INTERNATIONAL MONETARY FUND

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SRI LANKA

June 2018

2018 ARTICLE IV CONSULTATION AND FOURTH REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

In the context of the 2018 Article IV Consultation and the Fourth Review Under the Extended Arrangement Under the 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 June 1, 2018, following discussions that ended on March 13, 2018, with the officials of Sri Lanka on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 17, 2018.
- An **Informational Annex** prepared by the IMF staff.
- 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*
Selected Issues
*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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June 20, 2018

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IMF Executive Board Completes the Fourth Review Under the Extended Arrangement under the Extended Fund Facility and Concludes the 2018 Article IV Consultation with Sri Lanka

On June 1, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Sri Lanka and completed the fourth review under the Extended Arrangement under the Extended Fund Facility (EFF).[2] Completion of this review makes available SDR 177.774 million (about US$ 252 million). The EFF arrangement in a total amount of SDR 1.1 billion (about US$1.5 billion, or 185 percent of quota) was approved on June 3, 2016 (see Press Release No. 16/262).

The Sri Lankan economy is expected to normalize gradually. Following subdued growth in 2017 due to the lingering effects of weather-related shocks, a recovery is underway as agriculture has started to rebound and growth in exports remains robust. Real GDP growth is expected to reach 4 percent in 2018 and around 5 percent over the medium term. The Central Bank of Sri Lanka (CBSL) has effectively curbed credit growth and stabilized inflation, despite recent pressures. However, the economy remains vulnerable to adverse domestic and external shocks, given the still sizable public debt, large refinancing needs, and low external buffers.

Performance in the first half of the EFF program has remained broadly on track. Despite some implementation delays and weather-related shocks, the authorities achieved a primary surplus in 2017, through expenditure management and revenue mobilization. The CBSL conducted monetary policy prudently, bringing inflation back within its band. Taking advantage of favorable market conditions, the CBSL also stepped up its pace of reserve accumulation in 2017. The authorities have achieved major milestones in their reform agenda. These include the launch of the new Inland Revenue Act, important progress with SOE and energy-pricing reforms, as well as adoption of the CBSL's Roadmap to flexible inflation targeting. Going forward, the

1 Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

2 The EFF was established to provide support of comprehensive programs that include policies of the scope and character required to correct structural imbalances over an extended period. For more details see http://www.imf.org/en/about/factsheets/sheets/2016/08/01/20/56/extended-fund-facility

authorities should push ahead with their "Vision 2025" objectives, by further advancing fiscal consolidation through stronger fiscal rules and SOE governance; modernizing monetary and exchange rate frameworks; accelerating their inclusive growth reform agenda through trade liberalization, climate budgeting, and greater female labor force participation, as well as better-targeted social protection programs. Keeping the reform momentum is key to increase Sri Lanka's resilience to external shocks and lay the foundation for more sustainable and robust growth.

Executive Board Assessment[3]

Executive Directors commended the progress made by Sri Lanka under the Fund-supported program. Directors welcomed the authorities' efforts to improve the policy mix through continued fiscal consolidation, prudent monetary policy, and landmark structural reforms. However, they noted that the economy remains vulnerable to adverse shocks given the still sizable public debt, large refinancing needs, and low external buffers. Against this background, Directors welcomed the authorities' commitment to the program and agreed that sustained reform momentum is critical to safeguard the economic gains to date, strengthen resilience, and support inclusive growth.

Directors welcomed the launch of the new Inland Revenue Act (IRA) to support the authorities' fiscal consolidation efforts. They emphasized that progress with revenue mobilization can help safeguard important social and infrastructure spending, including in response to natural disasters. They also underscored the importance of enhancing public investment efficiency. In this area, they emphasized the need for systematic and transparent project appraisal and selection of large-scale investment projects, ensuring consistency with fiscal targets and mitigation of fiscal risks, given the country's still high public debt. Going forward, Directors supported the authorities' commitment to anchor debt reduction plans through a robust fiscal rule and medium-term debt management strategy.

Directors saw the recent approval of an automatic fuel pricing formula as a major achievement towards reducing the still elevated fiscal risks posed by state-owned enterprises (SOEs). They encouraged the authorities to complete energy pricing reforms with an automatic pricing formula for electricity, implement a restructuring plan for Sri Lankan Airlines to put it on a solid commercial footing, and further strengthen SOEs governance and transparency. Directors welcomed ongoing efforts to strengthen social safety nets to help mitigate the distributional impact on the most vulnerable.

Directors concurred that the Central Bank of Sri Lanka (CBSL) should continue to manage monetary policy prudently, following a data-dependent approach, in the face of inflationary

[3] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

pressures and market volatility. Directors underscored the need for continued efforts to build up international reserves and that exchange rate flexibility should be the first line of defense against volatile global capital flows. Directors welcomed the CBSL's roadmap to flexible inflation targeting and the planned amendments to the central bank law to further strengthen the CBSL's mandate, governance, and autonomy.

Directors welcomed efforts to further strengthen the resilience of the financial sector, including with Basel III implementation. They noted that macro-prudential tools could be used to rein in excessive credit growth in the real estate sector and encouraged the authorities to address identified weaknesses in non-bank financial institutions. They commended ongoing efforts to improve the AML/CFT regime and looked forward to timely implementation of FATF-compliant laws and regulations.

Directors underscored the importance of implementing growth-enhancing structural reforms as outlined in the authorities' medium-term strategy. They recommended gradual liberalization of the trade regime and further improvements to the investment climate, including through robust implementation of the new IRA. To foster inclusive growth, Directors encouraged additional measures to enhance the effectiveness of social safety nets and female labor force participation through labor market reforms and gender budgeting. They also noted that a well-designed natural disaster risk financing framework can help Sri Lanka address costs associated with climate change.

Sri Lanka: Selected Economic Indicators, 2015–23

	2015	2016	2017		2018		2019	2020	2021	2022	2023
			CR/18/3	Est.	CR/18/3	Proj.			Proj.		
GDP and inflation (in percent)											
Real GDP growth	5.0	4.5	4.2	3.1	4.6	4.0	4.5	4.7	4.8	4.9	5.0
Inflation (average)	2.2	4.0	6.0	6.6	4.8	4.8	4.8	4.9	4.9	4.9	4.9
Inflation (end-of-period)	4.6	4.5	5.1	7.1	5.0	4.7	4.8	4.9	4.9	4.9	4.9
Core inflation (end-of-period)	6.7	5.8	4.6	4.3	4.6	4.6	4.6	4.6	4.5	4.5	4.5
Savings and investment (in percent of GDP)											
National savings	28.8	32.8	28.7	33.9	29.1	34.4	35.0	35.1	35.2	35.4	35.6
Government	-2.2	-0.5	-0.9	-0.7	-0.3	0.1	1.3	1.4	1.5	1.6	1.6
Private	31.0	33.4	29.7	34.6	29.4	34.3	33.7	33.8	33.7	33.9	33.9
National Investment	31.2	35.0	31.7	36.5	31.6	36.9	37.5	37.6	37.5	37.6	37.7
Government	6.4	7.5	6.3	8.1	6.0	7.4	7.4	7.2	7.2	7.1	7.0
Private	24.7	27.5	25.4	28.4	25.6	29.5	30.1	30.3	30.4	30.5	30.7
Savings-Investment balance	-2.4	-2.2	-3.0	-2.6	-2.5	-2.5	-2.5	-2.4	-2.3	-2.2	-2.2
Government	-8.6	-8.0	-7.1	-8.8	-6.3	-7.3	-6.1	-5.9	-5.7	-5.5	-5.4
Private	6.3	5.9	4.2	6.1	3.8	4.8	3.6	3.5	3.3	3.3	3.2
Public finances (in percent of GDP)											
Revenue and grants	13.3	14.2	14.2	13.8	15.0	14.6	15.9	16.0	16.1	16.2	16.2
Expenditure	20.4	19.6	19.9	19.4	20.0	19.2	19.5	19.5	19.6	19.7	19.6
Primary balance	-2.2	-0.2	-0.2	0.0	1.0	1.0	2.0	2.1	2.1	2.1	2.0
Central government balance	-7.0	-5.4	-5.7	-5.5	-5.0	-4.6	-3.6	-3.5	-3.5	-3.5	-3.5
Central government net domestic financing	4.3	2.1	3.4	2.2	2.9	2.1	2.9	2.9	2.7	2.7	2.7
Central government debt	78.5	79.6	81.6	79.3	80.3	77.3	75.2	73.0	70.9	68.8	66.7
Money and credit (percent change, end of period)											
Reserve money	16.5	27.1	13.0	9.8	13.3	13.8	12.6	12.4	12.3	12.3	12.3
Broad money	17.8	18.4	18.9	16.7	15.0	14.0	13.7	13.3	13.0	12.6	12.6
Domestic credit	23.5	16.4	13.2	12.5	12.1	10.6	11.0	10.7	10.7	10.5	10.6
Credit to private sector	25.1	21.9	16.3	14.7	14.8	13.7	12.6	12.4	12.3	12.2	12.1
Credit to central government and public corporations	21.3	8.1	8.0	8.7	7.3	5.1	7.9	7.2	7.1	6.8	7.1
Balance of payments (in millions of U.S. dollars)											
Exports	10,547	10,310	11,244	11,360	11,861	11,922	12,504	13,103	13,768	14,536	15,347
Imports	-18,935	-19,183	-21,040	-20,978	-21,932	-22,294	-23,848	-25,035	-26,194	-27,430	-28,749
Current account balance	-1,882	-1,743	-2,461	-2,309	-2,180	-2,308	-2,514	-2,567	-2,667	-2,692	-2,844
Current account balance (in percent of GDP)	-2.4	-2.2	-3.0	-2.6	-2.5	-2.5	-2.5	-2.4	-2.3	-2.2	-2.2
Export value growth (percent)	-5.2	-2.2	9.1	10.2	5.5	4.9	4.9	4.8	5.1	5.6	5.6
Import value growth (percent)	-2.5	1.3	8.5	9.4	4.2	6.3	7.0	5.0	4.6	4.7	4.8
Gross official reserves (end of period)											
In millions of U.S. dollars	7,304	6,019	7,505	7,959	8,014	9,268	9,710	10,179	10,949	11,602	12,240
In months of prospective imports of goods & services	3.7	2.8	3.4	3.6	3.4	3.9	3.9	3.9	4.0	4.1	4.3
In percent of ARA composite metric	68.9	54.7	66.9	68.9	66.5	74.2	74.5	75.1	76.8	77.4	79.7
External debt (public and private)											
In billions of U.S. dollars	44.8	46.5	48.3	51.9	49.5	55.0	58.3	60.2	62.7	65.8	69.2
As a percent of GDP	56.4	57.4	58.2	59.3	57.4	58.9	58.5	56.7	55.3	54.2	53.2
Memorandum items:											
Nominal GDP (in billions of rupees)	10,951	11,907	13,027	13,289	14,271	14,524	15,899	17,437	19,142	21,034	23,134

INTERNATIONAL MONETARY FUND

SRI LANKA

May 17, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION AND FOURTH REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY

KEY ISSUES

Recent developments and outlook. After a series of weather calamities in 2017, the economy is stabilizing. Real GDP growth is projected to reach 4 percent in 2018, supported by a recovery in agriculture and industry as well as robust growth in services. Important progress has been made in fiscal consolidation and energy pricing reforms. The CBSL has effectively curbed credit growth and stabilized inflation despite recent pressures, while stepping up its pace of reserve accumulation.

Focus of the Article IV Consultation. Building on the authorities' ambitious *Vision 2025* strategy, discussions focused on strengthening institutions to promote stability and inclusive growth. Key priorities include promoting fiscal consolidation through more robust fiscal rules and SOE reforms; modernizing monetary and exchange rate frameworks; and accelerating growth-enhancing reforms.

Program performance. Despite the severe shocks and some implementation delays, program performance remains broadly on track. All end-December and continuous performance criteria were met. Due to a weather-related spike in food prices, inflation in December exceeded the upper limit for the inner band, but has since fallen back within the band. The authorities implemented all six structural benchmarks for this review, including an automatic fuel pricing mechanism, although with some delays.

Key challenges ahead. The economy remains vulnerable to adverse shocks given still sizable public debt, large refinancing needs, and low external buffers. Despite the authorities' firm commitment to the program, political uncertainty in the run-up to the 2019–20 elections could slow reforms. Sustained reform momentum is critical to sustain growth and strengthen resilience, through further revenue mobilization and SOE reforms, vigilant monetary policy and sustained reserve build up, in the context of greater exchange rate flexibility, as well as further steps to enhance competitiveness and economic inclusion.

Staff supports the authorities' request for completion of the fourth review. The purchases available upon completion of this review will be equivalent to SDR 177.774 million, bringing total purchases under the Extended Fund Facility (EFF) to SDR 715.230 million.

Approved By
Kenneth Kang and Martin Sommer

Discussions were held in Colombo during February 27–March 9, 2018, and in Washington DC during the Spring Meetings (April 18–20). The mission met with Prime Minister Wickremesinghe, 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 Ms. Goretti (Head), Ms. Jahan, Mr. Nozaki (all APD), Mr. Danforth (FAD), Mr. Lindner (MCM), Ms. Takebe (SPR), Ms. Kvintradze (resident representative), and Ms. Sundararaj (local economist). Mr. Kang (APD) joined part of the mission and Mr. Siriwardana (OED) participated in the policy discussions. Messrs. Chukwumah, Singh, and Sullivan (APD) also contributed to the preparation of this report.

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CONTEXT

1. **Sri Lanka is undertaking significant reforms under the EFF program.** The authorities requested the 3-year EFF arrangement in June 2016, in response to a difficult external environment and increasing strain from unbalanced macroeconomic policies. The first phase of the program has successfully re-set the policy mix to support stability and resilience. However, further efforts are still needed to lock-in this progress and complete the institutional and structural reforms necessary to achieve strong and sustained growth. In September 2017, the government announced their *Vision 2025*—an ambitious strategy to enhance Sri Lanka's competitiveness and unlock its economic potential to reach upper-middle income status through a range of structural, macro, and social reforms. The *Vision*'s philosophy and menu of reforms set the basis for the remainder of the authorities' program.

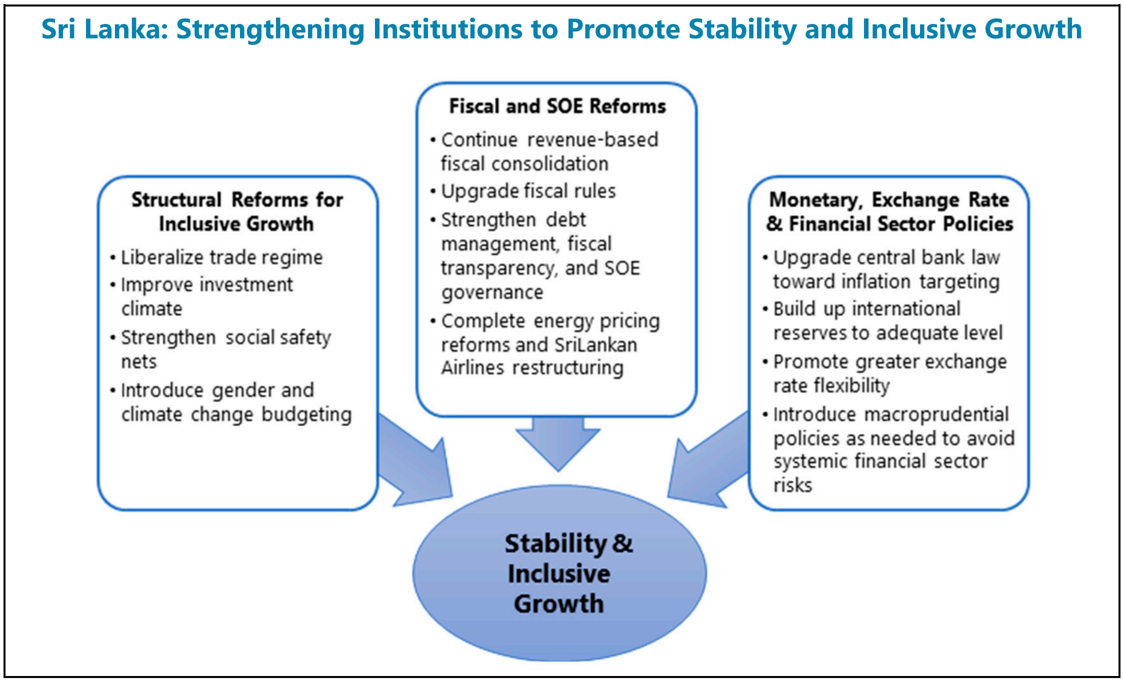
2. **Performance in the first half of the EFF program has remained broadly on track.** Despite some implementation delays and weather-related shocks, the authorities achieved a primary surplus in 2017, through expenditure management and revenue mobilization. Despite a challenging economic environment, the CBSL conducted monetary policy prudently, bringing inflation back within its band. Taking advantage of favorable market conditions in 2017, the CBSL also stepped up its pace of reserve accumulation. Major milestones include the launch of the new Inland Revenue Act, progress with SOE and energy-pricing reforms, as well as adoption of the CBSL's Roadmap to flexible inflation targeting.

3. **Despite progress under the program, many challenges still lie ahead in the run-up to the 2019-20 elections.** Public debt remains high and external buffers low against standard metrics, leaving the economy vulnerable to shocks, while limited export diversification and FDI suggest that the country's growth potential has yet to be realized through structural reforms. Political uncertainty has increased following the opposition's victory in the February 2018 local elections and two cabinet reshuffles. While the Prime Minister passed a no-confidence vote in April,[1] there is an elevated risk that the political window for enacting major reforms will narrow in the run-up to the presidential and parliamentary elections scheduled for late 2019 and 2020, respectively. To secure the hard-won gains under the program and support inclusive and sustained growth, the reform momentum needs to accelerate, buttressed by strong policy frameworks and institutions.

4. **Against this backdrop, this year's Article IV consultation and the remainder of the EFF program focus on strengthening institutions to promote stability and inclusive growth.** Key priorities include (i) promoting fiscal consolidation through further revenue mobilization, more robust fiscal rules, and SOE reforms; (ii) modernizing monetary and exchange rate frameworks to

[1] A two-party coalition government comprising the Sri Lanka Freedom Party led by President Sirisena and the United National Party led by Prime Minister Wickremesinghe has been in place since January 2015.

rebuild buffers; and (iii) accelerating the structural reform agenda to lay the foundation for more sustainable and inclusive growth in Sri Lanka.



MACROECONOMIC DEVELOPMENTS

5. Growth and inflation developments were mixed in 2017 mainly due to weather calamities, while external and financial conditions improved.

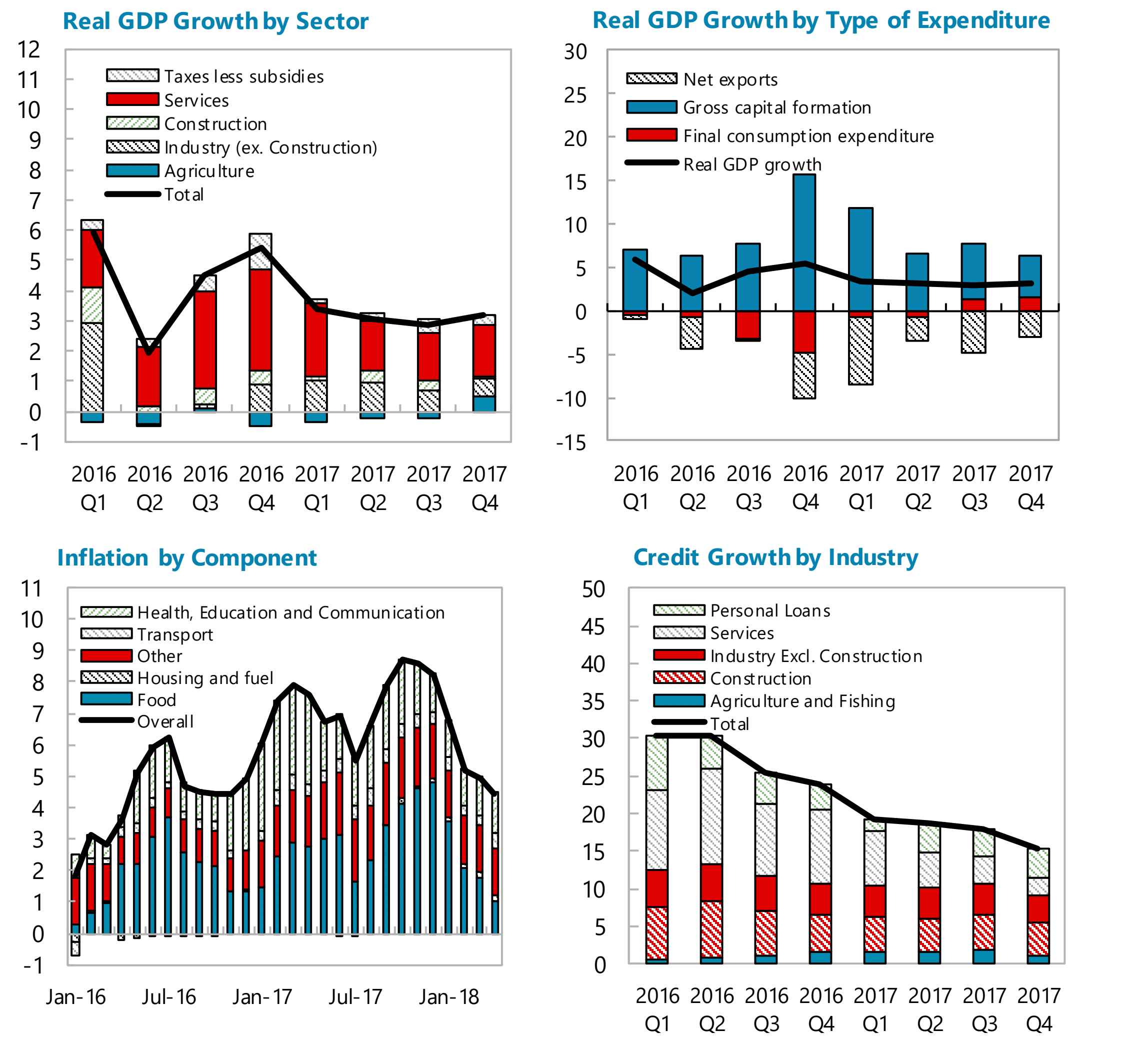
- *Real GDP growth* slowed to 3.1 percent in 2017, reflecting a contraction in agriculture from large-scale floods and lingering effects of a drought. Nonetheless, industry grew by about 4 percent in 2017, despite a deceleration in construction in the last quarter, while services and agriculture started to normalize in 2017Q4.[2] On the expenditure side, the 2017 slowdown reflected weak public and private consumption, and higher weather-related imports. While the economy is operating below potential, with a negative output gap of 0.3 percent in 2017, a pick-up in Purchasing Managers' Index readings in March 2018 points to a gradual recovery in economic activity.

- *Headline Colombo CPI inflation* peaked at 7.8 percent (y/y) in October 2017, driven by spikes in food inflation caused by domestic supply shortages following the floods and drought. It declined to 3.8 percent in April 2018, as agriculture production and food inflation normalized. Core inflation stood at 3.5 percent in April.

[2] National Income Account data for 2015 and 2016 were revised by the Department of Census and Statistics in March 2018, resulting in higher nominal GDP figures.

Sri Lanka: Recent Macroeconomic Developments

(In percent, year-on-year contribution)



Sources: CBSL; and IMF staff estimates.

- The *current account deficit* widened to 2.6 percent of GDP in 2017 from 2.2 percent in 2016, due to weather-related imports of food and fuel. Exports of goods grew at 10 percent in 2017, with improved access to EU trading partners from the Generalized Scheme of Preferences (GSP+) supporting seafood and textile exports. *Capital inflows* resumed in early 2017 accompanied by a strong rebound in portfolio inflows and FDI, which rose by 79 percent and 97 percent (y/y), respectively. Treasury bond yields declined by about 200 basis points during 2017, and the EMBI spread stabilized. Despite some market volatility and a moderation in portfolio flows in 2018Q1, the government successfully placed a US$2.5 billion international bond in April. *Gross international reserves* (GIR) increased from $7.3 billion at end-2015 to $8.0 billion at end-2017, although they remained relatively low at 3.6 months of imports and 69 percent of the ARA metrics. The rupee remained relatively stable against the US dollar in 2017, followed by a depreciation of around 3 percent as of mid-May 2018.

- *Credit growth* decelerated gradually to 14.7 percent (y/y) in December 2017 from its 28.5 percent peak in July 2016. However, credit to construction continued to grow rapidly at around 22.5 percent in 2017, reflecting buoyant real estate markets for both personal and commercial properties.[3] Land prices in Colombo appreciated by 10.4 percent (y/y) in December 2017. Real lending rates stood at above 5 percent for most of 2017 but increased to about 7 percent in February 2018 with the deceleration in inflation.

OUTLOOK AND RISKS

6. **The economy is projected to normalize gradually after the recent shocks.** Real GDP growth is expected to rise to 4 percent in 2018, supported by robust service growth and a sustained recovery in agriculture and industry led by construction. Consumption is projected to contribute positively to growth, offsetting the negative impulse from fiscal consolidation, estimated at 0.3 percent of GDP. Over the medium term, growth is expected to rise to about 5 percent, though still below its historical average, with TFP growth reaching 2 percent. With signs of a rebound in agricultural production and food prices stabilizing, inflation is projected to decline below 5 percent—the mid-point of the CBSL target—by end-2018.

7. **The balance of risks remains significantly tilted to the downside** (Annex II). Key domestic risks include implementation delays in fiscal reforms, exacerbated by political uncertainty in the run-up to the elections; new weather calamities leading to a slower-than-expected recovery in agriculture and high food inflation; and a reacceleration of credit growth, particularly in real estate, adding to macro-financial vulnerabilities. Against the backdrop of high public debt and large government financing needs, the main external risk stems from tighter global financial liquidity conditions, with a reversal of portfolio inflows raising government borrowing costs and slowing the buildup of foreign reserves. Structurally weak growth in key advanced economies or a significant slowdown in China could also lower exports of goods, tourism, and FDI inflows. On the upside, stronger external demand and FDI inflows could support activity.

8. **Sri Lanka's external position in 2017 was broadly consistent with fundamentals and desirable policy settings, but it remains vulnerable to shocks amid rising market volatility** (Annex III). The EBA-based current account gap for 2017 is estimated at -0.5 percent of GDP. The unexplained residual of the model may point to the need for further structural reforms to improve competitiveness. The CA gap estimates suggest a small REER overvaluation (3 percent), although alternative ones based on the EBA-lite REER model suggest a somewhat higher one (14 percent). External debt is sustainable, but currency and rollover risks remain high, in the context of still low

[3] See Selected Issues Paper "Sri Lanka's Credit Expansion: Engineering a Soft Landing while Financing Growth?"

reserve coverage, structural rigidities hampering competitiveness, and rising domestic and external volatility.

Authorities' Views

9. The authorities expect a stronger growth rebound for 2018 and beyond. While concurring with staff on the significant downside risks to the outlook, the CBSL projects growth to reach slightly above 5 percent in 2018 and accelerate to about 6 percent over the medium term, as various infrastructure projects, including the Colombo Port City Project, gather momentum. The CBSL projects headline inflation to stay within the targeted levels during 2018. With rising interest rates in real terms, the authorities project credit to grow at a sustainable level while noting that the real estate sector needs to be closely monitored. The authorities reiterated their commitment to implement economic reforms, despite recent political uncertainty. The authorities agreed that the country's external position is broadly consistent with fundamentals, while noting that staff's assessment of the CA gap and implied REER overvaluation was subject to a high degree of uncertainty.

ARTICLE IV DISCUSSIONS: STRENGTHENING INSTITUTIONS TO PROMOTE STABILITY AND INCLUSIVE GROWTH

A. Advancing Fiscal Consolidation through Stronger Institutions

The authorities remain committed to a fiscal deficit target of 3.5 percent of GDP by 2020 through greater revenue mobilization. In view of still high risks to public debt sustainability, discussions focused on the fiscal consolidation path and the need to strengthen institutions through more robust fiscal rules and medium-term debt management.

Background

10. Sri Lanka's fiscal consolidation efforts have advanced under the program, despite slower revenue mobilization and disaster-related spending. The primary balance reached a small surplus in 2017, from a deficit of 2.2 percent of GDP in 2015. The improvement was due to lower current non-interest expenditure (1.7 percentage points) and higher revenues (0.5 percentage points), with the tax to GDP ratio improving by 0.2 percentage points and falling slightly short of the 2017 target. The increase in VAT collections due to the 2016 VAT amendments (1.3 percent of GDP) was more than offset by: (i) the unwinding of temporary revenue increases in 2015 (about 1 percent of GDP); (ii) weak excise collections from lower liquor and tobacco sales; and (iii) a delay in implementing the new IRA. Nonetheless, capital expenditure remained broadly unchanged, while a realignment in the 2017 budget accommodated disaster-related spending of 0.4 percent of GDP, resulting in an overall fiscal deficit of 5.5 percent of GDP. Gross public debt stood at 84.6 percent of

GDP in 2017, broadly unchanged from 2016, as favorable debt dynamics were offset by the reclassification of the Hambantota Port loan from the Sri Lanka Ports Authority to the central government (Annex IV, Box 3).

11. Progress with fiscal structural reforms continues. The new IRA, a flagship reform under the program, was enacted in October 2017 and implemented in April 2018, one year later than originally envisaged. The new Act drastically simplifies the tax system in line with international best practice and is expected to boost income tax collections by ½ percent of GDP through rationalization of tax exemptions. Similarly, the 2016 VAT amendments not only raised the VAT rate from 11 percent to 15 percent but also substantially broadened the VAT base by removing exemptions, such as on telecommunications. The authorities also implemented risk-based VAT administration, rolled out the new Revenue Administration Management Information System (RAMIS), and introduced spending commitment controls.

12. The authorities' 2018 budget targets a primary surplus of 1 percent of GDP. The IRA and additional measures in the budget are expected to deliver 0.9 percent of GDP in revenue. The authorities' reduction of import duties on gasoline and diesel in December 2017 to mitigate losses of SOEs amid rising global prices is expected to lower revenue by ¼ percent of GDP in 2018. This shortfall is expected to be met by rationalizing and prioritizing capital spending, unless revenue performance is stronger than anticipated.

Sri Lanka: Summary of Central Government Operations

(In percent of GDP)

	2015	2016	2017			2018		2019	2020	
			EFF request	EFF 3rd review	Est.	EFF 3rd review	Proj.	Proj.	EFF request	Proj.
Total Revenue and grants	13.3	14.2	14.0	14.2	13.8	15.0	14.7	15.9	15.8	16.0
Of which: tax revenue	12.4	12.3	12.9	12.9	12.6	13.7	13.4	14.6	14.6	14.7
Total Expenditure	20.4	19.6	18.8	19.9	19.4	20.0	19.2	19.5	19.3	19.5
Current Expenditure	15.5	14.8	13.9	15.1	14.5	15.3	14.5	14.6	13.6	14.7
Of which: interest	4.8	5.1	4.7	5.5	5.5	5.9	5.6	5.6	4.5	5.6
Capital Expenditure	4.8	4.8	4.9	4.8	4.9	4.7	4.7	4.9	5.6	4.9
Overall balance	-7.0	-5.4	-4.7	-5.7	-5.5	-5.0	-4.5	-3.6	-3.5	-3.5
Primary balance	-2.2	-0.2	0.0	-0.2	0.0	1.0	1.0	2.0	1.0	2.1
Non-interest expenditure	15.5	14.5	14.1	14.4	13.8	14.0	13.7	13.9	14.8	13.9

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

Policy Discussions

13. Risks to public debt sustainability remain elevated (Annex IV). Gross public debt is projected at 83.7 percent of GDP in 2018, well-above peer emerging markets. This is in the context of sizable gross financing needs of around 18.6 percent of GDP in 2018 and international bond redemptions in 2019-22. Going forward, sustained fiscal efforts to reach an overall deficit of 3.5 percent of GDP by 2020 are expected to lower the debt ratio to 80 percent of GDP by 2020 and, under unchanged policies, to 73 percent by 2023, reducing the risk of debt distress. Sensitivity analyses point to high debt sustainability risks, especially if sizable contingent liabilities from SOEs, estimated at about 11 percent of GDP in 2017, were to materialize.

14. Frontloading fiscal consolidation in 2019 through further revenue mobilization will help anchor confidence in fiscal policy management. The authorities remain committed to a primary surplus of 2 percent of GDP in 2019, in line with the third EFF program review. Based on updated interest payment projections, this would advance their fiscal consolidation plans and help anchor investor confidence amid looming financing needs. Meeting the 2019 primary balance target will require additional measures of about 1 percent of GDP (see table). In staff's view, the package should focus on domestic revenue mobilization, due to limited room for further expenditure cuts and need to protect or raise social spending. Given the ambitious base-broadening already realized under the 2016 VAT amendments and envisaged under the IRA, staff discussed a menu of tax options for the 2019 budget, which included removing remaining VAT exemptions, expanding labor income tax withholding, and raising excise rates for fuel.[4] Efforts to strengthen tax compliance should be also stepped up (MEFP ¶12), to create space for para-tariff rationalization.

Sri Lanka: Illustrative Composition of Fiscal Consolidation for 2019
(In percent of GDP)

Revenue	**+1.25**
Baseline 1/	**+0.25**
IRA base effect	+0.25
Measures	**+1.00**
Strengthen labor income tax collections	+0.30
- Expand PIT withholding	
Eliminate VAT exemptions	+0.30
- Electricity, LPG, selected food products	
Raise petroleum excise rates	+0.40
- Unwind December 2017 cuts in import duty	+0.25
- Additional rate increase	+0.15
Strengthen tobacco and alcohol excises	+
- Measures to reduce smuggling	
Improved tax compliance	+
Rationalize para-tariffs	-
Non-interest expenditure	**+0.25**
Social safety net, healthcare, natural disasters	+
Capital spending	+
Other	0.00
Primary balance	**+1.00**

Source: IMF staff estimates.
1/ Assumes raising excise tax rates in line with inflation.

15. Improving efficiency of infrastructure spending can create space for social safety nets and natural disaster mitigation. Based on the IMF/World Bank Public Investment Management Assessment (PIMA), there is still ample scope to enhance public investment efficiency by upgrading the medium-term expenditure framework with binding multi-year spending ceilings, introducing systematic project appraisal and selection, and strengthening commitment-based spending controls by fully rolling out the new public financial management IT system (ITMIS). Savings could help expand coverage of social safety nets (¶47), accommodate gender and contingency budgeting for natural disasters (¶48-49), as well as improve public healthcare to reduce out-of-pocket costs.

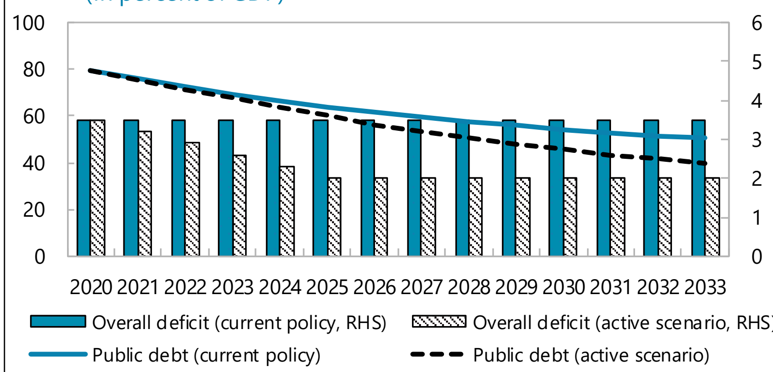
16. A stronger fiscal rule can help anchor debt sustainability beyond 2020.[5] In line with their *Vision 2025*, the authorities plan to upgrade the Fiscal Management (Responsibility) Act (FMA), which contains ceilings on central government debt, the budget deficit, and government

[4] The latter to offset the reduction in fuel import duties in December 2017.

[5] See Selected Issues Paper "Toward Second-Generation Fiscal Rules in Sri Lanka."

guarantees, but insufficient enforcement mechanisms and corrective actions. Given the still high risk to debt sustainability, staff recommended a more ambitious consolidation path beyond the program period than the overall deficit of 3.5 percent of GDP envisaged under current policies. Specifically, a reduction of the deficit to 2 percent of GDP by 2025 would bring the debt ratio to 50 percent by 2029, closer to the median debt ratios for emerging markets (active scenario; see chart).[6] If the fiscal deficit is maintained at 3.5 percent of GDP from 2020 onwards, the debt ratio would converge to 50 percent only in 2034. Given the repeated breaches under the existing FMA, a revised fiscal rule should also contain mechanisms to raise the reputational cost of noncompliance, including transparent monitoring, correction mechanisms, and clearly defined escape clauses. To reduce risks from quasi-fiscal operations, coverage of fiscal accounts should be as broad as possible under the rule to include extrabudgetary and quasi-fiscal operations.

Sri Lanka: Fiscal Deficit and Public Debt Paths
(In percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

17. Stronger debt management and fiscal reporting can also support investor confidence. Staff welcomed important steps taken to manage large external repayments in coming years, including cabinet approval of a strategy to cope with maturing international sovereign bonds and parliament approval of the Liability Management Act. To further strengthen debt management, the authorities are working on a proposal to consolidate debt management functions into an independent public debt management agency in charge of developing, implementing, and periodically publishing the Medium-Term Debt Management Strategy (MTDS), in line with global best practice. These arrangements would support investors' confidence and reduce issuance costs over time. Contingent risks from guaranteed debt can be mitigated by tightening the selection criteria and setting an administrative limit on the stock of guarantees. Staff also welcomed the authorities' plan to compile fiscal data in line with the 2014 Government Finance Statistics Manual, to clarify the perimeter of fiscal activities including quasi-fiscal operations of SOEs (MEFP ¶9).

Authorities' Views

18. The authorities reiterated their commitment to the 2020 fiscal target. They highlighted important progress in meeting the fiscal targets through revenue mobilization, emphasizing that the new IRA will not only boost revenues but also make Sri Lanka's tax system more equitable, by raising the share of direct taxes vis-à-vis indirect taxes. In view of lackluster growth in 2017, they agreed on

[6] Staff simulation shows that targeting a debt ratio of 50 percent of GDP over the medium-term would keep the debt ratio below the debt distress threshold for emerging markets of 70 percent with a 90 percent probability.

the need to make fiscal consolidation in 2018–19 as growth-friendly as possible, and address social and distributional consequences through expenditure reorientation toward priority areas. They highlighted that fiscal performance would continue to be reported to parliament on a quarterly basis, and any revenue shortfalls would prompt the government to realign expenditure under parliamentary oversight. The authorities agreed on the benefit of strengthening fiscal rules, public debt management, including by establishing an independent office, and fiscal reporting, and expressed interest in IMF and World Bank Technical Assistance (TA). While agreeing that strengthening fiscal rules is important, the authorities emphasized the importance of balancing growth and debt reduction considerations when defining the fiscal path beyond 2020.

B. Strengthening SOE Governance and Reducing Fiscal Risks

Given the sizable quasi-fiscal risks posed by SOEs to fiscal balance sheets, discussions focused on the remaining steps to institutionalize performance-based SOE supervision, complete energy pricing reforms, and expedite restructuring of Sri Lankan Airlines.

Background

19. The large and inefficient SOE sector continues to pose substantial fiscal risks. SOEs' financial obligations, estimated at 11 percent of GDP in 2017, consist mainly of project loans, short-term bank loans linked to fuel subsidies, and aircraft lease commitments. SOEs have engaged in quasi-fiscal operations such as supplying energy at subsidized prices and funding infrastructure projects, with their debt absorbed by the government in times of difficulties. Lack of transparency, including delays in publishing audited financial statements, has raised concerns over undisclosed liabilities. The authorities published Statements of Corporate Intent (SCIs) for 5 major SOEs in 2017 as a first step toward stronger governance and transparency.[7] Financial losses by Sri Lankan Airlines averaged 0.1-0.4 percent of GDP per year in 2011-17 and attempts to find a strategic partner have been unsuccessful so far.

Sri Lanka: Performance of CEB, CPC, and SLA, 2017

	Ceylon Electricity Board (CEB)		Ceylon Petroleum Corp. (CPC)		SriLankan Airlines (SLA)	
	Rupees billions	% of annual GDP	Rupees billions	% of annual GDP	Rupees billions	% of annual GDP
Revenue	227	1.7	457	3.4	150	1.1
Expenditure	275	2.1	454	3.4	168	1.3
Balance	-47	-0.4	4	0.0	-18	-0.1
Memorandum item:						
Outstanding financial obligations, end-2017	307	2.3	387	2.9	369	2.8

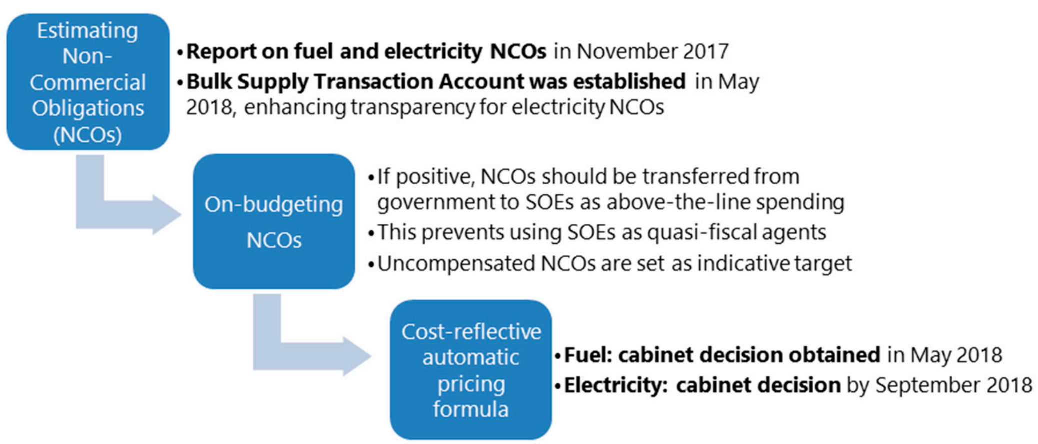
Sources: Sri Lankan authorities; and IMF staff estimates.

[7] Each SCI encompasses the SOE's mission, multiyear corporate plan, and performance indicators, providing the basis for enhanced oversight and financial discipline.

20. The authorities have made important progress with energy pricing reforms to address these risks. Fuel and electricity prices have been set administratively on an ad hoc basis and left unchanged since 2015, resulting in off-budget energy subsidies that have benefitted disproportionally the rich. In 2017Q4, the cost of non-commercial obligations (NCOs) to supply energy at prices below cost-recovery levels reached 0.2 percent of GDP. The authorities' planned reforms under the program aim at expensing NCOs within the budget limit and eventually eliminating them by setting retail prices above cost-recovery levels. Recent progress includes:

- Cabinet approved in May 2018 an *automatic fuel pricing mechanism* with immediate effect. As a result, one-off increases in gasoline, diesel, and kerosene prices were implemented to bring prices back in line with cost recovery levels. Going forward, formula-based price adjustments will take place on a quarterly basis. A targeted kerosene subsidy is planned by end-May to mitigate the distributional impact of the reform.
- The authorities have taken steps toward an *automatic electricity pricing mechanism*. An electricity tariff methodology was issued by the Public Utilities Commission in 2015 but remains to be implemented. A Bulk Supply Transaction Account (BSTA) was established in May 2018 to enhance transparency on electricity NCOs, as a precondition for the implementation of the automatic pricing mechanism, whose cabinet approval is envisaged by September.

Sri Lanka: Sequence of Energy Pricing Reforms



Source: IMF staff. Actions in bold are structural benchmarks under the EFF-supported program.

Policy Discussions

21. Further steps are needed to strengthen SOE governance and transparency. Building on earlier progress, discussions focused on how to use SCIs as a vehicle to monitor SOE performance and disseminate results periodically to the public. Staff welcomed the plan of the Ministry of Finance (MOF) to prepare SCI compliance reports biannually on key performance indicators for each SOE. Because SOE financial data are critical to assess contingent fiscal liabilities, staff urged the authorities to accelerate publication of audited financial statements.

22. Staff welcomed important progress with energy pricing reforms. Cabinet approval of the automatic fuel pricing formula and the BSTA establishment mark a clean break from the past. While energy prices reforms are fully implemented, the authorities committed to recognize the quasi-fiscal cost of fuel and electricity NCOs as central government expenditure to prevent further buildup of contingent liabilities. Staff also emphasized the importance of speeding up social safety net reforms, starting with the establishment of a social registry and means-testing criteria (¶47), to compensate the poor for higher energy prices as necessary.

23. The authorities stepped up efforts to restructure Sri Lankan Airlines (SLA), but implementation will be key. The newly established Restructuring Committee has engaged with an expert airline consulting firm to develop a detailed restructuring plan, updating the resolution strategy devised in 2015. Designed to place the airline on a sound financial and operational footing, the plan is expected to include further network and fleet optimization as well as debt resolution, and will be operationalized by a new board appointed in March. Staff welcomed the progress and urged the authorities to implement the restructuring plan expeditiously.

Authorities' Views

24. The authorities agreed on the need to further advance SOE reforms to contain fiscal risks. The authorities saw merit in greater transparency in SOEs' financial operations and prepared the first SCI compliance report in May. While they agreed on the importance to accelerate publication of SOEs' audited financial statements, they noted capacity constraints. The authorities intend to complete energy pricing reforms by 2018 and, with the appointment of a new Board for Sri Lankan Airlines, expect the implementation of the restructuring plan to advance rapidly and allow for the identification of a strategic partner. They recently established a PPP unit in the MOF to support this process and improve Sri Lanka's public-private partnership framework.

C. Modernizing Monetary and Exchange Rate Policy Frameworks

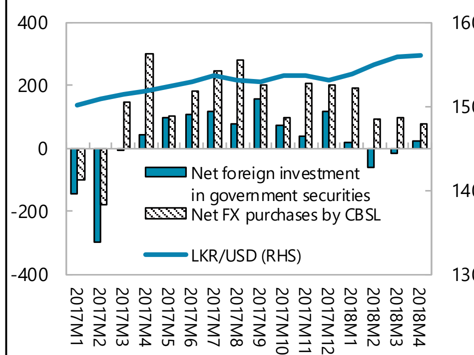
The CBSL has prudently managed monetary policy and accumulated reserves through FX purchases from the market. Discussions focused on the monetary policy stance, the pace of reserve accumulation amid rising uncertainty, as well as the next steps in implementing the roadmap to inflation targeting and a fully flexible exchange rate regime.

Background

25. The CBSL has managed monetary policy prudently in the face of several shocks. Throughout 2016–17, the CBSL maintained a tightening bias, raising the policy rate corridor three times to 7.25–8.75 percent through March 2017 and keeping real lending rates above 5 percent since mid-2016. While headline inflation temporarily breached the CBSL's consultation band in late 2017, mainly due to food price shocks, it has since fallen to 3.8 percent in April 2018. In view of lower inflation and lackluster growth, the CBSL lowered the standing lending facility rate by 25 basis points in April 2018, narrowing the policy rate corridor.

26. Since March 2017, the CBSL has steadily built up reserves through FX purchases. During October 2016-February 2017, the CBSL intervened in the FX market to reduce excessive exchange rate volatility in the face of large portfolio outflows. As a result, GIR declined to $6 billion by end-2016, with coverage dropping to about 3 months of next year's imports or 55 percent of the Fund's Assessing Reserve Adequacy (ARA) metrics. As portfolio inflows recovered in March 2017, the CBSL resumed FX purchases and overperformed against the end-2017 NIR target, purchasing on average $200 million per month. In the first part of 2018, the CBSL has continued to intervene in the FX market to accumulate reserves, although with some net FX sales during the most recent period of volatility. The CBSL has also allowed greater exchange rate flexibility, although currency volatility remains lower than in EM peers (Annex III). The CBSL also unwounded FX swaps with commercial banks from $2.5 billion at end-2016 to $1.2 billion in March 2018.

CBSL FX purchases, 2017-18
(In millions of U.S. dollars)



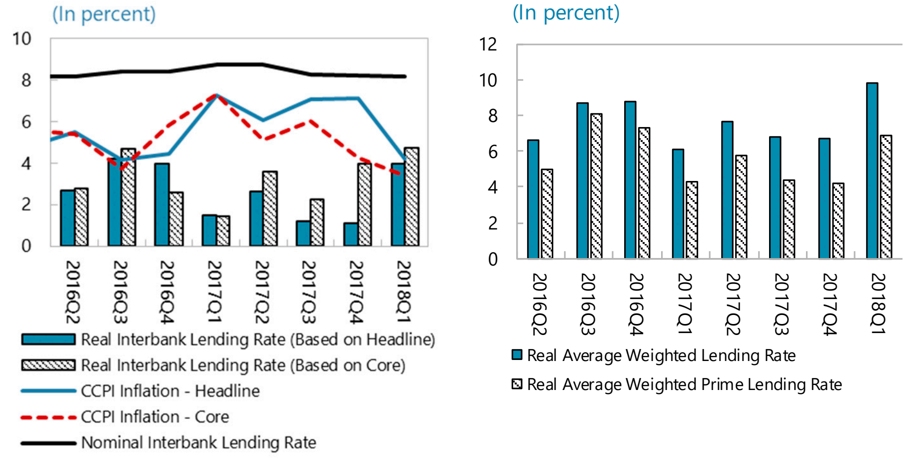
Sources: CBSL; and IMF staff estimates.

Policy Discussions

27. Monetary policy should remain vigilant and stand ready to adjust to evolving macroeconomic conditions. Despite the recent monetary loosening, staff projects inflation to remain slightly below 5 percent, the midpoint of the CBSL's target band, by end-year. The CBSL's cut in the interest rate reflected concerns about lower than expected growth beyond supply shocks, in the context of rising interest rates in real terms. While supporting the move, staff recommended a prudent data-dependent approach going forward, with any adjustment to the policy rate reflecting evolving macroeconomic conditions. This would balance downside risks to inflation from a weaker

Interbank Rates
(In percent)

Real Lending Rates
(In percent)

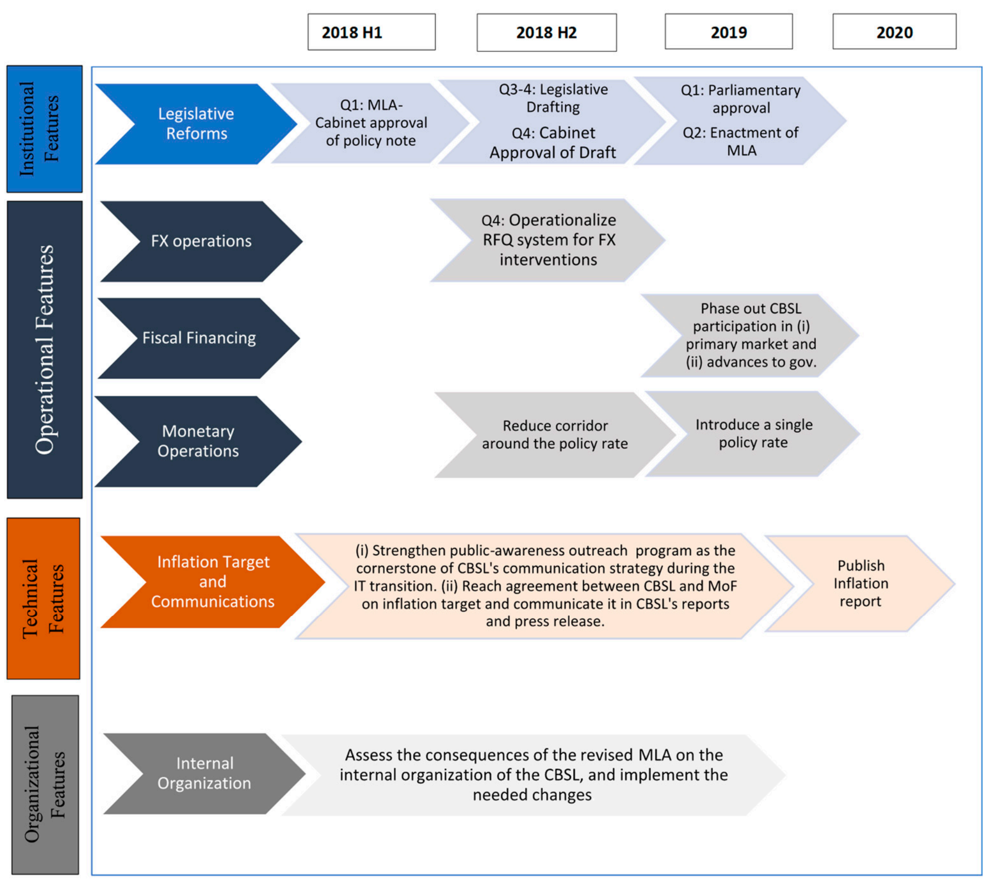


Sources: CBSL; and IMF staff estimates.

than projected economic recovery and a still negative output gap against upside risks from potential fiscal slippages and still robust credit growth. In addition, the CBSL should be vigilant against rising BOP pressures from domestic political uncertainty or global market conditions.

28. Upgrading the central bank law will be instrumental for the new inflation targeting framework. In October 2017, the CBSL adopted a comprehensive Roadmap for transitioning to inflation targeting and greater exchange rate flexibility by 2020, supported by IMF TA. A key milestone in the Roadmap is revising the Monetary Law Act (MLA) to strengthen the CBSL's mandate, autonomy, governance arrangements, transparency, and accountability. Cabinet recently approved a policy note with the key elements of the MLA amendments to be submitted to parliament by March 2019, including, among others, setting price stability as the CBSL's primary objective, ensuring operational autonomy by removing MOF voting rights in the monetary policy formulation process, and restricting CBSL's financing of the fiscal deficit.

Sri Lanka: Roadmap for Transition to Inflation Targeting by 2020



Source: IMF staff.

29. Further efforts to bolster international reserves and promote greater exchange rate flexibility are critical. Staff underscored the need to sustain the pace of reserve build-up to bolster the still low ARA metrics ratio and underpin market confidence ahead of large external debt repayments next year. Staff supported the CBSL's purchases in the FX market to accumulate reserves and stressed that exchange rate flexibility should be the first line of defense, in the event of a capital flow reversal. This would help increase two-way movements in the exchange rate and deepen the FX market. Staff also welcomed the CBSL's plan to intervene in FX markets through a Request-for-Quotes (RFQ) system (¶55).

30. Capital flow liberalization should be properly sequenced with macroeconomic adjustment and supporting reforms. Staff welcomed the new Foreign Exchange Act, which modernized the FX-related regulations by replacing the 1953 regime of exchange arrangements and provided market participants with more clarity on FX transactions. The FX repatriation requirements, introduced in April 2016 amid substantial BOP pressures, constitute a capital flow management measure (Annex III). Based on the Fund's Institutional View on capital flows, staff recommended removal of the measure with the timing linked to progress in macroeconomic adjustment and reserve buildup by the end of the program.

Authorities' Views

31. The authorities broadly concurred with staff views. The CBSL relaxed monetary policy, leaving its earlier tightening bias, due to lower than expected growth, low inflation, and high real interest rates. At the same time, they also noted that risks arising from global economic developments and the domestic fiscal front needed to be closely monitored going forward. The CBSL will continue to manage monetary policy prudently, monitoring closely macro-economic developments, and narrowing the policy corridor, as warranted, as they move toward inflation targeting. The authorities remain committed to implementing inflation targeting by 2020, as outlined in their Roadmap. The CBSL's FX purchases to accumulate reserves and the wind down of FX swaps with commercial banks have improved the level and quality of reserves. Further efforts toward greater exchange rate flexibility needed to proceed cautiously to guard against unforeseen market disruptions. However, the CBSL is committed to finalizing the RFQ system design and start its operation for FX interventions by end-year. The authorities planned to gradually liberalize the capital account and will assess removing the FX repatriation requirement, while noting that reforms will need to be timed with macroeconomic and market conditions.

D. Strengthening Financial Sector Resilience

While banks' balance sheets remain sound, continued efforts are needed to strengthen the resilience of the financial sector. Discussions focused on the systemic implications and policy response to rapid credit growth, progress with Basel III implementation and non-bank supervision, as well as actions to improve the AML/CFT regime.

Background

32. **Financial soundness indicators are generally sound for the banking sector, although weaknesses remain in non-banks.** Banks account for two thirds of total financial sector assets. Despite rapid credit growth, their capital adequacy ratio (CAR) stabilized at 15.2 percent in 2017, and NPL and provision coverage ratios improved to 2.5 and 70 percent, respectively. Non-bank financial institutions (NBFIs), leasing and financing companies which account for about 9 percent of total financial sector assets and cater to high-risk borrowers, are generally well capitalized with CAR at 13.1 percent by end-2017. However, ten NBFIs (out of 52 in total and not systemic in size) are either in negative equity or show other financial strains.

Sri Lanka: Selected Bank and NBFI Indicators, 2017

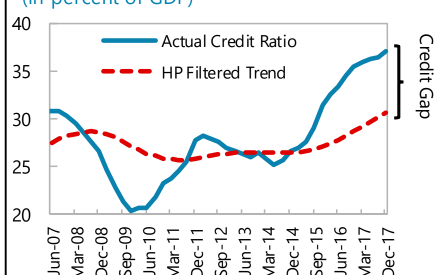
	Total assets (billions of rupees)	Total assets (percent of GDP)	Risk weighted CAR (percent)	Gross NPL to total gross loans (percent)	Provision coverage ratio (percent)
Banks					
Licensed Commercial Banks	8,926	8,926.4	15.2	2.3	77.8
Licensed Specialised Banks	1,366	1,366.2	15.0	4.3	31.1
Non-Bank Financial Institutions					
Licensed Finance Companies	1,227	1,227.5	11.5	6.3	63.5
Specialised Leasing Companies	128	127.5	34.9	2.1	80.8

Source: CBSL.

Policy Discussions

33. **Further macroprudential measures (MPMs) can help contain excessive credit growth.** Credit growth has decelerated gradually since mid-2016, likely reflecting a tightening bias in monetary policy and MPMs, including stricter LTV limits on vehicle loans. While staff's stress test analysis indicates that a rapid credit unwinding is unlikely to pose systemic risks,[8] credit gap estimates remain large at about 6 percent of GDP with credit concentrated in the construction sector. If credit pressures were to reemerge in this or other segments, further MPMs could be considered, including lower LTV limits and higher risk weights on mortgages and construction sector loans, as well as debt-to-income limits on consumer credit.

Sri Lanka: Credit Ratio and Cyclical Trend
(In percent of GDP)



Notes: 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). Various values of lambda were used, all of which gave a positive credit gap.
Sources: CBSL; and IMF staff estimates.

34. **Sri Lankan banks are strengthening their capital positions under Basel III migration.** The migration timeframe imposes a minimum CAR of 14 percent for six systemic banks and 12.5 percent for others by January 2019. Although the banking sector appears well prepared to meet the requirements, risks remain that an adverse shock could weaken asset quality and compel banks to raise additional capital. Staff recommended preparing contingency plans, including through consolidation of banks that may not meet the requirement to raise additional capital. A Financial System Stability Review is planned for FY2019.

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[8] See Selected Issues Paper "Sri Lanka's Credit Expansion: Engineering a Soft Landing while Financing Growth?"

35. **Staff welcomed steps to strengthen NBFI supervision.** The CBSL's six-fold increase in the end-2020 minimum equity capital requirement for NBFIs is expected to strengthen capital positions, while promoting consolidation of small institutions. With support from IMF TA, the CBSL also established a new Resolution and Enforcement Department, which is developing the legal foundation and staff capacity to commence enforcement actions. Staff recommended the CBSL to develop a comprehensive strategy to subject NBFIs to a level of oversight in line with their risks, and promptly resolve weak NBFIs under CBSL supervision.

36. **The authorities have stepped up efforts to improve the AML/CFT regime.** The Financial Intelligence Unit is taking measures to address strategic deficiencies of the AML/CFT framework identified by the Financial Action Task Force (FATF) in 2017, with the goal of having Sri Lanka removed from FATF scrutiny. The authorities plan to amend laws relating to international cooperation and beneficial ownership; ensure implementation of customer due diligence rules and beneficial ownership requirements by financial institutions and designated non-financial businesses and professions (DNFBPs); enhance risk-based supervision for financial institutions and DNFBPs; and establish a targeted financial sanctions regime to implement the relevant United Nations Security Council Resolutions.

Authorities' Views

37. **The authorities viewed the financial system as well-capitalized and stable.** They did not see systemic risks arising from credit to the construction sector but agreed on the need to remain vigilant, especially in high segments of the real estate market. The authorities also plan to amend the MLA to introduce a broader legal framework that facilitates macroprudential surveillance. They noted that banks were on track to fulfill all Basel III requirements, and financial sector weaknesses were concentrated in the NBFI sector. While weak NBFIs were not systemically important, they are working to improve supervision and initiate resolution and enforcement actions with the new Resolution and Enforcement Department. The authorities are committed to swiftly implement the FATF's recommended action plan to address weaknesses in the AML/CFT regime.

E. Accelerating Structural Reforms to Promote Inclusive Growth

Sri Lanka can boost its growth potential through trade liberalization, measures to promote the investment climate and gender equality in the labor market, well-targeted social safety nets, and contingency planning for natural disaster risks.

Background

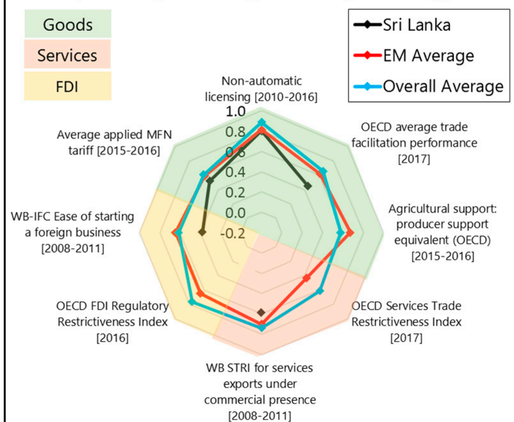
38. **In the authorities' *Vision 2025*, Sri Lanka aims to reach upper-middle income status by 2025.** The strategy, which would transform the country into an export-oriented Indian Ocean hub, shifts away from inward-looking and protectionist policies, and promotes exports, fiscal discipline, price stability, and inclusive growth. Accordingly, the *Vision* includes commitments to deliver over

2018–20 reforms on trade and investment regimes, female labor force participation, social safety nets, disaster risk management, and stronger governance.

39. Sri Lanka has a highly protective trade and investment regime. The introduction of para-tariffs,[9] to shield domestic industries and mobilize fiscal revenues, has effectively doubled the rate of protection in Sri Lanka over the last decade. According to a new IMF cross-country database,[10] trade and FDI regimes in the country are more restrictive than in other EM peers. Similarly, the 2016 World Economic Forum (WEF)'s Enabling Trade Index pointed to Sri Lanka's difficult market access, high tariff rates, and high tariffs faced in destination markets as key challenges. Paying taxes in Sri Lanka was one of the weakest areas identified by the World Bank's 2018 Doing Business indicators, reflecting the complex and unstable tax system and difficulties in trading across borders.

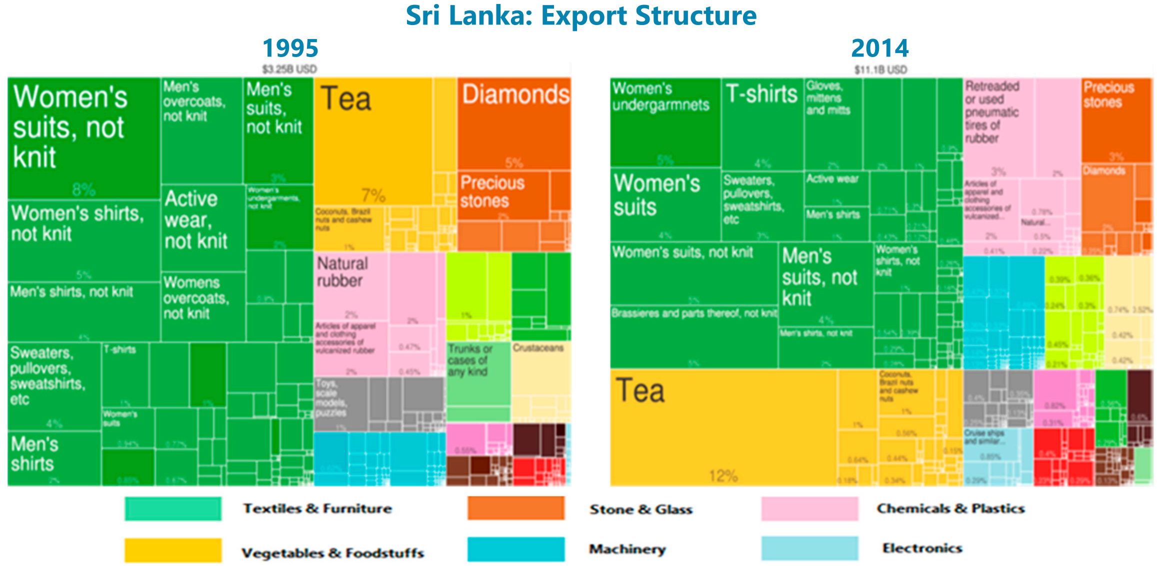
Sri Lanka: Overall Trade and FDI Regime

(0=least open country; 1=most open country)



Notes: The indicators reflect no judgement as to WTO compliance of underlying measures, nor whether certain measures (such as trade defense) are an appropriate response to the action of other countries. The "ease of starting a business" indicator is based on perceptions as part of an established IFC survey process. Year of data is in square brackets. Available indicators are presented for Sri Lanka. Please see IMF WP/18/32 for details.
Sources: WTO, World Tariff Profiles; UNCTAD TRAINS and COMTRADE; OECD; WB STRI, World Bank; Global Trade Alert; and IMF staff estimates.

Sri Lanka: Export Structure



Source: http://atlas.cid.harvard.edu/

40. Protectionist policies have hindered trade diversification and FDI. Sri Lanka's export structure has not changed in decades and remains concentrated in garments, tea, and rubber

[9] Para-tariffs are non-tariff barriers to trade and include the Ports and Airports Development Levy, the Commodity Export Subsidy Scheme, and the Special Commodity Levy.

[10] See IMF Working Paper WP/18/32 for more details.

products. Failure to diversify exports has led to a declining share in global trade. Despite extensive tax incentives, FDI has remained anemic at below 2 percent of GDP, well-below fast-growing Asian peers. Moreover, only a small share of FDI has reached sectors associated with global production and export networks.

41. Inclusive growth has been hindered by vulnerability to natural disasters, weak social safety nets, and low female labor force participation. Sri Lanka is prone to frequent weather-related natural disasters, possibly reflecting climate change, with recent floods and droughts taking a heavy toll (Box 1). While the country successfully reduced extreme poverty rates over the last decade, many households remain vulnerable to falling back into poverty, especially when hit by shocks. Social safety nets suffer from poor targeting and low coverage, with 2012–13 household survey data showing that more than half of the poor received no social safety benefits, while a third of social safety spending went to the richest 60 percent of the population. Despite the high female education attainment, Sri Lanka has a very low female labor force participation, amid an aging population and soon shrinking labor force (Box 2).

Policy Discussions

i. Liberalizing trade and improving the investment climate

42. Trade and economic liberalization can boost productivity growth. Staff analysis suggests that a weak business environment has limited productivity growth arising from mega-scale publicly-financed infrastructure projects in recent years. This contrasts to the 1970s and 80s experience when investment in tradable sectors drove the productivity boost, in the context of trade and market liberalization. Cross-country regressions suggest that product market reforms and tariff reductions could lift Sri Lanka's annual GDP growth by about 0.8 percentage points.[11]

43. The authorities are taking important steps to support trade and FDI. Staff welcomed the authorities' commitment to gradually rationalize para-tariffs and, given their significant revenue contribution (1.8 percent of GDP in 2017), ongoing work to identify alternative domestic revenue sources. Staff also welcomed plans to transition to a predictable, fair, and automated trade regime equipped with a one-stop shop to streamline export and import processes.

44. The new IRA is expected to improve the investment climate substantially. The previous income tax incentive regime, with various tax holidays, profit exemptions, and reduced tax rates, failed to promote FDI. The new IRA replaced it with rule-oriented and investment-based incentives designed to attract firms with substantial up-front investment. Moreover, it should improve Sri Lanka's business environment by promoting predictability and transparency of income taxes, aligning them with international best practice, and developing a level playing field for investors.

[11] See Selected Issues Paper "Sri Lanka: Structural Transformation—The New Frontier."

Box 1. Coping with Natural Disaster Risks[1]

Sri Lanka is prone to natural disasters. Sri Lanka's disaster risk profile is characterized by relatively frequent events with small-to-moderate severity (floods) and infrequent ones with larger impact (cyclones, droughts).[2] The combined average annual loss from natural disasters is estimated at about 0.5 percent of GDP. For high-risk events, Sri Lanka is estimated to face disaster costs of about 2.4 percent of GDP once every 100 years.

Natural disasters have resulted in large ex-post fiscal costs. In 2017, the central government spent 0.4 percent of GDP to cope with the floods and drought. Because spending for rehabilitation and cash support had not been appropriated in the original budget, the government had to realign the budget by mid-year.

Sri Lanka: Government Spending on Natural Disasters, 2017-18

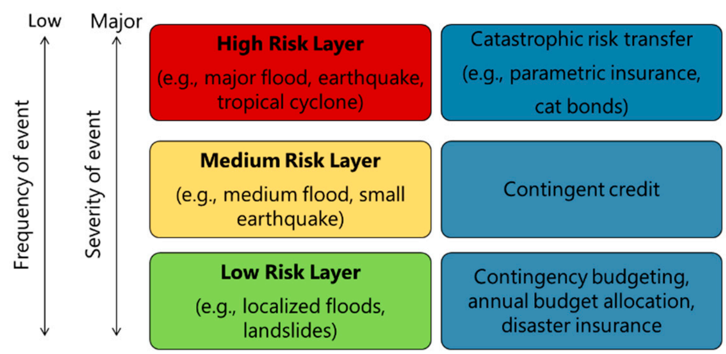
	2017 Actual		2018 Budget	
	Rs bn	% GDP	Rs bn	% GDP
Total	**53.5**	**0.41**	**21.0**	**0.15**
1. Mitigation	0.4	0.00	15.2	0.11
2. Rehabilitation	34.4	0.26	0.6	0.00
3. Cash support	5.2	0.04	0.0	0.00
4. Insurance	5.5	0.04	3.5	0.02
5. Other	8.0	0.06	1.7	0.01

Sources: MOF; and IMF staff estimates.

Public insurance schemes are currently in place to cover the population against disaster risks. Among others, the National Natural Disaster Insurance Scheme (NNDIS), introduced in April 2016, covers all households and small-medium enterprises for property losses caused by disasters (excluding droughts). The flooding in 2016 and 2017 resulted in net losses for the NNDIS, reflecting relatively high costs for reinsurance, which were not fully offset by the premium paid by the government. The World Bank is providing TA to improve risk management for the NNDIS to limit contingent liabilities.

Acknowledging the country vulnerability to weather-related natural disasters, the authorities' *Vision 2025* pledges to improve disaster management. This entails an assessment of the country's disaster risk profile and development of a risk management framework.

Disaster Risk Management: Three-Tiered Approach



Sources: World Bank (2016); and IMF and World Bank staff.

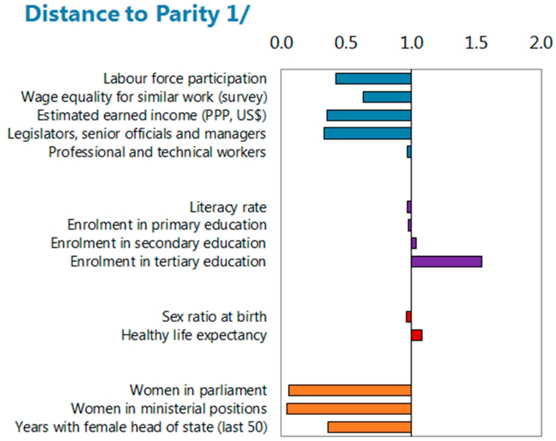
[1]See Selected Issues Paper "Coping with Natural Disaster Risks in Sri Lanka."

[2] See World Bank, 2016, "Fiscal Disaster Risk Assessment and Risk Financing Options: Sri Lanka," Washington, DC.

Box 2. Female Labor Force Participation[1]

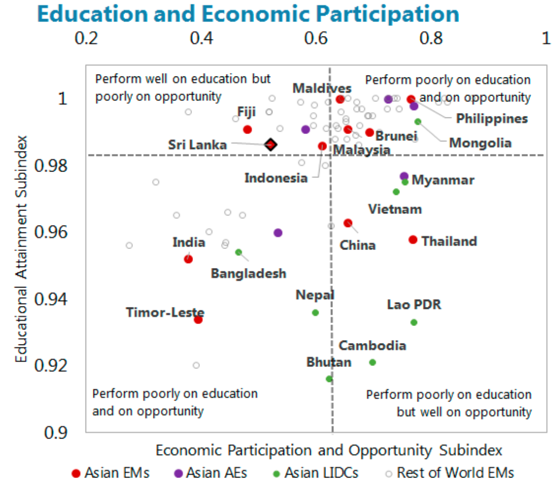
Sri Lanka has been a trendsetter in the region in advancing gender parity in education and health but lags in female labor force participation (FLFP). Provision of free state education and health care has helped women exceed gender parity in tertiary education and health. However, Sri Lanka ranks below peers in economic opportunity for women. The FLFP rate in Sri Lanka fell from 41 percent in 2010 to 37 percent, compared to 75 percent for men, in 2017. Based on the WEF's 2017 Global Gender Report, Sri Lanka's progress towards Economic Participation and Opportunity is relatively weak compared to peers.

Distance to Parity 1/



1/ Less than 1 indicates lower then parity for women

Education and Economic Participation



Notes: The Economic Participation and Opportunity sub-index is based on five indicators, one of which uses a survey to determine wage equality between women and men for similar work. The accuracy of this sub-index can be biased by experts' views (instead of facts on wage equality). This non-IMF indicator provides qualitative information about wage equality based survey. They do not represent the IMF's assessment of the level of wage equality in Sri Lanka.
Source: World Economic Forum; Gender Gap Report 2017.

Enhancing FLFP is estimated to boost incomes significantly. Key drivers of low FLFP in Sri Lanka include a low proportion of high skilled female workers and persistent skill mismatches; outdated labor laws that do not address flexible work arrangements; absence of child care facilities; and poor enforcement of laws for protection of females, especially in transportation. Closing this gap is especially important as Sri Lanka faces an aging population with a labor force that is projected to shrink as early as 2026. Model based simulations indicate that closing the gender gap in 50 years could raise incomes by about 21 percent by the year the gap is closed.[2]

Given this potential, the authorities have identified policies to bridge the gender gap in the labor market. Specifically, the *Vision 2025* has formulated a medium-term strategic plan to remove the above-mentioned constraints. As part of a program to mainstream gender-budgeting in every ministry, the authorities are developing key performance indicators starting with 20 ministries.

[1] See Selected Issues Paper "Female Labor Force Participation: A New Engine of Growth for Sri Lanka?"

[2] Cuberes, Newiak, and Teigner (2017), "Gender Inequality and Macroeconomic Performance", Chapter 3, in "Women, Work, and Economic Growth Leveling the Playing Field", Washington, D.C.

45. To reap the benefits of China's Belt and Road Initiative (BRI), Sri Lanka should carefully manage large-scale capital projects. Sri Lanka has undertaken important investment projects under the BRI, including the Hambantota Port and Colombo Port City (Box 3). While these projects can foster Sri Lanka's growth through greater regional trade and financial integration, they should be selected and managed carefully given the country's high public debt and social development needs. Staff stressed with the authorities the importance of sound and transparent project selection, consistency with fiscal targets and mitigation of fiscal risks, including by avoiding special tax treatments or gaps in financial and regulatory frameworks.

Box 3. Hambantota Port and Colombo Port City Projects

China has contributed to infrastructure development in Sri Lanka through direct investment and official loans. Infrastructure-related FDI from China averaged about $200 million annually over 2013–17 (¼ percent of GDP), while outstanding bilateral loans from China to Sri Lanka's public sector, including SOEs, are estimated at about US$4.6 billion at end-2016 (5.8 percent of GDP).[1] In partnership with China, the government has undertaken the development of two major projects, the Hambantota Port and the Colombo Port City, as part of China's Belt and Road Initiative.

- **Hambantota Port.** The port is located on the southern coast of Sri Lanka, close to the east-west shipping route, in the main Indian Ocean sea lane linking the Suez Canal and Malacca Straits. Under the 99-year concession agreement reached in December 2017, China Merchant Port Holdings (CMPH) acquired an 85 percent share in the capital of the Hambantota International Port Group and took charge of developing and operating the port.[2] In return, CMPH will pay the Sri Lankan government a total of US$1.1 billion (1.3 percent of GDP) over December 2017-June 2018. The port had originally been built with bilateral loans from China and started commercial operations in 2012, but suffered from low utilization.

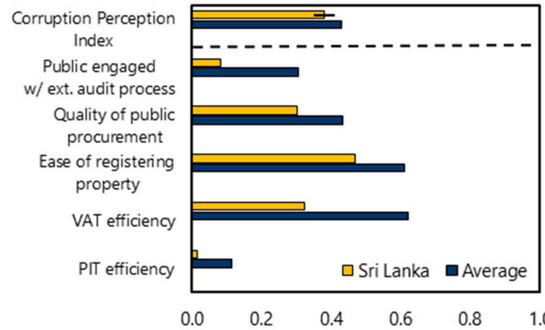
- **Colombo Port City.** The project aims to develop an urban city center on reclaimed land of 269 hectare adjacent to the Colombo Harbor. When completed, the city would accommodate residential, retail, financial, and commercial activities. A project company owned by China Harbour Engineering Company oversees the reclamation, ground improvement, and utility development for the city, with FDI totaling US$1.3 billion (1.5 percent of GDP). The government is considering the introduction of a special regulatory regime for the project.

[1] Based on data provided by the authorities, including Ministry of Finance Annual Reports, and IMF staff estimates.

[2] Based on disclosed information on the concession agreement published in the CMPH website (http://www.cmport.com.hk/en/).

46. The authorities are stepping up efforts to combat corruption. With Sri Lanka faring below peers on corruption-correlated indicators, the government has acted on its good governance and anti-corruption agenda since taking office. A new Audit Bill was submitted to parliament to strengthen the power of the Auditor General, and a special high court is being established to investigate bribery cases.[12] The Commission to Investigate Allegations of Bribery or Corruption is also taking steps to amend, draft, and implement new laws to comply with the United Nations Convention against Corruption treaty. Planned measures to address strategic deficiencies of the AML/CFT framework (¶36) are also critical. Cabinet approved in March a proposal for new provisions in the Companies Act related to ownership disclosure as an anti-money laundering tool. Ongoing efforts under the program to support transparent fiscal management through IT-based tax administration and expenditure management, integrated debt management, and stringent SOE governance can also help mitigate corruption.

Sri Lanka: Corruption Perception and Correlated Indicators (Index value, EMDEs)



Notes: Transparency International Corruption Perception Index is an indicator that measures perception of corruption. A higher value represents lower perceived levels of corruption. The confidence interval around the corruption perception index is also presented in the chart. The accuracy of the index can be biased by experts' views (instead of facts on corruption). Non-IMF indicators provide qualitative information about corruption. They do not represent the IMF's assessment of the level of corruption in Sri Lanka.
Sources: World Bank Doing Business Indicators; World Bank Benchmarking Public Procurement Database; PEFA; Transparency International Corruption Perception Index; and IMF staff estimates.

ii. Making growth more inclusive

47. The authorities should step up efforts to strengthen social safety nets. There is scope to improve targeting accuracy of social assistance programs and expand coverage. Staff urged the authorities to accelerate ongoing reforms, supported by the World Bank, to develop a centralized registry of social safety net beneficiaries and means-testing criteria for all targeted social assistance programs. These will allow the government to properly target cash transfers to mitigate the impact of adverse shocks to the poor and expand coverage to eligible applicants, while promoting exit of non-eligible beneficiaries.

48. Raising female labor force participation can boost growth in the long run. Drawing on recent analytical work, Sri Lanka could raise GDP by as much as 20 percent over the long-term by closing the gender gap in the workforce. Key measures include:

- *Labor law reforms* to support flexible work arrangements such as part-time work, telework, working from home, and night work.
- Effective *gender budgeting* to actively target gender equality, with a focus on vocational training, safe transportation, and child care support.
- Greater *financial inclusion* through access to microfinance institutions and formal financial institutions to promote entrepreneurship among women.

[12] In January 2018, a Presidential Commission, established to investigate any irregularities in government bond sales in 2015, found out that a primary bond dealer had made profits through illegal means.

49. Sri Lanka can benefit from a disaster risk financing framework. Staff welcomed the authorities' efforts to introduce disaster insurance and increase mitigation spending, and discussed options to improve disaster preparedness, with support from the World Bank:

- Starting in 2019, the budget should include *contingency budgeting* for emergency cash support and infrastructure rehabilitation. Unused appropriations can be channeled to build up reserves for future disasters, with stringent transparency requirements.

- The planned introduction of an *automatic pricing mechanism for electricity*, combined with well-targeted safety nets, can help contain fiscal risks from droughts, given Sri Lanka's reliance on hydro electricity generation.

- *Disaster insurance schemes* can be made more cost-effective by minimizing reinsurance costs and targeting coverage for the poor. Over the medium-term, a comprehensive *disaster risk financing strategy* should be developed, in line with Sri Lanka's debt sustainability, together with capacity to implement innovative approaches such as parametric insurance.

Authorities' Views

50. The authorities concurred with the need to accelerate pro-growth structural reforms. They saw trade liberalization and private sector investments as key to transform the economy and highlighted their commitment to phase out inward-looking protectionist policies, given the elevated level of trade restrictions in Sri Lanka compared to peers. However, they noted that trade liberalization would need to proceed gradually with due consideration on adjustment costs for protected industries. They expected the Hambantota Port and Colombo Port City projects to enhance Sri Lanka's growth prospects through greater trade and financial integration. They are strongly committed to their anti-corruption agenda and highlighted the progress made so far. They also continue to work closely with the World Bank to promote gender equality, reform social safety nets, and develop a disaster risk financing framework.

PROGRAM DISCUSSIONS

Program performance is broadly on track. Building on the Article IV discussions, the remainder of the EFF program will focus on institutional reforms in three critical areas: strengthening macro-policy frameworks; delivering long-lasting improvements in fiscal management and governance; and advancing structural reforms towards more sustainable and inclusive growth.

51. Despite recent shocks and some implementation delays, program performance remains broadly on track. The end-December quantitative performance criteria (QPCs) and the end-March indicative targets (ITs) on the primary balance and NIR as well as the continuous QPC on no new external arrears were all met.[13] The end-December and end-March IT on reserve money was

[13] External arrears with the Export Development Bank of Iran were cleared in February 2018 as scheduled.

met, but the IT on tax revenues was missed. Inflation exceeded the upper limit for the inner band under the Monetary Policy Consultation Clause (MPCC) for December, triggering a staff-level consultation. The authorities noted that the deviation reflected the temporary increase in food inflation, following the weather-related shocks, and agreed to remain vigilant against upside risks. Since then, inflation has fallen back within the inner band for March. The authorities implemented all six structural benchmarks (SBs) due by June 2018, although four with a delay.

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

	End-December 2017			End-March 2018 (IT)		
	Target	Actual	Met?	Target	Actual	Met?
Quantitative performance criteria						
Central government primary balance (floor, in billion rupees)	-23	2	Met	15	15	Met
Program net official international reserves (floor, in million US$)	2,212	2,933	Met	-216	-59	Met
Continuous performance criteria						
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	Met	0	0	Met
Monetary policy consultation clause: CPI inflation (y/y, in percent)						
Outer band (upper limit)	8.5	…		7.7	…	
Inner band (upper limit)	7.0	…	Outside	6.2	…	Within
Actual / Center point	5.5	7.5	inner	4.7	4.8	inner
Inner band (lower limit)	4.0	…	band	3.2	…	band
Outer band (lower limit)	2.5	…		1.7	…	
Indicative targets						
Central government tax revenue (floor, in billion rupees)	1,680	1,670	Not met	447	425	Not met
Reserve money of the CBSL (ceiling, stock, in billion rupees)	967	941	Met	1,020	978	Met
Cost of non-commercial obligations for fuel and electricity (ceiling, net of government transfers, in billion rupees)	…	…	…	0	19	Not met

1/ Cumulative from the beginning of the year, except for reserve money and CPI inflation.
Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.

Sri Lanka: EFF–Supported Program: Performance Against Structural Benchmarks

Benchmark	Due by	Status
Fiscal policy		
MOF to publish a detailed IRA tax manual with practical tax and administrative examples.	Jan-18	**Not met (implemented with delay).** The manual was published in May 2018 after the entry into force of the IRA in April.
MOF to implement an IT-based commitment control system with commitment ceilings for line ministries for the 2018 budget.	Jan-18	**Met.** The CIGAS IT system has been modified to accommodate quarterly commitment ceilings to line ministries.
Cabinet to approve a debt management strategy for international sovereign bonds maturing over 2019-22.	Jun-18	**Met.** In January, cabinet approved tender offers and parallel new issues to refinance maturing sovereign bonds from 2019.
SOE reforms		
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.	Mar-18	**Not met (implemented with delay).** Cabinet approved adoption of a cost-reflective fuel pricing mechanism in May.
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.	Mar-18	**Not met (implemented with delay).** The CEB and the PUC established a Bulk Supply Transactions Account in May 2018 and the PUC published monthly data on the account for 2016-17. This is a step in a sequence of reforms to put the automatic electricity pricing reform back on track.
Monetary policy		
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.	Mar-18	**Not met (implemented with delay).** The cabinet approved a policy note to amend the MLA in April.

Source: IMF staff.

A. Fiscal Policy

52. The program supports further revenue-based fiscal consolidation and stronger fiscal institutions:

- **Fiscal targets.** The authorities remain committed to targeting a primary surplus of Rs 141 billion (1 percent of GDP) in 2018. Considering slightly lower than targeted revenues in 2017 and limited prospect to fully offset the impact of the fuel import duty cut in December 2017, the tax revenue IT for 2018 is revised downward from Rs 1,954 billion (13.5 percent of GDP) to Rs 1,934 billion (13.3 percent of GDP).

- **Fiscal rules.** The authorities intend to revise the FMA to strengthen the country's fiscal rules by including legally binding targets, well-defined escape clauses, and correction mechanisms, supported by Fund TA. Cabinet approval of a policy note outlining key elements of the planned amendments is envisaged by March 2019 (proposed SB).

- **Debt management.** To manage large fiscal financing needs in coming years, the authorities plan to approve a MTDS for 2019–23 by October 2018 (proposed SB) and to eventually delegate responsibilities to an independent debt management agency, with cabinet approval of a time-bound plan for its establishment by March 2019 (proposed SB). Fund and World Bank TA will support these efforts. To contain contingent liabilities, a new quantitative IT on government guarantees has been set for end-2018.

B. SOE Reforms

53. The program envisages key steps to complete energy pricing reforms and put SLA on a commercial footing:

- **Energy pricing reforms.** The authorities remain committed to introducing an automatic pricing mechanism for electricity, with cabinet approval by September 2018 (existing SB). MOF plans to compensate CPC and/or CEB for the cost of NCOs which may arise as automatic pricing mechanisms are fully implemented, to meet the IT ceiling for fuel and electricity NCOs (net of government transfers) by end-year.

- **SLA restructuring.** Following the development of a comprehensive restructuring plan (¶23), cabinet is set to approve measures to cut operational and financial costs of SLA by July 2018 (proposed SB) to put the airline on a solid commercial footing.

C. Monetary and Exchange Rate Policies

54. The authorities plan to amend the MLA to lay a solid legal foundation for inflation targeting. Following cabinet approval in April of the policy note outlining the key elements of the

MLA revisions (existing SB), cabinet is set to approve the MLA amendment bill by December 2018 (proposed SB), with a view to submitting the bill to parliament by March 2019.

55. Efforts to build up reserves will continue under greater exchange rate flexibility. The authorities target to increase NIR (program definition) by US$1.771 billion in 2018, bringing the end-2018 GIR to US$9.3 billion, equivalent to 74 percent of the ARA metric and 4 months of import. The authorities will operationalize a RFQ system, under transparent rules and competitive bidding by all banks participating in FX trading, by December 2018 (proposed SB).[14]

D. Structural Reforms

56. As part of the strategy to foster sustainable and inclusive growth, the authorities plan to strengthen social safety nets and advance plans for trade liberalization:

- A new Social Registry, a beneficiary database to determine eligibility to welfare programs, will be developed starting with four major cash transfer programs. To improve coverage and targeting, cabinet is set to approve means-testing criteria by August 2018 (proposed SB).
- Following a stock-taking of Sri Lanka's trade regime, the authorities will prepare a strategy to rationalize remaining para-tariffs over the medium term, together with new revenue sources to offset revenue losses, for cabinet approval by March 2019 (proposed SB).

PROGRAM FINANCING AND MODALITIES

57. The attached Letter of Intent (LOI) and the MEFP describe the authorities' progress and commitments to implement their economic program (Appendix I). QPCs on the primary balance and the NIR for end-December 2018 are proposed (Table 1 attached to the MEFP and the TMU). ITs on tax revenues and reserve money as well as the MPCC band for end-September and December 2018 have been updated to reflect developments since the third review. Eight new SB are proposed for the remainder of the program (Table 2 attached to the MEFP).

58. The program remains fully financed for the next 12 months, but risks remain. While financing needs remain elevated, net domestic fiscal financing for 2018-19 is projected to be lower than expected at the time of the third program review, thanks to ongoing fiscal consolidation and higher cash buffers from the Hambantota Port concession. Market access prospects remain good, given the significant decline in rupee-denominated treasury bond yields since early 2017 and relatively stable sovereign spreads. Financing assurances from the World Bank, the Asian Development Bank, and key bilateral donors are also in place. Nonetheless, given still low external

[14] The system design, including possible implications under Article VIII obligations, will be discussed at the time of the fifth review.

and fiscal buffers, need for further macroeconomic adjustment and/or additional financing could emerge, if significant downside risks were to materialize.

59. Capacity to repay the Fund remains adequate. Fund's exposure is relatively low: outstanding Fund credit will peak at SDR 1,071 million in 2019 (1.6 percent of GDP and 7 percent of goods and services exports), while total debt service to the Fund will peak at SDR 195 million in 2024 (1 percent of goods and services exports) and taper off through 2030. Furthermore, Sri Lanka has an unblemished repayment history with the Fund and a strong external repayment history in general.

60. Notwithstanding the authorities' commitment, risks to the program remain significant. Key risks to the program are still present and include: revenue slippage; weaker than expected net capital inflows and reserves shortfall; lower than expected growth and/or new pressures on the trade account; slow progress in SOE reforms with larger than expected losses; and a reacceleration of credit growth adding to macro-financial vulnerabilities. Despite the authorities' firm commitment for the rest of the program as described in the MEFP, political uncertainty in the run-up to national elections could slow the reform momentum, amplifying these risks.

61. The planned amendments to the MLA are expected to address remaining issues identified by the IMF safeguards assessment. These include measures to strengthen CBSL's institutional, personal, and financial autonomy, as well as governance arrangements, such as removing the government's voting representation in monetary policy decisions, introducing recapitalization provisions, and limiting CBSL credit to the government.

STAFF APPRAISAL

62. The economy is expected to normalize gradually. Real GDP growth is projected to recover in 2018 and over the medium term, supported by a recovery in agriculture and industry and robust growth in services. Nonetheless, the balance of risks remains significantly tilted to the downside, stemming mainly from possible delays in fiscal reforms, political uncertainty, new weather calamities, and a reversal of portfolio inflows.

63. Despite weather-related shocks and some delays in implementation, program performance remains broadly on track. Important progress has been made in fiscal consolidation and energy pricing reforms. The CBSL has been effective in curbing credit growth and stabilizing inflation, while stepping up its pace of reserve accumulation.

64. While Sri Lanka's external position was broadly consistent with fundamentals in 2017, it remains vulnerable to adverse shocks given still sizable public debt and low external buffers. Looking ahead, to secure the hard-won gains under the program and support competitiveness and inclusive growth, the reform momentum needs to accelerate and policy frameworks and institutions to further strengthen.

65. Against this backdrop, the authorities should strengthen institutions to promote inclusive growth and macroeconomic stability. Their *Vision 2025* strategy rightly aims at ambitious structural, macro-economic, and social reforms. Key priorities include: (i) advancing fiscal consolidation through revenue mobilization, a more robust fiscal rule, and stronger SOE governance, (ii) modernizing monetary, financial and exchange rate policy frameworks, and (iii) accelerating growth-enhancing structural reforms.

66. Progress in revenue-based fiscal consolidation is critical to preserve space for public investment and social spending while bringing down public debt. Further revenue mobilization is needed to meet the primary surplus target for 2018–19 and reduce the overall deficit to 3.5 percent of GDP by 2020. The new IRA represents a major achievement towards a simpler and more equitable tax system, and its smooth implementation will be critical. There is also scope to further strengthen efficiency of public investment and social safety nets.

67. Beyond 2020, a well-designed fiscal rule can help build on this progress and place debt firmly on a downward path. In line with international best practices, the FMA should be amended to contain mechanisms to ensure greater compliance, supported by improvements in debt management and greater fiscal transparency.

68. Completing energy pricing reforms is a priority to contain fiscal risks from SOEs. Staff welcomes the cabinet decision to introduce an automatic fuel pricing mechanism, which will minimize fuel subsidies that benefit disproportionally the rich, and the planned introduction of an automatic pricing formula for electricity. Targeted social transfer programs can help mitigate the distributional impact of price adjustments. Further steps are needed to strengthen SOEs governance and transparency, including by expanding coverage of fiscal accounts. Sri Lankan Airlines restructuring plan should be implemented quickly to stop losses and put it on a solid commercial footing.

69. The CBSL has prudently managed monetary policy in the face of price shocks and market volatility. Monetary policy should focus on price stability as its primary objective and adjust nimbly with evolving macroeconomic conditions. Efforts to build up reserves should continue and, in the event of volatile global capital flows, exchange rate flexibility be the first line of defense. Planned changes to the Monetary Law Act, as part of the Roadmap towards flexible inflation targeting, are a key milestone to further strengthen the CBSL's mandate, governance, and autonomy.

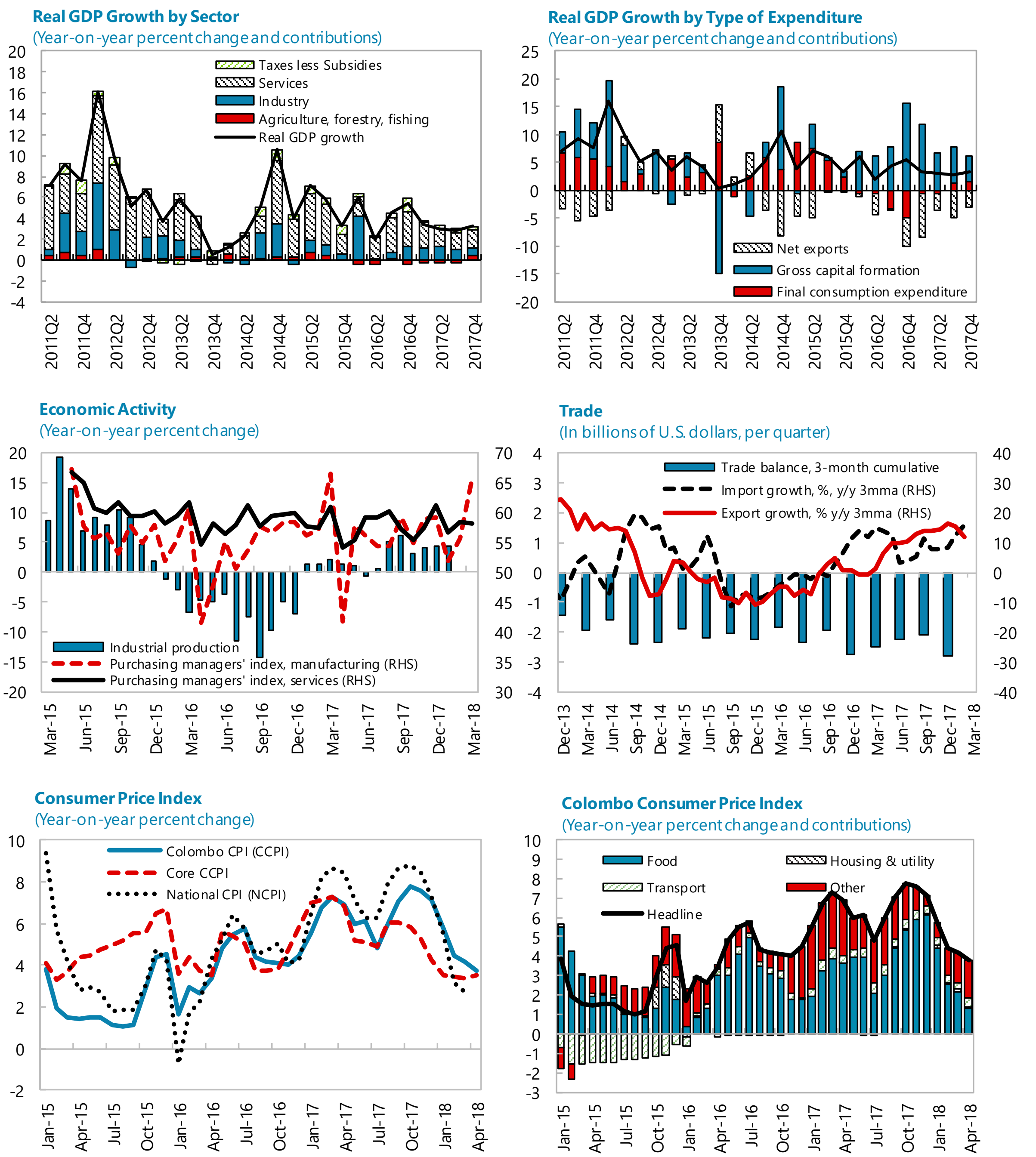
70. The authorities should remain vigilant against a buildup of systemic risks in the financial sector. Further macroprudential tools can help curb excessive credit growth in certain sectors. The banking sector is on track to meet the Basel III requirements and should prepare contingency plans to insure against adverse shocks. NBFIs should be subject to the same level of oversight as banks, with problem institutions promptly resolved.

71. The reforms under the authorities' *Vision 2025* are important in promoting strong and sustainable growth. Sri Lanka's protectionist trade regime should be gradually liberalized through fiscally-neutral reforms of tariffs and para-tariffs and simplification of export and import processes. Robust implementation of the new IRA and the one-stop shop for FDI will improve the investment climate. Efforts to combat corruption should be sustained, including through greater transparency in fiscal and SOE management and a stronger AML/CFT regime.

72. To foster inclusive growth, Sri Lanka needs to improve social safety nets, reduce its large gender gap, and cope with natural disaster risks. The authorities are taking important steps to improve targeting accuracy and coverage of social assistance programs. Boosting female labor force participation will require labor market reforms and effective gender budgeting, including through vocational training, flexible work arrangements, safe transportation, and child care support. A well-designed natural disaster risk financing framework can help Sri Lanka address costs associated with climate change.

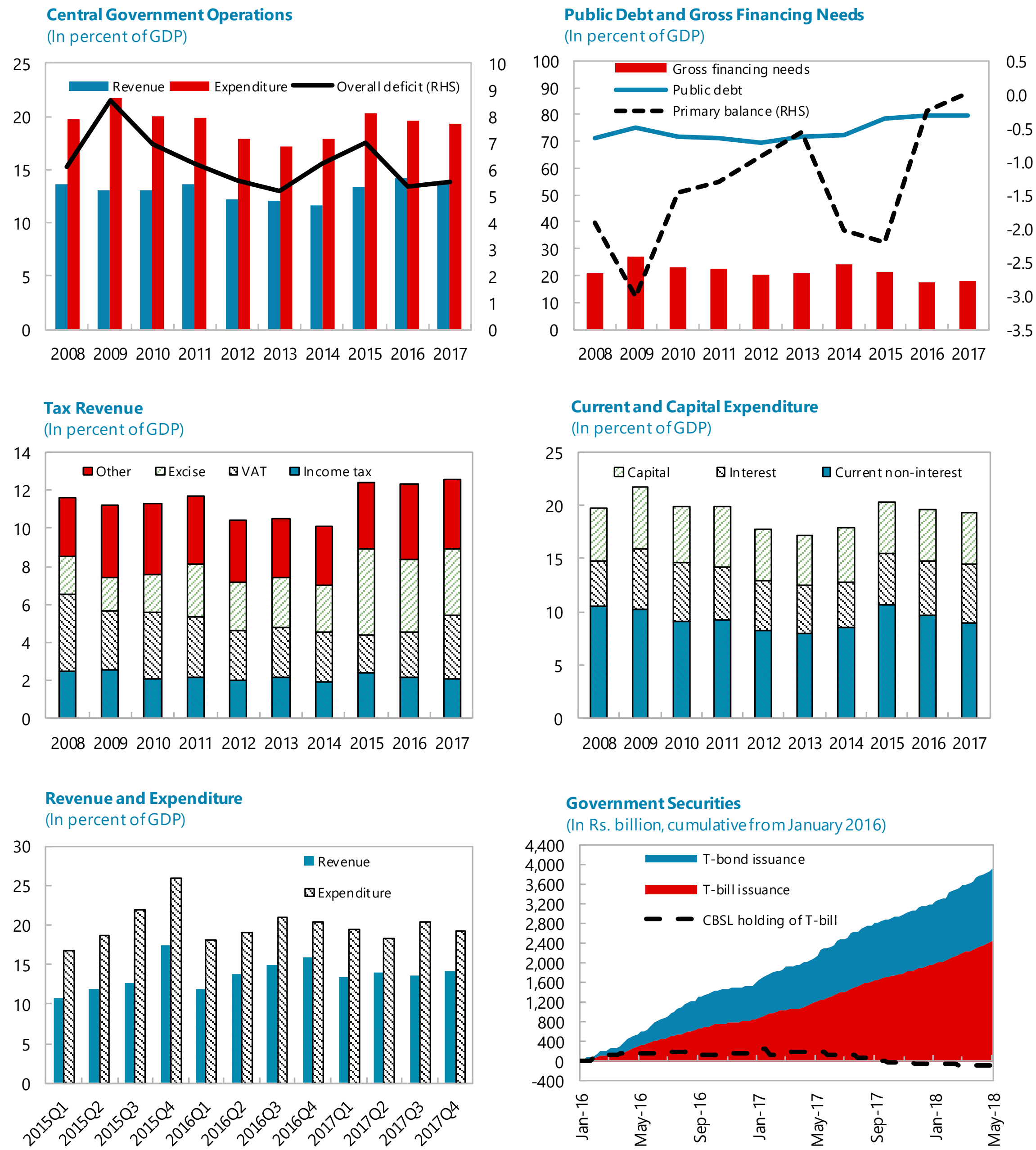
73. Staff recommends that the next Article IV Consultation takes place in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements, and supports the authorities' request for the completion of the fourth review under the EFF arrangement.

Figure 1. Sri Lanka: Real Sector



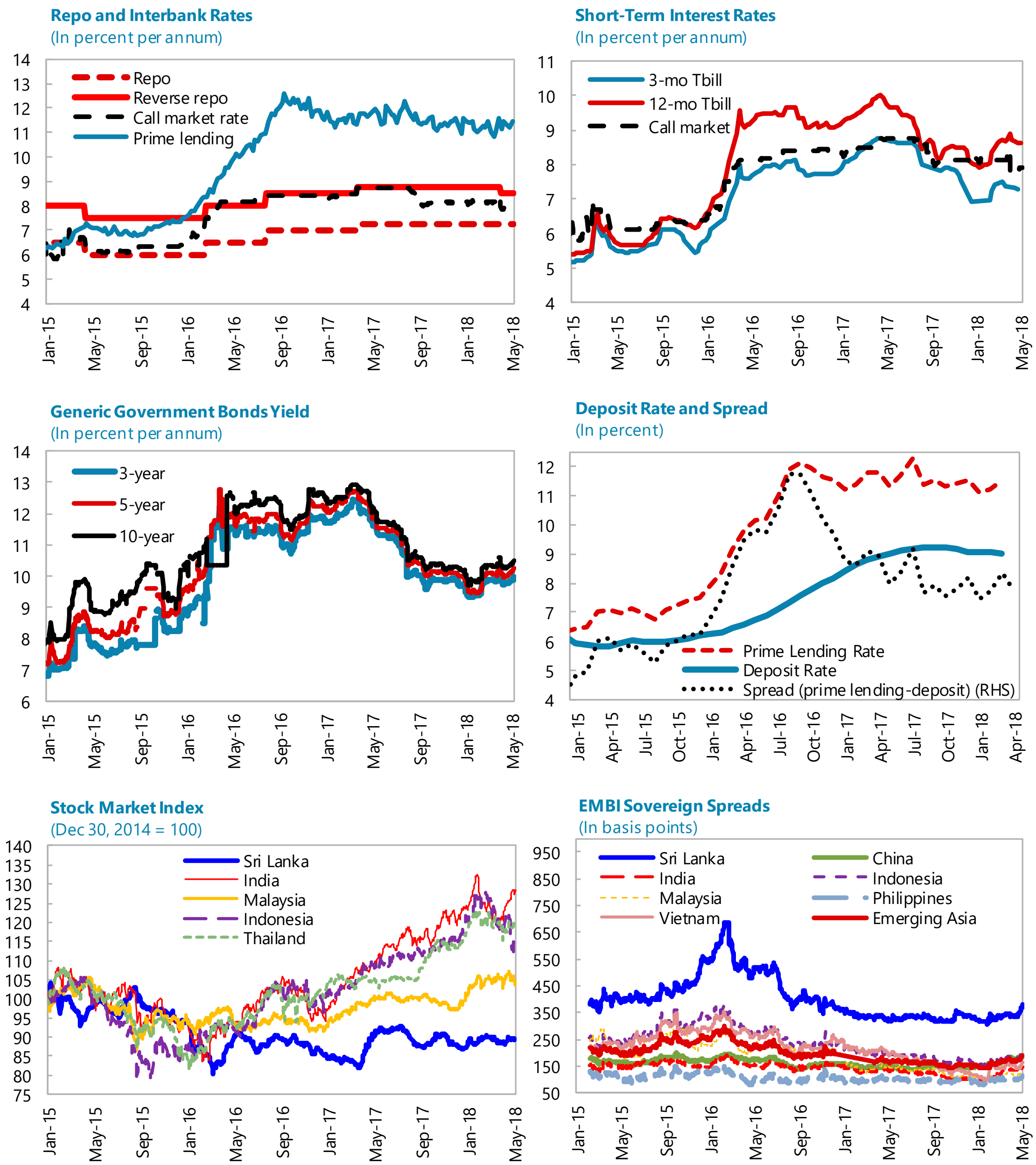
Sources: CBSL; and IMF staff estimates.

Figure 2. Sri Lanka: Fiscal Sector



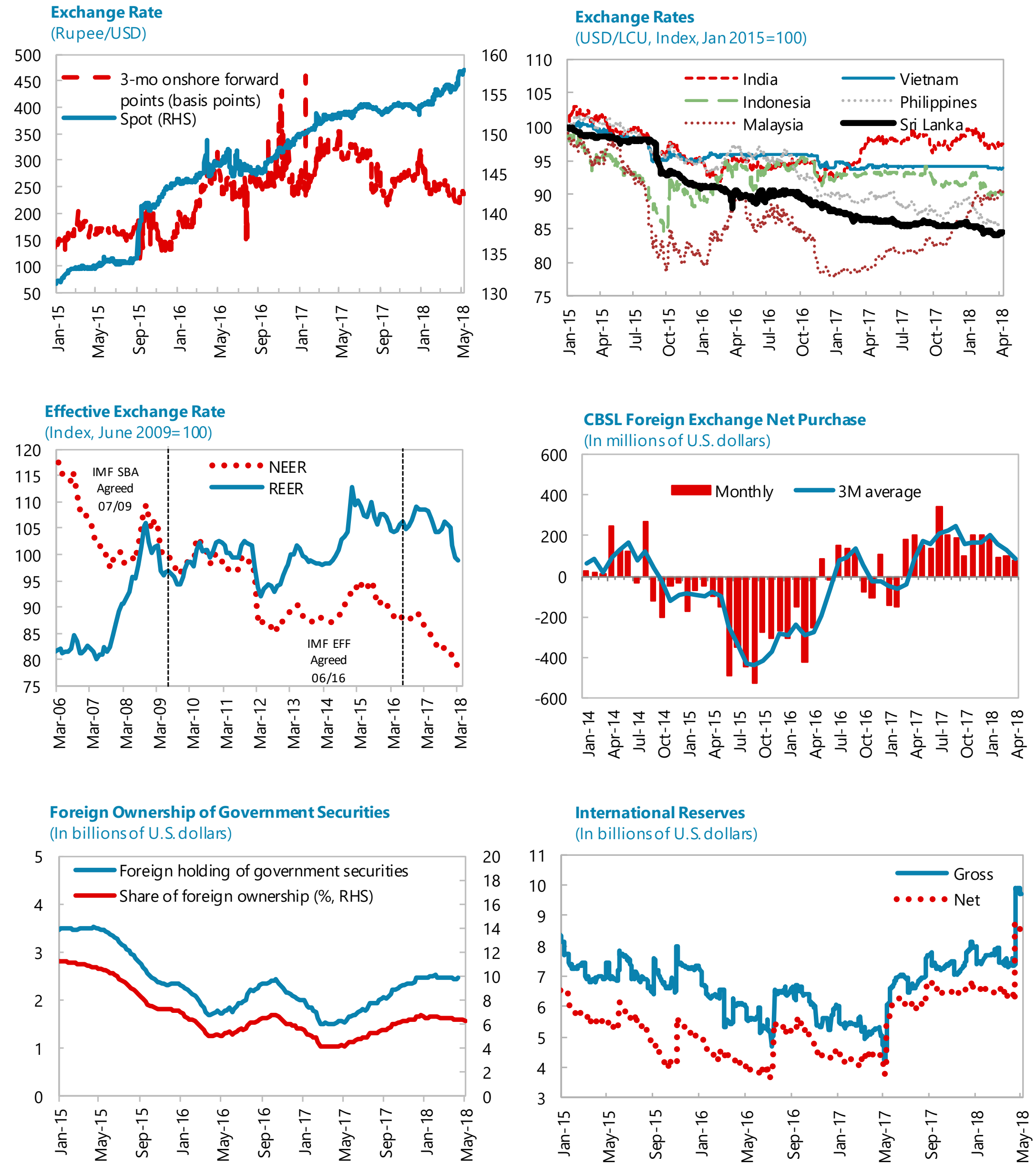
Sources: CBSL; Ministry of Finance; and IMF staff estimates.

Figure 3. Sri Lanka: Financial Market



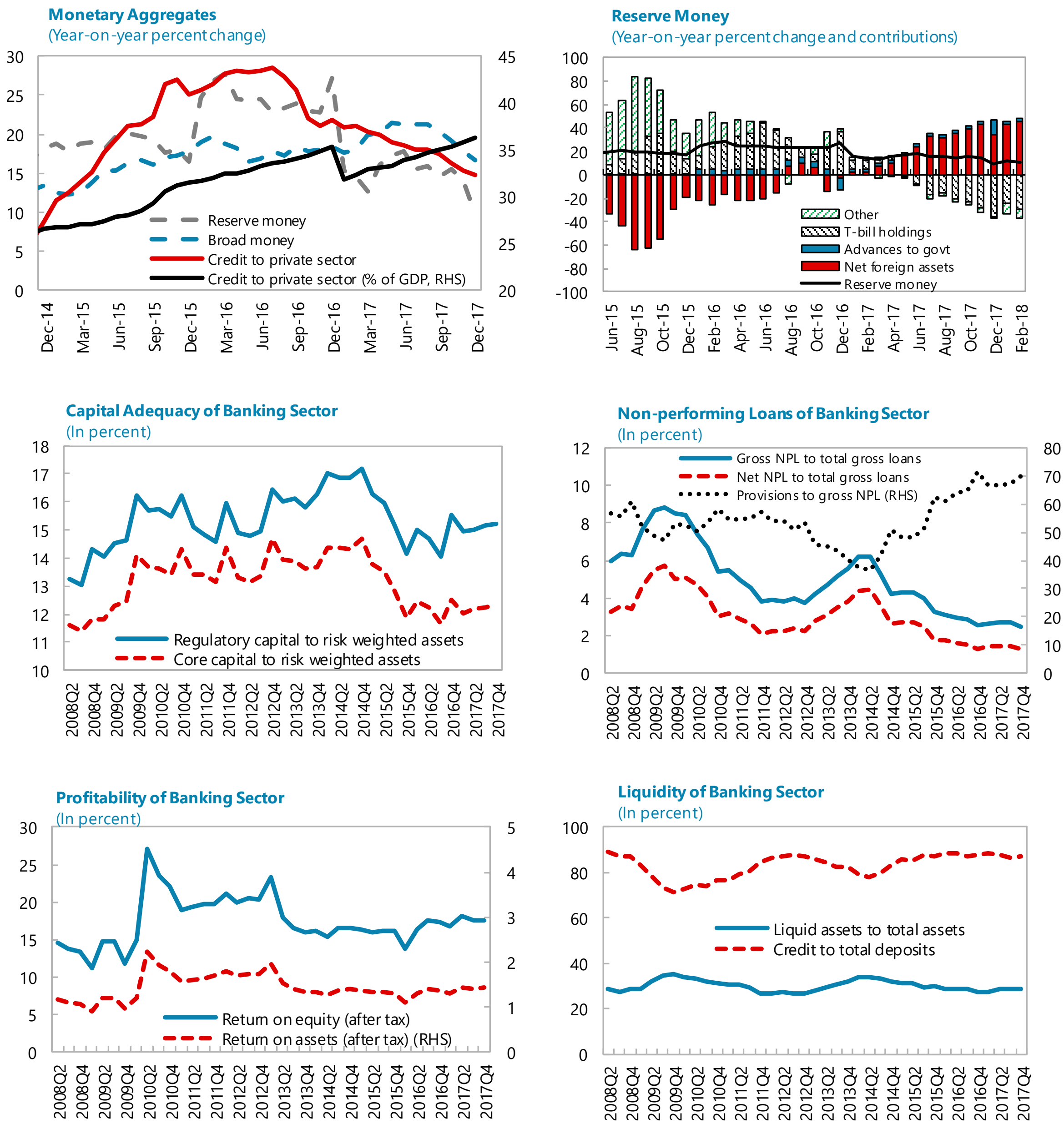
Sources: CBSL; CEIC Daily Database; Bloomberg Data LP; and IMF staff estimates.

Figure 4. Sri Lanka: Foreign Exchange Developments



Sources: CBSL; INS; Bloomberg Data LP; and IMF staff estimates.

Figure 5. Sri Lanka: Monetary and Financial Sector



Sources: CBSL; and IMF staff estimates.

Table 1. Sri Lanka: Selected Economic Indicators, 2015–23

	2015	2016	2017		2018		2019	2020	2021	2022	2023
			CR/18/3	Est.	CR/18/3	Proj.			Proj.		
GDP and inflation (in percent)											
Real GDP growth	5.0	4.5	4.2	3.1	4.6	4.0	4.5	4.7	4.8	4.9	5.0
Inflation (average)	2.2	4.0	6.0	6.6	4.8	4.8	4.8	4.9	4.9	4.9	4.9
Inflation (end-of-period)	4.6	4.5	5.1	7.1	5.0	4.7	4.8	4.9	4.9	4.9	4.9
Core inflation (end-of-period)	6.7	5.8	4.6	4.3	4.6	4.6	4.6	4.6	4.5	4.5	4.5
Savings and investment (in percent of GDP)											
National savings	28.8	32.8	28.7	33.9	29.1	34.4	35.0	35.1	35.2	35.4	35.6
Government	-2.2	-0.5	-0.9	-0.7	-0.3	0.1	1.3	1.4	1.5	1.6	1.6
Private	31.0	33.4	29.7	34.6	29.4	34.3	33.7	33.8	33.7	33.9	33.9
National Investment	31.2	35.0	31.7	36.5	31.6	36.9	37.5	37.6	37.5	37.6	37.7
Government	6.4	7.5	6.3	8.1	6.0	7.4	7.4	7.2	7.2	7.1	7.0
Private	24.7	27.5	25.4	28.4	25.6	29.5	30.1	30.3	30.4	30.5	30.7
Savings-Investment balance	-2.4	-2.2	-3.0	-2.6	-2.5	-2.5	-2.5	-2.4	-2.3	-2.2	-2.2
Government	-8.6	-8.0	-7.1	-8.8	-6.3	-7.3	-6.1	-5.9	-5.7	-5.5	-5.4
Private	6.3	5.9	4.2	6.1	3.8	4.8	3.6	3.5	3.3	3.3	3.2
Public finances (in percent of GDP)											
Revenue and grants	13.3	14.2	14.2	13.8	15.0	14.6	15.9	16.0	16.1	16.2	16.2
Expenditure	20.4	19.6	19.9	19.4	20.0	19.2	19.5	19.5	19.6	19.7	19.6
Primary balance	-2.2	-0.2	-0.2	0.0	1.0	1.0	2.0	2.1	2.1	2.1	2.0
Central government balance	-7.0	-5.4	-5.7	-5.5	-5.0	-4.6	-3.6	-3.5	-3.5	-3.5	-3.5
Central government net domestic financing	4.3	2.1	3.4	2.2	2.9	2.1	2.9	2.9	2.7	2.7	2.7
Central government debt	78.5	79.6	81.6	79.3	80.3	77.3	75.2	73.0	70.9	68.8	66.7
Money and credit (percent change, end of period)											
Reserve money	16.5	27.1	13.0	9.8	13.3	13.8	12.6	12.4	12.3	12.3	12.3
Broad money	17.8	18.4	18.9	16.7	15.0	14.0	13.7	13.3	13.0	12.6	12.6
Domestic credit	23.5	16.4	13.2	12.5	12.1	10.6	11.0	10.7	10.7	10.5	10.6
Credit to private sector	25.1	21.9	16.3	14.7	14.8	13.7	12.6	12.4	12.3	12.2	12.1
Credit to central government and public corporations	21.3	8.1	8.0	8.7	7.3	5.1	7.9	7.2	7.1	6.8	7.1
Balance of payments (in millions of U.S. dollars)											
Exports	10,547	10,310	11,244	11,360	11,861	11,922	12,504	13,103	13,768	14,536	15,347
Imports	-18,935	-19,183	-21,040	-20,978	-21,932	-22,294	-23,848	-25,035	-26,194	-27,430	-28,749
Current account balance	-1,882	-1,743	-2,461	-2,309	-2,180	-2,308	-2,514	-2,567	-2,667	-2,692	-2,844
Current account balance (in percent of GDP)	-2.4	-2.2	-3.0	-2.6	-2.5	-2.5	-2.5	-2.4	-2.3	-2.2	-2.2
Export value growth (percent)	-5.2	-2.2	9.1	10.2	5.5	4.9	4.9	4.8	5.1	5.6	5.6
Import value growth (percent)	-2.5	1.3	8.5	9.4	4.2	6.3	7.0	5.0	4.6	4.7	4.8
Gross official reserves (end of period)											
In millions of U.S. dollars	7,304	6,019	7,505	7,959	8,014	9,268	9,710	10,179	10,949	11,602	12,240
In months of prospective imports of goods & services	3.7	2.8	3.4	3.6	3.4	3.9	3.9	3.9	4.0	4.1	4.3
In percent of ARA composite metric	68.9	54.7	66.9	68.9	66.5	74.2	74.5	75.1	76.8	77.4	79.7
External debt (public and private)											
In billions of U.S. dollars	44.8	46.5	48.3	51.9	49.5	55.0	58.3	60.2	62.7	65.8	69.2
As a percent of GDP	56.4	57.4	58.2	59.3	57.4	58.9	58.5	56.7	55.3	54.2	53.2
Memorandum items:											
Nominal GDP (in billions of rupees)	10,951	11,907	13,027	13,289	14,271	14,524	15,899	17,437	19,142	21,034	23,134

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

Table 2a. Sri Lanka: Summary of Central Government Operations, 2015–23
(In billions of rupees)

	2015	2016	2017		2018		2019	2020	2021	2022	2023
			CR/18/3	Est.	CR/18/3	Proj.			Proj.		
Total revenue and grants	1,461	1,694	1,854	1,840	2,146	2,124	2,531	2,795	3,088	3,413	3,739
Total revenue	1,455	1,686	1,846	1,832	2,136	2,114	2,520	2,783	3,075	3,399	3,723
Tax revenue	1,356	1,464	1,680	1,670	1,954	1,934	2,323	2,567	2,838	3,138	3,436
Income taxes	263	259	272	275	323	343	478	533	604	685	765
VAT	220	283	435	444	545	515	624	701	784	876	978
Excise taxes	498	455	476	469	538	554	647	707	775	850	909
Other trade taxes	184	212	214	208	228	190	210	229	246	265	284
Other	191	254	283	275	321	332	364	397	429	464	501
Nontax revenue	99	222	166	161	182	180	197	216	237	261	287
Grants	6	7	8	8	10	10	11	12	13	14	16
Total expenditure and net lending	2,229	2,334	2,597	2,573	2,854	2,791	3,102	3,404	3,753	4,145	4,543
Current expenditure	1,702	1,758	1,973	1,928	2,189	2,111	2,328	2,555	2,807	3,086	3,360
Civil service wages and salaries	323	334	346	348	365	354	388	425	467	513	564
Other civilian goods and services	135	86	96	78	105	100	109	120	131	144	159
Security expenditure	297	307	331	309	355	343	375	411	451	496	546
Subsidies and transfers	419	419	480	458	515	507	572	627	688	756	832
Interest payments	527	611	720	736	849	807	885	972	1,069	1,176	1,260
Capital expenditure and net lending	527	576	624	645	665	680	774	849	946	1,060	1,183
Overall balance	-768	-640	-742	-733	-707	-667	-571	-609	-665	-732	-804
Financing	768	640	742	733	707	667	571	609	665	732	804
Net external financing	292	392	302	439	293	359	114	112	140	163	181
Net domestic financing	476	248	440	294	414	307	457	497	525	569	623
Memorandum items:											
Central government primary balance	-241	-29	-23	2	141	141	314	363	405	444	456
Nonfinancial SOE balance 1/	-23	34	…	…	…	…	…	…	…	…	…
Ceylon Electricity Board	21	-14	…	-47	…	…	…	…	…	…	…
Ceylon Petroleum Corporation	-18	70	…	4	…	…	…	…	…	…	…
Sri Lankan Airlines	-18	-30	…	-18	…	…	…	…	…	…	…
Other	-8	1	…	…	…	…	…	…	…	…	…
Central government debt	8,595	9,479	10,630	10,534	11,460	11,233	11,963	12,737	13,569	14,469	15,423
Domestic currency	4,686	5,121	5,493	5,349	5,958	5,463	6,075	6,755	7,464	8,253	8,670
Foreign currency	3,909	4,358	5,136	5,185	5,502	5,770	5,888	5,983	6,105	6,217	6,753
Publicly guaranteed debt	408	524	…	590	…	…	…	…	…	…	…
Financial obligations of nonfinancial SOEs 2/	1,501	1,414	…	1,432	…	…	…	…	…	…	…
Fund credit outstanding	110	83	119	118	208	203	251	256	255	235	197
Nominal GDP (in billion of rupees)	10,951	11,907	13,027	13,289	14,271	14,524	15,899	17,437	19,142	21,034	23,134

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, 2015–23

(In percent of GDP)

	2015	2016	2017		2018		2019	2020	2021	2022	2023
			CR/18/3	Est.	CR/18/3	Proj.			Proj.		
Total revenue and grants	13.3	14.2	14.2	13.8	15.0	14.6	15.9	16.0	16.1	16.2	16.2
Total revenue	13.3	14.2	14.2	13.8	15.0	14.6	15.9	16.0	16.1	16.2	16.1
Tax revenue	12.4	12.3	12.9	12.6	13.7	13.3	14.6	14.7	14.8	14.9	14.9
Income taxes	2.4	2.2	2.1	2.1	2.3	2.4	3.0	3.1	3.2	3.3	3.3
VAT	2.0	2.4	3.3	3.3	3.8	3.5	3.9	4.0	4.1	4.2	4.2
Excise taxes	4.5	3.8	3.7	3.5	3.8	3.8	4.1	4.1	4.0	4.0	3.9
Other trade taxes	1.7	1.8	1.6	1.6	1.6	1.3	1.3	1.3	1.3	1.3	1.2
Other	1.7	2.1	2.2	2.1	2.2	2.3	2.3	2.3	2.2	2.2	2.2
Nontax revenue	0.9	1.9	1.3	1.2	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Grants	0.1	0.1	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	19.6	19.9	19.4	20.0	19.2	19.5	19.5	19.6	19.7	19.6
Current expenditure	15.5	14.8	15.1	14.5	15.3	14.5	14.6	14.7	14.7	14.7	14.5
Civil service wages and salaries	3.0	2.8	2.7	2.6	2.6	2.4	2.4	2.4	2.4	2.4	2.4
Other civilian goods and services	1.2	0.7	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Security expenditure	2.7	2.6	2.5	2.3	2.5	2.4	2.4	2.4	2.4	2.4	2.4
Subsidies and transfers	3.8	3.5	3.7	3.4	3.6	3.5	3.6	3.6	3.6	3.6	3.6
Interest payments	4.8	5.1	5.5	5.5	5.9	5.6	5.6	5.6	5.6	5.6	5.4
Capital expenditure and net lending	4.8	4.8	4.8	4.9	4.7	4.7	4.9	4.9	4.9	5.0	5.1
Overall balance	-7.0	-5.4	-5.7	-5.5	-5.0	-4.6	-3.6	-3.5	-3.5	-3.5	-3.5
Financing	7.0	5.4	5.7	5.5	5.0	4.6	3.6	3.5	3.5	3.5	3.5
Net external financing	2.7	3.3	2.3	3.3	2.1	2.5	0.7	0.6	0.7	0.8	0.8
Net domestic financing	4.3	2.1	3.4	2.2	2.9	2.1	2.9	2.9	2.7	2.7	2.7
Memorandum items:											
Central government primary balance	-2.2	-0.2	-0.2	0.0	1.0	1.0	2.0	2.1	2.1	2.1	2.0
Cyclically adj. primary balance (in percent of potential GDP)	-2.3	-0.3	…	0.1	…	1.0	2.0	2.1	2.1	2.1	2.0
Nonfinancial SOE balance 1/	-0.2	0.3	…	…	…	…	…	…	…	…	…
Ceylon Electricity Board	0.2	-0.1	…	-0.4	…	…	…	…	…	…	…
Ceylon Petroleum Corporation	-0.2	0.6	…	0.0	…	…	…	…	…	…	…
Sri Lankan Airlines	-0.2	-0.2	…	-0.1	…	…	…	…	…	…	…
Other	-0.1	0.0	…	…	…	…	…	…	…	…	…
Central government debt	78.5	79.6	81.6	79.3	80.3	77.3	75.2	73.0	70.9	68.8	66.7
Domestic currency	42.8	43.0	42.2	40.2	41.7	37.6	38.2	38.7	39.0	39.2	37.5
Foreign currency	35.7	36.6	39.4	39.0	38.6	39.7	37.0	34.3	31.9	29.6	29.2
Publicly guaranteed debt	3.7	4.4	…	4.4	…	…	…	…	…	…	…
Financial obligations of nonfinancial SOEs 2/	13.7	11.9	…	10.8	…	…	…	…	…	…	…
Fund credit outstanding	1.0	0.7	0.9	0.9	1.5	1.4	1.6	1.5	1.3	1.1	0.8
Nominal GDP (in billion of rupees)	10,951	11,907	13,027	13,289	14,271	14,524	15,899	17,437	19,142	21,034	23,134

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
					Proj.			
Total revenue and grants	437	441	453	509	469	539	543	572
Total revenue	436	440	452	503	469	539	539	567
Tax revenue	415	404	421	430	425	499	504	506
Income taxes	63	61	83	68	72	92	94	86
VAT	111	108	105	120	118	135	133	129
Excise taxes	115	119	116	119	122	140	142	150
Other trade taxes	58	49	50	50	49	48	48	46
Other	69	66	66	74	64	84	88	95
Nontax revenue	21	36	31	73	44	40	35	61
Grants	1	1	1	6	0	1	4	5
Total expenditure and net lending	636	574	680	683	675	688	740	687
Current expenditure	484	434	520	490	528	496	576	511
Civil service wages and salaries	87	86	88	87	90	87	90	87
Other civilian goods and services	13	19	17	29	18	23	26	32
Security expenditure	71	78	78	81	78	85	88	92
Subsidies and transfers	103	112	110	132	121	122	131	133
Interest payments	209	140	227	160	221	179	241	166
Capital expenditure and net lendin(	152	140	160	193	148	192	164	176
Capital expenditure	147	139	160	192	148	191	163	174
Net lending	5	1	0	1	0	1	1	3
Overall balance	-200	-133	-227	-174	-206	-149	-197	-115
Primary balance	9	7	0	-14	15	30	44	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)

	2015	2016	2017	2018 Proj.	2018Q1	2018Q2	2018Q3	2018Q4
					Proj.			
Gross inflow	2,583	2,276	2,526	2,836	633	1,086	470	647
Primary surplus	0	0	2	141	15	30	44	51
Rupee-denominated debt disbursement	1,747	1,599	1,575	1,507	425	361	361	361
US-dollar denominated debt disbursement	829	609	904	1,082	178	605	65	235
Asset sales (net)	0	0	45	106	15	91	0	0
Other	7	68	0	0	0	0	0	0
Gross outflow	2,562	2,292	2,523	2,836	620	579	1,077	560
Primary deficit	241	29	0	0	0	0	0	0
Interest payment	527	611	736	807	221	179	241	166
Rupee-denominated debt amortization	1,490	1,178	1,095	1,393	200	400	400	393
US-dollar denominated debt amortization	304	473	692	635	199	0	436	0
Other	0	0	…	…	…	…	…	…
Net cash inflow	22	-15	3	0	13	507	-607	87
Government deposits, end of period	87	72	75	75	88	595	-12	75
Memorandum items:								
Overall deficit	768	640	733	667	206	149	197	115
US$ denominated debt disbursement (in US$ millions)	6,025	4,143	5,958	6,964	1,154	3,904	415	1,498
US$ denominated debt amortization (in US$ millions)	2,208	3,218	4,561	4,087	1,293	0	2,797	1
Government deposits, end of period (percent of GDP)	0.8	0.6	0.6	0.5	…	…	…	…
Net issuance of T-bill and T-bond (in Rp billions)	289	421	…	…	…	…	…	…
T-bills and T-bonds outstanding (In Rp billions)	4,267	4,663	4,590	…	…	…	…	…
Nonresidents' T-bills and T-bonds holding								
In Rp billions	304	260	323	…	…	…	…	…
In US$ millions	2,108	1,735	2,102	…	…	…	…	…

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/18/3	Est.	CR/18/3	Proj.
Central Bank of Sri Lanka						
Net foreign assets	576	559	938	846	961	978
Net domestic assets	97	298	29	94	134	91
Net claims on central government	230	413	184	225	213	211
Net claims on banks	-3	-2	-2	3	-2	3
Other items, net	-130	-113	-153	-134	-77	-123
Reserve Money	673	856	967	940	1,095	1,069
Monetary survey						
Net foreign assets	-298	-231	-27	122	-77	186
Monetary authorities	576	559	938	846	961	978
Deposit money banks	-874	-790	-965	-725	-1,038	-792
Net domestic assets	4,864	5,637	6,457	6,187	7,471	7,005
Net claims on central government	1,759	1,972	2,108	2,169	2,246	2,236
Credit to corporations	3,973	4,700	5,446	5,336	6,226	6,064
Public corporations	523	495	556	514	613	584
Private corporations	3,450	4,204	4,890	4,822	5,613	5,481
Other items (net)	-868	-1,035	-1,097	-1,318	-1,001	-1,295
Broad money	4,566	5,406	6,430	6,308	7,394	7,190
Memorandum Items						
Gross international reserves (in millions of U.S. dollars)	7,304	6,019	7,505	7,959	8,014	9,268
Net international reserves (in millions of U.S. dollars)	5,029	4,529	6,541	6,597	6,548	7,475
Net Foreign Assets (in millions of U.S. dollars)	3,999	3,725	5,736	5,513	5,610	6,215
Private credit (in percent of GDP)	31.5	35.3	37.5	36.3	39.3	37.7
Money multiplier	6.8	6.3	6.6	6.7	6.7	6.7
Broad money velocity 1/	2.4	2.2	2.0	2.1	1.9	2.0
Money and credit (percent change, end of period)						
Broad money	17.8	18.4	18.9	16.7	15.0	14.0
Reserve money	16.5	27.1	13.0	9.8	13.3	13.8
Credit to public corporations	17.2	-5.3	12.2	3.9	10.3	13.4
Credit to private sector	25.1	21.9	16.3	14.7	14.8	13.7

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

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

Table 4b. Sri Lanka: Monetary Accounts, 2015–18Q4

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

	2015	2016	2017	2018Q1	2018Q2	2018Q3	2018Q4
				Est.	Proj.		
Central Bank of Sri Lanka							
Net foreign assets	576	559	846	859	1,260	1,019	978
Net domestic assets	97	298	94	139	-235	26	91
Net claims on central government	230	413	225	262	227	230	211
Net claims on banks	-3	-2	3	-1	-1	-1	3
Other items, net	-130	-113	-134	-123	-462	-203	-123
Reserve Money	673	856	940	997	1,025	1,045	1,069
Monetary survey							
Net foreign assets	-298	-231	122	106	212	199	186
Monetary authorities	576	559	846	859	1,260	1,019	978
Deposit money banks	-874	-790	-725	-753	-1,048	-819	-792
Net domestic assets	4,864	5,637	6,187	6,500	6,445	6,775	7,005
Net claims on central government	1,759	1,972	2,169	2,278	2,148	2,217	2,236
Credit to corporations	3,973	4,700	5,336	5,579	5,610	5,824	6,064
Public corporations	523	495	514	535	517	538	584
Private corporations	3,450	4,204	4,822	5,044	5,093	5,285	5,481
Other items (net)	-868	-1,035	-1,318	-1,357	-1,313	-1,266	-1,295
Broad money	4,566	5,406	6,308	6,607	6,657	6,974	7,190
Memorandum Items							
Gross international reserves (in millions of U.S. dollars)	7,304	6,019	7,959	7,320	11,009	9,163	9,268
Net international reserves (in millions of U.S. dollars)	5,029	4,529	6,597	6,286	9,474	7,877	7,475
Money and credit (percent change, end of period)							
Broad money	17.8	18.4	16.7	16.4	13.4	13.7	14.0
Reserve money	16.5	27.1	9.8	11.8	15.0	14.9	13.8
Credit to private sector	25.1	21.9	14.7	15.3	13.0	13.4	13.7

Sources: CBSL; and IMF staff estimates.

Table 5a. Sri Lanka: Balance of Payments, 2015–23
(In millions of U.S. dollars, unless otherwise indicated)

	2015	2016	2017		2018		2019	2020	2021	2022	2023
			CR/18/3	Est.	CR/18/3	Proj.			Proj.		
Current account	**-1,882**	**-1,743**	**-2,461**	**-2,309**	**-2,180**	**-2,308**	**-2,514**	**-2,567**	**-2,667**	**-2,692**	**-2,844**
Balance on goods	-8,388	-8,873	-9,796	-9,618	-10,072	-10,372	-11,345	-11,932	-12,426	-12,894	-13,402
Credit (exports)	10,547	10,310	11,244	11,360	11,861	11,922	12,504	13,103	13,768	14,536	15,347
Debit (imports)	-18,935	-19,183	-21,040	-20,978	-21,932	-22,294	-23,848	-25,035	-26,194	-27,430	-28,749
Balance on services	2,324	2,879	3,081	3,337	3,542	3,932	4,384	5,015	5,464	5,970	6,399
Credit (exports)	6,396	7,138	7,668	7,759	8,358	8,535	9,218	9,955	10,552	11,186	11,745
Debit (imports)	-4,072	-4,259	-4,587	-4,422	-4,816	-4,603	-4,833	-4,940	-5,088	-5,215	-5,346
Primary income, net 1/	-2,012	-2,202	-2,236	-2,355	-2,300	-2,422	-2,510	-2,684	-2,824	-2,968	-3,121
Secondary income, net 2/	6,194	6,453	6,490	6,327	6,650	6,555	6,956	7,034	7,118	7,200	7,280
Of which: workers' remittances (net)	6,167	6,435	6,470	6,316	6,629	6,543	6,945	7,023	7,108	7,189	7,268
Capital account (+ surplus / - deficit)	**46**	**25**	**18**	**10**	**20**	**20**	**16**	**16**	**12**	**12**	**12**
Balance from current account and capital account	**-1,836**	**-1,718**	**-2,443**	**-2,299**	**-2,160**	**-2,288**	**-2,498**	**-2,551**	**-2,655**	**-2,680**	**-2,832**
Financial account (+ net lending / - net borrowing) 3/	**-3,172**	**-1,660**	**-3,478**	**-4,544**	**-1,968**	**-2,856**	**-2,455**	**-3,035**	**-3,484**	**-3,488**	**-3,713**
Direct investments	-628	-661	-873	-1,303	-925	-1,309	-931	-1,194	-1,230	-1,320	-1,400
Portfolio investments	-687	-992	-1,078	-1,773	-599	-1,610	-968	-1,120	-1,080	-1,080	-1,088
Equity and investment Fund shares	60	-24	-309	-360	-181	-378	-340	-320	-300	-300	-308
Debt instruments	-747	-968	-769	-1,413	-418	-1,232	-628	-800	-780	-780	-780
Of which: deposit taking corporations	0	0	594	500	682	290	172	0	0	0	0
Of which: general government	-747	-968	-1,362	-1,913	-1,100	-1,522	-800	-800	-780	-780	-780
T-bills, T-bonds, and SLDBs	903	532	138	-413	400	978	-300	-300	-280	-280	-280
Sovereign bonds	-1,650	-1,500	-1,500	-1,500	-1,500	-2,500	-500	-500	-500	-500	-500
Other investments 4/	-1,857	-7	-1,527	-1,468	-444	63	-555	-721	-1,174	-1,088	-1,225
Of which:											
Currency and deposits	-1,313	614	611	306	59	123	-39	-10	-41	-15	-36
Central bank	-1,097	701	400	401	0	0	0	0	0	0	0
Deposit taking corporations	-216	-87	211	-95	59	123	-39	-10	-41	-15	-36
Loans 4/	-1,266	-732	-2,394	-1,401	-256	-217	-286	-289	-962	-1,361	-1,641
Central bank 4/	0	0	0	0	0	0	0	0	0	0	0
Deposit taking corporations	-787	507	-1,028	-271	-380	-28	-454	14	-235	-520	-720
General government	-470	-1,103	-1,133	-1,030	340	27	573	96	-327	-441	-521
Disbursements 4/	-1,268	-2,120	-2,583	-2,240	-1,477	-1,863	-1,175	-1,400	-1,525	-1,600	-1,680
Amortizations	798	1,017	1,450	1,211	1,817	1,890	1,748	1,496	1,198	1,159	1,159
Other sectors	-9	-136	-233	-100	-216	-216	-405	-400	-400	-400	-400
Errors and omissions	-476	-477	177	158	0	0	0	0	0	0	0
Overall balance (- = need of inflow) 3/	**860**	**-535**	**1,213**	**2,403**	**-192**	**567**	**-44**	**484**	**829**	**808**	**881**
Total financing (- = inflow)	**862**	**-536**	**1,213**	**2,403**	**-192**	**567**	**-44**	**484**	**829**	**808**	**881**
Financing (- = inflow)	**862**	**-17**	**1,725**	**3,001**	**509**	**1,310**	**441**	**484**	**829**	**808**	**881**
Change in reserve assets	355	-472	1,486	2,762	509	1,310	441	470	770	654	638
Use of Fund credit, net	507	455	239	239	0	0	0	15	59	154	243
Purchases/Disbursements	0	0	0	0	0	0	0	0	0	0	0
Repurchases/repayments	507	455	239	239	0	0	0	15	59	154	243
Financing gap (- = inflow)	**0**	**-518**	**-512**	**-598**	**-701**	**-742**	**-485**	**0**	**0**	**0**	**0**
IMF	0	-333	-412	-413	-501	-517	-260	0	0	0	0
Other IFIs	0	-185	-100	-185	-200	-225	-225	0	0	0	0
Memorandum items:											
Current account (in percent of GDP)	-2.4	-2.2	-3.0	-2.6	-2.5	-2.5	-2.5	-2.4	-2.3	-2.2	-2.2
Gross official reserves	7,304	6,019	7,505	7,959	8,014	9,268	9,710	10,179	10,949	11,602	12,240
In months of prospective imports of goods and services	3.7	2.8	3.4	3.6	3.4	3.9	3.9	3.9	4.0	4.1	4.3
In percent of ARA composite metric	68.9	54.7	66.9	68.9	66.5	74.2	74.5	75.1	76.8	77.4	79.7
Net international reserves	5,029	4,529	6,541	6,597	6,548	7,475	7,656	8,140	8,969	9,777	10,658
In percent of ARA composite metric	47.5	41.1	58.3	57.1	54.4	59.8	58.7	60.0	62.9	65.2	69.4

Sources: Data provided by the CBSL; and IMF staff estimates.

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), and other international institutions' loan disbursement.

Table 5b. Sri Lanka: Balance of Payments, 2017–18

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

	2017					2018				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
								Proj.		
Current account	-408	-611	-187	-1,103	-2,309	-791	-522	-426	-569	-2,308
Balance on goods	-2,505	-2,246	-2,088	-2,779	-9,618	-2,691	-2,534	-2,501	-2,646	-10,372
Credit (exports)	2,774	2,623	3,027	2,936	11,360	3,033	2,789	3,003	3,097	11,922
Debit (imports)	-5,279	-4,870	-5,115	-5,714	-20,978	-5,723	-5,323	-5,504	-5,743	-22,294
Non-oil imports	-4,397	-4,128	-4,288	-4,738	-17,550	-4,806	-4,334	-4,744	-4,917	-18,800
Oil imports	-883	-742	-827	-977	-3,428	-918	-989	-761	-826	-3,494
Balance on services	955	579	889	914	3,337	1,039	826	1,053	1,014	3,932
Credit (exports)	2,087	1,689	1,975	2,008	7,759	2,174	1,974	2,169	2,218	8,535
Debit (imports)	-1,132	-1,110	-1,086	-1,094	-4,422	-1,136	-1,148	-1,115	-1,204	-4,603
Primary income, net 1/	-561	-417	-545	-832	-2,355	-644	-445	-620	-713	-2,422
Secondary income, net 2/	1,703	1,473	1,557	1,594	6,327	1,506	1,632	1,642	1,776	6,555
Capital account (+ surplus / - deficit)	2	9	0	-1	10	5	5	5	5	20
Balance from current account and capital account	-406	-602	-187	-1,104	-2,299	-786	-517	-421	-564	-2,288
Financial account (+ net lending / - net borrowing) 3/	-37	-2,428	27	-2,291	-4,729	-22	-3,948	1,426	-311	-2,856
Direct investments	-104	-225	-28	-946	-1,303	-90	-574	1	-646	-1,309
Portfolio investments	311	-1,384	-481	-219	-1,773	-272	-2,349	1,004	7	-1,610
Debt instruments	415	-1,235	-386	-207	-1,413	-24	-2,293	1,065	20	-1,232
Of which: general government	415	-1,735	-386	-207	-1,913	-124	-2,363	995	-30	-1,522
T-bills, T-bonds, and SLDBs	415	-235	-386	-207	-413	-124	137	995	-30	978
Sovereign bonds	0	-1,500	0	0	-1,500	0	-2,500	0	0	-2,500
Other investments 4/	-244	-819	536	-1,126	-1,653	340	-1,025	420	328	63
Of which: Currency and deposits	551	-58	41	-228	306	-26	50	50	49	123
Central bank	400	0	0	1	401	0	0	0	0	0
Loans 4/	-433	-842	-197	-114	-1,586	32	-657	-5	413	-217
Central bank 4/	0	0	0	0	0	0	0	0	0	0
Deposit taking corporations	-469	-158	216	140	-271	-148	134	-109	94	-28
General government	-58	-464	-471	-222	-1,215	236	-738	157	372	27
Disbursements	-423	-786	-631	-585	-2,426	-194.0	-1,256	-256	-156	-1,863
Amortizations	365	322	160	363	1,211	430	518	413	528	1,890
Other sectors	94	-220	58	-32	-100	-56	-53	-53	-53	-216
Errors and omissions	-243	246	739	-584	158	0	0	0	0	0
Overall balance (- = need of inflow) 3/	-612	2,072	526	603	2,588	-764	3,431	-1,847	-253	567
Total financing (- = inflow)	-612	2,072	526	603	2,588	-764	3,431	-1,847	-253	567
Financing (- = inflow)	-612	2,072	692	850	3,001	-639	3,689	-1,847	106	1,310
Change in reserve assets	-708	1,976	644	850	2,762	-639	3,689	-1,847	106	1,310
Use of Fund credit, net	96	96	48	0	239	0	0	0	0	0
Purchases/Disbursements	0	0	0	0	0	0	0	0	0	0
Repurchases/repayments	96	96	48	0	239	0	0	0	0	0
Financing gap (- = inflow)	0	0	-166	-246	-413	-125	-259	0	-359	-742
IMF	0	0	-166	-246	-413	0	-259	0	-259	-517
Other IFIs	0	0	0	0	0	-125	0	0	-100	-225
Memorandum items:										
Gross official reserves	5,117	6,959	7,280	7,959	7,959	7,320	11,009	9,163	9,268	9,268
In months of prospective imports of goods and services	2.3	3.1	3.2	3.6	3.6	3.1	4.6	3.8	3.9	3.9
In percent of ARA composite metric	44.3	60.2	63.0	68.9	68.9	58.6	88.1	73.4	74.2	74.2
Net international reserves	4,353	6,092	6,556	6,597	6,597	6,286	9,474	7,877	7,475	7,475
In percent of ARA composite metric	37.7	52.7	56.7	57.1	57.1	50.3	75.8	63.1	59.8	59.8

Sources: Data provided by the CBSL; and IMF staff estimates.
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), and other international institutions' loan disbursement.

Table 6. Sri Lanka: Gross External Financing, 2015–23
(In millions of U.S. dollars, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Proj.					
Current account	-1,882	-1,743	-2,309	-2,308	-2,514	-2,567	-2,667	-2,692	-2,844
Balance on goods	-8,388	-8,873	-9,618	-10,372	-11,345	-11,932	-12,426	-12,894	-13,402
Credit (exports)	10,547	10,310	11,360	11,922	12,504	13,103	13,768	14,536	15,347
Debit (imports)	-18,935	-19,183	-20,978	-22,294	-23,848	-25,035	-26,194	-27,430	-28,749
Balance on services	2,324	2,879	3,337	3,932	4,384	5,015	5,464	5,970	6,399
Primary and secondary income, net	4,182	4,251	3,972	4,132	4,446	4,350	4,294	4,232	4,159
Amortization	-509	-2,320	-2,164	-2,554	-3,784	-3,204	-2,794	-3,203	-3,166
General government	-1298	-1017	-1211	-1890	-3248	-2496	-2198	-2659	-2659
Sovereign bonds	-500	0	0	0	-1500	-1000	-1000	-1500	-1500
Syndicated loans	0	0	-280	-613	-560	-280	0	0	0
Bilateral and multilateral	-798	-1017	-930	-1276	-1188	-1216	-1198	-1159	-1159
Central bank	591	-1156	-640	0	0	-15	-59	-154	-243
IMF repurchases/repayments	-506	-455	-239	0	0	-15	-59	-154	-243
Other central bank liabilities, net	1097	-701	-401	0	0	0	0	0	0
Private sector loans	198	-147	-314	-664	-536	-693	-538	-390	-264
Gross external financing needs	-2,391	-4,063	-4,473	-4,862	-6,298	-5,771	-5,462	-5,895	-6,010
Sources of financing	2,391	4,063	4,473	4,862	6,298	5,771	5,462	5,895	6,010
Borrowing	2,746	3,072	6,637	5,429	6,254	6,240	6,232	6,549	6,648
General government	2,564	3,123	4,172	3,385	3,475	3,200	3,305	3,880	3,960
T-bills, T-bonds, and SLDBs, net	-903	-532	413	-978	300	300	280	280	280
Sovereign bonds	2,150	1,500	1,500	2,500	2,000	1,500	1,500	2,000	2,000
Syndicated loans	0	700	985	1,000	0	0	0	0	0
Bilateral and multilateral 1/	1,268	1,420	1,255	863	1,175	1,400	1,525	1,600	1,680
Official capital transfers	49	35	19	0	0	0	0	0	0
Other capital inflows, net	182	-51	2,465	2,045	2,779	3,040	2,927	2,669	2,688
Deposit-taking corporations, excl. central ba	787	-797	-120	-618	610	356	565	823	1,043
FDI inflows, net	628	661	1,303	1,309	931	1,194	1,230	1,320	1,400
Private sector loans	211	0	0	600	945	1,000	1,000	1,100	1,100
Other capital inflows, net	-1,444	85	1,282	753	293	491	132	-573	-855
Change in reserve assets	-355	472	-2,762	-1,310	-441	-470	-770	-654	-638
External financing gap	0	518	598	742	485	0	0	0	0
Financing	0	518	598	742	485	0	0	0	0
IMF	0	333	413	517	260	0	0	0	0
Other IFIs	0	185	185	225	225	0	0	0	0

Sources: CBSL; and IMF staff estimates.
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	2017 Q3	2017 Q4
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	15.1	15.1	15.2
Tier 1 capital/risk weighted assets	13.8	13.5	12.8	13.0	12.4	12.2	11.7	12.6	12.0	12.3	12.3	12.4
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	8.3	8.4
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	2.7	2.5
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	1.4	1.3
Provision coverage ratio (total)	48.1	48.4	51.6	62.3	61.2	64.3	64.5	71.8	66.8	66.8	67.2	69.9
Earnings and profitability												
Return on equity (after tax)	16.4	16.0	16.2	16.2	13.7	16.4	17.6	17.3	16.8	18.2	17.5	17.6
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	1.4	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	73.1	73.6
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	46.2	46.5
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	76.5	76.3
Net interest margin	3.8	3.7	3.6	3.6	3.6	3.6	3.5	3.6	3.6	3.5	3.5	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	28.8	28.6
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	71.2	71.9
Borrowings to total assets	21.4	20.6	21.7	21.8	21.9	21.0	19.8	18.8	19.0	17.8	16.4	15.6
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	86.7	86.9

Source: CBSL.

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, 2018–32 1/

(In millions of SDR, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Fund repurchases and charges															
In millions of SDR	10.0	22.8	33.7	63.3	126.7	183.8	195.4	192.0	178.6	145.6	78.9	18.4	3.5	3.5	3.5
In millions of U.S. dollars	14.6	33.4	49.5	93.5	187.0	271.3	288.4	283.4	263.7	214.9	116.4	27.2	5.1	5.1	5.1
In percent of exports of goods and NFS	0.1	0.2	0.2	0.4	0.7	1.0	1.0	1.0	0.8	0.7	0.3	0.1	0.0	0.0	0.0
In percent of quota	1.7	3.9	5.8	10.9	21.9	31.8	33.8	33.2	30.9	25.2	13.6	3.2	0.6	0.6	0.6
In percent of gross official reserves	0.2	0.3	0.5	0.9	1.6	2.2	2.3	2.2	1.9	1.5	0.8	0.2	0.0	0.0	0.0
Fund credit outstanding 2/															
In millions of SDR	893.0	1,070.8	1,060.8	1,020.8	916.4	752.8	574.3	395.9	227.4	88.9	14.8	0.0	0.0	0.0	0.0
In millions of U.S. dollars	1,303	1,571	1,563	1,510	1,355	1,113	849	586	336	131	22	0	0	0	0
In percent of quota	154.3	185.0	183.3	176.4	158.3	130.1	99.2	68.4	39.3	15.4	2.6	0.0	0.0	0.0	0.0
In percent of GDP	1.4	1.6	1.5	1.3	1.1	0.8	0.6	0.4	0.2	0.1	0.0	0.0	0.0	0.0	0.0
In percent of gross official reserves	14.1	16.2	15.4	13.8	11.7	9.2	6.7	4.5	2.5	0.9	0.2	0.0	0.0	0.0	0.0
Memorandum items:															
Exports of goods and services (in millions of U.S	20,457	21,721	23,058	24,320	25,721	27,092	28,358	29,776	31,264	32,828	34,469	36,192	38,002	39,902	41,897
Quota 2/	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8
Quota (in millions of U.S. dollars) 2/	845	849	853	856	859	859	859	859	859	859	859	859	859	859	859
Gross official reserves (in millions of U.S. dollar	9,268	9,710	10,179	10,949	11,602	12,240	12,602	13,102	13,602	14,102	14,602	15,102	15,602	16,102	16,602

Source: IMF staff estimates.
1/ As of May 3, 2018. Data for current year shows remaining payment in the year.
2/ As of the end of the year.

Annex I. Response to Past Fund Policy Advice

The authorities have actively engaged in a policy dialogue with the Fund since the last Article IV Consultation and approval of the EFF arrangement in June 2016. Most recommendations have been implemented since program approval. However, further progress is needed in several areas.

FUND ADVICE	AUTHORITIES RESPONSE
Increase revenue mobilization and conduct fiscal consolidation through tax policy and tax administration reform.	The authorities introduced VAT amendments in 2016 and legislated the new IRA. Nonetheless, these efforts have yet to raise tax revenues as planned, due to the need to offset one-off tax measures in 2015 and lower than projected collections for excise taxes.
Improve public financial management through expenditure commitment control.	The authorities started to implement quarterly expenditure commitment ceilings. Commitment control through the new PFM system (ITMIS) is being rolled out.
Undertake decisive reforms of state owned enterprises (SOEs) through completing a resolution strategy for the Sri Lankan Airlines, reforming energy pricing mechanisms, and publish statement of corporate intent (SCIs) for major SOEs.	Reforms of SOEs have progressed. SCIs for 5 major SOEs have been published. Cabinet approved an automatic fuel pricing mechanism and further energy reforms are planned in 2018. Cabinet is scheduled to approve a resolution strategy for Sri Lankan Airlines.
Monetary policy should aim to keep inflation in mid-single digits and preempt inflationary pressures.	The CBSL has managed monetary policy prudently, following a data-dependent approach. Inflation temporarily exceeded the inner band under the MPCC in December 2017 due to food price increases.
Transition towards a flexible inflation targeting regime.	The authorities developed a Roadmap for flexible inflation targeting with timebound measures. Cabinet approved a policy note with the key elements of the revision to the Monetary Law Act, planned by March 2019.
Demonstrate stronger exchange rate flexibility. Accumulate reserves to strengthen external buffers.	Since March 2017, CBSL has intervened in the FX market to accumulate reserves, helping to increase transactions in the spot market and two-way exchange rate movements. Nevertheless, there is still scope for greater exchange rate flexibility.
Monitor rapid credit growth against potential buildup of systemic risks, and use macroprudential measures to stabilize growth as necessary. Strengthen financial sector supervision, including smooth migration to Basel III and supervision on non-banks.	The authorities lowered the LTV ratio for motor vehicle loans. New surveys are underway in credit growth. Exposure to the real estate sector is closely monitored to detect vulnerabilities. Migration to Basel III has started. A new Resolution and Enforcement Department has been established within CBSL.
Reform trade and investment regimes toward more outward-oriented ones. Strengthen competitiveness through structural reforms.	In 2017, the authorities announced a strategy to enhance Sri Lanka's competitiveness through structural reforms (*Vision 2025*). Cabinet approved a New Trade Policy in 2017 to promote exports. The 2018 budget proposed to rationalize para-tariffs.

Annex II. Risk Assessment Matrix[1]

Source of Risks	Relative Likelihood / Time Horizon	Expected Impact on the Economy	Policy response
Potential Domestic Shocks			
Slippages in revenue-based fiscal consolidation	Medium / Short-term	**H**: Erodes confidence in macroeconomic policies, challenging Sri Lanka to address large gross financing needs.	Continue to implement revenue-based fiscal consolidation and structural fiscal reforms as planned.
Weather calamities (e.g., floods and droughts)	Medium / Short-term	**H**: Disrupts agriculture production and increase food inflation. Higher imports of food and fuel will worsen current account balance. Disaster-related spending will challenge fiscal consolidation.	Develop a comprehensive disaster financing framework, including contingency budgeting and disaster-linked social protections. Implement structural reforms to improve growth potential.
Continued rapid credit growth	Medium / Medium term	**M**: Systemic vulnerability can build up in the financial sector. Worsens the capital position of weak institutions.	Adjust monetary policy and use macroprudential measures as warranted.
Potential External Shocks			
Tighter global financial conditions	High / Short- and Medium-term	**H**: Raises government borrowing costs. Portfolio capital outflows can disrupt reserves buildup.	Continue fiscal consolidation and adjust monetary policy as warranted. Use greater exchange rate flexibility as the first line of defense against capital outflows.
Structurally weak growth in key advanced economies	High / Medium-term	**M**: Can cause a protracted slowdown in exports and tourism from AEs, weakening current account balance and growth.	Diversify export and tourism markets. Strengthen competitiveness through structural reforms. Continue to integrate with regional EMs through FTA.
Significant China slowdown and its spillovers	Low-Medium / Short- and Medium-term	**L**: Can lead to a decrease in FDI inflows to Sri Lanka.	Diversify economic integration with other EMs. Improve investment climate to attract FDI.

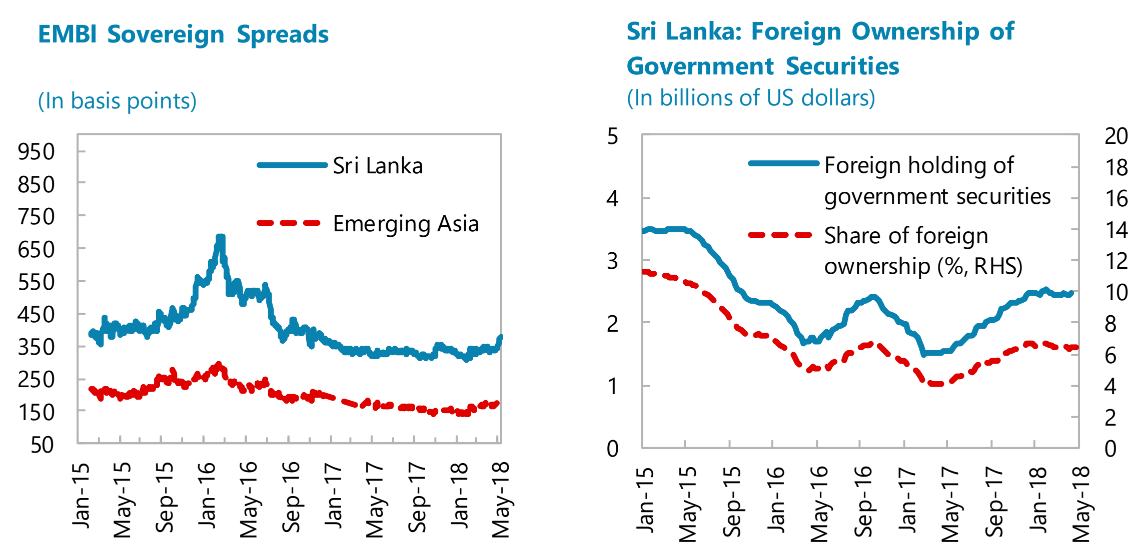
[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex III. External Sector Assessment

The External Sector Assessment finds that Sri Lanka's external position was broadly consistent with fundamentals in 2017, but remains vulnerable to shocks amid rising market volatility; reserve buffers have improved but remain inadequate; and export competitiveness has been constrained by past REER appreciation and structural factors. These findings highlight the importance of further building up reserves, allowing for greater exchange rate flexibility, continuing fiscal consolidation, while maintaining prudent monetary policy, and advancing structural reforms.

Background

1. Sri Lanka's balance of payments faced downside shocks in 2017, although in the context of favorable global market conditions. The current account deficit widened to 2.6 percent of GDP in 2017 from 2.2 percent in 2016 due to weather-related increases in food and fuel imports. As in previous years, tourism revenue and remittances partially offset the large trade deficit in goods at 11 percent of GDP at end-2017. Capital inflows resumed in Q2 2017 with broad-based increases in FDI, portfolio flows, and other investment, despite recent volatility in Q1 2018. After a decline of US$2.2 billion in 2015-16, gross international reserves (GIR) increased by US$1.9 billion in 2017, reaching US$8 billion at year end. Going forward, the current account deficit is expected to gradually decline to around 2 percent of GDP by 2023 as the public sector's negative saving-investment balance declines. Meanwhile, capital inflows are expected to continue but at somewhat lower level of around 3 percent of GDP over the next five years.



Source: CBSL; and IMF staff estimates.

2. Sri Lanka remains a net debtor country with large external liabilities and small external assets. Sri Lanka's net external liabilities increased slightly from 53 percent of GDP in 2012 to 55 percent of GDP in 2017. Roughly 20 percent of external liabilities are in the form of FDI and about 70 percent as debt portfolios or bank loans. Liabilities are mostly long-term (roughly 85 percent of total liabilities), although lumpy repayments starting in 2019 point to the need to speedily build up buffers. The government is the biggest debtor followed by commercial banks.

External Position

3. Sri Lanka's external position in 2017 was broadly consistent with medium-term fundamentals and desirable policies, but it remains vulnerable to shocks amid rising market volatility. Based on the External Balance Assessment (EBA), the cyclically adjusted current account balance is estimated at -2.5 percent of GDP, after adjusting for temporary factors (i.e., natural disasters), against the 2017 outturn of -2.6 percent of GDP.[1] The EBA-based current account gap for 2017 is estimated at -0.5 percent of GDP.[2] Nevertheless, the estimates are subject to a high degree of uncertainty, as highlighted by a residual of -0.9 percent of GDP, which may point to the need for further structural reforms to improve competitiveness. The CA gap estimates suggest a small REER overvaluation (3 percent),[3] although alternative estimates based on the EBA-lite REER model suggest a somewhat higher one (14 percent).

Sri Lanka: External Balance Assessment

	Percent of GDP	Coefficient	Policy gap = (P-P*)-(Pw-Pw*)
Actual CA	-2.6		
Actual CA adjusted temporary factors (i.e. natural disasters)	-2.2		
Cyclical adjusted CA	-2.5		
Cyclical adjusted CA norm	-2.0		
Total gap	-0.5		
Of which:			
Policy gaps	0.4		
Of which:			
Fiscal balance	-0.5	0.33	-1.5
Health exp.	0.3	-0.40	-0.7
Change in FX reserves	0.8	0.75	1.0
Private credit	-0.5	-0.10	5.0
Capital controls	0.4	0.04	11.5
Unexplained residuals	-0.9		

Note: (P-P*) and (Pw-Pw*) show Sri Lanka's and the world's policy gap.
Source: IMF staff estimates.

Reserve Adequacy

4. Sri Lanka's reserves remain inadequate. The Assessing Reserve Adequacy (ARA) metric of GIR recovered from 55 percent at end-2016 to 69 percent at end-2017, but remains lower than the recommended range of 100-150 percent.[4] Net international reserves (NIR) at end-2017 barely covered foreign exchange claims falling due in 2018, leaving Sri Lanka reliant on rolling over its external liabilities every year to meet its foreign claims. As a welcome development, the CBSL wound down liabilities from outstanding FX swaps with commercial banks from $2.5 billion (42 percent of GIR) at end-2016 to $1.2 billion (17 percent of GIR) at end-March 2018, improving the quality of

[1] The temporary factors, namely droughts and floods, are estimated to have increased the current account deficit for 2017 by 0.5 percentage points of GDP by mainly lowering exports and increasing imports.

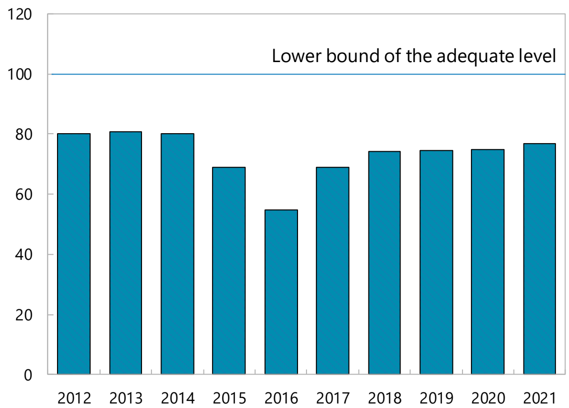
[2] The External Sector Assessment methodology was recently refined. The change from the previous assessment is mainly driven by a change in the norm based on a refined institutional quality variable.

[3] Cross-country elasticities are estimated at 0.71 for exports and 0.92 for imports.

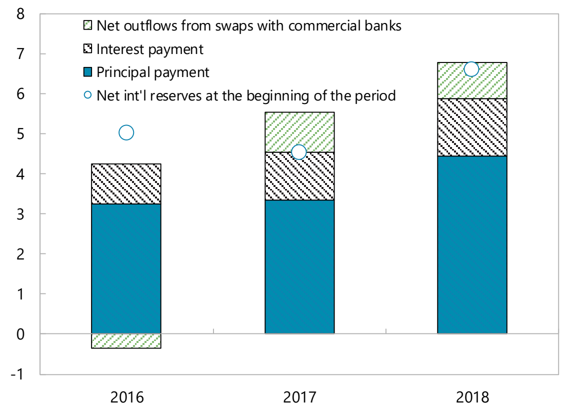
[4] See http://www.imf.org/external/np/spr/ara/ for more details.

reserves. Going ahead, the CBSL plans to continue accumulating international reserves as well as winding down the outstanding FX swaps with commercial banks. The ARA metric of GIR is projected to increase to about 75 percent by 2019.

Sri Lanka: Gross international Reserves
(In percent of ARA metric)



Sri Lanka: NIR Adequacy Against FX Payment Obligations
(In billions of US dollars)



Sources: CBSL; and IMF staff estimates.

Export Competitiveness

5. Past REER appreciation has constrained export competitiveness. In the past, attempts to stabilize the nominal exchange rate in the context of relatively high inflation led to a steady appreciation of the REER. This is consistent with Sri Lanka's anemic exports performance compared with peers and large trade deficit. The REER depreciated by 3.5 percent in 2017, as depreciation of the nominal effective exchange rate (8 percent) was partially offset by Sri Lanka's inflation differential with its trading partners (Figure AIII.1).

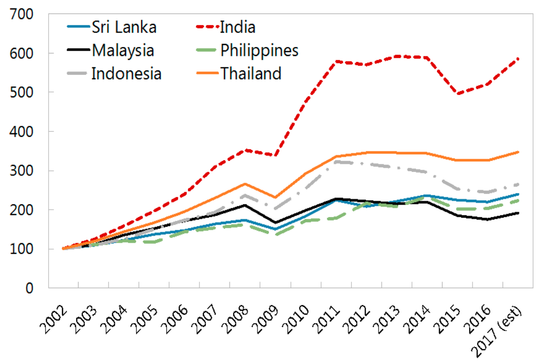
6. Competitiveness is also affected by structural factors (Figure AIII.1). Sri Lanka is one of the most protectionist countries in the world, with a multitude of high tariffs and para-tariffs. Sri Lanka's trade structure has not changed much over the decade, with the share of agricultural products, textiles and garments of total goods exports staying around 65–70 percent. The World Bank's *Doing Business* indicators marked Sri Lanka's distance to frontier at 59, pointing to weaknesses in registering property, enforcing contracts, and paying taxes.[5]

[5] The World Bank's Doing business indicators are third-party indicators (TPI). The accuracy of some TPIs may be biased by experts' views. These indicators serve to provide qualitative information and do not represent the Fund's assessment. The distance to frontier (DTF) measure shows the distance of each economy to the "frontier," which represents the best performance observed on each of the indicators across all economies in the Doing Business sample since 2005. An economy's distance to frontier is reflected on a scale from 0 to 100, where 0 represents the lowest performance and 100 represents the frontier.

Figure AIII.1. Sri Lanka: External Sector

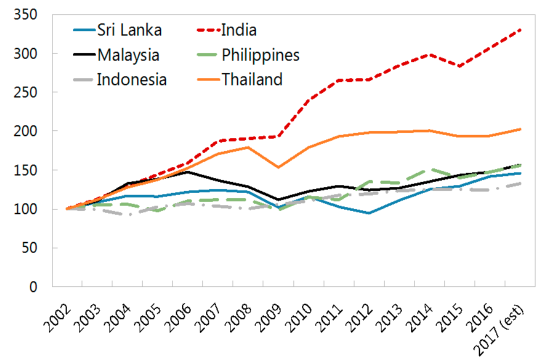
Sri Lanka lags behind peers in export performance both in export value growth....

Goods Export Values
(2002=100)



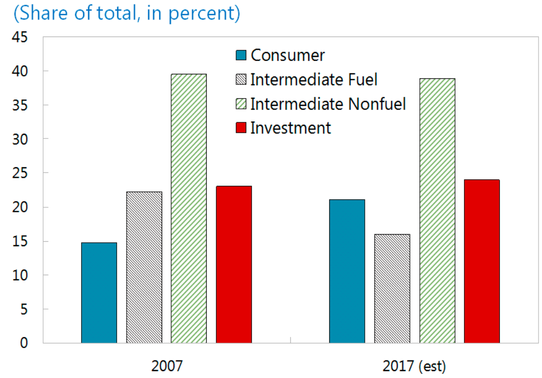
.... and export volume growth...

Goods Export Volumes
(2002=100)



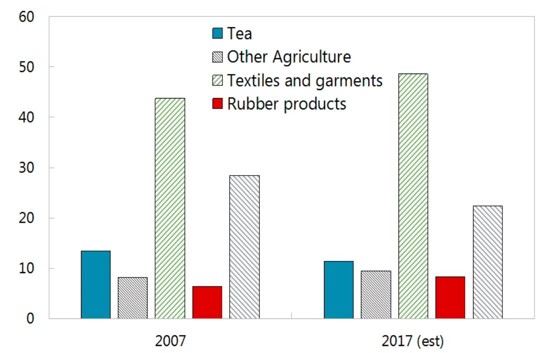
.... reflecting the country's challenge in diversifying its export components....

Sri Lanka's Import Structure
(Share of total, in percent)



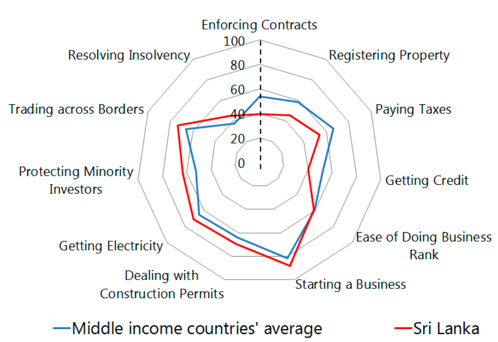
.... with high import dependency of intermediate and investment goods.

Sri Lanka's Export Structure
(Share of total, in percent)



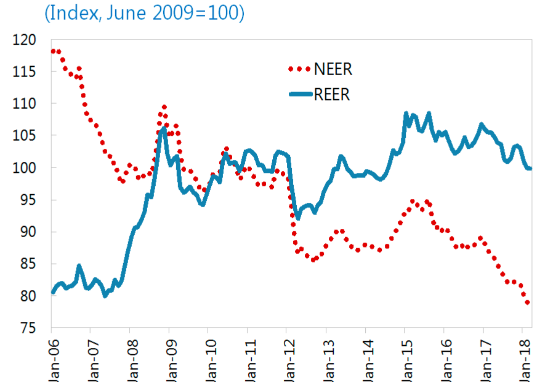
Complex investment framework and legal structure may be hindering investment...

Doing Business Distance to Frontier, 2018
(Higher score indicates closer to the frontier)



.... together with relatively low REER adjustment except for a few episodes.

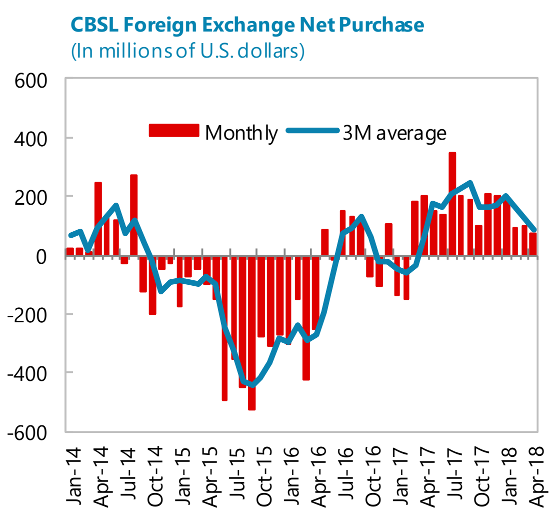
Effective Exchange Rate
(Index, June 2009=100)

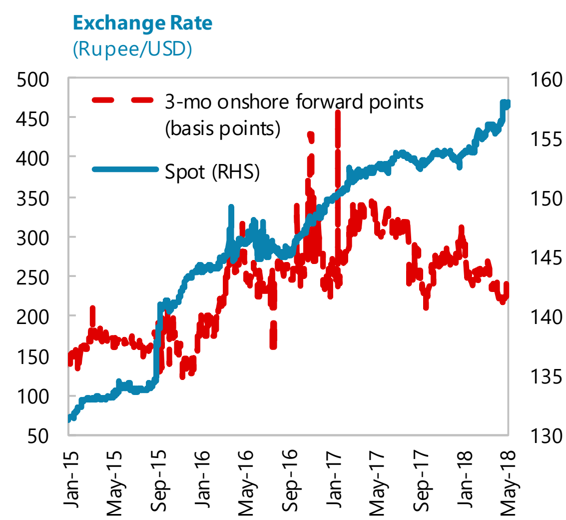


Sources: World Economic Outlook; CBSL; Haver Analytics; World Bank Doing Business Indicators; and IMF staff estimates.

Exchange Rate Policy

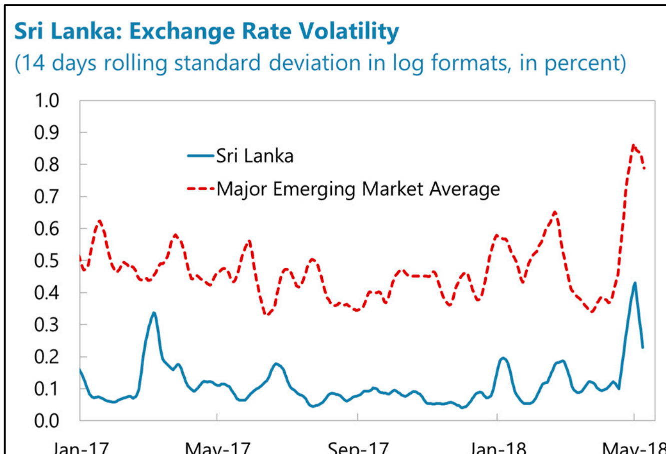
7. **The recent shift in FX intervention policy has helped deepen the FX market and enhanced price discovery.** The CBSL succeeded in purchasing $200 million per month during April-December 2017 on a net basis. Combined with sustained capital inflows in 2017, this has contributed to raising transaction volumes in the spot FX market and two-way exchange rate movements. Despite an increase in market volatility in 2018, the CBSL continued to intervene in the FX market to accumulate reserves, although with some FX sales in the most recent volatility episode. The authorities also plan to operationalize a RFQ system, under transparent rules and competitive bidding.





Source: CBSL; and IMF staff estimates.

8. **The CBSL should rely on a flexible exchange rate as a buffer against external shocks.** Sri Lanka has faced many episodes of portfolio capital outflows. For example, nonresidents cut their holdings of rupee-denominated treasury securities by around US$2 billion in April 2015-April 2016 and by around US$1 billion in October 2016-February 2017. During these episodes, the CBSL defended the exchange rate by intervening in the FX market, resulting in a heavy loss in reserves. Since then, Sri Lanka's exchange rate has become more flexible, although less than peer countries.



Sources: CBSL; Bloomberg; and IMF staff estimates.

Greater exchange rate flexibility should be the first line of defense against portfolio capital outflows and would help preserve international reserves and maintain competitiveness.

Capital Flow Liberalization

9. Sri Lanka could benefit from capital flow liberalization, but the process should be carefully managed. Sri Lanka's capital account is less open than in peer emerging and developing countries both in terms of *de jure* and *de facto* indices.[6] Capital flow liberalization can have benefits such as funding current accounts for productive investment and/or consumption smoothing, but also entails costs such as heightened macroeconomic volatility and vulnerability to crises. In this context, "the integrated approach of capital account liberalization" suggests an appropriate sequence to ensure that liberalization benefits outweigh the costs and consistent with institutional and financial development.[7]

10. Sri Lanka imposed in April 2016 a repatriation requirement for export proceeds, which constitutes a capital flow management measure (CFM). This measure was introduced in the face of substantial balance of payment pressures in June 2016. It could discourage exporters' outward investments (capital outflows) by increasing the cost of outward payments and transfers, and thus constitutes a CFM according to the Fund's Institutional View 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 somewhat helped to encourage exporters to keep FX within the domestic financial system and reduce the imbalance in the FX market. However, the role of this measure has diminished with continued macroeconomic adjustments and improved financial market confidence. Given their distortive nature, CFMs should be temporary and lifted when macroeconomic stability is restored in line with the Institutional View on capital flows.

[6] A country's *de jure* capital account openness is measured by the share of transactions that are not subject to capital controls and *de facto* openness by the sum of external assets and liabilities as a share of GDP. The *de jure* indicator is based on the IMF Annual Report on Exchange Arrangements and Exchange Restrictions using a binary indicator. Therefore, it does not reflect the liberalization in countries that have eased existing CFMs as opposed to removing them completely.

[7] IMF Occasional Paper No. 211, "Capital Account Liberalization and Financial Sector Stability",2002.

Annex IV. Debt Sustainability Analysis

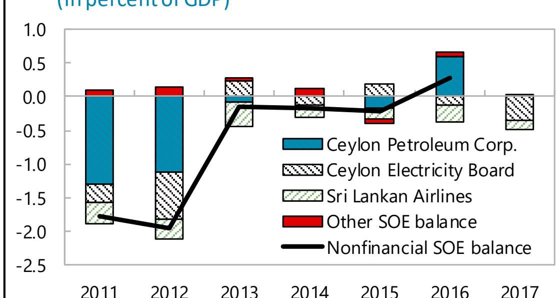
Sri Lanka's public debt remains high compared with peers, with one of the largest ratios of gross financing needs to GDP among emerging economies. Fiscal consolidation envisaged under the EFF-supported program would steadily reduce them. Downside risks, including from contingent liabilities, remain significant, with stress tests indicating a high risk to public debt sustainability. External debt remains sustainable, though with high currency and rollover risks.

A. Background and Key Assumptions

1. **Public debt stabilized at 84.6 percent of GDP at end-2017.** Public debt in this DSA covers debt owed by the central government (79.3 percent of GDP), outstanding amount of loans guaranteed by the central government (4.4 percent of GDP), and outstanding Fund credit (0.9 percent of GDP). Domestic debt (mostly treasury bills and bonds) accounted for about 54 percent of the central government debt. External debt consisted of multilateral and bilateral loans (27 percent of the central government debt), international sovereign bonds (14 percent), and nonresidents' holdings of treasury bills and bonds (3 percent). Foreign-currency denominated debt accounted for 50 percent of total, while debt owed to official and multilateral creditors accounted for about a quarter of the total. Sri Lanka's debt to GDP ratio remains higher than the median for emerging economies (53 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 10.8 percent of GDP based on the latest available data as of end-2017.** Sri Lanka has more than 200 state-owned enterprises, and the Ministry of Finance publishes financial performance of 41 nonfinancial SOEs. Three major SOEs—the Ceylon Petroleum Corporation (CPC) , the Ceylon Electricity Board (CEB), and Sri Lankan Airlines (SLA)—recorded a loss of 0.5 percent of GDP as a whole in 2017, as the small profit of the CPC was more than offset by the losses of the CEB and SLA (0.4 percent and 0.1 percent of GDP, respectively). Nonfinancial SOEs' financial obligations are estimated to have decreased by 1.1 percentage points of GDP in 2017, reflecting the absorption by the central government of the Hambantota Port loan from the Sri Lanka Port Authority. Debt of CEB increased by 0.4 percent of GDP due to financial losses and an increase in project loans. There is scope to improve the quality of public debt data by adopting the 2014 Government Financial Statistics Manual and publishing audited SOE financial data promptly. 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 1/
(In percent of GDP)



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

Sri Lanka: Public Debt, 2015–17

	2015				2016				2017	
	CR/17/253		Updated 1/		CR/17/253		Updated 1/		Est. 2/	
	Rs. Bn	% GDP	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**	**84.7**	**11,241**	**84.6**
Central government debt	**8,503**	**77.6**	**8,595**	**78.5**	**9,387**	**79.3**	**9,479**	**79.6**	**10,534**	**79.3**
Domestic	4,959	45.3	5,051	46.1	5,342	45.1	5,433	45.6	5,664	42.6
Treasury Bills	658	6.0	658	6.0	780	6.6	780	6.5	697	5.2
Treasury Bonds	3,305	30.2	3,397	31.0	3,715	31.4	3,806	32.0	3,892	29.3
Other	996	9.1	996	9.1	847	7.2	847	7.1	1,075	8.1
External	3,544	32.4	3,544	32.4	4,046	34.2	4,046	34.0	4,870	36.6
Multilateral and bilateral	2,237	20.4	2,237	20.4	2,437	20.6	2,437	20.5	2,842	21.4
International sovereign bonds	958	8.7	958	8.7	1,221	10.3	1,221	10.3	1,475	11.1
Nonresident holdings of T-Bills and T-Bonds	304	2.8	304	2.8	260	2.2	260	2.2	323	2.4
Other	45	0.4	45	0.4	128	1.1	128	1.1	230	1.7
Publicly guaranteed debt	**382**	**3.5**	**408**	**3.7**	**497**	**4.2**	**524**	**4.4**	**590**	**4.4**
Ceylon Electricity Board	3	0.0	3	0.0	20	0.2	20	0.2	15	0.1
Ceylon Petroleum Corporation	196	1.8	196	1.8	212	1.8	212	1.8	208	1.6
National Water Supply and Drainage Board	9	0.1	9	0.1	35	0.3	35	0.3	69	0.5
Road Development Authority	136	1.2	136	1.2	135	1.1	135	1.1	163	1.2
SriLankan Airlines	…	…	26	0.2	…	…	27	0.2	27	0.2
Other	38	0.3	38	0.3	95	0.8	95	0.8	109	0.8
Fund credit outstanding	**110**	**1.0**	**110**	**1.0**	**83**	**0.7**	**83**	**0.7**	**117**	**0.9**
Financial obligations of SOEs 3/	**1,280**	**11.7**	**1,501**	**13.7**	**…**	**…**	**1,414**	**11.9**	**1,432**	**10.8**
Ceylon Electricity Board	237	2.2	214	2.0	…	…	230	1.9	307	2.3
Ceylon Petroleum Corporation	424	3.9	425	3.9	…	…	385	3.2	387	2.9
Road Development Authority	…	…	136	1.2	…	…	135	1.1	163	1.2
Sri Lanka Ports Authority	240	2.2	233	2.1	…	…	237	2.0	62	0.5
SriLankan Airlines	309	2.8	405	3.7	…	…	317	2.7	369	2.8
Other	69	0.6	88	0.8	…	…	108	0.9	144	1.1
Memorandum item:										
Central government debt, Fund credit outstanding, and financial obligations of SOEs 3/	…	…	10,205	93.2	…	…	10,976	92.2	12,083	90.9
Nominal GDP	10,952	…	10,952	…	11,907	…	11,907	…	13,289	…

Sources: Sri Lankan authorities; and IMF staff estimates.

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

(1) Central government debt 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 includes the Eurobond amounting to US$175 million issued by SriLankan Airlines.

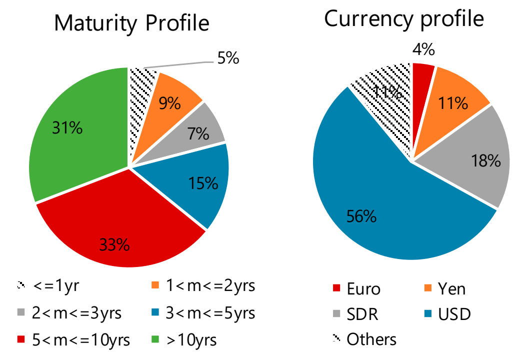
(3) Debt owed by Road Development Agency is added to financial obligations of SOEs.

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

2/ Central government domestic debt includes (i) treasury bonds amounting to Rs. 56,662 million, which originated from settlement of dues to CPC in January 2012 and (ii) treasury bonds amounting to Rs. 13,125 million issued to capitalize SriLankan Airlines in March 2013. Central government external debt includes outstanding project loan for the Hambantota port development, following reclassification of the loan from the Sri Lanka Ports Authority to the central government.

3/ 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.

Sri Lanka: Profile of Central Government External Debt, 2017



Sources: Sri Lankan Authorities; and IMF Staff Estimates

3. **External debt is estimated at 59 percent of GDP at end-2017.** It is predominantly owed by the public sector (36 percent of GDP 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 21 percent of GDP since 2014. The ratio of debt to exports is also high at 272 percent in 2017. Although rollover risks remain contained as 85 percent of private and public debt is medium or long term, preparation is needed as sovereign bond repayments fall due in 2019-22. More than half of the central government's external debt stock is denominated in U.S. dollars.

4. **The baseline scenario of the DSA reflects the medium-term macroeconomic projections and the proposed policies under the EFF-supported program.** Real GDP growth is projected to recover from 3.1 percent in 2017 to 5.0 percent by 2023. Inflation is projected to stay around 5 percent over the medium term. Fiscal deficits are programmed to decrease from 5.5 percent of GDP in 2017 to the authorities' target of 3.5 percent of GDP in 2020. This implies that the primary balance improves from a balanced position in 2017 to a surplus of 1 percent of GDP in 2018, followed by a surplus of 2.1 percent of GDP in 2020. Interest payments are projected on the basis of the interest payments for existing debt, and interest rates in the primary and secondary government security markets prevailing in 2018 for newly issued debt. Interest rates for newly issued debt are assumed to decrease gradually from these levels over the medium term. The projection also incorporates expected proceeds in 2018 from the concession agreement on the Hambantota Port. Publicly guaranteed debt is projected at 4.9 percent of GDP at end-2018, in line with the indicative target under the program, and kept constant as a percent of GDP through 2023. External debt projections are based on a projected reduction in the current account deficit from 2.6 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 84.6 percent in 2017 to 72.5 percent

in 2023.[1] The reduction in the debt to GDP ratio beyond 2018 is supported by favorable debt dynamics with a negative interest-rate-and-growth differential and primary surpluses. Gross financing needs are projected to rise to 18.6 percent of GDP in 2018 and decrease to around 10 percent of GDP by 2023, as fiscal consolidation reduces the overall deficit and debt amortization over the medium term.

6. Nevertheless, there are significant downside risks to the program scenario. If fiscal consolidation were to stall and the primary balance to return to its historical level (-1.4 percent of GDP), the debt-to-GDP ratio would remain at about 83 percent until 2023. Debt reductions would become less significant under individual shock scenarios on primary balance (lower primary surplus by 0.5 percentage points of GDP for 2019–20), GDP growth (2 percentage points lower than in the program scenario for 2019–20), the exchange rate (15 percent real depreciation in 2019 vis-à-vis the program scenario), and the interest rate (an increase by 300 basis points for new borrowings during 2018–21 vis-à-vis the program scenario). When these shocks are combined, the debt to GDP ratio would reach 91 percent in 2023. Similarly, in a conservative contingent liability shock scenario where the central government becomes liable for additional debt of 10 percent of GDP in 2018, the debt to GDP ratio would initially jump to 93 percent of GDP and gradually decline to 86 percent of GDP in 2023. While this represents a tail scenario, the likelihood of contingent liabilities materializing hinges on completing energy pricing reforms, which are crucial to ensure profitability of oil and electricity SOEs, and reducing losses from other SOEs. In the combined shock scenario and the contingent liability shock scenario, gross financing needs would remain elevated at 12−14 percent of GDP in 2023. Also, the debt level is high relative to revenues, constraining repayment capacity. The envisaged improvement in the cyclically-adjusted primary balance of around 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 initial conditions (under the program scenario, the debt to GDP ratio and gross financing needs as a percent of GDP were 84.6 percent and 18.1 percent in 2017, respectively). Debt profile analysis indicates a 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 59 percent of GDP in

[1] Interest payments were revised downward due to lower rates observed at the end of 2017 and into 2018 and changes to the treatment of discounts on treasury bonds (following Government Financial Statistics guidelines, they are now treated as interest costs that accrue over the life of the bond rather than a principal payment at maturity). The level of nominal GDP was also higher than expected in 2017, due to data revisions in March 2018.

2017 to around 53 percent in 2023. 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 78 percent by 2023. In the short run, tighter global liquidity and shifts in investor confidence could raise rollover vulnerabilities and costs. Despite the high share of medium- to long-term debt, lumpy repayments starting in 2019 and external financing at non-concessional terms, gradually substituting concessional financing, point to the need to speedily build up buffers. Lower than expected GDP or export growth would also deteriorate debt dynamics.

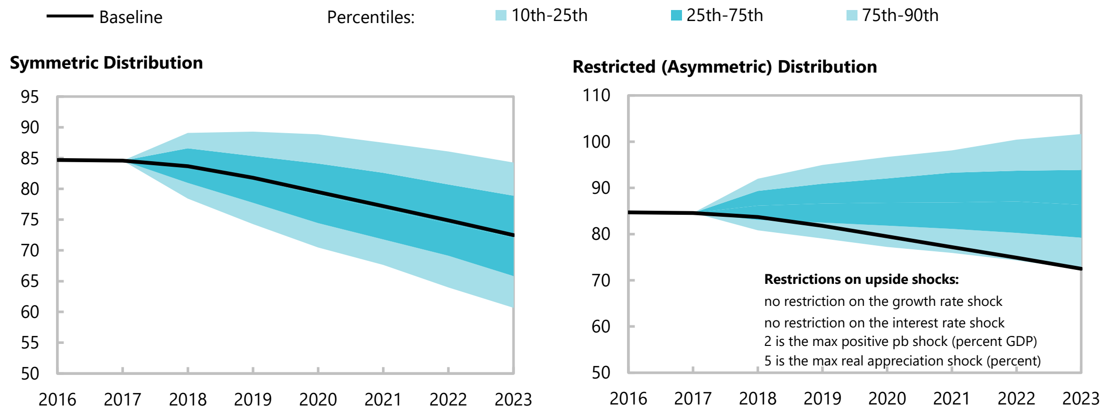
Sri Lanka: Public DSA Risk Assessment

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

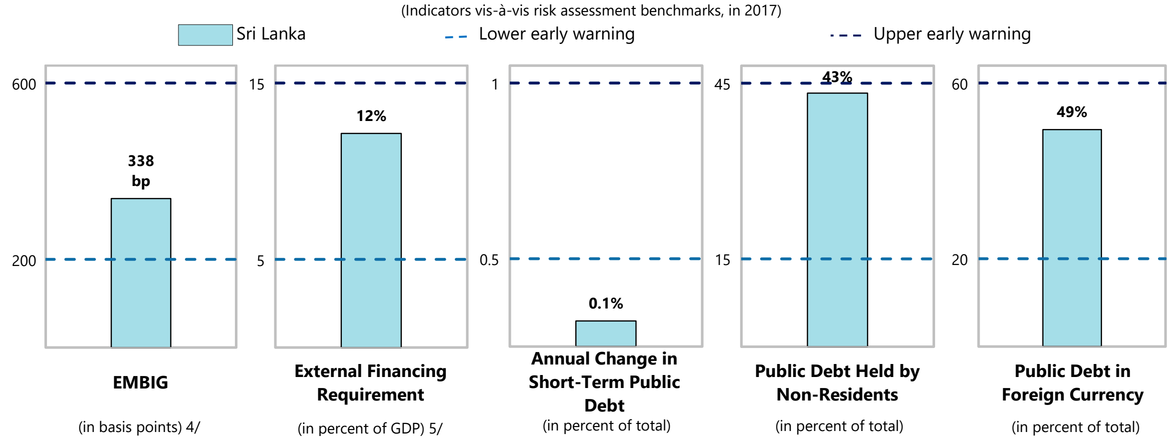
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



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:

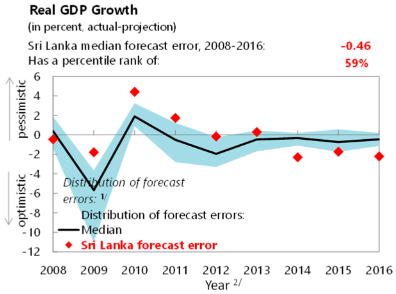
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

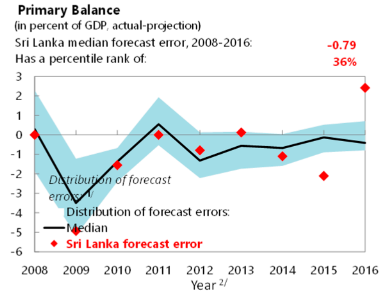
4/ EMBIG, an average over the last 3 months, 03-Feb-18 through 04-May-18.

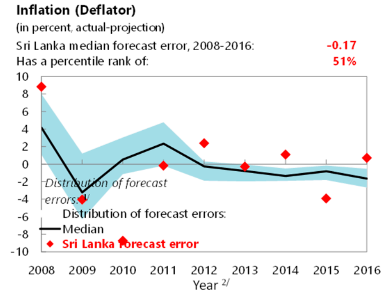
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Sri Lanka: Public DSA—Realism of Baseline Assumptions

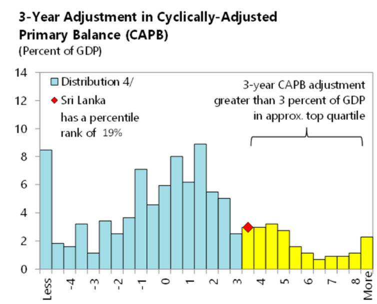
Forecast Track Record, versus program countries

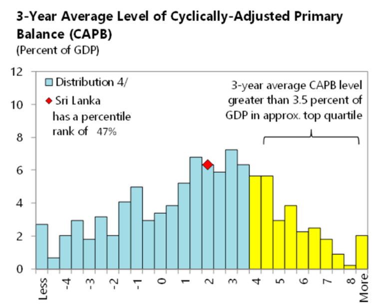




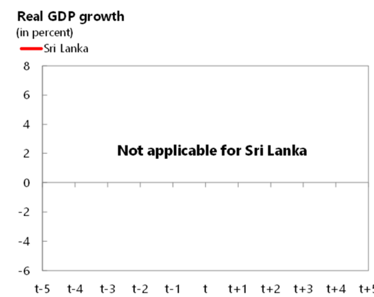


Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/



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

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

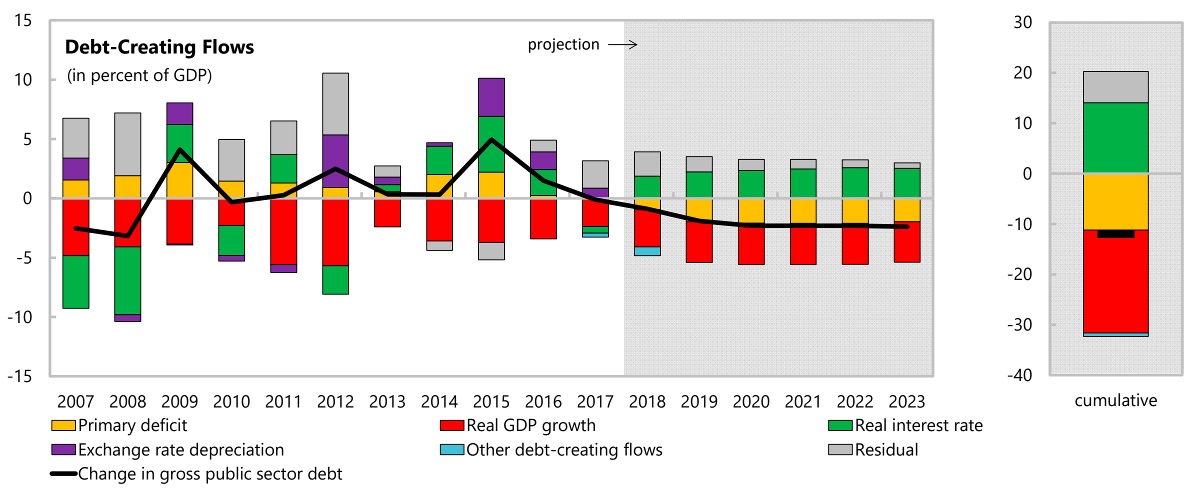
(In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of May 04, 2018		
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023			
Nominal gross public debt	76.4	84.7	84.6	83.7	81.8	79.5	77.2	74.9	72.5	Sovereign Spreads		
o/w: guarantees & Fund credit	3.6	5.1	5.3	6.4	6.5	6.4	6.3	6.1	5.8	EMBIG (bp) 3/		368
Public gross financing needs	22.4	17.5	18.1	18.6	15.9	15.2	12.6	13.6	10.2	5Y CDS (bp)		n.a.
Real GDP growth (in percent)	6.1	4.5	3.1	4.0	4.5	4.7	4.8	4.9	5.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	7.6	4.1	8.2	5.0	4.7	4.8	4.7	4.8	4.7	Moody's	B1	B1
Nominal GDP growth (in percent)	14.2	8.7	11.6	9.3	9.5	9.7	9.8	9.9	10.0	S&Ps	B+	B+
Effective interest rate (in percent) [4/]	7.5	7.1	7.8	7.7	7.9	8.1	8.4	8.7	8.7	Fitch	B+	B+

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing
Change in gross public sector debt	0.7	1.5	-0.1	-0.9	-1.9	-2.3	-2.3	-2.3	-2.4	-12.1	primary
Identified debt-creating flows	-1.4	0.5	-2.4	-3.0	-3.2	-3.2	-3.1	-3.0	-2.8	-18.3	balance [9/]
Primary deficit	1.7	0.2	0.0	-1.0	-2.0	-2.1	-2.1	-2.1	-2.0	-11.2	-0.9
Primary (noninterest) revenue and grants	13.0	14.2	13.8	14.6	15.9	16.0	16.1	16.2	16.2	95.1	
Primary (noninterest) expenditure	14.7	14.5	13.8	13.7	13.9	13.9	14.0	14.1	14.2	83.9	
Automatic debt dynamics [5/]	-3.0	0.3	-2.1	-1.3	-1.2	-1.2	-1.0	-0.9	-0.9	-6.3	
Interest rate/growth differential [6/]	-4.2	-1.2	-2.9	-1.3	-1.2	-1.2	-1.0	-0.9	-0.9	-6.3	
Of which: real interest rate	-0.2	2.2	-0.6	1.9	2.2	2.4	2.5	2.6	2.5	14.0	
Of which: real GDP growth	-4.0	-3.4	-2.4	-3.1	-3.4	-3.5	-3.5	-3.4	-3.4	-20.4	
Exchange rate depreciation [7/]	1.2	1.5	0.9	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	-0.3	-0.7	0.0	0.0	0.0	0.0	0.0	-0.7	
Privatization proceeds (negative)	0.0	0.0	-0.3	-0.7	0.0	0.0	0.0	0.0	0.0	-0.7	
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	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	2.1	1.0	2.3	2.1	1.3	0.9	0.8	0.7	0.5	6.2	



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).

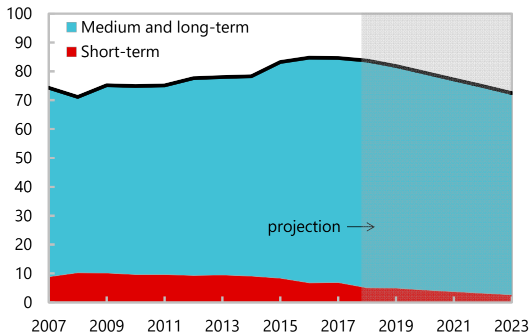
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

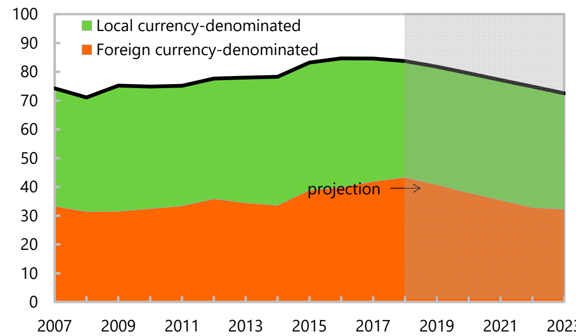
Sri Lanka: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



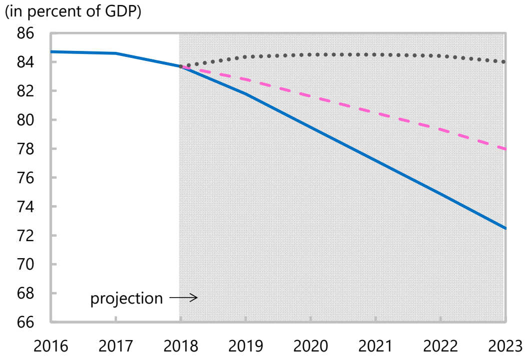
By Currency
(in percent of GDP)



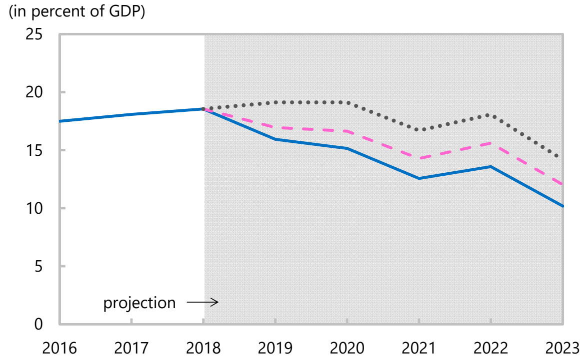
Alternative Scenarios

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)

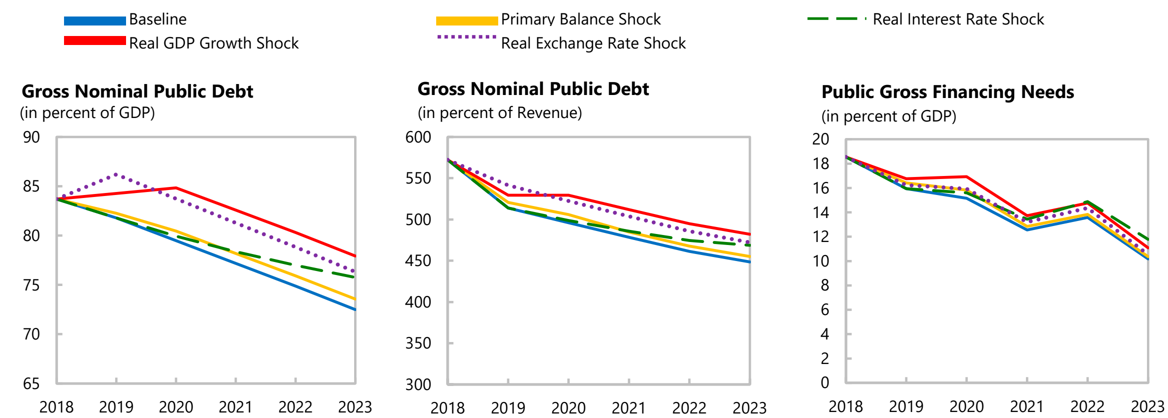
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	4.5	4.7	4.8	4.9	5.0
Inflation	5.0	4.7	4.8	4.7	4.8	4.7
Primary Balance	1.0	2.0	2.1	2.1	2.1	2.0
Effective interest rate	7.7	7.9	8.1	8.4	8.7	8.7
Constant Primary Balance Scenario						
Real GDP growth	4.0	4.5	4.7	4.8	4.9	5.0
Inflation	5.0	4.7	4.8	4.7	4.8	4.7
Primary Balance	1.0	1.0	1.0	1.0	1.0	1.0
Effective interest rate	7.7	7.9	8.2	8.4	8.7	8.8

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	5.5	5.5	5.5	5.5	5.5
Inflation	5.0	4.7	4.8	4.7	4.8	4.7
Primary Balance	1.0	-1.4	-1.4	-1.4	-1.4	-1.4
Effective interest rate	7.7	7.9	7.6	7.5	7.6	7.4

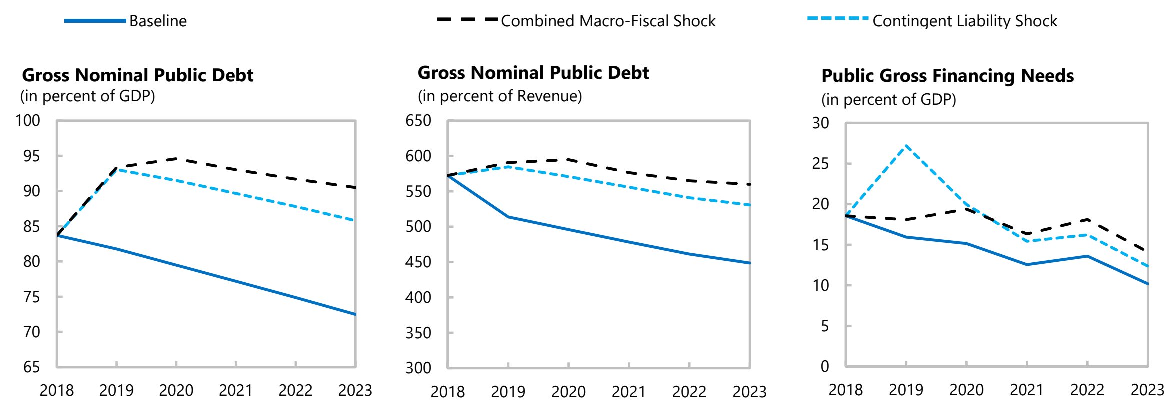
Source: IMF staff.

Sri Lanka: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



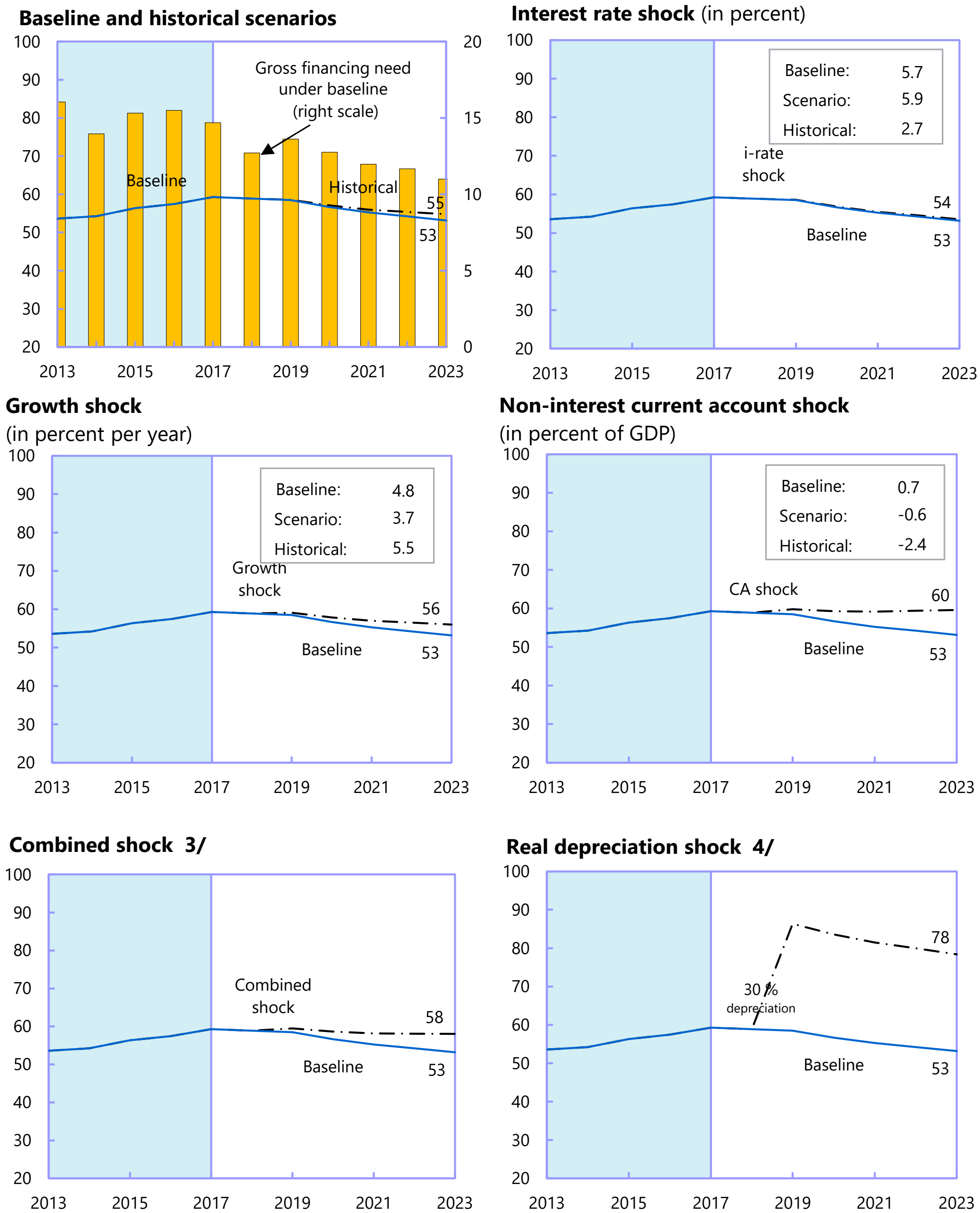
Underlying Assumptions
(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	4.5	4.7	4.8	4.9	5.0
Inflation	5.0	4.7	4.8	4.7	4.8	4.7
Primary balance	1.0	1.5	1.6	2.1	2.1	2.0
Effective interest rate	7.7	7.9	8.2	8.5	8.7	8.8
Real Interest Rate Shock						
Real GDP growth	4.0	4.5	4.7	4.8	4.9	5.0
Inflation	5.0	4.7	4.8	4.7	4.8	4.7
Primary balance	1.0	2.0	2.1	2.1	2.1	2.0
Effective interest rate	7.7	7.9	8.8	9.5	10.1	10.5
Combined Shock						
Real GDP growth	4.0	2.4	2.6	4.8	4.9	5.0
Inflation	5.0	4.2	4.2	4.7	4.8	4.7
Primary balance	1.0	1.5	1.2	2.1	2.1	2.0
Effective interest rate	7.7	8.3	8.4	9.2	9.8	10.3

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	2.4	2.6	4.8	4.9	5.0
Inflation	5.0	4.2	4.2	4.7	4.8	4.7
Primary balance	1.0	1.6	1.4	2.1	2.1	2.0
Effective interest rate	7.7	7.9	8.2	8.5	8.7	8.8
Real Exchange Rate Shock						
Real GDP growth	4.0	4.5	4.7	4.8	4.9	5.0
Inflation	5.0	9.9	4.8	4.7	4.8	4.7
Primary balance	1.0	2.0	2.1	2.1	2.1	2.0
Effective interest rate	7.7	8.3	7.8	8.1	8.4	8.5
Contingent Liability Shock						
Real GDP growth	4.0	4.5	4.7	4.8	4.9	5.0
Inflation	5.0	4.7	4.8	4.7	4.8	4.7
Primary balance	1.0	-8.0	2.1	2.1	2.1	2.0
Effective interest rate	7.7	9.7	9.1	9.1	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, 2013–23

(In percent of GDP, unless otherwise indicated)

	Actual 2013	2014	2015	2016	2017	10-Year Historical Average	10-Year Standard Deviation	Projections 2018	2019	2020	2021	2022	2023	Debt-stabilizing non-interest current account 6/
Baseline: External debt	53.6	54.2	56.4	57.4	59.3			**58.9**	**58.5**	**56.7**	**55.3**	**54.2**	**53.2**	**-1.8**
Change in external debt	-0.6	0.7	2.1	1.1	1.8			-0.4	-0.4	-1.8	-1.4	-1.0	-1.1	
Identified external debt-creating flows (4+8+9)	-2.5	-2.1	1.3	0.2	-3.2			-1.6	-1.2	-1.6	-1.5	-1.6	-1.7	
Current account deficit, excluding interest payments	2.0	1.0	0.9	0.7	1.0			0.3	0.2	-0.4	-0.9	-1.3	-1.0	
Deficit in balance of goods and services	8.6	8.1	7.6	7.4	7.2			6.9	7.0	6.5	6.1	5.7	5.4	
Exports	20.3	21.1	21.3	21.5	21.8			21.9	21.8	21.7	21.4	21.2	20.8	
Imports	28.9	29.2	28.9	28.9	29.0			28.8	28.8	28.2	27.6	26.9	26.2	
Net non-debt creating capital inflows (negative)	-1.5	-1.3	-0.7	-0.8	-1.5			-1.8	-1.3	-1.4	-1.3	-1.3	-1.3	
Automatic debt dynamics 1/	-3.0	-1.9	1.1	0.4	-2.8			-0.1	-0.1	0.2	0.7	0.9	0.7	
Contribution from nominal interest rate	1.4	1.5	1.5	1.5	1.6			2.1	2.4	2.8	3.3	3.5	3.2	
Contribution from real GDP growth	-1.7	-2.5	-2.7	-2.5	-1.7			-2.2	-2.5	-2.6	-2.5	-2.5	-2.5	
Contribution from price and exchange rate changes 2/	-2.7	-0.9	2.4	1.3	-2.7			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.9	2.8	0.8	0.9	5.1			1.2	0.9	-0.3	0.1	0.6	0.6	
External debt-to-exports ratio (in percent)	264.6	257.2	264.7	266.6	271.5			269.0	268.4	261.3	257.9	255.9	255.4	
Gross external financing need (in billions of US dollars) 4/	11.9	11.1	12.2	12.6	12.9			11.9	13.6	13.6	13.6	14.2	14.3	
in percent of GDP	16.0	14.0	15.3	15.5	14.7			12.7	13.6	12.8	12.0	11.7	11.0	
Scenario with key variables at their historical averages 5/								**58.9**	**58.6**	**57.1**	**56.0**	**55.4**	**54.8**	**-4.5**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	3.4	5.0	5.0	4.5	3.1	5.5	2.1	4.0	4.5	4.7	4.8	4.9	5.0	
GDP deflator in US dollars (change in percent)	5.3	1.5	-4.5	-2.6	4.9	3.6	7.6	2.6	2.0	1.9	1.9	1.9	2.1	
Nominal external interest rate (in percent)	2.9	2.9	2.8	2.7	3.0	2.7	0.3	3.8	4.3	5.1	6.2	6.7	6.3	
Growth of exports (US dollar terms, in percent)	11.1	11.0	1.2	3.0	9.6	7.8	10.6	7.0	6.2	6.2	5.5	5.8	5.3	
Growth of imports (US dollar terms, in percent)	-1.0	7.6	-0.6	1.9	8.4	8.8	19.9	5.9	6.6	4.5	4.4	4.4	4.4	
Current account balance, excluding interest payments	-2.0	-1.0	-0.9	-0.7	-1.0	-2.4	2.6	-0.3	-0.2	0.4	0.9	1.3	1.0	
Net non-debt creating capital inflows	1.5	1.3	0.7	0.8	1.5	1.2	0.4	1.8	1.3	1.4	1.3	1.3	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.

Appendix I. Letter of Intent

Colombo, May 16, 2018

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

Dear Ms. Lagarde:

This letter serves as an update to our previous Letters of Intent (LOI) for the Extended Arrangement. Our economic program, supported by the extended arrangement, has been instrumental in stabilizing the economy and achieving important structural reforms such as the implementation of the new Internal Revenue Act and the cabinet approval of an automatic fuel pricing mechanism. For this review, we have met all end-December and continuous quantitative performance criteria and implemented six structural benchmarks, albeit with some delay. Inflation exceeded the upper limit for the inner band for December, but has since fallen back within the inner band, in the context of prudent management of monetary policy by the CBSL.

The attached Memorandum of Economic and Financial Policies (MEFP) and Technical Memorandum of Understanding (TMU) update the versions dated November 17, 2017 and set out the economic policies that we intend to implement under the Fund-supported program in 2018–19. We believe that the policies set forth in the attached MEFP, together with the previously issued MEFP and LOI, are adequate to achieve the objectives of our economic program, but we stand ready to take additional measures as appropriate to ensure achievement of its objectives. We will continue to consult in advance with the Fund on adoption of new 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 our performance to date and our strong commitment going forward, we request completion of the Fourth Review of the Extended Arrangement under the EFF, after which we intend to draw one tranche amounting to SDR 177.774 million. In keeping with its policy of transparency, we authorize 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 in 2017 due to the lingering effects of the drought since late 2016 and floods in 2017**. Real GDP grew by 3.1 percent in 2017, the lowest in a decade, due to weather-related shocks and the resulting contraction in agriculture, which only started to normalize in the last quarter of 2017. Credit growth continued on its downward trend reaching 14.7 percent in December 2017. The current account deficit widened to about 2.6 percent of GDP due to higher imports of food and fuel from the weather-related shocks. We expect growth to rebound in 2018 as agriculture production normalizes and various infrastructure projects take off. As weather-related supply disruptions dissipate, headline inflation is stabilizing to mid-single digit and is expected to remain within the inner consultation band under the program for the remainder of the year.

II. PROGRAM PERFORMANCE

2. **Program performance for the fourth review has been broadly on track and the Cabinet approval of the automatic fuel pricing mechanism reaffirms our commitment towards reforms.** The end-December quantitative performance criterion and the end-March indicative target for the primary balance were both met. However, due to weather-related shocks and program implementation delays, the indicative targets for end-December and end-March on tax revenues were missed as well as the end-March indicative target on cost of non-commercial obligations for fuel and electricity (net of government transfers). The end-December NIR target was met by a margin of $721 million, and the reserve money target was below the IT target by about Rs 26 billion. Unfortunately, weather related supply disruptions caused a significant increase in food inflation leading to the breach of the inner consultation band under the Monetary Policy Consultation Clause (MPCC) in December 2017 but inflation stayed within the band in March 2018. Cabinet approval of an automatic fuel pricing mechanism and the establishment of the Bulk Supply Transaction Account for the electricity sector in early May have been critical steps to reduce fiscal risks from SOEs and enhance transparency. We have made progress on structural measures, especially on implementing an IT-based commitment control system with commitment ceilings for line ministries for the 2018 budget. Cabinet has approved a debt management strategy for international sovereign bonds maturing over 2019-22, ahead of schedule, in January 2018. Cabinet approved in April 2018 a policy note outlining the key elements of amendments to the Monetary Law Act (MLA) and a detailed IRA tax manual was published in May 2018, albeit with delays. 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 sustainable reduction of the fiscal deficit and public debt through domestic revenue mobilization. The government reduced the overall fiscal deficit to 5.5 percent of GDP in 2017. This consolidation was achieved by rationalizing current expenditure and bolstering VAT collections, which offset the unwinding of one-off tax increases in 2015. Looking ahead, we are committed to a steady deficit reducing path to ensure a sustained decline in the public debt to GDP ratio over the medium term. 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. To achieve this, the program targets 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 in 2019. The annual budget proposals for 2019 will be in line with the program targets as described in Table 2 (structural benchmark).

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. The primary balance target was met for 2017. The ratio of tax revenue to GDP increased by 0.3 percentage point to 12.6 percent in 2017, but fell slightly short of the program's indicative target by a 0.1 percentage point. This reflects the growth slowdown from the drought and the floods, 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 (an increase by about 1 percentage point of GDP due to the 2016 VAT amendment) could not offset. On the expenditure side, spending needs to address the drought and floods reached 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 was initiated in mid-2017 to generate the necessary budget space without unduly cutting productive expenditure. In the second half of 2017, 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 47 billion (0.4 percent of GDP) in 2017 for Ceylon Electricity Board (CEB), i.e., non-commercial obligations (NCOs) to provide electricity at below cost-recovery tariffs (see below for more discussions), of which the government transferred Rs 6 billion to CEB. Capital expenditure and net lending was increased to

4.9 percent of GDP, from 4.8 percent in 2016. As a result, the central government recorded a small primary surplus of Rs 2.1 billion in 2017, meeting the program target (floor) of a deficit of Rs 23 billion (0.2 percent of GDP). Ceylon Petroleum Corporation (CPC) recorded a profit of Rs 3.5 billion (0.02 percent of GDP).

6. **The 2018 budget targets a primary surplus of about Rs 145 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 measures, excise tax reforms for vehicle and beverage, new levies on telecom and financial institutions, and rate revision of fees and charges. Revenue losses from a cut in fuel import duties in late 2017 (estimated at ¼ percent of GDP for 2018) will be offset by phasing out the cut as the fuel pricing mechanism comes into effect and through prudent expenditure management. Expenditure space for productive human and physical capital will be preserved. Should revenues exceed the program targets, we plan to bring down debt. 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 continue to present our fiscal performance to Parliament on a quarterly basis, and any revenue shortfalls will prompt us to realign expenditure under Parliamentary oversight. We have missed the end-March indicative target on the NCOs for fuel and electricity (net of government transfers). However, the government will earmark resources within the budget to compensate by end-year CPC and/or CEB for the cost of the NCOs. The published budget speech contained a tax expenditure statement, a plan to rationalize tax expenditures, the estimated fiscal cost of NCOs for CPC and CEB, 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 remain focused on achieving our medium-term fiscal targets and intend to strengthen our fiscal rule legislation to lock in these hard-won gains.** While legislation governing fiscal rules has been in place since 2003, performance under the rule has been mixed due to lack of effective enforcement mechanisms. We intend to revise the Fiscal Management (Responsibility) Act, with technical assistance from the IMF, to design our fiscal rule so that it is consistent with our medium-term debt-reduction objectives and contains effective enforcement mechanisms. In terms of operational targets, we remain committed to achieving an overall deficit of 3.5 percent of GDP by 2020. In line with our Vision 2025 document and in view of the significant fiscal risks from the SOE sector, we will calibrate the rule to anchor our ambitious consolidation path beyond 2020 and reach prudent debt levels as soon as feasible. We will also introduce features in the rule to improve enforcement through use of correction mechanisms, while ensuring well-defined escape clauses are in place to account for unforeseen events such as natural disasters. We will obtain cabinet approval of a policy note outlining key elements of amendments to the Fiscal Management (Responsibility) Act of 2003, with a view to strengthening fiscal rules, with legally binding fiscal targets, a clearly defined escape clause, and automatic

correction mechanism in case of target breach, in consultation with the IMF, by March 2019 (**proposed structural benchmark**).

8. We continue to develop our medium-term debt management framework and strengthen technical capacity with multilateral and bilateral support. A cabinet paper outlining a strategy to manage international sovereign bond maturities between 2019 and 2022 was approved in January 2018 (structural benchmark). The Active Liability Management Act was approved by Parliament in March. This will enable the Government of Sri Lanka (GOSL) to proactively address part of the refinancing requirements ahead of time (reduce rollover peaks) and extend the maturity duration for both domestic and foreign debt, especially that of international sovereign bonds. Proceeds from commercializing public assets will be used effectively to smooth the bunching of debt service payments and to support liability management exercises, and earmarked for future debt service payments particularly for the international sovereign bonds starting to mature in 2019. We will approve a Medium-Term Debt Strategy (MTDS) for 2019–23 by October 2018 (**proposed structural benchmark**), supported by technical assistance from the IMF and the World Bank. The MTDS will (i) quantify the main risks of Sri Lanka's public debt portfolio; (ii) specify an appropriate currency and maturity composition of debt issuance and a strategy to achieve it; (iii) present debt issuance options based on cost-risk tradeoffs; (iv) be consistent with monetary and fiscal policy objectives; and (v) cover both debt and guarantees. To further strengthen public debt management, we will submit by March 2019 for approval to cabinet a plan with a clear timetable for the establishment of an independent debt management agency, in line with international best practices, with technical assistance from the IMF and the World Bank (**proposed structural benchmark**). The agency will (i) be endowed with financial and administrative autonomy, (ii) conduct, in line with an MTDS, all operations related to the issuance of debt and secondary market activities, and (iii) participate in the evaluation and approval of all debt, derivatives, and guarantees. To keep contingent liabilities in check, a **proposed indicative target** will be set for end-December 2018 on government guarantees that would keep the ratio of outstanding guarantees to GDP at 4.9 percent of GDP, which is higher than the end-2017 ratio of 4.4 percent of GDP to accommodate additional guarantees for water and transportation development projects.

9. We will continue to make progress with improving transparency in fiscal reporting. Beginning in the first quarter of 2017, we began reporting fiscal performance to Parliament on a quarterly basis. Tax expenditure statements were included for the first time in Budget 2017—a policy that was continued in Budget 2018 and strengthened further with the inclusion of non-commercial obligations of CPC and CEB. While we are committed to maintaining these good practices, we have room to improve our fiscal statistics, in line with the 2014 Government Finance Statistics Manual (GFSM). Supported by IMF technical assistance, by December 2018, we will compile GFSM-compatible tables on the cash operations and debt stock of the budgetary and extra-budgetary central government, and obtain cabinet approval by end-September 2018 of a strategy with a clear timetable to transition to accrual-based accounting for the general government, with support from IMF TA, by end-2022.

Revenue Mobilization

10. A number of tax policy 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, concluded that VAT expenditure is 1.3 percent of GDP. Informed by the review, Budget 2018 envisaged to broaden the VAT base further by eliminating exemptions on items including yarn, fabrics, industrial racks, electronic goods, and airplanes and parts, which are expected to yield about 0.2 percent of GDP in revenues.

- On the personal and corporate income tax side, an important policy milestone was reached with the legislation of the Inland Revenue Act (IRA) which came into force on April 1st, 2018. 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 income; and a transparent set of investment-based tax incentives.

- Looking ahead to Budget 2019 and recognizing the need for about 1 percent of GDP in additional revenue, we plan to focus on our policy efforts to broaden the base of income tax and VAT and rationalize excise taxes.

11. Now that the IRA has become effective our attention has turned to implementation. The IRA implementation steering committee has been meeting regularly and has outlined a detailed workplan to facilitate the rollout including:

- **Regulations.** Draft regulations relating to transitional provisions were published in early April 2018. Delegation of powers for administrative authority has been carried out for the relevant IRD staff.

- **Staff training.** IRD staff has undergone rigorous training and are now familiar with the inner workings of the law and its administrative provision. Head office staff has begun to expand training to regional IRD staff.

- **Comprehensive tax manual.** Although originally expected in January 2018 (a structural benchmark), the manual was published in May 2018 after the entry into force of the IRA on April 1st. The manual outlines practical tax and administrative examples and provides guidance to taxpayers on what to expect under the new law. Nevertheless, further administrative examples will continue to be added.

- **Communication and taxpayer awareness.** In addition to the manual, a comprehensive media campaign was rolled out, with taxpayer awareness programs in Colombo and key regional centers.

- **Changes to IT systems.** Funding for implementing changes to the RAMIS system has been secured.

- **Redesign of business processes.** The required modifications to internal business processes for the new taxes, including the capital gains tax and modified withholding taxes such as Pay-As-You-Earn income taxes, were introduced in March 2018.

12. The use of information technologies and improved administrative powers for IRD under the new IRA are expected to help generate revenues. IRD successfully rolled out the RAMIS IT system and adopted a VAT compliance strategy with risk-based audits first for large businesses (construction sector) and plan to expanded it to small and medium enterprises. Under the new IRA, IRD can charge interest and penalties on late filings and taxpayers are required to pay tax before filing an objection – all of which should improve compliance. 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.

Expenditure Reforms

13. A disciplined and prioritized approach to government 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. 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 and enhanced insurance schemes for natural disasters. In November 2016, Cabinet approved a plan to establish a gender-budgeting mainstreaming program in every ministry. We have initiated actions to develop key performance indicators to facilitate gender budgeting starting with 20 ministries (see paragraph 32).

14. We are enhancing social safety nets to ensure more effective and better targeted social welfare schemes. We have established a Welfare Benefits Board (WBB) under the MOF that aims at rationalizing and broadening the coverage of the various social assistance schemes through a consolidated national database for social assistance beneficiaries. With support from the World Bank, the WBB will develop and manage a new Social Registry, a database on welfare program beneficiaries to determine the eligibility of welfare programs, starting with four major cash transfer programs (Samurdhi, Elderly Benefit, Disabled Benefit, and Chronic Kidney Disease Benefit). To improve coverage and targeting of these welfare programs, we will obtain cabinet approval of the eligibility criteria for the four programs, based on objective and verifiable characteristics of beneficiaries by August 2018 (**proposed structural benchmark**). We plan to make the Social Registry operational, establishing and testing data capture processes, and starting to collect eligible beneficiaries' information by January 2019.

15. 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 it is now capable of imposing quarterly spending ceilings for all ministries (January 2018 structural benchmark). This will help prevent spending units from contracting with vendors beyond the commitment ceiling and allow the government to adjust and reallocate spending should the need arise during the year.
- The ITMIS should significantly expand PFM capabilities, including commitment control, budget preparation, treasury operations, and accounting. The adoption 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. A detailed rollout plan has been developed and, during the transition, CIGAS will remain operational. The ITMIS roll-out will be implemented on a staggered basis, with full roll-out expected by September 2019.

IV. STATE ENTERPRISES

16. The financial condition of some of our state enterprises and ultimate responsibility for their existing obligations are a long-standing 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 by 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).

17. To enhance fiscal discipline, we plan to improve financial disclosure of SOEs and step up monitoring of KPIs contained in their Statements of Corporate Intent. 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). Consistent with our engagement with these SOEs, we have submitted to cabinet a compliance report outlining the performance against KPIs in May 2018 and will update it by September 2018. We also plan to expand the coverage of the SCIs to an additional 10 SOEs. We will accelerate publications of audited financial statements for the SOEs with SCIs, starting with 2016 and 2017 reports by end-2018.

18. We will approve a restructuring plan to ensure SriLankan Airlines' commercial viability and increase its attractiveness to potential investors. After careful consideration of potential options, we determined that a comprehensive restructuring would be the least risky and most cost-effective way to resolve the financial issues of SriLankan Airlines. To oversee this process, we have created a Restructuring Committee and engaged an expert airline consulting firm to develop a detailed restructuring plan. This plan involves immediate and difficult changes including further network and fleet optimization as well as debt resolution. A new board was appointed in March and is tasked to implement restructuring measures to reduce operational and financial costs of the airline and eliminate future losses. We will obtain cabinet approval of such measures by July 2018 (**proposed structural benchmark**).

19. We will complete energy pricing reforms in 2018. The original structural benchmark for establishing automatic fuel and electricity pricing mechanisms by end-2016 was not met. We are pursuing a sequence of steps to put the reform process back on track. We completed a report outlining the cost of non-commercial obligations (NCOs) for fuel and electricity in November 2017 with a delay (structural benchmark), supported by IMF TA. To correctly estimate the cost of non-commercial obligations for electricity, the CEB and the Public Utilities Commission (PUC) have established a Bulk Supply Transactions Account and are using it to settle transactions between generators, the transmission operator, and distributors as specified in the November 2015 tariff methodology, with monthly submissions by CEB to PUC of related bank statements and other transactions, as of May 2018 (end-March structural benchmark). 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, a quarterly indicative target has been set on the cost of NCOs for fuel and electricity (net of government transfers) for 2018Q1-Q4 (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, cabinet approved the automatic pricing mechanism for fuel in May 2018 (end-March structural benchmark), based on cost reflective pricing formula developed by a governmental technical committee in 2015. We will obtain cabinet approval of the automatic pricing mechanism for electricity by September 2018 as described in Table 2 (structural benchmark). 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.

V. MONETARY AND EXCHANGE RATE POLICY

20. The focus of monetary policy will remain on keeping inflation in the mid-single digits. 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. Despite this tightening, the upper limit of the inner band of the MPCC was breached in December 2017, mainly driven by food inflation caused by weather-related supply disruptions. Since then, inflation has started to abate and the March inflation remained within the inner MPCC band. Considering the moderation in inflation during the first quarter of 2018 and favorable inflation outlook as well as the continued negative output gap, the CBSL reduced the Standing Lending Facility Rate (SLFR), which is the upper bound of the policy interest rate corridor by 25 basis points in April 2018. The CBSL considers the current monetary stance to be adequate to stabilize inflation and credit growth, since these have already begun to moderate and will continue to adjust it nimbly with evolving macroeconomic conditions. Monetary policy will continue to be monitored through the MPCC (see the Technical Memorandum of Understanding), supported by monitoring of reserve money developments.

21. We stand ready to further strengthen the CBSL's legal framework. Currently, the CBSL's effectiveness is hampered by monetary financing, non-core activities, and inadequate autonomy. These factors are structural impediments in the transition path towards flexible inflation targeting (FIT) and will also need to be addressed in response to the 2016 safeguards assessment, as described below. To remedy those issues, we are committed to modifying the Monetary Law Act (MLA). Following preparatory work by CBSL, a policy note outlining the key elements of amending the MLA was submitted to the cabinet in March 2018 and the cabinet approved the note (end-March structural benchmark) in early April 2018. As a next step, we will draft the amendments to the MLA to strengthen CBSL's mandate, decision-making structures, autonomy, accountability, transparency, and instruments for implementing inflation targeting in consultation with IMF staff, and we will obtain cabinet approval of the amended MLA by December 2018 (**proposed structural benchmark**). We will subsequently submit a bill to amend the MLA to parliament by March 2019. Specifically, the amendments to the MLA will, among other issues: (i) establish price stability as the primary objective of monetary policy; (ii) address the issue of Central Bank lending to the government related to purchases of treasury bills in the primary market and advances to the government; (iii) eliminate quasi-fiscal activities of the CBSL, if any; (iv) strengthen the CBSL's institutional, personal (e.g., the government's voting representation in monetary policy) and financial (e.g. on recapitalization and profit distribution) autonomy, accountability, and transparency; and (v) streamline decision-making and monetary policy formulation process.

22. We will make further progress on the roadmap towards flexible inflation targeting and flexible exchange rate regime formulated in October 2017. 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 are being incorporated into program reviews. 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; (iii) adopt FX intervention policies consistent with a flexible exchange rate regime; (iv) improve foreign exchange market functionality, including by further liberalizing financial account transactions, deepening the FX market, and introducing a transparent FX intervention mechanism; (v) ensure the stability of the financial sector by adequately assessing the risks associated with adopting greater FX flexibility; (vi) develop technical infrastructure, including through improved forecasting and modeling capabilities with continued support from IMF TA; (vii) establish a policy decision making process governed by the guidelines on the choice of targets and how unanticipated shocks would be addressed; and (viii) strengthen public-awareness outreach program as the cornerstone of CBSL's communication strategy during the IT transition.

23. In parallel with moving towards flexible inflation targeting, the CBSL will strengthen its 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 respond to disorderly FX market conditions, and will continue to do so. A "Request for Quotes" (RFQ) method can provide a more transparent structure for carrying out direct interventions. In this regard, we plan to intervene in FX markets through a Request-for-Quotes (RFQ) system that operates under transparent rules and permits competitive bidding by all banks that participate in FX trading. We will share our plans for the RFQ system design with the IMF and discuss possible implications on our obligations under Article VIII. We will finalize the RFQ system design and start using the system by December 2018 (**proposed structural benchmark**).

24. A strengthening of reserve coverage (guided by the IMF's ARA reserve metric) has been programmed, supported by regular FX purchases. Supported by a favorable external environment, we increased the pace of FX purchases bringing the level of program NIR (per the TMU definition) from $4.2 billion at end-June to $5.1 billion at end-December 2017. Between end-May 2017 and end-February 2018, the exchange rate has changed by -1.5 percent against the US$. We will continue to make the necessary FX purchases to enable the steady buildup of reserves, while allowing for greater exchange rate flexibility. Further, we are committed to having monthly consultations 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 $1.4 billion at end-February 2018. We plan to further reduce swap liabilities gradually during 2018.

25. 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, Sri Lanka enacted the Foreign Exchange Act which repealed the previous exchange control law to further liberalize the FX transactions. The CBSL and the government will also abstain from providing subsidized exchange guarantees for foreign currency borrowing.

26. We will assess removing the FX repatriation requirement. We introduced a repatriation requirement of export proceeds with the aim to encourage exporters to keep FX within the domestic financial system and reduce the imbalance of FX market in the face of substantial balance payment pressures. However, we consider that the role of this capital flows management measure has diminished as the balance of payment pressure receded. We will assess removing the requirement with the timing linked to progress with the macroeconomic adjustments (especially net international reserves) envisaged under the program.

VI. FINANCIAL SECTOR POLICIES

27. 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 2017 and will continue to ensure that banks comply with the current schedule by January 2019; and (ii) established in January 2018 a new Resolution and Enforcement Department within CBSL which will oversee any resolution action that is being duly transferred from the respective regulator of any financial institution supervised by CBSL in need of resolution.

28. To ensure greater stability of the financial sector, we intend to: (i) continue to monitor credit growth and report to the Monetary Board to analyze emerging issues and developments in credit by both banks and NBFIs; (ii) develop sets of macro- and micro-prudential tools, that can be implemented as needed in case credit expands too fast in a sector or individual firms are following imprudent lending practices; (iii) encourage the Condominium Management Authority to introduce a regulatory framework to have a mandatory certification process and actions prior to initiating a sale of a condominium; (iv) improve the management of exchange rate risk in the financial sector in the context of the move towards greater exchange rate flexibility; (v) use a Financial System Stability Review provided by IMF assistance to assess both FX risks of banks, and credit risks in banks and NBFIs; (vi) review and update several laws including the Banking Act, Finance Business Act, and the Microfinance Act to modernize the financial sector; (vii) ensure that all banks abide by the CBSL's schedule for increases in their capital adequacy ratios under Basel III, and that all banks and NBFIs meet their new core capital requirements as stipulated by CBSL; (viii) strengthen NBFI supervision so that cases where capital is significantly lacking, or where severe shortcomings in business practices were identified, are referred to the resolution and enforcement department for action; and (ix) properly authorize the CBSL's resolution and enforcement department to take resolution and enforcement actions and take steps to amend the legal framework in 2019 to enable the CBSL to carry out its enforcement and resolution functions effectively.

29. Despite progress, stepped-up efforts are needed to strengthen our anti-corruption framework and ensure effective implementation of Sri Lanka's Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regime. By end-December 2018, we will submit to Parliament a draft law to criminalize all outstanding United Nations Convention Against Corruption (UNCAC) offences and an amendment to our Asset Disclosure Law, covering a comprehensive range of public officials, including assets legally owned and beneficially owned, and subject to dissuasive sanctions for non-compliance or false declarations, verifiable and publicly available online. The Financial Intelligence Unit (FIU) is taking several measures to address key issues with relevant ministries and stakeholders to ensure all AML/CFT measures are implemented during 2018. The draft amendments to the Mutual Assistance in Criminal Matters Act (MACMA) have been finalized and will be submitted to Parliament in due course. It is expected to get this amendment passed by the Parliament before the end of June 2018. Amendments to Trust Ordinance have been passed by the Parliament in March 2018. Furthermore, cabinet approval has been obtained in March 2018 to amend the Companies Act No 7 of 2007 by including a new provision on beneficial ownership disclosures as an anti-money laundering tool and the drafting process has started. Customer due diligence (CDD) rules for the designated non-financial businesses and professions (DNFBPs) were issued in January 2018. Guidelines for casino, real estate and gem and jewelry sectors have been issued in April 2018. Guidelines on identification of beneficial ownership for financial institutions has been issued in April 2018. Sri Lanka has also issued regulation promulgating United Nations Security Council Resolution (UNSCR) 1718 on Democratic Socialist Republic of Korea (DPRK) in October 2017 and the implementation of the same has been completed. Going forward, we will enhance risk-based supervisory activities in the financial sector, including by imposing enforcement actions where appropriate, and introduce risk-based supervision of high-risk DNFBPs such as real estate dealers, casinos and the gem and jewelry sector. Further, regulation promulgating UNSCR 2231 has been drafted and is expected to be issued before June 2018. We will also ensure adequate resources for the FIU.

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

30. Greater integration into regional and global supply chains, higher levels of FDI, and enhanced prospects for private sector investment are critical steps to achieve our medium-term macroeconomic objectives. In addition to better infrastructure, improvements are necessary in the trade regime and investment climate. We have entered into a Free Trade Agreement with Singapore in January 2018, and started negotiations on new Free Trade Agreements with China, India, Japan, Malaysia and Thailand. The GSP plus trade status with EU—reinstated in May 2017—has already started to have a positive impact on our exports.

31. To boost trade and private sector development, we will seek to reduce costs and bolster competitiveness. In 2017, we removed around 1,200 para-tariffs. We will conduct a stock-taking review of Sri Lanka's trade regime, including an evaluation of tariffs and para-tariffs and other nontariff barriers that have led to a high level of effective protection and hampered trade by October 2018. Based on this review, we will prepare and obtain cabinet approval of a strategy to rationalize remaining para-tariffs over the medium term, together with new revenue sources to offset revenue losses by March 2019 (**proposed structural benchmark**). We are also 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 operationalize a one stop shop for foreign direct investment under the Board of Investment by October 2018. These steps should help create a predictable, consistent, and transparent trade regime which will improve competitiveness, attract FDI, and unlock new sources of growth. We are also making progress with the development of the Port City project. We are considering the introduction of a special regulatory regime for the project, with a view to reach the full growth and social impact potential of this mega-project while ensuring transparency and even-handedness in the investment development process. We will share our plans with the IMF and discuss any implications under the program.

32. We have undertaken several measures to remove barriers that constrain female labor force participation. We plan to launch gender budgeting in 20 ministries as pilots during the year with assistance from USAID and eventually expand it to all line ministries. With a view to improving access to good-quality and affordable child care facilities, we have already provided training to 450 childcare providers and established 35 new childcare facilities. Going forward, we will seek Cabinet approval on a policy guideline by October 2018 that will require employers to provide childcare services in housing complexes and industrial zones. We will take additional initiatives to facilitate part-time and flexible work arrangements by taking legislative measures as needed, and improving access to tertiary education and vocational training. These measures, by facilitating female labor force participation, are expected to boost growth in the long run.

VIII. RISKS AND CONTINGENCIES

33. The high degree of uncertainty continues to pose economic and financial risks to the program. The main domestic risks include: (i) weaker than projected revenues due to implementation delays in fiscal reforms; (ii) a slower-than-expected recovery in agriculture which keeps food inflation high; (iii) weaker than expected performance of state owned enterprises; and (iv) a reacceleration of credit growth, particularly in construction which would add to macro-financial vulnerabilities. External risks mainly stem from reversal of portfolio inflows which raises government borrowing costs and slows the buildup of foreign reserves. 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 stronger and resilient economy at the end of the program.

IX. PROGRAM MONITORING

34. 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 fifth and sixth reviews will require observance of the quantitative performance criteria for end-June 2018 and end-December 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 fifth and sixth reviews of the program are scheduled to take place on or after November 20, 2018, and April 20, 2019 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-Sep. (IT)				end-Dec.				end-Mar. (IT)				end-Jun.	end-Sep. (IT)	end-Dec.
	Prog.	Adj. Prog	Act.	Met / not met	Prog.	Adj. Prog	Act.	Met / not met	Prog.	Adj. Prog	Act.	Met / not met	Prog.	Prog.	Prog.
Quantitative performance criteria															
Central government primary balance (floor, in billion rupees)	-4	-4	16	Met	-23	-23	2	Met	15	15	15	Met	45	90	141
Program net official international reserves (Program NIR, floor, in million US$) 1/ 2/	1,976	2,057	2,568	Met	2,236	2,212	2,933	Met	1,053	-216	-59	Met	1,133	2,098	1,771
Continuous performance criteria (cumulative from beginning of the program)															
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	0	Met	0	0	0	Met	0	0	0	Met	0	0	0
Monetary policy consultation clause															
Year-on-year inflation in Colombo Consumers Price Index (in percent) 3/															
Outer band (upper limit)	8.8	8.8	...		8.5	8.5	...		7.7	7.7	...		7.7	8.1	7.8
Inner band (upper limit)	7.3	7.3	...	Within	7.0	7.0	...	Outside	6.2	6.2	...	Within	6.2	6.6	6.3
Actual / Center point	5.8	5.8	6.0	inner	5.5	5.5	7.5	inner	4.7	4.7	4.8	inner	4.7	5.1	4.8
Inner band (lower limit)	4.3	4.3	...	band	4.0	4.0	...	band	3.2	3.2	...	band	3.2	3.6	3.3
Outer band (lower limit)	2.8	2.8	...		2.5	2.5	...		1.7	1.7	...		1.7	2.1	1.8
Indicative targets															
Central government tax revenue (floor, in billion rupees)	1,232	1,232	1,240	Met	1,680	1,680	1,670	Not met	447	447	425	Not met	924	1,428	1,934
Reserve money of the CBSL (ceiling, end of period stock, in billion rupees) 4/	935	935	909	Met	967	967	941	Met	1,020	1,020	978	Met	1,025	1,045	1,069
Cost of non-commercial obligations (NCOs) for fuel and electricity (net of government transfers) (ceiling, in billion rupees) 5/	...	...	...		...	...	...		0	0	19	Not met	0	0	0
Treasury guarantees (ceiling, in billion rupees)	...	...	...		...	...	...		...	...	...		...	...	718
Memorandum items:															
Net official international reserves (CBSL's conventional definition, end of period stock, in million US$, market exchange rate) 1/	6,023	...	6,556		6,541	...	6,597		7,594	...	6,286		7,424	7,877	7,475
CBSL's outstanding liabilities in FX swaps with domestic commercial banks (in million US$)	...	...	1,851		...	...	1,495		...	...	1,235		...	...	...
Foreign program financing by the central government (in million US$) 2/	125	...	0		225	...	0		0	...	125		0	125	225
Net borrowings from SLDBs and FCBUs by the central government (in million US$) 2/	627	...	571		627	...	570		0	...	74		-150	-1,118	-1,118
External commercial loans by the central government (in million US$) 2/	1,950	...	2,482		2,200	...	2,482		1,500	...	0		1,500	3,500	3,500
Proceeds from commercialization of public assets to non-residents (in million US$) 2/	200	...	0		200	...	292		0	...	97		400	682	682
Amortization of official external debt by the central government (in million US$) 2/	889	...	959		1,065	...	1,181		365	...	430		572	1,055	1,276
Cost of NCOs for fuel (net of government transfers) 5/	...	...	...		...	...	...		0	...	10		0	0	0
Cost of NCOs for fuel	...	...	...		...	...	...		...	...	10		...	...	...
Government transfers for NCOs for fuel	...	...	...		...	...	...		...	...	0		...	...	...
Cost of NCOs for electricity (net of government transfers) 5/	...	...	...		...	...	...		0	...	9		0	0	0
Cost of NCOs for electricity	...	...	...		...	...	...		...	...	9		...	...	...
Government transfers for NCOs for electricity	...	...	...		...	...	...		...	...	0		...	...	...

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

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: Structural Benchmarks under the EFF-Supported Program	
A. Proposed Structural Benchmarks	**Target Completion Date**
Fiscal policy	
Senior management at the Ministry of Finance and CBSL to approve a Medium-Term Debt Strategy (MTDS) for 2019-23, which (i) quantifies the main risks of Sri Lanka's public debt portfolio; (ii) specifies an appropriate currency and maturity composition of debt issuance and a strategy to achieve it; (iii) presents debt issuance options based on cost-risk tradeoffs; (iv) is consistent with monetary and fiscal policy objectives; and (v) covers both debts and guarantees.	Oct-18
Cabinet to approve a policy note outlining key elements of amendments to the Fiscal Management (Responsibility) Act of 2003, with a view to strengthening fiscal rules with legally binding fiscal targets, a clearly defined escape clause, and correction mechanisms in case of a target breach, in line with staff recommendations.	Mar-19
Cabinet to approve a plan with a clear timetable for the establishment of an independent debt management agency, in line with international best practices, which consolidates public debt management functions currently belonging to CBSL, MOF, and Ministry of National Policies and Economic Affairs.	Mar-19
SOE reforms	
Cabinet to approve measures to reduce operational and financial costs of SriLankan Airlines and eliminate future losses.	July-18
Monetary and exchange rate policies	
Cabinet to approve the amended Monetary Law Act (MLA), for submission to Parliament by March 2019, to strengthen the CBSL's mandate, decision-making structures, autonomy, accountability, transparency, and instruments for implementing inflation targeting, in line with IMF staff recommendations.	Dec-18
CBSL to operationalize a "Request for Quotes" (RFQ) system, which operates under transparent rules and permits competitive bidding by all banks that participate in FX trading.	Dec-18
Structural reforms	
Cabinet to approve eligibility criteria for four major targeted cash transfer programs (Samurdhi, Elderly Benefit, Disabled Benefit, and Chronic Kidney Disease Benefit), based on objective and verifiable characteristics of beneficiaries.	Aug-18
Cabinet to approve a strategy to rationalize para-tariffs over the medium term, together with new revenue sources to offset revenue losses.	Mar-19

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

Structural Benchmarks	Target Completion Date	Status	Comment
B. Existing Structural Benchmarks			
Monetary and Exchange Rate Policies			
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	Not met (implemented with delay).	The cabinet approved of a policy note to amend the MLA in April 2018.
Fiscal Policy Management			
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 Administration Reform			
MOF to publish a detailed IRA tax manual with practical tax and administrative examples.	January 2018	Not met (implemented with delay).	The manual was published in May 2018 after the entry into force of the IRA in April 2018.
Public Financial Management			
MOF to implement an IT-based commitment control system with commitment ceilings for line ministries for the 2018 budget.	January 2018	Met.	Given delays in implementing the ITMIS modules for commitment control, the existing CIGAS system was 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.
Cabinet to approve a debt management strategy for international sovereign bonds maturing over 2019-22.	June 2018	Met.	In January 2018, cabinet approved tender offers and parallel new issues to refinance maturing sovereign bonds from 2019 onwards.

Table 2. Sri Lanka: Structural Benchmarks under the EFF-Supported Program (continued)			
State Enterprise Reform			
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	Not met (implemented with delay).	Cabinet approved adoption of a cost-reflective fuel pricing mechanism in May 2018. The target date had been reset to March 2018 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	Not met (implemented with delay).	The CEB and the PUC established a Bulk Supply Transactions Account in May 2018 and the PUC published monthly data on the account for 2016-17. This is 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 was reset at the second review to allow time for public consultation and education, followed by a sequence of reforms.
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.
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.

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

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.
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			
Fully roll out by MOF Inland Revenue Department new IT systems (RAMIS) for major domestic taxes (including income tax and VAT), including web- based tax filings for income tax and VAT.	December 2016	Met	
Adopt by MOF Inland Revenue Department 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: 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.
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.
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: Structural Benchmarks under the EFF-Supported Program (concluded)

State Enterprise Reform			
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.
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.
MOF, line ministries, and SOEs to sign and publish Statements of Corporate Intent for the six largest SOEs (Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lankan Airlines, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authorities).	December 2016	Met with delay	Draft Statement of Corporate Intents (SCIs) were finalized in December 2016 for each of the 6 SOEs except for Sri Lankan Airlines. Following Cabinet approval, the SCIs were signed in March 2017 and published in April 2017.
MOF to 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.
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.

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);

g) an indicative target on cost of non-commercial obligations for fuel and electricity (net of government transfers) (ceiling); and

h) an indicative target on treasury guarantees (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.

II. 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 2018 is higher than Rs 230 billion, the floor on the primary balance of the central government for end-December 2018 will be adjusted downward by the difference between the actual amount and Rs

[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.

230 billion. The downward adjustment of the primary balance target will be capped at Rs 20 billion. If the actual amount of gross cash disbursement of project loans in 2018 is lower than Rs 230 billion, the floor on the primary balance of the central government for end-December 2018 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. At end-2017, the Program NIR, evaluated at market exchange rates, stood at US$5,104.0 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). At end-December 2017, this amount was US$6,597.4 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, $2,496.9 million at end-December 2016, and US$1,495.2 million at end-December 2017.

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 measuring the program NIR, all foreign-currency related assets and liabilities will be converted into U.S. dollar terms at the exchange rates prevailed on January 2, 2018, as specified in Table 1. Monetary gold will be valued at US$1,306.34 per troy ounce, which was the price prevailed on January 2, 2018.

Table 1. Sri Lanka: Exchange Rates
(Rates as of January 2, 2018)

Currency	Sri Lankan Rupee per currency unit
U.S. dollar	153.4697
British pound	207.4066
Japanese yen	1.3613
Canadian dollar	122.3354
Euro	184.3478
Chinese yuan	23.6055
SDR	219.1740

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	125	225
Net borrowings from SLDBs and FCBUs by the central government	627	0	-150	-1,118	-1,118
External commercial loans (including Eurobonds and syndicated loans) by the central government	2,200	1,500	1,500	3,500	3,500
Proceeds from commercialization of public assets to non-residents	200	0	400	682	682
Amortization of official external debt by the central government	1,065	365	572	1,055	1,276

III. 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.

IV. MONETARY POLICY CONSULTATION CLAUSE

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

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

where

t = the month within which the test date is included

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

CCPI(t-k) = CCPI index (all items) as of k months before t

$CCPI^*(t) = \{ CCPI(t-2) + CCPI(t-1) + CCPI(t) \} / 3$

$CCPI^*(t-12) = \{ CCPI(t-14) + CCPI(t-13) + CCPI(t-12) \} / 3$

If the observed year-on-year inflation for the test date of end-June 2018 or end-December 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-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.

V. 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).

D. Indicative Target on Treasury Guarantees

22. Treasury guarantees are defined as outstanding debt guarantees issued by the central government. A guarantee of a debt refers to any explicit legal obligation of the central government to service such a debt in the event of nonpayment by the recipient. Treasury guarantees exclude letters of credit. Outstanding guarantees are defined as the drawn amounts of guaranteed debts. They differ from issued guarantees, which are defined as the total amount of guaranteed debts (including for debts that are not disbursed yet). Treasury guarantees include outstanding treasury guarantees published in the Statement of Contingent Liabilities contained in the Annual Report of the Ministry of Finance and the guarantee issued for the SriLankan Airlines' $175 million Eurobond. Rupee values for guarantees issued in other currencies will be calculated using the exchange rate for the last day of the calendar year as it appears in the Statement of Contingent Liabilities in the Annual Report of the Ministry of Finance. As of end-2017, the outstanding treasury guarantees were valued at Rs 591 billion (including the guarantee issued for the SriLankan Airlines' Eurobond amounting to Rs. 27 billion).

VI. DATA REPORTING REQUIREMENTS

23. 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. For the purpose of monitoring the performance against the indicative target on treasury guarantees, data will be provided in the format shown in Table 13 on a quarterly basis.

24. 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. Data relating to the indicative target on treasury guarantees (Table 13) will be furnished within no more than two months after the end of each quarter.

Table 3. Sri Lanka: Central Government Operations 1/

(In millions of rupees)

(In millions of rupees)

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

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

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

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

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

Table 5. Sri Lanka: Balance Sheet of the Central Bank of Sri Lanka 1/

(In millions of rupees)

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

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

Table 6. Sri Lanka: Foreign Exchange Cashflows of the Central Bank and the Government 1/
(In millions of U.S. dollars)

1. Total inflows
Loans
Program
IMF
Project (cash component only)
Commercial borrowing (incl. new and rolled over SLDBs)
Interest earnings, forex trading profits, cap gains
Purchases of foreign exchange
Change in balances in DST's A/Cs
Of which: Proceeds from commercialization of public assets
Other inflows
Borrowing from SLDBs
Loans from FCBUs
Syndicated Loans
International Swaps/Commercial Loans/Sovereign Bonds
OMO FX swap transactions
2. Total outflows
Public Debt Service Payments
Amortization
Principal (foreign loans)
Settlement SLDBs
Settlement FCBU
Settlement of syndicated loans
Interest
Foreign loans
Domestic foreign currency loans
SWAP/Loan interest
ISB interest
Payments to the IMF/ change in valuation of liabilities
Foreign exchange sales to commercial banks
OMO FX swap transactions
3. SWAP
Inflow
Outflow Including Interest
3. Net flow at current rates (1-2)
Net International Reserves (at market exchange rates)
Net International Reserves (at program exchange rates)
Gross International Reserves (at market exchange rates)

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

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

(In millions of U.S. dollars)

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

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

Table 8. 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)

	a=e-b	**b=c-d**	c	d	**e=f+g+h+i +j+k+l**	f	g	h	i	j	k	l	m
	Cost of NCOs	**revenue (net of sales**	Sales revenue	Sales taxes	**(net of sales taxes)**	Cost of sales	Terminal charge	Transport charge	Personnel cost	Other expenses	Exchange rate variation	Finance cost	Sales quantity
Product	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.

Table 13. Treasury Guarantees 1/

(In millions of rupees)

	Treasury Guarantees Issued	Treasury Guarantees Outstanding
Total Treasury Guarantees		
Ceylon Electricty Board		
Ceylon Petroleum Corporation		
National Water Supply and Drainage Board		
Road Development Authority		
SriLankan Airlines		
Other		

1/ As agreed for the purpose of monitoring the indicative target under the program.

INTERNATIONAL MONETARY FUND

SRI LANKA

May 17, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION AND FOURTH REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—INFORMATIONAL ANNEX

Prepared By Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of April 30, 2018)

Membership Status

Joined 8/29/50; accepted Article VIII in March 1994.

General Resources Account	**SDR Million**	**% Quota**
Quota	578.80	100.00
Fund holdings of currency (Holding Rate)	1,068.42	184.59
Reserve Tranche Position	47.86	8.27

SDR Department	**SDR Million**	**% Allocation**
Net cumulative allocation	395.46	100.00
Holdings	3.66	0.93

Outstanding Purchases and Loans	**SDR Million**	**% Quota**
Extended Arrangements	537.46	92.86

Latest Financial Arrangements

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
EFF	6/03/16	6/02/19	1,070.78	537.46
Stand-By	7/24/09	7/23/12	1,653.60	1,653.60
EFF	4/18/03	4/17/06	144.40	20.67

Projected Payments to Fund[2]

(SDR million; based on existing use of resources and present holdings of SDRs)

			Forthcoming		
	2018	**2019**	**2020**	**2021**	**2022**
Principal			9.99	39.96	89.58
Charges/interest	10.06	13.60	13.60	13.26	12.21
Total	10.06	13.60	23.59	53.22	101.78

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

The *de jure* exchange rate arrangement is free floating since its introduction by the Central Bank of Sri Lanka (CBSL) on January 23, 2001. The *de facto* exchange rate arrangement was classified as a crawl-like arrangement as of March 31, 2017. The Sri Lankan rupee depreciated by 2.0 percent in 2017 and was Rs 156.3 per U.S. dollar as of April 20, 2018. The CBSL maintains restrictions on payments and transfers for current international transactions solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51).

Safeguards Assessment

The 2016 update safeguards assessment found that the CBSL continued to strengthen its safeguards framework in a number of areas, including in its audit and financial reporting functions. Transparency in financial reporting has been maintained and the external audit mechanism is sound. Progress has been made in modernizing the internal audit function. However, the assessment found that the CBSL Monetary Law Act (MLA) fell short of leading international practices, especially in the areas of the bank's autonomy and aspects of its governance arrangements (e.g., the government's voting representation in the Monetary Board, absence of recapitalization provisions, and inadequate limits on credit to government). Legal reforms planned to address these shortcomings would also provide an opportunity to review the CBSL's mandate in non-core operations that pose financial and reputational risks to the bank. Further, the assessment also noted a need to clarify the treatment of foreign currency swaps with domestic banks in the quantitative performance criterion on international reserves under the EFF-supported program. This was addressed at the time of the first program review by introducing a new "program NIR" that excludes foreign currency swaps with commercial banks from gross international reserves (see IMF Country Report No. 16/371).

Article IV Consultation

It is proposed that the next Article IV Consultation takes place in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

FSAP and ROSC Participation

- MCM: Both the FSSA and the FSAP reports were completed in 2002. An FSAP update took place in July 2012. A Financial System Stability Review is planned for FY2019.

- STA: A data ROSC was completed and the report published in 2002.

- FAD: A fiscal transparency ROSC was completed and the report published in 2002. A ROSC update was completed and the report published in July 2005.

Resident Representative

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

Technical Assistance

- ***FAD.*** TA has been provided in a wide range of areas. TA missions on tax policy diagnosed Sri Lanka's income tax and VAT system (including VAT gap analysis) and presented reform options during 2015-17. On the revenue administration side, TA missions have assisted the Inland Revenue Department in improving VAT compliance and implementing the new Inland Revenue Act (IRA) since 2016. In addition, several TA missions took place during 2015–18 to strengthen public expenditure and financial management, including on improving spending commitment controls, assessing public investment management, reforming energy pricing, and drafting statements of corporate intent for major state-owned enterprises.

- ***ICD.*** Since August 2015, TA missions have provided the CBSL with assistance on macroeconomic forecasting, including developing a Forecasting and Policy Analysis System (FPAS) and a semi-structural Quarterly Projection Model (QPM). Phase I of the project, concentrating on developing medium- and short-term forecasting models and skills, was successfully completed in 2016. Under Phase II of the project, the focus will primarily be on integrating the FPAS into the decision-making processes of the CBSL.

- ***LEG.*** During 2016-18, TA missions assisted the authorities in drafting the new IRA and its tax manual as well as training IRD staff to implement the new law. An AML/CFT scoping mission took place in October 2016, followed by diagnostic missions during 2017-18. A TA mission in May 2017 addressed issues of monetary policy governance and the foreign exchange system.

- ***MCM.*** During 2016-18, TA missions addressed a wide range of areas, including transition to inflation targeting and a flexible exchange rate regime (May and September 2017), the government debt issuance process (December 2016, joint with the World Bank), financial sector stability (April 2016), resolution of deposit-taking, non-bank financial institutions (March 2017), and securities market enforcement by the Security and Exchange Commission (October 2017).

- ***STA.*** STA has been closely engaged with the authorities through TA in various areas, including national accounts, government finance statistics, and monetary accounts (see also the section on statistical issues below).

- ***SARTTAC***: SARTTAC has provided extensive TA and training in a wide range of areas. In the fiscal sector, TA has focused on support for the new Inland Revenue Act which came into force on April 1, 2018. To support for better public investment management practices and associated systems in Sri Lanka, a Public Investment Management Assessment (PIMA) was conducted jointly with FAD and the World Bank. SARTTAC has supported Sri Lanka's effort to strengthen its internal audit function by developing an internal audit manual, pooling of internal audit resources and training existing staff. Sri Lanka also participated in a joint SARTTAC/TAOLAM seminar on managing fiscal risks in emerging markets. In the real sector, TA was provided in price statistics as well as benchmarking/rebasing national accounts statistics. In-country courses on national accounts methodology and a regional quarterly national accounts workshop were conducted. SARTTAC has also provided Sri Lanka with TA to improve its monetary modeling and forecasting and FX operations. In coordination with ICD, a key SARTTAC customized training project has helped the CBSL to develop a forecasting and policy analysis system (FPAS) for forward-looking monetary policy formulation. In-country macro training courses also included macro-diagnostics.

RELATIONS WITH THE WORLD BANK GROUP

(As of May 8, 2018)

1. **The Systematic Country Diagnostic (SCD) prepared in 2015 identified critical constraints and opportunities that Sri Lanka faced in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner.** The SCD concluded that the challenges of i) fiscal sustainability; (ii) enhancing competitiveness and promoting more and better jobs for the bottom 40 percent, iii) providing for social inclusion for disadvantaged segments of the population; and (iv) longer term sustainability (especially of the environment, political stability, and an aging population) were priority areas. Governance was identified as a cross-cutting challenge.

2. **The Country Partnership Framework (2017- 2020, CPF) for the World Bank Group is anchored in the analysis of the SCD and consists of three major pillars.** Interventions under pillar one will seek to improve macroeconomic stability and competitiveness, pillar two will tackle the promotion of inclusion and opportunities, while pillar three will seek to enhance resilience and management of natural assets. Strengthening governance and improving gender equality are two cross-cutting objectives that are also integral to the CPF. The CPF underpins WBG support for Sri Lanka's transition to a more competitive, inclusive, and resilient upper-middle income country. The CPF's policy reform emphasis mirrors the strong policy reform orientation of the government, particularly in the areas related to improving macro-fiscal stability, enhancing the enabling environment for private sector development, export competitiveness and global integration. Support for improving living standards in the lagging regions, including the conflict affected areas of the Northern and Eastern regions, and strengthening education and training systems are viewed as indispensable to promoting social inclusion. Additionally, there is a focus on balancing development with environmental conservation and enhancing resilience to climate change. The Bank continues to provide policy advice, analytical support and technical assistance, funded both through trust funds and its own budget, to assist government efforts on fiscal reform, governance, capital markets, pension reform, trade and competitiveness, and sustainable urban development.

3. **The World Bank is supporting the Government of Sri Lanka (GoSL) in a number of macro-critical areas:**

- **Financial sector development.** The Financial Sector Modernization Project (FSMP) is designed to address several of the key challenges confronting the development of the financial sector in Sri Lanka. The results-based financing component of the project (component 1) addresses several mid-level Financial Sector Assessment Program (FSAP) policy recommendations, thus, facilitating a platform of engagement that enables downstream progress on high-level reforms. This component targets developing more competitive markets by requiring a holistic supervisory approach; switching to a forward-looking supervisory perspective; and leveling of the playing field within and across financial subsectors. It also aims to improve the investment performance of the pension provident funds to secure adequate replacement income for retirees. In component 2, the project aims to improve the financial market infrastructure (FMI), legal and regulatory framework for the financial system, and the institutional capacity of financial sector regulators, Central Bank of Sri Lanka (CBSL), Securities and Exchange Commission of Sri Lanka (SEC) and Insurance Regulatory Commission of Sri Lanka (IRCSL) the all of which are essential actions for a stronger financial sector. This is complemented by close to around USD 2 million in trust funds (capital market development, legal reforms TA, insurance TA, financial inclusion strategy, agriculture insurance, financial literacy and secured transactions reform). A joint Bank-Fund mission took place in December 2016 to review the primary market for government securities.

- **Trade policy and trade facilitation.** Sri Lanka has embarked on a major reform of trade policy, with critical support from the WBG for this process. The engagement has seen important results, including the Cabinet's approval of the New Trade Policy in 2017 and the start of the tariff reform program in the November 2017 budget. This tariff reform is expected to continue, as part of unilateral trade reforms as well as through new free trade agreements that have been signed or are in the pipeline. These reforms are being supported by ongoing technical assistance, a new trade report in FY19, and a report and dialogue on trade adjustment that is necessary to address winners and losers in trade reform. The WBG is also supporting improvements in trade facilitation, specifically strengthening Sri Lanka's compliance with TFA commitments under the WTO, including a well-functioning institutional framework (the National Trade Facilitation Committee), Targeted advice and support for the implementation of selected reforms (reform of the Customs Ordinance, risk management), and implementation of larger initiatives to improve transparency (Trade Information Portal) and pave the way for major reforms to streamline border clearance (National Single Window Blueprint).

- **Regulatory simplification and promoting investment including FDI.** Sri Lanka undertook a coordinated effort on regulatory simplification over the past several years, which is starting to bring results in terms of improved user experience for both foreign and domestic investors. Superficially, the World Bank has been supporting the improvement of the Ease of Doing Business in Sri Lanka through regulatory, institutional and legal reforms, per the Investment Climate Roadmap (launched in July 2017). Positive results are expected in 2018-19 in business registration, construction permits, property registration, minority shareholder rights, local e-government, as well as e-documents and pre-processing procedure amendments of the customs ordinance. Further support to GoSL is being provided in the area of Enhancing Investment Promotion capacity, helping BOI improve its effectiveness, focusing on its ability to identify, attract, and retain efficiency-seeking FDI. The World bank is also working with the "One Stop Shop for FDI" to assist the GoSL in the design and implementation of a One-Stop Shop (OSS) with the mandate of reducing the time and transaction costs incurred by foreign investors seeking to establish their operations in Sri Lanka. Further, BOI and the World bank cooperate on strengthening the effectiveness of investment incentives as a mechanism to attract private investment and pursue other policy objectives to minimize the fiscal costs to the country. At sectoral level, the World Bank is supporting the National Tourism Strategy (Cabinet approval 2016) via a WBG lending operation to implement the National Tourism Strategic Plan for 2017-2020. Finally, a National Quality Infrastructure Strategy and an Innovation and Entrepreneurship

Strategy have been drafted and are being finalized for submission to Cabinet supported by a national quality infrastructure gap analysis and an Exporter Marketplace Pilot Program.

- **Public financial management and transparency.** The Public Sector Efficiency Program (PSEP) will support the modernization of the core public financial management functions as well as the services affecting the private sector in order to strengthen public sector efficiency and, thereby contribute to the achievement of the Government's fiscal and economic policy objectives. It will also support the implementation of the government's transparency and accountability reforms. The project has three components focusing primarily on the Ministry of Finance: (i) strengthening allocative efficiency of public investments, programs and debt management, with a greater focus on performance. The Bank and Fund work and have worked together on various components, including a joint training of the Debt Sustainability Analysis for Market-Access Countries (MAC-DSA) in 2016, a joint Public Investment Management Assessment (PIMA) in December 2017 and prospective joint technical support on the Medium-Term Debt Management Strategy (MTDS) and a unified Debt Management Office (proposed structural benchmarks); (ii) improving the operational efficiency of budget execution and procurement; and (iii) strengthening the governance, transparency and efficiency of public services. The project is expected to be implement between the second half of 2018 and 2022.

- **Social protection sector development.** The Social Safety Nets project (SSNP) is designed to address some of the key challenges confronted in the development of the social protection sector in Sri Lanka. The project mainly focuses on improving the equity, efficiency and transparency of Sri Lanka's social safety net programs for the benefit of the poor and vulnerable. The first two components follow a results-based financing modality with disbursements made upon achievement of specific results measured by Disbursement Linked Indicators (DLIs). The first component supports the establishment of the Welfare Benefits Board (WBB), development of the unified social registry for identification and collection of information on beneficiaries. The second component supports the collection of data on current beneficiaries and new applicants of programs under the Welfare Benefit Schemes, and develop an integrated Management Information System for the harmonized management of programs. The third component includes technical assistance to support the implementation of the Welfare Benefits Act, developing a National Social Protection Strategy and use of the new system for monitoring and longer-term strategic planning. These activities are complemented by smaller amounts of trust funds to support targeting, development of exit and graduation strategy and integrate adaptive safety nets assistance to safety nets delivery system.

4. **The World Bank has been supporting Sri Lanka's development for close to six decades, having accompanied the country as it has grown to join the ranks of middle-income countries.** The current active IDA-IBRD portfolio consists of 15 projects with a total net commitment of nearly USD 1.9 billion (13 IDA, 1 IBRD and 1 Blend). Urban operations account for 21 percent of the overall portfolio, followed by water (16.5 percent) and resilience to climate and disaster risk (13 percent). The education (13 percent) and health (10 percent) sectors also continue to be core sectors for Bank

support. The World Bank has provided a mix of financing – investment project, development policy, and program-for-results – to support reforms.

Project Name	Board Approval	Closing Date	Net Commitment Amount ($ million)
Dam Safety & Water Resources Planning Project	03/27/2008	05/15/2018	148.33
Transforming School Education Project	11/29/2011	06/30/2018	100.00
Second Health Sector Development Project	03/27/2013	09/30/2018	200.00
Metro Colombo Urban Development Project	03/15/2012	06/30/2020	213.00
Sri Lanka Strategic Cities Dev Project	05/05/2014	12/31/2021	202.00
Skills Development Project	06/20/2014	12/31/2019	101.50
Transport Sector Project	05/09/2016	06/30/2026	125.00
Improving Climate Resilience Project	04/22/2014	05/30/2019	152.00
Water and Sanitation Improvement Project	06/24/2015	12/31/2020	165.00
Early Childhood Development Project	06/24/2015	06/30/2021	50.00
Agriculture Sector Modernization Project	06/28/2016	12/31/2021	125.00
Ecosystem Conservation and Management Project	04/25/2016	06/30/2021	45.00
LK-Social Safety Nets Project	12/02/2016	06/30/2022	75.00
Sri Lanka Financial Sector Modernization Project	04/05/2017	12/31/2022	75.00
Accelerate Higher Education Development Project	05/12/2017	06/30/2023	100.00

Source: World Bank.

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of May 2, 2018)

Country Partnership Strategy: ADB's Country Partnership Strategy (CPS, 2018-2022) for Sri Lanka, approved in 2017, will support country's transition to upper-middle income status. The next five-year operations are focused on two pillars: (i) strengthening the drivers of growth by expanding provision of growth-oriented infrastructure and logistics; developing economic corridors; upgrading human capital; (ii) improving the quality of growth by promoting inclusiveness through strengthening agriculture infrastructure and commercialization; improving rural connectivity; improving public service delivery and expanding small- and medium-sized enterprise access to finance.

Indicative Resources: Sri Lanka will graduate from ADB's concessional resources, effective 1 January 2019. The allocation for 2019-2021 consists of $1,895 million from regular ordinary capital resources (OCR). Co-financing and private sector operation opportunities will be actively explored.

Indicative Pipeline for 2018-20: Country Operations Business Plan for the period 2018–20 includes indicative projects to support the country's transition to an upper middle-income status. Having emphasized on human resource development, and completion of basic infrastructure development such as rural road connectivity and rural electrification in the previous country strategies, the future project pipeline shifts towards advanced infrastructure such as expressway, railways, ports and expansion into wind and solar power generation, integrated urban development, and higher education, while continuing support for inclusive growth. To the extent possible, thematic priorities such as private sector development, public-private partnership, gender, climate change, disaster risk management, and environment strengthening will be included in each project.

In the transport sector, the proposed Port Access Elevated Highway Project for 2018 will construct an elevated toll highway in Colombo between New Kelani Bridge and the city center of Galle Face, and support trade logistics facilitation. The proposed Colombo Suburban Railway Efficiency Improvement Project will improve telecom system, computerized ticketing system, equipment for railway training center, building for operation and train control center, workshop and equipment. The ongoing Transport Project Facility will prepare the detailed design required for the priority investment project in Kelani Valley Line for which physical investments will be done under the proposed Sri Lanka Railway Investment Program in 2020.

In the urban and water supply sector, ADB will continue to support secondary cities with growth potential, including those in the Colombo–Trincomalee economic corridor and the Western Megapolis. The strategy will support growth by boosting urban agglomerations to attract high-quality investments and improve urban governance. The proposed Urban Project Preparatory Facility technical assistance loan for approval in 2018 will strengthen project readiness by completing advanced feasibility studies, detailed designs, and procurement actions to meet

ADB's financing requirements, and build capacities of implementing agencies in the urban sector prior to project approval.

In the energy sector, interventions will focus on expanding nontraditional renewable energy using wind and solar and introducing innovation and advanced technology. The proposed Power System Reliability Strengthening Project for approval in 2019 will focus on system reliability, optimization of existing fault clearance system of the Ceylon Electricity Board network. A proposed TA loan for Preparing the Power Development and Interconnection Project will support connectivity and power trade between Sri Lanka and India.

Lending for education will further strengthen support for human capital development. In addition to continued support for secondary education and support for skills development, opportunity in higher education will be explored. The Skills Sector Enhancement Program (additional financing) will continue to support for the government's Skills Sector Development Program for 2017–2020, in improving quality, relevance and equitable access to TVET. The proposed Science and Technology Human Resource Development Project for approval in 2018 will support the government in establishing new technology degree programs and engineering degree programs with industry linkages and entrepreneurships in selected universities. Interventions in the higher education sector will support the government in strengthening innovation capacity through reorienting research and development in universities and research institutions.

ADB will support the health sector in 2018 with the proposed Health System Enhancement Project through which primary health care will be enhanced, focusing on improving equity and underserved communities' access to essential health services, and address gaps in core public health capacities in line with international health regulations.

In the finance sector, ADB approved an additional financing of $75 million in January 2018 to support the small- and medium-sized enterprises operating outside Colombo District, led by women, or are first-time bank borrowers.

In agriculture and natural resources sector, the proposed Northern Province Sustainable Fisheries Development Project for approval in 2018 will support investments to revive the fisheries sector in four conflict-affected coastal districts of Jaffna, Mannar, Mullaitivu, and Killinochchi. The project will finance the development of two fishery harbors, 8 anchorages and 27 fisheries landing sites, sustainably develop aquaculture, and improve the livelihoods of fisher communities.

ADB's Private Sector Operations supports finance sector development by providing loans, equity investments, or guarantees for banks or nonbank institutions to enable them to expand activities in targeted areas including housing, small- and medium-sized enterprise finance, leasing, renewable energy, and infrastructure lending. Opportunities for local currency lending, which have been a key constraint to nonsovereign domestic borrowing, will be pursued.

Ongoing Projects:

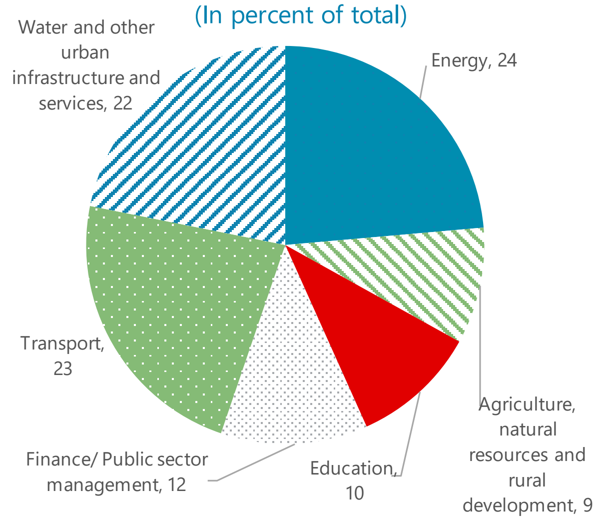
- **Projects approved in 2017:** During 2017, ADB approved 7 new sovereign projects for a total of $881 million and 1 new non-sovereign loan facility of $4 million as follows:

  - Wind Power Generation Project ($200 million from OCR)
  - Solar Rooftop Power Generation Project ($50 million from OCR)
  - Mahaweli Water Security Investment Program (tranche 2) ($179 million from OCR and $31 million from concessional OCR)
  - Second Integrated Road Investment Program (tranche 1) ($90 million from OCR and $60 million from concessional OCR)
  - Integrated Road Investment Program (tranche 4) ($150 million from OCR)
  - Jaffna Kilinochchi Water Supply Project Additional Financing ($95 million from OCR and $25 million from concessional OCR)
  - Project Design Advance for Northern Province Sustainable Fisheries Project ($1.3 million from concessional OCR)
  - Walkers Colombo Shipyard (private limited) for shipyard rehabilitation and infrastructure ($4 million from OCR)

- **Portfolio**: As of 31 March 2018, ADB has approved a total of 197 loans, with cumulative lending of $8.6 billion to Sri Lanka. In addition, ADB has provided $366 million grant assistance (including ADB-administered co-financed grants) for projects and $146 million through 300 technical assistance grants.

  The current portfolio includes 55 ongoing loans and grants for 33 projects with a net loan amount of $ 3.8 billion. Cumulative contract awards reached $1.9 billion, and disbursements $1.4 billion. About 69% of the ongoing portfolio are in transport, urban and water, and energy sectors. The sector composition of the ongoing loan portfolio is in Figure 1.

Figure 1. Sri Lanka: Loan Portfolio of Asian Development Bank, March 2018
(In percent of total)



Source: Asian Development Bank.

STATISTICAL ISSUES

(As of May 7, 2018)

I. Assessment of Data Adequacy for Surveillance
General: Macroeconomic statistics are broadly adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series.
National Accounts: In 2015, the Department of Census and Statistics (DCS) released a comprehensive revision of the national accounts. The revision included a change of base year from 2002 to 2010; an expanded coverage for the service sector; and several improvements in the compilation methods. An STA mission in November 2017 found that the DCS continues to make progress on technical preparations to update the base year and is developing supply and use tables for 2013, which will be used to benchmark the revised estimates. The DCS also updated its quarterly national accounts methodology and began publishing these estimates in 2015. The new quarterly estimates are now based on quarterly indicators for most economic activities. However, the data are presented relative to the same quarter of the previous year basis. GDP data by expenditure are only available on an annual basis and rely mostly on commodity flow methods.
Price Statistics: The DCS released a new national Consumer Price Index (CPI) and Producer Price Index (PPI) during 2015. The new indexes reflect international standards and best practices. The national CPI is based on weights from the 2012/13 Household Income and Expenditure Survey. The DCS continues to compile the Colombo Consumer Price Index (CCPI) and the national CPI (NCPI). A TA mission in 2017 recommended discontinuing publishing the separately compiled CCPI because: (1) multiple measures of inflation may confuse users; and (2) CCPI coverage is limited to urban households within the Colombo district only and is not appropriate for use as a headline inflation measure. The current PPI covers only agriculture, manufacturing, and utilities. Recently, the CBSL and national accounts staff expressed the need for expanding PPI coverage to include services and construction. In addition, the PPI weights (2010) are outdated and should be updated using data from a 2015 annual survey of industrial activity.
Government Finance Statistics: The Sri Lankan authorities report budgetary central government operations data in GFSM 2014 format on an annual basis and debt data to the World Bank's Public-Sector Debt Statistics database on a quarterly basis. The most recent STA mission took place in June 2016, in the context of the Japan-funded IMF project on implementing GFSM 2001 and its update (GFSM 2014), for compiling, analyzing and reporting fiscal data. As part of this effort, the authorities have incorporated the Chart of Accounts aligned with GFSM2014 into the new IFMIS system. Additional steps are underway to integrate fiscal data of the extra-budgetary central government, the local government and social security funds into the annual general government GFS reporting.
Monetary and Financial Statistics: The CBSL compiles and publishes monetary and financial statistics, with concepts, definitions, and classification that are broadly in line with the *Monetary and Financial Statistics Manual (MFSM) 2000*. Beginning in June 2011, data are based on a standardized report form (SRF) for the central bank and other depository corporations. Moving forward, monetary data should be expanded to include the financial accounts of other financial corporations (nonbank

financial institutions, such as pension funds, insurance corporations, investment funds, as well as leasing and finance companies) that account of about 34 percent of total financial sector assets.	
Financial sector surveillance: The CBSL regularly reports quarterly FSIs to the IMF for publication. Currently, the CBSL reports 11 core and 8 encouraged FSIs.	
External sector statistics (ESS): Since 2014, the CBSL is reporting to STA its International Investment Position (IIP) and balance of payments statistics (BOP) on a quarterly basis following the sixth edition of the *Balance of Payments Manual* (BPM6). The last TA mission on ESS conducted in May 2015 observed commendable progress in improving the quality of the data, including a better coverage of the balance of payments, IIP, CDIS and external debt. The CBSL has aligned their ESS framework and subscribed to the IMF's Special Data Dissemination Standards (SDDS) in November 2015.	
II. Data Standards and Quality	
Sri Lanka subscribed to the Special Data Dissemination Standards (SDDS) in November 2015.	A data ROSC mission visited Sri Lanka in 2001 and prepared a comprehensive report on the quality of its statistics.
III. Reporting to STA	
The authorities report key data to the Fund on a timely basis. On government finance, annual cash data are regularly reported for publication in the *GFS Yearbook*. These data cover only the budgetary accounts of central government; and no data on the extrabudgetary funds or the provincial and local governments are reported. At the same time, no sub-annual data are reported for publication in *IFS*. The authorities have been encouraged to reduce the time lag for data reporting and take steps to report data for the general government.	

Sri Lanka: Table of Common Indicators Required for Surveillance

As of May 7, 2018[1]

	Date of Latest Observation	Date Received	Frequency of Data[8]	Frequency of Reporting[8]	Frequency of Publication[8]
Exchange rates	Today	Today	D	D	D
International reserve assets and reserve liabilities of the Monetary Authorities[2]	03/2018	03/2018	D	D	D
Reserve/base money	03/2018	04/2018	M	M	M
Broad money	03/2018	04/2018	M	M	M
Central bank balance sheet	03/2018	04/2018	M	M	M
Consolidated balance sheet of the banking system	03/2018	04/2018	M	M	M
Interest rates[3]	Today	Today	D	D	D
Consumer price index (New Colombo CPI)	03/2018	04/2018	M	M	M
Revenue, expenditure, balance and composition of financing[4]—general government[5]	N/A	N/A	N/A	N/A	N/A
Revenue, expenditure, balance and composition of financing[4]—central government[5]	Q4/2017	03/2018	A	A	M
Stocks of central government and central government-guaranteed debt[6]	Q4/2017	03/2018	A	A	M
External current account balance	2017 Q4	04/2018	Q	Q	Q
Exports and imports of goods and services	02/2018	04/2018	Q	Q	Q
GDP/GNP	2017 Q4	04/2018	Q	Q	Q
Gross external debt	2017 Q4	03/2018	A	A	A
International Investment Position[7]	2017 Q4	04/2018	Q	Q	Q

[1] TCIRS latest updates based on National Summary Data Page.

[2] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

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

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

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

[6] Including currency and maturity composition.

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

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

Statement by Mr. Subir Vithal Gokarn, Executive Director for Sri Lanka, and Mr. Mahinda K.M. Siriwardana, Alternate Executive Director June 1, 2018

Our Sri Lankan authorities thank the IMF staff for their comprehensive report for 2018 Article IV Consultation and Fourth Review under the Extended Arrangement under the Extended Fund Facility (EFF), and insightful Selected Issues papers. They value the constructive and candid policy dialog that took place in Colombo during February/March 2018 and in Washington DC during the 2018 Spring Meetings with the staff mission, particularly regarding the ongoing EFF.

Sri Lanka has achieved a number of notable improvements during the last two years as a result of the stabilization policy measures undertaken by the authorities, with the support of EFF, amidst frequent natural calamities and a complex political environment. Significant strides were made in implementing difficult, but vital, stabilization policies to strengthen macroeconomic fundamentals, access foreign markets through exploiting trade and investment opportunities, and facilitate long-term growth towards transforming Sri Lanka into a hub of the Indian Ocean. Successful economic transformation and sustained progress inevitably involve consolidating the recent advancements to deal with current and future challenges proactively.

In the above context, our authorities remain committed to safeguarding the gains by vigorously continuing with the ongoing measures. This mainly involves institutionalizing frameworks related to monetary policy in line with flexible inflation targeting framework and fiscal policy to continue and strengthen fiscal consolidation process beyond the EFF program. Strengthening financial sector oversight and upgrading public debt management are also integral to this strategy. This will be complemented by reforms to address deficiencies in SOEs, easing of bottlenecks to increase competitiveness, enhance economic diversification, improve financial inclusion, address corruption and increase female labor force participation. Our authorities broadly concur with staff's assessment on the risks. The establishment of institutional frameworks in key policy areas is expected to help safeguard against the future macroeconomic management based on shortsighted political considerations.

Program Performance

Sri Lanka's EFF program is progressing well amidst recent temporary shocks. All end-December 2017 Quantitative Performance Criteria (QPC) and end-March 2018 Indicative Targets (IT) on the primary balance and NIR were met. The end-December and end-March IT on reserve money were met, while the IT on tax revenues was missed. Inflation exceeded the upper limit for the inner band under the Monetary Policy Consultation Clause (MPCC) for December. This triggered a staff-level consultation and our authorities explained to the staff that the temporary deviation was due to the increase in food prices following the weather-related supply disruptions and agreed to be vigilant on the potential upside risks to inflation. In March 2018, inflation decelerated reaching the inner band. In April 2018, inflation further decelerated to 24 month lowest since April 2016. The continuous QPC of accruing no new external arrears was also met. All six structural benchmarks (SBs) to be completed by June 2018 were implemented. Our authorities are strongly committed to continuing the reforms and achieving the desired targets. Hence, on the basis of the progress achieved, they request the approval of the Fourth EFF Review.

Economic Growth and Outlook

Economic growth moderated to 3.1 per cent in 2017, mainly reflecting the contraction in agriculture, due to severe drought conditions that prevailed particularly in the major cultivation areas and large-scale floods. Industry and Services contributed positively to economic growth, despite spillover effects from subdued agriculture performance.

However, growth is expected to rebound to around 5.0 per cent in 2018, supported by a recovery in agricultural production, the global upswing, particularly the positive spillovers from improved growth in Sri Lanka's trading partners, and improving domestic conditions that will enhance private sector investment. Although the ongoing fiscal consolidation may dampen growth prospects, the benefits of improved fiscal discipline, implementation of structural reforms, realization of higher FDI inflows, a conducive low inflation environment and a competitive exchange rate are expected to support the economy to reach its potential.

Monetary and Exchange Rate Policy

Consumer price inflation, which peaked in October 2017, moderated towards the desired mid-single digit levels thereafter with the improvements in domestic supply conditions. The Central Bank of Sri Lanka (CBSL) maintained a tight monetary policy from end 2015 to maintain macroeconomic stability and to contain the buildup of adverse price and wage inflation expectations. In response to monetary policy measures, core inflation moderated subsequently. The growth of credit to the private sector as well as overall monetary expansion moderated to desired levels by end 2017. Complementary macroprudential policies and tax adjustments were also supported this improvement.

The CBSL eased its monetary policy stance in April 2018 by reducing the upper bound of its policy interest rate corridor by 25 basis points, considering the favorable developments in inflation and inflation outlook as well as lower than expected real GDP growth that further widened the prevailing gap between actual and potential growth. The authorities believe that the current monetary policy stance is appropriate to stabilize inflation and address near term growth prospects. The monetary policy stance will remain prudent and data dependent, and our authorities stand ready to take appropriate action if inflationary pressures emerge.

A solid foundation is being laid, with a time bound action plan, in moving towards a flexible inflation targeting (FIT) framework by 2020. The Monetary Law Act (MLA) is being amended in line with the Road Map for Implementing FIT, approved by the Monetary Board in October 2017. These amendments, which were approved by the Cabinet of Ministers on 03 April 2018, encompass improving governance in the CBSL, strengthening Central Bank independence, facilitating the adoption of FIT as the monetary policy framework to sustain price stability and strengthening the financial sector oversight. The finalized bill, incorporating these amendments, is expected to be submitted to Parliament by March 2019.

Our authorities remain committed to pursuing a flexible exchange rate regime, aligned with macroeconomic fundamentals, to absorb shocks with intervention confined to avoid wide fluctuations and build official reserves. In fact, since March 2017, the reserve accumulation has been a legitimate policy objective of the CBSL intervention which has led to the buildup of quality reserves and going forward, this policy will be continued. The proposed Request for Quotes (RFQ) system for CBSL intervention in the forex market is expected to deepen its operations and transparency further. The flexible exchange rate management has depreciated the exchange rate in real terms, indicating an improvement in the external competitiveness of the country. Since second half of April 2018, Sri Lanka also experienced higher volatility in the exchange rate and some capital outflows in line with the recent surge in short-term capital outflows from emerging and frontier markets. The CBSL intervened to smoothen out excess volatility while allowing the currency to depreciate.

Financial Sector

The financial sector remains sound, with prudential indicators reflecting adequate capital and liquidity buffers, healthy profit levels and low NPLs. A number of prudential measures were introduced to further strength the regulatory framework governing the financial system to enhance its safety and resilience. The proposed amendments to the MLA are expected to facilitate macroprudential supervision by strengthening the CBSL's powers on regulation and supervision of financial institutions. The ongoing transition to IFRS 9 and Basel III regulatory requirements will also contribute to improving financial sector resilience further. A Financial Sector Stability Review (FSSR) is planned in 2019.

The CBSL prioritized the addressing possible regulatory forbearance, particularly in relation to non-bank financial institutions and primary dealers. Firm action was taken to resolve issues with regard to some non-bank financial institutions. The new Resolution and Enforcement Department was established at the CBSL in early 2018 to expedite resolution of weak financial institutions, without having to affect the stability of the financial system. Measures to strengthen the macroprudential framework are being taken and some macroprudential tools, such as LTVs on motor vehicles, have already been implemented. Meanwhile, the CBSL and the government continue with strategies to promote financial inclusion to ensuring inclusive growth and combatting poverty.

Our authorities are taking measures, on priority basis, to implement the time bound action plan of the Financial Action Task Force (FATF) in order to strengthen the AML/CFT regime of Sri Lanka. Authorities are taking steps to amend laws relating to international cooperation, beneficial ownership and introduce regulations on implementing United Nations Security Council Resolutions and strengthen AML/CFT supervision with the aim of improving Sri Lanka's compliance and the country rating. A concerted effort is being made to strengthen the fight against corruption by improving good governance, independence of the judiciary and the rule of law.

Fiscal Policy and SOE Reforms

The committed efforts by the authorities during the last two years have resulted in significant improvements in the fiscal situation. Although the budget deficit increased marginally in 2017, owing to weather related expenditures, a primary surplus was recorded in the budget after several decades mainly due to the gradual adjustments in non-interest recurrent spending. The government has expressed its strong commitment to reducing the budget deficit to 3.5 per cent of GDP by 2020.

Going forward, our authorities are committed to deepening the institutionalization of the fiscal framework by introducing revisions to the Fiscal Management (Responsibility) Act with binding fiscal rules, clearly defined escape clauses and correction mechanisms in case of a breach of fiscal targets. The strengthening of fiscal consolidation will help ensure debt sustainability in the medium-term.

Our authorities fully understand the need for further improving government revenue. The recent achievements, including the revision of VAT Act in 2016, introduction of the new Inland Revenue Act in 2017 and the RAMIS, the IT-based flagship tax administration improvement project, are expected to improve efficiency and effectiveness of tax collection and taxpayer services. These measures are expected to have far reaching long term benefits to the economy. The reforms in the VAT system are already yielding dividends by improved buoyancy of the VAT revenue.

The introduction of a commitment control system, improvements in Public Financial Management (PFM) and an IT-based treasury management system, ITMIS, have strengthened expenditure management. The four major cash transfer programs are to be streamlined to improve coverage and targeting while protecting the needy and vulnerable. The Active Liability Management Act, enacted in March 2018, provides a modern mechanism to effectively manage financing needs and payment obligations of the government over the medium to long-term. The receipts from the concession agreement signed with a foreign investor to operate the Hambantota Port as a Public Private Partnership (PPP) have strengthened cash buffers, supporting effective debt management. A Medium Term Debt Strategy (MTDS) for 2019-2023 is also being developed for better government debt management, which will eventually be delegated to an independent debt management agency.

Strong measures are being taken to mitigate fiscal risks related to contingent liabilities of SOEs while improving their governance and accountability. In this regard, the introduction of an automatic pricing formula while increasing the domestic retail petroleum prices with effect from 11 May 2018, and the establishment of a bulk supply transaction account (BSTA) as a key step towards revising electricity prices to reflect costs, are significant steps forward. In fact, the Staff Report has recognized these two measures as “a clean break from the past”. Authorities expect to complete the energy price reforms by end 2018, thus providing relief to the government budget. The Statements of Corporate Intent (SCIs), which created a framework to monitor the SOE performance under specific KPIs and were signed with key SOEs in 2017, are expected to expand to other SOEs as well. The restructuring and PPP process of the SriLankan Airlines (SLA) is being implemented with the guidance of the Officials Committee, chaired by the Secretary to the Treasury, to put the airline on a viable commercial footing and ensure its financial strength. The recently established PPP unit in the Ministry of Finance is also supporting this process while helping to leverage private sector for public investment initiatives.

External Sector

The marginal increase in the current account deficit in 2017 was triggered by the wider trade deficit due to weather-related imports, combined with widened primary income deficit, moderate earnings from tourism and lower workers' remittances. Higher inflows in terms of foreign direct investment were observed, while both the rupee-denominated government securities market and the Colombo stock market recorded net inflows. Our authorities expect that the current account deficit will be tapered over the medium-term with the expected improvements in the trade account, inflows to the services account and workers' remittances. The foreign reserves of US$ 9.9 billion, by end April 2018, were equivalent to about 5.4 months of imports. The Sri Lankan rupee has depreciated by 3.3 per cent against the US dollar up to May 28, this year. The gradual winding down of the swaps with commercial banks is being continued. The outstanding amount of domestic swaps has declined to US$ 0.9 billion by end May 2018 from US$ 2.5 billion recorded in end December 2016.

Trade and Investment Policy

Our authorities are committed to improving exports and investments by facilitating greater integration with global markets. This is expected mainly through the ongoing bilateral trade negotiations aimed at widening market access and diversifying the products and markets. In line with this, the Free Trade Agreement (FTA) with Singapore was signed in January 2018. Negotiations are continuing for the proposed Economic and Technology Cooperation Agreement (ETCA) between India and Sri Lanka, and the proposed China - Sri Lanka Free Trade Agreement (CSFTA). Sri Lanka is also considering the possibility of signing FTAs with Bangladesh, Malaysia, South Korea and Thailand. Safeguard measures have been introduced to address import surges while the Anti-Dumping and Countervailing Duties Act was passed in the Parliament in March 2018. Given the strong need for improving export competitiveness, the gradual phasing out of para-tariffs is being undertaken in fiscally-neutral manner to promote Sri Lanka for foreign investment. A Trade Adjustment Package is also being worked out with the assistance of the World Bank, EU and the International Trade Centre (ITC) to support local enterprises.

Natural Calamities

Our authorities are aware that the frequent occurrence of natural calamities, such as drought and floods, are becoming the 'new normal' in Sri Lanka, adversely affecting overall economic performance. This has necessitated diversification of growth drivers and taking measures to strengthen the economy's resilience. This entails such measures as mainstreaming sustainability into the planning and budgeting processes and improving disaster preparedness, mitigation and adaptation, supplemented by an appropriate natural disaster risk financing framework.

Conclusion

Our authorities highly appreciate the policy advice and continued support by the staff and the management of the Fund to Sri Lanka over the years. The authorities' policy agenda towards achieving a high and inclusive growth has been continuously supported by the Fund's technical assistance (TA) as well as the reforms under the Fund supported programs, including the ongoing EFF, particularly in fortifying macroeconomic and financial stability. They are committed to continuing structural reforms and building buffers to improve resilience and look forward to continued policy dialogue with the Fund, complemented by TA to get insights on the policy issues, to move forward with their economic reform agenda.