INTERNATIONAL MONETARY FUND

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SRI LANKA

January 2018

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

In the context of the third review under Extended Fund Facility, 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 December 6, 2017 following discussions that ended on September 29, 2017, with the officials of Sri Lanka on economic developments and policies underpinning the IMF arrangement. Based on information available at the time of these discussions, the staff report was completed on November 20, 2017.
- 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 by the authorities of Sri Lanka*
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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COMMUNICATIONS DEPARTMENT

Press Release No. 17/468
FOR IMMEDIATE RELEASE
December 7, 2017

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Completes Third Review of the Extended Arrangement Under the EFF with Sri Lanka and Approves US$ 251.4 Million Disbursement

On December 6, 2017, the Executive Board of the International Monetary Fund (IMF) completed the third 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 177.774 million (about US$ 251.4 million), bringing total disbursements under the arrangement to the equivalent of SDR 537.456 million (about US$ 759.9 million).

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 remained broadly on track since the second review. Macroeconomic and financial conditions have been stable, despite a series of weather-related supply shocks. The authorities remain committed to the economic reforms under the program and have undertaken measures to improve government revenue and accumulate international reserves. Going forward, it is important to build on the progress made and accelerate reforms to reduce fiscal and external vulnerabilities.

"Fiscal performance has been satisfactory and all targets until September were met. The new Inland Revenue Act will make the tax system more efficient and equitable, and generate resources for social and development programs. Nevertheless, Sri Lanka's high debt burden, large gross financing needs, and weak financial performance of state-owned enterprises increases the importance of further fiscal consolidation. Timely progress in structural reforms, including tax administration and energy pricing, will support fiscal consolidation.

“Inflation and credit growth remain on the high side. Maintaining a tightening bias for monetary policy is recommended until clear signs emerge that inflation pressures and credit expansion have subsided. Macroprudential tools should also be used to help rein in credit growth and head off systemic risks. While financial soundness indicators remain stable, financial sector supervision and the AML/CFT regime should be further strengthened.

“Along with efforts to deepen the foreign exchange market, it is important to further accumulate reserves and enhance exchange rate flexibility to reduce Sri Lanka’s external vulnerability.

“Structural reforms are also needed to enhance competitiveness and promote inclusive growth, including measures to improve trade and investment regimes.”

INTERNATIONAL MONETARY FUND

SRI LANKA

November 20, 2017

THIRD REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION

EXECUTIVE SUMMARY

Sri Lanka's economic reform program is supported by the extended arrangement under the Extended Fund Facility (EFF) that was approved in June 2016 for the amount of SDR 1.07078 billion (185 percent of quota and about US$ 1.5 billion) over 36 months. Three purchases equivalent to SDR 359.682 million have since been made, and another purchase equivalent to SDR 177.774 million will become available upon completion of the third review.

Performance under the program has remained broadly on track since the second review despite a series of weather-related supply shocks. All end-June and continuous performance criteria are met. Revenue mobilization has helped meet the quantitative fiscal targets, while strong capital inflows have supported the buildup of international reserves. Parliamentary submission of the 2018 budget consistent with the program was set as a prior action for the third review and was completed on November 9. The budget targets a primary surplus of 1 percent of GDP and frontloads fiscal consolidation towards the authorities' objective of reducing the overall fiscal deficit to 3.5 percent of GDP by 2020.

Nevertheless, Sri Lanka remains vulnerable to shocks given its high level of public debt, large financing needs, and weak external position. Therefore, it is important to build on the progress made and accelerate reforms to reduce fiscal and external vulnerabilities. Fiscal consolidation should continue, supported by effective tax administration and spending controls. On monetary policy, the central bank should maintain a tightening bias to contain inflation and credit growth pressures, while continuing to accumulate reserves accompanied by greater exchange rate flexibility. Reforms of key state enterprises, especially in the areas of energy pricing and airline restructuring, should proceed without further delays. Structural reforms are also needed to enhance competitiveness and promote inclusive growth.

Approved By
Kenneth Kang and Bob Traa

Discussions were held in Colombo during September 18–29, 2017, and in Washington DC during the Annual Meetings (October 10–15). The mission met with Prime Minister Wickremesinghe, Finance and Mass Media Minister Samaraweera, State Minister of Finance Wickramaratne, 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), Mr. Lindner (MCM), Ms. Tambunlertchai (SPR), Ms. Kvintradze (resident representative), and Mr. Wijeweera (local economist). Mr. Siriwardana (OED) participated in the policy discussions. Ms. Takebe (SPR) and Mr. Sullivan (APD) also contributed to the preparation of this report.

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BACKGROUND

1. Macro stabilization and two major tax reforms were the key outcomes of the first half of the program. Sri Lanka is pursuing a 3-year reform program with IMF support under the extended arrangement under the Extended Fund Facility (EFF) since June 2016. Performance has been broadly on track regarding fiscal consolidation, revenue mobilization, monetary policy management, and reserves accumulation. The government legislated in 2016 the VAT amendments which increased VAT rates and narrowed exemptions. The program's landmark reform, the new Inland Revenue Act, was legislated in October 2017 and will be implemented in April 2018. Consistent with the objectives of the EFF-supported program, the authorities announced a new far-reaching economic plan titled *Vision 2025* in September 2017.

2. Nonetheless, many challenges lie ahead to sustain the reform momentum. The government faces higher debt repayments starting in 2018 at a time when the economy remains vulnerable to shocks. Progress in several structural areas including SOE reforms remains slow. Sustained efforts are needed to further reduce the fiscal deficit, strengthen external buffers, and promote inclusive growth. Political cohesion of the coalition government may be strained in the run-up to the 2020 national elections.

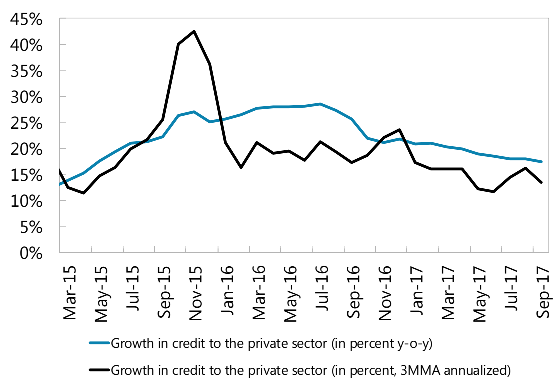
RECENT DEVELOPMENTS

3. Weather-related supply shocks dominated growth and inflation developments in 2017. Contracting agriculture—due to the 2016 drought and 2017 floods—pulled down GDP growth to 3.9 percent (y/y) in 2017H1 (Box 1). Services grew modestly and industry expanded strongly (5.8 percent) led by construction, mining and quarry. Headline inflation (y/y) exceeded expectations in October 2017 spiking to 7.8 percent, due to weather-driven food inflation and the base effect of VAT rate hikes in November 2016. However, Core inflation declined in October 2017.

4. Capital inflows strengthened, helping to finance the current account and fiscal deficits and reserves accumulation. The current account deficit widened to 3.5 percent of GDP in 2017H1, driven by weather-related imports of food and fuel. While exports strengthened through August due to improved EU access under GSP plus, workers' remittances and tourism receipts were weak. Portfolio inflows, however, strengthened in 2017Q2 amid a favorable global market environment, with some US$700 million flowing into government securities on net basis over April–September, helping to keep borrowing costs in check. Gross international reserves (GIR) increased from US$6 billion at end-2016 to US$7.3 billion at end-September (3.3 months of imports of goods and services), reflecting steady foreign exchange (FX) purchases by the central bank (about US$1.6 billion over March-October) and a successful placement of sovereign bonds of US$1.5 billion in May.

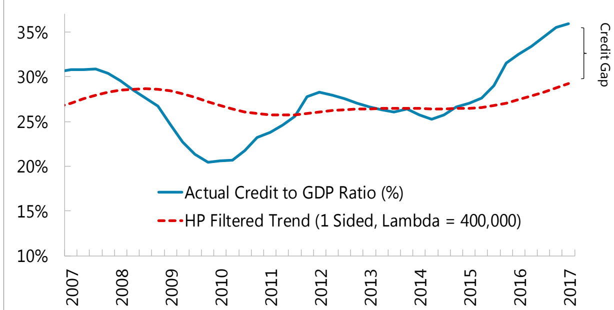
5. Market interest rates declined, and credit growth remained high. Treasury bond yields dropped by 250 basis points during March–September 2017, reflecting strong capital inflows and lower domestic financing, reversing the rising trend since early 2015. Sri Lanka's EMBI spread, at 330 bps in 2017Q3, has remained stable throughout 2017. Bank lending rates have been broadly stable since March. Though slowing down gradually with monetary tightening since 2016, private sector credit growth remained high at 17.5 percent (y/y) in September, about double the annual growth rate of nominal GDP. Despite dampening effects due to tightened loan-to-value (LTV) limits on vehicle loans in January, credit growth remained broad-based with no clear signs of a slowdown in month-on-month terms. Staff analysis suggests that the credit gap has widened to around 7 percent of GDP.

Private Sector Credit Growth
(Percent)



Source: CBSL and IMF staff calculations.

Credit to GDP Ratio and its Cyclical Trend
(Percent of GDP)



Source: CBSL and Staff Calculations

*Credit gaps were computed using the one-sided Hodrick-Prescott filter, with quarterly data and a relatively high smoothing parameter (lambda equal to 400,000). It is well documented that the results are sensitive to the choice of the filter and the smoothing parameter. Various values of lambda were used, all of which gave a positive credit gap.

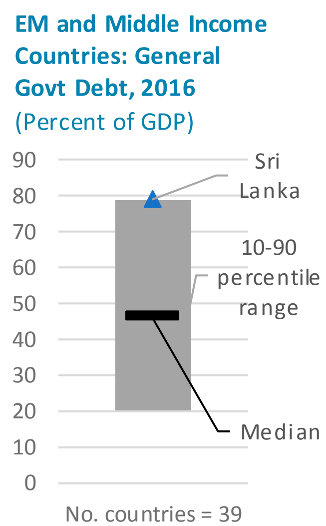
OUTLOOK AND RISKS

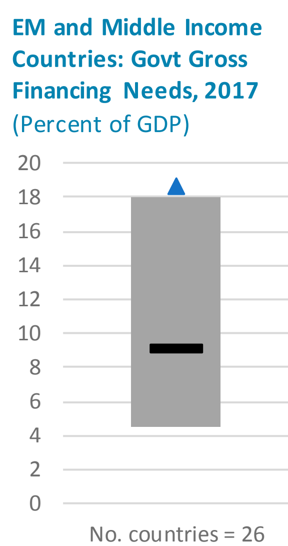
6. Staff's baseline envisages the economy normalizing in 2018. Real GDP growth is projected to increase from 4.2 percent in 2017 to 4.6 percent in 2018, as agriculture recovers with the return of normal weather conditions while construction and services remain resilient. Similarly, inflation is projected to revert to around 5 percent in end-2017 and throughout 2018. The current account deficit is projected to shrink from 3 percent of GDP in 2017 to 2.5 percent in 2018. Over the medium term, growth is projected to reach about 5 percent, consistent with staff estimate of potential growth.

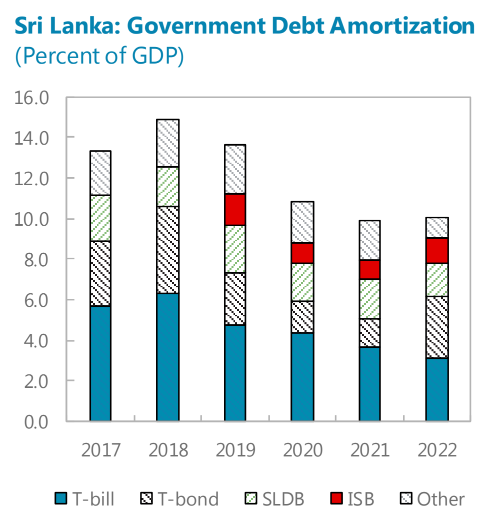
7. Downside risks remain significant. Given the high level of public debt and need for further fiscal consolidation, fiscal risks include ineffective implementation of the IRA, further delays in SOE reforms, and failure to provide for weather calamities. Too slow a deceleration in credit growth could add to the financial sector vulnerability, and some upside risks to near-term inflation outlook remain. External risks center around a possible reversal of the sizeable portfolio inflows which could raise domestic borrowing costs at a time when large external payments fall due, and could erode the recent gains in building external buffers if international reserves would again be used to defend the currency.

8. Sri Lanka's external position remains weaker than implied by fundamentals and desirable policy settings. While the current account gap remains moderate and international reserves have increased, reserve coverage remains low by most adequacy metrics (65 percent of the ARA metric and 86 percent of short-term debt at remaining maturity in September 2017). The real effective exchange rate has depreciated by 5 percent since end-2016, helping to reduce the overvaluation which was estimated to exceed 10 percent at the end of 2016 (CR/17/253). However, these gains could be offset quickly through higher inflation and structurally weak competitiveness (paragraph 26).

9. Risks to public debt sustainability remain elevated (Annex I). Public debt, comprising central government debt, guaranteed debt, and Fund credit outstanding, is expected to rise slightly to 87 percent of GDP in 2017 due to the still large fiscal deficit and the weaker exchange rate.[1] Moreover, the government faces large amortization payments in 2018, along with repayments on its international sovereign bonds starting in 2019. Gross financing needs (amortization payments plus overall deficit) are projected to reach 20 percent of GDP in 2018. Targeting an overall deficit of 3.5 percent of GDP by 2020 will reduce the risk of debt distress by lowering the debt ratio to 81 percent of GDP by 2020 and 75 percent by 2022. SOE liabilities also constitute a major fiscal risk, although they decreased from 13.7 percent of GDP in 2015 to 11.9 percent of GDP in 2016. External debt remains sustainable, though with high currency risks.







Sources IMF Fiscal Monitor database; Sri Lankan authorities; and IMF staff estimates.

PROGRAM PERFORMANCE

10. Quantitative targets. End-June quantitative performance criteria (QPC) on central government primary balance and net international reserves and indicative targets (IT) for June and September were all met. The continuous PC (no new external arrears) has also been met. The monetary policy consultation clause has not been triggered as inflation remained within the target band.

[1] The debt estimates have been revised upward since the second review, as detailed in Annex I.

Sri Lanka: EFF-Supported Program: Performance Against Quantitative Targets 1/

	June 2017			September 2017 (IT)		
	Target	Actual	Met?	Target	Actual	Met?
Quantitative performance criteria						
Central government primary balance (floor, in billion rupees)	-8	16	√	-4	16	√
Program net official international reserves (floor, in million US$)	1,874	2,049	√	2,057	2,568	√
Continuous performance criteria						
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	√	0	0	√
Indicative targets						
Central government tax revenue (floor, in billion rupees)	803	819	√	1,232	1,240	√
Reserve money of the CBSL (ceiling, stock, in billion rupees)	905	892	√	935	909	√

1/ Cumulative from the beginning of the year, except for reserve money.

11. Structural benchmarks (SBs). Four out of 5 SBs slated for completion by November 2017 were implemented (Table 2 attached to the Memorandum of Economic and Financial Policies (MEFP)).

- On November 9, the authorities submitted to Parliament the 2018 budget consistent with the program targets and staff recommendations, meeting the prior action for the third review[2]. In addition, the 2018 budget includes a tax expenditure statement, a plan to rationalize tax expenditures, and the estimated cost of SOEs' non-commercial obligations (SB, November 2017).
- A report outlining the cost of non-commercial obligations for fuel and electricity (SB, September 2017) was published in November as an annex to the 2018 budget.
- A diagnostic review of the VAT system (SB, June 2017) was completed in November.
- The authorities have opted to postpone designing compliance strategies for income taxes (SB, June 2017) until the new IRA is fully operational in 2018.
- The Monetary Board of the Central Bank of Sri Lanka (CBSL) approved a roadmap for flexible inflation targeting and flexible exchange rate regime (SB, October 2017).

POLICY DISCUSSIONS

The authorities pledged to target a primary surplus of 1 percent of GDP in 2018, while requesting a small adjustment of the end-2017 fiscal target due to the weather calamities. The authorities pledged to build up net international reserves by about US$700 million in 2018, and undertake energy pricing reforms.

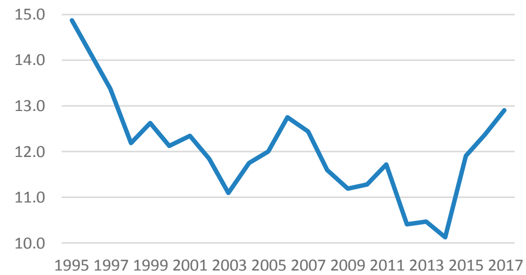
A. Fiscal Consolidation Needs to Continue

12. Revenue mobilization continues. Tax revenues increased by 9.3 percent (y/y) in real terms in January–September 2017, driven by a 56.6 percent surge in VAT collections following the VAT

[2] This prior action was set on the most macro-critical part the SB on the 2018 budget (due by November 2017).

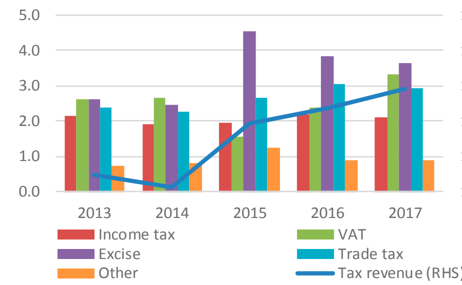
amendment in November 2016. The projected 2017 outturn implies a tax to GDP ratio of 12.9 percent, 1 percentage point higher than in 2015 (excluding one-off factors). When implemented, the new IRA is expected to boost revenues further by about ½ percent of GDP (annualized) largely through removal of tax exemptions. Revenue mobilization has also been supported by tax administration reforms, including roll-out of the RAMIS IT system and VAT compliance strategies.[3] Nevertheless, tax revenues are projected to fall short of the 2017 IT by 0.3 percent of GDP, reflecting temporary factors related to the weather calamities and the delay in implementing the new IRA.

Sri Lanka: Tax Revenue
(In percent of GDP)



Source: IMF staff calculations.
Note: The collection of the super gains tax in 2015 is excluded.

Sri Lanka: Tax Revenue
(In percent of GDP)



Source: IMF staff calculations.
Note: The collection of the super gains tax in 2015 is excluded.

13. The authorities requested relaxing the 2017 fiscal targets due to the exceptionally severe weather events. Between the protracted effects of the 2016 nationwide drought and the devastating 2017 floods in the southwest (Box 1), the spending needs exceeded the space that could be generated by mid-year budget reallocation and spending rationalization. As a result, the authorities requested lowering the QPC ceiling on primary deficit by Rs 20 billion to Rs 23 billion (0.2 percent of GDP) and the tax revenue IT floor by about 40 billion (0.3 percent of GDP) for end-2017. This temporary adjustment is smaller than the Rs 68 billion overperformance in the 2016 primary balance QPC and will be offset by higher disaster provisions and more front-loaded fiscal consolidation in the 2018 budget. Staff supports the request and offsetting adjustments, and noted that drought-driven cost for higher thermal electricity generation should be contained to limit the increase of SOE debt of Ceylon Electricity Board (CEB).

14. The authorities pledged to target a primary surplus of 1 percent of GDP in 2018, supported by a revenue package. The authorities' overall deficit target of 3.5 percent of GDP by 2020 is consistent with reaching a primary surplus of 2½ percent of GDP by 2020. To anchor investor confidence amid looming financing needs, the authorities agreed to frontload the fiscal consolidation path and target a primary surplus of 1 and 2 percent of GDP in 2018 and 2019, respectively, despite the lead time for revenue measures. The 2018 budget submitted to Parliament in November was consistent with these program targets and staff recommendations, meeting the prior action for the review. The revenue package in the budget is estimated to yield 0.8 percent of GDP, which comes mostly from selected removal of VAT exemptions, changes to excise taxes, and new levies on telecom usage and cash transactions by financial institutions. While the package safeguards social and infrastructure spending, its composition could have relied more on VAT base-

[3] For progress in fiscal structural reforms, including revenue mobilization, see Annex II.

broadening. The budget accommodates appropriations for natural disaster mitigation programs such as crop insurance and urban flood mitigation, totaling 0.15 percent of GDP.

Sri Lanka: Summary of Central Government Operations

	2015 Actual		2016 Actual		2017 EFF 2nd rev		2017 Proj.		2018 Proj.	2019 Proj.	2020 Proj.
	Rs Bln	% GDP	Rs Bln	% GDP	Rs Bln	% GDP	Rs Bln	% GDP	% GDP	% GDP	% GDP
Total Revenue and Grants	1,461	13.3	1,694	14.3	1,894	14.5	1,854	14.2	14.3	15.1	15.9
Total Revenue	1,455	13.3	1,686	14.2	1,884	14.4	1,846	14.2	14.2	15.0	15.8
Tax Revenue	1,356	12.4	1,464	12.4	1,718	13.1	1,680	12.9	12.9	13.7	14.5
Income Taxes	263	2.4	259	2.2	328	2.5	272	2.1	2.3	2.6	2.6
Tax on goods & services	804	7.3	842	7.1	1,018	7.8	1,029	7.9	7.8	8.4	9.2
VAT	220	2.0	283	2.4	372	2.8	435	3.3	…	…	…
Excise Taxes	498	4.5	455	3.8	513	3.9	476	3.7	…	…	…
Other taxes & levies	86	0.8	104	0.9	133	1.0	117	0.9	…	…	…
Tax on external trade	289	2.6	363	3.1	373	2.8	380	2.9	2.9	2.8	2.7
Non Tax Revenue	99	0.9	222	1.9	166	1.3	166	1.3	1.3	1.3	1.3
Grants	6	0.1	7	0.1	10	0.1	8	0.1	0.1	0.1	0.1
Total Expenditure and net lending	2,229	20.4	2,334	19.7	2,581	19.7	2,597	19.9	20.0	20.0	20.0
Current Expenditure	1,702	15.5	1,758	14.8	1,944	14.8	1,973	15.1	15.3	15.3	15.3
Salaries & wages	562	5.1	576	4.9	615	4.7	595	4.6	4.4	4.4	4.4
Goods & services	193	1.8	151	1.3	164	1.3	178	1.4	1.4	1.4	1.4
Interest payments	527	4.8	611	5.2	683	5.2	720	5.5	5.9	6.0	6.0
Subsidies & transfers	419	3.8	419	3.5	481	3.7	480	3.7	3.6	3.6	3.6
Capital Expenditure and Net Lending	527	4.8	576	4.9	637	4.9	624	4.8	4.7	4.7	4.7
Revenue measures	…	…	…	…	…	…	…	…	0.8	1.0	0.7
Overall balance	-768	-7.0	-640	-5.4	-687	-5.2	-742	-5.7	-5.0	-4.0	-3.5
Primary balance	-241	-2.2	-29	-0.2	-3	0.0	-23	-0.2	1.0	2.0	2.5
Revenue (including measures)	1,461	13.3	1,694	14.3	1,894	14.5	1,854	14.2	15.0	16.1	16.6
Tax revenue (including measures)	1,356	12.4	1,464	12.4	1,718	13.1	1,680	12.9	13.7	14.7	15.2

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

15. Implementing the new IRA in April 2018 and IT-based spending commitment control will support the 2018 budget. The IRA steering committee has outlined an implementation workplan, including publishing tax manuals (new SB by January 2018), updating regulations, training tax administrators, conducting taxpayer outreach, and updating IT systems. Risk of a revenue shortfall will be mitigated by realigning expenditures through the quarterly fiscal reporting to Parliament that started in 2017. The authorities also pledged to modify the existing IT system to implement quarterly commitment ceilings to reduce the risk of arrears in the case of revenue shortfalls, when line ministries start executing the 2018 budget (SB by January). However, staff urged swift implementation of a more effective commitment control by the new integrated IT system (ITMIS), which was delayed to start in 2019.

16. Strengthening public debt management and the fiscal responsibility framework will help manage large financing needs over the medium term. Staff welcomed the efforts to improve debt management, including by drafting a new Liability Management Bill which will allow the government to manage debt maturities and earmark proceeds from commercialization of public assets (e.g., the Hambantota port) for future debt service. The cabinet will approve a strategy for managing international sovereign bonds maturing over 2019–22 (a new SB by June 2018). To reinforce fiscal discipline, the authorities' *Vision 2025* aims to strengthen the Fiscal Management Responsibility Act with binding targets on fiscal deficit and government debt, which staff will support including through TAs.

B. Accelerate SOE Reforms

17. The weak financial performance of major SOEs in 2017 highlights the need for timely reforms. Three SOEs closely monitored under the program—CEB, Ceylon Petroleum Corporation (CPC), and SriLankan Airlines—recorded a combined loss of Rs 52 billion in 2017H1 (0.4 percent of GDP) as opposed to a combined profit of 0.2 percent of GDP in 2016. Rising oil prices and weather shocks raised the cost of non-commercial obligations (NCOs) to supply electricity and fuel at prices below cost-recovery levels. The efforts to restructure the airline has hit an impasse, as the search for a strategic partner restarted under the new task force overseen by the Prime Minister's office. Future program reviews will discuss the action plan for the airline and set key milestones as an SB. Leveraging upon the publication of Statements of Corporate Intent (SCIs) by 5 major SOEs in April 2017, the authorities are developing a framework for evaluating performance against key performance indicators, and plan to expand SCIs to other SOEs.

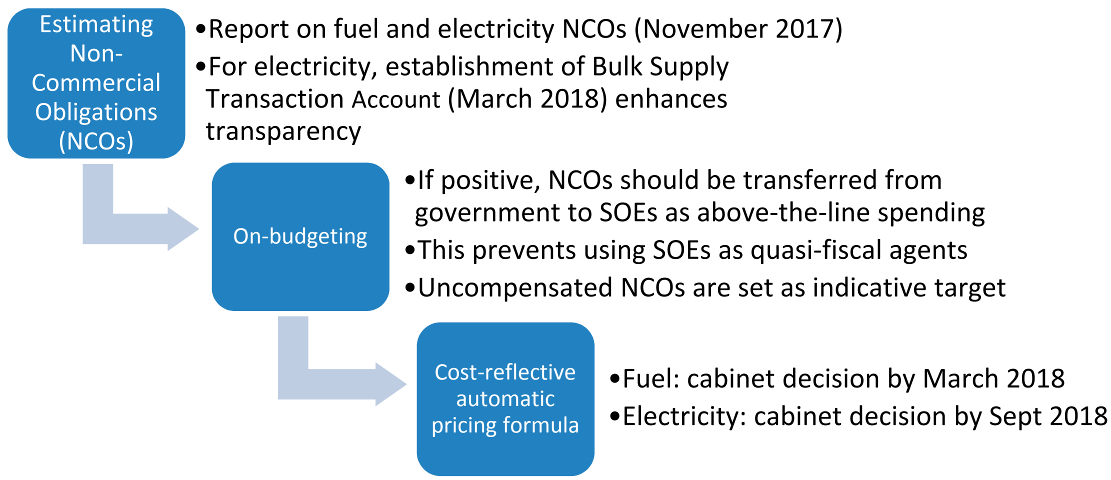
Sri: Lanka: Performance of CEB, CPC, and SriLankan Airlines, 2017H1

	Ceylon Electricity Board (CEB)		Ceylon Petroleum Corp. (CPC)		SriLankan Airlines	
	Rupees billions	% of annual GDP	Rupees billions	% of annual GDP	Rupees billions	% of annual GDP
Revenue	162	1.2	260	2.0	67	0.5
Expenditure	196	1.5	263	2.0	80	0.6
Balance	-34	-0.3	-4	0.0	-13	-0.1
Memorandum item:						
Outstanding financial obligations, end-2016	230	1.9	385	3.3	317	2.7

Sources: Sri Lankan authorities; and IMF staff estimates.

18. The authorities are embarking on fuel and electricity pricing reforms. To address the delay in adopting automatic pricing mechanisms, the second review recalibrated the reforms into a sequence of steps. The first step focuses on increasing transparency: a report outlining the cost of NCOs for fuel and electricity (SB) was completed with delay, and the establishment of a Bulk Supply Transactions Account is expected by March 2018 (SB) to enhance transparency of electricity NCOs. The second step sets at zero a new IT (ceiling) on uncompensated cost of fuel and electricity NCOs (i.e., cost of NCOs minus government transfers, Annex III) for 2018, which will encourage the authorities to recognize the quasi-fiscal subsidies as above-the-line government spending and incentivize cost-reflective pricing. Finally, cabinet will approve automatic pricing mechanisms for fuel by March 2018 and for electricity by September 2018 (SBs).

Sri Lanka: Sequence of Energy Pricing Reforms



Source: IMF staff.

C. Monetary Policy to Rein in Inflation Pressures

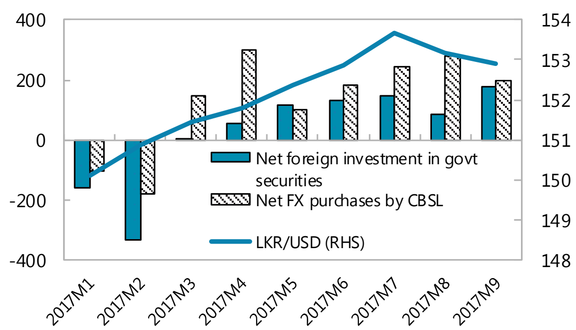
19. Monetary policy should maintain a tightening bias until clearer signs emerge that inflation and credit growth have stabilized, supported by macroprudential measures as needed. The CBSL has kept the policy rate unchanged since a 25-bps hike in March 2017, amid indications that credit growth and weather-related price pressures are moderating gradually. Near-term inflation, however, still faces upside risk from still high credit growth, a tight labor market, and the depreciating rupee. Reflecting these concerns, staff recommended the CBSL continue to assess the lagged response to monetary tightening since 2016, while maintaining a tightening bias until clear signs emerge that inflation and credit growth have stabilized. Macroprudential measures can be used to address systemic risks arising from excessive credit growth (paragraph 24).

20. The authorities reaffirmed their commitment to accumulate reserves while winding down FX swaps. Since resuming reserves accumulation in March 2017, the CBSL has accumulated net international reserves (NIR) beyond program targets through steady FX purchases against capital inflows. For 2018, the authorities target to increase NIR (program definition) by around US$700 million, bringing the end-2018 GIR to US$8.0 billion, equivalent to 67 percent of the ARA metric and 3.4 months of import. The CBSL plans to further wind down FX swaps with commercial banks (US$1.85 billion at end-September) to improve the composition of reserves.

21. In the face of substantial balance of payment pressures, Sri Lanka imposed in April 2016 a repatriation requirement for export proceeds while the country launched macroeconomic adjustments under the EFF-supported program in June 2016. This repatriation requirement could potentially discourage exporters' outward investments (capital outflows) by increasing the cost of outward payments and transfers, constituting a capital flow management measure (CFM), according to the Fund's Institutional View (IV) on capital flows. The repatriated export proceeds do not need to be converted into rupees and can be freely taken out from the country with no restrictions on their overseas use. Consequently, the measure has encouraged exporters to keep FX within the domestic financial system and helped reduce the imbalance in the FX market. The authorities are of the view that eliminating the measure at the current juncture could be premature as Sri Lanka remains vulnerable to shocks especially with international reserves remaining below the adequate level, while staff recommends removing this temporary measure as policy adjustments are implemented, for CFMs should not be used to substitute for warranted macroeconomic adjustment. The pace to phase out this temporary measure will be further discussed in the Article IV consultation in early 2018, together with Sri Lanka's overall efforts to further liberalize the capital account and develop the FX market.

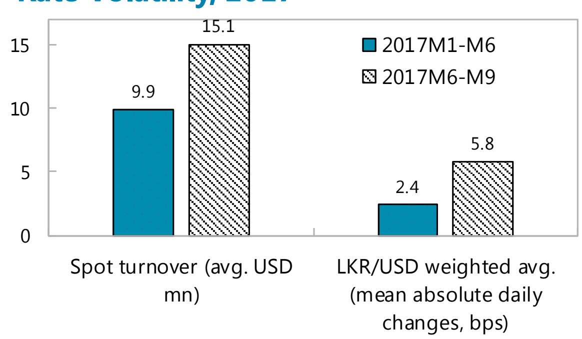
22. The FX market has deepened, enhancing price discovery. Since June 2017, the CBSL has withheld from intervening in the FX market, except to accumulate reserves. Combined with continued capital inflows, this has contributed to raising transaction volumes in the spot FX market and two-way exchange rate movements. Building on these positive developments, the authorities should consider adopting FX auctions and rules-based FX policies to further develop the FX market while providing a more transparent structure to accumulate reserves.

CBSL FX purchases, 2017
(In US$ millions)



Source: CBSL.

FX Market Turnover and Exchange Rate Volatility, 2017



Source: CBSL and IMF staff estimates.

23. The Monetary Board of the CBSL approved a roadmap for flexible inflation targeting and a flexible exchange rate regime (SB). Consistent with IMF TA recommendations, the roadmap identifies time-bound reform measures to be taken over the next few years, including: revising the Monetary Law Act (MLA) to establish price stability as the primary objective of monetary policy; addressing CBSL's direct fiscal financing for a clearer separation between fiscal and monetary policies; establishing a transparent auction mechanism for reserves accumulation while enhancing FX flexibility gradually; modifying the existing policy rate structure; assessing financial sector risks associated with adopting inflation targeting and greater FX flexibility; and strengthening public communication. The cabinet approval of a policy note outlining the key elements of amendments to the MLA has been set as a new SB due by March 2018.

D. Financial Policies to Safeguard Stability

24. While financial soundness indicators remain stable, credit growth needs further stabilizing to reduce the positive credit gap and head off a buildup of systemic vulnerability. The capital adequacy ratio of the banking system has stabilized at around 15 percent in 2017H1, and the NPL and provision coverage ratios have improved to 2.7 percent and 67 percent in 2017Q2, respectively. However, broad-based credit growth far above nominal GDP growth leaves open the positive credit gap (paragraph 5), raising the risk of negative systemic spillovers from financial shocks (e.g., a sizable reversal of portfolio inflows) propagated through excessive leverage associated with the real estate sector. Macroprudential measures, the need for which the authorities are evaluating through new surveys on credit growth, can include lower LTV limits on mortgages, higher capital weights on mortgages and other construction-related debt, and overall debt-to-income limits on consumer loans. The authorities also expressed preliminary interest in a Financial System Stability Review, which staff welcomes.

25. Financial sector supervision should be further strengthened to address potential vulnerabilities. The migration to the Basel III capital standards began in July 2017 and all banks met the initial requirements. With the minimum capital ratios set to rise to international standards by January 2019, banks should develop appropriate strategies to comply with the schedule. In addition, the authorities will establish a new Resolution and Enforcement Department within the CBSL; double the minimum equity capital requirement of all licensed banks by end 2020, to enhance stability and encourage consolidation; and upgrade legislation (e.g., the Banking Act). While some progress has been made in improving the AML/CFT regime, significant deficiencies remain, and Sri Lanka was placed under the Financial Action Task Force (FATF) monitoring process in October. Staff recommends that Sri Lanka enhance the effectiveness of the supervisory framework, enact FATF-compliant AML/CFT laws and regulations, and focus on the implementation of the International Cooperation Review Group (ICRG) action plan items.

E. Structural Reforms to Support Fiscal Consolidation and Inclusive Growth

26. Following progress in macroeconomic stabilization, structural reforms are needed to bolster competitiveness and facilitate inclusive growth. The authorities and staff initiated discussions of these reforms, which will be further explored in the upcoming Article IV consultation and be incorporated into the second half of the program. Published in September 2017 with endorsement by the coalition government, the authorities' *Vision 2025* identifies policies to promote inclusive growth in the areas of trade, labor market, logistic infrastructure, social safety nets, and natural disaster management. The program will support its implementation, giving priority to structural reforms in the following areas:

- **Reforms in trade and investment regimes**. The new IRA strengthens public governance and creates a transparent and predictable business environment, by adopting a simple and rules-based framework while shunning a discretionary and fragmented system of incentives. Automation of government's tax and public finance management systems (SBs) should continue to improve transparency and efficiency of government systems. The authorities have also formulated a new trade policy that aims to facilitate trade and remove barriers to foreign investment entry and establishment. Bilateral trade negotiations are ongoing with large regional markets, while GSP plus status with EU resumed in mid-2017. With the support of development partners, government has reviewed para-tariffs and other nontariff barriers for gradual phasing out, which should be aligned with the fiscal consolidation under the program.

- **Increasing female labor participation.** The low female labor participation (36 percent in 2017Q2) despite high education attainment calls for policies and labor market reforms that can increase female labor participation and enhance inclusive growth, including flexible work arrangements and more accessible child care service. The authorities are considering legislative reforms to introduce quotas on female representation in Parliament and local governments.
- **Addressing climate change.** Disaster management needs to strengthen to address Sri Lanka's vulnerability to natural disasters, which has imposed sizable costs in both economic and humanitarian terms. Recognizing the dangers from climate change, staff recommended strengthening adaptation and mitigation measures, including disaster-resilient infrastructure and stronger fiscal buffers in future budgets.

PROGRAM MONITORING

27. The attached Letter of Intent (LOI) and the MEFP describe the authorities' progress and commitments to implement their economic program (Appendix I). The authorities request, with staff supporting, to modify the primary balance QPC and the tax revenue IT for end-December to reflect the developments since the second review (Table 1 attached to the MEFP and the TMU). Quarterly targets for 2018 are proposed, including the June QPC on primary balance and NIR, and a new IT on NCOs for fuel and electricity. As a prior action for the third review, the authorities submitted the 2018 budget to Parliament consistent with the program and staff recommendations. The proposed list of SBs includes 3 new benchmarks (Table 2 attached to the MEFP).

28. The program remains fully financed for the next 12 months, but risks remain significant. Firm financing assurances from the World Bank, the Asian Development Bank, and key bilateral donors, are in place, and prospects are favorable 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 9). Key risks to the program are still present: (i) revenue slippage; (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 slow progress in SOE reforms (paragraph 7-9).

29. Other issues. The planned revision of the MLA is expected to address the issues identified by IMF safeguards assessment (August 2016), including on 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). Following the establishment of a payment platform, external arrears with the Export Development Bank of Iran are being paid based on a schedule shared with the Iranian authorities and will be cleared by February 2018. Staff will review the regulations associated with the new FX Act—albeit enacted to further liberalize FX transactions—for their adherence to the Article VIII obligation.

STAFF APPRAISAL

30. The EFF-supported program remains broadly on track. The authorities continue to make progress with revenue-based fiscal consolidation and reserves accumulation, while amending and legislating the VAT and the new IRA albeit with some delay. The 2018 budget consistent with the program was submitted to parliament, and a roadmap for inflation targeting has been approved by the Monetary Board. As the impact of the weather calamities subsides, growth and inflation are projected to normalize in 2018.

31. Nonetheless, downside risks and implementation delays call for a stronger ownership to uphold reform momentum. High public debt and low external buffers continue to expose Sri Lanka to severe downside risks. SOE operating results and debts present further fiscal and debt sustainability risks. Delays with the IRA implementation and SOE reforms could weaken confidence and reverse the progress made under the program, raising the need for stronger and more consistent ownership to accelerate reforms.

32. Revenue-based fiscal consolidation should continue. Front-loaded consolidation that targets 1 percent-of-GDP primary surplus in 2018 will help anchor investor confidence. Effective implementation of the new IRA and the tax package of the 2018 budget will also protect social and infrastructure spending. Stronger disaster provisions in the 2018 budget should mitigate weather-related adversities. Enhancing debt and fiscal management frameworks will support durable fiscal consolidation.

33. SOE reforms should progress without further delay. Following steps to raise the transparency of NCOs for fuel and electricity, the authorities should make timely progress in adopting the automatic pricing formula. The authorities should also resolve the impasse in restructuring Sri Lankan Airlines and move forward.

34. Reserves accumulation should continue with greater exchange rate flexibility. Greater reserve coverage and exchange rate flexibility will help contain external vulnerability and provide buffer against market volatility. The authorities should build on the growing depth of FX market by adopting FX auctions to enhance market development and transparency.

35. The central bank should focus on stabilizing inflation and manage financial sector risks. Monetary policy should maintain a tightening bias, supplemented by macroprudential measures as needed, until clearer signs emerge that inflation and credit growth have stabilized. Financial sector supervision should be strengthened to safeguard stability and protect against rapid credit growth.

36. Staff supports the completion of the third review under the EFF arrangement, in light of the progress so far and the authorities' commitment to ongoing reforms. Staff also supports the authorities' request for modification of program conditionality as described in paragraph 27.

Box 1. Sri Lanka: Coping with Natural Disasters

Sri Lanka has experienced exceptionally severe weather events since late 2016. Nationwide shortage of rainfall since late 2016, far below the average, has led to a historical drought across the country. The monsoon in May 2017 then triggered devastating floods and landslides in southwest regions, claiming more than 200 lives and damaging more than 9,000 houses. Nevertheless, the overall level of rainfall was insufficient to resolve the drought condition. The government estimates that more than 2 million people have been affected by these two severe weather events. Climate change would be a possible culprit for the erratic weather pattern—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").

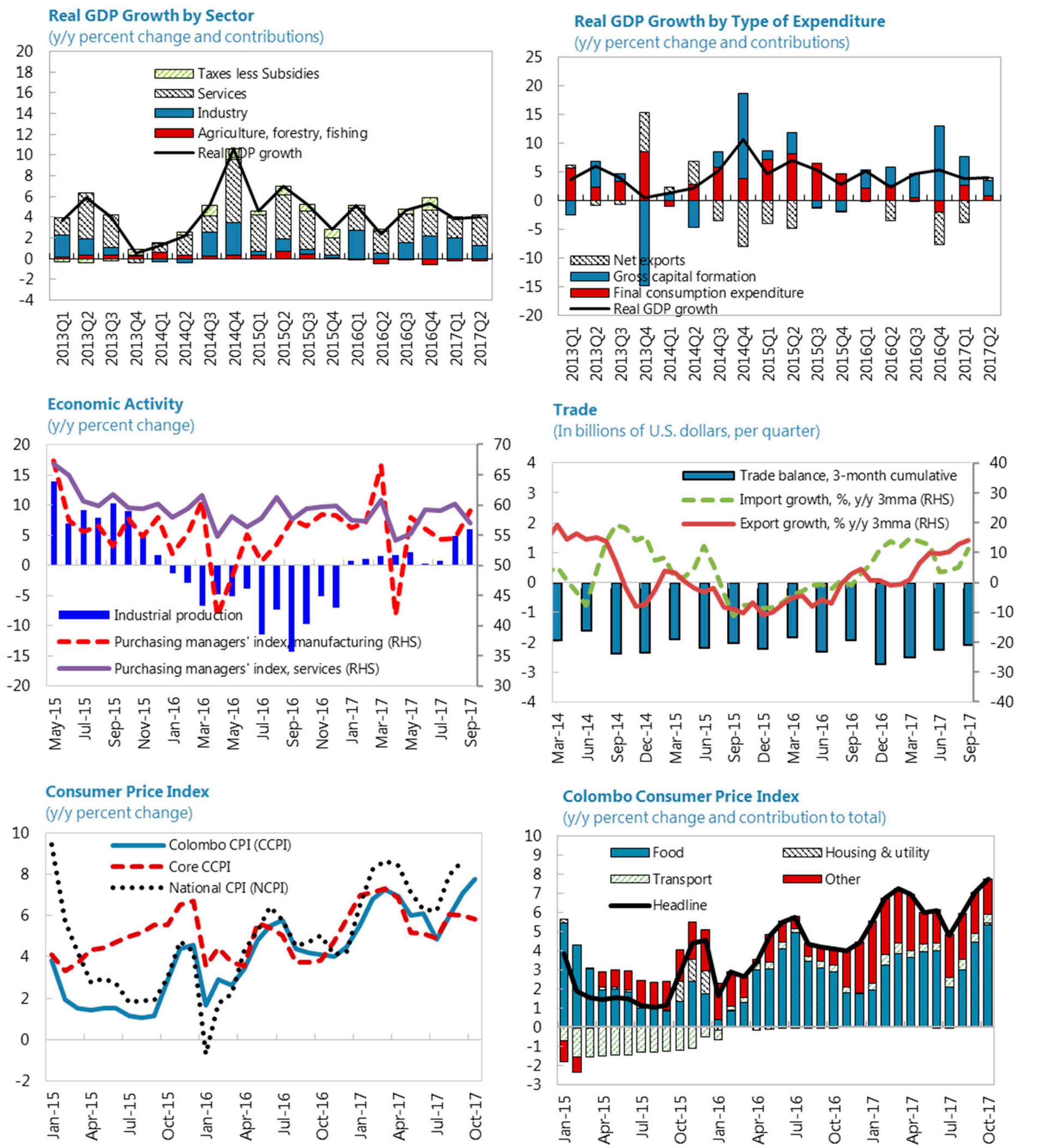
The weather calamities suppressed economic growth, raised inflation, and worsened trade deficit. With two rice cultivation cycles disrupted since fall 2016, the government estimates domestic rice production in 2017 to be the lowest in the last 10 years and meet only 7 months of national consumption. Affected also by the 2017 floods, agriculture GDP contacted by 3.1 percent in 2017H1, with adverse consequences on overall growth and tax revenues. The food shortage contributed to food inflation accelerating to 10.4 percent y/y in September and an increase in food imports by US$170 million over January–August 2017 (0.2 percent of annual GDP) compared with the same period last year. Moreover, the drought caused a shift in power generation from hydro to thermal sources, raising oil imports by US$560 million (0.7 percent of GDP) over January–August and the cost of power generation with it.

The impact has been felt disproportionately by the poor. The drought has deprived livelihood from families engaged in agricultural labor and subsistence. According to the UN World Food Program, the number of food insecure households rose to 277,000 by August, with 30 percent of them possibly consuming less than the daily minimum calorie intake. The property damage from the floods would also be more difficult for poor households to overcome.

Post-disaster relief efforts resulted in significant fiscal cost. Aside from indirect costs, immediate recovery and humanitarian assistance include: targeted income support that provides more than 800,000 severely affected households with a food voucher of Rs 5,000 (US$ 33); rehabilitation for damaged property, e.g., construction of new houses for landslide victims; and rehabilitation of road and irrigation systems. The government estimates the cost of these spending items to be 0.4 percent of GDP in 2017. In addition, the cost for higher thermal power generation caused CEB to record a financial loss of Rs 34 billion (0.3 percent of GDP) in 2017H1, for which the government transferred Rs 6 billion to CEB so far.

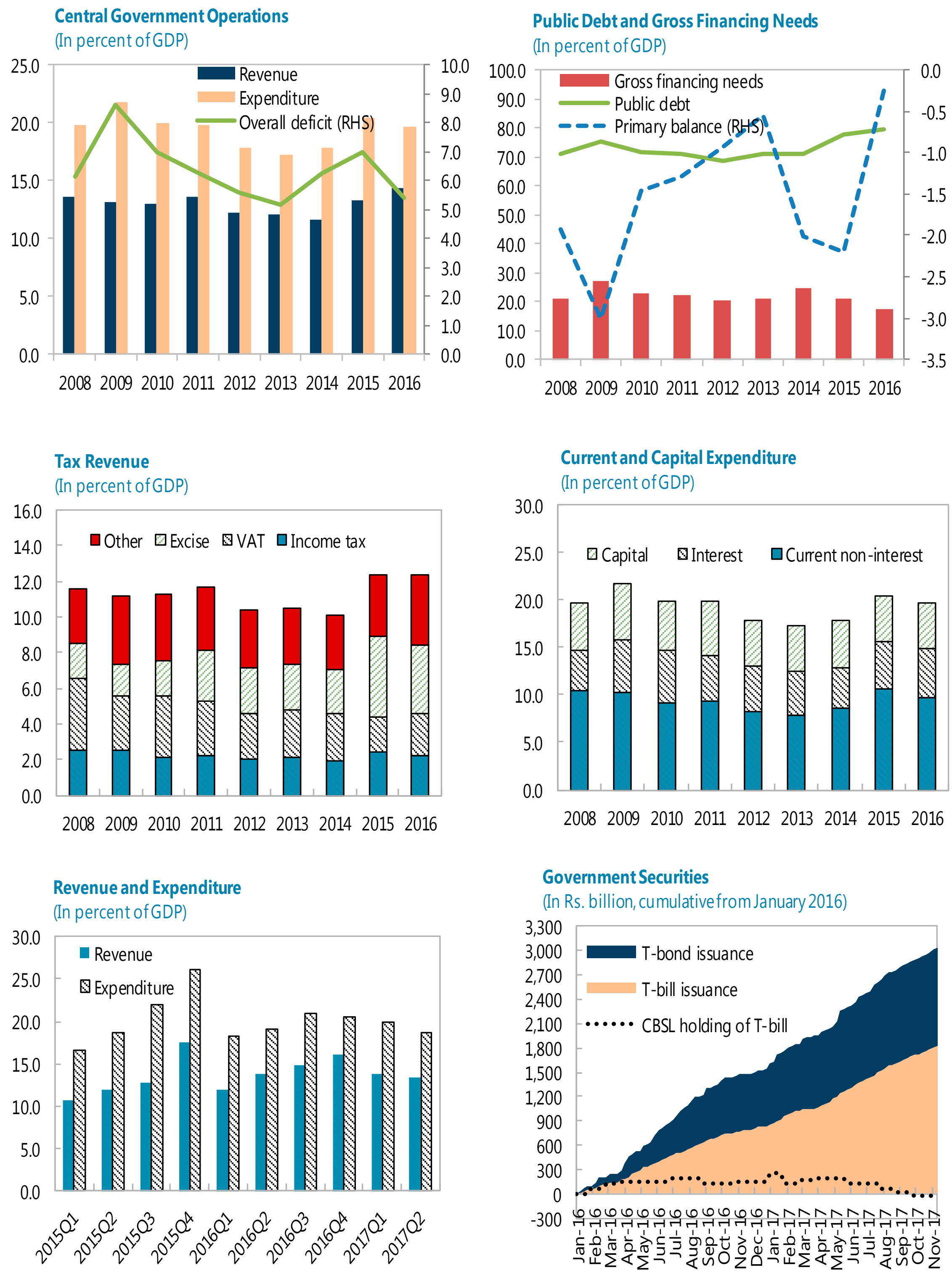
In recognition of the rising risk of damages from climate change, the authorities pledged to prioritize environmental protection and disaster management (Vision 2025). The government established a disaster insurance scheme for houses against natural disasters, and intends to establish a natural disaster reserve fund to finance post-disaster reconstruction. The government is considering resettling communities in landslide prone areas, as well as undertaking vulnerability and risk assessment.

Figure 1. Sri Lanka: Real Sector



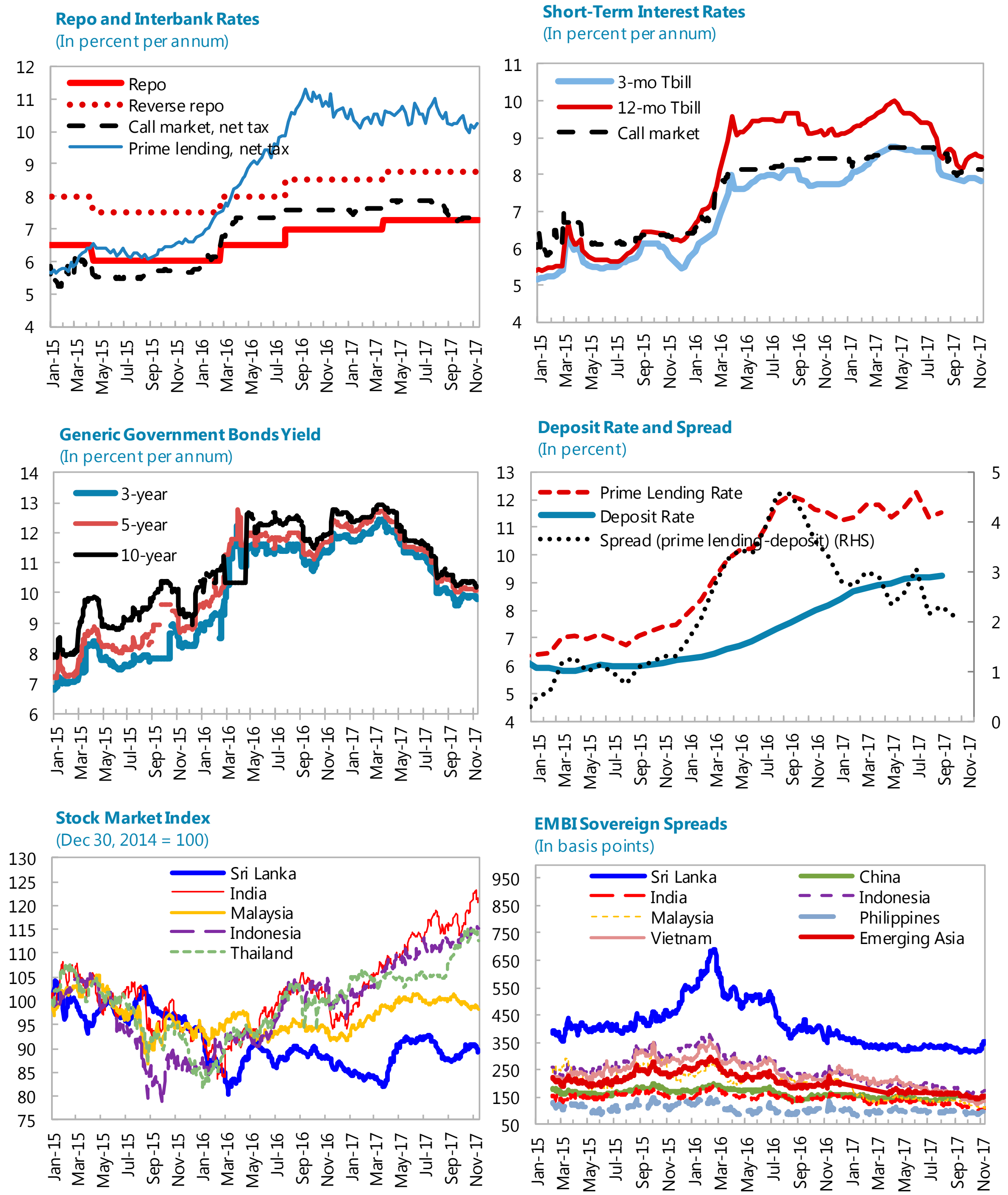
Sources: Central Bank of Sri Lanka; and IMF staff calculations.

Figure 2. Sri Lanka: Fiscal Sector



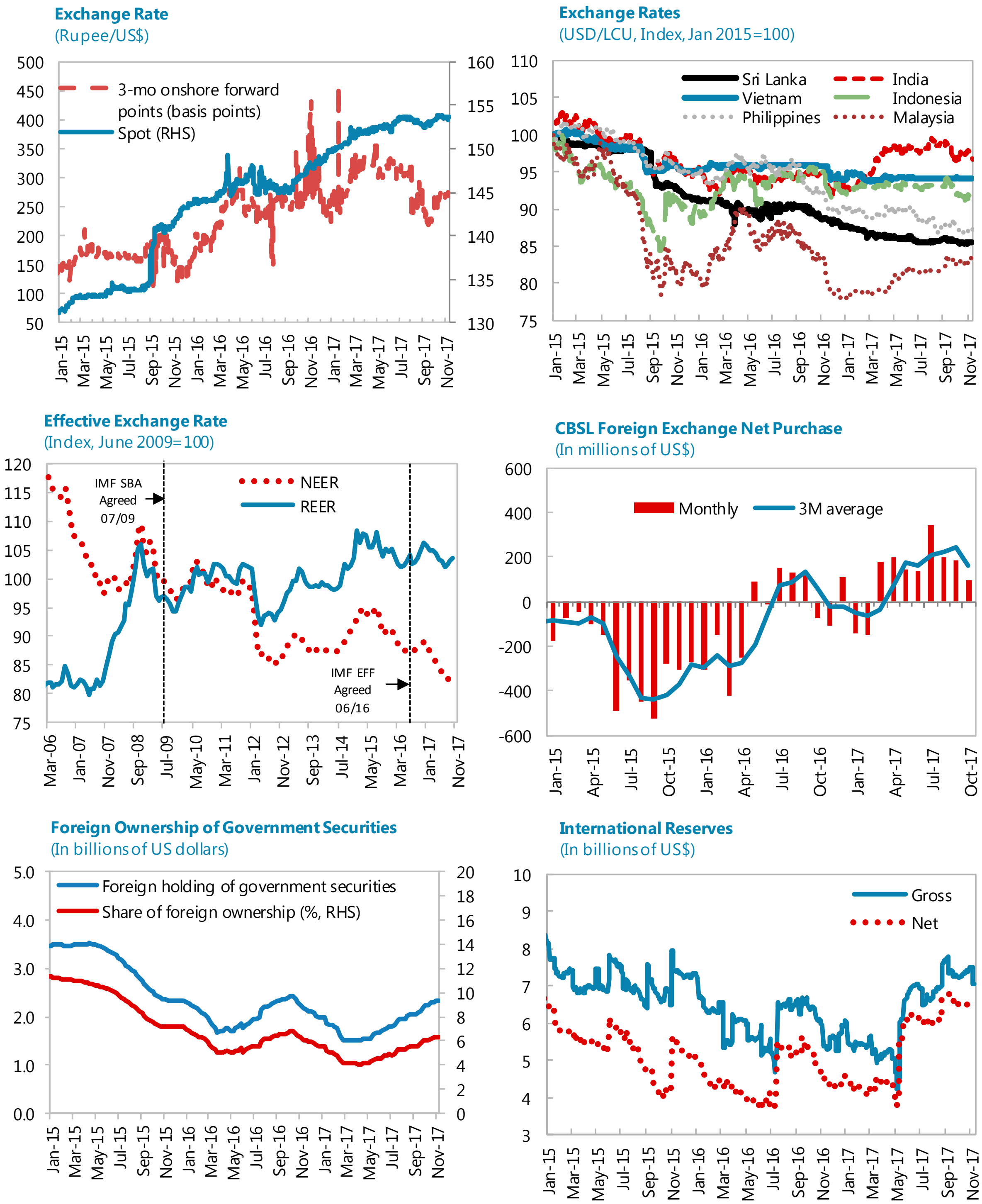
Sources: Central Bank of Sri Lanka; Ministry of Finance; and IMF staff calculations.

Figure 3. Sri Lanka: Financial Market



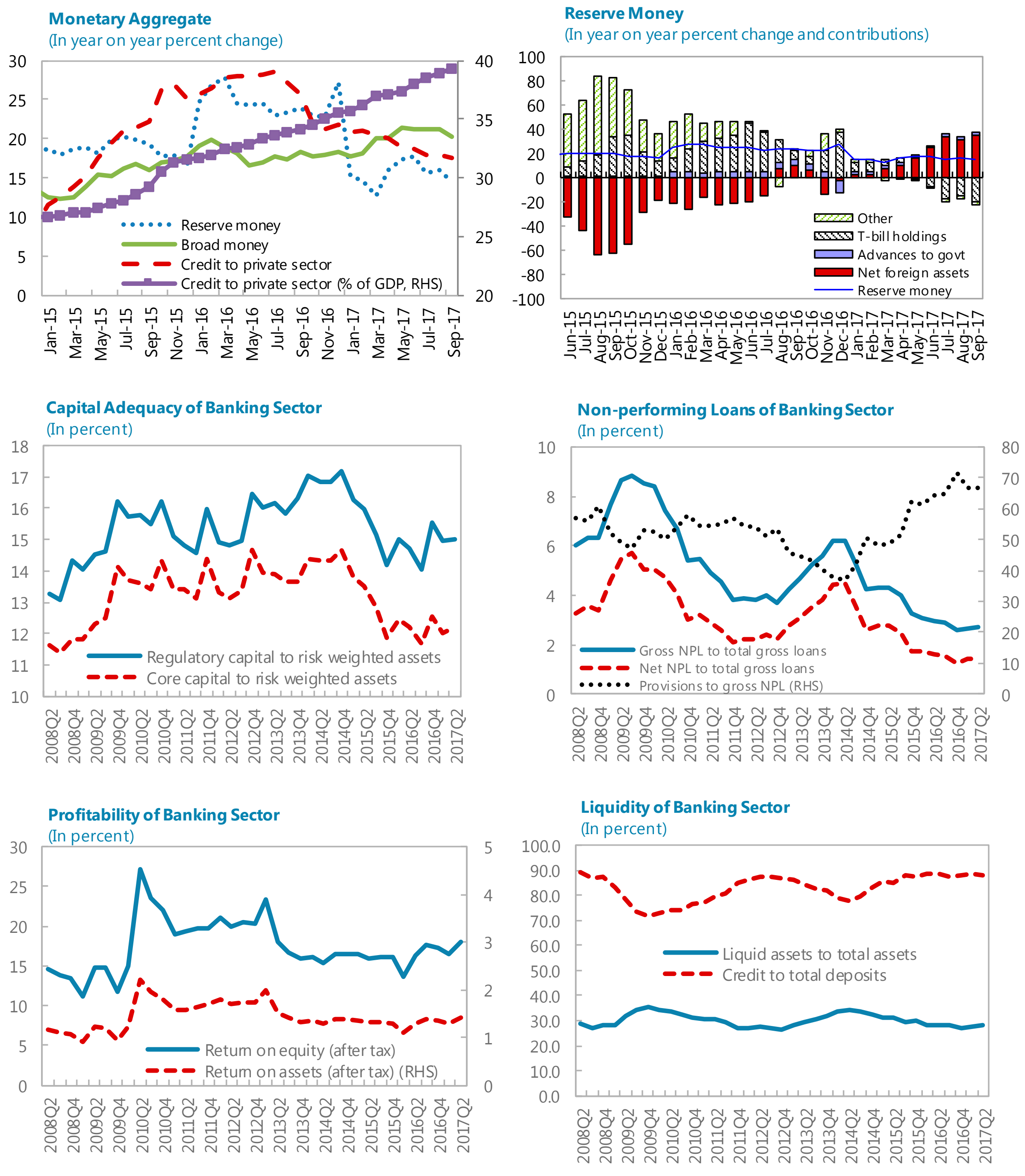
Sources: Central Bank of Sri Lanka; CEIC Daily Database; Bloomberg Data LP; and IMF staff calculations.

Figure 4. Sri Lanka: Foreign Exchange 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, 2015–22

	2015	2016	2017		2018	2019	2020	2021	2022
			CR/17/253	Proj.			Proj.		
GDP and inflation (in percent)									
Real GDP growth	4.8	4.4	4.7	4.2	4.6	4.7	4.8	4.9	5.0
Inflation (average)	2.2	4.0	6.0	6.0	4.8	5.0	5.0	5.0	5.0
Inflation (end-of-period)	4.6	4.5	5.1	5.1	5.0	5.0	5.0	5.0	5.0
Core inflation (end-of-period)	6.7	5.8	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Savings and investment (in percent of GDP)									
National savings	26.1	29.0	29.3	28.7	29.1	29.4	29.8	30.2	30.7
Government	-2.2	-0.5	-0.4	-0.9	-0.3	0.8	1.2	1.5	1.7
Private	28.3	29.6	29.7	29.7	29.4	28.7	28.5	28.8	28.9
National Investment	28.4	31.5	31.8	31.7	31.6	31.6	31.9	32.4	32.8
Government	5.5	7.8	6.4	6.3	6.0	6.0	5.9	6.0	6.1
Private	22.9	23.7	25.4	25.4	25.6	25.7	26.1	26.4	26.7
Savings-Investment balance	-2.4	-2.4	-2.5	-3.0	-2.5	-2.2	-2.2	-2.2	-2.1
Government	-7.7	-8.3	-6.7	-7.1	-6.3	-5.2	-4.6	-4.5	-4.4
Private	5.4	5.9	4.3	4.2	3.8	3.0	2.4	2.4	2.3
Public finances (in percent of GDP)									
Revenue and grants	13.3	14.3	14.5	14.2	15.0	16.1	16.6	16.7	16.8
Expenditure	20.4	19.7	19.7	19.9	20.0	20.0	20.0	20.2	20.3
Primary balance	-2.2	-0.2	0.0	-0.2	1.0	2.0	2.5	2.4	2.3
Central government balance	-7.0	-5.4	-5.2	-5.7	-5.0	-4.0	-3.5	-3.5	-3.5
Central government net domestic financing	4.3	2.8	3.4	3.4	2.9	3.2	2.8	2.7	2.6
Central government debt	78.5	80.1	79.6	81.6	80.3	77.6	74.7	72.1	69.6
Money and credit (percent change, end of period)									
Reserve money	16.5	27.1	13.0	13.0	13.3	12.6	12.7	12.5	12.0
Broad money	17.8	18.4	15.9	18.9	15.0	14.1	12.8	12.4	12.0
Domestic credit	23.5	16.4	10.8	13.2	12.1	11.4	10.4	10.2	10.1
Credit to private sector	25.1	21.9	13.7	16.3	14.8	13.3	12.9	12.4	12.1
Credit to government	21.3	8.1	6.1	8.0	7.3	7.7	5.2	5.3	5.4
Balance of payments (in millions of U.S. dollars)									
Exports	10,547	10,310	11,239	11,244	11,861	12,490	13,088	13,751	14,518
Imports	-18,935	-19,400	-20,517	-21,040	-21,932	-22,953	-24,197	-25,396	-26,716
Current account balance	-1,882	-1,943	-2,094	-2,461	-2,180	-2,046	-2,172	-2,331	-2,457
Current account balance (in percent of GDP)	-2.4	-2.4	-2.5	-3.0	-2.5	-2.2	-2.2	-2.2	-2.1
Export value growth (percent)	-5.2	-2.2	9.0	9.1	5.5	5.3	4.8	5.1	5.6
Import value growth (percent)	-2.5	2.5	5.8	8.5	4.2	4.7	5.4	5.0	5.2
Gross official reserves (end of period)									
In millions of U.S. dollars	7,304	6,019	7,246	7,505	8,014	8,788	9,624	10,283	10,864
In months of imports	3.7	2.8	3.3	3.4	3.4	3.6	3.8	3.8	3.9
External debt (public and private)									
In billions of U.S. dollars	44.8	46.0	47.4	48.3	49.5	52.7	54.9	57.3	60.3
As a percent of GDP	56.4	57.1	56.8	58.2	57.4	56.8	55.1	53.4	52.2
Memorandum items:									
Nominal GDP (in billions of rupees)	10,952	11,839	13,098	13,027	14,271	15,690	17,267	19,021	20,972

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

Table 2a. Sri Lanka: Summary of Central Government Operations, 2015–22

(In billions of rupee)

	2015	2016	2017 CR/17/253	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Total revenue and grants	1,461	1,694	1,894	1,854	2,146	2,523	2,858	3,175	3,523
Total revenue	1,455	1,686	1,884	1,846	2,136	2,512	2,846	3,162	3,508
Tax revenue	1,356	1,464	1,718	1,680	1,954	2,312	2,626	2,920	3,241
Income taxes	263	259	328	272	323	402	443	488	538
VAT	220	283	372	435	545	750	941	1,103	1,279
Excise taxes	498	455	513	476	538	575	615	660	708
Other trade taxes	184	212	213	214	228	243	259	276	295
Other	191	254	293	283	321	342	368	393	422
Nontax revenue	99	222	166	166	182	200	220	242	267
Grants	6	7	10	8	10	11	12	13	15
Total expenditure and net lending	2,229	2,334	2,581	2,597	2,854	3,143	3,461	3,842	4,250
Current expenditure	1,702	1,758	1,944	1,973	2,189	2,402	2,646	2,899	3,159
Civil service wages and salaries	323	334	348	346	365	399	439	483	533
Other civilian goods and services	135	86	96	96	105	116	127	140	155
Security expenditure	297	307	335	331	355	385	423	466	514
Subsidies and transfers	419	419	481	480	515	566	623	686	757
Interest payments	527	611	683	720	849	937	1,034	1,123	1,201
Capital expenditure and net lending	527	576	637	624	665	741	815	942	1,091
Overall balance	-768	-640	-687	-742	-707	-620	-602	-666	-727
Financing	768	640	687	742	707	620	602	666	727
Net external financing	292	307	240	302	293	121	118	147	171
Net domestic financing	476	333	447	440	414	499	484	520	556
Memorandum items:									
Central government primary balance	-241	-29	-3	-23	141	317	431	457	474
Nonfinancial SOE balance 1/	-23	34	…	…	…	…	…	…	…
Ceylon Electricity Board	21	-14	…	…	…	…	…	…	…
Ceylon Petroleum Corporation	-18	70	…	…	…	…	…	…	…
Sri Lankan Airlines	-18	-30	…	…	…	…	…	…	…
Other	-8	1	…	…	…	…	…	…	…
Central government debt	8,595	9,479	10,430	10,630	11,460	12,180	12,905	13,714	14,589
Domestic currency	4,686	5,121	5,354	5,493	5,958	6,552	7,118	7,734	8,277
Foreign currency	3,909	4,358	5,076	5,136	5,502	5,629	5,787	5,980	6,312
Publicly guaranteed debt	408	524	…	…	…	…	…	…	…
Financial obligations of nonfinancial SOEs 2/	1,501	1,414	…	…	…	…	…	…	…
Fund credit outstanding	110	83	114	119	208	256	259	255	234
Nominal GDP (in billion of rupees)	10,952	11,839	13,098	13,027	14,271	15,690	17,267	19,021	20,972

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

1/ For 42 nonfinancial SOEs reported in MOF Annual Reports.

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

Table 2b. Sri Lanka: Summary of Central Government Operations, 2015–22
(In percent of GDP)

	2015	2016	2017		2018	2019	2020	2021	2022
			CR/17/253	Proj.			Proj.		
Total revenue and grants	13.3	14.3	14.5	14.2	15.0	16.1	16.6	16.7	16.8
Total revenue	13.3	14.2	14.4	14.2	15.0	16.0	16.5	16.6	16.7
Tax revenue	12.4	12.4	13.1	12.9	13.7	14.7	15.2	15.3	15.5
Income taxes	2.4	2.2	2.5	2.1	2.3	2.6	2.6	2.6	2.6
VAT	2.0	2.4	2.8	3.3	3.8	4.8	5.5	5.8	6.1
Excise taxes	4.5	3.8	3.9	3.7	3.8	3.7	3.6	3.5	3.4
Other trade taxes	1.7	1.8	1.6	1.6	1.6	1.5	1.5	1.5	1.4
Other	1.7	2.1	2.2	2.2	2.2	2.2	2.1	2.1	2.0
Nontax revenue	0.9	1.9	1.3	1.3	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	0.1	0.1
Total expenditure and net lending	20.4	19.7	19.7	19.9	20.0	20.0	20.0	20.2	20.3
Current expenditure	15.5	14.8	14.8	15.1	15.3	15.3	15.3	15.2	15.1
Civil service wages and salaries	3.0	2.8	2.7	2.7	2.6	2.5	2.5	2.5	2.5
Other civilian goods and services	1.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Security expenditure	2.7	2.6	2.6	2.5	2.5	2.5	2.5	2.5	2.5
Subsidies and transfers	3.8	3.5	3.7	3.7	3.6	3.6	3.6	3.6	3.6
Interest payments	4.8	5.2	5.2	5.5	5.9	6.0	6.0	5.9	5.7
Capital expenditure and net lending	4.8	4.9	4.9	4.8	4.7	4.7	4.7	5.0	5.2
Overall balance	-7.0	-5.4	-5.2	-5.7	-5.0	-4.0	-3.5	-3.5	-3.5
Financing	7.0	5.4	5.2	5.7	5.0	4.0	3.5	3.5	3.5
Net external financing	2.7	2.6	1.8	2.3	2.1	0.8	0.7	0.8	0.8
Net domestic financing	4.3	2.8	3.4	3.4	2.9	3.2	2.8	2.7	2.6
Memorandum items:									
Central government primary balance	-2.2	-0.2	0.0	-0.2	1.0	2.0	2.5	2.4	2.3
Nonfinancial SOE balance 1/	-0.2	0.3	…	…	…	…	…	…	…
Ceylon Electricity Board	0.2	-0.1	…	…	…	…	…	…	…
Ceylon Petroleum Corporation	-0.2	0.6	…	…	…	…	…	…	…
Sri Lankan Airlines	-0.2	-0.3	…	…	…	…	…	…	…
Other	-0.1	0.0	…	…	…	…	…	…	…
Central government debt	78.5	80.1	79.6	81.6	80.3	77.6	74.7	72.1	69.6
Domestic currency	42.8	43.3	40.9	42.2	41.7	41.8	41.2	40.7	39.5
Foreign currency	35.7	36.8	38.8	39.4	38.6	35.9	33.5	31.4	30.1
Publicly guaranteed debt	3.7	4.4	…	…	…	…	…	…	…
Financial obligations of nonfinancial SOEs 2/	13.7	11.9	…	…	…	…	…	…	…
Fund credit outstanding	1.0	0.7	0.9	0.9	1.5	1.6	1.5	1.3	1.1
Nominal GDP (in billion of rupees)	10,952	11,839	13,098	13,027	14,271	15,690	17,267	19,021	20,972

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

1/ For 42 nonfinancial SOEs reported in MOF Annual Reports.

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

Table 2c. Sri Lanka: Summary of Central Government Operations, 2017–18
(In billions of rupees)

	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4
	Est.	Est.	Est.			Proj.		
Total revenue and grants	437	441	453	524	485	517	554	590
Total revenue	436	440	452	518	484	516	550	586
Tax revenue	415	404	421	440	447	476	514	516
Income taxes	63	61	83	65	59	63	100	100
VAT	111	108	105	111	119	142	142	142
Excise taxes	115	119	116	126	135	135	135	135
Other trade taxes	58	49	50	56	57	57	57	57
Other	69	66	66	82	78	80	80	82
Nontax revenue	21	36	31	78	37	40	36	69
Grants	1	1	1	6	1	1	4	4
Total expenditure and net lending	636	574	680	707	697	676	763	718
Current expenditure	484	434	520	535	551	514	598	526
Civil service wages and salaries	87	86	88	86	90	90	93	93
Other civilian goods and services	13	19	17	47	24	25	27	30
Security expenditure	71	78	78	103	84	88	91	92
Subsidies and transfers	103	112	110	155	126	124	133	132
Interest payments	209	140	227	144	227	188	253	180
Capital expenditure and net lending	152	140	160	172	146	161	165	192
Capital expenditure	147	139	160	171	145	160	164	191
Net lending	5	1	0	1	1	1	1	1
Overall balance	-200	-133	-227	-183	-212	-158	-209	-128
Primary balance	9	7	0	-38	15	30	45	51

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

Table 3. Sri Lanka: Central Government Financing Needs, 2015–18
(In billions of rupees, unless otherwise indicated, end of period)

	2015 Est.	2016 Est.	2017 Proj.	2018 Proj.	2016Q1 Est.	2016Q2 Est.	2016Q3 Est.	2016Q4 Est.	2017Q1 Est.	2017Q2 Est.	2017Q3 Proj.	2017Q4 Proj.
Gross inflow	**2,583**	**2,276**	**2,482**	**2,978**	**445**	**708**	**790**	**343**	**640**	**978**	**541**	**339**
Primary surplus	0	0	0	141	0	0	3	6	9	7	0	0
Rupee-denominated debt disbursement	1,747	1,599	1,578	2,030	289	580	532	196	364	514	514	184
US-dollar denominated debt disbursement	829	609	904	807	146	53	353	57	266	457	26	155
Asset sales (net)	0	0	0	0	0	0	0	0	0	0	0	0
Other	7	68	0	0	10	74	-99	84	0	0	0	0
Gross outflow	**2,562**	**2,292**	**2,482**	**2,978**	**453**	**720**	**785**	**342**	**503**	**737**	**859**	**398**
Primary deficit	241	29	23	0	26	12	0	0	0	0	0	38
Interest payment	527	611	720	849	154	135	181	140	209	140	227	144
Rupee-denominated debt amortization	1,490	1,178	1,205	1,566	132	460	465	121	135	470	476	124
US-dollar denominated debt amortization	304	473	534	564	141	113	138	81	159	127	156	92
Other	0	0	…	…	0	0	0	0	…	…	…	…
Net cash inflow	**22**	**-15**	**0**	**0**	**-9**	**-12**	**5**	**1**	**137**	**241**	**-318**	**-59**
Government deposits, end of period	87	72	72	72	78	66	70	72	208	449	131	72
Memorandum items:												
Overall deficit	768	640	742	707	181	148	178	134	200	133	227	183
US$ denominated debt disbursement (in US$ millions)	6,025	4,143	5,767	4,877	1,018	367	2,415	386	1,764	2,981	169	960
US$ denominated debt amortization (in US$ millions)	2,208	3,218	3,408	3,407	984	779	945	548	1,054	831	996	571
Government deposits, end of period (percent of GDP)	0.8	0.6	0.5	0.5	…	…	…	…	…	…	…	…
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 4a. Sri Lanka: Monetary Accounts, 2015–18
(In billions of rupees, unless otherwise indicated, end of period)

	2015	2016	2017		2018
			CR/17/253	Proj.	Proj.
Central Bank of Sri Lanka					
Net foreign assets	576	559	876	938	961
Net domestic assets	97	298	91	29	134
Net claims on central government	230	413	188	184	213
Net claims on banks	-3	-2	-2	-2	-2
Other items, net	-130	-113	-95	-153	-77
Reserve Money	673	856	967	967	1,095
Monetary survey					
Net foreign assets	-298	-231	-89	-27	-77
Monetary authorities	576	559	876	938	961
Deposit money banks	-874	-790	-965	-965	-1,038
Net domestic assets	4,864	5,637	6,356	6,457	7,471
Net claims on central government	1,759	1,972	2,111	2,108	2,246
Credit to corporations	3,973	4,700	5,285	5,446	6,226
Public corporations	523	495	506	556	613
Private corporations	3,450	4,204	4,779	4,890	5,613
Other items (net)	-868	-1,035	-1,039	-1,097	-1,001
Broad money	4,566	5,406	6,267	6,430	7,394
Memorandum Items					
Gross international reserves (in millions of U.S. dollars)	7,304	6,019	7,246	7,505	8,014
Net international reserves (in millions of U.S. dollars)	5,029	4,529	6,161	6,541	6,548
Net Foreign Assets (in millions of U.S. dollars)	3,999	3,725	5,356	5,736	5,610
Private credit (in percent of GDP)	31.5	35.5	36.5	37.5	39.3
Money multiplier	6.8	6.3	6.5	6.6	6.7
Broad money velocity 1/	2.4	2.2	2.1	2.0	1.9
Money and credit (percent change, end of period)					
Broad money	17.8	18.4	15.9	18.9	15.0
Reserve money	16.5	27.1	13.0	13.0	13.3
Credit to public corporations	17.2	-5.3	2.2	12.2	10.3
Credit to private sector	25.1	21.9	13.7	16.3	14.8

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

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

Table 4b. Sri Lanka: Monetary Accounts, 2015–18

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

	2015	2016	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4
			Est.	Est.	Est.	Proj.	Proj.			
Central Bank of Sri Lanka										
Net foreign assets	576	559	537	598	776	938	1,117	1,095	994	961
Net domestic assets	97	298	355	294	133	29	-96	-70	77	134
Net claims on central government	230	413	467	411	253	184	194	201	208	213
Net claims on banks	-3	-2	-1	-1	4	-2	-2	-2	-2	-2
Other items, net	-130	-113	-110	-116	-124	-153	-288	-269	-130	-77
Reserve Money	673	856	892	891.6	909	967	1,020	1,025	1,071	1,095
Monetary survey										
Net foreign assets	-298	-231	-372	-246	10	-27	-19	-51	-63	-77
Monetary authorities	576	559	537	598	776	938	1,117	1,095	994	961
Deposit money banks	-874	-790	-908	-844	-766	-965	-1,135	-1,145	-1,058	-1,038
Net domestic assets	4,864	5,637	6,049	6,119	6,122	6,457	6,825	7,012	7,244	7,471
Net claims on central government	1,759	1,972	2,215	2,235	2,224	2,108	2,101	2,159	2,227	2,246
Credit to corporations	3,973	4,700	4,929	5,056	5,157	5,446	5,632	5,757	5,926	6,226
Public corporations	523	495	553	551	498	556	527	543	565	613
Private corporations	3,450	4,204	4,375	4,505	4,659	4,890	5,106	5,213	5,361	5,613
Other items (net)	-868	-1,035	-1,094	-1,172	-1,259	-1,097	-909	-904	-909	-1,001
Broad money	4,566	5,406	5,677	5,873	6,132	6,430	6,806	6,961	7,180	7,394
Memorandum Items										
Gross international reserves (in millions of U.S. dollars)	7,304	6,019	5,117	6,959	7,280	7,505	8,559	8,639	7,996	8,014
Net international reserves (in millions of U.S. dollars)	5,029	4,529	4,353	6,092	6,555	6,541	7,594	7,424	6,781	6,548
Money and credit (percent change, end of period)										
Broad money	17.8	18.4	20.0	21.2	20.3	18.9	19.9	18.5	17.1	15.0
Reserve money	16.5	27.1	12.7	17.8	14.5	13.0	14.4	15.0	17.8	13.3
Credit to private sector	25.1	21.9	20.4	18.6	17.5	16.3	16.7	15.7	15.1	14.8

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

Table 5a. Sri Lanka: Balance of Payments, 2015–22

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

	2015	2016	2017		2018	2019	2020	2021	2022
			CR/17/253	Proj.		Proj.			
Current account	**-1,882**	**-1,943**	**-2,094**	**-2,461**	**-2,180**	**-2,046**	**-2,172**	**-2,331**	**-2,457**
Balance on goods	-8,388	-9,090	-9,278	-9,796	-10,072	-10,463	-11,109	-11,644	-12,198
Credit (exports)	10,547	10,310	11,239	11,244	11,861	12,490	13,088	13,751	14,518
Debit (imports)	-18,935	-19,400	-20,517	-21,040	-21,932	-22,953	-24,197	-25,396	-26,716
Balance on services	2,324	2,879	2,946	3,081	3,542	3,970	4,581	5,011	5,498
Credit (exports)	6,396	7,138	7,547	7,668	8,358	9,027	9,749	10,334	10,954
Debit (imports)	-4,072	-4,259	-4,601	-4,587	-4,816	-5,057	-5,168	-5,323	-5,456
Primary income, net 1/	-2,012	-2,185	-2,336	-2,236	-2,300	-2,383	-2,548	-2,680	-2,817
Secondary income, net 2/	6,194	6,453	6,574	6,490	6,650	6,830	6,904	6,983	7,061
Of which: workers' remittances (net)	6,167	6,434	6,555	6,470	6,629	6,809	6,883	6,962	7,039
Capital account (+ surplus / - deficit)	**46**	**25**	**55**	**18**	**20**	**16**	**16**	**12**	**12**
Balance from current account and capital account	**-1,836**	**-1,918**	**-2,039**	**-2,443**	**-2,160**	**-2,030**	**-2,156**	**-2,319**	**-2,445**
Financial account (+ net lending / - net borrowing) 3/	**-3,172**	**-1,765**	**-2,871**	**-3,478**	**-1,968**	**-2,328**	**-3,007**	**-3,034**	**-3,173**
Direct investments	-628	-662	-945	-873	-925	-988	-1,194	-1,080	-1,320
Portfolio investments	-687	-992	-1,196	-1,078	-599	-668	-880	-880	-880
Equity and investment Fund shares	60	-24	-120	-309	-181	-140	-160	-180	-180
Debt instruments	-747	-968	-1,076	-769	-418	-528	-720	-700	-700
Of which: deposit taking corporations	0	0	514	594	682	172	0	0	0
Of which: general government	-747	-968	-1,590	-1,362	-1,100	-700	-720	-700	-700
T-bills, T-bonds, and SLDBs	903	532	-90	138	400	-200	-220	-200	-200
Sovereign bonds	-1,650	-1,500	-1,500	-1,500	-1,500	-500	-500	-500	-500
Other investments 4/	-1,857	-111	-730	-1,527	-444	-672	-933	-1,075	-973
Of which:									
Currency and deposits	-1,313	614	194	611	59	56	-10	78	29
Central bank	-1,097	701	400	400	0	0	0	0	0
Deposit taking corporations	-216	-87	-206	211	59	56	-10	78	29
Loans 4/	-1,266	-877	-1,222	-2,394	-256	-561	-579	-1,079	-1,361
Central bank 4/	0	0	0	0	0	0	0	0	0
Deposit taking corporations	-787	507	-445	-1,028	-380	-504	-275	-352	-520
General government	-470	-1,288	-452	-1,133	340	348	96	-327	-441
Disbursements	-1,268	-2,305	-1,817	-2,583	-1,477	-1,400	-1,400	-1,525	-1,600
Amortizations	798	1,017	1,365	1,450	1,817	1,748	1,496	1,198	1,159
Other sectors	-9	-96	-325	-233	-216	-405	-400	-400	-400
Errors and omissions	-475	-200	0	177	0	0	0	0	0
Overall balance (- = need of inflow) 3/	**861**	**-353**	**832**	**1,213**	**-192**	**298**	**850**	**716**	**728**
Total financing (- = inflow)	**862**	**-536**	**832**	**1,213**	**-192**	**298**	**850**	**716**	**728**
Financing (- = inflow)	**862**	**-17**	**1,460**	**1,725**	**509**	**774**	**850**	**716**	**728**
Change in reserve assets	355	-472	1,227	1,486	509	774	836	659	580
Use of Fund credit, net	507	455	233	239	0	0	14	56	147
Purchases/Disbursements	0	0	0	0	0	0	0	0	0
Repurchases/repayments	507	455	233	239	0	0	14	56	147
Financing gap (- = inflow)	**0**	**-518**	**-628**	**-512**	**-701**	**-476**	**0**	**0**	**0**
IMF	0	-333	-403	-412	-501	-251	0	0	0
Other IFIs	0	-185	-225	-100	-200	-225	0	0	0
Memorandum items:									
Current account (in percent of GDP)	-2.4	-2.4	-2.5	-3.0	-2.5	-2.2	-2.2	-2.2	-2.1
Gross official reserves	7,304	6,019	7,246	7,505	8,014	8,788	9,624	10,283	10,864
In months of prospective imports of goods and services	3.7	2.8	3.3	3.4	3.4	3.6	3.8	3.8	3.9
In percent of ARA composite metric	68.9	56.2	64.8	66.9	66.5	70.1	73.6	74.8	75.3
Net international reserves	5,029	4,529	6,161	6,541	6,548	7,071	7,922	8,637	9,365
In percent of ARA composite metric	47.5	42.3	55.1	58.3	54.4	56.4	60.6	62.8	64.9
GDP	79,565	80,517	83,567	83,117	86,282	92,668	99,704	107,348	115,533

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 5b. Sri Lanka: Balance of Payments, 2016–18

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

	2016					2017					2018				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
			Est.			Est.	Est.	Proj.	Proj.	Proj.			Proj.		
Current account	35	-681	-126	-1,171	-1,943	-685	-796	-411	-569	-2,461	-758	-498	-393	-531	-2,180
Balance on goods	-1,855	-2,336	-1,969	-2,930	-9,090	-2,505	-2,249	-2,301	-2,741	-9,796	-2,614	-2,462	-2,427	-2,569	-10,072
Credit (exports)	2,739	2,391	2,656	2,524	10,310	2,774	2,623	2,833	3,014	11,244	3,017	2,775	2,988	3,081	11,861
Debit (imports)	-4,594	-4,727	-4,625	-5,454	-19,400	-5,279	-4,872	-5,134	-5,755	-21,040	-5,631	-5,237	-5,415	-5,650	-21,932
Non-oil imports	-4,108	-4,035	-4,126	-4,650	-16,919	-4,396	-4,130	-4,342	-5,029	-17,897	-4,881	-4,429	-4,794	-4,975	-19,080
Oil imports	-486	-692	-499	-804	-2,481	-883	-742	-792	-727	-3,143	-749	-808	-621	-675	-2,853
Balance on services	842	471	794	772	2,879	888	520	837	836	3,081	941	732	957	912	3,542
Credit (exports)	1,928	1,565	1,816	1,829	7,138	2,024	1,622	1,948	2,074	7,668	2,129	1,933	2,124	2,172	8,358
Debit (imports)	-1,086	-1,094	-1,022	-1,057	-4,259	-1,136	-1,102	-1,111	-1,237	-4,587	-1,188	-1,201	-1,167	-1,260	-4,816
Primary income, net 1/	-523	-449	-525	-688	-2,185	-574	-464	-572	-626	-2,236	-612	-424	-589	-676	-2,300
Secondary income, net 2/	1,571	1,633	1,574	1,675	6,453	1,506	1,397	1,625	1,962	6,490	1,526	1,656	1,666	1,802	6,650
Capital account (+ surplus / - deficit)	0	0	2	23	25	2	6	5	5	18	5	5	5	5	20
Balance from current account and capital account	35	-681	-124	-1,148	-1,918	-683	-790	-406	-564	-2,443	-753	-493	-388	-526	-2,160
Financial account (+ net lending / - net borrowing) 3/	353	318	-1,634	-802	-1,765	-71	-2,683	-608	-116	-3,478	-1,807	-323	355	-193	-1,968
Direct investments	-23	-33	-29	-577	-662	-96	-377	-147	-253	-873	-148	-327	-192	-258	-925
Portfolio investments	567	55	-1,942	328	-992	302	-1,338	8	-50	-1,078	-1,435	344	342	149	-599
Debt instruments	564	13	-1,918	373	-968	417	-1,252	66	0	-769	-1,500	450	432	200	-418
Of which: general government	564	13	-1,918	373	-968	417	-1,752	-27	0	-1,362	-1,500	200	0	200	-1,100
T-bills, T-bonds, and SLDBs	564	13	-418	373	532	417	-252	-27	0	138	0	200	0	200	400
Sovereign bonds	0	0	-1,500	0	-1,500	0	-1,500	0	0	-1,500	-1,500	0	0	0	-1,500
Other investments 4/	-191	296	337	-553	-111	-277	-968	-469	186	-1,527	-224	-339	205	-85	-444
Of which: Currency and deposits	250	598	9	-243	614	551	-32	7	86	611	-25	79	50	-45	59
Central bank	0	701	-1	1	701	400	0	0	0	400	0	0	0	0	0
Loans 4/	-846	10	-161	120	-877	-475	-1,026	-797	-96	-2,394	-210	100	-99	-47	-256
Central bank 4/	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Deposit taking corporations	-590	166	588	343	507	-469	-433	-80	-46	-1,028	-150	9	-84	-156	-380
General government	42	-141	-804	-385	-1,288	-54	-462	-642	25	-1,133	-4	144	38	162	340
Disbursements	-286	-305	-1,169	-545	-2,305	-419	-784	-1,053	-326	-2,583	-369	-369	-369	-370	-1,477
Amortizations	328	164	365	160	1,017	365	322	411	351	1,450	365	513	407	532	1,817
Other sectors	-298	-15	55	162	-96	48	-131	-75	-75	-233	-56	-53	-53	-53	-216
Errors and omissions	-675	84	91	300	-200	1	176	0	0	177	0	0	0	0	0
Overall balance (- = need of inflow) 3/	-993	-915	1,601	-46	-353	-611	2,069	202	-447	1,213	1,053	-170	-743	-332	-192
Total financing (- = inflow)	-990	-912	1,601	-234	-536	-611	2,069	202	-447	1,213	1,053	-170	-743	-332	-192
Financing (- = inflow)	-990	-745	1,601	118	-17	-611	2,069	368	-101	1,725	1,053	80	-643	18	509
Change in reserve assets	-1,134	-865	1,505	22	-472	-706	1,974	320	-101	1,486	1,053	80	-643	18	509
Use of Fund credit, net	144	120	96	96	455	95	95	48	0	239	0	0	0	0	0
Purchases/Disbursements	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Repurchases/repayments	144	120	96	96	455	95	95	48	0	239	0	0	0	0	0
Financing gap (- = inflow)	0	-167	0	-352	-518	0	0	-166	-346	-512	0	-250	-100	-350	-701
IMF	0	-167	0	-167	-333	0	0	-166	-246	-412	0	-250	0	-250	-501
Other IFIs	0	0	0	-185	-185	0	0	0	-100	-100	0	0	-100	-100	-200
Memorandum items:															
Gross official reserves	6,221	5,293	6,456	6,019	6,019	5,117	6,959	7,280	7,505	7,505	8,559	8,639	7,996	8,014	8,014
In months of prospective imports of goods and services	2.9	2.5	3.0	2.8	2.8	2.3	3.1	3.3	3.4	3.4	3.7	3.7	3.4	3.4	3.4
In percent of ARA composite metric	58.1	49.5	60.3	56.2	56.2	45.6	62.0	64.9	66.9	66.9	71.1	71.7	66.4	66.5	66.5
Net international reserves	4,309	3,843	5,272	4,529	4,529	4,353	6,092	6,555	6,541	6,541	7,594	7,424	6,781	6,548	6,548
In percent of ARA composite metric	40.3	35.9	49.3	42.3	42.3	38.8	54.3	58.4	58.3	58.3	63.0	61.6	56.3	54.4	54.4

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 6. Sri Lanka: Gross External Financing, 2015–22
(In millions of U.S. dollars, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022
			Proj.					
Current account	-1,882	-1,943	-2,461	-2,180	-2,046	-2,172	-2,331	-2,457
Balance on goods	-8,388	-9,090	-9,796	-10,072	-10,463	-11,109	-11,644	-12,198
Credit (exports)	10,547	10,310	11,244	11,861	12,490	13,088	13,751	14,518
Debit (imports)	-18,935	-19,400	-21,040	-21,932	-22,953	-24,197	-25,396	-26,716
Balance on services	2,324	2,879	3,081	3,542	3,970	4,581	5,011	5,498
Primary and secondary income, net	4,182	4,268	4,254	4,350	4,447	4,356	4,303	4,244
Amortization	-509	-2,280	-2,092	-2,477	-3,784	-3,203	-2,792	-3,196
General government	-1298	-1017	-1450	-1817	-3248	-2496	-2198	-2659
Sovereign bonds	-500	0	0	0	-1500	-1000	-1000	-1500
Syndicated loans	0	0	-280	-613	-560	-280	0	0
Bilateral and multilateral	-798	-1017	-1170	-1204	-1188	-1216	-1198	-1159
Central bank	591	-1156	-639	0	0	-14	-56	-147
IMF repurchases/repayments	-506	-455	-239	0	0	-14	-56	-147
Other central bank liabilities, net	1097	-701	-400	0	0	0	0	0
Private sector loans	198	-107	-3	-660	-536	-693	-538	-390
Gross external financing needs	-2,391	-4,223	-4,553	-4,657	-5,830	-5,376	-5,123	-5,654
Sources of financing	2,391	4,223	4,553	4,657	5,830	5,376	5,123	5,654
Borrowing	2,746	3,233	5,527	4,465	6,128	6,212	5,782	6,234
General government	2,564	3,308	3,945	2,577	3,600	3,120	3,225	3,800
T-bills, T-bonds, and SLDBs, net	-903	-532	-138	-400	200	220	200	200
Sovereign bonds	2,150	1,500	1,500	1,500	2,000	1,500	1,500	2,000
Syndicated loans	0	700	985	0	0	0	0	0
Bilateral and multilateral 1/	1,268	1,605	1,598	1,477	1,400	1,400	1,525	1,600
Official capital transfers	49	35	0	0	0	0	0	0
Other capital inflows, net	182	-76	1,582	1,888	2,528	3,092	2,557	2,434
Deposit-taking corporations, excl. central bank, net	787	-798	530	-43	449	637	594	804
FDI inflows, net	628	662	873	925	988	1,194	1,080	1,320
Private sector loans	211	0	200	600	945	1,000	1,000	1,100
Other capital inflows, net	-1,444	60	-21	406	146	261	-117	-790
Change in reserve assets	-355	472	-1,486	-509	-774	-836	-659	-580
External financing gap	0	518	512	701	476	0	0	0
Financing	0	518	512	701	476	0	0	0
IMF	0	333	412	501	251	0	0	0
Other IFIs	0	185	100	200	225	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 7. Sri Lanka: Financial Soundness Indicators—All Banks, 2015–17

	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2
Capital adequacy										
Regulatory capital to risk weighted assets	16.3	16.0	15.2	15.4	15.0	14.7	14.1	15.6	14.9	15.0
Tier 1 capital/risk weighted assets	13.8	13.5	12.8	13.0	12.4	12.2	11.7	12.5	12.0	12.2
Equity capital and reserves to assets ratio	8.2	8.2	8.1	7.9	7.8	7.9	7.8	7.8	7.7	8.0
Asset quality										
Gross nonperforming loans to total gross loans (without interest in suspense)	4.3	4.3	4.0	3.2	3.1	3.0	2.9	2.6	2.7	2.7
Net nonperforming loans to total gross loans	2.7	2.7	2.4	1.7	1.7	1.6	1.6	1.2	1.4	1.4
Provision coverage ratio (total)	48.1	48.4	51.6	62.3	61.2	64.3	64.5	71.8	66.8	66.8
Earnings and profitability										
Return on equity (after tax)	16.4	16.0	16.2	16.2	13.7	16.4	17.6	17.3	16.5	18.1
Return on assets (after tax)	1.4	1.3	1.3	1.3	1.1	1.3	1.4	1.4	1.3	1.4
Net Interest income to gross income	74.6	74.5	73.0	73.2	75.0	75.4	75.3	74.7	74.4	72.7
Staff expenses to noninterest expenses	45.6	46.6	45.6	45.5	39.9	44.8	45.4	44.9	45.1	46.7
Total cost to total income	73.7	73.9	73.8	73.1	78.4	76.0	75.8	75.6	77.7	76.2
Net interest margin	3.8	3.7	3.6	3.6	3.6	3.6	3.5	3.6	3.6	3.5
Liquidity										
Liquid assets to total assets	31.0	31.3	29.4	30.0	28.5	28.3	28.3	27.3	27.6	28.3
Assets/funding structure										
Deposits to total assets	66.6	67.4	66.5	66.9	66.7	67.5	68.7	69.6	69.4	70.4
Borrowings to total assets	21.4	20.6	21.7	21.8	21.9	21.0	19.8	18.8	19.0	17.8
Credit to deposits (loans net of interest in suspense to deposits)	85.5	85.0	87.7	87.3	88.4	88.5	87.1	88.0	88.7	88.1

Source: Central Bank of Sri Lanka.

Table 8. 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 9. Sri Lanka: Projected Payments to the Fund, 2017–28 1/

(In millions of SDR, unless otherwise indicated)

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Fund repurchases and charges												
In millions of SDR	2.9	14.2	19.2	29.8	59.4	123.0	180.3	192.4	189.4	176.6	144.0	77.6
In millions of U.S. dollars	4.0	19.9	27.0	42.0	83.8	173.4	254.3	271.3	267.2	249.0	203.1	109.4
In percent of exports of goods and NFS	0.0	0.1	0.1	0.2	0.3	0.7	1.0	1.0	0.9	0.8	0.6	0.3
In percent of quota	0.5	2.4	3.3	5.1	10.3	21.2	31.2	33.2	32.7	30.5	24.9	13.4
In percent of gross official reserves	0.1	0.2	0.3	0.4	0.8	1.6	2.3	2.3	2.2	1.9	1.5	0.8
Fund credit outstanding 2/												
In millions of SDR	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
In millions of U.S. dollars	757	1,259	1,512	1,497	1,439	1,292	1,061	809	558	321	125	21
In percent of quota	92.9	154.3	185.0	183.3	176.4	158.3	130.1	99.2	68.4	39.3	15.4	2.6
In percent of GDP	0.9	1.5	1.6	1.5	1.3	1.1	0.8	0.6	0.4	0.2	0.1	0.0
In percent of gross official reserves	10.1	15.7	17.2	15.6	14.0	11.9	9.4	6.9	4.5	2.5	0.9	0.2
Memorandum items:												
Exports of goods and services (in millions of U.S. dollars)	18,912	20,219	21,517	22,837	24,085	25,471	26,553	27,881	29,275	30,739	32,276	33,890
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
Quota (in millions of U.S. dollars) 2/	815	816	817	817	816	816	816	816	816	816	816	816
Gross official reserves (in millions of U.S. dollars) 2/	7,505	8,014	8,788	9,624	10,283	10,864	11,300	11,800	12,300	12,800	13,300	13,800
GDP (in millions of U.S. dollars)	83,117	86,282	92,668	99,704	107,348	115,533	125,242	135,261	146,082	157,769	170,390	184,022
U.S. dollars per SDR (eop)	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41
U.S. dollars per SDR (avg.)	1.38	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41

Source: IMF staff estimates.

1/ As of October 30, 2017. Data for current year shows remaining payment in the year.

2/ As of the end of the year.

Annex I. Debt Sustainability Analysis

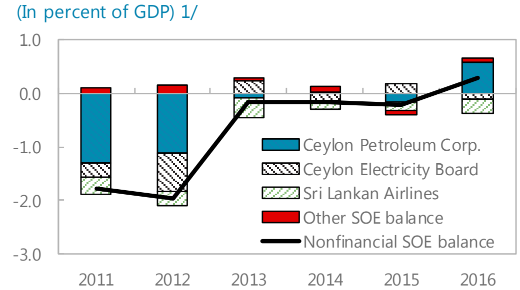
Sri Lanka's public debt and gross funding needs stand high compared with peers, with the ratio of gross financing needs to GDP being the third largest among emerging economies. Fiscal consolidation envisaged under the EFF-supported program would steadily reduce them. However, there are significant downside 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 85.2 percent of GDP at end-2016. Public debt in this DSA covers debt owed by the central government (80.1 percent of GDP), outstanding amount of loans guaranteed by the central government (4.4 percent of GDP), and outstanding Fund credit (0.7 percent of GDP). Compared with the figures reported in the staff report for the EFF second review (CR/17/253), the debt level has been revised up for the treasury bonds issued in the past to support SOEs and a guaranteed international bond that had not been part of the reported figure. Foreign-currency denominated debt accounted for 47 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.

2. The financial obligations of nonfinancial state-owned enterprises (SOEs) are estimated to be 11.9 percent of GDP at end-2016.[1] Sri Lanka has more than 200 state-owned enterprises, and Ministry of Finance publishes financial performance of 41 nonfinancial SOEs. They recorded a profit of 0.3 percent of GDP as a whole in 2016, as the profit of the Ceylon Petroleum Corporation (0.6 percent of GDP) offset the losses of the Ceylon Electricity Board and Sri Lankan Airlines (0.1 percent and 0.3 percent of GDP, respectively). Nonfinancial SOEs' financial obligations are estimated to have decreased by 1.8 percentage points of GDP in 2016, reflecting the fact that CPC used its profit for debt repayment and SriLankan Airlines cancelled part of future airplane lease commitments. Nonfinancial SOEs' financial obligations are not included in the public debt outstanding under this DSA, but the impact from possible realization of the contingent liabilities is assessed under a shock scenario.

Sri Lanka: Nonfinancial SOE Balance
(In percent of GDP) 1/



Source: MOF and IMF staff calculations.
1/ Comprises 41 nonfinancial SOEs reported by Ministry of Finance.

[1] The financial obligations now include debt owed by Road Development Authority and SriLankan Airlines' lease commitment on aircrafts on order.

Sri Lanka: Public Debt, 2015–16

	2015				2016			
	CR/17/253		Updated 1/		CR/17/253		Updated 1/	
	Rs. Bn	% GDP	Rs. Bn	% GDP	Rs. Bn	% GDP	Rs. Bn	% GDP
Public debt	**8,996**	**82.1**	**9,113**	**83.2**	**9,968**	**84.2**	**10,086**	**85.2**
Central government debt	**8,503**	**77.6**	**8,595**	**78.5**	**9,387**	**79.3**	**9,479**	**80.1**
Domestic	4,959	45.3	5,051	46.1	5,342	45.1	5,433	45.9
Treasury Bills	658	6.0	658	6.0	780	6.6	780	6.6
Treasury Bonds	3,305	30.2	3,397	31.0	3,715	31.4	3,806	32.2
Other	996	9.1	996	9.1	847	7.2	847	7.2
External	3,544	32.4	3,544	32.4	4,046	34.2	4,046	34.2
Multilateral and bilateral	2,237	20.4	2,237	20.4	2,437	20.6	2,437	20.6
International sovereign bonds	958	8.7	958	8.7	1,221	10.3	1,221	10.3
Nonresident holdings of T-Bills and T-Bonds	304	2.8	304	2.8	260	2.2	260	2.2
Other	45	0.4	45	0.4	128	1.1	128	1.1
Publicly guaranteed debt	**382**	**3.5**	**408**	**3.7**	**497**	**4.2**	**524**	**4.4**
Ceylon Electricity Board	3	0.0	3	0.0	20	0.2	20	0.2
Ceylon Petroleum Corporation	196	1.8	196	1.8	212	1.8	212	1.8
National Water Supply and Drainage Board	9	0.1	9	0.1	35	0.3	35	0.3
Road Development Authority	136	1.2	136	1.2	135	1.1	135	1.1
SriLankan Airlines	…	…	26	0.2	…	…	27	0.2
Other	38	0.3	38	0.3	95	0.8	95	0.8
Fund credit outstanding	**110**	**1.0**	**110**	**1.0**	**83**	**0.7**	**83**	**0.7**
Financial obligations of SOEs 2/	**1,280**	**11.7**	**1,501**	**13.7**	**…**	**…**	**1,414**	**11.9**
Ceylon Electricity Board	237	2.2	214	2.0	…	…	230	1.9
Ceylon Petroleum Corporation	424	3.9	425	3.9	…	…	385	3.3
Road Development Authority	…	…	136	1.2	…	…	135	1.1
Sri Lanka Ports Authority	240	2.2	233	2.1	…	…	237	2.0
SriLankan Airlines	309	2.8	405	3.7	…	…	317	2.7
Other	69	0.6	88	0.8	…	…	108	0.9
Memorandum item:								
Central government debt, Fund credit outstanding, and financial obligations of SOEs 2/	…	…	10,205	93.2	…	…	10,976	92.7
Nominal GDP	10,952	…	10,952	…	11,839	…	11,839	…

Sources: Sri Lankan authorities and IMF staff estimates.

1/ The main revisions from CR/17/253 are:

(1) Central government debt now includes treasury bonds amounting to Rs 78,447 million issued to settle dues to CPC in January 2012 and Rs 13,125 million issued to capitalize SriLankan Airlines in March 2013.

(2) Publicly guaranteed debt now includes the Eurobond amounting to US$175 million issued by SriLankan Airlines.

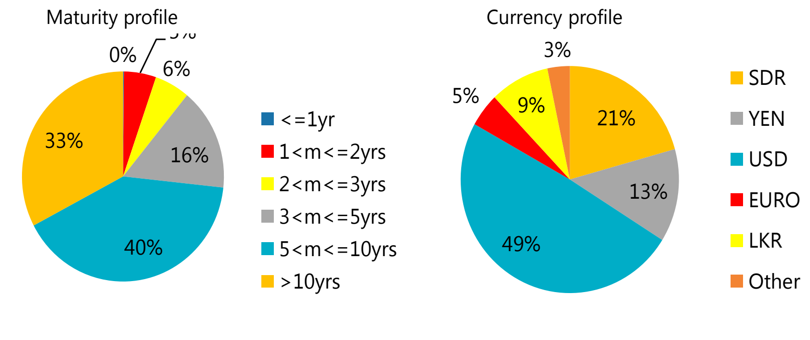
(3) Debt owed by Road Development Agency is now added to financial obligations of SOEs.

(4) Financial obligations of SriLankan Airlines now include lease commitment on aircrafts on order.

2/ IMF staff estimates. Including short-term debt, project loans, and SriLankan Airlines' liabilities related to aircraft lease. Data for SriLankan Airlines are as of end-March.

3. **External debt is estimated at 57 percent of GDP at end-2016.** It is predominantly owed by the public sector (34 percent of GDP is held by the general government and 2 percent by the central bank). Private external debt has been steady over the last few years, remaining at around 22 percent of GDP since 2014. The ratio of debt to exports is also high, at 264 percent in 2016. However, rollover risks remain contained as 85 percent of total debt (i.e., public and private) is medium or long term. However, preparation is needed as the next sovereign bond repayment of US$1.5 billion falls due in 2019. 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.

4. **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 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 surplus of 1 percent of GDP in 2018, followed by a surplus of 2.5 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 primary and 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 constant as a percent of GDP at the 2016 level. External debt projections are based on a projected path of the current account deficit from 3 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

5. **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 85.2 percent in 2016 to 75.1 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 13–14 percent of GDP in 2022.

6. **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 94 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 98 percent of GDP and gradually decline to 89 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 16−19 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.

7. **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 87 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

8. **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 around 52 percent in 2022. The decline is driven by robust GDP growth, a steady pace of fiscal consolidation, and gradual current account adjustments.

9. **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 could raise the external debt to GDP ratio to about 75 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 currently 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 speedily build up buffers. Lower than expected GDP or export growth would also deteriorate debt dynamics.

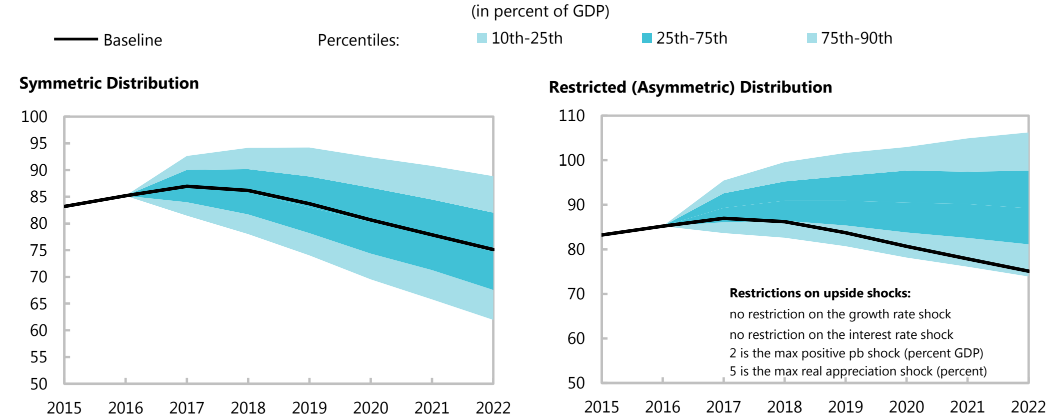
Sri Lanka: Public DSA Risk Assessment

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

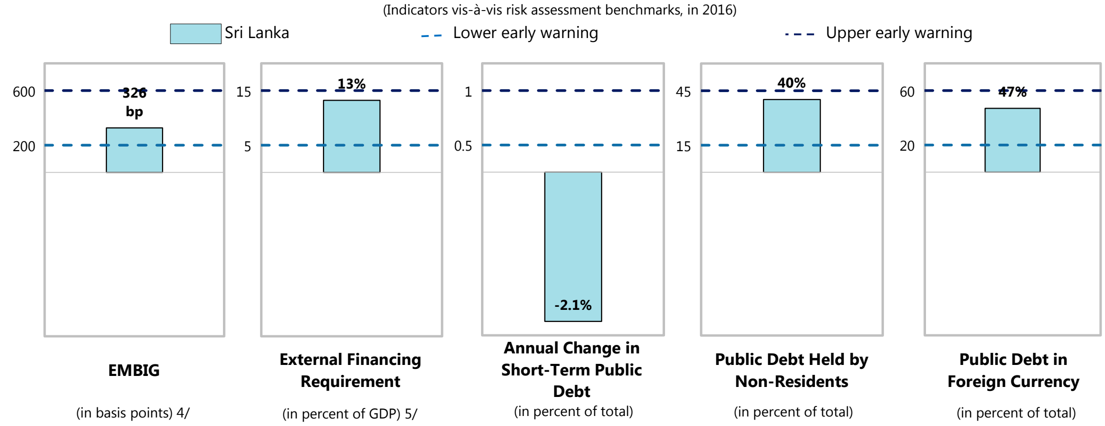
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

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



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.

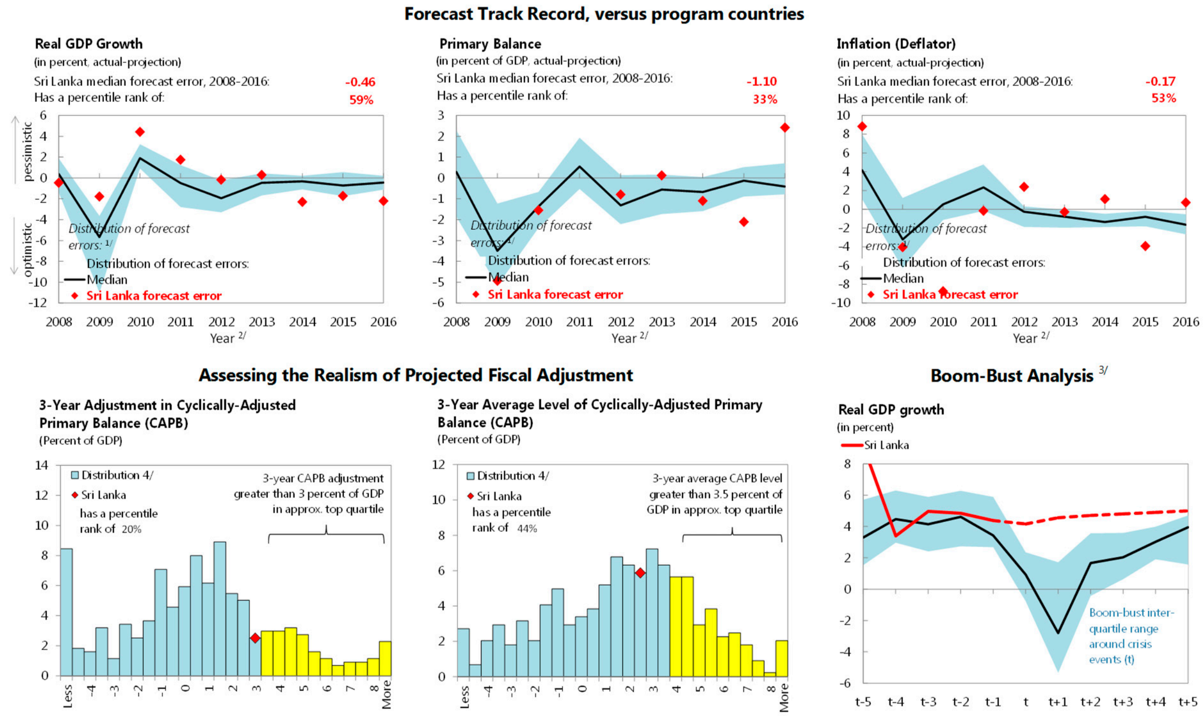
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 12-Aug-17 through 10-Nov-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/ Sri Lanka has had a positive output gap for 3 consecutive years, 2014-2016. For Sri Lanka, t corresponds to 2017; for the distribution, t corresponds to the first year of the crisis.

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)

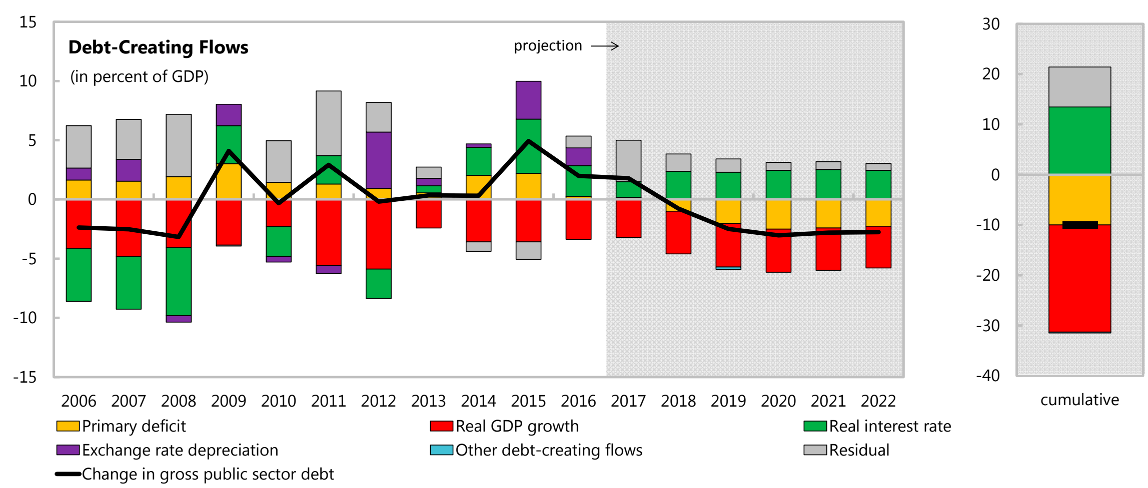
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	76.0	83.2	85.2	87.0	86.2	83.7	80.7	77.9	75.1
o/w: guarantees & Fund credit	3.4	4.7	5.1	5.4	5.9	6.1	5.9	5.8	5.6
Public gross financing needs	22.6	21.1	17.6	19.1	19.9	17.6	14.3	13.4	13.5
Real GDP growth (in percent)	6.2	4.8	4.4	4.2	4.6	4.7	4.8	4.9	5.0
Inflation (GDP deflator, in percent)	8.9	0.8	3.6	5.6	4.8	5.0	5.0	5.0	5.0
Nominal GDP growth (in percent)	15.7	5.7	8.1	10.0	9.5	9.9	10.1	10.2	10.3
Effective interest rate (in percent) [4/]	7.5	7.0	7.1	7.6	8.0	8.2	8.5	8.7	8.8

As of November 10, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		348
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	B+	B+
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	-0.1	4.9	2.0	1.8	-0.8	-2.5	-3.0	-2.8	-2.8	-10.1	
Identified debt-creating flows	-2.7	6.4	1.0	-1.7	-2.2	-3.6	-3.7	-3.5	-3.3	-18.0	
Primary deficit	1.6	2.2	0.2	0.2	-1.0	-2.0	-2.5	-2.4	-2.3	-10.0	-1.1
Primary (noninterest) revenue and grants	13.2	13.3	14.3	14.2	15.0	16.1	16.6	16.7	16.8	95.4	
Primary (noninterest) expenditure	14.8	15.5	14.6	14.4	14.0	14.1	14.1	14.3	14.5	85.4	
Automatic debt dynamics [5/]	-4.3	4.2	0.7	-1.9	-1.2	-1.4	-1.2	-1.1	-1.1	-7.8	
Interest rate/growth differential [6/]	-5.3	1.0	-0.8	-1.9	-1.2	-1.4	-1.2	-1.1	-1.1	-7.8	
Of which: real interest rate	-1.2	4.6	2.6	1.3	2.4	2.3	2.5	2.5	2.5	13.5	
Of which: real GDP growth	-4.1	-3.6	-3.4	-3.2	-3.6	-3.7	-3.7	-3.6	-3.5	-21.3	
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/]	2.6	-1.5	1.0	3.5	1.5	1.1	0.7	0.7	0.6	8.0	



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 - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (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.

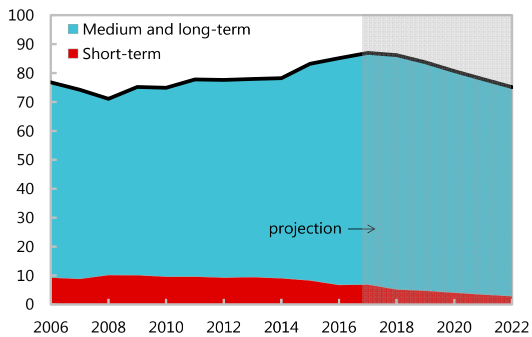
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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

Composition of Public Debt

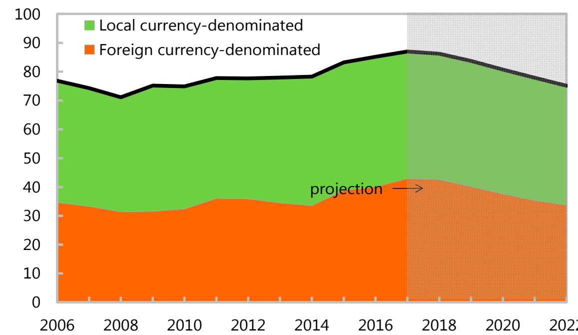
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

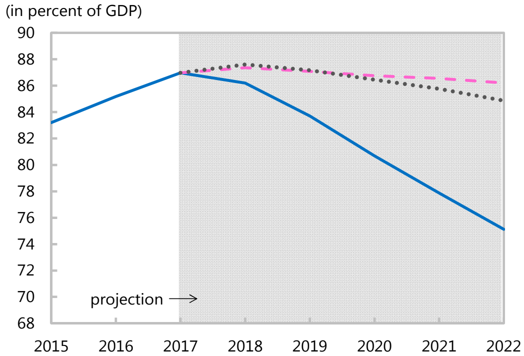


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

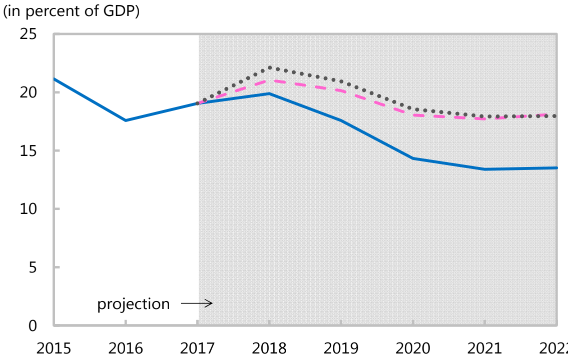
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

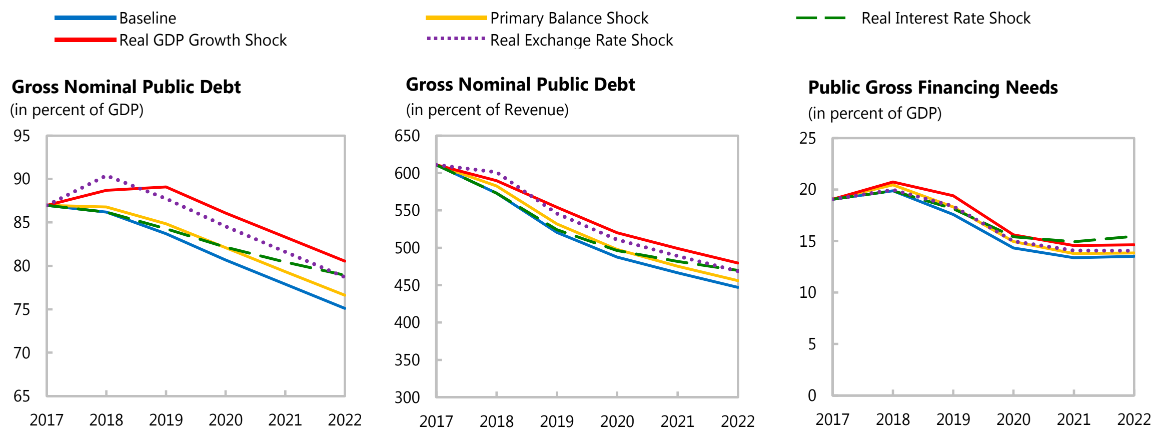
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	4.6	4.7	4.8	4.9	5.0
Inflation	5.6	4.8	5.0	5.0	5.0	5.0
Primary Balance	-0.2	1.0	2.0	2.5	2.4	2.3
Effective interest rate	7.6	8.0	8.2	8.5	8.7	8.8
Constant Primary Balance Scenario						
Real GDP growth	4.2	4.6	4.7	4.8	4.9	5.0
Inflation	5.6	4.8	5.0	5.0	5.0	5.0
Primary Balance	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Effective interest rate	7.6	8.0	8.2	8.5	8.8	8.8

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	5.9	5.9	5.9	5.9	5.9
Inflation	5.6	4.8	5.0	5.0	5.0	5.0
Primary Balance	-0.2	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	7.6	8.0	7.5	7.4	7.3	7.2

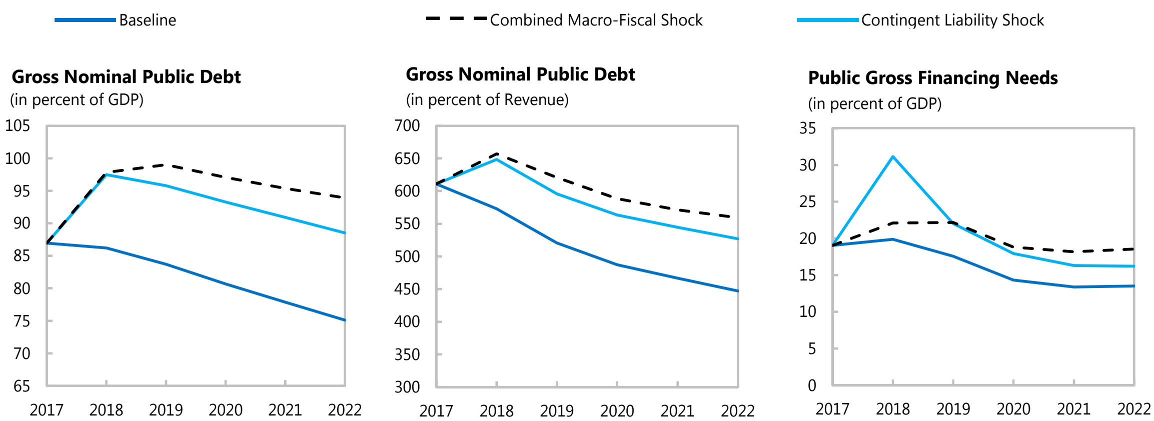
Source: IMF staff.

Sri Lanka: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

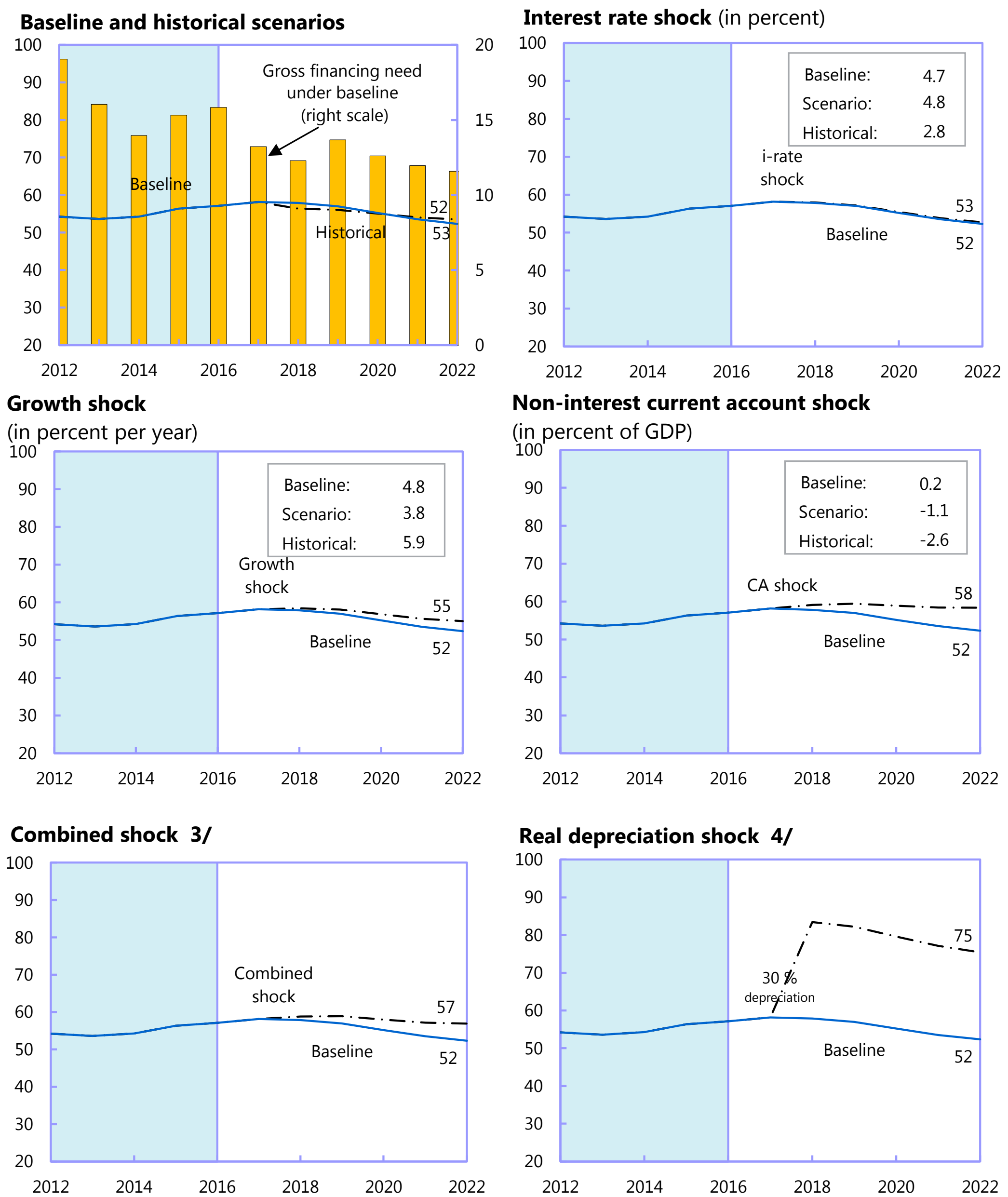
(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	4.6	4.7	4.8	4.9	5.0
Inflation	5.6	4.8	5.0	5.0	5.0	5.0
Primary balance	-0.2	0.4	1.5	2.3	2.4	2.3
Effective interest rate	7.6	8.0	8.2	8.6	8.8	8.8
Real Interest Rate Shock						
Real GDP growth	4.2	4.6	4.7	4.8	4.9	5.0
Inflation	5.6	4.8	5.0	5.0	5.0	5.0
Primary balance	-0.2	1.0	2.0	2.5	2.4	2.3
Effective interest rate	7.6	8.0	9.0	9.8	10.3	10.6
Combined Shock						
Real GDP growth	4.2	2.5	2.7	4.8	4.9	5.0
Inflation	5.6	4.3	4.5	5.0	5.0	5.0
Primary balance	-0.2	0.4	1.2	2.3	2.4	2.3
Effective interest rate	7.6	8.4	8.6	9.5	10.0	10.4

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	2.5	2.7	4.8	4.9	5.0
Inflation	5.6	4.3	4.5	5.0	5.0	5.0
Primary balance	-0.2	0.6	1.3	2.5	2.4	2.3
Effective interest rate	7.6	8.0	8.2	8.6	8.8	8.8
Real Exchange Rate Shock						
Real GDP growth	4.2	4.6	4.7	4.8	4.9	5.0
Inflation	5.6	9.9	5.0	5.0	5.0	5.0
Primary balance	-0.2	1.0	2.0	2.5	2.4	2.3
Effective interest rate	7.6	8.4	7.9	8.2	8.5	8.6
Contingent Liability Shock						
Real GDP growth	4.2	4.6	4.7	4.8	4.9	5.0
Inflation	5.6	4.8	5.0	5.0	5.0	5.0
Primary balance	-0.2	-9.0	2.0	2.5	2.4	2.3
Effective interest rate	7.6	9.7	9.2	9.2	9.3	9.3

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					10-Year	10-Year	Projections						
	2012	2013	2014	2015	2016	Historical Average	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			**58.2**	**57.9**	**57.0**	**55.2**	**53.5**	**52.3**	**-2.2**
Change in external debt	4.0	-0.6	0.7	2.1	0.8			1.0	-0.3	-0.9	-1.8	-1.7	-1.2	
Identified external debt-creating flows (4+8+9)	1.4	-2.5	-2.1	1.3	0.7			-0.4	-1.3	-1.4	-1.7	-1.5	-1.7	
Current account deficit, excluding interest payments	4.5	2.0	1.0	0.9	0.9			1.3	0.5	0.0	-0.2	-0.6	-0.8	
Deficit in balance of goods and services	11.9	8.6	8.1	7.6	7.7			8.1	7.6	7.0	6.5	6.2	5.8	
Exports	19.8	20.3	21.1	21.3	21.7			22.8	23.4	23.2	22.9	22.4	22.0	
Imports	31.8	28.9	29.2	28.9	29.4			30.8	31.0	30.2	29.4	28.6	27.8	
Net non-debt creating capital inflows (negative)	-1.7	-1.5	-1.3	-0.7	-0.9			-1.1	-1.3	-1.1	-1.4	-1.2	-1.3	
Net foreign direct investment, equity	1.3	1.2	1.0	0.8	0.8			1.1	1.1	1.0	1.2	1.0	1.1	
Net portfolio investment,equity	0.4	0.3	0.2	-0.1	0.0			0.0	0.2	0.2	0.2	0.2	0.2	
Automatic debt dynamics 1/	-1.5	-3.0	-1.9	1.1	0.7			-0.6	-0.6	-0.4	-0.2	0.3	0.4	
Contribution from nominal interest rate	1.3	1.4	1.5	1.5	1.5			1.7	2.0	2.2	2.4	2.8	2.9	
Contribution from real GDP growth	-4.4	-1.7	-2.5	-2.6	-2.4			-2.3	-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			1.4	1.0	0.6	-0.1	-0.2	0.5	
External debt-to-exports ratio (in percent)	273.3	264.6	257.2	264.6	263.5			255.6	246.9	245.5	241.1	238.6	237.4	
Gross external financing need (in billions of US dollars) 4/	13.0	11.9	11.1	12.2	12.8			11.0	10.6	12.7	12.6	12.8	13.4	
in percent of GDP	19.0	16.0	14.0	15.3	15.8			13.2	12.3	13.7	12.6	12.0	11.6	
Scenario with key variables at their historical averages 5/								**58.2**	**56.4**	**56.0**	**55.1**	**54.0**	**53.5**	**-4.7**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	9.1	3.4	5.0	4.8	4.4	5.9	2.0	4.2	4.6	4.7	4.8	4.9	5.0	
GDP deflator in US dollars (change in percent)	-4.0	5.3	1.5	-4.3	-3.0	3.7	7.7	-0.9	-0.7	2.6	2.7	2.6	2.5	
Nominal external interest rate (in percent)	2.7	2.9	2.9	2.8	2.7	2.8	0.3	3.0	3.5	4.0	4.5	5.5	5.9	
Growth of exports (US dollar terms, in percent)	-0.5	11.1	11.0	1.2	3.0	7.9	10.6	8.4	6.9	6.4	6.1	5.5	5.8	
Growth of imports (US dollar terms, in percent)	-2.4	-1.0	7.6	-0.6	2.8	9.0	19.9	8.3	4.4	4.7	4.8	4.6	4.7	
Current account balance, excluding interest payments	-4.5	-2.0	-1.0	-0.9	-0.9	-2.6	2.5	-1.3	-0.5	0.0	0.2	0.6	0.8	
Net non-debt creating capital inflows	1.7	1.5	1.3	0.7	0.9	1.2	0.4	1.1	1.3	1.1	1.4	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. State of Fiscal Structural Reforms

Area	Progress	Future actions
Tax policy	Amendments to VAT were introduced in 2016 which increased the VAT rate from 11 to 15 percent, removed exemptions on telecoms and health care (excluding diagnostic tests, dialysis and services provided by the Outpatient Department), and lowered the VAT threshold for wholesale and retail sectors. VAT diagnostics were used to identify the removal of exemptions that formed a key component of the 2018 Budget's revenue package. In order to simplify the income tax system and broaden its base, a new Inland Revenue Act (IRA) was drafted and submitted to Parliament in July 2017, and legislated in October 2017. This is a flagship reform of the program and key to revenue mobilization efforts.	With legislation of the new IRA complete, focus now turns to its implementation. Efforts will continue to identify further tax policy options, including base-broadening through the removal of VAT exemptions and the streamlining of other indirect taxes.
Tax administration	A VAT compliance strategy that includes a time-bound plan to implement risk-based audits, and key performance indicators on the number of the audits that have been conducted, has been implemented for large businesses on a pilot basis. Technical capacity to improve revenue administration was enhanced with the rollout of the RAMIS IT system in December 2016.	On income tax, the Implementation Steering Committee for the new IRA has drafted a detailed implementation plan that will be rolled over the next year. It includes publication of tax manuals (January 2018 structural benchmark), updating regulations, training tax administrators, taxpayer education, and modifications to the existing IT system. Extensive technical assistance has been, and will continue to be, provided to aid in these efforts. VAT compliance strategies will be implemented for all large taxpayers and extended to medium- and small-taxpayers.

Annex II. State of Fiscal Structural Reforms (continued)

Area	Progress	Future actions
Public financial management	The Ministry of Finance has modified its existing IT system and is now capable of tracking spending commitments for each line ministry on a monthly basis and has begun reporting fiscal performance to parliament on a quarterly basis. The complete operationalization of ITMIS, including the ability to centrally control commitments, has been delayed. ITMIS has been rolled out in the Ministries of Health and Finance but is currently being operated in parallel to the existing system and commitment ceilings are being modified manually.	ITMIS will be expanded to 100 spending units in 2018 and is expected to become fully operational in 2019. Starting in 2018, quarterly commitment ceilings will be established for line ministries through modification of the existing IT system (CIGAS) (January 2018 structural benchmark); but this will be administered manually. This will require training accounting officers in line departments and upgrading IT systems.
SOE reform	After some delays, Statements of Corporate Intent (SCIs) for five SOEs (electricity, petroleum, airport and aviation, water, and ports authority) were signed by MOF, line ministries, and SOE management, and published in April 2017. The SCIs should create a transparent framework for strategic performance oversight, hold SOEs' boards and management accountable for performance, and identify costs of non-commercial obligations. Restructuring of SriLankan Airlines is ongoing: a resolution strategy was approved by cabinet and the airline has undertaken route and fleet optimization. Securing a strategic partner and resolving the need for capital injection and debt consolidation has been significantly delayed.	The authorities are developing a framework for evaluating the five SOEs against key performance indicators contained in the SCIs and plan to expand them to other SOEs. The authorities aim to put SriLankan Airlines on a commercial footing and resolve fiscal contributions, if any, to the airline's liabilities. A government task force, overseen by the Prime Minister's office, has been set up to map out the reform timeline.

Annex II. State of Fiscal Structural Reforms (concluded)

Area	Progress	Future actions
Fuel and electricity pricing	Although the authorities have the capacity to design and implement automatic fuel and electricity prices, political sensitivity has hampered progress in this reform area. The reform sequencing has been recalibrated to allow time for public consultation and education. As the first step, a report on the cost of non-commercial obligations for fuel and electricity was completed and published as an annex to the 2018 budget.	A Bulk Supply Transactions Account will be established by March 2018 (structural benchmark) to refine estimates on the cost of non-commercial obligations for electricity. The authorities will then recognize the quasi-fiscal cost of fuel and electricity NCOs as central government expenditure by explicitly accounting for them in the EFF program targets. Specifically, starting in 2018, an indicative target is set on the cost of NCOs for fuel and electricity (net of government transfers). As the final step, cabinet approval of the automatic pricing mechanism will be obtained for fuel by March 2018 and for electricity by September 2018 (structural benchmarks).

Annex III. Compensating Fuel and Electricity NCOs

1. **Fuel prices and electricity tariffs are publicly administered in Sri Lanka and have been predominantly fixed since 2015.** Because of this, CEB and CPC, dominant state-owned suppliers of electricity and fuel in Sri Lanka, have been occasionally tasked with supplying electricity and fuel at prices below cost-recovery levels. This is referred to as non-commercial obligations (NCOs).

2. **Because the cost of NCOs is equivalent to quasi-fiscal energy subsidies, it should in principle be compensated by on-budget government transfers to CEB and CPC.** This has not been the case in Sri Lanka: in the past, the losses of CEB and CEB were financed by bank loans, resulting in large debt (CPC) or equity injections by the government (CEB).

3. **Adoption of automatic pricing mechanisms for fuel and electricity—envisaged by March and September 2018, respectively—would effectively eliminate the NCOs.** In the absence of pricing mechanisms, however, recording the cost of NCOs explicitly as on-budget spending enhances transparency and motivates public debate on adjustments in fuel and electricity prices.

4. **Against this backdrop, a zero ceiling on the cost of NCOs (net of government transfers) will be introduced as an indicative target under the EFF-supported program.** For CPC, the cost of NCOs is measured by the difference between the cost to provide fuel products minus revenue. For CEB, it will be defined as the decline in the balance of the Bulk Supply Transaction Account, which mirrors financial shortfall of the electricity sector in a given period.

Appendix I. Letter of Intent

Colombo, November 17, 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, November 3, 2016, and June 23, 2017, and the associated Memorandums of Economic and Financial Policies (MEFP) dated May 12, 2016, and June 23, 2017. The attached MEFP updates the MEFP dated June 23, 2017, 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 prior action for the third review (which we have met) as well as new structural benchmarks. We have also met all end-June PCs and continuous PCs and implemented most SBs. Tables 1 and 2 document progress with quantitative targets and 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 Third Review of the Extended Arrangement under the EFF, after which we intend to draw one tranche amounting to SDR 177.774 million. We are also seeking the modification of the performance criterion on central government primary balance and the indicative target on tax revenue for December 2017 as specified in Table 1 and TMU attached to the MEFP.

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 and Mass Media	Indrajit Coomaraswamy Governor Central Bank of Sri Lanka

Attachment I. Memorandum of Economic and Financial Policies

I. MACROECONOMIC OUTLOOK

1. **Growth has been subdued for most of 2017 due to lingering effects of the drought since late 2016 and floods in 2017**. Growth was 3.9 percent in 2017 H1 and is projected to be below 4.5 percent for the entire year, as growth in manufacturing, construction, and services will marginally offset the weather-inflicted agriculture. Credit growth will likely continue the downward trend, in a lagged response to monetary tightening in 2016 and 2017. The current account deficit is expected to widen due to higher imports of food and fuel as the after effects of the drought in 2016 and floods in 2017. As weather-related supply disruptions dissipate, headline inflation will stabilize to mid-single digit and will stay within the inner band for the remainder of the year. We expect growth to rebound in 2018 as agriculture production normalizes and various infrastructure projects take off.

II. PROGRAM PERFORMANCE

2. **Program performance for the third review has been on track and the passage of the Internal Revenue Act (IRA) reaffirms our commitment towards reforms.** The end-June quantitative targets were met for the primary balance and tax revenues, the NIR target was met by a margin of $174 million, and the reserve money target was below the IT target by about Rs 15 billion. Despite supply disruptions, inflation stayed within the inner consultation band. We have made progress on structural measures, especially on legislating the IRA which is essential for our strategy to raise revenue in a transparent and efficient manner. We have also made progress in implementing other structural measures, albeit with further delays in some areas than originally intended. We will take necessary corrective actions to ensure future structural benchmarks are met in a timely manner.

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 bolstering tax revenues—rather than one off measures—while containing recurrent, discretionary, and capital spending. Looking ahead, 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 and beyond. This decline in the deficit should lower the central government debt to about 75 percent of GDP in 2020 and further to 70 percent of GDP by 2022. To achieve this, the program targets a small primary deficit in 2017, followed by a primary surplus of 1 and 2 percent of GDP in 2018

and 2019, respectively. This entails an annual increase in the tax to GDP ratio by about 1 percentage point of GDP for three consecutive years (2017−19). Annual budget proposals for 2018−19 will be in line with the program targets as described in Table 2 (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.

4. Fiscal consolidation will rely mainly on broadening the tax base and improving the efficiency of spending. 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. Our strategy thus 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 in commitment control, and financial planning and discipline. We have improved transparency and accountability of the budget execution process by submitting quarterly reports to Parliament since 2017Q1.

5. For 2017, revenue underperformance and weather-related spending may hinder meeting the primary balance target. The ratio of tax revenue to GDP is projected to increase by ½ percentage point to about 13 percent in 2017, but fall short of the program's indicative target by 0.3 percentage point. This reflects a growth slowdown owing to the drought and the floods, the delay in implementing the new IRA, and weak excise collections due to a sharp drop in the volume of liquor and tobacco sales, which buoyant VAT collections could not offset. On the expenditure side, spending needs to address the drought and floods so far are expected to reach about Rs 50 billion (0.4 percent of GDP), including in-kind assistance to 840,000 needy families and reconstruction of damaged infrastructure. Spending reallocation has been initiated in mid-year to generate the necessary budget space without unduly cutting productive expenditure. Further, a drought-driven surge in thermal power generation pushed the electricity supply cost above current tariff levels. This resulted in quasi-fiscal losses of Rs 48 billion (0.3 percent of GDP) in 2017H1 for Ceylon Electricity Board (CEB), i.e., non-commercial obligations (NCOs) to provide electricity at below cost-recovery tariffs (see below for more discussions), for which the government transferred Rs 6 billion to CEB. As a result, the central government is expected to record a small primary deficit. Given the unusual and temporary nature of the deficit overrun, we request that the end-2017 quantitative performance criterion on primary balance (floor) be revised down from Rs -3 billion (0 percent of GDP) to Rs -23 billion (0.2 percent of GDP).

6. The 2018 budget targets a primary surplus of about Rs 140 billion (1 percent of GDP). This will be achieved by an increase in the revenue-to-GDP ratio by about 1 percentage point, anchored by a package of measures yielding Rs 110 billion (0.8 percent of GDP). The revenue package consists of VAT base-broadening, excise tax reforms for vehicle and beverage, new levies on telecom and cash transactions by financial institutions, and rate revision of fees and charges. Expenditure space for productive human and physical capital will be preserved. To prepare for possible weather-related disasters, mitigation programs such as river bank protection, crop insurance, urban flood mitigation and resettlement of people who are living in identified risk areas of landslides amounting to Rs 21 billion (0.15 percent of GDP), are appropriated within the total budget envelope. We will continue to present fiscal performance to Parliament on a quarterly basis, and any revenue shortfalls will prompt us to realign expenditure under Parliamentary oversight. If retail fuel prices or electricity tariffs dip below cost-recovery levels, the government will compensate Ceylon Petroleum Corporation (CPC) or CEB for the cost of the NCOs. The published budget speech contains a tax expenditure statement, a plan to rationalize tax expenditures, the estimated fiscal cost of NCOs for SOEs, and a report outlining the cost of fuel and electricity NCOs (structural benchmarks). A diagnostic review of the VAT system (structural benchmark completed in November) helped us to identify the VAT measures envisaged in the 2018 budget.

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-debt amortization over time. The Cabinet approved pre-funding of T-bonds maturity payments in early 2018 and is considering liability management operations for international sovereign bonds. 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. We will obtain cabinet approval of a debt management strategy on managing the international sovereign bonds maturing over 2019-22 by June 2018 (a new structural benchmark).

Revenue mobilization

8. A number of measures have been implemented 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 base 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. A diagnostic review of the VAT system (structural benchmark), completed with delay in November, concludes that VAT expenditure is 1.3 percent of GDP. Informed by the review, the VAT base will be further broadened in 2018 through rationalization of exemptions.

9. An important milestone in revenue mobilization was reached with the legislation of the Inland Revenue Act (IRA). The Act creates a predictable, stable, and transparent income tax system. Notable features include:

- Removal of tax exemptions to broaden the tax base;
- A modernized legal framework that utilizes a principle-based drafting style helping to streamline the law's structure, and simplify its language;
- Introduction of a capital gains tax on immovable property, increased taxes on dividends and interest incomes, and specified fees.
- A transparent set of investment-based tax incentives;
- Strengthened administrative powers for the Inland Revenue Department (IRD) which should improve compliance.

10. Our attention has now turned to implementation of the Act. With passage of the Act later than originally planned, its effective date has been set to April 1, 2018, to ensure taxpayers and IRD have sufficient time to prepare for activation of the new law. Adoption of compliance strategies for corporate and income taxes (structural benchmark originally planned for June 2017) will be postponed until the new IRA has been successfully implemented. The IRA implementation steering committee has outlined a detailed workplan to facilitate the transition:

- **Regulations.** Drafts of revised regulations are expected to be completed soon. They will be published in draft form, by January 2018, to allow taxpayers time to familiarize.
- **Staff training.** MOF and IRD staff will be trained during the fall of 2017 and then will, in turn, be tasked with training other head office and regional IRD staff in February 2018.
- **Communication and taxpayer awareness.** A detailed IRA tax manual has been developed outlining practical tax and administrative examples. We plan to publish it by January 2018 (a new structural benchmark). A comprehensive media campaign will be rolled out once the IRA is issued in the gazette, followed by taxpayer awareness programs in Colombo and key regional centers.
- **Changes to IT systems.** A detailed upgrade plan of the RAMIS system, including an appropriate funding, will be finalized by the end of 2017 and approved by the Steering Committee.
- **Redesign of business processes.** New taxes such as capital gains tax and modified withholding taxes such as Pay-As-You-Earn income taxes will require modifications to internal business processes for approval by the Steering Committee by December 2017.

11. Steadfast efforts to improve tax administration have been underway, including the use of information technologies. IRD successfully rolled out the RAMIS IT system and adopted a VAT compliance strategy with risk-based audits. IRD will first implement the VAT compliance strategy to large businesses and then extend to small- and medium-enterprises. 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.

12. A disciplined approach to government spending and prioritization of public spending 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, such as health, education, and infrastructure. 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. Ongoing social safety net reform aims to improve its targeting system through establishing a centralized registry of beneficiaries for various social assistance programs including the Samurdhi cash transfer program. The frequency of weather-related natural disasters has increased due to climate change, inflicting severe damage to both private and public sectors. We plan to cope with this challenge through mitigation and adaptation measures, which include contingent budgeting for natural disasters and enhanced insurance schemes for the agricultural sector.

IV. PUBLIC FINANCIAL MANAGEMENT

13. Reforms to improve public financial management (PFM) are underway, despite delays in rolling out the new Integrated Treasury Management Information System (ITMIS).

- MOF has modified the existing PFM IT system (CIGAS) and is now capable of tracking spending commitment on a real-time basis for a subset of line ministries. This helped the government to adjust and reallocate spending through cash management. Nonetheless, a system to *control* commitment, i.e., quarterly commitment ceilings over which the PFM IT system prevents spending units from contracting with vendors, has yet to be put in place, due to delays in rolling out the ITMIS. In the interim, we will further modify the CIGAS and equip it with capability to impose quarterly commitment ceilings for individual spending units from the beginning of 2018 (structural benchmark).

- The ITMIS should significantly expand PFM capabilities, including commitment control, budget preparation, treasury and accounting. This process has been delayed due to difficulties in upgrading IT equipment for spending units, especially in the regions, and delays in customizing the ITMIS software as per the requirements of Ministry of Finance. Phase I of the ITMIS system – the budget planning module – was used by Ministry of Finance and Ministry of Health in December 2016. Further, National Budget Department trialed ITMIS to prepare Budget Book by processing budget estimates sent by all ministries and departments in 2016. All ministries and departments used ITMIS in

October/November 2017 to send 2018 budget estimates. Regarding functionalities of revenue management, purchasing management, treasury management, expenditure management and general ledger, Ministry of Finance and Ministry of Higher Education and Highways will soon pilot the system. We plan to expand ITMIS functionalities to 100 additional spending units in 2018. Currently, the ITMIS is expected to become fully operational only in 2019.

- 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

14. 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 financial obligations of SOEs totaling Rs 1.4 trillion in end-2016, including Rs 1.2 trillion for CPC, CEB, SriLankan Airlines, and the Sri Lanka Ports Authority. Collectively they represent a risk to public finances (either directly or through the state banks which fund the largest SOEs). In the near-term, however, our strategy encompasses the following elements:

- To enhance oversight and financial discipline, Statements of Corporate Intent (SCIs) were signed 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 key performance indicators (KPIs). Our engagement with these SOEs will be based on the SCIs, with periodical monitoring of financial performance and compliance with the KPIs. They also include description and cost of non-commercial obligations (NCOs) such as utility subsidies to strengthen the transparency and fiscal accountability. 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 SriLankan Airlines, originally approved by Cabinet in 2015. The airline has already undertaken route and fleet optimization, reducing operational losses. The next step—securing a strategic partner and resolving the need for capital injection and debt consolidation, thereby effectively removing this company from the government's accounts—has been significantly delayed. The airline still operates with losses and is subject to a lease contract of 4 large airplanes which can further worsen profitability. We aim to put the airline on a commercial footing and resolve fiscal contributions, if any, to the airline's liabilities. To speed up the process, a government task force, overseen by the Prime Minister's office, has been set up to map out the reform timeline. If necessary, key milestones in the timeline will be set as a structural benchmark for future program reviews. We will continue to report the company's financial performance on a quarterly basis (see the Technical Memorandum of Understanding).

- The original structural benchmark for establishing automatic fuel and electricity pricing mechanisms by end-2016 has not been met. We are pursuing a sequence of steps to put the reform process back on track. First, we completed with delays a report outlining the cost of non-commercial obligations (NCOs) for fuel and electricity in November 2017 (structural benchmark), supported by IMF TA. To correctly estimate the cost of non-commercial obligations for electricity, the CEB and the Public Utilities 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 (structural benchmark). Second, we will recognize the quasi-fiscal cost of fuel and electricity NCOs as central government expenditure by explicitly accounting for them in the EFF program targets. Specifically, starting in 2018, an indicative target will be set on the cost of NCOs for fuel and electricity (net of government transfers) (see the Technical Memorandum of Understanding for detail). Finally, to reduce the possibility of future financial losses by CPC and 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 (structural benchmarks). To monitor progress, we will continue to report the financial performance of CPC and 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

15. The focus of monetary policy will remain on keeping inflation in the mid-single digits. Inflation peaked in October 2017 due to continued increase in food price and the base effect of lower price levels that prevailed in October 2016. 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. The CBSL considers the lagged response to monetary policy—which has been tightened since early 2016—will be adequate to stabilize inflation and credit growth that have begun to moderate. However, it will maintain a tightening bias until clear signs emerge that inflation and credit stabilize. This tightening bias will also help preempt potential capital outflows as interest rates in the US gradually rise. 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.

16. We completed a roadmap for flexible inflation targeting and flexible exchange rate regime in October 2017 (a structural benchmark). The roadmap, which aims to establish inflation as the nominal anchor allowing for greater exchange rate flexibility, identifies time-bound reform measures, consistent with IMF staff recommendations (TA in May 2017), and has been approved by the Monetary Board. These time-bound measures will be incorporated into future program reviews, and one of them has already been set as a structural benchmark (see below). We will amend the Monetary Law Act (MLA) that will establish price stability as the primary objective of monetary policy. Towards this goal, in consultation with the IMF, we will obtain cabinet consent for the amendments to the MLA, including those to strengthen the envisaged flexible inflation targeting framework by March 2018 (a new structural benchmark). By implementing the roadmap, we will also: (i) ensure there is a clear separation between fiscal and monetary policies; (ii) retain a role for the CBSL in smoothing excessive exchange rate volatility, (while guarding against a real or perceived conflict of objectives) and adopt FX intervention policies consistent with a flexible exchange rate regime; (iii) improve foreign exchange market functionality, including by further liberalizing financial account transactions, deepening the FX market, and introducing FX auction; (iv) ensure the stability of the financial sector by adequately assessing the risks associated with adopting greater FX flexibility; (v) develop technical infrastructure, including through improved forecasting and modeling capabilities with continued support from IMF TA; (vi) establish a policy decision making process governed by the guidelines on the choice of targets and how unanticipated shocks would be addressed; and (vii) strengthen public-awareness outreach program as the cornerstone of CBSL's communication strategy during the IT transition.

17. 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 CBSL (MLA) in consultation with the IMF.

18. In tandem with moving toward flexible inflation targeting, the CBSL will strengthen 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) adopt an intervention strategy, aimed at building external reserves to adequate level while maintaining exchange rate flexibility. Accordingly, since late May, 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. Introducing FX auctions can also provide a more transparent structure to accumulate reserves while promoting FX market development.

19. A strengthening of reserve coverage (guided by the IMF's ARA reserve metric) has been programmed, supported by regular FX purchases. Supported by FX purchase and financial inflows since March, the level of program NIR (per the TMU definition) recovered from a low level below the program target at end-2016 to $2.3 billion by end-April, and to $4.2 billion at end-June with the $1.5 billion Eurobond issuance in May and continuing FX purchase. Between January and May 2017, the exchange rate has depreciated by around 1.8 percent against the US$. We will continue to make the necessary FX purchases to enable the steady buildup of reserves with a view to fully offsetting the end-2016 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 have also gradually wound down FX swaps with domestic commercial banks, from $2.5 billion at end-2016 to $1.9 billion at end-August 2017. We plan to further reduce swap liabilities gradually during 2018.

20. 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. Recently, the Government of Sri Lanka enacted the Foreign Exchange act which repealed the previous exchange control law to further liberalize the FX transactions. We will ensure that the new regulations are consistent with Article VIII. The CBSL and the government will also abstain from providing subsidized exchange guarantees for foreign currency borrowing.

VII. FINANCIAL SECTOR POLICIES

21. We have recently implemented several measures to strengthen the financial system. We (i) implemented the first phase of the Basel III capital standards in July and will continue to ensure that banks comply with the schedule; and (ii) have taken steps to establish by January 2018 a new Resolution and Enforcement Department within CBSL which will oversee any resolution of financial institutions supervised by CBSL.

22. To ensure greater stability of the financial sector, we intend to: (i) start new surveys to analyze emerging issues and developments on credit growth with the intention of implementing macro-prudential tools, as needed; (ii) improve risk management of greater exchange rate flexibility within the financial sector, including through a Financial System Stability Review provided by IMF assistance; (iii) update several laws including the Banking Act, Finance Business Act, Finance Leasing Act, and the Microfinance Act to modernize the financial sector; and (iv) increase the minimum core capital requirement to strengthen the financial sector. While financial soundness indicators remain adequate for the banking system as a whole, the capital adequacy ratio (CAR) had been declining until recently as the broad-based and still high credit growth had increased risk-weighted assets.

VIII. STRUCTURAL REFORMS TO BOOST TRADE, INVESTMENT, AND INCLUSIVE GROWTH

23. **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. An immediate step toward this end has been to start negotiations on several new Free Trade Agreements. The lifting of the EU ban on fishery imports was a welcome change, and the GSP plus trade status with EU—reinstated in May 2017—has already started to have a positive impact on our exports. In July 2017, we signed a $1.1 billion deal with China for the operation and development of the southern deep sea port of Hambantota.

24. **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 have formulated a new Trade Policy along with a National Export Strategy which aims 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. We will also create a central portal for information on trade regulations in Sri Lanka. These steps should help create a predictable, consistent, and transparent trade regime which will improve competitiveness, attract FDI, and unlock new sources of growth.

25. **To boost growth, we have recently developed a 3-year economic delivery program that will ensure Sri Lanka's transition to a higher income country by 2025.** Structural reforms include the following, among others:

- Gender gap and inequality. We will facilitate female labor participation. This will be done through improving access to good quality and affordable child care facilities, facilitating part-time and flexible work arrangements, and improving access to tertiary education and vocational training.

- Climate change. Weak disaster management has raised Sri Lanka's vulnerability to natural disasters. We have already established a crop insurance scheme and a disaster insurance scheme under the National Insurance Trust Fund (NITF). A National Disaster Reserve Fund for financing post-disaster reconstruction will be established.

- Access to finance. To boost domestic private investment, we will integrate the SME sector into the formal sector through the financial system. We will implement policies to increase project-based lending rather than collateral-based lending.

IX. RISKS AND CONTINGENCIES

26. **The high degree of uncertainty continues to pose economic and financial risks to the program.** The main risks include; (i) weaker than projected revenues; (ii) 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; (iii) lower than expected growth or new pressures on the trade or financial account; (iv) weaker than expected performance of state owned enterprises; and (v) continued credit growth and higher inflation which could erode external competitiveness. 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

27. **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 fourth and fifth reviews will require observance of the quantitative performance criteria for end-December 2017 and end-June 2018, 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 fourth and fifth reviews of the program will take place on or after April 20, 2018 and November 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)

	2017									2018			
	end-Jun.				end-Sep. (IT)				end-Dec.	end-Mar. (IT)	end-Jun.	end-Sep. (IT)	end-Dec. (IT)
	Prog.	Adj. Prog	Act.	Met / not met	Prog.	Adj. Prog	Act.	Met / not met	Prog.	Prog.	Prog.	Prog.	Prog.
Quantitative performance criteria													
Central government primary balance (floor, in billion rupees)	-8	-8	16	Met	-4	-4	16	Met	-23	15	45	90	141
Program net official international reserves (Program NIR, floor, in million US$) 1/ 2/	2,027	1,874	2,049	Met	1,976	2,057	2,568	Met	2,236	1,053	1,133	922	690
Continuous performance criteria (cumulative from beginning of the program)													
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	0	Met	0	0	0	Met	0	0	0	0	0
Monetary policy consultation clause													
Year-on-year inflation in Colombo Consumers Price Index (in percent) 3/													
Outer band (upper limit)	7.9	7.9	…		8.8	8.8	…		8.5	7.7	7.7	7.9	8.0
Inner band (upper limit)	6.4	6.4	…	Within	7.3	7.3	…	Within	7.0	6.2	6.2	6.4	6.5
Actual / Center point	4.9	4.9	6.3	inner	5.8	5.8	6.0	inner	5.5	4.7	4.7	4.9	5.0
Inner band (lower limit)	3.4	3.4	…	band	4.3	4.3	…	band	4.0	3.2	3.2	3.4	3.5
Outer band (lower limit)	1.9	1.9	…		2.8	2.8	…		2.5	1.7	1.7	1.9	2.0
Indicative targets													
Central government tax revenue (floor, in billion rupees)	803	803	819	Met	1,232	1,232	1,240	Met	1,680	447	924	1,438	1,954
Reserve money of the CBSL (ceiling, end of period stock, in billion rupees) 4/	905	905	892	Met	935	935	909	Met	967	1,020	1,025	1,071	1,095
Cost of non-commercial obligations (NCOs) for fuel and electricity (net of government transfers) (ceiling, in billion rupees) 5/	…	…	…		…	…	…		…	0	0	0	0
Memorandum items:													
Net official international reserves (CBSL's conventional definition, end of period stock, in million US$, market exchange rate) 1/	6,168	…	6,092		6,023	…	6,556		6,541	7,594	7,424	6,781	6,548
CBSL's outstanding liabilities in FX swaps with domestic commercial banks (in million US$)	…	…	1,924		…	…	1,851		…	…	…	…	…
Foreign program financing by the central government (in million US$) 2/	125	…	0		125	…	0		225	0	0	100	200
Net borrowings from SLDBs and FCBUs by the central government (in million US$) 2/	627	…	627		627	…	571		627	0	-150	-150	-150
External commercial loans by the central government (in million US$) 2/	1,950	…	1,941		1,950	…	2,482		2,200	1,500	1,500	1,500	1,500
Proceeds from commercialization of public assets to non-residents (in million US$) 2/	0	…	0		200	…	0		200	0	400	400	400
Amortization of official external debt by the central government (in million US$) 2/	529	…	547		889	…	959		1,065	365	572	979	1,204
Cost of NCOs for fuel (net of government transfers) 5/	…	…	…		…	…	…		…	0	0	0	0
Cost of NCOs for fuel	…	…	…		…	…	…		…	…	…	…	…
Government transfers for NCOs for fuel	…	…	…		…	…	…		…	…	…	…	…
Cost of NCOs for electricity (net of government transfers) 5/	…	…	…		…	…	…		…	0	0	0	0
Cost of NCOs for electricity	…	…	…		…	…	…		…	…	…	…	…
Government transfers for NCOs for electricity	…	…	…		…	…	…		…	…	…	…	…

1/ The CBSL's conventional definition of net official international reserves (NIR) includes outstanding liabilities in foreign exchange swaps with domestic commercial banks. The Program NIR excludes the outstanding liabilities in foreign exchange swaps with domestic commercial banks from the CBSL's conventional NIR definition. See TMU for details.

2/ Program NIR will be adjusted upward/downward by the cumulative amounts of (i) foreign program financing by the central government, (ii) net borrowings from SLDBs and FCBUs by the central government, (iii) external commercial loans (including Eurobonds and syndicated loans) by the central government, and (iv) proceeds from commercialization of public assets to non-residents, that are higher/lower than assumed under the program; and by the cumulative amount of amortization of official external debt by the central government that is lower/higher than assumed under the program.

3/ 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).

4/ See TMU for details on the calculation of reserve money for the test date.

5/ NCOs refer to the obligation of CPC and CEB to supply fuel and electricity at administered prices. See TMU for how to measure the cost of NCOs.

Table 2. Sri Lanka: Prior Action and Structural Benchmarks under the EFF-Supported Program			
Prior Action			
Submit to Parliament the 2018 budget consistent with program targets and staff recommendations.			Met
Structural Benchmarks	**Target Completion Date**	**Status**	**Comment**
A. Proposed Structural Benchmarks			
Approval by cabinet of a policy note outlining the key elements of amendments (or replacement) to the Monetary Law Act (MLA), in consultation with the IMF.	March 2018		
Cabinet to approve a debt management strategy for international sovereign bonds maturing over 2019-22.	June 2018		
MOF to publish a detailed IRA tax manual with practical tax and administrative examples.	January 2018		
B. Existing Structural Benchmarks			
Monetary and Exchange Rate Policies			
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	Met	An IMF TA mission for designing the roadmap took place in May 2017. The Monetary Board approved this roadmap.

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

Fiscal Policy Management			
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	Met	At the second review, the structural benchmark for the 2018 budget was updated to incorporate the unmet structural benchmarks for a tax expenditure rationalization plan and publication of the noncommercial obligations for SOEs.
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		At the second review, the structural benchmark for the 2019 budget was updated to incorporate the unmet structural benchmarks for a tax expenditure rationalization plan and publication of the noncommercial obligations for SOEs.
Tax Policy Reform			
Complete by Ministry of Finance (MOF) a diagnostic review of the VAT system.	June 2017	Not met (implemented with delay)	MOF completed the review in November 2017 with inputs from FAD TA on VAT gap analysis.
Tax Administration Reform			
Adopt by MOF Inland Revenue Department compliance strategies for corporate and personal income taxes.	June 2017	Not met	The authorities will not design compliance strategies for corporate and personal income taxes until the new IRA is fully implemented. However, 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.

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

Public Financial Management			
MOF to implement an IT-based commitment control system with commitment ceilings for line ministries for the 2018 budget.	January 2018		Given delays in implementing the ITMIS modules for commitment control, the existing CIGAS system will be modified so that quarterly commitment ceilings will be operational for the 2018 budget. This enables MOF to transition from cash-based expenditure management to commitment-based control.
State Enterprise Reform			
MOF to complete a report outlining the cost of non-commercial obligations for fuel and electricity.	September 2017	Not met (implemented with delay)	A step in a sequence of reforms to put the automatic fuel and electricity pricing reform back on track. The report was published as an annex to the 2018 budget speech in November.
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 at the second review to allow time for public consultation and education, followed by a sequence of reforms.
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.
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 at the second review to allow time for public consultation and education, followed by a sequence of reforms.

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

C. Past 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.
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.
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 has been 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)	The new IRA was submitted to Parliament on July 5th satisfying the prior action for the second review.
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.

Table 2. Sri Lanka: Prior Action and Structural Benchmarks under the EFF-Supported Program (continued)			
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.
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	
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 started to report to parliament on the status of commitments in each quarter beginning in 2017Q2 and plan 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.
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.

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

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.

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);

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

g) an indicative target on cost of non-commercial obligations for fuel and electricity (net of government transfers) (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. The proceeds from privatization or commercialization of public assets to residents or non-residents (as defined in paragraph 10) will not be recorded as part of central government revenues. 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).

g) Proceeds from privatization or commercialization of public asset to residents and non-residents. In 2015, the total amount was Rs 0 billion.

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

[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.

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 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 $2,498.6 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 June 30, 2017, as specified in Table 1. Monetary gold will be valued at US$1,246.59 per troy ounce, which was the price prevailed on June 30, 2017.

Table 1. Sri Lanka: Exchange Rates
(Rates as of June 30, 2017)

Currency	Sri Lankan Rupee per currency unit
U.S. dollar	153.5100
British pound	199.9314
Japanese yen	1.3728
Canadian dollar	118.2757
Euro	175.6154
Chinese yuan	22.6789
SDR	213.5920

Source: CBSL and IMF.

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 to non-residents—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. 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-December 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-December 2017 and thereafter.

Table 2. Sri Lanka: Program Assumptions
(Cumulative from the beginning of the year, in million US$)

	Dec. 2017	Mar. 2018	Jun. 2018	Sep. 2018	Dec. 2018
Foreign program financing by the central government	225	0	0	100	200
Net borrowings from SLDBs and FCBUs by the central government	627	0	-150	-150	-150
External commercial loans (including Eurobonds and syndicated loans) by the central government	2,200	1,500	1,500	1,500	1,500
Proceeds from commercialization of public assets to non-residents	200	0	400	400	400
Amortization of official external debt by the central government	1,065	365	572	979	1,204

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 paragraph 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-December 2017 or end-June 2018 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-December 2017, end-March 2018, end-June 2018, end-September 2018, and end-December 2018, 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 Defense 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. From December 2017 onwards, reserve money for each test date is measured as the average reserve money from 16th to end of the month.

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.

C. Indicative Target on Cost of Non-Commercial Obligations for Fuel and Electricity (Net of Government Transfers)

18. The non-commercial obligations (NCOs) for fuel and electricity refer to the obligations of Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) to supply fuel and electricity at prices below cost-recovery levels. The indicative target is set on the cost of fuel and electricity NCOs net of government transfers, which corresponds to the cost of the NCOs that are not compensated by the central government budget.

19. The cost of NCOs for fuel during each quarter is measured as the cost of sales (including fuel cost, terminal charges, transport charges, personnel cost, other operational expenses, exchange rate variation, and finance cost; excluding sales taxes) minus revenues (net of sales taxes) with regard to fuel supplies by CPC for transport, power generation, aviation, industries, kerosene and LPG, and agrochemicals. If the revenues (net of taxes) exceed the cost of sales, the cost of NCOs for fuel is zero. The government transfers to cover the cost of fuel NCOs are measured as central government current transfers disbursed to CPC.

20. The cost of NCOs for electricity during each quarter is measured as total expenditures (including energy purchases and allowed revenue for transmission) minus total sales revenues from 5 distribution licensees under CEB, as shown in the statement of the Bulk Supply Transaction Account managed by CEB. If the total sales revenues exceed the total expenditures, the cost of NCOs for electricity is zero. The government transfers to cover the cost of electricity NCOs are measured as central government current transfers disbursed to CEB.

21. For the purpose of program monitoring, the cost of fuel and electricity NCOs net of government transfers is calculated as follows. This takes account of a time lag in estimating the cost of fuel and electricity NCOs.

For the test date of end-March 2018:

NCO(2017Q4) – G(2018Q1)

For the test date of end-June 2018:

{ NCO(2017Q4) + NCO(2018Q1) } – { G(2018Q1) + G(2018Q2) }

For the test date of end-September 2018:

{ NCO(2017Q4) + NCO(2018Q1) + NCO(2018Q2) }

– { G(2018Q1) + G(2018Q2) + G(2018Q3) }

For the test date of end-December 2018:

{ NCO(2017Q4) + NCO(2018Q1) + NCO(2018Q2) + NCO(2018Q3) }

– { G(2018Q1) + G(2018Q2) + G(2018Q3) + G(2018Q4) }

where

NCO(q) = cost of NCOs for fuel and electricity during quarter "q"

NCO_fuel(q) = cost of NCOs for fuel during quarter "q"

NCO_electricity(q) = cost of NCOs for electricity during quarter "q"

NCO(q) = NCO_fuel(q) + NCO_electricity(q)

G(q) = central government current transfers to CPC and CEB disbursed during quarter "q"

G_fuel(q) = central government current transfers to CPC disbursed during quarter "q"

G_electricity(q) = central government current transfers to CEB disbursed during quarter "q"

G(q) = G_fuel(q) + G_electricity(q).

V. DATA REPORTING REQUIREMENTS

22. 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—CEB, CPC, and SriLankan Airlines—data will be provided in the format shown in Tables 8, 9, and 10, respectively, on a quarterly basis. For the purpose of monitoring the performance against the indicative target on the cost of fuel and electricity NCOs (net of government transfers), data will be provided in the format shown in Tables 11 and 12 on a quarterly basis.

23. 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. Data relating to the indicative target on the cost of fuel and electricity NCOs (net of government transfers) (Table 11 and Table 12) will be furnished within no more than 5 weeks 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
(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. Sri Lanka: 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. Sri Lanka: 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. Sri Lanka: 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.

Table 11. Sri Lanka: Cost of Non-Commercial Obligations for Fuel 1/

(In millions of rupees, unless otherwise noted)

Product	a=e-b **Cost of NCOs**	b=c-d **Net sales revenue (net of**	c Sales revenue	d Sales taxes	e=f+g+h+i+j+k+l **Total cost (net of sales**	f Cost of sales	g Terminal charge	h Transport charge	i Personnel cost	j Other expenses	k Exchange rate variation	l Finance cost	m Sales quantity
	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Rs millions	Million liters
A.TRANSPORT													
Super petrol (92 octane)													
Unladed petrol (95 octane)													
Auto diesel													
Super diesel													
B.POWER GENERATION													
Auto diesel													
Fuel oil 800'													
Fuel oil 1500'													
Fuel oil 1500' low sulphur													
Fuel oil 200'													
Naphtha													
C.AVIATION													
Jet A-1 (Foreign)													
Jet A-1 (Sri Lankan Airline)													
Jet A-1 (Local)													
Avgas													
D.INDUSTRIES													
Ind Kero													
Fuel oil 800'													
S.B.P.													
Bitumen													
Lubricant													
E.DOMESTIC													
Kerosene													
LPG													
F.AGRO													
Agro chemicals													
Total (A-F)													

Memorandum item:	
Central government current transfers to CP	[x]

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

Table 12. Sri Lanka: Statement of Bulk Supply Transaction Account 1/
(In millions of rupees)

a	**Total revenue**
	Sales by DL1, 2, 3, 4, 5
	UNT adjustment
b	**Expenditures**
	Energy purchases
	Mahawell complex
	Laxapana complex
	Other hydro complex
	Thermal complex
	Coal complex
	Old Chunnakam+ Islands
	Uturu janani
	IPP plants
	NCRE
	Other
	UNT adjustment
	Transmission allowed revenue
	BSOB allowed revenue
	Other
	Subsidy Requirement from General Treasury/(surplus)
c=b-a	**Cost of electricity NCOs**
	Memorandum item:
	Central government current transfers to CEB

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

**Statement by Mr. Gokarn, Executive Director,
and Mr. Siriwardana, Alternate Executive Director on Sri Lanka
December 6, 2017**

Our Sri Lankan authorities value the constructive and candid policy dialogue they had in Colombo during September 2017 and in Washington DC during the Annual Meetings with the staff mission in relation to the Third Review under the Extended Arrangement under the Extended Fund Facility (EFF). They are grateful to the staff for the comprehensive set of documents. Our authorities also highly appreciate the advice and continued support by the staff and the management to Sri Lanka.

Program Performance

Sri Lanka's EFF program is progressing well, with all end-June 2017 Quantitative Performance Criteria (QPC) and end-September Indicative Targets (IT) having been met. The QPC related to the primary deficit was met, NIR exceeded the target and inflation remained within the target band, under the program. The continuous PC of making no new external arrears was also met. Four of the five Structural Benchmarks (SB) to be completed by November 2017 were implemented. The missed SB, on designing compliance strategies for income taxes, has been postponed until the new Inland Revenue Act (IRA) is fully operational in 2018. The prior action for the third review on submission of Budget 2018 consistent with the EFF program was also completed. Our authorities are strongly committed to continuing the reforms and achieving the desired targets. They view these as necessary to create robust macroeconomic fundamentals needed for accelerating growth and generating employment. Against this backdrop, they request the completion of the Third Review of the EFF.

Economic Growth, Inflation and Outlook

The Sri Lankan economy grew by 3.9 per cent during the first half of 2017, compared to the growth of 3.7 per cent over the same period of 2016, driven mainly by the expansion in Industry and Services. The contraction of Agriculture-related activities, resulting from severe drought and flood related disturbances, which had some spillover impact, particularly on manufacturing activities, weighed negatively on the economic growth. Growth in the second half of 2017 will be relatively low compared to the past, although higher than the first half, mainly reflecting the impact of inclement weather conditions. Overall, the economy is expected to grow by 4.0 – 4.5 per cent in 2017. Going forward, Sri Lanka's growth trajectory is expected to improve gradually over the medium-term, with the support of improving macroeconomic stability, ongoing structural adjustments and growth-consistent policies. The *Vision 2025*, which is the new economic plan of the government, announced in September 2017, contains far-reaching, growth-oriented economic policies to complement this process. Meanwhile, unemployment declined marginally to 4.3 per cent in the first half of 2017, from 4.4 per cent in the corresponding period of 2016.

Headline inflation followed an overall increasing trend, but with mixed patterns. High food inflation due to severe domestic supply disruptions was the main reason for the increase. Tax adjustments in 2016 and rising international commodity prices also contributed. However, core inflation remained low on average, reflecting the broadly contained demand driven inflationary pressures through prudent monetary policy measures adopted by the Central Bank. Although inflation is likely to remain elevated in the near term due to weather-related supply disruptions, well-anchored inflation expectations and forward-looking demand management policies are expected to contain inflation within the ranges specified in the monetary policy consultation clause of the program.

Monetary and Exchange Rate Policy

The Central Bank continued its tight monetary policy stance to preempt the buildup of excessive demand pressures and adverse inflation expectations in the economy. In addition to the 100 basis points (bps) increase in policy interest rates and the 1.50 percentage point increase in the Statutory Reserve Ratio (SRR) in 2016, the policy interest rates of the Central Bank were increased by 25 bps in March 2017. Responding to tighter monetary conditions, the most market interest rates moved upward, although short-term rates adjusted downwards recently due to increased liquidity in the domestic money market. Responding to the tight monetary policy measures and reduced loan to value ratio, growth in credit from commercial banks to the private sector also decelerated gradually to 16.2 per cent in October 2017 from the peak of 28.5 per cent in July 2016. Going forward, the overall credit expansion is expected to decelerate further with the gradual moderation in private sector credit growth and fiscal consolidation. Our authorities closely monitor the inflation dynamics and remain ready to take appropriate measures if inflationary threats emerge. They would also supplement such measures by adopting macroprudential measures, if necessary.

Further progress was made in transiting towards a flexible inflation targeting (FIT) framework in the medium-term. The Monetary Board of the Central Bank approved the Road Map for Implementing FIT in October 2017, which consists time-bound actions. This includes measures in the context of reaching consensus between the government and the Central Bank on inflation target and the time horizon, and FIT as the monetary policy framework; legislative reforms to ensure clear separation of monetary and fiscal policies; and monetary policy implementation, including monetary instruments, liquidity management and domestic market development. This process also involves building institutional and technical capacity, strengthening Central Bank credibility, autonomy and governance, as has been identified in the 2016 IMF safeguard assessment. This will be supported by enhancing monetary-fiscal policy coordination and revising the Fiscal Management (Responsibility) Act (FMRA) to strengthen responsible fiscal management.

The recently introduced market-based Treasury bond auction system and the proposed Liability Management Act are expected to insulate monetary policy from fiscal dominance, thereby enhancing the independence of the monetary policy. The new Treasury bond auction system has reduced the volatility in yields on government securities, corrected the distortion between the policy rates and market interest rates and reduced the monetization of fiscal deficits, thereby strengthening the effectiveness of the monetary policy.

Our authorities remain committed to pursuing a flexible exchange rate regime with intervention limited to preventing wide fluctuations and building up official reserves. This will also support the move towards the FIT framework. The Road Map for Implementing FIT contains several proposals to improve foreign exchange operations and the market. Greater exchange rate flexibility, introduction of a transparent auction mechanism to build up international reserves and adopting measures to deepen the foreign exchange market are key among those.

Meanwhile, the new Foreign Exchange Act (FEA), which was introduced by the government by repealing the Exchange Control Act, came in to effect from 20 November 2017. The new FEA envisages to further liberalizing capital flows and simplifying the processes associated with current account transactions and various types of foreign currency/rupee accounts. In line with this, the Central Bank recently established the Department of Foreign Exchange to implement the provisions of the new FEA, in place of the Exchange Control Department.

Financial Sector

The financial sector continued to expand and remained stable amidst challenging global and domestic conditions with higher levels of capital, adequate liquidity buffers, and healthy earnings. The asset base of the banking sector continued to grow and the NPL ratio improved. The bank branch network expanded, contributing to improved financial inclusion in the country, particularly in the regional areas. The implementation of the Basel III framework is progressing, which should further enhance the resilience of the banking sector. The asset base of non-bank financial institutions (NBFIs) expanded at a slower pace compared to that of 2016.

The Central Bank is in the process of establishing a new Resolution and Enforcement Department to further strengthen the regulatory and supervisory framework. Measures are being taken to strengthen the AML/CFT regime by addressing the remaining deficiencies, including the enactment of Financial Action Task Force (FATF) compliant AML/CFT laws and regulations. Scenario-based stress testing for the banking sector, systemic risk survey, early warning indicators, etc. are being used to strengthen the macroprudential surveillance framework while expansion of network analysis is in progress. The macroprudential surveillance framework would identify risks and vulnerabilities early in a holistic manner and would propose measures for systemic risk mitigation. These measures will further strengthen the macroprudential framework. Further, some macroprudential tools, such as LTVs on motor vehicles, have also been implemented.

Fiscal Policy, New Legislations and SOE Reforms

As highlighted in the staff report, revenue-based fiscal consolidation remains the key for improving the country's public finances. Our authorities' steadfast efforts towards fiscal consolidation have resulted in significant improvement in fiscal performance. Accordingly, the primary balance was maintained within the end-June PC and end-September IT. This was mainly due to improved revenue collection, reflecting the measures taken by the authorities in the context of tax policy and tax administration with the support of the EFF. In particular, there was a significant increase in tax revenue, driven by the VAT reforms introduced in 2016. In fact, the primary balance recorded a surplus during the first 6 months, although it declined thereafter to a deficit due to unexpected drought and flood related expenditures, which will also lead to a marginal deviation of the annual budget deficit from the envisaged target. The government, in its policy statements, has already announced its strong commitment to reduce the deficit gradually to 3.5 per cent of GDP and debt to GDP ratio to 70 per cent from the projected 80 per cent in 2017.

The recently presented Budget 2018 has the theme of "Blue-Green Enterprise Sri Lanka". It intends to achieve economic progress in an eco-friendly manner. The budget expects to continue to strengthen the fiscal performance on the already built foundation. The projected revenue target is expected to be met by consolidating the tax policy, including the implementation of the recently enacted IRA, which includes a simplified tax law, revisions to tax rates, realigned tax incentives and introduction of international best practices to the Sri Lankan tax system. It also places greater emphasis on improving tax administration to increase compliance and revenue collection by effectively using the automation through the newly established Revenue Administration Management Information System (RAMIS). Rationalization of expenditures, IT-based spending commitment controls and other improvement in public financial management is expected to keep expenditure on track. As a combined outcome of these policies, a primary surplus is expected in 2018 with a further decline in overall fiscal deficit. In compliance with program requirements, a tax expenditure statement and statement on fuel and electricity Non-Commercial Obligations (NCOs) also have been presented in Budget 2018, raising its transparency. The submission of Quarterly Expenditure and Income Outcome Reports to the Parliament strengthens Parliamentary control over public finances.

Budget 2018 expects to improve the overall performance of the economy by focusing mainly on enhancing private sector participation, creating a conducive environment to promote exports, supporting the digitalization of the economy and enhancing investments in human capital. It has also proposed to introduce revisions to several laws for Sri Lanka to be a more vibrant and a dynamic market economy. Accordingly, archaic and regressive laws, including the Public Contracts Act, Land (Restrictions and Alienation) Act, Rent Act, Shop and Office Employees Act and Bankruptcy laws will be amended. New Acts, such as Liability Management Act, Public Finance Management Act, National Audit Act, Demutualization Act, Securitization Act, Development Bank Act, and Public Enterprises Act will be introduced to facilitate economic progress.

The introduction of Liability Management Act will be a priority for our authorities to face the challenge of handling the bunching of scheduled debt service payments, particularly from 2019 onwards. This proposed Act will allow the Treasury to create a buffer fund to meet expenditure and debt service needs, and smoothen out the issuing process and maturity structure. It will also enable the use of funds from the commercialization of government assets for liability management purposes.

Our authorities are committed to implementing reforms in SOEs to improve the financial viability to lower the pressure on the government budget. Domestic prices of fuel and electricity are expected to be determined by a formula in March and September, as the first step of the recalibrated sequence of steps. Our authorities are also in the process of introducing a resolution strategy for SriLankan Airlines. The Statements of Corporate Intent (SCIs), which were signed with five key SOEs in March 2017, creating a framework to monitor their performance under specific KPIs, will be extended to other selected SOEs as well.

External Sector

Sri Lanka's external sector showed some signs of improvement in 2017. Exports recorded continuous growth since March 2017, reversing the lackluster performance during the past two years. However, trade deficit widened, since imports also increased due to higher demand for petroleum imports for domestic power generation and rice, due to severe drought conditions. Earnings from tourism declined while workers' remittances moderated amidst the slowdown in the Middle Eastern economies. Hence, the current account balance did not improve as expected. Despite the increased current account deficit, the pressure on the BOP continued to ease with higher inflows under the financial account.

With the improved external sector performance, the Central Bank limited its intervention in the foreign exchange market only to build up international reserves, with minimal impact on the exchange rate. The Sri Lankan rupee has depreciated by 2.6 per cent against the US dollar so far, this year. The gradual winding down of the swaps with commercial banks is being continued and the outstanding amount has declined to US$ 1.8 billion by end-October 2017 from US$ 2.5 billion recorded in end-December 2016.

Trade and Investment Regime

Sri Lanka has taken several important initiatives to promote exports. A New Trade Policy (NTP) was approved by the Cabinet of Ministers in August 2017 with the view of having more liberal, simple and transparent trade regime in the country. The government is negotiating new trade agreements with several partner countries and the FTA with Singapore is expected to be signed in January 2018. The EU-Sri Lanka Investor Dialogue was relaunched in 2017 to resolve trade and investment-related problems and enhance the bilateral economic cooperation.

Meanwhile, a National Trade Facilitation Committee was established to drive the implementation of commitments under the WTO Trade Facilitation Agreement (TFA), which

Sri Lanka ratified in 2016. On trade facilitation, a single electronic window has been established at Sri Lanka Customs and will be operational shortly. An Anti-Dumping and Countervailing Measures Bill and a Safeguard Measures Bill will be presented to the Parliament soon.

The Budget 2018 has proposed several measures, including to abolish para-tariffs applicable on selected tariff lines; introduce an "Export Market Access Support" program as a part of the trade adjustment program; establish a trade portal allowing the exporters to access reliable and timely trade information and trade promotional tools; facilitate product development assistance to exporters; drive a comprehensive "Multi-National Corporation Outreach" program to attract global electronic and electrical machinery players into the country to create value chain linkages or joint ventures with Sri Lankan exporters; and automate documentation processes, required for imports.

Technical Assistance

Our authorities highly value the continued support and insights provided through technical assistance by the Fund over the years, which has helped Sri Lanka to improve its policy formulation and implementation. They expect to continue this engagement to complement the efforts towards further strengthening of growth and macroeconomic stability in the country.

Conclusion

With the help of strong policy initiatives, complemented by the measures taken under the EFF, macroeconomic stability is being gradually restored in Sri Lanka, while achieving a satisfactory level of economic growth. This has helped to strengthen investor confidence. Given the progress of the reform momentum, Sri Lanka's sovereign rating outlook was revised from negative to stable by S&P on 20 November 2017. Our authorities are committed to continuing structural reforms and building buffers to improve resilience. Supported by the ongoing policies and reforms, the Sri Lankan economy is expected to return to a high and inclusive growth trajectory, thereby helping to achieve broader objectives of employment generation and raising incomes of its citizens.