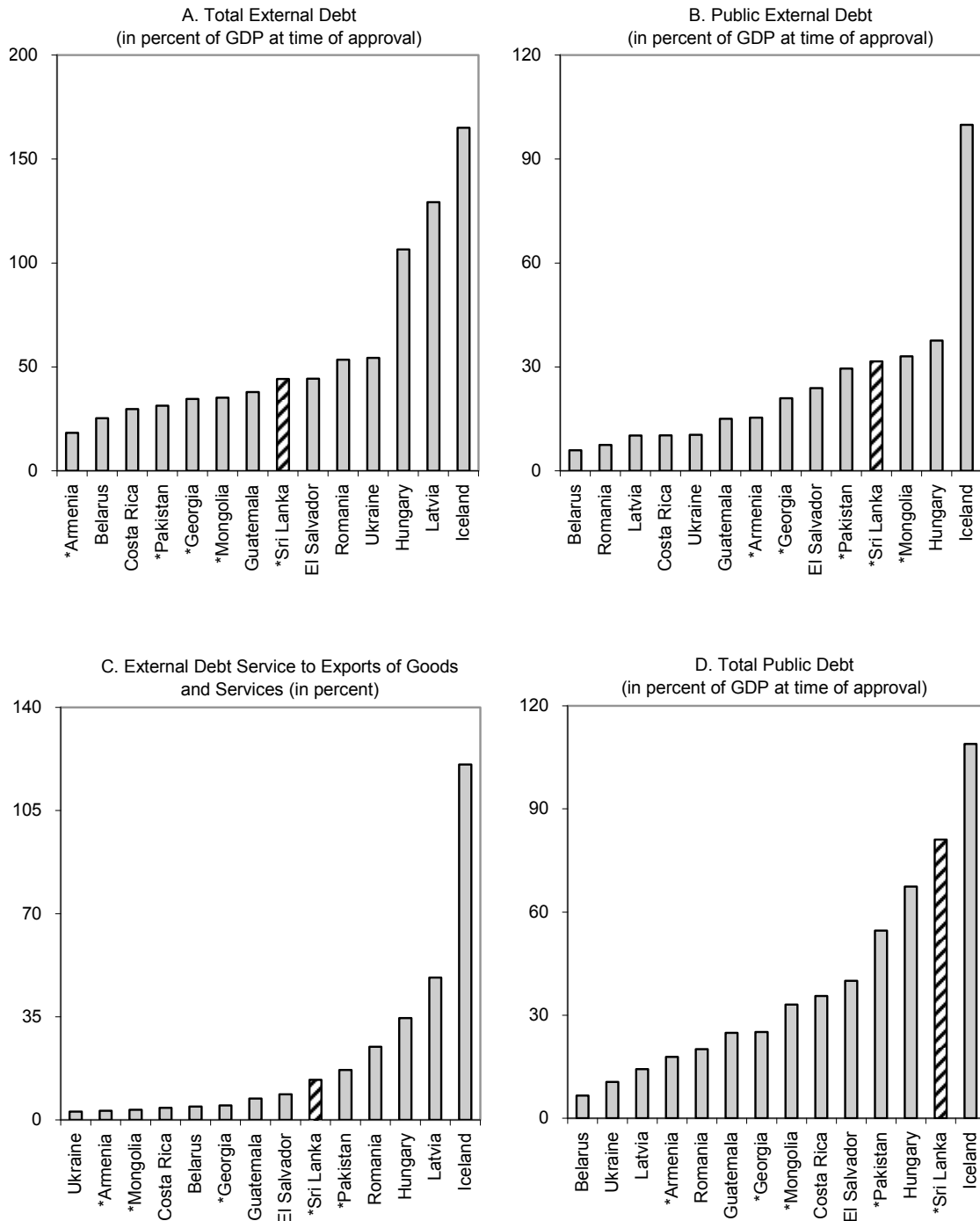
Source: Sri Lankan authorities and IMF staff estimates.

exceptional access cases though not among the few highest (Figure 3, Panels A and B).<sup>2</sup> Reflecting the country's debt stock, Sri Lanka's external medium and long-term debt service ratio to exports of goods and services is also somewhat higher than the median across recent exceptional access cases (Figure 3, Panel C).

4. **Public debt is high and about 39 percent is owed to external creditors.** Total public debt has dropped from about 102 percent of GDP in 2004 to about 81 percent at end-2008, which, however, is the second highest ratio among recent exceptional access cases (Figure 3, Panel D). Over the past four years external debt of the public sector has declined by about 10 percentage points of GDP to 32.7 percent in 2008.

<sup>2</sup> The exceptional access cases used as comparators in this paper are the SBAs approved since September 2008.

**Figure 3. Debt Ratios for Recent Exceptional Access Arrangements 1/**



Source: Sri Lankan authorities and IMF staff estimates, and World Economic Outlook.

1/ For arrangements approved since September 2008, estimates as reported in each staff report on the request of the Stand-By Arrangement. Ratios generated using end-2008 data, except for Guatemala for which projected end-2009 data were used. Asterisks indicate PRGF eligible countries.

## II. THE NEW STAND-BY ARRANGEMENT—RISKS AND IMPACT ON FUND'S FINANCES

### A. Risks to the Fund

#### 5. **Access under the proposed arrangement would be higher than in previous arrangements under the GRA for Sri Lanka and would surpass the annual access limit.**

- If all purchases were to be made as scheduled, Sri Lanka's outstanding use of GRA resources would rise to about 61 percent of quota upon approval, to 251 percent of quota during the first year of the arrangement, and then peak at about 401 percent of quota in March 2011.<sup>3</sup> In terms of quota, this projected peak exposure would be slightly lower than the median peak exposure in the recent exceptional access cases (Figure 4).
- If all purchases under the proposed SBA are made, GRA credit outstanding to Sri Lanka would be equivalent to 6.5 percent of GDP and about 60 percent of gross international reserves by 2011 (Table 4). The peak ratio in terms of gross reserves would be the second highest of recent exceptional access SBAs (Figure 5, Panel C), though around the median when expressed in terms of GDP.
- In terms of SDRs, the projected peak GRA exposure of SDR 1,659 million would be almost four times higher than Sri Lanka's previous peak in Fund credit outstanding reached in the early 1980s. While significant, this potential exposure, would, however, be much lower than in a number of recent exceptional access cases (Figure 6, Panel A).

#### 6. **If all purchases under the proposed SBA were to take place as scheduled, debt service ratios to the Fund would be within the range of other exceptional access cases, though higher than the average of these cases, and the share of the Fund in Sri Lanka's external debt service would also be large.** Sri Lanka's projected debt service to the Fund would peak at about SDR 762 million in 2014, and be about 78 percent of total public external debt service (Table 4). Peak debt service to the Fund as a share of exports of good and services, at about 8.3 percent, would be among the highest recent exceptional access cases (Figure 5, Panel D).<sup>4</sup>

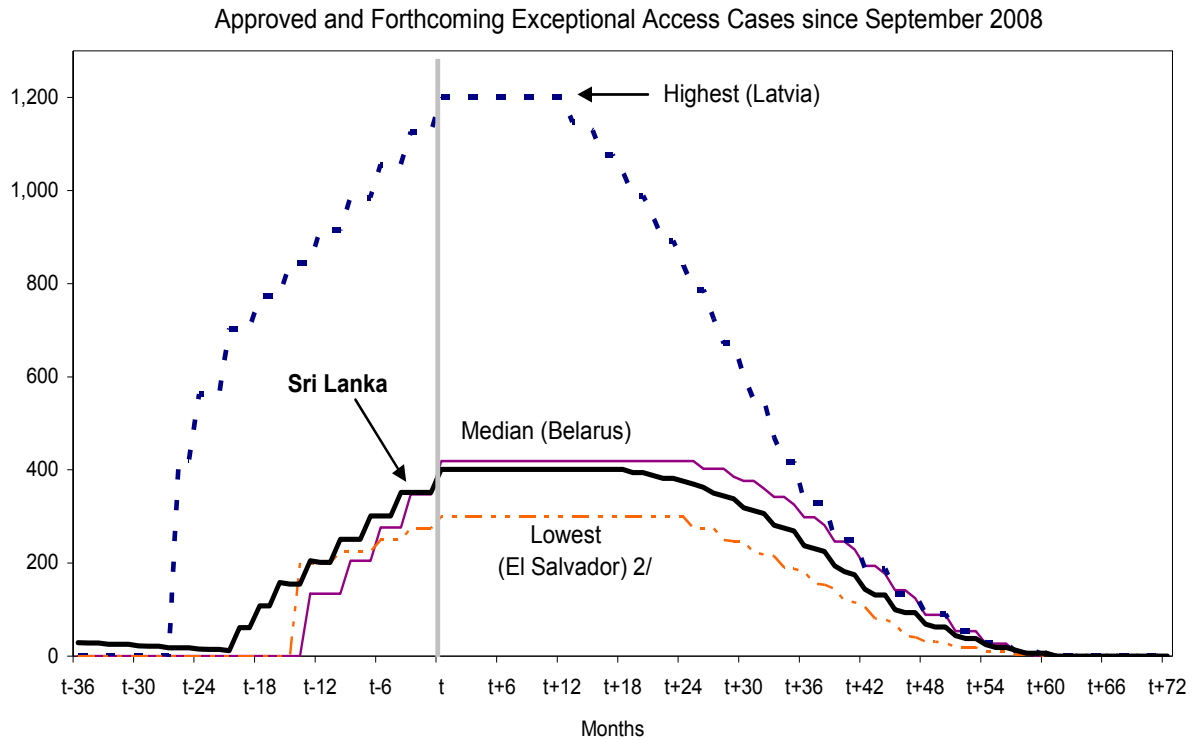
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<sup>3</sup> Amortization payments to the Fund are calculated assuming that all repurchases are made as scheduled, i.e., each purchase is repurchased in eight quarterly installments, beginning in 3¼ years after each purchase and ending after 5 years.

<sup>4</sup> Debt service to the Fund is calculated assuming that all repurchases are made as scheduled, i.e., each purchase is repurchased in eight quarterly installments, beginning in 3¼ years after each purchase and ending after 5 years. As for level-based surcharges, they are calculated according to the current schedule: 100 basis points for credit outstanding over 200 percent of quota and 200 basis points for credit outstanding above 300 percent

(continued)

**Figure 4. Fund Credit Outstanding in the GRA around Peak Borrowing 1/**  
(In percent of quota)



Source: IFS, Finance Department, and IMF staff estimates.

1/ Peak borrowing 't' is defined as the highest level of credit outstanding for a member. Repurchases are assumed to be on an obligations basis.

of quota. The new system of surcharges, which applies to credit outstanding above 300 percent of quota, will go in effect on August 1, 2009, subject to grandfathering at the member's request.

**Table 4. Sri Lanka—Capacity to Repay Indicators 1/**

	Jul-09	2009	2010	2011	2012	2013	2014	2015
<b>Exposure and Repayments (In SDR millions)</b>								
GRA credit to Sri Lanka 2/ (In percent of quota)	206.7 (50.0)	639.9 (154.8)	1,452.1 (351.3)	1,658.8 (401.3)	1,603.7 (387.9)	1,136.9 (275.0)	387.6 (93.7)	25.8 (6.3)
Charges due on GRA credit 3/ Debt service due on GRA credit 3/		4.4 32.0	16.1 30.7	28.9 28.9	30.9 86.0	25.3 492.1	12.4 761.7	3.5 365.3
<b>Debt and Debt Service Ratios 4/</b>								
In percent of GDP								
Total external debt	44.2	47.1	54.0	52.3	49.6	46.0	42.1	34.2
External debt, public	31.6	35.5	41.9	40.8	38.0	34.3	30.3	24.6
GRA credit to Sri Lanka	0.8	2.5	6.1	6.5	5.9	3.9	1.2	0.1
Total external debt service	3.5	4.2	3.5	3.8	4.5	3.1	4.3	3.4
Public external debt service	3.2	3.3	2.9	3.4	4.2	2.9	3.1	3.2
Debt service due on GRA credit		0.1	0.1	0.1	0.3	1.7	2.4	0.9
In percent of Gross International Reserves								
Total external debt	1,107.7	920.9	536.3	477.6	483.5	516.8	401.2	255.9
External debt, public	791.3	693.7	416.4	373.0	370.6	385.2	289.2	184.5
GRA credit to Sri Lanka	19.7	49.0	60.3	59.2	57.1	43.5	11.7	0.5
In percent of Exports of Goods and Services								
Total external debt service	13.6	17.6	12.8	14.3	16.8	11.9	14.7	13.9
Public external debt service	12.5	13.7	10.8	12.6	15.8	10.9	10.6	12.8
Debt service due on GRA credit		0.5	0.5	0.4	1.2	6.4	8.3	3.7
In percent of Total External Debt								
GRA credit to Sri Lanka	1.8	5.3	11.2	12.4	11.8	8.4	2.9	0.2
In percent of Total External Debt Service								
Debt service due on GRA credit		3.0	3.7	2.9	7.0	53.5	56.3	26.9
In percent of Total Public External Debt								
GRA credit to Sri Lanka	2.5	7.1	14.5	15.9	15.4	11.3	4.0	0.3
In percent of Total Public External Debt Service								
Debt service due on GRA credit		3.8	4.4	3.3	7.5	58.5	78.1	29.1

Sources: Sri Lankan authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

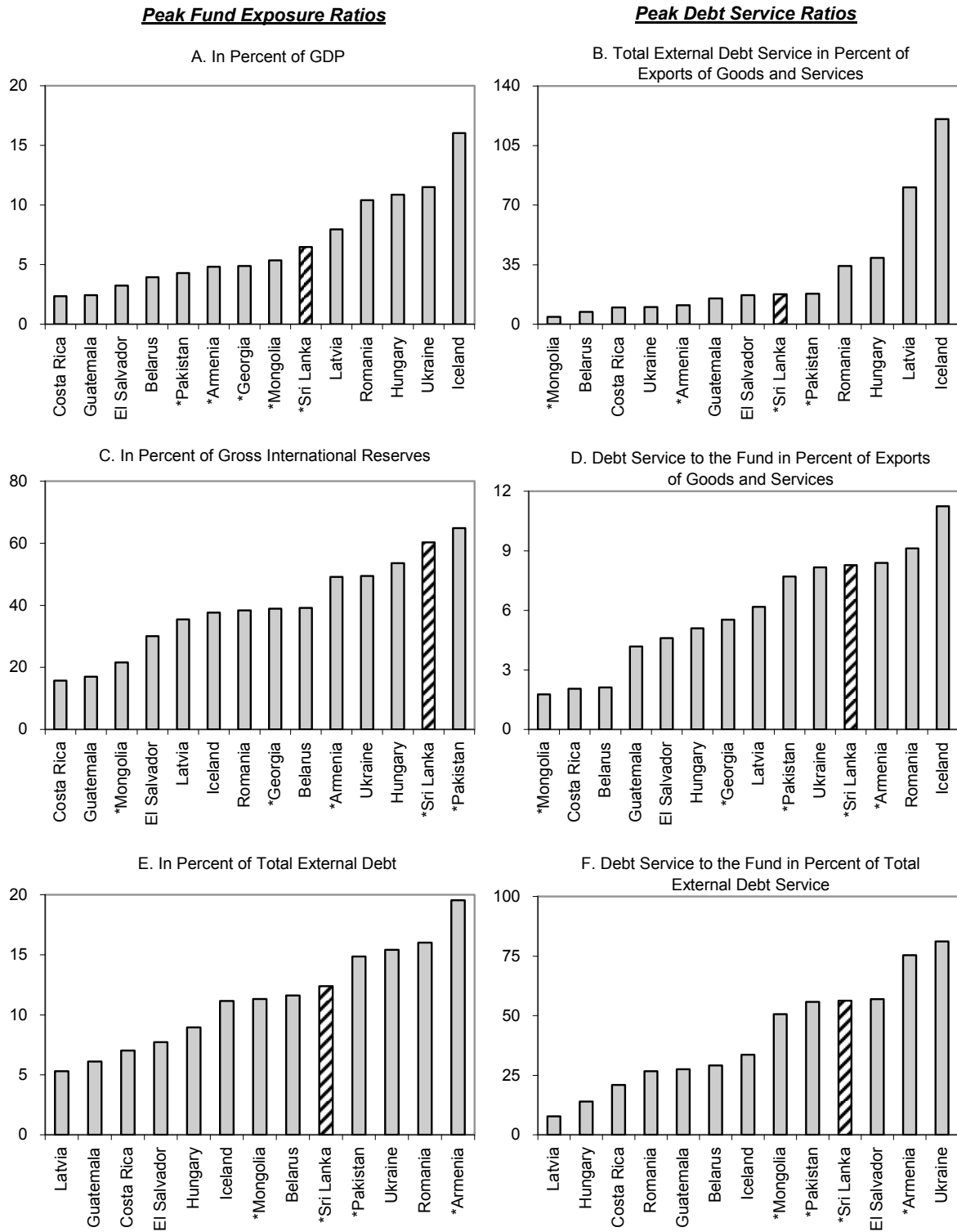
1/ Assumes full drawings.

2/ Repurchases follow the obligations schedule.

3/ Includes surcharges and service fees.

4/ Staff projections for external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed SBA. For July 2009, projections for external debt, GDP, gross international reserves, and exports of goods and services are as of end-December 2008.

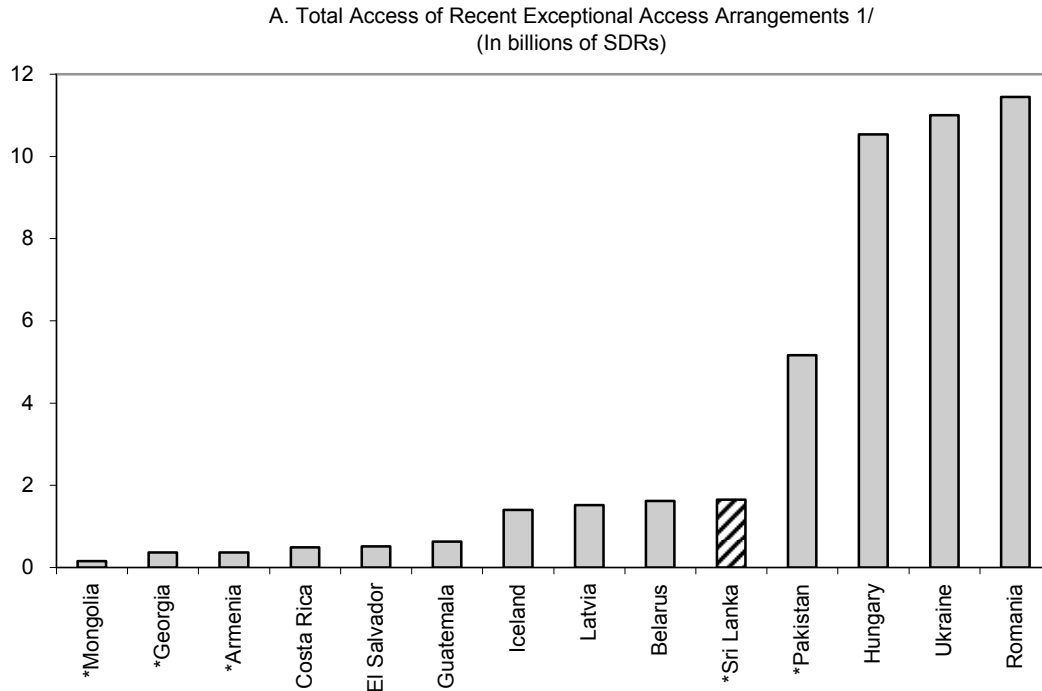
Figure 5. Peak Fund Exposure and Debt Service Ratios for Recent Exceptional Access Cases



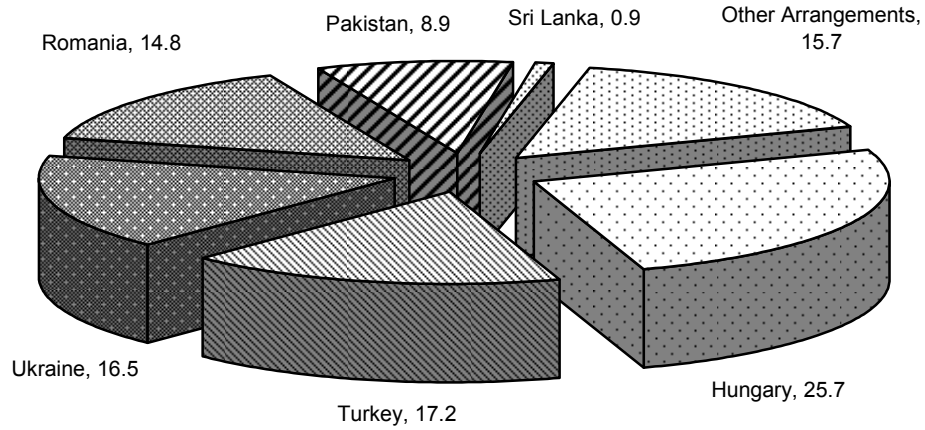
Source: Sri Lankan authorities and IMF staff estimates, and World Economic Outlook.

1/ Asterisks indicate PRGF eligible countries.

**Figure 6. Exceptional Access Levels and Credit Concentration**



B. Credit Concentration of Fund GRA Exposure 2/  
(As a percentage of total credit outstanding)



Source: Finance Department.

1/ Does not include FCL arrangements. Asterisks indicate PRGF eligible countries.

2/ Credit outstanding as of July 10, 2009 plus the first purchase under the proposed arrangement with Sri Lanka.

## B. Impact on the Fund's Liquidity Position and Risk Exposure

7. **The impact of the proposed arrangement on the Fund's liquidity and credit risk exposure is relatively modest.**

- **The proposed arrangement would reduce Fund liquidity by about 2 percent (Table 5).** Commitments under the proposed arrangement would reduce the one-year forward commitment capacity (FCC), which currently stands at SDR 91.5 billion, by about SDR 1.65 billion.<sup>5</sup>
- **If the first purchase is made, Fund credit to Sri Lanka would represent only 0.9 percent of total GRA Fund credit (Figure 6, Panel B),** making Sri Lanka one of the smaller users of Fund resources. The share of the top five users of Fund resources of total outstanding credit would decrease by a few percentage points to about 83 percent (Table 5).
- **In the event Sri Lanka were to fully draw on resources available under the proposed SBA, the Fund's burden sharing mechanism would be able to handle arrears on the charges accruing to Sri Lanka's GRA obligations.**<sup>6</sup> Charges on the GRA obligations would equal about SDR 4.4 million in 2009, about 15 percent of the current estimated residual burden-sharing capacity (Table 5). The impact on the Fund's burden sharing capacity of potential arrears from this arrangement would be expected to decline to the extent the demand for Fund resources continues to expand.
- **Potential GRA exposure to Sri Lanka would be small in relation to the current level of the Fund's precautionary balances.** After the first purchase, Fund credit to Sri Lanka would be about 2.9 percent of the Fund's current precautionary balances (Table 5), and the total access amounts to about 23.3 percent of current precautionary balances.

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<sup>5</sup> The FCC is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of GRA resources available for new financing over the next 12 months. See *Borrowing by the Fund—Operational Issues* (available via the internet at: <http://www.imf.org/external/np/pp/eng/2009/061709.pdf>).

<sup>6</sup> Under the burden-sharing mechanism, the financial consequences for the Fund that stem from the existence of overdue financial obligations are shared between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge, respectively. The mechanism is used to compensate the Fund for a loss in income when debtors do not pay charges. The Executive Board has set a floor for remuneration at 85 percent of the SDR interest rate. No corresponding ceiling applies to the rate of charge.



**Table 5. Sri Lanka—Impact on GRA Finances**

	as of 07/10/2009
<b>Liquidity measures</b>	
One-year Forward Commitment Capacity (FCC) (in millions of SDRs) 1/	91,534.1
Sri Lanka's impact on FCC 2/	(1,653.6)
<b>Prudential measures</b>	
Fund GRA credit outstanding to Sri Lanka (percent of current precautionary balances) 3/	2.9
Sri Lanka's annual GRA charges (percent of Fund's residual burden sharing capacity)	14.8
Fund GRA credit outstanding to Sri Lanka (percent of total GRA credit outstanding) 4/	0.7
<b>Memorandum items</b>	
Fund's precautionary balances (in millions of SDRs) 3/	7,093.0
Fund's residual burden sharing capacity (in millions of SDRs) 5/	30.0
Fund GRA credit outstanding to five largest debtors (percent of total GRA credit outstanding) 4/	83.1

Sources: Sri Lankan authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources minus undrawn balances under existing arrangements plus repurchases one-year forward minus a prudential balance. The FCC is determined on basis of available quota resources and resources available under bilateral borrowing arrangements. In addition, the Fund has access to SDR 34 billion under the NAB/GAB borrowing arrangements.

2/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.

3/ As of end-April 2009.

4/ Reflects total Fund credit outstanding plus the first purchase by Sri Lanka.

5/ Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

### III. ASSESSMENT

8. **The proposed Fund-supported program with Sri Lanka intends to support the authorities' economic program during a period of large external adjustment.** The proposed access aims at providing immediate relief to Sri Lanka's acute short-term balance of payments pressures. The proposed arrangement would also support the authorities' program of fiscal retrenchment while ensuring the availability of resources for reconstruction spending, greater exchange rate flexibility, and financial sector reform and social protection, while smoothing the necessary adjustment to the external shock that has hit the economy.

9. **There are substantial risks to the program that could affect Sri Lanka's capacity to repay the Fund.** The amount of depreciation required to meet the reserve targets over the next several months could exceed what the government might consider politically acceptable if market conditions worsen. It is also critically important that fiscal adjustment be sustained, implementing difficult measures now to offset the decline in revenues and to reign in spending in order to achieve the targeted deficit this year. Besides, the economy remains

vulnerable as weaknesses in the financial sector are likely to increase as the economy slows, particularly if Sri Lanka's trading partners were to experience a more rapid growth slowdown than currently expected. Finally, a sudden withdrawal of non-resident foreign exchange deposits from the banking sector, although unlikely at this point, would put pressure on reserves and could jeopardize the program's reserve targets.

10. **Overall, financial risks associated with the proposed arrangement for Sri Lanka are considerable, though the still comparatively small scale of access in absolute terms would contain the potential adverse impact on the Fund's finances.** While potential Fund exposure to Sri Lanka would be smaller than in a number of recent exceptional access SBAs, Fund exposure in terms of the stock of reserves and debt service to the Fund as a share of total external debt service will peak at levels that are higher than those in many recent exceptional access cases. However, the authorities' commitment to implementing firmly the program and to responding promptly to changes in economic conditions, together with Sri Lanka's track record of servicing external obligations, provides comfort that financial obligations to the Fund will be met in a timely manner.



Press Release No. 09/266  
FOR IMMEDIATE RELEASE  
July 24, 2009

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Executive Board Approves US\$2.6 Billion Stand-By Arrangement for Sri Lanka**

The Executive Board of the International Monetary Fund (IMF) today approved a 20-month Stand-By Arrangement for Sri Lanka in an amount equivalent to SDR 1.65 billion (about US\$2.6 billion) to support the country's economic reform program.

Upon the Executive Board's approval, an amount equivalent to SDR 206.7 million (about US\$322.2 million) becomes immediately available to Sri Lanka. The remaining amount will be phased in, subject to quarterly reviews. The total amount of IMF resources made available under the arrangement equals 400 percent of the country's quota.

The key objectives of the authorities' economic reform program supported by the Fund are to strengthen the country's fiscal position while ensuring the availability of resources for much needed post-conflict reconstruction and relief efforts. The program is also intended to rebuild international reserves and strengthen Sri Lanka's domestic financial system, and to protect the most vulnerable in the country from the burden of the needed economic adjustment. The program aims to lay a strong macroeconomic foundation that will help the authorities approach the broader international community for financial support in post-conflict reconstruction.

Following the Executive Board discussion on Sri Lanka, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chairman, stated:

“The global financial crisis has had a significant impact on Sri Lanka's economy. Persistently high budget deficits forced the government to rely on short-term financing from international markets. The global shock resulted in a sudden stop to this financing. Capital outflows and intervention by the central bank to prevent the exchange rate from depreciating—exacerbated by a decline in demand for Sri Lanka's exports—resulted in a significant loss of international reserves which, despite the recent rebound in capital inflows, remain very low.

“The government's ambitious program, supported by the IMF, intends to restore fiscal and external viability and address the significant reconstruction needs of the conflict-affected areas, thereby laying the basis for future higher economic growth.

“Reducing the central government fiscal deficit, while preserving spending on health and education and protecting the most vulnerable in society from the economic downturn, is a central goal of the government’s program. To that end, the authorities have put in place revenue enhancing measures and intend to introduce reforms to reduce tax exemptions and broaden the tax base beginning in the 2010 budget. This, together with savings on military spending and possible concessional donor financing, should help finance the considerable reconstruction spending needs.

“The program aims to rebuild reserves to prudent levels while allowing the flexibility in the exchange rate necessary to boost the competitiveness of Sri Lanka’s exports. At the same time, the central bank’s policies will aim to control inflation while ensuring adequate credit to the private sector.

“The government has also moved quickly to address vulnerabilities in the banking system, implementing a plan to recapitalize the troubled Seylan Bank. The government intends to develop a contingency plan to deal with potential stresses in the financial system and put in place measures to improve regulation and address financial sector supervisory gaps.

“The government’s program will require difficult economic reform measures. Nevertheless, the government should take advantage of the opportunity created by the end of the conflict to ensure national reconciliation, restore macroeconomic stability, and promote strong and durable growth,” Mr. Kato said.

## Recent Economic Developments

Sri Lanka has been hit hard by the global economic and financial crisis. After years of reliance on short-term financing from international markets to cover its fiscal deficit, Sri Lanka experienced a sudden stop of international capital flows as the global crisis hit. The central bank's initial efforts to keep the exchange rate from depreciating led to a significant loss of reserves. Despite a rebound in short-term capital inflows following the end of the conflict, reserves remain low and foreign exchange needs remain acute. The economic growth outlook has deteriorated with growth of around 3 percent expected this year compared to 6 percent in 2008. The financial sector has also been put under increasing stress as the economic slowdown takes its toll.

The end of the conflict further added policy challenges to the authorities. The reconstruction and humanitarian relief efforts are a large undertaking. Significant spending priorities need to be met while debt sustainability is maintained.

## Program Summary

Against this background, the Sri Lankan authorities have embarked on a program of economic reform and post-conflict reconstruction. They have requested IMF financial assistance to support their efforts.

The program includes the following key elements:

- **Fiscal policy:** The program aims at reducing the central government budget deficit to 5 percent of GDP by 2011, from a target of 7 percent of GDP this year, in line with the Fiscal Responsibility Act. Revenue increasing measures include broadening the tax base, reducing tax exemptions and improving enforcement, which are coupled with measures to rationalize expenditures. Cuts in military and other expenditures will help make room for post-conflict reconstruction and relief spendings.
- **Exchange rate and monetary policy:** The program envisions strengthening the country's international reserve position and restoring external viability. Allowing greater exchange rate flexibility is also needed to facilitate external adjustment and ensure export competitiveness.
- **Social protection:** With 15 percent of the population living below the poverty line and a large number of people in the North and East of the country displaced by the conflict, the program envisions protecting expenditures on social transfers to the country's most vulnerable. Spending on post-conflict humanitarian assistance will be also secured through savings from spending cuts and external financing and grants from multilateral institutions and the donor community.

- **Financial system:** To build confidence in the local financial system, the program includes measures to strengthen the banking system by improving the current regulatory framework and enhancing bank supervision.

Sri Lanka, which joined the Fund on August 29, 1950, has a quota of SDR 413.4 million (about US\$644.4 million).

**Statement by Adarsh Kishore, Executive Director for Sri Lanka  
and K.G.D.D. Dheerasinghe, Alternate Executive Director  
July 24, 2009**

1. Our Sri Lankan authorities wish to place on record their appreciation of the Fund staff for the useful discussions held in Colombo during February 26 – March 10, March 23 – 31 and July 6 - 11, 2009 and for the set of well focused papers that have been produced in connection with the proposed Stand-By Arrangement. Whilst thanking for the assistance provided to Sri Lanka in the past, our authorities also look forward to continued support and cooperation of the management and the Executive Board of the IMF in their future endeavour.

2. Sri Lanka's economy performed impressively in the recent past and real GDP growth rate, on average, during 2004 - 2008 was around 6.5 per cent, despite challenging external and domestic circumstances. Owing mainly to adverse global conditions, the growth rate for the first quarter of 2009 has dropped to a moderate 1.5 per cent. Sri Lankan economy, given its high degree of openness, suffered heavily from the contraction of external trade as its exports and imports dropped by 18.9 percent and 38.0 percent, respectively, during the first five months of 2009. However, with the ending of the war against terrorism that lasted for over two and a half decades in May 2009 and the Northern and Eastern Provinces of the country returning to normalcy, our authorities are confident that the growth performance of Sri Lanka, will bounce back mainly on account of the expansion of the domestic economy. With the hope that global economy will recover, Sri Lanka's growth performance is expected to be much better in 2010 and with external conditions becoming more conducive, Sri Lanka will return to its high growth trajectory in 2011.

### **Macroeconomic Policy Framework**

3. The development policy framework of Sri Lanka is outlined in the 'Mahinda Chinthana' vision for Sri Lanka and the 'Ten-year Horizon Development Framework: 2006-2016', a Policy document that covers different socio-economic situations, built up on the basis of free market concepts having regard to domestic aspirations to promote economic activity through both domestic and foreign investment. With the implementation of the policies of this development framework, growth of the economy accelerated, regional disparities reduced and unemployment and poverty levels reduced to historic low levels by 2008.

### **Recent Developments**

4. The economic fundamentals of Sri Lanka improved steadily until the third quarter of 2008. External official reserves rose to their all time high level of US\$ 3.6 billion in July 2008. The fiscal targets were on the consolidation path and public debt to GDP ratio dropped steadily from 102.3 percent in 2004 to 81.1 percent in 2008. The expansion in monetary aggregates was controlled and inflation had been on a declining trend since July 2008. The economy grew at an average rate of around 7.0 percent during the four year period from 2004 to 2007 before edging down to 6.0 percent in 2008. Sri Lanka's balance of payments, in

surplus since 2005, suffered severely in 2008 owing mainly to unprecedented surge in international food and fuel prices and reversal of capital flows with the intensification of global financial crisis .

### **The Impact of the Global Crisis**

5. The intensification of global financial crisis since September 2008 adversely impacted the economy as reflected in several economic indicators, particularly, those relating to the external sector, with their implications on fiscal position. The external official reserves dropped by more than 65.0 percent from US\$ 3.2 billion in September 2008 to US\$ 1.1 billion by the end of the first quarter of 2009 and this outcome was as a result of (a) sudden withdrawal of investment in government bonds by foreign investors; (b) reduction in the access to short term trade financing facilities; (c) contraction of other external commercial financing and (d) large valuation losses arising from the sharp depreciation of major international currencies against the US dollar. Real GDP growth is projected to decelerate to 3.0 percent in 2009 due to the impact of adverse global conditions. This situation has necessitated the request for assistance from the Fund.

### **Fiscal Policy**

6. Despite challenging conditions, the overall fiscal deficit was reduced from 8.4 percent of GDP in 2005 to 7.7 percent in 2008, while also arresting the declining trend in much needed public investment during this period. The Government is committed to a sound fiscal consolidation programme with the fiscal deficit targeted at around 5.0 percent of GDP in 2011. The medium term fiscal targets will be supported by at least 2.0 percent additional growth in tax revenue and rationalization of expenditures while placing strong emphasis on reconstruction and development efforts as well as the social safety nets for the vulnerable groups. The early resettlement of the internally displaced is the top most priority. The sharp decline in the yield rates of government securities from about 17.0 percent since the beginning of this year to around 11.0 percent in July, in line with the sharp reduction in inflation, will result in a significant reduction in interest cost of public debt. The interest cost of public debt will further reduce as the interest rates are currently on a declining trend.

### **The Fiscal Policy Strategy**

7. The revenue performance projected at 14.8 per cent of GDP for 2009 is expected to be achieved despite adverse global conditions. During the early part of the year, the expected government implemented several new tax measures to ensure that revenue targets are met and macro-economic stability is maintained. These measures include upward revision of the rate of Nation Building Tax from 1.0 to 3.0 percent, and raising of excise taxes on liquor, cigarettes and several other consumer items. As part of a further revenue measure in the medium term, it has been decided not to extend tax holidays granted under BOI Act at their expiry and limit such holidays in future to only 3 years. A directive has also been issued to all government institutions to maintain strict controls on expenditure.



8. The Government has formed a Tax Commission this month to review the current taxation policies and to make recommendations on a comprehensive approach to simplify the tax system, strengthen tax collection, and improve the auditing and enforcement. An interim report of the Tax Commission due in mid October 2009 is expected to come up with helpful recommendations to be incorporated in the 2010 Budget for early implementation.

### **Monetary Policy**

9. The Central Bank of Sri Lanka (CBSL) pursued a tight monetary policy stance through a quantity targeting approach by imposing limits on access to the CBSL credit and brought down sharply the monetary expansion and consequently inflation. In the wake of the rapid decline in inflation since late 2008, the CBSL has gradually eased its monetary policy stance in order to maintain economic activity buoyant. The CBSL thus far has removed the penal rate on reverse repurchase transactions, reduced the policy rates and lifted the limits imposed on access to CBSL windows by banks and primary dealers. The statutory reserve ratio was also reduced from 10.0 percent in October 2008 to 7.0 percent in February 2009. In response to these measures, market interest rates have shown a pronounced decline. The overnight call market rates have fallen and remain within the policy rate corridor of 8.5 percent and 11.0 percent. The yield rates of Treasury Bills and Bonds have shown a marked decline in the range of 630 – 680 basis points so far during the year. This situation has resulted in a substantial lowering of cost of funds to financial intermediaries, thus facilitating a gradual reduction in lending rates. The “Road Map - Monetary and Financial Sector Policies for 2009 and Beyond” stipulates among other things, actions to control inflation while ensuring adequate credit to the private sector.

### **Exchange Rate Policy**

10. The CBSL has allowed greater flexibility in the exchange rate in recent months to facilitate necessary adjustments in view of global economic and financial developments and to enable the building of its international reserves. Accordingly, the CBSL has not engaged in sale of foreign currency in the market since late March 2009 and the forex market has stabilized with a positive outlook following the end of the conflict in May 2009. In fact since March 2009 CBSL has purchased US\$ 704 million from the market and this has assisted in arresting appreciation pressures whilst building up its external reserve position. The gross official reserves of CBSL have improved by 48.0 per cent but the reserves need further strengthening to ensure sustainable macro economic stability.

11. The CBSL has also removed completely the margin requirements on the importation of certain categories of vehicles imposed in 2004 and enhanced in October 2008, and on selected consumer goods imposed in November 2008 in order to facilitate more flexibility in the exchange rate.

Our authorities wish to clarify that CBSL intervention in the market has not made the exchange rate overvalued. In fact, the CBSL intervention during the first half of 2008 prevented a sharp appreciation as large sums of excess foreign currency inflows were purchased by the CBSL. Such action has been continued by the CBSL to date since April

2009. Without such action by the CBSL, the exchange rate would have appreciated sharply by now. During the period of global financial turmoil, the CBSL maintained some stability in the nominal exchange rate by intervening in order to prevent disruptive movements of the exchange rate resulting from large outflows of short-term capital. Some appreciation of the real exchange rate caused during this period was reversed by bringing down inflation sharply to below one per cent in July 2009 from a high 28.2 per cent in mid 2008. Therefore, the statement that the CBSL intervention policy has resulted in an overvaluation of the exchange rate, is not justifiable.

### **External Sector**

12. Reflecting the impact of the global crisis, Sri Lanka's exports earnings decreased sizeably during the period January – May 2009, but as imports dropped at a faster pace as stated earlier, Sri Lanka's trade deficit contracted significantly by 61.9 per cent during the first five months of 2009 as compared to the corresponding period of 2008. The private remittances surged to US\$ 1,309 million during the first five months of 2009 as compared to US \$ 1,272 million during the same period of 2008 and have more than offset the trade deficit so far in 2009. The current account deficit is expected to narrow down to 1.2 percent of GDP in 2009 from 9.3 percent in 2008. The external debt and liabilities as a percentage of GDP is expected to decline to 43.5 percent this year as compared to 51.0 percent in 2007 and 43.7 percent in 2008.

13. Following a large outflow of capital in 2008 and in the first four months of 2009, Sri Lanka is now experiencing significant inflows. In addition to growing private remittances, inflows are on account of increased foreign investment in domestic currency denominated government securities and debt. Foreign investors have purchased Sri Lanka government securities amounting to US\$220 million since mid-May to mid-July 2009. The all-share price index of the Colombo Stock Exchange has risen by 59.3 percent from 1503.0 by end December 2008 to 2395 on July 17, 2009 mainly on account of growing investor confidence.

### **The Financial Sector and Regulatory Framework**

14. Sri Lanka has a strong and resilient banking system as manifested in impressive financial soundness indicators - high capital adequacy ratios, relatively low non-performing loan (NPL) ratios and healthy profitability ratios - though they have deteriorated marginally in 2008 compared to 2007.

15. The regulatory framework of banks remains strong with the implementation of Basel II and a mandatory Direction on Corporate Governance. The other regulatory measures that were put in place recently include a revised direction on loan classification, provisioning and income recognition including a general provision of one percent on all outstanding performing loans, limits on share ownership and maximum amount of accommodation. In order to further strengthen the supervisory framework for banks it is proposed to amend the Banking Act and issue guidelines on integrated risk management of banks.

16. Swift action by the CBSL ensured the stability of a systemically important licensed bank that was affected by failure of an unregulated credit card company in a large financial conglomerate in the country. The CBSL will continue to implement the eight-point stimulus package for finance and leasing companies with the objective of avoiding spillovers to healthy financial institutions.

### **Post-Conflict Reconstruction and Development of the Northern Province**

17. Since the full liberation of the terrorist controlled areas in the Northern Province and end of conflict in May 2009, our authorities have accorded the highest priority, and have moved quickly in providing humanitarian assistance to nearly 300,000 Internally Displaced Persons (IDPs) affected by the conflict and to develop a post conflict reconstruction and development plan. The authorities have got hands-on experience from handling a similar situation in the Eastern Province which was liberated from the terrorists in late 2007 and the overall reconstruction strategy in the newly liberated Northern Province is built on the experience gained from the Eastern Province which has now returned to normalcy. In the Eastern Province, de-mining has been almost completed and development projects in the areas of roads and bridges, electricity, water supply and drainage etc. are being fast completed. Some cottage industries such as weaving, clay products and handlooms etc. are promoted as livelihood activities while agriculture, especially paddy, maize and vegetable cultivation and fisheries and livestock farming have been restored. Almost all IDPs in the Eastern Province have now been resettled in their original places or places of their choice of residence. Local Government and Provincial Council elections were also held.

18. A high powered institutional and administrative structure including a Presidential Task Force (in terms of Article 33 (f) of the constitution of Sri Lanka) and a Consultative Committee on Humanitarian Assistance consisting of members of the international community were constituted by the government immediately after the war came to an end in May 2009. The Task Force is entrusted with the formation and implementation of the post war reconstruction plan for the Northern Province.

19. The programme being implemented is based on (a) De-militarization; (b) Development; (c) Democratization and (d) Devolution. The Task Force has declared a timeframe of 180 days to accomplish the tasks assigned to it and it is expected to resettle at least 80 percent of the IDPs during this period. De-mining and sanitization are a pre-requisite for resettlement of IDPs and this is being done by the military with the assistance of local and international NGOs. Significant progress has thus far been made on the de-militarization process and restoration of law and order. Resettlement of IDPs, is a part of “Development” and this process has already begun. The basic needs of IDPs which include provision of adequate food, water for drinking and other purposes, healthcare and sanitation facilities, education, counseling, welfare programs for displaced children and disabled, legal and all other services to ensure early return to normalcy are being ensured.

20. Under “Democratization” it is expected to re-establish the civil administration soon. As the first step in this process, elections to main local government institutions will be held

on August 8, 2009. The elections to other local authorities and the Northern Provincial Council will be held as soon as the de-militarization programme comes to an end.

21. Reconstruction activities are now funded through Rs.18.0 billion (US \$ 157 million) set aside for the purpose in the 2009 Budget and donor assistance. The authorities are confident that enhanced funding from multilateral agencies such as the World Bank, Asian Development Bank and other development partners will be available for more medium to long-term projects relating to infrastructure programs such as, power generation and distribution, water supply, improving the railways and road network, construction of schools and hospitals. The government has already identified major projects in the above areas and is hoping to complete most of the work during the next 2-3 years with a major part of infrastructure development programme to take place in 2010 and 2001.

### **Conclusion**

22. Our Sri Lankan authorities have a clear understanding of the goals and sequencing of the Fund programme. The proposed SBA with the IMF will boost investor confidence and help the country in passing through this challenging period towards successful implementation of reconstruction and development programmes in the war torn areas, while also making progress in the development programmes in the rest of the country. Our authorities are fully committed to implementation of the programme in all aspects. They are confident that with the support of the Fund, the economy of Sri Lanka will return to its trajectory of high growth with stability by the end of the programme.