INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/253

SRI LANKA

August 2017

SECOND REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY, REQUEST FOR WAIVERS OF APPLICABILITY AND NONOBSERVANCE OF PERFORMANCE CRITERION, AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR DIRECTOR FOR SRI LANKA

In the context of the Second Review Under the Extended Arrangement Under the Extended Fund Facility, Request for Waivers of Applicability and Nonobservance of Performance Criterion, Request for Modification of Performance Criterion, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 17, 2017, following discussions that ended on March 7, 2017 with the officials of Sri Lanka on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on June 27, 2017.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Sri Lanka.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Sri Lanka*
Memorandum of Economic and Financial Policies*
Technical Memorandum of Understanding*
*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Press Release No. 17/288
FOR IMMEDIATE RELEASE
July 17, 2017

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review of the Extended Arrangement Under the EFF with Sri Lanka and Approves US$ 167.2 Million Disbursement

- IMF Executive Board completed the second review of Sri Lanka's Extended Fund Facility (EFF) arrangement, which enables the disbursement of about US$ 167.2 million.

- The new Inland Revenue Act will support fiscal consolidation, make the tax system more efficient and equitable, and generate resources for social and development programs.

- Further accumulating international reserves and enhancing exchange rate flexibility will help reduce Sri Lanka's external vulnerability.

On July 17, 2017, the Executive Board of the International Monetary Fund (IMF) completed the second review of Sri Lanka's economic performance under the program supported by a three-year extended arrangement under the Extended Fund Facility (EFF) arrangement. Completion of the review enables the disbursement of the equivalent of SDR 119.894 million (about US$ 167.2 million), bringing total disbursements under the arrangement to the equivalent of SDR 359.682 million (about US$ 501.5 million).

In completing the review, the Executive Board granted a waiver of nonobservance of the continuous performance criterion on accumulation of external arrears which was missed due to continued difficulties of establishing a payment platform and waivers of applicability of the performance criteria for end-June 2017 on floor of the central government primary balance and the program net official international reserves of the Central Bank of Sri Lanka, given the unavailability of the information necessary to assess observance.

Sri Lanka's three-year extended arrangement was approved on June 3, 2016 in the amount of about SDR 1.1 billion (US$1.45 billion, or 185 percent of quota in the IMF at that time of approval of the arrangement. See Press Release No. 16/262). The government's reform program, supported by the IMF, aims to reduce the fiscal deficit, rebuild foreign exchange reserves, and introduce a simpler, more equitable tax system to restore macroeconomic stability and promote inclusive growth.

Following the Executive Board's discussion of the review, Mr. Mitsuhiro Furusawa, Acting Chair and Deputy Managing Director, said:

"Sri Lanka's performance under the Fund-supported program has been broadly satisfactory. Macroeconomic and financial conditions have been stable, despite severe weather events and global market volatility. The authorities launched fundamental income tax reform, undertook meaningful corrective actions to achieve program targets on international reserves, and remain committed to the reform program. Going forward, the reform momentum should strengthen further with greater ownership, building on the progress made so far.

"Fiscal performance has been strong. Targets for the fiscal balance and tax revenue have been met. The new Inland Revenue Act, which has been submitted to parliament, will support fiscal consolidation, make the tax system more efficient and equitable, and generate resources for social and development programs. Nevertheless, Sri Lanka's high debt burden and gross financing needs require further revenue-based consolidation. Timely progress in structural reforms, including tax administration and energy pricing, will strengthen the platform for durable consolidation.

"Inflation and credit growth remain on the high side. While monetary policy was tightened in March, further tightening is desirable until clear signs emerge that inflation pressures and credit expansion have subsided. While financial soundness indicators remain stable, banks' capital adequacy ratio has declined due to rapid credit growth. Financial sector supervision should be strengthened, and macro-prudential measures could be deployed to rein in credit growth if needed.

"Continued international reserves accumulation and enhanced exchange rate flexibility, to which the authorities are committed, would reduce Sri Lanka's external vulnerabilities."

INTERNATIONAL MONETARY FUND

SRI LANKA

June 27, 2017

SECOND REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY, REQUEST FOR WAIVERS OF APPLICABILITY AND NONOBSERVANCE OF PERFORMANCE CRITERION, AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION

EXECUTIVE SUMMARY

Sri Lanka's economic reform program is supported by an Extended arrangement under the Extended Fund Facility (EFF) that was approved in June 2016 for the amount of SDR 1.1 billion (185 percent of quota and about US$ 1.5 billion) over 36 months. So far two purchases equivalent to SDR 239.788 million have been made, and another purchase equivalent to SDR 119.894 million will be made available upon completion of the second review.

Economic growth held up in 2016 despite the fiscal consolidation and weather-related shocks. Growth was supported by robust activity in the industry and service sectors, and improved confidence following the EFF program agreement in June. Despite some delay in passing the VAT amendments, the authorities met the program targets on tax revenues and the primary balance. However, the end-2016 reserve target was missed reflecting the resumption of portfolio outflows late in the year and intervention to limit currency depreciation. Progress has been made in most fiscal-structural reforms, but energy pricing reforms have stalled due to political resistance.

The authorities remain committed to the economic reform program and undertook meaningful corrective actions where targets were missed. As a prior action, the new Inland Revenue Act (IRA) will be submitted to parliament. The authorities also strengthened tax administration and are conducting a diagnostic review of VAT. SOE oversight is improving, and energy pricing reforms are being recalibrated to address earlier setbacks. The central bank took steps to address the missed end-2016 reserve target by resuming since March 2017 the build-up of reserves. In response to high inflation, the central bank tightened monetary policy in March 2017, and stands ready to tighten further should inflation or credit growth stay high.

Going forward, the reform momentum should strengthen further, building on the progress made so far. To reduce the risk of debt distress, fiscal consolidation should continue at steady pace. This would require legislating and implementing the new IRA, strengthening the VAT system and administration, and making further progress in expenditure management and SOE reforms. Monetary policy should be tightened to rein in inflation and credit growth, and reserve accumulation should continue while allowing for greater exchange rate flexibility.

Approved By
Kenneth Kang and Bob Traa

Discussions were held in Colombo during February 21–March 7, 2017, and in DC during the Spring Meetings week (April 25–30). The mission met with Prime Minister Wickremesinghe, then Finance Minister Karunanayake, Central Bank of Sri Lanka Governor Coomaraswamy, Secretary to the Treasury Samarathunga, other senior officials and private sector and civil society representatives. The mission comprised Mr. Lee (Head), Ms. Jahan, Mr. Nozaki (all APD), Mr. Danforth (FAD), Ms. Tambunlertchai (SPR), Ms. Kvintradze (resident representative), and Mr. Wijeweera (local economist). Mr. Kang (APD) and a TA mission comprising Messrs. Hillier and Aw (both LEG) joined for part of the mission, and Ms. Gunaratne (OED) participated in the policy discussions. Messrs. George and Sullivan also contributed to the preparation of this report.

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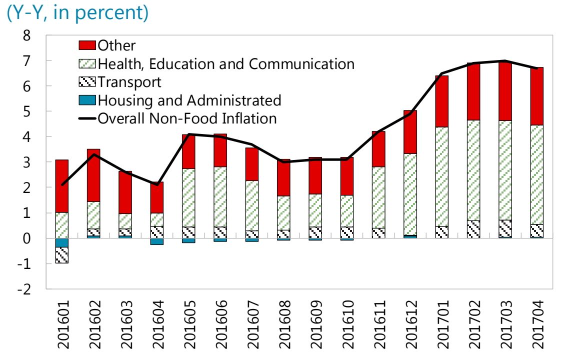
CONTEXT

1. Sri Lanka has been pursuing a multi-year reform program with the IMF support under the Extended Fund Facility (EFF) since June 2016. Domestic revenue mobilization based on sweeping tax reforms constitutes the core of multi-year fiscal consolidation aimed at reducing external vulnerability and laying the foundation for sustained growth. Other key elements of the reform program are to: build up international reserves and allow for greater exchange rate flexibility; strengthen tax administration and public financial management; and improve financial conditions of major state enterprises. The reform program was adopted by the coalition government, which came to power in 2015 led by President Sirisena and Prime Minister Wicrkemesinghe.

RECENT DEVELOPMENTS

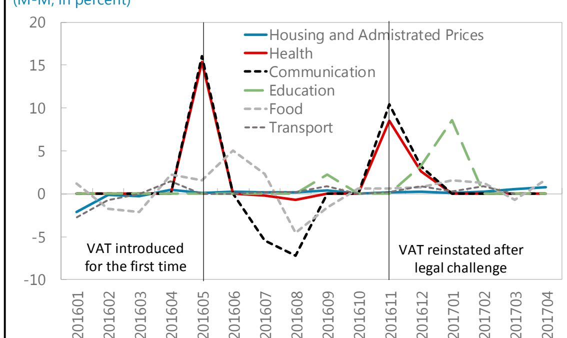
2. Growth has held up despite severe weather and inflation has picked up. Real GDP growth in 2016 was 4.4 percent, supported by construction and service related activities which offset a sharp contraction in agriculture due to the floods in May and the drought in Q4 (Box 1). Headline inflation peaked at 7.3 percent in March 2017 largely due to a VAT rate hike and the drought-related increases in food prices, before easing slightly to 6.9 percent in April. To contain inflation expectations, the Central Bank of Sri Lanka (CBSL) raised the policy rate by 25 basis points (bps) in March, after having kept the policy rate unchanged since a 50 bp hike last July. Average lending rates increased by about 200 bps between January 2016 and April 2017.

Contributions to Non-Food Inflation
(Y-Y, in percent)



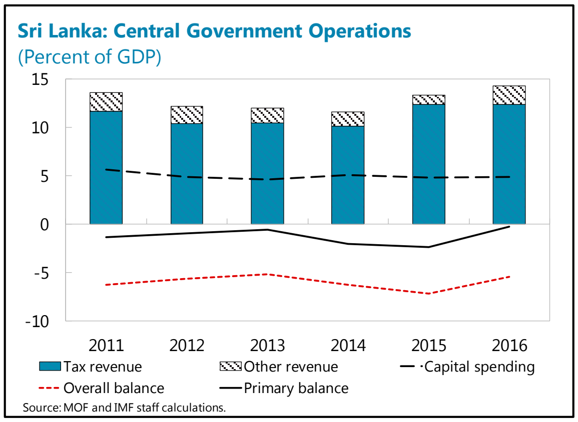
Sources: Central Bank of Sri Lanka and Staff Calculations

Inflation by Component
(M-M, in percent)

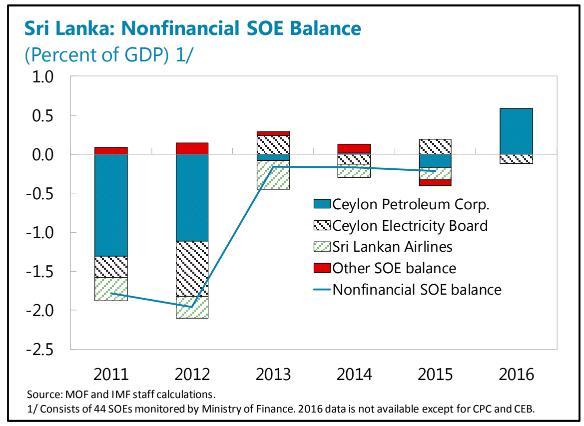


Sources: Central Bank of Sri Lanka and IMF Staff Calculations

3. Public finances have strengthened under the program. The overall fiscal deficit decreased from 7 to 5.4 percent of GDP between 2015 and 2016, underpinned by a 2 percent-of-GDP reduction in the primary deficit. The tax-to-GDP ratio remained unchanged at 12.4 percent in 2016 as one-off revenue increases in 2015 were replaced by buoyant tax collections. The expenditure-to-GDP ratio fell below 20 percent owing to rationalization of goods and services spending, while capital spending increased slightly. Two energy SOEs—the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB)—also recorded a combined profit of 0.5 percent of GDP in 2016 compared to balance in 2015. Nevertheless, public debt rose from 82 to 84 percent of GDP between 2015 and 2016 largely due to exchange rate depreciation and an increase in guaranteed debt (Annex I).

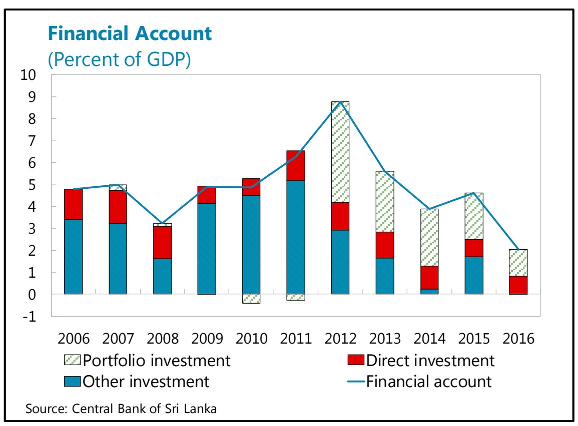


Sri Lanka: Central Government Operations
(Percent of GDP)
Source: MOF and IMF staff calculations.

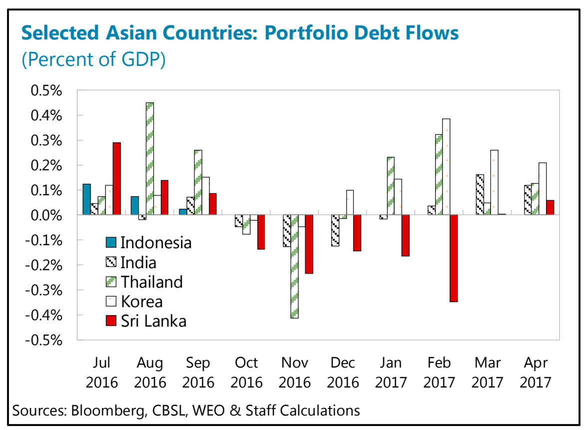


Sri Lanka: Nonfinancial SOE Balance
(Percent of GDP) 1/
Source: MOF and IMF staff calculations.
1/ Consists of 44 SOEs monitored by Ministry of Finance. 2016 data is not available except for CPC and CEB.

4. The current account remained in a small deficit. The current account deficit was contained at 2.4 percent of GDP in 2015 and 2016, helped by strong tourism and remittances which offset the sizable goods trade deficit of 11 percent of GDP. The financial account came under pressure with the reversal of portfolio flow and unwinding of an official swap line ($700 million) in Q4. Reflecting the global EM sell-off in Q4, foreign investors repatriated their holdings of rupee-denominated government securities by $372 million (0.5 percent of GDP). Strong FDI ($636 million) and project disbursements provided some reprieve.



Financial Account
(Percent of GDP)
Source: Central Bank of Sri Lanka

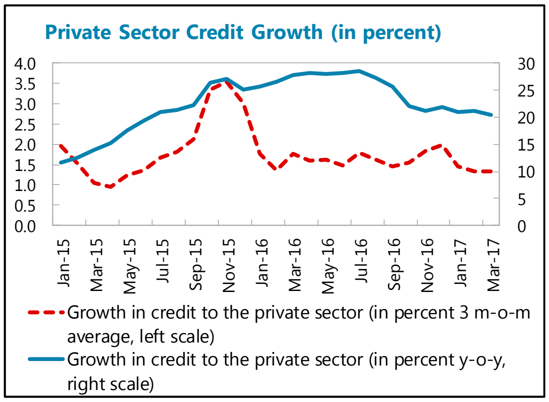


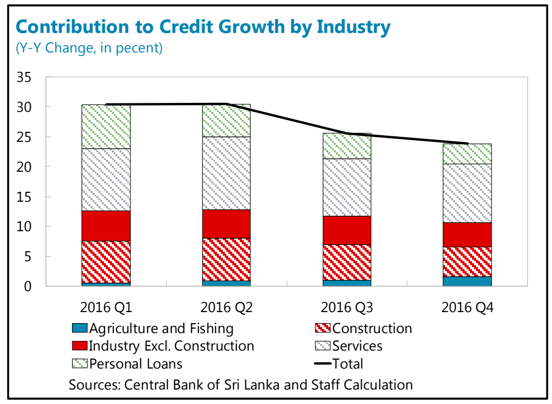
Selected Asian Countries: Portfolio Debt Flows
(Percent of GDP)
Sources: Bloomberg, CBSL, WEO & Staff Calculations

5. As a result of large portfolio outflows, international reserves hit their bottom in February 2017. The CBSL intervened in the foreign exchange (FX) market to keep the exchange rate stable, selling $89 million on a net basis in 2016Q4 in the face of portfolio outflows. The rupee depreciated by only 2 percent in Q4 against the US$, much less than other EM currencies. Gross international reserves (GIR) declined to $6.0 billion at end-2016, with reserve coverage dropping to about 3 months of import cover or 56 percent of the ARA metric—a level short of foreign currency claims coming due in 2017 (Annex II). Portfolio outflows continued into February, and reserves declined by $384 million. Since late February, outflows have stabilized and the CBSL resumed accumulation of reserves via net FX purchases. A successful placement of sovereign bonds of $1.5 billion in early May increased reserves by as much.[1]

[1] The bonds have a 10-year maturity and were priced at 6.2 percent.

6. Despite some slowing, credit growth remains high. After peaking at 28.5 percent y/y in July 2016, credit growth decelerated to 20.4 percent in March 2017, reflecting largely the base effect caused by a bank merger in October 2015. Credit growth was robust across most sectors except for personal loans whose growth slowed from 31 percent in 2016Q1 to 15 percent in 2016Q4 (y/y).





OUTLOOK AND RISKS

7. Outlook. Real GDP growth is projected to recover gradually to 4.7 percent in 2017, supported by the continued momentum in construction and service sectors since late 2016. Headline inflation peaked in March but will likely stay above 5 percent for much of the year due to high food prices and base effects from the VAT rate hike in 2016. The current account deficit is expected to widen slightly to 2.5 percent of GDP due to drought-driven increases in oil and food imports, and higher capital goods imports. While a small negative output gap is estimated for 2017, GDP growth is projected to reach 5.2 percent over the medium term in line with potential (Box 2).

8. Significant downside risks confront the economy. The main external downside risk is the resumption of capital outflows in response to a significant further strengthening of the US dollar and higher rates, or due to a weakening of the external position. The yet-unproven commitment to exchange rate flexibility under capital outflows adds to the risk. The main domestic risks stem from further delays in revenue mobilization and SOE reforms, as well as pressures from the government's large gross financing needs (19 percent of GDP in 2017), of which 40 percent is financed externally. A larger-than-estimated fiscal cost of drought could also add to these financing pressures. Another risk emanates from the still uncertain economic consequence of the floods in late-May 2017.

9. Risks to public debt sustainability continue to remain high. Public debt is expected to rise slightly to 85 percent of GDP in 2017 due to still large fiscal deficit and exchange rate depreciation (Annex I). The medium-term overall deficit target of 3.5 percent of GDP remains appropriate for reducing the risk of debt distress, and would lower the public debt to GDP ratio to 76 percent of GDP by 2020 under the programmed fiscal consolidation. If contingent SOE debt is included, total public debt would rise to 94 percent of GDP (considered as a shock scenario in DSA) and decline below 90 percent of GDP by 2020. The likelihood of such a scenario has increased due to delays in energy pricing reform (¶23). External debt remains sustainable but is high at 57 percent of GDP and vulnerable to currency risks. And rollover need will increase as external sovereign debt begins to mature in 2019, calling for advance planning and medium-term debt management.

Box 1. Drought and its Macroeconomic Implications

Drought. Rainfall over August–December 2016 fell far short of the historical average, with September being the lowest at less than 20 percent of a normal year. The drought was preceded by heavy rain and flooding in May, an erratic weather pattern possibly caused by climate change.[1] Although rainfall has recovered since January, the water availability in the nation's reservoirs was only 40 percent of capacity in March, still below 70 percent a year ago.

Economic impact. Agricultural production has suffered, bringing down GDP by an estimated 0.3 percentage points in 2017 and water supply for drinking and hydropower generation fell. A food shortage and an increase in thermal power generation are expected to raise imports of food and oil by 0.3 percent of GDP this year. Food inflation accelerated to 8.6 percent in April, and about one third of the affected population experienced income losses.

Fiscal impact. The government is providing cash transfers to affected families for a limited duration, with the cost estimated at 0.05–0.1 percent of GDP. The increase in thermal power generation in late 2016–early 2017 could—at current tariffs—inflict financial losses of about ¼ percent of GDP for the CEB, the state electricity company. This will eventually raise public debt if not covered by future tariff increases.

1/ Global warming is projected to make monsoon rainfall more variable in South Asia, with greater frequency of devastating floods and droughts (World Bank, 2013, "Turn Down the Heat: Climate Extremes, Regional Impacts, and the Case for Resilience").

PROGRAM PERFORMANCE

10. Quantitative targets. Both the end-2016 and end-March 2017 targets were met for the primary balance and tax revenues, while both the end-2016 and end-March 2017 targets were missed for net international reserves and reserve money. The monetary policy consultation clause was not triggered as inflation remained within the target band.

- The primary deficit was contained to Rs 29 billion, meeting the quantitative performance criteria (QPC) ceiling of Rs 97 billion in 2016 (text table ¶16). Tax revenue was Rs 1,464 billion, above the indicative target (IT) of Rs 1,428 billion. At end-March, the primary balance and tax revenue were Rs 9 and 415 billion, overperforming respective ITs of Rs -5 and 383 billion.

- The December QPC floor on net international reserves (NIR) was missed by US$411 million, due to net FX sales of $89 million in 2016Q4 rather than the net FX purchase of $330 million as envisaged in the program. FX purchases resumed in late February but were insufficient to make up for the shortfall, resulting in the March IT floor being missed by US$ 169 million.

- December reserve money at Rs 856 billion breached the IT ceiling (Rs 810 billion) reflecting stronger-than-expected credit growth and a surge in seasonal demand for cash. Despite a partial reversal since January, reserve money still exceeded the March IT ceiling, partly due to sizable FX purchases.

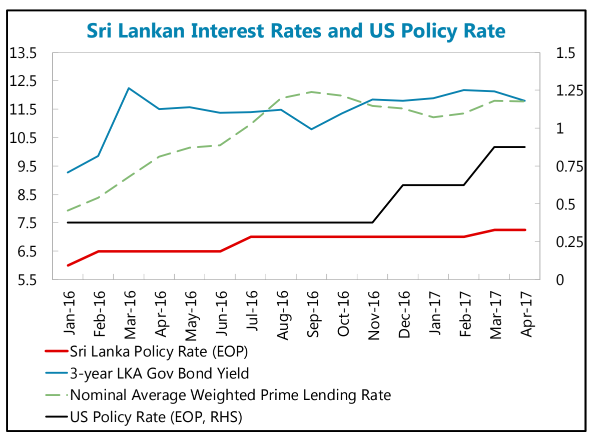
11. Structural benchmarks (SBs) set for completion by March 2017 were mostly implemented (Table 2 attached to the Memorandum of Economic and Financial Policies (MEFP)). Of the 15 benchmarks, 8 were met on time, 1 met with delay, and 6 were not met by April despite several partial implementations. The six unmet SBs were: (i) cabinet approval of a strategy to reduce tax expenditures; (ii) establishment of commitment record and control systems; (iii) introduction of an automatic fuel and electricity pricing mechanisms (two separate SBs); (iv) recording of the fiscal cost of non-commercial obligations (NCOs) in the budget; and (v) parliamentary submission of the new IRA which was set as a prior action for the second review. Progress has been made for these SBs except for the automatic fuel and electricity pricing mechanisms.

POLICY DISCUSSIONS AND CORRECTIVE ACTIONS

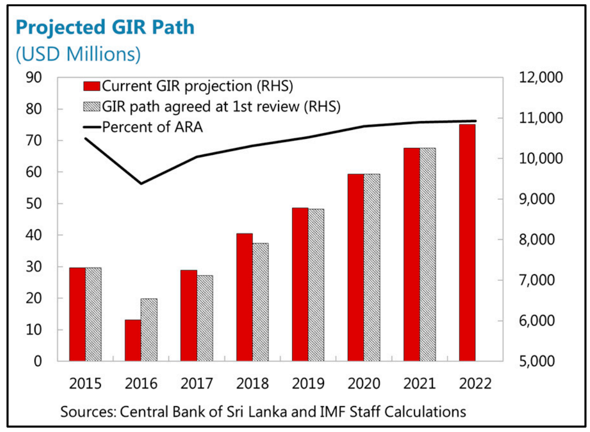
The authorities undertook substantial corrective policy actions, including by resuming international reserves buildup since March and recalibrating energy pricing reforms. They will also submit the new IRA to parliament in early July. Looking ahead, pursuing fiscal consolidation, rebuilding reserves, and strengthening the reform momentum are critical for reducing Sri Lanka's high external and fiscal vulnerabilities.

A. Monetary and Exchange Rate Policies

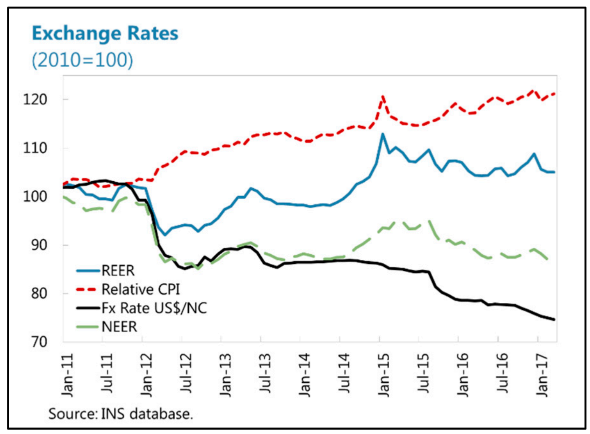
12. Following a 25bp hike in March, monetary policy should be tightened further to avoid prolonging high inflation and credit growth. The authorities hiked 25bps to head off rising inflation expectation and stand ready to tighten further if needed. They see the monetary tightening since 2016 as still working through the system toward slowing credit growth with a long lag, including through a significant rise in lending rates. Nevertheless, headline inflation remains in the upper range of the target band, and credit growth still exceeds 20 percent (y/y) with various indicators not yet presenting clear evidence of cooling credit demand. Nor have Sri Lankan interest rates kept pace with the global trend as represented by the US policy rate since late 2016. Further monetary tightening would head off the second-round effects of currently high inflation, rein in credit expansion, and protect against potential capital outflows from further US rate hikes. Other measures to slow credit growth include raising the reserve requirement and employing macroprudential instruments, such as: broader use of limits on loan-to-value ratios in vulnerable sectors, and a credit limit or increasing risk weights in the housing sector. The authorities agreed to closely monitor credit growth, particularly to ensure that credit growth was directed towards productive economic activity, and to tighten monetary policy further and use macro-prudential measures, if necessary.



13. **As a key corrective action for missing the NIR PC for end-2016, the authorities committed to a net outright FX purchase of $300 million over March–April.** With a tapering of foreign outflows from government securities, the CBSL purchased $442 million over March–April, exceeding the committed amount by a substantial margin. The CBSL will continue to make net FX purchases, as well as draw upon a syndicated loan of US$700 million, with monthly monitoring of the progress. By end-2017, the GIR will return to the pre-programmed path under the first review—about $7.2 billion at 65 percent of the ARA metric and 3.3 months of prospective imports. FX swaps with domestic commercial banks have been declining since end-2016, and are expected to gradually fall to around $2 billion by end-2017.



14. **The reserve accumulation should be accompanied by greater exchange rate flexibility.** In the event of capital outflows, greater exchange rate flexibility should be the first line of defense. Greater flexibility would also support the buildup of reserves and external competitiveness with the real effective exchange rate assessed to be overvalued relative to medium-term fundamentals and desirable policies, notwithstanding large statistical uncertainty (Annex II). The authorities also pledged to avoid an overvalued exchange rate at the expense of reserves and shift towards an inflation targeting regime in their 2017 Roadmap, but have yet to demonstrate the commitment to sufficient exchange rate flexibility under external shocks.



15. **The authorities are developing by October a roadmap for a flexible inflation targeting and exchange rate regime (new SB).** The CBSL has developed a macro forecasting model toolkit and now intends to take the next steps, including by establishing price stability—inflation in the mid-single digits—as the primary objective of monetary policy and publicly communicating the inflation targets. While the CBSL can retain a role for smoothing excessive exchange rate volatility, it should adopt FX intervention policies consistent with greater exchange rate flexibility under flexible inflation targeting. Once the roadmap is developed with inputs from IMF TA (May), time-bound reform measures will be incorporated into future program reviews.

B. Fiscal Policy

16. **The 2017 budget continues to pursue revenue-based fiscal consolidation as envisaged under the program.** Building on the fiscal overperformance in 2016, the authorities aim at a primary surplus of 0.4 percent of GDP in 2017, providing a buffer to achieve the QPC ceiling on the primary

deficit of Rs 3 billion (0 percent of GDP). The program targets an increase in tax collections by 0.7 percentage points of GDP to 13.1 percent of GDP (IT), underpinned by the full-year effect of the 2016 VAT amendment and the revenue package in the 2017 budget.[2]

Sri Lanka: Summary of Central Government Operations

	2015 Est.		2016 EFF 1st rev		2016 Est.		2017 Budget		2017 Prog.	
	Rs Billion	% GDP	Rs Billion	% GDP	Rs Billion	% GDP	Rs Billion	% GDP	Rs Billion	% GDP
Total Revenue and Grants	1,461	13.3	1,598	13.1	1,694	14.3	2,020	15.4	1,894	14.5
Total Revenue	1,455	13.3	1,587	13.0	1,686	14.2	2,010	15.3	1,884	14.4
Tax Revenue	1,356	12.4	1,453	11.9	1,464	12.4	1,821	13.9	1,718	13.1
Income Taxes	263	2.4	243	2.0	259	2.2	335	2.6	328	2.5
Tax on goods & services	804	7.3	843	6.9	842	7.1	1,086	8.3	1,018	7.8
VAT	220	2.0	271	2.2	283	2.4	…	…	372	2.8
Excise Taxes	498	4.5	466	3.8	455	3.8	…	…	513	3.9
Other taxes & levies	86	0.8	106	0.9	104	0.9	…	…	133	1.0
Tax on external trade	289	2.6	366	3.0	363	3.1	400	3.1	373	2.8
Non Tax Revenue	99	0.9	134	1.1	222	1.9	189	1.4	166	1.3
Of which: profits & dividends	30	0.3	…	…	108	0.9	…	…	…	…
Of which: fines, fees & charges	45	0.4	…	…	73	0.6	…	…	…	…
Grants	6	0.1	12	0.1	7	0.1	10	0.1	10	0.1
Total Expenditure and net lending	2,229	20.4	2,298	18.9	2,334	19.7	2,645	20.2	2,581	19.7
Current Expenditure	1,702	15.5	1,770	14.5	1,758	14.8	1,946	14.9	1,944	14.8
Salaries & wages	562	5.1	590	4.8	576	4.9	…	…	615	4.7
Goods & services	193	1.8	153	1.3	151	1.3	…	…	164	1.3
Interest payments	527	4.8	603	5.0	611	5.2	680	5.2	683	5.2
Subsidies & transfers	419	3.8	424	3.5	419	3.5	…	…	481	3.7
Capital Expenditure and Net Lending	527	4.8	528	4.3	576	4.9	699	5.3	637	4.9
Overall balance	-768	-7.0	-699	-5.7	-640	-5.4	-625	-4.8	-687	-5.2
Primary balance	-241	-2.2	-97	-0.8	-29	-0.2	55	0.4	-3	0.0

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

17. **The new Inland Revenue Act (IRA) will be submitted to parliament, satisfying a prior action for the second review.** Building on the international best practice, the new IRA aims to broaden the tax base by removing excessive tax exemptions; rationalize corporate tax incentives toward an investment-oriented regime; and strengthen powers of the tax administrator. The new IRA, if well implemented, would serve as the foundation for sustained fiscal consolidation over the medium term and provide resources for essential social services and growth-enhancing capital spending. The Inland Revenue Department (IRD) has started preparing for its implementation, including by establishing a steering committee and project teams, drafting detailed tax manuals, and initiating communication with stakeholders. These efforts will continue to receive extensive IMF TA support.

18. **Prudent budget execution is needed to manage near-term fiscal risks.** The main risk is revenue underperformance in the early phase of the new income tax regime. To avoid fiscal slippage, the authorities will benchmark the spending level to the EFF program target and align expenditures with revenue outturns on a quarterly basis under Parliamentary oversight. In case of revenue overperformance, the authorities will use the surplus to cover possible weather-related costs above the current estimates (Box 1), and then bring down debt.

[2] The revenue package consisted of base-broadening of income taxes, hikes in excise rates and user fees, and one-off transfers from SOEs. The combined revenue yields were estimated to be about 1 percent of GDP in the budget. The program target envisages lower revenue yields in light of delays in implementing these measures.

19. Further medium-term fiscal consolidation is necessary to ensure public debt sustainability, and should be complemented by steps to strengthen debt management. Under staff projections, the authorities' commitment to reducing the overall deficit to 3.5 percent of GDP by 2020 would require further consolidation to a primary surplus of about 2¼ percent of GDP by 2020. Several supporting frameworks for steady medium-term consolidation will be further discussed in future program reviews. Developing the debt management framework under multilateral and bilateral TA support should continue, and aim to spread out the amortization of international sovereign bonds and lengthen the maturity of domestic borrowings. The authorities also plan to ring-fence proceeds from commercializing public assets for debt services over the medium term. To ensure fiscal consolidation beyond 2019, the Fiscal Responsibility (Management) Act should establish binding targets for government deficit and public debt.

20. Further revenue mobilization will rest on stronger tax administration and VAT reforms. Improvements in tax administration capacity have laid the foundation for enhancing tax compliance and collection. In this regard, the IRD met all December 2016 SBs: (i) adoption of Key Performance Indicators on risk-based audit, (ii) adoption of a VAT compliance strategy, and (iii) roll-out of the new IT system (RAMIS) for major domestic taxes. A diagnostic review of the VAT system (June 2017 SB), supported by IMF TA, will help identify areas for further VAT base-broadening reforms and administrative improvements. Tax expenditures will be further rationalized under a plan to be included in the 2018 budget (November 2017 SB).

21. Commitment-based expenditure control should be further strengthened to reduce the risk of arrears from revenue shortfalls. With the capacity to track monthly spending commitments for each line ministry (partially implementing a December 2016 SB), the Ministry of Finance (MOF) plans to establish commitment ceilings by mid-year and align expenditures and revenue outturns on a quarterly basis (¶19). The rollout of the new IT system (ITMIS) is proceeding: the budget planning module was rolled out to all ministries while maintaining the existing system during the transition (January 2017 SB). The authorities will next implement an IT-based commitment control system for the 2018 budget (January 2018 SB).

C. SOE Reforms

22. Five key SOEs have improved their transparency and oversight by publishing Statements of Corporate Intent (SCIs), meeting December 2016 SB with delay (text table). Each SCI encompasses the SOE's mission, multiyear corporate plan, and performance indicators, providing the basis for enhanced oversight and financial discipline. The December 2016 SB for a resolution strategy for the SriLankan Airlines was met, and the authorities have been implementing the resolution strategy approved by the Cabinet in 2015. The airline has undertaken route and fleet optimization, and now aims at securing a strategic partner and resolving any fiscal contributions to its liabilities. During the ongoing negotiation, the airline's financial performance will be monitored quarterly.

Statements of Corporate Intents (SCIs) for State-Owned Enterprises	
For 5 major SOEs, SCIs were signed in March 2017 by the CEOs, line ministries, and Ministry of Finance, and published in April 2017.	
Objectives	- Establish a transparent framework for strategic performance oversight on SOEs - Define the working relationship between the government and SOEs and allow adequate managerial and operational autonomy of SOEs - Hold SOEs' Board and management accountable for performance, based on Key Performance Indicators - Identify and cost SOEs' non-commercial obligations, for which the government is ultimately responsible
Which SOEs published SCIs? (SriLankan Airlines did not participate, given ongoing restructuring)	- Airport and Aviation Services Ltd (AASL) - Ceylon Electricity Board (CEB) - Ceylon Petroleum Corporation (CPC) - National Water Supply and Drainage Board (NWSDB) - Sri Lanka Ports Authority (SLPA)
Non-commercial obligations clarified in SCIs	- Provision of fuel, electricity, and water for certain products/segments at prices below commercial cost recovery (CPC, CEB, and NWSDB)
Key Performance Indicators set in SCIs	- Passenger processing time for arrival and departure (AASL) - Average cost per unit of electricity at selling point; network interruption duration and frequency (CEB) - Refinery net margin; gross transport fuel margin (CPC) - Percentage population access to safe drinking water; debtors in arrears (NWSDB) - Average waiting time for container ships; ratio of total cost per tonnage (SLPA)

Financial Performance of Major SOEs, 2016

	Airport and Aviation Services Ltd	Ceylon Electricity Board	Ceylon Petroleum Corp.	National Water Supply and Drainage Board	Sri Lankan Airlines 1/	Sri Lanka Ports Authority
			(In billions of rupees)			
Revenue	20	217	435	24	103	44
Expenditure	13	231	365	21	124	33
Balance	7	-14	70	3	-21	11
Outstanding obligations (2015)	...	237	424	...	309	240
			(In percent of GDP)			
Revenue	0.2	1.8	3.7	0.2	0.9	0.4
Expenditure	0.1	2.0	3.1	0.2	1.0	0.3
Balance	0.1	-0.1	0.6	0.0	-0.2	0.1
Outstanding obligations (2015)	...	2.2	3.9	...	2.8	2.2

Sources: Ministry of Finance.
1/ April-December 2017.

23. **The timing of energy pricing reforms has been recalibrated.** The December 2016 SBs for automatic pricing mechanisms for fuel and electricity were not met, reflecting the difficulty of forging political consensus within the coalition government. Although both the CPC and CEB performed adequately in 2015–16 owing to low oil prices, they may still incur large losses given their non-commercial obligations (NCOs) to supply fuel and electricity at administered prices. To address this constraint, the authorities are adopting a phased approach. First, with inputs from IMF TA, a report will outline the fiscal cost of NCOs for fuel and electricity (September 2017 SB), which will

then be incorporated in program targets. Second, the CEB and the Public Utility Commission will establish a Bulk Supply Transactions Account which will estimate and settle the cost of the electricity NCOs transparently for all concerned (March 2018 SB). Third, building on access to greater information and after further consultation with stakeholders, the cabinet will approve automatic pricing mechanisms for fuel and electricity by March 2018 and September 2018, respectively (reset from December 2016). In the meantime, the financial performance of the CPC and CEB will be monitored quarterly.

D. Financial Sector and Trade Reforms

24. Financial sector issues. Financial soundness indicators remain stable for the banking system as a whole, with the capital adequacy ratio (CAR) above 14 percent—far exceeding the minimum requirement—and the NPL ratio declining. Nonetheless, the CAR has been declining as rapid credit growth increases risk-weighted assets. To strengthen the financial sector, several policy measures have been implemented or under consideration. The Basel III Minimum Capital Requirement is being implemented on a staggered basis since July 2017. All licensed commercial and specialized banks will have to maintain the minimum capital ratios and buffers starting in July 2017 (the requirement ratio will gradually increase to reach the international standard by January 2019). Efforts are being made to resolve distressed non-bank financial companies, following IMF TA in March. The World Bank is leading a program to modernize the financial market infrastructure, upgrade legal and regulatory framework, and strengthen the institutional capacity of financial regulators. The ongoing IMF TA on AML/CFT is also supporting the strengthening of the financial sector.

25. Trade and investment regimes. The proliferation of para-tariffs in the last decade has made Sri Lanka one of the most protected economies in the world, undermining its competitiveness and economic resilience. Its investment regime, rife with case-by-case incentives, has failed to boost FDI. Tax reforms supported by the EFF, including the new IRA, could substantially improve the regime by creating a transparent and predictable business environment and by creating fiscal space for reducing para-tariffs over the medium term. To improve structural competitiveness, the authorities secured the resumption of GSP plus status with EU; are exploring new trade agreements with Asian economies; submitted a New Trade Policy to the cabinet which recommends implementing domestic trade reforms well as improving legal and regulatory structure; and are in the process of setting up a unit in the Prime Minister's office dedicated to improving the business environment.

PROGRAM MONITORING

26. The attached Letter of Intent (LOI) and the MEFP describe the authorities' progress in implementing their economic program and sets out their commitments (Appendix I). The authorities seek waivers of applicability of the June 2017 QPCs for primary balance and the NIR on the grounds of non-availability of data for end-June for the planned July 2017 Board meeting, and for the nonobservance of the continuous PC against accumulation of external arrears on the grounds of being *de minimis* in nature. Staff endorses the request for waivers. Modification of the NIR QPC for end-June, the new QPCs for end-December 2017, and modification of the ITs through end-

December 2017 and the inflation target bands under the monetary policy consultation clause (MPCC) are proposed, with the targets on NIR, tax revenue, reserve money, and the center point of the inflation target band being adjusted to reflect the developments since the first review (Table 1 attached to the MEFP and the TMU). As a prior action for the second review, the authorities will submit the new IRA to the parliament. The proposed list of structural benchmarks includes 4 new benchmarks and 4 modified benchmarks recalibrated to address partial or delayed progress (Table 2 attached to the MEFP).

27. Sri Lanka has accumulated US$42 million in external arrears to the Export Development Bank of Iran. The arrears started in 2013 due to payment barriers. Owing to continued difficulties of establishing the payment platform in the aftermath of sanctions, the arrears increased by $6.5 million each in September 2016 and March 2017, breaching the continuous PC on non-accumulation of external debt payments arrears. The resulting increase in arrears for debt service on project loans was small at $13 million (0.016 percent of GDP), did not materially impact the assessment of Sri Lanka's program performance, and did not undermine the overall balance or NIR positions. As corrective actions, the authorities have now established a payment platform and expect to clear the arrears on the basis of repayment schedules which are being negotiated with the Iranian authorities. Staff thus supports the authorities' request for waivers for the non-observance of the continuous PC.

28. The program remains fully financed for the next 12 months, but risks remain significant. Firm financing assurances from the World Bank, Asian Development Bank, and key bilateral donors, are in place, and there are good prospects for adequate multilateral and bilateral financing for the remainder of the program. Capacity to repay the Fund remains adequate under the baseline scenario, while the downside risks discussed above may necessitate further adjustment or additional financing (Table 7). Key risks to the program are still present: (i) revenue slippage or failure to implement key revenue-related reforms; (ii) weaker than expected net capital inflows and reserves shortfall; (iii) lower than expected growth and/or new pressures on the trade account; and (iv) larger than expected losses at SOEs and lack of progress in SOE reforms.

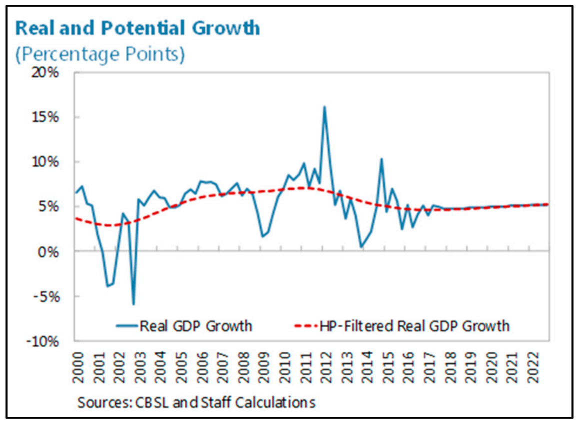
29. Safeguards. The safeguards assessment, updated in August 2016, identified weaknesses in the areas of the CBSL's autonomy, governance arrangements, and legal framework (e.g., the government's voting representation in the Monetary Board). These issues should be addressed when the authorities amend the legal framework for central banking, starting with IMF TA on a flexible inflation targeting and flexible exchange rate regime (¶15).

Box 2. Sri Lanka: A Break in Potential Growth?

Sri Lanka's GDP growth averaged at around 5.5 percent during 2000–16, but slowed lately reflecting weaker productivity. Medium-term potential growth is estimated to be around 5 percent conditional on an investment and productivity rebound. Strong progress in economic reforms could further enhance growth potential.

Sri Lanka has experienced uneven growth over the last fifteen years buffeted by external and domestic shocks. The early 2000s began with a low growth resulting from widespread civil conflict. Following a ceasefire in 2002, real GDP growth rose to average about 6 percent between 2003–2009, despite a number of shocks including the end of the Multi-Fiber Arrangement and deterioration in the security situation. Following the end of the civil conflict in 2009, growth jumped to an average of 8.5 percent over 2010–2012 despite the post-global financial crisis era. Since then growth has slowed significantly with average real GDP growth at 4.4 percent during 2013–16.

Does the slower growth reflect lower potential growth? To estimate Sri Lanka's potential growth and output gap, staff applied both filtering and production function approaches. Using quarterly data between 1997Q1 to 2021Q4, the HP filter estimates potential growth to be between about 5–5.3 percent over the medium term. The results also show that potential growth was at close to 7 percent during 2010–2012 when the economy was operating above potential. These results are similar to a previous study (IMF Working Paper WP/14/40) that also found potential growth to be around 7 percent in 2012. Since then, potential growth has declined and is expected to be slightly above 5 percent over the medium term.



Growth accounting approach indicates that the recent decline in potential growth was due to productivity slowdown. Over 2004–2012, total factor productivity (TFP) was the main contributor to Sri Lanka's strong growth, as the contributions of capital and labor increased little. In the recent past (2013–2016), TFP growth declined substantially—a trend also experienced by other emerging markets. To reach a growth rate of 5–5.5 percent, TFP growth will have to increase, accompanied by strong growth in capital stock.

Decomposition of Actual Growth Rates (in percent)

	2003-2009	2010-2012	2013-2016	Medium Term	
Real GDP Growth Rate	**5.94**	**8.53**	**4.39**	**5.0**	**5.5**
Capital	2.60	2.72	2.39	2.4	2.6
Labor	0.53	0.53	0.66	0.7	0.7
TFP	2.81	5.28	1.35	1.9	2.2

Growth momentum can be strengthened by productivity-enhancing reforms. Recent analytical work (see IMF Regional Economic Outlook: Asia and Pacific, April 2017) indicates that productivity growth can be increased through a rise in FDI inflows, greater trade openness, and developing human capital. Case studies reveal that productivity can also be increased when governments proactively engage with the private sector including by providing infrastructure, a strong regulatory environment and secure legal framework. These reforms will also help boost productivity in Sri Lanka and are in line with the EFF program.

STAFF APPRAISAL

30. Reforms under the program have moved forward and the momentum needs to increase with greater ownership. Notwithstanding the severe drought, economic growth has held up and government finances have been strengthened consistent with the program. Progress has been made in fiscal structural reforms, but with some delays in energy pricing and expenditure commitment control. The authorities have begun to address the NIR shortfall through FX purchases.

31. Fiscal consolidation should continue, supported by the new IRA. Targets for 2016 fiscal balance and revenue collection have been met, owing to revenue overperformance. The new IRA will be submitted to parliament (prior action), and will provide the foundation for further fiscal consolidation upon legislation. Nevertheless, Sri Lanka's debt burden and gross financing needs remain very high, raising the urgency for further fiscal consolidation. Continued revenue mobilization, including through robust implementation of the IRA and further improvements of the VAT, will remain the key to upholding medium-term fiscal consolidation.

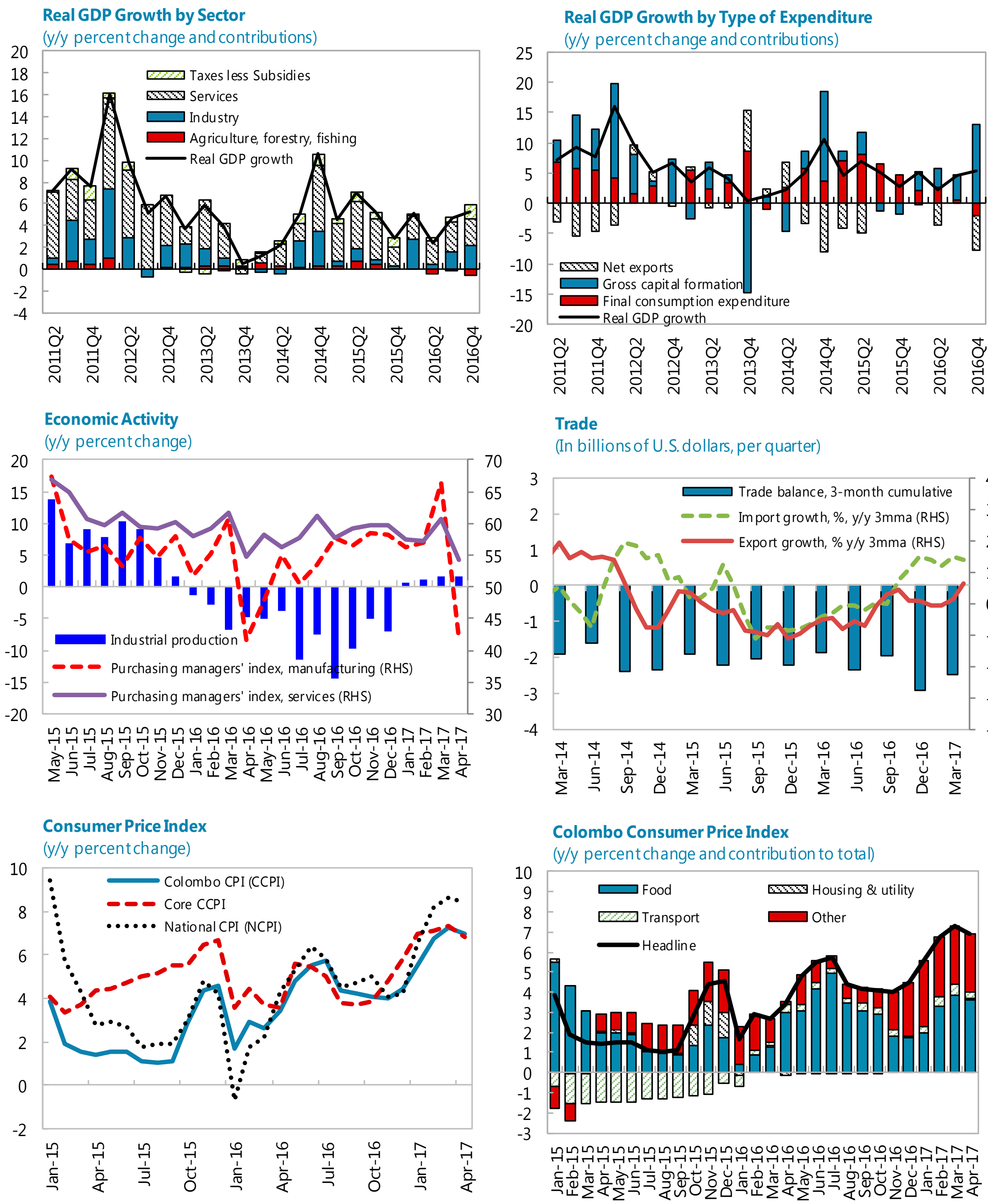
32. Greater ownership is needed to accelerate fiscal structural reforms. Risk-based tax administration should strengthen further, IT systems for tax and expenditure administration should be fully utilized, and energy pricing reforms should make tangible progress. Timely progress in these areas will strengthen the platform for steady fiscal consolidation.

33. Building on the recent corrective action, the authorities should continue accumulating NIR and demonstrate their commitment to greater exchange rate flexibility. Given the primacy of reducing Sri Lanka's high external vulnerability, NIR accumulation based on FX purchases and greater exchange rate flexibility should remain a high priority for building external buffers and improving competitiveness. Greater exchange rate flexibility should be the first response to greater market volatility.

34. Monetary policy should be tightened further, and financial sector risks managed prudently. Following the rate hike in March, the central bank should tighten monetary stance further until clear signs emerge that inflation pressures and credit expansion have subsided. Financial sector supervision and resolution should be strengthened, and credit growth contained including by deploying macro-prudential measures as needed.

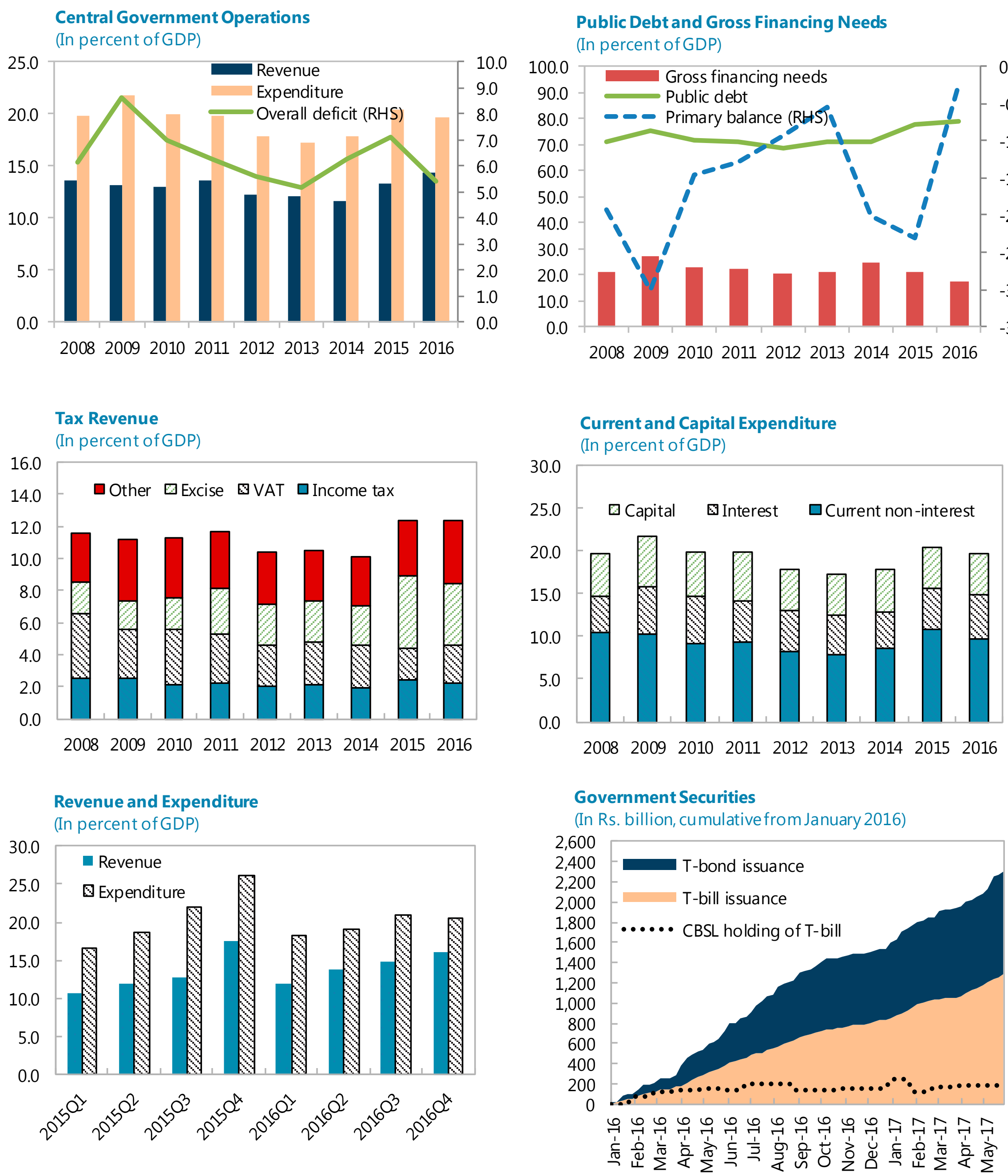
35. Staff supports the completion of the second review under the EFF arrangement, in light of the progress so far—including the corrective actions for NIR shortfall as well as the steps undertaken to clear external arrears—and the authorities' policy commitment to ongoing reforms. Staff also supports the authorities' request for modification of the NIR QPC, ITs, MPCC, SBs and the TMU, as well as a waiver of applicability of the June 2017 QPCs.

Figure 1. Sri Lanka: Real Sector



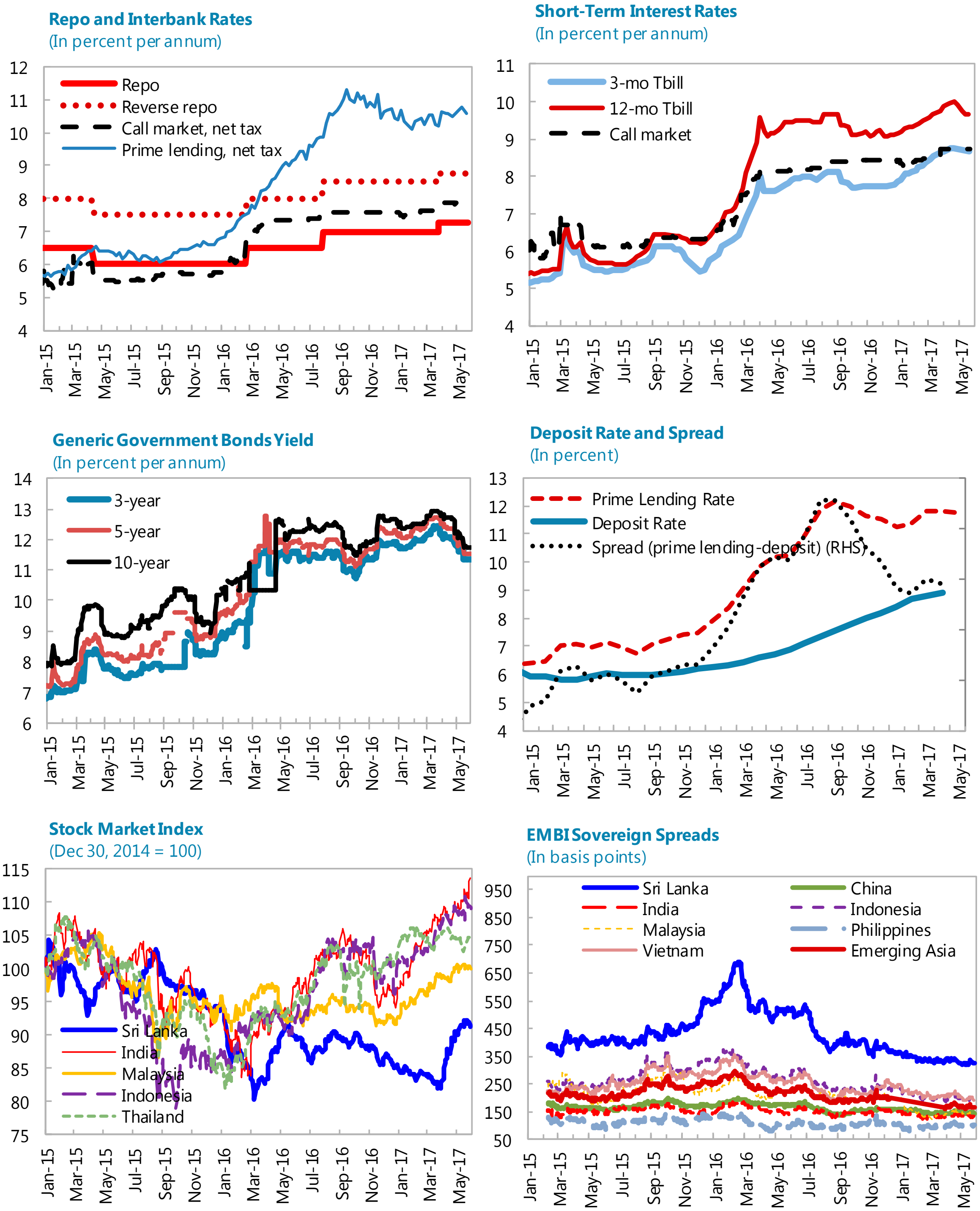
Sources: Central Bank of Sri Lanka; and IMF staff calculations.

Figure 2. Sri Lanka: Fiscal Sector



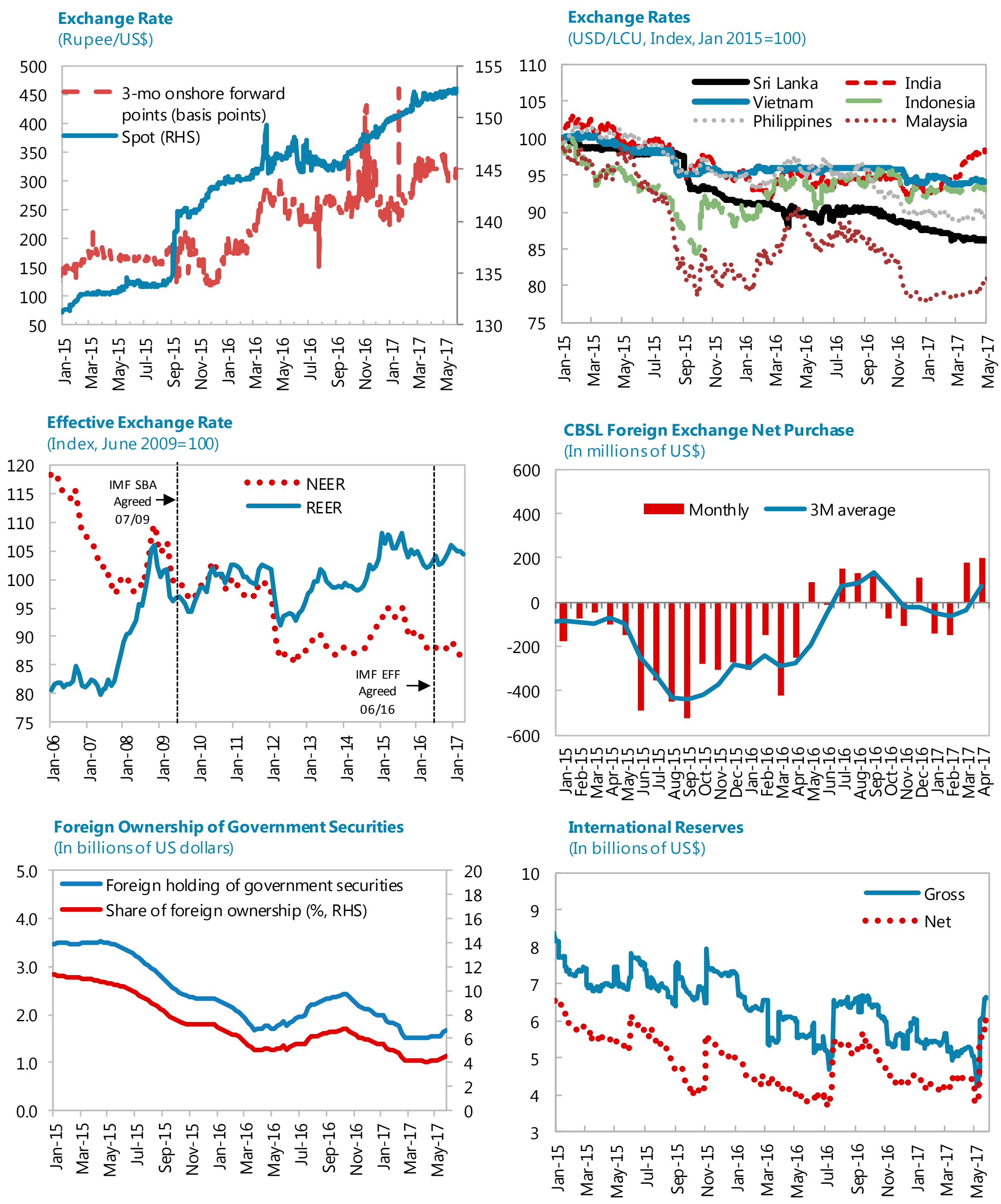
Sources: Central Bank of Sri Lanka; Ministry of Finance; and IMF staff calculations.

Figure 3. Sri Lanka: Financial Market



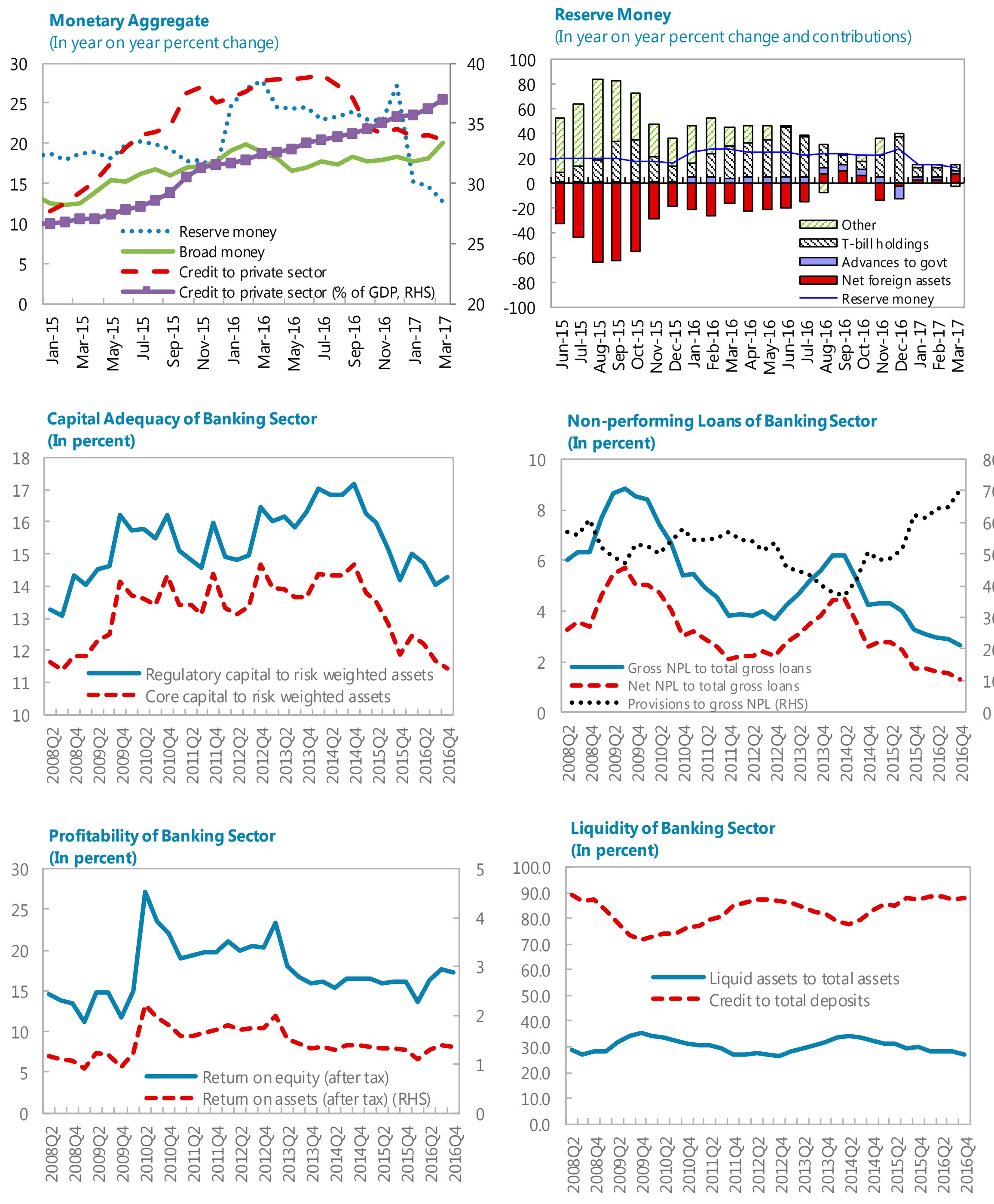
Sources: Central Bank of Sri Lanka; CEIC Daily Database; Bloomberg Data LP; and IMF staff calculations.

Figure 4. Sri Lanka: Foreign Exchange and Reserves



Sources: Central Bank of Sri Lanka; APDCORE Database; Bloomberg Data LP; and IMF staff calculations.

Figure 5. Sri Lanka: Monetary and Financial Sector



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

Table 1. Sri Lanka: Selected Economic Indicators, 2015–21

	2015	2016			2017			2018	2019	2020	2021
		CR/16/150	CR/16/371	Est.	CR/16/150	CR/16/371	Proj.		Proj.		
GDP and inflation (in percent)											
Real GDP growth	4.8	5.0	4.5	4.4	5.0	4.8	4.7	4.8	4.9	5.0	5.1
Inflation (average)	2.2	4.1	4.0	4.0	5.3	5.1	6.0	5.0	5.0	5.0	5.0
Inflation (end-of-period)	4.6	5.4	5.1	4.5	5.2	5.1	5.1	5.0	5.0	5.0	5.0
Core inflation (end-of-period)	6.7	4.5	4.2	5.8	4.3	4.2	4.6	4.6	4.6	4.6	4.6
Savings and investment (in percent of GDP)											
National savings	26.1	26.9	27.3	29.0	26.0	28.6	29.3	29.8	30.1	30.6	30.9
Government	-2.2	-0.9	-1.4	-0.5	0.2	-0.4	-0.4	0.4	1.5	1.8	2.0
Private	28.3	27.8	28.7	29.6	25.9	29.0	29.7	29.4	28.6	28.8	28.9
National Investment	28.4	28.3	29.4	31.5	28.8	30.8	31.8	32.1	32.2	32.5	32.9
Government	5.5	6.5	4.4	7.8	6.9	4.8	6.4	6.6	6.5	6.5	6.5
Private	22.9	21.9	25.0	23.7	21.9	26.0	25.4	25.5	25.6	26.1	26.4
Savings-Investment balance	-2.4	-1.5	-2.1	-2.4	-2.8	-2.2	-2.5	-2.3	-2.1	-2.0	-2.0
Government	-7.7	-7.4	-5.7	-8.3	-6.8	-5.2	-6.7	-6.1	-5.0	-4.7	-4.5
Private	5.4	6.0	3.7	5.9	4.0	3.0	4.3	3.9	3.0	2.8	2.5
Public finances (in percent of GDP)											
Revenue and grants	13.3	13.0	13.1	14.3	14.0	13.9	14.5	15.4	16.5	16.7	16.9
Expenditure	20.4	18.4	18.9	19.7	18.8	19.2	19.7	20.2	20.3	20.3	20.4
Primary balance	-2.2	-0.8	-0.8	-0.2	0.0	0.0	0.0	1.0	2.0	2.2	2.1
Central government balance	-7.0	-5.4	-5.7	-5.4	-4.7	-5.2	-5.2	-4.7	-3.7	-3.5	-3.5
Central government net domestic financing	4.3	2.3	2.9	2.8	3.0	3.5	3.4	3.2	3.3	3.0	3.0
Central government debt	77.6	77.2	77.0	79.3	75.5	76.4	79.6	77.6	74.8	72.1	69.7
Money and credit (percent change, end of period)											
Reserve money	16.5	18.4	20.3	27.1	12.0	17.0	13.0	12.8	12.7	12.5	12.4
Broad money	17.8	10.8	20.0	18.4	15.4	18.2	15.9	13.9	13.2	12.8	12.4
Domestic credit	23.5	8.5	15.4	16.4	11.7	12.9	10.8	11.2	10.6	10.3	10.1
Credit to private sector	25.1	10.0	20.1	21.9	14.3	15.5	13.7	13.7	12.7	12.4	12.0
Credit to government	21.3	6.2	8.4	8.1	7.7	8.6	6.1	6.6	6.4	5.8	6.1
Balance of payments (in millions of U.S. dollars)											
Exports	10,547	10,456	10,530	10,310	10,942	10,983	11,239	11,861	12,490	13,088	13,751
Imports	-18,935	-18,392	-19,013	-19,400	-20,763	-20,051	-20,517	-21,273	-22,360	-23,506	-24,763
Current account balance	-1,882	-1,202	-1,738	-1,942	-2,419	-1,953	-2,094	-1,980	-1,933	-1,983	-2,219
Current account balance (in percent of GDP)	-2.4	-1.5	-2.1	-2.4	-2.8	-2.2	-2.5	-2.3	-2.1	-2.0	-2.0
Export value growth (percent)	-5.2	-0.5	0.2	-2.2	4.6	4.3	9.0	5.5	5.3	4.8	5.1
Import value growth (percent)	-2.5	-2.9	0.4	2.5	12.9	5.5	5.8	3.7	5.1	5.1	5.4
Gross official reserves (end of period)											
In millions of U.S. dollars	7,304	7,853	6,542	6,019	9,372	7,118	7,246	8,155	8,786	9,618	10,276
In months of imports	3.7	3.7	3.2	2.9	4.1	3.3	3.3	3.6	3.7	3.8	3.9
External debt (public and private)											
In billions of U.S. dollars	44.8	45.9	45.1	46.0	49.0	47.0	47.4	48.6	51.4	53.8	56.1
As a percent of GDP	56.4	55.8	54.3	57.1	55.9	53.3	56.8	55.7	54.7	53.0	51.2
Memorandum items:											
Nominal GDP (in billions of rupees)	10,952	12,147	12,166	11,839	13,374	13,342	13,098	14,413	15,875	17,502	19,315

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

Table 2a. Sri Lanka: Summary of Central Government Operations, 2015–21
(In billions of rupees)

	2015	2016			2017			2018	2019	2020	2021
		CR/16/150	CR/16/371	Est.	CR/16/150	CR/16/371	Proj.		Proj.		
Total revenue and grants	1,461	1,574	1,598	1,694	1,878	1,860	1,894	2,224	2,622	2,930	3,256
Total revenue	1,455	1,562	1,587	1,686	1,868	1,850	1,884	2,221	2,619	2,926	3,252
Tax revenue	1,356	1,428	1,453	1,464	1,721	1,703	1,718	2,038	2,417	2,704	3,007
Income taxes	263	226	243	259	344	358	328	424	586	692	814
VAT	220	311	271	283	384	354	372	518	657	753	841
Excise taxes	498	452	466	455	499	497	513	549	589	632	680
Other trade taxes	184	199	205	212	227	214	213	226	242	257	275
Other	191	240	267	254	267	280	293	321	344	370	397
Nontax revenue	99	134	134	222	148	147	166	183	201	222	245
Grants	6	12	12	7	10	10	10	3	4	4	4
Total expenditure and net lending	2,229	2,233	2,298	2,334	2,510	2,558	2,581	2,906	3,216	3,551	3,933
Current expenditure	1,702	1,688	1,770	1,758	1,856	1,919	1,944	2,162	2,380	2,620	2,876
Civil service wages and salaries	323	335	335	334	369	348	348	383	422	465	513
Other civilian goods and services	135	71	91	86	78	96	96	106	116	128	142
Security expenditure	297	301	317	307	331	335	335	369	406	448	494
Subsidies and transfers	419	419	424	419	449	446	481	479	527	581	641
Interest payments	527	562	603	611	629	694	683	827	909	998	1,086
Capital expenditure and net lending	527	545	528	576	654	638	637	743	835	930	1,057
Overall balance	-768	-659	-699	-640	-632	-697	-687	-682	-593	-621	-676
Financing	768	659	699	640	632	697	687	682	593	621	676
Net external financing	292	376	345	307	234	224	240	224	70	101	104
Net domestic financing	476	283	354	333	399	473	447	458	524	520	573
Memorandum items:											
Primary balance	-241	-97	-97	-29	-3	-3	-3	145	316	378	409
Central government debt	8,503	9,376	9,372	9,387	10,092	10,199	10,430	11,187	11,875	12,619	13,462
Domestic currency	4,595	4,975	5,066	5,029	5,312	5,427	5,354	5,869	6,502	7,117	7,795
Foreign currency	3,909	4,401	4,306	4,358	4,780	4,772	5,076	5,318	5,373	5,502	5,667
Publicly guaranteed debt	382	…	…	497	…	…	…	…	…	…	…
Fund credit outstanding	105	85	84	82	115	114	114	199	244	247	243
Financial obligations of nonfinancial SOEs 1/	1,280	…	…	…	…	…	…	…	…	…	…
Nominal GDP (in billion of rupees)	10,952	12,147	12,166	11,839	13,374	13,342	13,098	14,413	15,875	17,502	19,315

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

1/ The figure does not cover all nonfinancial SOEs. It covers financial obligations of Ceylon Electricity Board, Ceylon Petroleum Corporation, Sri Lanka Ports Authority, Sri Lankan Airlines, and other SOEs.

Table 2b. Sri Lanka: Summary of Central Government Operations, 2015–21
(In percent of GDP)

	2015	2016			2017			2018	2019	2020	2021
		CR/16/150	CR/16/371	Est.	CR/16/150	CR/16/371	Proj.		Proj.		
Total revenue and grants	13.3	13.0	13.1	14.3	14.0	13.9	14.5	15.4	16.5	16.7	16.9
Total revenue	13.3	12.9	13.0	14.2	14.0	13.9	14.4	15.4	16.5	16.7	16.8
Tax revenue	12.4	11.8	11.9	12.4	12.9	12.8	13.1	14.1	15.2	15.5	15.6
Income taxes	2.4	1.9	2.0	2.2	2.6	2.7	2.5	2.9	3.7	4.0	4.2
VAT	2.0	2.6	2.2	2.4	2.9	2.7	2.8	3.6	4.1	4.3	4.4
Excise taxes	4.5	3.7	3.8	3.8	3.7	3.7	3.9	3.8	3.7	3.6	3.5
Other trade taxes	1.7	1.6	1.7	1.8	1.7	1.6	1.6	1.6	1.5	1.5	1.4
Other	1.7	2.0	2.2	2.1	2.0	2.1	2.2	2.2	2.2	2.1	2.1
Nontax revenue	0.9	1.1	1.1	1.9	1.1	1.1	1.3	1.3	1.3	1.3	1.3
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Total expenditure and net lending	20.4	18.4	18.9	19.7	18.8	19.2	19.7	20.2	20.3	20.3	20.4
Current expenditure	15.5	13.9	14.5	14.8	13.9	14.4	14.8	15.0	15.0	15.0	14.9
Civil service wages and salaries	3.0	2.8	2.8	2.8	2.8	2.6	2.7	2.7	2.7	2.7	2.7
Other civilian goods and services	1.2	0.6	0.7	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Security expenditure	2.7	2.5	2.6	2.6	2.5	2.5	2.6	2.6	2.6	2.6	2.6
Subsidies and transfers	3.8	3.4	3.5	3.5	3.4	3.3	3.7	3.3	3.3	3.3	3.3
Interest payments	4.8	4.6	5.0	5.2	4.7	5.2	5.2	5.7	5.7	5.7	5.6
Capital expenditure and net lending	4.8	4.5	4.3	4.9	4.9	4.8	4.9	5.2	5.3	5.3	5.5
Overall balance	-7.0	-5.4	-5.7	-5.4	-4.7	-5.2	-5.2	-4.7	-3.7	-3.5	-3.5
Financing	7.0	5.4	5.7	5.4	4.7	5.2	5.2	4.7	3.7	3.5	3.5
Net external financing	2.7	3.1	2.8	2.6	1.7	1.7	1.8	1.6	0.4	0.6	0.5
Net domestic financing	4.3	2.3	2.9	2.8	3.0	3.5	3.4	3.2	3.3	3.0	3.0
Memorandum items:											
Primary balance	-2.2	-0.8	-0.8	-0.2	0.0	0.0	0.0	1.0	2.0	2.2	2.1
Central government debt	77.6	77.2	77.0	79.3	75.5	76.4	79.6	77.6	74.8	72.1	69.7
Domestic currency	42.0	41.0	41.6	42.5	39.7	40.7	40.9	40.7	41.0	40.7	40.4
Foreign currency	35.7	36.2	35.4	36.8	35.7	35.8	38.8	36.9	33.8	31.4	29.3
Publicly guaranteed debt	3.5	…	…	4.2	…	…	…	…	…	…	…
Fund credit outstanding	1.0	0.7	0.7	0.7	0.9	0.9	0.9	1.4	1.5	1.4	1.3
Financial obligations of nonfinancial SOEs 1/	11.7	…	…	…	…	…	…	…	…	…	…
Nominal GDP (in billion of rupees)	10,952	12,147	12,166	11,839	13,374	13,342	13,098	14,413	15,875	17,502	19,315

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

1/ The figure does not cover all nonfinancial SOEs. It covers financial obligations of Ceylon Electricity Board, Ceylon Petroleum Corporation, Sri Lanka Ports Authority, Sri Lankan Airlines, and other SOEs.

Table 2c. Sri Lanka: Summary of Central Government Operations, 2016–17
(In billions of rupees)

	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
	Est.	Est.	Est.	Est.	Est.		Proj.	
Total revenue and grants	346	397	438	514	437	428	464	566
Total revenue	346	396	438	507	436	425	462	562
Tax revenue	325	360	382	396	415	388	429	486
Income taxes	47	58	91	63	63	56	80	128
VAT	57	74	64	89	111	87	99	76
Excise taxes	111	110	115	119	115	128	126	144
Other trade taxes	54	54	50	54	58	49	51	55
Other	56	64	63	72	69	69	73	83
Nontax revenue	20	37	55	110	21	37	33	76
Grants	0	0	0	7	1	3	3	4
Total expenditure and net lending	526	544	616	648	636	596	663	685
Current expenditure	427	409	473	449	484	449	517	493
Civil service wages and salaries	81	90	79	84	87	86	89	87
Other civilian goods and services	22	9	26	29	13	23	25	35
Security expenditure	70	70	78	90	71	83	86	95
Subsidies and transfers	99	105	109	107	103	107	116	155
Interest payments	154	135	181	140	209	151	203	120
Capital expenditure and net lending	100	135	143	198	152	147	146	193
Capital expenditure	95	140	146	195	147	147	145	200
Net lending	5	-5	-3	3	5	0	2	-7
Overall balance	-181	-148	-178	-134	-200	-168	-199	-119
Primary balance	-26	-12	3	6	9	-17	4	1

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

Table 2d. Sri Lanka: Central Government Financing Needs, 2015–17
(In billions of rupees, unless otherwise indicated, end of period)

	2015	2016	2017	2018	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
	Est.	Est.	Proj.	Proj.	Est.	Est.	Est.	Est.	Proj.	Proj.	Proj.	Proj.
Gross inflow	**2,583**	**2,276**	**2,465**	**2,973**	**445**	**708**	**790**	**343**	**640**	**955**	**560**	**324**
Primary surplus	0	0	0	145	0	0	3	6	9	0	4	1
Rupee-denominated debt disbursement	1,747	1,599	1,530	2,084	289	580	532	196	364	499	499	169
US-dollar denominated debt disbursement	829	609	904	744	146	53	353	57	266	457	26	155
Asset sales (net)	0	0	31	0	0	0	0	0	0	0	31	0
Other	7	68	0	0	10	74	-99	84	0	0	0	0
Gross outflow	**2,575**	**2,292**	**2,434**	**2,973**	**453**	**720**	**785**	**342**	**505**	**768**	**837**	**337**
Primary deficit	254	29	3	0	26	12	0	0	0	17	0	0
Interest payment	527	611	683	827	154	135	181	140	209	151	203	120
Rupee-denominated debt amortization	1,490	1,178	1,205	1,568	132	460	465	121	135	470	476	124
US-dollar denominated debt amortization	304	473	542	578	141	113	138	81	161	129	158	93
Other	0	0	…	…	0	0	0	0	…	…	…	…
Net cash inflow	**9**	**-15**	**31**	**0**	**-9**	**-12**	**5**	**1**	**135**	**187**	**-277**	**-13**
Government deposits, end of period	74	58	90	90	65	53	57	58	193	380	103	90
Memorandum items:												
Overall deficit	781	640	687	682	181	148	178	134	200	168	199	119
US$ denominated debt disbursement (in US$ millions)	6,025	4,143	5,767	4,502	1,018	367	2,415	386	1,764	2,981	169	960
US$ denominated debt amortization (in US$ millions)	2,208	3,218	3,457	3,496	984	779	945	548	1,069	843	1,010	579
Government deposits, end of period (percent of GDP)	0.7	0.5	0.7	0.6	…	…	…	…	…	…	…	…
Net issuance of T-bill and T-bond (in Rp billions)	289	421	…	…	157	121	67	75	…	…	…	…
T-bills and T-bonds outstanding (In Rp billions)	4,267	4,663	…	…	4,364	4,538	4,686	4,663	4,757	…	…	…
Nonresidents' T-bills and T-bonds holding												
In Rp billions	304	260	…	…	221	253	314	260	196	…	…	…
In US$ millions	2,108	1,735	…	…	1,538	1,739	2,141	1,735	1,296	…	…	…

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

Table 3a. Sri Lanka: Monetary Accounts, 2014–17

(In billions of rupees, unless otherwise indicated, end of period)

	2014	2015	2016			2017		
			CR/16/150	CR/16/371	Est.	CR/16/150	CR/16/371	Proj.
Central Bank of Sri Lanka								
Net foreign assets	688	576	707	664	559	926	748	876
Net domestic assets	-110	97	91	146	298	-33	200	91
Net claims on central government	150	230	267	273	413	297	238	188
Net claims on banks	17	-3	-3	-3	-2	-3	-3	-2
Other items, net	-277	-130	-173	-124	-113	-327	-35	-95
Reserve Money	578	673	797	810	856	893	948	967
Monetary survey								
Net foreign assets	15	-298	-216	-244	-231	-13	-190	-89
Monetary authorities	688	576	707	664	559	926	748	876
Deposit money banks	-673	-874	-922	-908	-790	-939	-938	-965
Net domestic assets	3,861	4,864	5,277	5,724	5,637	5,853	6,667	6,356
Net claims on central government	1,436	1,759	1,854	1,878	1,972	1,987	2,035	2,111
Credit to corporations	3,204	3,973	4,364	4,738	4,700	4,961	5,435	5,285
Public corporations	446	523	570	596	495	623	651	506
Private corporations	2,758	3,450	3,793	4,142	4,204	4,337	4,784	4,779
Other items (net)	-779	-868	-941	-892	-1,035	-1,095	-802	-1,039
Broad money	3,876	4,566	5,061	5,480	5,406	5,840	6,477	6,267
Memorandum Items								
Gross international reserves (in millions of U.S. dollars)	8,208	7,304	7,853	6,542	6,019	9,372	7,118	7,246
Net international reserves (in millions of U.S. dollars)	6,517	5,029	5,700	5,490	4,529	7,043	5,890	6,161
Net Foreign Assets (in millions of U.S. dollars)	5,244	3,999	4,670	4,459	3,725	6,013	4,859	5,356
Private credit (in percent of GDP)	26.6	31.5	31.2	34.0	35.5	32.4	35.9	36.5
Money multiplier	6.7	6.8	6.3	6.8	6.3	6.5	6.8	6.5
Broad money velocity 1/	2.7	2.4	2.4	2.2	2.2	2.3	2.1	2.1
Money and credit (percent change, end of period)								
Broad money	13.4	17.8	10.8	20.0	18.4	15.4	18.2	15.9
Reserve money	18.3	16.5	18.4	20.3	27.1	12.0	17.0	13.0
Credit to public corporations	22.2	17.2	9.1	13.9	-5.3	9.3	9.2	2.2
Credit to private sector	8.8	25.1	10.0	20.1	21.9	14.3	15.5	13.7

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

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

Table 3b. Sri Lanka: Monetary Accounts, 2015–2017

(In billions of rupees, unless otherwise indicated, end of period)

	2015	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
		Est.	Est.	Est.	Est.	Est.		Proj.	
Central Bank of Sri Lanka									
Net foreign assets	576	474	414	498	559	537	831	826	876
Net domestic assets	97	318	344	295	298	355	74	109	91
Net claims on central government	230	407	456	397	413	467	196	189	188
Net claims on banks	-3	4	1	2	-2	-1	-1	-1	-2
Other items, net	-130	-93	-114	-104	-113	-110	-121	-79	-95
Reserve Money	673	792	757	794	856	892	905	935	967
Monetary survey									
Net foreign assets	-298	-440	-492	-278	-231	-372	-63	-76	-89
Monetary authorities	576	474	414	498	559	537	831	826	876
Deposit money banks	-874	-914	-905	-776	-790	-908	-894	-902	-965
Net domestic assets	4,864	5,172	5,336	5,374	5,637	6,049	5,656	5,948	6,356
Net claims on central government	1,759	1,954	2,005	1,949	1,972	2,215	2,154	2,321	2,111
Credit to corporations	3,973	4,149	4,283	4,418	4,700	4,929	4,802	4,988	5,285
Public corporations	523	515	485	452	495	553	449	467	506
Private corporations	3,450	3,635	3,798	3,965	4,204	4,375	4,353	4,521	4,779
Other items (net)	-868	-932	-953	-992	-1,035	-1,094	-1,300	-1,361	-1,039
Broad money	4,566	4,732	4,844	5,096	5,406	5,677	5,593	5,872	6,267
Memorandum Items									
Gross international reserves (in millions of U.S. dollars)	7,304	6,221	5,293	6,456	6,019	5,117	6,897	6,868	7,246
Net international reserves (in millions of U.S. dollars)	5,029	4,309	3,843	5,272	4,529	4,353	6,168	6,023	6,161
Money and credit (percent change, end of period)									
Broad money	17.8	18.9	17.0	18.4	18.4	20.0	15.5	15.2	15.9
Reserve money	16.5	27.8	24.5	23.9	27.1	12.7	19.5	17.8	13.0
Credit to private sector	25.1	27.7	28.2	25.6	21.9	20.4	14.6	14.0	13.7

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

Table 4a. Sri Lanka: Balance of Payments, 2015–21
(In millions of U.S. dollars, unless otherwise indicated)

	2015	2016			2017			2018	2019	2020	2021
		CR/16/150	CR/16/371	Proj.	CR/16/150	CR/16/371	Proj.		Proj.		
Current account	**-1,882**	**-1,202**	**-1,738**	**-1,942**	**-2,419**	**-1,953**	**-2,094**	**-1,980**	**-1,933**	**-1,983**	**-2,219**
Balance on goods	-8,388	-7,936	-8,484	-9,090	-9,820	-9,067	-9,278	-9,412	-9,870	-10,417	-11,012
Credit (exports)	10,547	10,456	10,530	10,310	10,942	10,983	11,239	11,861	12,490	13,088	13,751
Debit (imports)	-18,935	-18,392	-19,013	-19,400	-20,763	-20,051	-20,517	-21,273	-22,360	-23,506	-24,763
Balance on services	2,324	2,760	2,796	2,879	3,251	2,963	2,946	3,395	3,812	4,411	4,831
Credit (exports)	6,396	7,133	7,141	7,138	7,905	7,570	7,547	8,227	8,885	9,595	10,171
Debit (imports)	-4,072	-4,373	-4,346	-4,259	-4,654	-4,607	-4,601	-4,831	-5,073	-5,185	-5,340
Primary income, net 1/	-2,012	-2,376	-2,400	-2,184	-2,315	-2,276	-2,336	-2,404	-2,490	-2,662	-2,799
Secondary income, net 2/	6,194	6,350	6,350	6,453	6,464	6,427	6,574	6,440	6,615	6,685	6,761
Of which: workers' remittances (net)	6,167	6,322	6,322	6,434	6,435	6,398	6,555	6,420	6,594	6,664	6,740
Capital account (+ surplus / - deficit)	**46**	**43**	**13**	**25**	**27**	**12**	**55**	**20**	**16**	**16**	**12**
Balance from current account and capital account	**-1,836**	**-1,159**	**-1,725**	**-1,917**	**-2,392**	**-1,941**	**-2,039**	**-1,960**	**-1,917**	**-1,967**	**-2,207**
Financial account (+ net lending / - net borrowing) 3/	**-3,172**	**-1,505**	**-761**	**-1,766**	**-3,536**	**-2,140**	**-2,871**	**-2,063**	**-2,309**	**-2,813**	**-2,919**
Direct investments	-628	-662	-570	-662	-852	-685	-945	-1,000	-1,073	-1,168	-1,203
Portfolio investments	-687	-793	-1,237	-992	-808	-1,182	-1,196	-294	-358	-426	-416
Equity and investment Fund shares	60	0	-10	-24	-178	-150	-120	-122	-130	-140	-150
Debt instruments	-747	-793	-1,227	-968	-630	-1,032	-1,076	-172	-228	-286	-266
Of which: deposit taking corporations	0	-200	324	0	-230	558	514	689	172	134	134
Of which: general government	-747	-593	-1,551	-968	-400	-1,590	-1,590	-861	-400	-420	-400
T-bills, T-bonds, and SLDBs	903	1,407	635	532	-100	-90	-90	139	-200	-220	-200
Sovereign bonds	-1,650	-2,000	-2,186	-1,500	-300	-1,500	-1,500	-1,000	-200	-200	-200
Other investments 4/	-1,857	-50	1,046	-112	-1,876	-273	-730	-769	-878	-1,219	-1,300
Of which:											
Currency and deposits	-1,313	1,000	751	614	-250	-150	194	-6	-10	-101	-25
Central bank	-1,097	1,100	1,101	701	0	0	400	0	0	0	0
Deposit taking corporations	-216	-100	-350	-87	-250	-150	-206	-6	-10	-101	-25
Loans 4/	-1,266	-1,050	-212	-877	-1,626	-473	-1,222	-410	-444	-844	-1,196
Central bank 4/	0	0	0	0	0	0	0	0	0	0	0
Deposit taking corporations	-787	-200	-40	507	-200	-420	-445	-401	-432	-340	-408
General government	-470	-550	-172	-1,288	-1,231	17	-452	207	348	-104	-388
Disbursements	-1,268	-1,500	-1,200	-2,305	-2,300	-1,200	-1,817	-1,477	-1,400	-1,600	-1,600
Amortizations	798	950	1,028	1,017	1,070	1,217	1,365	1,684	1,748	1,496	1,212
Other sectors	-9	-300	0	-96	-195	-70	-325	-216	-360	-400	-400
Errors and omissions	-308	0	0	283	0	0	0	0	0	0	0
Overall balance (- = need of inflow) 3/	**1,027**	**346**	**-964**	**132**	**1,143**	**200**	**832**	**103**	**391**	**846**	**712**
Total financing (- = inflow)	**862**	**346**	**-964**	**-536**	**1,143**	**200**	**832**	**103**	**391**	**846**	**712**
Financing (- = inflow)	**862**	**1,006**	**-304**	**-17**	**1,760**	**817**	**1,460**	**908**	**632**	**846**	**712**
Change in reserve assets	355	549	-762	-472	1,519	576	1,227	908	632	832	658
Use of Fund credit, net	507	456	458	455	241	242	233	0	0	14	54
Purchases/Disbursements	0	0	0	0	0	0	0	0	0	0	0
Repurchases/repayments	507	456	458	455	241	242	233	0	0	14	54
Financing gap (- = inflow)	**0**	**-659**	**-660**	**-518**	**-617**	**-618**	**-628**	**-805**	**-240**	**0**	**0**
IMF	0	-334	-335	-333	-417	-418	-403	-480	-240	0	0
Other IFIs	0	-325	-325	-185	-200	-200	-225	-325	0	0	0
Memorandum items:											
Current account (in percent of GDP)	-2.4	-1.5	-2.1	-2.4	-2.8	-2.2	-2.5	-2.3	-2.1	-2.0	-2.0
Gross official reserves	7,304	7,853	6,542	6,019	9,372	7,118	7,246	8,155	8,786	9,618	10,276
In months of prospective imports of goods and services	3.7	3.7	3.2	2.9	4.1	3.3	3.3	3.6	3.7	3.8	3.9
In percent of ARA composite metric	70.6	79.1	65.7	56.3	86.9	67.1	64.8	67.8	70.1	73.4	74.7
Net international reserves	5,029	5,700	5,490	4,529	7,043	5,890	6,161	6,589	6,980	7,826	8,538
In percent of ARA composite metric	48.6	57.4	55.1	42.3	65.3	55.6	55.1	54.8	55.7	59.7	62.1
GDP	79,565	82,239	83,044	80,517	87,626	88,137	83,567	87,234	94,050	101,556	109,638

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

1/ Under BPM5 known as Income.

2/ Under BPM5 known as Transfers.

3/ Excluding changes in reserves assets and credit and loans with the IMF.

4/ Excluding credits and loans with the IMF, other than reserves (net purchases and repurchases).

Table 4b. Sri Lanka: Balance of Payments, 2016–17
(In millions of U.S. dollars, unless otherwise indicated)

	2016					2017				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
	Est.					Proj.				
Current account	35	-679	-126	-1,172	-1,942	-684	-367	-485	-557	-2,094
Balance on goods	-1,855	-2,335	-1,969	-2,931	-9,090	-2,360	-2,170	-2,337	-2,410	-9,278
Credit (exports)	2,739	2,391	2,656	2,524	10,310	2,859	2,629	2,831	2,920	11,239
Debit (imports)	-4,595	-4,727	-4,625	-5,454	-19,400	-5,219	-4,799	-5,169	-5,330	-20,517
Non-oil imports	-4,109	-4,034	-4,126	-4,650	-16,919	-4,341	-3,992	-4,299	-4,433	-17,065
Oil imports	-486	-692	-499	-804	-2,481	-878	-807	-870	-897	-3,451
Balance on services	842	471	794	772	2,879	788	598	803	758	2,946
Credit (exports)	1,928	1,565	1,816	1,829	7,138	1,923	1,745	1,918	1,962	7,547
Debit (imports)	-1,086	-1,094	-1,022	-1,057	-4,259	-1,135	-1,148	-1,115	-1,204	-4,601
Primary income, net 1/	-523	-448	-525	-688	-2,184	-624	-431	-597	-685	-2,336
Secondary income, net 2/	1,571	1,633	1,574	1,675	6,453	1,512	1,636	1,646	1,780	6,574
Capital account (+ surplus / - deficit)	0	0	2	23	25	40	5	5	5	55
Balance from current account and capital account	35	-679	-124	-1,149	-1,917	-644	-362	-480	-552	-2,039
Financial account (+ net lending / - net borrowing) 3/	353	317	-1,634	-802	-1,766	169	-2,111	-336	-594	-2,871
Direct investments	-23	-33	-29	-577	-662	-134	-158	-247	-406	-945
Portfolio investments	567	55	-1,942	328	-992	73	-1,325	39	18	-1,196
Debt instruments	564	13	-1,918	373	-968	103	-1,295	69	48	-1,076
Of which: general government	564	13	-1,918	373	-968	35	-1,525	-25	-75	-1,590
T-bills, T-bonds, and SLDBs	564	13	-418	373	532	35	-25	-25	-75	-90
Sovereign bonds	0	0	-1,500	0	-1,500	0	-1,500	0	0	-1,500
Other investments 4/	-191	295	337	-553	-112	231	-628	-127	-207	-730
Of which: Currency and deposits	250	598	9	-243	614	275	-50	7	-38	194
Central bank	0	701	-1	1	701	400	0	0	0	400
Loans 4/	-846	10	-161	120	-877	-29	-607	-255	-331	-1,222
Central bank 4/	0	0	0	0	0	0	0	0	0	0
Deposit taking corporations	-590	166	588	343	507	-144	-175	-80	-46	-445
General government	42	-141	-804	-385	-1,288	290	-332	-150	-260	-452
Disbursements	-286	-305	-1,169	-545	-2,305	-95	-636	-509	-576	-1,817
Amortizations	328	164	365	160	1,017	385	304	359	316	1,365
Other sectors	-298	-15	55	162	-96	-175	-100	-25	-25	-325
Errors and omissions	-222	51	227	227	283	0	0	0	0	0
Overall balance (- = need of inflow) 3/	-540	-945	1,737	-120	132	-814	1,748	-145	42	832
Total financing (- = inflow)	-990	-912	1,601	-234	-536	-814	1,748	-145	42	832
Financing (- = inflow)	-990	-745	1,601	118	-17	-814	1,873	18	383	1,460
Change in reserve assets	-1,134	-865	1,505	22	-472	-907	1,780	-29	383	1,227
Use of Fund credit, net	144	120	96	96	455	93	93	47	0	233
Purchases/Disbursements	0	0	0	0	0	0	0	0	0	0
Repurchases/repayments	144	120	96	96	455	93	93	47	0	233
Financing gap (- = inflow)	0	-167	0	-352	-518	0	-125	-162	-341	-628
IMF	0	-167	0	-167	-333	0	0	-162	-241	-403
Other IFIs	0	0	0	-185	-185	0	-125	0	-100	-225
Memorandum items:										
Gross official reserves	6,221	5,293	6,456	6,019	6,019	5,117	6,897	6,868	7,246	7,246
In months of prospective imports of goods and services	3.0	2.5	3.1	2.9	2.9	2.4	3.2	3.2	3.3	3.3
In percent of ARA composite metric	58.2	49.5	60.4	56.3	56.3	45.8	61.7	61.4	64.8	64.8
Net international reserves	4,309	3,843	5,272	4,529	4,529	4,353	6,168	6,023	6,161	6,161
In percent of ARA composite metric	40.3	35.9	49.3	42.3	42.3	38.9	55.2	53.9	55.1	55.1

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

1/ Under BPM5 known as Income.

2/ Under BPM5 known as Transfers.

3/ Excluding changes in reserves assets and credit and loans with the IMF.

4/ Excluding credits and loans with the IMF, other than reserves (net purchases and repurchases).

Table 4c. Sri Lanka: Gross External Financing, 2015–21

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

	2015	2016	2017	2018	2019	2020	2021
		Est.			Proj.		
Current account	-1,882	-1,942	-2,094	-1,980	-1,933	-1,983	-2,219
Balance on goods	-8,388	-9,090	-9,278	-9,412	-9,870	-10,417	-11,012
Credit (exports)	10,547	10,310	11,239	11,861	12,490	13,088	13,751
Debit (imports)	-18,935	-19,400	-20,517	-21,273	-22,360	-23,506	-24,763
Balance on services	2,324	2,879	2,946	3,395	3,812	4,411	4,831
Primary and secondary income, net	4,182	4,269	4,238	4,037	4,125	4,023	3,962
Amortization	-909	-2,173	-2,098	-2,068	-3,788	-3,110	-1666
General government	-1,298	-1,017	-1,365	-1,684	-3,248	-2,496	-2212
Sovereign bonds	-500	0	0	0	-1,500	-1,000	-1000
Syndicated loans	0	0	-280	-560	-560	-280	0
Bilateral and multilateral	-798	-1,017	-1,085	-1,124	-1,188	-1,216	-1212
Central bank	590	-1,156	-633	0	0	-14	-54
IMF repurchases/repayments	-507	-455	-233	0	0	-14	-54
Other central bank liabilities, net	1,097	-701	-400	0	0	0	0
Private sector loans	-202	0	-100	-384	-540	-600	600
Gross external financing needs	-2,791	-4,115	-4,192	-4,048	-5,721	-5,093	-3,885
Sources of financing	2,791	4,115	4,192	4,048	5,721	5,093	3,885
Borrowing	3,312	3,125	4,791	4,151	6,112	5,925	4543
General government	2,564	3,308	3,407	2,338	3,300	3,020	3000
T-bills, T-bonds, and SLDBs, net	-903	-532	90	-139	200	220	200
Sovereign bonds	2,150	1,500	1,500	1,000	1,700	1,200	1200
Syndicated loans	0	700	700	0	0	0	0
Bilateral and multilateral 1/	1,268	1,605	1,117	1,477	1,400	1,600	1600
Official capital transfers	49	35	0	0	0	0	0
Other capital inflows, net	748	-183	1,384	1,813	2,812	2,905	1,543
Deposit-taking corporations, excl. central bank, net	787	-797	438	7	557	595	587
FDI inflows, net	628	662	945	1,000	1,073	1,168	1,203
Private sector loans	211	0	425	600	900	1,000	1,000
Other capital inflows, net	-878	-48	-424	207	282	143	-1,247
Change in reserve assets	-355	472	-1,227	-908	-632	-832	-658
External financing gap	0	518	628	805	240	0	0
Financing	0	518	628	805	240	0	0
IMF	0	333	403	480	240	0	0
Other IFIs	0	185	225	325	0	0	0

Sources: Central Bank of Sri Lanka; and IMF staff estimates and projections.
1/ Based on existing and expected commitments (incl. ADB, China, and Japan).

Table 5. Sri Lanka: Financial Soundness Indicators—All Banks, 2012–16

(In percent)

	2012	2013	2014	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4
Capital adequacy											
Regulatory capital to risk weighted assets	16.4	16.3	17.2	16.3	16.0	15.2	15.4	15.0	14.7	14.1	14.3
Tier 1 capital/risk weighted assets	14.7	13.7	14.6	13.8	13.5	12.8	13.0	12.4	12.2	11.7	11.4
Capital to assets ratio	8.6	8.2	8.2	8.2	8.2	8.1	7.9	7.8	7.9	7.8	7.8
Asset quality											
Gross nonperforming loans to total gross loans (without interest in suspense)	3.7	5.6	4.2	4.3	4.3	4.0	3.2	3.1	3.0	2.9	2.6
Net nonperforming loans to total gross loans	2.2	3.8	2.6	2.7	2.7	2.4	1.7	1.7	1.6	1.6	1.3
Provision coverage ratio (total)	53.4	40.4	50.7	48.1	48.4	51.6	62.3	61.2	64.3	64.5	70.0
Earnings and profitability											
Return on equity (after tax)	20.3	16.0	16.6	16.4	16.0	16.2	16.2	13.7	16.4	17.6	17.3
Return on assets (after tax)	1.7	1.3	1.4	1.4	1.3	1.3	1.3	1.1	1.3	1.4	1.4
Net interest income to gross income	71.4	69.6	69.3	74.6	74.5	73.0	73.2	75.0	75.4	75.3	74.7
Staff expenses to noninterest expenses	45.8	44.9	43.5	45.6	46.6	45.6	45.5	39.9	44.8	45.4	44.9
Total cost to total income	75.2	79.3	75.9	73.7	73.9	73.8	73.1	78.4	76.0	75.8	75.6
Net interest margin	4.1	3.5	3.5	3.8	3.7	3.6	3.6	3.6	3.6	3.5	3.6
Liquidity											
Liquid assets to total assets	26.6	31.9	32.2	31.0	31.3	29.4	30.0	28.5	28.3	28.3	27.3
Assets/funding structure											
Deposits to total assets	71.1	70.2	67.2	66.6	67.4	66.5	66.9	66.7	67.5	68.7	69.6
Borrowings to total assets	15.8	17.1	20.8	21.4	20.6	21.7	21.8	21.9	21.0	19.8	18.8
Credit to deposits (loans net of interest in suspense to deposits)	86.9	82.2	83.1	85.5	85.0	87.7	87.3	88.4	88.5	87.1	88.0

Source: Central Bank of Sri Lanka.

Table 6. Sri Lanka: Reviews and Purchases under the Three-year Extended Arrangement

Availability date	Amount (SDR millions)	Percent of Quota (%)	Conditions
June 3, 2016	119.894	20.714	Board Approval of the Extended Arrangement
November 18, 2016	119.894	20.714	Completion of the first review based on end-June 2016 and continuous performance criteria
April 20, 2017	119.894	20.714	Completion of the second review based on end-December 2016 and continuous performance criteria
November 20, 2017	177.774	30.714	Completion of the third review based on end-June 2017 and continuous performance criteria
April 20, 2018	177.774	30.714	Completion of the fourth review based on end-December 2017 and continuous performance criteria
November 20, 2018	177.774	30.714	Completion of the fifth review based on end-June 2018 and continuous performance criteria
April 20, 2019	177.776	30.715	Completion of the sixth review based on end-December 2018 and continuous performance criteria
Total	1070.780	185.000	

Source: IMF staff.

Table 7. Sri Lanka: Projected Payments to the Fund, 2016–2030 1/

(In millions of SDR, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Fund repurchases and charges															
In millions of SDR	36.1	39.7	14.3	19.2	29.8	59.4	122.9	180.3	192.3	189.4	176.6	144.0	77.6	17.4	2.4
In millions of U.S. dollars	50.1	53.8	19.3	25.9	40.2	80.3	166.0	243.4	259.7	255.8	238.4	194.4	104.8	23.4	3.3
In percent of exports of goods and NFS	0.3	0.3	0.1	0.1	0.2	0.3	0.7	0.9	0.9	0.9	0.8	0.6	0.3	0.1	0.0
In percent of quota	6.2	6.9	2.5	3.3	5.1	10.3	21.2	31.1	33.2	32.7	30.5	24.9	13.4	3.0	0.4
In percent of gross official reserves	0.8	0.7	0.2	0.3	0.4	0.8	1.5	2.2	2.2	2.1	1.9	1.5	0.8	0.2	0.0
Fund credit outstanding 2/															
In millions of SDR	412.0	537.5	893.0	1,070.8	1,060.8	1,020.8	916.4	752.8	574.3	395.9	227.4	88.9	14.8	0.0	0.0
In millions of U.S. dollars	555	727	1,207	1,447	1,433	1,377	1,236	1,016	775	534	307	120	20	0	0
In percent of quota	71	92.9	154.3	185.0	183.3	176.4	158.3	130.1	99.2	68.4	39.3	15.4	2.6	0.0	0.0
In percent of GDP	0.7	0.9	1.4	1.5	1.4	1.3	1.0	0.8	0.6	0.4	0.2	0.1	0.0	0.0	0.0
In percent of gross official reserves	9.2	10.0	14.8	16.5	14.9	13.4	11.5	9.0	6.6	4.4	2.4	0.9	0.1	0.0	0.0
Memorandum items:															
Exports of goods and services (in millions of U.S. dollars)	17,448	18,786	20,087	21,375	22,683	23,922	25,118	26,374	27,693	29,078	30,532	32,058	33,661	35,344	37,111
Quota 2/	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8
Quota (in millions of U.S. dollars) 2/	780	782	782	782	782	781	781	781	781	781	781	781	781	781	781
Gross official reserves (in millions of U.S. dollars) 2/	6,019	7,246	8,155	8,786	9,618	10,276	10,776	11,276	11,776	12,276	12,776	13,276	13,776	14,276	14,776
GDP (in millions of U.S. dollars)	80,517	83,567	87,234	94,050	101,556	109,638	118,409	127,882	138,112	149,161	161,094	173,982	187,900	202,932	219,167
U.S. dollars per SDR (eop)	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35
U.S. dollars per SDR (avg.)	1.39	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35

Source: IMF staff estimates.

1/ As of June 15, 2017 using the new quota (effective in February 17, 2016).

2/ As of the end of the year.

Annex I. Debt Sustainability Analysis

Sri Lanka's public debt and gross funding needs stand high compared with peers, with the ratio of gross financing needs to GDP being the third largest among emerging economies. Fiscal consolidation envisaged under the EFF-supported program would steadily reduce them. However, there are significant downside risks including those related to contingent liabilities, with stress tests indicating a high risk to public debt sustainability. External debt remains sustainable, though with high currency risks. Risks to external debt sustainability are mitigated by long maturities and Sri Lanka's access to international financial markets.

A. Background and Key Assumptions

1. Public debt reached 84.2 percent of GDP at end-2016. Public debt in this DSA covers debt owed by the central government (79.3 percent of GDP), outstanding amount of loans guaranteed by the central government (4.2 percent of GDP), and outstanding Fund credit (0.7 percent of GDP). SOEs' financial obligations identified by recent FAD TA (12 percent of GDP at end-2015) are not included in the public debt outstanding. Nevertheless, the impact from possible realization of the contingent liabilities is assessed under a shock scenario. Foreign-currency denominated debt accounted for 48 percent of total, while debt owed to official and multilateral creditors accounted for about a quarter of the total. Gross financing needs are estimated at 17.6 percent of GDP in 2016, comprising amortization payments (including short-term debt repayment) of 12.2 percent of GDP and an overall deficit of 5.4 percent of GDP. Sri Lanka's debt to GDP ratio remains higher than the median for emerging economies (57 percent; excluding major oil exporters), and gross funding needs are the third largest among them.

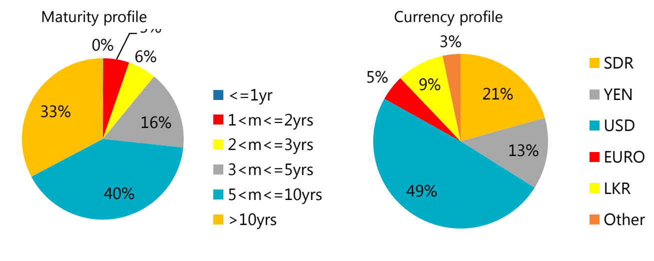
Sri Lanka: Public Debt, 2015–16

	2015		2016	
	Rs. billion	% of GDP	Rs. billion	% of GDP
Public debt	8,996	82.1	9,968	84.2
Central government debt	8,503	77.6	9,387	79.3
Domestic	4,959	45.3	5,342	45.1
Treasury Bills	658	6.0	780	6.6
Treasury Bonds	3,305	30.2	3,715	31.4
Other	996	9.1	847	7.2
External	3,544	32.4	4,046	34.2
Multilateral and bilateral	2,237	20.4	2,437	20.6
International sovereign bonds	958	8.7	1,221	10.3
Nonresident holdings of T-Bills and T-Bonds	304	2.8	260	2.2
Other	45	0.4	128	1.1
Publicly guaranteed debt	382	3.5	497	4.2
Fund credit outstanding	110	1.0	83	0.7
Financial obligations of SOEs 1/	1,280	11.7	…	…
Ceylon Electricity Board	237	2.2	…	…
Ceylon Petroleum Corporation	424	3.9	…	…
Sri Lanka Ports Authority	240	2.2	…	…
Sri Lankan Airlines	309	2.8	…	…
Other	69	0.6	…	…
Memorandum item:				
Public debt and financial obligations of SOEs 1/	10,276	93.8	…	…

Sources: Sri Lankan authorities and IMF staff estimates.
1/ IMF staff estimates. Including short-term debt, project loans, and Sri Lankan Airlines' liabilities related to aircraft lease.

2. External debt is estimated at 56 percent of GDP at end-2015. It is predominantly owed by the public sector (55 percent held by the general government and 6 percent by the central bank). However, private external debt has risen over the years, in particular with debt of deposit-taking financial institutions rising from 13 percent of total in 2011 to 20 percent in 2015. The ratio of debt to exports is also high, at 265 percent in 2015. However, rollover risks are currently low as 83 percent of total debt (i.e., public and private) is medium or long term, while the next sovereign bond repayment is due in 2019 (US$1.5 billion). About half of the central government's external debt stock is denominated in dollars.

Sri lanka: Profile of central government external loans (2015)



Source: Sri Lankan authorities.

3. The baseline scenario of the DSA reflects the macroeconomic framework and the proposed policies under the EFF-supported program. Real GDP growth is projected to recover from 4.4 percent in 2016 to 5.2 percent by 2022. Inflation is projected to stay around 5 percent over the medium term. Fiscal deficit is programmed to decrease from 5.4 percent of GDP in 2016 to the authorities' target of 3.5 percent of GDP in 2020. This implies that primary balance improves from deficit of 2.2 percent of GDP in 2015 to a balance in 2017 and a surplus of 2.2 percent of GDP in 2020. Interest payments are projected on the basis of the projected interest payments for existing debt, and the interest rates in the secondary government security markets prevailing thus far in 2017 for the newly issued debt in 2017. Interest rates for newly issued debts are assumed to decrease gradually from these levels over the medium term. Publicly guaranteed debt is projected to remain broadly unchanged at the 2016 level in nominal terms. External debt projections are based on a projected path of the current account deficit from 2.5 percent of GDP in 2017 to around 2 percent of GDP over the medium term, and incorporate planned purchases under the Fund's Extended Arrangement and disbursements of program loans by multilateral and bilateral creditors.

B. Public Debt Sustainability

4. Fiscal consolidation envisaged under the EFF-supported program would steadily reduce public debt. The consolidation path envisaged under the program scenario is projected to bring down the ratio of public debt to GDP from 84.2 percent in 2016 to 70.5 percent in 2022. It will reduce the debt to GDP ratio by about 2–3 percent annually from 2018 onwards, supported by favorable debt dynamics with a negative interest-rate-and-growth differential and primary surpluses. Gross financing needs are projected to rise to 20 percent of GDP in 2018 and then decrease to around 13 percent of GDP in 2022.

5. Nevertheless, there are significant downside risks to the program scenario. If fiscal consolidation stalls and primary balance remains at a historical level (-1.5 percent of GDP), the debt-to-GDP ratio would remain at about the same level as in 2016. Debt reductions would become less significant under individual shock scenarios on primary balance (lower primary surplus by 0.5 percentage points of GDP for 2018−19), GDP growth (2 percentage points lower than in the program scenario for 2018–19), the exchange rate (15 percent real depreciation in 2018 vis-à-vis the program scenario), and the interest rate (an increase by 300 basis points for new borrowings during 2017–20 vis-à-vis the program scenario). When these shocks are combined, the debt to GDP ratio would reach 89 percent in 2022. Similarly, in a contingent liability shock scenario (the central government becomes liable for additional debt of 10 percent of GDP in 2017), the debt to GDP ratio would initially jump to 94 percent of GDP and gradually decline to 84 percent of GDP in 2022. The likelihood of such a scenario has increased due to delays in introducing fuel and electricity pricing mechanisms, which are crucial to ensure profitability of oil and electricity SOEs. In the combined shock scenario and the contingent liability shock scenario, gross funding needs would remain elevated at 16–18 percent of GDP in 2022. Also, the debt level is high relative to revenues, constraining repayment capacity. The envisaged improvement in the cyclically adjusted primary balance by 3.3 percentage points of GDP over 2016–18 is higher than in 80 percent of international experiences, highlighting the challenge of the fiscal consolidation plan.

6. Heat map analysis indicates a high risk to debt sustainability. The debt burden benchmark of 70 percent of GDP and gross financing need benchmark of 15 percent of GDP are exceeded in the program and the shock scenarios during the projection period, reflecting the initial conditions (under the program scenario, the debt to GDP ratio and gross financing needs as a percent of GDP were 85 percent and 19 percent in 2017, respectively). Debt profile analysis indicates moderate degree of vulnerabilities related to market perception, external financing requirement, debt held by non-residents, and debt denominated in foreign currency.

C. External Debt Sustainability

7. The ratio of external debt to GDP is projected to gradually decline over the medium term. Under the program scenario, external debt is projected to decrease from 57 percent of GDP in 2016 to 50 percent in 2022. The decline is driven by robust GDP growth and gradual current account adjustments, with increased FDI and other debt-creating private capital inflows.

8. Nevertheless, vulnerabilities linked to inadequate reserve coverage, exchange rate depreciation, and deleveraging could pose a risk for debt servicing. Currency risk, notably related to the dollar, is high. Large rupee depreciation could pose a significant risk, if sustained; as stress tests show that a 30 percent real depreciation would raise the external debt to GDP ratio to about 73 percent by 2022. In the short run, tighter global liquidity and shifts in investor confidence could raise rollover vulnerabilities and costs. Although rollover risks are generally low due to the high share of medium- to long-term debt, there are lumpy repayments starting in 2019, and external financing at non-concessional terms gradually substitutes concessional financing, pointing to a need to build up buffers. Lower than expected GDP or export growth would also deteriorate debt dynamics.

Sri Lanka: Public DSA Risk Assessment

Heat Map

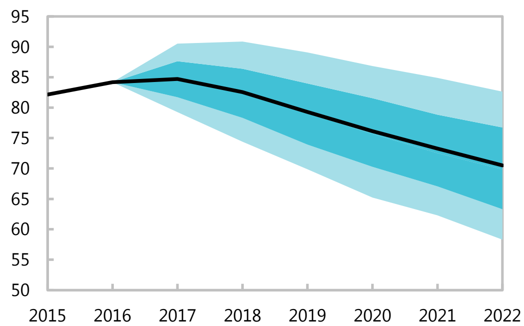
Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception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

Evolution of Predictive Densities of Gross Nominal Public Debt

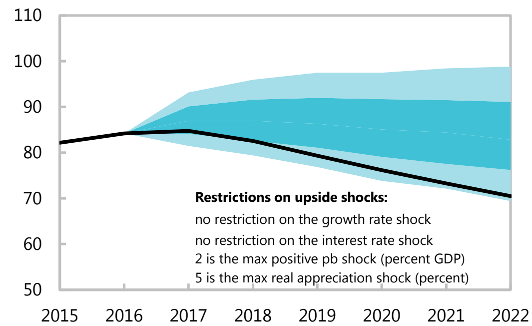
(in percent of GDP)

Baseline   Percentiles: 10th-25th   25th-75th   75th-90th

Symmetric Distribution



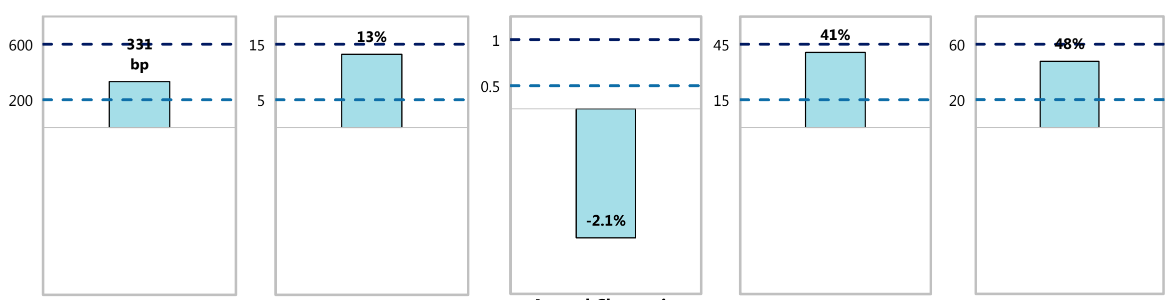
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)

Sri Lanka   Lower early warning   Upper early warning



EMBIG	**External Financing Requirement**	**Annual Change in Short-Term Public Debt**	**Public Debt Held by Non-Residents**	**Public Debt in Foreign Currency**
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

Source: IMF staff.

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

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

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

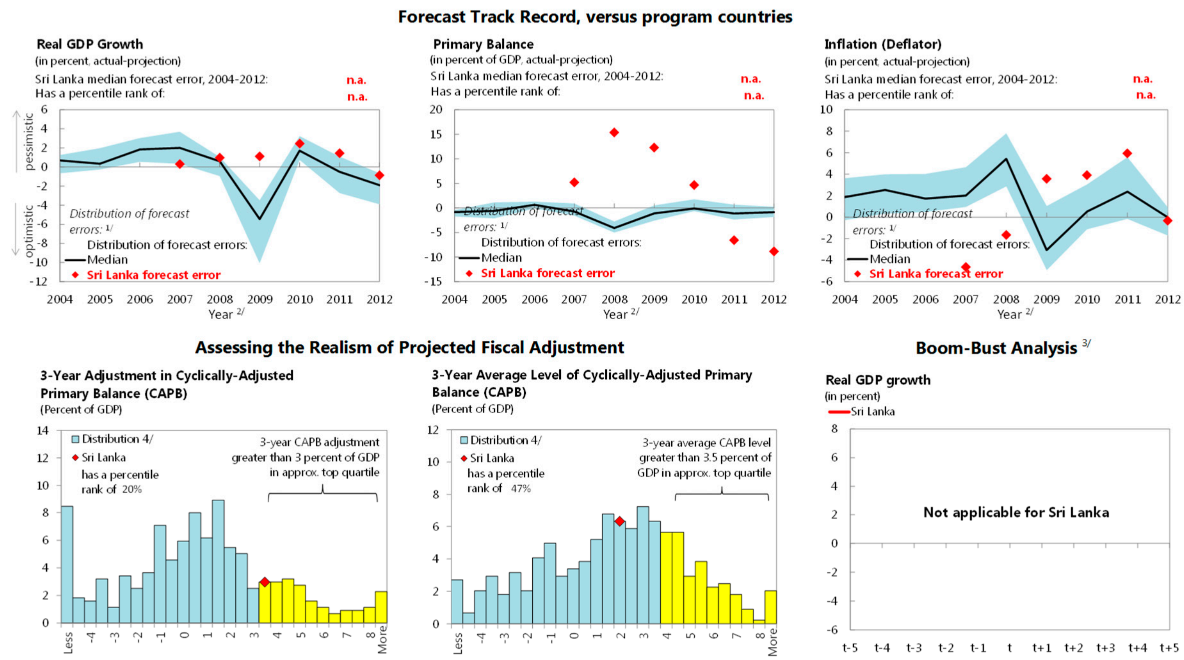
Lower and upper risk-assessment benchmarks are:

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

4/ EMBIG, an average over the last 3 months, 25-Feb-17 through 26-May-17.

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

Sri Lanka: Public DSA – Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Sri Lanka, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

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

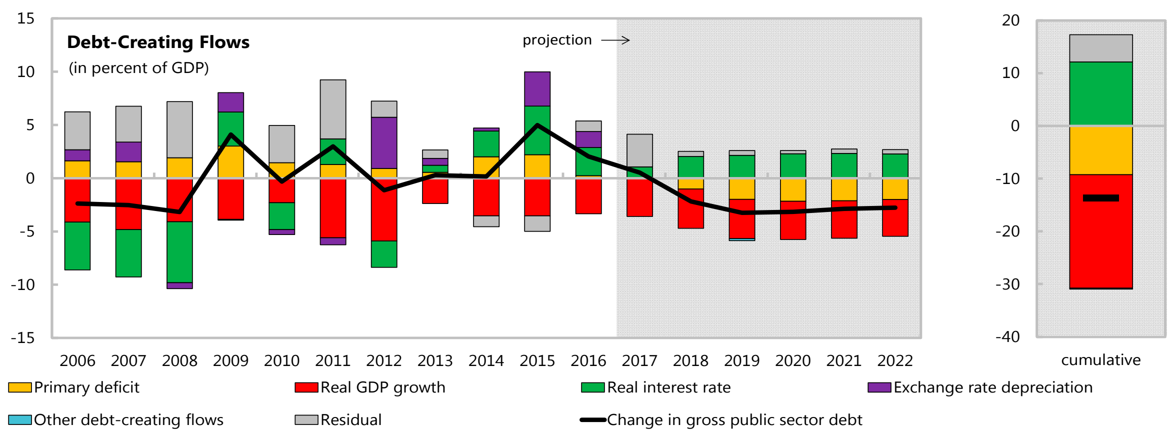
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1]

	Actual			Projections						As of May 26, 2017		
	2006-2014 [2]	2015	2016	2017	2018	2019	2020	2021	2022			
Nominal gross public debt	75.7	82.2	84.2	84.7	82.6	79.3	76.1	73.3	70.5	Sovereign Spreads		
Of which: guarantees	3.3	4.5	4.9	4.7	4.8	4.7	4.3	3.8	3.4	EMBIG (bp) 3/		325
Public gross financing needs	22.6	21.1	17.6	18.6	19.6	17.3	14.3	13.3	13.2	5Y CDS (bp)		n.a.
Real GDP growth (in percent)	6.2	4.8	4.4	4.7	4.8	4.9	5.0	5.1	5.2	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	8.9	0.8	3.6	5.6	5.0	5.0	5.0	5.0	5.0	Moody's	B1	B1
Nominal GDP growth (in percent)	15.7	5.7	8.1	10.6	10.0	10.1	10.3	10.4	10.5	S&Ps	B+	B+
Effective interest rate (in percent) [4]	7.5	7.1	7.2	7.3	7.9	8.1	8.4	8.6	8.7	Fitch	B+	B+

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	-0.2	5.0	2.0	0.5	-2.2	-3.3	-3.2	-2.9	-2.8	-13.7	
Identified debt-creating flows	-2.7	6.4	1.1	-2.5	-2.7	-3.7	-3.5	-3.3	-3.2	-18.8	
Primary deficit	1.6	2.2	0.2	0.0	-1.0	-2.0	-2.2	-2.1	-2.0	-9.2	-1.2
Primary (noninterest) revenue and grants	13.2	13.3	14.3	14.5	15.4	16.5	16.7	16.9	16.9	96.9	
Primary (noninterest) expenditure	14.8	15.5	14.6	14.5	14.4	14.5	14.6	14.7	14.9	87.7	
Automatic debt dynamics [5]	-4.3	4.2	0.8	-2.5	-1.7	-1.5	-1.3	-1.2	-1.2	-9.4	
Interest rate/growth differential [6]	-5.3	1.0	-0.7	-2.5	-1.7	-1.5	-1.3	-1.2	-1.2	-9.4	
Of which: real interest rate	-1.2	4.6	2.6	1.0	2.0	2.2	2.3	2.3	2.3	12.1	
Of which: real GDP growth	-4.1	-3.5	-3.3	-3.6	-3.7	-3.7	-3.6	-3.5	-3.4	-21.5	
Exchange rate depreciation [7]	1.0	3.2	1.5	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.0	0.0	-0.2	
Privatization proceeds for DSA (negative	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.0	0.0	-0.2	
Residual, including asset changes [8]	2.5	-1.5	1.0	3.1	0.5	0.4	0.3	0.4	0.4	5.1	



Source: IMF staff.

1/ Public sector is defined as central government and includes public guarantees, defined as outstanding amount of loans guaranteed by the central government and Fund credit outstanding.

2/ Based on available data.

3/ EMBIG.

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

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

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

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

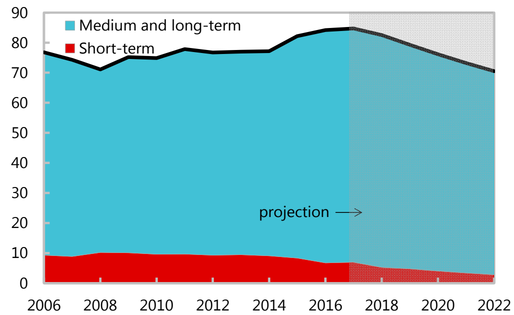
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

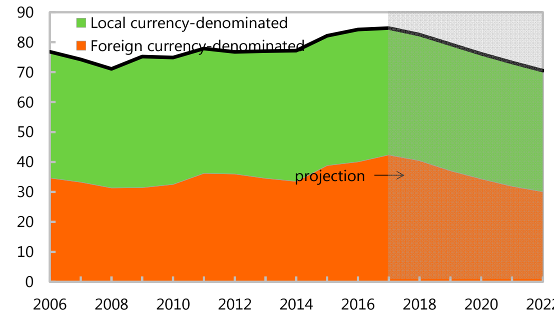
Sri Lanka: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



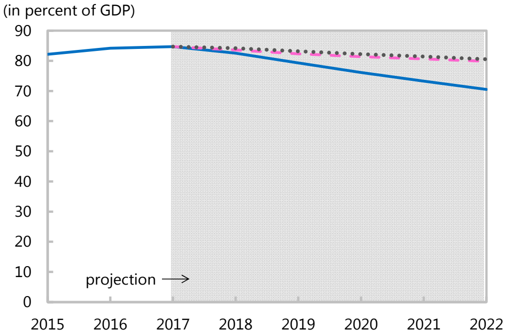
By Currency
(in percent of GDP)



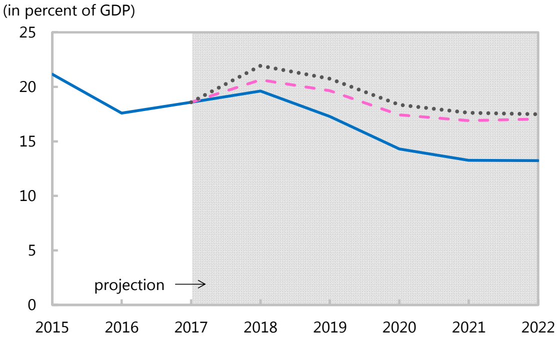
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

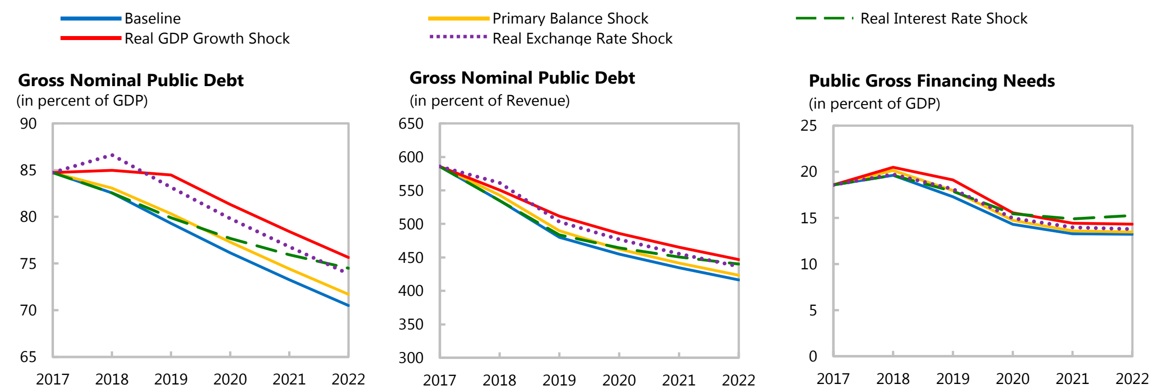
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.7	4.8	4.9	5.0	5.1	5.2
Inflation	5.6	5.0	5.0	5.0	5.0	5.0
Primary Balance	0.0	1.0	2.0	2.2	2.1	2.0
Effective interest rate	7.3	7.9	8.1	8.4	8.6	8.7
Constant Primary Balance Scenario						
Real GDP growth	4.7	4.8	4.9	5.0	5.1	5.2
Inflation	5.6	5.0	5.0	5.0	5.0	5.0
Primary Balance	0.0	0.0	0.0	0.0	0.0	0.0
Effective interest rate	7.3	7.9	8.1	8.5	8.7	8.7

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.7	5.9	5.9	5.9	5.9	5.9
Inflation	5.6	5.0	5.0	5.0	5.0	5.0
Primary Balance	0.0	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	7.3	7.9	7.5	7.4	7.3	7.1

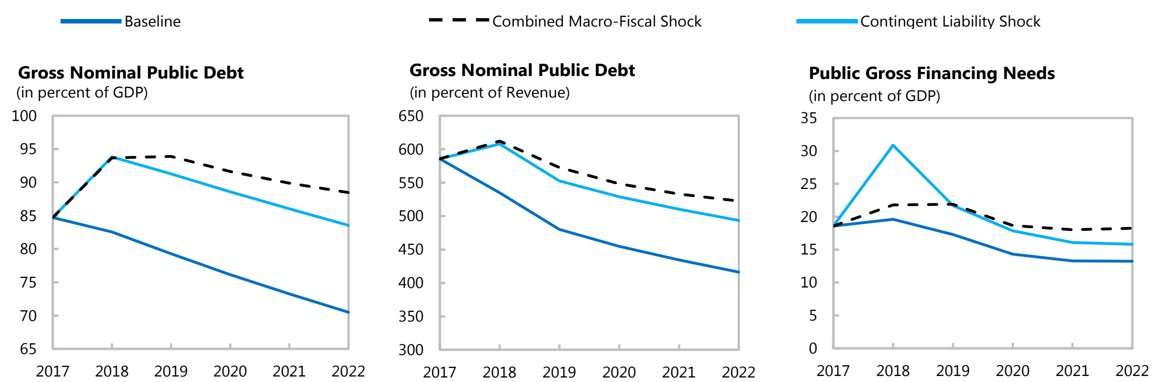
Source: IMF staff.

Sri Lanka: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

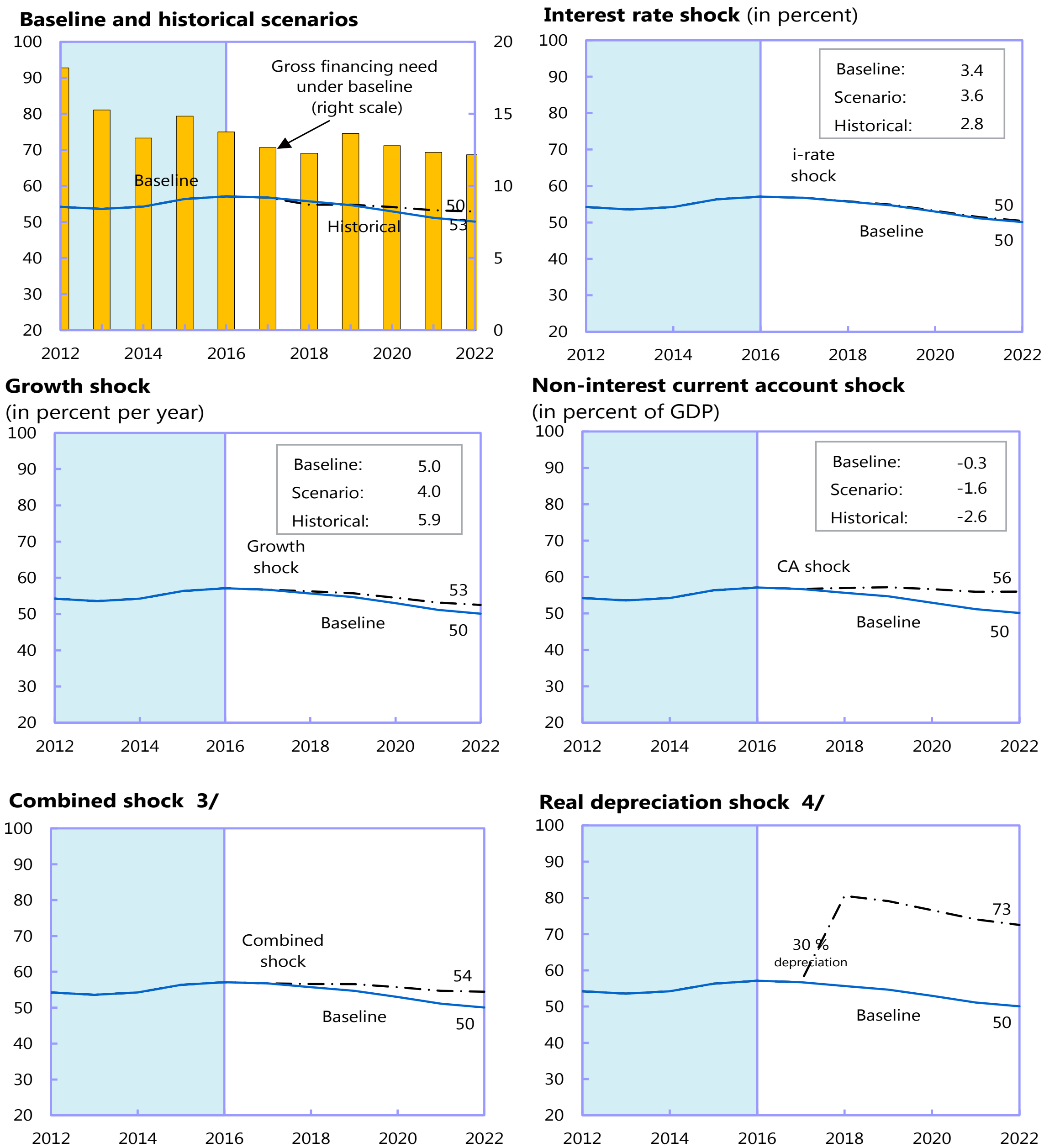
	2017	2018	2019	2020	2021	2022
Primary Balance Shock						
Real GDP growth	4.7	4.8	4.9	5.0	5.1	5.2
Inflation	5.6	5.0	5.0	5.0	5.0	5.0
Primary balance	0.0	0.5	1.5	2.1	2.1	2.0
Effective interest rate	7.3	7.9	8.2	8.5	8.7	8.7
Real Interest Rate Shock						
Real GDP growth	4.7	4.8	4.9	5.0	5.1	5.2
Inflation	5.6	5.0	5.0	5.0	5.0	5.0
Primary balance	0.0	1.0	2.0	2.2	2.1	2.0
Effective interest rate	7.3	7.9	9.0	9.8	10.4	10.7
Combined Shock						
Real GDP growth	4.7	2.8	2.9	5.0	5.1	5.2
Inflation	5.6	4.5	4.5	5.0	5.0	5.0
Primary balance	0.0	0.5	1.1	2.1	2.1	2.0
Effective interest rate	7.3	8.3	8.6	9.6	10.1	10.5

	2017	2018	2019	2020	2021	2022
Real GDP Growth Shock						
Real GDP growth	4.7	2.8	2.9	5.0	5.1	5.2
Inflation	5.6	4.5	4.5	5.0	5.0	5.0
Primary balance	0.0	0.6	1.3	2.2	2.1	2.0
Effective interest rate	7.3	7.9	8.1	8.5	8.7	8.7
Real Exchange Rate Shock						
Real GDP growth	4.7	4.8	4.9	5.0	5.1	5.2
Inflation	5.6	10.1	5.0	5.0	5.0	5.0
Primary balance	0.0	1.0	2.0	2.2	2.1	2.0
Effective interest rate	7.3	8.3	7.8	8.2	8.4	8.5
Contingent Liability Shock						
Real GDP growth	4.7	4.8	4.9	5.0	5.1	5.2
Inflation	5.6	5.0	5.0	5.0	5.0	5.0
Primary balance	0.0	-8.9	2.0	2.2	2.1	2.0
Effective interest rate	7.3	9.7	9.2	9.1	9.2	9.2

Source: IMF staff.

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

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2017.

Sri Lanka: External Debt Sustainability Framework, 2012–2022

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2012	2013	2014	2015	2016	10-Year Historical Average	10-Year Standard Deviation	2017	2018	2019	2020	2021	2022	Debt-stabilizing non-interest current account 6/
Baseline: External debt	54.2	53.6	54.2	56.4	57.1			**56.8**	**55.7**	**54.7**	**53.0**	**51.2**	**50.1**	**-3.3**
Change in external debt	4.0	-0.6	0.7	2.1	0.8			-0.4	-1.1	-1.0	-1.7	-1.8	-1.1	
Identified external debt-creating flows (4+8+9)	1.4	-2.5	-2.1	1.3	0.7			-1.2	-1.6	-1.8	-1.9	-1.7	-1.7	
Current account deficit, excluding interest payments	4.5	2.0	1.0	0.8	0.8			0.8	0.5	0.3	0.2	0.3	0.4	
Deficit in balance of goods and services	11.9	8.6	8.1	7.6	7.7			7.6	6.9	6.4	5.9	5.6	5.3	
Exports	19.8	20.3	21.1	21.3	21.7			22.5	23.0	22.7	22.3	21.8	21.2	
Imports	31.8	28.9	29.2	28.9	29.4			30.1	29.9	29.2	28.3	27.5	26.5	
Net non-debt creating capital inflows (negative)	-1.7	-1.5	-1.3	-0.7	-0.9			-1.1	-1.3	-1.3	-1.3	-1.2	-1.3	
Net foreign direct investment, equity	1.3	1.2	1.0	0.8	0.8			1.1	1.1	1.1	1.2	1.1	1.1	
Net portfolio investment,equity	0.4	0.3	0.2	-0.1	0.0			0.0	0.1	0.1	0.1	0.1	0.2	
Automatic debt dynamics 1/	-1.5	-3.0	-1.9	1.2	0.8			-0.9	-0.9	-0.8	-0.8	-0.8	-0.8	
Contribution from nominal interest rate	1.3	1.4	1.5	1.5	1.6			1.7	1.7	1.8	1.8	1.7	1.7	
Contribution from real GDP growth	-4.4	-1.7	-2.5	-2.6	-2.4			-2.6	-2.6	-2.5	-2.5	-2.5	-2.5	
Contribution from price and exchange rate changes 2/	1.6	-2.7	-0.9	2.3	1.6			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	2.7	1.9	2.8	0.8	0.0			0.9	0.6	0.7	0.1	-0.1	0.6	
External debt-to-exports ratio (in percent)	273.3	264.6	257.2	264.7	263.5			252.5	241.9	240.6	237.1	234.5	236.9	
Gross external financing need (in billions of US dollars) 4/	12.4	11.4	10.6	11.8	11.1			10.6	10.7	12.8	13.0	13.5	14.4	
in percent of GDP	18.2	15.3	13.3	14.8	13.7			12.7	12.3	13.6	12.8	12.3	12.2	
Scenario with key variables at their historical averages 5/								**56.8**	**54.8**	**54.8**	**54.2**	**53.3**	**52.9**	**-4.6**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	9.1	3.4	5.0	4.8	4.4	5.9	2.0	4.7	4.8	4.9	5.0	5.1	5.2	
GDP deflator in US dollars (change in percent)	-4.0	5.3	1.5	-4.3	-3.0	3.7	7.7	-0.9	-0.4	2.8	2.8	2.7	2.5	
Nominal external interest rate (in percent)	2.7	2.9	2.9	2.8	2.9	2.8	0.3	3.1	3.2	3.4	3.5	3.5	3.5	
Growth of exports (US dollar terms, in percent)	-0.5	11.1	11.0	1.2	3.0	7.9	10.6	7.7	6.9	6.4	6.1	5.5	4.5	
Growth of imports (US dollar terms, in percent)	-2.4	-1.0	7.6	-0.6	2.8	9.0	19.9	6.2	3.9	5.1	4.6	4.9	4.0	
Current account balance, excluding interest payments	-4.5	-2.0	-1.0	-0.8	-0.8	-2.6	2.6	-0.8	-0.5	-0.3	-0.2	-0.3	-0.4	
Net non-debt creating capital inflows	1.7	1.5	1.3	0.7	0.9	1.2	0.4	1.1	1.3	1.3	1.3	1.2	1.3	

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

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

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

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

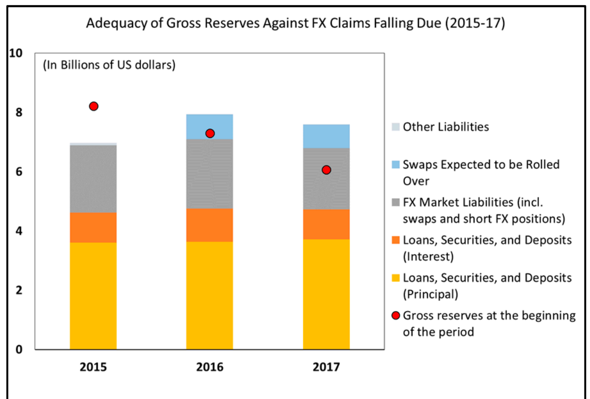
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

Annex II. External Sector Assessment

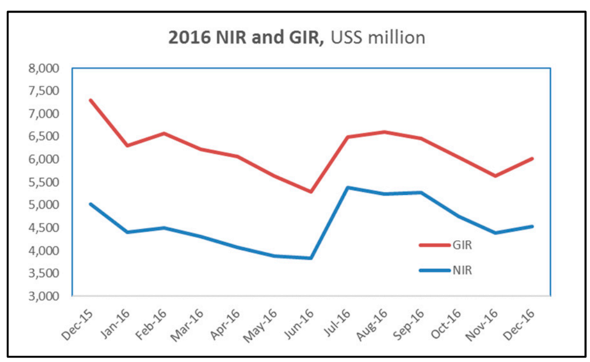
Sri Lanka's external position is weaker than implied by fundamentals and desirable policy settings. The current account gap points to a moderate overvaluation of the real effective exchange rate (REER), reflecting policy imbalances and structural competitiveness challenges. Reserve coverage has deteriorated owing to capital outflows and heavy intervention in the foreign exchange market. Sri Lanka's immediate priorities for strengthening external sustainability are to rebuild reserves and rebalance macroeconomic policies. Longer-term policies should address structural competitiveness issues that hold back export expansion and capital inflows, particularly high quality FDI.

1. **External sustainability in Sri Lanka remains an important vulnerability, with continued balance of payment pressures and reserves losses in 2016.** Sri Lanka's balance of payments continued to deteriorate in 2016 owing to capital outflows. The current account deficit was contained at 2.4 percent of GDP, the same as in 2015, as strong tourism revenue and remittances offset the large trade deficit of 11 percent of GDP. The capital and financial account saw heavy outflows from government securities and decreased rollover of liabilities in the banking sector. After having fallen by US$900 million in 2015, gross international reserves (GIR) further declined by US$1.3 billion in 2016. GIR at end-2016 stood at around 3 months of imports, and 56 percent of the ARA metric. This level of GIR covers only about 80 percent of foreign exchange claims falling due in 2017, leaving Sri Lanka heavily reliant on rolling over its FX swaps and other external liabilities to meet its foreign claims. The program-defined NIR stood at US$2.0 billion—covering about one month of import—after having declined by more than US$800 million during 2016.

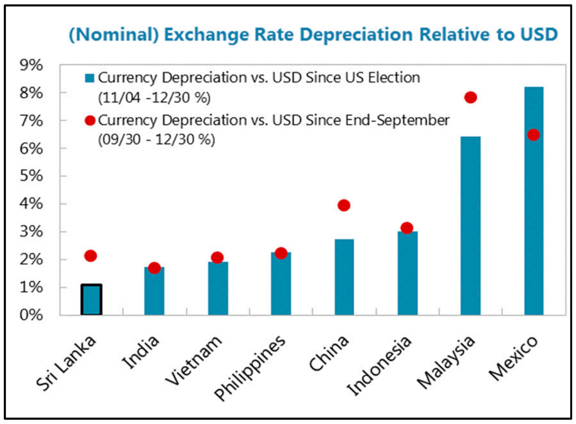


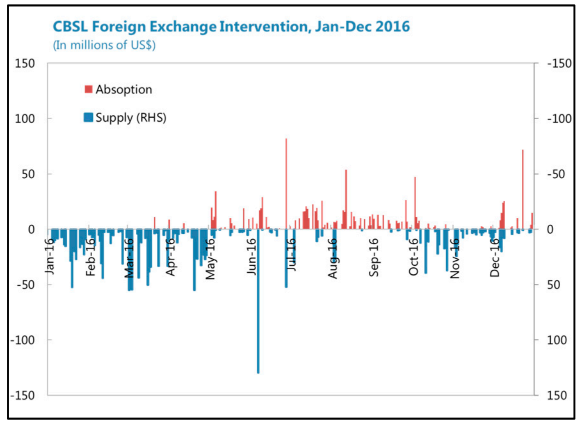
Source: Central Bank of Sri Lanka

2. **The CBSL intervened heavily in the FX market, in response to depreciation pressures on the rupee.** The first wave of capital outflow amounting to over US$500 million occurred between January and April 2016 (before the EFF). During this time, the net sales of FX in the spot market reduced gross reserves by US $1.2 billion, while the rupee depreciated by only 0.12 percent during this period. Between May-September, capital outflows reversed with inflows to government securities of US$ 613 million, and the CBSL accumulated quite some reserves. Market pressures then resumed in mid-October, concomitant with capital outflows. The CBSL drew down FX reserves further, supplying around $170 million to the foreign exchange market in October and November, which helped keep the spot rate little changed. After the U.S. elections in

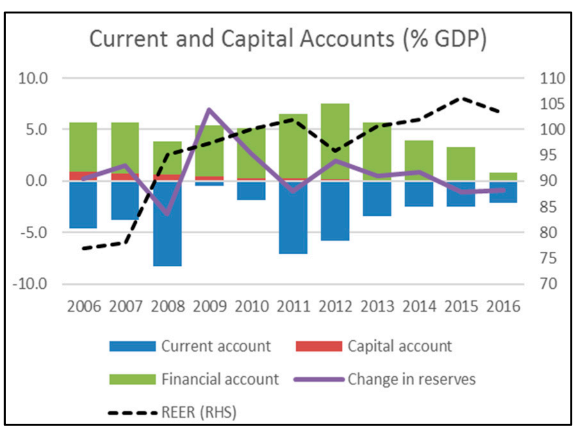


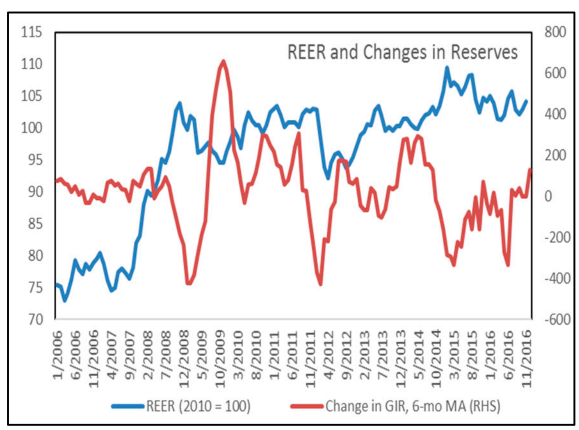
November, most EM currencies depreciated by sizable margins. In contrast, Sri Lanka's exchange rate moved the least among EM peers despite similar movements in bond spreads. The CBSL's sizable FX purchase in December was not enough to make up for earlier losses. The program's end-December NIR target was missed by a substantial margin.





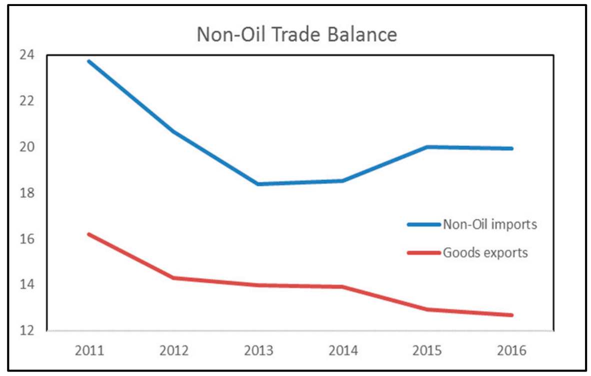
3. **Over time, a notable relationship between the real effective exchange rate and reserve accumulation has emerged.** The tendency to defend the nominal exchange rate has led to a steady appreciation of the real effective exchange rate (REER) accompanied by low reserve accumulation. High frequency data confirm that periods of REER appreciation have tended to coincide with reserve losses. While swings in reserves are not a new feature of Sri Lanka, the trend decline in reserves over the last 2½ years indicates that the strategy to prevent depreciation by intervention cannot be sustained without the risk of a sudden and more disruptive nominal exchange rate adjustment later. Moreover, as the country becomes more integrated with global capital markets, external buffers will be scrutinized. Although Sri Lanka's current risks are mitigated by relatively long portfolio maturities, and limited foreign participation in government securities—at around 5 percent of outstanding Tbills and Tbonds—rollover risks will rise significantly over the medium term as large sovereign bond repayments begin to fall due.





4. **Reflecting the REER appreciation, Sri Lanka's competitiveness challenges have deepened.** These challenges manifest through the high trade deficit and declining capital flows. Although Sri Lanka's current account deficit has steadily improved since 2011, the trend has been driven primarily by lower oil prices and higher service exports. The non-oil trade deficit, on the other

hand, has worsened in the last two years, now standing at 7.2 percent of GDP, close to the level seen in 2011 when the current account deficit was more than 7.1 percent of GDP. The worsening trade balance has been due to a steady decline in goods exports, and higher non-oil goods imports over the last two years—a pattern consistent with an appreciated REER. Over the last five years, capital inflows have also been rapidly shrinking amid declining investor confidence. These developments together suggest that the current account adjustments of the last few years have been caused by the declining competitiveness and tightening FX liquidity constraint.



5. Standard models for assessing the external balance, which do not fully account for FX liquidity constraints, provide limited guidance on Sri Lanka's exchange rate misalignment. Indeed, given Sri Lanka's fundamentals and policy gap, the current account model of the External Balances Assessment (EBA) predicts a cyclically adjusted current account norm of -1.0 percent of GDP, against the 2016 outturn of -2.4 percent.[1] Estimation of the real exchange rate misalignment using the EBA's CA methodology therefore concludes that Sri Lanka's CA gap is -1.4 percent weaker than implied by fundamentals and desired policies. This gap is consistent with an exchange rate overvaluation of around 8 percent.[2] The large positive residual of the model suggests that there may be important fundamentals or policy distortions that are not captured by the model. Possible missing fundamental variables include remittances, tourism revenue, and FX liquidity constraints on the economy. Remittances are generally negatively associated with the current account (as shown by the EBA Lite model) while tourism revenue and FX liquidity constraints have likely contributed to improve or contain the current account deficit in Sri Lanka.[3] Missing policy variables likely include structural rigidities that contribute to an uncompetitive business environment, discussed below. Using the EBA Lite equilibrium REER model, Sri Lanka's REER overvaluation is estimated at around 18 percent. The positive residual in the EBA Lite model

CA model	
Cyclically adjusted CA outturn	**-2.4%**
Cyclically adjusted CA norm	**-1.0%**
CA gap	-1.4%
Policy gap	1.1%
Fiscal	*0.1%*
Change in reserves/GDP	*-0.3%*
Private credit/GDP	*0.1%*
Health expenditure	*0.7%*
Capital control	*0.5%*
Residual	-2.6%

[1] EBA current account methodology. Estimations of the other two EBA methodologies are not available for Sri Lanka.

[2] Based on an assumed semi-elasticity of CA/GDP to REER of 0.18, using a common cross-country elasticity assumption of 0.71 for exports and 0.92 for imports, adjusted by the size of exports and imports in GDP, where $\varepsilon = x\varepsilon_x - m(\varepsilon_m - 1)$ and $\ln(REER) - \ln(REER^*) = \frac{1}{\varepsilon} * (CA - CA^*)$.

[3] The correlation coefficient of tourism receipts and the current account in Sri Lanka is high at 0.66.

suggests factors outside the model—e.g., limited exchange rate flexibility—contribute to the REER overvaluation.

6. Sri Lanka's competitiveness challenges also reflect structural factors. Despite many advantages, Sri Lanka has had limited success in attracting FDI. The country's geographic location offers an ideal production base for exports to Asia, Africa, and the Middle East. FDI, however, averages only around 1 percent of GDP. Sri Lanka is ranked 110th out of 190 countries in the World Bank's 2017 *Doing Business* report. The country performs relatively poorly on enforcement of contracts, paying taxes, and registering property. The report notes Sri Lanka's progress in strengthening the rights of minority shareholders and streamlining the business incorporation process by waiving the stamp duty on issued shares. But the report also points out labor market rigidities—Sri Lanka has the second highest severance pay in the world for workers with more than 10 years of tenure, creating a bias against young workers while protecting possibly less productive workers, particularly in small and medium firms that cannot afford the high severance pay. Anecdotal evidence also points to the frequent changes in investment and tax frameworks as important obstacles for doing business in Sri Lanka.

7. Current FDI has been concentrated in the construction, utilities, and service sectors.[4] While FDI into these non-tradable sectors has fostered infrastructural development and improved service sector productivity, it generally creates few opportunities for technology transfer, import replacement, or export expansion. Several studies have shown that FDI into the tradable sector has positive effects on the country's export performance.[5] Similarly, an IMF study on sectoral composition of FDI shows that for countries in Central and Eastern Europe, FDI into the tradable sector led to an improvement in the external balance.[6] The same study also shows that countries where FDI in the non-tradable sector dominated tended to have larger current account deficits.

8. Over the short term, Sri Lanka's immediate priority for strengthening external sustainability is to rebuild reserves and rebalance macroeconomic policies. Depreciation pressures may return when EMs experience outflows. In this regard, fiscal savings as envisaged under the EFF can contribute to reduce external imbalances. Along with this, a strengthened monetary framework, another pillar of the program, will help stem capital outflows while containing inflation. Longer-term policies must address structural competitiveness issues that hold back export expansion and capital inflows, particularly high quality FDI.

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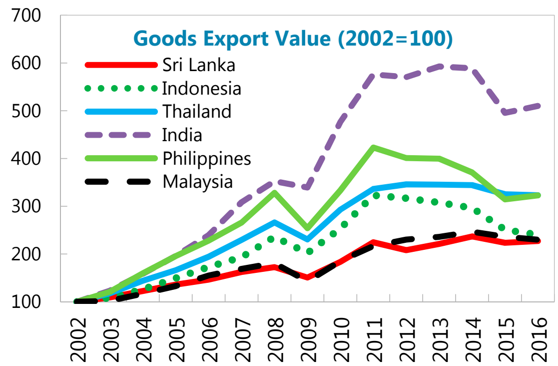
[4] https://www.oxfordbusinessgroup.com/analysis/opening-door-opportunities-abound-government-seeks-significant-rise-foreign-direct-invest-0

[5] See, for example, Ichihashi, M. and R. Rahmaddi, 2012, "The Impact of Foreign Direct Investment on Host Country Exports: Sector Based Evidence from Indonesian Manufacturing," Hiroshima University, Graduate School for International Development and Cooperation, IDEC DP2 Series No. 2–10; and Zhang, K. H., 2005, "How Does FDI Affect a Host Country's Export Performance? The Case of China," Paper presented in International Conference of WTO, China, and the Asian Economies, III. In Xi'an, China, June 25–26, 2005.

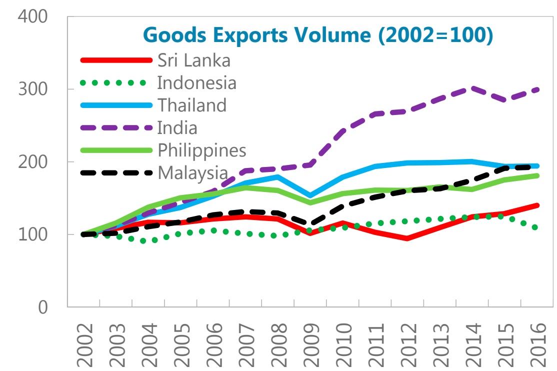
[6] Kinoshita, Y., 2011, "Sectoral Composition of Foreign Direct Investment and External Vulnerability in Eastern Europe," IMF Working Paper 11/123 (Washington: International Monetary Fund.)

Sri Lanka: External Sector

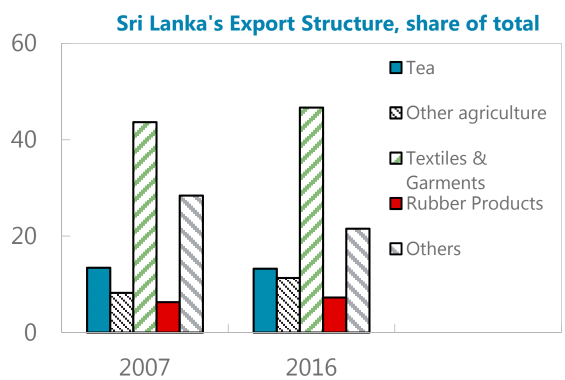
Sri Lanka lags behind peers in export performance, both in export value growth…



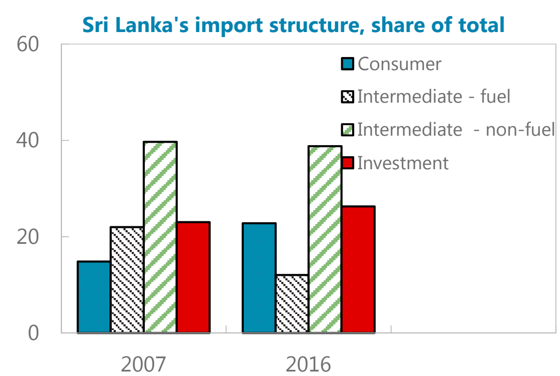
…and export volume growth…



…reflecting the country's challenge in diversifying its export components, which have remained unchanged.



Savings from lower oil prices have been channeled towards higher consumer goods imports



Complex investment framework and legal structure may be hindering investments…

Source: World Bank's *Doing Business* database.

…while labor market rigidities hinder the ability to adjust.

Appendix I. Letter of Intent

Colombo, June 23, 2017

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Lagarde:

This letter serves as a supplement to our Letters of Intent dated May 12, 2016, and November 3, 2016, and the associated Memorandum of Economic and Financial Policies (MEFP) dated May 12, 2016. The attached MEFP updates the MEFP dated May 12, 2016, by describing reform progress so far and setting out the plans and policies of the authorities of Sri Lanka for 2017−2019. Table 1 and Technical Memorandum of Understanding (TMU) attached to the MEFP set out quantitative targets that are to be observed under the Extended Arrangement. Table 2 attached to the MEFP sets out a proposed prior action for approval of the second review as well as new and modified structural benchmarks.

We believe that the policies set forth in the attached MEFP, together with the previously issued MEFP and Letters of Intent, are adequate to achieve the objectives of our economic program, but the Government stands ready to take additional measures as appropriate to ensure achievement of its objectives. We will continue to consult in advance with Fund staff on adoptions of measures or revisions of the policies contained in the MEFP and in this letter, in accordance with the Fund's policies on such consultations. We will provide the Fund with the information it requests for monitoring program implementation.

Against the background of our performance to date and our strong commitment going forward, we request completion of the Second Review of the Extended Arrangement under the EFF, after which we intend to draw one tranche amounting to SDR 119.894 million. We are also requesting waivers on the nonobservance of non-accumulation of external arrears as steps have been taken to clear the arrears, and a waiver of applicability of the end-June 2017 QPCs. We are also seeking the modification of the performance criterion on the net official international reserves and ITs for June 2017 as well as structural benchmarks, as specified in the tables 1 and 2 of the MEFP and TMU.

In keeping with its policy of transparency, the Government has authorized the publication of this letter and its attachments as well as the associated staff report.

Sincerely yours,

/s/	/s/
Mangala Samaraweera Minister of Finance	Indrajit Coomaraswamy Governor Central Bank of Sri Lanka

Attachment I. Memorandum of Economic and Financial Policies

I. MACROECONOMIC OUTLOOK

1. **The economic outlook is broadly stable despite headwinds from severe weather events.** Growth is projected to recover gradually from 4.4 percent in 2016 to around 5 percent in 2017, as growth in manufacturing, construction, and services will somewhat offset the impact of the drought in 2017 Q1 and the floods in 2017 Q2 on agriculture. Credit growth will likely slow in coming months, in a lagged response to monetary tightening in 2016 and the recent tightening in 2017. The current account deficit is expected to improve in 2017. However, the current account could be adversely affected by severe weather events which will increase oil and food imports. Mainly driven by higher food prices, headline inflation is projected to temporarily rise above the midpoint of the program's inflation consultation band, but is expected to stay within the inner band.

II. PROGRAM PERFORMANCE

2. **Since July 2016, fiscal policy has been largely on track under our program, but reserve accumulation and some structural measures have been delayed**. While the end-December quantitative targets were met for the primary balance and tax revenues, the NIR target was missed by $411 million and the reserve money target was breached by Rs 46 billion. Inflation stayed within the consultation band. We have made progress on structural measures, albeit with further delays in some areas than originally intended.

III. FISCAL POLICY

Fiscal stance

3. **The main priority for fiscal policy remains a durable reduction of the fiscal deficit and public debt through domestic revenue mobilization**. The government reduced the overall fiscal deficit to 5.4 percent of GDP in 2016, from a deficit of 7 percent in 2015. This deficit reduction was achieved through a bolstering of tax revenues—rather than one off measures—while containing recurrent, discretionary, and capital spending. For 2017, the budget targets a primary surplus of Rs 55 billion (0.4 percent of GDP), supported by revenue measures equivalent to Rs 140 billion (1 percent of GDP), thereby aiming to exceed the program targets for 2017 in both primary surplus and tax revenues. We mitigate the risk of revenue underperformance by committing to align expenditures with revenue outturns on a quarterly basis, as specified in the budget. We also aim to improve transparency and accountability of the budget execution process by submitting quarterly reports to Parliament since Q2.

4. **In light of the high public debt, expenditures in 2017 will be benchmarked to the level consistent with the program targets**. Should revenues exceed the program targets, the surplus will be saved as a buffer to cover the cost of unexpected natural disasters or be used to bring down debt. In the event of revenue shortfall, we will rationalize discretionary spending on goods and

services and capital projects. Such precautions will help create space for addressing the impact of natural disasters including the drought, if needed, and strengthen international reserves accumulation. The drought in late 2016 has increased thermal power generation and is expected to result in financial losses of the CEB for 2017. These losses will be compensated by necessary adjustments in the tariff and central government on-budget transfers to the CEB as necessary, and not permanently increase contingent fiscal liabilities in the form of higher borrowing by the CEB. The 2017 budget contained a tax expenditure statement (structural benchmark) and a plan to rationalize selected tax incentives in 2017.

5. It is critical that fiscal consolidation continue over the medium-term. We are committed to a steady path of lowering fiscal deficits to ensure a medium-term reduction in the public debt to GDP ratio. As first indicated in the Prime Minister's November 2015 speech to parliament, we aim to bring the overall central government deficit down to at least 3.5 percent of GDP by 2020, which should lower the central government debt to about 70 percent of GDP. Specifically, we target to overperform the program target of primary balance in 2017 and a primary surplus of adequate size in 2018, anchored by an increase in the tax to GDP ratio by about 1 percentage point of GDP annually in 2017−18. Annual budget proposals for 2018−19 will be in line with the program targets as described in Table 2 (modified structural benchmark). We will ensure fiscal consolidation beyond 2019 by revising the Fiscal Management (Responsibility) Act to include binding targets for the government deficit and level of overall public debt.

6. Fiscal consolidation will rely mainly on measures to broaden the tax base and improve the efficiency of collection and spending rather than expenditure cuts. Sri Lanka's fiscal deficits stem not from exceptionally high expenditures, but from a steady erosion of the tax base over the last two decades. Sri Lanka's tax-to-GDP ratio fell to one of the lowest in the world, and the nation's tax efficiency ratio is also below that of comparator countries—particularly for the VAT. Our strategy to re-set tax policies and bolster tax administration focuses on: (i) broadening the tax base; (ii) rationalizing the tax system and removing the many exemptions, holidays, and special rates that have undermined fair and effective tax administration; (iii) strengthening capacity for risk-based revenue administration to improve tax compliance; and (iv) bolstering public financial management, in particular on commitment control, and financial planning and discipline.

7. We have been developing the medium-term debt management framework and strengthening technical capacity with multilateral and bilateral TA support. Legislative reforms toward active liability management are underway, with a view to smoothing out the government's amortization requirements over time. Proceeds from commercializing public assets, if any, will be earmarked for debt services over the medium term, including for maturing international sovereign bonds starting in 2019.

Revenue mobilization

8. A number of measures were implemented in 2016 to improve revenue performance. As an initial step towards rationalizing tax incentives, the Cabinet suspended the Board of Investment Act in May 2016, annulling its capacity to grant tax exemptions and other forms of preferential treatment and instead concentrating these powers in the Ministry of Finance, which has ultimate oversight of tax policy. The VAT amendment enacted in November 2016 raised the VAT rate from 11 percent to 15 percent and broadened the VAT net by eliminating exemptions for telecommunication and private healthcare, excluding diagnostic tests, dialysis and services provided by the Outpatient Department (OPD), while the VAT continues to apply to wholesale and retail trade.

9. Further measures to broaden the tax base are envisaged for 2017 and the medium term. The 2017 budget includes measures to broaden the tax base, including transforming corporate tax exemptions to investment-based ones and eliminating exemptions for financial income tax. Thresholds for personal income tax will be maintained at levels that capture a sufficient portion of the tax base.

- We have been revamping the income tax law by redrafting the Inland Revenue Act (IRA) over the course of 2016 and 2017. The new IRA aims to establish a predictable, stable, transparent and even-handed framework, and widens the tax net through the elimination of tax exemptions so that over time, tax rates may be reduced.

- We will submit to Parliament the new IRA consistent with the IMF staff recommendations to:

  - increase tax revenue by broadening the base through removing exemptions;

  - modernize the legal framework for taxation by adopting principle-based drafting, streamlining the law's structure, and simplifying its language;

  - promote the business climate by enhancing taxpayers' protections and providing greater certainty on their tax affairs;

  - improve compliance by strengthening administrative powers of the Inland Revenue Department (IRD).

- We will complete a diagnostic review of the VAT system by June 2017 (structural benchmark), and implement amendments to simplify and strengthen the VAT system. This review will provide a foundation for further revenue mobilization in 2018.

- Starting with the 2017 budget presented last November, annual budgets began to include a catalogue of tax expenditures (tax exemptions, holidays, and other incentives), along with an estimate of their cost so that their merits can be debated openly. Cabinet did not yet adopt a time bound strategy to reduce or eliminate these tax expenditures, as agreed with IMF staff (structural benchmark). The government will include a plan to rationalize tax expenditures and a tax expenditure statement in the annual budgets for 2018 and 2019, as described in Table 2 (modified structural benchmark).

10. Improvements to tax administration complement tax policy reforms. Changes to tax policy will be ineffective in raising revenue unless accompanied by a concerted effort to strengthen capacity on revenue administration. Laudable efforts have been underway at the IRD for some time—including essential steps toward automation and the use of information technologies that are standard in many middle-income economies. Our reform agenda include structural benchmarks to bolster these efforts and raise our tax administration to the highest standard.

- End-December structural benchmarks for tax administration were met. With respect to VAT administration, IRD adopted a VAT compliance strategy that includes a time-bound plan to implement risk-based audits and KPIs to measure their effectiveness. IRD also fully rolled out the RAMIS IT system.

- With respect to income tax administration, a concrete plan is critical to ensure that the new IRA is implemented in a timely and effective manner, including the training of tax officers. We have initiated the implementation plan by establishing a steering committee and its terms of reference, creating project teams at the IRD, and initiating the stakeholder consultation and communication process through the publication of detailed tax manuals. Public outreach campaign is also planned, to educate and sensitize taxpayers to the new framework. IRD will adopt compliance strategies for corporate and personal income taxes (structural benchmark), following a successful implementation of the new IRA.

- More broadly, organizational and business procedure reform has begun at the IRD including restructuring along functional lines, creating a design and monitoring unit, making management structure more efficient to speed up interaction with taxpayers, strengthening the Large Taxpayer Unit, introducing mandatory e-filing, and enhancing the use of taxpayer identification numbers. The IT system for customs administration (ASYCUDA) has been improved, with case selection for risk-based cargo audit now automated.

11. A disciplined approach to government spending and prioritization of public investment (both in physical and human capital) complements revenue-based fiscal consolidation. We intend to keep the overall spending envelope under control, while reallocating spending within this envelope to areas that will bolster our medium-term prospects for robust and inclusive economic growth. To ensure a more effective, targeted and expanded social welfare scheme, we established the Welfare Benefits Board that will rationalize the various social assistance schemes through a consolidated national database for social assistance beneficiaries. To ameliorate the impact of the drought, the government will provide cash support to affected families within the overall budget envelope. With the assistance of the World Bank and other development partners, we will also upgrade our procurement processes, produce a national policy statement for public investment management, and strengthen our capacity in the area of debt management.

IV. PUBLIC FINANCIAL MANAGEMENT

12. Further improvements in fiscal management and transparency are planned to address past irregularities and prevent future occurrences. For both credibility and to fully meet our financial commitments, we see careful monitoring of government spending commitments as essential.

- A commitment recording system has been established. Through modification of the existing IT system (CIGAS) and manual reporting from line ministries, the MOF is now capable of tracking spending commitment for each line ministry on a monthly basis. As discussed earlier, we are reporting to parliament on the status of commitments in each quarter and then adjust spending through careful commitment and cash management. We plan to put in place an IT-based commitment control system by mid-2017 with commitment ceilings for line ministries for the rest of the year. The commitment control system will be implemented from the beginning of 2018 using the ITMIS system as described in Table 2 (new structural benchmark).

- The rollout of the new Integrated Treasury Management Information System (ITMIS) should significantly expand PFM capabilities, including commitment control, budget preparation, treasury, accounting, and procurement, among others.

    - Phase I of the ITMIS system – the budget planning module – was rolled out to all ministries in December 2016, including Ministries of Finance and Health (structural benchmark). This module includes a system of commitment controls that can be used to implement a formal commitment record system and quarterly expenditure ceilings. While the system has been fully rolled out, it is being operated in parallel to existing system to ensure it is functioning properly, with plans to operationalize it beginning in 2018.

    - Phases II and III of ITMIS have been rolled out to the Ministries of Finance and Health with full rollout of these modules expected next year as internal capacity to run the system is being developed.

- To boost transparency, the MOF will begin publishing quarterly financial bulletins summarizing government fiscal operations, ensure that annual budgets explicitly cost out tax expenditures, and adhere to Government Finance Statistics Manual (GFSM) standards. Budgets will also include an analysis of fiscal risks, including those related to SOEs and public-private partnerships (PPPs).

V. STATE ENTERPRISES

13. **The financial condition of some of our state enterprises and ultimate responsibility for their existing obligations are a challenge we seek to address and resolve as part of the program.** Sri Lanka currently has about 200 public enterprises representing a substantial share of the nation's economic activity. With technical assistance from the IMF, we identified outstanding obligations of the central government and SOEs totaling Rs 1.36 trillion in end-2015. These included (i) outstanding obligations of the central government, totaling Rs 58 billion, which were settled during 2016; and (ii) those of 4 SOEs (CPC, CEB, Sri Lankan Airlines, and the Sri Lanka Port Authority), totaling Rs 1.2 trillion. Although some SOEs are profitable and performing well, collectively they represent a risk to public finances (either directly or through the state banks which fund the largest SOEs). A comprehensive strategy for SOE reform and a more rules-based approach to financial

management is being developed. In the near-term, however, our strategy encompasses the following elements:

- To enhance oversight and financial discipline, Statements of Corporate Intent (SCIs) were signed in March 2017 and published in April 2017 for the five largest SOEs (CPC, CEB, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authority). The SCIs encompass the SOE's mission, high level objectives, and multiyear corporate plan; capital expenditure and financing plans; and explicit financial and non-financial targets. They also include description and cost of non-commercial obligations (NCOs) such as utility subsidies to strengthen the transparency and fiscal accountability. We plan to publish NCOs in the annual budget for 2018 and 2019, as described in Table 2 (modified structural benchmark). We will also look at strengthening the legal framework for the governance and oversight of SOEs, including through establishment of coherent financial regulations for SOEs on governance, accountability, and funds management.

- We have been implementing a resolution strategy for Sri Lankan Airlines, originally approved by Cabinet in 2015. The airline has already undertaken route and fleet optimization, reducing operational losses. The next step is to secure a strategic partner and resolve the need for capital injection and debt consolidation, thereby effectively removing this company from the government's accounts. To monitor progress, we will report the company's financial performance on a quarterly basis (see the Technical Memorandum of Understanding). In light of ongoing restructuring efforts, Sri Lankan Airlines did not participate in the publication of SCI. We aim to put the airline on a commercial footing and resolve fiscal contributions, if any, to the airline's liabilities. This milestone can be set as a structural benchmark for future program reviews.

- The structural benchmark for establishing automatic fuel and electricity pricing mechanisms has not been met. We are pursuing a sequence of steps to put the reform process back on track. First we will complete a report outlining the cost of non-commercial obligations for fuel and electricity by September 2017 (new structural benchmark), supported by IMF TA. To correctly estimate the cost of non-commercial obligations for electricity, the CEB and the Public Utility Commission will establish a Bulk Supply Transactions Account and start using it to settle transactions between generators, the transmission operator, and distributors as specified in the November 2015 tariff methodology by March 2018 (new structural benchmark). Second, once the extent of the non-commercial obligations for fuel and electricity is known, we will explicitly account for them in our program targets beginning in the third review. Finally, to reduce the possibility of future financial losses by the CPC and the CEB and avoid large ad hoc adjustments in retail prices, while allowing time for public consultation and education, we will obtain cabinet approval of the automatic pricing mechanism for fuel by March 2018 and for electricity by September 2018 as described in Table 2 (modified structural benchmarks). To monitor progress, we will report the financial performance of the CPC and the CEB on a quarterly basis (see the Technical Memorandum of Understanding). We intend to introduce cost-reflective water tariff settings when the PUC starts regulating the water sector.

VI. MONETARY AND EXCHANGE RATE POLICY

14. The focus of monetary policy will remain on keeping inflation in the mid-single digits. Throughout 2016, the CBSL tightened monetary policy by raising the statutory reserve ratio in January 2016 and raising the policy rates by 50 bps each in February 2016 and again in July 2016. While credit growth slowed due to these policy changes, it remained robust at 20.4 percent y-o-y in March 2017 and inflation picked up in early 2017 due to the implementation of VAT amendments in November and the impact of drought. To rein in inflationary pressure and curtail the buildup of adverse inflation expectations as well as to control credit growth, the CBSL raised policy rates by 25 bps in March 2017 and stands ready to further tighten monetary policy in 2017 as warranted. This tightening will also help preempt potential capital outflows. Monetary policy will continue to be monitored through a monetary policy consultation clause (see the Technical Memorandum of Understanding), supported by monitoring of reserve money developments.

15. A roadmap for flexible inflation targeting will be completed by October 2017 to establish inflation as the nominal anchor moving away from using the exchange rate as the de-facto anchor. While continuing to develop a macro forecasting model with IMF TA, the CBSL will take next steps, including establishing price stability as the primary objective of monetary policy and publicly communicating the inflation targets. While the CBSL intends to retain a role for smoothing excessive exchange rate volatility, it will guard against a real or perceived conflict of objectives and adopt FX intervention policies consistent with a flexible exchange rate regime. Foreign exchange market functionality can be improved, including by further liberalizing financial account transactions and deepening the FX market. The CBSL will develop a road map and identify time-bound reform measures as described in Table 2 (new structural benchmark), guided by IMF TA in May 2017. These time-bound measures will be incorporated into future program reviews. Through this process, we will establish among other things: (i) the legal framework, including central bank independence from fiscal or political pressures that would conflict with an inflation objective; (ii) a sound financial system that would reduce the risk of conflict between monetary and financial system stability objectives; (iii) well developed technical infrastructure, including improved forecasting and modeling capabilities, and (iv) a policy decision making process governed by the guidelines on the choice of targets and how unanticipated shocks would be addressed.

16. In tandem with moving toward flexible IT, the CBSL will continue a market-oriented approach to exchange rate policy. It is the CBSL’s intention to durably transition to a more flexible exchange rate regime. In this context, the CBSL will aim to develop (i) a deeper and more liquid foreign exchange market; (ii) adequate systems to review and manage exchange rate risks; and (iii) a transparent intervention policy, consistent with an inflation targeting regime. Accordingly, since late February, the CBSL has intervened in the FX market only to build up reserves or to stem excessive movements in the exchange rate and will continue to do so.

17. A strengthening of reserve coverage (guided by the IMF's ARA reserve metric) has been programmed, supported by regular FX purchases. With gross official reserves (GIR) close to 3 months of imports by end-April 2017, we are acutely aware of the importance of building up external buffers. Towards this goal, we renewed our commitment to greater exchange rate flexibility and undertook corrective actions that facilitated the steady build-up of reserves. In particular, as a corrective action for missing the NIR target for end-2016, we made a net outright FX purchase of $442 million in March and April, with significantly limited FX sales during that period and monetary tightening. Supported by FX purchase and financial inflows, the level of program NIR (per the TMU definition) recovered from a low level at end-2016 to $2.3 billion by end-April. Between January to end-May 2017, the exchange rate has depreciated by around 1.8 percent against the US$. We will continue to take appropriate corrective actions to enable the steady buildup of reserves with a view to fully offsetting the end-December NIR shortfall within 2017, while allowing for greater exchange rate flexibility. Further, we are committed to having monthly consultation with the IMF in making necessary corrective actions in foreign exchange intervention if there are significant deviations from an agreed upon benchmark. However, in the event that the gap between supply and demand of foreign exchange results in a highly disruptive movement of the exchange rate, we will consult with the Fund staff on the appropriate policy response. We also plan to gradually wind down FX swaps with domestic commercial banks to around US dollars 2.0 billion by end December 2017, and further reduce swap liabilities gradually during 2018.

18. During the program, we will not impose or intensify restrictions on the making of payments and transfers for current international transactions; introduce or modify multiple currency practices; conclude bilateral payments agreements that are inconsistent with Article VIII; or impose or intensify import restrictions for balance of payments reasons. The CBSL and the government will also abstain from providing exchange guarantees for foreign currency borrowing.

VII. FINANCIAL SECTOR POLICIES

19. To strengthen our financial system, we intend to undertake several measures: (i) deploy, as needed, macro-prudential tools such as a sector-specific limit on the loan-to-value ratio including in the construction and real estate sectors; (ii) implement the Basel III capital standard and assess its impact on capital positions of state owned banks; (iii) improve the financial sector risk management of greater exchange rate flexibility; and (iv) develop a resolution mechanism for distressed non-bank financial companies (in coordination with IMF TA in April 2017). While financial soundness indicators remain adequate for the banking system as a whole, the capital adequacy ratio (CAR) has been declining as the broad-based and still robust credit growth has increased risk-weighted assets.

20. We stand ready to further strengthen CBSL's autonomy and governance arrangement. The IMF safeguards assessment, completed in August 2016, identified issues in the areas of the CBSL's autonomy and governance arrangement (e.g., the government's voting representation in the Monetary Board, absence of recapitalization provisions, and inadequate limits on credit to government). These issues will be addressed as we amend the legal framework for the central bank. A step was taken with IMF Legal department's participation in the IMF TA on inflation targeting in May, and we will take next steps with a dedicated TA later in 2017.

VIII. POLICIES TO STRENGTHEN TRADE AND INVESTMENT

21. **Achieving medium-term macroeconomic objectives will require a renewed effort toward greater integration into regional and global supply chains, higher levels of FDI, and enhancing prospects for private sector investment**. In addition to better infrastructure, this will entail improvements in the trade regime and investment climate. Immediate steps toward this end have been the establishment of an Agency for Development (which will seek to prioritize infrastructure development), as well as an Agency for International Trade (responsible for trade promotion and negotiation of trade and investment agreements). The lifting of EU ban on fishery imports was a welcome change, and the GSP plus trade status with EU was reinstated in May 2017.

22. **To boost trade and private sector development, we will seek to reduce costs and bolster competitiveness.** A key element in this work would be a review of Sri Lanka's trade regime including an evaluation of para-tariffs and other nontariff barriers that have led to a high level of effective protection and hampered exports. We are working with the World Bank to strengthen our structural competitiveness. We aim to increase the efficiency of trade facilitation, remove barriers to foreign investment entry and establishment (including access to land), enhance access to finance, and strengthen financial market infrastructure. These steps should help attract FDI and complement public investment.

IX. RISKS AND CONTINGENCIES

23. **The high degree of uncertainty in the global economic environment has elevated economic and financial risks to the program.** The main risks include (i) acceleration of capital outflows, reflecting further strengthening of the US dollar and higher rates which could lead to a further decline in the already low reserves; (ii) weaker than projected revenues; (iii) weaker than expected capital inflows, which would widen the projected financing gap given already substantial gross fiscal financing needs of about 19 percent of GDP in 2017; (iv) lower than expected growth or new pressures on the trade account; and (v) weaker than expected performance of state owned enterprises. These risks could further challenge public debt and external sustainability. Should such risks materialize, the government stands ready to adjust promptly its policies, in close consultation with the IMF staff, to ensure the achievement of a sustainable external position at the end of the program.

X. PROGRAM MONITORING

24. **Our program will be subject to semiannual reviews** with performance criteria and indicative targets set out in Table 1 attached to this MEFP and Technical Memorandum of Understanding (TMU). Completion of the third and fourth reviews will require observance of the

quantitative performance criteria for end-June 2017 and end-December 2017, respectively, as well as continuous performance criteria, as specified in Table 1 attached to this MEFP. The reviews will also assess progress toward observance of the structural benchmarks specified in Table 2 attached to this MEFP. The third and fourth reviews of the program will take place on or after November 20, 2017 and April 20, 2018, respectively.

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

(Cumulative from the beginning of the year, unless otherwise noted)

	2016						2017					
	Sep. 1/			Dec.			Mar. 1/			Jun.	Sep. 1/	Dec.
	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog	Act.	Prog.	Prog.	Prog.
Quantitative performance criteria												
Central government primary balance (floor, in billion rupees)	-85	-85	-35	-97	-97	-29	-5	-5	9	-8	-4	-3
Net official international reserves (CBSL's conventional definition, floor, in million US$) 2/ 3/ 4/ 5/	330	675	243	…	…	…	…	…	…	…	…	…
Program net official international reserves (Program NIR, floor, in million US$) 2/ 3/ 4/ 5/	…	…	…	262	-267	-678	1,161	56	-113	2,027	1,976	2,236
Continuous performance criteria (cumulative from beginning of the program)												
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$) 6/	0	0	7	0	0	7	0	0	13	0	0	0
Monetary policy consultation clause												
Year-on-year inflation in Colombo Consumers Price Index (in percent) 7/												
Outer band (upper limit)	7.5	7.5	…	7.9	7.9	…	8.2	8.2	…	7.9	8.8	8.5
Inner band (upper limit)	6.0	6.0	…	6.4	6.4	…	6.7	6.7	…	6.4	7.3	7.0
Actual / Center point	4.5	4.5	4.5	4.9	4.9	4.2	5.2	5.2	6.5	4.9	5.8	5.5
Inner band (lower limit)	3.0	3.0	…	3.4	3.4	…	3.7	3.7	…	3.4	4.3	4.0
Outer band (lower limit)	1.5	1.5	…	1.9	1.9	…	2.2	2.2	…	1.9	2.8	2.5
Indicative targets												
Central government tax revenue (floor, in billion rupees)	1,021	1,021	1,067	1,428	1,428	1,464	383	383	415	803	1,232	1,718
Reserve money of the CBSL (ceiling, end of period stock, in billion rupees)	794	794	794	810	810	856	851	851	892	905	935	967
Memorandum items:												
Foreign program financing by the central government (in million US$) 3/	200	…	0	325	…	185	0	…	0	125	125	225
External commercial loans by the central government (in million US$) 3/	2,000	…	2,186	2,186	…	2,186	1,500	…	0	1,950	1,950	2,200
Proceeds from commercialization of public assets (in million US$) 3/	…	…	…	…	…	…	…	…	…	0	200	200
The cumulative net change in the amount of SLDBs and foreign holdings of Treasury Bills, Treasury Bonds assumed under the program (in million US$) 4/	-1,124	…	-621	…	…	…	…	…	…	…	…	…
Net borrowings from SLDBs (in million US$) 4/	…	…	…	-669	…	-1,056	0	…	408	…	…	…
Net borrowings from SLDBs and FCBUs (in million US$) 4/	…	…	…	…	…	…	…	…	…	627	627	627
Amortization of official external debt by the central government (in million US$) 5/	713	…	858	1,015	…	1,017	352	…	365	529	889	1,065
CBSL's outstanding liabilities in FX swaps with domestic commercial banks (in million US$)	…	…	2,466	…	…	2,497	…	…	2,339	…	…	…
Net official international reserves (CBSL's conventional definition, end of period stock, in million US$, market exchange rate) 2/	5,359	…	5,272	5,490	…	4,529	6,446	…	4,353	6,168	6,023	6,161

1/ Indicative target.

2/ Under the CBSL's conventional definition of net official international reserves (NIR), outstanding liabilities in foreign exchange swaps with domestic commercial banks are not part of the CBSL's foreign liabilities. The Program NIR is measured as the difference between the CBSL's conventional definition of NIR and outstanding liabilities in foreign exchange swaps with domestic commercial banks. See the TMU on details.

3/ If (i) the amount of foreign program financing by the central government, (ii) the amount of external commercial loans (including Eurobonds and syndicated loans) by the central government, and (iii) proceeds from commercialization of public assets is higher/lower in U.S. dollar terms than assumed under the program, the floor on the Program NIR will be adjusted upward/downward by the cumulative differences on the test date.

4/ For end-September 2016, if the cumulative net change in the amount of SLDBs and foreign holdings of Treasury Bills and Treasury Bonds are higher/lower in U.S. dollar terms than assumed under the program, the floor on net official international reserves will be adjusted upward/downward by the cumulative differences on the test date. For end-December 2016 and end-March 2017, if the cumulative net borrowings of the government from SLDBs are higher/lower in U.S. dollar terms than assumed under the program, the floor on the Program NIR will be adjusted upward/downward by the cumulative differences on the test date. For end-June 2017 and thereafter, if the cumulative net borrowings of the government from SLDBs and FCBUs are higher/lower in U.S. dollar terms than assumed under the program, the floor on the Program NIR will be adjusted upward/downward by the cumulative differences on the test date.

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

6/ Arrears arising due to Iranian payment issue.

7/ See the TMU for how to measure year-on-year inflation. Note June 2017 onwards the MPCC and inflation is based on the new index (2013=100).

Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program

Proposed Prior Action			
Submit to Parliament a new Inland Revenue Act, complete with schedules for investment incentives and exemptions, with a view to simplifying and broadening the income tax in line with staff recommendations.			
Structural Benchmark	**Target Completion Date**	**Status**	**Comment**
New structural benchmarks			
MOF to implement an IT-based commitment control system with commitment ceilings for line ministries for the 2018 budget.	January 2018		The ITMIS modules for budget planning and commitment control will be operational for the 2018 budget. This enables MOF to transition from cash-based expenditure management to commitment-based control.
MOF to complete a report outlining the cost of non-commercial obligations for fuel and electricity.	September 2017		A step in a sequence of reforms to put the automatic fuel and electricity pricing reform back on track.
CEB and the Public Utilities Commission (PUC) to establish a Bulk Supply Transactions Account and start using it to settle transactions between generators, the transmission operator, and distributors as specified in the November 2015 tariff methodology.	March 2018		A step in a sequence of reforms to put the automatic electricity pricing reform back on track.
Develop a roadmap for flexible inflation targeting and flexible exchange rate regime that identifies timebound reform measures to be taken during the program period.	October 2017		An IMF TA mission for designing the roadmap took place in May 2017.
Modified structural benchmarks			
Submit to Parliament the 2018 budget that is in line with the program targets and includes: (i) a tax expenditure statement, (ii) a plan to rationalize tax expenditures in 2018 as agreed with IMF staff, and (iii) the estimated fiscal cost of non-commercial obligations (including subsidies) for SOEs.	November 2017		The structural benchmark for the 2018 budget is updated to incorporate the unmet structural benchmarks for a tax expenditure rationalization plan and publication of the noncommercial obligations for SOEs.

Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)

Submit to Parliament the 2019 budget that is in line with the program targets and includes: (i) a tax expenditure statement, (ii) a plan to rationalize tax expenditures in 2019 as agreed with IMF staff, and (iii) the estimated fiscal cost of non-commercial obligations (including subsidies) for SOEs.	November 2018		The structural benchmark for the 2019 budget is updated to incorporate the unmet structural benchmarks for a tax expenditure rationalization plan and publication of the noncommercial obligations for SOEs.
Cabinet to approve automatic fuel pricing mechanism (agreed with IMF staff) that ensures retail prices above cost-recovery levels and a financial position of Ceylon Petroleum Corporation capable of covering debt service.	March 2018		The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms.
Cabinet to approve automatic electricity pricing mechanism (agreed with IMF staff) that ensures retail prices above cost-recovery levels and a financial position of Ceylon Electricity Board capable of covering debt service.	September 2018		The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms.
Existing structural benchmarks			
Fiscal Policy Management			
Submit to Parliament the 2017 budget in line with the program targets.	November 2016	Met	The 2017 budget was submitted to Parliament on November 10, 2016.
Submit to Parliament the 2018 budget in line with the program targets.	November 2017		To be replaced with the new structural benchmark for the 2018 budget (see above).
Submit to Parliament the 2019 budget in line with the program targets.	November 2018		To be replaced with the new structural benchmark for the 2019 budget (see above).
Tax Policy Reform			
Publish a tax expenditure statement as part of the official government budget.	December 2016	Met	Published as part of the 2017 budget.

Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)

Approve by cabinet a time-bound strategy (agreed with IMF staff) to reduce or eliminate tax expenditures.	December 2016	Not met	In the context of the 2017 budget, Cabinet approved a plan to rationalize profit-based corporate tax incentives and tax exemptions for financial income in 2017. However, a comprehensive multi-year plan for reducing or eliminating tax expenditures has not been adopted. This remaining step is built into the benchmarks for the 2018 and 2019 budgets.
Submit to Parliament a new Inland Revenue Act with a view to simplifying and broadening the income tax.	March 2017	Not met (implemented as a prior action)	A complete draft of the new Inland Revenue Act that incorporates all 2017 budget measures and comments from IRD and the private sector has been prepared, supported by IMF TA. The submission of the Act, complete with schedules for investment incentives and exemptions in line with staff recommendations, is a prior action for the second review.
Complete by Ministry of Finance (MOF) a diagnostic review of the VAT system.	June 2017	In progress	IMF TA missions for VAT diagnostics took place during April–May 2017.
Tax Administration Reform			
Adopt by MOF Inland Revenue Department Key Performance Indicators on the number of risk-based VAT audit.	December 2016	Met	The Key Performance Indicators for risk-based VAT audit were included in the VAT compliance strategy for large taxpayers.
Adopt by MOF Inland Revenue Department a VAT compliance strategy that includes a time-bound plan to implement risk-based audit.	December 2016	Met	Draft VAT compliance strategies for large, medium and small taxpayers were developed with support from IMF TA in October 2016. Considering the IRD's capacity, a decision has been made to first implement the VAT compliance strategy to large businesses and then extend to small- and medium-sized businesses.

Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)

Fully roll out by MOF Inland Revenue Department new IT systems (RAMIS) for major domestic taxes (including income tax and VAT), including web-based tax filings for income tax and VAT.	December 2016	Met	
Adopt by MOF Inland Revenue Department compliance strategies for corporate and personal income taxes.	June 2017	In progress	A FAD TA mission visited Colombo in January to provide guidance on implementation of new Inland Revenue Act. The new Act contains increased powers for the Inland Revenue Department (e.g., interest and penalties on late filings) which should improve compliance in general. The compliance strategies for income taxes will be prepared as part of the implementation plan.
Public Financial Management			
Establish by MOF a commitment record system (with quarterly reports produced no later than one month after the end of each quarter) and quarterly expenditure commitment ceilings for the 2016 budget and the 2017 budget.	December 2016	Not met (implemented partially)	Through modification of the existing IT system (CIGAS) and manual reporting from line ministries, the MOF is now capable of tracking spending commitment for each line ministry on a monthly basis. The authorities plan to report to parliament on the status of commitments in each quarter beginning in 2017Q2 and put in place a system of commitment ceilings for line ministries for the rest of the year.
MOF to roll out ITMIS with an automated commitment control module for Ministry of Finance.	January 2017	Met	The system has been fully rolled out to all ministries including Ministries of Finance and Health. It is being operated in parallel to the existing IT system to ensure it is functioning properly, with plans to operationalize it beginning in 2018.
MOF to roll out ITMIS with an automated commitment control module for Ministry of Health.	January 2017	Met	The system has been fully rolled out to all ministries including Ministries of Finance and Health. It is being operated in parallel to the existing IT system to ensure it is functioning properly, with plans to operationalize it beginning in 2018.

Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)

State Enterprise Reform			
Cabinet to approve a resolution strategy for Sri Lankan Airlines.	December 2016	Met	Substantial reforms have been undertaken under a strategy approved by the Cabinet in June 2015. The airline has taken restructuring measures (e.g., route and fleet optimization) and reduced operational losses under the oversight of the Ministry of Public Enterprise Development and a Cabinet Committee. The authorities will report the airline's financial performance to IMF staff on a quarterly basis.
Record the fiscal cost of non-commercial obligations (including subsidies) for SOEs in the central government budget, starting in 2017.	November 2016	Not met (implemented in effect for major SOEs)	The 2017 budget did not report the cost of the non-commercial obligations. Nonetheless, the Statement of Corporate Intent includes information on non-commercial obligations of the respective SOE. Therefore, the benchmark has been effectively fulfilled since the SCIs for the 5 large SOEs were published in April 2017. Publication of the non-commercial obligations is built into the benchmarks for the 2018 and 2019 budgets.
MOF, line ministries, and SOEs to sign and publish Statements of Corporate Intent for the six largest SOEs (Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lankan Airlines, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authorities).	December 2016	Met with delay	Draft Statement of Corporate Intents (SCIs) were finalized in December 2016 for each of the 6 SOEs except for Sri Lankan Airlines. Following Cabinet approval, the SCIs were signed in March 2017 and published in April 2017.
MOF to introduce automatic fuel pricing mechanism that ensures retail prices above cost-recovery levels and a financial position of Ceylon Petroleum Corporation capable of covering debt service.	December 2016	Not met	While the authorities have capacity to design an automatic fuel pricing mechanism, they have not decided on its implementation given political sensitivity. The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms to put the reform process back on track.

Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (concluded)

MOF to introduce automatic electricity pricing mechanism that ensures retail prices above cost-recovery levels and a financial position of Ceylon Electricity Board capable of covering debt service.	December 2016	Not met	While the authorities have capacity to design an automatic electricity pricing mechanism, they have not decided on its implementation given political sensitivity. The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms to put the reform process back on track.

Attachment II. Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out a framework for monitoring the performance of Sri Lanka under the program supported by the Extended Arrangement under the Extended Fund Facility (EFF). It specifies the performance criteria and indicative targets (including adjustors) under which Sri Lanka's performance will be assessed through semiannual reviews. Monitoring procedures and reporting requirements are also specified.

2. The quantitative performance criteria and indicative targets specified in Table 1 attached to the Memorandum of Economic and Financial Policies (MEFP) are listed as follows.

a) a quantitative performance criterion on central government primary balance (floor);

b) a quantitative performance criterion on net official international reserves (floor);

c) a continuous quantitative performance criterion on new external payment arrears by the nonfinancial public sector and the CBSL (ceiling);

d) a monetary policy consultation clause;

e) an indicative target on central government tax revenue (floor); and

f) an indicative target on reserve money of the CBSL (ceiling).

3. Throughout this TMU, the central government is defined to include line ministries, departments, and other public institutions. The Central Bank of Sri Lanka (CBSL), state-owned enterprises, parastatals and other agencies that do not receive subventions from the central government are excluded from the definition of central government. Debt is defined in accordance with paragraph 8 of the Guidelines on Public Debt Conditionality in Fund Arrangements attached to Executive Board Decision No. 15688-(14/107), adopted December 5, 2014.

I. PERFORMANCE CRITERIA

A. Performance Criterion on Central Government Primary Balance

4. The primary balance of the central government on cash basis is defined as central government revenues and grants minus expenditures and net lending, plus interest payments. Spending will be recorded in the period during which cash disbursements are made.

5. For the purpose of program monitoring, the primary balance of the central government on cash basis will be measured as the overall balance of the central government plus the interest payment of the central government. The overall balance of the central government is measured from the financing side, as the negative of the sum of the items listed below. Here, net borrowings refer to gross disbursements minus principal repayments. For 2015, the primary balance of the central government on cash basis measured in this manner was Rs –241 billion (the overall balance was Rs –768 billion and the interest payment was Rs 527 billion).

a) Net borrowings from issuances of Treasury Bills, Treasury Bonds, and Rupee Loans.[1] In 2015, the total amount of such net borrowings was Rs 257.6 billion.

b) Net borrowings from Sri Lankan Development Bonds (SLDBs) and commercial borrowings including international sovereign bonds and syndicated loans. In 2015, the total amount was Rs 455.7 billion.

c) Net borrowings from project and program loans. In 2015, the total amount was Rs 69.7 billion, after adjustment for program loans that were contracted and disbursed during 2014 but were recorded in the 2015 fiscal account (Rs 61.6 billion).

d) Net increases in non-market borrowings, CBSL advances, government import bills, government overdraft from the banking system, cash items in process of collection, and borrowings from offshore banking units of domestic commercial banks. In 2015, the total amount was Rs –10.1 billion.

e) Net decreases in the deposit of the central government in the banking system. In 2015, the total amount was Rs –4.4 billion (an increase in deposit).

f) Net borrowings from all other bonds, loans, and advances contracted by the central government. In 2015, the total amount was Rs –0.5 billion (net repayment).

The following adjustment will apply:

6. If the actual amount of gross cash disbursement of project loans in 2017 is higher than Rs 230 billion, the floor on the primary balance of the central government for end-December 2017 will be adjusted downward by the difference between the actual amount and Rs 230 billion. The downward adjustment of the primary balance target will be capped at Rs 20 billion. If the actual amount of gross cash disbursement of project loans in 2017 is lower than Rs 230 billion, the floor on the primary balance of the central government for end-December 2017 will not be adjusted.

B. Performance Criterion on Net Official International Reserves

7. For the purpose of program monitoring, net official international reserves (NIR) will be measured as the difference between (a) and (b) below, and will be called the "Program NIR." At

[1] Rupee Loans are a medium to long-term debt instrument issued with maturities more than two years on tap basis or as private placements by the CBSL on behalf of the government under the Registered Stock and Securities Ordinance.

end-2015, the Program NIR, evaluated at market exchange rates, stood at US$ 2,893.1 million. At end-2016, the Program NIR, evaluated at market exchange rates, stood at US$ 2,032.1 million. Targets for the Program NIR are set for cumulative flows from the end of the previous year. To calculate the cumulative flows, the Program NIR at the test dates and the end of the previous year are evaluated at the program exchange rates and gold price specified in paragraph 9.

a) The CBSL's conventional definition of the NIR, that is, (i) the difference between the gross foreign assets and liabilities of the CBSL and (ii) the balance of State Treasury's (DSTs) Special Dollar, Japanese Yen, and Chinese Yuan 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. Foreign exchange balances, securities, and bills denominated in Chinese Yuan are part of the gross foreign assets of the CBSL. 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 (including currency swap arrangements with foreign central banks); the use of Fund credit; and Asian Clearing Union debit balance. Commitments to sell foreign exchange to residents arising from derivatives such as futures, forwards, swaps, and options, such as commitments arising from currency swaps with domestic commercial banks, are not included in the gross foreign liabilities. DST accounts are foreign currency accounts held by the Treasury and managed by the CBSL as an agent of the government. At end-December 2015, the NIR as per the CBSL's conventional definition, evaluated at market exchange rates, stood at US$ 5,028.8 million. At end-December 2016, this amount was US$4,529.0 million (evaluated at market exchange rates).

b) The CBSL's outstanding liabilities (i.e., net short positions) in foreign exchange swaps with domestic commercial banks, which stood at US$ 2,135.7 million at end-December 2015 and $2,496.9 million at end-December 2016.

8. The framework to wind down outstanding liabilities in foreign exchange swaps with domestic commercial banks will include discontinuing the provision of FX swaps on concessional terms and gradually reducing outstanding net short positions of FX swaps with commercial banks as described in the MEFP.

9. For the purpose of the program, all foreign-currency related assets and liabilities will be converted into U.S. dollar terms at the exchange rates prevailed on January 2, 2017 (January 3, 2017 for SDR), as specified in Table 1. Monetary gold will be valued at US$1,151.84 per troy ounce, which was the price prevailed on January 2, 2017.

Table 1. Sri Lanka: Exchange Rates
(Rates as of January 2, 2017)

Currency	Sri Lankan Rupee per currency unit
U.S. dollar	149.9747
British pound	185.2338
Japanese yen	1.2835
Canadian dollar	111.7047
Euro	157.7659
Chinese yuan	21.5095
SDR 1/	200.49

Source: CBSL and IMF.
1/ As of January 3, 2017

The following adjustment will apply:

10. If (i) the amount of foreign program financing by the central government, (ii) the amount of net borrowings from SLDBs and FCBUs by the central government, (iii) the amount of external commercial loans (including international sovereign bonds and syndicated loans) by the central government, and (iv) proceeds from commercialization of public assets—as set out in Table 2—are higher/lower in U.S. dollar terms than assumed under the program, the floor on the program NIR will be adjusted upward/downward by the cumulative differences on the test date. The proceeds from commercialization of public assets are defined as cash receipts from the sale or lease of publicly held assets to non-residents. Such assets will include, but not be limited to, publicly held land, public holdings of infrastructure or commercial real estate, and public or quasi-public enterprises. These adjustors will apply to the NIR floor for end-June 2017 and thereafter.

11. If the amount of amortization of official external debt by the central government in U.S. dollar terms—as set out in Table 2—is higher/lower than assumed under the program, the floor on the program NIR will be adjusted downward/upward by the cumulative differences on the test date. Official external debt refers to external debt owed to multilateral and official bilateral creditors, as defined in the *2013 External Debt Statistics: Guide for Compilers and Users*. These adjustors will apply to the NIR floor for end-June 2017 and thereafter.

Table 2. Program Assumptions (cumulative from the beginning of the year, in million US$)			
	Jun. 2017	Sep. 2017	Dec. 2017
Foreign program financing by the central government	125	125	225
Net borrowings from SLDBs and FCBUs by the central government	627	627	627
External commercial loans (including Eurobonds and syndicated loans) by the central government	1,950	1,950	2,200
Proceeds from commercialization of public assets	0	200	200
Amortization of official external debt by the central government	529	889	1,065

II. CONTINUOUS PERFORMANCE CRITERIA

A. Performance Criterion on New External Payment Arrears by the Nonfinancial Public Sector and the CBSL

12. A continuous performance criterion applies to the non accumulation of new external payments arrears on external debt contracted or guaranteed by the nonfinancial public sector and the CBSL. The nonfinancial public sector is defined following the 2001 Government Finance Statistics Manual and the 1993 System of National Accounts. It includes (but is not limited to) the central government as defined in ¶3 and nonfinancial public enterprises, i.e., boards, enterprises, and agencies in which the government holds a controlling stake. External payments arrears consist of debt-service obligations (principal and interest) to nonresidents that have not been paid at the time they are due, as specified in the contractual agreements, subject to any applicable grace period. 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.

III. MONETARY POLICY CONSULTATION CLAUSE

13. The inflation target bands around the projected 12-month rate of inflation in consumer prices, as measured by the headline Colombo Consumers Price Index (CCPI) published by the Department of Census and Statistics of Sri Lanka, are specified in Table 1 attached to the MEFP. The new CCPI index (2013=100) will be used to measure actual inflation. For this purpose, the year-on-year inflation for each test date is measured as follows:

$$\{ CCPI^*(t) – CCPI^*(t-12) \} / CCPI^*(t-12)$$

where

t = the month within which the test date is included

CCPI(t) = CCPI index (all items) for month t

CCPI(t-k) = CCPI index (all items) as of k months before t
CCPI*(t) = { CCPI(t-2) + CCPI(t-1) + CCPI(t) } / 3
CCPI*(t-12) = { CCPI(t-14) + CCPI(t-13) + CCPI(t-12) } / 3

If the observed year-on-year inflation for the test date of end-June 2017 or end-December 2017 falls outside the outer bands specified in Table 1 attached to the MEFP, the authorities will complete a consultation with the IMF Executive Board which would focus on: (i) the stance of monetary policy and whether the Fund-supported program remains on track; (ii) the reasons for the deviation; and (iii) on proposed policy response. When the consultation with the IMF Executive Board is triggered, access to Fund resources would be interrupted until the consultation takes place and the relevant program review is completed. In addition, if the observed year-on-year inflation falls outside the inner bands specified in Table 1 attached to the MEFP for the test date of end-June 2017, end-September 2017, or end-December 2017, the authorities will complete a consultation with IMF staff on the reasons for the deviation and the proposed policy response.

IV. INDICATIVE TARGETS

A. Indicative Target on Central Government Tax Revenue

14. Central government tax revenue refers to revenues from taxes collected by the central government. It excludes all revenues from asset sales, grants, and non tax revenues. The revenue target is calculated as the cumulative flow from the beginning of the year. For 2015, central government tax revenue defined in this manner was Rs. 1,356 billion.

B. Indicative Target on Reserve Money of the CBSL

15. 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 2015, reserve money defined in this manner stood at Rs. 673.4 billion.

The following adjustment will apply:

16. 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.

17. 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 ΔM 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; Δr is the change in the reserve requirement ratio; and ΔB denotes the immediate change in the reservable base as a result of changes to its definition.

V. 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 and Letters of Intent. All the program monitoring data will be provided by the Ministry of Finance and the CBSL. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 3 and 4. For the purpose of monitoring the monetary targets under the program, data will be provided in the format shown in Table 5. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 6 and 7. For the purpose of monitoring the financial performance of three state-owned enterprises—the Ceylon Electricity Board, the Ceylon Petroleum Corporation, and the SriLankan Airlines—data will be provided in the format shown in Tables 8, 9, and 10, respectively.

19. Data relating to the fiscal targets (Table 3 and Table 4) will be furnished within no more than five weeks after the end of each month, except for the data on salaries and wages, goods and services, subsidies and transfers (and its subcomponents) that will be furnished within no more than seven weeks after the end of each month (the data on total recurrent expenditure and interest payments will be furnished within no more than five weeks after the end of each month). Data relating to the external and monetary targets (Tables 5, Table 6, and Table 7) will be furnished within no more than three weeks after the end of each month. Data relating to the three state-owned enterprises (Tables 8–10) will be furnished within no more than 2 months after the end of each quarter.

Table 3. Sri Lanka: Central Government Operations 1/
(In millions of rupees)

Total Revenue & Grants
Total Revenue
Tax revenue
Income Tax
Personal & Corporate
Corporate & non-corporate
PAYE
Economic Service Charge
Tax on interest income
Taxes on goods & services
VAT
Excise Taxation
Liquor
Cigarettes
Motor vehicles
Petroleum
Other
Other Taxes & Levies
NBT
Stamp duties
Telecommunication Levy
Motor vehicles Taxes & Other
Sales tax
Debit tax
Telephone Subscriber Levy
National Security Levy
Tax on treasury bills
Taxes on External Trade
Imports
Cess
Special Commodity Levy
PAL
Non-Tax Revenue
Property income
Fines,Fees & Charges
Other
Grants
Total Expenditure
Recurrent Expenditure
Salaries & wages
Goods & Services
Interest Payments
Subsidies & Transfers
Public Corporations
Public Institutions
Households
Capital Expenditure
Net lending
Primary Balance
Overall balance
Total Financing
Total Foreign Financing (Net)
Total Domestic Financing (Net)
Privatization

1/ As agreed for the purpose of monitoring the program.

Table 4. Sri Lanka: Central Government Financing 1/
(In millions of rupees)

1. Domestic instrument borrowings
T-Bills (net)
T-Bonds
Rupee Loans
Other
2. Domestic non-instrumental borrowings
Sri Lankan Development Bonds (SLDB)
Non market borrowings
CBSL advances
Government deposit at CBSL
Government import bills
Cash items in process of collection (CIPC)
Overdraft to government
Short term loans
Deposit with commercial banks
Oversee Banking Units
Other
3. Net foreign financing
Net T-Bill purchase by nonresidents
Net T-Bond purchase by nonresidents
International sovereign bonds
Project loans
Other
Total financing (1+2+3)
Memorandum items:
T-Bonds
Gross borrowings
Repayments
Net borrowings
SLDBs
Gross borrowings
Repayments
Net borrowings
ISBs
Gross borrowings
Repayments
Net borrowings
Project loans
Gross borrowings
Repayments
Net borrowings

1/ As agreed for the purpose of monitoring the program.

Table 5. Sri Lanka: Balance Sheet of the Central Bank of Sri Lanka 1/
(In millions of rupees)

Net foreign assets
Foreign assets
Cash and balances abroad
Foreign securities
Claims on ACU
IMF Related Assets
SDRs
RR on FCDs of banks
Receivables (Accrued Interest)
Derivative Financial Instruments
Foreign liabilities
IMF & nonresident a/c
SDRs
Liabilities to ACU
Payables
Derivative Financial Instruments
Net domestic assets
Claims on Government
Advances
Treasury bills & Treasury Bonds
Treasury Bonds
Cash items in collection
Government deposits
Claims on commercial banks
Medium and long-term
Short-term
Other assets (net)
Reserve money
Currency in circulation
Commercial bank deposits
Government agencies deposits

1/ As agreed for the purpose of monitoring the program.

Table 6. Sri Lanka: Foreign Exchange Cashflows of the Central Bank and the Government 1/ (In millions of U.S. dollars)
1. Total inflows
Loans
Program
IMF
Project (cash component only)
Commercial borrowing (incl. new and rolled over SLDBs)
Interest earnings, forex trading profits, cap gains
Purchases of foreign exchange
Change in balances in DST's A/Cs
Of which: Proceeds from commercialization of public assets
Other inflows
Borrowing from SLDBs
Loans from FCBUs
Syndicated Loans
International Swaps/Commercial Loans/Sovereign Bonds
OMO FX swap transactions
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
SWAP/Loan interest
ISB interest
Payments to the IMF/ change in valuation of liabilities
Foreign exchange sales to commercial banks
OMO FX swap transactions
3. SWAP
Inflow
Outflow Including Interest
3. Net flow at current rates (1-2)
Net International Reserves (at market exchange rates)
Net International Reserves (at program exchange rates)
Gross International Reserves (at market exchange rates)
1/ As agreed for the purpose of monitoring the program.

Table 7. Sri Lanka: Gross Official Reserve Position 1/

(In millions of U.S. dollars)

Date	Central Bank				Government				Gross Official Reserves		Liabilities					Net International Reserves	Overall balance	Memorandum Items - Swaps with Commercial Banks		
	Reserves managed by IOD		Reserve Position at I.M.F. & SDR hol.	Total	Crown Agent's Credit Balance	D S T's Special Dollar Revolving Cr.balance	DST's Yen Accounts	Total	(without ACU & DA & with Swap)	(with ACU & SWAP & without DA)	Other Deposits	Asian Clearing Union	Drawings from the IMF	International Currency Swap	Total					
	Foreign Assets (FA) (with ACU & Without DA)	Domestic Assets (DA) (BOC & PB)		(1)+(2)				(4)+(5)+(6)	(8) - (10)	(3)+(7)								1st Leg (New)	2nd Leg (Maturity)	Outstanding stock (Short position)
	1		2	3	4	5	6	7		8										

1/ As agreed for the purpose of monitoring the program.

Table 8. Financial Outturn of Ceylon Electricity Board 1/
(In millions of rupees)

Total revenue
Sale of electricity
Other income
Total expenditure
Direct generation cost
Generation, transmission, and distribution O&M cost
Corporate expenses
Interest on borrowings and delayed payments
Depreciation
Other cost
Operating profit/loss
Liquidity position
Borrowings from banks
Payments to banks
Outstanding debt to banks
Purchases from CPC and IPP
Payments to CPC and IPP
Outstanding to CPC and IPP

1/ As agreed for the purpose of monitoring the program.

Table 9. Financial Outturn of Ceylon Petroleum Corporation 1/
(In millions of rupees)

Total revenue
Octane 90
Diesel
Other products
Other income
Total expenditure
Cost of sales
Sales and distribution
Administration
Finance cost
Depreciation
Other cost
Operating profit/loss
Outstanding dues to state banks

1/ As agreed for the purpose of monitoring the program.

Table 10. Financial Outturn of Sri Lankan Airlines 1/ (In millions of rupees)
Total revenue
Passenger
Cargo
Other income
Total expenditure
Aircraft fuel cost
Employee cost
Other operating expenses
Financial cost
Operating profit/loss
Capital contribution

1/ As agreed for the purpose of monitoring the program.

INTERNATIONAL MONETARY FUND

SRI LANKA

July 11, 2017

SECOND REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY, REQUEST FOR WAIVERS OF APPLICABILITY AND NONOBSERVANCE OF PERFORMANCE CRITERION, AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION—SUPPLEMENTARY INFORMATION

Prepared by	Asia and Pacific Department

This supplement updates the Staff Report that was issued to the Executive Board on June 28. It does not alter the thrust of the staff appraisal.

1. The new Inland Revenue Act (IRA)—consistent with staff recommendations—was submitted to parliament in early July, meeting a prior action of the second review. The new IRA will support fiscal consolidation by making the tax system more efficient and equitable. Its implementation will be assisted by further IMF TA as needed.

2. Efforts are continuing to recover from the severe floods in May 2017, caused by heavy monsoon rainfall across southwestern regions of the country. Development partners and emergency humanitarian funds have provided financial and in-kind support. While it is too early to assess the economic impact of the floods, the government will soon conduct a Rapid Impact and Needs Assessment, supported by the United Nations and the World Bank. At the same time, the northern part of the country is still recovering from the 2016 drought.

3. Latest data and information releases are broadly consistent with staff projections:

- *GDP and credit growth*. The Sri Lankan economy grew by 3.8 percent (year-on-year) in 2017Q1, as agriculture contracted by 3.2 percent due to the lingering effects of the 2016 drought. However, industry (construction in particular) and services grew by 6.3 and 3.4 percent respectively in Q1. Private sector credit growth slowed somewhat but remained high at 20 percent in April 2017, despite rising lending rates.

- *Inflation*. Headline inflation declined to 6.1 percent (year-on-year) in June 2017 from its March peak of 7.3 percent. However, food inflation has been persistently higher at about 9 percent during March–June, reflecting supply disruptions caused by the late-2016 drought and the May-2017 floods. The 3-month average inflation in June (6.3 percent) remained within the inner band under the Monetary Policy Consultation Clause.

- *Current account and reserves*. The current account deficit was US$708 million (0.8 percent of annual GDP) in 2017Q1 compared to a surplus of US$35 million one year ago, with oil imports rising due to the drought-induced demand for more thermal power generation. Nevertheless, the efforts to rebuild reserves continued after the authorities overperformed on the committed corrective action in March and April 2017. During May–June, the CBSL made additional net FX purchases of about US$280 million and the exchange rate depreciated by about 1 percent against the US dollar.

- *Fiscal developments*. Over January–April 2017, the primary surplus was Rs 9 billion, comparing favorably with the program floor of Rs -8 billion for the January–June period. This was underpinned by strong revenue performance over January–April as tax revenues increased by 26 percent (year-on-year).

- *Monetary policy*. The Monetary Board meeting in late June kept the policy interest rates unchanged on the anticipation of further deceleration in private sector credit growth and moderation of inflation as weather-related supply disruptions dissipate.

Statement by Mr. Subir Vithal Gokarn, Executive Director and
Mr. Mahinda K.M. Siriwardana, Alternate Executive Director on Sri Lanka
July 17, 2017

1. Our Sri Lankan authorities are appreciative of the constructive and candid discussions they had in Colombo during February - March, 2017 and in Washington DC during the Spring Meetings with the staff mission. They welcome the comprehensive assessment on the macroeconomic developments of the Sri Lankan economy as well as the reports produced in relation to the Second Review under the Extended Arrangement under the Extended Fund Facility (EFF). On their behalf, we would like to thank the management, Executive Board and staff for their sustained and supportive engagement with Sri Lanka. Sri Lanka's program performance was broadly on track in terms of meeting quantitative performance criteria (QPC) and indicative targets (IT), amidst challenging domestic and external conditions. The QPC related to primary deficit was met and inflation remained within the target band in December 2016 as well as in March 2017. However, the QPC related to net international reserves (NIR) was missed amidst high capital outflows. Targets related to tax revenue was met but reserve money exceeded the targets. Our authorities agreed with the IMF Second Review mission, concluded in March 2017, to a new outright foreign exchange purchase target for March and April 2017 as a corrective action for missed NIR target. The purchase of foreign exchange was exceeded by the Central Bank, thereby resuming the buildup of reserves. The accumulation of external arrears, which is a continuous performance criteria, was unintended and was due to the non-availability of a payment platform to make due payments to the Export Development Bank of Iran (EDBI), although our authorities were ready and willing to make the due payments. Most of the Structural Benchmarks (SB) were implemented and significant progress has been made in ensuring that missed SB targets are back on track. However, the Second Review was impacted by the delay in submitting the new Inland Revenue Act (IRA) to the Parliament (Prior Action). Subsequently, corrective action was taken by the authorities and the IRA was submitted to Parliament on July 04, 2017.

Economic Growth and Outlook

2. Reflecting the impact of unfavorable weather conditions and weak global economic recovery, the Sri Lankan economy grew at a slower rate of 4.4 per cent in 2016 compared to 4.8 per cent in the previous year and the average growth of 6.8 per cent during 2010-2014 period. The unemployment rate declined to 4.4 per cent in 2016 from 4.7 per cent in 2015. The economy grew moderately by 3.8 per cent during the first quarter of 2017, supported by the Industry and Services sectors amidst the contraction in the Agriculture sector with the severe drought conditions affecting several provinces. Headline inflation peaked at 7.3 per cent in March 2017, reflecting the impact of drought conditions on food supply and adjustments to the tax structure, which had a one-off impact. Inflation decreased to 6.1 per cent by end June 2017. Going forward, inflation is expected to remain within the inflation

band agreed under the EFF, supported by prudent and timely monetary policy measures, and the ongoing fiscal consolidation process.

3. The successful implementation of the reforms, supported by the EFF, is expected to strengthen macroeconomic stability further while improving investor confidence, thereby facilitating higher economic growth. GDP growth in 2017 is envisaged at around 4.5 – 5.0 per cent, mainly due to weather related adverse shocks experienced during the first half of the year. GDP growth is expected to rebound to around 5.5 per cent in 2018 and keep the pace over the medium term.

Monetary and Exchange Rate Policy

4. With the commencement of the monetary tightening cycle since last quarter of 2015, the Central Bank imposed cash margin requirements (subsequently removed) and maximum Loan to Value (LTV) Ratio on selected types of lending towards the last quarter of 2015, as macro prudential measures. The Central Bank also increased the Statutory Reserve Ratio (SRR) by 150 basis points with effect from January 2016 and the policy interest rates by 100 basis points in two steps, in February and in July 2016. Monetary policy was tightened further in March 2017 by raising the policy interest rates by 25 basis points as a precautionary measure to contain possible acceleration of demand side inflationary pressures due to high money and credit growth, and the build-up of adverse inflation expectations. LTV ratios implemented earlier were revised in 2017 based on type of vehicle as proposed in the Budget 2017. The policy rate increases have resulted in a significant increase in short term market interest rates and yield rates of government securities. Following the policy rate increases, lending rates of banks have also adjusted upwards. Although the expansion in credit to the private sector continued at elevated levels until February 2017, there were some signs of deceleration thereafter due to monetary policy measures and prudential measures, and year-on-year growth of credit was 20.0 per cent in April 2017. According to the most recent data, the excessive expansion in credit to certain sectors (i.e. construction sector) appears to be moderating. Our authorities are very closely monitoring these developments and remain ready to tighten monetary policy further, if private sector credit growth continues to remain high and inflationary threats emerge.

5. The monetary policy framework is being strengthened further, in line with the intention of moving towards a flexible inflation targeting monetary policy framework in the medium term. In this context, the Central Bank and the government have fulfilled a number of prerequisites over the years. As an important element of this transition, the Central Bank, jointly with a technical assistance (TA) team from the IMF, has built a Forecasting and Policy Analysis System (FPAS) to provide improved forecasts for policy analyses. The number of Monetary Policy Committee (MPC) meetings has been reduced to 8 from 12 per year, in order to provide more time to undertake analyses on economic developments and make better forecasts. Towards the successful transition to the inflation targeting framework, measures are being taken to fulfill the remaining institutional and technical pre-requisites as

well. These include building the consensus among key responsible institutions on the practical implementation steps, introducing required legal and governance reforms and broadening the public understanding of inflation targeting related reforms, with the TA from the Fund.

6. Our authorities remain committed to pursuing a flexible exchange rate regime with intervention limited to prevent wide fluctuations and to build up official reserves, which will also support the move towards the flexible inflation targeting framework. The full flexibility in determination of the exchange rate is constrained by the high reserve target set by the IMF under the program, which requires the Central Bank to purchase foreign exchange from the market. A gradual correction in the overvaluation of the exchange rate is envisaged, under the flexible inflation targeting regime.

Financial Sector Developments

7. The financial sector remained sound and resilient amidst challenging global and domestic conditions. The capital and liquidity levels of the banking sector were maintained well above statutory minimum requirements. The asset base of the banking system increased by 14.9 per cent in May 2017, driven by expansion in loans and advances in line with the growth in deposits while its non-performing loans (NPLs) remained at a healthy level of 2.8 per cent, by end May. The bank branch network expanded, thereby enhancing financial inclusion in the country. Commencing from July 01, 2017, licensed commercial banks will adopt Basel III capital standards to strengthen their resilience. This is based on the Direction issued by the Central Bank in late 2016 in line with the Basel III guidelines issued by the Bank for Resettlement (BIS), related to capital, leverage and liquidity, to strengthen resilience of banks. Licensed banks will meet the increased Basel III minimum capital requirements against risk weighted assets on a staggered basis in line with the international timeline for full implementation by January 01, 2019. Going forward, the Central Bank envisages issuing guidelines to banks on Basel III Leverage Ratio and Net Funding Ratio standards as well in line with the international timelines. Several amendments are planned to be introduced to the Banking Act to streamline and strengthen the regulatory and supervisory framework for licensed banks in line with the best global standards and practices taking note of potential business expansion, activities and innovations in the banking industry.

8. The performance of the non-bank financial sector improved in terms of asset growth, capital position, profitability and branch network expansion. In the context of few financially distressed finance companies, the Central Bank has already established an enforcement unit to further strengthen the regulatory and supervisory framework. In order to regulate microfinance institutions, the Microfinance Act was enacted in 2016.

External Sector Policies

9. The country's external balance was adversely affected by high net foreign outflows. This reflected the continued domestic demand for imports from certain sectors of the

economy, the impact of rising global interest rates, particularly on the government securities market, weak external demand for domestic products and relatively low foreign direct investment flows. Despite the improvements in earnings from tourism and other service exports as well as workers' remittances, these developments resulted in a deficit in the BOP, thereby decreasing the country's official external reserves. Although developments during the first half of the year 2016 were favorable in meeting the NIR target comfortably, subsequent developments made the meeting of NIR target a difficult task. The unexpectedly high capital outflows since October 2016, which continued until end February 2017, created considerable pressure on the domestic forex market, compelling the Central Bank to intervene in the forex market by supplying foreign exchange. The total net supply amounted to US$ 367.3 million during this period. Amidst these developments, the rupee depreciated against US dollar by 3.8 per cent during 2016 and 2.5 per cent so far during 2017 up to July 10, 2017, helping to improve the country's competitiveness. With the easing of the pressure on capital outflows by February 2017, the forex market stabilized and the Central Bank was able to purchase from the market and build up foreign reserves. Preliminary data reveals that gross official reserves are estimated at US$ 7 billion by end June 2017, supported by the proceeds from the International Sovereign Bond issue of US$ 1.5 billion, syndicated loans of US$ 450 million and outright purchases of foreign exchange from the market. The reserve coverage is estimated to have increased to 4.1 months of imports as at end June 2017. As agreed with the staff, foreign exchange swaps with commercial banks have been excluded from the reserve assets in calculating the program NIR. The gradual wind down of these swaps is being continued and the outstanding amount has declined to US$ 1.9 billion by April 2017 from US$ 2.4 billion.

Fiscal Policy and SOE Reforms

10. The improvement in fiscal performance in 2016 continued, as reflected by the performance during the first four months of 2017. This was mainly due to the efforts taken to improve tax policy, tax administration and public financial management by the authorities with the support of the EFF. The end December target of primary balance under the program was met comfortably and the overall deficit was also declined significantly to 5.4 per cent of GDP in 2016, supported mainly by the over performance in revenue compared to the program target. This improvement is expected to continue to ensure medium term debt sustainability. During the first four months of 2017, total revenue increased by 24.6 per cent, led by 90.9 per cent increase in VAT, reflecting the positive impact of the VAT reforms introduced in 2016 and improvements in tax administration.

11. The VAT reforms introduced in 2016, including the tax rate increase from 11 per cent to 15 per cent and the removal of number of exemptions, despite the stiff opposition by some segments in the society, signify the authorities' commitment to reforms under the ongoing revenue based fiscal consolidation process. Our authorities accept the fact that more public awareness is necessary to sensitize the general public about the need and future benefits of tax as well as other reforms. While consolidating the VAT reforms further, the new Inland

Revenue Act (IRA), which has been drafted with TA from the Fund and submitted to Parliament on July 04, 2017, is expected to play a catalytic role in transforming Sri Lanka's income tax system by providing clarity, simplicity and administrative convenience while increasing tax compliance and improving tax administration further. Under this, a new investor investment incentive scheme, based on enhanced depreciation allowance, which will be linked to the extent of investment undertaken, employment generation and geographical location, will be introduced, leading to the closing of widespread loopholes in the existing income tax system.

12. The introduction of compliance strategies for VAT and corporate personal income taxes (on-going), risk-based VAT audits and roll out of the Revenue Administration Management Information System (RAMIS) at the Inland Revenue Department (IRD), which automates the tax collection process, will strengthen tax administration further. The IRD is doing preparatory work to implement the new IRA with the support of IMF, particularly to improve public awareness of the new revisions to ensure smooth transition to the new income tax system. The newly rolled out Integrated Treasury Management Information System (ITMIS) at the Ministry of Finance (MOF) will be operationalized beginning in 2018, automating the key functions related to public financial management system in Sri Lanka.

13. Efforts are being made to manage the economic and social implications of the two natural disasters, drought and floods, that occurred in the first half of 2017, which had an adverse impact on this year's growth. These have had some impact on the government budget as well. Additional expenditure will be required for reconstruction and rehabilitation activities, particularly for the infrastructure and houses damaged due to the most recent floods as well as for the provision of assistance to the people affected by the severe drought in some parts of the country. Policies to better manage climate related adversities are being seriously considered by the authorities as it appears that the country has increasingly become vulnerable to devastating natural disasters.

14. Measures to strengthen the State-Owned Enterprises (SOEs) are progressing. A resolution strategy has been introduced for Sri Lankan Airlines and the Statements of Corporate Intent (SCIs) were signed by five key SOEs in March 2017, creating a framework to monitor their performance under specific KPIs. Our authorities are committed to implementing the energy pricing formula in line with the new timeline indicated in the staff report, despite the missing of the original date of meeting the SB.

15. As per the Budget 2017, it is required to submit a quarterly progress report on actual expenditure and revenue of the budget to Parliament. Accordingly, the quarterly expenditure and income outcome report for the first quarter of 2017 was presented to the Parliament on July 05, 2017. This includes a summary report on actual expenditure, a detailed report of the actual expenditure and a report on the revenue.

Strengthening Trade and Foreign Direct Investments (FDI)

16. Our Sri Lankan authorities have clearly identified the enormous potential of the country to become a trading and service hub in the South Asian region through the enhancement of trade and FDI, thereby benefiting from a changing global marketplace. The measures indicated in the staff report are among the key priorities in this context of improving growth potential and strengthening external sustainability. As the improvement of doing business environment in the country is also a high priority in attracting and sustaining investments, our authorities, on July 05, 2017, launched a *Road Map to Improve Investment Climate in Sri Lanka*, in collaboration with the Australian Government and the World Bank Group, which provides a holistic platform for reforming the investment climate in Sri Lanka. It defines the roles and responsibilities of all stakeholders grouped under eight Task Forces (which will each cover one of eight areas under the Doing Business ranking), a set of initial reforms that will be pursued, the timeframe for accomplishment of the reforms expected and a mechanism to monitor progress on an ongoing basis, and promptly identify and address bottlenecks. The implementation of this Road Map is expected to eliminate unnecessary regulatory and procedural obstacles to enterprises and entrepreneurs.

Technical Assistance

17. Our Sri Lankan authorities highly value the continued support provided through technical assistance by the Fund. Over the years, the TA has mainly been in the areas of tax policy and tax administration, public financial management, monetary and exchange rate policy, macroeconomic modelling and forecasting, financial system stability and national accounts. The insights provided through these TA have helped the country to improve policies and processes and our authorities expect to continue this engagement to complement the efforts towards strengthening macroeconomic stability.

Conclusion

18. The Sri Lankan economy showed signs of stabilization during 2016, which is continuing in 2017. The EFF played an important role in helping the authorities to achieve this progress, particularly in implementing reforms and strengthening macroeconomic stability, while strengthening much needed investor confidence. In this context, despite the delay in completing the second review, our authorities remain committed to the successful completion of the EFF as a step towards achieving the broader objectives of socio economic and social policies. Going forward, our Sri Lankan authorities are strongly committed to implement appropriate policy reforms to sustain this improvement towards creating external and fiscal buffers and a conducive environment to achieve high and sustainable economic growth with the support of the international community and in close association with the Fund and staff, complemented by continued technical assistance. In this context, our authorities request the completion of the Second Review of the Extended Arrangement under the EFF.