May 2001
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Sri Lanka: 2000 Article IV Consultation and Request for A Stand-by Arrangement—Staff Report; Public Information Notice; and Press Release on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2001 Article IV consultation with Sri Lanka and request for a Stand-by Arrangement, the following documents have been released and are included in this package:

- the staff report for the combined 2001Article IV consultation and request for a Stand-by Arrangement, prepared by a staff team of the IMF, following discussions that ended on **January 31, 2001** with the officials of Sri Lanka on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on March 20, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) and a Press Release, summarizing the **views of the Executive Board as expressed during its April 20, 2001 discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

The document(s) listed below have been released.

Letter of Intent by the authorities of the member country*
Memorandum of Economic and Financial Policies by the authorities of the member country*
Technical Memorandum of Understanding*

*May also be included in Staff Report.

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

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Washington, D.C.**

INTERNATIONAL MONETARY FUND

SRI LANKA

Staff Report for the 2001 Article IV Consultation and Request for Stand-By Arrangement

Prepared by the Asia and Pacific Department and the Policy Development and Review Department

(In consultation with other departments)

Approved by R. Anthony Elson and Mark Allen

March 20, 2001

- **In concluding the 1999 Article IV consultation, Executive Directors stressed the critical importance of accelerating key structural reforms to lay the foundation for strong, sustainable and private-sector-led growth**. Since the Presidential election in December 1999, there has been some progress on reforms, particularly in the financial sector. However, despite steady economic growth, the fiscal situation has worsened in the past year and the external position has deteriorated sharply—resulting from a combination of higher oil costs, increased military spending and limited adjustment.
- **A staff team visited Colombo during January 18–31, 2001 to conduct the 2001 Article IV consultation discussions and to discuss the authorities' request for Fund financial support**. The Board completed the 1999 consultation on October 13, 1999—the 2000 consultations had originally been scheduled for May/June 2000, but were delayed because of the political and economic problems, and, later, election timing. Discussions were held with the President, the deputy ministers of finance, the ministers of ports, labor, and higher education, the Governor of the Central Bank of Sri Lanka (CBSL), the Finance Secretary, and other senior officials.
- **Sri Lanka accepted the obligations of Article VIII, Sections 2, 3, and 4 in March 1994**, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.
- The staff team comprising J. Carter (head), W. Abdelati, D. Kanda, and I. H. Lee (all APD), S. Singh (PDR), A. Annett (FAD) and S. Menon (administrative assistant), was assisted by the Senior Resident Representative, Mr. Haque. Mr. Jayatissa, Alternate Executive Director, participated in the discussions.

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I. Introduction

1. **In concluding the 1999 Article IV consultation with Sri Lanka on October 13, 1999, Executive Directors stressed the need to address the longstanding economic problems that were impeding Sri Lanka's growth.** They encouraged the authorities to strengthen macroeconomic policies and accelerate structural reforms. It was hoped that the international financial community could support such an effort in the form of an arrangement under the Poverty Reduction and Growth Facility (PRGF). However, the emergence of macroeconomic imbalances in mid-2000 created a need for immediate stabilization measures and led the authorities to consider requesting quick-disbursing resources under a Stand-By Arrangement.

2. **Macroeconomic management and structural reform have been complicated by a difficult political situation.** Following her re-election in December 1999, President Kumaratunga attempted to reach agreement with the opposition party on proposals to resolve the prolonged and costly ethnic conflict and to introduce constitutional reform. Meanwhile, the fighting with the Liberation Tigers of Tamil Eelam (LTTE) remained fierce, with frequent bombing episodes in the capital adversely affecting business confidence. The LTTE inflicted a major military defeat on the government forces in April 2000. To offset this threat, the government stepped up military spending significantly. The parliamentary elections in October 2000 required the Peoples Alliance to form a coalition with two minor Tamil parties to retain power, while there was a strong showing by the extreme left-wing Janatha Vimukthi Peramuna (JVP) party. More recently, political developments have been more favorable—the Norwegian government has led recent peace initiatives, and the LTTE declared a series of monthly ceasefires since Christmas.

3. **Against this background, the 2001 Article IV consultation discussions focused on ways to address the serious immediate economic problems and to resume progress toward medium-term fiscal consolidation in the 2001 budget.** The structural reforms necessary for Sri Lanka to sustain higher growth, that could be supported under a PRGF arrangement, were also discussed, but it was recognized that full implementation would need to wait for the economic and political situation to improve.

4. **In the attached letter dated March 19, 2001, the authorities request the approval of a 14-month Stand-By Arrangement in an amount equivalent to SDR 200 million in support of their economic program.** The accompanying Memorandum on Economic and Financial Policies (MEFP) reviews economic developments and policies in 2000, discusses the program macroeconomic framework, and describes associated structural policy measures. Notwithstanding the risks associated with a program in the context of ongoing civil conflict, in terms of the government's ability to carry through with the policies needed to achieve the objectives and ensure capacity to repay the Fund, the staff supports the request.

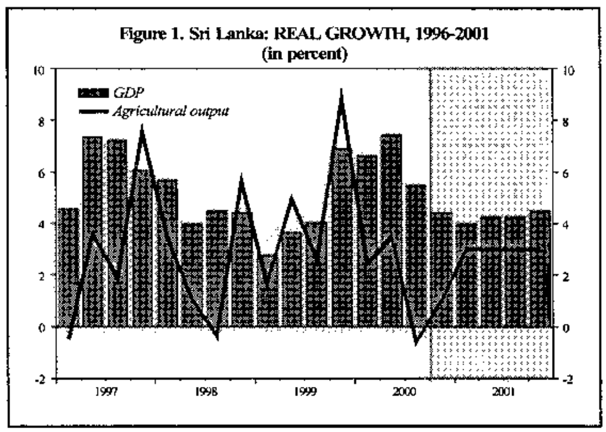
II. The Economic Setting

5. **Over the last decade, Sri Lanka's economy has grown steadily, but at a slow rate, despite the civil conflict, which has been going on for over 17 years.** During the

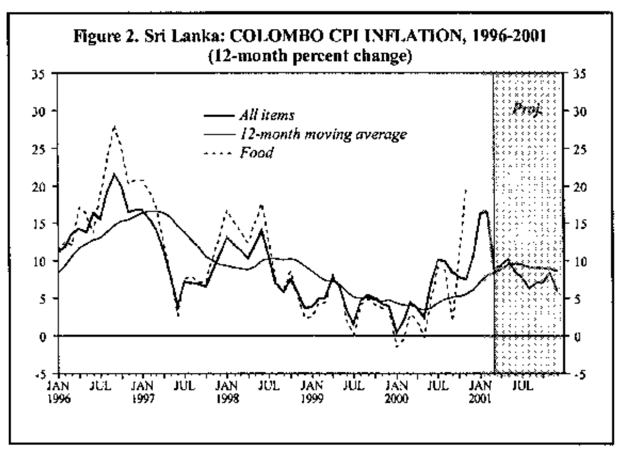
late 1980s and early 1990s, financial markets were liberalized, the outward orientation of the economy was significantly increased, and a more diversified export base established. Progress was also made in other areas, notably privatization. However, underlying the modest growth performance have been relatively low levels of saving and investment. Prolonged periods of public dissaving reflected substantial fiscal deficits that averaged more than 9 percent of GDP. Moreover, a lack of progress in key structural areas, including civil service restructuring, state monopolies, financial and labor market reforms, as well as insufficient spending on education and health, undermined the economy's growth potential. Thus, structural reform remains critical to resolving the long-term problems facing the country.

6. **From late 1999, macroeconomic problems emerged.** While GDP growth was buoyant, inflation picked up, and external reserves fell to vulnerable levels.

- **After slowing in 1998 and early 1999 in the aftermath of the Asian crisis, output in the manufacturing and services sectors picked up from mid-1999 before moderating in late-2000.** Real GDP grew at an annual pace of 6–6½ percent between mid-1999 and the third quarter of 2000, boosted by strong export growth (Table 1). In the fourth quarter, growth eased, despite continued record exports, as poor monsoons affected agricultural output and high interest rates worsened the general business environment.



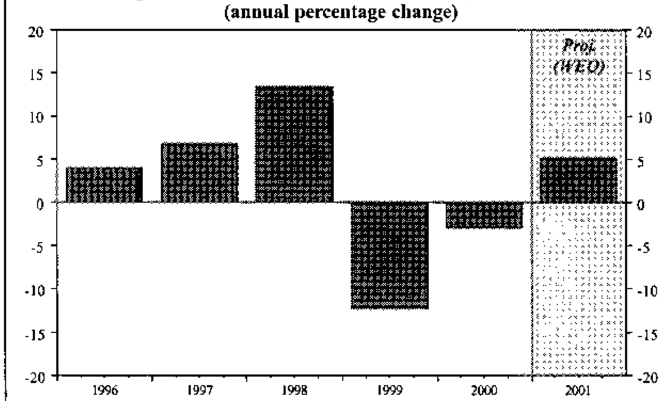
- **Depreciation of the exchange rate and increases in administered prices on fuel, wheat, transport fares, and public utility charges contributed to a step up in inflation in 2000.** Inflation, which had fallen to 4 percent at end-1999, as import prices fell and domestic supplies of agricultural goods increased, rose sharply to 11 percent (on a 12-month basis) by December 2000. The terms of trade worsened by a further 3 percent in 2000, as a result of higher oil, food, and fertilizer import prices.



7. **In late 2000, Sri Lanka came close to a foreign exchange crisis**, with low reserves, large import bills due, and an exchange rate level and regime (a crawling band) that was no longer credible, suggesting the possibility of significant capital flight.

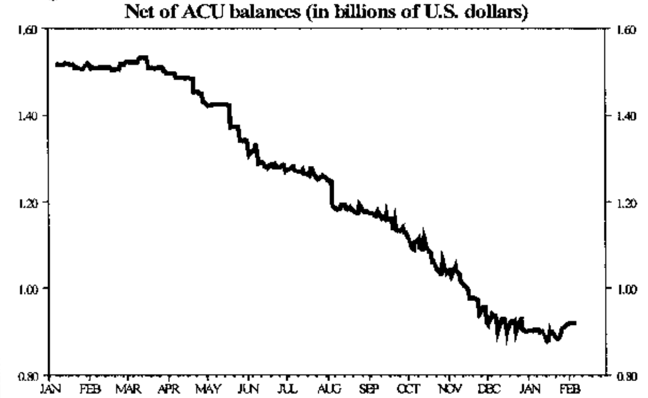
- The rupee came under considerable pressure from the fourth quarter of 1999, and during 2000 official reserves dropped by $613 million, to less than 1½ months of imports.[1] Although exports increased by over 20 percent, the higher cost of oil imports (estimated to have increased by $400 million in 2000) and military imports ($200 million) resulted in a doubling of the external current account deficit to 7 percent of GDP.[2] Moreover, export proceeds were not fully repatriated, and there was some capital flight (estimated at $100 million). In the absence of asset sales, and the failure of the authorities to implement aid projects with balance of payments support, gross official reserves declined, as the central bank was forced to defend the lower end of the exchange rate band. As Table 6 shows, the external vulnerability indicators reflect these problems.

Figure 3. Sri Lanka: TERMS OF TRADE, 1996-2001
(annual percentage change)



- Responding to these pressures, the authorities depreciated the rupee by 10 percent against the dollar during the second half of 2000, progressively widening the exchange rate band (to +/- 5 percent in January 2001). However, because of the weakening of other partner country exchange rates vis-à-vis the dollar, the rupee only depreciated by 6½ percent in nominal effective terms (and appreciated by 1½ percent in real effective terms). Moreover, because of political concerns in the run up to the parliamentary elections, the adjustments were delayed, resulting in accelerated market pressures on the rupee and loss of reserves.

Figure 4: Sri Lanka: DAILY GROSS OFFICIAL RESERVES, 2000-01
Net of ACU balances (in billions of U.S. dollars)



8. **After a reduction in the overall fiscal deficit in 1999, the budget deficit deteriorated by over 2 percentage points of GDP in 2000 to about 9¾ percent (Table 2).**

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[1] Gross reserves exclude Asian Clearing Account balances (liabilities that can reach more than $150 million but which are cleared every two months, reducing useable reserves).

[2] As in 1999, imports included three aircraft ($300 million) by Sri Lankan Airlines.

Whereas the original 2000 budget targeted a reduction in the overall fiscal deficit to 7½ percent of GDP, the outcome reflected increases in current expenditure on defense and interest payments, and a revenue shortfall. The government took some tax measures at midyear, mainly raising excises on tobacco and alcohol, in response to the need for increased defense spending following the LTTE military successes. However, these measures failed to generate sufficient revenues to offset problems in the collection of import duties and lower-than-expected goods and services tax (GST) receipts. Moreover, the financial troubles of the public utilities, especially with losses being incurred by the Ceylon Electricity Board (CEB) and Ceylon Petroleum Corporation (CPC), cut into income tax receipts and dividend revenue.

9. **Current spending overshot the original budget because of the higher security-related expenditures—defense spending increased to 4½ percent of GDP, primarily in the form of military hardware imported—and a higher civilian wage bill, following the award of a 10–13 percent pay rise in October**. There were savings achieved in nonwage recurrent costs, despite the increased price of fuel, through requiring all ministries to reduce outlays on nonessential supplies by 5 percent. The government also responded to the fiscal pressures by slowing the investment program, delaying both domestic and foreign-financed projects (donor aid finances about two thirds of government capital spending).

10. **Domestic borrowing by the government in 2000 rose to 8½ percent of GDP (compared with an original target of 3 percent of GDP), including the government's recourse to a $100 million one-year foreign syndicated bank loan through a local bank.** On a net basis, the central bank provided most of the bank financing to the government, as the commercial banks used the reverse repo facility to acquire needed liquidity. The major nonbank sources of government financing continued to be the Employee Provident Fund (EPF), the National Savings Bank, and the Employees Trust Fund. These "captive sources" were unable to broaden their portfolios because of the pressing need for government financing, though new lending was on market terms, primarily in the form of treasury bonds. Privatization receipts were negligible during 2000 because of delays in the expected sale of Telecom shares and other problems.

11. **Borrowing by public corporations surged owing to delays in raising domestic prices in response to higher world prices of oil**. Although the government raised public sector prices significantly during 2000, the pass-through was still not complete. As a result, losses of the state oil, electricity, and transport companies rose to more than 2 percent of GDP in 2000, compared to ¾ percent of GDP in 1999. The government did not cover these losses through additional budgetary support to the enterprises (transfers of only ½ percent of GDP were provided for in the 2001 budget). Consequently, these enterprises borrowed heavily from the domestic commercial banks in an amount equivalent to 1½ percent of GDP, while also having recourse to short-term external financing.

12. **High public sector borrowing requirements and exchange rate pressures put upward pressure on interest rates and worsened the financial position of companies and the banking community**. The central bank was forced to raise rates to defend the rupee, with the overnight repo and reverse repo rates rising in the second half of 2000 by 6–

7 percentage points—the reverse repo rate reached 23 percent in mid-January. Yields on government securities rose steadily, with a general flattening of the yield curve. By February 2001, yields on 90-day treasury bills were 20 percent (compared with 11½ percent a year earlier), while recent auctions of two-year treasury bonds were about 22 percent. The spread between commercial bank deposits and lending rates remained large. Although lending rates were broadly unchanged in real terms, the higher nominal interest rates in the latter part of 2000 could lead to an increase in nonperforming loans in 2001. The high interest rates contained broad money growth to 13 percent in the 12 months to December 2000, in line with nominal income, while reserve money grew by less than 5 percent.

Figure 5. Sri Lanka: Contributions To Broad Money, 1998-2000 (In percent)

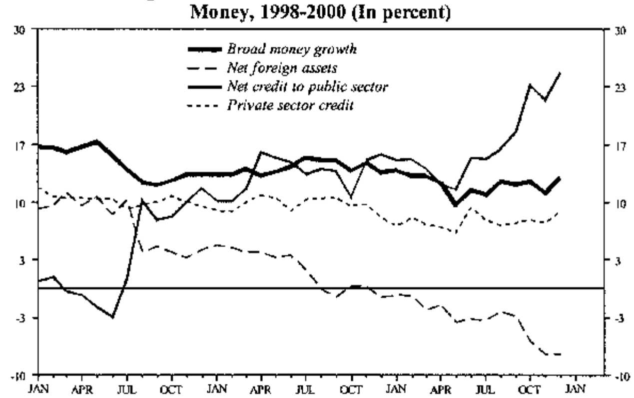
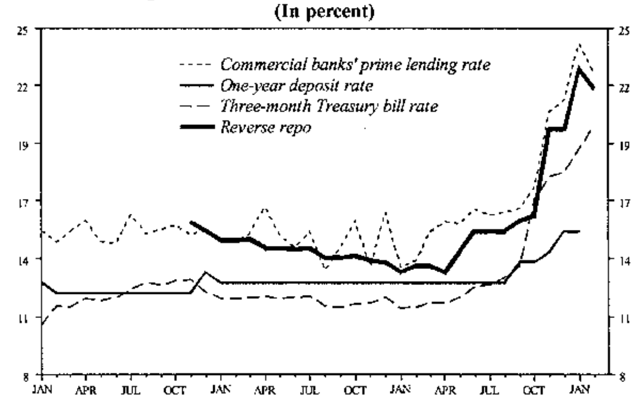


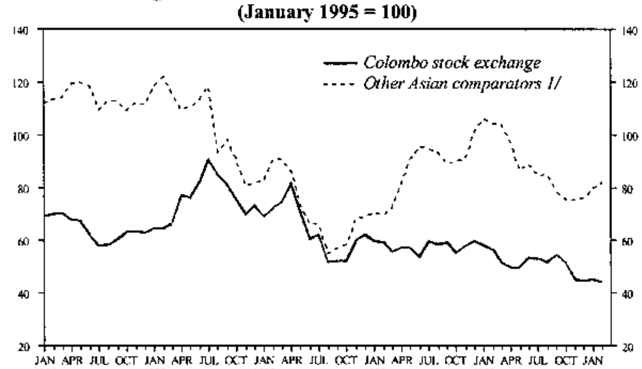
Figure 6. Sri Lanka: Interest Rates, 1998-2001 (In percent)



13. **In its conduct of monetary policy, the CBSL utilized a range of indirect instruments of monetary control to influence interbank interest rates and broad money growth.** In managing the path of reserve money at a time of declining foreign assets, the CBSL increased its portfolio of treasury bills in the weekly auctions, raising its share of total government debt to 9 percent in 1999 and 14½ percent in 2000, after having declined to 5 percent in 1997. Interbank rates exhibited considerable instability, reflecting developments in the foreign exchange market, and, with the increases in the repo and reverse repo rates, rose to a peak of 32 percent at end-2000. The reserve requirements have not been changed since 1999.

14. **Share prices and turnover on the Colombo stock market remain depressed. Foreign investors were net sellers in 1999 and 2000.** At end-December 2000, the All Share Index was 50 percent below the peak of two and a half years earlier. The earlier expectations of new issues being floated on the exchange, including Telecom, were not realized because of the decline in business confidence.

Figure 7. Sri Lanka: Stock Market 1996-2001 (January 1995 = 100)



1/ Unweighted average of India, Indonesia, Malaysia, Pakistan, Philippines, and Thailand stock exchange indices.

III. Report on Program Discussions for 2001–02

15. **The discussions on the macroeconomic outlook and policy framework for 2001 focused on the immediate task of averting a balance of payments crisis.** The authorities recognized the importance of reducing sharply the public sector borrowing requirements. They also were cognizant of the need to allow the exchange rate to adjust to strengthen the external position. In the discussions, the staff emphasized that, in view of the weak reserve position, the authorities would need to keep monetary policy tight and sustain a strong revenue effort throughout 2001 to meet the budget deficit targets. The staff also stressed that a substantial acceleration of structural reforms, particularly in the public administration and state enterprise sectors, would be necessary to facilitate bilateral financing from the international community, and to provide a springboard for the higher growth needed to reduce poverty.[3]

A. Macroeconomic Framework

16. **As set out in the MEFP, reduced growth of 4–4½ percent is expected in 2001, led by slower growth in services and manufacturing output.** Continued buoyancy of the garment sector should boost manufacturing activity, as the European Union has removed quota restrictions. However, the rapid expansion of garment sales to the United States in 2000 is not expected to be maintained. Early indications are that agricultural output will remain sluggish, affected by delayed and poor monsoon rains. Tourism receipts are projected to pick-up after the poor performance of 2000 because of the reduced conflict. The pace of inflation is expected to ease by midyear (to less than ½ percent monthly) once the step impact on the CPI (4–4½ percentage points) of the exchange rate depreciation and the government's recent process of passing through imported energy costs has been completed. The major impact of the stabilization program will be to reduce domestic demand, especially for consumer imports, through the higher tax burden and lower real incomes. Hinging on substantial official financing and privatization proceeds, gross official reserves would rise to $1½ billion at end-2001, equivalent to two months of imports of goods and nonfactor services.

B. Exchange Rate Policy

17. **The mission stressed that a flexible exchange rate policy that allowed the rupee to respond to market forces was needed because of the low level of reserves, and the vulnerability of the balance of payments—including the dependence on sizable inflows of external financing.** The CBSL concurred, and on January 23, 2001 announced that it would refrain from announcing the buying and selling rates in advance—at the time the CBSL band was Rs 77–85, while the commercial bank rate was Rs 85. Instead, the CBSL would use intervention to build up reserves, and stand ready to buy or sell only on a very

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[3] Although the discussion of the structural agenda is not extensive in this report, the background and issues remain those set out in SM/99/225, paragraphs 25–34 and Appendix.

limited basis, at the market rate, to dampen volatility. The new arrangement was intended to permit free transactions in the market and to stabilize the value of the rupee. The CBSL also announced its hope that the high interest rates would ease later on, promoting investment and longer-term economic growth, as they would no longer be needed to support the rupee. After initial extreme fluctuations, the rate has settled around Rs 87/$; the CBSL recently bought foreign exchange (Box 1).

18. **To accompany the float, the CBSL put in place a number of regulations, aimed at stabilizing market operations and encouraging prudential conduct of commercial banks.**[4]

- Penalties were set to encourage exporters to settle letters of credit financing promptly and limit the working balances of foreign exchange of commercial banks.
- Banks were notified that customers were not to be allowed to pre-pay import bills.
- Importers were required to provide a 50 percent deposit requirement, in respect of new forward contracts, to remain with the bank until the contract settled.
- The government instructed state enterprises to cover their foreign exchange needs through the state banks to avoid disruption when their large bills fell due for payment.

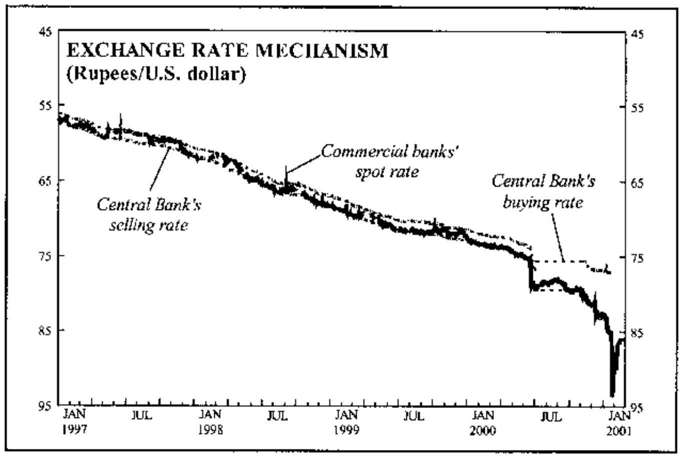
19. **The mission proposed that these regulations be removed or be amended to become conventional prudential controls**. The authorities agreed that the regulations would be relaxed in the coming weeks. The mission stressed that the interbank market must be liquid if it is to perform its functions efficiently. In this regard, the mission's assessment was that speculation by the commercial banks was not a major threat to the rupee and that the regulations should not be used to restrict the market determination of the exchange rate. In particular, the staff was concerned that the directive requiring public enterprises to transact their business with the two state-owned banks could damage market confidence, while liquidity could be eroded by a combination of the mandatory penalties on exporters with overdue credits outstanding, and the shortened tenor of forward exchange deals. The mission recommended that limits on net open positions, if required, be linked to capital adequacy.

C. Monetary Policy

20. **The mission stressed that the central bank's key task in the period ahead should be to bring inflation down to a low single digit range while rebuilding reserves.** Under the program, once the initial impact of the recent increase in administered prices had been

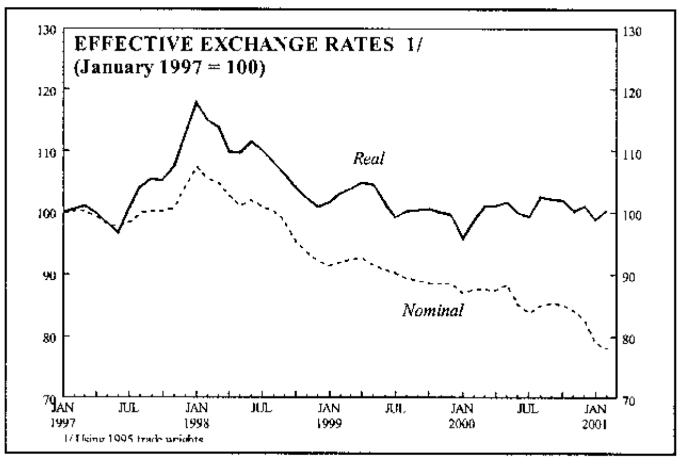
[4] The Legal Department assessed that none of these measures gives rise to formal exchange restrictions, as they do not impede the payment of current transactions on their due date.

Box 1. Sri Lanka: Exchange Rate Developments



Sri Lanka operated a managed float[1] from 1977, with the rupee exchange rate determined by demand and supply in the foreign exchange market. The Central Bank of Sri Lanka attempted to guide the rate towards a medium-term target that maintained export competitiveness, and avoided sharp fluctuations in the rate. Up to January 23, 2001, volatility of the rupee vis-à-vis the US dollar—the CBSL's intervention currency—was limited by an exchange rate band. At the beginning of each day the CBSL would announce buying and selling rates for the U.S. dollar, at which it stood ready to trade with participants in the foreign exchange market. Between March 1995 and June 2000, these rates were set 2 percentage points apart.

In 2000, the rupee came under tremendous pressure as a result of a sharp increase in international oil prices and defense imports, and a lack in privatization receipts. As a result, the CBSL experienced substantial reserve losses through most of the year, thus forcing it to depreciate the rupee by widening the exchange rate band to +/- 2½ percent in June , +/- 3 percent in November, +/- 4 percent in December, and +/- 5 percent in January 2001. This, however, proved insufficient to staunch reserve loss. To protect its remaining reserves, the central bank announced the floating of the rupee on January 23. Under the new regime, the central bank refrains from announcing its daily buying and selling rates in advance. Instead, it intervenes in the market only to meet its reserves targets, to moderate the rate of change of the rupee, and to prevent undue fluctuations in the rate.



Following initial volatility after the float, where the interbank rate rose as high as Rs 98/$, the rupee has stabilized at about Rs 87/$, thus implying a nominal depreciation of over 16 percent since May 2000.

Despite the nominal depreciation, in real effective terms the rupee appreciated by 1½ percent on a 12-month basis in February 2001, as the U.S. dollar appreciated against Sri Lanka's major trading partners, notably the euro and yen.

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[1] The classification of exchange rate regimes is in accordance with the Compilation Guide for the Annual Report on Exchange Arrangements and Exchange Restrictions (see MAE website).

completed, inflation is projected to decline to 8 percent, on a 12-month basis, by end-2001, and to 5 percent a year later. To provide a nominal anchor, the central bank's monetary program, agreed with the staff, aims to limit reserve money growth below 13 percent in 2001, consistent with the inflation objective. Consistent with the target of broad money growth of 13 percent, and an increase in net foreign assets, domestic credit growth would be very low, reflecting the sharply reduced borrowing by the public sector. As long as fiscal policy remained on track and privatization receipts reduced the need for bank financing of the deficit, private sector credit could grow by 10 percent. No changes in reserve requirements are intended.

21. **In view of the uncertainty surrounding the money demand projections, the monetary targets may need to be adjusted during the year**. The first review under the program will provide an opportunity to undertake adjustments in the financial program, based on monetary developments in the first half of 2001. There should be scope for significant cuts in nominal interest rates later in the year, once confidence strengthens, reserves increase with the external financing package, and inflation lessens. Subsequent to the mission, the CBSL reduced the repo and reverse repo rates by one percentage point, citing the stability of the exchange rate. In response to concerns raised by the staff that this easing of interest rates may have been premature, the authorities have emphasized that they stood ready to raise interest rates again, if market conditions warranted.

D. Fiscal Consolidation and Social Safety Net

2001 Budget

22. **The programmed fiscal adjustment for 2001 will represent a significant improvement in the public finances**. The authorities stressed the importance of revenue measures, the restraint on operational expenditures, and the increase in public investment. For 2001, they were committed to fiscal consolidation, containing the deficit to 8½ percent of GDP through lower security-related spending (Box 2), tight expenditure control and improved tax collection. A 2 percent of GDP improvement was targeted for public savings.

23. **Tax revenue in 2001 is projected to increase by 1¾ percentage points to 16¼ percent of GDP**. This would result from a number of different revenue measures including surcharges on import duties and the income tax and an increase in the National Security Levy (NSL) rate from 6½ percent to 7½ percent. Furthermore, the base for the consumption-based taxes (GST and NSL) is expected to grow significantly faster than nominal GDP in 2001, reflecting buoyancy gains and administrative improvements. For details see Box 3 and paragraph 6 of the MEFP.

24. **The mission's strong preference was that the authorities should not continue to rely on the NSL, a cascading turnover tax, at the expense of the GST**. The authorities, however, responded that raising the GST rate would not lead to the extra revenue benefits projected by the staff until substantial administrative improvements take place. The GST presented far greater challenges to the Inland Revenue Department (IRD) than a turnover tax

Box 2. Sri Lanka: Developments in Security-Related Expenditure

Security-related expenditure rose substantially in 2000 in response to the escalation of conflict in the north of the country, to 5½ percent of GDP. Included in the total spending is expenditure on public order and safety (police, immigration, etc.) Abstracting from this item, defense spending rose from 3½ percent in 1999 to 4½ percent in 2000. The increase reflected purchases of military equipment to deal with the renewed insurgency—the military wage bill is reasonably stable at around 1¾ percent of GDP. Related to the conflict, payments to disabled soldiers also increased in 2000, and this is not included in the total. None of these numbers include regular pensions paid to retired soldiers.

Security-Related Expenditure, 1996-2001

	1996	1997	1998	1999	2000	2001
	(In percent of GDP)					
Security-related expenditure	5.8	5.1	5.0	4.4	5.6	4.4
Defense	**4.8**	**4.0**	**3.9**	**3.4**	**4.6**	**3.3**
Wages and salaries	1.1	1.4	1.7	1.7	1.7	1.6
Goods and services	3.7	2.5	2.2	1.7	2.8	1.7
Public order and safety	**1.0**	**1.1**	**1.1**	**1.0**	**1.0**	**1.0**
Wages and salaries	0.6	0.5	0.5	0.5	0.5	0.5
Goods and services	0.4	0.6	0.6	0.5	0.5	0.5
Memorandum items						
Imports of military goods	...	...	...	0.7	2.4	0.9
Payments to disabled soldiers	0.1	0.1	0.1	0.1	0.2	0.2

Source: Sri Lankan Authorities.

The president has committed to reduce security-related expenditure in 2001. Total security-related expenditure will be contained at Rs 63 billion (4½ percent of GDP), its level in 1999.[1] In particular, defense spending is expected to decline to 3¼ percent of GDP, through a reduction in military purchases. Total defense related imports are projected to fall sharply in 2001, as procurement of most big-ticket hardware items took place in 2000 (See also paragraph 7 of the MEFP).

Imports of military goods and services in 2001 will be paid directly from the budget, with no major loan financing. In the past, a substantial component of military imports was financed by loans—amounting to 26 percent of total defense-related imports in 1999, and 32 percent in 2000. All large military purchases require the signed approval of the Finance Secretary. Based on cash accounting, the budget records direct payments for goods imported in the current year and repayments on past loans, but not actual commitments incurred in the year in question. In 2001, no major new loans will be contracted, and half of the payments for imports will consist of repayments on past loans.

Military expenditure in Sri Lanka, while high, is similar to that in many other countries.

Comparative Defense Expenditure, 1999

Countries	World	Asia	Egypt	Ethiopia	Korea	Nigeria	Pakistan	Turkey	Cambodia
(in percent of GDP)	2.4	1.4	2.7	3.5	2.9	2.8	4.9	4.9	3.8

Source: WEO.

[1] The Executive Board has decided that data on military expenditures should not serve as the basis for performance criteria or similar conditions associated with Fund-supported programs (BUFF/91/186).

that is levied at each stage of production and requires no administration of an input-credit mechanism or refunds. The authorities also expressed concern over the political ramifications of raising the rate of GST, a fairly new and very unpopular tax at this point. They felt that the direct connection between the NSL and the war in the minds of the populace made for easier acceptance of a rate increase. The staff reluctantly accepted this position for 2001. There was agreement that, in the medium term, Sri Lanka must rely more on the GST and phase out the NSL. The Fiscal Affairs Department will be providing additional technical assistance in the coming weeks. The authorities have pledged as part of the program to shift from the NSL to the GST beginning in the 2002 Budget, with a significant rate reduction in NSL and a corresponding rate increase in GST.

25. **Tax administration is being strengthened under the program, although the effects of any measures are difficult to quantify, especially in 2001.** Specific measures include: strengthening the Large Taxpayers Unit (a program structural benchmark) and extending its mandate to include GST. The Board of Investment (BOI) customs regime is to be unified with the Customs Department. The preferential BOI tax regime will be eliminated in the 2002 budget, and no new concessions will be granted.[5]

26. **Under the program, total expenditure as a percent of GDP will stay roughly constant in 2001, while current expenditure will decline by more than ½ percent of GDP.** The March 8 budget presented both spending savings and measures to improve the general monitoring of outlays during the year.

27. **To curb further growth in the wage bill (currently 3¼ percent of GDP), the authorities have indicated that no further increases in the wage structure will be made** before the end of 2001and that the hiring freeze will remain at all levels of government and public institutions.[6] On this basis, and with projected retirement levels and no voluntary retirement scheme in operation, a one percent reduction in government employees is anticipated. Nonetheless, the civil service wage bill will increase marginally in 2001, reflecting the full effects of the wage award in October 2000, plus annual increments.

28. **A major concern for the mission was to obtain a credible assurance that defense expenditure would not undermine the fiscal elements of the stabilization program.** Although it was understood that the government could not be held to a specific target, the authorities stressed that (i) no major military hardware was expected to be purchased in 2001; (ii) the President had given her strong commitment not to exceed the budgeted

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[5] The budget proposed the extension of tax holidays for some infrastructure projects, which are available under the BOI law, to other companies not under the BOI law, and introduced some new tax holidays. The staff has expressed its concern that such holidays not undermine revenue goals.

[6] Some specific recruitment will take place to meet critical shortages in health service.

figure; and (iii) transactions will be recorded and tightly monitored through the budget (see Box 3).

29. **Security-related spending would be reduced by 1¼ percent of GDP in 2001**. For defense spending itself, which excludes police and immigration, projected spending would amount to 3¼ percent of GDP. The mission emphasized that, notwithstanding the commitment given by the government to contain security spending, a risk remained that unforeseen events could require further government spending in this area at some later point. The authorities responded that any supplementary spending request would be offset fully by further measures. In addition to raising excises on cigarettes, the authorities would consider excises on other items, a possible increase in the GST, and immediate expenditure cuts on goods and services and domestically-financed capital spending.

30. **Other nonwage recurrent expenditure is expected to remain roughly constant as a percent of GDP**. Expenditure control will be strengthened over recurrent items and the limit on procurement costs imposed last year have been extended. Benefits to ministers have been reduced. Pensions remain roughly constant at 1¾ percent of GDP. Savings in the general welfare scheme, *Samurdhi,* as a result of better targeting, allow additional funds to be channeled towards the most vulnerable elements in society (see below). Reflecting higher prevailing interest rates and the impact of currency depreciation on foreign debt service, interest payments are expected to increase from more than 5¾ percent of GDP to 6¼ percent of GDP. The path of interest rates is projected to decline but, because of the maturity structure, interest payments will only be reduced significantly in 2002.

31. **Capital expenditure and net lending is projected to increase from 6½ percent to nearly 7½ percent of GDP in 2001, focusing on foreign-financed projects that have now reached their major construction phase**. Other priority areas will be health, education, power, and road rehabilitation. Rupee-funded projects will be kept to a minimum; the construction of new buildings in particular will be curtailed.

32. **Domestic debt financing of the budget will be reduced, in part through increased privatization proceeds, enabling a substantial shift from bank borrowing of 4 percent of GDP in 2000 to net repayments of 1 percent of GDP in 2001.** Altogether, asset sale receipts are expected to amount to 1¾ percent of GDP or about $275 million (see below for details). Lowering the government's domestic borrowing requirement would enable the authorities to reduce dependence on captive sources by issuing bonds with market-determined yields and a full range of maturities.

Social Safety Net

33. **The mission emphasized that the administered price increases and budget measures would require measures for protecting the poor and other vulnerable groups in society**. The authorities noted that they already had in place several programs providing relief for specific vulnerable groups as well as the national social welfare program,

Box 3. Sri Lanka: Key Measures in the 2001 Budget[1]

Revenue Measures

- A 40 percent surcharge imposed on the pre-existing duty rates (introduced 21/2/01).
- A 20 percent surcharge imposed on corporate tax revenue for one year.
- The NSL rate was raised from 6.5 percent to 7.5 percent, and the exemption for gems and jewellery removed.
- Administered fees and charges raised. The betting levy increased.
- Concessionary duties and taxes for importation of motor vehicles by parliamentarians and public servants suspended.
- Tax administration strengthened. In particular, the Large Taxpayers Unit coverage extended to include the large GST taxpayers.
- The tax and customs regime for apparel harmonized for BOI and non-BOI companies operating outside enterprise zones.
- Some minor tax holidays announced.

Expenditure Measures

- A hiring freeze implemented for employees at all levels of government. Overtime regulations and cadre management enforced strictly.
- Expenditure controls maintained over non-wage recurrent items.
- Ministerial expenditure curtailed. Limits imposed on many items, including support staff, vehicles, fuel expenses, and telephone charges (introduced 2/12/01).
- Expenditure ceilings for public servants and government agencies applied strictly, especially for utilities, traveling, and other services
- Security-related spending cut to Rs 63 billion, from Rs 71 billion in 2000.
- Arising from better targeting, expenditure on *Samurdhi* payments restricted.
- Rationalization of public institutions will begin. Over 30 redundant entities in the process of being liquidated.
- Borrowing by public corporations subject to Treasury approval and Treasury ceilings.
- Capital expenditure to increase from 6.5 percent to 7.4 percent of GDP. Priority given to key foreign-financed projects, such as the long-awaited Southern Highway (to open up rural markets), as well as projects in health, education, power, and road rehabilitation. New buildings and non-priority projects postponed for 6 months.

Financing

- Net external financing will increase from 0.9 percent of GDP to 2.8 percent of GDP.
- Bank financing to be eliminated and the government will pay back 1 percent of GDP to the banking system.
- Privatization proceeds will increase to 1.7 percent of GDP, reducing domestic financing accordingly.
- Domestic non-bank financing, excluding asset sales, will be 4.5 percent of GDP.

[1] For more details see paragraphs 6-10 of the MEFP.

Samurdhi.[7] Moreover, the authorities argued that many of the administered price increases will have only limited direct impact on the rural "very poor" who have limited access to electricity, public transport, or oil-based fuel. Nevertheless, the authorities were concerned about the effectiveness of the existing programs to meet the current challenge.

34. **The authorities are putting in place measures to achieve better targeting under the various social safety net mechanisms, for which 1½ percent of GDP is allocated.** Specifically, through better targeting of genuine beneficiaries, expenditure on *Samurdhi* payments to the less poor has been reduced in the 2001 Budget, while additional funds have been allocated for the social safety net for the very poor, through existing programs, including the poorest recipients of *Samurdhi*. The World Bank has also proposed further revisions of the *Samurdhi* program to reduce costs and improve targeting of its benefits. In addition, the authorities avoided broadening the base in some of the tax measures because such a move would have meant taxing basic food items, further burdening immediately the most vulnerable. In the mission's view, if the above welfare programs were implemented efficiently, they would significantly improve targeting of the poor and the vulnerable and provide protection for living cost increases.

2002 Budget

35. **For 2002, the program envisages the overall budget deficit (excluding grants) to decline further to 6¾ percent of GDP, reflecting further spending reductions and higher revenue mobilization**. Improved administration, the elimination of the Board of Investment (BOI) tax regime, and a shift towards GST, would raise the revenue-GDP ratio from 18¼ percent to nearly 19 percent of GDP. Current expenditure is projected to decline by over 1 percent of GDP. The wage bill would decline further in terms of GDP, as the hiring restraint continues. A declining interest rate path would enable interest costs to be somewhat lower as a percent of GDP. The government intends of reduce security-related expenditure by a further half a percent of GDP. This projection also includes lower transfers to households and public institutions, and increased capital spending in the context of the medium-term public investment program.

E. Administered Prices and Public Enterprise Reform

36. **Under the proposed program, the authorities have moved to eliminate or reduce operational losses by key enterprises, and will accelerate the restructuring and privatization program** (see Box 4). In particular, the CPC is breaking even with the new price structure, though it continues to cross-subsidize between petrol and kerosene. The

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[7] According to the World Bank, past design and implementation weaknesses limited *Samurdhi*'s effectiveness at tackling poverty. Over 5 years, *Samurdhi* has expanded into a large poverty-alleviation scheme, dealing with a wide array of activities, covering more than 50 percent of all Sri Lankan households, and costing around one percent of GDP a year.

Box 4. Sri Lanka: Administered Price Developments

The government continues to set prices for a wide range of goods and services, including petroleum products, electricity tariffs, bus fares, rail fares, water rates, postal rates, wheat flour prices, and telecom charges. Infrequent price adjustment, combined with other weaknesses such as overstaffing, a lack of proper management, and inadequate capital investment, has resulted in many public corporations relying heavily on budgetary subsidies or bank borrowing. Subsidization has led to inefficient pricing; for example, the policy of cross-subsidizing petroleum products led to a situation whereby the retail price of diesel was only 26 percent that of gasoline at the start of 2000. The government has recognized that administered price adjustment is the first step in imposing hard budget constraints and improving financial discipline in the public corporations.

Problems in the state-owned sector were exacerbated in 2000 owing to rising crude oil prices. The Ceylon Petroleum Corporation (CPC), the state petroleum monopoly, failed to pass on higher crude prices to consumers of petroleum products on a sufficiently timely basis. Thus, although the government did raise the retail prices of diesel, kerosene, and fuel oil in three separate stages, by a cumulative 86 percent, 77 percent, and 80 percent respectively, the losses of CPC reached Rs 15 billion (1¼ percent of GDP) by the end of 2000. Overall, the public corporations made losses amounting to 2 percent of GDP in 2000.

To restore profitability to the key public corporations, the government has planned further price adjustments in 2001. The program envisages a sequence of administered price increases that will enable the public corporations to repay around Rs 7 billion (½ percent of GDP) to the banking system. It focuses in particular on three key public corporations which borrowed extensively: CPC, the Ceylon Electricity Board (CEB), and the Cooperative Wholesale Establishment (CWE).

Although CPC is now breaking even, the government plans to increase product prices further in the first half of 2001 to generate profits to repay debts that financed around half of its accumulated losses from 2000 (see also paragraphs 11 and 12 of the MEFP). Fuel oil prices will increase by Rs 2 per liter and diesel prices will be raised by Rs 3 per liter. Based on a crude oil price assumption of US$25 a barrel (the WEO projection) and an exchange rate of Rs 90/ US$, these higher prices would allow for an operational profit of Rs 9 billion in 2001. This scenario is subject to considerable downside risk, however: if world crude prices average $28 a barrel, CPC would lose Rs 3 billion. This points to the need for a mechanism to ensure that prices are adjusted automatically based on transparent formulae tied to the import prices of refined products. The authorities plan to implement such a system for petroleum product prices by end-2001, and to liberalize prices in the medium-term.

Electricity bills will increase in 2001 to prevent further losses by the CEB. In 2000, the company faced higher costs for fuel (since 1999 CEB has been paying CPC, based on world prices), while a shortage of rainfall meant greater reliance on expensive thermal power—investment plans to increase hydro-capacity have been delayed. Despite an increase in average tariffs by 5¼ percent, CEB had an operating loss of Rs 4 billion in 2000. In response, the authorities levied a 25 percent surcharge on February 1, with the aim of achieving an operational profit of Rs 2½ billion in 2001.

The government has vowed to stem losses from wheat subsidization by liberalizing the market for flour in 2001. The CWE made a loss of Rs 1¼ billion from its wheat operations in 2000 and will lose a further Rs ½ billion in the first quarter of 2001. The current administered price of wheat flour charged by CWE is Rs 16.15/kg, while the average cost of flour is currently Rs 20.3/kg and is expected to rise further in 2001. To halt the losses and rationalize the process, the authorities intend to hand over the wheat importation and distribution to the milling company by end-March 2001.

Other administered price increases are planned to reduce losses and budgetary transfers. Water rates were increased in January 2001, by 5-25 percent. Although it recorded a profit in 2000, losses of Rs ½ billion arising from higher electricity and wage costs were expected for the water company in 2001 had the tariff structure remained unchanged. Bus fares were increased by 15 percent in January 2001, the third such increase in a year. To reduce the need for budgetary transfers, railway fares are to be increased by 15-20 in mid-2001.

government plans to increase petroleum prices further in the first half of 2001, enabling CPC to meet the program goal of repaying around half its accumulated losses from 2000. The authorities plan to put in place an automatic pass-through formula for adjusting petroleum product prices (a structural benchmark for December 2001 under the program), and to liberalize importation to 2002.

37. **The large amount of privatization proceeds expected are to be achieved through a series of transactions underway**. In January 2001, $25 million of privatization receipts was received for the latest phase of the sale of shares in Sri Lanka Airlines to Emirates. The sale of the CWE's wheat operation to Prima is ongoing, while the sale of Sri Lanka Shell and Sri Lanka Telecom shares and the opening of the insurance sector are planned for the second half of 2001. To accompany these sales, the authorities also have a strategy to restructure the ports, the postal department, and to plan for the unbundling of the CEB. Other smaller projects are also underway.

F. Balance of Payments Outlook and External Financing Issues

38. **After the sharp increase in 2000, the external current account deficit is expected to decline to 3 percent of GDP, as the terms of trade improve, military imports are limited, and domestic demand is constrained by tight fiscal and monetary policies**. The rupee is expected to depreciate somewhat, maintaining export competitiveness. Total export volume growth is projected at almost 9 percent, driven by continued growth in industrial exports. In particular, textile and garment volumes are forecast to increase by 11 percent, owing to removal of the EU quota offsetting the impact of a slowdown in the U.S. market. Driven by the compression of domestic demand and rupee depreciation, import growth should contract sharply with volumes increasing by 3½ percent, compared with 14 percent in 2000. Defense imports are projected to contract by over $250 million to $140 million in 2001, due to one-off purchases in 2000 and the cap placed on military spending. The surplus on the services account is projected to increase with a modest recovery in tourist receipts, while the income account deficit is forecast to widen, due to higher interest payments on official debt. Private transfers are assumed to continue to grow in line with nominal GDP growth in industrial countries (5 percent).

39. **External financing needs in 2001 are sizable, reflecting the current account deficit and the envisaged buildup of reserves**. Given the capital account projections, which incorporate modest levels of foreign direct investment and other private capital inflows, the staff estimates a gross financing requirement of about $1.9 billion in 2001 and a financing gap of $530 million (Table 7). To meet this financing gap, the program foresees additional financing support from the private sector, the international financial institutions (IFIs) and bilateral donors. Regarding the private sector, the authorities are negotiating a $200 million medium-term foreign bank loan to replace the one-year syndicated loan provided in 2000. From the IFIs, $200 million is already scheduled under the existing pipeline in the form of program and project loans from the AsDB and the World Bank. In addition, the World Bank proposes a $130 million Private Sector Program loan linked to a ports project and specific reforms in the areas of labor market, land and pensions, to be disbursed late 2001 or early 2002. There will also be a $17 million World Bank loan for central bank restructuring. From

bilateral sources, as well as the existing commitments for aid disbursements of $350 million, the government obtained additional program lending commitments of $25 million from the Japanese government, DM 55 million ($26 million) on long-term but nonconcessional basis from Germany and a $6 million grant from China.

40. **Apart from the proposed Fund support, much of the additional financing for 2001 may not be received until late in the year**. The timetable assumed by the staff is deliberately conservative, and efforts are being made to advance disbursements. For 2002, the identified financing gap will be filled in part by further bilateral support (including Pakistan and India), a World Bank program loan for Poverty Reduction Support Credit (PRSC) and an additional balance of payments support of $50 million from the AsDB, through the acceleration of their program lending operations.

41. **Sri Lanka's outstanding external debt remains sustainable because of its mainly concessional nature.** Although external debt increased to 64 percent of GDP at end-2000, owing to project disbursements, commercial borrowing for defense imports ($120 million), and a second loan to finance commercial aircraft, the debt-service ratio declined to 14¼ percent as the nominal increase in exports of goods and services (16 percent) exceeded the increase in the nominal debt service (9 percent). In 2001, despite increased nonconcessional debt of $200 million (against a total external debt stock of $10 billion), debt service remains low, at 16 percent.

G. Financial Sector

42. **Improvements in the banking sector are underway.** The soundness of Sri Lanka's banking sector remains a concern—intermediation costs are high and the share of nonperforming loans in total loans is 17 percent for the sector as a whole. However, tighter prudential regulations and new accounting standards are intensifying market discipline. The inefficiencies of the large state banks, however, continue to allow other banks to maintain large spreads. To increase competition and encourage foreign expertise, in March 2000 the authorities raised the limit on foreign ownership of commercial banks from 40 percent to 60 percent.

43. **The mission noted considerable progress in the performance of the two large state banks** (People's Bank and Bank of Ceylon), following the President's announced intention to reform these banks, including with private participation. In both cases, the mission saw the need for staff reductions, and the authorities hoped to begin a voluntary retirement scheme as an early part of the restructuring. Both banks now have boards comprised of the leading representatives of the private sector. The new CEO and management team of Peoples Bank are rationalizing its noncommercial operations and have halted operating losses through a program of loan recovery, tighter accounting, and other cost-cutting measures. The 2000 annual accounts, currently being audited, will make full provisioning for all past bad loans. This accounting will mean that the bank will reveal negative net worth (estimated at ½ percent of GDP). The mission supported the government's decision to keep pressure on the People's Bank staff and management to improve operations, by making clear that recapitalization would not be considered until

reforms were well underway—the bank is operating under a temporary letter of comfort from the government, prior to a full restructuring plan being agreed which is a structural benchmark under the program.[8]

44. **The authorities' assessment of the Bank of Ceylon (BOC) was that the bank could be made to operate as a profitable commercial bank with some reorganization and improved management**. BOC met all its performance goals for 2000, profits increased even after full provisioning, and capital adequacy is above the new requirement. A new board, also comprising private sector representatives and aided by a foreign-recruited CFO and international consultants, has set itself ambitious performance targets for the year. The aim is to move BOC toward a listing on the stock market by the end of 2001.

45. **The mission stressed the need for further progress in improving financial sector supervision and the regulatory functions of the central bank**. In that regard, the CBSL increased its supervision staff, who now receive specialized training. In 2000, there were 14 on-site inspections completed for the 26 banking institutions and the reporting time has been shortened. On average, private domestic and foreign banks maintained a capital adequacy ratio (CAR) of 11½ percent, and 14 percent, respectively. Private domestic and foreign banks have had lower ratios of nonperforming loans (16 percent and 13 percent, respectively), compared with the state banks (19 percent). Only one small bank was in breach of the single borrower limit (30 percent) and two small private banks were taking steps to meet the higher (9 percent) capital adequacy requirement introduced January 2001. In response to the mission's concern that the stabilization program could have an adverse impact on the banking sector, the authorities and the banks themselves were confident that the situation was manageable because of the continued growth in the economy. The focus was currently on strengthening off-site inspection procedures, concentrating on the higher risk institutions, and initiating fit and proper tests for Bank directors.[9] To support these reforms, the authorities intend to revise the Banking Act and amend the Monetary Law Act. Sri Lanka will participate in a Financial Sector Assessment Program in 2001 with a preliminary mission scheduled for early-May 2001, which will also provide technical assistance.

H. Other Structural Reform Agenda

Public Administration

46. **Civil service reform has been on the agenda for a long time and some progress has been made, while pension reform is in the design stage**. The civil service is

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[8] Recapitalization, not envisaged in 2001–02, would have annual recurrent fiscal costs of only 0.1–0.2 percent of GDP.

[9] The accompanying Recent Economic Developments paper has a fuller discussion of banking soundness issues.

overstaffed and restrictive work practices limit mobility and effectiveness. The authorities are taking steps to restructure the Ministry of Finance, while the CBSL has started an internal reorganization, with support provided by the World Bank. The 2001 budget announced the closure of several redundant agencies. The focus of pension reform remains to make the civil service system more affordable in the long run and the general public retirement benefits more appropriate. Civil servants enjoy generous pensions, currently not on a funded basis, while private sector workers receive limited benefits, based on their compulsory contributions to the EPF. The authorities envisaged a reform program designed to put the civil service system on a fiscally sustainable path and to treat government and nongovernment employees in a similar way.

Labor Market

47. **The rigidity of the labor market remains a critical constraint on private sector development and timely public sector reform**. The mission called for an overhaul of existing legislation to simplify the legal requirements and allow enterprises to determine appropriate staffing levels. The authorities acknowledged that procedures for the resolution of labor disputes need to be strengthened, while the implementation of these procedures by the Labor Tribunals and Commissioner of Labor should be speeded up. They intended to establish standardized formulae for termination compensation, and to establish fixed time limits for dealing with involuntary employee separation cases.

Trade and Capital Account Issues

48. **The Indo-Lanka Free Trade Agreement (ILFTA) came into effect following the Budget in February 2000**. In terms of Sri Lanka's imports from India, only 6 percent of the tariff lines are subject to complete tariff removal, whereas another 25 percent receive no reduction, as they are on the negative list. The European Union (EU) and Sri Lanka also signed a Memorandum of Understanding in trade in textiles and clothing products on December 5, 2000, which suspended all quantitative restrictions on Sri Lanka's textile and garment exports from January 2001. In return, Sri Lanka agreed to tariff bindings on various imports.

49. **The mission urged the government to rationalize further the tariff regime as soon as feasible.** A two-band tariff system was introduced with the 2000 Budget, and the maximum standard rate was reduced from 35 to 25 percent. At the same time, the authorities also eliminated licensing requirements on maize, wheat, and wheat flour. They are also in the process of liberalizing petroleum products. With the removal of remaining restrictions on imports of oil products, there are no major nontariff barriers; however, Sri Lanka's index of trade restrictiveness has increased to 4 (ten is most restrictive) because of the introduction of the duty surcharge.[10] The staff noted that a temporary uniform tariff increase would have

[10]The simple average tariff was lowered from 16 to 12 percent by the 2000 Budget. Also, for "luxury" items, the high rates were replaced by excise duties, as the staff recommended. The import surcharge raised the simple average back to over 15 percent

been preferred. Notwithstanding the surcharge as a time-bound revenue-raising measure, which the authorities have agreed to remove by no later than 2003, the mission also stressed that the two-band system should be accompanied by an eventual reduction in the maximum rate. Under the program, a key element of the tariff reform will be the elimination from 2002 of the special tariff regime in place for companies covered by the Board of Investment scheme.

50. **Some gradual relaxation of Sri Lanka's broad range of capital account controls should be possible.** As part of the 2000 budget, measures were introduced to liberalize foreign investment in the banking and insurance sectors. The mission welcomed the intention to remove remaining limits on inward equity and direct investment, starting this year. The mission noted that following implementation of the financial sector reforms, a phased reduction of restrictions on capital outflows by residents could also be considered. The authorities responded that they would consider such an approach when the timing was appropriate.

IV. Medium-Term Macroeconomic Outlook

51. **The government is publicly committed to building a strong private sector-driven market economy in which rising employment and income act to reduce poverty.** Increased public saving would allow some expansion in investment, while containing the external current account deficit and limiting any further build up of debt (government domestic debt would decline from 54 percent of GDP at end-2000 to 38 percent of GDP at end-2005). Based on such policies and the baseline assumptions for oil prices, international interest rates, and world import demand, the macroeconomic framework could envisage annual growth of 5–6 percent, with inflation moderating to below 5 percent by 2004. With the conflict continuing, defense spending is reduced only slowly. The overall fiscal deficit declines to 4½ percent of GDP, and the external current account deficit would fall back to 2½ percent of GDP, financed with rising private capital inflows. The appendix provides more details on this framework.

52. **Risks to the program's baseline projections would be posed by escalation of the conflict, slippage in domestic policy or a deterioration in the external environment.** To illustrate these risks, the appendix also sets out alternative scenarios. In scenario A, higher defense spending results in slow reserve accumulation, though macroeconomic stability is maintained because of implementation of the other policy measures. In contrast, under alternative scenario B, despite defense spending being reasonably contained, slippages in fiscal policy result in reserves continuing to decline, and GDP growth would be significantly lower over the medium term. The staff's alternative scenario C assumes world oil prices are substantially higher than in the baseline and the slowdown in the advanced economies worsens, thus lowering the prospects for world GDP and trade growth. Under this scenario, both reserves and GDP growth would still increase over the medium term, although at lower rates than projected in the program.

53. **While the baseline describes a situation with strong domestic policy implementation and a favorable external environment, it is by no means the best**

possible outcome—which would see the end of the civil conflict and introduction of constitutional reform. With that outcome, GDP growth and donor assistance are likely to be much higher than in our forecast, due to reconstruction and rehabilitation and a surge in business optimism and investment. The mission stressed that the authorities should prepare for the fiscal impact of the decentralization that is a key feature of the proposed constitutional reform. Changes would be needed in the collection of taxes at the provincial level and the allocation of expenditures between the central and provincial authorities

V. Medium-Term Poverty Reduction Strategy

54. **Despite the extensive welfare programs and per capita income close to the upper limit for World Bank IDA-lending, one fifth of the population still lives below the poverty line**. Moreover, the concerns are even greater for those areas in the North and Eastern regions most affected by the civil conflict.[11] With the assistance of a World Bank study, the government has formulated its poverty analysis. Educational reform includes improving the job skills of graduates, while health reforms must also address the needs of an aging population. Following consultations with civil society, this analysis was presented to the donors at the Development Forum in Paris in December 2000. Based on comments from both civil society and donors, the government is preparing its policy framework, *Vision 2010*, for tackling the identified problems. The aim is to present an Interim-Poverty Reduction Strategy Paper to the Boards of the World Bank and the Fund by early summer.

VI. Other Issues

55. **Key economic statistics are supplied to the Fund on a timely basis and are adequate for monitoring economic developments in Sri Lanka**. Sri Lanka is a participant in the General Data Dissemination System, and is expected to meet the Special Data Dissemination Standard (SDDS) requirements by the end of this year. The authorities have begun publication of quarterly estimates of GDP and a monthly industrial production index. The new format for the presentation of the Budget Estimates from 2000 onwards gives a comprehensive analysis of the general government sector, including the provincial councils and public institutions, enhancing governance and accountability.

56. **As required under the policy on safeguards assessment (BUFF/00/48), a Stage One assessment is being undertaken**. The assessment, based on documentation already provided by the authorities, will be completed at headquarters by the time of the first review.

57. **Technical assistance priorities will focus on tax administration and monetary policy** advice in light of the proposed shift to reliance on the GST, and the adoption of the floating exchange rate.

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[11] The forthcoming RED will have detailed analysis of the disparities in regional poverty levels, based on World Bank work.

VII. Program Access, Monitoring and Risks

58. **Access of SDR 200 million, equivalent to 48 percent of Sri Lanka's quota (41 percent of quota on an annual basis), is proposed under the Stand-By Arrangement.**[12] The staff views such access under the Fund arrangement as appropriate in light of (i) the large balance of payments need, reflecting the need to build up reserves; (ii) the strength of the authorities' stabilization efforts; and (iii) the need to boost market confidence, which will be essential for the successful implementation of the program.

59. **The Fund's exposure to Sri Lanka will remain limited, relative to Sri Lanka's capacity to generate resources, even after the purchases under the proposed Stand-By Arrangement.** Sri Lanka's track record of discharging obligations to all creditors, including the Fund, has been consistently good. On the assumption that all purchases under the Stand-By Arrangement are made, total Fund credit outstanding would increase to SDR 228 million by end-June 2002, or 55 percent of quota. Repayments, repurchases and charges to the Fund would average 1 percent of exports of goods and services over 2001–5, and 1¾ percent of government revenues.

60. **The attached MEFP introduces quantitative performance criteria for end-June 2001, end-September 2001, and for end-December 2001**, and indicative targets for end-March 2002 (Table 1 of the attached MEFP). Performance criteria will be set for end-March 2002 at the time of the second review. The MEFP also establishes structural benchmarks, as detailed in Table 2 of the MEFP. In addition, the program contains three reviews, the first of which, scheduled for August 2001, will be combined with a financing assurances review. According to the information received from the authorities, the prior actions on the exchange rate and the 2001 budget have been implemented and the prior action on the remaining increase in diesel and fuel oil prices will be completed at least one week before the Executive Board's consideration of the request for a Stand-By Arrangement.

61. **The on-going civil conflict poses a risk for the success of the program, both in achieving the short-term stabilization goals and the medium-term reforms needed to ensure repayment to the Fund.** The government's capacity to control spending in the event of escalation of the conflict was limited in 2000. However, as the medium-term scenarios illustrate, even in such circumstances the authorities should be in a position to meet their obligations, as they have in the past during similar circumstances. Equally, cuts or delays in external financing would be likely to limit the reserve accumulation, but not derail the other elements of the program. It also should be noted that, under the program there is a significant increase in commercial borrowing, which Sri Lanka has avoided in the past given its access to donor assistance.

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[12] Phasing of access is described in Table 3 of the MEFP.

VIII. Staff Appraisal

62. **Despite broadly favorable growth and export performance, an increasingly serious foreign exchange problem confronted Sri Lanka in 2000.** As world oil prices rose, the terms of trade deteriorated and inflation picked up. Moreover, because of the intensified civil conflict and insufficient adjustment, the fiscal consolidation of 1999 was reversed. Increased government spending, together with the high world oil prices, led to a sharp increase in the external current account deficit for 2000 and declining official reserves.

63. **The staff strongly supports the approach adopted by the government to tackle these imbalances through a concerted improvement in the financial position of the public sector, supported by a flexible exchange rate.** Revenue and current expenditure measures will be necessary to achieve fiscal consolidation, while safeguarding spending on social services and key foreign-financed capital expenditure. While reluctantly accepting the constraints on raising GST immediately, the staff views the value-added tax as key for the longer-term structure of the tax system, allowing the government to reduce its dependence on the cascading NSL and to remove the temporary duty and income tax surcharges as soon as possible. The government should expand the GST base through reducing exemptions and extending coverage to the retail level, and increase the rate in 2002. The staff commends the authorities for their determination to cap and tightly monitor defense spending. Containing civil service costs, and improving the targeting of social welfare spending, will also allow allocation of resources to protect the most vulnerable.

64. **In the medium term, fiscal consolidation is needed to release funds for financing productive private sector activities.** We strongly endorse, therefore, the objective to reduce the overall deficit to below 5 percent of GDP over the medium term. Measures must be sustainable and must improve the quality of the budget, through reform of the tax system, including a restriction in tax holidays or other ad hoc concessions, rationalization of institutions, and staff reductions. Increased public saving would allow expansion in investment, while containing the external account deficit and limiting any buildup of debt.

65. **The impact of high oil prices was considerable in 2000 and, rightly, the authorities have implemented very significant increases in administered prices.** The staff supports these changes, which should go toward reversing the operating losses of the CPC by the end of 2001 and lessen the fiscal cost of the other current subsidies. The introduction of an automatic oil-price pass-through mechanism will also be important. The authorities are urged to protect the most vulnerable groups, though many of the price increases have only limited direct impact on the rural very poor.

66. **On the exchange rate, the key policy issue is for the Central Bank to allow the rupee to adjust to market supply and demand conditions.** With the rupee floating, and only very limited interventions in the foreign exchange market to dampen volatility, the central bank needs to focus on building up reserves, taking advantage of any upward pressure on the rupee. Downward pressure should not be resisted and some modest depreciation would help preserve export competitiveness. In this regard, the staff urges the CBSL to rationalize the existing foreign exchange regulations without delay.

67. **Monetary policy must remain tight, at least until the fiscal adjustment takes hold, inflation declines, and reserves start to increase**. The staff cautions against any premature easing of interest rates. The authorities will also need to ensure that the use of open-market operations is consistent with the monetary targets—the CBSL should further develop its reserve money framework, with the assistance of MAE.

68. **The staff supports the announced elimination of the preferential Board of Investment tariff regime, because of the inefficiencies of a parallel administration and the compliance problems**. Other trade reforms should focus on resuming the shift toward open trade policies and low uniform tariffs. Further liberalization of capital account controls following the planned removal of limits on inward investment would require significant progress in financial sector reform.

69. **Priority needs to be given to strengthening the financial system and increasing its efficiency**. Fundamental reform of the Peoples Bank should be implemented, with the government committing public funds only after serious restructuring takes place. Improving further the central bank's role in supervising the financial sector will also be very important.

70. **Moving to a higher growth path will require pressing ahead with an ambitious structural agenda to improve the performance of the public sector and enhance prospects for private business.** Public administration reform should be implemented as soon as possible, redundant institutions closed, and staff reassigned or let go. Plans should also be advanced to make the civil service pension scheme more affordable and the treatment of government and nongovernment employees should be unified to increase labor mobility.

71. **The authorities have successfully embarked upon the divestment of key government enterprises, and the staff fully supports an acceleration of the current public enterprise restructuring and privatization program.** High priority should be given to restructuring the port and power sectors and opening up the insurance industry. Efforts should continue to eliminate duplication and inefficiencies in the institutions remaining in the public sector, supported by retrenchment schemes.

72. **To improve the functioning of the labor market, the staff would support the proposed revision of the procedures for dispute settlement and arbitration**. An overhaul of key labor legislation would also allow enterprises greater freedom to determine appropriate staffing levels and thereby facilitate job creation.

73. **Key economic statistics are supplied to the Fund on a timely basis and are adequate for macroeconomic surveillance**. The authorities are urged to take the remaining necessary steps for observance of the SDDS, while also continuing to improve the presentation of the fiscal accounts and the timeliness of capital expenditure monitoring.

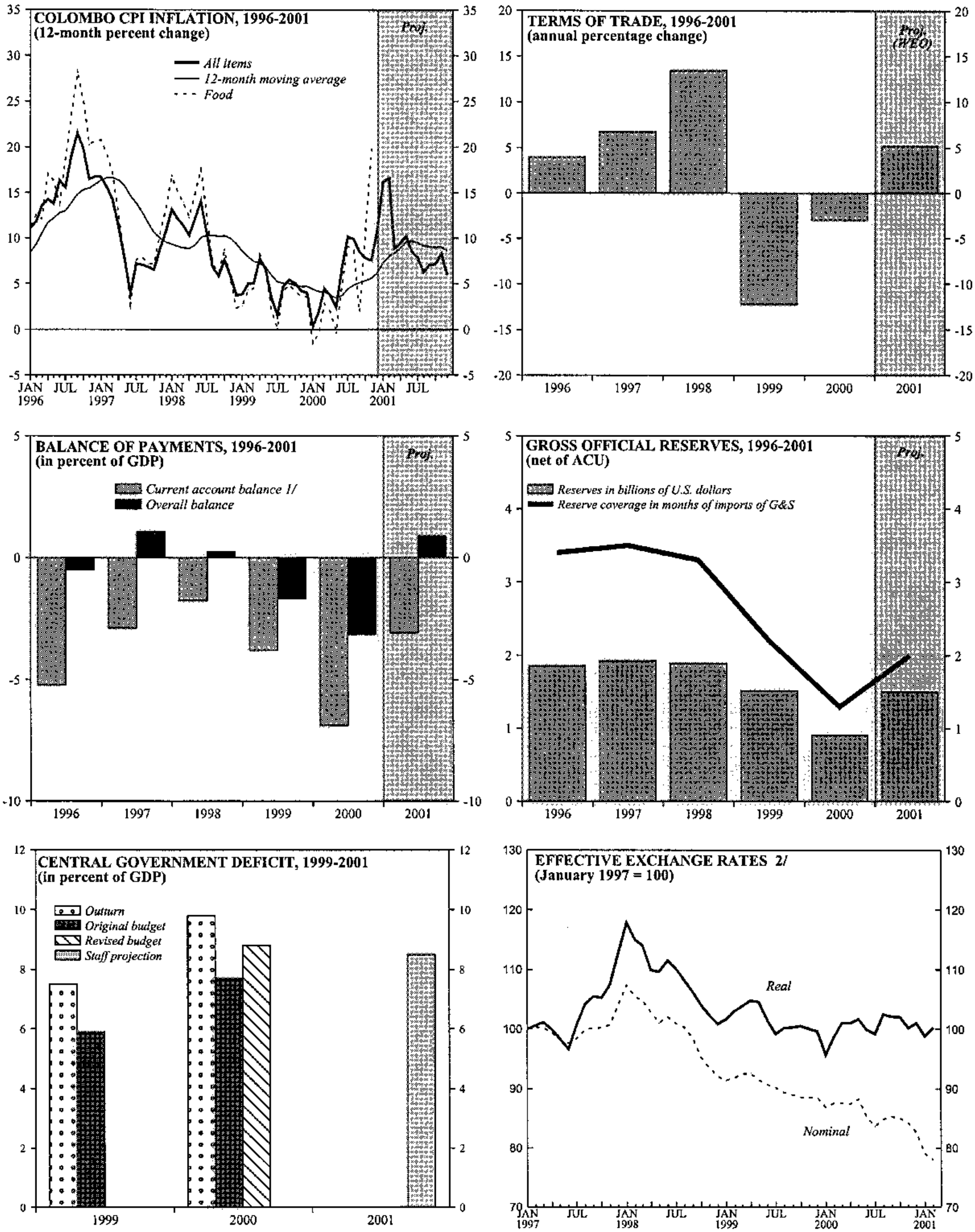
74. **The stabilization program entails significant risks, some of which also apply to the medium-term macroeconomic framework.** First, the required public sector adjustment is substantial and necessitates increased tax revenue and containing current spending, especially on defense. Moreover, with reliance on temporary surcharges and increased use of

the NSL, fundamental improvements will be needed if revenue performance is to be strengthened over the medium term. Budget implementation will need to be sufficiently robust in case additional security spending is unavoidably needed should the conflict deteriorate. Second, the economy is vulnerable to a variety of shocks, with implications for the current account balance and the external financing requirements. In particular, if the political or security situation were to deteriorate, there would be a risk that the government would be unable to carry through with the structural reform agenda needed to realize the program's anticipated improvement in the country's growth potential. Under such circumstances, the external financing expected under the program might not be forthcoming. Third, the use of nonconcessional external borrowing will raise debt service costs, though not substantially, and such loans will need to be replaced even before the Fund is repaid.

75. **Despite the above-mentioned risks and the remaining uncertainty on the exact timing of the external financing package, in the staff's view, the proposed program deserves support**. The program contains substantial stabilization measures, of which most are already in place, and steps have been taken to initiate a structural reform agenda that should put the country on the path to sustainable growth and poverty reduction. Accordingly, the staff recommends approval of the Stand-By Arrangement.

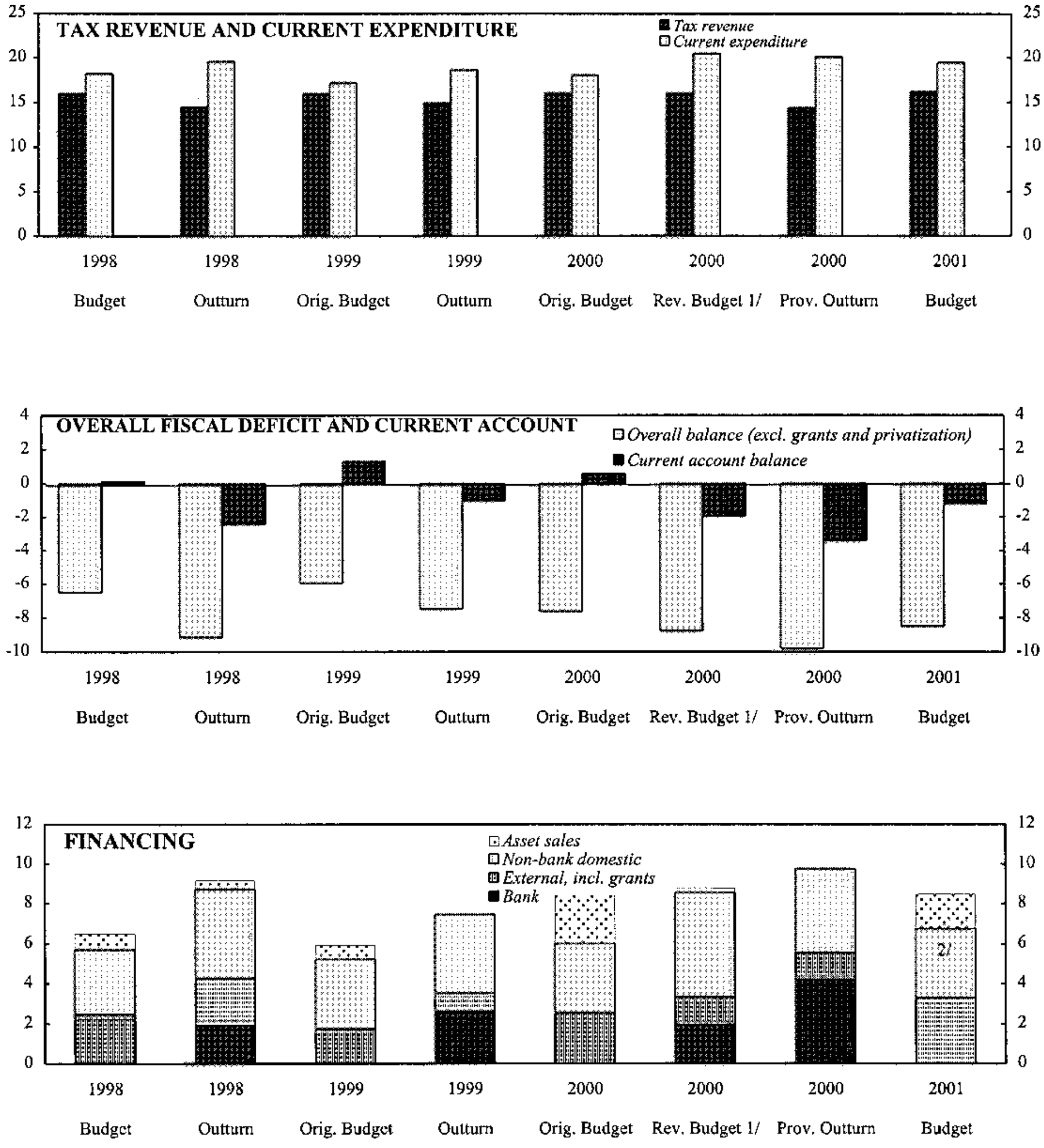
76. **It is recommended that the next Article IV consultation be held on the standard 12-month cycle.**

Chart 1. Sri Lanka: Selected Economic Indicators



Source: Data provided by the Sri Lankan authorities; and staff estimates and projections.
1/ Excluding official transfers; from 1999 includes aircraft, ports, and telecom capital imports.
2/ Using 1995 trade weights.

Chart 2. Sri Lanka: Selected Fiscal Indicators, 1998-2001
(in percent of GDP)



Sources: Sri Lanka authorities; and staff estimates and projections.

1/ As of October 31.
2/ The 2001 budget projection is 4.5 percent of GDP, shown here offset by bank financing of -1.0 percent of GDP.

Table 1. Sri Lanka: Selected Economic Indicators, 1997-2001

Nominal GDP (1999): US$15.8 billion
Population (1999): 18.8 million
GDP per capita (1999): US$840
Quota: SDR 413 million

	1997	1998	1999	2000 Prov.	2001 Proj.	Latest 1/
			(Percent change)			
Real GDP	6.4	4.7	4.3	6.0	4.3	...
Colombo consumer price index (end-of-period)	10.7	3.7	4.0	10.8	8.0	16.6
Colombo consumer price index (period average)	9.6	9.4	4.7	6.2	12.0	8.7
Saving and investment			(Percent of GDP)			
National saving	21.5	23.4	23.9	21.7	24.3	...
Gross investment	24.4	25.1	27.1	29.1	27.4	...
Government budget			(Percent of GDP)			
Revenue	18.5	17.2	17.6	16.7	18.3	...
Expenditure and net lending	26.4	26.3	25.1	26.6	26.9	...
Primary balance (including grants)	-0.8	-3.1	-1.3	-3.8	-1.7	...
Overall balance (excluding grants and privatization)	-7.9	-9.2	-7.5	-9.8	-8.5	...
Overall balance (incl. grants and excl. privatization)	-7.0	-8.4	-6.9	-9.4	-8.0	...
Current account surplus (+)/deficit (-)	-2.2	-2.4	-1.0	-3.4	-1.2	...
Defense expenditure (excl. pub. order and safety)	4.0	3.9	3.4	4.6	3.3	...
Money and credit 2/			(Annual percent change; end-of-period)			
Reserve money	-2.1	10.9	8.2	4.7	13.7	...
Broad money	15.6	13.2	13.4	12.9	13.0	...
Domestic credit (percent contribution to M2)	10.6	13.9	16.8	27.3	2.6	...
Private sector (percent contribution to M2)	11.6	9.5	8.2	9.0	7.2	...
Public sector (percent contribution to M2)	-0.9	4.4	8.6	18.3	-4.6	...
91-day t-bill rate (percent, end of period)	10.2	12.0	11.8	18.0	...	18.6
Balance of payments 2/			(Millions of U.S. dollars)			
Export volume growth (percent change)	10.6	-1.5	6.1	14.7	8.7	...
Import volume growth (percent change)	12.4	8.5	-1.4	13.9	3.5	...
Trade balance	-1,225	-1,091	-1,381	-1,828	-1,222	...
Current account balance (excl. official transfers) 3/	-437	-278	-601	-1,132	-493	...
Current account balance (percent of GDP) 3/	-2.9	-1.8	-3.8	-6.9	-3.1	...
Overall balance	163	37	-263	-516	140	...
Gross official reserves (end of period, US$ millions) 4/	1,922	1,892	1,519	906	1,500	914
Exchange rates						
Rupees per U.S. $ (end of period level)	61.3	67.8	72.1	83.0	...	85.5
NEER (annual percentage change, e.o.p.) 5/	5.2	-11.5	-4.0	-6.6	-9.3	-10.9
REER (annual percentage change, e.o.p.) 5/	13.4	-10.5	-1.2	1.4	-4.6	1.5
Vulnerability and reserve adequacy indicators						
Private sector credit (percent of GDP)	29.6	29.0	29.3	28.8	27.6	...
Gross official reserves (percent of broad money)	35.3	33.9	25.6	15.6	24.7	...
Gross official reserves (percent of short-term debt) 6/	122.1	140.2	122.5	61.6	99.6	...
Gross official reserves (months of imports of g&s)	3.5	3.3	2.2	1.3	2.0	...
Foreign currency deposits (percent of total deposits)	15.2	18.9	20.4	21.1	...	...
Short-term debt (percent of GDP) 7/	11.1	9.1	8.6	9.8	10.3	...

Sources: Data provided by the Sri Lanka authorities; and staff estimates and projections.
1/ Latest observations: T-bill, March 5; CPI, end-February; exchange rate, March 20 effective exchange rates, end January; gross official reserves, mid-March.
2/ Includes foreign currency banking units.
3/ Includes aircraft purchases by Sri Lankan Airlines (3 in 1999 valued at $297.5 million, and 3 in 2000 valued at $297.5 million).
4/ Excluding central bank ACU balances.
5/ Percent change from December of previous year. Projections based on staff estimates of partner country inflation and exchange rates. 1995 trade weights.
6/ As reserves exclude ACU balances, they are also excluded from short-term debt for consistency.
7/ Short-term debt defined as trade credits, borrowings from FCBUs, Central Bank ACU balances, commercial bank liabilities, CPC acceptance credits, and amortization due.

Table 2a. Sri Lanka: Summary of Central Government Operations, 1999-2002

(In percent of GDP; unless otherwise indicated)

	1999	2000 Provisional Outturn	2001 Program	2002 Projection
Total revenue	17.6	16.7	18.3	18.9
Tax revenue	14.9	14.4	16.2	16.7
Income taxes	2.5	2.2	2.4	2.6
Turnover taxes/GST	3.4	3.6	3.9	4.4
Excise taxes	3.2	3.4	3.5	3.5
National security levy	2.5	2.7	3.3	2.9
Taxes on international trade	2.5	1.9	2.4	2.4
Other	0.8	0.7	0.8	0.9
Nontax revenue	2.7	2.3	2.1	2.2
Total expenditure and net lending	25.1	26.6	26.9	25.7
Current expenditure	18.7	20.1	19.5	18.5
Civil service wages and salaries	3.0	3.2	3.3	3.0
Other civilian goods and services	1.4	1.5	1.6	1.5
Security related expenditure	4.4	5.6	4.4	3.8
Public order and safety	1.0	1.0	1.0	0.0
Defense expenditure	3.4	4.6	3.3	3.8
Subsidies and transfers	4.2	4.1	4.0	3.8
Households	3.3	3.3	3.2	3.0
Of which : Samurdhi	0.7	0.8	0.7	0.6
Of which : Pensions	1.7	1.7	1.7	1.6
Institutions, corporations, other govt.	0.9	0.8	0.8	0.8
Interest payments	5.6	5.6	6.3	6.4
Foreign	0.8	0.8	0.9	0.9
Domestic	4.8	4.9	5.4	5.4
Capital expenditure and net lending	6.4	6.5	7.4	7.2
Capital expenditure	5.4	5.3	5.8	5.7
Net lending	1.0	1.2	1.5	1.5
Overall balance (excl. grants and privatization)	-7.5	-9.8	-8.5	-6.8
Overall balance (incl. grants, excl. privatization)	-6.9	-9.4	-8.0	-6.3
Financing	7.5	9.8	8.5	6.8
Net external financing	0.1	0.9	2.8	2.8
Disbursements	2.0	3.0	5.4	4.8
Amortization	-1.9	-2.0	-2.6	-2.1
Net domestic financing	6.7	8.5	3.4	2.9
Bank	2.3	4.2	-1.0	-2.0
Non-bank	4.4	4.2	4.5	4.9
Asset sales	0.0	0.0	1.7	0.6
Grants	0.6	0.4	0.5	0.5
Memorandum items:				
Current account balance	-1.0	-3.4	-1.2	0.4
Primary balance (excl. grants)	-1.9	-4.2	-2.2	-0.4
Health spending	1.4	...	1.6	1.7
Education spending	2.6	...	2.8	2.9
Foreign-financed capital expenditure (in percent)	48.9	64.1	67.1	79.4
Nominal GDP (in billions of rupees)	1,111	1,263	1,443	1,613
Real GDP growth	4.3	6.0	4.3	5.5
Total debt	94.7	96.4	97.3	98.9
Of which : domestic debt	48.9	53.6	48.5	51.1

Sources: Information provided by the Sri Lanka authorities; and staff estimates.

Table 2b. Sri Lanka: Summary of Central Government Operations, 1999-2002

(In billions of rupees)

	1999	2000 Provisional Outturn	2001 Program	2002 Projection
Total revenue	196	211	264	304
Tax revenue	166	182	234	269
Income taxes	28	27	34	42
Turnover taxes/GST	37	46	56	71
Excise taxes	36	43	50	56
National security levy	28	34	47	47
Taxes on international trade	28	24	35	39
Other	9	9	11	15
Nontax revenue	30	29	30	35
Total expenditure and net lending	279	336	388	414
Current expenditure	207	254	281	298
Civil service wages and salaries	34	40	47	49
Other civilian goods and services	16	19	23	24
Security related expenditure	49	71	63	62
Public order and safety	11	13	15	0
Defense expenditure	38	58	48	58
Subsidies and transfers	47	52	58	61
Households	36	42	46	48
Of which : Samurdhi	8	10	10	10
Of which : Pensions	20	22	25	26
Institutions, corporations, other govt.	11	10	12	13
Interest payments	62	71	91	102
Capital expenditure and net lending	72	82	106	116
Capital expenditure	60	67	84	91
Net lending	12	15	22	24
Overall balance (excl. grants and privatization)	-83	-124	-123	-110
Overall balance (incl. grants, excl. privatization)	-76	-119	-115	-101
Financing	83	124	123	110
Net external financing	3	12	41	45
Net domestic financing	73	107	50	47
Bank	29	53	-15	-32
Non-bank	44	54	64	79
Asset sales	0	0	25	9
Grants	7	5	8	9
Memorandum items:				
Current account balance	-11	-42	-17	6
Primary balance (excl. grants)	-21	-53	-32	-7
Foreign-financed capital expenditure	29	43	56	73
Nominal GDP	1111	1263	1443	1613
Real GDP growth	4.3	6.0	4.3	5.5
Total debt	1051	1219	1405	1596
Of which : domestic debt	543	677	700	825

Sources: Information provided by the Sri Lanka authorities; and staff estimates.

Table 3. Sri Lanka: Monetary Program, 1998-2002 1/

	1998 Dec Actual	1999 Dec Actual	2000 Dec 2/ Estimate	2001 Mar	2001 Jun	2001 Sep	2001 Dec 3/	2002 Mar	2002 Dec
Monetary authorities				(In billions of Sri Lankan rupees; end of period)					
Net foreign assets	101.7	89.3	57.9	63.7	66.3	71.2	107.9	118.7	152.1
Net domestic assets	-8.9	11.2	47.2	47.0	45.6	43.1	10.7	2.7	-20.8
Net credit to government	25.9	46.7	91.6	95.6	96.1	94.9	63.9	56.2	32.4
Reserve money	92.9	100.4	105.2	110.7	112.0	114.3	118.7	121.4	131.3
				(12 month change in percent of reserve money at start of period)					
Net foreign assets	14.1	-13.4	-31.2	-25.9	-14.0	-0.2	47.5	49.8	37.2
Net domestic assets	-3.2	21.6	35.9	33.4	24.3	13.4	-34.7	-40.1	-26.6
Reserve money	10.9	8.2	4.7	7.5	10.3	13.2	12.8	17.3	10.6
Monetary Survey									
				(In billions of Sri Lankan rupees; end of period)					
Broad money	377.7	428.3	483.4	505.7	512.8	525.7	546.3	559.7	605.1
Net foreign assets	105.6	102.1	69.5	76.9	80.2	85.5	133.0	145.4	183.3
Monetary authorities	101.7	89.3	57.9	63.7	66.3	71.2	107.9	118.7	152.1
Commercial banks	3.9	12.8	11.6	13.3	13.8	14.4	25.1	26.6	31.2
Net domestic assets	272.1	326.2	413.9	428.8	432.6	440.1	413.2	414.3	421.8
Domestic credit	369.5	432.9	549.9	572.9	578.4	587.6	562.4	562.7	575.6
Public sector	74.6	107.0	185.6	201.5	202.1	199.3	163.4	154.8	131.3
Government (net)	64.6	93.9	147.3	156.4	153.1	158.3	132.6	124.6	101.1
Public corporations 4/	10.0	13.0	38.3	45.1	49.1	41.0	30.8	30.2	30.2
Private sector	294.9	325.9	364.4	371.4	376.3	388.3	399.0	407.9	444.4
Other items (net)	-97.4	-106.7	-136.0	-144.1	-145.8	-147.4	-149.1	-148.4	-153.8
				(Annual percentage change)					
Broad money	13.2	13.4	12.9	14.5	15.8	14.9	13.0	10.7	10.8
Net foreign assets	16.7	-3.4	-31.9	-22.4	-7.9	-2.4	91.3	88.9	37.8
Monetary authorities	13.1	-12.2	-35.1	-29.6	-17.6	-0.3	86.2	86.5	40.9
Commercial banks	591.1	228.0	-9.6	52.8	113.3	-11.7	116.8	100.4	24.2
Domestic Credit	14.4	17.1	27.0	28.9	21.6	18.9	2.3	-1.8	2.4
Public Sector 4/	24.6	43.3	73.5	80.5	56.1	37.7	-12.0	-23.2	-19.6
Government	42.8	45.3	56.8	46.3	31.9	7.5	-10.0	-20.3	-23.8
Public corporations 4/	-31.6	30.1	193.2	99.7	71.4	7.1	-19.6	-33.1	-1.9
Claims on private sector	12.1	10.5	11.8	11.9	8.7	11.1	9.5	9.8	11.4
				(Percent contribution to broad money growth 12 months ago)					
Net foreign assets	4.5	-0.9	-7.6	-5.0	-1.5	-0.5	13.1	13.5	9.2
Net domestic assets	8.7	14.3	20.5	19.5	17.3	15.3	-0.1	1.9	1.6
Domestic credit	13.9	16.8	27.3	29.1	23.2	20.4	2.6	-2.0	2.4
Public sector credit 4/	4.4	8.6	18.3	20.3	16.4	11.9	-4.6	-9.2	-5.9
Government	5.8	7.8	12.5	13.8	10.4	9.2	-3.0	-6.3	-5.8
Public corporations 4/	-1.4	0.8	5.9	6.3	6.0	2.7	-1.5	-3.0	-0.1
Claims on private sector	9.5	8.2	9.0	8.9	6.8	8.4	7.2	7.2	8.3
Memorandum items									
CPI percent change (e.o.p.)	3.7	4.0	10.8	8.0	9.9	5.7	8.0	6.5	5.0
Nominal GDP growth (in percent)	14.3	9.1	13.7	11.4	11.6	11.8	14.2	11.3	10.8
Broad money multiplier	4.07	4.26	4.60	4.57	4.58	4.60	4.60	4.61	4.61
Velocity of broad money (e.o.p.)	2.69	2.59	2.61	2.82	2.81	2.80	2.80	2.75	2.82

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

1/ Using the program exchange rate ofRs 90/US$ from March 2001 onward. Excludes any recapitalization of commercial banks.

2/ Net official reserves at $745 million excluding ACU balances (including Treasury revolving balance).

3/ Assumes fiscal deficit of 8 1/2 percent of GDP, privatization proceeds of $275 mn, government borrowing $200 mn from commercial banks

4/ From December 1998, the Sri Lanka Telecom was reclassified as a private enterprise.

Table 4. Sri Lanka: Balance of Payments 1997-2002

	1997	1998	1999 Prov.	2000 Proj.	2001 Proj.	2002 Proj.
	(In millions of U.S. dollars)					
Trade balance	**-1,225**	**-1,091**	**-1,381**	**-1,828**	**-1,222**	**-1,226**
Exports	4,639	4,798	4,600	5,522	5,977	6,542
Imports	5,864	5,889	5,981	7,350	7,199	7,767
Services, net	**159**	**145**	**147**	**28**	**49**	**86**
Receipts	876	914	966	963	1,022	1,119
Payments	716	770	819	935	973	1,033
Income, net	**-159**	**-180**	**-254**	**-293**	**-330**	**-286**
Receipts	234	214	167	156	150	184
Payments	393	394	421	449	480	470
Private transfers, net	**788**	**848**	**887**	**961**	**1,010**	**1,080**
Current account (excluding grants)	-437	-278	-601	-1,132	-493	-345
Official transfers	**44**	**53**	**24**	**23**	**29**	**34**
Current account (including grants)	-392	-225	-577	-1,108	-464	-311
Capital and financial account	**601**	**414**	**358**	**657**	**604**	**652**
Capital transfers, (net)	87	80	75	48	57	60
Financial account	515	334	282	609	547	592
Long-term:	716	398	425	498	596	684
Direct investment	**430**	**193**	**177**	**202**	**463**	**327**
Foreign direct investment, net	129	137	177	202	188	227
Privatization proceeds	301	56	0	0	275	100
Private, long-term (net) 1/	**47**	**2**	**188**	**136**	**6**	**23**
Disbursements	150	147	353	302	168	200
Amortization	102	145	165	166	163	177
Government, long-term (net)	**239**	**203**	**60**	**160**	**127**	**333**
Disbursements	500	493	379	495	542	690
Amortization	262	290	319	335	414	357
Short-term, net	**-201**	**-64**	**-143**	**110**	**-49**	**-91**
Portfolio investment, net (CSE)	13	-24	-13	-45	25	40
Private short-term, net	-20	8	-10	135	48	-64
Commercial banks (net)	-194	-48	-120	20	-122	-68
Government short-term, net	0	0	0	0	0	0
Errors and omissions 2/	-45	-152	-45	-64	0	0
Overall balance	163	37	-263	-516	140	341
Financing requirement	163	37	-263	-516	668	554
Net international reserves	-163	-37	263	516	-468	-554
Of which: Use of existing Fund credit, net	-66	-82	-99	-97	-74	-53
Increase in gross official reserves (-)	-92	45	344	613	-594	-501
Central bank borrowing, net	-5	0	19	0	0	0
Financing gap	0	0	0	0	528	213
Of which: Commercial Banks					200	0
World Bank					87	60
ADB					0	50
IMF					200	64
Bilaterals					41	39
	(In percent of GDP)					
Memorandum items:						
Current account (excl. official transfers)	-2.9	-1.8	-3.8	-6.9	-3.1	-2.0
Current account (incl. official transfers)	-2.6	-1.4	-3.7	-6.8	-2.9	-1.8
Overall balance	1.1	0.2	-1.7	-3.1	0.9	2.0
Total external debt (incl IMF)	62.3	61.0	63.0	63.9	70.0	67.2
Total debt service (percent of exports of g&s)	13.3	13.3	15.2	14.2	15.8	11.0
Gross official reserves (US$ millions)	1,922	1,892	1,519	906	1,500	2,001
(In months of imports)	3.5	3.3	2.2	1.3	2.0	2.5
Net official reserves (US$ millions)	1,488	1,524	1,260	744	1,213	1,767
GDP (in millions of U.S. dollars)	15,092	15,761	15,779	16,413	16,029	17,390

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

1/ Includes public corporations.
2/ Includes valuation gains or losses from 1998 onwards.

Table 5: Sri Lanka--Macroeconomic Framework 1998-2005

(in percent of GDP unless otherwise noted)

	1998	1999	2000	2001	2002	2003	2004	2005
Real sector								
GDP at market prices (% change)	4.7	4.3	6.0	4.3	5.5	6.0	6.5	6.5
o/w: Domestic demand (% change)	8.8	5.6	7.8	2.5	6.1	6.4	7.2	6.9
o/w: Priv. Consumption	7.5	6.4	6.7	1.4	6.1	6.6	6.9	6.8
Govt. consumption	3.5	-2.5	18.1	1.3	0.6	-1.5	0.8	2.4
Fixed capital form.	15.3	6.4	7.1	6.2	7.9	8.8	10.1	8.4
Net exports (% contrib.)	-5.2	-2.1	-3.2	1.6	-1.5	-1.4	-1.9	-1.5
Consumption deflator (% change)	4.5	2.7	8.1	11.0	5.4	5.0	4.8	4.5
Gross national saving	23.4	23.9	21.7	24.3	25.1	25.3	25.6	25.8
Gross domestic saving	19.1	19.8	17.7	20.1	20.5	20.9	21.2	21.4
Private	21.5	20.9	21.1	21.2	20.1	19.2	18.5	18.0
Public	-2.4	-1.0	-3.4	-1.2	0.4	1.7	2.7	3.4
Gross investment	25.1	27.1	29.1	27.4	27.1	27.5	28.2	28.4
Private	18.4	20.7	22.6	20.0	19.9	19.6	20.2	20.4
Public	6.7	6.4	6.5	7.4	7.2	7.8	7.9	8.0
Fiscal sector								
Total revenue	17.2	17.6	16.7	18.3	18.9	18.9	19.0	19.0
Total expenditure and net lending	26.3	25.1	26.6	26.9	25.7	25.0	24.2	23.6
Current expenditure	19.6	18.7	20.1	19.5	18.5	17.2	16.2	15.6
o/w Security related expenditure	5.0	4.4	5.6	4.4	3.8	3.4	3.1	3.0
Capital expenditure	6.7	6.4	6.5	7.4	7.2	7.8	7.9	8.0
Overall balance	-9.2	-7.5	-9.8	-8.5	-6.8	-6.1	-5.2	-4.6
Primary balance	-3.8	-1.9	-4.2	-2.2	-0.4	-0.5	0.1	0.3
Current account balance (Public savings)	-2.4	-1.0	-3.4	-1.2	0.4	1.7	2.7	3.4
Net external financing (incl. Grants)	1.7	0.7	1.4	3.4	3.3	2.7	2.2	2.2
Net domestic financing	7.0	6.7	8.5	3.4	2.9	3.2	2.7	2.2
of which: Bank financing	1.9	2.3	4.2	-1.0	-2.0	0.0	0.0	0.0
Asset sales	0.4	0.0	0.0	1.7	0.6	0.3	0.2	0.2
Total government debt	90.8	94.7	96.4	97.3	98.9	88.4	88.0	78.4
Domestic	45.5	48.9	53.6	48.5	51.1	42.1	43.8	35.9
Foreign	45.3	45.7	42.9	48.8	47.8	46.3	44.2	42.5
External sector								
Rs/US$ exchange rate (per. avg.)	64.6	70.4	77.0	...	...	...	...	...
Trade balance	-6.9	-8.8	-11.1	-7.6	-7.0	-7.0	-7.3	-7.3
Goods export value (US$ billion)	4.8	4.6	5.5	6.0	6.5	7.1	7.7	8.3
Goods import value (US$ billion)	5.9	6.0	7.3	7.2	7.8	8.4	9.2	10.0
of which: Petroleum	0.3	0.5	0.9	0.8	0.7	0.7	0.8	0.8
of which: Military	0.2	0.1	0.4	0.1	0.1	0.1	0.1	0.1
Exports (in volume terms, % change)	-1.5	6.1	14.7	8.7	8.9	8.3	8.1	8.0
Imports (in volume terms, % change)	8.5	-1.4	13.9	3.5	9.2	8.5	9.1	8.3
External current account balance (incl. Transfers)	-1.4	-3.7	-6.8	-2.9	-1.8	-2.0	-2.5	-2.6
Overall balance	0.2	-1.7	-3.1	0.9	2.0	2.7	1.7	1.5
Gross official reserves less ACU bal. (US$b)	1.9	1.5	0.9	1.5	2.0	2.7	3.2	3.7
(months of imports of goods and services)	3.3	2.2	1.3	2.0	2.5	3.1	3.4	3.5
External debt								
Total external debt	61.0	63.0	63.9	70.0	67.2	65.0	62.2	59.5
Short-term debt	9.1	8.6	9.8	10.3	9.2	8.8	8.3	7.9
Debt service (% of exports of GNFS)	13.3	15.2	14.2	15.8	11.0	9.6	10.2	10.1
Monetary sector								
Broad money (% change)	13.2	13.4	12.9	13.0	10.8	10.7	11.2	11.0
Net credit to government	42.8	45.3	56.8	-10.0	-23.8	0.0	0.0	0.0
Credit to commercial sector	12.1	10.5	11.8	9.5	11.4	11.5	10.7	11.1
Memorandum items:								
Partner country import volumes (% change)	6.6	6.9	11.0	7.6	6.4	6.4	6.3	6.2
Terms of trade (% change)	13.4	-12.2	-3.0	5.2	1.7	0.4	0.1	0.1
Oil price ($ per barrel)	13.1	18.0	28.2	25.0	21.5	20.0	19.7	19.5

Table 6. Sri Lanka: Vulnerability Indicators, 1996-2000

(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000 Proj
Official risk indicators 1/					
Share of nonperforming loans (as percent of total loans)					
State-owned commercial banks	18.9	20.2	19.5	18.5	18.6 2/
Domestic private banks	12	12.4	13.4	15.9	15.8 2/
Foreign banks	...	...	...	10.7	12.7 2/
Risk-based capital asset ratio (capital over risk-weighted assets) 3/					
State-owned commercial banks	10.7	9.2	8.2	8.4	7.9 2/
Domestic private banks	11.8	10.9	12.3	12.2	11.2 2/
Foreign banks	13.8	13.87	13.9	12.4	13.7 2/
Financial sector risk indicators					
Public sector debt	93.3	85.8	90.8	94.7	96.4
Broad money (percent change, 12-month basis) 4/	11.3	15.6	13.2	13.4	12.9
Private sector credit (percent change, 12 month basis) 4/	8.9	14.5	12.1	10.5	11.8
Share of deposits in broad money 4/	85.3	86.3	86.3	86.3	87.3
Share of foreign currency deposits in total deposits 4/	14.6	15.2	18.9	20.4	21.1
Share of foreign exchange loans in total loans 4/	19	19	20	17	19
Share of private credit collateralized by immovable property, plant, and machinery 5/	26.9	25.7	26.6	26.2	...
Share of housing and property development in private credit 5/	12.3	11.6	12.9	...	...
Market assessment indicators					
Stock market index (1985=100, e.o.p.)	603	702	597	573	448
Share price index of financial institutions (1985=100, e.o.p.)	1,728	1,772	1,356	1,214	828
External indicators					
Exports (percent change, 12-month basis in US$)	7.6	13.3	3.4	-4.1	20.0
Imports (percent change, 12-month basis in US$)	2.4	7.8	0.4	1.6	22.9
Current account balance (excluding official transfers)	-5.2	-2.9	-1.8	-3.8	-6.9
Capital and financial account balance	3.3	4.0	2.6	2.3	4.0
o/w: Portfolio investment	0.0	0.1	-0.2	-0.1	-0.3
Medium- and long-term inflows, net	2.7	4.7	2.5	2.7	3.0
Foreign direct investment	0.6	0.9	0.9	1.1	1.2
Gross official reserves excl. ACU bal. (in millions of US$)	1,855	1,922	1,892	1,519	906
Central Bank short-term foreign liabilities excl. ACU bal. (in millions of US$)	1.0	1.0	0.0	0.0	0.0
Short-term foreign assets of commercial banks (in millions of US$) 4/	709	974	832	850	1,001
Short-term foreign liabilities of commercial banks (in millions of US$) 4/	903	1,023	817	722	880
Foreign currency exposure of commercial banks 4/ 6/	107	96	103	...	...
Gross official international reserves (as percent of imports of goods & services)	30.4	29.2	28.4	22.3	10.9
Gross official international reserves (as percent of broad money)	36.4	35.3	33.9	25.6	15.6
Short-term debt 7/	11.1	11.1	9.1	8.6	9.8
Gross official international reserves (as percent of short-term debt)	125.3	120.7	137.6	120.5	64.9
Total external debt	68.6	62.3	61.0	63.0	63.9
External interest payments (as percent of exports goods & services)	6.3	5.5	5.1	5.3	5.0
Debt service (as percent of exports goods & services)	15.3	13.3	13.3	15.2	14.2
Exchange rate (Rupee per US$, period average)	55.3	59.0	64.6	70.4	77.0

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

1/ Excluding foreign currency banking units (FCBUs).
2/ September 2000.
3/ Weighted averages of individual bank data.
4/ Including foreign currency banking units (FCBUs).
5/ Based on quarterly survey of loans and advances of commercial banks.
6/ Foreign currency liabilities as a percent of foreign currency assets.
7/ Includes CPC acceptance credits, other trade credits, borrowings from FCBUs, Central Bank ACU balances, and commercial bank liabilities.

Table 7. Sri Lanka: External Financing Needs and Sources

(In millions of U.S. dollars)

	1998	1999	2000 Prov.	2001 Proj.	2002 Proj.
Gross financing needs	**789**	**970**	**1,192**	**1,875**	**1,609**
External current account deficit (exc. official transfers)	278	601	1,132	493	345
Debt amortization	475	614	577	715	710
Medium and long term debt	435	484	501	577	534
Public sector	290	319	335	414	357
Multilateral 1/					
Corporate private sector	145	165	166	163	177
Short-term debt 2/	40	130	76	138	176
Gross reserves accumulation (- = increase) 3/	45	344	613	-594	-501
IMF repurchases and repayments	82	99	97	74	53
Financing Sources	**789**	**970**	**1,192**	**1,347**	**1,397**
Foreign direct investment (net)	193	177	202	463	327
Debt financing from private creditors	147	353	533	232	245
Medium- and long-term financing	147	353	302	168	200
Short-term financing	0	0	231	64	45
Official creditors 4/	545	403	519	571	724
Other flows 5/	-96	37	-61	82	100
Financing gap 6/	0	0	0	528	213

1/ Excluding the IMF.
2/ Original maturity of less than 1 year. Stock at the end of the previous period. Includes all short term outflows.
3/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.
4/ Includes both loans and grants.
5/ Includes all other net financial flows, and errors and omissions.
6/ Includes prospective IMF disbursements.

Table 8. Sri Lanka: Indicators of Fund Credit 1998 - 2005

	1998	1999	2000	2001	2002	2003	2004	2005
				Program Projections		Proj.	Proj.	Proj.
Outstanding use of Fund credit 1/								
In millions of SDRs	261	188	123	219	228	206	158	67
In millions of U.S. Dollars	354	257	162	286	299	270	208	88
In percent of:								
Quota	63.1	45.5	29.8	53.0	55.2	49.8	38.3	16.3
GDP	2.2	1.6	1.0	1.8	1.8	1.5	1.1	0.4
Exports 2/	6.2	4.6	2.5	4.1	3.9	3.3	2.3	0.9
Public and Publicly Guaranteed Debt								
Debt Service to the Fund 3/	62	74	66	58	52	36	61	101
(in millions of SDR)								
o/w Repurchases	0	0	0	0	0	0	42	91
PRGF Repayments	60	73	65	50	39	22	6	0
Charges and interest	2	1	1	8	13	14	13	10
In percent of:								
Quota	15.0	17.9	15.9	14.1	12.6	8.8	14.7	24.5
GDP	0.5	0.6	0.5	0.5	0.4	0.3	0.4	0.6
Exports 2/	1.5	1.8	1.3	1.1	0.9	0.6	0.9	1.4
Public and Publicly Guaranteed Debt	0.7	0.9	0.8	0.6	0.6	0.4	0.6	1.0
Central Government Revenues (excluding grants)	2.3	2.7	2.4	2.0	1.6	1.0	1.6	2.4
Memo								
Disbursements under the Stand-by Arrangement	0	0	0	152	48	0	0	0

Sources: Treasurer's Department and staff calculations.

1/ End-of-period.
2/ Exports of Goods and Services.
3/ Based on repurchase obligations.

Sri Lanka—Fund Relations
(As of January 31, 2001)

I. **Membership Status**: Joined 8/29/50; accepted Article VIII, Sections 2, 3 and 4 March 1994.

II. **General Resources Account**:	**SDR Million**	**Percent Quota**
Quota	413.4	100.0
Fund holdings of currency	365.7	88.5
Reserve position in Fund	47.7	11.5

III. **SDR Department**:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	70.9	100.0
Holdings	0.9	1.3

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**Percent Quota**
ESAF arrangements	117.6	28.4

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
ESAF	9/13/91	7/31/95	336.00	280.00
SAF	3/09/88	10/21/91	156.17	156.17
Stand-by	9/14/83	7/31/84	100.00	50.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue (11/30/00)	Forthcoming				
		2001	2002	2003	2004	2005
Principal	--	50.4	39.2	22.4	5.6	
Charges/interest	--	3.6	3.3	3.2	3.1	3.1
Total	--	54.0	42.5	25.6	8.7	3.1

VII. **Exchange Rate Arrangement**:

Independent float. The central bank floated the rupee on January 23, 2001.

VIII. **Article IV Consultation**:

Sri Lanka is on the standard 12-month consultation cycle. The Executive Board concluded the 1999 Article IV consultation (SM/99/225) on October 13, 1999.

IX. **Technical Assistance, 1996–2000**:

Department		**Purpose**	**Date**
FAD	-	Improving public expenditure management	August–September 1996, March 1998
	-	Expert on treasury cash management and expenditure monitoring	February 1997–February 1998
	-	Expert on implementing a Goods and Services Tax (GST) and strengthening tax administration	January–February 1997; March 1997–March 1998; extended to September 1998
	-	GST Seminar	July 1999
MAE	-	Government securities market	December 1999
STA	-	General Data Dissemination System	June–July 1997, February-March 2000
	-	Review existing consumer price indices and the wholesale price index and make recommendations for developing a producer price index	October 1998

X. **Resident Representative**:

A resident representative has been stationed in Sri Lanka since October 1977. Mr. Haque is currently the Senior Resident Representative.

Sri Lanka—Statistical Issues

Staff assessment

Overall, the coverage and timeliness of available data in Sri Lanka are adequate. The authorities supply key data to the Fund on a timely basis, the Government regularly publishes economic information and data, and daily information on stock, money, and foreign exchange market developments is readily available through electronic media. However, as noted below, there are deficiencies in the statistical base which, if rectified, would improve the ability to monitor developments and formulate appropriate economic policies. Sri Lanka is a participant in the General Data Dissemination System (GDDS) and metadata were posted on the Fund's DSBB in July 2000. The authorities have committed to meet the SDDS requirements as quickly as feasible.

Outstanding statistical issues

Sri Lanka produces several consumer price indices. The official price measure—the Colombo Consumer Price Index (CCPI)—produced by the Department of Census and Statistics (DCS) uses an outdated consumption basket and weighting system and has become increasingly irrelevant as a measure of general inflation. The DCS also publishes a Greater Colombo Price Index (GCPI), including Colombo city and the suburbs, and is preparing a new CCPI reflecting the results of the 1995/96 Labor Force and Socio-Economic Survey. The Central Bank of Sri Lanka (CBSL) produces a Colombo District CPI (CD-CPI) and a Wholesale cum-Producer Price Index (WPI/PPI).

A technical assistance report by STA (October 1998) recommended that the **official CPI** should cover all households (rather than just lower-income ones), and include a reliable price indicator for rent and owner-occupied housing. The authorities should produce a single, high quality official CPI which can be published within three weeks following the collection of price statistics rather than by the last day of the current month. Finally, the need for a wholesale-cum-producer price index should be reviewed, including the linkages to the quarterly national accounts which are being compiled since end-1998, and the responsibility for publication should be shifted from the CBSL to the DCS.

Since early 1999, the authorities have published **quarterly national accounts**.

Consolidated **central government data** regularly provided for publication in the *GFS Yearbook* cover the budgetary accounts. The authorities are planning to reduce the lag in producing expenditure details to 45 days, and to revise the presentation to conform to GFS standards. They are also beginning to compile current and historical data on the budgetary operations of Provincial Councils.

Foreign Currency Banking Units (FCBUs) are now classified as resident institutions in the **monetary survey** (since 1998). To adjust for the proportion of nonresident foreign currency deposits (NRFC), which are actually held by residents (mainly returning migrant workers), 50 percent of these deposits are reclassified out of foreign liabilities into domestic deposits. The authorities have not yet started reporting to STA the adjusted monetary data for publication in *IFS.*

The reclassification of FCBUs as resident institutions in the monetary survey has led to changes in the net foreign asset position of commercial banks; reflected in the **balance of payments** back to 1994. The authorities have changed the presentation of balance of payments statistics to conform with BPM5. The staff has encouraged the authorities to report quarterly balance of payments data to STA on a regular and timely basis (the latest reported data are for Q3 2000).

SRI LANKA: CORE STATISTICAL INDICATORS
(As of March 2, 2001)

	Exchange rates	International reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance	Overall government balance	GDP/GNP	External debt
Date of latest observation	Mar 2 2001	Feb 26 2001	Dec 2000	Dec 2000	Dec 2000	Feb 20 2001	Feb 2001	Oct 2000	Sept 2000	2000	Q3 2000	1999
Date received	Mar 2 2001	Feb 26 2001	Feb 23 2000	Feb 23 2000	Feb 23 2000	Mar 2 2001	Mar 1 2001	Dec 1 2000	Dec 2000	Jan 2001	Nov 28 2000	March 17 2000
Frequency of data 1/	D	D	D/M	M	M	D/W	M	M	Q	M/A	A/Q	A
Frequency of reporting 2/	D	W	M 3/	M	M	W	M	M	Q	Q	Q	A
Source of data 4/	P	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting 5/	E	C	C	C	C	O	C	C	C	C	C	C
Confiden-tiality 6/	C	C	C	C	C	C	C	C	C	D	C	C
Frequency of Publication	D	W	M	M	M	D	M	M	Q	M	Q	A

1/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, or O-other.
2/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, V-irregularly in conjunction with staff visits, or O-other irregular basis.
3/ Daily observations available upon request with a one-week time lag; end-month data reported on a routine basis.
4/ A-direct reporting by central bank, Ministry of Finance, or other official agency, N-official publication or press release, P-commercial publication, C-commercial electronic data provider, E-IMF's Economic Information System (EIS), O-other.
5/ E-electronic data transfer, C-cable or facsimile, T-telephone, M-mail, V-staff visits, O-other.
6/ A-for use by the staff only, B-use by the staff and the Executive Board, C-unrestricted use, D-embargoed for a specified period and thereafter for unrestricted use, E-subject to other use restrictions.

Sri Lanka—Relations with the World Bank Group[1]

Sri Lanka has received 12 IBRD loans totaling $131 million and 81 IDA credits totaling $2,013 million since joining the World Bank group in 1954, and loans of $45 million and equity commitments of $25 million since joining the IFC in 1970. Two MIGA guarantees totaling $7 million were approved in FY97–98. During FY89–01, IDA approved 32 credits totaling $1.2 billion.

The Country Assistance Strategy (CAS) Progress Report of January 1999 featured support for macroeconomic and sector reforms to achieve sustained growth, employment, and poverty reduction by promoting private sector-led growth in a manner consistent with the country's concern for social welfare and equity. The proposed lending program includes a number of relatively high risk, high return operations to address policy issues in health, poverty and rural development, infrastructure, urban development, and civil service. The Bank's Country Assistance Strategy is currently being updated, with Board presentation scheduled for May 2001.

In FY99, IDA approved a Year 2000 Emergency Assistance project to help the banking system and government agencies. In FY00, IDA approved the North-East Irrigated Agriculture Project that will help conflict affected communities in the North-East Province to reestablish a subsistence level of production and basic community services, and the Legal and Judicial Reforms Project that provides assistance to improve the existing legal and judicial framework by making it more efficient, transparent and responsive to the needs of the public at large and of the private sector in particular. In FY01, IDA approved a project to help improve distance learning capacity in the country. In the future, the World Bank will provide IDA credits and non-lending analysis and advice to help increase agricultural productivity, improve land titling and reduce rural poverty. Support will also be considered to restructure and promote private investment in various sub-sectors. Support to the social sectors will improve quality, access, financing, and management of education and address health issues raised by an aging population, financing constraints, and declining quality. IDA will also provide assistance to strengthen the Central Bank and to help improve land titling. In addition, a possible $130 million Private Sector Program loan is being considered, linked to reforms in the areas of labor market, land and pensions, to be disbursed late 2001 or early 2002. There will also be a $17 million World Bank loan for central bank restructuring.

If the government were to elaborate a Poverty Reduction Strategy containing a well-defined reform program, the World Bank would consider supporting reforms in public administration and the financial sector. The Bank chaired the Development Forum in December 2000, that focused on Relief, Rehabilitation and Reconciliation (RRR), Governance, Tertiary Education, and the Framework for Poverty Reduction. An updated analysis of poverty is being prepared, with a draft to be ready in March 2001.

Lending by the World Bank Group, 1994–2000 1/

	1994	1995	1996	1997	1998	1999	2000
			(In millions of U.S. dollars)				
IBRD (net)	-7.7	-6.7	-6.4	-5.9	-5.8	-6.1	-5.3
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	7.7	6.7	6.4	5.9	5.8	6.1	5.3
IDA (net)	70.6	98.3	94.9	67.8	85.1	33.9	28.3
Disbursements	77.5	106.2	104.1	78.3	98.2	48.4	46.7
Amortization	6.9	7.9	9.2	10.5	12.9	14.5	18.4
Total loans/credits (net)	62.9	91.6	88.5	61.9	79.5	27.8	23.0
Interest and charges	14.7	15.5	15.1	14.3	13.9	14.3	13.5
IBRD	5.5	4.9	4.1	3.2	2.5	2.1	1.4
IDA	9.2	10.6	11.0	11.1	12.2	12.2	12.1

Source: Data provided by the World Bank, Controller's Department.
1/ As of March 1, 2001.

[1] Prepared by World Bank staff.

Sri Lanka—Relations with the Asian Development Bank[1]

The Asian Development Bank (AsDB) started its operation in Sri Lanka in 1969 and has provided 93 public sector loans totaling about $2.5 billion and 181 TAs totaling about $79 million. AsDB has also assisted 9 private sector projects (4 loans and 6 equity investments) amounting $83 million (with $72.1 million in loans and $10.9 million in equity investments).

In 2000, AsDB approved a record level of assistance for Sri Lanka totaling $208.7 million in loans and $6.7 million in technical assistance grants, to support development and reforms in key areas of the economy. The AsDB assistance supported private sector development, secondary education modernization, and natural resources management for poverty reduction.

AsDB also provided, through its private sector window, a loan of $26 million without Government guarantee and a partial risk guarantee of commercial co-financing of $52 million, to support private sector power supply in Sri Lanka. AsDB's strategy to enhance private sector development to contribute to enhance growth and poverty reduction has a two-pronged approach: (i) the promotion of an enabling environment for private sector activities through AsDB's public sector operations, and (ii) direct investment in private sector companies in the form of loan and equity through operations of AsDB's Private Sector Group.

Over the medium term, the AsDB aims to help reduce poverty and achieve sustainable growth by supporting: (i) reforms to promote private sector development and improve public sector management; (ii) human development; (iii) enhancement of infrastructure; (iv) preservation of the natural resource base; and (v) measures to mitigate the social and environmental impact of the transition to a higher growth path.

As of 31 December 2000, the sectoral distribution of the loan portfolio is agriculture, 36.3 percent; social infrastructure, 19.7 percent; energy, 10.5 percent; finance and industry, 17.4 percent; transport and communications, 15.5 percent and others, 0.6 percent.

Lending by the Asian Development Bank, 1994–2002

								Proj.	
	1994	1995	1996	1997	1998	1999	2000	2001	2002
	(In millions of U.S. dollars)								
Commitment	130.0	140.0	44.0	166.1	190.0	183.8	208.7	...	...
Net resource transfer	75.4	66.5	127.0	70.9	92.5	72.4	44.0	...	...
Disbursement	92.1	87.3	149.0	95.5	126.1	98.7	76.0	110.0	177.9

Source: Data provided by the AsDB; and staff estimates.

[1]Based on material prepared by AsDB staff.

Sri Lanka: Social and Demographic Indicators

	Units	Sri Lanka		Comparator Groups		
		15-20 years ago	Most recent estimate	South Asia	Low-income countries	Lower-middle-income countries
General						
Land Area	000 km^2	66	66	4,781	41,383	36,096
Arable land	Percent of land area	36.0	36.0	42.4	12.4	9.2
GNP per capita	US Dollars	370	810	430	520	1,740
Income distribution						
Highest quintile	Percent of income	43	43	...	...	...
Lowest quintile	Percent of income	7	8	...	...	...
Population characteristics						
Population	Millions	16	19	1,305	3,536	887
Population density	per km^2	216	291	273	85	25
Population growth rate	Percent per annum	1.5	1.2	1.5	1.3	0.9
Life expectancy at birth	Years	69	73	62	63	68
Age dependency ratio 1/	Percent	65	51	70	60	60
Urban population	Percent	22	23	28	30	58
Labor force						
Labor force participation rate 2/	Percent	39	43	44	50	44
Females in labor force	Percent	30	36	33	41	40
Labor force growth	Percent	2.0	1.2	2.1	1.6	1.6
Health and nutrition						
Physicians	Per thousand people	0.1	0.2	0.4	1.0	2.0
Hospital beds	Per thousand people	2.9	2.7	0.7	1.8	5.1
Immunisation from measles	Percent of children under 12 months	2	94	81	80	89
Safe water	Percent of population with access	37	46	81	69	78
Total fertility rate	Births per woman	3.3	2.1	3.4	3.1	2.5
Infant mortality rate	Per thousand live births	30	16	75	68	35
Education						
Male illiteracy	Percent of male population 3/	9	6	35	22	11
Female illiteracy	Percent of female population 3/	21	12	59	41	17
Primary school enrollment	Percent of school-age population	96	100	77	86	94

Source: *World Bank, World Development Indicators.*

1/ Ratio of dependents (total number of individuals aged less than 15 years and greater than 64 years) to working age population (number of individuals aged between 15 and 64 years).

2/ Total labor force as a percentage of population.

3/ Fifteen years old or older.

Sri Lanka—Medium-Term Macroeconomic Framework

1. **The medium-term growth projection assumes the Stand-By arrangement agreed with the Fund is followed by a program of substantial structural reform, which could be supported by a PRGF.** This would include continued fiscal consolidation, labor market reforms, public enterprise restructuring and privatization, reform of public administration, the removal of impediments to foreign direct investment, and a substantial increase in public expenditure on infrastructure. The WEO projection of partner country imports for Sri Lanka indicates strong growth over the medium term. In this environment, GDP growth is expected to increase steadily to 6½ percent, led by strong capital formation and exports, and increased private consumption. The strong growth in consumption leads to a slight reduction in the private domestic saving rate, but this is offset by increased public saving and savings from abroad. Given WEO projections of declining oil prices, fiscal consolidation, and restrained monetary policy, inflation is expected to decline to 4½ percent over the medium term.

2. **Strong revenue measures and sustained improvements in tax administration are expected to increase the revenue-GDP ratio by 1½ percentage points in 2001 and a further ¾ percentage points over the medium term.** This, combined with the containment of military expenditure to levels in the early 1990s, a reduction in transfers, rationalization of government departments, and tighter expenditure controls, would enable the authorities to reduce the overall deficit to 4½ percent of GDP, in spite of a substantial increase in capital expenditure. The adoption of a formula to pass-through increases in international oil prices would eliminate the need for the authorities to directly finance the losses of public enterprises in energy related sectors. Deficit reduction and strong GDP growth permit a reduction in government debt by 15 percentage points of GDP over the medium term. Of this reduction, declining public external debt would account for 8 percentage points of GDP.

3. **Given the WEO projection of strong partner country imports growth over the medium term, export volume growth is expected to be above 8 percent.** After declining in 2001, import volume growth is projected to grow strongly as the beneficial effect of fiscal and other structural adjustments on economic activity becomes evident. As a result, after an initial contraction, the current account deficit widens slightly to 2½ percent of GDP in the medium term. The real exchange rate vis-à-vis the U.S. dollar is assumed to remain constant over the medium term, so that the rate of depreciation of the rupee is given by the inflation differential between Sri Lanka and the United States.

4. **With reasonably strong capital inflows, gross official reserves are expected to increase steadily to $3½ billion, or 3½ months of imports.** While these inflows would lead to an increase in the U.S. dollar value of Sri Lanka's external debt, strong GDP growth would imply an 11½ percentage point reduction of the external debt-GDP ratio.

5. **Consistent with reducing inflation, broad money growth is expected to decline over the medium term** to 11 percent, with much of this decline attributable to reduced credit to government. Net credit to the private sector is expected to increase in line with the expected private sector led increase in economic activity.

6. **Major risks to the forecast include the following:**

- An escalation of the civil conflict which makes it impossible to contain military expenditure over the medium term.
- Slippages in the implementation of the agreed stabilization program, particularly with regard to fiscal consolidation.
- A significant worsening of the external environment, including higher international oil prices and lower growth in world trade and GDP. This would adversely affect growth, inflation, the external current account, and official reserves.
- The elimination of quotas on textiles and garments in 2005. This could adversely affect exports by increasing competition in Sri Lanka's major export markets.
- One major possible upside risk would be an end to the civil conflict. In this case, the fiscal deficit is likely to be much higher in view of the need for major reconstruction, spanning a number of years (which could be of the order of 50–60 percent of GDP); much of this additional expenditure would be donor financed; and GDP growth is likely to be much higher, due to reconstruction and a likely surge in business optimism and investment.

To illustrate the impact of some of these risks on the forecast, the staff prepared three alternative scenarios.

Alternative Scenario A

7. **Under this scenario, the authorities implement the agreed measures in the program, but are unable to contain security related expenditure as a result of an escalation of the civil conflict.** Security expenditure as a share of GDP would remain at 2000 levels over the medium term. As required under the program, offsetting revenue and expenditure measures are taken in 2001, but this is not sustainable over the medium term, and the overall deficit is much higher. With the authorities distracted by the conflict, efforts to improve tax administration and increase revenue from the GST would be reduced. As the NSL rate is already very high, and its base very broad, there would be little room for increasing the tax-GDP ratio beyond 2001. Under these conditions, capital expenditure would be significantly reduced in order to contain the deficit. With increased donor and business pessimism, capital inflows and private investment would be also reduced, thus lowering the prospects for GDP and export growth. In addition, imports would be higher as a result of increased imports of military hardware. As a result, the external current account would be worse, and gross official reserves lower, than under the baseline. Nonetheless, the staff's projections suggest that this scenario would not result in major macroeconomic instability.

Alternative Scenario B

8. **This scenario describes the situation where the authorities are unable to implement the fiscal measures required under the program.** Here, there are no further increases in administered prices, and only weak revenue and expenditure measures are announced in the budget. The overall fiscal deficit would decline only to 7½ percent of GDP over the medium term, with the revenue-GDP ratio essentially stagnant, and current

expenditure declining largely as a result of a moderation in military expenditure—assuming a de-escalation of the civil conflict to levels in the mid-1990s. In this environment, structural reforms would be significantly delayed, business optimism and private investment much lower, and there would also be much less room for increasing public capital expenditure. As a result, the economy grows at only 5 percent over the medium term. With the reduction in capacity building, export growth is also reduced, and the external current account is significantly worse. This, coupled with weaker capital inflows, causes a further deterioration in the gross official reserves position to about $600 million (about 2½ weeks of imports).

Alternative Scenario C

9. **This scenario describes the situation where the authorities implement all the measures agreed in the Stand-By program, and subsequently embark on substantial structural reforms, but are faced with a more hostile external environment.** In particular, we assume that partner country import growth is significantly lower over the medium term, and the oil price stays at $28 per barrel over the medium term. Export growth is reduced, and the current account deficit is larger by 1½ percentage points of GDP over the medium term. As a result, gross official reserves increase to only $2 billion, well below the $3.5 billion envisaged under the Standby arrangement. Nevertheless, the policy changes and structural reforms generate a steady increase in GDP growth to 5¾ percent over the medium term.

Alternative Macroeconomic Scenario A: 1999–2005 1/
(In percent of GDP, unless otherwise noted)

	1999	2000	2001	2002	2003	2004	2005
Real sector							
GDP at market prices (percent change)	4.3	6.0	4.0	4.3	4.5	4.8	5.0
Consumption deflator (percent change)	2.7	8.1	12.0	8.0	7.2	7.0	6.8
Gross national saving	23.9	21.7	21.7	20.8	20.6	20.7	21.0
Gross domestic saving	19.8	17.7	17.4	15.9	16.0	20.7	21.0
Of which: Private	20.9	21.1	19.8	17.2	16.7	16.5	16.5
Gross investment	27.1	29.1	26.1	24.6	24.7	24.6	24.5
Of which: Private	20.7	22.6	19.9	18.4	17.9	17.6	17.2
Fiscal sector							
Total revenue	17.6	16.7	18.2	18.6	18.6	18.7	18.7
Total expenditure and net lending	25.1	26.6	26.8	26.1	26.1	26.2	26.2
Current expenditure	18.7	20.1	20.6	19.9	19.3	19.1	18.9
Of which: Security-related expenditure	4.4	5.6	5.6	5.6	5.6	5.6	5.6
Capital expenditure	6.4	6.5	6.2	6.2	6.8	7.1	7.2
Overall balance	-7.5	-9.8	-8.5	-7.5	-7.5	-7.5	-7.5
External sector							
Exports in volume terms (percent change)	6.1	14.7	8.7	6.8	7.3	7.1	7.0
Imports in volume terms (percent change)	-1.4	13.9	7.6	8.6	7.3	7.0	6.1
External current account balance (including transfers)	-3.7	-6.8	-4.2	-3.9	-4.0	-3.9	-3.4
Gross official reserves less ACU balance (US$billion)	1.5	0.9	1.3	1.4	1.5	1.5	1.6
(months of imports of goods and services)	2.2	1.3	1.7	1.7	1.7	1.7	1.7
Memorandum items:							
Total external debt	63.0	63.9	70.2	68.5	66.6	64.2	61.9
Partner country import volumes (percent change)	6.9	11.0	7.6	6.4	6.4	6.3	6.2
Oil price ($ per barrel)	18.0	28.2	25.0	21.5	20.0	19.7	19.5

1/ Assuming defense expenditure as share of GDP remains at 2000 levels over the medium term.

Alternative Macroeconomic Scenario B: 1999–2005 1/
(In percent of GDP, unless otherwise noted)

	1999	2000	2001	2002	2003	2004	2005
Real sector							
GDP at market prices (percent change)	4.3	6.0	4.5	5.0	5.0	5.0	5.0
Consumption deflator (percent change)	2.7	8.1	11.0	8.5	7.5	7.0	6.5
Gross national saving	23.9	21.7	22.2	21.1	20.2	19.7	19.8
Gross domestic saving	19.8	17.7	18.2	16.7	15.8	15.3	15.3
Of which: Private	20.9	21.1	22.9	19.8	17.9	16.7	16.4
Gross investment	27.1	29.1	26.0	24.8	24.4	24.4	24.4
Of which: Private	20.7	22.6	19.9	18.4	17.9	17.9	18.1
Fiscal sector							
Total revenue	17.6	16.7	17.1	17.1	17.1	17.2	17.2
Total expenditure and net lending	25.1	26.6	28.0	26.6	25.6	26.1	24.6
Current expenditure	18.7	20.1	21.8	20.2	19.2	18.7	18.4
Of which: Security-related expenditure	4.4	5.6	4.9	4.3	3.9	3.5	3.4
Capital expenditure	6.4	6.5	6.2	6.4	6.4	6.6	6.3
Overall balance	-7.5	-9.8	-10.9	-9.5	-8.5	-7.0	-7.4
External sector							
Exports in volume terms (percent change)	6.1	14.7	8.7	6.6	6.5	6.3	6.2
Imports in volume terms (percent change)	-1.4	13.9	4.6	8.9	7.6	7.5	6.3
External current account balance (including transfers)	-3.7	-6.8	-3.7	-3.5	-4.0	-4.5	-4.5
Gross official reserves less ACU balance (US$billion)	1.5	0.9	0.8	0.7	0.7	0.7	0.5
(months of imports of goods and services)	2.2	1.3	1.0	0.9	0.9	07	0.6
Memorandum items:							
Total external debt	63.0	63.9	65.7	64.9	3,2	612	59.4
Partner country import volumes (percent change)	6.9	11.0	7.6	6.4	6.4	6.3	6.2
Oil price ($ per barrel)	18.0	28.2	25.0	21.5	20.0	19.7	19.5

1/ Assuming no further increases in administered prices, weak revenue and expenditure measures to contain the fiscal deficit, and no SBA.

Alternative Macroeconomic Scenario C: 1999–2005 1/
(In percent of GDP, unless otherwise noted)

	1999	2000	2001	2002	2003	2004	2005
Real sector							
GDP at market prices (percent change)	4.3	6.0	4.3	5.5	5.8	5.8	5.9
Consumption deflator (percent change)	2.7	8.1	11.0	5.9	5.9	5.2	5.0
Gross national saving	23.9	21.7	24.1	24.5	24.5	24.6	24.4
Gross domestic saving	19.8	17.7	19.9	20.0	20.1	20.2	20.0
Private	20.9	21.1	21.1	19.0	18.0	17.2	16.5
Public	-1.0	-3.4	-1.2	1.0	2.1	2.9	3.5
Gross investment	27.1	29.1	27.8	27.8	28.3	28.8	28.6
Private	20.7	22.7	20.5	20.0	20.0	20.6	20.5
Public	6.4	6.4	7.3	7.7	8.2	8.1	8.1
Fiscal sector							
Total revenue	17.6	16.7	18.2	18.8	18.8	18.9	18.9
Total expenditure and net lending	25.1	26.6	26.7	25.6	24.9	24.1	23.5
Current expenditure	18.7	20.1	19.4	17.8	16.7	15.9	15.5
Capital expenditure	6.4	6.4	7.3	7.8	8.2	8.1	8.1
Overall balance	-7.5	-9.8	-8.5	-6.8	-6.1	-5.2	-4.6
External sector							
Exports in volume terms (percent change)	6.1	14.7	8.2	8.2	7.6	7.3	7.2
Imports in volume terms (percent change)	-1.4	13.9	3.5	9.2	8.3	8.4	6.5
External current account balance (including transfers)	-3.7	-6.8	-3.5	-3.1	-3.6	-4.1	-4.1
Gross official reserves less ACU balance (US$billion)	1.5	0.9	1.4	1.7	2.0	2.1	2.2
(months of imports of goods and services)	2.2	1.3	1.9	2.1	2.2	2.2	2.1
External debt							
Total external debt	63.0	63.9	70.0	74.3	71.4	68.3	65.4
Memorandum items:							
Partner country import volumes (percent change)	6.9	11.0	7.0	5.8	5.8	5.7	5.6
Oil price ($ per barrel)	18.0	28.2	28.2	28.2	28.2	28.2	28.2

1/ Assuming weaker partner country import growth, and higher oil prices over the medium term.

Colombo, Sri Lanka
March 19, 2001

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Köhler:

1. The Sri Lankan authorities have held discussions with Fund staff on an economic program that could be supported by a Stand-By Arrangement. Based on these discussions, the attached Memorandum on Economic and Financial Policies (MEFP) discusses the macroeconomic framework for the government's economic program for 2001–02. In support of these policies, the government requests that the Executive Board of the Fund approve a 14-month Stand-By Arrangement in an amount equivalent to SDR 200 million.

2. The government of Sri Lanka will provide the Fund with such information as the Fund may request in connection with Sri Lanka's progress in implementing the economic and financial policies and achieving the objectives of the program. The government believes that the policies set out in the attached MEFP and Technical Memorandum of Understanding are adequate to achieve the objectives of the program. However, it stands ready to take any additional measures appropriate for this purpose, and will consult with the Fund in accordance with the policies of the Fund on such consultations.

Sincerely yours,

/s/

H.E. Chandrika Bandaranaike Kumaratunga
Minister of Finance

/s/

Governor A. S. Jayawardena
Central Bank of Sri Lanka

Attachments:
Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

March 19, 2001

Sri Lanka—Memorandum on Economic and Financial Policies

I. Background

1. **Real GDP grew at an annual rate of 6 percent in 2000 as output in the manufacturing, in particular the textile industry, and services sectors picked up.** Domestic demand, led by the public sector, rose sharply in 2000 and the external current account widened from 3¾ percent of GDP in 1999 to about 7 percent. Merchandise imports expanded by 23 percent, in part because of one off items relating to military hardware. Domestic demand and rising world prices also led to higher inflation which rose from 4 percent (year on year) to 11 percent by end-2000.

2. **The widened savings and investment balance was attributed in large part to increased government spending and bank borrowing by public enterprises, and adverse terms of trade shock.** The fiscal deficit worsened by 2½ percentage points of GDP in 2000 to about 10 percent (excluding grants), reflecting increases in security related spending, interest payments, and a revenue shortfall. While the government responded by delaying development spending, domestic borrowing in 2000 rose to 8½ percent of GDP. Several public corporations have been financially hit by the rising world oil price as domestic price adjustments lagged behind. As a result, losses of the state oil, electricity, and transport companies amounted to 2 percent of GDP, compared with ¾ percent of GDP a year earlier.

3. **To finance these shortfalls, bank borrowing by the public sector amounted to more than 140 percent of broad money growth in 2000.** As a result, official foreign reserves declined by more than $600 million as the central bank intervened in the foreign exchange market. Import cover declined from 2¼ months at end-1999 to 1¼ months by end-2000. The nominal exchange rate was adjusted in small steps throughout the year and the rupee depreciated by 14½ percent per U.S. dollar. In addition, short-term interest rates were raised as banks became short of liquidity. The reverse repo rate rose from 13 percent at end-1999 to 20 percent at end-2000. By mid-January, the reverse repo rate rose further to 23 percent.

II. Macroeconomic Policies in 2001-02

4. **The principal objectives of the economic and financial policies in 2001 and early 2002 are to regain macroeconomic stability, start reversing the loss in official foreign reserves, while maintaining economic growth at about 4½ percent in 2001.** To this end, the government is addressing the fiscal imbalance and the rigidity of the exchange rate regime. Fiscal measures are being introduced in the 2001 budget and domestic prices have been adjusted to eliminate operating losses of public corporations. A flexible exchange rate system was adopted on January 23, 2001 to help preserve the level of official reserves.

Fiscal policy

5. **Fiscal consolidation will be a key component of macroeconomic policies in 2001-02**. Under the 2001 budget, the fiscal deficit will be reduced from 10 percent of GDP in 2000 to 8½ percent of GDP, excluding grants (or 8 percent of GDP with grants). An adjustment of more than 2½ percent of GDP will be required, beyond offsetting the increases in interest payments from 5¾ percent of GDP to 6½ percent of GDP (owing to the larger debt stock and higher interest rates) and the larger wage bill as the full impact of wage increases in October 2000 will be realized. In addition, public corporations will repay bank borrowing by about ½ percent of GDP (a turnaround of almost 3 percentage points of GDP from a net borrowing of 2¼ percent of GDP in 2000).

6. **Revenue will be raised by 1½ percent of GDP through several measures to be implemented in March with the announcement of the 2001 budget.** These measures include introducing a temporary surcharge of 40 percent on import tariff, except those with tariff rates of zero and two percent (to be removed by 2003 at the latest), raising the National Security Levy (NSL) rate by 1 percentage points to 7½ percent, and imposing a 20 percent surcharge on corporate income tax. In addition, the coverage of Large Taxpayer Unit will be expanded to include the largest GST tax payers. Other administration processes will be strengthened. As a contingency measure, excises on cigarettes would be raised if needed. All new tax incentives approved by the BOI in 2001 would be subject to review in two years, but such reviews would to have to conform to the legislative requirement in Sri Lanka.

7. **On the expenditure side, civil servants will receive no pay rise during 2001, and outlays on other goods and services will be tightly controlled.** There will also be a hiring freeze on civil servants. As during 2000, compulsory savings requirement of 5 percent on procurement costs for each ministry will continue to remain in place, and benefits to parliamentarians and ministers will be reduced. Security related spending will be reduced to Rs 63 billion in 2001 implying a reduction of nearly 1¼ percent of GDP. All transactions will be recorded and monitored through the budget, and any overspending of security related expenditure will be offset instantaneously by further measures. In addition to raising excises on cigarettes, consideration would be given to excises on other items, a possible increase in the GST and immediate expenditure cuts on goods and services and domestically financed capital spending.

8. **Specific provision will be made, however, for temporary, targeted, transfers to the very poor to partially offset the impact of the price increases.** Savings from improved targeting of the general *Samurdhi* welfare program will be used to offset some of the increase in the cost. Detailed modalities will be worked out with the assistance of the World Bank. Prompt increase in administered prices (see below) will allow a reduction in subsidies and transfers to public enterprises.

9. **Capital spending will be increased by more than ¾ percent of GDP in line with faster disbursement of foreign financed projects**. Priority areas will be health, education, power, and road rehabilitation. In particular, as large foreign-financed infrastructure projects

are entering a major construction phase, disbursements are expected to increase. Other rupee-funded projects, however, will be kept to a minimum; the construction of new buildings in particular will be curtailed.

10. **Domestic debt financing of the budget will be reduced in part through increased privatization proceeds.** In January, 2001 we received $25 million of privatization receipts for the latest phased the sale of shares in Sri Lanka Airlines to Emirates. The sale of the Co-Operative Wholesale Establishment's wheat operation to Prima is ongoing and we expect the sale of Shell and Telecom shares and the opening of the insurance sector by the fourth quarter of 2001. Altogether receipts are expected to amount to 1¾ percent of GDP or about $275 million. The 2001 budget clearly spells out privatization and restructuring plans for the year, consistent with the envisaged privatization receipts. The quarterly targets for privatization receipts that we envisage under the program appear in Table 1 of the Technical Memorandum of Understanding.

Administered prices

11. **The government has set out a timetable for adjusting administered prices, especially those for oil products, public transportation, and utilities.** Increases in oil product prices on December 27 brought the rise in diesel and kerosene prices to about 80 percent since February 2000. Electricity prices were raised in February, 2001. By March 2001, domestic petroleum product price increases will have eliminated operating losses of the Ceylon Petroleum Corporation (based on the WEO scenario of oil prices falling to $25/barrel for 2001). The remaining price increases of fuel oil and diesel are prior actions.

12. **These price adjustments will enable the public corporate sector to repay Rs 7 billion to the banking system (½ percent of GDP).** A ceiling has been set on public sector bank borrowing to ensure these corporations adjust their prices as needed for any change in world prices so that operating profit is maintained. To this end, the government will draw up contingent measures including further price adjustments, in consultation with Fund staff to be implemented by midyear, in case the WEO price projections are exceeded. An automatic pricing mechanism will be put in place by end-2001 that will ensure that domestic fuel prices are adjusted sufficiently on a timely basis to pass on changes in international costs, enabling CPC to avoid recourse to bank financing.

Exchange rate and monetary policies

13. **The government adopted a floating exchange rate regime on January 23, 2001**. The market response has been favorable and the rate has stabilized at around Rs 86-88 per U.S. dollar. The central bank will no longer announce its daily buying and selling rates within an exchange rate band. The exchange rate will continue to be determined by the demand and supply in the market, with the central bank announcing the weighted average interbank rate on a daily basis. The authorities attach great importance to maintaining the competitiveness of the Sri Lankan economy and strengthening the reserves position. The Central Bank of Sri Lanka (CBSL) remains ready to intervene in a limited manner in the foreign exchange market to

dampen extreme volatility, but will not intervene to prevent adjustment of the exchange rate to macroeconomic fundamentals. The Central Bank of Sri Lanka will not have any administrative interference with the market determination of the exchange rate. To prevent commercial banks building large positions, limits have been imposed on net foreign open positions of their working balances. The authorities will consult regularly with the Fund staff on their exchange rate policy.

14. **Monetary policy will need to remain tight until fiscal consolidation can be credibly advanced**. A monetary framework will be developed during 2001, with technical assistance from the Fund and Sweden that would be consistent with the floating regime. The aim is to move toward a more explicit inflation objective over the medium term. Meanwhile, to provide a nominal anchor, the growth of reserve money will be limited to below 13 percent, which is consistent with a constant money multiplier and inflation target of 8 percent. Several other indicators of monetary conditions will be closely monitored, including domestic inflation, forward exchange rates and foreign interest rates. Open market operations using treasury bills will be the main monetary policy instrument. Repo and reserve repo rates will also be used to control liquidity condition in the market. High real interest rates are expected to remain in the first half of 2001, given inflation expectations and the need to stabilize the exchange rate. There could be room for some modest interest rate reduction in the latter part of 2001 as fiscal consolidation is advanced.

External targets and policies

15. **Under the fiscal and monetary policy mix, the external current account balance is expected to fall from 7 percent of GDP in 2000 to 3 percent of GDP in 2001**. The privatization receipts, net government borrowing of about \$130 million, and foreign direct investment close to \$190 million, are expected to finance the current account deficit. However, to rebuild the low level of reserves to at least above 2 months imports in 2001, i.e., \$1½ billion, and to avoid excessive slowing down of the economy, balance of payments support of \$530 million is required. Of this amount, about \$200 million is expected to be financed from commercial borrowing (of which \$100 million is refinancing of the syndicated loan extended to the Ministry of Finance in 2000), while the remaining amount will be provided by multilateral and bilateral official creditors. Assurances on financial support have been received from the international community, especially the World Bank, the Asian Development Bank, bilateral creditors and the private sector, that would be sufficient to meet financing needs in 2001 and 2002.

16. **To ensure that Sri Lanka maintains its repayments capacity, external commercial borrowing will be limited.** Assuming that Sri Lanka's external borrowing in the medium term will be largely on concessional terms, its debt service ratio will remain below 18 percent of exports of goods and services. External public debt will peak around 2001 at 70 percent of GDP and is expected to decline as structural issues are addressed. Short term debt as percent of gross reserves will remain broadly at 50 percent during 2001–02.

III. Medium-Term Outlook

17. **The government is publicly committed to building a strong private sector-driven market economy**. Such a medium-term strategy requires a macroeconomic policy mix supportive of private sector expansion, through fiscal consolidation, lower real interest rates, and extensive structural reform. The macroeconomic framework could envisage annual growth of 5½–6½ percent, with inflation moderating to below 5 percent. The external current account deficit would decline to below 3 percent of GDP, financed with rising private capital inflows. Official reserves could be brought back to an appropriate level (around 3½ months of import cover) over the medium term which could require additional financing from both official and private sources under a medium term framework.

18. **Fiscal consolidation would lower the overall fiscal deficit to below 5 percent of GDP by 2005.** Spending will be in line with the poverty reduction strategy presented to the Development Forum. Transfers to public corporations will be gradually eliminated, and steps will be taken to move the civil service pension scheme on to an actuarially sound basis. The focus of capital spending would be on rural education, health, and infrastructure, with a provision for retrenchment schemes. Domestic financing will be reduced, including from nonbank sources, so as not to inhibit development of a broader capital market.

IV. Structural Issues

19. **Efforts will continue to carry forward structural reform in 2001-02.** Public enterprise restructuring will include privatization of commercial activities and administrative restructuring of the Ministry of Finance and the CBSL. Labor market reform will aim to facilitate greater labor mobility while ensuring that adequate social safety net is put in place. A working group on labor market reform will establish standardized formulae for compensation, and establish fixed time limits for approval by the Commissioner of Labor for involuntary employee separation. The social safety net will be dedicated to job counseling, job placement and retraining of displaced workers.

20. **Banking sector soundness has been further improved**. Bank supervision has been strengthened and onsite inspection has become more frequent. Most banks meet the risk-weighted capital adequacy ratio of 9 percent, and even though nonperforming loans are still large, adequate provisioning have been made by banks. The government has agreed to participate in the Financial Sector Assessment Program (FSAP) process. Bank of Ceylon's Board members have been replaced by people from the private business community and profits were made in 2000, notwithstanding the fact that full provisioning was made for nonperforming loans. A new restructuring plan is under preparation, including steps to achieve performance targets that will include a reduction in the level of nonperforming loans through enhanced loan evaluation and recovery. This restructuring plan will replace the previous memorandum of understanding, which expires in June 2001.

21. **The People's Bank has a new management team, some from internationally reputable banks, in place since early March.** The Bank improved its financial position in the

second half of 2000, achieving a break even point in its operations. By September 2001, the new management team will provide a detailed proposal for restructuring that would make the bank commercially viable in the medium term. Measures are being introduced to ensure no operating loss in 2001 even after full provisioning has been made. The government will not provide additional capital until it is satisfied that the proposed restructuring plan is viable and will be implemented. Meanwhile, the bank's 2000 financial statement will be prepared by end-March and an audit completed by end May 2001.

22. **To address the structure of the budget and enhance transparency, dependence on the NSL will be reduced.** The changeover will be initiated with the 2002 Budget. There will be a significant reduction of NSL and a compensating increase in GST, with the timing and the amounts to be decided during the September program review. We envisage the full integration of the NSL with the GST by end-2004. Starting with the 2002 budget, no new tax incentives will be provided by the Board of Investment, which will be subsequently eliminated, and the granting and monitoring of all tax preferences will be consolidated to the Inland Revenue Department. In particular, subject to resolution of the legal dispute, the customs regime of BOI and non-BOI importers will be unified under the Customs Department. To promote private sector activity, limits on inward foreign direct investment will be phased out, starting from mid-2001.

V. Program Monitoring and Data Issues

23. The government is aware that purchases under the stand-by arrangement would be conditioned on the observance of quantitative performance criteria (Table 1) and completion of reviews. There will be three reviews under the program, which will be completed by August 29, 2001, November 29, 2001, and May 14, 2002. The amounts available are proposed to be phased in accordance with Table 1. The monitoring of the program will also take into account indicative targets and structural benchmarks (Table 2). Quantitative performance criteria, indicative targets, and precise definitions of quantitative variables monitored under the program are set out in the attached Technical Memorandum of Understanding. The standard clauses on overdue financial obligations to the Fund, accumulation of external payments arrears, exchange restrictions, multiple currency practices, bilateral payments agreements inconsistent with Article VIII, and import restrictions for balance of payments purposes are also applicable as performance criteria.

24. We understand that prior actions under the program would have to be implemented at least five days before the Board meeting. We will also transmit to Fund staff all the necessary documentation required under the Fund's safeguard rules, before the Board meeting.

25. Monitoring the program described in this memorandum will require timely and accurate data, for which a separate arrangement has been made with Fund staff.

Table 1. Performance criteria and Indicative Targets, March 2001-March 2002
(in billions of rupees; unless otherwise indicated)

	Estimate 2000 end-December	Indicative 2001 end-March	2001 end-June	2001 end-September	2001 end-December	Indicative 1/ 2002 end-March
Performance Criteria						
Ceiling on banks' net claims on government 2/	147	157	153	158	133	125
Ceiling on net domestic assets of the CBSL 2/	47	47	46	44	12	3
Floor on net international reserves of CBSL 3/ (in millions of U.S. dollars)	745	710	745	810	1,195	1,310
Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the public sector	...	350	350	350	350	400
Ceiling on the stock of short-term external debt outstanding	150	150	150	150	150	150
Accumulation of external payments arrears						
Continuous performance criterion during the program period	0	0	0	0	0	0
Indicative targets						
Floor on central government revenue						
Cumulative from January 1, 2001	211	58	119	190	258	...
Cumulative from January 1, 2002						67
Primary fiscal balance of central government excluding interest payments						
Cumulative from January 1, 2001	-53	-9	-15	-20	-32	...
Cumulative from January 1, 2002						-5
Stock of Domestic Debt of the Central Government 4/	661	692	714	740	729	754
Credit to public corporations by the banking system 5/	38	45	50	42	31	30
Ceiling on reserve money of the CBSL	105	111	113	115	120	122

1/ Performance criterion to be set at the time of second review when 2002 budget will be discussed.
2/ Adjusted downward by the full amount of excess rupee equivalent of privatization receipts and upward by shortfall of rupee amount of privatization up to quarterly limits as set out in Table 1 of the TMU; adjusted upward/downward by shortfall/excess.
3/ Adjusted upward by the full amount of excess privatization receipts and downward by shortfall in privatization receipts up to quarterly limits as set out in Table 1 of the TMU; adjusted upward/downward by excess/shortfall of foreign program assistance as set out in Table 2 of the TMU.
4/ Based on the stock of government domestic debt as specifically defined in the TMU.
5/ Based on the stock of credit to public corporations by the banking system.

Table 2. Sri Lanka: Prior Actions and Structural Benchmarks

Prior actions		
1.	Shift to a flexible exchange rate regime	Jan. 23, 2001-Done
2.	Increase administrative prices of energy and transport fares aimed at eliminating operational loses of public enterprises. In addition to the administered price increases announced already, further price increases will be made on Diesel (by Rs. 3 per liter) and Fuel oils (by Rs. 2 per liter)	March 25, 2001
3.	Announce revenue and expenditure measures in 2001 budget to achieve program fiscal target, including commitments on privatization and expected receipts.	March 8, 2001 Done
Structural benchmarks		
1.	The new management of People's Bank to prepare a detailed proposal for restructuring to make the bank commercially viable in the medium term.	September 2001
2.	The new management of Bank of Ceylon to prepare a new restructuring plan which will replace the previous memorandum of understanding.	September 2001
3.	Bring the GST into the Coverage of the Large Taxpayer Unit (LTU).	November 2001
4.	Starting with the 2002 budget, all tax concessions to be consolidated into the Inland Revenue Department Act; the Board of Investment will cease to grant new tax incentives.	November 2001
5.	Reduce dependence on the National Security Levy (NSL) by announcing a significant reduction in the NSL rate and a compensating increase in the GST rate in the 2002 budget.	November 2001
6.	Start phasing out remaining limits on inward foreign direct investment.	December 2001
7.	Adopt an automatic petroleum pricing method to permit timely pass through of input costs that would ensure nonrecurrence of operating losses of Ceylon Petroleum Corporation.	December 2001

Table 3. Sri Lanka: Proposed Schedule of Reviews and Purchases

Date	Amount of Purchase (in millions of SDRs)	In Percent of Quota	Conditions
Board approval	103.35	25.0	Approval of Stand-By arrangement.
August 30, 2001	24.16	5.8	Observance of end-June 2001 performance criteria and completion of first review.
November 30, 2001	24.16	5.8	Observance of end-September 2001 performance criteria and completion of second review.
February 28, 2002	24.16	5.8	Observance of end-December 2001 performance criteria.
May 15, 2002	24.16	5.8	Observance of end-March 2002 performance criteria and completion of third review.
Total	200.0	48.4	
Memorandum item:			
Total quota	413.4	100.0	

SRI LANKA

TECHNICAL MEMORANDUM OF UNDERSTANDING ON THE PROGRAM SUPPORTED BY STAND-BY ARRANGEMENT

March 19, 2001

1. This memorandum sets out the understandings between the Sri Lankan authorities and the Fund relating to the monitoring of the program for 2001–2 supported by the Stand-by Arrangement. It specifies the quantitative performance criteria and indicative targets, and the content and frequency of the data to be provided for monitoring the financial program.

I. FISCAL TARGETS

A. Performance Criterion on Net Claims on the Government by the Banking System

	Ceiling (In billions of rupees)
Outstanding stock as of :	
March 31, 2001 (indicative target)	157
June 30, 2001 (performance criterion)	153
September 30, 2001 (performance criterion)	158
December 31, 2001 (performance criterion)	133
March 31, 2002 (indicative target) 1/	125

1/ Performance criterion to be set at the time of the Second Review of the arrangement.

2. **Net claims on government by the banking system** is defined as the difference between banks' claims on government, and the deposits of government, the central and provincial governments with the banking system. The ceiling on net claims on government is cumulative from the start of the fiscal year.

The following adjustments will apply:

3. **The ceiling on net claims on government** will be adjusted downwards by the full amount of excess rupee equivalent of privatization receipts and upward by shortfall of rupee amount of privatization up to limits as set out in Table 1; adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program assistance as set out in Table 2. However, the upward adjustment for shortfalls in foreign program financing will be limited to a maximum of $25 million at end-March 2001, $50 million at end-June 2001, $100 million at end-September and $200 million at both end-December 2001 and end-March 2002 as described in Section III below using program exchange rate in Table 4.

4. **The ceiling** will be adjusted downward by the full amount of any privatization receipts from residents in rupee equivalent amount using the program exchange rates if receipts are in foreign currency. The same adjusters on net claims to government will also apply to the indicative target on net domestic debt in Table D below.

B. Indicative Target on the Primary Fiscal Balance

	Ceiling (In billions of rupees)
Cumulative balance from January 1, 2001 to:	
March 31, 2001 (indicative target)	-9
June 30, 2001 (indicative target)	-15
September 30, 2001 (indicative target)	-20
December 31, 2001 (indicative target)	-32
Cumulative balance from January 1, 2002 to:	
March 31, 2002 (indicative target) 1/	-5

1/ Indicative target to be set at the time of the Second Review of the arrangement.

5. **Government primary fiscal balance** is defined as the overall central government fiscal deficit minus interest payments and the ceiling on government primary balance will be monitored according to this definition. For monitoring purposes, primary fiscal balance excludes grants and privatization receipts. The ceiling on government primary balance is cumulative from the start of the fiscal year. However, the government primary balance should also broadly equal the sum of net foreign financing, net bank financing, and non-bank financing as recorded by the Public Debt Department, Central Bank of Sri Lanka, minus interest payments.

C. Indicative Target on the Central Government Revenue

	Floor (In billions of rupees)
Cumulative balance from January 1, 2001 to:	
March 31, 2001 (indicative target)	58
June 30, 2001 (indicative target)	119
September 30, 2001 (indicative target)	190
December 31, 2001 (indicative target)	258
Cumulative balance from January 1, 2002 to:	
March 31, 2002 (indicative target) 1/	67

1/ Indicative target to be set at the time of the Second Review of the arrangement.

6. **Central government revenue** is defined as the central government revenue as reported in the treasury accounts, and excludes foreign grants and privatization receipts. The floor on central government revenue is cumulative from the start of the fiscal year.

D. Indicative Target on Stock of Net Domestic Debt of the Central Government

	Ceiling (In billions of rupees)
Stock Balance at the end of:	
March 31, 2001 (indicative target)	692
June 30, 2001 (indicative target)	714
September 30, 2001 (indicative target)	740
December 31, 2001 (indicative target)	729
Stock Balance at the end of:	
March 31, 2002 (indicative target) 1/	754

1/ Indicative target to be set at the time of the Second Review of the arrangement.

7. For the purpose of program monitoring, the stock of net domestic debt (NDD) of the central government will be measured by instruments and would be the sum of the stocks of the following government debt instruments less government deposits: (a) Rupee securities, (b) Treasury Bills (c) Treasury Bonds (d) Treasury Certificates of Deposits (e) Provisional advances from the CBSL (f) Other – which consist of overdraft, import bills and syndicated loans with People's Bank and Bank of Ceylon *less* government deposits with the CBSL, People's Bank and Bank of Ceylon. The reporting requirement for NDD appears in Table 6. The data on the instruments (a) through (d) will be provided by the public debt office and data on (e) and (f) will be based on the balance sheet data of CBSL, People's Bank and Bank of Ceylon as provided by the CBSL. The adjusters to net claims on government will also apply to the indicative target on NDD.

E. Indicative Target on Credit to Public Corporations by the Banking System

	Ceiling (In billions of rupees)
Outstanding stock as of :	
March 31, 2001 (indicative target)	45
June 30, 2001 (indicative target)	50
September 30, 2001 (indicative target)	42
December 31, 2001 (indicative target)	31
March 31, 2002 (indicative target) 1/	30

1/ Indicative target to be set at the time of the Second Review of the arrangement.

8. **Credit to public corporations by the banking system** is defined as credit of the banking system to public corporations. It comprise both credit from deposit banking units and from foreign currency banking units. Public enterprises comprise of companies currently classified as public corporations under the CBSL's classification in the monetary survey (Table 3).

II. Monetary Targets

A. Performance Criterion on Net Domestic Assets of the CBSL

	Ceiling (In billions of rupees)
Outstanding stock as of :	
March 31, 2001 (indicative target)	47
June 30, 2001 (performance criterion)	46
September 30, 2001 (performance criterion)	44
December 31, 2001 (performance criterion)	12
March 31, 2002 (indicative target) 1/	3

1/ Performance criterion to be set at the time of the Second Review of the arrangement.

9. **Net domestic assets of the CBSL** is defined as the difference between reserve money and net foreign assets of the CBSL valued in rupee. Reserve money is defined below in II.B. Net foreign assets of the CBSL are the net claims on nonresidents, in all currency denominations and government (net). For program monitoring purposes, net foreign assets will be calculated using the exchange rate given in Table 4.

The following adjustments will apply:

10. **The NDA ceiling is based on a baseline path of NFA that excludes reserve losses on forwards (III.A).** The NDA ceiling will be adjusted downwards by the full amount of excess rupee equivalent of privatization receipts and upwards by shortfall of rupee amount of privatization up to quarterly limits as set out in Table 1; adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program assistance as set out in Table 2 using the program exchange rate in Table 4. However, the upward adjustment for shortfalls in foreign program financing will be limited to a maximum of $25 million at end-March 2001, $50 million at end-June 2001, $100 million at end-September and $200 million at both end-December 2001 and end-March 2002 as described in Section III below using program exchange rate in Table 4.

11. **The NDA ceiling** will be adjusted downward by the full amount of any privatization receipts from residents in rupee equivalent amount using the program exchange rates if receipts are in foreign currency.

12. **Changes in required reserve regulations will modify the NDA ceiling according to the formula:**

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

where r_0 denotes the reserve requirement ratio prior to any change; B_0 denotes the programmed reserve money base in the period prior to any change; Δr is the change in the reserve requirement ratio; and ΔB denotes the immediate change in the reservable base as a result of changes in its definition.

B. Indicative Target on Reserve Money of the CBSL

	Ceiling (In billions of rupees)
Outstanding stock as of :	
March 31, 2001 (indicative target)	111
June 30, 2001 (indicative target)	113
September 30, 2001 (indicative target)	115
December 31, 2001 (indicative target)	120
March 31, 2002 (indicative target) 1/	122

1/ Indicative target to be set at the time of the Second Review of the arrangement.

13. **Reserve money of the CBSL** consists of currency in circulation (with banks and with the rest of the public), and financial institutions' deposits at the CBSL, and government agencies deposits (as defined in CBSL's balance sheet in Table 5). As of end-December 2000, reserve money defined in this manner stood at Rs 105 billion (including government agencies deposits which were less than Rs 50 million).

14. **The ceiling on reserve money will be adjusted for changes in reserve regulations in line with the adjustment generated to the NDA limit.**

III. External Sector Targets

A. Performance Criterion on Net International Reserves of the CBSL

	Floor (In millions of U.S. dollars)
Outstanding stock as of :	
March 31, 2001 (indicative target)	710
June 30, 2001 (performance criterion)	745
September 30, 2001 (performance criterion)	810
December 31, 2001 (performance criterion)	1,195
March 31, 2002 (indicative target) 1/	1,310

1/ Performance criterion to be set at the time of the Second Review of the arrangement.

15. **Net international reserves of the CBSL** is defined as the difference between its gross foreign assets and gross foreign liabilities. Gross foreign assets of the CBSL consists of (i) gold, foreign exchange balances held outside Sri Lanka, foreign securities, foreign bills purchased and discounted, net IMF position and SDR holdings, Crown Agent's credit balance, DSTs' Special Dollar Revolving balance, and (ii) the net forward position, if any, of the CBSL, defined as the difference between the face value of foreign currency denominated CBSL off-balance sheet claims on nonresidents and foreign currency obligations to both residents and nonresidents. Excluded from gross foreign assets will be participation in international financial institutions, holdings of nonconvertible currencies, holdings of precious metals other than gold, and claims on residents (e.g., statutory reserves on foreign

deposits of commercial banks) pledged, collateralized or otherwise encumbered assets, 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 contracted maturity up to one year, the use of Fund credit, and Asian Clearing Union debit balance.

The following adjustments will apply:

16. **The NIR floor will be adjusted** upward by the full amount of excess privatization receipts and downward by shortfall in privatization receipts up to quarterly limits as set out in Table 1; adjusted downward/upward by the shortfall/excess of foreign program financing as set out in Table 2 but the downward adjustment for shortfalls in foreign program financing will be limited to a maximum of $25 million at end-March 2001, $50 million at end-June 2001, $100 million at end-September and $200 million at both end-December 2001 and end-March 2002.

B. Performance Criterion on New Nonconcessional External Debt

	Ceiling (In millions of U.S. dollars)
Cumulative balance from January 1, 2001 to:	
March 31, 2001 (indicative target)	350
June 30, 2001 (performance criterion)	350
September 30, 2001 (performance criterion)	350
December 31, 2001 (performance criterion)	350
March 31, 2002 (indicative target) 1/	400

1/ Performance criterion to be set at the time of the Second Review of the arrangement.

17. **Contracting or guaranteeing of new medium and long-term nonconcessional external debt** is defined as contracting or guaranteeing new nonconcessional external debt by the public sector (all central and provincial government ministries and departments, public corporations and institutions, and the CBSL) with an original maturity of more than one year. Non-concessional debt is defined as borrowing containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are credits extended by the IMF and from the program financing assistance envisaged under the program, including from IBRD and AsDB, and other bilateral creditors as specified in Table 2. Debt contracted with the private sector as part of the program financing assistance will also be subject to this ceiling. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time of the contract is entered into, or guarantee issued.

C. Performance Criterion on Stock of Short-Term Debt

	Ceiling (In millions of U.S. dollars)
Outstanding stock as of:	
March 31, 2001 (indicative target)	150
June 30, 2001 (performance criterion)	150
September 30, 2001 (performance criterion)	150
December 31, 2001 (performance criterion)	150
March 31, 2002 (indicative target) 1/	150

1/ Performance criterion to be set at the time of the Second Review of the arrangement.

18. **Stock of short-term external debt outstanding** is defined as debt with original maturity of up to one year owed or guaranteed by the public sector (as defined above). The term debt is defined as set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), August 24, 2000), but excludes normal import-related credits, forward contracts, swaps, and other future market contracts and short-term liabilities of the banking system. The ceilings also apply to debt instruments with put options that would be triggered within one year after the contracting date.

IV. Data Reporting Requirements

19. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Table 7 and 8:

20. For the purpose of external sector performance under the program, data will be provided in the format as shown in Table 9 and 10.

21. All the program monitoring data would be provided by the Ministry of Finance and the Central Bank of Sri Lanka (CBSL). All the data relating to the above programmed targets will be furnished within six weeks after the end of each month.

Table 1. Privatization Receipts and Adjustments 1/
(In millions of U.S. dollars)

	2001 March	2001 June	2001 September	2001 December	2002 March
Privatization receipts (in millions of U.S. dollars)					
Cumulative from January 1, 2001	25	90	90	275	275
Maximum adjustment in the case of shortfall 2/					
In millions of U.S. dollars	25	50	50	50	50
In millions of rupees	50,025	100,050	100,050	100,050	100,050

1/Projected privatization receipts from non-residents only.
2/ Full adjustment will be made for any excess of privatization receipts

Table 2. Foreign Financing Assumption; Cumulative from January 1, 2001
(In millions of U.S. dollars)

	2001 March	2001 June	2001 September	2001 December	2002 March
Multilateral creditors	50	69	98	203	247
World Bank	0	0	7	87	117
Asian Development Bank	33	47	66	88	100
Others	17	22	25	28	30
Bilateral creditors	0	11	62	65	76
o/w Japan	0	11	25	25	25
Germany	0	0	17	20	26
Others	0	0	20	20	25
Private creditors	0	0	0	200	200
Total	50	80	160	468	523

Table 3. List of Public Corporations as Defined by the Central Bank of Sri Lanka 1/

1. Ceylon Electricity Board
2. Ceylon Petroleum Corporation
3. C.W.E.
4. Ceylon Shipping Corporation
5. State Pharmaceuticals Corporation
6. Building Materials Corporation
7. Ceylon Plywood Corporation
8. National Livestock Development Board

1/ Does not include Sri Lanka Telecom, Sri Lankan Airlines—companies in which the state has large equity shares but which are privately operated.

Table 4. Exchange Rates and Gold Prices to be Used Under the Program 1/

	Rupees per Unit of Foreign Currency
U.S. dollar	90
Japanese yen	0.8
SDR	117
EURO	83
Gold prices (U.S. dollars per ounce)	265

1/ Currencies not shown here will be converted first into U.S. dollars using the official rate used by Fund's Treasury Department on January 31, 2001.

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

Net Foreign Assets
Foreign assets
Cash and balance abroad
Foreign securities
Claims on ACU
SDRs
Foreign currency reserve
Foreign liabilities
IMF and nonresident account
Liabilities to ACU
Government (net)
Net Domestic Assets
Claims on government
Advances
Treasury bills and bonds
Cash items in collection
Government deposits
Claims on commercial banks
Medium and long term
Short term
Other items net
Reserve money
Currency in circulation
Commercial bank deposits
Government agencies deposits

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

Table 6. The Stock of Domestic Debt of Central Government of Sri Lanka 1/

Stock of Total Domestic Debt By Debt Instruments
Rupee securities
Treasury Bills
Treasury Bonds
Treasury Certificates for Central Bank
Provisional Advances for Central Bank
Other liabilities with People's Bank and Bank of Ceylon net of government deposits
Overdraft with People's Bank
Overdraft with Bank of Ceylon
Government deposits with CBSL
Government deposits with Bank of Ceylon
Government deposits with People's Bank
Import Bills – Bank of Ceylon
Imports Bills – People's Bank
Syndicated Loans with Bank of Ceylon
Syndicated Loans with People's Bank

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

Table 7. Revenue Collection
(in Rs millions)

Total Revenue
Tax revenue
Income taxes; of which
Save the Nation Contribution
Turnover taxes/GST; of which
Imports
TT on banking and finance
Excise taxes
Liquor
Tobacco
Other
National security levy
Taxes on international trade
Stamp duty
License fee/motor vehicles
Nontax revenue
Property income
CB profits
Interest
Profits and dividends
Rents
Fees and charges
Other

Table 8. Expenditures
(in Rs millions)

Total expenditure and net lending
Current expenditure
Civil service wages and salaries
Military wages and salaries
Goods and services
Subsidies and transfers; of which
Pensions
Samurdhi
Local and provincial governments
Interest payments
Foreign
Domestic
Capital expenditure and net lending
Rupee funds (incl. Counterpart funds)
Foreign financed
Overall balance (excl. grants and privatization)
Overall primary balance (excl. grants and privatization)

Table 9. Net International Reserves
(in millions of U.S. dollars)

Date	Central Bank				Government				Liabilities			
	Foreign exchange balance.	Reserve position with the Fund	Forex currency deposit due to SRR 1/	Total	Crown Agent's Credit Balance	DST's special dollar rev. balance	Total	Total gross official reserves	Deposits	Asian Clearing Union	PRGF	Total

1/ Foreign currency deposits held by the CBSL on account of statutory reserve requirement on foreign currency deposits by commercial banks.

Table 10. Contracting or Guaranteeing of New Nonconcessional External Debt by the Public Sector

Creditor	Name of project	Date of agreement	Maturity period	Grace period	Interest rate	Currency	Amount	Disbursement

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 01/45
FOR IMMEDIATE RELEASE
May 14, 2001

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Sri Lanka

On April 20, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sri Lanka.[1]

Background

Over the last decade, Sri Lanka's economy has grown steadily, but at a relatively slow rate. During the late 1980s and 1990s, financial markets were liberalized, the outward orientation of the economy was significantly increased, and a more diversified export base established. Progress has been made in other areas, most notably privatization. However, underlying the modest growth performance have been relatively low levels of saving and investment. Prolonged periods of public dissaving have reflected substantial fiscal deficits that averaged more than 9 percent of GDP. Moreover, modest progress was made in other key structural areas, including restructuring of the civil service and state monopolies, financial and labor market reforms, and increased spending on education and health, thus undermining the economy's growth potential.

After slowing in the aftermath of the Asian crisis, economic activity picked up from mid-1999 to the third quarter of 2000 (with annualized growth increasing to about 7 percent) as a result of recovery in Sri Lanka's main export markets, particularly for textiles, garments, and tea. Growth subsequently slackened to about 5 percent, as poor monsoons affected agricultural output and high interest rates worsened the general business environment. The savings-investment gap widened to 7 percent of GDP: gross domestic investment

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the April 20, 2001 Executive Board discussion based on the staff report.

increased as a result of increased private investment in the garments and textiles sector, ports, and power plants, while gross national savings declined as a result of a substantial decline in public savings.

From the fourth quarter of 1999 the rupee came under considerable pressure. Although exports grew strongly, the higher cost of oil imports, and increased military imports resulted in a sharp increase in the external current account deficit in 2000. As a result, gross official reserves dropped by more than $600 million, to less than 1½ months of imports in 2000. Despite progressively widening the band to allow a 10 percent depreciation of the rupee against the dollar during the second half of 2000, the central bank was forced to defend the lower end of the exchange rate band. However, because of the weakening of other partner country exchange rates vis-à-vis the dollar, the rupee only depreciated by 6½ percent in nominal effective terms, and appreciated by 1½ percent in real effective terms. Some external vulnerability indicators worsened in 2000, but the high share of concessional external debt, and limited portfolio flows, suggest medium-term external vulnerability is not especially high.

After declining in 1999 and the first half of 2000, consumer price inflation rose sharply in the second half of 2000, on account of increases in administered prices of petroleum products, transport fares, and public utility charges. As a result, inflation was 10¾ percent at end-2000, and has increased further in the first two months of 2001, owing to the impact of the depreciation and further utility price increases.

The overall fiscal deficit rose to 9¾ percent of GDP in 2000, reversing the fiscal consolidation achieved in 1999. This outcome, sharply worse-than-originally projected, reflected both increased security-related expenditure due to the escalation of the civil conflict, and a shortfall in tax revenue. As a result, public savings were significantly negative and domestic bank financing was 3½ percentage points of GDP higher than projected.

Monetary policy has been constrained by the fiscal situation, requiring high real interest rates to counter exchange rate and inflationary pressures. As a result, the Central Bank of Sri Lanka raised the overnight repo and reverse repo rates by 6-7 percentage points in the second half of 2000. In spite of the sharp increase in lending to the public sector, overall broad money growth was contained at 13 percent as a result of a sharp decline in net foreign assets, reflecting the fall in official reserves.

Structural reforms are focused on current plans to improve the financial sector, public enterprises, public administration, and pensions. The authorities are implementing plans for restructuring and management changes in the two state banks and for an enhanced bank supervision framework for the commercial bank sector. While the privatization and state enterprise restructuring program continues, the challenge remains to reform the civil service and pensions systems. Prospects for regional trade integration were boosted by the Indo-Lanka Free Trade Agreement, which came into effect in February 2000.

Economic Prospects

Reduced growth of 4-4½ percent is expected in 2001, led by slower growth in services and manufacturing output. Although continued buoyancy of the garment sector should boost manufacturing activity, the rapid expansion of garment sales to the U.S. in 2000 is not expected to be maintained. Early indications are that agricultural output will remain sluggish, affected by delayed and poor monsoon rains. The pace of inflation is expected to ease by mid year once the exchange rate depreciation and increases in administered prices have taken their full effect. The new stabilization program will reduce domestic demand, especially for consumer imports, through a higher tax burden and lower real incomes. With substantial official financing and privatization proceeds, gross official reserves are projected to rise to US$1.5 billion, about two months of imports of goods and services.

Executive Board Assessment

They noted that notwithstanding the effect of the civil conflict on Sri Lanka's economy, robust growth of exports supported by the authorities' efforts to implement sound macroeconomic policies have led to respectable economic growth over the past decade. Against the background of the serious economic difficulties that arose in 2000, the Directors generally welcomed policy adaptations adopted by the authorities, especially the substantial fiscal consolidation, the concerted improvement in the financial position of the public enterprises, and a flexible exchange rate policy. Directors expressed serious concern, however, at the slow pace of reform implementation.

Directors agreed that the fiscal targets for 2001 and 2002 and the underlying revenue and expenditure measures were appropriate. In this context, they considered that the main challenge facing the authorities in the short term was to arrest the severe deterioration in the fiscal accounts that took place in 2000 by putting security-related spending under control and improving revenue collection.

Directors called for strengthening the financial position of the public enterprises. In this regard, they noted that the impact of high oil prices was considerable in 2000, and commended the authorities for significant increases in administered prices. These changes should reverse the operating losses of the Ceylon Petroleum Corporation by the end of 2001 and lessen the fiscal cost of other subsidies. Directors welcomed the authorities' commitments to put in place an automatic pass-through mechanism, which would ensure that domestic fuel prices respond to changing world oil prices.

Directors welcomed the authorities' adoption of a fully flexible exchange rate mechanism. They emphasized that the central bank should limit its intervention in the foreign exchange market to dampening volatility, as well as to permit the central bank to build up reserves. In this regard, Directors welcomed the recent relaxation of foreign exchange regulations and urged the authorities to rationalize the remaining regulations in order to reinforce the market determination of the exchange rate.

Directors expressed concern over the increase in inflation in 2000, while noting that this was largely related to exogenous developments. Nevertheless, Directors urged the authorities to maintain tight monetary policy, at least until the fiscal adjustment takes hold, inflation declines, and reserves start to increase. In this context, several Directors cautioned against any premature easing of interest rates. The authorities would also need to ensure that the use of open-market operations is consistent with the monetary targets. Directors urged the central bank to develop further its reserve money framework with the assistance of MAE.

Looking forward, Directors noted that for Sri Lanka's medium-term viability, the authorities would need to press ahead with an ambitious structural reform agenda. In view of widespread poverty, Directors expressed the hope that the authorities would design and implement a program to foster sustainable growth and poverty reduction under a program that could be supported by a PRGF arrangement. In this context, Directors urged the authorities to improve the performance of the public sector, and improve the prospects for private sector activity to establish an economic environment conducive to a higher growth path. They noted that the structural reform agenda should be supported by medium-term fiscal consolidation, which would help release resources for more productive private sector activities. Thus, Directors endorsed the government's medium-term objective to reduce the overall deficit to below 5 percent of GDP. Looking ahead to a possible PRGF arrangement, some Directors stressed the critical importance of controlling security-related expenditures and ensuring that they did not crowd out social programs and outlays for poverty alleviation.

Directors recommended that plans be developed to make the civil service pension scheme more affordable, while the treatment of government and nongovernment employees should be unified to increase labor mobility. They called on the authorities to improve the functioning of the labor market by moving ahead with the proposed revision of the procedures for dispute settlement and arbitration. An overhaul of key labor legislation would also allow enterprises greater freedom to determine appropriate staffing levels and thereby facilitate job creation.

Directors emphasized the need to strengthen the financial system and increase its efficiency, and in this context they welcomed the authorities' participation in the joint Bank-Fund Financial Sector Assessment Program. They called on the authorities to implement fundamental reform of the state banks without delay, with the government committing public funds only after serious restructuring has taken place.

Directors noted that the authorities have been providing the Fund with key economic statistics on a timely basis that are adequate for program monitoring and macroeconomic surveillance, while urging the authorities to take the remaining necessary steps for subscription to the SDDS.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Sri Lanka: Selected Economic Indicators

(in millions of US dollars except where otherwise noted)

	1995	1996	1997	1998	1999	2000 Prov.
Domestic Economy						
Change in real GDP (percent)	5.5	3.8	6.4	4.7	4.3	6.0
Change in CPI (percent, end of period)	11.5	16.8	10.7	3.7	4.0	10.8
National savings (percent of GDP)	19.5	19.0	21.5	23.4	23.8	21.7
Gross investment (percent of GDP)	25.7	24.2	24.4	25.1	27.2	29.1
Fiscal position						
Revenue (percent of GDP)	20.4	19.0	18.5	17.2	17.6	16.7
Expenditure (percent of GDP)	30.5	28.5	26.4	26.3	25.1	26.6
Overall deficit (percent of GDP) 1/	-10.1	-9.4	-7.9	-9.2	-7.5	-9.8
External Economy						
Exports	3,807	4,095	4,639	4,798	4,600	5,522
Imports	5,311	5,439	5,864	5,889	5,981	7,350
Current account balance (excl. official transfers)	-847	-727	-437	-278	-601	-1,132
(in percent of GDP)	-6.5	-5.2	-2.9	-1.8	-3.8	-6.9
Capital and financial account balance	704	457	600	414	358	657
Of which, direct investment	57	119	430	193	177	202
Gross official reserves (less ACU balances)	1,989	1,855	1,922	1,892	1,519	906
Change in the real effective exchange rate (annual percent change) 2/	-1.1	10.4	13.4	-10.5	-1.2	1.4
External debt (in percent of GDP)	75.0	68.6	62.3	61.0	63.0	63.9
Debt service (in percent of goods and services exports)	16.5	15.3	13.3	13.3	15.2	14.2
Financial Variables						
Broad money growth (annual percent change) 3/	21.1	11.3	15.6	13.2	13.4	12.9
Interest rate (in percent; e.o.p.) 4/	19.3	17.5	10.2	12.0	11.8	18.0

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

1/ Excluding grants and privatization receipts.
2/ (-) = depreciation.
3/ Including foreign currency banking units.
4/ Three-month treasury bill rate.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US$253 Million Stand-By Arrangement For Sri Lanka

The Executive Board of the International Monetary Fund (IMF) today approved a 14-month stand-by credit for SDR 200 million (about US$253 million) for Sri Lanka to support the government's economic program for 2001-02. The decision will enable Sri Lanka to draw SDR 103 million (about US$131 million) from the IMF immediately.

In commenting on the Executive Board's decision, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, said:

"The program aims to restore macroeconomic stability through an improvement in the financial position of the public sector and the rebuilding of official reserves, supported by a flexible exchange rate. The program should also lay the foundation for a move to a higher sustainable growth path. To support these objectives, the government has strengthened macroeconomic policies and is developing a structural reform agenda that emphasizes fiscal consolidation, improvements in public administration, public enterprise restructuring, and improvements in the functioning of labor markets.

"Fiscal consolidation will be a key component of the program. Under the 2001 budget, the overall government deficit will be reduced from 9.8 percent of GDP in 2000 to 8.5 percent of GDP, with further reductions over the medium term to 5 percent. The budget target is to be achieved through increased tax revenue by widening the tax base and increasing tax rates, as well as lower security-related spending and strict expenditure controls. In addition, administered prices for petroleum products, public transportation, and utilities, have been adjusted to reflect changes in international oil prices, in order to reverse the buildup of losses in energy related public enterprises.

"The authorities adopted a floating exchange rate regime on January 23, 2001, and the rupee has since stabilized. To support its flexible exchange rate policy, the Central Bank of Sri Lanka has relaxed the regulations that were introduced temporarily to prevent unduly large fluctuations. Maintaining a flexible market-determined exchange rate is an important feature of the government's program. Continued progress with structural reform will be necessary to attract private investment, achieve high growth, and alleviate poverty over the medium term. In addition, there is an urgent need to accelerate privatization, strengthen the integrity of the banking sector and improve public administration, the financial position of public enterprises, and the labor market.

"The financing of the program will involve substantial contributions from the international financial institutions, official bilateral creditors, and the private sector. Financing from the World Bank and the Asian Development Bank will be used to support structural reform. The successful implementation of the program and the finalization of major structural reform plans, as well as progress in developing a poverty reduction strategy, could establish medium-term financial support from the Fund under the Poverty Reduction and Growth Facility," Mr. Sugisaki said.

ANNEX

Program Summary

After slowing in the aftermath of the Asian crisis, economic activity picked up from mid-1999 to the third quarter of 2000 (with annualized growth increasing to about 7 percent) because of recovery in Sri Lanka's main export markets, particularly for textiles, garments, and tea. Growth subsequently slackened, however, as poor monsoons affected agricultural output and the business environment worsened.

From the fourth quarter of 1999, macroeconomic problems emerged, and the rupee came under considerable pressure. Although exports grew strongly, the higher cost of oil imports, and increased military imports caused by an escalation of the civil conflict, resulted in a sharp increase in the external current account deficit in 2000. As a result, gross official reserves dropped to less than 1½ months of imports. Domestically, there was a substantial expansion in the fiscal deficit, which was accompanied by a sharp increase in interest rates of about 7 percentage points in 2000.

In light of these developments, the authorities have framed an economic program focused on fiscal consolidation and the rebuilding of reserves, supported by a restrained monetary policy and a flexible exchange rate.

Fiscal policy is aimed at reducing the overall deficit (before grants) by 1¼ percentage points to 8½ percent of GDP in 2001, mainly by means of increased revenue. The increased revenue would be generated largely from increased taxes on turnover, corporate income, and imports, as well as improved tax administration. Total expenditure is targeted to increase slightly as a substantial increase in spending on priority capital projects is expected to more than offset reductions in current expenditure. The reduction in current expenditure reflects lower security-related expenditure, a civil service wage constraint and hiring freeze, and strict expenditure controls. The 2002 budget would lower the deficit further, to 6¾ percent of GDP, based on a further widening of the tax base and continued improvements in tax administration, as well as reduced security-related expenditure.

Monetary policy restraint will be maintained in order to bring inflation down to single digits by the end of 2001, while rebuilding gross official reserves to about $1.5 billion. However, some reduction of interest rates could be expected in the latter part of the year as the impact of administered price increases and exchange rate depreciation diminishes. In support of the new floating exchange rate regime, the central bank will intervene in the foreign exchange market only to meet its reserve targets and to prevent undue fluctuations in the rate.

Structural reforms will be focused on improving the performance of the state sector through privatization and restructuring of public enterprises, enhancement of tax administration and improving the performance of GST for government revenue over the medium term. Other key reforms include improvements in the operations of the two state banks, rationalization of the civil service, reform of the civil service pension system, improvements in the functioning of labor markets, and the removal of remaining limits on inward foreign direct investment.

Sri Lanka joined the IMF on August 29, 1950, and its quota[1] is SDR 413.4 million (about US$524 million). Its outstanding use of IMF financing currently totals SDR 112 million (about US$142 million).

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its share in the allocation of SDRs.

Sri Lanka: Selected Economic Indicators
(in millions of US dollars except where otherwise noted)

	1995	1996	1997	1998	1999	2000 Prov.	2001 Program
Domestic Economy							
Change in real GDP (percent)	5.5	3.8	6.4	4.7	4.3	6.0	4.3
Change in CPI (percent, end of period)	11.5	16.8	10.7	3.7	4.0	10.8	8.0
National savings (percent of GDP)	19.5	19.0	21.5	23.4	23.9	21.7	24.3
Gross investment (percent of GDP)	25.7	24.2	24.4	25.1	27.1	29.1	27.4
Fiscal position							
Revenue (percent of GDP)	20.4	19.0	18.5	17.2	17.6	16.7	18.3
Expenditure (percent of GDP)	30.5	28.5	26.4	26.3	25.1	26.6	26.9
Overall deficit (percent of GDP) 1/	-10.1	-9.4	-7.9	-9.2	-7.5	-9.8	-8.5
Total government debt (percent of GDP)	95.2	93.3	85.8	90.8	94.7	96.4	97.3
External Economy							
Exports	3,807	4,095	4,639	4,798	4,600	5,522	5,977
Imports	5,311	5,439	5,864	5,889	5,981	7,350	7,199
Current account balance (excl. official transfers)	-847	-727	-437	-278	-601	-1,132	-493
(in percent of GDP)	-6.5	-5.2	-2.9	-1.8	-3.8	-6.9	-3.1
Capital and financial account balance	704	457	600	414	358	657	604
Of which, direct investment 2/	57	119	430	193	177	202	463
Gross official reserves (less ACU balances)	1,989	1,855	1,922	1,892	1,519	906	1,500
(in months of prospective imports)	3.9	3.4	3.5	3.3	2.2	1.3	2.0
Change in the real effective exchange rate (percent, end of period) 3/	-1.1	10.4	13.4	-10.5	-1.2	1.4	-4.6
External debt (in percent of GDP)	75.0	68.6	62.3	61.0	63.0	63.9	70.0
Debt service (in percent of goods and services exports)	16.5	15.3	13.3	13.3	15.2	14.2	15.8
Financial Variables							
Broad money growth (annual percent change) 4/	21.1	11.3	15.6	13.2	13.4	12.9	13.0
Of which, net credit to government	23.3	21.9	-4.0	42.8	45.3	56.8	-10.0
Of which, credit to the private sector	28.8	8.9	14.5	12.1	10.5	11.8	9.5
Interest rate (percent, end of period) 5/	19.3	17.5	10.2	12.0	11.8	18.0	...

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

1/ Excluding grants and privatization receipts.
2/ Includes privatization receipts.
3/ (-) = depreciation.
4/ Including foreign currency banking units.
5/ Three-month treasury bill rate.