

Sri Lanka: First and Second Reviews Under the Stand-By Arrangement and Requests for Waiver of Performance Criterion and for Extension of the Arrangement—Staff Report; Staff Statement; and News Brief on the Executive Board Discussion

In the context of the First and Second Reviews Under the Stand-By Arrangement and Requests for Waiver of Performance Criterion and for Extension of the Arrangement, the following documents have been released and are included in this package:

- the staff report for the First and Second Reviews Under the Stand-By Arrangement and Requests for Waiver of Performance Criterion and for Extension of the Arrangement, prepared by a staff team of the IMF, following discussions that ended on **February 14, 2002**, 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 April 1, 2002.** 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 staff statement of **April 15, 2002** updating information on recent developments.
- a News Brief summarizing the **views of the Executive Board as expressed during its April 15, 2002 discussion** of the staff report that completed the review.

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

Letter of Intent sent to the IMF by the authorities of Sri Lanka
Memorandum of Economic and Financial Policies by the authorities of Sri Lanka
Technical Memorandum of Understanding

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

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SRI LANKA

First and Second Reviews Under the Stand-By Arrangement and Requests for a Waiver of Performance Criterion and for Extension of the Arrangement

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

Approved by Yusuke Horiguchi and Anne McGuirk

April 1, 2002

- **A 14-month Stand-By Arrangement (SBA), amounting to SDR 200 million (48 percent of quota), was approved on April 20, 2001**, on which occasion the Executive Board also concluded the 2001 Article IV Consultations (EBS/01/41). In approving the arrangement, Directors welcomed the authorities' adoption of a flexible exchange rate mechanism, but noted that the main challenges were to arrest the severe deterioration in the fiscal accounts that took place in 2000 and to press ahead with an ambitious structural reform agenda.
- **Adverse political and economic developments since then derailed the program during the second half of 2001, but the new government, which came to power in December, has sought to bring the program back on track.** Accordingly, discussions for the first and second reviews under the SBA were held in Colombo during February 1-14, 2002.
- **In terms of program conditionality, all performance criteria were met with the exception of the fiscal target on net credit to government by the banking system, and the prior actions have also been implemented.** The performance criteria refer to end-December 2001 targets. The prior actions relating to the Safeguards Assessment were completed by early March 2002, and the remainder (including outstanding measures in the original program) were announced as part of the 2002 Budget on March 22.
- **In the attached letter dated April 1, 2002, the authorities request the completion of the delayed first and second reviews under the SBA and seek a waiver for the non-observance of the fiscal performance criterion.** The attached Memorandum of Economic and Financial Policies (MEFP) supplements the MEFP dated March 19, 2001, and describes the new government's policy intentions for 2002.
- **As the reviews originally scheduled for completion in August 2001 and November 2001 were delayed, disbursements are being rephased and the arrangement extended by two months.** Under the new schedule, the second purchase in the amount of SDR 48 million will become available upon completion of the first and second reviews.
- The staff team consisted of Messrs. Carter (head), Kanda and Leigh (all APD), Annett (FAD), Singh (PDR), and Ms. Lee (Administrative Assistant, APD), and was assisted by Mr. Ul Haque (Senior Resident Representative). The staff met President Kumaratunga, Prime Minister Wickremesinghe, Finance Minister Choksy, Minister of Economic Reform Moragoda, other cabinet ministers, Governor Jayawardena of the Central Bank (CBSL), officials, businessmen, and NGOs. Mr. Jayatissa, Alternate Executive Director, participated in the discussions, as did Mr. Anoop Singh for the last week.

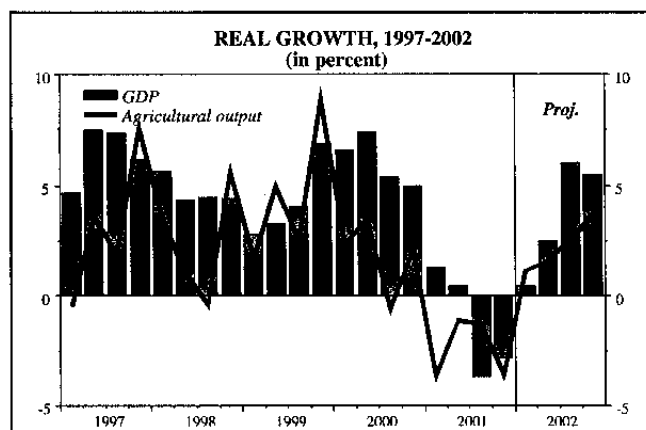
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I. INTRODUCTION AND BACKGROUND

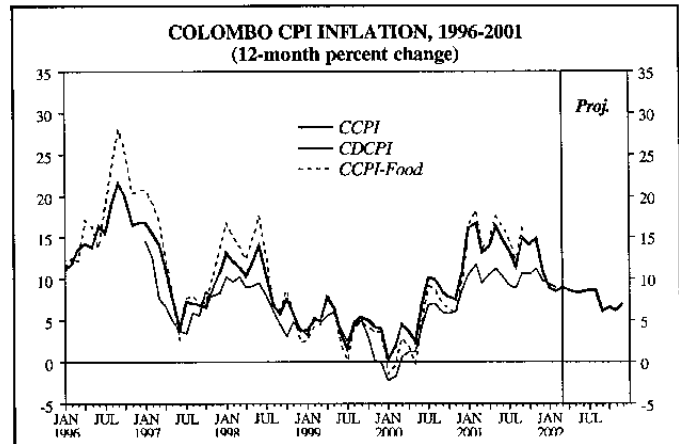
1. **The program supported by the current Stand-By Arrangement (SBA) approved in April 2001 achieved its initial objective of halting reserve losses.** The current account deficit narrowed as envisaged, and the CBSL succeeded in building up net international reserves in the context of a broadly stable exchange rate in a floating regime adopted in January 2001. At end-June 2001, the program had met all its key objectives.
2. **However, political and economic developments complicated economic policy-making during the second half of 2001 and led to a hiatus in the SBA.** The global slowdown, an attack on Colombo airport, the events of September 11, and a prolonged drought led to the economy contracting for the first time since independence. Moreover, a political crisis began in June when the ruling PA government lost its parliamentary majority and had to rely on the support of the Marxist JVP party, and eventually culminated in elections in December. During this time, the government was not able to take corrective policies to keep the program on track in the face of worsening circumstances. Thus, the reviews under the program could not be completed.
3. **Following victory in the December elections, the United National Front government (UNF) committed to deal with the major economic challenges it faced and move ahead with the program.** In its first budget, presented on March 22, it demonstrated its commitment to fiscal consolidation, and initiated structural reforms to enhance growth in the medium term. The President, although now of the opposition party, continues to chair the Cabinet and supports the economic program, which she sees as continuing the thrust of her reform agenda. Nevertheless, there are tensions between the UNF and the President.
4. **In addition, major initiatives have been taken to resolve the civil conflict.** On February 22, the government and the LTTE signed an indefinite ceasefire, aiming to hold formal talks in the coming months.

II. PERFORMANCE AND POLICIES THROUGH EARLY-2002

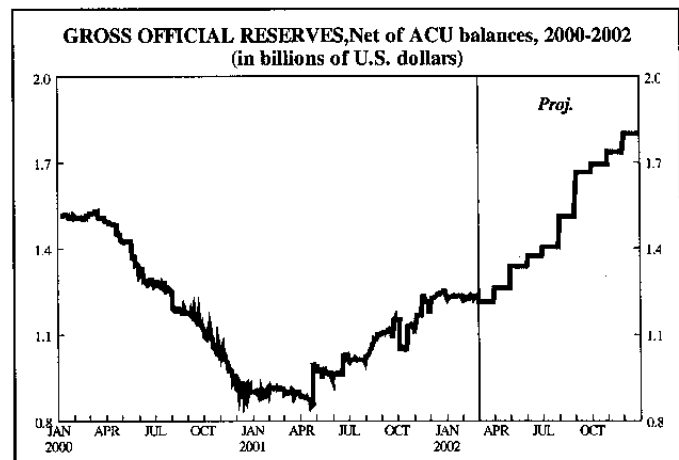
5. **Sri Lanka experienced a very difficult year in 2001.** GDP contracted 1¼ percent—the first contraction since independence in 1948. The global recession led to a drop in demand overseas for garments and textiles—which account for more than half of exports. Due to the drought, agricultural output declined more than 3 percent and low water reservoir levels led to widespread power cuts. The attack on the airport and the September 11 events shook business confidence, sharply curtailed tourism, and squeezed external trade by increasing war risk insurance premia for ships and airlines.



6. **While underlying inflation was close to the program target of 8 percent (end-year basis) for 2001, drought-affected food prices drove up the headline rate.** The official Colombo Consumer Price Index (food items account for 65 percent of the CCPI basket) increased 10¾ percent in the 12 months to December 2001, while the wider-based Colombo District index (CDCPI) increased 9¾ percent. Increases in administered prices of petroleum products and the depreciation of the rupee were other causes of price pressures. Recently, inflation has eased somewhat, with the headline inflation price indices up about 8½-9 percent in the 12 months to February 2002.



7. **The external reserve losses of 2000 were partly reversed but balance of payments developments in 2001 were weaker than programmed due to the external and domestic shocks and delays in external financing.** The current account deficit narrowed as import compression outweighed the export slowdown, but privatization receipts, foreign direct investment, and other financing fell below expectations as structural reforms were delayed and investor confidence was undermined.



Hence, the overall surplus was \$300 million lower than program expectations. Nevertheless, the net international reserves target for end-December was observed because of the sale of foreign currency bonds to domestic banks and the program's adjustors for financing shortfalls.¹ The performance criteria on external debt and external arrears were also met. Reserves have been stable over the first quarter of 2002, as the central bank offset large debt service obligations with purchases from the market.²

¹ The program's reserve targets and outturns are measured at historic cost, as was the convention in Sri Lanka. The authorities now also report the figures at market prices. Because the sharp drop in world interest rates increased the market value of securities, the excess in the historic cost value over the market value narrowed from \$56 million at end-2000 to \$34 million at end-2001.

² At mid-March 2002, net international reserves were \$985 million.

8. **After a good start, the envisioned fiscal stabilization in 2001 did not materialize.** In the second half of the year, the slowing economy and a lack of resolve weakened the budget performance considerably. The December 2001 fiscal and quasi-fiscal program targets—pertaining to government and public enterprise borrowing, the primary deficit, and revenue—were not observed. Box 1 provides an overview of the nature of the fiscal and quasi-fiscal slippage.³

9. **Instead of declining as planned, the fiscal deficit rose in 2001 by 1 percentage point to almost 11 percent of GDP.** Revenue suffered from slower growth, election-related tax cuts, and a lack of progress on tax administration reform. On the expenditure side, despite tight controls on non-wage recurrent spending, the authorities failed to tackle the politically sensitive spending on Samurdhi and subsidies.⁴ Fiscal laxity intensified in the run-up to the December elections, with the granting of large wage and pension increases. There was also an over-run in defense spending, reflecting the disbursement of unspent funds authorized under the 2000 budget.⁵

10. **As a result, government debt has risen to more than 100 percent of GDP and total interest payments are now by far the largest spending component.** Domestic financing was almost 5 percent of GDP higher than expected, because of the higher deficit, a shortfall in external financing (about 1 percent of GDP), and a shortfall in privatization receipts (about 1 percent of GDP).⁶

11. **Public corporations also failed to curb sufficiently their borrowing from the banking system.** The Ceylon Petroleum Corporation (CPC) only moved into profit late in the year as world oil prices fell—the authorities had deferred increasing domestic prices to offset the earlier rise in world prices. Meanwhile, Ceylon Electricity Corporation (CEB) incurred mounting losses because of the drought-induced shift to thermal power. Both enterprises continue to be overstaffed and badly managed.

³ One extra factor for the higher government borrowing was the need to borrow \$50 million to place in escrow with Lloyds of London, to reduce airlines' insurance premia following the airport attack. This deposit was returned in March 2002 and Bank of Ceylon was repaid.

⁴ Currently, half of the population could receive benefits under the Samurdhi welfare scheme. According to a World Bank report, however, the program misses almost 40 percent of households in the lowest expenditure quintile.

⁵ Ministry of Finance officials approved the purchases, ordered in 2000 but delivered and paid for in early 2001. However, these purchases were not included in either the 2000 outturn or the 2001 budget projected totals and were not properly recorded until late in 2001.

⁶ The shift between domestic and foreign financing is explained by foreign loans arranged through local banks and domestic purchase of the development bonds.

Box 1: Causes of Fiscal and Quasi-Fiscal Slippage in 2001

There was considerable slippage in 2001 compared with the program on the fiscal and quasi-fiscal fronts. The budget deficit turned out to be 10¾ percent of GDP, as opposed to a programmed 8½ percent. Meanwhile, credit to public corporations grew by more than ¼ percent of GDP, rather than the programmed debt reduction of ½ percent of GDP. The table below identifies the key factors accounting for this slippage.

Contribution to Slippages in Fiscal and Public Corporations Targets in 2001

(In percent of GDP)			
Program fiscal deficit	-8.5	Program increase in bank credit to public corporations	-0.5
Actual fiscal deficit	-10.8	Actual increase in bank credit to public corporations	0.2
Revenue shortfall	-1.9	Higher borrowing by CEB	0.5
Current expenditure overruns	1.9	Lower repayment by CPC	0.1
Capital expenditure cuts	-1.4	Other	0.1
Contributions to deviation from target	-2.3	Contributions to deviation from target	0.7
Impact of economic slowdown	-1.3	Drought—higher use of thermal power	0.3
Impact of pre-election giveaways	-0.8	Failure to adjust electricity prices to match fuel prices	0.1
Impact of other net expenditure	-0.1	Failure to adjust oil prices relative to world price movements	0.1
Impact of tax administration weakness	-0.2	Governance and operational problems	0.2

Source: Staff calculations.

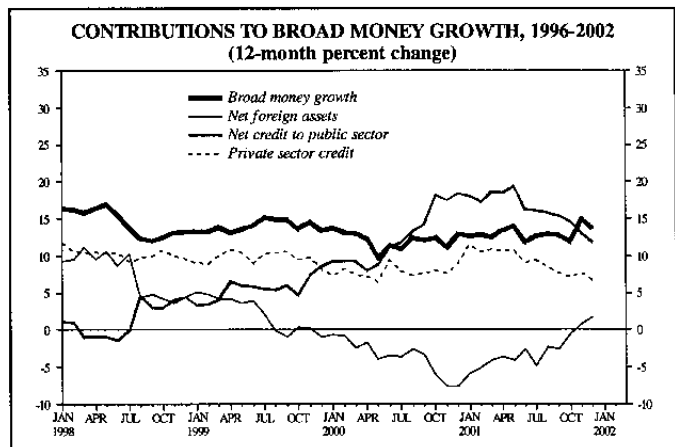
Revenue: Revenue was almost 2 percentage points of GDP below projections; most of this slippage was accounted for by the weaker economic activity, which affected GST and import duties in particular. A package of pre-election tax cuts granted in the last quarter of 2001 also led to a shortfall of 0.4 percentage points.¹ Moreover, political uncertainty led to the failure of the authorities to implement any of the tax administration improvements expected under the program, especially related to incorporating GST taxpayers into the Large Taxpayers Unit, (accounting for a further revenue slippage of 0.2 percent of GDP).

Expenditure: Over-runs in current spending amounting to 1.9 percent of GDP were largely offset by cuts in capital spending (1.4 percent of GDP). Part of this slippage (0.4 percent of GDP) can be attributed to large pre-election wage and pension increases. The remainder is accounted for by higher subsidies and transfers, especially for Samurahi payments, fertilizer and wheat subsidies, and railways, postal service, and bus companies (0.6 percent of GDP); over-runs in defense spending (0.5 percent of GDP); and higher interest payments owing to excessive reliance on overdrafts towards the end of the year (0.4 percent of GDP).

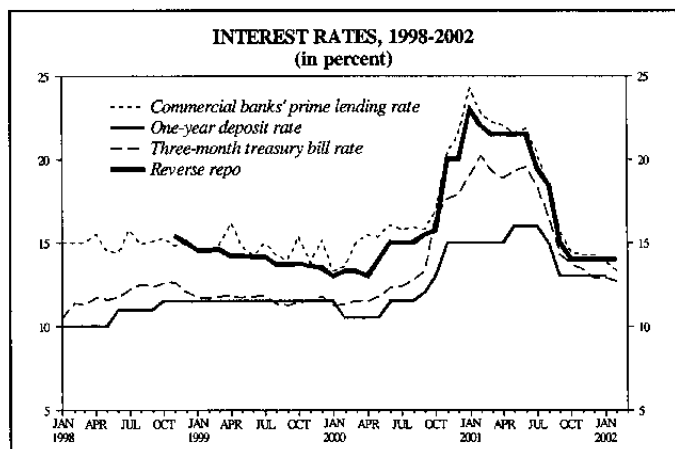
Public Corporations: The 0.7 percent of GDP slippage in the credit to public corporations target is almost entirely attributable to CEB and CPC. While CPC made reasonable profits because of lower world oil prices, the reduction in CPC debt to the banking system in 2001 was 0.1 percent of GDP less than programmed. On the other hand, the continuing drought forced CEB to rely on expensive thermal power plants, and to purchase power, leading to significant losses, and a 0.5 percent of GDP increase in borrowing. For both companies, domestic petroleum and electricity prices were not fully adjusted to reflect costs. Moreover, operational inefficiencies—including poor procurement methods, overstaffing, high interest costs reflecting inadequate debt management, and poor operational management—plagued both corporations, leading to higher overhead costs.

¹Reduction in the NSL by one percentage point, abolition of 1 percent turnover tax on banking and finance, reduction in stamp duty on letters of credit from 2 percent to 1 percent, abolition of Save the Nation Contribution, abolition of the diesel vehicle tax, and reduction in import duty on cement and 993 other raw materials deemed essential for production.

12. **The program's monetary objectives were broadly achieved in 2001 through tight control of reserve money.** Reserve money targets were met comfortably as was the performance criterion on central bank NDA. Annual broad money growth was ½ percent higher than projected. The sizeable public sector borrowing offset the reduced demands of the private sector, which reflected high interest rates and the economic slowdown.



13. **As the economy began to exhibit signs of a severe slowdown, the CBSL eased interest rates significantly during the second half of 2001 from the very high levels used in late 2000 to prop up the exchange rate.** Between May and October, it reduced the reverse repo rate by 750 bps.⁷ The statutory reserve requirement was also lowered from 11 percent to 10 percent in October. Nevertheless, the general structure of interest rates lagged behind the reduction in the policy rates, with realignment taking place only in late 2001. Banks' balance sheets reflected the impact of the weak economy—non-performing loans rose by a percentage point in relation to GDP by end 2001, to about 5 percent (on broadly international standards). The authorities recognized the possibility that, as suggested by the Financial Sector Assessment Program (FSAP) mission, vulnerabilities in the banking system could cause public confidence in private banks to erode, unless remedial measures were taken.



14. **The exchange rate float has worked reasonably well and most administrative controls have been removed.** After a initial period of volatility following establishment of the float, the rupee stabilized at Rs 90-91 to the U.S. dollar for most of 2001, as import demand contracted and oil import bills were met through foreign borrowing by CPC. In real effective terms, the rupee depreciated by ½ percent during 2001. Once concerns about overshooting proved unfounded, the exchange regulations enforced after the float—notably on banks' working

⁷ Coinciding with the budget presentation, the repo and reverse repo rates were reduced by 50 bps in March 2002. Subsequently, the reverse repo rate was increased by 15 bps.

balances, settlement of trade credits, pre-payment of import bills, and deposit requirements on forward contracts—were removed. Nevertheless, as the recent FSAP mission noted, the functioning of the market is still weak—liquidity is below the level maintained in 2000, and there are concerns about market fragility. From March 1, 2002, the CBSL also widened the limits on banks' foreign currency exposure and relaxed the time limit on forward transactions from six to twelve months. The exchange rate is currently stable at about Rs 93-95 per U.S. dollar.

15. **Insufficient progress was made on the structural front in 2001.** With regard to conditionality under the SBA, the automatic petroleum pricing formula for CPC was only put in place at end-December 2001. Moreover, the structural benchmarks relating to tax policy and tax administration were not met because of delays in the 2002 budget presentation. Although the CBSL Monetary Board approved the removal of remaining restrictions on FDI inflows (mainly in the construction, financial and utilities sectors) in late December 2001, cabinet approval was delayed. Furthermore, although the Prima flour mill was sold in the first half of the year, the much anticipated sale of shares in Sri Lanka Telecom did not materialize. Nevertheless, the outstanding structural benchmarks in the original program have now been implemented as prior actions for the completion of the first and second reviews.

III. POLICY FRAMEWORK

A. Macroeconomic Objectives for the Remainder of 2002

16. **Real output is expected to increase by 3¾ percent in 2002**, with a strong pickup in the second half of the year as the global economic recovery gathers momentum and business confidence grows. Although rainfall is still less than optimal, agricultural output is expected to recover and significant efforts are underway to increase power generation capacity (power cuts will remain in the near term). Meanwhile, the indefinite ceasefire agreement and renewed political stability have improved business sentiment.

17. **In line with the expected increase in food supplies, 12-month inflation is expected to moderate to 7-8 percent by end-2002.** The scope for a further decline in inflation in 2002 is limited because of increases in administered prices, particularly electricity.

18. **The 2002 program aims to strengthen the external position.** The current account deficit is projected to remain at around 2½ percent of GDP, slightly higher than originally projected; export growth remains sluggish while imports would rebound as domestic activity recovers. Capital inflows are expected to increase significantly. Asset sales and program loans delayed from 2001 should materialize as well as foreign direct and portfolio investment buoyed by increased investor confidence and private sector participation in infrastructure and utilities. Gross reserves would slowly increase to \$1.8 billion, slightly less than originally envisaged but still equivalent to almost 3 months of import cover.

B. Fiscal and Public Enterprise Policies

19. **The 2002 budget attempts to regain the initiative lost in 2001.** The new government recognizes that stabilization is its immediate economic priority—to restore credibility and lay the

groundwork for medium-term fiscal sustainability. Accordingly, the overall deficit (before grants) is targeted at 8½ percent of GDP, requiring an adjustment larger than originally sought for 2001. Rather than relying on poor quality revenue measures as in the past, the government opted for a prudent mix of high quality revenue enhancing measures and expenditure cuts, each yielding 1-1¼ percent of GDP (see Box 2).

20. **A major overhaul of tax policy was announced in the budget.** In recent years the revenue-GDP ratio has declined while the tax system became increasingly complex and non-transparent—the existence of widespread exemptions giving rise to a narrow tax base. The 2002 budget represents a bold attempt to simplify the system, broadly following the guidelines of a recent FAD technical assistance report, adopting revenue measures geared towards a structural improvement in the tax system (MEFP paragraph 10).⁸

21. **In particular, the authorities announced the elimination of the National Security Levy (NSL), and the adoption of a dual rate VAT, with a substantial broadening of the base.** Staff would have preferred a single rate VAT with exemptions only for basic foodstuffs, but considered the budget proposal an acceptable way of eliminating the NSL and broadening the tax base. The staff did stress the need for the Inland Revenue Department to administer the changeover efficiently, without revenue leakage.

22. **The budget announced the harmonization of the tax incentive regime between Board of Investment (BOI) and non-BOI companies under the Inland Revenue Act, although tax incentives continue.** The BOI will focus on investment promotion and facilitation. The harmonization represents a major step forward, as it should improve tax administration, and enhance transparency, taxpayer equity, and governance. However, the authorities opted, against the advice of staff, to grant limited new tax holidays, arguing that the scale of tax incentives granted in the region meant that they needed to have some measure available. For some priority sectors, they announced limited five-year holidays (full relief will be given for only the first three years). The staff noted that if absolutely necessary, it would be preferable to grant only a low corporate tax rate initially to qualifying investment, consistent with moving later to a low uniform rate. The budget also announced 5-10 year incentives targeting private participation in specific large infrastructure areas that are currently state-run, such as power, railways, highways, and ports. The authorities stressed that very few projects are expected to qualify.

23. **The staff welcomed the phasing out of the import surcharge and urged the authorities to phase out in the future the exceptional duties in place to protect certain domestic agricultural production.** The authorities were keen to remove the surcharge quickly. On the protection for specified agricultural products, they noted that the intention in the budget was to replace quantitative import restrictions and rely only on tariffs.

⁸ In 2001, the government relied on a number of surcharges and the distortionary NSL.

Box 2. Key Measures in the 2002 Budget

Revenue Measures

- NSL merged into the GST through the introduction of a dual rate VAT, with 20 percent and 10 percent rates. Major exempt items such as petroleum products, water, electricity above 30 kwh, and most basic foodstuffs will be brought into the net at the lower rate. [**Revenue gain: Rs 3.5 billion**]
- Personal income tax threshold raised, and rates reduced from four to three. [**Revenue loss: Rs 1.3 billion**]
- Income tax simplified, with final withholdings of 10 percent on interest and dividends, and elimination of the capital gains tax and the Advance Corporation Tax (ACT). A 10 percent withholding tax on non-residential rent and a lower corporate tax rate of 20 percent for enterprises with taxable income of Rs 5 million or less was introduced. The general corporate rate will be lowered to 30 percent in 2003, and 20 percent in 2004. The surcharge was removed. [**Net revenue gain: Rs 2.3 billion**]
- Tax incentives harmonized. All tax incentives, including those presently granted by the BOI, to be included under the revised Inland Revenue Act. Only limited new incentives will be granted.
- Stamp duties eliminated, replaced by a 0.1 percent levy on travelers checks, bills of exchange, checks, credit cards and debits of bank accounts. A 1 percent levy applies to all imports (including BOI imports), replacing the stamp duty. [**Net revenue gain: Rs 2.8 billion**]
- Excise duty increased on wine, and imposed on aerated water. To simplify administration, only one department will now be responsible for excises on beer and hard liquor. [**Revenue gain: Rs 0.5 billion**]
- Continuation of the import surcharge at half of the rate—20 percent at the end of April 2002, to be eliminated by the end of the year. [**Revenue gain: Rs 3.4 billion**]
- Higher import duty on a small number of goods, and an increase in taxable value of used vehicles. [**Revenue gain: 0.7 billion**]
- Other efforts to boost revenue include higher administrative fees and rents on government property and increased collection of levies from gambling and lotteries. [**Revenue gain: Rs 0.8 billion**]
- In terms of tax administration, a council will be established to develop the legal framework for a revenue authority and to undertake the necessary management reforms. Short-term improvements will be implemented through strengthening the Large Taxpayers Unit. [**Revenue gain: Rs 0.7 billion**]

Expenditure measures

- The current broad embargo on hiring maintained, and no further wage increases granted; this applies to the central government, provincial government, and public institutions covered by the budget.
- Security-related spending will be lowered to nearly 1 percent of GDP, to 4 percent of GDP (Rs 64 billion). A Defense Spending Monitoring Committee, responsible to the Prime Minister and Minister of Finance, established to ensure all outlays are authorized and monitored through the budget. [**Saving: Rs 1 billion**]
- New public servants to contribute to a pension scheme (8 percent), while government contributes 12 percent. Salaries will be revised accordingly [**no effect in the current year**].
- Samurdhi outlays will be reduced to 0.6 percent of GDP through improved targeting. [**Saving: Rs 2 billion**]
- The general fertilizer subsidy principally replaced by a limited grant payable directly to farmers; the flour subsidy has been eliminated. [**Saving: Rs 2 billion**]
- Action will be taken, including raising tariffs, to significantly reduce subsidies to railways, posts, and bus companies. [**Saving: Rs 1 billion**]
- A new youth development force program launched. [**Cost: Rs 0.3 billion**]
- Capital expenditure and net lending will decline to 5 percent of GDP. Foreign financed projects are protected, increasing from \$400 million to \$525 million.
- Cuts in nonwage recurrent spending. [**Saving: Rs 2.5 billion**]
- Restructuring of debt through running down overdrafts. [**Saving on interest payments: Rs 2.2 billion**]

Financing

- Statutory debt limit amended to encompass all government debt, including advances, to improve debt management.
- The financing includes privatization proceeds of Rs 21 billion, which assumes the sale of significant holdings of SLT and SLIC shares and completion of other sales including Shell Lanka and Lanka Marine.
- Net external financing will increase from 1.6 percent to 3.2 percent of GDP.
- The government will pay 1.3 percent of GDP back to the banking system.

24. **To improve tax administration, the authorities are adopting the measures proposed by the FAD technical assistance report.** Improving tax registration, tax audits, and the operations of the Large Taxpayer Unit (LTU) will achieve immediate gains. For the longer term, the budget also announced the setting up of a unified revenue authority, combining Inland Revenue, Customs, and the Excise Department, to better coordinate tax policy and collection. The mission welcomed the proposal, but noted that the short-term improvements should be the first priority, especially broadening the scope of the LTU.

25. **Current spending is set to fall by ½ percent of GDP in 2002** (see MEFP paragraphs 11-12). The staff acknowledged the measures to limit transfers, freeze the wage bill, and constrain security-related spending to be a good start, but noted that bolder efforts were needed to reduce the size of the public sector. The staff noted that the size of government was too large relative to revenue-raising capacity, and that growth-inducing stabilization required a serious effort to cut wasteful expenditure. Unfortunately, the scope for expenditure reduction was constrained by a number of large locked-in expenditure items. The full year effect of the 2001 wage increases is significant for the 2002 wage and pension bill, and raised labor costs (and the demand for transfers) for all public institutions. Moreover, despite lower interest rates this year, the interest bill is projected to increase by ¾ percent of GDP to 7½ percent of GDP, given a large increase in the debt in 2001, combined with poor debt management decisions.

26. **The budget also indicated longer-term plans to address the wage bill and tackle rising pension costs.** The staff supported the plan that from next year all ministries will start to cut their cadre levels each year. To limit a buildup in liabilities arising from the current unfunded civil service pension as the population ages, the staff also supported plans to set up a fully-funded scheme—all new public servants will contribute to a new pension scheme, to be operated by the Employees Provident Fund (EPF), with some adjustment in their starting salary, (MEFP, paragraph 12).⁹ The staff also suggested a review of the tax exempt status of civil service salaries. The authorities accepted that this issue should be considered. For now, they were focusing on starting to collect tax due on outside incomes of such employees.

27. **Despite the expenditure adjustment planned, basic social safety nets are protected.** One of the key aims of the budget is to ensure better targeting and less politicization of the extensive social programs, especially Samurdhi.¹⁰ Some of the most vulnerable are the inhabitants of the war-torn North and East; the government included large allocations for refugee relief and infrastructure development in the north in the budget and further direct assistance is being provided by donors. A youth development force is also being launched this year to train unemployed young people from disadvantaged areas. The authorities are committed to maintaining social spending, particularly on health and education.

⁹ Given the few new recruits, the impact of the higher gross salaries for new recruits is small.

¹⁰ The announced rationalization, based on a new welfare benefit law, seeks to use objective criteria for the scheme's operations, and protect the most vulnerable.

28. **Achieving the adjustment target will mean cutting capital spending by around ¾ percent of GDP.** Nonetheless, foreign financed projects should rise significantly (from \$400 million to \$525 million) at the expense of domestic capital expenditure. Although the staff would have preferred more savings on the current side to protect the capital budget, it recognized that many of the targeted areas for cuts were capital transfers to unproductive public sector entities, and hence not especially growth-promoting.

29. **Apart from possibly further raising the rate of VAT, the authorities generally found it difficult to identify significant contingency measures in case of fiscal slippage.** Nevertheless, they are committed to take additional measures in the event of unavoidable defense overruns or revenue problems, such as increases in levies on public corporations and implementation of tight monthly cash limits on expenditures on purchases and overtime (MEFP, paragraph 11). In reaching this deficit target the budget has essentially exhausted the list of high quality revenue and expenditure measures that are politically feasible. Rather than resort to poor quality measures, such as renewed surcharges, the mission encouraged the government to speed up the removal of subsidies to public institutions. The authorities noted that privatization of such institutions would be required if the current subsidies were to be reduced significantly.

30. **The budget deficit will be financed by relying more on aid inflows and asset sales, which, together with improved debt management and strong fiscal discipline, should limit the recourse to bank financing.** Both net external financing and privatization receipts are projected to double in 2002, reducing the strain on the domestic side. Nonetheless, domestic non-bank financing is still set to rise by ½ percent of GDP (to 5 percent of GDP) to facilitate a repayment to the banking system of 1¼ percent of GDP. Debt management will be improved by switching from a restrictive statutory treasury bill limit to a global debt limit, and the mission urged the authorities to reduce their reliance on costly overdraft facilities.

31. **The budget also announced plans to stabilize the debt of public corporations to the banking sector, while starting to tackle their fundamental weaknesses.** CPC is expected to make reasonable profits in 2002, based on the new automatic price adjustment mechanism. The specific debt recovery factor built into the formula for diesel and gasoline has been incorporated into increased excise duties and will be used by the government to pay down directly about Rs 6 billion of CPC's bank debt this year. The government has no plans to reduce the relative price distortion that currently exists between diesel and petroleum.¹¹ To reduce their losses, CEB announced increases in electricity tariffs averaging about 35 percent, to take effect from April 1. To address the deep-seated problems of these entities, the government has decided to restructure them completely by early 2003 (see below and MEFP paragraphs 14-17).

¹¹ The retail price of auto diesel is around half that of gasoline.

C. Monetary and Exchange Rate Policies

32. **The mission stressed that monetary policy would need to remain tight until fiscal consolidation starts to take hold.** Reserve money will continue to be the nominal anchor and its growth in 2002 will be limited to about 12 percent. Assuming a broadly unchanged velocity and money multiplier, broad money growth for 2002 is targeted at about 12½ percent, consistent with the inflation target of 7-8 percent. Interest rates are likely to remain significantly positive in real terms, although nominal rates could decline as inflation and fiscal pressures abate.

33. **The mission noted that progress had been made to implement MAE's recommendations to enhance the transparency and credibility of the CBSL's monetary framework and improve the effectiveness of policy instruments.** As next steps, both the reserve money program and progress in meeting these targets will be made public. Moreover, with MAE assistance following the recent FSAP mission, the CBSL will rely more on active open market instruments to maintain the monetary policy stance.

34. **The central bank has committed to continue to allow the rupee to float freely, and measures will be taken to improve the functioning of the foreign exchange market.** The CBSL agreed to refrain from moral suasion and intervention in the market will be limited to dampening excessive volatility and to meeting its reserve objective. The staff welcomed the steps being taken to promote a more active interbank market, while maintaining normal prudential foreign exchange exposure limits. Consistent with the FSAP recommendations, the CBSL is considering further relaxing these limits in line with each bank's participation in the foreign exchange market and risk management capacity. Public enterprises will be allowed to conduct their foreign exchange business with any commercial bank. Finally, both the SBA and FSAP missions stressed that foreign currency commercial borrowing by the public sector also required careful management; the balance of payments projection builds in a further reduction in the CPC's foreign exchange exposure.

D. Structural Agenda and Safeguards

35. **The mission supported the broad structural reform agenda, which the government subsequently presented with the 2002 Budget.** The mission advised the authorities that reform measures should focus on a core set of policy actions that are critical to the program's macroeconomic objectives and which the government can realistically achieve in the near term. Thus, it was agreed that for the remainder of the SBA period, the focus would be on **financial sector reform, some public enterprise restructuring and privatization, and initial labor market reform.** The authorities hoped that such an agenda would lay the foundations for a PRGF arrangement this year. The full structural reform strategy will also be incorporated into their PRSP, due to be completed by June 2002.

- **On financial sector reform,** the authorities agreed on the need for an ambitious strategy for the two state banks (which account for half total banking assets). As a first step, reviews of the relationship between the banks and public sector clients and their dealings with recalcitrant debtors would be completed by June. The staff supported the authorities'

willingness to consider options for a radical restructuring of Peoples Bank. MAE and the World Bank are providing technical assistance. Any fiscal costs would be incorporated in the budget. However, such costs are not expected until 2003.

Box 3. Structural Conditionality

1. Coverage of Structural Conditionality in the Current Program

The conditionality in the current SBA focuses on four main areas, which are critical to the program's macroeconomic objectives, especially the fiscal and quasi-fiscal targets. They were state bank reform, privatization, steps to improve petroleum pricing, and tax reforms. In addition, to promote investment and improvement in the external position, also included was liberalization of FDI flows. The structural benchmarks in the original program (EBS/01/41) covered most of these areas, and the measures in the remainder of the SBA focus on completing the outstanding measures in the original program (as prior actions), while building further on some of the steps already undertaken. Measures focus on a core set of actions that can be realistically achieve in the near term. Finally, critical actions identified by the Safeguards Assessment have been included.

2. Status of Structural Conditionality from Earlier Programs

The structural benchmarks that were set for November in the original program (EBS/01/41) relating to tax policy and tax administration as well as phasing out restrictions on FDI were not met (MEFP Table 2). Moreover, the last arrangement that Sri Lanka had with the Fund was an ESAF-supported program, approved in September 1991. Previously, a SAF was approved in March 1988. Both the SAF and ESAF programs had aimed at civil service and pension reform as well as tackling the problems of the state banks and implementing tax policy and tax administration reform. However, progress was mixed and several key objectives were not met.

3. Structural Areas Covered by World Bank Lending and Conditionality

The World Bank project lending has covered improvements in education, land titling, and rural infrastructure. In terms of program lending structural conditionality, the focus is on the central bank and private sector development. In particular, disbursements under the PSD credit (during 2002) target reform measures in the area of land (amending legislation), the labor market (introduction of binding compensation formula and time limits for resolution of disputes), public enterprise restructuring, and privatization (see paragraph 35). The AsDB's PSD loan also focuses on labor market reform and public enterprises restructuring.

4. Other Relevant Structural Conditions not Included in Current Program

Areas in which the current program has not set formal conditionality, and which have macroeconomic relevance, include civil service and pension reform as well as trade. The program has not included related structural conditions in part to streamline conditionality but also because the AsDB currently covers some of these areas in its private sector development program. It is expected that a future PRGF arrangement will address some of these subjects while avoiding cross-conditionality with World Bank and AsDB programs as well as build on the structural agenda in the SBA (see 1 above). To streamline conditionality several moderate priority recommendations of the Safeguards report were excluded.

- **To address banking system vulnerabilities,** the authorities intend from next year to increase the capital requirements for commercial banks to 10 percent of risk-weighted assets and to develop a regulatory response policy for handling weak banks. The FSAP mission urged an early announcement of these steps. Measures to address banking sector vulnerabilities would

include a total review of the quality of the loan portfolio, additional provisioning where needed, aggressive loan collection, phasing out of government directed lending, and better underwriting policies.

- **The mission supported the authorities' initiation of a major reform of CPC**, which is in addition to the automatic petroleum pricing formula that as presently set out should eliminate CPC losses in the medium term. Steps are being taken to hive off the distribution and retail functions of CPC, and amend the regulatory framework to open up imports of fuel and distribution to private competition.
- **Concerning CEB, apart from raising tariffs, the authorities discussed plans for major restructuring.** The aim is to upgrade the management, unbundle the generation, transmission, and distribution activities. Early steps to introduce private sector participation will include amending the electricity regulatory act to remove current CEB's legal monopoly on all aspects of electricity supply.
- **Consistent with the objectives of the World Bank-supported private sector development (PSD) program, the mission urged the authorities to proceed quickly with the privatization program.** In early March, the authorities published their intention to sell shares in Lanka Marine, National Insurance Corporation, Pelwatte Sugar, and two plantation companies by mid-2002, and divest shares in Sri Lanka Telecom (SLT), Sri Lanka Insurance Company (SLIC), and Shell Lanka by end-2002. To accelerate the SLT sale, the authorities have set out their Telecommunication Policy framework and should amend the regulatory arrangements by May in time for a private placement of the shares.
- **Although labor market reform is not part of the explicit conditionality of the SBA, it is critical for both state sector reform and private sector led growth.** The World Bank and AsDB have put emphasis on this reform with regard to providing adjustment lending. The authorities will shortly implement a regulatory change to permit labor mobility by defining and adopting minimum compensation rules for terminated staff and introduce time-bound resolution of labor issues. Pending a complete overhaul of the Termination of Employed Workmen Act (TEWA), the measures to be undertaken are expected to mitigate labor mobility problems caused by the rigidity of the Act.
- **The authorities have removed the remaining limits on inward foreign direct investment**—a prior action for the completion of the reviews.
- **All the critical and most of the other recommendations of the Safeguards Assessment report have been executed, and the others are in hand (Annex I).** The World Bank is financing external advisors to assist with the remaining steps. One outstanding measure relates to the 2001 financial audit of the CBSL—an external auditor has been appointed and will complete its work by June. For the remaining moderate priority actions, a new internal audit charter will be adopted by June. The review of the high-level internal CBSL control systems, formal risk management procedures, and external review of the management and audit department will be completed by September.

E. Medium-Term Macroeconomic Framework

36. **The revised medium term framework is based on similar key assumptions as in the original program**, but takes into account the impact on the near term outlook of worsened external conditions, and recent slippages in fiscal consolidation. The SBA-supported program is assumed to be followed by a program of significant structural reforms, which could be supported by a PRGF arrangement.

37. **Under this scenario, relatively weak near-term economic activity would be followed by a steady increase in GDP growth to 6½ percent over the medium term**, led by investment and exports. From 2003 onwards, the staff expect a return to strong export volume growth, although the elimination in 2005 of quotas on textile and clothing exports under the Agreement on Textiles and Clothing will have a significant adverse impact on small-scale garment manufacturers. Inflation is targeted to decline to 4½ percent. Although reasonably significant capital inflows are assumed, the pace of reserve accumulation is slower than originally envisaged. Nevertheless, by 2006 reserves are projected to increase to \$3¼ billion (almost 4 months of imports).

38. **Fiscal consolidation takes the form of strong revenue measures and the rationalization of expenditure.** A simplified and transparent tax system and improvements in tax administration aim to increase the revenue-GDP ratio by 4 percentage points over the medium term. Expenditure measures would focus on containing defense spending, reducing public employment, rationalizing government departments and transfers, and improving expenditure controls. As a result, the fiscal deficit would decline to 4 percent in 2006, and the debt-GDP ratio to about 84 percent of GDP.

39. **Sri Lanka's capacity to repay the Fund remains good.** This reflects the low external debt service ratios (Table 8) and Sri Lanka's impeccable debt servicing record.

IV. EXTERNAL FINANCING ISSUES

40. **The program assumes large inflows of external financing to cover the current account deficit and enable the envisaged build up of reserves.** For 2002, the gross financing requirement is estimated at \$1.8 billion, with a financing gap of \$440 million. This gap is expected to be met by support from the international financial institutions, most of which was delayed from 2001, bilateral donors, and further financing from the private sector.

- **The World Bank's PSD credit** (up to \$130 million) is expected to be disbursed from the third quarter. To this end, a policy matrix with key deliverables for May has been drawn up and an appraisal mission is expected to take place in June. The **AsDB** expects to provide about \$50 million in program support in 2002, comprised of one tranche from each of its private sector, small and medium enterprise (SME), and power sector loans. **Bilateral** sources are expected to provide \$30 million in program support.
- **With respect to private sector financing**, the authorities are expected to rollover the \$100 million syndicated loan contracted through Bank of Ceylon, and raise a further

\$40 million directly from abroad. The mission cautioned the authorities not to rely on commercial borrowing in foreign currency from the domestic market.

- **Through June, a financing need of \$121 million is projected**, to be fully covered by one tranche of the SBA (\$63 million), AsDB disbursements under the SME and private sector loans (\$35 million), disbursement under the World Bank's central bank restructuring loan (\$10 million) and bilateral program aid of \$13 million. The program is fully financed through the end of the SBA.
- **Following completion of the SBA, it is assumed that financing could be provided by a follow-on PRGF arrangement.**

V. RISKS

41. **On the political front, the main risks to the program's baseline projections would arise from a failure of the peace process to take hold and a resumption of political instability.** If the indefinite ceasefire is to lead to a political solution to the conflict, the government will need to overcome political opposition, including from the Marxist JVP party, and ensure the President broadly supports their efforts. More generally, even though the government received a clear mandate, reinforced by the recent local elections, the coalition is fragile and a political impasse could recur.

42. **There are also risks from a slower recovery in the external environment, slippages in policy due to political opposition, and implementation capacity constraints.**

- There is a downside risk of a slower recovery in Sri Lanka's main trading partners, higher oil prices, and delays in external financing, particularly from privatization. Persistence of the drought would also weaken growth.¹²
- Undertaking difficult measures such as administered price increases, and banking sector and labor reform, will raise political opposition. In this regard, it is very important that the President continues to support the current program.
- In terms of the budget, the revenue projections are subject to more than the usual degree of uncertainty, given the significant tax policy changes that are envisaged—the introduction of the dual rate VAT may magnify the Inland Revenue Department's problems administering the GST. Any outbreak of hostilities could boost defense spending, while holding the line on subsidies and transfers may prove difficult.

¹² Staff estimates that stagnation in external demand and continuation of the drought into the late 2002 would cost the economy about 2 percentage points of growth. Under this scenario, revenue shortfalls would lead the fiscal deficit to increase by about ½ percent of GDP.

43. **The prospects for Sri Lanka could also be significantly better than the baseline scenario.** If agreement on the civil conflict is reached earlier or a more ambitious structural reform agenda is pursued, GDP growth and donor assistance, especially for reconstruction in conflict affected areas, could accelerate towards the end of the year due to resumption of normal economic activity, higher investment and improved business confidence.

VI. PROGRAM MONITORING AND DESIGN

44. **To strengthen monitoring of the fiscal program,** the mission agreed with the authorities that net domestic financing of the budget would become a performance criterion and net credit to government from the banking system be amended to an indicative target.

45. **Despite the progress made on improving the expenditure control system,** monitoring and procurement problems led to defense spending not being contained to the budget total despite the previous government's commitment. To prevent a repeat of such problems, the new government has established a defense spending monitoring committee, responsible to the Prime Minister. The monitoring committee will ensure accountability of defense spending and ensure that all transactions are recorded in the Budget. A Fund fiscal ROSC is being provided to the authorities.

46. **To accommodate the delay in completion of the reviews, it is proposed to rephase remaining disbursements under the SBA in two tranches of about SDR 48 million.**¹³ While completion of the first and second reviews is subject to performance criteria for end-December 2001, the completion of the final review would be based on meeting the end-April 2002 performance criteria. To allow for completion of the final review, it is proposed that the current stand-by arrangement, which would expire on June 19, 2002, be extended by two months to August 19, 2002.

VII. STAFF APPRAISAL

47. **The Fund-supported program achieved its immediate goal of halting the precipitous drop in official reserves.** Nevertheless, overall macroeconomic performance under the program was mixed with broadly satisfactory inflation occurring in the context of a sharp drop in output. The output decline—the first since independence—was principally linked to the external shocks and drought. However, the growth performance was also affected by the erosion of confidence resulting from the political instability in the second half of the year that led to fiscal policy reversal, escalation of government debt, and cessation of structural reform.

¹³ Because of past policy slippages, the staff indicated to the authorities that they should not request all three (SDR 72.5 million) of the tranches under the original arrangement timetable that were to be due by March 2002.

48. **Looking ahead, the new government faces the tremendous challenge of reestablishing conditions for fiscal sustainability and lasting growth.** Reining in the fiscal deficit and losses incurred by the state enterprises, along with implementing an ambitious structural reform agenda, are top priorities. Progress on the peace front—if it proves possible—should significantly improve both business confidence and the willingness of the donor community to support reform. However, without major progress on the economic policy front, the full benefits of peace cannot be reaped.

49. **It is essential that the authorities stick to their short-term fiscal strategy to reduce the overall budget deficit by more than 2 percent of GDP through tax reform and tight control on spending.** On the revenue side, particularly welcome are the steps being taken to put into place the recommendations of the FAD by rationalizing the GST and NSL into one value added tax, simplifying the income tax and import duty regime, and shifting away from the temporary surcharges that were imposed in 2001. Although the revenue loss is expected to be limited, the new tax holidays announced in the budget for target sectors undermine the move away from such incentives. It would have been preferable to provide lower corporate tax rates, if such incentives were necessary.

50. **The scope for significant savings on overall current spending in 2002 is limited because of higher interest payments, the legacy of pay increases granted by the previous administration, and the need to cope with continuing financial problems of the state institutions.** Nevertheless, the 2002 budget demonstrates a clear commitment of the authorities to a significant reduction in security-related spending, rationalization of the operations of public agencies, and a focus in the capital budget on key donor-financed projects. Moreover, the planned reductions of the civil service cadre and new pension arrangements should save resources in the longer term.

51. **With significant privatization receipts and foreign financing, the announced budget would allow a prudent monetary policy while leaving room for satisfactory private credit growth.** If the government can adhere to the fiscal targets and inflation remains on track, there are prospects for reducing nominal interest rates further in the coming months. Nevertheless, private sector credit growth is likely to be limited during the first half of 2002, reflecting the fact that economic recovery is likely to gather pace only during the second half of 2002.

52. **The initial experience with the rupee float has been favorable, with concerns about the lack of technical preparedness proving to be less than well founded.** It now seems sensible to move ahead with steps to improve the functioning of the interbank foreign exchange market.

53. **The early implementation of the authorities' structural reforms, especially those focused on the operations of the loss-making state sector, are critical for both macroeconomic stability and promotion of private sector-led growth.** In this context, the staff strongly supports the measures taken to address the financial position of the CPC and CEB through price adjustments, accompanied by early steps to break up these enterprises and invite private participation. Also, most welcome are further efforts being made to strengthen bank

supervision and the actions to improve the labor market through timely and consistent resolution of disputes—critical for the business community.

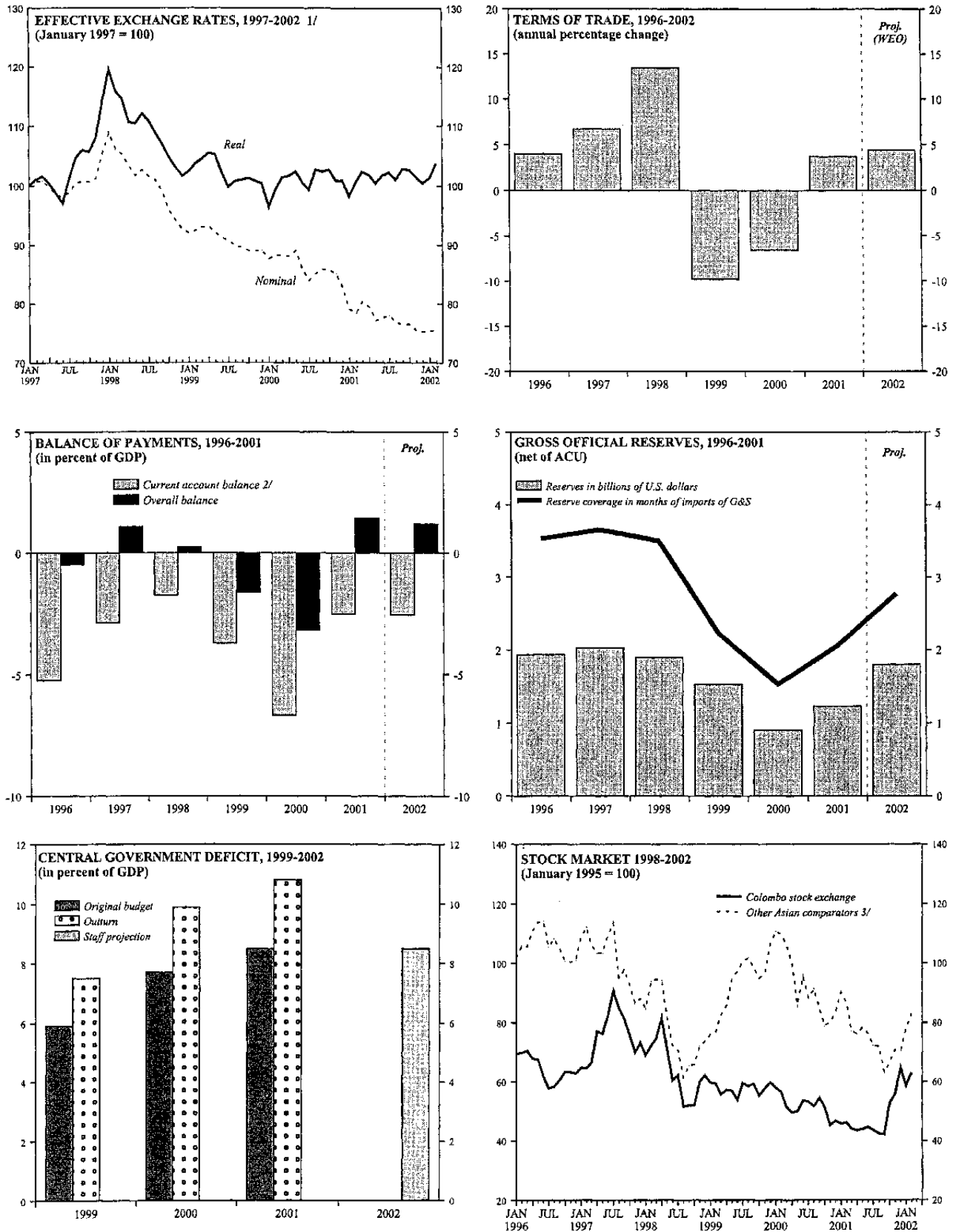
54. Financing needs for the coming year remain large, but the securing of program financing through the end of the year should not pose significant problems. A key priority in this context is to implement the measures on land, labor market and enterprise reform to ensure timely disbursements from the World Bank and Asian Development Bank.

55. The considerable progress in implementing the Safeguards Report recommendations illustrates the authorities' determination to demonstrate the security of the Fund's resources. The critical and high priority measures have been taken and the remaining actions will be near completion by the time of the next review.

56. There are significant risks to achieving the program objectives. Persistence of the drought would weaken growth. Moreover, if the global economic recovery were delayed the resulting lower demand for Sri Lanka's exports would affect the ability to build up reserves. External balances also remain vulnerable to higher oil prices—especially if the drought-related switch from hydropower to thermal power generation persists. Equally important, resumption of political uncertainties could thwart the drive for peace and limit the government's ability to press ahead with its structural agenda. Moreover, there are clear risks that the fiscal consolidation envisaged in the budget could be undermined by such shocks and implementation capacity problems.

57. Despite the risks, the government's strong commitment to prudent financial policies, and the actions taken to initiate key structural reforms, merit continued Fund support. Accordingly, the staff recommends granting the waiver of the performance criterion for end-December 2001 on net credit to government from the banking system, completion of the first and second reviews under the Stand-By Arrangement, and the proposed two-month extension.

Figure 1. Sri Lanka: Selected Economic Indicators



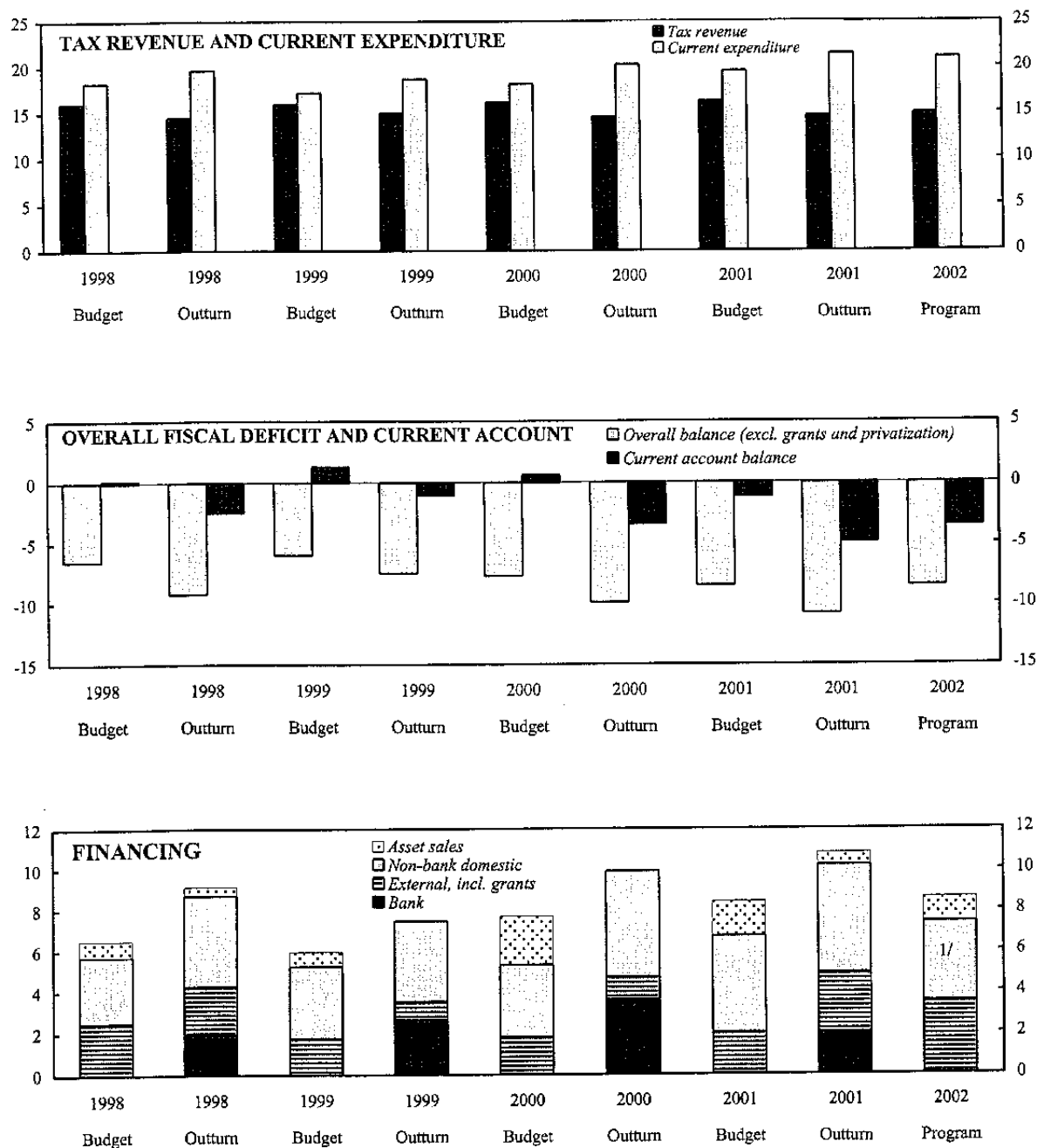
Source: Data provided by the Sri Lankan authorities; and staff estimates and projections.

1/ Using 1995 trade weights, and CCPI as the inflation indicator.

2/ Excluding official transfers, from 1999 includes aircraft, ports, and telecom capital imports.

3/ An unweighted average index of the India, Indonesia, Malaysia, Pakistan, Philippines, and Thailand stock exchange indices.

Figure 2. Sri Lanka: Selected Fiscal Indicators, 1998-2002
(in percent of GDP)



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

1/ The 2002 budget projection is 5.2 percent of GDP, shown here offset by bank financing of -1.3 percent of GDP.

Table 1. Sri Lanka: Selected Economic Indicators, 1999-2002

Nominal GDP (2001): US\$15.7 billion
 Population (2001): 18.7 million
 GDP per capita (2001): US\$839
 Quota: SDR 413 million

	1999	2000	2001		2002		
			Orig. Prog.	Prov.	Orig. Prog.	Rev. Proj. Latest Data 1/	
(Percent change)							
Real GDP	4.3	6.0	4.3	-1.3	5.5	3.7	...
Colombo consumer price index (CCPI, end-of-period)	4.0	10.8	8.0	10.8	5.0	7.5	8.5
Colombo consumer price index (CCPI, period average)	4.7	6.2	12.0	14.2	8.0	9.0	12.8
Colombo district consumer price index (CDCPI, end-of-period)	-0.1	8.5	8.0	9.7	5.0	7.5	9.0
(Percent of GDP)							
Saving and investment							
National saving	23.5	21.5	24.3	19.5	25.1	21.3	...
Gross investment	27.3	28.0	27.4	22.1	27.1	24.0	...
(Percent of GDP)							
Government budget							
Revenue	17.7	16.8	18.3	16.5	18.9	17.5	...
Expenditure and net lending	25.2	26.7	26.9	27.3	25.7	26.1	...
Primary balance (including grants)	-1.3	-3.8	-1.7	-3.7	0.4	-0.6	...
Overall balance (excluding grants and privatization)	-7.5	-9.9	-8.5	-10.8	-6.8	-8.5	...
Overall balance (incl. grants and excl. privatization)	-6.9	-9.5	-8.0	-10.5	-6.3	-8.0	...
Current account surplus (+)/deficit (-)	-1.0	-3.4	-1.2	-4.9	0.4	-3.4	...
Defense expenditure (excl. pub. order and safety)	3.4	4.6	3.3	3.8	2.8	3.0	...
(Annual percent change; end-of-period)							
Money and credit 2/							
Reserve money	8.2	4.7	12.8	7.0	10.6	12.0	7.3
Broad money	13.4	12.9	13.0	13.6	10.8	12.5	13.3
Domestic credit (percent contribution to M2)	16.8	27.3	2.6	18.4	2.4	4.1	...
Private sector (percent contribution to M2)	8.2	9.0	7.2	6.7	8.3	9.2	...
Public sector (percent contribution to M2)	8.6	18.3	-4.6	11.7	-5.9	-5.1	...
91-day t-bill rate (percent, end of period)	11.8	18.0	...	...	...	...	12.8
(Millions of U.S. dollars)							
Balance of payments 2/							
Export volume growth (percent change)	5.1	18.3	8.7	-8.0	8.9	1.9	...
Import volume growth (percent change)	0.2	13.0	3.5	-10.7	9.2	6.6	...
Trade balance	-1,369	-1,798	-1,222	-1,157	-1,226	-1,277	-131
Current account balance (excl. official transfers) 3/	-586	-1,090	-493	-397	-345	-451	...
Current account balance (percent of GDP) 3/	-3.7	-6.7	-3.1	-2.5	-2.0	-2.7	...
Overall balance	-259	-522	468	220	341	231	...
Gross official reserves (end of period, US\$ millions) 4/	1,530	911	1,500	1,181	2,001	1,800	1,190
Exchange rates							
Rupees per U.S. \$ (end of period level)	72.1	82.7	...	93.2	...	...	94.7
NEER (annual percentage change, e.o.p.) 5/	-4.0	-6.8	-9.3	-9.2	...	-4.9	-3.9
REER (annual percentage change, e.o.p.) 5/	-1.2	0.6	-4.6	-0.4	...	0.2	3.3
Vulnerability and reserve adequacy indicators							
Private sector credit (percent of GDP)	29.5	29.0	27.6	28.3	27.6	28.2	...
Gross official reserves (percent of broad money)	25.8	15.6	24.7	20.0	29.8	28.7	...
Gross official reserves (percent of short-term debt) 6/	123.4	60.2	99.6	78.3	133.0	120.6	...
Gross official reserves (months of imports of g&s)	2.2	1.5	2.0	2.0	2.5	2.7	1.9
Foreign currency deposits (percent of total deposits)	20.4	21.1	...	21.3	...	...	...
Short-term debt (percent of GDP) 7/	8.7	10.1	10.3	10.5	9.2	9.9	...

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

1/ Latest observations: T-bill, March 25; CPI, end-February; gross reserves, March 13; exchange rate, March 20; effective exchange rates, February; monetary and trade, January.

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/ At historical cost, and excluding central bank ACU balances.

5/ 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 2. Sri Lanka: Summary of Central Government Operations, 2000-02

(In percent of GDP; unless otherwise indicated)

	2000	2001		Projection (no measures)	2002	
		Budget	Outturn		Program	Program Jan-June
Total revenue	16.8	18.3	16.5	16.7	17.5	8.3
Tax revenue	14.5	16.2	14.6	14.1	15.0	7.1
Income taxes	2.2	2.4	2.5	2.4	2.5	1.2
Value Added Tax/GST	3.6	3.9	3.3	3.5	5.6	2.3
Excise taxes 1/	3.4	3.5	3.2	3.3	3.3	1.6
National security levy	2.7	3.3	3.1	2.9	1.1	0.8
Taxes on international trade	1.9	2.4	1.9	1.6	1.9	0.9
Other	0.7	0.8	0.7	0.5	0.7	0.3
Nontax revenue	2.3	2.1	1.9	2.6	2.6	1.1
Total expenditure and net lending	26.7	26.9	27.3	26.7	26.1	12.9
Current expenditure	20.2	19.5	21.4	21.6	21.0	10.4
Civil service wages and salaries	3.2	3.3	3.4	3.5	3.5	1.7
Other civilian goods and services	1.6	1.6	1.7	1.6	1.5	0.7
Security related expenditure	5.6	4.4	4.9	4.1	4.0	2.1
<i>Of which</i> : Defense	4.6	3.4	3.8	3.1	3.0	1.6
Subsidies and transfers	4.2	4.0	4.7	4.9	4.6	2.2
Households	3.3	3.2	3.7	3.7	3.4	1.7
<i>Of which</i> : Samurdhi	0.8	0.7	0.9	0.8	0.6	0.3
<i>Of which</i> : Pensions	1.7	1.7	1.9	2.0	2.0	0.9
Institutions, corporations, other govt.	0.9	0.8	1.0	1.2	1.2	0.5
Interest payments	5.7	6.3	6.7	7.5	7.4	3.7
Foreign	0.8	0.9	0.8	0.8	0.8	0.4
Domestic	4.9	5.4	6.0	6.7	6.6	3.4
Capital expenditure and net lending	6.5	7.4	5.9	5.1	5.1	2.4
Capital expenditure	5.4	5.8	4.8	4.5	4.5	2.0
Net lending	1.1	1.5	1.1	0.7	0.7	0.4
Overall balance (excl. grants and privatization)	-9.9	-8.5	-10.8	-10.0	-8.5	-4.6
Overall balance (incl. grants, excl. privatization)	-9.5	-8.0	-10.5	-9.5	-8.0	-4.4
Financing	9.9	8.5	10.8	10.0	8.5	4.6
Net external financing	0.7	2.8	1.6	3.2	3.2	0.9
Net domestic financing	8.8	3.4	8.2	5.1	3.6	3.4
Bank	4.2	-1.0	3.9	-1.3	-1.3	-0.1
Nonbank	4.5	4.5	4.4	6.5	5.0	3.5
Asset sales	0.0	1.7	0.6	1.2	1.2	0.1
Grants	0.4	0.5	0.4	0.5	0.5	0.2
Memorandum items:						
Current account balance	-3.4	-1.2	-4.9	-4.9	-3.4	-2.2
Primary balance (excl. grants)	-4.2	-2.2	-4.1	-2.5	-1.2	-0.8
Health spending	1.6	1.8	1.3	1.7	1.7	...
Education spending	2.5	2.6	2.0	2.8	2.8	...
Foreign-financed capital expenditure (in percent)	51.5	53.1	68.5	81.5	81.5	...
Nominal GDP (in billions of rupees)	1,258	1,443	1,403	1,586	1,586	1,586
Real GDP growth	6.0	4.3	-1.3	3.7	3.7	...
Total debt	96.8	97.3	103.0	102.6	101.1	...
<i>Of which</i> : Domestic debt	53.8	48.5	56.5	55.1	53.6	...

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

1/ Revenue and expenditure data exclude conversion of debt recovery charge on petroleum products into the excise tax, and direct repayment CPC debt by the government.

Table 3. Sri Lanka: Monetary Program, 2000-02 1/

	2000	2001		2002				
	Dec Actual	Dec. Orig. prog.	Dec. Actual	Mar Rev. Prog.	June Rev. Prog.	Sept Rev. Prog.	Dec Orig. prog.	Dec Rev. Prog.
(In billions of Sri Lankan rupees; end of period)								
Monetary authorities								
Net foreign assets 2/	58	108	88	89	95	113	152	128
Net domestic assets	47	11	25	31	19	5	-21	-2
Net credit to government	92	64	85	88	85	79	32	76
Reserve money	105	119	113	120	114	118	131	126
(12 month change in percent of reserve money at start of period)								
Net foreign assets	-31.2	47.5	28.2	21.2	28.7	35.5	37.2	35.7
Net domestic assets	35.9	-34.7	-21.2	-8.6	-18.5	-25.1	-26.6	-23.7
Reserve money	4.7	12.8	7.0	15.7	9.1	13.1	10.6	12.0
Monetary Survey								
(In billions of Sri Lankan rupees; end of period)								
Broad money	483	546	549	566	554	569	605	618
Net foreign assets	70	133	77	83	92	113	183	132
Monetary authorities	58	108	88	89	95	113	152	128
Commercial banks	12	25	-10	-6	-3	0	31	4
Net domestic assets	414	413	472	484	462	456	422	486
Domestic credit	550	562	639	651	635	630	576	661
Public sector	186	163	242	246	239	228	131	214
Government (net)	147	133	201	206	200	192	101	180
Public corporations	38	31	41	40	38	36	30	34
Private sector	364	399	397	406	396	402	444	447
Other items (net)	-136	-149	-167	-168	-173	-174	-154	-175
(Annual percentage change)								
Broad money	12.9	13.0	13.6	13.9	12.0	10.3	10.8	12.5
Net foreign assets	-31.9	91.3	11.3	2.0	22.4	49.5	37.8	70.2
Monetary authorities	-35.1	86.2	51.1	34.0	45.6	50.8	40.9	45.9
Commercial banks	-9.6	116.8	-188.1	-143.1	-127.6	-77.7	24.2	-138.2
Domestic credit	27.0	2.3	16.2	13.6	8.1	5.0	2.4	3.5
Public sector	73.5	-12.0	30.5	26.9	18.8	5.8	-19.6	-11.6
Government	56.8	-10.0	36.7	32.7	29.7	11.6	-23.8	-10.6
Public corporations	193.2	-19.6	6.7	3.6	-17.5	-17.5	-1.9	-16.4
Claims on private sector	11.8	9.5	8.9	6.8	2.6	4.6	11.4	12.7
(Percent contribution to broad money growth 12 months ago)								
Net foreign assets	-7.6	13.1	1.6	0.3	3.4	7.2	9.2	9.9
Net domestic assets	20.5	-0.1	12.0	13.6	8.6	3.0	1.6	2.6
Domestic credit	27.3	2.6	18.4	15.7	9.6	5.8	2.4	4.1
Public sector credit	18.3	-4.6	11.7	10.5	7.6	2.4	-5.9	-5.1
Government	12.5	-3.0	11.2	10.2	9.3	3.9	-5.8	-3.9
Public corporations	5.9	-1.5	0.5	0.3	-1.6	-1.5	-0.1	-1.2
Claims on private sector	9.0	7.2	6.7	5.2	2.0	3.4	8.3	9.2
Memorandum items:								
CPI percent change (e.o.p.)	10.8	8.0	10.8	10.5	9.0	8.0	5.0	7.5
Broad money multiplier	4.6	4.6	4.9	4.7	4.9	4.8	4.6	4.9
Velocity of broad money (e.o.p.) 3/	2.6	2.8	2.8	2.8	2.9	2.7	2.8	2.8

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

1/ Using the program exchange rate of Rs 94/US\$ from March 2002 onward. Excludes any recapitalization of commercial banks.

2/ NFA is valued at historical cost as in the original program.

3/ Adjusted by a geometric mean.

Table 4. Sri Lanka: Balance of Payments, 1999-2002

	1999	2000	2001	2001	2002	2002	2002
		Prov.	Proj.	Prov.	Proj.	Proj.	Proj.
			Orig. Prog.		Orig. Prog.	Rev. Proj.	Jan-June
(In millions of U.S. dollars)							
Trade balance	-1,369	-1,798	-1,222	-1,157	-1,226	-1,277	-771
Exports	4,610	5,522	5,977	4,817	6,542	5,058	2,355
Imports	5,979	7,320	7,199	5,974	7,767	6,336	3,126
Services, net	149	38	49	109	86	72	75
Receipts	968	953	1,021	1,270	1,119	970	535
Payments	819	915	973	1,161	1,033	898	459
Income, net	-253	-304	-330	-286	-286	-275	-125
Receipts	167	152	150	100	184	103	53
Payments	420	456	480	386	470	379	178
Private transfers, net	887	974	1,010	938	1,080	1,030	523
Current account (excluding grants)	-586	-1,090	-492	-397	-346	-451	-297
Official transfers	26	25	29	22	34	29	20
Current account (including grants)	-560	-1,065	-463	-375	-312	-422	-277
Capital and financial account	372	446	932	560	652	653	321
Capital transfers, (net)	80	52	57	197	60	63	44
of which Aircraft disposal				148			
Financial account	292	395	875	363	592	590	278
Long-term:	435	307	924	185	684	661	302
Direct investment	177	176	463	170	327	375	149
Foreign direct investment, net	177	173	188	80	227	175	114
Privatization proceeds	0	3	275	90	100	200	35
Private, long-term (net) 1/	196	83	6	-238	23	78	64
Disbursements	361	301	168	64	200	195	118
Amortization	165	217	163	302	177	117	54
Government, long-term (net)	62	47	455	253	333	208	89
Disbursements	381	355	870	576	690	595	277
Amortization	319	308	414	323	357	387	189
Short-term, net	-143	88	-49	178	-91	-72	-24
Portfolio investment, net (CSE)	-13	-45	25	-11	40	40	7
Private short-term, net	-10	100	48	-16	-64	-12	-6
Commercial banks (net)	-120	33	-122	254	-68	-150	-75
Government short-term, net	0	0	0	-50	0	50	50
Errors and omissions 2/	-72	97	0	36	0	0	0
Overall balance	-259	-522	468	220	341	231	45
Financing requirement	-259	-522	468	220	554	668	166
Net international reserves	259	522	-468	-220	-554	-542	-129
Of which: Use of existing Fund credit, net	-99	-97	126	53	-53	-49	-28
Increase in gross official reserves (-)	340	619	-594	-270	-501	-619	-138
Central bank borrowing, net	18	0	0	-3	0	0	0
Financing gap					213	437	121
Of which: World Bank					60	157	10
ADB					50	50	35
IMF					64	126	63
Bilaterals					39	30	13
Unidentified 3/						74	0
(In percent of GDP)							
Memorandum items:							
Current account (excl. official transfers)	-3.7	-6.7	-3.1	-2.5	-2.0	-2.7	-1.8
Current account (incl. official transfers)	-3.6	-6.5	-2.9	-2.4	-1.8	-2.6	-1.7
Overall balance	-1.6	-3.2	0.9	1.4	2.0	1.4	0.3
Total external debt (incl IMF)	63.2	61.8	70.0	64.7	67.2	66.4	64.7
Total debt service (percent of exports of g&s)	15.2	14.3	15.8	15.5	11.0	12.6	15.5
Gross official reserves (US\$ millions)	1,530	911	1,500	1,181	2,000	1,800	1,372
(In months of imports)	2.2	1.5	2.0	2.0	2.5	2.7	2.0
Net official reserves (US\$ millions)	1,272	750	1,212	970	1,768	1,513	1,102
GDP (in millions of U.S. dollars)	15,712	16,346	16,029	15,672	17,390	16,433	16,433

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.

3/ Currently assumed to be filled from non-Fund sources, but could be from Fund financing.

Table 5: Sri Lanka: Program Macroeconomic Framework, 1999-2006

(In percent of GDP unless otherwise noted)

	1999	2000	2001	2002	2003	2004	2005	2006
Real sector								
GDP at market prices (percent change)	4.3	6.0	-1.3	3.7	5.5	6.0	6.5	6.5
GDP deflator (% change)	4.2	7.3	13.0	9.0	6.2	5.0	4.6	4.4
Gross national saving	23.5	21.5	19.5	21.3	22.8	24.5	25.8	27.0
Gross investment	27.3	28.0	22.1	24.0	25.6	27.1	28.5	29.6
Fiscal sector								
Total revenue	17.7	16.8	16.5	17.5	19.8	20.1	20.3	20.3
Total expenditure and net lending	25.2	26.7	27.3	26.1	26.4	25.5	24.9	24.3
Current expenditure	18.7	20.2	21.4	21.0	18.8	17.7	17.1	16.5
<i>Of which</i> : Defense expenditure	3.4	4.6	3.8	3.0	2.5	2.1	2.1	2.1
<i>Of which</i> : Interest payments	5.6	5.7	6.7	7.4	6.0	5.7	5.4	5.1
Overall balance	-7.5	-9.9	-10.8	-8.5	-6.6	-5.4	-4.6	-4.0
Primary balance	-1.9	-4.2	-4.1	-1.2	-0.6	0.3	0.8	1.1
Net external financing (including grants)	0.7	1.1	2.0	3.7	2.2	2.3	2.0	2.0
Net domestic debt-financing	6.8	8.8	8.2	3.6	3.5	2.8	2.3	1.8
Total government debt	95.1	96.8	103.0	101.1	97.4	93.2	88.5	83.9
Domestic	49.1	53.8	56.5	53.6	51.4	49.0	46.3	43.4
Foreign	45.9	43.1	46.6	47.6	46.0	44.3	42.2	40.4
External sector								
Trade balance	-8.7	-11.0	-7.4	-7.8	-8.0	-7.7	-7.9	-7.7
External current account balance (incl. Transfers)	-3.6	-6.5	-2.4	-2.6	-2.6	-2.5	-2.6	-2.5
Overall balance	-1.6	-3.2	1.4	1.4	0.6	1.0	1.1	1.6
Gross official reserves less ACU balance (US\$b)	1.5	0.9	1.2	1.8	2.1	2.5	2.8	3.3
(months of imports of goods and services)	2.2	1.5	2.0	2.7	2.9	3.2	3.4	3.7
External debt								
Total external debt	63.2	61.8	64.7	66.4	63.5	60.8	58.3	56.7
Monetary sector								
Broad money (percent change)	13.4	12.9	13.6	12.5	10.6	11.3	11.4	11.2
Memorandum items:								
Oil price (\$ per barrel)	18.0	28.2	24.3	23.0	22.0	21.0	21.0	21.0

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

Table 6. Sri Lanka: Vulnerability Indicators, 1997-2001

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001 Latest 1/
Official risk indicators 2/					
Share of nonperforming loans (as percent of total loans)					
State-owned commercial banks	20.2	19.5	18.5	15.4	18.2
Domestic private banks	12.4	13.4	15.9	14.9	15.7
Foreign banks	...	...	10.7	12.7	13.2
Risk-based capital asset ratio (capital over risk-weighted assets) 3/					
State-owned commercial banks	9.2	8.2	8.4	2.2	0.1
Domestic private banks	10.9	12.3	12.2	11.4	10.4
Foreign banks	13.87	13.9	12.4	13.0	16.0
Financial sector risk indicators					
Public sector debt	85.8	90.8	95.1	96.8	103.0
Broad money (percent change, 12-month basis) 4/	15.6	13.2	13.4	12.9	13.6
Private sector credit (percent change, 12 month basis) 4/	14.5	12.1	10.5	11.8	8.9
Share of deposits in broad money 4/	86.3	86.3	86.3	87.3	88.1
Share of foreign currency deposits in total deposits 4/	15.2	18.9	20.4	21.1	21.3
Share of foreign exchange loans in total loans 4/	19	20	17	19	...
Share of private credit collateralized by immovable property, plant, and machinery 5/	25.7	26.6	26.2	...	...
Share of housing and property development in private credit 5/	11.6	12.9	...	...	...
Market assessment indicators					
Stock market index (1985=100, e.o.p.)	702	597	573	448	621
Share price index of financial institutions (1985=100, e.o.p.)	1,772	1,356	1,214	870	1,356
External indicators					
Exports (percent change, 12-month basis in US\$)	13.3	3.4	-3.9	19.8	-12.8
Imports (percent change, 12-month basis in US\$)	7.8	0.4	1.5	22.4	-18.4
Current account balance (excluding official transfers)	-2.9	-1.8	-3.7	-6.7	-2.5
Capital and financial account balance	4.0	2.6	2.4	2.7	3.6
Of which: Portfolio investment	0.1	-0.2	-0.1	-0.3	-0.1
Medium- and long-term inflows, net	4.7	2.5	2.8	1.9	1.2
Foreign direct investment	0.9	0.9	1.1	1.1	0.5
Gross official reserves excl. ACU balance (in millions of US\$)	1,922	1,899	1,530	911	1,181
Central Bank short-term foreign liabilities excluding ACU balance (in millions of US\$)	1.0	0.0	0.0	0.0	0.0
Short-term foreign assets of commercial banks (in millions of US\$) 4/	974	832	850	1,001	...
Short-term foreign liabilities of commercial banks (in millions of US\$) 4/	1,023	817	722	880	...
Foreign currency exposure of commercial banks 4/ 6/	96	103	100	100	100
Gross official international reserves (as percent of imports of goods & services)	29.2	28.5	22.5	11.1	16.6
Gross official international reserves (as percent of broad money)	35.3	34.1	25.8	15.6	20.0
Short-term debt 7/	11.1	9.1	8.7	10.1	10.5
Gross official international reserves (as percent of short-term debt)	120.7	138.1	121.4	63.5	80.1
Total external debt	62.3	61.0	63.2	61.8	64.7
External interest payments (as percent of exports goods & services)	5.5	5.1	5.3	5.0	5.5
Debt service (as percent of exports goods & services)	13.3	13.3	15.2	14.3	15.5
Exchange rate (Rupee per US\$, period average)	59.0	64.6	70.4	76.9	89.5

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

1/ Official risk indicators, fourth quarter; Financial sector indicators, Stock market, Reserves, and external debt, end-December; BOP and exchange rate, Jan - Dec.

The deterioration in the capital asset ratios of state-owned banks and worsening of the level of non-performing loans can be partly explained by compliance to tighter provision requirements as well as the impact of high real interest rates on the balance sheets of banks during the past 12 months.

2/ Excluding foreign currency banking units (FCBUs).

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, 1998-2002

(In millions of U.S. dollars)

	1998	1999	2000	2001 Prov.	2002 Proj.	2002 Proj Jan-June
Gross financing needs	789	958	994	1,101	1,807	798
External current account deficit (exc. official transfers)	278	586	1,090	397	451	297
Debt amortization	475	614	426	356	689	336
Medium and long term debt	435	484	525	625	503	243
Public sector	290	319	308	323	387	189
Corporate private sector	145	165	217	302	117	54
Short-term debt 1/	40	130	-99	-269	185	93
Gross reserves accumulation (- = increase) 2/	45	340	619	-270	-619	-138
IMF repurchases and repayments	82	99	97	78	49	28
Financing sources	789	958	994	1,101	1,370	677
Foreign direct investment (net)	193	177	176	170	375	149
Debt financing from private creditors	147	361	335	-18	269	180
Medium- and long-term financing	147	361	301	64	195	118
Short-term financing	0	0	35	-82	74	62
Official creditors 3/	545	407	380	729	624	297
Other flows 4/	-96	14	104	220	103	51
Financing gap 5/	0	0	0	0	437	121

1/ Original maturity of less than 1 year. Stock at the end of the previous period. Includes all short term outflows and changes in commercial banks' NFA.

2/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.

3/ Includes both loans and grants. Includes the IMF.

4/ Includes all other net financial flows, and errors and omissions.

5/ Includes prospective IMF disbursements.

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

	1998	1999	2000	2001	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.
Outstanding use of Fund credit 1/								
In millions of SDRs	260.8	188.1	123.2	170.6	228.0	179.8	104.4	30.2
In millions of U.S. dollars	353.8	257.2	162.5	217.1	287.7	227.2	132.9	38.4
In percent of:								
Quota	63.1	45.5	29.8	41.3	55.2	43.5	25.2	7.3
GDP	2.2	1.6	1.0	1.4	1.8	1.3	0.7	0.2
Exports 2/	6.2	4.6	2.5	4.5	5.7	4.1	2.3	0.9
Public and publicly guaranteed debt	4.1	2.8	1.8	2.4	3.1	2.4	1.4	0.4
Debt service to the Fund 3/ (in millions of SDR)	61.9	73.9	65.7	61.2	45.4	55.3	81.2	77.7
o/w Repurchases	0.0	0.0	0.0	0.0	0.0	25.8	69.8	74.2
PRGF repayments	60.4	72.7	64.9	56.0	39.2	22.4	5.6	0.0
Charges and interest	1.5	1.2	0.8	5.2	6.2	7.1	5.8	3.5
In percent of:								
Quota	15.0	17.9	15.9	14.8	11.0	13.4	19.6	18.8
GDP	0.5	0.6	0.5	0.5	0.3	0.4	0.5	0.5
Exports 2/	1.5	1.8	1.3	1.6	1.1	1.3	1.7	1.5
Public and publicly guaranteed external debt	0.7	0.9	0.8	0.9	0.6	0.7	1.1	1.0
Central government revenues (excluding grants)	2.3	2.7	2.4	3.0	2.0	2.0	2.7	2.3
Memorandum item:								
Disbursements under the Stand-by Arrangement (SDRs)	0.0	0.0	0.0	103.4	96.7	0.0	0.0	0.0

Sources: Treasurer's Department and staff calculations.

1/ End-of-period.

2/ Exports of Goods and Services.

3/ Based on prospective purchases and repurchase obligations.

SRI LANKA—SAFEGUARDS ASSESSMENTS
SUMMARY OF CONCLUSIONS AND PROGRESS REPORT ON THE IMPLEMENTATION OF
VARIOUS REMEDIES

Safeguards Assessment: A Stage Two on-site safeguards assessment of the CBSL confirmed critical weaknesses in the bank's external audit mechanism, financial reporting framework, and internal control system. The safeguards assessment proposed recommendations in each of the five safeguards areas, as detailed below. The authorities have accepted the need for the proposed remedies and management has endorsed the recommendations.

Status: The staff has integrated the remedies in the ongoing SBA and the CBSL has already implemented most of the recommendations.

External Audit Mechanism: The external audit of the CBSL, which is conducted by the Auditor General of Sri Lanka, is largely related to compliance with rules and regulations, and falls short of international best practices. The safeguards assessment, therefore, proposed that: (i) the CBSL appoint an external audit firm to conduct the financial audit of the bank, beginning in 2001; and (ii) the CBSL establish an audit committee of its Monetary Board to handle relations with internal and external auditors, including the selection of external auditors for the 2001 financial year audit, and to improve overall corporate governance.

Status: An audit committee was appointed in August 2001. An external audit firm was appointed in March 2002. The auditor commenced work on April 1, 2002 and the audited accounts of the CBSL will be published by June 30, 2002.

Legal Structure and Independence: While, in practice, the CBSL enjoys a large degree of independence from the government in the conduct of its monetary and exchange rate operations, the legislation governing CBSL could be amended at some point to bring the provisions concerning auditing, accounting, and credit to government in line with best practices. In the interim, staff recommends that the Monetary Board of the CBSL adopt resolutions in the areas of accounting and auditing.

Status: The CBSL's Monetary Board adopted resolutions in the areas of accounting and auditing in September 2001.

Financial Reporting: The CBSL does not apply an internationally recognized set of accounting standards in the preparation of its financial statements. Furthermore, the published financial statements include only a summary balance sheet and income statement. To address these vulnerabilities, staff recommends that the CBSL adopt International Accounting Standards, publish its financial statements in full, and institute a training program for accountants.

Status: The CBSL completed the preparation of an IAS-compliant financial reporting template and restated FY 2000 financial statements in accordance with IAS and prepared IAS-compliant financial statements for FY 2001 in January 2002. In addition, monthly balance sheets would be prepared from April on an accrual basis to be fully consistent with the IAS-based annual accounts.

Internal Audit Mechanism: The internal audit function at the CBSL focuses on compliance reviews of operational controls and does not have the capacity of perform risk-based, financial, or IT audits of

CBSL operations. Bank management has identified the internal audit function as a beneficiary of its current bank-wide restructuring effort, and staff recommends that the CBSL continue to improve internal audit with the assistance of external consultants.

Status: A new Chief Accountant has been appointed. The external auditor will initiate work on the review of the management audit department and will submit an interim report by mid-August 2002. The external review of the management audit department would be formally completed by end-September, 2002.

System of Internal Controls: The CBSL has a number of low-level controls in the area of reserves management. Nevertheless, there remain significant vulnerabilities related to the valuation of the bank's foreign and domestic assets. In particular, the CBSL records its foreign securities at historical cost, and in so doing, considerably overstates their value. In addition, there are concerns about the concentration of authority for foreign exchange dealing, settlement, and accounting in one department of the bank. Staff therefore recommends that the CBSL develop a formal system of verifying the value of data reported to the Fund and ensure that reported data reflect the market value of the underlying assets. The CBSL should also segregate duties in the area of foreign exchange operations during its current restructuring effort.

Status: The CBSL has adopted a formal mechanism of verifying the data reported to the Fund and now regularly reports reserves expressed in terms of both market value and historical costs. With effect from January 2002, as part of its ongoing restructuring exercise, the CBSL has reconstituted the Banking Department into four departments namely the International Operations Department (IOD), Domestic Operations Department (DOD), Payments & Settlements Department (PSD) and the Finance Department (FD). The CBSL has also now allocated foreign exchange dealing to the IOD, settlements to PSD and accounting to FD. The CBSL has resolved small unconfirmed foreign exchange balances with correspondent banks abroad. The work on the review of the high level internal control system and adopting a formal risk management process will begin in June 2002, an interim report will be submitted by mid-August, and a final report will be completed by end-September, 2002.

SRI LANKA—FUND RELATIONS

(As of February 28, 2002)

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	413.40	100.00
	Fund holdings of currency	468.99	113.45
	Reserve position in Fund	47.79	11.56

III.	SDR Department:	SDR Million	Percent Allocation
	Net cumulative allocation	70.87	100.00
	Holdings	0.39	0.55

IV.	Outstanding Purchases and Loans:	SDR Million	Percent Quota
	Stand-By Arrangements	103.35	25.00
	ESAF arrangements	61.60	14.90

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Apr 20, 2001	Jun 19, 2002	200.00	103.35
ESAF	Sep 13, 1991	Jul 31, 1995	336.00	280.00
SAF	Mar 09, 1988	Oct 21, 1991	156.17	156.17

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

	Overdue (01/31/02)	Forthcoming				
		2002	2003	2004	2005	2006
Principal	--	33.60	22.40	31.40	51.70	25.80
Charges/interest	--	3.60	4.60	4.40	3.20	1.90
Total	--	37.20	27.0	35.80	54.90	27.70

VII. **Exchange Rate Arrangement:**

Independent float. The central bank floated the rupee on January 23, 2001. The CBSL has removed all the foreign exchange regulations that were imposed immediately after the float. The requirement for state enterprises to cover their foreign exchange needs through state banks was lifted in March 2001, the settlement period for export credits was extended to 180 days in June, the deposit requirement on new forward contracts was removed in July 2001, and the ban on pre-payment of import bills was eliminated in August 2001.

VIII. Safeguards Assessment

Under the Fund's safeguards assessment policy, Central Bank of Sri Lanka (CBSL) is subject to a full Stage One safeguards assessment with respect to the Stand-By Arrangement, which was approved on April 20, 2001, and is scheduled to expire on August 19, 2002. A Stage One safeguards assessment of the CBSL was completed on June 13, 2001. The assessment concluded that high risks may exist in the external audit mechanism, the financial reporting framework, and the system of internal controls and recommended a Stage Two (on-site) assessment. The Stage Two (on-site) assessment was completed on August 30, 2001. A summary of staff's findings and recommendations is contained in Annex I.

VIII. Article IV Consultation:

Sri Lanka is on the standard 12-month consultation cycle. The Executive Board concluded the 2001 Article IV consultation (EBS/01/41) on April 20, 2001.

IX. FSAP and ROSC Participation:

MAE: Two FSAP missions visited Colombo during November 1-14, 2001 and February 6-20, 2002. The FSAP report is being drafted, and will be forwarded to the authorities for review and comment. The mission identified a number of vulnerabilities which could lead to systemic problems if left unaddressed. Follow-up technical assistance is planned.

STA: A statistical ROSC mission visited Colombo during June 7-22, 2001, and the authorities' comments were incorporated in the final report, which was presented to the Executive Board. The authorities have requested follow-up technical assistance in the areas of national accounts, government finance statistics, and compiling the international investment position. A mission is planned for May 23-24, 2002 to discuss the technical assistance request as well as publication of the ROSC report.

FAD: A fiscal ROSC is planned for 2002.

X. Technical Assistance, 1997-2001:

Department	Purpose	Date
FAD	▪ Public expenditure management	March 1998
	▪ Cash management and expenditure monitoring	February 1997-February 1998
	▪ Implementing a Goods and Services Tax and tax administration	January-February 1997; March 1997-March 1998; extended to September 1998
	▪ GST Seminar	July 1999
	▪ Tax policy and administration	May, September 2001

MAE	<ul style="list-style-type: none">▪ Government securities market▪ Monetary Policy Instruments	December 1999 May 2001
STA	<ul style="list-style-type: none">▪ General Data Dissemination System▪ Price indices	June-July 1997, February-March 2000 October 1998

XI. Resident Representative:

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

SRI LANKA—RELATIONS WITH THE WORLD BANK GROUP¹

Sri Lanka has received 12 IBRD loans totaling \$210.7 million and 83 IDA credits totaling \$2.355 billion 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. As of December 31, 2001, MIGA's portfolio in Sri Lanka consists of one guarantee contract with a gross exposure of US\$ 1.7 million. Two MIGA guarantees totaling \$7 million were approved in FY 1997-98. During FY 1989-2001, IDA approved 34 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 included a number of operations to address policy issues in health, poverty and rural development, infrastructure, urban development, private sector development and civil service/governance.

In FY 2000, IDA approved two projects designed to: (i) help improve living standards in conflict-affected communities in the North-East Province; and (ii) improve the existing legal and judicial framework by making it more efficient, transparent and responsive. In FY 2001, IDA approved three projects designed to: (i) help establish distance learning capacity; (ii) pilot the design and implementation of land titling reforms; and (iii) support the reorganization and strengthening of the Central Bank. In the future, the World Bank will likely provide IDA credits and advice to help increase agricultural productivity, reduce rural poverty, reform tertiary education, expand access to rural electrification, rural water and sanitation, and promote private investment in various sub-sectors. Other analytical work in the near future will focus on public expenditures, financial management, and procurement. If the government elaborates and adopts a comprehensive well-defined structural adjustment program, the Bank would consider supporting reforms in private sector development and public administration.

The Bank chaired the Development Forum (DF) in Paris in December 2000, and a local DF is planned in Colombo for May 2002. The local meeting will focus on the government's draft PRSP and the Framework for Relief, Rehabilitation and Reconciliation (RRR). The Bank/IMF are currently assisting the government to prepare the PRSP, which is expected to be presented to the Bank/IMF Boards towards the end of FY 2002 or early in FY 2003. A poverty analysis was finalized in June 2001 and shared with the government and other stakeholders.

Sri Lanka: Lending by the World Bank Group, FY 1996–2002^{1/}

	1996	1997	1998	1999	2000	2001	2002 ^{2/}
IBRD (net)	-6.7	-6.2	-5.9	-6.0	-6.1	-4.4	-4.2
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	6.7	6.2	5.9	6.0	6.1	4.4	4.2
IDA (net)	100.5	77.7	60.1	73.1	30.3	24.9	18.9
Disbursements	108.9	87.7	71.3	87.0	45.9	47.4	52.0
Amortization	8.4	10.0	11.2	13.9	15.6	22.5	33.1
Total loans/credits (net)	93.8	71.5	54.3	67.1	24.2	20.5	14.7
Interest and charges	15.6	14.7	14.1	14.2	13.9	13.0	12.5
IBRD	4.6	3.6	2.8	2.3	1.8	1.1	0.7
IDA	10.9	11.1	11.3	11.9	12.1	11.9	11.8

Source: Data provided by the World Bank, Controller's Department.

^{1/} As of March 1, 2002.

^{2/} Estimated.

¹ Prepared by World Bank staff.

SRI LANKA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK¹

The Asian Development Bank (AsDB) started its operation in Sri Lanka in 1969 and has provided 105 public sector loans totaling about \$2.7 billion and 189 TAs totaling about \$74 million. AsDB has also assisted 10 private sector projects totaling \$85.6 million (with \$72 million in loans and \$13.6 million in equity investments).

In 2001, AsDB approved \$146 million in loans for Sri Lanka and \$4.1 million in technical assistance grants, to support development and reforms in key areas of the economy. The AsDB assistance supported rehabilitation of the North and East, efficiency enhancements and expansion of Colombo port, small and medium enterprise development, and rural economic advancement.

AsDB also provided, through its private sector window, an equity investment of \$360,000 in a housing bank. 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 2001, the sectoral distribution of the loan portfolio was agriculture, 33.6 percent; social infrastructure, 18.8 percent; energy, 10.6 percent; finance and industry, 19.6 percent; transport and communications, 15.9 percent and others, 1.5 percent.

Sri Lanka: Lending by the Asian Development Bank, 1994–2002

	1994	1995	1996	1997	1998	1999	2000	2001	Proj. 2002
(In millions of U.S. dollars)									
Commitment	130.0	140.0	44.0	166.1	190.0	183.8	208.7	146.0	...
Net resource transfer	73.4	66.5	126.9	71.0	92.5	72.4	44.3	64.0	...
Disbursement	92.2	87.3	148.9	100.5	120.1	103.2	81.0	103.5	177.9

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

¹ Based on material prepared by AsDB staff.

**Statement by the IMF Staff Representative
April 15, 2002**

1. **This statement provides an update on recent economic developments and financing issues since the staff report was issued on April 1 (EBS/02/59).** The information contained in this statement does not alter the analysis or the appraisal in the staff report.
2. **The 2002 budget, which was approved by Parliament today, is in line with the program framework.** Because of technical complications, the new VAT will become effective from July 1, a delay of one month.
3. **The latest consumer price data show that the trend of inflation continues to decline.** While the Colombo Consumers' Price Index (CCPI) increased by about ½ percent in March, the Colombo District Consumer Price Index (CDCPI), which covers a wider geographical area and has more current weights, declined by about ¾ percent. Both indices continue to show a gradual deceleration on an annual average basis. The decline in inflation is closely related to the decline in food prices, reflecting a gradual improvement in supply conditions.
4. **The latest information on gross official reserves indicates that the level has been stable since late March.** As of April 8, gross official reserves (expressed in market prices) amounted to about \$1.2 billion. The rupee is currently trading at Rs 95.8/\$1 and has slightly depreciated against the dollar and other trading partner currencies since late March 2002.
5. **The monetary policy stance continues to be tight.** The data on reserve money at end-March suggest that the program's end-April reserve money target is likely to be observed. The Central Bank of Sri Lanka raised its key overnight reverse repo rate by 20 basis points to 13.85 percent on April 4, in response to an increase in banks' demand for funds from the reverse repurchase window ahead of the mid-April Sinhala and Tamil new year festival. Other rates have also increased slightly—for the week ending April 5, the 3-month treasury bill yield was 12.9 percent, compared with 12.7 percent at late March, while the prime lending rate was 14.0 percent, compared with 13.6 percent at late March.
6. **On financing issues, the authorities and the World Bank staff have reached broad agreement on the policy framework for the Private Sector Development (PSD) credit. The program loans from the AsDB are also broadly on track.** While a few details of the \$130 million PSD credit have not yet been completely finalized, it is expected that the Bank's Operations Committee would discuss an Initiating Memorandum in May. An appraisal mission is scheduled for June and the first tranche of the PSD credit (at least 50 percent) could be released by the third quarter of 2002. Although the SBA-supported program itself, which runs through mid-August, is fully financed, the timing of disbursement of the PSD credit would affect the post-program balance of payments prospects. Any financing gap for 2002 arising from a delay into 2003 of the remaining PSD credit disbursements could be filled by a combination of further policy adjustment and additional financing from other sources.

7. **The program assumes the current WEO oil price projection of \$23 per barrel for 2002.** However, if the recent increase in oil prices continues, it could add additional pressure on the balance of payments.

NEWS  BRIEF

FOR IMMEDIATE RELEASE

News Brief No. 02/31
FOR IMMEDIATE RELEASE
April 15, 2002

International Monetary Fund
700 19th Street, NW
Washington, DC 20431 USA

IMF Completes Review Under Sri Lanka's Stand-By Arrangement and Approves US\$60 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first and second review of Sri Lanka's economic performance under a 14-month Stand-By Arrangement (see [Press Release No. 01/16](#)). This enables the immediate release of a further SDR 48.3 million (about US\$60 million) from the arrangement, which would bring total disbursements under the IMF-supported program to SDR 151.7 million (about US\$190 million). The Board also approved Sri Lanka's request for extension of the period of the current arrangement by two months to August 19, 2002.

After the Executive Board's discussion on Sri Lanka, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, made the following statement:

"Sri Lanka's program has achieved its immediate goal of halting the precipitous drop in official reserves. In this regard, the authorities' decision in January 2001 to float the exchange rate, while maintaining a tight monetary stance, has proved very effective. Nevertheless, the overall macroeconomic performance under the program has been mixed. A decline in output was principally linked to the external shocks related to the global slowdown, the attack on Colombo airport, the events of September 11, and the drought. However, the growth performance was also affected by the erosion of confidence resulting from the political instability in the second half of the year that led to fiscal policy reversal, an escalation of government debt, and a cessation of structural reform.

EXTERNAL RELATIONS DEPARTMENT

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“Against this background, the new government faces the challenge of re-establishing conditions for fiscal sustainability and lasting growth. Reining in the fiscal deficit and losses incurred by the state enterprises must be top priorities. The Fund supports the policies enshrined in the new government’s 2002 Budget, which, if implemented and backed by prudent monetary policy, will go a long way to address the macroeconomic imbalances. In particular, the Fund welcomes the focus on reform of the tax system and administration, and the steps to rationalize expenditure.

“Another key challenge for the authorities is early implementation of the government’s structural reform and poverty reduction agenda, which would lay the foundations for a possible longer-term arrangement under a Poverty Reduction and Growth Facility (PRGF) that would focus on restructuring the state sector, and on areas that are critical for promotion of private sector-led growth. In this vein, the Fund strongly supports the specific steps in the Budget to improve the financial position of the state petroleum and electricity companies through price adjustments, accompanied by early steps to restructure these enterprises with private participation. In addition, the Fund welcomes the further efforts being made to address the weaknesses of the state banks and strengthen bank supervision, and the actions to improve the labor market through timely and consistent resolution of disputes. These efforts will need to be sustained over the medium term.

“Finally, progress on the peace front should significantly improve business confidence, strengthen the willingness of the international community to support reforms in Sri Lanka, and enhance growth and reduce poverty over the medium term,” Mr. Sugisaki said.