INTERNATIONAL MONETARY FUND

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SRI LANKA

March 2023

REQUEST FOR AN 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 Request for an 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 March 20, 2023, following discussions that ended on September 1, 2022, with the officials of Sri Lanka on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on March 6, 2023.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Sri Lanka.

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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PR 23/79

IMF Executive Board Approves US$3 Billion Under the Extended Fund Facility (EFF) Arrangement for Sri Lanka

FOR IMMEDIATE RELEASE

- The IMF Board approved a 48-month extended arrangement under the Extended Fund Facility (EFF) of SDR 2.286 billion (about US$3 billion) to support Sri Lanka's economic policies and reforms.
- The objectives of the EFF-supported program are to restore macroeconomic stability and debt sustainability, safeguarding financial stability, and stepping up structural reforms to unlock Sri Lanka's growth potential. All program measures are mindful of the need to protect the most vulnerable and improving governance.
- Close collaboration between Sri Lanka and all its creditors will be critical to expedite a debt treatment that will restore debt sustainability consistent with program parameters.

Washington, DC – **March 20, 2023:** The Executive Board of the International Monetary Fund (IMF) approved today a 48-month extended arrangement under the Extended Fund Facility (EFF) with an amount of SDR 2.286 billion (395 percent of quota or about US$3 billion).

Sri Lanka has been hit hard by a catastrophic economic and humanitarian crisis. The economy is facing significant challenges stemming from pre-existing vulnerabilities and policy missteps in the lead up to the crisis, further aggravated by a series of external shocks.

The EFF-supported program aims to restore Sri Lanka's macroeconomic stability and debt sustainability, mitigate the economic impact on the poor and vulnerable, safeguard financial sector stability, and strengthen governance and growth potential. The Executive Board's decision will enable an immediate disbursement equivalent to SDR 254 million (about US$333 million) and catalyze financial support from other development partners.

Following the Executive Board discussion on Sri Lanka, Ms. Kristalina Georgieva, Managing Director, issued the following statement:

"Sri Lanka has been facing tremendous economic and social challenges with a severe recession amid high inflation, depleted reserves, an unsustainable public debt, and heightened financial sector vulnerabilities. Institutions and governance frameworks require deep reforms. For Sri Lanka to overcome the crisis, swift and timely implementation of the EFF-supported program with strong ownership for the reforms is critical.

"Ambitious revenue-based fiscal consolidation is necessary for restoring fiscal and debt sustainability while protecting the poor and vulnerable. In this regard, the momentum of ongoing progressive tax reforms should be maintained, and social safety nets should be strengthened and better targeted to the poor. For the fiscal adjustments to be successful, sustained fiscal institutional reforms on tax administration, public financial and expenditure management, and energy pricing are critical.

“Having obtained specific and credible financing assurances from major official bilateral creditors, it is now important for the authorities and creditors to make swift progress towards restoring debt sustainability consistent with the IMF-supported program. The authorities’ commitments to transparently achieve a debt resolution, consistent with the program parameters and equitable burden sharing among creditors in a timely fashion, are welcome.

“Sri Lanka should stay committed to the multi-pronged disinflation strategy to safeguard the credibility of its inflation targeting regime. As the market regains confidence, the authorities’ recent introduction of greater exchange rate flexibility will help to rebuild the reserve buffer.

“Maintaining a sound and adequately capitalized banking system is important. Implementing a bank recapitalization plan and strengthening financial supervision and crisis management framework are crucial to ensure financial sector stability.

“The ongoing efforts to tackle corruption should continue, including revamping anti-corruption legislation. A more comprehensive anti-corruption reform agenda should be guided by the ongoing IMF governance diagnostic mission that conducts an assessment of Sri Lanka’s anti-corruption and governance framework. The authorities should step up growth-enhancing structural reforms with technical assistance support from development partners.”

Sri Lanka: Selected Economic Indicators 2019-2026 1/

	2019	2020	2021	2022	2023	2024	2025	2026
	Act.	Act.	Act.	Prel.	Proj.	Proj.	Proj.	Proj.
GDP and inflation (in percent)								
Real GDP growth	-0.2	-3.5	3.3	-8.7	-3.0	1.5	2.6	3.0
Inflation (average) 2/	4.3	4.6	6.0	46.4	28.5	8.7	5.6	5.2
Inflation (end-of-period) 2/	4.8	4.2	12.1	57.2	15.2	6.7	5.6	5.2
GDP Deflator growth	3.9	3.1	8.1	46.6	30.0	10.7	5.6	5.2
Nominal GDP growth	3.6	-0.4	11.7	33.9	26.0	12.3	8.3	8.4
Savings and investment (in percent of GDP)								
National savings	32.0	32.3	31.5	24.8	26.4	28.0	28.9	29.3
Government	-2.5	-8.2	-7.3	-6.7	-4.4	-2.0	-0.6	-0.4
Private	34.6	40.5	38.8	31.5	30.9	30.0	29.5	29.7
National Investment	34.1	33.7	35.3	26.8	28.0	29.4	30.3	30.7
Government	6.6	6.4	7.0	5.2	4.5	5.0	5.0	5.0
Private	27.5	27.3	28.2	21.5	23.5	24.5	25.3	25.7
Savings-Investment balance	-2.1	-1.4	-3.8	-1.9	-1.6	-1.4	-1.4	-1.4
Government	-9.2	-14.6	-14.3	-11.9	-9.0	-7.0	-5.6	-5.4
Private	7.1	13.2	10.5	9.9	7.4	5.6	4.2	4.0
Public finances (in percent of GDP)								
Revenue and grants	11.9	8.7	8.3	8.5	11.0	13.3	14.9	15.0
Expenditure	19.5	20.7	19.9	18.9	19.0	19.7	19.9	19.9
Primary balance	-1.9	-5.9	-5.7	-3.8	-0.7	0.8	2.3	2.3
Central government balance	-7.5	-12.1	-11.6	-10.4	-8.0	-6.4	-5.0	-4.8
Central government gross financing needs	21.7	26.1	31.0	34.5	26.6	17.9	15.4	15.9
Central government debt	82.6	95.7	102.2	117.7	100.0	101.6	103.3	102.2
Public debt 3/	89.0	104.0	114.3	128.1	111.2	108.5	107.8	106.8
Money and credit (percent change, end of period)								
Reserve money	-3.0	3.4	35.4	3.3	23.5	11.2	7.3	8.4
Broad money	7.0	23.4	13.2	15.5	22.6	11.2	7.3	8.4
Domestic credit	6.5	24.6	19.5	18.8	11.4	3.2	1.5	2.5
Credit to private sector	4.2	6.5	13.1	6.4	11.2	8.1	8.6	9.2
Credit to private sector (adjusted for inflation)	-0.1	1.9	7.2	-40.0	-17.3	-0.6	3.1	4.0
Credit to central government and public corporations	10.4	53.6	26.5	31.1	11.5	-0.8	-4.7	-4.2
Balance of payments (in millions of U.S. dollars)								
Exports	11,940	10,048	12,499	13,106	13,666	14,517	15,270	16,065
Imports	-19,937	-16,055	-20,638	-18,291	-20,597	-21,479	-22,506	-23,794
Current account balance	-1,844	-1,187	-3,343	-1,458	-1,184	-1,092	-1,077	-1,124
Current account balance (in percent of GDP)	-2.1	-1.4	-3.8	-1.9	-1.6	-1.4	-1.4	-1.4
Current account balance net of interest (in percent of GDP)	-0.2	0.5	-2.2	-0.5	0.2	0.9	1.1	0.8
Export value growth (percent)	0.4	-15.9	24.4	4.9	4.3	6.2	5.2	5.2
Import value growth (percent)	-10.3	-19.5	28.5	-11.4	12.6	4.3	4.8	5.7
Gross official reserves (end of period)								
In millions of U.S. dollars	7,642	5,664	3,139	1,898	4,431	6,128	8,520	10,888
In months of prospective imports of goods & services	5.0	3.2	1.9	1.0	2.2	3.0	3.9	4.8
In percent of ARA composite metric	61.6	45.8	24.5	16.3	36.1	48.7	65.5	80.7
Usable Gross official reserves (end of period) 4/								
In millions of U.S. dollars	7,642	5,664	1,565	462	2,995	4,692	8,520	10,888
In months of prospective imports of goods & services	5.0	3.2	1.0	0.2	1.5	2.3	3.9	4.8
In percent of ARA composite metric	61.6	45.8	12.2	4.0	24.4	37.3	65.5	80.7
External debt (public and private)								
In billions of U.S. dollars	54.6	53.4	57.3	58.7	56.2	58.3	61.1	63.9
As a percent of GDP	61.4	62.6	64.4	78.0	74.7	76.7	78.0	78.6

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

1/ This table is based on data as of March 6.

2/ Colombo CPI.

3/ Comprising central government debt, publicly guaranteed debt, and CBSL external liabilities (i.e., Fund credit outstanding and international currency swap arrangements).

4/ Excluding PBOC swap ($1.4bn in 2022) which becomes usable once GIR rise above 3 months of previous year's import cover.

INTERNATIONAL MONETARY FUND

SRI LANKA

March 6, 2023

REQUEST FOR AN EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY

EXECUTIVE SUMMARY

Context. Sri Lanka fell into an unprecedented crisis as a result of a series of shocks and policy missteps. Debt rose to unsustainable levels resulting from large fiscal imbalances, and access to international capital markets was lost soon after large tax cuts and the onset of the COVID-19. Reserves were depleted, leading to a sharp exchange rate depreciation, and debt service was suspended in the spring of 2022. Sizable monetary financing to meet fiscal obligations contributed to a surge in inflation. Sri Lanka's economy is in deep recession and financial stability is at risk given the tight financial-sovereign nexus. People are suffering from food and energy shortages, exacerbating deep-rooted public dissatisfaction and creating a vulnerable political and social environment.

Recent Policies. To address the crisis, extraordinary measures have been put in place to manage the economic challenges and jumpstart reforms. Import restrictions and other balance of payment measures were tightened to alleviate foreign exchange (FX) shortages and depreciation pressure. A digital fuel rationing system helped manage access to fuel. Social transfers were scaled up alongside external humanitarian support to protect the vulnerable. The authorities have taken decisive policy actions since mid-2022, including a downsizing of monetary financing and raising policy rates to rein in inflation, introducing tax measures to improve fiscal balance, raising electricity prices and introducing automatic energy pricing mechanisms, and embarking on institutional and other structural reforms.

Program Strategy. Staff proposes a 48-month normal-access Extended Arrangement under the Extended Fund Facility (EFF), with an access to Fund resources of SDR 2.286 billion (395 percent of quota or about US$3 billion). The program prioritizes: (i) an ambitious revenue-based fiscal consolidation, accompanied by stronger social safety nets, fiscal institutional reforms, and cost-recovery based energy pricing; (ii) restoration of public debt sustainability, including through a debt restructuring; (iii) a multi-pronged strategy to restore price stability and rebuild reserves under greater exchange rate flexibility; (iv) policies to safeguard financial sector stability; and (v) structural reforms to address corruption vulnerabilities and enhance growth. Policy actions that are key to tackling the root causes of the crisis and building confidence during the initial stabilization phase, such as revenue measures and central bank autonomy, will be implemented upfront. Long-lasting institution building reforms to

ensure macroeconomic stability and debt sustainability will be implemented under visible reform ownership and carefully sequenced under the program.

Program Risks. Risks to program implementation are exceptionally high, given the complex debt restructuring process, unfavorable external environment, elevated risks of persistently high inflation, and challenging political and social situation. Given Sri Lanka's weak track record of reform implementation, the program runs significant risks of slippages regarding fiscal consolidation, revenue mobilization, and reserves buildup. A deeper crisis induced by a further economic fallout, the weakened banking sector, exchange rate pressure, and loss of market confidence could also complicate program implementation. In this regard, contingency plans are crucial and policies should remain agile to adjust to the evolving circumstances.

Approved By
Anne-Marie Gulde-Wolf and Bikas Joshi

Discussions were held virtually during May 16–23, 2022, and in Colombo during June 20–30 and August 24–September 1, 2022. The mission met with President Rajapaksa; President, Prime Minister and Finance Minister Wickremesinghe; Prime Minister Gunawardena; Central Bank of Sri Lanka Governor Weerasinghe; Secretary to the Treasury Siriwardana; other senior officials; C. Amarasekara (OED); and representatives of the Parliamentary Opposition, the business community, civil society, and international partners. The staff team comprised P. Breuer, M. Nozaki (Co-Heads), M. Li, K. Hellwig, H. Selim, Y. Zhang (all APD), M. Kryshko (SPR), F. Vitek, D. Rozhkov (FAD), M. Adam, H. Miao (both MCM), and T. Feridhanusetyawan (ICD), S. Jahan (resident representative), and M. Abeyawickrama (local economist). A. Gulde-Wolf (APD) and T. Yan (COM) also joined for part of the missions. P. Polec and M. Odoño (both APD) assisted in the preparation of this report.

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CONTEXT AND RECENT DEVELOPMENT

1. Preexisting vulnerabilities, significant policy missteps, and major economic shocks set the stage for a full-blown crisis in Sri Lanka.

- Despite progress made under the 2016-19 EFF program, Sri Lanka's vulnerabilities were aggravated by substantial shocks during the period, including the 2017 drought, the 2018 political crisis, and the 2019 terrorist attacks.

- Following a change in government in late 2019, unsustainable policies were implemented involving significant tax cuts and delays of anticipated reforms, which further exacerbated vulnerabilities. The government, headed by President Rajapaksa following national elections in 2019-20, pledged to develop a people-centric economy through tax policy changes to promote production and reduce the cost of living. Income tax and value-added tax (VAT) were drastically cut in late 2019, with estimated revenue losses exceeding 2 percent of GDP. The automatic fuel pricing mechanism was discontinued, and legislative reforms to enhance central bank autonomy and fiscal rules were suspended. The EFF-supported arrangement expired in June 2020 after the 6th program review was completed in November 2019.

- As a result, Sri Lanka entered the pandemic with a thin reserves buffer, high debt level, and no fiscal space. Access to international capital markets has been lost since the spring of 2020. Despite elevated foreign exchange (FX) debt payment obligations and significantly reduced FX income, externally issued bonds continued to be repaid and the exchange rate was effectively fixed from April 2021. As a result, usable gross international reserves declined from $7.6 billion at end-2019 to $1.6 billion (less than 1 month of imports) at end-2021. Given heavy reliance on tourism and energy consumption, Sri Lanka fell into a deep crisis after the severe impact of the war in Ukraine in early 2022. With reserves depleted, the authorities suspended external debt service on April 12, 2022, and formally defaulted on their international sovereign bonds (ISBs) on May 18, 2022.[1] The rupee had depreciated by about 40 percent (in dollar terms) in 3 months since February 2022. The economy contracted sharply and inflation soared. Following the authorities' request in April 2022, IMF staff and the authorities reached a staff-level agreement on a 48-month arrangement under the Extended Fund Facility on September 1, 2022.[2]

2. Economic hardship ignited social unrest and political instability. Severe shortages of food, fuel, cooking gas, and daily power cuts fueled nationwide anti-government protests in March, May, and July 2022, followed by escalated violence causing deaths and hundreds of injuries, leading to the resignations of leaders and top government officials including the President and the Prime

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[1] On April 12, 2022, the government announced its intention to seek external debt restructuring and a suspension of payments on public sector foreign-law-governed and FX-denominated debt to bilateral official and commercial creditors (excluding debts to multilateral creditors, trade credits, and currency swaps), resulting in arrears to the applicable debt. With the lapse of a grace period, Sri Lanka has defaulted on its ISBs on May 18, 2022.

[2] https://www.imf.org/en/News/Articles/2022/09/01/pr22295-imf-reaches-staff-level-agreement-on-an-extended-fund-facility-arrangement-with-sri-lanka.

Minister. Protests subsided after the newly appointed president Ranil Wickremesinghe declared a state of emergency in late July. Access to gas and electricity has also improved somewhat, and a digital fuel rationing system has reduced queues at gas stations, though 33 percent of households are experiencing some form of food insecurity according to the World Food Program. Political vulnerabilities remain high, given elevated public dissatisfaction with alleged corruption and the hardships implied by economic reforms. The new government remains dependent on the same party in parliament that supported the previous administration. Local elections planned for early March have been postponed.

3. The recession and heightened inflation reflect the sharp adjustment under way in Sri Lanka. Real GDP contracted by 7.1 percent y/y in the first three quarters of 2022, largely driven by manufacturing and construction sectors. Latest high frequency indicators point to further contraction of industrial production and business activities. Despite weak demand, service activities are showing positive signs, with PMI in December 2022 back in the expansion territory, possibly reflecting easing fuel shortages. Inflation measured by Colombo CPI (CCPI) slowed recently on the back of falling food prices, from the peak of 70 percent y/y in September to 54 percent in January 2023. Core inflation also declined, albeit more modestly, from 50 percent to 46 percent during the same period.[3] The sharp acceleration in inflation in the first half of 2022 was driven primarily by monetary financing, rupee depreciation, and global commodity price surge, followed by steady increases reflecting the second-round effects of hikes in administrative prices amid de-anchored inflation expectations.

4. The balance of payments (BOP) remains under pressure while reserves are depleted.

- During 2022, exports expanded (5 percent y/y) helped by slightly better export prices and improved competitiveness, while imports contracted (-11 percent y/y) due to lower demand after depreciation, FX shortages, and import restrictions. Remittances are slowly picking up from a low level, and tourist arrivals and inflows recovered in December 2022 to about a third of pre-pandemic levels. Following a sharp depreciation, the exchange rate stabilized at about 360 Rupee/Dollar under FX market guidance from the Central Bank of Sri Lanka (CBSL) since May 2022, despite continued FX shortages. The CBSL has announced that with effect from March 7, 2023 this FX market guidance will be eliminated.

- FX external financing remains tight. The World Bank and Asian Development Bank (ADB) continued to disburse by repurposing the existing project loans for emergency assistance. India extended emergency loans for fuel and humanitarian purposes and provided currency swaps, while payments through the Asian Clearing Union were deferred.[4]

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[3] A rebased CPI index for 2022 onwards was published on February 28, 2023. Inflation development and projections in this document are based on the previous index.

[4] The Asian Clearing Union (ACU) balance arises from the CBSL's obligation to collect FX payments from Sri Lankan banks on behalf of the ACU members.

- Gross international reserves (GIR) stood at about $1.9 billion (about 1 month of prospective imports) at end-December 2022, including unusable $1.4 billion worth of yuan deposits at the People's Bank of China (PBOC). Freely usable reserves are insufficient to cover essential imports such as fuel and energy, even after the external debt default.

5. **The 2022 fiscal balance improved on account of spending restraint, reflecting tight cash constraints**. The cash primary deficit declined to 3.8 percent of GDP in 2022 from 5.7 percent of GDP in 2021 (see text table), due to capital spending restraint on the back of cash constraints and a limited degree of inflation indexation for current spending. The 2022 primary deficit was also slightly smaller than the target of 4 percent of GDP previously agreed with Fund staff. The tax revenue-to-GDP ratio increased only marginally in 2022 as gains from tax policy measures (see ¶12) were partly offset by a cyclical decline in revenue and a decrease in import-related taxation associated with the recession and import compression.[5] Financing constraints led to broadly maintaining the size of the stock of unpaid bills of LKR 106 billion (0.5 percent of GDP) at end-December, of which LKR 60 billion are considered in arrears.[6] Expenditure in 2022 included on-lending of a short-term loan from the government to the Ceylon Petroleum Corporation (CPC) in the amount of about 1 percent of GDP.[7]

Sri Lanka: Fiscal Outturn, 2021-22

	2021		2022	
	Act.		Act.	
	Billion Rupees	percent of GDP	Billion Rupees	percent of GDP
Total Revenue and Grants	**1,463**	**8.3**	**2,012**	**8.5**
Total Revenue	**1,457**	**8.2**	**1,979**	**8.4**
Tax Revenue	**1,298**	**7.3**	**1,751**	**7.4**
Income Taxes	302	1.7	534	2.3
Taxes on property	0	0.0	0	0.0
Tax on goods & services	646	3.7	876	3.7
VAT	308	1.7	463	2.0
Excise Taxes	307	1.7	343	1.4
Other taxes & levies	31	0.2	70	0.3
Tax on external trade	350	2.0	341	1.4
Non Tax Revenue	**159**	**0.9**	**228**	**1.0**
Grants	7	0.0	33	0.1
Total Expenditure and net lending	**3,522**	**19.9**	**4,473**	**18.9**
Current Expenditure	**2,748**	**15.5**	**3,520**	**14.9**
Salaries & wages	846	4.8	956	4.0
Goods & services	169	1.0	183	0.8
Interest payments	1,048	5.9	1,565	6.6
Subsidies & transfers	685	3.9	815	3.4
Social Safety Net			142	0.6
Capital Expenditure and Net Lending	**774**	**4.4**	**953**	**4.0**
Capital Expenditure	768	4.3	715	3.0
Net Lending	7	0.0	237	1.0
Overall balance	**-2,058**	**-11.6**	**-2,460**	**-10.4**
Primary balance	**-1,010**	**-5.7**	**-895**	**-3.8**

Source: Sri Lankan authorities; and IMF staff calculations.

6. **Financial sector vulnerabilities are elevated with deteriorating credit quality, a severe FX liquidity shortage, and large sovereign exposures**. Banks are expected to face large upfront capital shortfalls following the sovereign debt restructuring and additional provisioning for non-performing loans (NPLs).

- ***Deteriorating credit quality***. Backward-looking reported capital positions of banks remained stable, with the sector's Common Equity Tier 1 capital ratio falling slightly from 12.9 percent at

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[5] Preliminary data suggest that VAT on imports. excises, trade taxes in 2022 were down by 0.8 percentage points of GDP relative to 2021.

[6] Unpaid bills declined in 2022 from 0.6 percent of GDP at end-2021. Arrears are defined as unpaid bills outstanding for more than 90 days.

[7] The on-lending is related to fuel credit lines from India. Under the Government Finance Statistics Manual (GFSM) 1986, this net lending is included in expenditure. The loans were due for repayment in 2022, but the CPC has not been in a position to repay. While the Treasury has asked for repayment in 2023, the repayment is not assumed in the baseline fiscal projections due to uncertainty. Without this loan the primary deficit would have declined to 2.8 percent of GDP in 2022.

end-2021 to 12.2 percent in September 2022. However, the actual capital position will decline because credit quality continues to deteriorate as the crisis deepens, with non-performing loans increasing from 7.6 percent at end-2021 to 10.9 percent in September 2022.[8] A wider measure including loans with a significant deterioration in credit quality rose to 32 percent of loans.[9]

- ***Liquidity constraints***. Banks continue to face substantial FX liquidity challenges. Income from their investments in FX sovereign debt has been suspended, although improving remittances and import restrictions have provided some alleviation. As a result, banks are reluctant to provide FX trade credit to importers while securing FX deposits with elevated interest rates and ad-hoc withdrawal restrictions. The government's decision to settle maturing Sri Lanka Development Bonds[10] (SLDBs) in Rupees upon request has reduced banks' FX credit exposure to the government, but is expected to weaken banks' FX positions. The cost of Rupee deposit funding has also risen sharply, especially for state-owned banks. Interbank liquidity is scarce and segmented, with foreign banks depositing substantial surplus funds with the CBSL. The CBSL has provided needed liquidity to domestic banks through term repos.

- ***Large exposure to public sector debt***. Total exposure to the public sector accounts for over 40 percent of banks' assets, including two large state-owned commercial banks' exposures to insolvent SOEs. Market values of FX denominated sovereign securities—albeit subject to illiquid trading conditions—imply a loss of more than 60 percent of face value, partially offset by provisions of over 20 percent. Provisions on domestic currency public sector exposures are minimal.

7. The authorities have been managing the crisis with exceptional measures while making progress on reforms under the prospective EFF-supported program.

- ***Administrative BOP measures***. FX shortages triggered the tightening of import restrictions on non-essential goods since March 2022. The authorities also tightened FX management measures (some of them giving rise to multiple currency practices and exchange restrictions) to mitigate FX shortages and depreciation pressure.

- ***Fuel and food support system***. A digital fuel rationing system was put in place to address fuel shortage, which helped reduce queues at fuel stations in recent months. The authorities also launched the Food Security and Livelihood Restoration Emergency Assistance in August 2022 to improve access to food and protect livelihoods for the poor and vulnerable.

- ***Social transfers***. Social safety nets (SSN) programs, including the poverty-targeted Samurdhi cash transfers, support for the elderly, disabled people, kidney patients, and the COVID-19 relief have helped to partly mitigate the adverse impact to the poor. The authorities have raised annual SSN spending from about LKR 60 billion on average before the pandemic to

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[8] Loans classified as Stage 3 under IFRS9.

[9] Loans classified as Stage 2 or Stage 3 under IFRS9.

[10] A local-law debt instrument denominated in U.S. dollars issued by the government.

LKR 100-140 billion during 2020-22, and used the existing SSN delivery systems to provide emergency support. However, the real value of cash transfers eroded in 2022, especially for poorer households facing disproportionately higher inflation.

- ***Monetary financing***. Constrained by limited market access, the government significantly increased borrowing from the CBSL to finance the budget, resulting in expanding monetary financing and contributing to elevated inflation. To rein in inflation, the CBSL has been downscaling monetary financing—purchases of government securities in the primary market have fallen from the peak of a three-month average of LKR 120 billion a month in June 2022 to LKR 43 billion a month in January 2023.

- ***Tax measures***. As part of a comprehensive tax reform, the authorities implemented several revenue measures (see ¶12) to strengthen personal income tax (PIT), corporate income tax (CIT), and VAT.

- ***Energy pricing***. The adoption of automatic price adjustment mechanisms for fuel and electricity in 2022 set up the framework for elimination of energy subsidies in 2023. The monthly fuel price adjustment mechanism is operational, and electricity tariffs were raised substantially in August 2022 and February 2023.

- ***Spending restraint***. The revised 2022 budget, approved by Parliament in September 2022, reduced the primary deficit target to 4 percent of GDP from 5.7 percent of GDP in 2021 (subsequently outperformed at 3.8 percent of GDP in 2022). In addition to tax policy measures, this was achieved by reducing the capital spending envelope while making room for additional SSN spending and for transfers to the CEB to cover its 2022 losses from below-cost electricity pricing. The spending restraint helped the government to address fiscal financing shortfalls.

OUTLOOK AND RISKS

8. The outlook reflects macroeconomic adjustments supported by the EFF-supported program, envisaging successful implementation of reforms and a sovereign debt restructuring that meets debt sustainability targets.

- Real GDP is projected to contract by 8.7 percent in 2022 and 3 percent in 2023, before a moderate expansion by 1.5 percent in 2024 and gradual convergence towards the growth potential of around 3 percent over the medium term. This reflects: (i) fuel shortages, power cuts, and supply disruptions of intermediate goods (including construction materials and fertilizer) in the near term; (ii) fiscal adjustment under the program, with the fiscal multiplier assumed at 0.5;[11] (iii) the banking sector's limited capacity to support private sector activity; and (iv) a significant sovereign debt restructuring requiring bank recapitalization. The growth path is broadly in line with what was observed under previous crisis non-concessional IMF-supported

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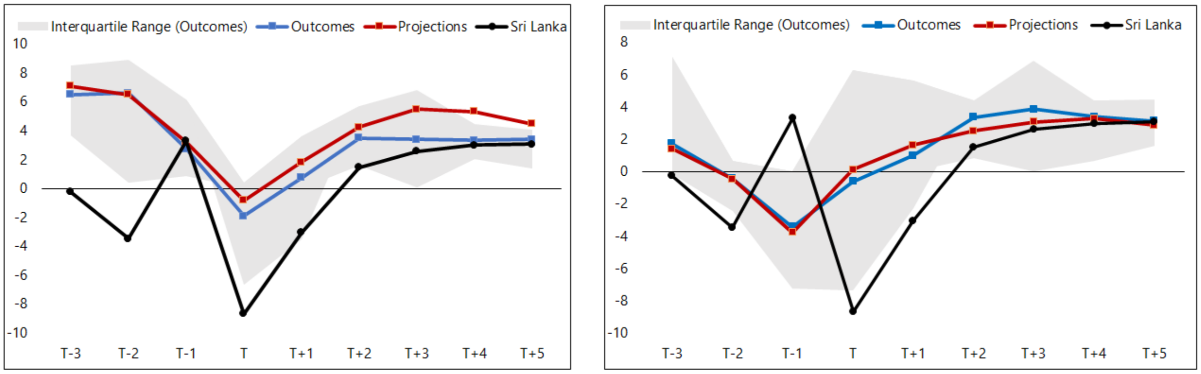
[11] Based on the "bucket approach" discussed in "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections", IMF Technical Notes and Manuals 14/04.

programs and those that involved sovereign debt restructurings, with output in 2024 estimated below trend real GDP by 18 percent.

- Inflation peaked at 70 percent in September 2022 and is projected to decline towards 15 percent by end-2023 before eventually reaching the CBSL's target band of 4-6 percent by early 2025, supported by monetary policy tightening, discontinuation of monetary financing, fiscal consolidation, along with the waning base effects from the currency depreciation and moderation of imported inflation.

Sri Lanka: Cross-country Comparison of Real GDP Growth

(In percent, cross-country medians)



GRA Crisis

Programs with Debt Operations

Sources: IEO, 2021. Growth and adjustment in IMF-supported programs; and IMF staff calculations.

- Sri Lanka's external position in 2022 is assessed as weaker than the level implied by medium-term fundamentals and desirable policies (Annex I). The REER depreciated by about 5 percent in 2022 in average terms, with initial sharp real depreciation largely dialed back by soaring inflation. Going forward, the removal of the CBSL's exchange rate guidance, the commitment to a flexible exchange rate, and ongoing disinflation will support additional real deprecation. Fiscal adjustment and export competitiveness gains from the envisaged real exchange rate depreciation will help restore a non-interest external current account surplus starting in 2023, supporting rebuilding reserves.

- Sovereign debt restructuring will restore public debt sustainability on a forward-looking basis (see ¶18 and public debt sustainability analysis (DSA, Annex II)). A preliminary contingency of banking sector recapitalization needs of around 6 percent of 2022 GDP—arising from impairments on banks' exposures to the public sector through debt restructuring and to the private sector through adverse macro developments—is incorporated in the public DSA. The estimate is sensitive to the design of the restructuring.

9. Large uncertainty and downside risks remain. Downside risks should be mitigated by restoring confidence and macroeconomic stability, addressing key corruption vulnerabilities, and boosting potential growth through structural reforms. Contingency planning for additional policy actions is also critical (¶42).

- ***External risks*** associated with intensification of regional conflicts, supply disruptions, and renewed surge in global commodity prices could induce further exchange rate depreciation and runaway inflation. A global growth slowdown, further exacerbated by systemic financial vulnerabilities, could weigh on exports and the recovery.

- ***Domestic risks*** could arise from renewed social unrest and political instability triggered by public dissatisfaction arising from reform fatigue and alleged corruption. Sri Lanka's weak track record for reform poses an additional risk. Given elevated upside inflationary pressure, the risk of persistently high inflation is significant (¶20). FX liquidity shortfalls or sharp deterioration of banks' asset quality led by the sovereign debt restructuring or macroeconomic shocks could trigger banking sector stress with severe repercussion to the broader economy. Risks related to program implementation are discussed in ¶41.

- ***Upside risks*** could materialize from a faster than expected growth recovery led by stronger tourism and FDI.

PROGRAM OBJECTIVES

10. The EFF-supported program for Sri Lanka aims to restore macroeconomic stability and debt sustainability, mitigate the economic impact on the poor and vulnerable, safeguard financial sector stability, and strengthen governance and medium-term growth potential. Consistent with the IMF's policy recommendations under the 2021 Article IV consultation,[12] the comprehensive policy package comprises: an ambitious revenue-based fiscal consolidation, accompanied by fiscal institutional reforms and stronger social safety nets and SOEs (Section A); a deep restructuring of public debt (Section B); a multi-pronged strategy to restore price stability and rebuild reserves under greater exchange rate flexibility (Section C); policies to safeguard financial sector stability (Section D); and stepped up structural reforms to reduce corruption vulnerabilities (Section E) and enhance growth (Section F).

A. Advancing Revenue-Based Fiscal Consolidation, Reforms to Social Safety Nets, Fiscal Institutions, and State-Owned Enterprises

11. Leading up to the economic crisis, Sri Lanka ran persistently large fiscal deficits, which reached 12.1 percent of GDP in 2020 and 11.6 percent of GDP in 2021. After losing international sovereign debt market access at the onset of the pandemic, financing these fiscal deficits necessitated recourse to large scale monetary financing, which contributed to the surge in inflation in 2022. These large fiscal deficits reflected substantially low tax revenues and high debt service

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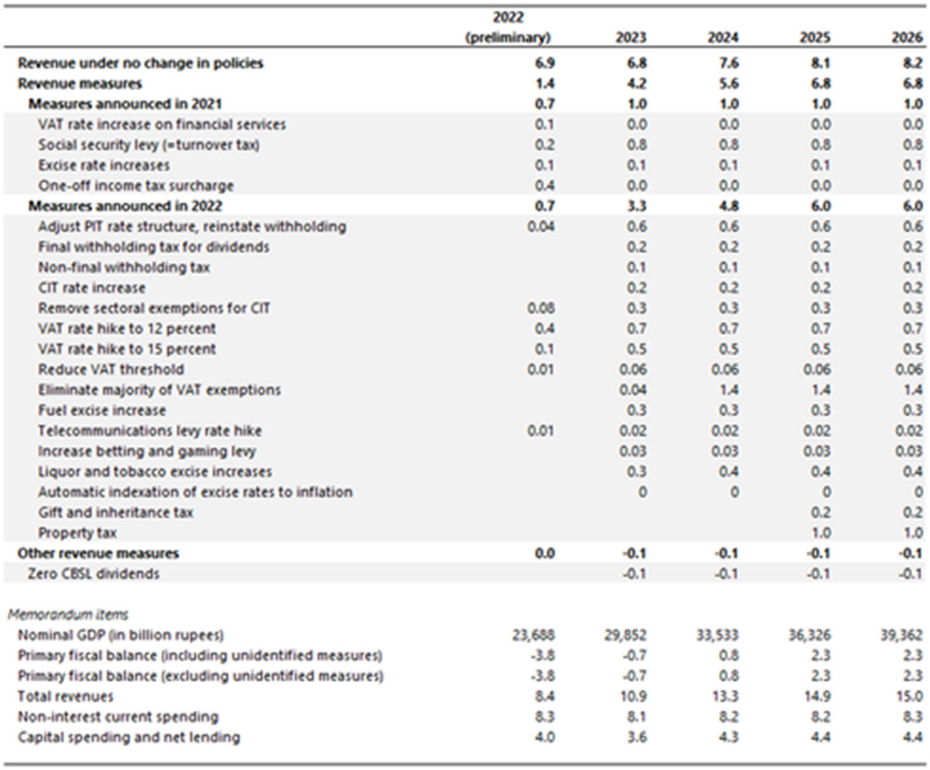
[12] https://www.imf.org/en/Publications/CR/Issues/2022/03/25/Sri-Lanka-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-515737

costs, while non-interest government expenditures were not excessively high. Indeed, the tax revenue to GDP ratio was among the lowest in the world, at only 7.3 percent in 2021. This weak tax revenue performance reflected a combination of low tax rates, narrow tax bases, and low collection efficiency. To achieve needed fiscal consolidation in Sri Lanka, the program addresses all of these problems with wide-ranging tax reforms.

12. The authorities are committed to an ambitious and primarily revenue-based fiscal consolidation strategy. The 2023 budget aims to reduce the primary deficit to 0.7 percent of GDP in 2023 (**quantitative performance criterion**) from 3.8 percent of GDP in 2022, with tax revenue targeted to reach about 10 percent of GDP (**indicative target**). The program aims to improve the primary balance to a surplus of 0.8 percent of GDP in 2024 and 2.3 percent of GDP from 2025 onwards, an ambitious but feasible medium-term fiscal path. The national budgets will be consistent with program parameters and needed revenue measures will be implemented in a timely fashion (**structural benchmarks**). Achieving the targets entails additional revenue measures of 2.7 percent of GDP in 2024-25, combined with expenditure rationalization. The authorities are also committed to clearing all outstanding spending arrears by end-June 2023 (**quantitative performance criterion**).

Sri Lanka: Cumulative Impact of Revenue Measures, Relative to Unchanged Policies from 2021

(In percent of GDP)



	2022 (preliminary)	2023	2024	2025	2026
Revenue under no change in policies	**6.9**	**6.8**	**7.6**	**8.1**	**8.2**
Revenue measures	**1.4**	**4.2**	**5.6**	**6.8**	**6.8**
Measures announced in 2021	**0.7**	**1.0**	**1.0**	**1.0**	**1.0**
VAT rate increase on financial services	0.1	0.0	0.0	0.0	0.0
Social security levy (=turnover tax)	0.2	0.8	0.8	0.8	0.8
Excise rate increases	0.1	0.1	0.1	0.1	0.1
One-off income tax surcharge	0.4	0.0	0.0	0.0	0.0
Measures announced in 2022	**0.7**	**3.3**	**4.8**	**6.0**	**6.0**
Adjust PIT rate structure, reinstate withholding	0.04	0.6	0.6	0.6	0.6
Final withholding tax for dividends		0.2	0.2	0.2	0.2
Non-final withholding tax		0.1	0.1	0.1	0.1
CIT rate increase		0.2	0.2	0.2	0.2
Remove sectoral exemptions for CIT	0.08	0.3	0.3	0.3	0.3
VAT rate hike to 12 percent	0.4	0.7	0.7	0.7	0.7
VAT rate hike to 15 percent	0.1	0.5	0.5	0.5	0.5
Reduce VAT threshold	0.01	0.06	0.06	0.06	0.06
Eliminate majority of VAT exemptions		0.04	1.4	1.4	1.4
Fuel excise increase		0.3	0.3	0.3	0.3
Telecommunications levy rate hike	0.01	0.02	0.02	0.02	0.02
Increase betting and gaming levy		0.03	0.03	0.03	0.03
Liquor and tobacco excise increases		0.3	0.4	0.4	0.4
Automatic indexation of excise rates to inflation		0	0	0	0
Gift and inheritance tax				0.2	0.2
Property tax				1.0	1.0
Other revenue measures	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Zero CBSL dividends		-0.1	-0.1	-0.1	-0.1
Memorandum items					
Nominal GDP (in billion rupees)	23,688	29,852	33,533	36,326	39,362
Primary fiscal balance (including unidentified measures)	-3.8	-0.7	0.8	2.3	2.3
Primary fiscal balance (excluding unidentified measures)	-3.8	-0.7	0.8	2.3	2.3
Total revenues	8.4	10.9	13.3	14.9	15.0
Non-interest current spending	8.3	8.1	8.2	8.2	8.3
Capital spending and net lending	4.0	3.6	4.3	4.4	4.4

Sources: Sri Lankan authorities; and IMF staff estimates.

- ***Tax policy measures***. The authorities have implemented a progressive tax reform package since May 2022, entailing: (i) raising the marginal PIT rate schedule, reducing the PIT tax-free allowance, and introducing mandatory withholding taxes starting from January 2023; (ii) raising the statutory CIT rate from 24 to 30 percent and removing almost all sector-specific CIT exemptions from October 2022; (iii) raising the VAT rate from 8 percent to 12 percent in May 2022 and to 15 percent in September 2022, and reducing the VAT registration threshold from September 2022; and (iv) raising fuel excises to yield 0.3 percent of GDP in January 2023. The adverse distributional impacts of the VAT rate hikes were mitigated by maintaining VAT exemptions on basic food items. To bring the tax to GDP ratio to at least 14 percent by 2025, the authorities commit to revamping the VAT system before 2024, by removing almost all product-specific VAT exemptions. They also commit to significantly speeding up valid VAT refunds and abolishing the Simplified VAT (SVAT) system.[13] Finally, the authorities commit to introducing a property tax, as well as a gift and inheritance tax before 2025. These tax policy reforms focus on base-broadening and progressive measures to mobilize revenue while promoting economic efficiency and equity. They are supported by IMF capacity development (CD).

- ***Revenue administration reforms*** are needed to adapt the operations of tax collection agencies to the revamped tax system, and to boost their tax collection efficiency. To strengthen PIT collection efficiency, the authorities reinstated mandatory withholding taxes on employment income, services payments, and capital income from October 2022. To strengthen tax collection efficiency and enhance fiscal transparency, the authorities will improve the Large Taxpayer Unit, strengthen IT-based tax administration, and publish the estimated direct costs of corporate tax incentives. The reform plan will be further upgraded with IMF CD support, including a revenue administration diagnostic assessment in January 2023. In addition, the transparency of audit could be strengthened by establishing a systematic third-party information sharing with the revenue authorities and centralizing all tax audits using risk-based filters; the World Bank is providing CD support.

- ***Expenditure rationalization measures***. The authorities will develop strategies to limit growth in the public sector wage bill and public pension spending. After a steady increase in the wage bill in recent years, high inflation has significantly reduced real current spending in 2022. The authorities have decided to restrain wage and pension increases to well below inflation in 2023. While excessive cuts to capital spending should be avoided under the program, fiscal space for capital spending will be constrained. To address this, the authorities will take measures to raise public investment efficiency and strengthen the processes to prioritize capital projects.

13. The program aims to strengthen the social safety nets (SSN) to help cushion the impact of the economic crisis on the poor and vulnerable (Annex IV). The ambitious fiscal consolidation should protect SSN spending. In addition, Sri Lanka's SSN programs have suffered from poor adequacy, coverage, and targeting. A World Bank study found that, in 2019, only

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[13] SVAT is a parallel system for exporters and other firms whose sales are mostly VAT exempt to avoid paying VAT on their inputs, adding complexity to the VAT system.

38 percent of the poorest income quintile received targeted cash transfers under the Samurdhi program, while 12 percent of the richest income quintile received the transfers. Accordingly:

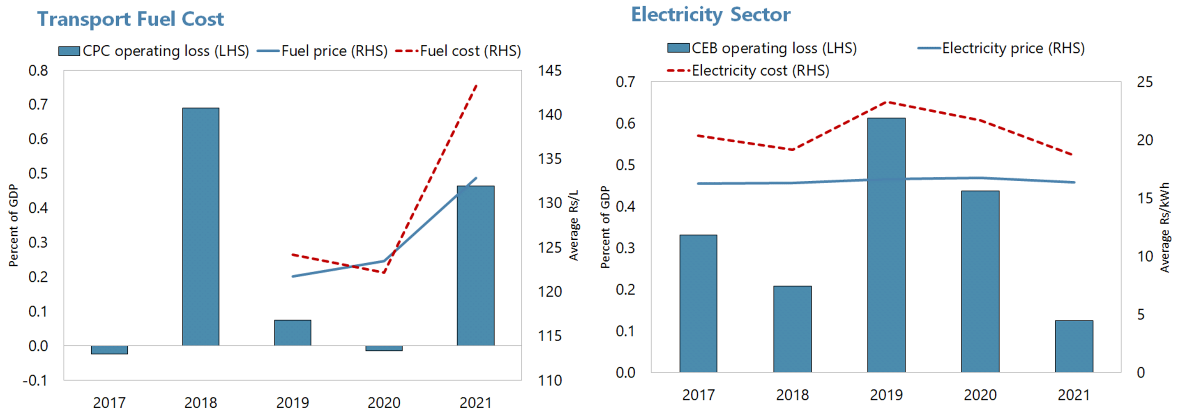
- The program will set a floor on SSN spending of LKR 187 billion in 2023 (0.6 percent of GDP, **indicative target**). This will allow the major four SSN programs (Samurdhi cash transfers and support for elderly, disabled, and chronic kidney disease) to mitigate inflation eroding per-household benefits. Beyond 2023, the authorities will maintain SSN spending at least at 0.6-0.7 percent of GDP.

- In parallel, the authorities will implement broader institutional reforms to improve efficiency, coverage, and targeting of the SSN. The authorities have made the Welfare Benefits Board (WBB) operational as the legal entity responsible for coordinating all SSN programs and reforms. They have also populated a new Social Registry, an electronic database of SSN beneficiaries, and obtained parliamentary approval of the new eligibility criteria for selecting beneficiaries for SSN programs. The eligibility criteria, developed with support from the World Bank, are based on objective and verifiable characteristics of households. Parliamentary approval of the welfare benefit payment scheme and application of the new eligibility criteria are expected by May 2023 (**structural benchmark**), which will allow the WBB to start selecting SSN beneficiaries using the new eligibility criteria. By January 2024, beneficiaries who are ineligible according to the eligibility criteria would no longer receive Samurdhi cash transfers. These reforms will be assisted by the World Bank and will help ensure that the SSN is well targeted and covers all eligible low-income and vulnerable households.

14. The authorities will strengthen the core public financial management (PFM) functions. Under the current PFM framework and practice, government budgets have systematically overestimated revenues, expenditure management has been ineffective, and the fiscal rules framework has not been satisfied since its inception in 2003, resulting in budget overruns and spending arrears. To fundamentally improve the weak PFM framework, the program entails: (i) enacting a new PFM law, which clarifies the budget process, specifies the roles of government agencies, and includes a revamped fiscal rules framework, with submission to Parliament by December 2023 (**structural benchmark**); (ii) developing a medium-term fiscal framework to provide binding multi-year fiscal policy guidance; (iii) completing the rollout of the Integrated Treasury Management Information System (ITMIS) by September 2023 (**structural benchmark**); (iv) strengthening the recently established Macro-Fiscal Unit in the MOF; (v) improving public investment efficiency by strengthening the processes for project appraisal and selection; and (vi) updating fiscal reporting to the GFSM 2014 standard.

15. The authorities have introduced automatic fuel and electricity pricing mechanisms, paving the way for resolving debt overhangs and low efficiency in the energy sector. With retail fuel and electricity prices generally set below cost-recovery levels on a discretionary basis, the CPC and the Ceylon Electricity Board (CEB) made losses for years. These losses have been treated as off-budget subsidies, financed by FX loans from state-owned banks to the CPC (accumulated to 3.8 percent of GDP at end-2022) and resulting in delays in settling account payables from the CEB to the CPC (accumulated to 0.4 percent of GDP at end-2021). The resultant debt overhangs hindered needed infrastructure investments—notably, inadequate investment in electricity generation has led to a high production cost of electricity. Against this background, the program aims to depoliticize energy pricing:

Sri Lanka: Profitability of Energy SOEs, 2017-21



Sources: 2021 MOF Annual Report, CPC Product Wise Profitability Statements, CEB Financial Outturn Statements, and IMF staff calculations.

- Retail fuel prices will be set to their cost-recovery levels with monthly formula-based adjustments (**continuous structural benchmark**). The authorities already established a framework to implement this. In 2022H1, retail fuel prices were raised to their cost-recovery levels through multiple large price hikes, passing through the surge in global fuel prices and the large depreciation of the rupee to consumers. In November 2022, Cabinet approved an automatic fuel pricing mechanism, based on the 2018 fuel pricing formula that was suspended in November 2019.

- The end-user electricity tariff schedule will be set to its cost-recovery level with semi-annual formula-based adjustments (**continuous structural benchmark**). The authorities have started implementing the tariff-setting framework under the Electricity Act. The electricity tariff schedule was increased in August 2022—for the first time in 9 years—by 75 percent on average across different types of consumers. In November 2022, Cabinet approved an automatic electricity pricing mechanism, under which the electricity tariff schedule will be adjusted on a semi-annual forward-looking basis to its cost-recovery level, without planned power cuts. Under this framework, the electricity tariff schedule was raised by 66 percent on average in February 2023.

- Despite automatic fuel and electricity pricing, retail fuel or electricity prices may temporarily fall below their costs. The gap would be considered as non-commercial obligations for the CPC and CEB that need to be recorded as government expenditure to avoid off-budget subsidies. To achieve this objective, the cost of non-commercial obligations of the CPC and the CEB will be compensated by government transfers (**indicative target and continuous structural benchmarks**). By December 2023, the authorities will improve the Bulk Supply Transaction Account (BSTA) used to settle transactions between generators, the transmission operator, and distributors. This would allow to accurately measure the cost-recovery based electricity tariff and government transfer requirement (**structural benchmark**).

16. The program will strengthen the governance of SOEs and address their debt overhangs. Beyond the energy pricing reforms, SOE reforms will include: (i) Cabinet approval of a comprehensive strategy to restructure the balance sheets of the CPC, CEB, the Road Development Authority, and SriLankan Airlines by June 2023 (**structural benchmark**); (ii) prompt publication of audited financial statements for all 52 major SOEs; and (iii) prohibition of new FX borrowing by non-financial SOEs with limited FX revenues. In addition, the authorities commit to further strengthen SOE governance by clarifying the mandates of key SOEs through Statements of Corporate Intent, and by reviewing the framework for selecting SOE board members.

B. Restoring Public Debt Sustainability

17. Sri Lanka's public debt is assessed as unsustainable. The debt-to-GDP ratio is projected to have reached 128 percent of GDP in 2022, due to exchange rate depreciation, the fiscal deficit, and negative real GDP growth. The authorities' fiscal adjustment alone cannot reduce debt to sustainable levels.

18. The authorities are committed to restoring debt sustainability (see Annex II). Their objectives are to: (i) reduce the level of public debt below 95 percent of GDP by 2032; (ii) reduce average central government gross financing needs (GFNs) in 2027–32, including from the materialization of contingent liabilities, below 13 percent of GDP, so that rollover risks under stress are manageable; (iii) keep FX debt service of the central government below 4.5 percent of GDP in any year during 2027-32; and (iv) ensure that the fiscal and external financing gaps are closed. Following an external debt service moratorium announced on April 12, 2022, the authorities have hired financial and legal advisors and started to engage with their creditors on a restructuring strategy (which has been presented in part at official creditor meetings) that entails the following. The authorities, assisted by their advisors, will continue to engage with staff on their scenario analysis and are expected to make an announcement on the coverage and parameters of the external and domestic debt operations before end-April 2023. Debt data and information sharing (¶38) will continue, along with the reconciliation of debt sustainability and relief analysis with creditors, followed by eventual agreements with official creditors and debt exchanges with private creditors.

- ***Foreign law foreign currency (FLFC) debt***. The authorities' proposed restructuring perimeter excludes debt owed to international financial institutions (IFIs), central bank currency swaps, emergency credit lines extended in 2022, and any new disbursements made after the moratorium announcement. The remaining FLFC debt to official bilateral and commercial creditors is expected to be restructured through extension of grace period and maturity, interest rate reduction, nominal haircut, or a combination of these.

- ***Local law foreign currency (LLFC) debt***. The authorities plan to restructure their LLFC debt—held in Sri Lanka Development Bonds (largely held by banks) and FX bank loans of the government and SOEs—with an aim of achieving substantial flow relief. An option to convert

LLFC debt to local currency debt instruments has also been offered by the authorities and taken up by some creditors.

- ***Local law local currency (LLLC) debt***. The maturity shortening and interest rate increase of LLLC debt in the recent periods contributed to a sharp increase in the government's GFNs. The authorities and their financial advisors are weighing different options and their associated legal procedures to optimize the design of an LLLC debt treatment while preserving financial stability.

19. The authorities are committed to improving public debt management and debt transparency. They will establish an operationally independent debt management agency and have begun to publish a quarterly debt bulletin. The new PFM law (see ¶14) will clarify the definition of central government debt and strengthen the guidelines for issuing treasury guarantees, prohibiting the issuance of guarantees for SOEs with negative equity and on SOE liabilities in foreign currency.

C. Restoring Price Stability and Rebuilding External Buffers

20. Inflation reached unprecedented levels and expectations were de-anchored last year amid significant exchange rate depreciation, but there are early signs of deceleration in recent months. Sizable monetary financing, sharp Rupee depreciation, and second round effect of imported inflation contributed to rapid acceleration of headline and core inflation rates to the peak of 70 percent and 50 percent, respectively, in September 2022, unseen in the last two decades. One-year ahead inflation expectations rose from the 4-6 percent target range and peaked above 50 percent in September 2022. Although headline and core inflation rates have both fallen in recent months driven by lower food prices, underlying inflationary pressure excluding food and other energy prices remain elevated. Going forward, the waning base effect of the depreciation and commodity prices, and weak demand as the economy continues to shrink will support a disinflationary path. However, upside inflationary pressures remain due to the lagged effect of monetary financing, possible exchange rate adjustments as exchange rate guidance and FX control measures are gradually lifted, and potential second round effects from the increase in electricity prices.

21. The CBSL is committed to restoring Sri Lanka's price stability through maintaining tight monetary stance and discontinuing monetary financing. Monetary policy will be guided by an overriding objective of reducing the headline CCPI inflation (y/y) back to the CBSL's target band of 4-6 percent by early 2025.[14] Under the program, this will be monitored through a monetary policy consultation clause (MPCC; featuring inner/outer bands of ±1.5/3 percentage points for June 2023

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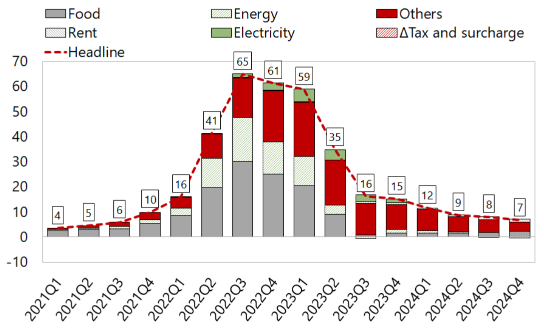
[14] Colombo CPI (CCPI) is used by the CBSL in its flexible inflation targeting framework.

and thereafter)[15] and achieved through a multi-pronged disinflation strategy that includes a strong commitment to necessary monetary policy changes and discontinuing monetary financing.

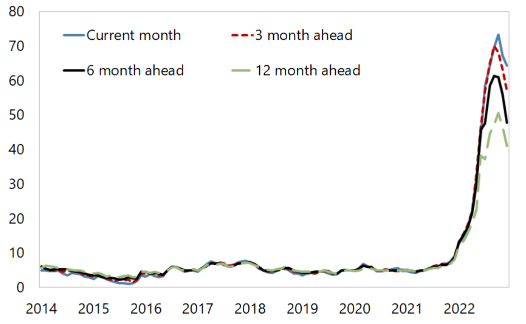
Sri Lanka: Contributions to CCPI Inflation
(In percent, y-o-y)



Sources: Sri Lanka authorities, and IMF staff calculations.

- Following the policy rate hikes by 700 basis points in April 2022 and by 100 basis points in July 2022, the CBSL raised the policy rate a further 100 basis points in March 2023 to 15.5-16.5 percent. Separately, prime lending and term repo rates have spiked due to market uncertainty surrounding a possible domestic debt restructuring, effectively tightening monetary conditions. Maintaining a tight monetary stance is warranted to bring inflation down durably towards the target, through managing inflation expectations and containing inflation persistence from compounding second round effects.

Sri Lanka: Corporate Sector Inflation Expectations
(In percent, y-o-y)



Source: IMF Staff Calculations.

- Going forward, inflation and inflation expectations need to be closely monitored, and the CBSL should stand ready to further adjust its policy stance over the coming monetary policy review cycles (which happen eight times a year) to deliver the programed inflation path. To enhance the speed and effectiveness of policy transmission, this should be accompanied by an explicit and strong commitment by the CBSL through its routine policy communication to pursue sufficiently positive real policy rates (on a forward-looking basis) until inflationary pressures are clearly receding. This should help bring the forward-looking real policy rates steadily toward a neutral stance, informed by an estimated natural rate of interest of 2.5 percent.

- Supported by fiscal consolidation and external financing, the program will ensure that the CBSL refrains from direct financing of the budget deficit and unwinds its large holdings of treasury securities. This will be monitored through a ceiling on the CBSL's net credit to the government (**quantitative performance criterion**). The CBSL's primary T-bill market purchases and special issuances to finance the budget deficit since 2020 reached 14 percent of 2021 GDP as of December 2022. The large-scale monetary financing has compromised the CBSL's operational independence and jeopardized its price stability mandate. Since August 2022, the CBSL has started to downscale monetary financing and plans to offload holdings of treasury securities under the program, to support a normalization of its balance sheet and help prevent excessive

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[15] Under the MPCC, a breach of the inner and outer bands would require completion of a policy consultation with the IMF staff and the IMF Board, respectively.

money expansion, with close attention to reserve money growth. Under the program, monetary financing is envisaged only in the case of a shortfall in budget support from IFIs during the first 6 months of the program.[16]

22. The authorities are firmly committed to allowing greater exchange rate flexibility and rebuilding international reserves.

- They are committed to restoring a market-determined and more flexible exchange rate to serve as a buffer against external shocks and to underpin the inflation targeting regime. The market guidance by the CBSL (to confine daily exchange rate movements within a pre-defined band around the weighted average interbank spot rate of the previous trading day) temporarily helped limit excessive volatility in the official FX market but has helped to keep the exchange rate effectively pegged at around LKR 360 per U.S. dollar since early May 2022. To restore a market-determined exchange rate, the authorities have announced to drop the guidance with effect of March 7, 2023.

- The CBSL will gradually rebuild gross international reserves including through outright FX purchases in the market, supported by a non-interest current account surplus, new external financing and other non-debt creating inflows, and sovereign debt relief. Meeting the program targets on Net Official International Reserves (NIR) (**quantitative performance criterion**) is predicated on the CBSL's outright FX purchases on a net basis of $1.4 billion in 2023. To avoid an "on and off" approach to exchange rate flexibility and to allow the rupee to adjust to changing fundamentals, foreign exchange interventions should be (i) limited to truly disorderly market conditions, (ii) transparently disclosed to guide market expectations, and (iii) capped at an amount consistent with meeting the NIR targets.

23. The authorities have tightly restricted FX flows in response to the sharp currency depreciation and pressures on reserves, and these temporary FX control measures are expected to be unwound during the program period once conditions allow. These measures include import restrictions, exchange restrictions, multiple currency practices (MCPs), and capital flow management (CFM) measures.

- Over 2020-22, the import of many non-priority non-critical goods was suspended, which helped contain the import bill and relieved BOP pressures, but also hurt economic activity.

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[16] This contingency is covered by a program adjustor to the net credit government target. See Technical Memorandum of Understanding for details.

- Sri Lanka also has in place measures that give rise to eight exchange restrictions and seven MCPs,[17] adopted new Capital Flow Measures (CFMs), and tightened existing CFMs during the pandemic and recent crisis.[18]

- Given acute BOP tensions and ongoing crisis, maintaining the CFM measures in the short run is appropriate. While the mentioned import restrictions, exchange restrictions, MCP-related measures and CFMs could help mitigate FX shortages in the near term, they should not be a substitute for the comprehensive policy package and ongoing macroeconomic adjustment, and should be phased out as the balance of payments stabilizes. To this end, by June 2023, the authorities will prepare a plan for the phased removal of these measures during the program period that will be conditioned on progress with achieving macroeconomic stability. In the meantime, the authorities have requested approval[19] of all but one exchange restrictions and all

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[17] A recent jurisdictional analysis identified the following measures which give rise to **exchange restrictions**: (i) the prioritization and rationing of FX by the CBSL and the CBSL's informal guidance to authorized dealers (ADs) to prioritize access to FX for essential items, which results in undue delays and payment arrears for current international transactions; (ii) prohibitions on converting LKR into FX for certain current international transactions (e.g., servicing certain external loans, payment of any income on certain nonresident investments); (iii) unremunerated cash margin deposit requirements on imports of certain items under letters of credit (LC), documents on payment (DP) and documents on acceptance (DA) payment terms; (iv) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (v) the levy of a 14 percent remittance tax on nonresidents' profits; (vi) limits on repatriation by nonresidents of proceeds derived from current transactions; (vii) the requirement to provide a tax clearance certificate prior to permitting transfers for certain current transactions; and (viii) Sri Lanka's net debtor position under the Asian Clearing Union payment arrangement that is pending settlement for longer than 90 days. Staff has identified **MCPs** arising from the following measures: (i) unremunerated cash margin deposit requirement on imports of certain items made under LC, DA, and DP payment terms; (ii) the use of a weekly volume weighted average exchange rate for the mandatory surrender of FX by ADs of certain proceeds to the CBSL; (iii) the official exchange rate calculated based on the previous day's transactions in the interbank FX market and used for CBSL's FX transactions with the government; (iv) the use of the weekly volume weighted average rate for CBSL's FX sales in bilateral non-Request for Quote outright spot transactions with ADs; (v) the levy of a 2.5 percent stamp duty on credit card transactions abroad; and (vi) the levy of a 14 percent remittance tax on nonresidents' profits. In addition, at the time of Sri Lanka's 2022 Article IV consultation, Sri Lanka maintained one MCP arising from incentives on inward worker remittances that result in a more favorable effective exchange rate for such transactions, and, although there have been some changes to the incentives offered, the MCP remains in place. Specifically, an incentive of LKR 1,000 provided through ADs towards covering the transactions costs of each inward worker remittance equivalent to LKR 20,000 or more that is converted into LKR through such ADs remains in place. Previously, inward remittances of FX sent by workers abroad through ADs in Sri Lanka and exchanged into LKR were converted at an exchange rate that was LKR 2 per 1 USD above the exchange rate used by ADs for conversion of any other inward remittances (terminated on January 1, 2023). For a short period between December 2021 and March 2022, an additional incentive of LKR 8 per 1 USD was paid (discontinued on March 8, 2022).

[18] Main measures constituting CFMs under the Fund's Institutional View on Liberalization and Management of Capital Flows introduced or tightened in 2020-2022 and currently in force include: (i) a repatriation requirement for exports of goods and services; (ii) a surrender requirement for exporters on proceeds from exports of goods; (iii) a surrender requirement for banks on purchases of export proceeds; (iv) a surrender requirement for banks on purchases of inward worker remittances; (v) suspension of outward remittances on capital transactions; (vi) restrictions on purchases of Sri Lankan ISBs by local banks; and (vii) restrictions on outward transfers of funds for emigrants.

[19] Approval of exchange restrictions is based on the following criteria: that the restriction is imposed (i) for balance of payments reasons, (ii) is not discriminatory, and (iii) that its use will be temporary while the member is seeking to eliminate the need for them. Approval of MCPs introduced for BoP reasons is based on the following criteria: (i) the measure is temporary; (ii) the member is endeavoring to eliminate its balance of payments problems; and (iii) it does not give the member an unfair competitive advantage.

MCPs.[20] Staff assesses that approval criteria are met and supports the authorities' request for temporary Fund approval in line with Fund policy.

- During the program period, the authorities will not: (i) introduce or intensify exchange restrictions or introduce or modify MCPs; (ii) impose or intensify import restrictions for balance of payments purposes; or (iii) conclude any bilateral payment agreements inconsistent with Article VIII (**continuous performance criteria**).

24. The institutional framework will be strengthened to support flexible inflation targeting and greater exchange rate flexibility. Central bank autonomy will be strengthened by enacting the new Central Bank Act (CBA) with critical improvements over the current Monetary Law Act (see Annex VI): (i) strengthening the CBSL's mandate by establishing price stability as its primary objective of monetary policy and financial stability as its other objective; (ii) buttressing its operational autonomy by preventing any form of government representation or participation on the Governing Board or Monetary Policy Board; and (iii) prohibiting the CBSL from providing monetary financing and from primary market purchases of treasury securities. The new CBA was approved by the Cabinet in December 2022, with Parliamentary approval expected by April 2023 (**structural benchmark**). In concurrence with the ongoing IMF CD on macroeconomic modeling, the CBSL's macro-forecasting models will play a more prominent role in informing its data-dependent policy decisions, paving the way for a new Monetary Policy Report (that includes an in-depth analysis of forward-looking inflation dynamics) to enhance its policy communication. To further enable and support exchange rate flexibility, the authorities are committed to fostering a deeper and more liquid FX market and developing adequate systems for managing exchange rate risks.

D. Ensuring Financial Stability

25. Maintaining a sound and adequately capitalized banking system as well as addressing banking sector vulnerabilities are crucial elements to safeguard financial stability. Bank vulnerabilities built up during the pandemic as forbearance measures on loan repayment and provisioning were introduced. External financing of the public sector had dried up earlier, strengthening the domestic sovereign-bank nexus, with public sector exposures accounting for more than 40 percent of bank assets. Although backward-looking reported capital ratios have remained stable, and high net interest margins have so far allowed banks to absorb rising impairments (Figure 5), the current crisis will continue to crystallize these vulnerabilities. Banks are likely to face ongoing credit losses from sharply rising NPLs, while the restructuring or repayment in rupees of FX-denominated government securities (around 5 percent of bank assets) is expected to result in losses, worsen severe FX liquidity shortages, and create currency mismatches. The large state-owned banks have, in addition, substantial FX loans to the government and SOEs, which are expected to be restructured or repaid in Rupees. At the same time, the cost of rupee funding remains well above CBSL policy rates (average rates on new deposits reached 23 percent in

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[20] No approval is sought or recommended for the exchange restriction arising from Sri Lanka's net debtor position under the Asian Clearing Union payment arrangement, as such arrangements are considered inherently discriminatory.

December) and some banks have seen periods of rupee liquidity stress. With banks' seeking to conserve capital in anticipation of future losses, credit growth has turned negative since the depreciation of the rupee in 2022Q2. As significant recapitalization needs are possible, including at public banks, the DSA also incorporates a contingency for recapitalization costs (Annex V).

26. Against this background, the program envisages measures to adequately recapitalize the banking system. The CBSL has hired two internationally reputable independent specialist firms to conduct a diagnostic exercise for nine major banks, including a comprehensive asset quality review (AQR).[21] AQRs for the two largest state-owned banks and the three largest private banks will be completed by April 2023 (**structural benchmarks**). To support the diagnostic exercise, the authorities will provide the assessors with guidance on the expected impact of the debt restructuring. By July 2023, the CBSL will develop a roadmap for financial sector restructuring and recapitalization to address capital and FX liquidity shortfalls identified through the diagnostic exercise, and to intervene in banks assessed to be non-viable (**structural benchmark**). By October 2023, the government will determine conditions for any potential use of public funds to support the roadmap and to close capital shortfalls at viable banks (**structural benchmark**). A coordination committee on financial stability will be established as soon as possible to manage current and future risks to financial stability.

27. There is an urgent need to strengthen financial sector supervision and safety nets as well as enhance crisis management capacity. The cabinet has approved the Banking (Special Provisions) Act, which will strengthen banking resolution tools for the CBSL to deal with potential bank failures in an efficient manner with clear legal mandates and improved funding arrangements. A full revision of the Banking Act is underway, with Cabinet and Parliamentary approval expected by June and December 2023, respectively (**structural benchmarks**). These Acts will strengthen: (i) the resolution authority, mandate, and powers of the CBSL; (ii) the deposit insurance framework and the regime for liquidation of financial institutions; and (iii) regulatory standards in areas including bank licensing, bank ownership, consolidated supervision, the capital and liquidity framework, large exposures and related party transactions, governance requirements, and recovery planning and early intervention powers. The CBSL's emergency liquidity assistance (ELA) framework has also been updated.

28. The regulatory and governance framework for state-owned banks will also be strengthened. The Banking Act will ensure that the state-owned banks meet the same regulatory requirements as private banks, including on large exposures, related party lending, and governance. The Act will include binding time-bound transition periods for the reduction of existing large exposures to SOEs. In parallel with broader reforms to SOE governance, the framework for appointment of directors and senior managers for state-owned Licensed Commercial Banks and Licensed Specialized banks will be changed to ensure that nominees are independent, have clear periods of appointment, and possess appropriate professional experience. Clear mandates will be

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[21] Accounting for more than 70 percent of domestically-owned bank assets as of end-June 2022, including the two largest state-owned banks and the three largest private sector banks, based on a Terms of Reference to be agreed with IMF staff.

defined to ensure that state-owned banks are run at arm's length and lend to SOEs on a commercial basis. They will be supervised by the CBSL and within standard prudential requirements as defined by the Banking Act, including for concentration risk, foreign currency lending, and the suitability and independence of board members and senior executives. New nomination and appointment processes will be defined for directors and management.

29. Heightened supervision of the smaller non-bank deposit-taker sector (8 percent of deposit-taker assets) will continue. The CBSL has already taken steps to tighten non-performing loan classification and capital requirements in line with requirements for banks, and liquidated five leasing companies whose licenses had previously been suspended. Reported NPLs have risen as a result of the change in classification (from 11 percent at end 2021 on the previous standard to 17 percent at end-September 2022), although almost all lending in this sector is collateralized.

E. Reducing Corruption Vulnerabilities

30. Strengthening Sri Lanka's governance and anti-corruption framework is crucial to restore and sustain long-run economic, social, and political stability. Given governance weaknesses in several state functions and a high level of corruption, a reform agenda should be developed to combat corruption, improve SOE governance, leverage e-government platforms for revenue collection and expenditure management, ensure public sector transparency, and strengthen the Anti-money laundering/combating the financing of terrorism (AML/CFT) framework (Annex VII).

- ***Governance diagnostic***. An IMF governance diagnostic mission has started to assess Sri Lanka's governance and anti-corruption framework. The diagnostic report will be published by September 2023 (**structural benchmark**). The report's findings will help identify specific priority and time-bound reforms to be implemented under the program.

- ***Anti-corruption legislation***. The authorities are upgrading the anti-corruption legislation to ensure harmonization with the United Nations Convention against Corruption (UNCAC), supported by IMF CD. The legislation aims to strengthen the asset declaration system, including the coverage of officials and public access to the declaration results. It also creates a new anti-corruption independent commission with strengthened investigative power. The draft legislation, which does not cover comprehensive asset recovery provisions, is currently under review by a government review committee before final approval by the Cabinet, with Parliamentary approval expected by June 2023 (**structural benchmark**). To ensure full compliance with UNCAC, the draft law should also clearly delineate a transparent and merit-based process for the selection of independent commission members. Moreover, comprehensive asset recovery provisions in compliance with the UNCAC standard are expected to be developed in consultation with IMF staff and incorporated into a separate draft legislation by March 2024. In parallel, the authorities will step up efforts to reduce opportunities for corruption by expanding the reliance on digitalization in areas such as revenue administration and procurement.

- ***Fiscal transparency***. The authorities are also committed to improving the timeliness and accuracy of fiscal data. An online transparency platform will be established to enhance transparency of debt, public procurement contracts, and tax exemptions.[22]

- ***AML/CFT***. The authorities should sustain efforts to strengthen their AML/CFT regime. Work to amend the legal framework on beneficial ownership of legal persons to bring it in line with international standards should incorporate the recently updated FATF standards. The effectiveness of the risk-based AML/CGT supervision should be further strengthened. Financial intelligence should be used more extensively to identify corruption activities with enhanced cooperation between the Financial Intelligence Unit, law enforcement, and Anti-corruption Commission to facilitate parallel investigations and prosecutions.

F. Raising Potential Growth

31. Sri Lanka's growth engines have been hindered by profound structural impediments. Potential growth already slowed prior to the crisis. Investments were held back by debt overhang and macroeconomic uncertainties, while labor force growth and productivity stagnated reflecting aging population and resource misallocation. Sri Lanka's highly protective trade regime has hindered import competition, export diversification, as well as the entry and establishment of foreign firms. The labor force participation (LFP) rate has fallen to a decade low, with female LFP disproportionally hit by the crisis and youth unemployment higher than Sri Lanka's peers. Growth potential of the private sector, especially for SMEs, has been impeded by limited credit and land access, administrative restrictions, and inefficient delivery of power, water, transport, and energy. There is substantial scope to improve the operational efficiency of SOEs that have been playing significant roles in the economy across key sectors including ports, energy, water, finance, retail, production of basic food, mining, and construction.

32. The authorities should step up growth-enhancing reforms. They are pursuing various reforms in the following areas, with support expected from the World Bank, ADB, and other development partners. While the near-term policy measures under the EFF-supported program would focus on stabilizing the economy and restoring debt sustainability, a structural reform agenda will be developed later in the program.

- ***Trade and investment***: To liberalize Sri Lanka's highly protective trade regime, the authorities will develop a concrete medium-term plan to rationalize para-tariffs. The implementation of the plan will be carefully phased with due consideration given to its revenue implications and be complemented with measures to support local businesses. It is also important to reform Sri Lanka's restrictive and cumbersome investment regime, for example through fully implementing a national single window.

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[22] Publishing on a semi-annual basis (i) all significant public procurement contracts, (ii) a list of all firms receiving tax exemptions through the Board of Investment, and (iii) a list of individuals and firms receiving tax exemptions on luxury vehicle imports.

- ***Opportunities for women and youth***: Targeted reforms are needed to boost female LFP and reduce youth unemployment, including through improved access to transportation and financial services, proper benefits and remuneration from flexible work arrangements, provision of affordable childcare, and expanded technical and vocational education programs to close skills gaps.

- ***SOEs and private sector***: Reducing the government's and SOEs' role in the economy is important for a more efficient allocation of resources, foster competition, and boost productivity. Reforms to strengthen SOE governance under the program (¶16) are a critical first step in this regard. Further, adopting digital technology and promoting access to digital platforms including for SMEs can contribute to increasing productivity across industries and firms. Reforms to improve the private sector's access to land, upgrade labor skills, and enhance labor market flexibility are essential to improve private firms' competitiveness, which can also help develop greater linkages between foreign and local firms (especially SMEs) and encourage informal firms to formalize.

- ***Electricity sector***: Following the adoption of automatic cost-recovery tariff adjustment, structural reforms in the electricity sector should be urgently pursued with technical support from development partners to reduce Sri Lanka's high electricity cost and address large investment needs in generation and transmission as a matter of priority.

- ***Climate change***: Given Sri Lanka's climate vulnerabilities, Sri Lanka should strengthen efforts to adapt to climate change, including through contingency budgeting and insurance schemes for natural disasters.

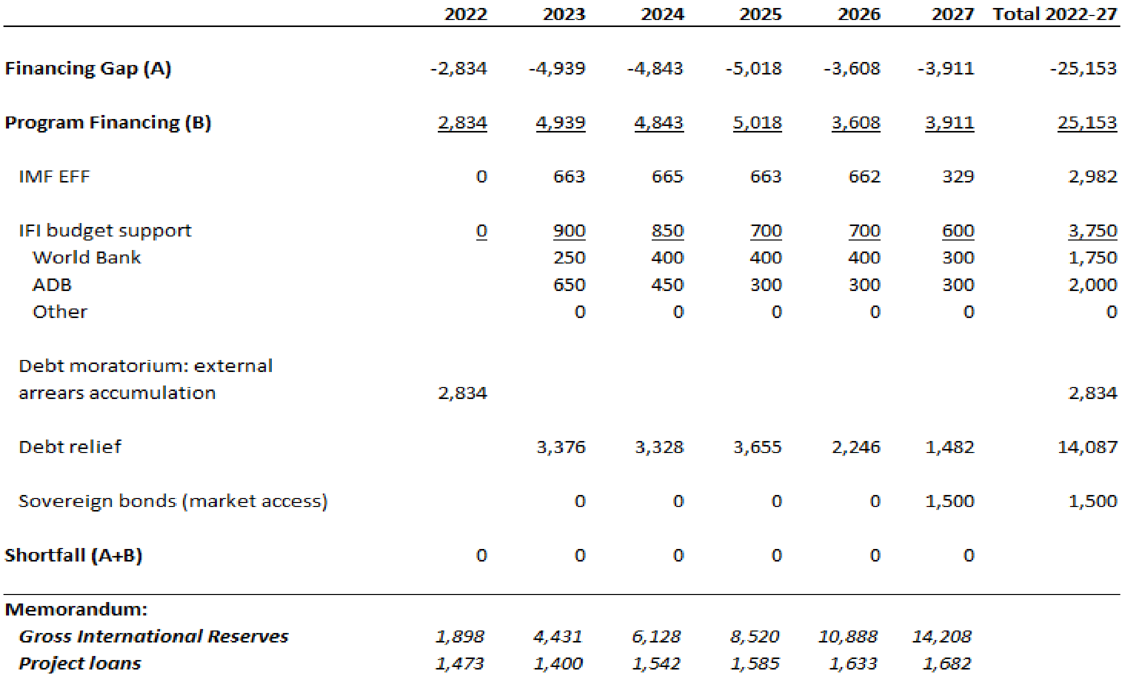
PROGRAM MODALITIES

33. Type of Arrangement. Staff proposes a 48-month normal-access EFF arrangement given the structural nature of Sri Lanka's protracted fiscal and BOP imbalances as well as the need for extensive structural and institutional reforms to support fiscal consolidation, reserves buildup, financial sector stability, and sustainable growth.

34. Access. The access level of SDR 2.286 billion (395 percent of quota or about $3 billion) is justified by Sri Lanka's large BOP needs and the strength of the program. The program is expected to catalyze additional external support, with budget support from the World Bank and ADB in the amount of US$3.75 billion expected under the program. These resources, together with external public debt service relief, will close the external financing gap and allow Sri Lanka to rebuild its gross international reserves to about 100 percent of the ARA metric by end-2027 (text table). To ease domestic financing needs of the government, all purchases under the EFF arrangement are proposed to take the form of budget support. The external financing needs in 2022 were covered by savings from the debt moratorium ($2.8 billion), emergency support from the IFIs from repurposing of existing project loans and support from key bilateral partners, such as India (food and fuel credit lines, currency swap, and ACU balances accumulation).

Sri Lanka: External Financing Gap and Program Financing, 2022-27

(In millions of U.S. dollars)



	2022	2023	2024	2025	2026	2027	Total 2022-27
Financing Gap (A)	-2,834	-4,939	-4,843	-5,018	-3,608	-3,911	-25,153
Program Financing (B)	2,834	4,939	4,843	5,018	3,608	3,911	25,153
IMF EFF	0	663	665	663	662	329	2,982
IFI budget support	0	900	850	700	700	600	3,750
World Bank		250	400	400	400	300	1,750
ADB		650	450	300	300	300	2,000
Other		0	0	0	0	0	0
Debt moratorium: external arrears accumulation	2,834						2,834
Debt relief		3,376	3,328	3,655	2,246	1,482	14,087
Sovereign bonds (market access)		0	0	0	0	1,500	1,500
Shortfall (A+B)	0	0	0	0	0	0	
Memorandum:							
Gross International Reserves	*1,898*	*4,431*	*6,128*	*8,520*	*10,888*	*14,208*	
Project loans	*1,473*	*1,400*	*1,542*	*1,585*	*1,633*	*1,682*	

35. Phasing. Staff proposes to phase the access uniformly over the duration of the arrangement, with semi-annual reviews following the approval (proposed schedule of reviews and purchases is in Table 8), to help sustain reform momentum throughout the program period.

36. Prior actions (PAs) and important upfront measures. The authorities have completed the following nine prior actions, to set the stage for broader reform plans, restore macro and financial stability, and regain market confidence. Three important upfront measures have also been implemented: (i) Parliamentary approval of the 2023 budget that is in line with program parameters; (ii) Parliamentary approval of necessary legislative revisions to implement the 2023 revenue measures; and (iii) update by the CBSL of the Emergency Liquidity Assistance framework for banks.[23]

Sri Lanka: Prior Actions Under the EFF-Supported Program
Cabinet approval of revenue measures to support fiscal consolidation during 2023, in line with program parameters
Parliament approval of a revised 2022 budget that is in line with program parameters
Submission to Parliament of the 2023 Appropriation Bill that is in line with program parameters

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[23] At the time of the staff-level agreement on the EFF-supported program in September 2022, the authorities agreed to implement the three measures by end-2022.

Sri Lanka: Prior Actions Under the EFF-Supported Program (concluded)
Cabinet approval to automate monthly retail fuel price adjustment as prescribed by the 2018 fuel pricing formula to achieve cost recovery
Cabinet approval to automate semi-annual cost-recovery based electricity price adjustment
Cabinet approval of the new Central Bank Act with amendments from the bill submitted to Parliament in November 2019 in consultation with IMF staff
Cabinet approval of Banking (Special Provisions) Act to strengthen key elements of the CBSL's crisis management powers
Hiring by the CBSL of an independent firm to conduct banking sector diagnostic exercise based on Terms of Reference and timeline established in consultation with IMF staff
Increase monetary policy interest rates by 100 basis points to ensure forward-looking real policy rates on a firmly upward path

37. Program monitoring. Performance will be monitored through quantitative performance criteria (QPCs), continuous performance criteria related to external arrears and Article VIII obligations, indicative targets (ITs), and the monetary policy consultation clause (Table 1 attached to the MEFP). Considering the authorities' capacity constraints, structural reforms will be sequenced appropriately throughout the program period. The program incorporates a comprehensive set of structural benchmarks (Table 2 attached to the MEFP), focusing on government budgets consistent with program parameters; PFM and SSN reforms; cost-recovery energy price adjustments; stronger central bank autonomy; financial sector stability; and stronger governance and anti-corruption frameworks. Reform implementation will be supported by extensive IMF CD (see CD Matrix in Annex III).

38. Lending into arrears and financing assurances. Credible and specific assurances on debt relief and financing or consent to IMF lending notwithstanding official arrears have been obtained from official bilateral creditors. The authorities are also making good faith efforts on debt restructuring with private creditors in line with filling program financing gaps and restoring debt sustainability. Further, the PBoC has indicated that it will consider renewing its swap arrangement with the CBSL in 2024 for another three years, if there is no significant situation change. With these and envisaged IFI financing, staff assesses that Sri Lanka's program is fully financed, having firm commitments of financing for the first 12 months and good prospects for adequate financing for the remaining program period. The progress on the debt restructuring to restore debt sustainability will be assessed at each program review in the context of financing assurances reviews, with a view to completing debt operations within a reasonable time frame, normally by the first review under the Fund arrangement. The authorities have indicated that there are no arrears to international financial institutions.

- Official bilateral creditors are expected to provide debt relief that is compatible with the parameters of the authorities' Fund-supported program. Specific and credible financing assurances in this regard have been obtained from Paris Club creditors, India, Hungary, and the Export-Import Bank of China (which holds more than 90 percent of the Chinese official bilateral claims subject to restructuring).[24] These creditors, in their assurances, indicated their readiness to finalize the specifics of the debt treatment in the coming months. On top of this, China also consented to Fund financing notwithstanding arrears to Chinese Government and the China Export and Credit Insurance Corporation (the guarantor for several Chinese commercial loans that are in default). Sri Lanka also owes official arrears to Iran, Kuwait, Pakistan, and Saudi Arabia. All four need more time to consider consenting to Fund financing notwithstanding these arrears. An update will be circulated to the Executive Board prior to the scheduled Board consideration. Recognizing that servicing debt on the original terms would not be consistent with debt sustainability, the authorities have committed in the MEFP and a letter to the Paris Club to resolve debt to all official bilateral creditors on comparable terms and to refrain from making payments to any of their creditors until a debt treatment can be agreed that restores debt sustainability in line with the EFF-supported program. The authorities are willing to use additional safeguards mechanisms, including appropriate form of contractual commitments such as most favored creditor clauses, acceptable to relevant creditors at the time. On the basis of the Sri Lankan authorities' commitment noted above and the close and continuing engagement Sri Lanka has had with its bilateral creditors (including through several coordination meetings and bilateral exchanges), staff expect that remaining arrears and their associated claims will be treated on terms consistent with the program parameters and in an equitable fashion. These arrears constitute a form of financing contribution to the program prior to the restructuring. These commitments will be assessed through financing assurances reviews at each program review and the IMF disbursements are evenly phased to safeguard the Fund's lent resources.

Sri Lanka: Sovereign Arrears to Foreign Creditors

(In millions of U.S. dollars)

	End-2022
Total	**2,752**
Official creditors	**774**
Paris Club	349
Non Paris Club, o.w.	425
China	311
India	71
Commercial creditors	**1,978**
Sri Lanka ISB holders	1,633
China Development Bank	338
Others	7

Sources: Sri Lankan authorities; and IMF staff calculations.

- Sri Lanka has been in arrears to external private creditors since the April 2022 moratorium, including $1,633 million to International Sovereign Bond (ISB) holders, $338 million to China Development Bank (CDB), and $7 million to other foreign commercial creditors as of

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[24] The Exim Bank of China's financing assurances also include a moratorium on debt service payments due through 2023.

December 2022.[25] The authorities, through their financial and legal advisors, are making good faith efforts to reach a collaborative agreement with these private creditors. In particular, they have engaged in early dialogue with them since June 2022, and shared relevant information through an investor presentation held in September 2022 (followed by a detailed document addressing investors' questions) and the publication of detailed debt statistics in November 2022. The authorities' advisors have also shared, under non-disclosure agreements with the advisors to ISB holder committees and CDB, key information presented to official bilateral creditors so that private creditors have an early opportunity to provide input on the design of restructuring strategies. The ad hoc group of ISB holders (holding about half of outstanding ISBs) issued an open letter to the IMF in February 2023 expressing its readiness to negotiate a debt relief with Sri Lanka that restores debt sustainability consistent with program parameters. Staff assesses that the good faith efforts made by the authorities, along with the assessment that prompt Fund support is considered essential for the successful implementation of the member's adjustment program, satisfy the Fund's Lending into Arrears (LIA) policy. Staff is not aware of private sector external debt arrears arising from the imposition exchange controls (¶23).

39. Safeguards. An update safeguards assessment was completed in February 2023. The update assessment reiterated the need to complete legal reforms for the CBSL to strengthen its mandate, aspects of governance arrangements, and its autonomy, including a monetary financing prohibition. The recommended legal amendments will be addressed by the new CBA. The CBSL's audit and financial reporting functions are based on international standards. The CBSL's internal control environment is anchored in a strong compliance culture, but some functions require continued modernization, including through an expanded scope of financial risk management. While the CBSL's financial position has deteriorated during the crisis, the CBSL has started forward-looking assessment of its balance sheet with the aim of developing a medium-term plan to strengthen its financial position, supported by IMF CD.

40. Capacity to repay the Fund. Capacity to repay the Fund (Table 7), while assessed to be adequate under the program scenario, is subject to significant risks and critically contingent on the successful implementation of program measures and debt restructuring that restore debt sustainability. At end-December 2022, the Fund's exposure to Sri Lanka stood at SDR 798 million (138 percent of quota or about 56 percent of gross reserves). Under the program, Fund credit outstanding would peak at 3.6 percent of GDP in 2026, corresponding to 12.7 percent of exports of goods and services and 27 percent of gross reserves. The EFF repurchases and charges would peak in 2031, at 2.1 percent of exports of goods and services and 3.5 percent of gross reserves. Delays in finalizing debt restructuring with bilateral and private creditors and/or weak implementation of policy commitments may erode capacity to repay and further increase risks.

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[25] The government guaranteed international bond of the SriLankan Airlines went into arrears ($6 million) in January 2023, after a consent solicitation (to defer December 2022 and June 2023 coupons) failed to attract sufficient participation. The authorities are continuing their bilateral discussions with the bondholders.

PROGRAM RISKS AND CONTINGENCY PLANNING

41. Risks to program implementation are high, given adverse initial conditions, political risk, a complex debt restructuring with a potential for delay, ambitious fiscal consolidation, large downside risks to the baseline scenario, and Sri Lanka's weak track record for reform and program implementation.

- ***Macroeconomic risks***. Unexpected economic and financial developments as highlighted in ¶9 could deepen the crisis and complicate program implementation. Given elevated upside inflationary pressure, the risk of persistently high inflation is significant (¶20).

- ***Commitment to the ambitious fiscal consolidation targets and wide-ranging fiscal reforms***. Historically, Sri Lanka has only had a primary surplus on three occasions, and never for more than two years; and fiscal consolidation efforts in Sri Lanka's past IMF-supported programs were quickly reversed after the program. The size of the programmed fiscal adjustment is unprecedented for Sri Lanka, but necessary given that it started with one of the lowest revenue-to-GDP ratios in the world after previous fiscal reforms were undone. For example, large real cuts to public sector wages and public pension payments amid high inflation in 2022 could prompt a backlash against the program from current and retired civil servants.

- ***Finalizing a restructuring agreement with all creditors in line with program parameters*** could be delayed. Realization of debt sustainability risks could require broader and deeper debt restructuring, raising significant risks to financial stability given banks' substantial sovereign exposure, which in turn implies an additional fiscal burden.

- ***Implementation capacity***. The broad scope of proposed reforms may pose risks to the authorities' ability to implement their multi-faceted program.

42. Contingency plans and agile policy adjustments are important in this context. Program implementation risks are mitigated by (i) support for economic reforms in principle from the business community and the Parliamentary opposition; (ii) upfront implementation of critical reform measures ahead of the program, including for revenue measures, automatic cost-recovery energy pricing, social safety nets, and central bank autonomy; and (iii) extensive CD support from the IMF and development partners. In addition, the authorities stand ready to deploy contingency measures as follows, should downside risks materialize.

- During the program, policy slippages would need to be corrected by remedial measures. For example, a delay in implementing revenue measures and cost-recovery energy pricing would require further cuts in capital spending on non-priority or low-efficiency projects to minimize adverse effects on growth; a slippage on the NIR target to unduly defend the exchange rate can warrant introduction of explicit FX intervention rules (e.g., monthly and/or quarterly FX intervention budgets built into program conditionality); and undue delays in any key structural reforms will jeopardize program reviews.

- In the near term, the lack of macroeconomic policy space severely hampers the authorities' ability to address the downside risks. Further depreciation pressure and signs of runaway inflation would warrant an emergency policy rate hike.
- The risk of banking sector stress would reinforce the need to implement measures to adequately recapitalize the banking system, strengthen the crisis management framework, and develop a detailed contingency plan.
- Technical implementation capacity can be compensated by extensive CD support from the IMF and developing partners (see Annex III on capacity development).
- Program overperformance resulting from better-than-expected outturns should be locked in to the extent possible, to secure the program objectives. In this regard, the CBSL's commitment to save any overperformance with regard to the NIR target is welcome.

43. Enterprise risks are high but are partly mitigated by the program design and CD support. The Fund faces three types of enterprise risks. First, *financial risks* arise from significant risks to Sri Lanka's capacity to repay (¶40). Second, *operational risks* stemming from social unrest and socio-political tensions, which may pose risks to the operations of IMF staff missions and the field office if they escalate. Third, *reputational risks* would be of concern if the public perceives policies under the program as too tight, weakening public support for the program. Key mitigation measures include the authorities' firm commitment to restore debt sustainability through public debt restructuring (¶18); upfront implementation of critical reform measures early on in the program (¶42); focus on social safety nets (¶13) and anti-corruption (¶30) as key pillars of the program; and extensive CD support from the IMF and other developing partners to help ensure timely delivery of reforms under the program.

STAFF APPRAISAL

44. Sri Lanka is facing tremendous challenges. The country is still operating with depleted reserves and no access to international capital market, relying on exchange and capital controls, and rationalizing fuel and electricity usage. Economic and financial conditions remain fragile with FX shortages in the banking system, an unsustainable public debt, and high inflation amid a severe recession. The authorities started implementing economically and politically challenging policy actions to combat inflation, improve the fiscal position, reform energy pricing and social safety nets, and tackle corruption, setting the stage for broader reforms in bringing the economy back on a sustainable path. Swift and timely reform implementation, under strong and consistent ownership by the authorities, is critical for the success of the EFF-supported program.

45. Ambitious fiscal consolidation efforts supported by strengthened fiscal frameworks are much needed to restore fiscal sustainability and promote a clean break from past policy slippages. The revenue-based fiscal consolidation strategy is crucial and would principally help rebuild fiscal space and restore sustainability. Sustained efforts to implement these measures are key. For the fiscal adjustments to be successful, deep institutional reforms to the fiscal framework, capacity building (e.g., revenue administration and PFM), and strong ownership across the political spectrum are critical. Adhering to the automatic pricing mechanisms to ensure cost recovery energy pricing and ensuring their efficiency will be crucial to minimize fiscal risks from the state-owned enterprises. At the same time, rigorous SOE and energy sector reforms are critical to ease burden for electricity users and bring down energy costs.

46. One important priority of the program is to protect the vulnerable from the impact of crisis and policy adjustments. The authorities are committed to strengthen SSN by ensuring minimum SSN spending and improving the coverage and targeting of the SSN. The tax reform package under the program are also designed to be progressive and promote equity.

47. Commitment to the multi-pronged disinflation strategy is crucial to mitigate adverse economic and social consequences from persistently high level of inflation. The authorities have increased the policy rates and started to unwind monetary financing to reduce inflation. Further steps are needed as inflation levels remain high with signs of rising persistence, which continues to dampen demand and erode real income and wealth, particularly among the poor. To reduce inflation as guided by the MPCC, inflation needs to be closely monitored, and monetary policy needs to stand ready to act pre-emptively against entrenching inflation expectations, while being supported by fiscal consolidation and discontinuing monetary financing. In this regard, the new CBA sets a strong legal foundation to support the disinflation strategy and safeguard the credibility of the CBSL's inflation target regime.

48. Greater exchange rate flexibility will facilitate external rebalancing and rebuild reserve buffer. Sri Lanka's external position is assessed as weaker than the level implied by medium-term fundamentals and desirable policies. The authorities are committed to phasing out the administrative measures imposed to temporarily support the balance of payments. As the market regains confidence, the authorities will need to refrain from market intervention and allow exchange rates to adjust freely to changing fundamentals with due regard to potential disorderly market conditions and adverse balance sheet effects. In turn, a non-interest current account surplus and new external financing would help gradually rebuild reserves buffer.

49. Financial stability hinges on a well recapitalized banking system and strengthened legal framework. Informed by a thorough diagnostic exercise, banks' exposure to the sovereign and problem loans under forbearance will need to be closely monitored along with intensified supervision. A plan with binding deadlines for financial sector recapitalization will be needed to address capital and FX-liquidity shortfalls and support the economic recovery. In the meantime, efforts to strengthen financial supervision and crisis management framework are crucial to enhance resilience and prepare Sri Lanka's financial system for time of stress.

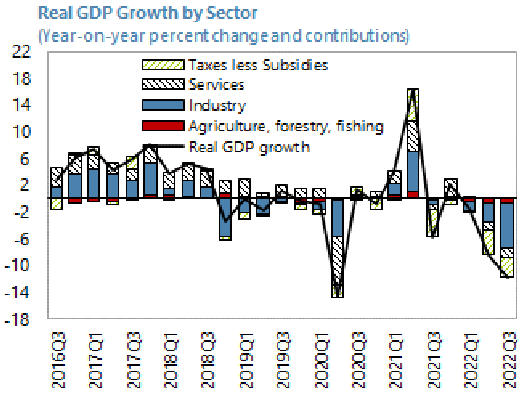
50. Reforms to tackle corruption, strengthen governance, and boost growth potential are critical for Sri Lanka's long run sustainability. Developing an anti-corruption legislation that harmonizes with the UNCAC is an important step in the right direction. However, tackling corruption hinges on effective implementation of the legislation as a part of a more comprehensive anti-corruption agenda. These efforts can be supported by the findings of the ongoing governance diagnostic mission that conducts thorough assessment of the anti-corruption framework and broader governance issues along with recommendations suited in the context of Sri Lanka's social and political environment. The authorities are also working closely with the development partners on growth-enhancing reforms including liberalizing trade and promoting female labor force participation.

51. The program faces substantial risks. The authorities' capacity to implement an ambitious fiscal adjustment and wide-ranging structural reforms will be tested against reform fatigue and already high social discontent. Sri Lanka's complex creditor structure could complicate the process of reaching an eventual debt resolution, potentially aggravating sustainability and stability risks while the economy has little buffers to cushion adverse economic and financial developments. These risks should be mitigated by the authorities' strong resolve to sustain adjustments and advance reforms.

52. In view of Sri Lanka's structural balance of payments needs and the comprehensive package of adjustment measures proposed by the authorities, staff supports the authorities' request for a 48-month extended arrangement under the EFF in the amount equivalent to SDR 2,286 million (395 percent of quota). **Staff supports the approval of all but one exchange restrictions (¶23) for a period of twelve months, as the measures giving rise to them are maintained for BOP reasons, are non-discriminatory, and are temporary. Staff supports the approval of all MCPs for a period of twelve months, as the measures giving rise to them are maintained for BOP reasons, are temporary, and don't give Sri Lanka an unfair competitive advantage.**

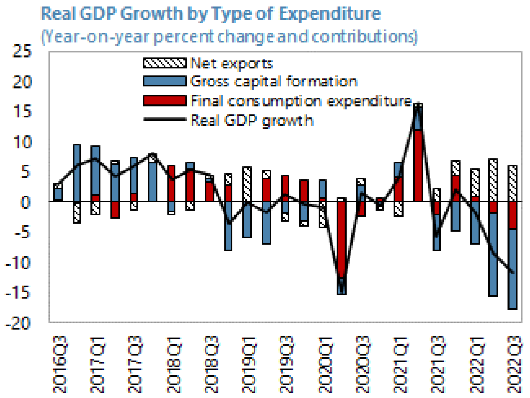
Figure 1. Sri Lanka: Real Sector

Economy contracted in 2022, largely reflecting subdued manufacturing activities,…



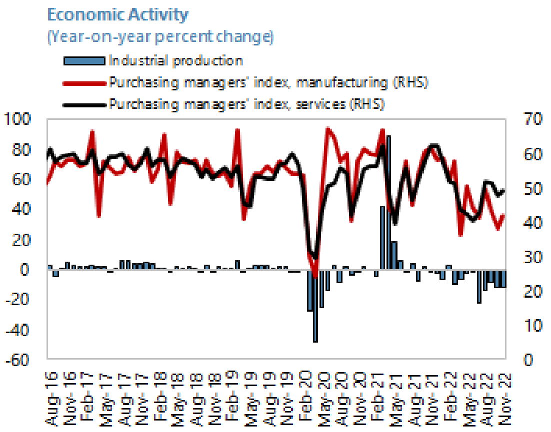
Real GDP Growth by Sector
(Year-on-year percent change and contributions)

… weak consumer demand and declining new investments, under a severe debt and BOP crisis.



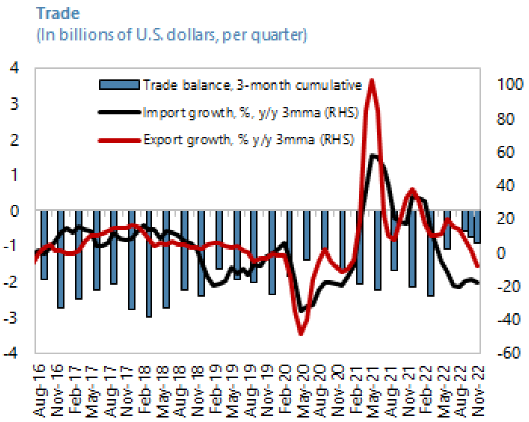
Real GDP Growth by Type of Expenditure
(Year-on-year percent change and contributions)

High frequency indicators point to a continued contraction in manufacturing activities despite some improvement in the service sector.



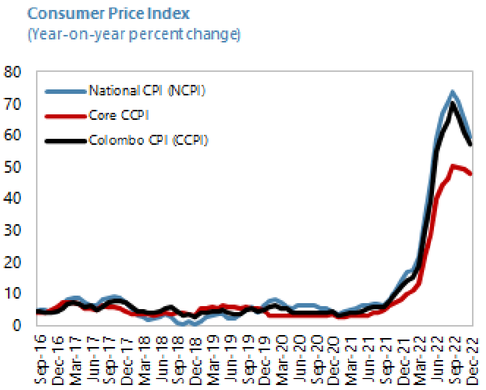
Economic Activity
(Year-on-year percent change)

Exports remain relatively resilient while imports contracted sharply on the account of administrative restraints.



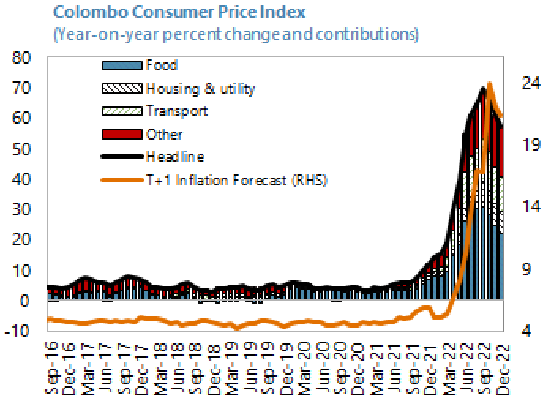
Trade
(In billions of U.S. dollars, per quarter)

Inflation peaked at 70 percent in September 2022,



Consumer Price Index
(Year-on-year percent change)

… reflecting large imported inflation, exchange rate depreciation, and supply shortages.

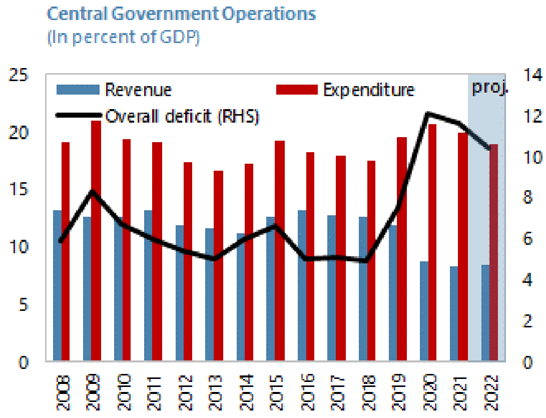


Colombo Consumer Price Index
(Year-on-year percent change and contributions)

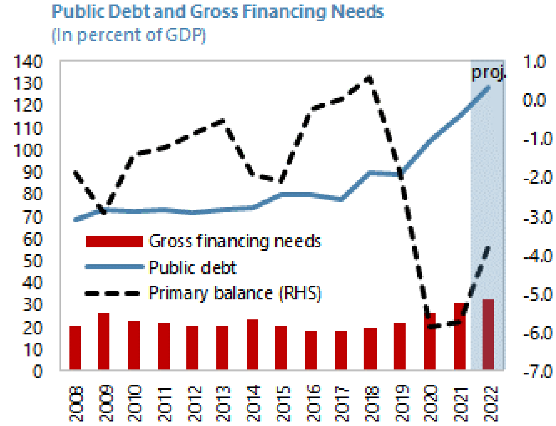
Sources: Department of Census and Statistics; CBSL; IMF Consensus Forecast Database; and IMF staff estimates.

Figure 2. Sri Lanka: Fiscal Sector

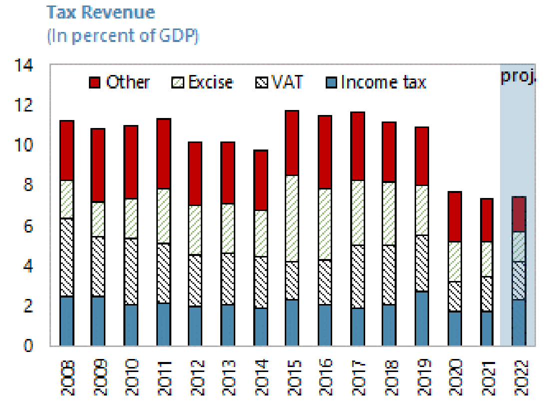
Tax cuts in late-2019 and pandemic-related spending have led to double-digit fiscal deficits in 2020-22.


Central Government Operations
(In percent of GDP)

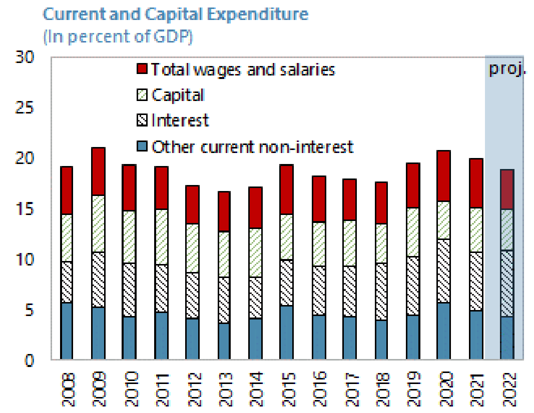
Public debt and financing needs have increased to unsustainable levels.


Public Debt and Gross Financing Needs
(In percent of GDP)

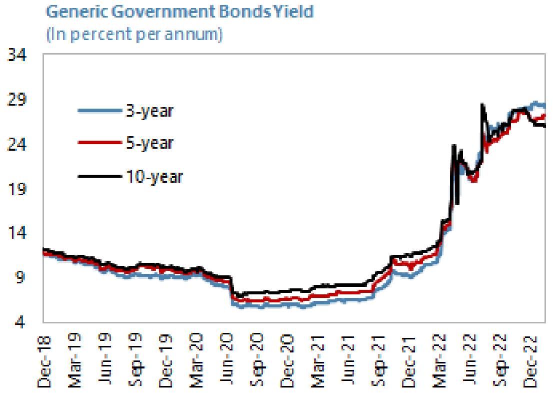
Following a policy reversal in 2019, the tax revenue to GDP ratio fell to below 8 percent, among the lowest in the world.


Tax Revenue
(In percent of GDP)

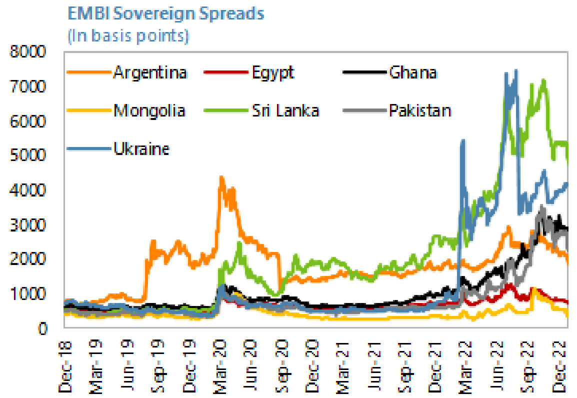
The large interest bill severely squeezes fiscal space for growth-enhancing spending.


Current and Capital Expenditure
(In percent of GDP)

Domestic fiscal financing conditions have deteriorated since the onset of the crisis…


Generic Government Bonds Yield
(In percent per annum)

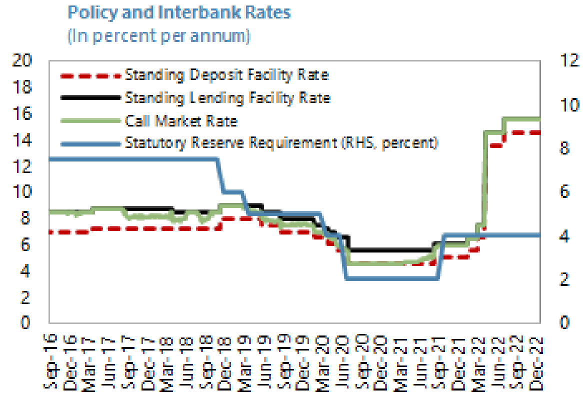
… while external market access has been lost since early 2020.


EMBI Sovereign Spreads
(In basis points)

Sources: CBSL; Bloomberg; Ministry of Finance; JP Morgan Chase & Co.; and IMF staff estimates.

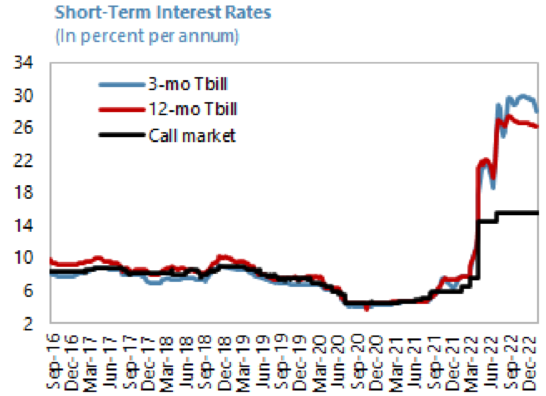
Figure 3. Sri Lanka: Financial Market

Monetary policy rates were raised three times in 2022, including a 700 basis point hike in April 2022.



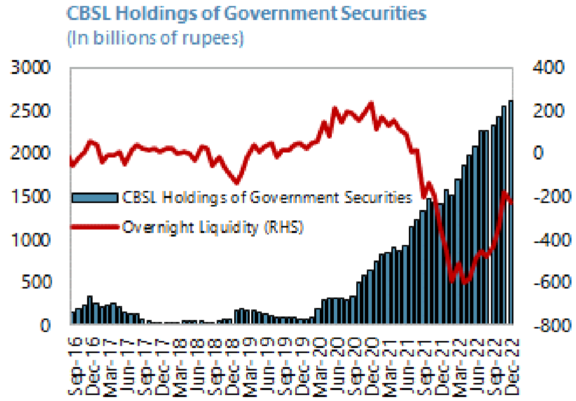
Policy and Interbank Rates
(In percent per annum)

Money market interest rates increased by more than the policy rate increase, reflecting rising risk premium.



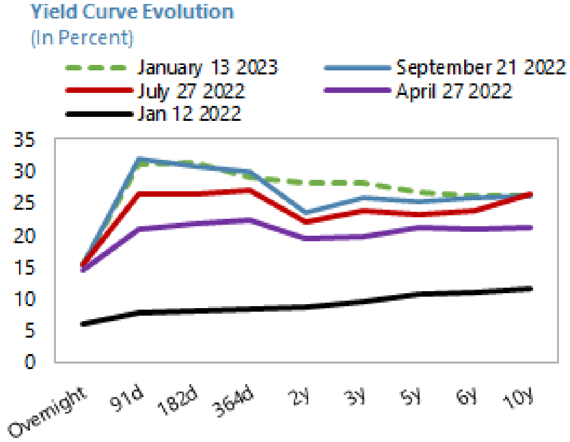
Short-Term Interest Rates
(In percent per annum)

Monetary financing of fiscal deficit continues.



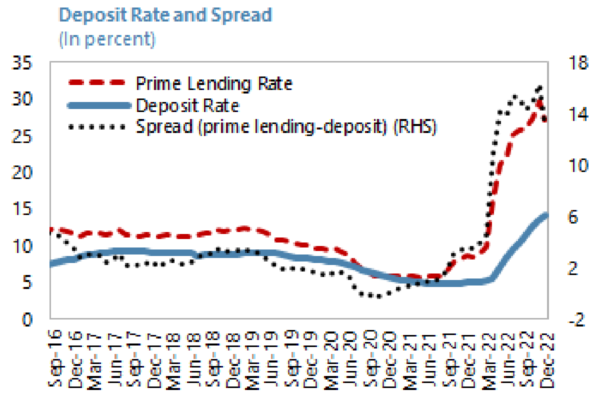
CBSL Holdings of Government Securities
(In billions of rupees)

Treasury yield curve continues to shift upward.



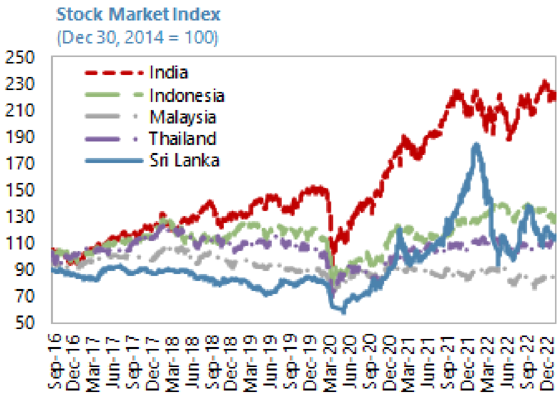
Yield Curve Evolution
(In Percent)

Market deposit and lending rates also increased substantially.



Deposit Rate and Spread
(In percent)

Stock market remains volatile on high uncertainty.

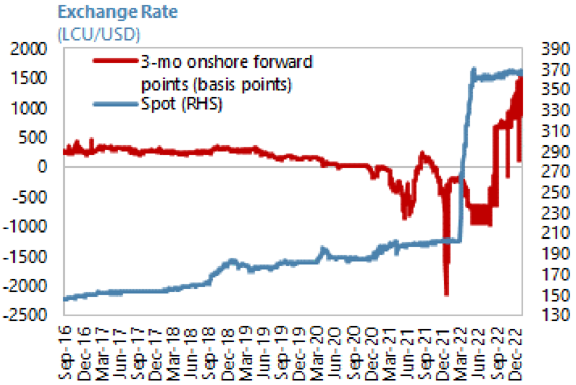


Stock Market Index
(Dec 30, 2014 = 100)

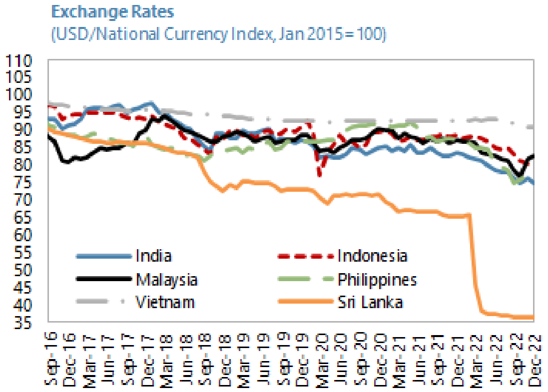
Sources: CBSL; CEIC Daily Database; Bloomberg Data LP; and IMF staff estimates.

Figure 4. Sri Lanka: Foreign Exchange and Reserves

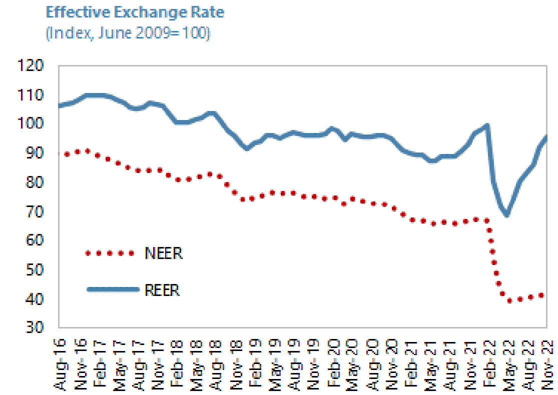
Following a sharp depreciation at the onset of the crisis, the rupee stabilized amid administrative measures.


Exchange Rate
(LCU/USD)

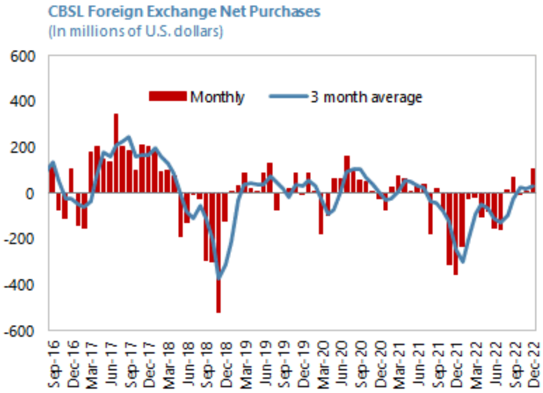
As a result, the nominal exchange rate depreciated much more than the currencies of regional peers.


Exchange Rates
(USD/National Currency Index, Jan 2015=100)

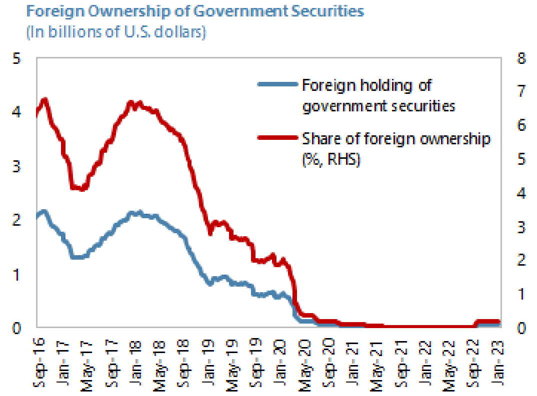
But the rupee's real depreciation has been partially reversed by high domestic inflation.


Effective Exchange Rate
(Index, June 2009=100)

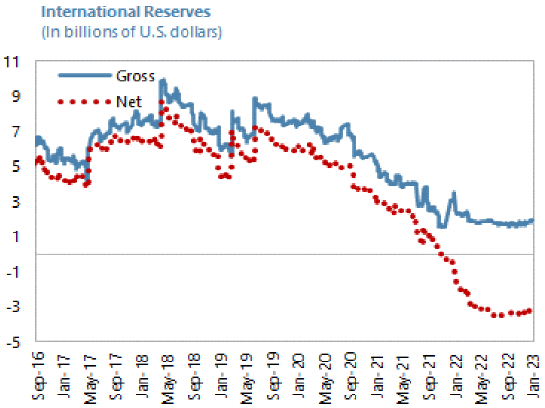
CBSL net intervention in the FX market has been limited to financing critical imports amid depleted reserves.


CBSL Foreign Exchange Net Purchases
(In millions of U.S. dollars)

Foreign holders of local T-Bills and T-bonds exited Sri Lanka and stayed out.


Foreign Ownership of Government Securities
(In billions of U.S. dollars)

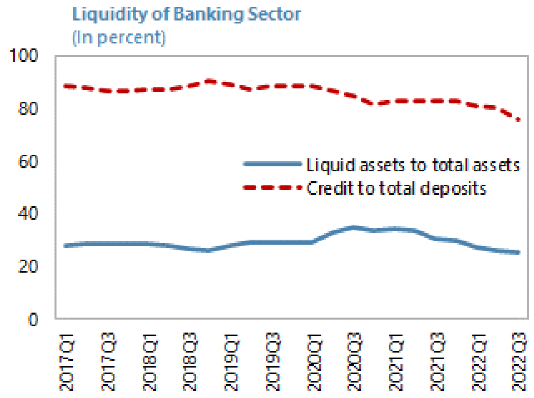
Gross international reserves remain depleted, while net international reserves are deeply negative.


International Reserves
(In billions of U.S. dollars)

Sources: CBSL; and IMF staff estimates.

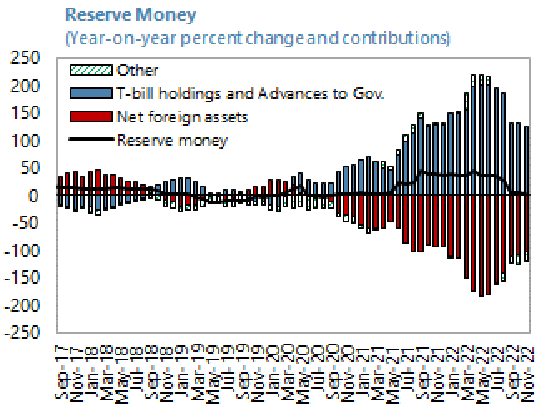
Figure 5. Sri Lanka: Monetary and Financial Sector

Despite some liquidity stresses, bank liquidity is cushioned by large holdings of CBSL-eligible government securities.



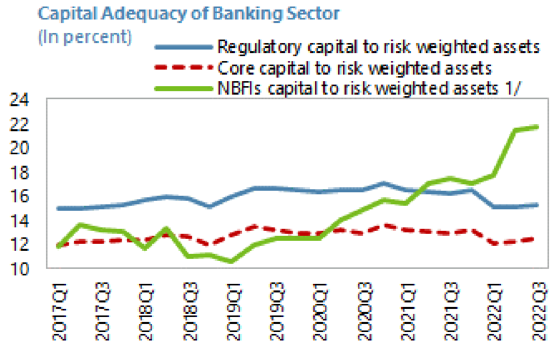
Liquidity of Banking Sector
(In percent)

Reserve money growth is subdued as monetary finance for the government coincided with loss of FX reserves.



Reserve Money
(Year-on-year percent change and contributions)

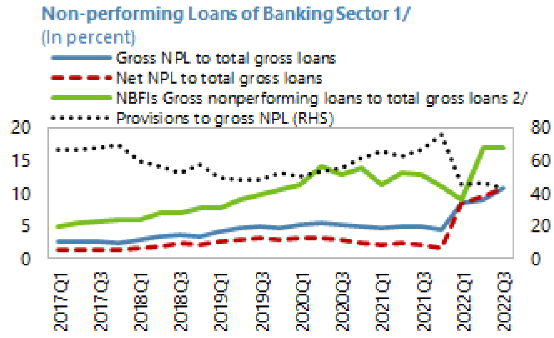
Backward-looking indicators like bank capital ratios have so far remained steady.



Capital Adequacy of Banking Sector
(In percent)

1/ NBFI stands for Licensed Finance Companies and Specialized Leasing Companies.

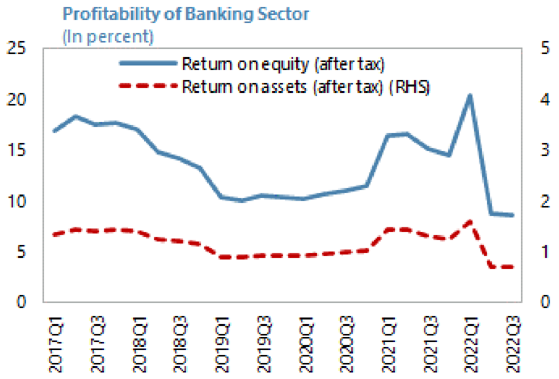
… despite NPLs rising…



Non-performing Loans of Banking Sector 1/
(In percent)

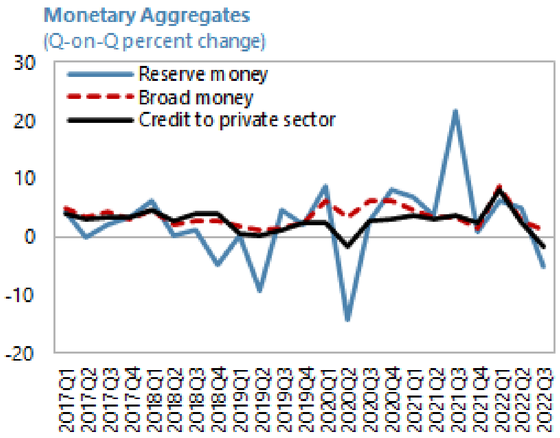
1/ IFRS9 Stage 3 loans from Q1 2022 onwards.
2/ NBFI stands for Licensed Finance Companies and Specialized Leasing Companies.

..as impairments were offset by an increase in net interest margins, resulting in a modest fall in profitability.



Profitability of Banking Sector
(In percent)

Banks are conserving capital and cutting lending in anticipation of future losses.



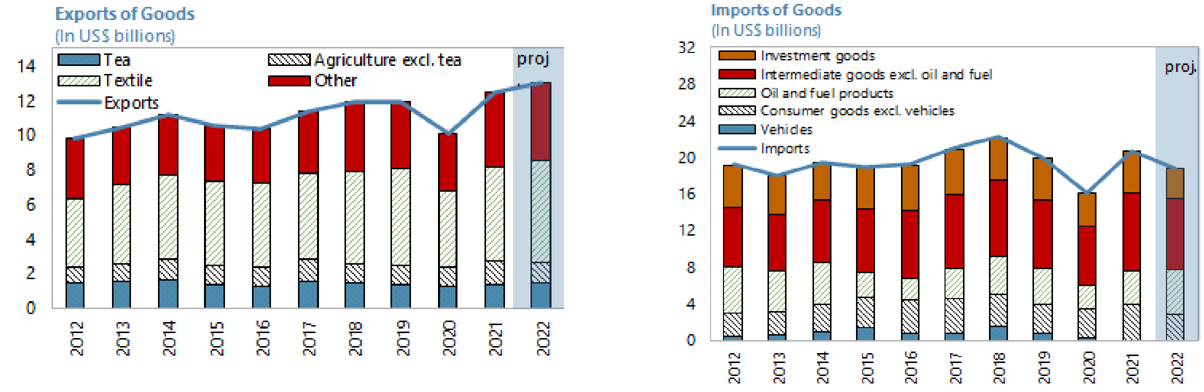
Monetary Aggregates
(Q-on-Q percent change)

Sources: CBSL; and IMF staff estimates.

Figure 6. Sri Lanka: Balance of Payments

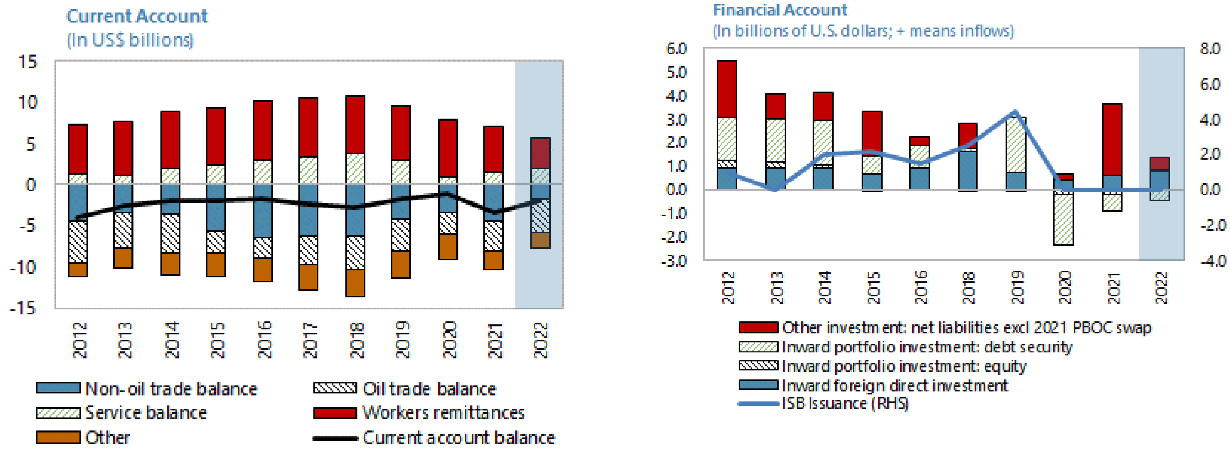
Goods exports rebounded strongly in 2021 and are expected to grow further supported by real depreciation,

... while imports are expected to contract reflecting FX shortages and import restrictions.



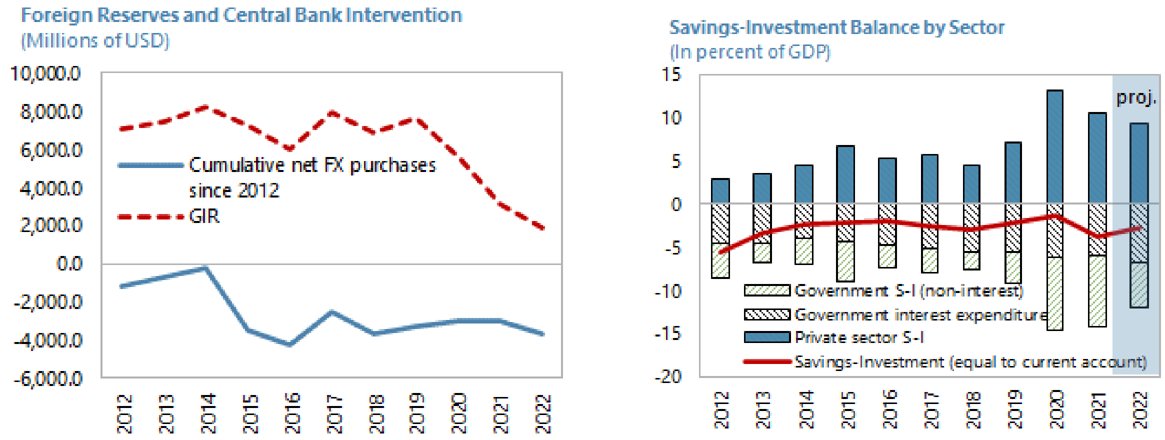
As a result, the current account deficit is projected to narrow somewhat,

... while external financing conditions remain very difficult given the loss of access to external financing.



Most of reserve accumulation and FX intervention before Covid-19 was financed by external borrowing,

... which led to high interest bill for the government, contributing to current account deficits.



Sources: CBSL; Haver; Ministry of Finance; and IMF staff calculations.

Table 1. Sri Lanka: Selected Economic Indicators, 2019–2028 (Restructuring Scenario)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
		Act.		Prel.			Proj.			
GDP and inflation (in percent)										
Real GDP growth	-0.2	-3.5	3.3	-8.7	-3.0	1.5	2.6	3.0	3.1	3.1
Inflation (average) 1/	4.3	4.6	6.0	46.4	28.5	8.7	5.6	5.2	5.1	5.0
Inflation (end-of-period) 1/	4.8	4.2	12.1	57.2	15.2	6.7	5.6	5.2	5.1	5.0
GDP Deflator growth	3.9	3.1	8.1	46.6	30.0	10.7	5.6	5.2	5.1	5.0
Nominal GDP growth	3.6	-0.4	11.7	33.9	26.0	12.3	8.3	8.4	8.3	8.3
Savings and investment (in percent of GDP)										
National savings	32.0	32.3	31.5	24.8	26.4	28.0	28.9	29.3	29.7	29.6
Government	-2.5	-8.2	-7.3	-6.7	-4.4	-2.0	-0.6	-0.4	0.0	0.4
Private	34.6	40.5	38.8	31.5	30.9	30.0	29.5	29.7	29.7	29.2
National Investment	34.1	33.7	35.3	26.8	28.0	29.4	30.3	30.7	31.1	30.9
Government	6.6	6.4	7.0	5.2	4.5	5.0	5.0	5.0	5.0	5.0
Private	27.5	27.3	28.2	21.5	23.5	24.5	25.3	25.7	26.0	25.9
Savings-Investment balance	-2.1	-1.4	-3.8	-1.9	-1.6	-1.4	-1.4	-1.4	-1.3	-1.3
Government	-9.2	-14.6	-14.3	-11.9	-9.0	-7.0	-5.6	-5.4	-5.0	-4.6
Private	7.1	13.2	10.5	9.9	7.4	5.6	4.2	4.0	3.6	3.3
Public finances (in percent of GDP)										
Revenue and grants	11.9	8.7	8.3	8.5	11.0	13.3	14.9	15.0	15.1	15.3
Expenditure	19.5	20.7	19.9	18.9	19.0	19.7	19.9	19.9	19.6	19.4
Primary balance	-1.9	-5.9	-5.7	-3.8	-0.7	0.8	2.3	2.3	2.3	2.3
Central government balance	-7.5	-12.1	-11.6	-10.4	-8.0	-6.4	-5.0	-4.8	-4.5	-4.2
Central government gross financing needs	21.7	26.1	31.0	34.5	26.6	17.9	15.4	15.9	14.2	13.1
Central government debt	82.6	95.7	102.2	117.7	100.0	101.6	103.3	102.2	97.6	96.6
Public debt 2/	89.0	104.0	114.3	128.1	111.2	108.5	107.8	106.8	104.4	101.3
Money and credit (percent change, end of period)										
Reserve money	-3.0	3.4	35.4	3.3	23.5	11.2	7.3	8.4	8.3	8.3
Broad money	7.0	23.4	13.2	15.5	22.6	11.2	7.3	8.4	8.3	8.3
Domestic credit	6.5	24.6	19.5	18.8	11.4	3.2	1.5	2.5	3.3	4.2
Credit to private sector	4.2	6.5	13.1	6.4	11.2	8.1	8.6	9.2	9.4	9.3
Credit to private sector (adjusted for inflation)	-0.1	1.9	7.2	-40.0	-17.3	-0.6	3.1	4.0	4.3	4.3
Credit to central government and public corporations	10.4	53.6	26.5	31.1	11.5	-0.8	-4.7	-4.2	-3.6	-2.4
Balance of payments (in millions of U.S. dollars)										
Exports	11,940	10,048	12,499	13,106	13,666	14,517	15,270	16,065	16,869	17,717
Imports	-19,937	-16,055	-20,638	-18,291	-20,597	-21,479	-22,506	-23,794	-24,649	-25,596
Current account balance	-1,844	-1,187	-3,343	-1,458	-1,184	-1,092	-1,077	-1,124	-1,140	-1,201
Current account balance (in percent of GDP)	-2.1	-1.4	-3.8	-1.9	-1.6	-1.4	-1.4	-1.4	-1.3	-1.3
Current account balance net of interest (in percent of GDP)	-0.2	0.5	-2.2	-0.5	0.2	0.9	1.1	0.8	1.0	1.0
Export value growth (percent)	0.4	-15.9	24.4	4.9	4.3	6.2	5.2	5.2	5.0	5.0
Import value growth (percent)	-10.3	-19.5	28.5	-11.4	12.6	4.3	4.8	5.7	3.6	3.8
Gross official reserves (end of period)										
In millions of U.S. dollars	7,642	5,664	3,139	1,898	4,431	6,128	8,520	10,888	14,208	15,875
In months of prospective imports of goods & services	5.0	3.2	1.9	1.0	2.2	3.0	3.9	4.8	6.0	6.5
In percent of ARA composite metric	61.6	45.8	24.5	16.3	36.1	48.7	65.5	80.7	99.6	107.1
Usable Gross official reserves (end of period) 3/										
In millions of U.S. dollars	7,642	5,664	1,565	462	2,995	4,692	8,520	10,888	14,208	15,875
In months of prospective imports of goods & services	5.0	3.2	1.0	0.2	1.5	2.3	3.9	4.8	6.0	6.5
In percent of ARA composite metric	61.6	45.8	12.2	4.0	24.4	37.3	65.5	80.7	99.6	107.1
External debt (public and private)										
In billions of U.S. dollars	54.6	53.4	57.3	58.7	56.2	58.3	61.1	63.9	67.7	69.8
As a percent of GDP	61.4	62.6	64.4	78.0	74.7	76.7	78.0	78.6	79.6	77.6
Memorandum items:										
Nominal GDP (in billions of rupees)	15,911	15,840	17,686	23,688	29,852	33,533	36,326	39,362	42,634	46,154
Nominal GDP (in billions of U.S. dollars)	89.0	85.3	89.0	75.3	75.3	76.0	78.4	81.3	85.0	89.9
REER appreciation (percent, period average)	-5.1	1.0	-2.8	-8.2	-8.5	-4.6	-2.0	-2.0	-1.5	-0.3
Exchange Rate (period average)	178.7	185.6	198.8	314.6	....	....	....	....	....	....
Exchange Rate (end of period)	181.6	186.4	200.4	363.1	....	....	....	....	....	....

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

1/ Colombo CPI.

2/ Comprising central government debt, publicly guaranteed debt, and CBSL external liabilities (i.e., Fund credit outstanding and international currency swap arrangements).

3/ Excluding PBOC swap ($1.4bn in 2022) which becomes usable once GIR rise above 3 months of previous year's import cover.

Table 2a. Sri Lanka: Summary of Central Government Operations, 2019–28 (Restructuring Scenario)

(In billions of rupees)

	2019	2020	2021	2022	2023		2024	2025	2026	2027	2028
		Act.		Prel.	Budget	Proj.			Proj.		
Total revenue and grants	1,899	1,373	1,464	2,012	3,415	3,280	4,463	5,425	5,916	6,458	7,047
Total revenue	1,891	1,368	1,457	1,979	3,408	3,268	4,449	5,410	5,900	6,441	7,028
Tax revenue	1,735	1,217	1,298	1,751	3,130	3,005	4,154	5,090	5,553	6,035	6,589
Income taxes	428	268	302	534	912	895	1,010	1,096	1,191	1,290	1,397
VAT	444	234	308	463	912	796	1,456	1,607	1,763	1,917	2,088
Excise taxes	399	322	307	343	557	526	671	799	874	947	1,043
Other taxes on goods and services	132	31	31	70	291	297	343	372	403	437	473
Taxes on international trade	332	362	350	341	458	492	674	780	849	933	1,035
Property taxes	0	0	0	0	0	0	0	436	472	512	554
Nontax revenue	156	151	159	228	278	263	295	320	347	406	439
Grants	8	5	7	33	7	12	13	15	16	17	19
Total expenditure and net lending	3,095	3,284	3,522	4,473	5,819	5,681	6,594	7,247	7,815	8,365	8,974
Current expenditure	2,301	2,672	2,748	3,520	4,609	4,608	5,142	5,647	6,066	6,445	6,867
Wages and salaries	686	794	846	956	1,012	1,012	1,207	1,308	1,417	1,535	1,662
Goods and services	162	180	169	183	300	300	335	363	394	426	462
Subsidies and transfers	552	717	685	815	1,104	1,104	1,199	1,319	1,451	1,596	1,755
of which: social safety net transfers	...	...	...	142	...	187	201	218	236	256	277
Interest payments 1/	901	980	1,048	1,565	2,193	2,192	2,400	2,657	2,804	2,888	2,989
Capital expenditure and net lending	794	612	774	953	1,210	1,073	1,453	1,599	1,749	1,920	2,107
Capital expenditure	799	615	768	715	1,210	1,073	1,453	1,599	1,749	1,920	2,107
Net lending	-5	-4	7	237	0	0	0	0	0	0	0
Overall balance	-1,196	-1,910	-2,058	-2,460	-2,404	-2,401	-2,132	-1,822	-1,899	-1,907	-1,927
Memorandum items:											
Central government primary balance	-295	-930	-1,010	-895	-211	-209	268	835	905	981	1,062
Central government debt 1/	13,142	15,158	18,082	27,872	...	29,856	34,084	37,512	40,216	41,608	44,601
Nominal GDP (in billion of rupees)	15,911	15,840	17,686	23,688	30,320	29,852	33,533	36,326	39,362	42,634	46,154

Sources: Data provided by the Sri Lankan authorities; and IMF staff estimates.
1/ Based on illustrative restructuring terms

Table 2b. Sri Lanka: Summary of Central Government Operations, 2019–28 (Restructuring Scenario)

(In percent of GDP)

	2019	2020	2021	2022	2023		2024	2025	2026	2027	2028
		Act.		Prel.	Budget	Proj.			Proj.		
Total revenue and grants	11.9	8.7	8.3	8.5	11.3	11.0	13.3	14.9	15.0	15.1	15.3
Total revenue	11.9	8.6	8.2	8.4	11.2	10.9	13.3	14.9	15.0	15.1	15.2
Tax revenue	10.9	7.7	7.3	7.4	10.3	10.1	12.4	14.0	14.1	14.2	14.3
Income taxes	2.7	1.7	1.7	2.3	3.0	3.0	3.0	3.0	3.0	3.0	3.0
VAT	2.8	1.5	1.7	2.0	3.0	2.7	4.3	4.4	4.5	4.5	4.5
Excise taxes	2.5	2.0	1.7	1.4	1.8	1.8	2.0	2.2	2.2	2.2	2.3
Other taxes on goods and services	0.8	0.2	0.2	0.3	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Taxes on international trade	2.1	2.3	2.0	1.4	1.5	1.6	2.0	2.1	2.2	2.2	2.2
Property taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.2	1.2	1.2	1.2
Nontax revenue	1.0	1.0	0.9	1.0	0.9	0.9	0.9	0.9	0.9	1.0	1.0
Grants	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure and net lending	19.5	20.7	19.9	18.9	19.2	19.0	19.7	19.9	19.9	19.6	19.4
Current expenditure	14.5	16.9	15.5	14.9	15.2	15.4	15.3	15.5	15.4	15.1	14.9
Wages and salaries	4.3	5.0	4.8	4.0	3.3	3.4	3.6	3.6	3.6	3.6	3.6
Goods and services	1.0	1.1	1.0	0.8	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Subsidies and transfers	3.5	4.5	3.9	3.4	3.6	3.7	3.6	3.6	3.7	3.7	3.8
of which: social safety net transfers	...	...	...	0.6	...	0.6	0.6	0.6	0.6	0.6	0.6
Interest payments 1/	5.7	6.2	5.9	6.6	7.2	7.3	7.2	7.3	7.1	6.8	6.5
Capital expenditure and net lending	5.0	3.9	4.4	4.0	4.0	3.6	4.3	4.4	4.4	4.5	4.6
Capital expenditure	5.0	3.9	4.3	3.0	4.0	3.6	4.3	4.4	4.4	4.5	4.6
Net lending	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-7.5	-12.1	-11.6	-10.4	-7.9	-8.0	-6.4	-5.0	-4.8	-4.5	-4.2
Memorandum items:											
Central government primary balance	-1.9	-5.9	-5.7	-3.8	-0.7	-0.7	0.8	2.3	2.3	2.3	2.3
Central government debt 1/	82.6	95.7	102.2	117.7	...	100.0	101.6	103.3	102.2	97.6	96.6
Nominal GDP (in billion of rupees)	15,911	15,840	17,686	23,688	30,320	29,852	33,533	36,326	39,362	42,634	46,154

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

1/ Based on illustrative restructuring terms

Table 3. Sri Lanka: Monetary Accounts, 2019–28 1/ (Restructuring Scenario)

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

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
		Act.					Proj			
Central Bank of Sri Lanka										
Net foreign assets	896	527	-387	-1,606	-480	688	1,761	2,775	4,309	4,988
Net domestic assets	37	438	1,693	2,956	2,146	1,165	226	-622	-1,977	-2,463
Net claims on central government	363	869	2,094	3,432	3,260	2,810	1,960	1,110	460	210
o.w. Holdings of government securities for monetary operations 2/	52	-8	529	698	626	526	376	226	126	76
Other items, net	-328	-546	-544	-465	-1,102	-1,634	-1,723	-1,721	-2,426	-2,662
Reserve Money	933	964	1,306	1,349	1,666	1,853	1,987	2,153	2,332	2,525
Currency in circulation	678	835	1,005	1,027	1,105	1,188	1,234	1,303	1,381	1,519
Commercial banks' deposits	255	130	301	323	561	664	753	850	952	1,006
Monetary survey										
Net foreign assets	101	-209	-982	-1,753	-907	137	1,114	2,026	3,436	4,101
Monetary authorities	896	527	-387	-1,606	-480	688	1,761	2,775	4,309	4,988
Deposit money banks	-795	-736	-595	-146	-426	-551	-647	-749	-874	-887
Net domestic assets	7,523	9,615	11,629	14,049	15,984	16,630	16,869	17,460	17,670	18,747
Net claims on central government	2,796	4,548	5,832	7,466	8,517	8,434	7,950	7,547	7,209	6,994
Credit to corporations	6,615	7,173	8,170	9,161	10,000	10,675	11,449	12,342	13,334	14,413
Public corporations	818	1,002	1,188	1,735	1,739	1,742	1,744	1,744	1,744	1,744
Private corporations	5,797	6,171	6,981	7,427	8,261	8,933	9,705	10,598	11,590	12,669
Other items (net)	-1,887	-2,106	-2,373	-2,579	-2,534	-2,478	-2,530	-2,429	-2,873	-2,659
Broad money	7,624	9,406	10,647	12,296	15,077	16,767	17,983	19,486	21,106	22,849
Memorandum Items										
Gross international reserves (in millions of U.S. dollars)	7,642	5,664	3,139	1,898	4,431	6,128	8,520	10,888	14,208	15,875
Net international reserves (in millions of U.S. dollars)	5,871	3,543	-423	-3,229	-221	2,416	4,613	6,513	9,685	11,536
Net Foreign Assets of commercial banks (in millions of U.S. dollars)	-4,379	-3,950	-2,967	-403	-992	-1,217	-1,365	-1,516	-1,714	-1,714
Reserve money (in percent of GDP)	5.9	6.1	7.4	5.7	5.6	5.5	5.5	5.5	5.5	5.5
Private credit (in percent of GDP)	36.4	39.0	39.5	31.4	27.7	26.6	26.7	26.9	27.2	27.4
Money multiplier	8.2	9.8	8.2	9.1	9.1	9.1	9.1	9.1	9.1	9.1
Broad money velocity	2.1	1.7	1.7	1.9	2.0	2.0	2.0	2.0	2.0	2.0
					(Annual percentage change)					
Nominal GDP	3.6	-0.4	11.7	33.9	26.0	12.3	8.3	8.4	8.3	8.3
Broad money	7.0	23.4	13.2	15.5	22.6	11.2	7.3	8.4	8.3	8.3
Reserve money	-3.0	3.4	35.4	3.3	23.5	11.2	7.3	8.4	8.3	8.3
Credit to private sector	4.2	6.5	13.1	6.4	11.2	8.1	8.6	9.2	9.4	9.3
Credit to private sector (adjusted for inflation)	-0.1	1.9	7.2	-40.0	-17.3	-0.6	3.1	4.0	4.3	4.3

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

1/ Covers the monetary authorities and commercial banks.

2/ Arise from purchases of government securities, for monetary policy purposes, on temporary basis with an agreement to reverse the transaction after an agreed number of days.

Table 4. Sri Lanka: Balance of Payments, 2019–28 (Restructuring Scenario)

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

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
		Act.		Proj.			Proj.			
Current account	**-1,844**	**-1,187**	**-3,343**	**-1,458**	**-1,184**	**-1,092**	**-1,077**	**-1,124**	**-1,140**	**-1,201**
Balance on goods	-7,997	-6,008	-8,139	-5,185	-6,931	-6,962	-7,235	-7,729	-7,780	-7,879
Credit (exports)	11,940	10,048	12,499	13,106	13,666	14,517	15,270	16,065	16,869	17,717
Debit (imports)	-19,937	-16,055	-20,638	-18,291	-20,597	-21,479	-22,506	-23,794	-24,649	-25,596
Non-oil imports	-16,045	-13,513	-16,895	-13,394	-15,943	-17,469	-18,592	-19,888	-20,721	-21,634
Oil imports	-3,892	-2,543	-3,743	-4,897	-4,654	-4,010	-3,914	-3,906	-3,928	-3,962
Balance on services	2,850	819	1,586	1,915	3,507	4,066	4,363	4,575	4,689	4,808
Credit (exports)	7,475	3,035	2,475	3,187	5,511	6,298	6,674	6,975	7,182	7,398
Debit (imports)	-4,625	-2,216	-889	-1,272	-2,004	-2,232	-2,311	-2,401	-2,493	-2,590
Primary income, net	-2,462	-2,205	-2,018	-1,595	-1,993	-2,456	-2,534	-2,420	-2,574	-2,731
Secondary income, net	5,765	6,207	5,227	3,408	4,233	4,259	4,330	4,450	4,525	4,601
Of which: workers' remittances (net)	5,754	6,194	5,221	3,398	4,223	4,249	4,321	4,441	4,516	4,591
Capital account (+ surplus / - deficit)	**23**	**28**	**25**	**12**	**12**	**12**	**12**	**12**	**12**	**12**
Balance from current account and capital account	**-1,821**	**-1,159**	**-3,318**	**-1,446**	**-1,172**	**-1,080**	**-1,065**	**-1,112**	**-1,128**	**-1,189**
Financial account (+ net lending / - net borrowing) 1/	**-2,469**	**1,636**	**-2,347**	**-912**	**-3,211**	**-2,320**	**-3,001**	**-3,012**	**-4,300**	**-3,040**
Direct investments	-666	-419	-580	-783	-950	-1,280	-1,365	-1,432	-1,529	-1,549
Portfolio investments	-2,312	2,382	906	372	-101	-110	-113	-120	-1,620	-367
Equity and investment Fund shares	5	216	236	-82	-90	-100	-100	-100	-100	-100
Debt instruments	-2,317	2,166	669	454	-11	-10	-13	-20	-1,520	-267
Of which: deposit taking corporations	250	0	0	0	0	0	0	0	0	0
Of which: general government	-2,567	2,166	669	454	-11	-10	-13	-20	-1,520	-267
T-bills, T-bonds, and SLDBs	333	531	29	-46	-11	-10	-13	-20	-20	-20
Sovereign bonds	-2,900	1,635	640	500	0	0	0	0	-1,500	-247
Other investments 2/	509	-327	-2,673	-501	-2,160	-930	-1,523	-1,460	-1,151	-1,124
Of which:										
Currency and deposits	-259	79	-3,709	-118	27	421	43	25	-16	21
Central bank	0	-400	-1,375	-400	200	400	0	0	0	0
Deposit taking corporations	-259	479	-2,334	282	-173	21	43	25	-16	21
Loans 2/	573	-136	1,495	623	-2,619	-2,306	-1,777	-1,404	-1,198	-1,207
Deposit taking corporations	281	-75	2,152	1,518	-416	-246	-191	-176	-182	-195
General government	89	-116	-664	-1,163	-2,023	-1,848	-1,374	-1,016	-804	-800
Disbursements	-448	-1,076	-2,100	-2,316	-3,009	-2,392	-2,285	-2,333	-2,282	-1,732
Amortizations	1,814	1,855	1,815	1,153	986	544	912	1,317	1,478	932
Other sectors	203	56	7	268	-180	-212	-212	-212	-212	-212
SDR allocation	0	0	-787	0	0	0	0	0	0	0
Other accounts receivable/payable (incl. ACU balance)	-25	114	-180	-1,472	736	997	261	0	0	0
Errors and omissions	-640	765	-1,498	-568	0	0	0	0	0	0
Overall balance (- = need of inflow) 1/	**8**	**-2,030**	**-2,469**	**-1,102**	**2,039**	**1,240**	**1,936**	**1,900**	**3,172**	**1,851**
Financing (- = inflow)	**336**	**-1,977**	**-2,469**	**-1,102**	**2,702**	**1,905**	**2,599**	**2,560**	**3,498**	**1,870**
Change in reserve assets	336	-1,991	-2,526	-1,242	2,533	1,697	2,392	2,368	3,320	1,667
Use of Fund credit, net	0	14	57	139	168	208	206	192	178	204
Financing gap (- = inflow) 4/	**-327**	**-53**	**0**	**0**	**-663**	**-665**	**-663**	**-662**	**-329**	**0**
IMF	-327	0	0	0	-663	-665	-663	-662	-329	0
Other IFIs	0	-53	0	0	0	0	0	0	0	0
Memorandum items:										
Current account (in percent of GDP)	-2.1	-1.4	-3.8	-1.9	-1.6	-1.4	-1.4	-1.4	-1.3	-1.3
Gross official reserves	7,642	5,664	3,139	1,898	4,431	6,128	8,520	10,888	14,208	15,875
In months of prospective imports of goods and services	5.0	3.2	1.9	1.0	2.2	3.0	3.9	4.8	6.0	6.5
In percent of ARA composite metric	61.6	45.8	24.5	16.3	36.1	48.7	65.5	80.7	99.6	107.1
Usable Gross official reserves 3/	7,642	5,664	1,565	462	2,995	4,692	8,520	10,888	14,208	15,875
In months of prospective imports of goods and services	5.0	3.2	1.0	0.2	1.5	2.3	3.9	4.8	6.0	6.5
In percent of ARA composite metric	61.6	45.8	12.2	4.0	24.4	37.3	65.5	80.7	99.6	107.1
Net international reserves	5,871	3,543	-423	-3,229	-221	2,416	4,613	6,513	9,685	11,536
In percent of ARA composite metric	47.4	28.6	-3.3	...	...	19.2	35.5	48.2	67.9	77.9
Nominal GDP	89,015	85,349	88,979	75,296	75,267	76,011	78,417	81,327	84,950	89,900

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

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

2/ Excluding credits and loans with the IMF, other than reserves (net purchases and repurchases), and other international institutions' loan disbursement.

3/ Excluding PBOC swap ($1.4bn in 2022) which becomes usable once GIR rise above 3 months of previous year's import cover.

4/ In this table, all program financing in 2022-2027 (IFI budget support, debt relief, external arrears) except the IMF financing is included above the line.

Table 5. Sri Lanka: Composition of Public Debt (Including Arrears)

	2021			2022 (prel. estimate)		
	billion LKR	**million US$**	**percent of GDP**	**billion LKR**	**million US$**	**percent of GDP**
Total public debt	**20,219.7**	**100,880**	**114.3**	**30,355**	**83,595**	**128.1**
Foreign-law debt	**8,129**	**40,556**	**46.0**	**15,060**	**41,474**	**63.6**
Multilateral (incl. IMF)	**2,244**	**11,196**	**12.7**	**4,174**	**11,495**	**17.6**
Official bilateral	**2,249**	**11,219**	**12.7**	**4,147**	**11,419**	**17.5**
Paris Club creditors	1,094	5,458	6.2	1,737	4,784	7.3
Japan	649	3,236	3.7	1,027	2,828	4.3
France	82	410	0.5	152	418	0.6
Korea	67	332	0.4	115	317	0.5
Other	297	1,481	1.7	443	1,221	1.9
Non-Paris Club creditors	1,155	5,761	6.5	2,409	6,635	10.2
China[1]	916	4,572	5.2	1,628	4,483	6.9
India	173	864	1.0	666	1,833	2.8
Saudi Arabia	26	130	0.1	51	139	0.2
Other	39	195	0.2	65	180	0.3
Private	**3,280**	**16,367**	**18.5**	**6,000**	**16,524**	**25.3**
Bonds	2,651	13,225	15.0	4,853	13,364	20.5
China Dev. Bank [2]	578	2,883	3.3	1,053	2,901	4.4
Riggs National Bank	2	8	0.0	3	8	0.0
SOE trade payables (non-guaranteed)	50	251	0.3	91	251	0.4
Central bank swap lines	**356**	**1,774**	**2.0**	**739**	**2,036**	**3.1**
Local-law debt	**12,091**	**60,324**	**68.4**	**15,295**	**42,121**	**64.6**
Local currency	**10,904**	**54,400**	**61.7**	**13,817**	**38,052**	**58.3**
Tbills	2,271	11,329	12.8	4,126	11,364	17.4
of which: held by CBSL	1,391	6,940	7.9	2,598	7,155	11.0
Tbonds	6,968	34,764	39.4	8,722	24,020	36.8
Bank loans	761	3,796	4.3	709	1,952	3.0
of which: guaranteed SOE loans	623	3,108	3.5	629	1,731	2.7
CBSL advances	150	749	0.8	236	649	1.0
Bank overdrafts	754	3,761	4.3	24	67	0.1
Foreign currency	**1,187**	**5,924**	**6.7**	**1,478**	**4,069**	**6.2**
Sri Lanka Development Bonds	460	2,295	2.6	401	1,103	1.7
Bank loans [3]	727	3,629	4.1	1,077	2,966	4.5
of which: guaranteed SOE loans and payables	578	2,886	3.3	131	361	0.6
Memorandum item:						
Central government debt	18,082	90,216	102.2	27,872	76,758	117.7

Source: Sri Lankan authorities; and IMF staff calculations.

1/ includes all loans from China EXIM and Sinosure-backed loans from private lenders, including China Development Bank

2/ Excludes Sinosure-backed loan

3/ Government guaranteed FX loans of the Ceylon Petroleum Corporation were transferred to the Central Government balance sheet, effective December 31, 2022.

Table 6. Sri Lanka: Gross External Financing, 2019–2028 (Restructuring Scenario)

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

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
							Proj.			
Current account	-1,844	-1,187	-3,343	-1,458	-1,184	-1,092	-1,077	-1,124	-1,140	-1,201
Balance on goods	-7,997	-6,008	-8,139	-5,185	-6,931	-6,962	-7,235	-7,729	-7,780	-7,879
Credit (exports)	11,940	10,048	12,499	13,106	13,666	14,517	15,270	16,065	16,869	17,717
Debit (imports)	-19,937	-16,055	-20,638	-18,291	-20,597	-21,479	-22,506	-23,794	-24,649	-25,596
Balance on services	2,850	819	1,586	1,915	3,507	4,066	4,363	4,575	4,689	4,808
Primary and secondary income, net	3,303	4,002	3,209	1,812	2,240	1,803	1,795	2,030	1,951	1,870
Amortization	-3,999	-3,099	-2217	-2112	-2075	-1872	-1839	-2231	-2379	-3164
General government	-3,314	-2,855	-2,815	-1,653	-986	-544	-912	-1,317	-1,478	-2,260
Sovereign bonds	-1,500	-1,000	-1000	-500	0	0	0	0	0	-1328
Syndicated loans	-474	-335	-92	0	0	0	0	0	0	0
Bilateral and multilateral	-1,341	-1,520	-1,723	-1,153	-986	-544	-912	-1,317	-1,478	-932
Central bank	0	386	1318	261	-368	-608	-207	-194	-181	-184
IMF repurchases/repayments	0	-14	-57	-139	-168	-208	-207	-194	-181	-184
Other central bank liabilities, net	0	400	1375	400	-200	-400	0	0	0	0
Private sector loans	-685	-630	-720	-720	-720	-720	-720	-720	-720	-720
Debt service on treated CG and guaranteed debt on pre-restructuring terms	...	...	...	-2,834	-3,722	-4,018	-4,345	-2,936	-2,982	-2,531
Principal	...	...	...	-2,107	-2,708	-3,130	-3,570	-2,319	-2,508	-2,172
Interest	...	...	...	-727	-1,014	-888	-775	-617	-474	-359
Debt service on treated CG and guaranteed debt debt post-restructuring	...	...	...	0	345	690	690	690	1,500	2,269
Principal	...	...	...	0	0	0	0	0	810	1,620
Interest	...	...	...	0	345	690	690	690	690	650
Gross external financing needs	-5,843	-4,285	-5,560	-6,404	-6,636	-6,292	-6,571	-5,601	-5,002	-4,627
Sources of financing	5,843	4,285	5,560	6,404	6,636	6,292	6,571	5,601	5,002	4,627
Borrowing	5,851	2,294	3034	2,897	4,230	3,146	3,945	4,361	5910	6032
General government	4,531	622	2082	2,362	2,120	1,552	1,598	1,653	3202	3327
T-bills, Tbonds, and SLDBs, net	-333	-531	-29	46	11	10	13	20	20	20
Sovereign bonds	4,400	0	0	0	0	0	0	0	1500	1575
Syndicated loans	0	500	800	0	0	0	0	0	0	0
Bilateral and multilateral	448	629	1300	2,316	2,109	1,542	1,585	1,633	1682	1732
Official capital transfers	16	24	11	0	0	0	0	0	0	0
Other capital inflows, net	1,321	1,672	952	534	2,110	1,594	2,347	2,708	2,709	2,705
Deposit-taking corporations, excl. central bank, net	-460	-437	362	-1,805	533	213	125	136	184	160
FDI inflows, net	666	419	580	783	950	1,280	1,365	1,432	1,529	1,549
Private sector loans	482	574	713	452	900	932	932	932	932	932
Other capital inflows, net	632	1,116	-703	1,104	-274	-831	-75	208	64	64
Change in reserve assets	-336	1,938	2,526	674	-2,533	-1,697	-2,392	-2,368	-3,320	-1,667
External financing gap	327	53	0	2,834	4,939	4,843	5,018	3,608	2,411	262
Exceptional Financing	...	...	...	2,834	4,939	4,843	5,018	3,608	2,411	262
IMF EFF	...	...	...	0	663	665	663	662	329	0
IFI budget support	...	...	...	0	900	850	700	700	600	0
Debt moratorium: external arrears accumulation	...	...	...	2,834	0	0	0	0	0	0
Debt relief	...	...	...	0	3,376	3,328	3,655	2,246	1,482	262

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

Table 7. Sri Lanka: Projected Payments to the Fund, 2023–2036 1/

(In millions of SDRs, unless otherwise indicated)

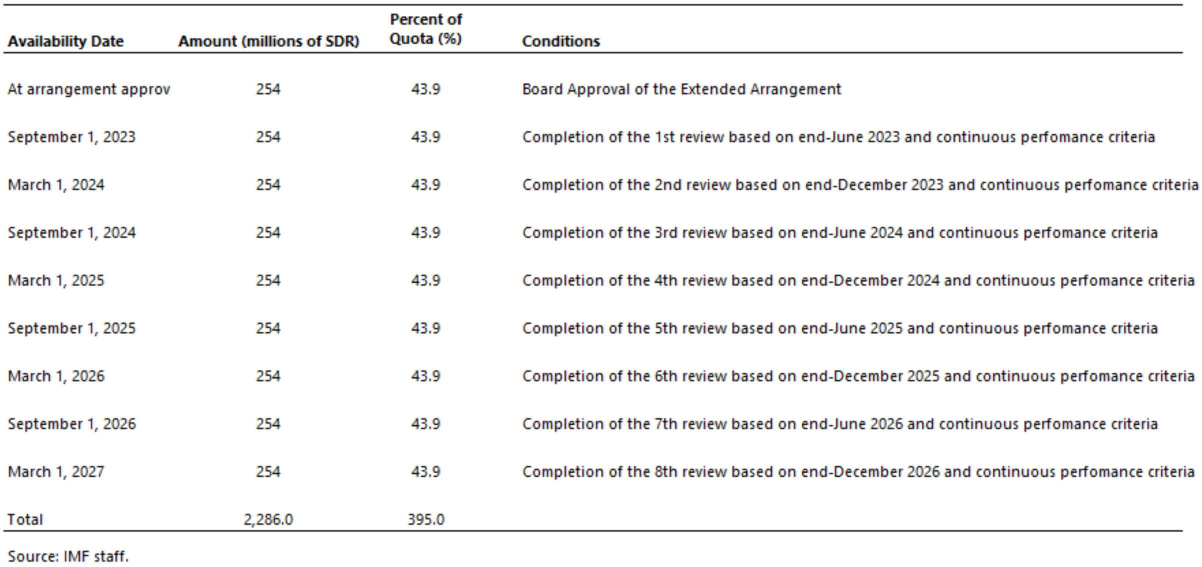
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036
Fund repurchases and charges														
In millions of SDR	196.6	255.9	278.4	291.0	305.8	330.1	379.0	416.5	478.6	472.1	429.9	330.3	234.5	142.5
In millions of U.S. dollars	256.4	335.0	363.6	379.1	396.4	428.0	491.3	540.0	620.4	612.0	557.3	428.2	304.1	184.8
In percent of exports of goods and services	1.3	1.6	1.7	1.6	1.6	1.7	1.9	2.0	2.2	2.0	1.8	1.3	0.9	0.5
In percent of government fiscal revenue	3.1	3.3	3.1	3.1	3.1	3.1	3.4	3.5	3.7	3.5	2.9	2.1	1.4	0.8
In percent of quota	34.0	44.2	48.1	50.3	52.8	57.0	65.5	72.0	82.7	81.6	74.3	57.1	40.5	24.6
In percent of gross official reserves	5.8	5.5	4.3	3.5	2.8	2.7	3.0	3.2	3.6	3.4	3.0	2.3	1.6	0.9
Fund credit outstanding 2/														
In millions of SDR	1,176.8	1,526.1	1,875.4	2,234.7	2,348.8	2,188.6	1,968.5	1,693.3	1,333.5	952.5	592.7	317.5	127.0	21.2
In millions of U.S. dollars	1,537	2,000	2,437	2,933	2,924	2,725	2,450.6	2,108.1	1,660.1	1,185.8	737.8	395.3	158.1	26.4
In percent of exports of goods and services	8.0	9.6	11.1	12.7	12.2	10.8	9.3	7.7	5.8	4.0	2.4	1.2	0.5	0.1
In percent of government fiscal revenue	18.6	19.8	20.9	24.1	22.8	19.9	16.8	13.5	10.0	6.7	3.9	2.0	0.7	0.1
In percent of quota	203.3	263.7	324.0	386.1	405.8	378.1	340.1	292.6	230.4	164.6	102.4	54.9	21.9	3.7
In percent of GDP	2.0	2.6	3.1	3.6	3.4	3.0	2.6	2.1	1.6	1.1	0.6	0.3	0.1	0.0
In percent of gross official reserves	34.7	32.6	28.6	26.9	20.6	17.2	15.0	12.5	9.6	6.6	4.0	2.1	0.8	0.1
Memorandum items:														
Exports of goods and services (in millions of U.S. dollars)	19,177	20,815	21,944	23,041	24,051	25,114	26,245	27,426	28,660	29,949	31,297	32,705	34,177	35,715
Central government fiscal revenue (billion of Rupees)	3,268	4,449	5,410	5,900	6,441	7,028	7,669	8,369	9,132	9,965	10,874	11,866	12,949	14,130
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
Quota (in millions of U.S. dollars) 2/	756	759	752	760	721	721	721	721	721	721	721	721	721	721
Gross official reserves (in millions of U.S. dollars) 2/	4,431	6,128	8,520	10,888	14,208	15,875	16,375	16,875	17,375	17,875	18,375	18,875	19,375	19,875

Source: IMF staff estimates.

1/ Projections as of February 23, 2023.

2/ As of the end of the year.

Table 8. Sri Lanka: Reviews and Disbursements Under the Proposed Four-Year Extended Arrangement



Availability Date	Amount (millions of SDR)	Percent of Quota (%)	Conditions
At arrangement approv	254	43.9	Board Approval of the Extended Arrangement
September 1, 2023	254	43.9	Completion of the 1st review based on end-June 2023 and continuous perfomance criteria
March 1, 2024	254	43.9	Completion of the 2nd review based on end-December 2023 and continuous perfomance criteria
September 1, 2024	254	43.9	Completion of the 3rd review based on end-June 2024 and continuous perfomance criteria
March 1, 2025	254	43.9	Completion of the 4th review based on end-December 2024 and continuous perfomance criteria
September 1, 2025	254	43.9	Completion of the 5th review based on end-June 2025 and continuous perfomance criteria
March 1, 2026	254	43.9	Completion of the 6th review based on end-December 2025 and continuous perfomance criteria
September 1, 2026	254	43.9	Completion of the 7th review based on end-June 2026 and continuous perfomance criteria
March 1, 2027	254	43.9	Completion of the 8th review based on end-December 2026 and continuous perfomance criteria
Total	2,286.0	395.0	

Source: IMF staff.

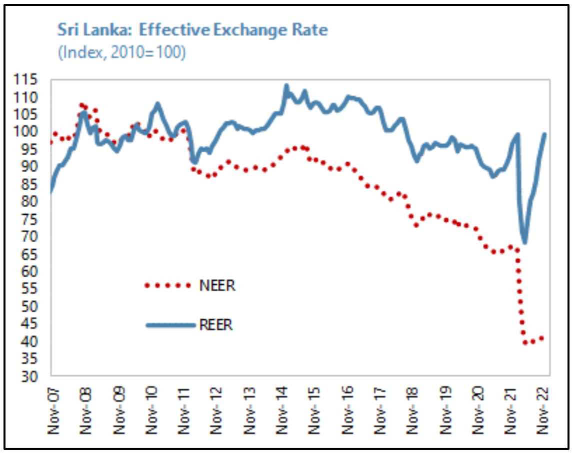
Annex I. External Sector Assessment

Sri Lanka's external position in 2022 is assessed as weaker than the level implied by medium-term fundamentals and desirable policies. This assessment is informed by the current account model, based on staff's estimate for the 2022 current account, while they are subject to large uncertainty. High external debt vulnerabilities materialized when the country defaulted on external public debt in April 2022. Since then, the level of reserves remained precariously low against an adequate level, leading to widespread foreign exchange shortages and posing severe vulnerabilities to external shocks. As envisaged by the policy package under the EFF-supported program, improving Sri Lanka's external position would require, among others, restructuring public debt in line with program parameters to restore debt sustainability, implementing primarily revenue-based fiscal consolidation, conducting prudent monetary policy accompanied by a flexible and market determined exchange rate, and rebuilding international reserves to adequate levels. In addition, structural reforms to boost Sri Lanka's export capacity and steps to encourage FDI in export sectors would be key.

1. Sri Lanka's balance of payments remained under extreme pressure in 2022 amid external default and depletion of reserves.

- Pre-existing vulnerabilities and policy missteps led to a full-blown balance of payments and sovereign debt crisis. Sri Lanka entered the pandemic with a thin reserves buffer, high debt level, and eroded fiscal space, and the access to international capital markets was lost. Sri Lanka continued to pay elevated external debt service from reserves, while tightening import restrictions and FX control measures, and resorted to monetary financing to fill fiscal gaps amid an effectively fixed exchange rate from April 2021. With severely limited external financing, reserves depleted, resulting in a sharp exchange rate depreciation and default on external public debt in the spring of 2022.

- The 2022 current account deficit is projected to shrink to 1.9 percent of GDP from 3.8 percent in 2021, as exports expanded by 5 percent y/y, helped by better export prices and improved competitiveness, while imports contracted by 11 percent y/y due to lower demand after exchange rate depreciation, widespread FX shortages, and import restrictions. Remittances have been slowly picking up from a low level. Tourist related inflows more than doubled to 2021 but remained far below their pre-pandemic levels.


Sri Lanka: Effective Exchange Rate
(Index, 2010=100)

- Gross international reserves (GIR) stood at about $1.9 billion (about 1 month of prospective imports) at end-December 2022, including unusable $1.4 billion worth of yuan deposits at the People's Bank of China

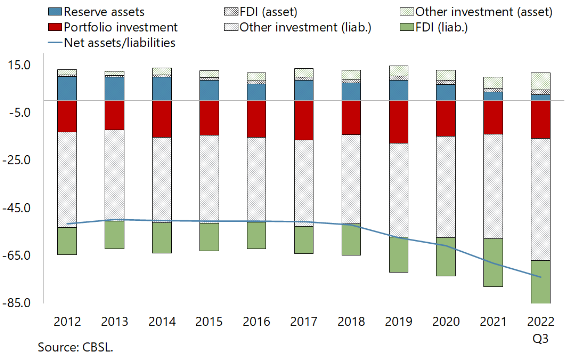
(PBOC). Freely usable reserves were insufficient to cover essential imports such as fuel and energy, even after the external debt default.

- Following sharp depreciation, the exchange rate stabilized at about 360 rupees per U.S. dollar under the FX market guidance from the CBSL since May 2022. The real effective exchange rate (REER) depreciated by about 5 percent in 2022 in average terms, with initial sharp real depreciation largely dialed back by soaring inflation.

2. **Sri Lanka remains a net debtor country, with large external liabilities and depleted external assets**. Sri Lanka's net external liabilities increased sizably from 51 percent of GDP on average during 2012-2018 to 74 percent of GDP in 2022Q3, primarily due to a jump in gross external liabilities from 64 to 86 percent of GDP amid high government borrowing and substantial rupee depreciation, in particular in 2022. Gross external assets dropped from 15 percent of GDP in 2019 to 11.7 percent of GDP in 2022, with the depleted GIR somewhat offset by an increase in other investment assets and a valuation effect. FDI accounted for about a quarter of net external liabilities, and other investment (debt portfolios and/or bank loans) accounted for about 60 percent. About 85 percent of the total external debt liabilities (74 percent of GDP) are long-term, with the government remaining the largest debtor, holding 70 percent of the total external debt liabilities.

Sri Lanka: International Investment Position

(In percent of GDP)



Source: CBSL.

3. **Sri Lanka's public debt is assessed as unsustainable (Annex II)**. Restoring Sri Lanka's debt sustainability to bring external public debt and debt service down to manageable levels will help raise Sri Lanka's Net International Investment Position and reduce risks to external sustainability from elevated gross external liabilities and potential adverse valuation effects.

Sri Lanka: External Balance Assessment: CA Model

(In percent of GDP, unless otherwise noted)

Projected 2022 CA	**[1]**	**-1.9%**
Cyclical contributions	[2]	1.6%
Cyclically adjusted actual CA	**[3] = [1]-[2]**	**-3.6%**
Covid-19 adjustors	[4]	0.7%
Tourism/Travel		0.7%
Adjusted CA	**[5] = [3]+[4]**	**-2.9%**
CA Norm (from model) 1/	**[6]**	**-0.8%**
Adjustment to the norm	[7]	0.0%
Adjusted CA Norm	**[8]=[6]+[7]**	**-0.8%**
CA Gap	**[9]=[5]-[8]**	**-2.1%**
of which Relative policy gap		-3.7%
Fiscal balance		-1.2%
Health expenditure		0.2%
Change in FX reserves		-2.3%
Private credit		-0.6%
Elasticity	[10]	-0.25
REER gap, in % 2/	**[11]=[9]/[10**	**8.2%**

1/ Cyclically adjusted, including multilateral consistency adjustment.
2/ "-" undervalued ER; "+" overvalued ER

External Position

4. **While staff assessment is subject to large uncertainty, Sri Lanka's external position in 2022 is weaker than the level implied by the medium-term fundamentals and desirable policy settings**.

- The External Balance Assessment (EBA) CA model estimates Sri Lanka's current account norm of about -0.8 percent of GDP.

- The cyclically adjusted CA balance, based on staff's estimate for the 2022 CA of -1.9 percent, is estimated at -3.6 percent of GDP in 2022. This is subject to additional adjustment due to temporary impact of the COVID-19 pandemic on tourism and travel (0.7 percent of GDP). Accordingly, the adjusted projected CA is estimated at -2.9 percent of GDP.

- With adjusted projected CA of -2.9 percent of GDP, against adjusted CA norm of -0.8 percent of GDP, the EBA-based current account gap for 2022 is estimated at -2.1 percent of GDP. Policy gaps (mainly a large fiscal deficit and critically low FX reserves) account for -3.7 percent of GDP, while 1.6 percent of GDP is a residual. The estimated current account gap points to a REER overvaluation of about 8 percent.

- The EBA-lite REER model yields a similar REER overvaluation of about 8 percent (corresponding CA gap -2.0 percent of GDP), while the EBA External Sustainability (ES) approach—calibrated at stabilizing the NFA/GDP at a benchmark level—points to a REER undervaluation of about 1.3 percent.

Sri Lanka: EBA-lite REER Model

Ln(REER) AVG Q42022	**[1]**	**4.56**
Ln(REER) Fitted	**[2]**	**4.40**
Ln(REER) Norm	**[3]**	**4.48**
Residual	[1]-[2]	0.16
REER Gap 1/	**[4] = [1]-[3]**	**8.0%**
Elasticity	[5]	-0.25
CA gap, % GDP	**[6]=[4]*[5]**	**-2.0%**

1/ "-" undervalued ER; "+" overvalued ER

Sri Lanka: EBA External Sustainabililty Model

(In percent of GDP, unless otherwise noted)

Benchmark NFA/GDP 1/	**[1]**	**-50.9%**
Projected 2022 CA	**[2]**	**-1.9%**
Cyclical contributions	[3]	1.6%
Cyclically adjusted actual CA	**[4] = [2]-[3]**	**-3.6%**
CA stabilizing NFA at benchmark	**[5]**	**-3.9%**
CA Gap	**[6]=[4]-[5]**	**0.3%**
Elasticity	[7]	-0.25
REER gap, in % 2/	**[8]=[6]/[7]**	**-1.3%**

1/ Average NFA/GDP over 2012-2018, preceding Covid-19 pandemic and 2019 terrorist attack.

2/ "-" undervalued ER; "+" overvalued ER

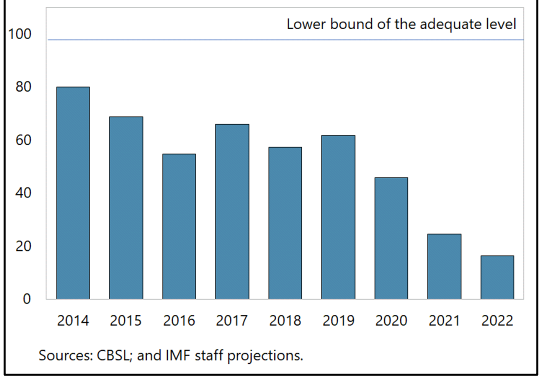
- Placing greater weight on the EBA CA and EBA-lite REER models, which use a rich set of cross-country information, and incorporate estimated adjustments for COVID-19 impacts, and accounting for critically low GIR, staff assesses Sri Lanka's external position to be weaker than the level implied by medium-term macroeconomic fundamentals and desirable policy settings. Sri Lanka has a negative current account gap in 2022, exceeding 2 percent of GDP, and consistent with a REER overvaluation of about 8 percent. Nonetheless, the degree of overvaluation would be subject to large uncertainty given that the 2022 CA reflects Sri Lanka's extraordinary circumstances under a full-fledged BOP and debt crisis.

Reserve Adequacy

5. **Sri Lanka's international reserve position remains precariously low against an adequate level**. GIR, historically supported by extensive external government borrowing, declined from 62 percent of the Fund's Assessing Reserve Adequacy (ARA) metric at end-2019 to 25 percent at end-2021 and 16 percent at end-December 2022, much below the recommended adequacy range of 100-150 percent. Excluding the

Sri Lanka: Gross International Reserves

(In percent of ARA metric)



Sources: CBSL; and IMF staff projections.

temporarily unusable assets related to the PBOC swap, usable GIR in 2022 are estimated at 4 percent of the ARA metric.

6. **The CBSL pursued an interventionist approach to exchange rate policy**. Initially in response to the pandemic and in 2022 in the runup to the BOP crisis, the authorities suspended certain non-priority imports, introduced surrender requirements for exports and converted remittances, and resorted to other FX control measures to stabilize the exchange rate and preserve scarce international reserves. Depletion of reserves and external default led to sharp nominal depreciation of the rupee. Since May 2022, the CBSL market guidance (to confine daily exchange rate movements in the interbank FX market within a time-varying predefined band around weighted average interbank spot rate of the previous day) kept the rupee effectively pegged at about 360 rupees per U.S. dollar. Net FX interventions were substantially on a sell side, funded by surrender requirement (in 2022, the CBSL has cumulatively sold $4.8 billion and purchased $4.0 billion in spot and forward FX markets), with spot sales primarily directed at financing critical imports such as fuel and energy.

FX Control and Capital Flow Management

7. **In response to the sharp currency depreciation and pressures on reserves, the authorities have tightly restricted FX flows by introducing or tightening temporary FX control measures**. These measures include import restrictions, exchange restrictions, multiple currency practices (MCPs), and measures constituting capital flow management (CFM) measures under the Fund’s Institutional View on Liberalization and Management of Capital Flows. Over 2020-22, the imports of many non-priority non-critical goods were suspended, which helped contain the import bill and relieved BOP pressures, but also hurt economic activity and distorted markets. Sri Lanka also introduced measures that gave rise to exchange restrictions and MCPs, adopted new CFMs, and tightened existing CFMs, including during the pandemic and recent crisis (see the main text of the Staff Report ¶23 for details). Given the acute BOP tensions and ongoing crisis, maintaining the CFM measures in the short run is appropriate. While the import restrictions, exchange restrictions, MCP-related measures and CFMs could help mitigate FX shortages in the near term, they should not be a substitute for the comprehensive policy package and ongoing macroeconomic adjustment, and should be phased out as the balance of payments stabilizes.

Annex II. Public Debt Sustainability Analysis

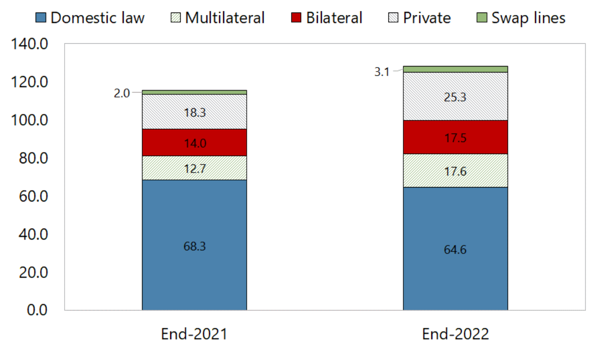
Current Debt Situation

1. Definition. For the purposes of the debt sustainability analysis (DSA), public debt includes central government debt, SOE debt guaranteed by the central government, and external liabilities of the central bank of Sri Lanka (CBSL) arising from the 2016-20 Extended Funds Facility and from bilateral currency swap arrangements with foreign central banks.[1]

- Sri Lanka's public debt-to-GDP ratio increased substantially in 2022, to 128 percent. The 14 percentage point increase since 2021 is largely attributed to the depreciation of the Rupee and a still large fiscal deficit (text charts below). FX depreciation also increased the share of foreign-law debt to half of Sri Lanka's public debt. The real value of domestic debt was significantly reduced by high inflation.

Sri Lanka: Public Debt Stock

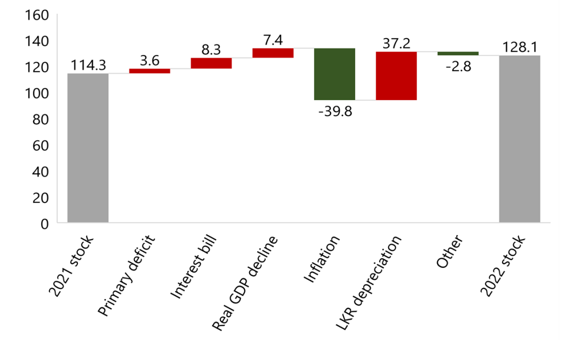
(In percent of GDP)



Sources: Sri Lanka authorities; and IMF staff calculations.

Sri Lanka: Decomposition of Debt Dynamics

(In percent of GDP)



Sources: Sri Lanka authorities; and IMF staff calculations.

2. Following the external debt service suspension, announced on April 12, 2022, Sri Lanka has accumulated considerable sovereign arrears (close to $3 billion as of end-2022). The authorities have stopped servicing their foreign-law government and government guaranteed debt, except multilateral debt and emergency credit lines received from India in 2022. They hired legal and financial advisors and have engaged in a dialogue with Sri Lanka's official and private creditors to achieve a durable solution to the debt crisis.

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[1] The project loans from China EXIM Bank to Sri Lanka Port Authority, Ceylon Electricity Board, and Airport and Aviation Services (amounting to about US$1.4 billion) that were previously considered SOE debt have been reclassified as central government debt and transferred to the central government's balance sheet accordingly in February 2023.

Sri Lanka: Decomposition of Public Debt and Debt Service by Creditor, 2023-25 1/

	Debt Stock (end of period, incl. arrears)			Debt Service on end-2022 debt stock (on contractual terms)					
	2022			2023	2024	2025	2023	2024	2025
	(In US$mn)	*(Percent total debt)*	*(Percent GDP)*	*(In US$mn)*			*(Percent GDP)*		
Total public debt	**83,595**	**100.0**	**128.1**	**27,727**	**10,164**	**9,887**	**36.8**	**13.4**	**12.6**
External (foreign law)	**41,474**	**49.6**	**63.6**	**7,356**	**5,190**	**5,803**	**9.8**	**6.8**	**7.4**
Multilateral creditors[2]	11,495	13.8	17.6	1,080	1,141	1,152	1.4	1.5	1.5
IMF	1,062	1.3	1.6	212	244	236	0.3	0.3	0.3
World Bank	3,836	4.6	5.9	284	291	307	0.4	0.4	0.4
ADB	5,973	7.1	9.2	521	525	530	0.7	0.7	0.7
Other Multilaterals	624	0.7	1.0	63	81	80	0.1	0.1	0.1
Bilateral Creditors	11,419	13.7	17.5	1,755	1,167	1,377	2.3	1.5	1.8
Paris Club	4,784	5.7	7.3	473	422	392	0.6	0.6	0.5
o/w: Japan	2,828	3.4	4.3	197	188	180	0.3	0.2	0.2
Non-Paris Club	6,635	7.9	10.2	1,282	745	985	1.7	1.0	1.3
o/w: China	4,483	5.4	6.9	596	576	519	0.8	0.8	0.7
India	1,833	2.2	2.8	653	137	438	0.9	0.2	0.6
Bonds	13,364	16.0	20.5	2,010	2,343	2,741	2.7	3.1	3.5
Commercial creditors	3,159	3.8	4.8	479	540	533	0.6	0.7	0.7
o/w: China Development Bank	2,901	3.5	4.4	477	538	532	0.6	0.7	0.7
Central bank bilateral currency swaps	2,036	2.4	3.1	2,033	-	-	2.7	0.0	0.0
Domestic (local law)	**42,121**	**50.4**	**64.6**	**20,372**	**4,973**	**4,084**	**27.1**	**6.5**	**5.2**
T-Bills	11,364	13.6	17.4	10,404	-	-	13.8	0.0	0.0
Bonds	25,124	30.1	38.5	6,106	4,829	3,946	8.1	6.4	5.0
Loans	5,633	6.7	8.6	3,862	144	138	5.1	0.2	0.2
Memo items:									
Collateralized debt[3]	0	0	0						
o/w: Related	0	0	0						
o/w: Unrelated	0	0	0						
Contingent liabilities									
o/w: Public guarantees	(included in public debt)								
o/w: Other explicit contingent liabilities									
Exchange rate (eop., Rupees/$)	363								
Nominal GDP (billions of Rupees)	23,688								

1/As reported by the Sri Lankan authorities according to their classification of creditors, including by official and commercial. Debt coverage is the same as the DSA.

2/Multilateral creditors" are simply institutions with more than one official shareholder and may not necessarily align with creditor classification under other IMF policies (e.g. Lending Into Official Arrears).

3/Debt is collateralized when the creditor has rights over an asset or revenue stream that would allow it, if the borrower defaults on its payment obligations, to rely on the asset or revenue stream to secure repayment of the debt. Collateralization entails a borrower granting liens over specific existing assets or future receivables to a lender as security against repayment of the loan. Collateral is "unrelated" when it has no relationship to a project financed by the loan. An example would be borrowing to finance the budget deficit, collateralized by oil revenue receipts. See the joint IMF-World Bank note for the G20 "Collateralized Transactions: Key Considerations for Public Lenders and Borrowers" for a discussion of issues raised by collateral.

DSA Assumptions

3. **Macroeconomic assumptions**:

- Real GDP is projected to contract by 3 percent in 2023 before the growth rate starts a recovery toward its medium-term potential of 3.1 percent under the baseline.

- CCPI inflation is projected to trend down from 57 percent (y-o-y) at end-2022 toward 15 percent by end-2023 and back within its target band of 4-6 percent by early 2025.
- Primary balance is projected to improve from -3.8 percent of GDP in 2022 to 2.3 percent of GDP by 2025 under an ambitious but feasible fiscal adjustment underpinned by major tax reforms.
- The real effective exchange rate (REER) is projected to depreciate by about 30 percent in 2022-27, to achieve the external adjustment under the program, and gradually stabilize around its new norm over the medium-term.

4. Financing assumptions:

- Until 2026, external financing is limited to financing from official sources, in line with program assumptions. During the program years (2023-27), official program financing includes about $3 billion from the IMF over 4 years, and $3.75 billion from other multilateral institutions.
- Project loan disbursements are assumed to decline to $1.4 billion in 2023, as most bilateral lenders have scaled back their disbursements following the debt moratorium. Project loan disbursements are assumed to increase to $1.5 billion in 2024 and to grow at 3 percent annually (in U.S. dollar terms) thereafter.
- To be robust to delays in market access, the DSA assumes that external market access is only restored in 2027—in line with the experience of similar EM restructuring cases—with annual international bond issuance of $1.5 billion (1.8 percent of GDP) that year and growing broadly in line with GDP thereafter.
- Residual fiscal financing needs are met from domestic sources, through the issuance of T-bills and T-bonds. As inflation declines towards the target band, domestic T-bond interest rates are assumed to gradually decline from around 21 percent (period average) in 2022 to their steady-state level of around 10 percent in 2026. Similarly, T-bill rates are assumed to decline from around 20 percent in 2022 (period average) to 7.5 percent in 2026. The market rates are expected to adjust higher if inflation surprises on the upside.

5. Materialization of contingent liabilities: Given the weak SOE balance sheets, the DSA assumes that the central government will need to pay the debt service of (i) guaranteed FX debt of SOEs, and (ii) guaranteed local-currency debt of the Road Development Authority, an SOE with very little own revenues. These debts are included in the debt stock used in the DSA. The DSA also assumes that bank recapitalization needs (around 6 percent of 2022 GDP) arise from the recognition of non-performing loans to the private sector caused by the recession, in addition to losses arising from the sovereign debt restructuring. The DSA assumes that banks need capital injections from the government to meet their capital requirements.

Debt Sustainability Targets

6. The authorities' debt restructuring is guided by quantitative targets developed under the IMF Sovereign Risk and Debt Sustainability Framework (SRDSF).[2] The objectives of these targets are (i) to ensure a high likelihood of debt reduction; (ii) to keep rollover risks manageable; (iii) to avoid a renewed buildup of external pressures from debt service needs in the post-program years; and (iv) to ensure that financing gaps during the program period are closed.

7. Specifically, the debt restructuring should meet the following requirements:

- Debt stock: Public debt should decline below 95 percent of GDP by 2032.
- Post-program gross financing needs: average annual gross financing needs of the central government in 2027-32 should remain below 13 percent of GDP.
- Post-program FX debt service: annual FX debt service of the central government should remain below 4.5 percent of GDP in each year over 2027-32.
- Program financing gaps: debt service reduction during 2023-27 should be sufficient to close external financing gaps. Under staff's baseline scenario, US$17 billion in debt service reduction is required, including the arrears accumulated in 2022.

Scenario Without Debt Restructuring

8. Under an illustrative "pre-restructuring" scenario, debt would remain unsustainable, despite the large fiscal adjustment. For illustrative purposes, this scenario assumes that the external financing gap in 2022-27 is closed through additional new external financing, which Sri Lanka does not presently have access to.[3] The charts below show that, under the baseline macroeconomic assumptions, the debt stock and gross financing needs would remain above the targets of 95 percent of GDP and 13 percent of GDP throughout the projection horizon. If additional downside risks were to materialize, debt would fail to stabilize. FX debt service would spike in the post-program period, exceeding the new financing, which would lead to a rapid decline in reserves.

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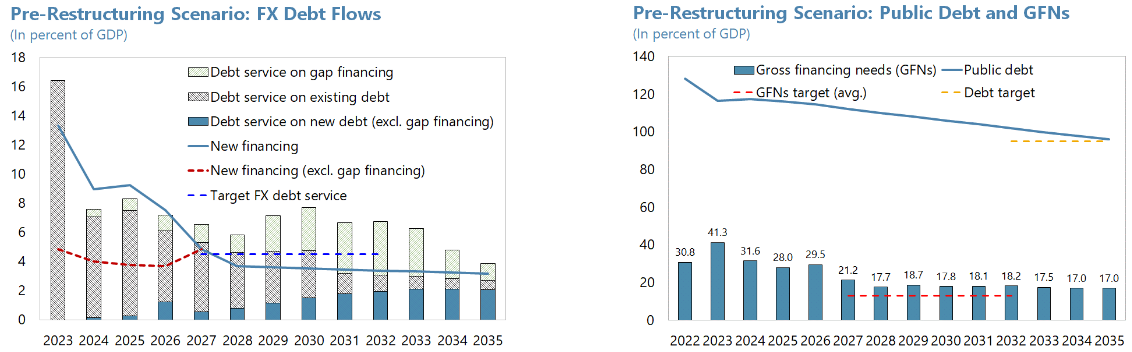
[2] SRDSF is the IMF's new Market-Access Country DSA framework approved in February 2021. The August 2022 staff guidance note lays out the principles for the framework's application in restructuring cases.

[3] Assuming a 6 percent interest rate, 5-year grace period, and 10-year maturity.

Sri Lanka: Debt Dynamics Under an Illustrative Pre-Restructuring Scenario



Sources: Sri Lanka authorities; and IMF staff calculations.

Sources: Sri Lanka authorities; and IMF staff calculations.

Sources: Sri Lankan authorities; and IMF staff calculations.

Restructuring Scenario

9. Staff's restructuring scenario serves purely illustrative purposes. There are many alternative ways of restructuring Sri Lanka's debt that would also achieve the debt restructuring targets described above. The authorities have indicated their objective to take each creditor's specific needs into account when designing the restructuring operation, while also stressing the importance of fair burden sharing across creditors. The perimeter of restructuring is based on preliminary considerations shared by the authorities and their financial advisors, taking into account the need to safeguard domestic financial stability. Accordingly, under the staff's illustrative restructuring scenario: T-bills held by the Central Bank are exchanged into longer term debt instruments[4]; a select pool of the remaining domestic debt is assumed to be reprofiled to reduce gross financing need, while limiting the impact on the financial sector. For external private debt, a principal reduction is assumed, with amortization beyond the program period, implying a large NPV reduction. For official bilateral debt, similar debt relief in NPV terms is assumed, implemented through a long maturity extension – with amortization payments starting in 2033.

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[4] Potential implications on the CBSL's balance sheet and its capital position are contingent liabilities of the government.

Table 1. Sri Lanka: Risk of Sovereign Stress (Restructuring Scenario)

Horizon	Mechanical signal	Final assessment	Comments
Overall	…	High	Sri Lanka is in debt distress. The fiscal adjustment, combined w ith debt restructuring w ill eventually restore debt sustainability. How ever, dow nside risks remain high under a restructuring scenario.
Near term 1/	n.a.	n.a.	Not applicable
Medium term	High	High	Risks remain high under a restructuring scenario due to relatively high levels of debt and GFNs, a strong sovereign-bank nexus, and the economy's vulnerability to large shocks.
Fanchart	High	…	
GFN	High	…	
Stress test	...	…	
Long term	…	High	Long-term risks include slow ing grow th due to a declining labor force and climate vulnerabilities.
Sustainability assessment 2/	…	Sustainable	The debt operation w ill put Sri Lanka on a firm dow nw ard path. But the reduction of debt vulnerabilities to safe levels w ill take time. Meanw hile, external shocks or domestic policy reversals could lead to renew ed debt increase.
Debt stabilization in the baseline			Yes

DSA summary assessment

Sri Lanka is in a deep crisis, as debt is unsustainable. Deep fiscal reforms are necessary but not sufficient to address the situation in a durable manner. Contributions from creditors are therefore needed, along w ith new concessional financing, to restore debt sustainability. Even after a successful program and debt restructuring, debt risks w ill remain high for many years.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress w ithout its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases w here there is a disbursing IMF arrangement. In surveillance-only cases or in cases w ith precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases w here there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases w ith IMF arrangements w ith normal access, the qualifier indicating probability of sustainable debt ("w ith high probability" or "but not w ith high probability") is deleted before publication.

Table 2. Sri Lanka: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	[✓ CG]	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					Yes	

2. Subsectors included in the chosen coverage in (1) above:

		Subsectors captured in the baseline	Inclusion	Comments
CPS NFPS GG: expected CG	1	Budgetary central government	Yes	
	2	Extra budgetary funds (EBFs)	No	
	3	Social security funds (SSFs)	No	
	4	State governments	No	
	5	Local governments	No	
	6	Public nonfinancial corporations	Yes	Guaranteed debt
	7	Central bank	Yes	Fund credit and bilateral swaps
	8	Other public financial corporations	Yes	Guaranteed debt

3. Instrument coverage:	Currency & deposits	[✓ Loans]	[✓ Debt securities]	Oth acct. payable 2/	IPSGSs 3/

	Basis of recording		Valuation of debt stock		
4. Accounting principles:	Non-cash basis 4/	[✓ Cash basis]	Nominal value 5/	[✓ Face value 6/]	Market value 7/

5. Debt consolidation across sectors:	Consolidated	[✓ Non-consolidated]

Color code: 🟩 chosen coverage 🟥 Missing from recommended coverage ▨ Not applicable

Reporting on intra-government debt holdings

		Holder / Issuer	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS NFPS GG: expected CG	1	Budget. central govt	▨						2834	4228	7062
	2	Extra-budget. funds		▨							0
	3	Social security funds			▨						0
	4	State govt.				▨					0
	5	Local govt.					▨				0
	6	Nonfin pub. corp.						▨		702	702
	7	Central bank							▨		0
	8	Oth. pub. fin. corp								▨	0
		Total	0	0	0	0	0	0	2834	4930	7764

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.

2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.

3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.

4/ Includes accrual recording, commitment basis, due for payment, etc.

5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).

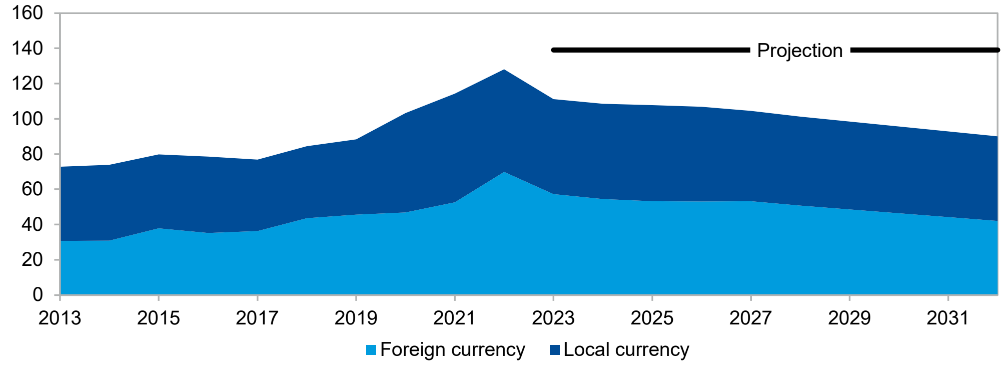
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.

7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

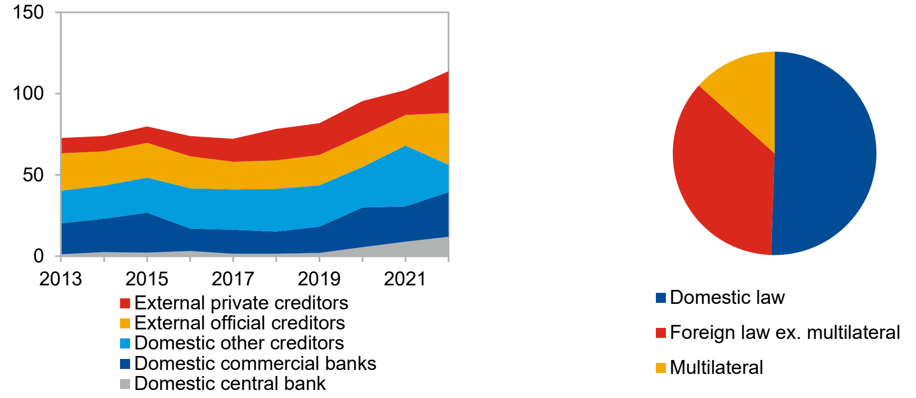
Commentary: The DSA perimeter includes (i) central government debt; (ii) SOE debt guaranteed by the central government; and (iii) liabilities of the central bank arising from the 2016-20 EFF and bilateral swap arrangements. Note: Oth. pub. fin. corp. holdings of CG debt includes holdings by state-owned banks (estimated based on end-September information) but excludes retirement funds.

Table 3. Sri Lanka: Public Debt Structure Indicators

Debt by currency (percent of GDP)



Note: The perimeter shown is central government.

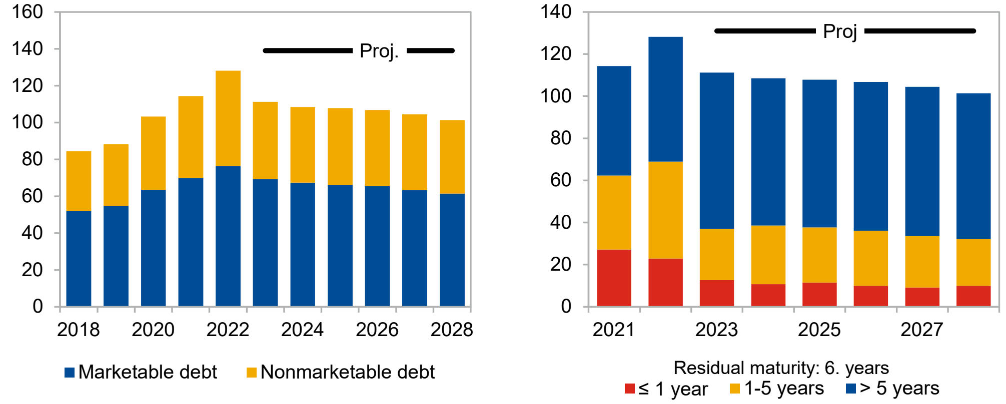


Public debt by holder (percent of GDP)

Public debt by governing law, 2022 (percent)

Note: The perimeter shown is central government.

Note: The perimeter shown is central government.



Debt by instruments (percent of GDP)

Public debt by maturity (percent of GDP)

Note: The perimeter shown is central government.

Note: The perimeter shown is central government.

Commentary: Accelerating inflation has reduced the real value of domestic debt in 2022, while exchange rate depreciation has led to a large increase in external and foreign-currency debt. Foreign-law debt accounts for more than half of Sri Lanka's debt. The debt operation is assumed to rebalance the maturity profile.

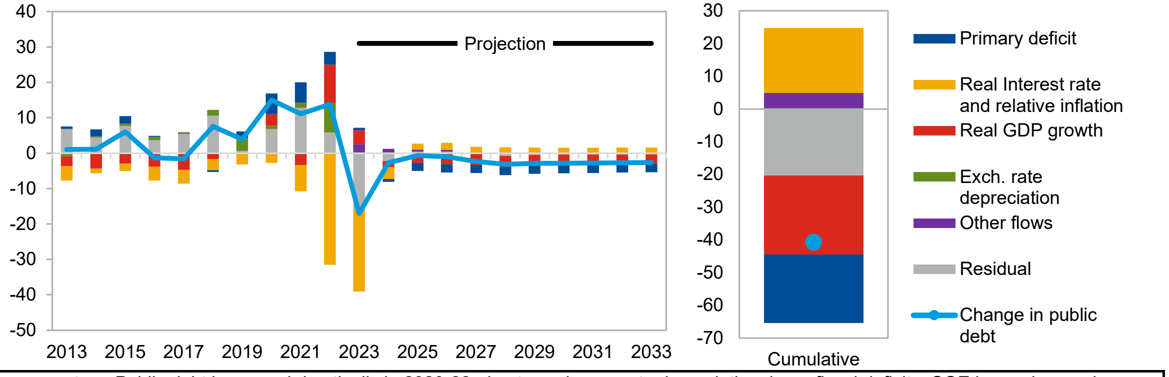
Table 4. Sri Lanka: Baseline Scenario (Restructuring Scenario)

(Percent of GDP unless indicated otherwise)

	Prel.	Medium-term projection						Extended projection				
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Public debt	128.1	111.2	108.5	107.8	106.8	104.4	101.3	98.5	95.6	92.8	90.1	87.5
Change in public debt	13.8	-17.0	-2.7	-0.7	-1.0	-2.4	-3.1	-2.8	-2.8	-2.8	-2.7	-2.7
Contribution of identified flows	7.9	-1.0	-0.4	-1.1	-1.4	-2.2	-2.3	-2.3	-2.4	-2.4	-2.3	-2.3
Primary deficit	3.6	0.7	-0.8	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Noninterest revenues	8.4	10.9	13.3	14.9	15.0	15.1	15.1	15.1	15.1	15.1	15.1	15.1
Noninterest expenditures	12.0	11.6	12.5	12.6	12.7	12.8	12.8	12.8	12.8	12.8	12.8	12.8
Automatic debt dynamics	4.3	-4.2	-0.9	0.7	0.3	0.1	0.0	0.0	-0.1	-0.1	0.0	0.0
Real interest rate and relative inflation	-14.8	-8.2	0.8	3.4	3.5	3.3	3.1	3.0	2.8	2.8	2.8	2.7
Real interest rate	-31.6	-23.2	-3.4	1.7	1.9	1.8	1.7	1.6	1.5	1.5	1.6	1.6
Relative inflation	16.8	14.9	4.2	1.7	1.5	1.5	1.5	1.4	1.3	1.3	1.2	1.2
Real growth rate	10.8	4.0	-1.6	-2.8	-3.1	-3.2	-3.1 .	-3.0	-3.0	-2.9	-2.8	-2.7
Real exchange rate	8.3	…	…	…	…	…	… .	…	…	…	…	…
Other identified flows	0.0	2.5	1.2	0.6	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	0.0	2.5	1.2	0.6	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contribution of residual	5.9	-16.0	-2.3	0.4	0.4	-0.1	-0.8	-0.5	-0.4	-0.4	-0.4	-0.4
Gross financing needs	34.5	26.6	17.9	15.4	15.9	14.2	13.1	14.0	12.2	12.5	12.2	11.5
of which: debt service	30.9	25.9	18.7	17.7	18.2	16.5	15.4	16.3	14.5	14.8	14.5	13.8
Local currency	21.5	21.3	14.5	13.1	14.9	13.0	11.1	11.9	10.0	10.3	10.2	9.8
Foreign currency	9.4	4.6	4.2	4.5	3.3	3.5	4.3	4.3	4.5	4.4	4.3	3.9
Memo:												
Real GDP growth (percent)	-8.7	-3.0	1.5	2.6	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Inflation (GDP deflator; percent)	46.6	30.0	10.7	5.6	5.2	5.1	5.0	5.0	5.0	5.0	5.0	5.0
Nominal GDP growth (percent)	33.9	26.0	12.3	8.3	8.4	8.3	8.3	8.3	8.3	8.3	8.3	8.3
Effective interest rate (percent)	9.7	7.2	7.2	7.3	7.2	6.9	6.7	6.7	6.7	6.7	6.8	6.9

Contribution to change in public debt

(percent of GDP)



Staff commentary: Public debt increased drastically in 2020-22, due to exchange rate depreciation, large fiscal deficits, SOE borrowing, and external borrowing by the Central Bank. In the near term, inflation and contribution from creditors will lead to a sizable drop in public debt. The debt reduction over the longer term rests on continued fiscal discipline.

Table 5. Sri Lanka: Realism of Baseline Assumptions

Forecast track Record 1/	t+1	t+3	t+5
Public debt to GDP	🟧	🟧	
Primary deficit	🟧	▨	▨
r - g	🟥	🟥	
Exchange rate depreciaton	🟧	🟧	🟧
SFA	🟧	🟧	
	real-time	**t+3**	**t+5**
Historical output gap revisions 2/			

Comparator group:

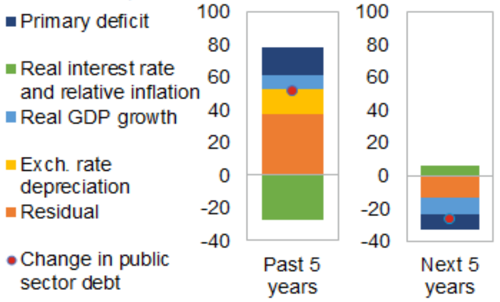
Emerging Markets, Non-Com. Exporter, Program

Color code:

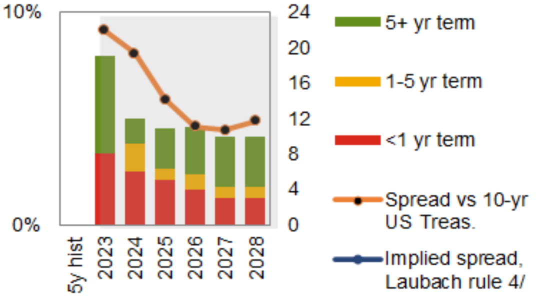
Optimistic	🟥 > 75th percentile 🟧 50-75th percentile
Pessimistic	▨ 25-50th percentile 🟩 < 25th percentile

Public Debt Creating Flows

(Percent of GDP)

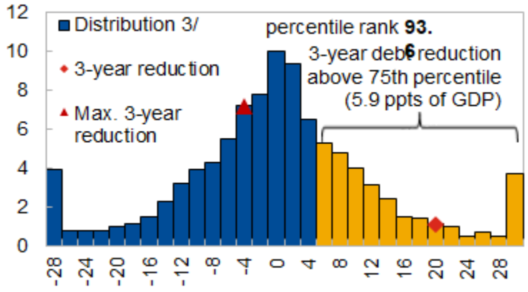


Bond Issuances (bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))

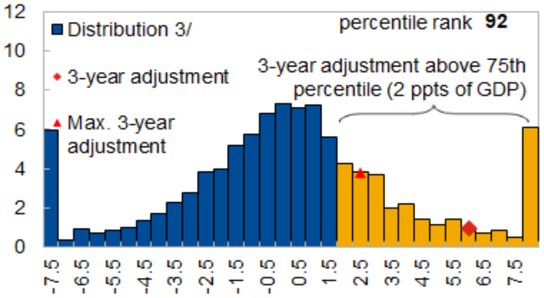


3-Year Debt Reduction

(Percent of GDP)

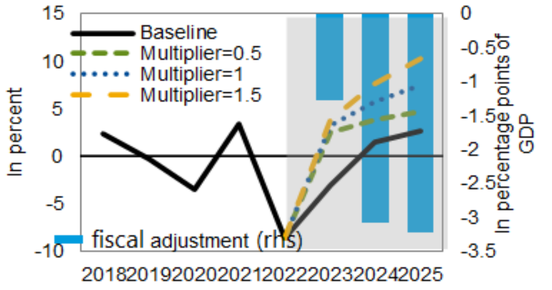


3-Year Adjustment in Cyclically-Adjusted Primary Balance (percent of GDP)



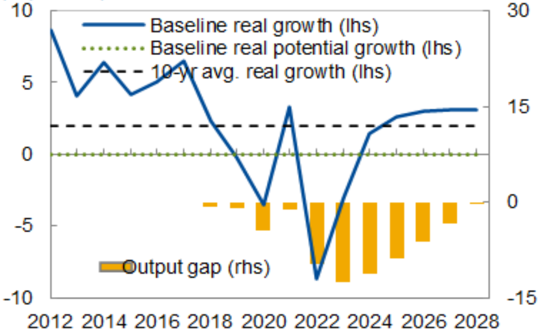
Fiscal Adjustment and Possible Growth Paths

(lines, real growth using multiplier (LHS); bars, fiscal adj. (RHS)



Real GDP Growth

(in percent)



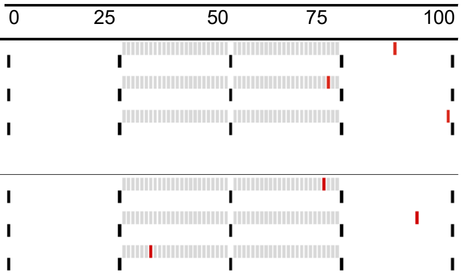
Commentary: Domestic yields are presently high but expected to normalize under the program. The fiscal adjustment efforts are ambitious but backed by identified measures that are needed to restore fiscal sustainability. Growth recovery will be slow due to sovereign default and economic crisis, as well as the associated balance sheet impact.

Table 6. Sri Lanka: Medium-Term Risk Analysis

Debt fanchart and GFN financeability indexes

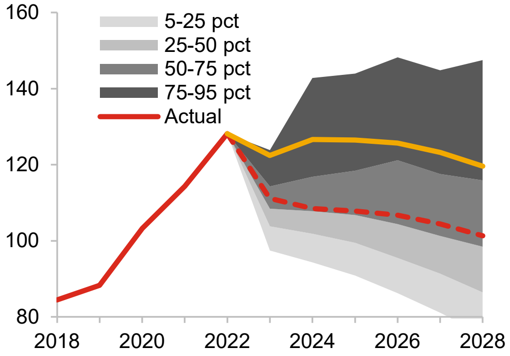
(percent of GDP unless otherwise indicated)

Module	Indicator	Value	Risk index	Risk signal	Emerging Markets, Non-Com. Exporter, Program
Debt fanchart module	Fanchart width	72.0	1.0	…	
	Probability of debt not stabilizing (pct)	11.3	0.1	…	
	Terminal debt level x institutions index	64.5	1.4	…	
	Debt fanchart index	**…**	**2.5**	**High**	
GFN finance-ability module	Average GFN in baseline	15.1	5.1	…	
	Bank claims on government (pct bank assets)	34.1	11.1	…	
	Chg. in claims on govt. in stress (pct bank assets)	12.8	4.3	…	
	GFN financeability index	**…**	**20.5**	**High**	

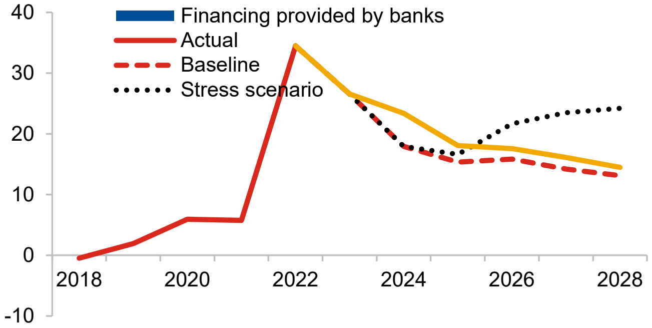


Legend: ▨ Interquartile range 🟥 Sri Lanka

Final fanchart (pct of GDP)



Gross Financing Needs (pct of GDP)

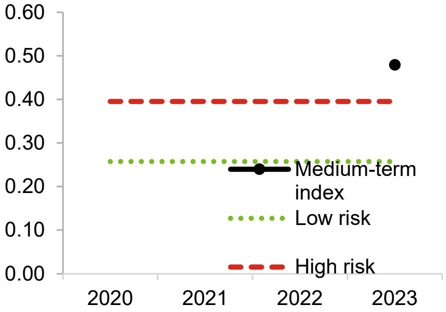


Triggered stress tests (stress tests not activated in gray)

Banking crisis Commodity prices Exchange rate Contingent liab. 🟧 Natural disaster

Medium-term index

(index number)



Medium-term risk analysis

	Low risk threshold	High risk threhsold	Weight in MTI	Normalized level
Debt fanchart index	1.1	2.1	0.5	0.6
GFN finaceability index	7.6	17.9	0.5	0.4
Medium-term index (MTI)	0.3	0.4	…	0.5, High

Prob. of missed crisis, 2023-2028 (if stress not predicted): 54.5 pct.

Prob. of false alarm, 2023-2028 (if stress predicted): 3.4 pct.

Commentary: Both MT tools point to high level of risks, associated with relatively high levels of debt and GFNs, a strong sovereign-bank nexus, and the economy's vulnerability to large shocks.

Annex III. Capacity Development

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
Advancing Fiscal Consolidation and Strengthening Institutions				
Primarily revenue-based fiscal consolidation, accompanied by fiscal institutional reforms and cost-recovery based energy pricing, aimed at restoring fiscal sustainability and strengthening fiscal discipline				
Tax Policy Reforms	Raise the tax-to-GDP ratio to at least 14 percent by 2026, by implementing a sequenced package of tax measures	**FAD/LEG**: VAT Reform; Property and inheritance taxation; Establishing a tax policy unit	The government announced a wide-ranging tax reform package on May 30, 2022 worth about 0.5 percent of GDP in 2022 which increased the marginal personal income tax (PIT); raised the standard corporate income tax (CIT) and removed firm-specific tax holidays; raised standard value added tax (VAT), lowered the VAT registration threshold, and removed some VAT exemptions; and reinstated mandatory income tax withholding.	• **2023**: Reduce the primary deficit to 0.7 percent of GDP by 2023 by (i) increasing the marginal PIT rate schedule; (ii) reintroducing non-final withholding taxes on all payments other than dividends; (iii) removing all sector specific CIT exemptions and unifying the CIT rate structure; (iv) raising the standard VAT rate, removing a selected list of VAT exemptions, and lowering the VAT registration threshold; (v) increasing excises on alcohol and tobacco products; and (vi) introducing a fuel tax. Parliamentary approval of the necessary legislative revisions to implement the 2023 revenue measures will be taken. • **2024**: A primary fiscal surplus of 0.8 percent of GDP will be achieved by (i) abolishing the vast majority of VAT exemptions; (ii) speeding-up valid VAT refunds and abolishing the Simplified VAT system; and (iii) introducing automatic indexation of excises to inflation. • **2025**: A primary fiscal surplus of 2.3 percent of GDP will be achieved by (i) revamping the property tax system and introducing a wealth transfer tax; (ii) introducing a gift and inheritance tax.

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
Revenue Administration	Strengthen tax compliance, enhance fiscal transparency, and reinforce the progressivity of the tax system.	**FAD/SARTTAC**: TADAT Assessment (with WB and ADB); RAMIS diagnostic; Strengthening VAT Management; New LTX for revenue reforms	• A newly introduced paper-based and digital sticker system has already boosted alcohol excise revenues. • The authorities have shifted towards risk-based compliance management, the strengthening of the Large Taxpayer Unit, and the increased use of digitization in revenue administration.	• Develop a robust reform plan in collaboration with authorities to increase efficiency and effectiveness of revenue administration. • Step up administration efforts to ensure compliance with PIT withholding requirements. • Strengthen the capacity of the Large Taxpayer Unit • Strengthen VAT compliance by taking advantage of e-filing and the fully implemented RAMIS IT system. • Strengthen the capacity of the Large Taxpayer Unit
Public Financial Management (PFM)	Strengthen the core PFM functions of macro-fiscal analysis and forecasting, fiscal data collection and reporting, fiscal management, budget formulation and execution, and public debt management through sequenced reforms.	**FAD/SARTTAC**: Training the Macro-Financial Unit (MFU) on Fiscal Risk Management; ITMIS and regular and automated exchange of data between systems; Treasury operations (inc. commitment control and cash management); GFS **FAD/LEG**: PFM Law and Fiscal Rules (with WB); PFM Reform Strategy; New LTX for PFM Reform; Training MFU on Fiscal Rules/MTFF; Budget preparation **WB**: Public Investment	• A draft PFM bill was developed under the 2016-20 EFF program. An updated draft bill along with fiscal rules will be formulated.	• Submit to Parliament new PFM Law (with new fiscal rules) • Complete rollout of the Integrated Treasury Management Information System (ITMIS), a full-fledged IT-based PFM platform. Expand its coverage to all 220 national budget execution agencies • Strengthen MFU's macro-fiscal analytical, forecasting, and reporting capacity. • Progress towards developing a medium-term fiscal framework. • Improve public investment efficiency as recommended by the 2018 Public Investment Management Assessment and updating fiscal reporting to the GFSM 2014 standard.

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
		Management, e-procurement. National Audit Office		
Energy SOEs	Mitigate fiscal risks arising from the energy SOEs	**FAD**: Energy Pricing Reform (TA delivered during the 2016-20 program)	• In 2022H1, retail fuel prices were raised to their cost-recovery levels through multiple price hikes, passing through the surge in global fuel prices and the large depreciation of the rupee to consumers. • Cabinet approved the entry of additional private sector firms into the downstream petroleum sector in June 2022. • Cabinet Memo authorizing reinstatement of 2018 fuel pricing formula was approved by Cabinet on November 21, 2022. • The electricity tariff schedule was increased on August 10, 2022—for the first time in 9 years—by 75 percent on average across different types of consumers. • Cabinet Memo authorizing introduction of automatic tariff adjustment mechanism was approved by Cabinet on November 21, 2022. Under this framework, the electricity tariff schedule was raised by 66 percent on average in February 2023.	• Set retail fuel prices to their cost recovery levels with monthly formula-based adjustments, and compensate the CPC for providing any fuel subsidies with on-budget transfers. • Set the end-user electricity tariff schedule to its cost-recovery with semi-annual formula-based adjustments and compensate the electricity sector for providing any residual subsidies with on-budget transfers. Improve the Bulk Supply Transaction Account (BSTA) to accurately measure the electricity subsidy. • By June 2024, introduce legislative reforms making the Minister of Power and Energy responsible for implementing cost-recovery based fuel and electricity price adjustments.

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
Governance of SOEs	Implement structural reforms to make SOEs financially viable	**WB**: SOE law and regulations; SOE reforms and disinvestment options	• Audited financial statements of several major SOEs for 2021 were published, including CPC.	• Cabinet approval of a comprehensive strategy to restructure the balance sheets of the CEB, CPC, SriLankan Airlines, and the Road Development Authority. • Publish audited financial statements of all 52 major SOEs for 2021 and for 2022 by end-June 2023; • Prohibit new FX borrowing by non-financial SOEs with less than 20 percent of their revenues denominated in FX.
Social Safety Net	Expand spending on social protection, supported by structural reforms to improve social safety nets, with improved coverage and targeting to those in need.	**WB**: Cash transfers, new eligibility criteria, emergency social safety net scheme	• SSN spending was increased in 2022 to help protect the poor during the crisis. Supported by emergency assistance from the World Bank and Asian Development Bank (ADB), top-up and/or additional cash transfers was provided. • The Welfare Benefits Board (WBB) was operationalized to strengthen institutional framework to improve the effectiveness and efficiency of the SSN programs. • A new Social Registry, an electronic database of applicants for welfare programs, will be operationalized by May 2023 and new eligibility criteria for targeted cash transfers have been developed with technical support from the World Bank.	• Parliamentary approval of the welfare benefit payment scheme and the application of the new eligibility criteria to identify low-income families for receiving welfare benefit payments.

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
Statistics	Improve the timeliness, accuracy, and coverage of fiscal data	**SARTTAC**: GFS		• By end-September 2023, the MOF's Department of State Accounts to report monthly cash flows from revenues, expenditures, and financing by the third business day of the subsequent month. • Update fiscal reporting framework to the GFSM 2014 standard. • Form a committee that will hold bi-weekly meetings to address any issues regarding the timeliness, accuracy, and coverage of fiscal data.
Public Debt Sustainability				
A sovereign debt restructuring strategy aimed at restoring public debt sustainability				
Public debt sustainability	Develop a comprehensive strategy to restore debt sustainability, as fiscal consolidation and macroeconomic policy adjustments alone cannot restore Sri Lanka's debt sustainability.		• Fiscal reforms have been undertaken (see section above). • Authorities are engaged with official creditors and continue good-faith negotiations with private creditors on debt treatments.	• Reduce the ratio of public debt to GDP to below 95 percent by 2032 • Reduce the central government's annual gross financing needs below 13 percent of GDP, on average, in 2027-32 • Reduce the central government's annual debt service in foreign currency below 4.5 percent of GDP in every year in 2027-32
Debt Management and Transparency	Improve debt management and transparency	**MCM/LEG/FAD**: Institutional Framework for Public Debt Management; Debt Management Office (with WB) **SARTTAC**: Long-term expert (LTX) to deliver technical assistance on debt management	• A quarterly bulletin on public debt and debt service has been drafted.	• Establish a public debt management agency by December 2023 and complete the establishment of the agency by December 2024. • The MOF to publish a quarterly bulletin on public debt and debt service.

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
Restoring Price Stability and Rebuilding External Buffers				
A multi-pronged strategy to restore price stability and rebuild international reserves under greater exchange rate flexibility				
Price Stability	Deliver the program disinflation path by: (i) maintaining the forward-looking real policy rates at sufficiently positive levels until inflationary pressures are clearly receding; (ii) refraining from monetary financing	**ICD**: FPAS **ICD/SARTTAC**: FPP	The policy rates were raised by 700 basis points in April 2022, 100 bps in July 2022, and 100 bps in March 2023.	• Reduce the headline CCPI inflation and stabilizing it around its target band of 4-6 percent (YoY) by end-2024. • Reduce CBSL's T-bill holdings and discontinue monetary financing
Inflation Targeting Framework	Strengthen the CBSL's independence and modernize its policy framework to enable credible inflation targeting	**MCM**: Central Bank Recapitalization; Monetary Policy Framework and Liquidity Management **LEG:** Central Bank Law	A new draft Central Bank Act (CBA) has been approved by the Cabinet.	Parliamentary approval of the new Central Bank Act
Exchange Rate Flexibility and Rebuilding International Reserves	Allow the rupee to adjust to changing fundamentals; limit FX intervention to truly disorderly market conditions	**MCM**: Exchange rate flexibility (TA delivered during the 2016-20 program)	• Temporarily introduced market guidance to confine daily exchange rate movements within a pre-defined band. Guidance on exchange rate from CBSL has been announced to be removed effective March 7, 2023.	• Rationalize FXI decision based on objective criteria and subordinate it to the CBSL's price stability mandate, while ensuring that FX intervention budget is consistent with meeting the NIR targets. • Foster a deeper and more liquid foreign exchange market and develop adequate systems for managing exchange rate risks

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
Ensuring Financial Stability				
Ensuring a healthy and adequately capitalized banking system and addressing the significant vulnerabilities in the banking system.				
Banking System	Ensure a healthy and adequately capitalized banking system and address the significant vulnerabilities in the banking system	**MCM**: Support on bank diagnostic and recapitalization exercise (via program team); strengthening macro-prudential policy and stress-testing; LTX on bank stress-testing.	Assessors appointed for bank diagnostic exercise	• Completion of the bank diagnostic exercise • Development by the CBSL of a roadmap for addressing banking system capital and FX liquidity shortfalls and intervening in banks assessed to be non-viable. • Determination by the government of the size, instruments, and terms and conditions for potential government recapitalization of viable banks
Financial Sector Supervision and Crisis Management	Strengthen frameworks for financial sector supervision and crisis management	**MCM/LEG**: Support for revision of bank crisis management legislative framework **MCM/LEG**: Support for comprehensive revision of Banking Act **WB**: Deposit insurance operations, single borrower limits, insolvency framework	• A new Banking (Special Provisions) Act has been approved by Cabinet, updating the current Banking Act to strengthen key elements of the CBSL's crisis management powers • Update by the CBSL of the Emergency Liquidity Assistance framework for banks • Drafting of revised Banking Act is underway	• Parliamentary approval of the Banking (Special Provisions) Act • Cabinet and Parliamentary approval of revised Banking Act

Specific Area	Objectives	Ta/Training Engagement	Measures Taken	Future Program Outcomes
Governance of State-owned Banks (SOBs)	Strengthen the resilience and governance of SOBs by ensuring they meet the same regulatory requirements as private banks; ensure SOBs have clearly defined mandates	**MCM/LEG**: Support for comprehensive revision of Banking Act, including its application to SOBs; SOB governance (as part of comprehensive governance diagnostic) **WB**: SOB risk management		• Provisions in the Banking Act to strengthen resilience and governance of SOBs. • Reforms to governance of SOBs and appointment process for directors and senior management
Reducing Corruption Vulnerabilities				
Focused Reforms to Address Governance and Corruption Vulnerabilities				
Governance	• Improve governance by identifying specific priority reforms • Strengthen the asset declaration system and the independence of the CIABOC • Reduce opportunities for corruption by expanding the reliance on digitalization in areas such as revenue administration and procurement.	**LEG**: Review new anti-corruption legislation **LEG/FAD**: Governance diagnostic to assess Sri Lanka's anti-corruption framework **WB**: Parliamentary Budget Support Office	•Draft of the anti-corruption legislation is underway	• Enact new anti-corruption legislation to harmonize it with the United Nations Convention Against Corruption • Publication of the report of an IMF-led governance diagnostic mission •Publish on a semi-annual basis: (i) all significant public procurement contracts; (ii) a list of all firms receiving tax exemptions through the Board of Investment; (iii) a list of individuals and firms receiving tax exemptions on luxury vehicle imports. • Operationalize an online transparency platform by March 2023.
Statistics	Fiscal and debt transparency	**SARTTAC**: GFS	• A quarterly bulletin on public debt and debt service has been drafted which will help enhance debt transparency.	• Improve fiscal transparency by improving the timeliness and accuracy of fiscal data and enhancing debt transparency.

Table 1. Sri Lanka: Capacity Development Activities

TA/Training Missions	Provider	Date
Tax Policy		
Tax Policy Reform	FAD/LEG	Jun 6-17, 2022
VAT and Excise Tax	FAD	Jan 12-25, 2023
Revenue Administration		
Strengthening the Large Taxpayer Office	FAD/SARTTAC/STX/LTX	Feb 15 - Mar 8, 2022
Implement Large Taxpayer Office	FAD/STX	Apr 4-18, 2022
TADAT training	FAD	Dec 5-9, 2022
TADAT Assessment	SARTTAC (with ADB and WB	Jan 9-26, 2023
RAMIS	SARTTAC	Mar 7-20, 2023
Public Financial Management		
Strengthening macro-fiscal unit: Fiscal Analysis and Forecasting	SARTTAC	Mar 15-26, 2021
TA Mission on Strengthening the Macro-Fiscal Unit	FAD/SARTTAC/STX/LTX	Jan 20 - Feb 9, 2022
Macro-Fiscal Unit and MTFF	FAD/SARTTAC/LTX	Sep 19-23, 2022
Fiscal Risks Management	FAD/SARTTAC/LTX	Oct 3-7, 2022
PFM Diagnostic Scoping Mission/ PFM Reform Agenda	FAD/SARTTAC/STX/LTX	Dec 8-20, 2022
Debt Management Office	MCM/LEG (with WB)	Feb 20 - Mar 3, 2023
PFM Law (including fiscal rules)	FAD/LEG	Mar 13-23, 2023
Monetary and Foreign Exchange Operations		
Monetary Policy Operations	MCM/SARTTAC	Jun 1 - Jul 2, 2021
Monetary Policy Frameworks and Implementation	MCM/SARTTAC	Jun 6-17, 2022
Forecasting and Policy Analysis System	ICD/SARTTAC	Nov 28 - Dec 9, 2022
Financial Programming and Policies: National Training	SARTTAC	June, 2023 (planned)
Financial Sector Supervision and Regulation		
Strengthening Technology Risk Management of NBFIs & Building Supervisory Capacity	MCM	May 11 - Nov 12, 2021
FSSR Follow-up and Stress Testing	MCM	May 1 -12, 2021
FSSR Macroprudential TA/ Resident Advisor	MCM	Aug 1, 2021 - July 31, 2023
Liquidity Monitoring	MCM/SARTTAC	Sep 1-9, 2022
Policy discussion on revsion of PSSA	MCM	Oct 24 - Nov 4, 2022
Central Bank Balance Sheet	MCM	Dec 1-12, 2022
Governance and Anti-corruption		
Governance Diagnostic Scoping Mission	LEG	March 9-14, 2023
Governance Diagnostic Mission	LEG/FAD/MCM/FIN	Mar 20-31, 2023
Government Finance Statistics		
Implementing a Strategy for Broadening the Coverage and Scope of GFS to General Government	SARTTAC	Jan 24 - Feb 3, 2022
Expanding Compilation for Whole of Central Government	SARTTAC	Jan 23-27, 2023
Real Sector Statistics		
National Accounts: GDP Rebasing	SARTTAC	Mar 29 - Apr 23, 2021
National Accounts: GDP Rebasing	SARTTAC	Aug 16-20, 2021
Price Statistics: Updating the Index of Industrial Production and PPI	SARTTAC	Nov 1-26, 2021
National Accounts: GDP Rebasing	SARTTAC	Feb 7-8, 2022
Institutional Sector Accounts - Sequence of Accounts	SARTTAC	Nov 21-25, 2022
Updating the CPI	SARTTAC	Dec 19-23, 2022
Others		
Scoping Mission: Model-Based FPP	ICD	Jan 30 - Feb 3, 2023

Annex IV. Reforming the Social Safety Nets

A. Recent Developments and Challenges

1. **The ongoing economic crisis has adversely affected poor households**. The slowdown in economic activities has led to widespread job and income losses, and poorer households have limited access to emergency funding to compensate for income losses. Rapid increase in inflation, particularly food inflation, has disproportionately affected poorer households with a larger share of their budgets spent on food, leading to around 33 percent of the households facing food insecurity (World Food Program, February 2023). The World Bank (2022) estimates that a median poor household in 2022 faced an inflation rate of 66.4 percent in the cost of their consumption bundle, compared to 56.2 percent inflation faced by a median non-poor household.

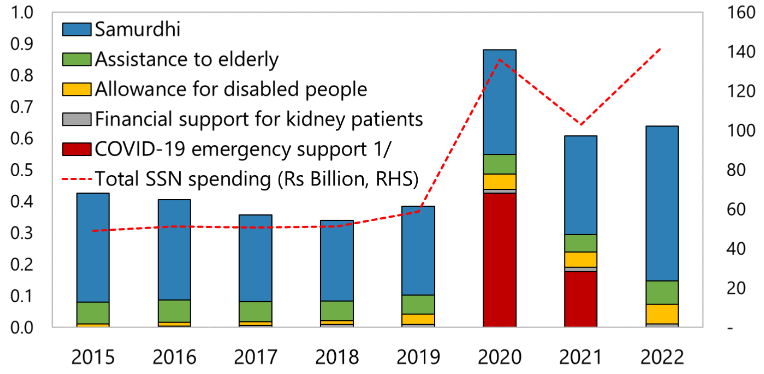
2. **The poverty rate is estimated to have doubled and inequalities have widened over the past two years**. Based on the $3.65 per day poverty line, which is the international threshold for lower middle-income countries, the World Bank estimated that poverty increased from the pre-pandemic rate of 11.3 percent to 25.6 percent in 2022 (World Bank, 2022). Moreover, existing inequalities have widened, as the World Bank report shows that consumption in 2022 would have declined by 9.5 percent among the bottom 40 percent of the population, compared to a decline of 7.1 percent for the top 60 percent. The Gini index is projected to increase from 37.7 in 2019 to 39.9 in 2022 (World Bank, 2022).

3. **As the poor and vulnerable have suffered from the crisis, the Social Safety Nets (SSN) would play a vital role in mitigating the adverse impact**. Sri Lanka's SSN programs monitored under the EFF-supported program comprise the Samurdhi program (largest poverty-targeted cash transfer program in Sri Lanka), as well as assistance to the elderly (over 70 years), allowance for disabled people, and financial support for kidney patients. These SSN programs and their existing delivery systems have been utilized to provide emergency support to the poor and vulnerable since the COVID-19 pandemic and during the ongoing crisis.

4. **Government spending on SSN programs has increased in recent years, in part due to COVID-19 relief in 2020-21 and emergency cash transfers in 2022**. SSN spending was broadly constant at around 0.4 percent of GDP during 2015-19 before increasing to 0.9 percent of GDP in 2020 and 0.6 percent of GDP in 2021 because of additional COVID-19 relief. SSN spending was around 0.6 percent of GDP in 2022, partly due to emergency support of around $326 million (0.4 percent of GDP) from the World Bank and Asian Development Bank that repurposed their existing project loans to provide emergency support for the poor and vulnerable. The number of beneficiaries increased by about 40 percent from 2.3 million in 2019 to about 3.3 million in 2022. Preliminary evidence suggests that this emergency support helped mitigate the impact of the crisis on the poor and vulnerable. For instance, the scaled-up SSN transfers are estimated to have had a poverty-reducing impact of 3.1 percent in 2022, meaning that the poverty rate would have been 28.7 percent, compared to the current projection of 25.6 percent (World Bank, 2022).

Figure 1. Sri Lanka: Spending on Social Safety Net (SSN) Programs, 2015-22

(In percent of GDP)



Source: Ministry of Finance (2021) and World Bank (2022)

1/ The COVID-19 emergency support was given to the existing and waitlisted beneficiaries of the four main SSN programs. However, the disaggregated figures by program was not available.

5. Despite an increase in SSN spending and beneficiaries in recent years, there is significant scope for improving its adequacy, coverage, and targeting.

- ***Adequacy***. In 2019, social assistance in Sri Lanka represented 12 percent of the beneficiary pre-transfer consumption, which is lower than the average of low and upper middle-income countries at over 30 percent (World Bank, 2022). For the four SSN programs considered here, the adequacy of cash transfers was even lower at just 10 percent of average household consumption in the poorest 20 percent of households (Table 1). Despite the increase in the average per-household cash transfers in 2020-22, the real value of cash transfers eroded in 2022, especially for poorer households facing a disproportionately higher rate of inflation.

Table 1. Sri Lanka: Adequacy of SSN Cash Transfers in 2019

Average transfer/ month (Rs)	2,117
Samurdhi	2,067
Categorical	2,290
Total beneficiaries ('000)	2,314
Samurdhi	1,800
Categorical	514
Average monthly household expenditure in the poorest quintile (Rs) [1]	19,246
Adequacy of cash transfers (percent) [2]	11

Source: Ministry of Finance (2022) and DCS (2019)

1/ Based on the 2019 Household Income and Expenditure Survey

2/ Adequacy of cash transfers is defined as the total amount received per beneficiary as a percentage of total household expenditure in the poorest quintile.

- ***Coverage and targeting***. SSN programs in Sri Lanka are fragmented, with several implementation agencies[1], which has led to a lack of ownership and widespread inefficiencies in delivery of SSN programs. For example, the latest available data suggests that the coverage and targeting of Samurdhi beneficiaries have worsened over time. In 2006, over 50 percent of the poorest quintile received Samurdhi transfers, whereas only 38 percent of the poorest quintile received Samurdhi transfers in 2019 (World Bank, 2022). This indicates that beneficiary lists are likely outdated and the lack of transparent eligibility criteria and exit mechanisms could have resulted in some beneficiaries remaining in the Samurdhi program, even when they are no longer eligible. For instance, data shows that around 12 percent of households in the richest quintile received SSN transfers in 2019, indicating that SSN programs suffer from poor targeting.

B. Reform Priorities Under the EFF-Supported Program

Under the EFF-supported program, the authorities intend to address the above challenges by raising the SSN spending and improving the coverage and targeting of the SSN.

6. **The authorities have committed to SSN spending of Rs. 187 billion (0.6 percent of GDP) in 2023**. This spending floor target covers the four SSN programs monitored under the EFF-supported program and takes into account projected inflation in 2023 to mitigate real erosion of the cash transfers per household. Total beneficiaries are initially expected to remain at around 3.3 million (the same level as at end-2022); going forward, the total number of beneficiaries would be determined by the application of the new eligibility criteria (see below). Under the new criteria, the composition is expected to improve owing to lower inclusion and exclusion errors for all SSN programs. Beyond 2023, the authorities plan to maintain SSN spending at least at around 0.6-0.7 percent of GDP.

7. **The authorities are also undertaking far-reaching institutional reforms to improve efficiency, coverage, and targeting of SSN programs**.

- ***Operationalizing the Welfare Benefit Board (WBB)***. As a start, the authorities have operationalized the WBB under the Ministry of Finance as the legal entity responsible for coordination of all SSN programs and reforms. After being dormant since 2019, the WBB was revived in August 2022 with the appointment of a new Chairman and staff, including at the divisional secretariat level. The WBB is entrusted with establishing a social registry, selecting beneficiaries for SSN programs in accordance with prescribed eligibility criteria, and coordinating payments of all welfare benefits. Parliament approved the regulations that have empowered the WBB to carry out the above functions in line with the Welfare Benefits Act, No. 24 of 2002.

- ***Developing a new Social Registry (SR) and eligibility criteria***. In an effort to improve coverage and targeting, and with support from the World Bank, the WBB has been developing a new SR, an electronic database of applicants that would be used to select beneficiaries for SSN

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[1] Currently, SSN programs are implemented by several agencies, including the Department of Samurdhi Development, the National Secretariat for Elders, and the National Secretariat for Persons with Disabilities.

programs. Good progress has been made in populating the SR, with 3.7 million applicants registering to receive welfare payments. In parallel, the WBB has established new eligibility criteria that are based on objective and verifiable household characteristics, such as the status of education, health, income, assets, and housing conditions. The next step would be to start the enumeration process to validate the SR data provided by the applicants. After this, each prospective beneficiary will be ranked based on a deprivation score calculated using the eligibility criteria. Cut-off thresholds will be applied to select the beneficiaries.

- ***Introducing a new Welfare Benefit Payment Scheme***. The Welfare Benefit Payment Scheme specifies details of SSN programs including the date of commencement, the financial benefit to recipients, the period for which recipients are entitled to receive benefits, and the total number of beneficiaries. The new Scheme will cover the four SSN programs monitored under the EFF-supported program. The WBB will finalize the Scheme following the SR data validation process and selection of beneficiaries. Parliamentary approval of the new Scheme, expected by May 2023, would enable benefit payments under the Scheme to commence in June 2023.

- ***Managing the transitional period***. Some current SSN beneficiaries may no longer qualify under the new Scheme, and their welfare benefits are expected to be gradually phased out. In this context, the authorities plan to allow a transitional period until end-2023 to fully implement the new Scheme. Accordingly, by January 2024, ineligible beneficiaries would no longer receive cash transfers and could graduate onto a lighter package of support, such as Samurdhi livelihood programs.

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Annex V. Financial-Sovereign Nexus

Sri Lanka's bank-denominated financial system is heavily exposed to the public sector and moderately capitalized and could face material capital and FX shortfalls following a debt restructuring.

1. The financial system is dominated by banks. Total assets of financial institutions amounted to 141 percent of GDP by the end of 2021. 32 commercial and specialized banks constitute 70 percent of total system assets. Four banks are designated by the CBSL as domestically systemically important. The nonbank financial institutions (NBFIs) consist mainly of deposit-taking Licensed Finance Companies (LFCs), pension funds, and insurance companies (see table below).

Sri Lanka: The Structure of the Financial Sector, end-2021

	Number of Instituitions	Assets in % of GDP	Market Share (%)
Banks		**98.8**	**70.1**
Licensed Commercial Banks (LCBs)	25	85.6	60.7
State-Owned Banks	2	33.1	23.5
Domesitc Private Banks	11	45.0	31.9
Foreign Banks	12	7.6	5.4
Licensed Specialized Banks (LSBs)	7	13.1	9.3
NBFIs		**42.2**	**29.9**
Licensed Finance Companies (LFCs)	44	9.2	6.5
Pension Funds	130	24.3	17.2
Insurance Companies	27	5.2	3.7
Total		**141**	**100**

Source: CBSL and IMF staff estimates

2. The state plays a key role in the financial sector. The two largest commercial banks are state-owned, accounting for over one third of total banking assets. Most specialized banks are fully or significantly government-owned, and the retirement fund sector is dominated by the government-owned Employees' Provident Fund (EPF) and Employees' Trust Fund (ETF), which manage over 90 percent of total retirement fund assets. The government also has indirect ownership stakes in several private banks through the state-owned banks and Employee's Provident Fund.

3. The sovereign-bank nexus is very strong and impairment charges against public sector exposures remain lower than market valuations would imply. Public sector credit exposure accounts for more than 40 percent of banks' assets, and higher at state-owned banks. More than two thirds of this exposure is in domestic currency, and around half in the form of Treasury bonds. Exposures in foreign currency include holdings of Sri Lanka's International Sovereign Bonds (ISBs) and Sri Lanka Development Bonds (SLDBs), and state-owned bank loans to SOEs and the government. While banks have made substantial provisions against their holdings of ISBs in 2022, these still imply lower losses than market valuations of these bonds, which currently trade at prices below 40 percent of par. Banks therefore remain vulnerable to losses arising from debt restructuring. In addition, most local currency government bonds are now accounted for on an amortized cost basis and are booked at well above their current market value, as 10-year T-bond yields have risen to around 28 percent from 12 percent at end-2021.

4. **NBFIs are heavily exposed to sovereign risk through their investments in government bonds**. Pension funds are one of the largest holders of local currency government debt. The EPF holds around 29 percent of total domestic local currency government debt, with 94 percent of its investments in government debt. Similarly, the ETF invested 80 percent of its portfolio in government debt by 2021. In addition, insurance companies are also highly exposed to government debt. Exposures of insurance companies to government debt accounted for 43½ percent of their assets.

5. **Banks could face significant capital and FX shortfalls as a result of a sovereign debt restructuring**. A sovereign debt restructuring will crystalize both sovereign credit risk and FX risk facing the banks. Banks' exposure to the public sector as of end-September 2022 amounts to 33 percent of projected 2022 GDP, more than 5 times their total capital of 6½ percent of GDP. Staff's analysis indicates that, the illustrative restructuring scenario considered in the public debt sustainability analysis (Annex II), combined with a severe asset quality shock consistent with the economic downturn, could result in capital shortfalls for some banks. Private sector capital may be difficult to secure until the economy has stabilized, especially for the state-owned banks. The authorities have therefore committed in the MEFP to a plan for potential bank recapitalization and the DSA includes a contingent liability to reflect this.

6. **Moreover, banks' net open foreign exchange position would deteriorate significantly as a result of a sovereign debt restructuring**. The depreciation of the rupee has increased the share of FX assets from 16 percent at end-2021 to 25 percent of banks' assets. Restructuring of public FX debt, or repayment in rupees could cause banks' FX liabilities to significantly exceed their FX assets. These FX short positions could lead to more losses if the rupee depreciates further, if banks are unable to secure sufficient FX inflows. Thus, banks and the authorities will also require a plan to close the net open FX position in the banking sector.

Annex VI. Central Bank Act

1. **To strengthen central bank legislation, the authorities are committed to introducing a new Central Bank Act under the EFF-supported program**. The current legal framework is governed by the Monetary Law Act (MLA), which was enacted in 1949 and amended several times over the last six decades. The current MLA incorporates the amendments up to 2014. The authorities had attempted to replace the MLA with brand-new legislation under the 2016-20 EFF program, with a bill submitted to Parliament in November 2019. However, the 2019 bill was not enacted. Since mid-2022, the authorities have developed a Central Bank Act (2023 CBA), drawing on the 2019 bill and supported by IMF capacity development. Cabinet approved the 2023 CBA in December 2022, with Parliamentary approval expected by April 2023.

The 2023 CBA has the following key features:

- ***The CBSL's key objectives are clarified***. There has been no hierarchy among objectives under the current MLA. The new CBA clarifies price stability as the CBSL's primary objective, ensuring Sri Lanka's commitment to becoming a flexible inflation targeter under a flexible exchange rate regime. It also clarifies financial stability as a secondary objective of the CBSL.

- ***The CBSL's autonomy will be strengthened***. Under the current MLA, the Secretary to the Treasury, a key senior government official from the Ministry of Finance, is a member of the Monetary Board at the CBSL. Since the Monetary Board is in charge of monetary policy decisions, the government has significant influence on monetary policy, jeopardizing central bank autonomy. To prevent this and enhance the CBSL's institutional autonomy, the new CBA removes the government representation from both the Governing Board (which oversees the CBSL's decision making and daily operations other than monetary policies) and the Monetary Policy Board (which is in charge specifically of monetary policies). The qualification criteria also closes any potential loophole for future appointment of government officials as members of the Monetary Policy Board or Governing Board as the new CBA automatically disqualifies the government officials from being board members.[1]

- ***Monetary financing will be prohibited***. Under the MLA, the CBSL is allowed to provide advances and guarantees to the government and participate in primary T-bill auctions (participation in primary T-bonds auctions is prohibited). Monetary financing through primary T-bill auctions has happened frequently when fiscal deficits widened and/or the government faced financing shortfalls. As a result, sizable purchases of government securities and by the CBSL during the crisis have contributed to acceleration of inflation and dented the credibility of the

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[1] A Monetary Policy Board will be established to formulate monetary policy, while the Governing Board will have explicit oversight functions including approving the CBSL's budget, overseeing financial reporting, risk management and internal controls.

CBSL's inflation targets.[2] To restore price stability and limit fiscal dominance in the future, the new CBA will prohibit monetary financing. Specifically, the CBSL will be prohibited from (i) purchasing securities issued by the government or any other public entity in the primary market, and (ii) directly or indirectly granting credits to the government or any public entities.

- ***Transparency and accountability for the CBSL will be enhanced***. In addition to the current publication of the annual report and financial statements, the new CBA legally mandates the CBSL to communicate Monetary Policy Board decisions. It also requires the CBSL to submit reports to the Minister of Finance in the event of economic disturbances threatening price stability. The new Act provides a legal underpinning for the establishment of the Audit Committee, consisting of non-executive Board members, to assist the Governing Board in its oversight of the CBSL.

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[2] Li, Mike (2022), "Government Financing During COVID-19 and Its Implications for Money and Inflation in Sri Lanka". Sri Lanka Selected Issues Paper.https://www.imf.org/en/Publications/CR/Issues/2022/11/10/Sri-Lanka-Selected-Issues-Sri-Lanka-Selected-Issues-525593.

Annex VII. Governance Diagnostic and Anti-Corruption Legislation

Addressing corruption vulnerability is critical to ensure sustainable and inclusive economic recovery in Sri Lanka. The Government has made progress with drafting a new anti-corruption legislation that includes significant improvements, with further efforts needed to ensure full compliance with the UNCAC standards. More importantly, a more comprehensive reform agenda is needed to effectively address corruption, which would be supported and guided by IMF's Governance Diagnostic Assessment and the recommendations from this exercise.

Governance Diagnostics

1. IMF's Governance Diagnostic (GD) mission will provide a comprehensive assessment of Sri Lanka's governance weaknesses and corruption vulnerabilities.

- ***Objective***. At the request from the authorities, GD will examine the severity of corruption in Sri Lanka and identify key governance weaknesses and corruption vulnerabilities that are macro-economically critical. It will also assess the adequacy of the anti-corruption framework and policies given the nature of corruption vulnerabilities and international commitments. GD does not aim to identify corrupt institutions, individuals, or transactions.

- ***Scope***. GD will identify governance weaknesses and corruption risks across six core state functions: (i) fiscal governance, (ii) financial sector oversight, (iii) central bank governance, (iv) market regulations, (v) rule of law, and (vi) AML/CFT.[1]

- ***Modality***. The GD mission comprising IMF experts on the core functions will interact with the authorities to gather information, consult on findings, and develop recommendations. It will also engage with broader stakeholders including civil society organizations and international partners to collaborate on governance reforms.

- ***Output***. The findings will be published in a Governance Diagnostic report by September 2023.[2] The report is expected to include a holistic set of prioritized, tailored, and sequenced recommendations to reduce exposure to corruption risks and improve governance. It will inform subsequent IMF engagement with the authorities on specific reform measures and capacity development support.

Anti-Corruption Legislation and Implementation

2. The authorities are committed to introducing new anti-corruption legislation aimed to significantly improve the legal and institutional framework for addressing corruption. The new

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[1] For detailed description of the six functions, see the 2018 IMF policy paper titled "Review of 1997 Guidance Note on Governance - A Proposed Framework for Enhanced Fund Engagement" (https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/04/20/pp030918-review-of-1997-guidance-note-on-governance), page 13-15.

[2] Past governance diagnostic reports are published at the IMF website: https://www.imf.org/en/Topics/governance-and-anti-corruption.

anti-corruption law is currently being reviewed by a government review committee before submission to the Parliament; it is expected to be enacted by June 2023. The draft law provides for: (i) the creation of an anti-corruption commission vested with the authority to initiate investigations on its own accord; (ii) asset declaration requirements for public officers in accordance with the G-20 High-Level Principles on asset disclosure by public officials, including coverage of officials and reporting standards; (iii) a strengthened conflict of interest system that clearly establishes standards and procedures to avoid private influence on public decisions; (iv) the creation of a centralized system to receive, manage, verify asset and conflict declarations; and (v) dissemination of asset declarations to the public. To ensure full compliance with United Nations Convention against Corruption (UNCAC), the authorities plan to introduce an additional bill by March 2024 that covers comprehensive asset recovery provisions with technical assistance from the IMF. Asset recovery provisions, as required by UNCAC, include measures to identify, trace, freeze return and dispose foreign assets upon conviction. Moreover, the new anti-corruption law should clearly delineate a transparent and merit-based process for the selection of independent commission members as required by UNCAC.

3. Timely implementation of the anti-corruption legislation is important. For example, it is recommended to specify a timeline for implementing electronic asset declaration system and verification, and the interaction of the Commission with other law enforcement and oversight agencies giving the overlapping offenses in the draft. This is particularly relevant for corruption-related offenses in the Penal Code and the Money Laundering Act.

4. The adoption of a new anti-corruption law should be part of a broader and more comprehensive anti-corruption agenda. Establishing platforms for meaningful public participation would be essential to the success of a broader anti-corruption agenda in Sri Lanka. In addition, a successful anti-corruption agenda should aim to ensure that anti-corruption institutions have sufficient resources and members of the judiciary are independent and qualified, while also promoting international cooperation, particularly with regards to proceeds of corruption.

Appendix I. Letter of Intent

March 6, 2023
Colombo

Ms. Kristalina Georgieva
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Georgieva:

Sri Lanka is facing the worst economic crisis in its history. With virtually depleted foreign exchange reserves, the population is suffering from acute shortages of food, fuel, and pharmaceuticals and from cuts in power and water. Following a sharp depreciation of the rupee in April 2022 and rising world prices for food and fuel, inflation peaked at 70 percent in September 2022. With growth and revenues weakening, the government has faced acute cashflow problems. Poverty is rising sharply and the effects of the crisis on the poor and most vulnerable are dire. The confluence of consecutive economic and global shocks in recent years and ill-timed policy choices against the backdrop of institutional weaknesses have contributed to the current crisis. We are determined to use this opportunity to durably address the institutional weaknesses.

We fully commit to undertake a comprehensive economic adjustment program to address the crisis and restore sustained and inclusive growth. We have already taken significant adjustment measures. Parliament approved 2022 and 2023 budgets as well as tax policy measures to achieve an ambitious fiscal adjustment. Fuel and electricity prices were raised in line with international prices. Social safety net reform is underway to dramatically improve its effectiveness in assisting the poor and vulnerable. The Central Bank of Sri Lanka (CBSL) tightened monetary policy, the Cabinet approved a new Central Bank Act to bolster central bank autonomy, and the CBSL's crisis management powers have been strengthened.

In support of Sri Lanka's economic program, we request that the Executive Board of the IMF approve a 48-month Extended Arrangement under the Extended Fund Facility (EFF) in the amount of SDR 2,286 million (395 percent of quota) for balance of payments and budget support. We also request that the IMF Executive Board approve to make available SDR 254 million (43.9 percent of quota) upon approval of the arrangement. The Extended Arrangement will catalyze financial support from Asian Development Bank and the World Bank, helping us to rebuild confidence in the Sri Lankan economy.

The attached Memorandum of Economic and Financial Policies (MEFP) sets out the specific plans and policies that we intend to implement under our IMF-supported program. The implementation of the program will be monitored through quantitative targets and structural benchmarks as described in the MEFP and in the attached Technical Memorandum of Understanding (TMU). There will be eight semi-annual reviews by the IMF under the IMF arrangement to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

We also commit to restore Sri Lanka's public debt sustainability. Following our declaration of a debt service standstill in mid-2022, we have actively engaged with our creditors in a transparent manner. We have already received financing assurances and consent from major bilateral official creditors and engaged in a good faith effort to reach a collaborative agreement with private external creditors. We commit to continue working with all creditors to achieve a debt treatment consistent with program parameters. We also reiterate our commitment to transparency and a comparable treatment of all our external creditors. The MEFP sets out our specific commitments in this regard.

In line with the IMF's policies, the CBSL has undergone an update safeguards assessment, which was completed in February 2023. We will put in place a memorandum of understanding between the Central Bank of Sri Lanka and the Ministry of Finance that clarifies the responsibilities for timely servicing of our financial obligations to the IMF. We request the temporary approval of all exchange restrictions and multiple currency practices that can be approved under the IMF's policies.

We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but we will take any additional measures that may become appropriate for this purpose. We will consult in advance with the IMF on the adoption of these measures and on any revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultation. We will refrain from policies that would be inconsistent with the program's objectives. We will provide IMF staff with the data and information it requests for the purpose of program monitoring.

In keeping with its policy of transparency, we consent to the IMF's publication of this letter and its attachments as well as the associated staff report.

Sincerely yours,

/s/

Ranil Wickremesinghe
Minister of Finance, Economic Stabilization,
and National Policies

/s/

Nandalal Weerasinghe
Governor
Central Bank of Sri Lanka

Attachments: - Memorandum of Economic and Financial Policies

- Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

I. Background

1. Sri Lanka encountered the most challenging year in 2022 in its post-independence economy history. Headwinds due to consecutive economic shocks in recent years, including the Easter Sunday attacks in 2019, the outbreak of COVID-19 in 2020, and its protracted impact on activity in 2021, the socioeconomic and political crisis in 2022 amidst catastrophic balance of payments pressures, along with unprecedented policy tradeoffs, have severely affected economic activity, inflicting significant hardships to individuals and businesses. Livelihoods were lost, as real incomes plummeted. Structural economic impediments that existed across various spheres of the economy over decades were compounded by these economic shocks, along with ill-timed policy choices, thereby loosening macroeconomic balances and resulting in a sudden and multipronged setback for our nation.

II. Economic Program

2. To restore macroeconomic stability and public debt sustainability in Sri Lanka, we have embarked on a comprehensive economic reform program that rests on the following key pillars: (i) an ambitious primarily revenue-based fiscal consolidation, accompanied by fiscal institutional reforms and cost-recovery based energy pricing, aimed at restoring fiscal sustainability and strengthening fiscal discipline; (ii) a stronger social safety net to protect the most vulnerable; (iii) a sovereign debt restructuring strategy aimed at restoring public debt sustainability, (iv) a multi-pronged strategy to restore price stability and rebuild international reserves under greater exchange rate flexibility; (v) policies to safeguard financial stability; (vi) focused reforms to address governance and corruption vulnerabilities; and (vii) broader structural reforms to unlock Sri Lanka's growth potential.

3. The economic situation remains difficult and is expected to gradually stabilize under the program baseline scenario:

- Real GDP is projected to contract by 8.7 percent in 2022 and 3 percent in 2023, and to converge gradually towards growth of 3.1 percent over the medium term. This reflects, among others: (i) fuel shortages, power cuts, and supply disruptions of intermediate goods (including construction materials and fertilizer) in the near term; (ii) significant fiscal policy tightening under the program; and (iii) the banking sector's limited capacity to support private sector activity. Our commitments under this economic program will help restore confidence, improve liquidity in foreign exchange that alleviates shortages and help tourism to recover. This should help stabilize the economy and restore economic growth.

- Inflation slowed to 57 percent by end-2022 due to easing food inflation, following a surge driven by sharp rupee depreciation and imported inflation, that peaked by September. Tight monetary policy under the program, together with the moderation of imported inflation and base effects, will support a disinflation path consistent with the target bands under the Monetary Policy Consultation Clause (¶17), and toward the CBSL's target band of 4-6 percent by end-2024.

- Fiscal adjustment, recovery in tourism, and competitiveness gains through exchange rate adjustment will help restore a non-interest current account surplus in the near term, supporting rebuilding reserves.

III. Advancing Revenue-Based Fiscal Consolidation and Reforms to Social Safety Nets, Fiscal Institutions, and SOEs

4. We are committed to undertaking an ambitious primarily revenue-based fiscal adjustment while protecting the vulnerable. Our program will achieve a central government primary surplus of 2.3 percent of GDP by 2025 and in subsequent years. To reach this target, the primary balance will improve from -3.8 percent of GDP in 2022 (preliminary estimate) to -0.7 percent of GDP in 2023, and 0.8 percent of GDP in 2024 (**quantitative performance criterion**). Throughout the program, we will ensure that the national budgets approved by Parliament are consistent with program parameters including the targets on the primary balance, revenues, and non-interest expenditure, and that needed revenue measures are approved by Cabinet by July of the preceding year (**structural benchmarks**). The 2023 Appropriation Bill (which sets spending limits for line ministries) submitted to Parliament in October 2022 was consistent with the program targets (**prior action**) and so was the final 2023 budget approved by Parliament. We will ensure that the burden of adjustment falls on those who can shoulder it, by making the tax system more progressive. To shield vulnerable households from the impact of the crisis and macroeconomic adjustments, we will expand spending on social protection, supported by structural reforms to improve social safety nets, with improved coverage and targeting to those in need (see ¶9). Quantitative targets will ensure our commitment to (i) increase tax revenue collection (**indicative target**), (ii) protect and increase social safety net spending (**indicative target**), (iii) reduce the stock of budget expenditure arrears to zero (**quantitative performance criterion**), and (iv) limit the issuance of treasury guarantees (**indicative target**).

5. In 2022, fiscal policy was guided by the revised 2022 budget. The revised 2022 budget approved by Parliament was in line with program parameters (**prior action**) and targeted a 2022 primary deficit of Rs 954 billion (4.0 percent of GDP), supported by the revenue measures introduced in 2022 (see ¶6). The outturn overperformed relative to this target by Rs 59 billion (0.25 percent of GDP).

- In the revised budget, capital expenditure was limited to Rs 801 billion. We have allocated Rs 140 billion in additional cash transfers to ease the effects of the crisis on vulnerable households. While the electricity tariff increase on August 10 reduced the losses incurred by the Ceylon Electricity Board (CEB) in 2022, we allocated Rs 93 billion to cover the remaining losses. While the 2022 outturn was broadly in line with the revised budget, capital spending reached only Rs 715 billion (3 percent of GDP).

- The revised 2022 budget also allowed for short-term government loans to the Ceylon Petroleum Corporation (CPC) to address the fuel emergency. The loans amounting to US$0.7 billion were initially due to be repaid to the government by end-2022. However, CPC is now required to make advance payments on its purchases of fuel, due to arrears to banks and suppliers, and therefore has larger than expected working capital requirements. To avoid a disruption of fuel supplies, the loan has been extended and will be repaid in 2023.

6. To achieve the needed fiscal consolidation, we have announced and begun to implement an ambitious and progressive tax reform package. At 7.3 percent in 2021, Sri Lanka's tax revenue to GDP ratio was among the lowest in the world. We aim to raise the ratio to at least 14 percent by 2026, by implementing a sequenced package of tax measures including (see Appendix 1):

- The government announced a wide-ranging tax reform package on May 30, 2022, worth about 0.5 percent of GDP in 2022 (1.2 percent of GDP in annual terms). This package proposed: (i) increasing the marginal personal income tax (PIT) rate schedule, raising the top marginal rate to 32 percent and reducing the tax-free allowance to Rs 1.8 million, with the tax rate rising by 4 percentage points for every Rs 1.2 million above this allowance up to the top rate; (ii) raising the standard corporate income tax (CIT) rate from 24 to 30 percent and removing some firm-specific tax holidays; (iii) raising the standard value added tax (VAT) rate from 8 to 12 percent, lowering the VAT registration threshold to Rs 120 million, and removing some VAT exemptions; and (iv) reinstating mandatory income tax withholding. The VAT rate hike took effect on June 1.

- However, additional and more ambitious revenue measures were needed to reduce the primary fiscal deficit to 0.7 percent of GDP by 2023. We have therefore implemented additional tax measures, including: (i) increased the marginal PIT rate schedule, setting the top marginal rate to 36 percent and the tax-free allowance to Rs 1.2 million, with the tax rate rising by 6 percentage points for every Rs 0.5 million above this allowance up to the top rate; (ii) reintroduced non-final withholding taxes on all payments other than dividends, and introduced a final withholding tax for dividends, at the tax rates specified under the May 30 tax reform package; (iii) removed all sector-specific CIT exemptions, unifying the CIT rate structure at the standard rate of 30 percent; (iv) raised the standard VAT rate from 12 to 15 percent, removed a selected list of VAT exemptions, and lowered the VAT registration threshold to Rs 80 million; (v) increased excises on alcohol and tobacco products by 20 percent each on January 3, 2023, and January 1, 2023, respectively, and will do so again before end-June 2023, with the latter adjustment subject to review in consultation with IMF staff; and (vi) increased fuel excises yielding 0.3 percent of GDP. We obtained Cabinet approval of the revenue measures needed for programmed fiscal consolidation in 2023 (**prior action**). Legislative revisions needed to implement the 2023 revenue measures were approved by Parliament in December 2022.

- To realize a primary fiscal surplus of 0.8 percent of GDP by 2024, we will revamp the VAT system. In particular, we will abolish the vast majority of exemptions. In parallel, we will take measures to significantly speed up valid VAT refunds and abolish the Simplified VAT (SVAT) system. The reform proposal will be submitted to Cabinet for approval by April 2023. To prevent the erosion of excise taxes in real terms, we will introduce automatic indexation of excises to inflation by January 1, 2024.

- To reach a primary fiscal surplus of 2.3 percent of GDP by 2025, we will revamp the property tax system and introduce a wealth transfer tax. In particular, we will introduce a nationwide real property tax, and adjust the system of transfers between the central and provincial governments. We will also introduce a gift and inheritance tax with a tax-free allowance and minimal exemptions. Preparatory work for these tax reforms will commence by mid-2023, supported by IMF technical assistance.

7. Revenue administration reforms are needed to strengthen tax compliance, enhance fiscal transparency, and reinforce the progressivity of the tax system. A newly introduced paper-based and digital sticker system has already boosted our alcohol excise revenues. To strengthen PIT collection, we made withholding tax mandatory for all employees earning more than the tax free allowance, and imposed withholding tax on service payments exceeding Rs 100,000 per month to individuals such as high-income professionals at the rate of 5 percent, both effective from January 1, 2023 (included in the May 30 tax package). We will step up administration efforts to ensure compliance with these withholding requirements. We will also continue to strengthen the capacity of the Large Taxpayer Unit by adopting the recommendations from IMF TA; will strengthen VAT compliance, taking advantage of VAT e-filing and the fully implemented RAMIS IT system; will document all tax expenditures provided under the Strategic Development Projects and Board of Investment Acts; and will implement necessary measures and arrangements to ensure timely implementation of the SVAT abolishment and the VAT refund reform, as well as the introduction of the property, gift, and inheritance taxes.

8. We will reinforce the primarily revenue-based fiscal consolidation with expenditure rationalization, while preserving spending on priority areas. To contain recurrent expenditure, we will develop strategies to limit growth in the public sector wage bill and public pension spending, while avoiding salary cuts and allowing for limited public sector salary and public pension payment increases to partially account for inflation during the program within the program's primary balance targets. Given fiscal space constraints on capital expenditure, we will take measures to boost public investment efficiency, as recommended by the 2018 IMF Public Investment Management Assessment. While expenditure rationalization will contribute to fiscal consolidation, we will preserve spending on health, education, and social protection.

9. We will enhance Social Safety Nets (SSN) to help cushion the poor and vulnerable from the impact of the economic crisis and policy adjustments. We will gradually raise the spending on SSN programs and improve the coverage and targeting to reduce inclusion and exclusion errors.

- We increased the SSN spending in 2022 to help protect the poor during the crisis. Supported by emergency assistance from the World Bank and Asian Development Bank (ADB), we have been providing top-up and/or additional cash transfers to reach Rs 5,000-7,500 per month per family during May-December 2022 to 2.5 million existing recipients and 0.8 million waitlisted recipients of the Samurdhi program (the largest poverty-targeted cash transfer program) and categorical programs (benefits for elderly, disabled, and chronic kidney disease). The SSN spending on these programs have reached Rs 142 billion in 2022 (0.6 percent of GDP).

- Under the program, we plan to implement a deep reform of SSN programs by raising SSN spending and improving the coverage and targeting. On the categorical programs, we plan to improve the coverage by including all eligible recipients and increasing the per-beneficiary amount. In 2023, with support from the World Bank, we plan to provide new cash transfers targeted to the poorest quintile of households by implementing new selection criteria (see below).

- In this context, we will gradually raise the budget allocation of SSN spending during the program to help cushion the potential impact of macroeconomic adjustment on the poor and vulnerable groups. To achieve this, a spending floor on SSN spending of Rs 187 billion in 2023 (**indicative target**) that comprises cash transfers under the Samurdhi and the abovementioned three categorical programs have been set under the program. Towards this goal, we allocated Rs 134.33 billion in the 2023 budget and received Cabinet approval for an additional Rs 53.75 billion for spending on these SSN programs through the contingency budget allocation under the Department of National Budget. Additionally, we will raise and protect social spending related to nutrition and education (i.e., school nutrition program and nutrition for expectant mothers) over the medium-term.

- In parallel, we are strengthening our institutional framework to improve the effectiveness and efficiency of the SSN programs. We have operationalized the Welfare Benefits Board (WBB) under the Ministry of Finance, appointed the Chairman and assigned staff, and will obtain parliamentary approval of all WBB-related regulations to ensure that the WBB is fully functional as the key coordination agency for all welfare relief benefits including SSN programs and reforms. The WBB would carry out registration, selection and validation of beneficiaries, and coordinate payments of welfare benefits. We have been developing a new Social Registry, an electronic database of applicants for welfare programs used to select beneficiaries for the programs, and have populated the new registry. With the aim of finalizing the Social Registry, we will complete data validation of the registered applicants. To improve coverage and targeting of these programs, new eligibility criteria for targeted cash transfers based on objective and verifiable characteristics were developed with technical support from the World Bank and approved by Parliament in February 2023. We will obtain Parliamentary approval of the welfare benefit payment scheme and the application of the new eligibility criteria to identify low-income families for receiving welfare benefit payments by May 2023 (**structural benchmark**), so that the process for selecting the beneficiaries using the new eligibility criteria could start in June 2023. We will ensure that the WBB would be able to use the new eligibility criteria to select beneficiaries of the four SSN programs. Starting from January 2024, no ineligible beneficiaries will receive Samurdhi cash transfers. In facilitating the transition process, we are also developing a program under which the Samurdhi recipients who no longer require full support are graduated onto a lighter package of support such as the Samurdhi livelihood program. In terms of institutional arrangement, we are establishing donor coordination teams within the Ministry of Finance to lead discussions on external financing for SSN programs.

10. We will implement automatic fuel and electricity pricing mechanisms to mitigate fiscal risks arising from the energy SOEs. With retail fuel and electricity prices generally set below cost-recovery levels on a discretionary basis, the Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) have generally been loss-making for years, and the resulting debt overhang has hindered needed infrastructure investments. While retail fuel prices have been adjusted in line with cost-recovery following multiple price hikes, retail electricity prices remained below cost-recovery levels until they were adjusted early 2023. To depoliticize energy pricing:

- We obtained Cabinet approval to automate monthly retail fuel price adjustment as prescribed by the 2018 fuel pricing formula to achieve cost recovery (**prior action**). Going forward, consistent with this Cabinet approval, we will set retail fuel prices to their cost-recovery levels on a monthly basis using the formula, and will compensate the CPC for providing any residual fuel subsidies with on-budget transfers (**continuous structural benchmark**).

- We obtained Cabinet approval to automate semi-annual cost-recovery based electricity price adjustment (**prior action**). Electricity tariffs were raised significantly by 75 percent in August 2022 and by 66 percent in February 2023. Going forward, consistent with this Cabinet approval, the end-user electricity tariff schedule will be adjusted to its cost-recovery level (overall across different types of final consumers) with semi-annual formula-based adjustments on a forward-looking basis in January and July each year (effective from January 1 and July 1, respectively); the CEB will submit tariff revision requests to the Public Utility Commission of Sri Lanka by end-October (for January tariff revisions) and by end-April (for July tariff revisions); and we will compensate the electricity sector for providing any residual electricity subsidies with on-budget transfers (**continuous structural benchmark**). We will improve the Bulk Supply Transaction Account (BSTA) to accurately measure the electricity subsidy, and will start using it to determine the cost-recovery based electricity tariff and government transfer requirement by December 2023 (**structural benchmark**).

- To ensure that the CPC and the electricity sector are fully compensated for the residual fuel and electricity subsidies with on-budget transfers, a zero ceiling on the cost of non-commercial obligations for fuel and electricity (net of government transfers) will be set under the program (**indicative target**; see the Technical Memorandum of Understanding for detail).

- By June 2024, we will introduce legislative reforms making the Minister of Power and Energy responsible for implementing cost-recovery based fuel and electricity price adjustments.

11. We will improve the timeliness, accuracy, and coverage of fiscal data. By end-September 2023, the MOF's Department of State Accounts will report monthly cash flows from revenues, expenditures, and financing by the third business day of the subsequent month. We will also update our fiscal reporting framework to the GFSM 2014 standard. Finally, we will form a committee that will hold bi-weekly meetings to address any issues regarding the timeliness, accuracy, and coverage of fiscal data.

12. We will strengthen the core public financial management (PFM) functions of macro-fiscal analysis and forecasting, fiscal data collection and reporting, fiscal management, budget formulation and execution, and public debt management through sequenced reforms. Under the current PFM framework and practice, government budgets have systematically overestimated revenues and underestimated interest payments, which combined with weak expenditure management has often led to budget overruns and spending arrears. To tackle these problems:

- We will better integrate the MOF's recently established Macro-Fiscal Unit into fiscal policy decision making by clearly defining its roles and responsibilities, and strengthening its macro-fiscal analytical, forecasting, and reporting capacity.

- We will strengthen commitment-based spending controls by completing our rollout of the Integrated Treasury Management Information System (ITMIS), a full-fledged IT-based PFM platform, and by introducing a more rigorous IT-based commitment control framework such as an e-procurement system for public investment. In particular, we will realize the full functionality of the accounting, budget execution, and commitment modules of the ITMIS, and expand its coverage to all 220 heads (national budget execution agencies), by end-September 2023 (**structural benchmark**). This will enable us to improve the analytical content of in-year budget execution reports.

- To provide binding multi-year guidance for the budget and public investment, we will make progress towards developing a medium-term fiscal framework (MTFF). To start with, in 2023, we will develop multi-year baseline fiscal projections, and work towards producing a Fiscal Policy Statement early in the budget preparation cycle, to provide binding multi-year guidance for the budget and public investment.

- To provide legal clarity on the budget formulation process, we will enact a new PFM law, supported by IMF TA. This legislation will clarify the budget formulation process, specify the roles and responsibilities of the MOF and spending agencies, and establish information and accountability requirements. This new PFM law will also include a revamped fiscal rules framework drawing on the draft bill developed under the 2016-20 EFF program, including a legally binding government debt ceiling consistent with the outcome of debt restructuring, augmented with an automatic correction mechanism and well-defined escape clause. The new PFM law will set a legal definition of public debt and government deficit, consistent with international best practice as described in the GFSM 2014 and the Public Debt Statistics Guide for Compilers and Users. The new PFM law will also include stricter guidelines regarding the issuance of treasury guarantees (see ¶14). We will submit this new PFM law to Parliament by end-December 2023 (**structural benchmark**).

- To improve public investment efficiency, we will continue to implement the reforms recommended by the 2018 IMF Public Investment Management Assessment, focusing on strengthening the processes for project appraisal and selection by relying more on cost-benefit analysis.

13. Structural reforms are needed to strengthen the governance of SOEs and make them financially viable.

- To avoid a renewed build-up of CPC liabilities, we will (i) make automatic cost-recovery based fuel price adjustments (¶10), and (ii) take steps to make the CPC more efficient. In addition, Cabinet approved the entry of additional private sector firms into the downstream petroleum sector in June 2022.

- We have reduced the debt overhang of the CPC by transferring the majority of its government-guaranteed FX debt to the government's balance sheet (see also ¶15). We will, by end-June 2023, obtain Cabinet approval of a comprehensive strategy with clear timelines and modalities to restructure the balance sheets of the CEB, CPC, SriLankan Airlines (SLA), and the Road Development Authority, in consultation with IMF staff (**structural benchmark**). In this regard, we have also obtained Cabinet approval in November 2022 of a draft strategy by the SOE restructuring unit to reform the business model of SriLankan Airlines to make it financially viable, through a phased divestment of the three subsidiaries. Following the envisaged restructuring of the SLA's balance sheet, any residual government-guaranteed FX loans will be transferred to the government's balance sheet by September 2023. At that point, there will be no more government guarantees for the SLA's FX loans.

- To strengthen the governance of SOEs and enhance their financial transparency, we will: (i) clarify the mandates of key SOEs through Statements of Corporate Intent and hold their management accountable for delivering satisfactory results informed by key performance indicators; (ii) review the framework for selecting SOE board members to ensure that they are qualified and independent; and (iii) ensure that all 52 major SOEs publish their audited financial statements. The financial statements can be accessed on a dedicated website. For 2021, 33 SOEs have so far published audited financial statements for 2021. We will ensure that the remaining 19 major SOEs will also publish audited financial statements for 2021 and that audited financial statements for 2022 will be published by end-June 2023.

14. We will strengthen the framework for SOE borrowing. Throughout the program, we will ensure that new SOE borrowing is limited to the financing of commercially viable activities (e.g., investment projects), whereas subsidies and other quasi-fiscal activities will be remunerated through government transfers. We will also ensure that, with the exception of project loans on-lent by the Treasury and short-term trade financing, there will be no new borrowing in foreign currency for non-financial SOEs with less than 20 percent of revenues denominated in foreign currency. Our new PFM law (¶12) will: (i) prohibit new Treasury guarantees to SOEs with negative equity; and (ii) prohibit new Treasury guarantees on SOE liabilities in foreign currency. We will also strengthen the governance and oversight of state-owned banks to ensure that their lending to SOEs is guided solely by commercial considerations (see ¶24).

IV. Restoring Public Debt Sustainability

15. We are committed to putting public debt onto a sustainable path.

- We are committed to reducing the ratio of public debt to GDP to below 95 percent by 2032 from around 128 percent in 2022; reducing the central government's annual gross financing needs below 13 percent of GDP, on average, in 2027-32, from 34.6 percent of GDP in 2022; and reducing the central government's annual debt service in foreign currency below 4.5 percent of GDP in every year in 2027-32, from 9.4 percent of GDP in 2022.

- We have reached several important milestones in our efforts to restructure public debt. After suspending external debt service payments to certain categories of creditors including private and official bilateral creditors from April 12, 2022 onwards, we have hired legal and financial advisors to support our engagement with creditors and continue our good-faith negotiations.

- On the perimeter of public debt, loans from China Exim Bank to the government which had earlier been reclassified as debts of the CEB, Sri Lanka Ports Authority (SLPA), and Airport and Aviation Services Sri Lanka (AASL), have been recognized as central government debt. The majority of guaranteed FX debt of the CPC has also been recognized as central government debt (see also ¶13). These reclassifications, concluded in February 2023, are effective retroactively at end-December 2022. A cabinet decision to this effect was taken in January 2023.

- We are committed to a debt resolution consistent with the IMF program parameters and a fair and equitable burden sharing among creditors. In this regard, we have engaged external commercial creditors in good faith through early dialogues, timely information sharing, and opportunities for them to provide input on the design of restructuring strategies. On bilateral official debt, we have received specific and credible assurances from the Paris Club, India, Hungary, and the Export-Import Bank of China that they will provide debt relief consistent with restoring Sri Lanka's debt sustainability under the IMF program. We appreciate our other bilateral official creditors' consent to Fund financing notwithstanding arrears to them and their commitment to continue working with us towards a debt treatment that is consistent with restoring debt sustainability. In line with our commitment to equitable treatment of all our external creditors, Sri Lanka will refrain from resuming debt service payments to any external commercial or bilateral creditor unless it agrees to a comprehensive debt treatment in line with the IMF program parameters, debt sustainability targets, and the comparability of treatment principle. We are willing to use additional safeguard mechanisms, including appropriate forms of contractual commitments such as Most Favored Creditor Clause, acceptable to relevant creditors at the time. We are also exploring options for a domestic debt operation which is aimed at providing substantial liquidity relief to the government, in line with the program parameters, while preserving financial stability to avoid further eroding Sri Lanka's repayment capacity. In this regard, we are concluding our preparatory work and plan to make an announcement on the coverage and parameters of the external and domestic debt operations before end-April 2023.

- We have provided amounts and terms on all outstanding debt obligations, including contingent liabilities, to IMF staff. We confirm that none of the loans obtained or guaranteed by the government are collateralized.

16. We are committed to improving debt management and debt transparency.

- Currently, public debt is managed by the CBSL's Public Debt Department, the MOF's External Resources Department and Treasury Operation Department. To improve debt management, we will complete necessary legislative requirements to establish a public debt management agency (PDMA) in line with international best practices by December 2023 and complete the establishment of the agency by December 2024. The PDMA (i) will report to and be accountable to the Ministry of Finance but have significant operational autonomy; (ii) assume overall policy responsibility for debt management by formulating medium-term debt strategies and annual borrowing plans; and (iii) direct the implementation of annual borrowing plans, including taking decisions on auction cut-offs. The PDMA will oversee all domestic and international market-based financing decisions and participate in the evaluation of all debt, derivatives, and guarantees.

- We will further improve debt transparency. The MOF will regularly publish a quarterly bulletin of public debt and debt service. The first such bulletin was published in February 2023 and covers the debt situation as of end-September 2022. We will continue this debt bulletin on a quarterly basis and publish by end-April 2023 the debt situation as of end-2022. We are committed to gradually broaden the bulletin's coverage to stock and debt service flows of all liabilities and contingent liabilities of the budgetary central government and of extrabudgetary central government units. In line with international best practice, we will issue guidelines regarding the statistical treatment of guaranteed debt of distressed corporations, and the transfer of government liabilities to SOEs, to be approved by Cabinet.

V. Restoring Price Stability and Rebuilding External Buffers

17. We have tightened our monetary policy stance against rising inflation and are ready to take further steps to restore price stability through a multi-pronged disinflation strategy.

- Reducing the headline CCPI inflation towards and stabilizing it around its target band of 4-6 percent (YoY) by end-2024 is a key objective of the CBSL, which will be monitored through a Monetary Policy Consultation Clause (MPCC), including both inner and outer bands (of ±1.5 and 3 percentage points). A policy consultation will be held with the IMF staff ahead of each Monetary Policy Board meeting before the inflation target is reached. A breach of the inner and outer bands would require completion of a policy consultation with the IMF staff and the IMF Board, respectively (see Technical Memorandum of Understanding).

- Following the increases in policy rates by 700 basis points in April and100 bps in July 2022, the CBSL raised the policy rate by another 100 bps in March 2023 **(prior action),** which currently stand at 15.5-16.5 percent. Headline and core inflations eased to 54 and 46 percent by

January 2023 as food inflation moderated. Inflation levels may remain high in the coming months due to the electricity price hike announced in February 2023. In the period ahead, we expect inflationary pressures to gradually ease, as the recent tightening of monetary conditions help gradually re-anchor inflation expectations, supported by a moderation of cost-push inflation and base effects. Notably, the Treasury yields and the prime lending rate have risen to 28 and 24 percent, respectively, and the private credit has been contracting in the context of contracting economic activity.

- Under a flexible inflation targeting framework, the CBSL stands ready to adjust its policy stance, consistent with its price stability mandate, to deliver the programmed disinflation path. We are committed to reach and maintain the forward-looking real policy rates at sufficiently positive levels until inflationary pressures are clearly receding. During the program period, we stand ready to tighten further as needed and guided by the inflation performance against the MPCC. In doing so, we will closely monitor the underlying inflation pressures, mindful of a potentially strong persistence amid heightened wage pressures and de-anchored expectations as well as rising interest rates' implication for financial stability.

18. To support our disinflation strategy, we will refrain from monetary financing. The fiscal adjustment, debt relief, and new external financing envisaged under the program will allow budget deficits to be financed in a more sustainable way once the program is in place, without relying on inflationary monetary financing (i.e., direct credit to government to finance budget deficits) that has jeopardized price stability. The reduction in net domestic financing needs of the government and the improvement in the net international reserves position will also enable the CBSL to gradually unwind its remaining large holdings of Treasury securities. The pace of the reduction is informed by the market's estimated capacity to absorb the CBSL's divestment and a need to prevent excessive expansion of the CBSL's balance sheet from rebuilding reserves. The reduction in the CBSL's holdings of Treasury securities and the discontinuation of monetary financing will be monitored by a **quantitative performance criterion** on the ceiling of the CBSL's net credit to the government (excluding the CBSL's temporary holdings of treasury securities for short-term monetary operations; see TMU). The ceiling for end-June 2023 is set at the level recorded at end-January 2023, and is programmed to be reduced by Rs 150 billion during 2023H2. A program adjustor will be introduced to allow monetary financing in the case of a potential shortfall in external program financing in the first 6 months of the program.

19. We are firmly committed to allowing greater exchange rate flexibility and rebuilding international reserves.

- We are committed to restoring a market-determined and flexible exchange rate to serve as a buffer against external shocks. The sharp rupee depreciation since March 2022 is expected to close the REER and current account gaps by 2023, supporting the external adjustment (the 2021 Article IV consultation Fund staff report estimated a real overvaluation of 17 percent in 2021). Against excessive volatility in the official FX market which had resulted in persistent depreciation pressures, we temporarily introduced market guidance to confine daily exchange rate movements within a pre-defined band around the weighted average spot interbank rate of the previous trading day. We will eliminate this market guidance with effect of March 7, 2023. We believe our comprehensive policy adjustment package and decisive initial actions would help rebuild confidence and allow this transition to happen, while mitigating the degree of exchange rate overshooting which has adverse implications for the cost of living and unhedged balance sheets of the government, banks, and corporates.

- We will gradually rebuild gross international reserves including through outright FX purchases in the market, supported by a non-interest current account surplus, new external financing and other non-debt creating inflows, and sovereign debt relief. We commit to meet the program targets on Net Official International Reserves (NIR) (**quantitative performance criterion**), which are predicated on the CBSL's outright FX purchases on a net basis by $1.4 billion in 2023. Going forward, we commit to save any overperformance in accumulating the NIR.

- To avoid an "on and off" approach to exchange rate flexibility and allow the rupee to adjust to changing fundamentals, we will limit FX intervention to truly disorderly market conditions that could lead to destabilizing inflation and/or balance sheet effects and transparently disclose our intervention transactions in order to guide market expectations. In this regard, we will rationalize our intervention decision based on objective criteria and subordinate it to the CBSL's price stability mandate, while ensuring that our FX intervention budget is consistent with meeting the NIR targets.

20. We will strengthen the institutional frameworks supporting flexible inflation targeting and greater exchange rate flexibility.

- A new Central Bank Act (CBA) was prepared during the 2016-20 EFF arrangement with IMF technical assistance and submitted to Parliament for approval in November 2019. We remain committed to enacting the new CBA, which will greatly strengthen the CBSL's independence and modernize its policy framework to enable credible inflation targeting. In particular, provisions are made under the draft Act to (i) establish price stability as the CBSL's primary objective and financial stability as a core objective, (ii) buttress the CBSL's operational autonomy by removing government representation from the Monetary Policy Board, and (iii) prohibit monetary financing of the fiscal deficit. The Act will also include a modification to remove government representation from the Governing Board to further strengthen the CBSL's institutional autonomy and a new transitional arrangement for gradually unwinding the CBSL's large government securities holdings (¶18). In addition, the authorities have worked in consultation with IMF staff on amendments so as to ensure (i) consistency of the Act with the Constitution; (ii) accountability of the central bank to parliament; and (iii) a coordination mechanism between the CBSL and the MOF. To allow the new Act to become effective in 2023, we obtained Cabinet approval in December 2022 (**prior action**) and submitted the new Act to Parliament in February 2023, with an aim to ensuring its approval by Parliament by end-April 2023 (**structural benchmark**).

- To further enable and support exchange rate flexibility, we are committed to fostering a deeper and more liquid foreign exchange market and developing adequate systems for managing exchange rate risks, including with the technical assistance of the IMF.

21. We will phase out the administrative measures imposed to support the balance of payments, including those introduced on an emergency basis, once conditions allow. These measures include import restrictions, exchange restrictions, multiple currency practices (MCPs), and capital flow management (CFM) measures.

- Over 2020-22 we suspended the import of many non-priority non-critical goods, which helped contain the import bill and relieved BOP pressures but also hurt economic activity.

- We have in place the following exchange restrictions: (i) the prioritization and rationing of FX by CBSL and CBSL's informal guidance to Authorized Dealers (ADs) to prioritize access to FX for essential items, which results in undue delays and payment arrears for current international transactions; (ii) prohibitions on converting LKR into FX for certain current international transactions (e.g. servicing certain external loans, payment of any income on certain nonresident investments); (iii) unremunerated cash margin deposit requirements on imports of certain items under letters of credit (LC), documents on payment (DP) and documents on acceptance (DA) payment terms; (iv) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (v) the levy of a 14 percent remittance tax on nonresidents' profits; (vi) limits on repatriation by nonresidents of proceeds derived from current transactions; (vii) the requirement to provide a tax clearance certificate prior to permitting transfers for certain current transactions; and (viii) Sri Lanka's net debtor position under the Asian Clearing Union payment arrangement that is pending settlement for longer than 90 days.

- We also have in place the following measures giving rise to MCPs: (i) unremunerated cash margin deposit requirement on imports of certain items made under LC, DA and DP payment terms; (ii) the use of a weekly volume weighted average exchange rate for the mandatory surrender of FX by ADs of certain proceeds to the CBSL; (iii) official exchange rate calculated based on the previous day's transactions in the interbank FX market and used for CBSL's FX transactions with the government; (iv) the use of the weekly volume weighted average rate for CBSL`s FX sales in bilateral non-Request for Quote outright spot transactions with ADs; (v) the levy of a 2.5 percent stamp duty on credit card transactions abroad; and (vi) the levy of a 14 percent remittance tax on nonresidents' profits. In addition, at the time of Sri Lanka's 2022 Article IV consultation, Sri Lanka maintained one MCP arising from incentives on inward worker remittances that result in a more favorable effective exchange rate for such transactions, which, although there have been some changes to the incentives offered, remains in place[35].

- Alongside, we also introduced new CFMs and tightened existing CFMs, including on payments outside of Sri Lanka from foreign currency deposit accounts during the pandemic and recent crisis.[36]

- While the mentioned import restrictions, exchange restrictions, MCPs and CFMs could help mitigate FX shortages in the near term, we believe they should not be a substitute for the comprehensive policy package and ongoing macroeconomic adjustment. We are committed to phasing these measures out as the balance of payments stabilizes. To this end, by June 2023, we will prepare a plan for the phased removal of these measures during the program period as we make progress with achieving macroeconomic stability, particularly with respect to the exchange rate, debt sustainability, and financial stability, improved market access prospects, and accumulation of reserves above critical levels.

- We are seeking temporary approval of exchange restrictions (i)-(vii) and all MCPs. We understand that exchange restriction (viii) cannot be approved under Fund policies. During the program period, we will not: (i) introduce or intensify exchange restrictions or MCPs; (ii) impose or intensify import restrictions for balance of payments purposes; or (iii) conclude any bilateral payment agreements inconsistent with Article VIII (**continuous performance criteria**).

VI. Ensuring Financial Stability

22. We are committed to ensuring a healthy and adequately capitalized banking system and addressing the significant vulnerabilities in the banking system. Banks face large exposures to the public sector, increasing credit risk in their private sector loan books, and shortages of foreign exchange. Against this background:

- The CBSL hired two internationally reputable independent specialist firms without conflicts of interest to undertake a diagnostic exercise for a group of banks accounting for more than 70 percent of domestically-owned bank assets as of end-June 2022, including the two largest state-owned banks and the three largest private sector banks, based on a Terms of Reference agreed with IMF staff. The diagnostic exercise will assess the impact on banks' capital from asset

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[35] An incentive of LKR 1,000 provided through ADs towards covering the transactions costs of each inward worker remittance equivalent to LKR 20,000 or more that is converted into LKR through such ADs remains in place. Previously, inward remittances of FX sent by workers abroad through ADs in Sri Lanka and exchanged into LKR were converted at an exchange rate that was LKR 2 per 1 USD above the exchange rate used by ADs for conversion of any other inward remittances (terminated on January 1, 2023). For a short period between December 2021 and March 2022, an *additional* incentive of LKR 8 per 1 USD was paid (discontinued on March 8, 2022).

[36] Main CFM measures introduced or tightened in 2020-2022 and currently in force include: (i) a repatriation requirement for exports of goods and services; (ii) a surrender requirement for exporters on proceeds from exports of goods; (iii) a surrender requirement for banks on purchases of export proceeds; (iv) a surrender requirement for banks on purchases of inward worker remittances; (v) suspension of outward remittances on capital transactions; (vi) restrictions on purchases of Sri Lankan ISBs by local banks; (vii) restrictions on outward transfers of funds for emigrants.

quality deterioration, FX depreciation, and the sovereign default. To support the diagnostic exercise, the CBSL will provide the assessors with guidance on the expected impact of debt restructuring on impairment and the risk-weighting of public sector debt exposures. It will ensure heightened supervision of banks' valuation, classification, and impairment practices for exposures to the sovereign and the broader public sector, and to loans which have benefited from moratoria and forbearance measures. The independent firms to conduct the diagnostic have been hired (**prior action**), with the asset quality review component of the diagnostic exercise for the five banks to be completed by April 2023 (**structural benchmark**) and the remaining components shortly after key debt restructuring terms are clarified. The asset quality review will be completed by August 2023 for four more banks (three private and one public) accounting for a further 20 percent of domestically owned banking assets.

- The five assessed banks will be required to submit time-bound plans for capital restoration and closure of their FX net open positions by June 2023. The CBSL will define the content of these, review them to determine their credibility, and oversee their implementation. The CBSL will take appropriate action regarding banks unable to ensure their viability, beginning with intensifying supervision and imposing prompt corrective actions. The CBSL will, by July 2023, develop a roadmap for financial sector restructuring and recapitalization, to address capital and FX liquidity shortfalls identified through the diagnostic exercise, and intervene in banks assessed to be non-viable (**structural benchmark**). This roadmap will include binding deadlines for compliance with capital requirements including buffers to be restored. To support compliance with the roadmap, the MOF will determine the size, timing, instruments, and terms and conditions for potential government recapitalization of viable banks which are unable to close capital shortfalls from private sources by October 2023 (**structural benchmark)**. A similar process for capital restoration planning will be completed for the remaining four banks. The CBSL will develop a roadmap by November 2023 and the MOF will determine the detailed recapitalization plan by January 2024. The authorities will consult with IMF staff on the design and implementation of these steps.

- To ensure current and future risks to financial stability are effectively managed, we will establish as soon as possible a coordinating committee to manage our response to financial sector issues. The committee will include representatives from the MoF, the CBSL (including the departments responsible for resolution and deposit insurance) and other CBSL departments and authorities as needed (e.g., regulators for insurance and pension funds). It will have responsibility for high-frequency monitoring, in-crisis coordination, information-sharing and effective communication among the authorities and the general public. The committee will oversee the development of contingency plans for the regulated entities. The CBSL will work as the secretariat for the committee.

23. The frameworks for financial sector supervision and crisis management will be strengthened. The Cabinet approved the Banking (Special Provisions) Act in November 2022 to strengthen key elements of the CBSL's crisis management powers, which are currently set out in the Banking Act (**prior action**); Parliamentary approval will be obtained by April 2023. A full revision of the Banking Act will be approved by Cabinet by June 2023 (**structural benchmark**) and approved by Parliament by December 2023 (**structural benchmark**), with a view to implementing it by January 2024. These Acts will strengthen: (i) the resolution authority mandate of the CBSL, as well as powers, tools, and appropriate funding mechanisms for resolution of distressed financial institutions; (ii) the deposit insurance framework – including appropriate backstop funding arrangements from the government – and the regime for liquidation of financial institutions; (iii) regulatory standards in areas including bank licensing, bank ownership, consolidated supervision, the capital and liquidity framework, large exposures and related party transactions, governance requirements, and recovery planning and early intervention powers; and (iv) regulation and supervision of state-owned banks (see paragraph 24). For non-bank deposit-takers the CBSL has already eliminated regulatory arbitrage on non-performing loan classification and capital requirements. The review of the Banking Act and the Finance Business Act will take further steps to end regulatory arbitrage. In parallel, the structure, staffing, and funding of the Resolution and Enforcement Directorate in the CBSL will be strengthened to ensure it is able to effectively carry out its expanded responsibilities. The CBSL updated its framework for Emergency Liquidity Assistance for banks in November 2022 and will review the framework for access by non-bank financing companies; liquidity provision to these companies by the deposit insurance fund will be ended. These initiatives will closely follow international best practices and be developed in consultation with IMF staff.

24. We will strengthen the resilience and governance of state-owned banks. The government will include in the Banking Act revision described in the previous paragraph provisions ensuring state-owned banks meet the same regulatory requirements as private banks, including on large exposures, related party lending, and governance, including binding time-bound transition periods for the reduction of existing large exposures. In parallel with broader reforms to SOE governance, the framework for appointment of directors and senior managers for state-owned Licensed Commercial Banks and Licensed Specialized banks will be changed to ensure that nominees are independent, have clear periods of appointment, and appropriate professional experience. Clear mandates will be defined to ensure that state-owned banks are run at arm's length, lend to SOEs on a commercial basis and within standard prudential limits on concentration risk and foreign currency lending, require clearly defined mandates, and set requirements for the suitability, independence, and appointment processes for board members and senior executives of state-owned Licensed Commercial Banks and Licensed Specialized banks, with supervision by the CBSL equivalent to its supervision of private banks.

VII. Reducing Corruption Vulnerabilities

25. We are committed to advance governance and anti-corruption reforms as a central pillar of our program.

- As a first step, we have asked IMF staff to conduct a governance diagnostic TA mission to assess Sri Lanka's anti-corruption framework. The IMF's governance diagnostic report is an in-depth, country-tailored assessment of corruption and governance vulnerabilities that draw heavily on local knowledge and expertise, and provide prioritized and sequenced recommendations. We will publish the report by end-September 2023 (**structural benchmark**). The report's findings will help identify specific priority reforms to be implemented under the program.

- We will develop a comprehensive piece of legislation that harmonizes anti-corruption legislation with the United Nations Convention against Corruption (UNCAC), supported by IMF technical assistance. The legislation will include strengthening the asset declaration system in accordance with the G-20 High-Level Principles on asset disclosure by public officials, including coverage of officials and reporting standards. The legislation will create an anti-corruption commission vested with the authority and strengthened independence for investigations. The draft legislation, which does not cover comprehensive asset recovery provisions, is currently under review by a review Committee before final approval by the Cabinet. This legislation will be enacted by June 2023 (**structural benchmark**). A transparent and merit-based process for selecting members of the independent commission will also be integrated explicitly into this legislation. Comprehensive asset recovery provisions in compliance with the UNCAC standard are expected to be developed in consultation with IMF staff and incorporated into a separate draft legislation pertaining to Proceeds of Crime by March 2024.

- In parallel, we will step up efforts to reduce opportunities for corruption by expanding the reliance on digitalization in areas such as revenue administration and procurement.

- Our program also aims to improve fiscal transparency by improving the timeliness and accuracy of fiscal data and enhancing debt transparency. Moreover, we are committed to publishing on a semi-annual basis (i) all significant public procurement contracts, (ii) a list of all firms receiving tax exemptions through the Board of Investment, and (iii) a list of individuals and firms receiving tax exemptions on luxury vehicle imports. An online transparency platform will be operational by March 2023.

- We will continue to strengthen our AML/CFT regime. With technical assistance from the World Bank, we are updating the National ML/FT Risk Assessment (NRA), the results of which will inform the development of our national AML/CFT strategy for 2023-28. Further, we are strengthening the AML/CFT legal framework by introducing amendments to align with international standards. The Companies Act will be amended to strengthen the beneficial ownership provisions relating to legal persons, the only remaining non-compliant aspect of the FATF 40 Recommendations. Amendments are also being finalized for the Prevention of Money Laundering Act, the Convention on Suppression of Terrorist Financing Act, the Financial Transactions Reporting Act, and the Voluntary Social Service (Registration and Supervision) Act. Besides, risk-based AML/CFT supervision is being strengthened through regular supervision of financial institutions and designated non-finance businesses and professions and joint supervisory activities via other regulatory bodies (BSD, SNBFI, SEC & IRCSL). We will conduct AML/CFT risk-based supervision focusing on compliance by reporting entities with beneficial ownership requirements and enhanced due diligence measures for politically exposed persons. We will also strengthen the use of financial intelligence to identify potential corruption activities and the cooperation between FIU, law enforcement, and Commission to Investigate Allegations of Bribery or Corruption (CIABOC) to facilitate parallel investigations and prosecutions. We will leverage the support from our development partners in these key reform areas. We will strengthen the institutional framework of the FIU by providing adequate resources.

VIII. Advancing Growth-Enhancing Structural Reforms

26. Our growth-enhancing reform agenda will focus on key areas critical for unlocking Sri Lanka's growth potential. Our commitments in the near-term focus on stabilizing the macro economy and restoring debt sustainability. Later in the program we will develop an agenda of structural reforms designed to allow Sri Lanka to reach its full potential, including by making state owned enterprises more efficient.

- We are fully committed to trade liberalization, which is critical for attracting investment and boosting productivity growth. In this regard, we will revisit the 5-year plan for rationalizing remaining para-tariffs developed under the 2016-20 EFF arrangement, aimed at removing an important impediment for foreign investment. The implementation of the plan will be carefully phased with due consideration given to its revenue implications and be complemented with measures to support local businesses in enhancing their competitiveness. We are strengthening the implementation of a single window for trade and will pursue further trade reforms with technical assistance from development partners.

- In light of a large gender gap in employment, labor market reforms under the program will be geared toward promoting female labor force participation as an effective counterforce to population aging's negative impact on labor supply. In this regard, we will develop a comprehensive and actionable strategy, which can include: (i) improving public transport infrastructure, (ii) promoting financial inclusion including through credit guarantee schemes supporting female entrepreneurs, (iii) increasing the number of affordable child and elderly care facilities, (iv) providing a legal framework for flexible work arrangements and ensuring proper benefits and renumeration, and (v) expanding training and vocational education programs aimed at closing the gender gap in skills and more generally upgrading skills needed to promote higher labor productivity.

- With the support of development partners, we will embark on broader reforms to address Sri Lanka's challenges and growth impediments, including impediments to private investment; the large role of the public sector in the economy; an inefficient electricity sector; and climate change. Reforms could be targeted to facilitate investment by reducing red tape and modernizing the regulatory and doing business environment; reducing electricity cost by improving the generation mix and electricity distribution efficiency; reducing the government's and SOEs' role in the economy to enable a more efficient allocation of resources, foster competition, and boost productivity; and strengthening climate change adaptation, including through contingency budget and insurance scheme for natural disasters.

IX. Program Risks and Contingency Planning

27. We stand ready to deploy contingency measures should downside risks materialize. Risks to program implementation are high, given adverse initial conditions, a complex debt restructuring with a potential for delays, and large downside risks to the program baseline scenario:

- A delay in concluding debt restructuring negotiations with creditors could suspend Sri Lanka's much needed access to the financial support from IFIs, causing a deeper and prolonged BOP crisis. Realization of debt sustainability risks could require broader and deeper debt restructuring. We will step up our engagement with creditors to minimize this risk and commit to stay current on our payments to the IMF and Multilateral Development Banks.

- In the near term, the lack of macroeconomic policy space severely hampers our ability to address the downside risks vis-à-vis the baseline. Further depreciation pressures and signs of runaway inflation would need to be addressed by a tighter monetary policy stance than envisaged under the baseline, aimed at reaching positive real policy rates (on a forward-looking basis) at a much faster speed.

- The stress on the banking system reinforces the need to strengthen crisis management and develop a detailed contingency plan, including strengthening the CBSL's emergency liquidity framework, measures to strengthen bank capital as described above, and other steps if needed.

- Any program underperformance will be corrected by remedial measures. For example, (i) unforeseen increases in current non-interest spending will be financed through additional revenue measures, so that substantial cuts to capital spending can be avoided; (ii) delays in implementing revenue measures and cost-recovery based electricity pricing would require further cuts in capital spending; slower-than-programmed reserves buildup would require the introduction of explicit FX intervention rules to avoid hindering needed exchange rate adjustment; and delays in key structural reforms should be avoided to allow program reviews to conclude as scheduled; and (iii) program overperformance resulting from better-than-expected outturns should be locked in to the extent possible, to assure achieving the program objectives.

X. Program Monitoring and Safeguards

28. Our program will be subject to semiannual reviews with performance criteria, the MPCC bands, and indicative targets set out in Table 1 attached to this MEFP and Technical Memorandum of Understanding (TMU). Completion of the first and second reviews will require observance of the quantitative performance criteria for end-June 2023 and end-December 2023, 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 first two reviews of the program will take place on or after September 1, 2023 and March 1, 2024, respectively. We request the use of IMF financing for budget support and, in this respect, will finalize a Memorandum of Understanding between the CBSL and the Ministry of Finance on responsibilities for servicing financial obligations to the IMF. We also recognize the importance of the safeguards assessment of the Central Bank which was finalized in February 2023, and we will take steps necessary to address the resulting recommendations.

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

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

	2022	2023			
	end-Dec.	end-Mar.	end-Jun.	end-Sep.	end-Dec.
	Actual	IT	PC/IT	IT	PC/IT
Proposed quantitative performance criteria					
Central government primary balance (floor, in billion rupees)	-895	-56	-113	-160	-209
Program net official international reserves (Program NIR, floor, end of period stock, in million US$) 1/ 2/	-3,540	-3,188	-2,830	-2,068	-1,592
Net credit to the government of the CBSL (ceiling, end of period stock, in billion rupees) 3/	2,834	2,890	2,890	2,840	2,740
Stock of expenditure arrears of the central government (ceiling, in billion rupees)	60	30	0	0	0
Proposed continuous performance criteria (cumulative from beginning of the program)					
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	0	0	0
Proposed monetary policy consultation clause					
Year-on-year inflation in Colombo Consumers Price Index (in percent) 4/					
Outer band (upper limit)	...	55.0	34.0	20.0	18.0
Inner band (upper limit)	...	53.5	32.5	18.5	16.5
Actual / Center point	61.3	52.0	31.0	17.0	15.0
Inner band (lower limit)	...	50.5	29.5	15.5	13.5
Outer band (lower limit)	...	49.0	28.0	14.0	12.0
Proposed indicative targets					
Central government tax revenue (floor, in billion rupees)	1,751	650	1,300	2,100	2,940
Social spending by the central government (floor, in billion rupees)	142	35	70	120	187
Cost of non-commercial obligations (NCOs) for fuel and electricity (net of government transfers) (ceiling, in billion rupees) 5/	...	0	0	0	0
Treasury guarantees (ceiling, in billion rupees)	1,159	1,700	1,700	1,700	1,700

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, (iv) the amount of project loans and grants, and (v) proceeds from commercialization of public assets to non-residents, that are higher/lower than assumed under the program; and by the cumulative amounts of (vi) amortization and interest payment of total external debt of the central government, and (vii) interest payments on SLDBs and FCBUs by the central government in US dollar terms, that are

3/ Excludes holdings of treasury securities for monetary policy purposes and Rupee-denoimated government deposits. See TMU for details on the calculation for the test date.

4/ See the TMU for how to measure year-on-year inflation.

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: Proposed Prior Actions and Structural Benchmarks Under the EFF—Supported Arrangement

Prior Actions	**Timing**
Cabinet approval of revenue measures to support fiscal consolidation during 2023, in line with program parameters	Met
Parliament approval of a revised 2022 budget that is in line with program parameters	Met
Submission to Parliament of the 2023 Appropriation Bill that is in line with program parameters	Met
Cabinet approval to automate monthly retail fuel price adjustment as prescribed by the 2018 fuel pricing formula to achieve cost recovery	Met
Cabinet approval to automate semi-annual cost-recovery based electricity price adjustment	Met
Cabinet approval of the new Central Bank Act with amendments from the bill submitted to Parliament in November 2019 in consultation with IMF staff	Met
Cabinet approval of Banking (Special Provisions) Act to strengthen key elements of the CBSL's crisis management powers	Met
Hiring by the CBSL of an independent firm to conduct banking sector diagnostic exercise based on Terms of Reference and timeline established in consultation with IMF staff	Met
Increase policy interest rates by 100 basis points to ensure forward-looking real policy rates on a firmly upward path	Met
Structural Benchmarks	
Fiscal, SOE, and Social Safety Net Reforms	
Set retail fuel prices to their cost-recovery levels with monthly formula-based adjustments, and compensate the CPC for providing any fuel subsidies with on-budget transfers	Continuous
Adjust the end-user electricity tariff schedule to its cost-recovery level (overall across different types of final consumers) with semi-annual formula-based adjustments on a forward-looking basis in January and July each year (effective from January 1 and July 1, respectively); the CEB submits tariff revision requests to the Public Utility Commission of Sri Lanka by end-October (for January tariff revisions) and by end-April (for July tariff revisions); and compensate the electricity sector for providing any residual subsidies with on-budget transfers	Continuous
Parliamentary approval of the welfare benefit payment scheme and the application of the new eligibility criteria to identify low-income families for receiving welfare benefit payments	End-May 2023
Cabinet approval of a comprehensive strategy (laying out clear timelines and modalities) to restructure the balance sheets of the CEB, CPC, SriLankan Airlines, and the Road Development Authority, in consultation with IMF staff	End-June 2023

Table 2. Sri Lanka: Proposed Prior Actions and Structural Benchmarks Under the EFF—Supported Arrangement (concluded)

Cabinet approval of revenue measures to support fiscal consolidation during 2024, in line with program parameters	End-July 2023
Completion of the rollout of the ITMIS, expanding its coverage to all 220 heads (national budget execution agencies)	End-September 2023
Submission to Parliament for the first reading of the 2024 Appropriation Bill that is in line with program parameters	End-October 2023
Parliamentary approval of the 2024 Appropriation Act and the spending allocations in line with program parameters	End-December 2023
Submission to Parliament of a new PFM law, in consultation with IMF staff, that will authorize the budget formulation process, roles and responsibilities of relevant agencies, and information and accountability requirements	End-December 2023
Improve the Bulk Supply Transaction Account (BSTA) to accurately measure the electricity subsidy, and start using it to determine the cost-recovery based electricity tariff and government transfer requirement	End-December 2023
Monetary and Exchange Rate Policies	
Parliamentary approval of the new Central Bank Act prepared in consultation with IMF staff	End-April 2023
Financial Sector	
Completion of the asset quality review component of bank diagnostic exercise for the two largest state-owned banks and the three largest private sector banks	End-April 2023
Cabinet approval of a full revision of the Banking Act in consultation with IMF staff	End-June 2023
Development by the CBSL of a roadmap for addressing banking system capital and FX liquidity shortfalls and intervening in banks assessed to be non-viable	End-July 2023
Determination by the MOF of the size, timing, instruments, and terms and conditions for potential government recapitalization of viable banks which are unable to close capital shortfalls from private sources	End-October 2023
Parliament approval of a full revision of the Banking Act in consultation with IMF staff	End-December 2023
Governance	
Enact new anti-corruption legislation to harmonize it with the United Nations Convention Against Corruption, pending comprehensive asset recovery provisions, in consultation with IMF staff	End-June 2023
Publication of the report of an IMF-led governance diagnostic technical assistance mission to assess Sri Lanka's anti-corruption framework	End-September 2023

Appendix 1. Tax Reforms to be Implemented for 2022-25 /1

	To take effect on or before:
Personal Income Tax	
Labor Income	
Introduce a progressive reform of the structure of the personal income tax (PIT) system. Set the tax-free allowance to Rs 1,200,000 per year, and raise the marginal PIT rate by 6 percentage points for every Rs 500,000 per year up to a top rate of 36 percent.	Implemented (January 1, 2023)
Make withholding tax on employment income (APIT/PAYE) mandatory for all taxpayers exceeding the tax-free allowance of Rs 1,200,000 per year.	Implemented (January 1, 2023)
Impose withholding tax on service payments exceeding Rs 100,000 per month made to individuals such as professionals at the rate of 5 percent.	Implemented (January 1, 2023)
Capital Income	
Reintroduce non-final withholding taxes on all payments other than dividends. Refrain from introducing a separate allowance for interest income.	Implemented (January 1, 2023)
Introduce a final withholding tax for dividends.	Implemented (January 1, 2023)
Corporate Income Tax	
Remove all sector-specific exemptions and reduced corporate income tax (CIT) rates provided under the Inland Revenue Act, and increase the statutory CIT rate to 30 percent. 2/	Implemented (October 1, 2022)
Start estimating and publishing the direct costs imposed by tax incentives granted under the Strategic Development Projects and Board of Investment Acts.	January 1, 2024
Value-Added Tax	
Raise the standard VAT rate to 15 percent.	Implemented (September 1, 2022)
Reduce the VAT registration threshold to Rs 80 million and apply the same threshold to the wholesale and retail sectors.	Implemented (October 1, 2022)
Remove the zero-rating of tourism-related services.	Implemented (June 1, 2022)
Remove the VAT exemption on condominium residential apartments.	Implemented (January 1, 2023)
Revamp the VAT system by abolishing the vast majority of exemptions.	January 1, 2024
Take measures to significantly speed up valid VAT refunds and abolish the SVAT system.	January 1, 2024

Appendix 1. Tax Reforms to be Implemented for 2022-25 /1 (concluded)

Excises and Customs Duties	
Increase excise taxes on alcohol and tobacco products by 20 percent. The second increase is subject to a review.	The first increase was implemented on January 1 for tobacco and on January 3 for alcohol; the second increase to be implemented before end-June 2023
Introduce automatic indexation of excises to inflation.	January 1, 2024
Property, Wealth, and Wealth Transfer Taxes	
Introduce a nationwide real property tax including a review of related fiscal transfers, requesting technical assistance as needed.	January 1, 2025
Introduce a gift and inheritance tax with a tax-free allowance and minimal exemptions.	January 1, 2025
Other Taxes	
Introduce a "Social Security Contribution" on liable turnover over Rs 120 million per year at the rate of 2.5 percent.	Implemented (October 1, 2022)
Introduce a fuel tax yielding 0.3 percent of GDP.	Implemented (January 1, 2023)
Increase the tax rates pertaining to the Betting and Gaming Levy in line with the May 30 tax proposal.	April 1, 2023

1/ See the IMF's 2022 TA report "Sri Lanka: Revenue-Raising Tax Policy Reform Options" for detailed discussions of the tax reforms.

2/ A reduced CIT rate of 14 percent applies only to the EPF, provident funds, pension funds, and termination funds.

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 the stock of expenditure arrears of the central government (ceiling);

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

d) a quantitative performance criterion on the CBSL's net credit to the government (ceiling);

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

f) a monetary policy consultation clause;

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

h) an indicative target on social safety net spending (floor);

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

j) 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. 16919-(20/103), adopted October 28, 2020.

I. PERFORMANCE CRITERIA

A. Performance Criterion on Central Government Primary Balance

4. Unless otherwise specified, all definitions follow the GFSM1986. 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 2021, the primary balance of the central government on cash basis measured in this manner was minus Rs 1,010 billion (the overall balance was minus Rs 2,058 billion and the interest payment was Rs 1,048 billion).

a) Net borrowings from issuances of Treasury Bills, Treasury Bonds, and loans in local currency. In 2021, the total amount of such net borrowings was Rs 1898 billion.

b) Net decreases in the balances (deposits minus overdrafts) of the central government in the banking system. In 2021, the total amount was Rs 334.6 billion (a decline in bank balances).

c) Net increases in CBSL advances, net of changes in central government deposits at the CBSL. In 2021, the total amount was Rs -3.0 billion.

d) Net borrowings from Sri Lankan Development Bonds (SLDBs) and domestic loans in foreign currency. In 2021, the total amount was Rs -170 billion.

e) Commercial borrowings issued under foreign law, including international sovereign bonds and syndicated loans. In 2021, the total amount was Rs -69 billion.

f) Net borrowings from official project and program loans and trade credit lines. In 2021, the total amount was Rs 55 billion.

g) Net borrowings from all other bonds, loans, and advances contracted by the central government. In 2021, the total amount was Rs 12 billion.

h) Proceeds from privatization or commercialization of public asset to residents and nonresidents. In 2021, the total amount was Rs 0 billion.

6. For the purpose of program monitoring, the government's equity injections into banks for recapitalization purposes will not be recorded as central government expenditure.

Accordingly, the primary balance as defined in paragraph 5 will be reduced by the amounts transferred to banks. By contrast, the government's equity injections into other corporations (both private and state-owned) will be recorded as central government expenditure, consistent with GFSM 1986. Accordingly, the primary balance as defined in paragraph 5 will not be reduced by the amounts transferred to other corporations. Net lending by the government is recorded as a government expenditure, in line with GFSM1986. For example, funds lent by the government to CPC in 2022 related to fuel credit lines from India are recorded above the line (increasing the deficit). A repayment in 2023 will similarly be recorded above the line (reducing the deficit).

B. Performance Criterion on the Stock of Expenditure Arrears of the Central Government

7. Expenditure arrears of the central government are defined as: (i) any invoice that has been received by a spending agency of the central government from a supplier of goods, services, and capital goods delivered and verified, and for which payment has not been made within the contractually agreed period (taking into account any applicable contractual grace period), or in the absence of a grace period, within 3 months after the due date; and (ii) wages, pensions, or transfers expensed by the central government, for which payment has been pending for longer than 3 months to domestic or foreign residents.

C. Performance Criterion on Net Official International Reserves

8. For the purpose of program monitoring, the stock of net official international reserves (NIR) will be measured as the difference between (a) and (b) below, and will be called the "Program NIR." On January 3, 2023, the Program NIR, evaluated at market exchange rates, stood at minus US$3,524 million. The Program NIR at the test dates will be evaluated at the program exchange rates and gold price specified in paragraph 9. On January 3, 2023, the Program NIR, evaluated at the program exchange rates, stood at minus US$3,520 million.

a) The CBSL's conventional definition of the NIR, which is the sum of (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, including the assets held under the People's Bank of China (PBOC) swap arrangement, 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;[1] 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

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[1] Convertible currencies include the currencies of the SDR basket (US dollar, UK pound, Japanese yen, Chinese yuan, Euro) as well as Canadian dollar, Australian dollar, and Swiss franc.

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; except for assets held under the PBOC swap arrangement); claims on overseas subsidiaries of domestic commercial banks 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 (including for budget support purposes); 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. On January 3, 2023, the NIR as per the CBSL's conventional definition, evaluated at market exchange rates, stood at minus US$3,222 million.

b) The CBSL's outstanding liabilities (i.e., net short positions) in foreign exchange swaps with domestic commercial banks, which stood at US$302.4 million on January 3, 2023.

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 prevailing on January 3, 2023, as specified in Table 1. Monetary gold will be valued at US$1,831.615 per troy ounce, which was the price prevailing on January 3, 2023 as per CBSL.

Table 1. Sri Lanka: Program Exchange Rates

(Rates as of January 3, 2023)

Currency	Units of Currency per 1 US dollar
Sri Lanka rupee	363.11
British pound	0.838012
Japanese yen	132.650000
Canadian dollar	1.365800
Euro	0.948317
Chinese yuan	6.892800
Australian dollar	1.497006
Swiss franc	0.939650
SDR	0.752014
Memorandum:	
Gold price, US$/oz	1831.62

Source: IMF, CBSL

Note: JPY and AUD rates as of December 23, 2022

The Following Adjustment Will Apply:

10. If (i) the amount of foreign program financing (exclusive of EFF disbursements) 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, (iv) the amount of project loans and grants disbursed to the central government, and (v) 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 2022 and thereafter.

11. If the sum of amortization of total external debt and interest payments on total external debt owed by the central government (excluding IMF) in U.S. dollar terms, as well as the sum of interest payments on SLDBs and FCBUs 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. Total external debt refers to external debt owed by the central government to all foreign creditors (excluding IMF), as defined in the *2013 External Debt Statistics: Guide for Compilers and Users*. These adjustors will apply to the NIR floor for end-December 2022 and thereafter.

Table 2. Sri Lanka: Program Assumptions

(Cumulative from the beginning of each calendar year, in million US$)

	Mar. 2023	Jun. 2023	Sep. 2023	Dec. 2023
Foreign program financing of the central government	0	330	750	900
Net borrowings from SLDBs and FCBUs by the central government	0	0	0	0
External commercial loans (including Eurobonds and syndicated loans) by the central government	0	0	0	0
Proceeds from commercialization of public assets to non-residents	0	0	0	0
Amortization of total external debt owed by the central government (excl. IMF)	239	778	877	989
Interest payments on total external debt owed by the central government (excl. IMF)	47	107	337	568
Interest payments on SLDBs and FCBUs by the central government in US dollar terms	0	0	0	0
Project loans and grants disbursed to the central government	219	548	876	1,204

12. In the event NIR outcome outperforms its program target(s), the CBSL will consult with IMF staff on raising the targets for subsequent test dates accordingly to safeguard such overperformance.

D. Performance Criterion on the CBSL's Net Credit to the Government (NCG)

13. **The CBSL's net credit to the Government (NCG)** will be measured as the difference between a) and b) below.

(a) The CBSL's claims on the central government, which include provisional advances, government securities acquired by the CBSL through primary market purchases, the central government's special direct issuances to the CBSL, and long-term or outright open market operations. For the program monitoring purpose, government securities acquired through purchases of government securities, solely for monetary policy purposes (e.g., standing lending facility and short-term open market operations) and emergency liquidity assistance (ELA) operations, on a temporary basis with an agreement to reverse the transaction in less than 90 days, will be excluded from the CBSL's claims on the central government. For the program monitoring purpose, the stock of government securities held by the CBSL will be measured in the face value.

(b) The central government's Rupee-denominated deposits at the CBSL. The deposits related to foreign program financing (including IMF disbursements) placed at the government's account at the CBSL are not part of the central government's Rupee-denominated deposits at the CBSL.

The Following Adjustment Will Apply**:**

14. The ceiling on the CBSL's NCG will be adjusted upward by the amount of shortfalls in foreign program financing of the central government (measured against programmed amounts as set out in Table 2). This adjustor will only apply to the NCG ceiling during six months after the program approval. It will not apply to the NCG ceiling for end-December 2023 and thereafter. The foreign currency amounts will be converted to Sri Lankan rupees using the program exchange rates defined in paragraph 9.

II. CONTINUOUS PERFORMANCE CRITERIA

E. Performance Criterion on New External Payment Arrears of the Nonfinancial Public Sector and the CBSL

15. 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. Arrears resulting from the nonpayment of debt service, for which a rescheduling or restructuring agreement is being sought, are excluded from this definition. This continuous performance criterion will be monitored continuously by the authorities and any non-observance will be immediately report to the Fund.

F. Other Continuous Performance Criteria

16. During the program period, Sri Lanka will not:

a) impose or intensify **restrictions on the making of payments and transfers** for current international transactions;

b) introduce or modify **multiple currency practices** (MCPs);

c) conclude **bilateral payment agreements** that are inconsistent with Article VIII of IMF Articles of Agreement; and

d) impose or intensify **import restrictions** for balance of payments purposes.

III. MONETARY POLICY CONSULTATION CLAUSE

17. 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 CCPI index (2021=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 2023 or end-December 2023 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-March 2023, end-June 2023, end-September 2023, and end-December 2023, the authorities will complete a consultation with IMF staff on the reasons for the deviation and the proposed policy response.

IV. INDICATIVE TARGETS

F. Indicative Target on Central Government Tax Revenue

18. 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 2021, central government tax revenue defined in this manner was Rs 1,298 billion.

G. Indicative Target on Social Safety Net Spending

19. The Social Safety Net (SSN) spending is the central government’s spending on SSN programs[2] comprising of: (1) Samurdhi cash transfers; (2) assistance to the elderly (over 70 years of age); (3) allowance for disabled people; and (4) financial support for kidney patients. These classifications are in line with the reporting in the Ministry of Finance Annual Report as in Table 9).

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

20. 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.

21. 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

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[2] Including additional relief, defined as relief to those who are affected by difficult economic circumstances and allocated to the four programs defined here.

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.

22. Starting on January 1, 2024, the cost of NCOs for electricity during each quarter will be 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. Until January 1, 2024, the cost of NCOs for electricity during each quarter will be measured by total losses as reported on the CEB's financial statement. 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 transfers disbursed (including capital injection as specified in paragraph 6) to CEB.

23. 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 2023:

NCO(2022Q4) – G(2023Q1)

For the test date of end-June 2023:

{ NCO(2022Q4) + NCO(2023Q1) } – { G(2023Q1) + G(2023Q2) }

For the test date of end-September 2023:

{ NCO(2022Q4) + NCO(2023Q1) + NCO(2023Q2) }

– { G(2023Q1) + G(2023Q2) + G(2023Q3) }

For the test date of end-December 2023:

{ NCO(2022Q4) + NCO(2023Q1) + NCO(2023Q2) + NCO(2023Q3) }

– { G(2023Q1) + G(2023Q2) + G(2023Q3) + G(2023Q4) }

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 transfers to CPC and CEB disbursed during quarter "q"

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

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

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

I. Indicative Target on Treasury Guarantees

24. 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 comfort. 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. 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-2021, the outstanding treasury guarantees were valued at Rs 1,506 billion.

V. DATA REPORTING REQUIREMENTS

25. 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 and expenditure arrears under the program, data will be provided in the format as shown in Tables 3, 4, and 5. For the purpose of monitoring the NCG targets under the program, data will be provided in the format shown in Table 6. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 7 and 8. For the purpose of monitoring the performance against the indicative target on social safety net spending, data will be provided in the format shown in Table 9 on a quarterly basis. 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 10, 11, and 12, respectively, on a quarterly basis. For the purpose of monitoring the performance against the indicative target on the cost of fuel NCO (net of government transfers), data will be provided in the format shown in Table 13 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 14 on a quarterly basis.

26. Data relating to the fiscal targets (Table 3, Table 4, and Table 5) 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 monetary targets (Table 6) will be furnished within no more than four weeks after the end of each month. Data relating to the external targets (Table 7 and Table 8) will be furnished within no more than three weeks after the end of each month. Data relating to the indicative target on social safety net spending (Table 9) will be furnished within no more than two months after the end of each quarter. Data relating to the three state-owned enterprises (Tables 10-12) 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 NCO (net of government transfers) (Table 13) 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 14) will be furnished within no more than two months after the end of each quarter.

27. For the purpose of monitoring the financial sector, the authorities will provide a monthly written update on the progress of the bank diagnostic exercise and the following information on a bank-by-bank basis:

- Liquidity monitoring template, with breakdown by currency (daily)
- Liquidity forecast template, with breakdown by currency (weekly)
- LCR template, with breakdown by currency (monthly)
- Net open foreign currency positions (weekly)
- Exposures to the central government and SOEs, with breakdown by entity, currency, and instrument (monthly)
- Maturities of exposures to the central government and SOEs (monthly)
- Arrears of state-owned banks (monthly)
- Impairment schedule including breakdown of impairments on public sector exposures (monthly)
- Monthly supervisory returns to CBSL including statements of financial position and comprehensive income (monthly)
- Top 10 largest depositors (quarterly)
- Large exposures exceeding 15 percent of capital (quarterly)
- Capital adequacy template (quarterly)
- Financial soundness indicators (quarterly)

Daily financial sector data will be provided within one week of the end of the reporting period; weekly data within two weeks; monthly data within four weeks; quarterly data within six weeks.

Table 3. Sri Lanka: Central Government Operations

(In millions of rupees)

- **Total Revenue and Grants**
  - Total Revenue
    - Tax Revenue
      - Income Taxes
        - Personal & corporate
          - Corporate & non-corporate
            - Personal
            - Corporate
          - Personal Income Tax (PAYE)
        - Economic Service Charge
        - Interest Income tax
      - Tax on goods & services
        - VAT
          - Domestic
          - Imports
        - Excise Taxes
          - Liquor
          - Cigarettes
          - Motor vehicles
          - Petroleum
          - Other
        - Other taxes & levies incl. SSCL
          - Social Security Contribution Levy
            - Domestic
            - Financing
          - Other Taxes and Levies
      - Tax on external trade
        - Import Duties
        - Cess Levy
        - Special Commodity Levy
        - Port & Airport Development Levy
    - Non Tax Revenue
      - Property Income
      - Fines, Fees and Charges
      - Other
  - Grants
- **Total Expenditure**
  - Current 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 Finanicng (Net)
  - Total Domestic Financing (Net)
- Privatization

Table 4. Sri Lanka: Central Government Financing

(In millions of rupees)

	(i) Borrowing / Cash inflow	(ii) Repayment / Cash outflow	(iii) Net
1. Domestic financing in local currency			
T-Bills (net) 1/			
T-Bonds 1/			
Loans			
Deposits and overdrafts at banks			
CBSL advances and deposits			
Other (specify)			
2. Domestic financing in foreign currency			
Sri Lankan Development Bonds (SLDB) 1/			
Loans			
Other (specify)			
3. Net foreign financing			
International Soverign Bonds 2/			
Official project loans			
Official program loans			
Official trade credit			
Syndicated loans			
Other (specify)			
4. Privatization receipts			
Total financing (1+2+3+4)			

1/ including net purchases by non-residents

2/ including net purchases by residents

Table 5. Sri Lanka: Unpaid Bills and Arrears 1/

(In millions of rupees)

Recurrent
Capital
Total
o.w. more than 3 months:
Recurrent
Capital
Total

1/ as agreed for the purpose of monitoring the program

Table 6. Sri Lanka: CBSL's Balance Sheet 1/

(In millions of rupees)

Net foreign assets
Foreign assets
Foreign liabilities
o.w. Reserve liabilities
Net dometic assets
Net credit to government
Claims on government
Provisional advances
Treasury bills, o.w.,
Acquired through primary market purchases 1/
Acquired through standing lending facility operations
Acquired through ST OMOs
Acquired through LT OMOs
Acquired through outright OMOs
Acquired through emergency liquidity assistance
Treasury bonds, o.w.,
Acquired through standing lending facility operations
Acquired through ST OMOs
Acquired through LT OMOs
Acquired through outright OMOs
Government deposits 2/
Claims on commercial banks
Other items (net)
Reserve money
Currency in circulation
Commercial bank deposits
Memo: Net worth of the CBSL

1/ includes direct issuances of treasury securities by the government to the CBSL.

2/ Rupee-denominated deposits, excluding those converted from foreign program financing.

Table 7. Sri Lanka: Foreign Exchange Cashflows of the Central Bank and the Government 1/

(In millions of U.S. dollars)

1. Total inflows, without swaps
Loans (public sector)
Program loans (budget support)
Project loans and grants
SLDBs
FCBUs
Commerical loans
Syndicated loans
Sovereign bonds
Other inflows
Interest receipts, forex trading profits, capital gains
Change in balances in DST account
o/w proceeds from public assets

2. Total outflows, without swaps
Public sector debt service
Public sector amortization (excl. to IMF)
Official loans
multilateral creditors
India credit lines
other loans
SLDBs
FCBU loans
Syndicated loans
Settlement of ISBs
Public sector interest payment (incl. to IMF)
Interest to IMF
Interest to external creditors
Interest on domestic FX debt (SLDB, FCBU, etc)

3. Net FX purchases from market
Outright purchases of FX from commercial banks
Outright sales of FX to commercial banks

4. Swaps with domestic commercial banks
OMO FX swap transactions-inflows
OMO FX swap transactions-outflows

Net inflows (incl. swaps = 1-2+3+4) at current rates
Net inflows (excl. swaps = 1-2+3) at current rates

Net International Reserves (at market rates)
Net International Reserves (at program rates)
Gross International Reserves (at market rates)

Changes in Reserve Related Liabilities
Change in ACU liabilities
Change in liabilities to IMF
existing debt service (amortization)
new purchases
International swaps with foreign CBs
inflows
outflows
Valuation changes

Changes in CBSL other liabilities

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

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

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

Table 9. Sri Lanka: Social Safety Net Spending (by Month) 1/

(In millions of rupees)

Budget Code		Total	Of which, externally financed
	Total Social Safety Net Spending [2/] = (1)+(2)+(3)+(4)		
	Cash transfers to empower the vulnerable and needy 2/		
331-2-02-001-1501	(1) Samurdhi cash transfers		
171-2-7-011-1501, 171-2-7-012-1501	(2) Assistance to elderly (over 70 years and over 100 years)		
171-2-7-001-1501	(3) Allowance for disabled people		
171-2-7-004-1501	(4) Financial support for kidney patients		
	Memorandum items:		
	Relief to those affected by the difficult economic circumstances from January to April 2023		
	Relief to those affected by the difficult economic circumstances from May to September 2023		

1/ In line with the reporting of the Ministry of Finance Annual Report

2/ Includes relief to those affected by the difficult economic circumstances. Recipients include current, waitlisted, and new beneficiaries of the four main SSN programs i.e., (1), (2), (3), (4) above.

Table 10. 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 11. 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 12. 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 13. 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 14. Sri Lanka: 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

March 14, 2023

REQUEST FOR AN EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—SUPPLEMENTARY INFORMATION AND REVISED PROPOSED DECISIONS

Prepared By	Asia and Pacific Department

This supplement provides an update on recent developments since the issuance of the report on March 7, 2023. The update does not alter the thrust of the staff appraisal.

Lending into Official Arrears. As noted in the staff report, Iran, Kuwait, Pakistan, and Saudi Arabia required more time to consent to the IMF financing notwithstanding Sri Lanka's arrears owed to them. Since then, consent has been received from Pakistan, Saudi Arabia, and Kuwait on March 8, March 9, and March 12, 2023, respectively. Having not received such consent from Iran, staff has examined the application of the three criteria under the Lending into Official Arrears policy with respect to the provision of Fund financing for Sri Lanka in view of their claims. Based on staff's assessment (see Annex I attached to this supplement) all three criteria are satisfied.

President's open letter to bilateral creditors. The President of Sri Lanka issued an open letter to the country's official bilateral creditors on March 14, 2023.[1] In the letter, he encouraged bilateral creditors to coordinate—in any form they deem appropriate—and makes three specific commitments: (i) to communicate transparently on financial liabilities and agreed debt treatments; (ii) not to resume debt service without a treatment consistent with IMF program parameters and comparability of treatment (CoT); and (iii) to ensure comparable treatment of all external creditors.

Signed MoU on financial obligations to the IMF. On March 10, the Central Bank of Sri Lanka and the Ministry of Finance signed a memorandum of understanding that clarifies the responsibilities for timely servicing of their financial obligations to the IMF.

Abolishment of banks' surrender requirements.

- **The CBSL has recently abolished the requirements that banks surrender, to the CBSL, a certain portion of converted foreign exchange inflows from exports and inward worker remittances, thus eliminating a related Multiple Currency**

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[1] The letter is available on the website of Ministry of Finance, Economic Stabilization and National Policies.

Practice (MCP) and two Capital Flow Measures (CFMs). Effective March 7, 2023, the requirement for banks to sell to the CBSL a fraction of their purchases of FX from export proceeds and inward workers' remittances has been repealed. As a result, the MCP arising from the use of a weekly volume weighted average rate for the mandatory surrender of FX by banks of these proceeds to the CBSL has been eliminated. In addition, it also implies that the two outflow CFMs—a surrender requirement for banks on purchases of export proceeds and a surrender requirement for banks on purchases of inward worker remittances—have been eliminated as well.

- **Staff continues to support the approval of all remaining MCPs, for a period of twelve months or until the next Article IV consultation, whichever is sooner, as the measures giving rise to them are maintained for BOP reasons, are temporary, and do not give Sri Lanka an unfair competitive advantage over other members or discriminate among members**.

Annex I. Lending into Arrears to Official Bilateral Creditors—Staff's Assessment of Three Criteria

Staff assesses that the conditions are met for the Fund to provide financing to Sri Lanka in line with the policy on arrears to official bilateral creditors, notwithstanding its outstanding arrears to Iran. In particular:

1. Prompt financial support from the Fund is considered essential and the member is pursuing appropriate policies. Sri Lanka continues to face significant macroeconomic challenges. The Fund's prompt financial support is considered essential to address Sri Lanka's balance of payments problems and restore its debt sustainability. The authorities are pursuing appropriate policies under the EFF-supported arrangement, notably by implementing an ambitious revenue-based fiscal consolidation supported by a comprehensive debt restructuring, pursuing a multi-pronged strategy to restore price stability and rebuild external buffers, safeguarding financial stability and social safety net, reducing corruption vulnerabilities, and enhancing growth prospects.

2. The debtor is making 'good faith' efforts to reach agreement with the creditor on a contribution consistent with the parameters of the Fund-supported program:

- *In terms of process*, Sri Lanka has engaged in good faith with its bilateral official creditors. Iran received bilateral letters from the authorities on process updates on two occasions. The Alternative Executive Director representing Sri Lanka at the IMF also reached out bilaterally to his Iranian counterpart to provide him with the latest debt data and information.

- *In terms of requested relief*, the authorities are committed to continue their good faith efforts until all the remaining arrears are resolved on terms consistent with restoring debt sustainability and program parameters, and to offer all creditors comparable terms to avoid disproportionate contributions from any of their bilateral creditors.

3. The decision to provide financing despite these arrears is not expected to have an undue negative effect on the Fund's ability to mobilize official financing packages in future cases. Creditors representing a large majority of official bilateral claims (95 percent) subject to a debt treatment have indicated their commitment to debt restructuring and provided specific and credible financing assurances, including China, Hungary, India and the Paris Club. Saudi Arabia has also "expressed its support for the process and acknowledged the importance to offer financing assurances in the near future."[1] Debt service to Iran (0.7 percent) is small relative to total official bilateral debt service subject to restructuring, so that the contribution to financing the program from Iran would be small relative to the contribution of other official bilateral creditors. Historically, Iran has a very limited track record of providing relief in the context of Fund-supported programs (including no provision of HIPC relief to its 3 completion-point debtors). Overall, in staff's view,

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[1] As recorded in the statement following the Paris Club meeting to provide financing assurances, held in the presence of representatives of Saudi Arabia and the Kuwait Fund for Arab Economic Development.

providing financing to Sri Lanka despite its arrears is not expected to have an undue negative effect on the Fund's ability to mobilize future financing packages, given strong support from the international community in the context of the Fund-supported program, including credible and specific assurances from creditors accounting for a large majority of bilateral claims, and the Sri Lankan authorities efforts to resolve the arrears in a timely manner.

INTERNATIONAL MONETARY FUND

SRI LANKA

March 16, 2023

REQUEST FOR AN EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY—FURTHER SUPPLEMENTARY INFORMATION

Prepared By	Asia and Pacific Department

This supplement provides an update on recent developments since the issuance of the first staff supplement on March 15, 2023. The update does not alter the thrust of the staff appraisal.

1. **This supplement reports on information that has become available since Supplement 1 was circulated to the Executive Board on March 15, 2023.** Staff has subsequently learnt that the Iranian authorities have indicated that they consent to the provision of Fund financing to Sri Lanka, notwithstanding official arrears owed by Sri Lanka to Iran.

2. **Consent by the Iranian authorities under the Fund's Lending into Official Arrears ("LIOA") policy means that the assessment proposed in Supplement 1 is no longer necessary.** Given that the creditor member has now consented to the provision of Fund financing notwithstanding arrears, under the LIOA policy, this consent is sufficient for the Fund to proceed to provide financing to Sri Lanka notwithstanding its official arrears to Iran.

Statement by Krishnamurthy Subramanian, Executive Director for Sri Lanka and Chandranath Amarasekara, Alternate Executive Director

March 20, 2023

Our Sri Lankan authorities express their deep appreciation to the mission team led by Messrs. Breuer and Nozaki for the series of candid discussions in Colombo, in Washington DC, and virtually, over the past 12-months on an appropriate Fund-supported Program for Sri Lanka. The authorities thank the Managing Director and the management team of the Fund and the Asia Pacific Department for their leadership that greatly facilitated the process. Our authorities also extend their sincere gratitude to all nations – particularly to India for leading the way – for providing the necessary financing assurances and required support, thereby enabling staff to submit Sri Lanka's request for a 48-month Extended Arrangement under the Extended Fund Facility (EFF), with an access to Fund resources of approximately US$ 3 billion (395 percent of quota), to the Executive Board for its consideration. The authorities express hope that the implementation of the economic program supported by the EFF will bring about much-needed stability to the Sri Lankan economy, paving the way for longer-term sustained and inclusive growth in Sri Lanka.

In 2022, Sri Lanka experienced the worst socio-economic and political crisis in its post-independent history. Although fiscal and monetary policy stimuli helped a rebound of the economy from time to time over the past few years, events that unfolded since 2018, including the constitutional crisis in 2018, the Easter Sunday terrorist attacks in 2019, and the COVID-19 pandemic thereafter, considerably weakened the Sri Lankan economy. The situation was exacerbated by grave policy missteps that included unsustainable direct and indirect tax cuts, continued monetary financing of fiscal deficits at suppressed interest rates, a prolonged period of low interest rates that caused excessive monetary expansion and balance of payments pressures, flawed pricing policies for petroleum products, electricity and other public utilities, an ill-timed ban on chemical fertilizer, and the defense of the exchange rate at the expense of the country's foreign exchange reserves.

Sri Lanka had lost access to the conventional international financial markets with the onset of the pandemic, and had exhausted all fiscal, monetary, external sector and financial sector buffers by early 2022. Rising inflation and shortages of essentials, including basic food items, pharmaceutical supplies, cooking gas and domestic petroleum products, together with long power cuts, resulted in a collapse of business confidence, severely affected the ongoing recovery in tourism, and most importantly, triggered widespread public protests of an unprecedented scale that resulted in a change of key positions of the government over the next few months.

In the meantime, the government expressed its desire for close IMF engagement and made a request for a Fund-supported stabilization program. The government also announced a debt service standstill in April 2022, as almost all usable foreign exchange reserves of the country had been exhausted. The government commenced introducing necessary stabilization measures broadly in line with the recommendations of the 2021 Article IV consultations, and introduced additional measures to address the shortages of essentials with the assistance of friendly nations. In this regard, the authorities extend their special thanks to India for stepping in during the country's hour-of-need and providing emergency financing through multiple channels, at a time of extreme uncertainties surrounding the recovery of such financing – a rare act of kindness by any standard. The government also embarked on discussions with creditors to seek support for an IMF-backed program to regain debt sustainability and restore macroeconomic stability. Following intense negotiations, the authorities reached a Staff-Level Agreement (SLA) with the Fund on September 1, 2022, and continued to introduce policy adjustments and reforms to stabilize the economy while meeting the prerequisites needed for program approval. The delay in obtaining the approval for the EFF and the unpopular, yet essential, reform measures have caused some tensions in Sri Lanka in the past few weeks. However, our authorities, with a deep sense of conviction and ownership, reiterate their resolve to carry out the necessary reforms and take steps to institutionalize reforms in order to prevent any return to populist and unsustainable policies that would be detrimental to the country's progress in the long run.

Macroeconomic Stabilization as an Immediate Priority

The Sri Lankan economy contracted by an unprecedented 7.8 percent in 2022[a] reflecting the magnitude of the crisis it faced during the year. All three sectors of the economy, namely, Agriculture, Industry, and Services, were severely affected in 2022, and the impact of corrective policy measures is also having a dampening effect on economic activity in the near term. While the recovery in some agricultural subsectors, the rebound in tourism and the gradual return of business confidence are expected to aid economic recovery, the economy is projected to contract by around 3 percent in 2023. Our authorities, while hoping for a faster recovery over the medium-term, understand that normalization of economic activity following a debt crisis could be slow. At the same time, the authorities realize that the immediate priority for the Sri Lankan economy is to stabilize the economy, which is a prerequisite for long-term growth. Accordingly, the stabilization program proposed by the authorities includes measures to ensure durable fiscal consolidation, restore public debt sustainability, restore price stability, rebuild external reserves, and safeguard financial stability, along with those aimed at strengthening social safety nets, addressing governance and corruption vulnerabilities, and implementing other structural reforms that would help unlock Sri Lanka's growth potential.

Fiscal Developments and Policies

At 8.7 percent, 8.3 percent, and 8.4 percent of GDP in 2020, 2021 and 2022, respectively, Sri Lanka's central government revenue collection is one of the lowest in the world. On the other hand, the rigid government expenditure, including wages and salaries, subsidies and transfers and interest payments, prevents any effective developmental activity without increasing the fiscal deficit and debt levels. To raise revenue collection to 15.0 percent of GDP by 2026, reduce the overall fiscal deficit to below 5.0 percent of GDP by 2025, and register a primary surplus of 2.3 percent of GDP by 2025, the government has introduced a series of decisive fiscal measures. In the near term, the primary balance is projected to improve to -0.7 percent of GDP in 2023 from -5.7 percent in 2021.

Key revenue measures implemented over the past few months include a) increasing the schedule of rates for marginal personal income tax (PIT), raising the top marginal rate, reducing tax-free threshold, and rationalizing incremental tax slabs, b) increasing the standard rate for corporate income tax (CIT), removing tax holidays as well as sector-specific CIT exemptions, and unifying the rate structure for CIT, c) reinstating the value added tax (VAT) rate at 15 percent from 8 percent, lowering the VAT registration threshold, and removing some VAT exemptions, d) reinstating the mandatory withholding tax, and e) increasing rates for excise tax on alcohol and tobacco products, and on fuel. Going forward, the government expects to further revamp the VAT system to minimize exemptions, speed up valid VAT refunds, and abolish the Simplified VAT system that has created distortions. In addition, in 2024, our authorities plan to implement automatic indexation of excise taxes to inflation. In 2025, the authorities plan to revamp the property tax system and introduce a wealth transfer tax. The above measures are expected to make Sri Lanka's tax system more progressive, and gradually shift the focus of taxation from indirect to direct sources. The government has also embarked on revenue administration reforms to strengthen tax compliance, keeping in mind the relatively large size of the informal sector of the country. In order to enhance fiscal transparency, the government will document all tax expenditures provided under the Strategic Development Projects Act and the Board of Investment Act.

Expenditure containment measures would complement the government's efforts towards fiscal consolidation. Measures have been introduced to reduce operational expenses of the government and increase accountability of spending. The government proposes to limit the expansion of the wage and public sector pension bill, while ruling out pay cuts. Public investment, which has declined to unsustainably low levels, is expected to be raised over the medium-term, with measures to enhance its efficiency and transparency. The government has also taken steps to reduce the stock of budget expenditure arrears to zero, while limiting the issuance of treasury guarantees, and these measures are encapsulated in the proposed program.

Expenditure rationalization is not expected to compromise spending on health, education, and social protection. The crisis has increased the incidence of poverty and reversed the gains achieved in recent decades. The poorest of the poor are the most affected by the crisis, and there is evidence that many others are falling into poverty because of reduced real incomes and loss of livelihoods. The ongoing social safety net reforms are expected to improve coverage and targeting, thereby supporting the poor and the vulnerable, particularly during the ongoing adjustment phase. The authorities, with the assistance from the World Bank and the Asian Development Bank (ADB), maintained social safety net spending at Rs. 142 billion (0.6 percent of GDP) in 2022, and the government has proposed a spending floor of Rs. 187 billion for 2023. The Welfare Benefits Board (WBB) is being operationalized as the key focal point for social safety nets, and a donor coordination system is being established to lead discussions on external financing.

In the meantime, measures are being introduced to mitigate fiscal risks arising from state-owned business enterprises (SOBEs) and to reform the SOBE sector. Fuel and electricity prices have been adjusted in line with international market prices, and regular formula-based price revision mechanisms have been introduced. Such measures are expected to depoliticize pricing of energy and other public utilities, while eliminating the spillover effects of mispricing on the fiscal and financial sectors. A comprehensive strategy to reform the key SOBEs is expected to be introduced by mid-2023. The government expects to strengthen the framework for SOBE borrowing by limiting such borrowing to commercially viable activities and preventing foreign currency borrowing by non-financial SOBEs without adequate sources of foreign currency revenue. The government will transparently remunerate any subsidies and quasi-fiscal activities of SOBEs through government transfers.

A new Public Financial Management (PFM) law is expected to be in place from 2024, thereby introducing binding fiscal rules, including a legally binding government debt ceiling. The PFM law is also expected to establish the legal definitions for public debt and government deficit, clarify the budget formulation process, specify the responsibilities of the Ministry of Finance and spending units, establish information and accountability requirements, and introduce stricter guidelines on issuing treasury guarantees.

Inflation, Monetary Developments and Monetary Policy

Inflation (Colombo Consumer Price Index (CCPI) based, year-on-year) accelerated from 5.7 percent in September 2021 to 69.8 percent in September 2022, i.e., over a space of merely one year. Causes for this acceleration included the depreciation of the Sri Lanka rupee, disruptions to domestic food production, global fuel and food price shocks, price revisions of domestic fuel, electricity, and cooking gas supplies along with the associated increases in other prices, and unsustainable monetary financing of the fiscal deficits that de-anchored inflation expectations. Inflation has decelerated thereafter in response to policy tightening, measuring 50.6 percent in February 2023. A sharper deceleration is projected over the next few months. Monthly inflation has hovered within a range of -0.7 percent and 0.5 percent over the past five months, indicating that high year-on-year inflation recorded at present is due to legacy effects than due to ongoing inflationary pressures.

The policy interest rate corridor of the Central Bank of Sri Lanka (CBSL) was increased from 5.00-6.00 percent at end 2021 to 15.50-16.50 percent by March 2023, with a decisive seven percentage-point hike in April 2022. The latest monetary policy adjustment in March 2023 was carried out after much deliberation between the Fund staff and the CBSL. The CBSL remains committed to a data-driven monetary policymaking process, and is confident of bringing down inflation to single digit levels by end 2023, and subsequently to the target range of 4-6 percent by 2024.

Most market interest rates increased, with the prime lending rate and yields on Sri Lanka Rupee denominated Government securities peaking at 29.67 percent and 33.14 percent, respectively. The year-on-year growth of credit to the private sector by commercial banks decelerated from 20.3 percent in April 2022 to 6.2 percent at end 2022. Credit to the private sector, after adjusting its foreign currency-denominated component for exchange rate depreciation, contracted by 3.3 in 2022. Credit to small and medium scale enterprise (SME) sector contracted by 8.3 percent in 2022. In the absence of required foreign financing flows to the government, domestic financing has continued to expand. Within domestic financing, financing by the CBSL still accounts for a significant portion. Monetary financing of the fiscal deficit shall be prohibited under the new Central Bank bill that is expected to be enacted by end-April 2023, while further safeguards are proposed under the program for the interim period. Borrowing requirements of SOBEs are expected to decline notably, due to the introduction of cost-recovery based pricing mechanisms.

The enactment of the new Central Bank bill will also assist in firmly anchoring inflation expectations by prohibiting monetary financing, introducing institutional reforms that would enhance the independence of the CBSL, institutionalizing the flexible inflation targeting monetary policy framework with exchange rate flexibility, and increasing accountability of the CBSL in relation to price stability.

External Sector Developments

Sri Lanka faced severe balance of payments pressures over the past few years, with catastrophic effects in 2022. The Easter Sunday attacks, the COVID-pandemic and the uncertainties in 2022 significantly affected earnings from tourism. Worker remittances declined considerably in 2021 and 2022. While merchandise exports remained resilient, the expectation of an imminent exchange rate depreciation increased imports in late 2021, resulting in a large trade deficit of US$ 8.1 billion in 2021, despite the imposition of import controls. After Sri Lanka lost access to the international conventional capital market, flows to the financial account dried up. This loss, combined with sizable debt service payments that were made until mid-April 2022, caused a significant loss of gross official reserves (GOR) in 2020, 2021 and 2022, and exhausted the usable reserves.

The sharp depreciation of the Sri Lanka Rupee in early 2022, the tight monetary policy stance, decline in real incomes and purchasing power, and tighter controls on imports resulted in a narrower trade deficit of US$ 5.2 billion in 2022. Worker remittances are on an upward trend while tourist arrivals have also begun to show signs of sustained recovery.[b] The stability of the foreign exchange market also benefitted from the debt service standstill that is in place and the capital flow measures (CFM), as well as the quota system for fuel distribution. With positive sentiments in the domestic foreign exchange market rising, the CBSL eliminated the guidance given to the market on the exchange rate and allowed the exchange rate to be determined by market forces. Thus far in 2023, the CBSL has been able to purchase over US$ 950 million on a net basis towards building up reserves, while the Sri Lanka Rupee has appreciated by around 11 percent against the US$ during this period, reflecting improving market sentiments in anticipation of the Executive Board approval of the EFF.

The CBSL remains committed to a flexible exchange rate policy that is consistent with the flexible inflation targeting framework, and to building up reserves through regular intervention in the domestic foreign exchange market as envisaged in the program. The authorities have also requested temporary approval of the remaining exchange restrictions and multiple currency practices until a sustainable outcome in the foreign exchange market is achieved.

Financial Sector Developments and Stability

The impact of the economic crisis had severe implications on the financial system through various channels. Subdued economic activity, reduced disposable income, and lack of demand for credit resulted in a deceleration in asset growth in the banking sector and a deterioration in the asset quality and profitability of the sector in 2022. The rest of the regulated financial sector is also experiencing similar developments. Amidst these risks, the government and the CBSL remain committed to ensuring the stability of the financial system by addressing any vulnerabilities in the system. The authorities are mindful of the significant impact on financial sector activity arising from the macroeconomic stabilization measures that have been put in place, as ensuring financial system stability is vitally important in facilitating economic recovery and for effective monetary policy transmission.

A comprehensive diagnostic exercise is ongoing for a group of banks covering more than 70 percent of domestically-owned bank assets. The asset quality review component of this diagnostic is expected to be concluded by April 2023. The CBSL will develop a roadmap for financial sector restructuring and recapitalization by July 2023. The asset quality review is expected to be extended to a larger group of banks accounting for an additional 20 percent of domestically-owned banking assets, and this exercise is expected to be completed in August 2023.

The CBSL's crisis management powers and the framework for financial sector supervision are being strengthened through appropriate legislation that is to be enacted this year. The CBSL has already updated its framework for Emergency Liquidity Assistance for banks. In addition, a coordinating committee will be appointed to ensure the effectively management of risks to financial stability, with representation of the financial sector regulators and the Ministry of Finance. The new Central Bank Act will also establish the CBSL's authority for macroprudential regulation and supervision, supporting the maintenance of financial system stability.

The authorities are continuing to strengthen the country's AML/CFT framework. These efforts include legislative reforms to further align the existing framework with international standards.

Envisaged amendments to the Companies Act will address the only remaining non-compliant aspect of the FATF 40 recommendations.

Restoring Public Debt Sustainability

Given the depth of Sri Lanka's debt problem, fiscal consolidation efforts led by the series of significant revenue measures outlined in Paragraph 7 above alone are insufficient to ensure a return of the public debt to a more sustainable level. In line with the IMF's debt sustainability analysis (DSA) and program parameters, a) the ratio of public debt to GDP needs to be reduced from around 128 percent in 2022 to below 95 percent over a 10-year period, and b) the central government's annual gross financing needs and its annual debt service in foreign currency need to be reduced. Achieving these outcomes requires the assistance of the creditor community. For this purpose, the government has engaged with all creditors in a transparent manner and has also hired legal and financial advisors.

In order to facilitate transparent negotiations on debt treatment, the government, in consultation with Fund staff, has reclassified certain debts that were previously included in SOBE balance sheets and recognized them as central government debt. A comprehensive Public Debt Summary[c] and a Quarterly Bulletin of Public Debt and Debt Service[d] are now in the public domain, with the most up-to-date information.

The government is appreciative of the specific and credible financing assurances from India, the Paris Club, Hungary, and China, as well as the consent of other official bilateral creditors to Fund financing to Sri Lanka notwithstanding the arrears. The authorities also appreciate the cooperation of external commercial creditors in this regard. The government reiterates its commitment to a debt resolution consistent with the IMF program parameters and stands ready to use additional safeguard mechanisms to ensure comparable treatment, as appropriate. In this regard, the authorities have issued a Presidential letter addressed to all bilateral official creditors a) assuring transparency on any debt treatment terms that are agreed with any creditor or group of creditors, before being formalized, b) committing not to resume debt service to any creditor unless that creditor agrees on a comprehensive debt treatment in line with IMF-supported program parameters and the comparability of treatment principle, and c) reiterating commitment to a comparable treatment of all external creditors, with a view to ensuring all-round equitable burden sharing for all restructured debts.[e] An announcement on the coverage and parameters of debt operations is expected to be made before end-April 2023.

Reforms to Facilitate Long-Term Growth and Sustainability

While the program components outlined above would strengthen macroeconomic fundamentals and place Sri Lanka on a stronger footing for sustained growth and development, the government will continue to facilitate growth-supportive reforms to address long-identified barriers to sustained high growth. These include reforms to improve the investment climate of the country, trade liberalization and export diversification, and reforms to address deficiencies in the labor market and other factor markets to improve the overall productivity in the economy. The government is working with the World Bank, ADB and other development partners on implementing these reforms. Being an island economy susceptible to climate shocks, climate change adaptation and mitigation also remain key areas of reform towards achieving long-term growth and sustainability. As the stabilization phase of the IMF-supported program progresses, greater focus would be directed to such structural reforms.

The government considers its efforts to reduce corruption vulnerabilities as a critical component of the reform program. In this regard, the Fund has been invited to conduct a governance diagnostic of Sri Lanka's anti-corruption framework. The government is committed to supporting the diagnostic exercise, publishing the report by end-September 2023, and implementing the identified reforms under the EFF. The government will work with the IMF to strengthen legislation and enhance compliance in line with international best practices. Efforts to digitalize revenue administration, procurement processes and other government services are also expected to reduce opportunities for corruption.

Concluding remarks

The Sri Lankan government recognizes that the approval of the EFF alone is insufficient to resolve the issues the country is currently facing. While the delay in seeking Fund assistance is regretted, due to various reasons, it has taken a period of 12 months, as well as extraordinary efforts from all stakeholders, to design an appropriate stabilization program, complete the prerequisites, coordinate with creditors, and secure the necessary financing assurances, before reaching the current stage of Executive Board approval. The government hopes that the next steps in finalizing debt treatment would be faster, as further delays could lengthen the Sri Lanka's economic recovery process.

The government has benefitted from the close engagement with the Fund during the past year, particularly through policy discussions and technical assistance in the areas of fiscal reforms, financial sector reforms, and institutional reforms through necessary legislative changes. The government also expects that the approval of the EFF will lead to notable catalytic effects to mobilize support from the World Bank, ADB and other bilateral and multilateral development partners, as well as to rebuild confidence in the economy as the reform program progresses.

The government is aware of the serious downside risks that the economy is facing and is determined to decisively address these under the IMF-supported economic program. Recognizing the fact that a major reason for the country's lack of continued progress is the deficiency in implementing the identified essential reforms, our authorities express their willingness to learn from countries that have faced similar crises and recovered through the timely implementation of successful reform programs. In essence, in the spirit of the motto "never waste a crisis," our authorities are determined to use the current crisis and the IMF-supported reform program as an opportunity to durably address Sri Lanka's institutional weaknesses and ensure macroeconomic stability and sustainability, going forward.

Following the Executive Board approval, our authorities also propose to present the IMF-supported economic program to the Parliament for discussion and to mobilize the necessary consensus for the successful implementation of the program.

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[a] National Account estimates for the year 2022 were released on March 15, 2023.

[b] Provisionally, worker remittances are estimated at US$ 885 million in the first two months of the year, while earnings from tourism are estimated at US$ 332 million during the same period.

[c] https://treasury.gov.lk/api/file/a969a81b-13d9-4337-a5b7-858d31eb3715

[d] https://treasury.gov.lk/api/file/d857ad94-e632-4fc6-a221-cab9965d7085

[e] https://treasury.gov.lk/api/file/9a7403c4-83bd-4c25-b618-ff8e01f4e5fc