November 2007
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Sri Lanka: 2007 Article IV Consultation—Staff Report; Staff Supplements; Public Information Notice on the Executive Board Discussion; and Statement by the Alternate Executive Director for Sri Lanka

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Sri Lanka, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 10, 2007, 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 November 7, 2007. 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 supplement on debt sustainability analysis.

- A staff supplement of November 19, 2007 updating information on recent economic developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 21, 2007 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Alternate Executive Director for Sri Lanka.

The document listed below has been or will be separately released.

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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SRI LANKA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Article IV Consultation with Sri Lanka

Approved by Masahiko Takeda and Mark Plant

November 7, 2007

- **Discussions**: Colombo, June 25–July 10, 2007.
- **Team**: Mses. Liu (head), Duma, and Ruiz-Arranz (all APD), Rehm (FAD), and Rahman (PDR). Mr. Herat (OED) participated in discussions.
- **Sri Lanka representatives**: The Finance Secretary, the Governor of the Central Bank of Sri Lanka, and other senior government officials, as well as representatives from opposition parties, the private sector, the donor community, and labor unions. The mission also met with President Mahinda Rajapaksa.
- **Fund arrangements**: The three-year PRGF and EFF arrangements for SDR 413 million (SDR 59 million disbursed) expired in 2006. After the tsunami disaster, the Executive Board approved, on January 13, 2005, the extension of repurchase expectations arising in the remainder of 2005 (SDR 74 million) and on March 4, 2005, a purchase under the Fund's Emergency Assistance Policy for Natural Disasters (SDR 103 million).
- **2006 Article IV consultation**: The Executive Board discussion is summarized in the Public Information Notice (PIN) No. 06/132 at www.imf.org.
- **Exchange rate**: Managed float with no predetermined path.
- **Exchange system**: Accepted the obligations of Article VIII, Sections 2, 3, and 4 in March 1994. Import margin requirements (50 percent) with respect to certain goods, introduced in last October, were removed in May 2007, but the 100 percent margin requirement on the import of certain vehicles remain in place. The Board approved these restriction until November 2, 2007 or the completion of the 2007 Article IV consultation with Sri Lanka, whichever came earlier.
- **Statistics**: Adequate for conducting effective surveillance. A participant of GDDS.

Contents Page

EXECUTIVE SUMMARY

Sri Lanka's recent growth performance, while impressive, has been underpinned in part by monetary and fiscal stimulus, resulting in strong demand pressures. Rising inflation, a high current account deficit, and low unemployment rate indicate that the economy may be operating at full capacity. High oil prices, slow fiscal consolidation, and security concerns are key risks to the near-term growth-inflation outlook.

High stock of public debt, rising near-term debt service needs, and a low level of reserves point to elevated external vulnerabilities. Fiscal deficits in the past few years resulted in an accumulation of short-term dollar-denominated commercial debt, posing refinancing risks.

Concerted tightening in macroeconomic policies is needed in the near term to reduce inflation and vulnerabilities, while facilitating the refinancing of the domestic dollar-denominated commercial debt.

- **A more determined fiscal consolidation is essential for demand management and debt sustainability.** The revised 2007 budget deficit target (at 7.8 percent of GDP) represents a modest withdrawal of fiscal stimulus, but remains high. Additional measures of about ½ percent of GDP may be required in the remainder of the year to help limit inflationary financing. Further overruns on wages and military spending pose upside risks to the fiscal deficit. Going forward, a credible fiscal consolidation in 2008 and over the medium-term, supported by well-defined and quality revenue measures, is essential for ensuring macroeconomic stability and debt sustainability.

- **Further monetary tightening is warranted in view of the current fiscal stance and high rate of inflation.** Open market operations should be stepped up and treasury security rates be allowed to adjust to levels that would help contain liquidity and bring inflation down to single digits.

- **Greater flexibility in the exchange rate is essential to safeguard reserves.** The real effective exchange rate appears broadly in line with economic fundamentals and competitiveness does not seem to be of immediate concern. Nevertheless, sustained high oil prices and an emerging refinancing burden from the public dollar-denominated commercial debt could strain the balance of payments. Further exchange rate flexibility will help contain vulnerabilities.

Sri Lanka's medium-term economic prospects depend critically on peace, the pace of fiscal consolidation, and other policy adjustments to reduce external risks. Essential structural reforms are also key to improve competitiveness and productivity through broadening the tax base, improving debt dynamics, and strengthening the stability and efficiency of the financial system.

I. Background

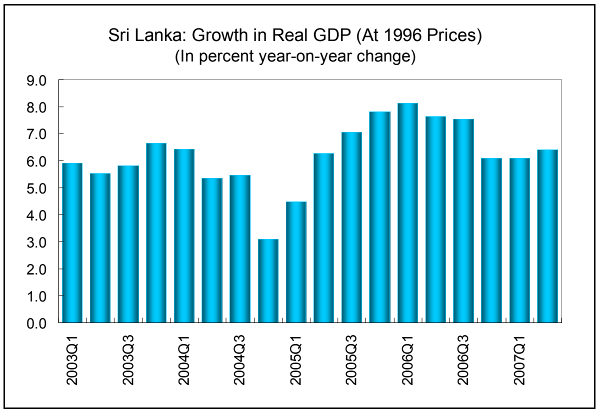
1. **Sri Lanka's strong economic growth in the past four years has lifted per capita income to about $1,300, well exceeding its regional peers.** To support this favorable growth momentum, the authorities launched a Ten-Year Horizon Development Plan (Plan) in early 2007, aimed at strengthening investment in industrial infrastructure (including power, roads, and ports). Bilateral and multilateral funding for some of these projects has been secured and implementation is underway.

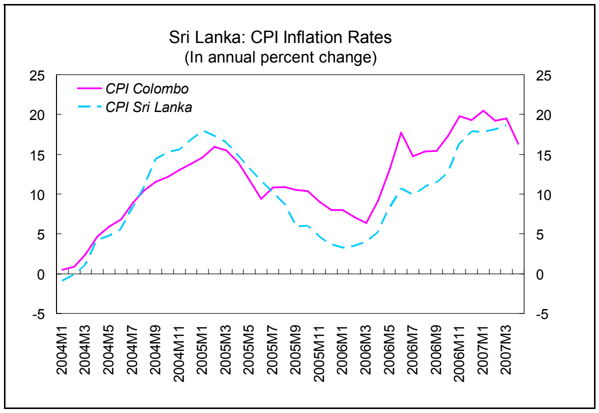
2. **This growth-oriented strategy, which is increasingly relying on commercial borrowing, requires Sri Lanka to implement policies that will improve economic fundamentals and foster favorable investor sentiment.** This strategy requires skillful management on several policy fronts to contain vulnerabilities while ensuring sustainable growth.

3. **The near-term macroeconomic impact of the conflict is expected to be limited but remains a concern.** The government has recently captured a large part of the East and administrative institutions are being established. However, there has been limited progress on future peace talks.

II. Recent Economic Developments

4. **Sri Lanka's growth performance continued to reflect strong resilience to shocks, including the impact of high oil prices, the end of the Multi-Fiber Arrangement (MFA), and a period of sharp deterioration in security conditions.** Real GDP growth in 2006, at 7½ percent, was broad-based and supported by buoyant domestic demand, growing at about 8.7 percent (Table 1, Figure 1).





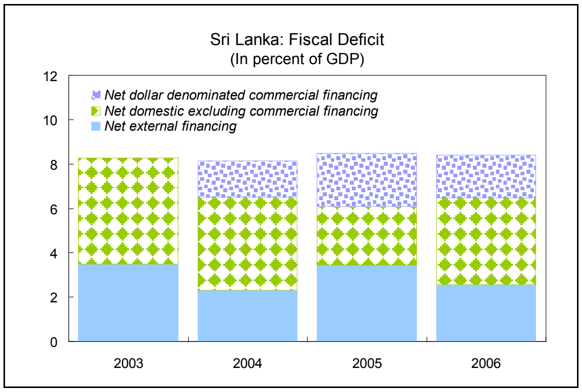
5. **CPI inflation accelerated to nearly 18 percent by end-2006 (from about 4 percent at end-2005).** Strong demand pressure was the primary factor underlying this trend, and to a lesser extent adjustments in administered prices during September–October 2006 (a weighted average of about 25 percent on fuel products, electricity, and transportation). Under the pressure from labor unions, the government approved in May 2007

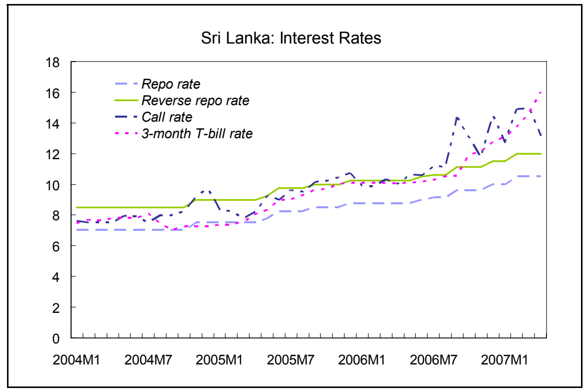
a major increase in minimum wages for the public sector (from Rs. 3000 to Rs. 5000 per month). Consequently, Sri Lanka's overall minimum wage index increased by about 40 percent during May-August, correcting a cumulative real term decline of about 30 percent since June 2004.

6. **Monetary policy was tightened in several steps in 2006 but insufficient to contain inflation, and additional measures were taken in early 2007.** The Central Bank of Sri Lanka (CBSL) announced its "Road Map" in January, aiming at reducing inflation to single digits by end-2007 (Table 2). The CBSL also limited banks' access to the reverse repo window to contain liquidity, together with a strengthening in prudential measures to contain excessive exposure to sectoral risks. Moreover, the CBSL stepped up its open market operations and allowed further increases in treasury security rates to about 17½ percent at end-April (from 12½ percent at end-2006). These measures, together with a dissipation of pass-through effects from administered price adjustments, contributed to a deceleration in inflation to (annualized) single digits in the first four months of 2007, and real interest rates turned positive.

7. **This favorable inflation trend has reversed, however, since May and inflation increased to 21¾ percent (yoy) in August**. The combined effect of the elimination of remaining fuel subsidies (a weighted average increase of 22 percent during May-July, on top of a 25 percent adjustment in last September-October), increases in food prices, and a pause in further monetary tightening during July-August (evidenced by the refusal of bids in a number of treasury auctions to limit further increases in treasury security rates) contributed to an acceleration in inflation.

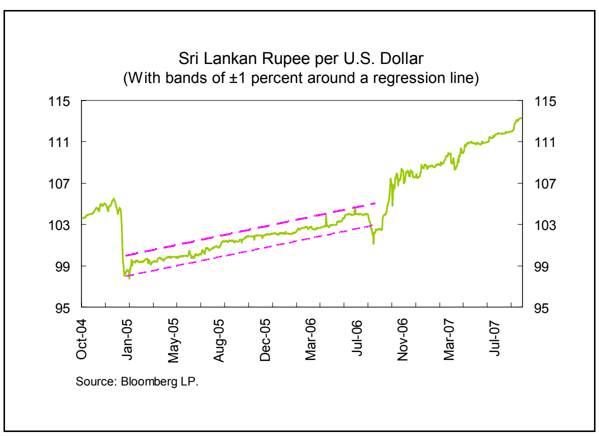
8. **The authorities' revised fiscal deficit target for 2007, at 7.8 percent of GDP, indicates a modest fiscal consolidation from a deficit of 8.4 percent of GDP in 2006** (Table 3). Compared with the 2006 outcome, the revised fiscal projection envisages a substantial increase in tax revenue, a full elimination of fuel subsidies, and a containment of the wage bill. Together, they are expected to more than offset increases in military expenditure, spending on goods and services, and capital spending. Revenue grew by 25 percent in the first half of 2007, but it was still at about 40 percent of the ambitious annual target. Wages and military spending appeared to be in line with their respective targets as of June, but they could continue to pose fiscal risks in the period ahead.

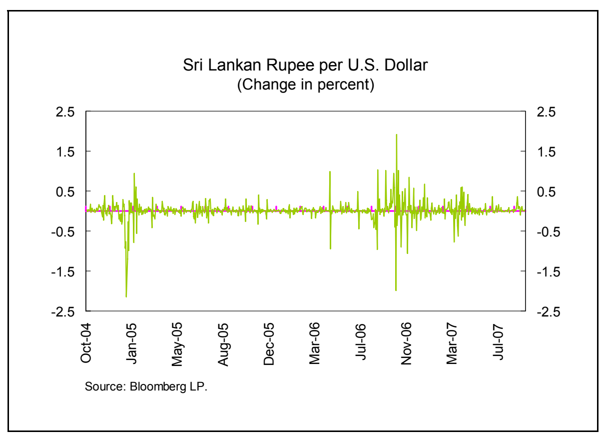




9. **The current account deficit is projected to narrow to 4.6 percent of GDP in 2007 (from 5 percent in 2006) while reserves are expected to remain below comfortable levels** (Table 4, Figure 2). In the first half of 2007, exports and remittances continued to grow strongly, while import growth decelerated mainly owing to limited increases in world oil prices during that period. For the year as a whole, healthy exports and remittances are expected to be largely offset by the implementation of mega infrastructure projects and high oil prices since July.

10. **The rupee exchange rate depreciated gradually (5¼ percent) during January–September 2007, supported by two-way intervention.** The CBSL purchased foreign exchange of $196 million during January-April, contributing to reserve build up. However, pressures started to emerge in May and the CBSL intervened by selling foreign exchange amounting to $272 million during May-September, while transaction volumes in the spot market declined sharply. As a result, gross international reserves declined to below $2.6 billion (2.2 months of imports of goods and services) at end-September 2007, from its peak of $2.9 billion in April.





11. **In light of favorable local and global liquidity conditions in the last two years, the government has continued to resort to dollar-denominated borrowing to finance the budget while supporting reserves.** By end-2006, public domestic dollar commercial debt reached $1.6 billion (or 6 percent of GDP) at an average maturity of 1½ years. Over 90 percent of this debt was financed from domestic sources, including remittances. A build up of this debt has resulted in a bunching of foreign exchange debt service over the next few

years, but so far favorable market conditions have allowed the government to refinance this debt at low cost.[1] In October, the government successfully issued its first $500 million international sovereign bond at a yield of 8¼ percent and maturity of 5 years.[2]

III. Outlook and Risks

12. **While growth remains robust, near-term risks have increased since the last Article IV consultation.** Demand pressures are intensifying, high world oil prices remain a challenge, and Sri Lanka's increased reliance on dollar-denominated commercial debt also exposes the economy to refinancing risks.

- Real GDP growth is projected at around 6 percent in 2007 (taking into account the preliminary official estimates of 6¼ percent in the first half of 2007). Strong domestic demand is expected to continue to offset weaker external demand.[3] Inflation is projected to moderate to 13 percent (eop) by end-2007, as the administered price pass-through effects are expected to dissipate and macroeconomic policies be further tightened towards the end of 2007.

- Risks to this growth-inflation outlook remain significant. They include a worsening of the security situation, a surge in world oil prices, and a larger than projected fiscal deficit that requires significant inflationary financing and/or further recourse to dollar-denominated debt.

- Key risks to the current account outlook arise from stiff competition in the apparel sector, slower-than-expected remittance growth, and further oil price hikes. A significant global growth slowdown could also affect Sri Lanka's exports given its exposure to the United States and European Union.

- Capital account risks arise mainly from the need to refinance the existing public dollar-denominated commercial debt. Over the next 2–3 years, about $1.6 billion of such debt is expected to fall due given its short average maturity. At the same time, external concessional financing as a ratio to GDP is expected to gradually decline as Sri Lanka moves towards emerging market status.

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[1] This includes the issuance of Sri Lanka Development Bonds (SLDB) of $215 million and syndicated loans of $210 million (both with maturities of 2–3 years). In addition, the government issued $400 million rupee-denominated treasury bonds to nonresidents during January-April.

[2] The recent turmoil in global financial markets has had limited impact on Sri Lanka. The Colombo Stock Exchange Index increased by about 1½ percent since August, following a decrease of about 10 percent during January–July 2007.

[3] See Chapter I of the Selected Issues.

13. **The medium-term macroeconomic outlook depends critically on peace, the pace of fiscal consolidation, and other policy adjustments to strengthen the balance of payments to deal with shocks.**

- Real GDP growth is projected at 6 percent over 2008–12, supported in part by a major increase in investment to address supply bottlenecks in key sectors, a continued expansion of the services sector, and improvement in productivity. However, major downside risks, including a sustained oil shock and intensified security concerns, could lower growth.

- Fiscal consolidation, if delivered without delay, would provide scope for private sector-led growth, reduce debt service pressures, and improve investor confidence. The authorities envisage a fiscal consolidation path to lower the deficit to 5 percent of GDP and bring about a primary balance by 2010 (Table 5). However, the lack of clearly-defined quality measures to broaden the tax base and risks of wages and military spending overruns remain serious concerns.

- The external current account deficit is expected to narrow to 3 percent of GDP by 2011 as oil imports pose less of a burden as prices stabilize and mega infrastructure developments are completed. Nevertheless, public debt service is expected to remain high, and external reserve coverage is projected at around 2½ months of imports in the absence of significant increases in capital inflows.

IV. Policy Discussions

Growing vulnerabilities appear to be rooted primarily in domestic policies of the past few years. The current trend of high fiscal deficits, if not reversed timely and decisively, could lead to intensified macroeconomic imbalances and a deterioration in public debt dynamics, which would require deeper policy adjustments eventually.

A. Fiscal Policy

14. **Staff stressed that the authorities revised 2007 fiscal deficit target is still high, but is a step in the right direction.** To achieve a more balanced policy mix and foster a lower inflationary environment, further fiscal tightening amounting to about ½ percent of GDP in 2007 is needed to contain budget financing in line with the CBSL's "Road Map" targets. Revenue performance has been encouraging so far, but meeting the revised revenue target of 18.5 percent of GDP (from 17.1 percent of GDP in 2006) remains a challenge and will require further administrative efforts. Restraint is also essential to limit potential recurrent expenditure overruns in order to protect priority development spending while delivering a lower deficit. Preliminary data as of mid-October indicate that external project financing was significantly lower than expected. Staff advised that, with more than three quarters of the year already gone, there may be a need to further rationalize the portion of the capital budget that is not fully externally financed. This will help contain domestic financing

of the budget, reduce inflation risks and debt service cost going forward, and support private sector and capital market developments.

15. **The authorities were confident that the revised fiscal deficit target for 2007 will be met, or even lowered in the event of external financing shortfall.** They expected the strong revenue performance to continue in the second half of 2007, and intended to further strengthen their efforts in tax administration to ensure that measures introduced in 2006–07, as well as new mid-year measures, are effectively implemented.[4] They noted that the elimination of the oil subsidy in the budget removed a major fiscal risk. Also, as the revised capital budget is still above the historical trend, there is further scope to rationalize projects that are not fully externally financed.

16. **The authorities indicated their renewed commitment to the medium-term fiscal consolidation to reduce the budget deficit to 5 percent of GDP and achieve a primary balance by 2010–11.** Staff supported this consolidation path as it would reduce total public debt to 73 percent of GDP by 2010 (from 95 percent of GDP at end-2006), lower interest costs, create space for private investment, and support demand management. In particular, staff noted the importance of a credible fiscal consolidation in 2008 to reduce the budget deficit to 6¼ percent of GDP (as indicated in the recent Budget Call) while articulating clearly the fiscal strategy underpinning this deficit reduction.

17. **Staff emphasized, and the authorities agreed, that quality measures are needed to support the medium-term fiscal consolidation.** They envisaged a further broadening of the income tax base, a strengthening of tax administration, and a gradual simplification of the VAT system. However, they saw political difficulties in extending the VAT net to cover the retail and wholesale sectors over the next few years. They noted objections of the provincial councils regarding revenue sharing over sales taxes, which are currently being collected and retained by local governments. Staff highlighted risks to fiscal consolidation in the absence of strong and sustainable revenue measures which could undermine investor confidence.

18. **Staff further stressed the importance of streamlining tax incentives starting in 2008, and the need to conduct a fresh review of benefits and costs of the current exemption regime.** In particular, staff expressed concerns over new exemptions introduced in the 2007 budget (including leather, construction, film, rubber, and coconut processing industries). The current corporate exemption regime under the Board of Investment (BOI) also distorts resource allocation and undermines tax buoyancy. This is particularly worrisome given that mega infrastructure projects are likely to fall under these schemes. The authorities

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[4]These include income tax measures to increase the top corporate rate, register 38,000 additional taxpayers, and place limits on loss carry forward; and VAT measures to raise the markup on imports to counter under-invoicing.

indicated that while BOI companies pay little corporate tax, their contribution to growth, income generation, employment, and other taxes are significant. They also noted that tax incentives have been widely used in Asia, and Sri Lanka has to operate within this competitive environment to meet its goal of industrial development.

19. **The authorities have identified loopholes in VAT refunds as a major factor undermining the VAT system.** They noted that a large number of fraudulent claims were found, and steps have been taken to separate high risk traders from the rest. Staff suggested that announcing a clear timetable for returning to a normal refund schedule f ollowing the cleanup process will help facilitate the forward planning of the business community and protect the credibility of the VAT system.

20. **Sri Lanka's ambitious public investment plan over the next few years has placed a premium on the need to rationalize recurrent expenditure.** In particular, staff advised restraint on real wage growth going forward, supported by policies to reduce inflation, limit public sector hiring, and resist pressures on sharp nominal wage increases. The authorities responded that overall public nominal wage increases have been limited to 20 percent over 2007–09, and real wage growth has already been curtailed in 2007 (compared to the outcome in 2006).

21. **The authorities concurred that financial viability of the energy sector is central to fiscal consolidation and debt sustainability over the medium term.** Ceylon Electricity Board (CEB) is likely to incur financial losses of about Rs. 20 billion (¾ percent of GDP) in 2007, due primarily to the lack of adjustment in electricity tariffs, which have fallen well below cost recovery levels. A large part of these losses was financed by loans from public banks, posing risks to the financial sector. The authorities' medium-term strategy is to use alternative and cheaper energy sources to reduce Sri Lanka's heavy reliance on oil-based thermal power generation. The construction of three coal power plants (total 900 MW) is expected to be completed during 2008–10. This will not only address the acute energy shortage in Sri Lanka but also significantly lower the cost of energy production (by about one-third from the current level) and bring the CEB to cost recovery levels.

B. Monetary Policy

22. **Staff advised a tighter monetary stance to contain demand pressures and improve the near term growth-inflation outlook.** The CBSL's policy decision to allow the treasury security rates to increase by 500 bps during the first half of 2007 has been instrumental in bringing about positive real interest rates and contributed to reduce inflation. In fact, these rates have de facto become the key indicators to transmit the CBSL's policy stance, as well as influence banks' decisions on setting their lending and deposit rates. However, the recent pause in monetary tightening is a source of concern in view of fiscal risks, continued high domestic credit growth, and rising inflationary expectations. Going

forward, it is critical to step up open market operations and allow treasury rates to increase to levels that will help effectively contain liquidity and reduce inflation to single digits.

23. **The authorities underscored that limiting banks' access to the reverse repo window has been effective in containing liquidity.** Nevertheless, they concurred that this measure is not the first best and has resulted in periodic increases in volatility in the call money market. Staff advised and the authorities agreed that, when inflation moderates sufficiently, the CBSL should consider a gradual exit from this arrangement, accompanied by adjustments in policy rates to align with treasury security rates to restore the signaling role of policy rates in the conduct of monetary policy and proper functioning of the standing facility.

24. **Improved coordination between monetary and fiscal policy is critical to support demand management.** Meeting the CBSL's "Road Map" targets for external reserve accumulation and domestic credit growth is a critical step in fighting inflation, particularly in light of fiscal risks in the current budget framework. The recent pick up in bank financing of the budget to above target levels during August-September warrants intensified coordination to identify timely corrective actions if needed. Improving open market operations will also require a stepped up coordination between the CBSL and Ministry of Finance in liquidity forecasting.

C. Exchange Rate Policy

25. **Staff analysis suggests that the real effective exchange rate (REER) appears broadly in line with economic fundamentals and competitiveness does not seem to be an immediate concern.**[5]

- Sri Lanka's REER is broadly in the range of regional competitors although it has exhibited substantial variation over time. Following a depreciation of 23 percent during 1998–2004, the REER appreciated by about 14 percent in 2005–2006, reflecting largely the impact of tsunami-related inflows and high domestic inflation. The unwinding of these effects, together with a nominal exchange rate depreciation of 3 percent, has resulted in a REER depreciation of about 2 percent in the first half of 2007. Estimates of the equilibrium REER using various approaches also indicate that the REER in the first half of 2007 is close to equilibrium.

- Trade performance indicators suggest that REER competitiveness may not be of immediate concern. While Sri Lanka's apparel exports to the United States has slowed, utilization of the European Union's GSP II quotas has increased, together with Sri Lanka's E.U. market share. Moreover, other exports continue to enjoy

[5] See Chapter II of the Selected Issues.

relatively high profit margins, which may be an indication of Sri Lanka's comparative advantage in certain commodity markets (e.g., tea and spices).

- Nevertheless, other indicators warrant close monitoring, particularly in view of Sri Lanka's labor productivity, which appears to be low relative to regional competitors. Wage growth seems to have outpaced labor productivity in the past few years and unit labor costs in industry appear to be increasing. Moreover, the export base remains narrow and vulnerable to global commodity and apparel price changes.

26. **In response, the authorities indicated that the export performance has been healthy despite stiff competition and the post MFA shock.** They noted that exports continue to grow at above 10 percent in dollar terms and order books of the apparel sector in 2007 are full. Also, efforts are being made to strengthen export sector competitiveness, including by establishing backward linkages of the apparel industry to the textile sector.

27. **Turning to exchange rate management, staff noted that a more market-based exchange rate regime would serve Sri Lanka well.** Given the persistent nature of high oil prices, a rising debt service burden going forward, and low level of reserves, growing pressures on the foreign exchange market are likely and should not be resisted. In this context, staff advised greater flexibility in the rupee exchange rate to help contain external vulnerabilities and safeguard reserves and limiting intervention to smoothing excessive volatility.

28. **The authorities underscored their commitment to a market-based exchange rate.** They emphasized that the rupee has been allowed to depreciate in an orderly manner throughout the year. They explained that increased intervention has been prompted primarily by lumpy oil import bills which were far larger than the daily size of the foreign exchange market. To help minimize the future impact of oil bills on the foreign exchange market, steps have been taken to allow the Ceylon Petroleum Corporation (CPC, a state-owned oil company) to gradually accumulate foreign exchange funds earmarked for future oil imports.

29. **The authorities confirmed that import margin requirements (50 percent) with respect to certain goods, introduced in October 2006, were removed in May 2007.** However, they plan to maintain the margin requirements (100 percent) with respect to certain vehicles in view of continued high demand for vehicle imports. They agreed to review this decision during the 2008 Article IV consultation discussions. The Board approval of this restriction expired on November 2, 2007. At this point, staff do not propose an approval of this restriction.

D. Debt Policy[6]

30. **The main challenge in the near term is to lengthen the maturity of domestic dollar-denominated commercial debt.** While this short-term financing for the budget was at more favorable interest rates than rupee funds, it has rendered Sri Lanka vulnerable to exchange rate and refinancing risks. Unless addressed promptly, the ensuing foreign exchange debt service bunching could lead to a sharp deterioration in debt sustainability.

31. **To address the near-term debt service challenge, the authorities are currently reviewing all options.** This includes issuing longer-term SLDBs to replace those with shorter maturity falling due and tapping funds from international financial markets under favorable conditions. The recent success in issuing Sri Lanka's first sovereign debt of $500 million with five-year maturity is encouraging, and this would help set a benchmark for issuing longer term SLDBs. Staff advised that proceeds from international bond issue should be used mainly to retire the short-term dollar-denominated commercial debt and/or the most expensive rupee debt. Efforts to mobilize other funding sources, including remittances, remain important. Staff underscored that sound macroeconomic policies are critical to foster stability and investor confidence to further lengthen the maturity of the public debt. In particular, a comfortable level of external reserves is indispensable during the transition period towards improved debt dynamics.

32. **The authorities noted that a new debt management strategy (mainly on domestic rupee debt) has been endorsed by the Cabinet and implementation is underway.** As a first step, trading of treasury securities has been extended to retail investors through bank branches in the urban and rural areas. Continued efforts will be made to develop the benchmark issues with longer maturities, introduce inflation indexed bonds, and develop a domestic corporate bond market. Several challenges remain, including strengthening the primary dealer system, providing adequate incentives to brokers to promote government securities, and encouraging long-term savings.

33. **Staff sought clarification regarding the financing modalities of mega infrastructure projects under the Plan.** Out of a total of $4.5 billion targeted for key infrastructure development during 2007−09, about $1.5 billion has been secured from major bilateral and multilateral donors, mostly with long maturities and on concessional or soft terms. The government is currently seeking financing for the remaining $3 billion, including from private sector investors in the form of PPPs. The authorities indicated that they are being guided by the principle of ensuring balanced risk sharing with the private sector and minimizing contingent liabilities. In this context, staff recommended that a legal framework governing the PPPs should be the first step to ensure proper risk management and good

[6]See Sri Lanka: Debt Sustainability Analysis 2007.

governance. Staff also advised that financing of the mega infrastructure projects should be fully accounted for in the medium-term budget framework.

34. **Staff shared its debt sustainability analysis (DSA) with the authorities, indicating that Sri Lanka has a moderate risk of external debt distress.** However, the risk of debt distress increased to moderate-to-high for total foreign exchange debt, assuming refinanced and new dollar-denominated commercial debt are at maturity of 2 years. Lengthening the maturity of the dollar-denominated debt could significantly reduce the debt service burden and improve debt dynamics.

- While the external debt-service ratios are contained, total debt service in foreign exchange, including for servicing the public domestic dollar-denominated commercial debt, is projected to increase sharply over 2008−2009 (to $600 and $800 million based on the end-2006 stock).

- An illustrative simulation, assuming full refinancing of the end-2006 debt stock at existing maturities with new money of $300 million each year starting from 2008, indicates an increased total debt service in foreign exchange to about 20−25 percent of exports over the medium term. Mitigating factors include mobilizing medium to long-term international and domestic funds to retire the short-term foreign exchange commercial debt.

- However, debt dynamics are highly sensitive to fiscal deficit, growth, exports, and interest rates. Extreme stress tests including lower growth, lower exports, and interest rate shocks, could bring total debt service in foreign exchange to around 30 percent, indicating a high risk of debt distress.

E. Financial Sector Policy[7]

35. **Since the 2002 FSAP, the authorities have made significant progress in improving financial sector stability.** Salient features include a sharp decline in the NPL ratios across banks, a marked strengthening in the capital base of the banking industry, and a sustained improvement in banks' operating profits (Table 6). Moreover, implementation of the Basel Core Principles has advanced to facilitate a planned adoption of Basel II in 2008. Nevertheless, underlying structural and operational weaknesses remain. Further efforts should focus on:

- Improving banking sector resilience to shocks through improving asset quality and strengthening credit and liquidity risk management: Stress testing indicates that more

[7]Among the issues identified by the overlapping FSAP update mission (June 20–July 2), staff focused on the issues that have significant macroeconomic implications. For details, see Sri Lanka FSAP Update, 2007.

than half of the banking system assets are highly vulnerable to interest rate and liquidity shocks, and to a lesser extent to exchange rate risk and deterioration in asset quality. The sharp rise in credit to deposit ratios (from about 80 percent in 2003 to 94 percent in 2006) suggests that banks have become increasingly reliant on commercial borrowing to fund their asset growth, thereby accentuating credit and liquidity risks in the banking system.

- Strengthening risk-based supervision: This is particularly important in view of the recent rapid growth in sectoral lending. While the expansion in private sector credit over the past few years reflects financial deepening to a large extent[8], its uneven growth and concentration across sectors is a source of concern. In particular, consumer and housing sectors grew by 59 percent and 45 percent by end-March, respectively, on top of high growth in 2006, which have contributed to asset price inflation.

- Advancing structural and operational restructuring in state-owned banks and limiting state interference: During 2002–06, NPLs in state-owned banks declined markedly while the capital base strengthened (Bank of Ceylon's capital adequacy ratio is well above the 10 percent minimum requirement). Commercial business of these banks has also shown a healthy expansion. However, state influence remains significant evidenced by large loan exposures of these banks to the government and public corporations, as well as directed lending to some sectors. Moreover, overstaffing has resulted in high personnel costs, accounting for three-quarters of total operating cost.

V. Staff Appraisal

36. **Sri Lanka's recent growth performance has been impressive, supporting a sharp reduction in unemployment and an improvement in per capita income.** Sustaining this growth momentum over the medium term will require macroeconomic stability and strengthened structural reforms to improve competitiveness, promote FDI, and enhance productivity. Emphasis should be placed on tax reforms to broaden the resource base, streamline tax incentives, improve the stability and efficiency of the financial sector, and address financial imbalances in the energy sector.

37. **Concerted policy tightening is needed in the near term to reduce inflation and vulnerabilities.** While the economy continues to show remarkable resilience against adverse shocks, near-term risks have emerged. Inflation has been rising, the external current account deficit remains large, and gross official reserves are below comfortable levels. A tighter

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[8] See Chapter III of the Selected Issues.

macroeconomic policy stance is needed to rebalance the growth-inflation outlook while ensuring balance of payments viability.

38. **A more determined fiscal consolidation in 2007 is critical for demand management and debt sustainability.** The revised lower fiscal deficit target in 2007 is a step in the right direction, but it still remains high. Additional fiscal measures may be required to contain the fiscal deficit to 7½ percent of GDP so as to limit inflationary financing and help meet the "Road Map" targets. This may call for additional rationalization of capital spending to the historical norms while protecting key development spending. Meeting the revised ambitious revenue target remains a challenge despite strong performance in the first half of 2007, and it will require continued efforts to ensure that measures introduced in 2006–07 are fully implemented. Prudence is also important going forward to limit risks of future recurrent expenditure overrun.

39. **Further monetary tightening in the near term is warranted in view of the current fiscal stance and the rate of inflation.** Further efforts are necessary to conduct open market operations so as to allow treasury security rates to adjust to levels that would help bring down inflation to single digit levels. At the same time, policy rates could be adjusted upwards gradually to align with treasury security rates, restoring its signaling role in the conduct of monetary policy and allowing a proper functioning of the standing facility in liquidity management. Timely actions on these fronts will be instrumental in ensuring macroeconomic stability.

40. **Looking ahead, greater downward flexibility in the exchange rate is needed to help reduce vulnerability and safeguard reserves in a challenging environment.** Sustained high oil prices and an emerging refinancing burden from the existing public dollar-denominated commercial debt could exert pressures on the balance of payments and will require improved exchange rate policy to manage risks. Frequent intervention may send mixed signals to the market and generate uncertainty. The authorities should limit intervention in the foreign exchange market to smoothing excessive volatility. The REER appears to be in line with economic fundamentals given the recent trade performance. Nevertheless, other indicators warrant close monitoring, particularly in view of Sri Lanka's relatively low labor productivity.

41. **Over the next few years, managing the refinancing of the public dollar-denominated commercial debt is expected to take center stage.** The key is to limit further reliance on short-term dollar-denominated commercial borrowing and managing refinancing of this debt through longer maturity while favorable market conditions last. This will need to be underpinned by sound macroeconomic policies to ensure stability and investor confidence. Continued efforts in broadening financing sources, including through remittances and long-term international market funds are crucial.

42. **Sri Lanka's medium-term debt sustainability hinges critically on the strength of fiscal consolidation and prospects for attracting nondebt-creating flows.** In this context, it is essential to advance fiscal consolidation without delay. The authorities' fiscal consolidation path to reduce the fiscal deficit to 5 percent of GDP by 2011 will help reduce the public debt stock, lower debt service pressures, and create space for productive investment over the medium term. This requires the adoption of sound and sustainable revenue enhancing measures, including extending VAT to retail and wholesale stages, further broadening the income tax base, and strengthening tax administration, supported by greater prioritization and efficiency in expenditure. Moreover, financing of the mega infrastructure projects will need to be fully incorporated in the medium-term budget framework. Efforts should also be made to establish a legal framework for PPPs to ensure that quasi-fiscal risks are minimized.

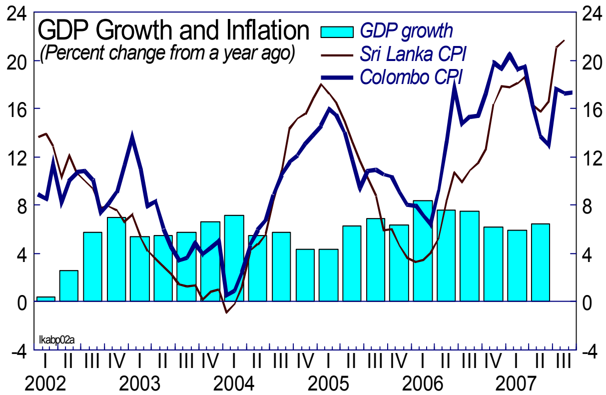
43. **Financial sector reform efforts could focus on implementing the FSAP update recommendations.** Priorities include further improving the resilience of the banking sector, strengthening risk-based supervision, advancing the preparatory work for Basel II adoption in 2008, and accelerating operational restructuring of the public banks to improve their risk management and efficiency. State interference in public bank should also be limited.

44. **The authorities' energy policy may help lower the cost of energy production over the medium term, but timely measures are needed during the transition period to address the current financial imbalances in CEB.** The most effective and sound approach is to increase electricity tariffs to cost recovery levels, starting in the 2008 budget, to help minimize the quasi-fiscal losses and potential damage to public banks. Safety net provisions could be considered to protect the poor.

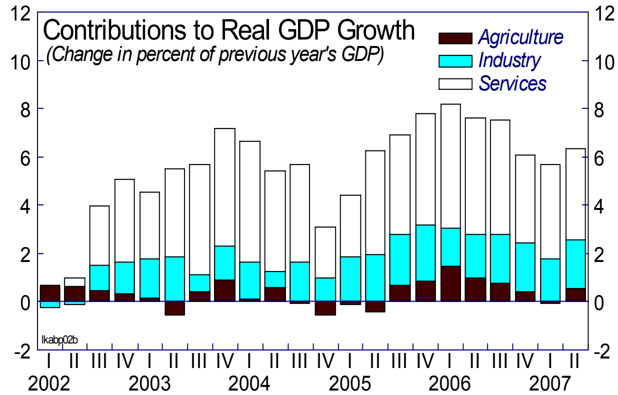
45. It is recommended that the next Article IV consultation with Sri Lanka take place on a standard 12-month cycle.

Figure 1. Sri Lanka: Real, Fiscal, and Monetary Sector Developments

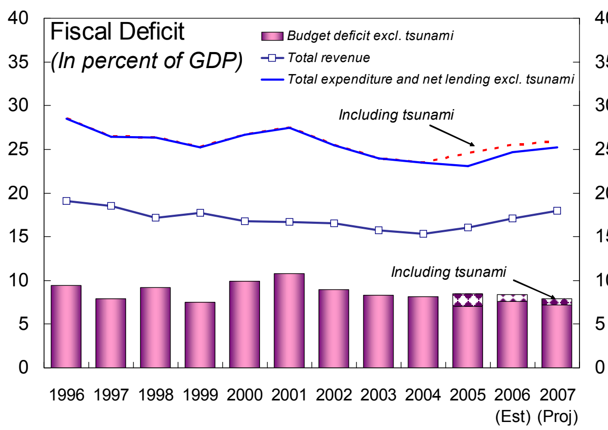
Real GDP growth was strong in 2006, however, rising demand pressure fuelled inflation.



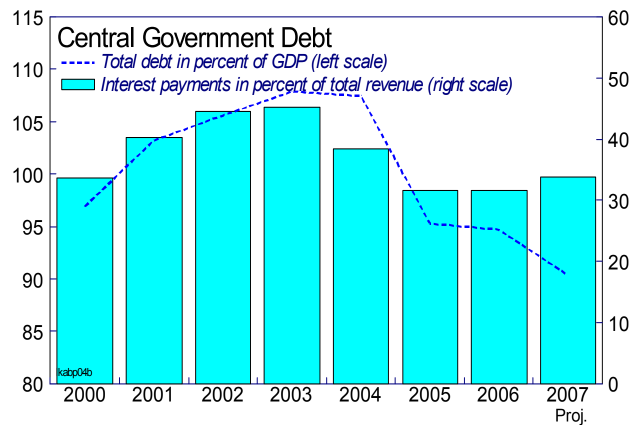
Economic growth in was robust and broad based in 2006 and this continued in the first half of 2007, though weaker than the same period last year.



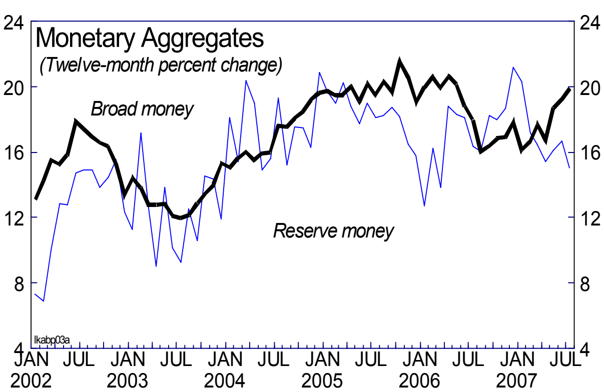
The fiscal deficit (at 8.4 percent) was below the budget target but remained high.



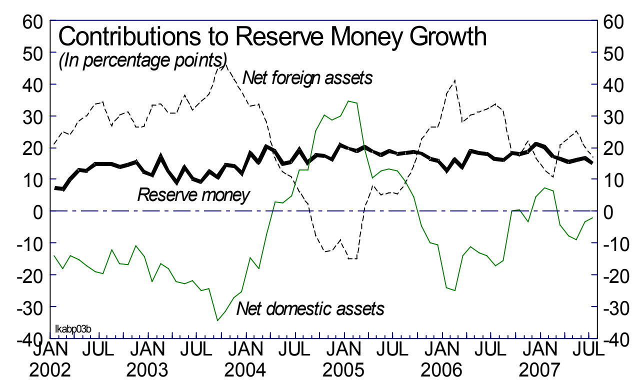
Public debt declined marginally relative to GDP.



Monetary policy aimed to facilitate growth, but was insufficient to contain inflation.



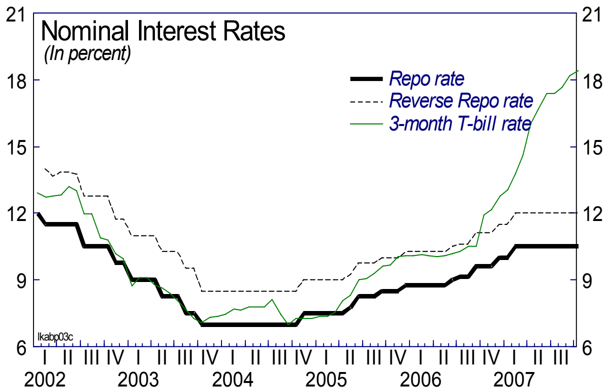
Growth in reserve money was mainly the result of an increase in net domestic assets.



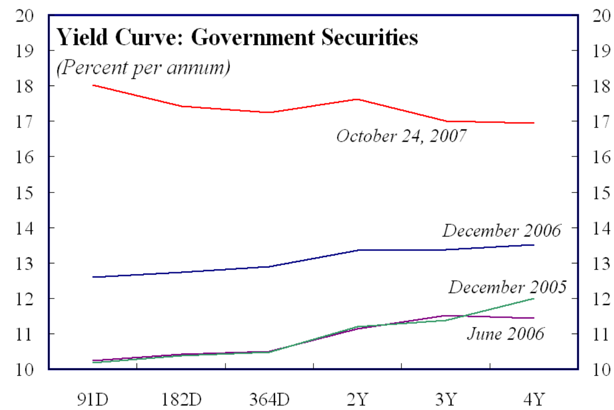
Sources: Data provided by the Sri Lankan authorities; and CEIC Data Company Ltd.

Figure 2. Sri Lanka: Financial and External Sector Developments

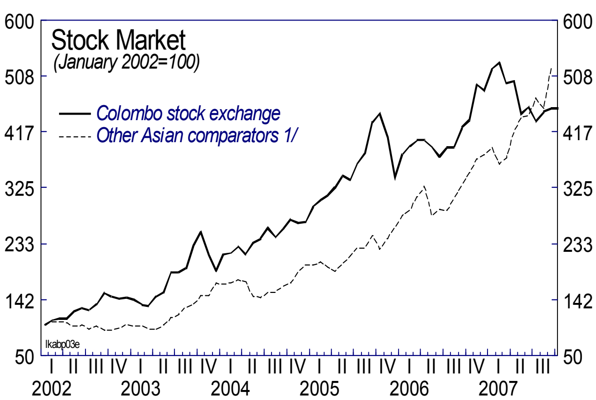
The Central Bank has allowed treasury rates to increase to close to 18 percent bringing about positive real interest rates.



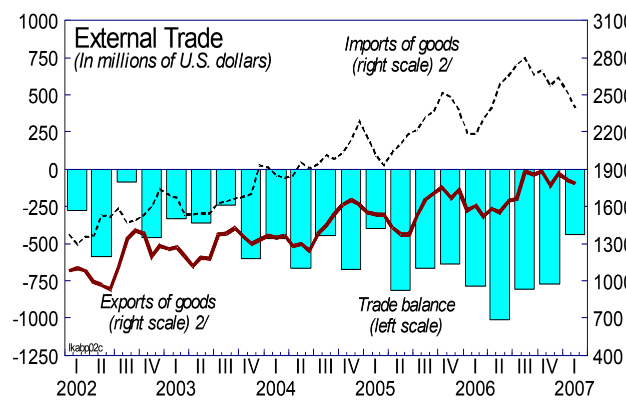
The yield curve inverted slightly recently.



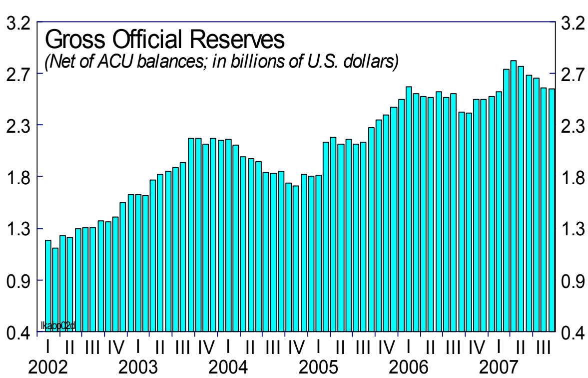
Stock market performance was strong in 2006 but showed signs of deceleration in the first half of 2007.



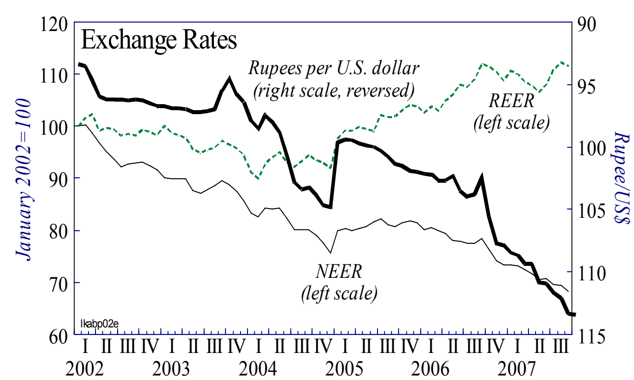
Following a deterioration in 2006, the trade deficit narowwed in the first half of 2007 owing to strong export growth and modest import growth.



Gross official reserves stand at 2.2 months of imports, about the same level as end-2006



The rupee depreciated by 5.7 percent against the dollar in 2006 and a further 5¼ percent in the first three quarters of 2007.



Sources: Data provided by the Sri Lankan authorities; Bloomberg LP and CEIC Data Company Ltd.

1/ Weighted average of indices of India, Malaysia, Indonesia, Pakistan, and Philippines.
2/ Three-month moving average.

Table 1. Sri Lanka: Selected Economic Indicators, 2004–2008

Main exports (percent of total, 2005): garment (48), tea (14)
GDP per capita (2006, est.): US$1,300
Unemployment rate (2006): 6.3 percent
Poverty rate (2004, incidence): 22 percent
FDI (2006): $451 million
Public debt (2006): 94.7 percent of GDP
Foreign public debt (percent of total, 2006): 43

	2004	2005	2006	2007	2008
				Projection	
GDP and inflation (in percent)					
Real GDP growth	5.4	6.0	7.4	6.0	6.0
Inflation (Sri Lanka CPI; average)	7.9	10.6	9.5	17.7	11.5
Inflation (Sri Lanka CPI; end-of-period)	16.8	3.6	17.9	13.0	11.0
Public finances (in percent of GDP)					
Revenue	15.3	16.1	17.1	18.3	18.6
Expenditure	23.5	24.7	25.5	26.0	24.9
Primary balance	-2.2	-3.6	-3.0	-2.6	-0.8
Overall balance	-8.2	-8.7	-8.4	-7.8	-6.3
Overall balance (excluding tsunami)	-8.2	-7.3	-7.6	-7.4	-6.3
Domestic financing	5.8	5.2	5.8	3.3	3.9
Government debt (domestic and external)	107.5	95.3	94.7	90.1	86.2
Money and credit (percent change, end of period)					
Reserve money	20.9	15.8	21.2	11.5	12.7
Broad money	19.6	19.1	17.8	16.3	14.0
Domestic credit	22.4	19.1	29.5	17.0	17.9
Private sector credit	22.1	26.3	24.0	21.9	21.0
Public sector credit	23.2	1.8	46.1	4.4	8.7
91-day T-bill rate (in percent, end of period)	7.3	10.1	12.8	19.0	14.5
Balance of payments (in millions of U.S. dollars)					
Exports	5,757	6,347	6,883	7,646	8,412
Imports	7,999	8,863	10,260	11,307	12,532
Current account balance	-646	-650	-1,339	-1,337	-1,528
Current account balance (in percent of GDP)	-3.2	-2.8	-5.0	-4.6	-4.8
Export value growth (percent)	12.2	10.2	8.4	11.1	10.0
Import value growth (percent)	19.9	10.8	15.8	10.2	10.8
Gross official reserves (end of period)					
In millions of U.S. dollars 1/	1,833	2,458	2,515	2,912	2,854
In months of imports	2.2	2.5	2.4	2.5	2.2
As a percent of short-term debt 2/	88	92	82	91	82
External debt (public and private)					
In billions of U.S. dollars	12.8	13.0	14.2	15.4	16.3
As a percent of GDP	63.9	55.4	52.8	52.6	51.6
Total stock of public dollar commercial debt 3/					
In millions of U.S. dollars	550	1,065	1,609	2,396	2,209
As a percent of GDP	2.7	4.5	6.0	8.2	7.0
As percent of gross official reserves	30	43	64	82	77
Memorandum items:					
Nominal GDP (in billions of rupees)	2,029	2,366	2,802	3,311	3,825
Nominal GDP (in billions of U.S. dollars)	20.1	23.5	26.9	29.3	31.5

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

1/ Excluding central bank Asian Clearing Union (ACU) balances.
2/ As reserves exclude ACU balances, they are also excluded from short-term debt to compute this ratio.
3/ Staff estimates based on total stock outstanding of foreign exchange commercial debt plus nonresident purchase of rupee-denominated treasury bonds.

Table 2. Sri Lanka: Monetary Accounts, 2005–2008

	2005	2006	2007			2008
	Dec.	Dec.	August	Dec.	Dec.	Dec.
	Act.	Act.	Act.	Staff proj.	Auth. Proj.	Proj.
Monetary authorities			(In billions of Sri Lankan rupees)			
Net foreign assets	197	230	252	286	268	287
Net domestic assets	1	10	5	-19	0	14
Of which : net credit to government	74	113	127	76	118	91
Reserve money	198	240	257	267	268	301
			(Contribution to reserve money growth, in percent)			
Net foreign assets	26.5	16.6	14.7	23.4	15.8	0.5
Net domestic assets	-10.7	4.5	5.5	-11.9	-4.2	12.2
Reserve money (percent change)	15.8	21.2	20.2	11.5	11.6	12.7
Monetary survey			(In billions of Sri Lankan rupees)			
Net foreign assets	205	171	178	227	172	195
Monetary authorities	197	230	252	286	268	287
Deposit money banks	8	-59	-74	-59	-96	-93
Net domestic assets	817	1,033	1,163	1,174	1,211	1,402
Domestic credit	1,067	1,382	1,562	1,617	1,603	1,907
Public sector (net)	266	389	429	406	398	441
Government (net) 1/	250	357	385	371	374	408
Public corporations	17	32	45	36	24	34
Private sector 2/	801	993	1,132	1,211	1,205	1,465
Other items (net)	-250	-349	-399	-443	-392	-504
Broad money	1,022	1,205	1,341	1,401	1,383	1,597
			(Annual percent change)			
Net foreign assets	20.3	-16.4	0.3	32.7	0.2	-14.3
Monetary authorities	29.8	16.7	14.2	24.4	16.5	0.5
Deposit money banks	-57.4	-842.6	70.7	0.0	63.9	57.8
Net domestic assets	18.7	26.4	26.4	13.6	17.2	19.5
Domestic credit	19.1	29.5	30.8	17.0	16.0	17.9
Public sector (net)	1.8	46.1	49.5	4.4	2.4	8.7
Government (net)	13.2	43.2	43.2	3.7	4.7	10.1
Public corporations	-59.5	89.3	139.3	12.7	-23.3	-5.6
Private sector	26.3	24.0	24.9	21.9	21.3	21.0
Broad money	19.1	17.8	22.2	16.3	14.8	14.0
			(Contribution to broad money growth, in percentage points)			
Net foreign assets	4.0	-3.3	0.1	4.6	0.0	-2.3
Net domestic assets	15.0	21.1	22.1	11.7	14.7	16.3
Domestic credit	20.0	30.8	33.5	19.5	18.3	20.7
Public sector (net)	0.5	12.0	13.0	1.4	0.8	2.5
Government (net)	3.4	10.5	10.6	1.1	1.4	2.7
Public corporations	-2.9	1.5	2.4	0.3	-0.6	-0.1
Private sector	19.4	18.8	20.6	18.1	17.6	18.1
Memorandum items:						
Broad money multiplier	5.2	5.0	5.2	5.2	5.2	5.3
Velocity of broad money	2.5	2.5	...	2.5	...	2.6
Private sector credit (in percent of GDP)	33.9	35.4	...	36.6	31.5	38.3
Foreign currency deposits (Rs. billions)	207.1	224.4	270.4	...	...	

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

1/ Restructuring bonds worth Rs.19.4 bn. issued by the government to the two state banks were converted to Treasury bonds upon maturity in October 2006. This amount, which previously appeared under Other items net, has been included in Net credit to the government.

2/ Includes assets and liabilities of National Development Bank that merged with NDB Bank Ltd. with effect from August 2005.

Table 3. Sri Lanka: Summary of Central Government Operations, 2006–2011
(In percent of GDP, unless otherwise indicated)

	2006	2007			2008	2009	2010	2011
		Budget	Projection	1st Half	Projection			
Total revenue	17.1	18.4	18.3	7.8	18.6	19.0	19.4	19.8
Tax revenue	15.3	16.6	16.3	6.9	16.8	17.2	17.6	18.0
Income taxes	2.9	3.1	3.4	1.4	...	...	...	...
Value added tax/GST	5.9	6.2	6.1	2.6	...	...	...	...
Excise taxes	3.3	3.3	3.3	1.3	...	...	...	...
Taxes on international trade	1.9	2.2	1.8	1.0	...	...	...	...
Other	1.4	1.8	1.7	0.6	...	...	...	...
Nontax revenue	1.7	1.8	1.9	0.9	1.8	1.8	1.8	1.8
Total expenditure and net lending	25.5	27.7	26.0	11.8	24.9	24.5	24.3	24.0
Current expenditure	19.6	18.4	19.0	9.1	18.4	18.0	17.8	17.5
Civil service wages and salaries	4.1	3.8	4.1	1.8	3.9	3.9	3.9	3.9
Other civilian goods and services	1.1	1.4	1.3	...	1.3	1.3	1.3	1.3
Security related expenditure	3.8	4.1	4.2	1.9	3.9	3.9	3.8	3.8
Subsidies and transfers	5.1	3.9	4.2	...	3.8	3.7	3.7	3.7
Households	3.7	3.1	3.3	...	...	...	...	...
Of which : Samurdhi	...	0.0	0.3	...	...	...	...	...
pensions	...	1.9	2.1	1.0	2.0	2.0	2.0	2.0
petroleum	...	0.0	0.0	...	…	…	…	…
tsunami	...	...	...	...	…	…	…	…
Institutions, corporations, other government agenc	1.4	...	0.9	...	...	...	...	...
Interest payments 1/	5.4	5.2	5.2	2.5	5.5	5.2	5.1	4.8
Foreign	0.6	...	0.7	0.3	0.7	0.7	0.7	0.7
Commercial			0.4	...	0.4	0.4	0.4	0.4
Domestic	4.8	...	4.1	...	4.4	4.1	4.1	3.8
Capital expenditure and net lending	5.9	9.3	7.0	2.7	6.5	6.5	6.5	6.5
Of which : tsunami	0.8	0.7	0.4	0.0	0.1	0.0	0.0	0.0
mega projects		3.6	1.6	-2.3	1.5	1.5	1.5	1.5
Overall balance	-8.4	-9.2	-7.8	-3.5	-6.3	-5.5	-4.9	-4.2
Overall balance (without tsunami measures) 1/	-7.6	-8.6	-7.4	...	-6.3	-5.5	-4.9	-4.2
Financing	8.4	9.2	7.8	3.9	6.3	5.5	4.9	4.2
Net external financing	1.5	3.7	3.7	0.9	1.9	1.9	1.7	1.5
Net commercial borrowing	1.9	...	0.0	...	1.0	0.9	0.8	0.7
Net other domestic financing	3.9	4.8	3.3	...	3.0	2.3	2.0	1.6
Privatization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	1.1	0.7	0.8	0.5	0.5	0.4	0.4	0.4
Memorandum items:								
Current account balance (excluding grants)	-2.5	0.1	-0.8	-1.3	0.2	1.0	1.6	2.3
Primary balance (excluding grants)	-3.0	-4.0	-2.6	-1.4	-0.8	-0.3	0.2	0.6
Primary balance (including grants)	-2.0	-3.3	-1.8	-1.0	-0.3	0.1	0.6	1.0
Paris Club debt moratorium	...				...	...	...	...
Nominal GDP (in billions of rupees)	2,802	3,242	3,311	...	3,825	4,420	5,106	5,900
Total debt	94.7	93.3	90.1	...	86.2	82.1	77.8	73.0
Of which : domestic debt	54.3	51.7	49.2	...	46.5	43.4	40.4	37.3

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

1/ Measures include tsunami expenditure and in 2005 interest savings from Paris Club debt moratorium.

Table 4. Sri Lanka: Balance of Payments, 2006–2012

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

	2006	2007	2008	2009	2010	2011	2012
	Act.	Projection					
Current account	-1,339	-1,337	-1,528	-1,467	-1,351	-1,251	-1,223
Trade balance	-3,377	-3,661	-4,120	-4,379	-4,639	-4,942	-5,263
Exports	6,883	7,646	8,412	9,199	10,056	10,957	11,940
Of which: textiles and garments	3,080	3,428	3,671	3,893	4,129	4,379	4,644
Imports	10,260	11,307	12,532	13,577	14,695	15,899	17,203
Non-oil imports	8,192	8,992	9,871	10,840	11,845	12,907	14,051
Oil imports	2,068	2,315	2,661	2,737	2,850	2,992	3,152
Services	257	283	287	308	346	398	362
Receipts	1,625	1,788	1,913	2,047	2,190	2,343	2,413
Income	-389	-404	-424	-445	-468	-491	-516
Transfers	2,170	2,445	2,729	3,050	3,409	3,784	4,194
Private (net)	2,069	2,359	2,677	2,998	3,358	3,728	4,138
Official (net)	101	87	52	52	51	56	56
Capital and financial account	1,808	1,736	1,541	1,725	1,635	1,748	1,747
Capital transfers (net)	291	219	190	166	77	78	80
Financial account	1517	1517	1351	1559	1558	1670	1667
Long-term flows	907	1170	894	1091	1088	1238	1233
Direct investment	451	350	420	483	572	658	724
Private sector borrowing 1/	-35	55	25	100	40	130	130
Official sector borrowing	491	765	449	508	475	450	379
Disbursements	932	1,320	1,069	1,118	950	950	1,400
Of which: Program	35	20	35	40	50	50	50
Of which: Project	897	800	1034	1078	900	900	850
Amortization	442	555	620	610	475	500	1021
Short-term flows	610	347	457	468	470	432	434
Errors and omissions	-264	0	0	0	0	0	0
Overall balance	204	399	13	258	284	497	524
Financing	-204	-399	-13	-258	-284	-497	-524
Debt service moratorium	0	0	0	0	0	0	0
Gross reserves	-57	-396	58	-161	-247	-480	-506
Reserve liabilities (- is outflow)	-147	-3	-71	-97	-37	-17	-17
Memorandum items:							
Current account (in percent of GDP)	-5.0	-4.6	-4.8	-4.3	-3.7	-3.1	-2.8
Non-oil current account (in percent of GDP)	2.7	3.3	3.6	3.7	4.1	4.3	4.4
Tsunami Inflows	386	105	100	75	0	0	0
Export growth (in percent)	8.4	11.1	10.0	9.4	9.3	9.0	9.0
Import growth (in percent)	15.8	10.2	10.8	8.3	8.2	8.2	8.2
Oil	25.0	11.9	14.9	2.9	4.1	5.0	5.4
Gross official reserves 2/ 3/	2,515	2,912	2,854	3,015	3,262	3,742	4,248
(In months of imports of goods and nonfactor services)	2.4	2.5	2.2	2.2	2.2	2.3	2.5
(In percent of short-term debt)	82	91	82	81	83	95	107
Net international reserves	2,280	2,679	2,692	2,950	3,234	3,731	4,255
Gross fx commercial borrowing (SLDBS and FCBUs) 4/	1,135	421	831	1,313	1,341	1,613	1,641
Amortization (SLDBS and FCBUs) 4/	491	421	531	1,013	1,041	1,313	1,341
Net fx commercial borrowing (SLDBs and FCBUs) 4/	644	0	300	300	300	300	300
Total stock of public commercial dollar debt 5/	1,609	2,396	2,209	…	…	…	…
GDP (US$ millions)	26,947	29,280	31,531	34,133	36,982	40,310	44,155
Oil price (US$ per barrel)	64.3	68.5	75.0	72.3	70.5	69.5	68.8

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

1/ Includes public corporations.
2/ Net of ACU debit balances.
3/ Valued at historical cost through 2002, and at market cost ince then.
4/ Comprises Sri Lanka Development Bonds (SLDBs), Foreign Currency Banking Union (FCBU) borrowing and other commercial loans.
5/ Comprises SLDBs, FCBUs, other commercial loans. For 2007 includes $287 million nonresident purchase of rupee treasury bonds and $500m Eurobond issue. Does not include bilateral/multilateral external liabilities.

Table 5. Sri Lanka: Medium-Term Macroeconomic Framework, 2006–2012

	2006	2007	2008	2009	2010	2011	2012
		Projection					
Real sector (percent change)							
Real GDP	7.4	6.0	6.0	6.0	6.0	6.0	6.0
Contribution of domestic demand	10.1	5.8	7.5	8.4	8.7	8.8	8.7
Contribution of external demand	-2.8	0.2	-1.6	-2.4	-2.7	-2.8	-2.7
Inflation (Sri Lanka CPI; average)	9.5	17.7	11.5	10.5	9.5	9.0	8.5
Inflation (Sri Lanka CPI; end-of-period)	17.9	13.0	11.0	10.0	9.5	9.0	8.5
Savings-investment balance (in percent of GDP)							
Gross national saving	23.7	25.3	25.0	25.9	27.1	28.1	29.5
Gross domestic investment	28.7	29.9	29.9	30.2	30.7	31.2	32.3
Private	24.8	25.3	25.6	26.0	26.5	27.0	28.0
Public	3.8	4.6	4.3	4.2	4.2	4.2	4.3
Public finances (in percent of GDP)							
Total revenue	17.1	18.3	18.6	19.0	19.4	19.8	19.9
Total expenditure and net lending	25.5	26.0	24.9	24.5	24.3	24.0	23.9
Current expenditure	19.6	19.0	18.4	18.0	17.8	17.5	17.3
Of which : interest payments	5.4	5.2	5.5	5.2	5.1	4.8	4.5
Capital expenditure and net lending	5.9	7.0	6.5	6.5	6.5	6.5	6.6
Overall balance	-8.4	-7.8	-6.3	-5.5	-4.9	-4.2	-4.0
Overall balance (excluding tsunami)	-7.6	-7.4	-6.3	-5.5	-4.9	-4.2	-4.0
Primary balance	-3.0	-2.6	-0.8	-0.3	0.2	0.6	0.5
Net external financing (including grants)	2.6	4.5	2.4	2.3	2.1	1.9	1.0
Net domestic financing	5.8	3.3	3.9	3.2	2.9	2.3	2.9
Assets sales	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total government debt	94.7	90.1	86.2	82.1	77.8	73.0	68.4
Of which : domestic debt	54.3	49.2	46.5	43.4	40.4	37.3	35.3
Balance of payments (in percent of GDP)							
Trade balance	-12.5	-12.5	-13.1	-12.8	-12.5	-12.3	-11.9
Current account balance	-5.0	-4.6	-4.8	-4.3	-3.7	-3.1	-2.8
Overall balance	0.8	1.4	0.0	0.8	0.8	1.2	1.2
Gross official reserves (in millions of U.S. dollars) 1/	2,515	2,912	2,854	3,015	3,262	3,742	4,248
(in months of imports of goods and services)	2.4	2.5	2.2	2.2	2.2	2.3	2.5
Total external debt (public and private)	52.8	52.6	51.6	50.5	49.2	47.6	45.7
Money and credit (in percent of GDP)							
Reserve money	8.6	8.1	7.9	7.7	7.5	7.3	7.1
Broad money	43.0	42.3	41.7	41.0	40.3	39.6	38.9
Domestic credit	49.3	48.8	49.8	50.2	50.5	50.7	50.4
Private sector credit	35.4	36.6	38.3	39.6	40.7	41.7	41.2
Public sector credit	13.9	12.3	11.5	10.6	9.8	9.0	9.2
Memorandum item:							
Oil price (U.S. dollar per barrel)	64.3	68.5	75.0	72.3	70.5	69.5	68.8

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

1/ Excluding central bank Asian Clearing Union (ACU) balances.

Table 6. Sri Lanka: Vulnerability Indicators, 2002–2006

(In percent of GDP, unless otherwise indicated; end-of-period)

	2002	2003	2004	2005	2006
Banking sector indicators 1/					
Nonperforming loans (as percent of total loans)	14.5	12.5	8.9	6.8	5.4
Risk-based capital asset ratio (total capital over risk-weighted assets)	10.3	10.3	10.3	12.8	11.9
Financial indicators					
Broad money (percent change, 12-month basis) 2/	13.4	15.3	19.6	19.1	17.8
Private sector credit (percent change, 12 month basis) 2/	12.0	16.9	22.1	26.3	24.0
Share of deposits in broad money 2/	87.9	88.1	88.4	88.8	88.8
Share of foreign currency deposits in total deposits 2/	22.1	21.7	23.8	22.8	21.0
Stock market index (ASPI; 1985=100)	815	1,062	1,507	1,922	2,722
External indicators					
Exports (annual percent change)	-2.4	9.2	12.2	10.2	8.4
Imports (annual percent change)	2.2	9.3	19.9	10.8	15.8
Current account balance (excluding official transfers)	-1.6	-0.6	-3.4	-3.2	-5.3
Capital and financial account balance	2.7	3.6	2.8	5.2	6.7
Of which : portfolio investment	0.2	0.0	0.1	0.3	0.2
Medium- and long-term inflows, net	2.0	3.6	3.1	3.4	3.4
Foreign direct investment	1.1	0.9	1.1	1.0	1.7
Exchange rate (Sri Lankan rupee per U.S. dollar, period average)	95.7	96.5	101.2	100.5	104.0
Reserves indicators					
Gross official reserves (millions of US$; excl. ACU balance)	1,560	2,146	1,833	2,458	2,515
As percent of broad money	24.2	28.8	22.4	24.5	22.5
As percent of short-term debt 3/ 4/	79.6	109.0	87.5	92.1	82.1
Debt indicators					
Government debt (domestic and external)	105.6	107.9	107.5	95.3	94.7
Total external debt (public and private)	62.6	63.0	63.9	55.4	52.8
Debt service (as percent of exports goods & services)	12.3	10.9	10.1	7.4	11.5
Short-term debt (in percent of GDP) 3/ 4/	9.7	9.1	10.4	9.9	9.8

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

1/ Indicators are weighted averages of individual bank data.
2/ Including foreign currency banking units (FCBUs).
3/ Includes CPC acceptance credits, other trade credits, central bank ACU balances, and commercial bank liabilities.
4/ Based on residual maturity, including amortization of public and publicly guaranteed debt.

Table 7. Sri Lanka: Projected Payments to the Fund, 2006–2012

(In millions of SDRs, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments 1/	104.4	1.7	46.0	62.8	24.0	11.1	11.1
Charges/interest 1/	8.8	7.5	9.4	6.6	4.0	3.4	3.2
Stock of outstanding use of Fund resources	162.4	160.7	114.6	51.8	27.8	16.7	5.6
Memorandum items:							
Debt service							
Payments to the Fund/exports GNFS	2.0	0.1	0.8	1.0	0.4	0.2	0.2
Payments to the Fund/Quota	27.4	2.2	13.4	16.8	6.8	3.5	3.4
Payments to the Fund/GDP	0.6	0.0	0.3	0.3	0.1	0.1	0.1
Payments to the Fund/reserves	6.6	0.5	3.0	3.6	1.3	0.6	0.5
Outstanding use of Fund resources							
Outstanding UFR/exports GNFS	2.8	2.6	1.7	0.7	0.4	0.2	0.1
Outstanding UFR/quota	39.3	38.9	27.7	12.5	6.7	4.0	1.3
Outstanding UFR/GDP	0.9	0.8	0.6	0.2	0.1	0.1	0.0
Outstanding UFR/reserves	9.5	8.4	6.2	2.7	1.3	0.7	0.2

Source: Fund staff estimates.

1/ On an obligation basis.

Table 8. Sri Lanka: Millennium Development Goals 1/

	1990	2002	2004	2006
Eradicate extreme poverty and hunger 2/	(2015 target = halve 1990 $1 a day poverty and malnutrition rates)			
Income share held by lowest 20 percent	9.0	7.0	...	…
Malnutrition prevalence, weight for age (in percent of children under 5)	...	29.4	...	…
Poverty gap at $1 a day - PPP (in percent)	0.7	0.8	...	…
Poverty headcount ratio at $1 a day - PPP (in percent of population)	3.8	5.6	...	…
Poverty headcount ratio at national poverty line (in percent of population)	20.0	...	...	…
Prevalence of undernourishment (in percent of population)	...	...	22.0	…
Achieve universal primary education 3/	(2015 target = net enrollment to 100)			
Literacy rate, youth total (in percent of people ages 15-24)	95.1	…	…	95.6
Persistence to grade 5, total (in percent of cohort)	92.2	…	...	…
Primary completion rate, total (in percent of relevant age group)	92.2	...	...	…
School enrollment, primary (in percent of net)	...	...	97.2	…
Promote gender equality 4/	(2005 target = education rate to 100)			
Proportion of seats held by women in national parliament (in percent)	5.0	5.0	4.0	4.9
Ratio of girls to boys in primary and secondary education (in percent)	100.7	102.3	102.4	…
Ratio of young literate females to males (in percent of ages 15-24)	98.3	…	…	101.1
Share of women employed in the nonagricultural sector (in percent of total nonagricultural employment)	39.1	37.3	43.2	…
Reduce child mortality 5/	(2015 target = reduce 1990 under 5 motality by two thirds)			
Immunization, measles (in percent of children ages 12-23 months)	80.0	99.0	96.0	99.0
Mortality rate, infant (per 1,000 live births)	25.6	16.1	…	12.0
Mortality rate, under-5 (per 1,000)	32.3	19.4	…	14.0
Improved maternal health 6/	(2015 target = reduce 1990 maternal mortality by three fourths)			
Births attended by skilled health staff (in percent of total)	...	96.0	...	…
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	92.0	...	…
Combat HIV/AIDS, malaria, and other diseases 7/	(2015 target = halt, and begin to reverse, AIDS, etc.)			
Children orphaned by HIV/AIDS	...	...	...	…
Contraceptive prevalence (in percent of women ages 15-49)	...	70.0	...	…
Incidence of tuberculosis (per 100,000 people)	60.5	60.5	60.5	…
Prevalence of HIV, female (in percent of ages 15-24)	...	0.0	...	
Prevalence of HIV, total (in percent of population ages 15-49)	...	…	0.1	0.1
Tuberculosis cases detected under DOTS (in percent)	...	66.2	70.2	85.8
Ensure environmental sustainability 8/	(2015 target = various /1)			
CO2 emissions (metric tons per capita)	0.2	0.6	0.5	…
Forest area (in percent of land area)	36.4	32.2	…	29.9
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	7.3	8.6	8.3	…
Improved sanitation facilities (in percent of population with access)	64.0	…	89.0	…
Improved water source (in percent of population with access)	68.0	…	79.0	…
Nationally protected areas (in percent of total land area)	...	...	13.5	…
Develop a global partnership for development 9/	(2015 target = various /2)			
Aid per capita (current U.S. dollars)	42.8	18.1	26.7	60.6
Debt service (PPG and IMF only, in percent of exports of Goods and Services, excl. workers' remittances)	15.0	10.0	9.0	…
Fixed line and mobile phone subscribers (per 1,000 people)	7.2	95.5	164.8	234.7
Internet users (per 1,000 people)	0.0	8.0	14.5	…
Personal computers (per 1,000 people)	0.2	9.3	27.2	…
Total debt service (in percent of exports of goods, services and income)	13.8	9.8	8.6	…
Unemployment, youth female (in percent of female labor force ages 15-24)	46.9	30.9	39.8	37.1
Unemployment, youth male (in percent of male labor force ages 15-24)	22.8	19.9	22.5	20.1
Unemployment, youth total (in percent of total labor force ages 15-24)	33.3	23.6	28.9	26.2
General indicators				
Fertility rate, total (births per woman)	2.5	2.0	1.9	1.9
GNI per capita, Atlas method - current (in U.S. dollars)	470.0	850.0	1,000.0	1,160.0
GNI, Atlas method - current (in billions of U.S. dollars)	7.9	16.1	19.5	22.8
Gross capital formation (in percent of GDP)	22.6	21.2	25.0	26.2
Life expectancy at birth, total (years)	71.2	73.9	…	74.7
Literacy rate, adult total (in percent of people ages 15 and above)	88.7	...	…	90.7
Population, total (in millions)	17.0	19.0	19.5	19.6
Trade (exports and imports of goods and services, in percent of GDP)	67.2	78.9	81.9	79.6

Source: *World Development Indicators* database, April 2007

1/ In some cases the data are for earlier or later years than those stated.
2/ Halve between 1990 and 2015 the proportion of people whose income is less than one dollar a day. Halve between 1990 and 2015 the proportion of people who suffer from hunger.
3/ Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.
4/ Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.
5/ Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.
6/ Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.
7/ Have halted by 2015 and begun to reverse the spread of HIV/AIDS. Have halted by 2015 and begun to reverse the incidence of malaria and other major diseases.
8/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water.
9/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states.

INTERNATIONAL MONETARY FUND

SRI LANKA

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

November 7, 2007

Contents Page

ANNEX I: SRI LANKA—FUND RELATIONS

(As of September 30, 2007)

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	489.58	118.43
Reserve position in Fund	47.86	11.58

III. **SDR Department**	SDR Million	Percent Allocation
Net cumulative allocation	70.87	100.00
Holdings	0.33	0.47

IV. **Outstanding Purchases and Loans**	SDR Million	Percent Quota
Emergency Assistance	103.35	25.00
Extended arrangements	20.67	5.00
PRGF arrangements	38.39	9.29

V. **Financial Arrangements**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	Apr 18, 2003	Apr 17, 2006	144.40	20.67
PRGF	Apr 18, 2003	Apr 17, 2006	269.00	38.39
Stand-by	Apr 20, 2001	Sep 19, 2002	200.00	200.00

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

	2007	2008	2009	2010	2011
Principal	1.72	46.04	62.80	24.04	11.12
Charges/interest	2.43	8.67	6.13	3.65	3.15
Total	4.16	54.71	68.92	27.70	14.27

VII. Exchange Rate Arrangement

Managed float. The central bank floated the rupee on January 23, 2001. The CBSL has removed the foreign exchange regulations that were imposed after the float. All import margin requirements (50 percent) with respect to certain goods (which are a "normal short term banking and credit facility" under Article XXX(d)), introduced in last October, were removed in May 2007, but the 100 percent margin requirements on the import of certain vehicles remain in place.

VIII. Safeguards Assessment

Under the Fund's safeguards assessment policy, the CBSL is subject to a full safeguards assessment with respect to the PRGF arrangement which was approved on April 18, 2003. The assessment was completed on July 30, 2003 and concluded that the CBSL had made commendable progress in strengthening its safeguards since the 2001 assessment. As a result, the risk ratings have been upgraded in four of the five areas of the safeguards framework. The report found a few remaining vulnerabilities that could be addressed through a series of measures to further strengthen the CBSL's operations. The authorities have already implemented most of the proposed measures, including the full implementation of International Accounting Standards, and committed to implementation of the outstanding ones, including in the context of the new Central Banking Act.

IX. Article IV Consultation

It is expected that the next Article IV consultation with Sri Lanka will be in accordance with the provisions applying to countries on the standard consultation cycle. The Executive Board is expected to conclude the 2007 Article IV consultation on October 29, 2007.

X. FSAP and ROSC Participation

- MFD: Both the FSSA and the FSAP reports were completed in 2002.
- MCM: An FSAP update took place in June 2007.
- STA: A data ROSC was completed and the report published in 2002.

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

XI. **Resident Representative**

The resident representative office in Colombo was closed in January 2007.

ANNEX II: SRI LANKA—RELATIONS WITH THE WORLD BANK GROUP[9]

(As of October 12, 2007)

The Bank's last Country Assistance Strategy (CAS) for Sri Lanka was presented at a time of great optimism in April 2003. Since that time, much has happened in Sri Lanka—most notably, the devastating tsunami in December 2004. In addition, the peace talks have stalled and the country is engulfed in renewed violence. While average growth has remained at about 5-6 percent, this has not been adequate for significantly reducing poverty beyond urban areas. The fiscal situation remains under stress and needed reforms have proved elusive in the face of the political instability. In short, the political constraints and uncertainties have affected the peace process, policy implementation and the environment for pro-poor, broad-based economic growth.

A. IMF-World Bank Collaboration in Specific Areas

World Bank Activities

Support on the implementation of reforms in public administration and public expenditure management, include the ***e-Sri Lanka Development Project*** that aims to enhance growth, employment and equity by promoting affordable access to and wide use of on-line public information and services by citizens and businesses and private sector competitiveness, particularly of knowledge industries and small and medium enterprises. The Bank has also led the dialogue on public expenditure issues, primarily to assist in the efforts to implement a medium term budget framework (MTBF).

In the health sector, the ongoing ***National HIV/AIDS Prevention*** project is assisting in curbing the spread of HIV infection. The Bank also worked closely with the authorities in developing a health sector strategy/program that resulted in the financing of the ***Health Sector Development*** operation. Analytical work is underway on ageing and was recently completed on nutrition.

In the education sector, the Bank is involved in the ***Education Sector Development Project*****,** which promotes equitable access to and improved quality of basic and secondary education. With regard to reform of the tertiary sector, Bank support is being provided through the ***Improving the Relevance and Quality of Undergraduate Education*** project.

In rural development**,** the Bank completed a major study—*"Sri Lanka: Promoting Agricultural and Rural Non-Farm Sector Growth"*—that identified key constraints, including poor access to critical infrastructure and services, ineffective public sector

[9] Prepared by the World Bank staff.

expenditure programs, poor flow of information on technology transfer and dominance of public sector as a service provider and underutilization of private sector initiatives. Another major study focuses on the constraints to and actions needed to sustain the growth of the tea and rubber sectors, and to improve the welfare of the large number of tea and rubber dependent households. The ***Community Development and Livelihood "Gemi Diriya"*** project addresses poverty reduction and reinvigoration of the rural economy.

In the area of peace and reconstruction of the North and East (NE), the ***North East Irrigated Agriculture Project II*** (NEIAP II) helps conflict-affected communities in the NE and adjoining areas in restoring livelihoods, enhancing agricultural and other production and incomes, and building capacity for sustainable, social and economic reintegration. To address housing needs, the ***North East Housing Reconstruction Project*** (NEHRP) is providing the poorest conflict-affected families in the NE (that meet accepted vulnerability criteria) with improved and affordable housing units. The ***Sri Lanka Puttalam Housing Project*** supports the integration of internally displaced persons (IDPs) in Puttalam by upgrading and improving the habitat, water and sanitation facilities of both IDPs and select non-IDPs.

To assess and improve the environment for the private sector, the Bank and ADB jointly conducted a comprehensive **Investment Climate Assessment** (ICA) of the urban formal sector and entrepreneurship in the rural areas. The ***Legal and Judicial Reform Project,*** which closed in early 2007 with a second stage now under preparation, focused on making the existing legal and judicial framework more efficient, transparent and responsive.

Through the ***Renewable Energy for Rural Economic Development*** (RERED) project, the Bank is helping to improve the quality of rural life by utilizing off-grid renewable energy technologies to bring electricity to remote communities and promote private sector power generation from renewable energy resources from the main grid. In addition, through the ***Second Community Water Supply and Sanitation*** (CWSSP II) project, the Bank is supporting the implementation of demand-responsive and sustainable rural water and sanitation services. A large ***Road Sector Assistance Project*** aims to lower transportation costs through sustainable delivery of an efficient national road system.Related to the tsunami, the Bank—in collaboration with ADB and Japan Bank for International Cooperation—conducted a preliminary damage and needs assessment and released a joint report in early February 2005. The assessment formed the basis for a ***Tsunami Emergency Recovery Program*** (TERP) covering roads, rail, power, water, housing, health, education and livelihoods.

World Bank and IMF Collaboration

The Bank and the IMF are working closely together on financial sector issues. The Bank is embarking on a ***Corporate Governance Review of the Banking Sector***, which will complement the upcoming IMF FSAP review. Previously, a completed sector work entitled *"Sri Lanka: Improving Access to Financial Services"* highlighted numerous opportunities for promoting higher financial inclusion and points to the need for a multi-pronged approach to address current gaps and serve the diverse needs of households and businesses.

Finally, given the importance of trade to achieving Sri Lanka's growth and poverty reduction objectives, the Bank carried out a trade policy analysis as part of the last Development Policy Review. The contribution of the IMF will continue to be on supporting trade reforms focused on making progress toward a simplified and transparent two-band tariff system, including reducing agricultural protection.

B. World Bank Group Strategy and Lending Operations

Country Assistance Strategy. The CAS for Sri Lanka was considered by the Bank's Board on April 1, 2003. The CAS was designed to support the 2003 PRSP's three core themes: peace, growth and equity. In December 2005, a CAS Progress Report was prepared to reflect the significantly changed operating environment. While the program continues to provide strong support to the peace and equity pillars along with the added assistance to tsunami-related reconstruction and recovery, the emphasis of the program has shifted with regard to the growth pillar. In this revised program of support, there is a strong bias towards lending operations that: (i) support human development; (ii) further recovery in the conflict-affected areas; and (iii) assist roads and irrigation as the core infrastructure needed to support-pro-poor growth via reduced transport costs and sustained access to water for agriculture. A new CAS is now under preparation and will to go to the Board in mid-FY08.

Bank Assistance Program in Sri Lanka. The Bank's active portfolio as of October 12, 2007 comprises 13 IDA credits/grants and one Global Environmental Facility (GEF) grant for a total commitment (net of cancellation) of $778.4 million (Table II.1). The FY07 lending program included one new project (Puttalam Housing) approved in February 2007 and a supplemental financing (Renewable Energy) approved in June 2007.

Economic and Sector Work. A number of important sector reports/policy notes were completed during FY04–FY07, including: *Treasures of the Education System in Sri Lanka: Restoring Performance, Expanding Opportunities and Enhancing Prospects; Sri Lanka: Improving the Rural and Urban Investment Climate; Post-Tsunami Recovery Program: Preliminary Damage and Needs Assessment; Sri Lanka Development Forum: The Economy, The Tsunami and Poverty Reduction; Attaining the Millennium Development Goals in Sri Lanka; Sri Lanka: Improving Access to Financial Services; Decentralization and Service Delivery in Sri Lanka: Assessment and Options; Poverty Assessment for Sri Lanka—Engendering Growth with Equity: Opportunities and Challenges; and Tea and Rubber Sector Review.*

Other key diagnostic work completed over the last few years includes the Country Procurement Assessment Review (CPAR), Country Financial Accountability Assessment (CFAA), ROSC Accounting and Auditing Assessment, Health Sector Policy Note and Roads Policy Note. Economic and sector work currently under way includes work on ageing, corporate governance in the banking sector, higher education, private renewable energy and growth potential in lagging regions.

Table II.1. Summary of World Bank Operations
(As of September 30, 2007)

Credit/ Grant #	FY[1/]	Name of Operation	IDA Amount	GEF Amount	Undisbursed[2/]
			In millions of US$		
3673	2002	Renewable Energy for Rural Economic Development	115.0		43.8
3781	2003	Improving Relevance and Quality of Undergraduate Education	40.3		19.0
H013	2003	National HIV/AIDS Prevention	12.6		7.5
H035	2003	Second Community Water	39.8		18.8
H078	2004	Community Development and Livelihood	51.0		27.2
H095	2004	Health Sector Development	60.0		22.5
3935	2004	North-East Irrigated Agricultural Project II	64.7		55.4
4014	2005	North East Housing Reconstruction Program	75.0		37.2
3986	2005	E-Sri Lanka Development	53.0		37.3
4039/ H147	2005	Tsunami Emergency Reconstruction Program Phase II	75.0		4.6
H196	2006	Education Sector Development Project	60.0		44.4
4138	2006	Road Sector Assistance	100.0		72.6
4261	2007	Puttalam Housing	32.0		30.6
GEF Projects[4/]					
51248	2002	Renewal Energy for Rural Economic Development[5/]		8.0	0.9
		Total	778.4	8.0	422.0

[1/] FY is the fiscal year of Board approval.
[2/] All loan accounting is done in SDR. As these figures are in U.S. dollars, exchange rate fluctuations may result in undisbursed balances that are greater than original principal amounts.
[3/] LIL: Learning and Innovation Loan.
[4/] Global Environment Facility.
[5/] Not counted as a separate project.

IFC's Activities in Sri Lanka. As of September 30, 2007, IFC's held portfolio in Sri Lanka consisted of investments in eight companies, with a total committed exposure of US$155 million. The portfolio is spread over financial institutions, power, health care, manufacturing, ports and telecommunications. Greater investment involvement is linked to progress on the political/security situation. IFC remains interested in investing in Sri Lanka (especially in infrastructure, manufacturing and financial markets) depending upon progress on reforms. In FY06, IFC opened a dedicated small and medium enterprise development technical assistance program for Sri Lanka and the Maldives under the South Asia Enterprise Development Facility ('IFC-SEDF'). The IFC and the Governments of the Netherlands and Norway have provided the initial funding of US$5.5 million. Fund raising efforts are continuing and Program activities will be expanded as more donors participate in the Program. The program aims to support the growth of SMEs through three components:

Access to Finance, Value Addition to Firms (VAF) and Business Enabling environment. It contributes to broader-based economic growth, and hence to sustainable poverty reduction in Sri Lanka and Maldives.

Questions may be referred to Elaine Tinsley (458-4920) and on IFC to Neil Gregory (473−8559).

ANNEX III: SRI LANKA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Sri Lanka has received $3.76 billion for 135 public sector loans and $93.90 million for 223 technical assistance projects since joining the Asian Development Bank (ADB) in 1966. As of December 2006, there were 47 ongoing public sector loans for a total loan amount of $1.7 billion, including $156 million in three program loans and one from the Asian Tsunami Fund. Of these 47 loans, 12 were financed from ordinary capital resources (OCR) and 34 from the Asian Development Fund (ADF).

The Asian Development Bank approved supplementary financing of $60 million for the Secondary Towns and Rural Community-Based Water Supply and Sanitation Project in 2006. The project has a significant community participation component, involving all stakeholders in project design, which is especially relevant for its components in the north and east of the country. Some of the loans scheduled for 2006 were postponed to 2007, but lot of work was completed in 2006. The project to expand Colombo Port moved ahead with a memorandum of understanding signed between the minister of ports and aviation and ADB in September 2006. The bulk of the work for a small and medium-sized enterprise development project was completed in 2006. Major progress has been made on the upgrading of a major expressway to the south to four lanes.

ADB approved four technical assistance grants in 2006 for a total of $ 2.3 million.

ADB is working on the new Country Partnership Strategy (CPS) for Sri Lanka in 2007. The new strategy will determine ADB's assistance program for the next three years, including the sectors and project pipeline. The new CPS will take into consideration the conflict situation, within which operations have to be carried out. It will also reflect government priorities outlined in the national strategy, the "Mahinda Chinthana."

ADB's top priorities in Sri Lanka are supporting broad-based economic growth, advancing social development and supporting improved governance. Emphasis will be placed on poorer regions and those encountering particular hardship.

As of December 2006, the sectoral distribution of the loan portfolio was Agriculture and Natural Resources, 14 percent; Education, 10 percent; Energy, 6 percent; Finance, 8 percent; Industry and Trade, 4 percent; Law, Economic Management and Public Policy, 4 percent; Transport and Communications, 24 percent; Water Supply, Sanitation and Waste Management, 15 percent; Multi-sectors, 14 percent.

Lending by the Asian Development Bank, 2002–2006
(In millions of U.S. dollars)

	2002	2003	2004	2005	2006
Approvals	236.5	275	195	253	60
Net resource transfer	107	162	126	134	97
Disbursement	171	225	186	206	180

Source: Asian Development Bank.

ANNEX IV: SRI LANKA—STATISTICAL ISSUES

Staff Assessment

Overall, the coverage and timeliness of available data are adequate for program monitoring and surveillance purposes. The authorities supply key data to the Fund on a timely basis, and publish data regularly, including daily information on stock, money, and foreign exchange through electronic media. However, as noted below, there are deficiencies in the statistical base which, if rectified, would improve the ability to monitor developments and formulate economic policies. Sri Lanka is a participant in the General Data Dissemination System (GDDS) and its metadata were posted on the Fund's DSBB in July 2000. Quarterly national accounts and monthly monetary and fiscal revenue data are published regularly. The authorities have expressed their intention to subscribe to the Special Data Dissemination Standard (SDDS) and appointed an SDDS coordinator in February 2003. However, substantial work is still needed for meeting all SDDS requirements and preparing the necessary metadata before Sri Lanka is ready for subscription.

Most data ROSC recommendations have been implemented while others are expected to be implemented in the near future. In particular, most data are now being disseminated in the Census and Statistics and central bank websites; a census of industries is underway while a Census of Agriculture (including the North and East) has been finalized; a labor force survey is being conducted on a quarterly basis; the CBSL has issued an advance release calendar and designated a contact person to assist data users.

Outstanding Statistical Issues

Real Sector

Several consumer price indices are produced. The official price measures are the Sri Lanka Consumer Price Index (SLCPI) and the Colombo Consumer Price Index (CCPI), produced by the Department of Census and Statistics (DCS). The SLCPI is based on the spending patterns of the lowest 80 percent of households for the entire country excluding the Northern and Eastern provinces. The CCPI is based on the spending patterns of the lowest 40 percent of households within the Colombo municipal area. The CCPI, however, uses an outdated consumption basket and weighting system and has become increasingly irrelevant as a measure of general inflation. The DCS also publishes a Greater Colombo Price Index (GCPI), including Colombo city and the suburbs. The Central Bank of Sri Lanka (CBSL) produces a Colombo District CPI (CDCPI) and a Wholesale cum-Producer Price Index (WPI/PPI).

The national accounts suffer from a lack of data sources and from undeveloped statistical techniques. Sri Lanka does not have periodic comprehensive benchmarks or a system for conducting regular annual surveys of establishments. A statistical business register, which would serve as the main basis for conducting sample surveys, is not available. As a result, the few surveys that are conducted do not have good sample frames. Most of the data used for regular compilation are obtained on a timely basis. However, detailed data needed to measure both output and intermediate consumption are mostly unavailable or not collected. As a result, the estimates of gross value added are prepared directly relying on outdated fixed ratios established from the base year 1996, often with outdated studies or ad hoc assumptions. Quarterly indicators are used for compiling quarterly value added estimates. The methodology for deriving GDP at constant prices is not satisfactory. Expenditure estimates are available only annually and rely mostly on commodity flow techniques. Whenever possible, estimates are validated and checked with other sources.

Fiscal Sector

In May 2003, a STA mission followed up on the ROSC recommendation to develop a migration path to compile data in accordance with the *Government Finance Statistics Manual 2001 (GFSM 2001)*. As part of that plan, the authorities agreed to revise from end–2003 the budgetary classifications and the accounting structure to eventually match the *GFSM 2001* classifications of stocks and flows and to apply that chart of accounts to all general government units. Progress with the implementation of these improvements needs to be assessed. Cash data through 2005 were reported for publication in the 2006 *GFS Yearbook.* These data cover only the budgetary accounts of central government. No data on the four extra-budgetary funds or the provincial and local governments are provided. No sub-annual data are provided for publication in IFS.

Monetary Sector

Foreign Currency Banking Units (FCBUs) are classified as resident institutions in the monetary survey since 1998. To adjust for the proportion of nonresident foreign currency deposits (NRFC), which are actually held by residents (mainly returning migrant workers), 50 percent of these deposits are reclassified from foreign liabilities to domestic deposits.

In June 2003, a STA mission followed up on issues raised during the 2001 ROSC mission. In particular, the mission clarified the methodology for the treatment of Fund accounts; recommended that repos be treated as collateralized loans (rather than on a change of ownership basis); and resolved discrepancies between the monetary authorities' data reported to STA and to APD, which reflected problems in the valuation of Fund accounts and different methodological treatments.

The authorities have not submitted data for the monetary authorities' accounts since September 2006 and the most recent data published in *IFS* are for April 2006.

External Sector

The Central Bank of Sri Lanka publishes balance of payments statistics on a quarterly and annual basis. Quarterly data are available three months after the end of the quarter. The data largely follow the fifth edition of the *Balance of Payments Manual*.

A STA mission visited Colombo in December 2004. The highest priority issues identified by the mission included dealing with some shortcomings in the international transactions reporting system (ITRS), which is the primary data source for the balance of payments. The recommended improvements included addressing the large values of unclassified transactions, inclusion of FCBUs (foreign currency banking units) in the data, and providing an instruction book to assist ITRS reporters to apply classifications and coding more accurately. The mission advised the authorities on the need to develop a comprehensive survey to implement their medium-term plan to introduce international investment position statistics. The GDDS website indicates that FCBUs are now included in the data and that work has been done toward compiling international investment position statistics.

Sri Lanka: Table of Common Indicators Required for Surveillance

As of September 20, 2007

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memorandum Items:	
						Data Quality—Methodological Soundness[7]	Data Quality Accuracy and Reliability[8]
Exchange rates	9/20/2007	9/20/2007	D	D	D		
International reserve assets and reserve liabilities of the Monetary Authorities[1]	7/31/2007	9/2007	D	W	W		
Reserve/base money	7/31/2007	9/11/2007	W	W	W	LO, LO, LO, LO	LO, O, O, NA, NA
Broad money	7/31/2007	9/11/2007	M	M	M		
Central bank balance sheet	7/31/2007	9/11/2007	M	M	M		
Consolidated balance sheet of the banking system	7/31/2007	9/11/2007	M	M	M		
Interest rates[2]	9/7/2007	9/11/2007	W	W	W		
Consumer price index (SLCPI)	7/2007	9/2007	M	M	M	O, LNO, LO, O	O, LO, O, NA, NA
Revenue, expenditure, balance and composition of financing[3]—general government[4]							
Revenue, expenditure, balance and composition of financing[3]—central government	6/2007	9/2007	M	M	M	O, O, O, O	LO, NA, LO, NA, LO
Stocks of central government and central government-guaranteed debt[5]	6/2007	9/2007	M	M	M		
External current account balance	Q2/2007	9/2007	Q	Q	Q		
Exports and imports of goods and services	Q2/2007	9/2007	Q	Q	Q	LO, LO, LO, LO	LO, LO, LO, NA, LO
GDP/GNP	Q2/2007	9/2007	Q	Q	Q	LO, LO, LNO, LNO	LNO, LNO, LO, NA, O
Gross external debt	12/2006	3/30/2007	A	A	A		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in May 2002 and based on the findings of the mission that took place during June 2001 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO), not applicable (NA).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

SRI LANKA

Debt Sustainability Analysis 2007

Prepared by the Staff Representatives of the International Monetary Fund[1]

Approved by Masahiko Takeda and Mark Plant

November 7, 2007

The low-income country debt sustainability analysis (LIC DSA) for Sri Lanka indicates a moderate risk of debt distress for the external debt. However, this risk rises to moderate-to-high when total debt service in foreign exchange, including public dollar-denominated domestic commercial debt, is taken into account.[2] The public DSA suggests that although Sri Lanka's overall debt dynamics are sustainable over the projection period, sound fiscal adjustment and prudent macroeconomic policies are critical to help reduce the debt burden, promote a favorable environment for refinancing, and lower interest costs going forward.

I. Background

1. **Sri Lanka's total public debt stock (including publicly guaranteed debt) declined to 95 percent of GDP in 2006 from its peak of 106 percent of GDP in 2003, benefiting mainly from buoyant economic growth**. The debt stock is composed of 46 percent, 7 percent, and 47 percent of external debt, domestic dollar-denominated commercial debt, and domestic rupee debt, respectively.

A. External Debt

2. **Sri Lanka's external debt remains primarily concessional and public or publicly guaranteed**. Historically, multilateral and bilateral donors have been Sri Lanka's main external creditors comprising about 70 percent of total external debt during 2001–2006. At end-2006,

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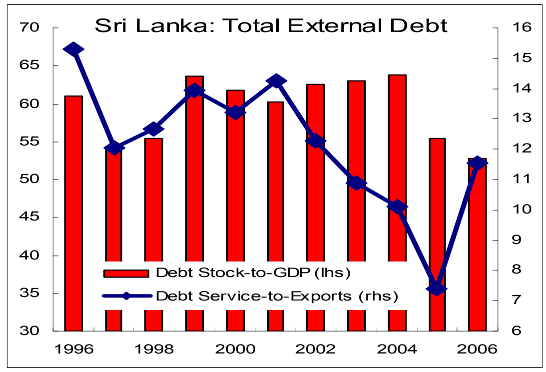
[1] World Bank Staff were consulted in the preparation of this DSA. Co-authorship with the Bank is no longer required as Sri Lanka has recently become a "gap" country for IDA.

[2] Debt classification in Sri Lanka is based on the residency criterion. Public dollar-denominated commercial debt issued to residents is classified under domestic public debt and includes SLDBs, FCBU borrowings and syndicated loans from domestic sources; rupee-denominated public debt to nonresidents is classified under external debt; and international sovereign bond issues as external debt.

medium-to-long-term debt accounted for about 82 percent of total external debt with an effective interest rate of just over 2.5 percent, and a stable currency composition comprising primarily SDRs, Japanese yens, and U.S. dollars.

3. **Although high in a regional context, Sri Lanka's external debt stock and service indicators have shown signs of improvement over 2002–2006**. In particular, strong GDP growth and moderate exchange rate movements have reduced the debt-to-GDP ratio by 10 percent during this period. External debt service indicators have been relatively stable (at an average of 10.5 percent of exports) over 2002–06, although there were some variations with the Paris club debt moratorium in 2005 and subsequent resumption of payments in 2006.



B. Public Dollar-denominated Commercial Debt

4. **Sri Lanka has become increasingly reliant on dollar-denominated commercial debt in the last two years to finance its budget while supporting reserves**. The stock of debt reached \$1.6 billion by end-2006 (or 6 percent of GDP and about 65 percent of gross official reserves). This debt consists mainly of Sri Lanka Development Bonds (SLDB), loans from the Foreign Currency Banking Units (FCBUs), and syndicated loans from local and offshore banks. The major funding source of SLDBs and FCBUs has been domestic foreign currency deposits (FCDs), originated to a large extent from remittance inflows. The stock of this debt has an average interest rate of LIBOR+150 bps and a short average maturity of 1½ year, resulting in a bunching of debt service over 2007–09.

5. **In the first eight months of 2007 public dollar-denominated commercial borrowing has continued mainly to rollover existing debt falling due**. In March, the government issued \$215 million of SLDBs and in April borrowed an additional \$210 million in syndicated loans through foreign banks. The average maturity of the new debt increased to about 2½ years and interest rates have remained favorable (i.e., LIBOR+150 bps). Nevertheless, debt service pressures are expected to increase sharply from 2008 given the short maturity of this debt. Preliminary estimates indicate that about \$165 million would come due in the fourth quarter of 2007, and a total of about \$600 and \$800 million, respectively, are expected in 2008 and 2009.

6. **In October 2007, the government successfully debuted its \$500 million Eurobond, attracting \$1.25 billion bids and was issued at a yield of 8¼ percent and maturity of 5 years**. The authorities indicated that proceeds will be used in part to retire the most expansive rupee debt. This issuance is also expected to help set a benchmark for the refinancing of future SLDBs coming due, as well as for future issuance of corporate bonds.

C. Domestic Rupee Debt

7. **Sri Lanka's domestic rupee debt consists mainly of treasury bonds and bills (about 70 percent) and other loans including advances from banks**. In recent years, the share of longer term treasury bonds in the total stock of this debt has increased, reaching nearly three times of treasury bills outstanding at end 2006. Interest rates on treasury securities have increased substantially in recent years, from around 7½–10 percent during 2004–05 to about 12 percent by end 2006, and further to 18¼ percent at mid-October 2007, reflecting monetary tightening of the Central Bank of Sri Lanka in fighting inflation.

II. Baseline

8. **Sri Lanka's DSA builds on a baseline scenario of modest growth, fiscal consolidation, and a gradual increase in commercial borrowing as concessional financing declines in real terms (Box 1)**. Baseline assumptions take into account historical ten-averages, a period of intense civil conflict, and also four-year historical averages since 2002 when the peace agreement was signed. Given the current scale of the conflict, the latter may be the more appropriate benchmark.

Sri Lanka: Baseline Vis-a-Vis 10-year Historical Averages (used in the DSA) and 4-year Historical Averages Since the Ceasefire in 2002

	Baseline 2007–12	2013–27	10-year Historical Averages 1997–2006	4-year Historical Averages 2003–06
Real GDP growth (in percent)	6.0	5.5	4.9	6.2
GDP deflator (in U.S. dollar terms, change in percent)	1.8	0.9	2.0	6.4
Current account deficit (percent of GDP)	3.6	2.6	3.0	2.8
Growth of exports (U.S. dollar, in percent)	8.9	7.9	6.0	9.3
Growth of imports (U.S. dollars, in percent)	8.8	8.2	7.1	13.3

Sources: Staff estimates.

Box 1. Baseline Assumptions

- **Real GDP growth** over 2007–2012 is projected at 6 percent, spurred by increased economic activity as mega infrastructure projects in the energy, ports, and roads come online. Over the longer run, real growth is projected to moderate to 5.5 percent as the mega investments unwind and the economy returns to a more modest growth rate. This is slightly above the historical ten-year average growth rate of 5 percent reflecting efficiency gains from earlier investments, but less than the historical four-year average growth rate of 6¼ percent.

- **The GDP deflator** is projected to increase at 9 percent over 2007–2012 in local currency terms and about 2.5 percent in U.S. dollar terms.

- **Fiscal consolidation** assumes a reduction in the fiscal deficit from 8½ percent of GDP in 2006 to 5 percent of GDP by 2010, and gradually to about 3 percent of GDP by 2027 while the primary fiscal surplus (excluding grants) would be achieved from 2011 onwards. Key components of achieving this target are tax revenue measures, including those introduced in the 2006–07 budgets (i.e., to broaden the income tax base, strengthen tax administration, and improve the VAT system). These measures have increased revenue by about one percent of GDP in 2006 and another 1 percent of GDP is expected in 2007. Rationalization of the recurrent expenditure and prioritization of the capital budget are expected to compliment revenue efforts. Effective interest rates for public debt service are assumed to be positive in real terms (averaged at about 2 percent).

- **The current account balance** is projected to decline from 5 percent of GDP in 2006 to about 3 percent of GDP by 2012 (as mega infrastructure investment imports decrease) and remain at that level in the long-term. Export value growth is assumed at 9 percent over 2007–2012 and 8 percent over 2013–2027, slightly lower than the average growth rates of 10 percent over 2003–2006 due to increased competition in the apparel and textile sector. Import value growth is projected at 9 percent over 2007–2012, higher than the historical average of 7 percent given higher oil prices and increased investment imports for infrastructure investments. From 2013–2027, import growth is expected to moderate to 8 percent.

- **External reserves** are assumed at around 2–2½ months of imports of goods and services over the projection period. External financing in concessional terms is expected to decline as a ratio to GDP, reflecting Sri Lanka's income per capita increases to above IDA thresholds. A net increase in foreign exchange borrowing is needed to compensate for this decline and would help maintain minimum reserve coverage. Based on discussions on future financing plans with the authorities, the baseline assumes net commercial borrowing from external creditors of about $100 million per year over 2008–12 and $200 million from 2013 onwards; net borrowing in dollars from domestic sources of $300 million per year over 2008−2012 and $200 million from 2013 onwards. The recent $500 million Eurobond issue has been included, on the assumption of full refinancing when it falls due.

- **Mega infrastructure financing of** $2.5 billion, out of a targeted total of $4.5 billion, has been included in the baseline over 2007−2012. Debt financing from bilateral and multilateral sources on soft terms has been assumed, $1.5 billion of which has been committed as of mid-2007.

III. External DSA

A. Baseline

9. **The baseline scenario indicates medium-term external debt ratios are on a sustainable path, reflecting a gradual decline in external concessional debt**. Ratios of the NPV of PPG external debt, as a percent of GDP, exports, and revenues, are projected to decline over 2007–2027 (Table 1 and 2, and Figure 1) and remain well below the indicative thresholds of debt distress for low-income countries with medium policy frameworks.[12] The grant element in external debt is projected to fall continuously, together with a mild degree of debt decummulation given the projected extent of Sri Lanka's market access.

10. **The baseline and historical scenarios reflect similar tendencies in the medium term over 2007–2012.** In the longer term they diverge slightly as the historical scenario reflects the severe conflict, whereas the baseline reflects a moderate level of disruption to economic activity from any renewed conflict. Nevertheless, both scenarios indicate that debt stock ratios, including the planned mega infrastructure investments, would be contained even under a low-growth scenario as illustrated by the historical scenario.

11. **External debt-service ratios appear to be contained within the debt distress thresholds.** Both debt-service ratios initially decline over 2007−2012 as concessional debt (including repayment of the Paris Club moratorium) is repaid, but subsequently rise from 2012 as repayments for the medium-term external commercial debt commences. This is particularly marked for the debt-service-to-revenue ratio indicating that fiscal consolidation is key to containing debt service pressures in the long-term.

Comparison of IMF/World Bank Indicative Debt-Burden Thresholds with Sri Lanka's Medium-Term Baseline

	Indicative Thresholds (Medium performer)	Sri Lanka's Medium-Term Baseline		
		2007	2012	2027
NPV of debt/exports	150	105	84	28
NPV of debt/GDP	40	34	27	11
NPV of debt/revenues	250	186	138	53
Debt service/exports	20	10	11	9
Debt service/revenues	30	18	18	16

[12] Based on debt and debt service thresholds approved by Boards of the Fund and Work Bank for use in the assessment of LIC DSA framework. Sri Lanka is classified as a medium performing country based on the average of its 2004−06 Country Policy and Institutional Assessment Index (CPIA) score of 3.62.

B. Stress Tests

12. **Sensitivity analyses show a contained trajectory for PPG external debt stock ratios but indicate potential vulnerabilities in the debt-service ratio under simultaneous shocks**. While a one standard deviation shock to the historical export value growth would increase the NPV of external debt to GDP to 40 percent in 2009, a combined shock on GDP, exports, the deflator and new borrowing, would increase it to 47 percent. Stress tests on the debt-service indicators reflect increased vulnerability to export growth and combination shocks, particularly in 2012 when the most extreme test shows an increase in the debt-service ratio to about 17 percent of exports and to 27 percent of revenues.

C. Inclusion of Public Dollar-Denominated Commercial Debt

13. **While the baseline external debt-service ratios are contained, total debt service in foreign exchange including for servicing the public dollar-denominated commercial debt is projected to increase sharply over 2008−2009**. An illustrative simulation indicates that full refinancing of the end-2006 debt stock at existing maturities (about two years), with new money of $300 million each year over 2008-2012 and $200 million over 2013–2027, could increase debt service in total foreign exchange to close to the debt service distress threshold of 20 percent of exports over the medium term (i.e., for countries with a medium CPIA rating). Under the same scenario, debt-service to revenue would increase to 30–35 percent, above the debt distress threshold of 30 percent (Figure 2).

14. **Lengthening the maturity of this short-term debt to beyond three years will be essential to ease the bunching pressures in debt service going forward**. In this regard, the recent successful international bond issuance of $500 million at 5-year maturity (with a substantial oversubscription) is encouraging, indicating a favorable market appetite for longer-term dollar instruments from Sri Lanka. This issuance would also help set a benchmark for future issuance of longer term SLDBs. While FCD inflows are relatively stable, net annual inflows, at about $200–$300 million in recently years, limit the scope for raising additional funds from this source. As a result, Sri Lanka may need to continue to rely on international capital markets for funds, in which case an increase in global risk aversion could lead to a surge in risk premia.

IV. Public DSA

A. Baseline

15. **The baseline brings the path of the total central government debt to GDP from about 90 percent in 2007 to 69 percent in 2012, and further to about 32 percent in 2027** (Table 3 and 4, Figure 3). Under this scenario, NPV of debt-to-GDP, debt-to-revenue, and debt service-to-revenue are expected to decline at a similar rate. The main contributor to this improvement is fiscal consolidation and a continued growth/interest rate differential (as the real

growth rate is assumed to exceed the real interest rate on government debt by about 3 percent, broadly similar to the historical average of the past 10 years).

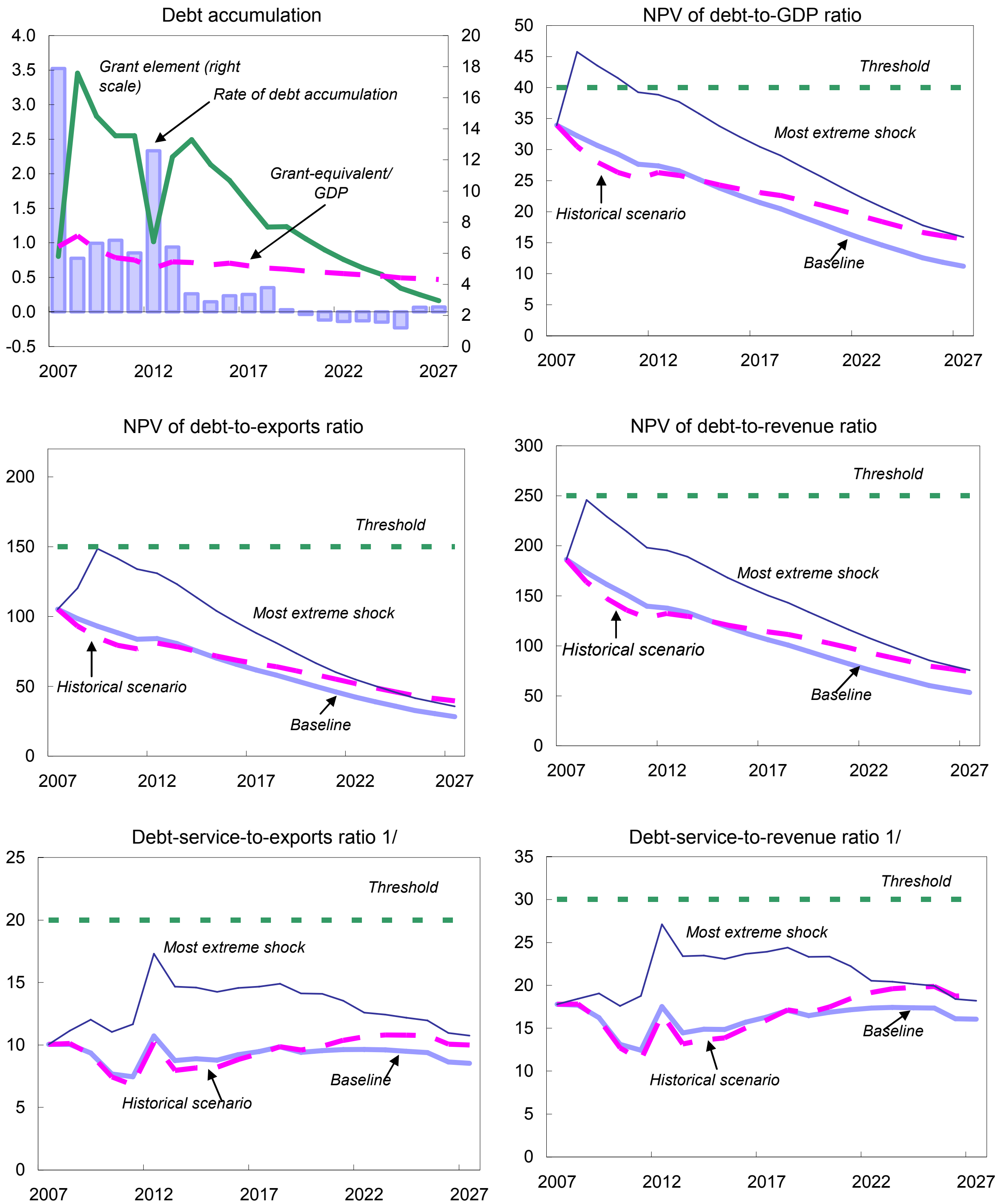
B. Stress Tests

16. **Sensitivity tests indicate that a lack of fiscal consolidation could subject the baseline to substantial risks**. Assuming the baseline growth rate, but with fiscal deficit staying around 7½ percent of GDP, the NPV of debt–to-GDP would decline to only about 83 percent by 2027, well above the values in the baseline. Moreover, the NPV of debt-to-revenue and debt service-to-revenue ratios would also exceed the baseline values by substantial margins. The baseline is also sensitive to interest rate shocks. A one standard deviation increase in the LIBOR and treasury rates (about 2 percentage and 3 percentage points, respectively) for 2008–09 increases debt service costs as a share of revenue by about 4 percent over 2011–17, narrowing to about 2 percent of revenue by 2027.

V. Conclusion

17. **Sri Lanka has a moderate risk of debt distress based on external debt service indicators and a declining public debt stock to GDP under the baseline scenario of modest growth and fiscal consolidation**. The public DSA suggests that overall debt dynamics are sustainable over the projection period. However, the risk of debt distress increases to moderate-to-high when the total debt service in foreign exchange is taken into account. A credible fiscal consolidation path over the medium term, together with prudent macroeconomic policies to contain inflation and an effective debt management strategy to lengthening maturity, are critical to help reduce Sri Lanka's high stock of debt and debt service burden.

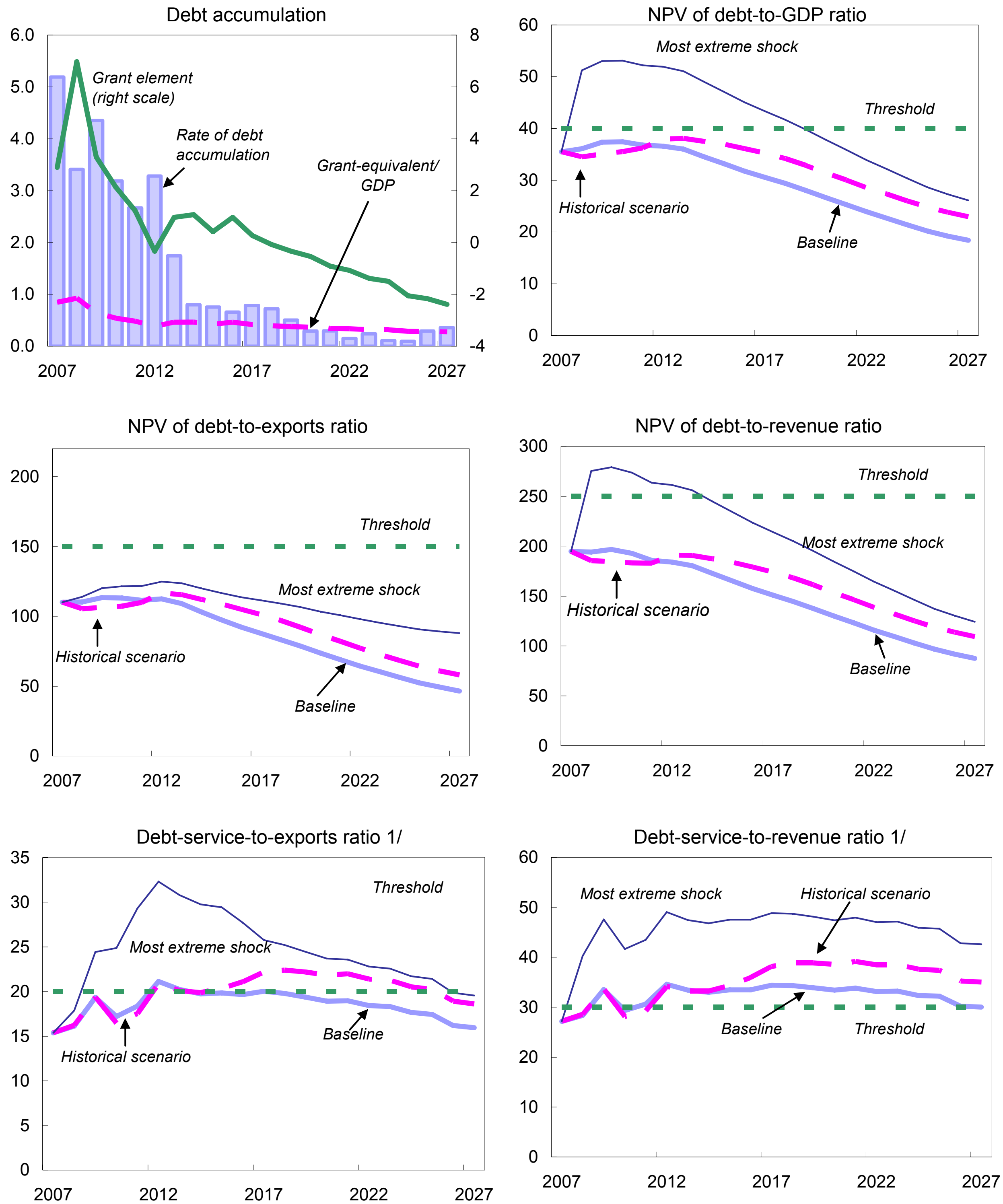
Figure 1. Sri Lanka: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2007–2027 1/



Sources: Staff projections and simulations.

1/ Does not include public domestic commercial dollar-debt (i.e., FCBUs and SLDBs).
In addition to regular external debt includes non-resident holdings of rupee Treasury bonds and 2007 Eurobond issuance of $500m.

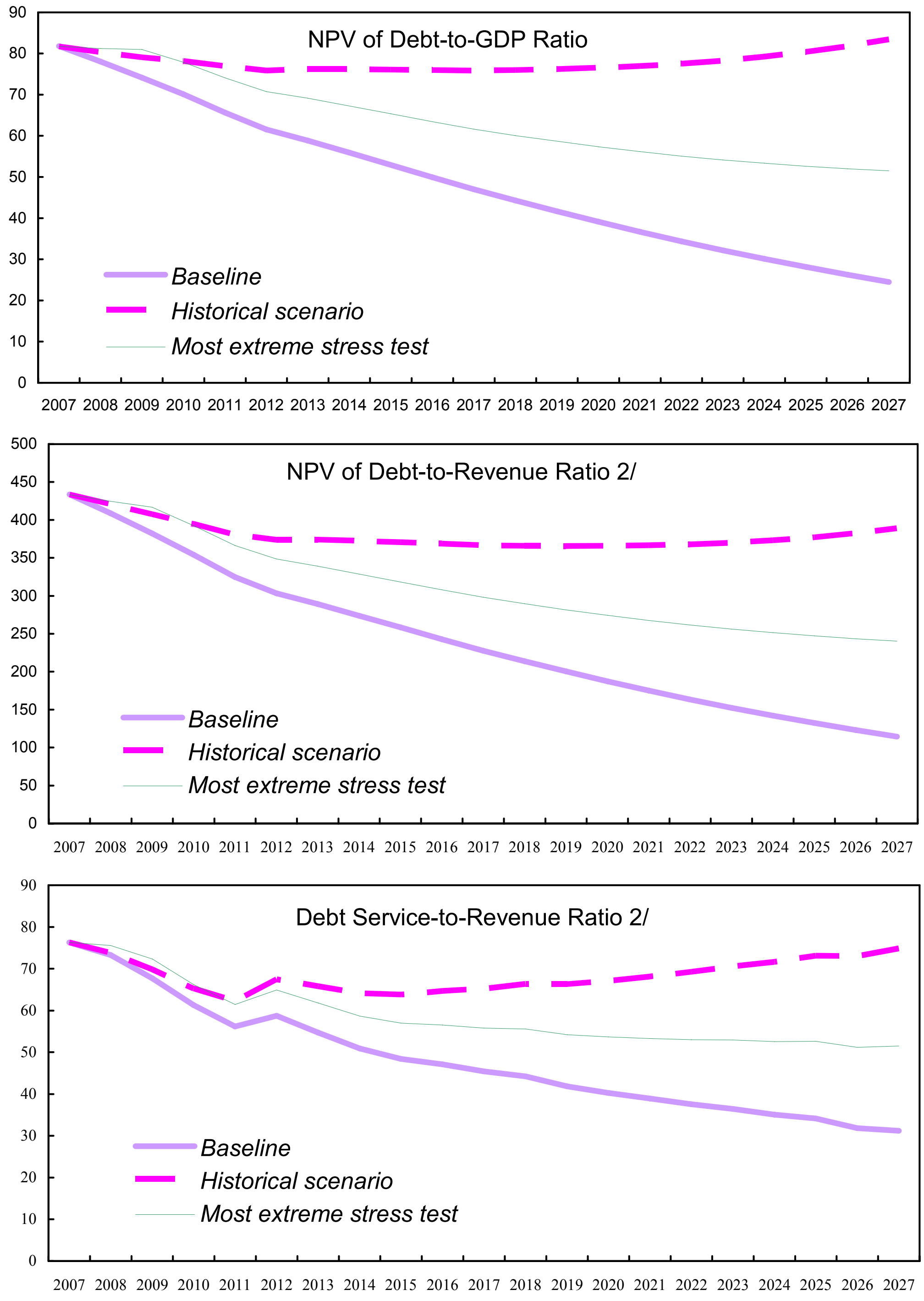
Figure 2. Sri Lanka: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2007–2027 1/



Sources: Staff projections and simulations.

1/ Includes public domestic commercial dollar-debt (i.e., FCBUs and SLDBs), and in addition to regular external debt includes nonresident holdings of rupee Treasury bonds and 2007 Eurobond issuance of $500m.

Figure 3. Sri Lanka: Indiacators of Public Debt Under Alternative Scenarios, 2007–2027 1/



Source: Staff projections and simulations.

1/ Most extreme stress test is test that yields highest ratio in 2017.
2/ Revenue including grants.

Table 1. Sri Lanka: External Debt Sustainability Framework, Baseline Scenario, 2004–2027 1/

(In percent of GDP, unless otherwise indicated)

	Actual					Projections									
	2004	2005	2006	Historical Average 6/	Standard Deviation 6/	2007	2008	2009	2010	2011	2012	2007–12 average	2017	2027	2013–27 average
External debt (nominal) 1/	63.9	55.4	52.8			52.6	51.6	50.5	49.2	47.6	45.7		41.4	33.5	
Of which : public and publicly guaranteed (PPG)	61.8	53.7	51.4			51.1	50.1	48.8	47.5	45.8	43.7		39.2	30.9	
Change in external debt	0.8	-8.5	-2.6			-0.2	-1.0	-1.1	-1.4	-1.5	-2.0		-0.8	-0.7	
Identified net debt-creating flows	-3.5	-7.7	-3.7			0.5	0.6	0.0	-0.7	-1.2	-1.5		-1.2	-0.9	
Non-interest current account deficit	2.0	1.9	3.6	1.3	1.9	3.2	3.5	3.0	2.4	1.9	1.6		1.5	1.6	1.6
Deficit in balance of goods and services	9.1	9.2	11.6			11.5	12.2	11.9	11.6	11.3	11.1		12.7	16.1	
Exports	36.3	33.5	31.6			32.2	32.7	32.9	33.1	33.0	32.5		34.8	39.5	
Imports	45.4	42.7	43.2			43.8	44.9	44.9	44.7	44.3	43.6		47.5	55.6	
Net current transfers (negative = inflow)	-6.9	-7.8	-8.1	-6.6	0.8	-8.4	-8.7	-8.9	-9.2	-9.4	-9.5		-11.2	-14.5	-12.2
Of which : official	-0.1	-0.4	-0.4			-0.3	-0.2	-0.2	-0.1	-0.1	-0.1		-0.1	0.0	
Other current account flows (negative = net inflow)	-0.2	0.4	0.1			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Net FDI (negative = inflow)	-1.1	-1.0	-1.7	-1.0	0.3	-1.2	-1.3	-1.4	-1.5	-1.6	-1.6		-1.8	-2.0	-1.8
Endogenous debt dynamics 2/	-4.4	-8.6	-5.6			-1.6	-1.6	-1.6	-1.5	-1.5	-1.4		-0.9	-0.4	
Contribution from nominal interest rate	1.2	0.9	1.4			1.3	1.3	1.3	1.3	1.2	1.2		1.3	1.3	
Contribution from real GDP growth	-3.1	-3.3	-3.6			-2.9	-2.9	-2.9	-2.8	-2.7	-2.6		-2.2	-1.8	
Contribution from price and exchange rate changes	-2.6	-6.2	-3.4			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	4.4	-0.8	1.1			-0.6	-1.6	-1.1	-0.7	-0.3	-0.5		0.3	0.2	
Of which : exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	...	...	34.8			35.5	33.7	32.4	30.9	29.5	29.4		23.7	13.8	
In percent of exports	...	...	110.2			110.1	103.0	98.3	93.4	89.4	90.3		68.0	34.9	
NPV of PPG external debt	...	...	33.3			33.9	32.2	30.7	29.3	27.7	27.4		21.5	11.2	
In percent of exports	...	...	105.6			105.3	98.4	93.1	88.4	83.8	84.2		61.6	28.3	
In percent of government revenues	...	...	195.5			186.4	173.3	161.5	150.9	139.7	137.7		106.0	53.3	
Debt service-to-exports ratio (in percent)	10.1	7.4	11.5			12.1	12.7	11.3	10.1	8.7	11.9		11.4	10.2	
PPG debt service-to-exports ratio (in percent)	8.0	5.0	9.5			10.1	10.0	9.4	7.7	7.5	10.7		9.5	8.5	
PPG debt service-to-revenue ratio (in percent)	18.8	10.5	17.6			17.8	17.7	16.2	13.1	12.4	17.5		16.3	16.1	
Total gross financing need (billions of U.S. dollars)	2.6	2.9	3.8			4.4	4.6	4.8	4.9	4.9	5.7		8.4	17.0	
Non-interest current account deficit that stabilizes debt ratio	1.2	10.4	6.2			3.4	4.6	4.1	3.7	3.4	3.6		2.3	2.3	
Key macroeconomic assumptions															
Real GDP growth (in percent)	5.4	6.0	7.4	4.9	2.5	6.0	6.0	6.0	6.0	6.0	6.0	6.0	5.5	5.5	5.5
GDP deflator in U.S. dollar terms (change in percent)	4.2	10.7	6.6	2.0	4.6	2.5	1.6	2.1	2.2	2.8	3.3	2.4	0.9	0.9	0.9
Effective interest rate (percent) 5/	2.2	1.6	2.8	2.7	0.7	2.8	2.7	2.7	2.7	2.7	2.7	2.7	3.2	4.1	3.4
Growth of exports of G&S (U.S. dollar terms, in percent)	11.3	8.3	7.9	6.0	7.3	10.9	9.4	8.9	8.9	8.6	7.9	9.1	7.8	7.8	7.9
Growth of imports of G&S (U.S. dollar terms, in percent)	18.5	10.5	15.5	7.1	10.3	10.2	10.5	8.2	8.0	7.9	7.9	8.8	8.3	8.1	8.2
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	5.8	17.6	14.8	13.6	13.6	6.7	12.0	9.2	2.9	7.4
Aid flows (in billions of U.S. dollars) 7/	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Of which : grants	0.1	0.3	0.3			0.2	0.2	0.1	0.1	0.2	0.2		0.2	0.5	
Of which : concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			0.9	1.1	0.9	0.8	0.8	0.6		0.7	0.5	0.6
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			17.2	28.1	23.8	24.2	25.1	16.6		20.1	17.0	19.5
Memorandum items:															
Nominal GDP (billions of U.S. dollars)	20.1	23.5	26.9			29.3	31.5	34.1	37.0	40.3	44.2		60.4	113.2	
(NPVt-NPVt-1)/GDPt-1 (in percent)						3.5	0.8	1.0	1.0	0.9	2.3	1.6	0.3	0.1	0.1

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
7/ Defined as grants, concessional loans, and debt relief.
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the NPV of new debt).

Table 2. Sri Lanka: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2007–27

(In percent)

		Projections										
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2027
	NPV of debt-to-GDP ratio											
Baseline	34	32	31	29	28	27	27	25	24	23	21	11
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2008–27 1/	34	30	28	26	25	26	26	25	24	24	23	16
A2. New public sector loans on less favorable terms in 2008–27 2/	34	33	32	31	30	30	30	29	28	27	27	21
B. Bound tests												
B1. Real GDP growth at historical average minus one standard deviation in 2008–09	34	33	33	31	30	29	28	27	26	24	23	12
B2. Export value growth at historical average minus one standard deviation in 2008–09 3/	34	35	40	38	36	35	33	31	29	27	25	12
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2008–09	34	34	34	32	30	30	29	28	26	25	23	12
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008–09 4/	34	36	38	36	34	33	32	30	28	26	24	11
B5. Combination of B1-B4 using one-half standard deviation shocks	34	39	47	45	42	40	38	36	33	31	29	13
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	34	46	44	42	39	39	38	36	34	32	30	16
	NPV of debt-to-exports ratio											
Baseline	105	98	93	88	84	84	81	75	70	66	62	28
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2007–26 1/	105	93	85	79	77	81	78	75	72	69	66	40
A2. New public sector loans on less favorable terms in 2007–26 2/	105	101	97	94	90	92	90	87	83	80	77	54
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2008–09	105	98	93	88	84	84	81	75	70	66	62	28
B2. Export value growth at historical average minus one standard deviation in 2008–09 3/	105	120	149	142	134	131	123	114	104	96	88	36
B3. US dollar GDP deflator at historical average minus one standard deviation in 2008–09	105	98	93	88	84	84	81	75	70	66	62	28
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008–09 4/	105	109	116	110	104	102	96	89	82	75	70	29
B5. Combination of B1-B4 using one-half standard deviation shocks	105	121	148	141	133	130	121	112	102	93	85	33
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	105	98	93	88	84	84	81	75	70	66	62	28
	NPV of debt-to-revenue ratio											
Baseline	186	173	162	151	140	138	133	126	119	112	106	53
A. Alternative scenarios												
A1. Key variables at their historical averages in 2007–26 1/	186	164	147	136	128	132	129	125	121	117	114	74
A2. New public sector loans on less favorable terms in 2007–26 2/	186	177	168	160	150	151	149	145	140	136	133	102
B. Bound tests												
B1. Real GDP growth at historical average minus one standard deviation in 2008–09	186	179	173	162	150	148	143	135	127	120	114	57
B2. Export value growth at historical average minus one standard deviation in 2008–09 3/	186	191	210	197	182	175	166	155	144	133	124	55
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2008–09	186	181	177	165	153	151	146	138	130	122	116	58
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008–09 4/	186	192	200	188	173	167	159	149	138	129	120	55
B5. Combination of B1-B4 using one-half standard deviation shocks	186	208	246	231	213	203	193	179	165	153	141	60
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	186	246	229	214	198	195	189	179	168	159	150	76
	Debt service-to-exports ratio											
Baseline	10	10	9	8	7	11	9	9	9	9	9	9
A. Alternative scenarios												
A1. Key variables at their historical averages in 2008–27 1/	10	10	9	7	7	10	8	8	8	9	9	10
A2. New public sector loans on less favorable terms in 2008–27 2/	10	10	7	6	5	10	8	7	8	8	8	11
B. Bound tests												
B1. Real GDP growth at historical average minus one standard deviation in 2008–09	10	10	9	8	7	11	9	9	9	9	9	9
B2. Export value growth at historical average minus one standard deviation in 2008–09 3/	10	11	12	11	12	17	15	15	14	15	15	11
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2008–09	10	10	9	8	7	11	9	9	9	9	9	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008–09 4/	10	10	10	9	9	13	11	11	11	11	11	9
B5. Combination of B1-B4 using one-half standard deviation shocks	10	11	11	11	12	17	15	15	14	14	15	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	10	10	9	8	7	11	9	9	9	9	9	9
	Debt service-to-revenue ratio											
Baseline	18	18	16	13	12	18	14	15	15	16	16	16
A. Alternative scenarios												
A1. Key variables at their historical averages in 2008–27 1/	18	18	16	13	11	17	13	14	14	15	16	19
A2. New public sector loans on less favorable terms in 2008–27 2/	18	18	12	9	9	16	13	12	13	13	14	21
B. Bound tests												
B1. Real GDP growth at historical average minus one standard deviation in 2008–09	18	18	17	14	13	19	16	16	16	17	17	17
B2. Export value growth at historical average minus one standard deviation in 2008–09 3/	18	18	17	15	16	23	20	20	20	20	21	17
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2008–09	18	18	18	14	14	19	16	16	16	17	18	18
B4. Net non-debt creating flows at historical average minus one standard deviation in 2008–09 4/	18	18	17	15	16	22	19	19	19	19	20	16
B5. Combination of B1-B4 using one-half standard deviation shocks	18	18	19	18	19	27	23	23	23	24	24	18
B6. One-time 30 percent nominal depreciation relative to the baseline in 2008 5/	18	25	23	19	18	25	21	21	21	22	23	23

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), noninterest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

Table 3. Sri Lanka: Public Sector Debt Sustainability Framework, Baseline Scenario, 2004-2027
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2004	2005	2006	Historical Average 5/	Standard Deviation 5/	2007	2008	2009	2010	2011	2012	2007-12 Average	2017	2027	2013-27 Average
Public sector debt 1/	107.5	95.3	94.7			90.3	86.4	82.2	77.9	73.1	68.5		53.9	31.8	
o/w foreign-currency denominated	56.1	48.7	49.5			47.5	46.3	44.9	43.5	41.7	39.5		32.3	20.6	
Change in public sector debt	-0.4	-12.2	-0.6			-4.4	-3.9	-4.2	-4.3	-4.8	-4.6		-2.6	-2.0	
Identified debt-creating flows	-0.5	-8.8	-3.1			-3.6	-3.2	-3.6	-3.7	-4.3	-4.2		-2.3	-2.0	
Primary deficit	1.8	2.2	2.0	2.1	1.1	1.6	0.3	-0.1	-0.6	-1.0	-0.9	-0.1	-0.8	-1.6	-1.0
Revenue and grants	15.8	17.4	18.1			18.9	19.1	19.4	19.8	20.2	20.3		20.7	21.4	
of which : grants	0.4	1.4	1.1			0.7	0.5	0.4	0.4	0.4	0.4		0.4	0.4	
Primary (noninterest) expenditure	17.6	19.6	20.1			20.5	19.4	19.3	19.2	19.2	19.4		19.8	19.8	
Automatic debt dynamics	-4.2	-11.5	-7.1			-5.2	-3.6	-3.5	-3.1	-3.3	-3.3		-1.4	-0.5	
Contribution from interest rate/growth differential	-5.4	-7.0	-6.6			-5.3	-3.6	-3.5	-3.0	-2.8	-2.7		-1.7	-0.7	
of which : contribution from average real interest rate	0.2	-0.9	0.0			0.1	1.5	1.4	1.6	1.6	1.5		1.2	1.1	
of which : contribution from real GDP growth	-5.6	-6.1	-6.5			-5.4	-5.1	-4.9	-4.7	-4.4	-4.1		-2.9	-1.8	
Contribution from real exchange rate depreciation	1.2	-4.4	-0.5			…	…	…	…	…	…		...	...	
Other identified debt-creating flows	1.9	0.5	2.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-0.1	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	2.0	1.3	1.6			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	-1.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.3	0.3			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	0.0	-3.4	2.5			-0.8	-0.6	-0.6	-0.6	-0.5	-0.4		-0.4	0.0	
NPV of public sector debt	...	...	86.1			81.8	78.0	74.1	70.1	65.6	61.5		47.0	24.5	
o/w foreign-currency denominated	...	...	41.0			39.1	37.9	36.9	35.8	34.2	32.5		25.4	13.3	
o/w external	...	...	33.3			33.9	32.2	30.7	29.3	27.7	27.4		21.5	11.2	
NPV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	28.5	28.4	26.0			25.7	23.9	22.1	20.2	18.6	18.0		14.0	8.3	
NPV of public sector debt-to-revenue and grants ratio (in percent)	...	...	475.1			433.6	408.5	382.1	354.3	324.9	303.5		227.6	114.4	
NPV of public sector debt-to-revenue ratio (in percent)	...	...	505.0			449.5	419.5	390.1	361.6	331.5	309.6		232.1	116.6	
o/w external 3/	...	...	195.5			186.4	173.3	161.5	150.9	139.7	137.7		106.0	53.3	
Debt service-to-revenue and grants ratio (in percent) 4/	91.2	84.9	80.9			76.3	73.3	67.7	61.3	56.2	58.7		45.4	31.2	
Debt service-to-revenue ratio (in percent) 4/	93.7	92.2	86.0			79.1	75.3	69.1	62.6	57.3	59.9		46.3	31.8	
Primary deficit that stabilizes the debt-to-GDP ratio	2.3	14.4	2.6			6.1	4.2	4.1	3.7	3.8	3.7		1.8	0.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.4	6.0	7.4	4.9	2.5	6.0	6.0	6.0	6.0	6.0	6.0	6.0	5.5	5.5	5.5
Average nominal interest rate on forex debt (in percent)	1.5	0.6	1.5	1.5	0.4	2.5	2.6	2.6	2.7	2.8	2.8	2.7	3.2	3.9	3.4
Average real interest rate on domestic currency debt (in percent)	1.8	0.8	1.6	5.0	3.4	0.5	3.0	3.1	3.7	3.8	4.0	3.0	3.8	6.1	4.1
Real exchange rate depreciation (in percent, + indicates depreciation)	2.3	-8.6	-1.1	0.5	4.6	…	...	...	...	...	…	…	…	…	…
Inflation rate (GDP deflator, in percent)	9.3	9.9	10.3	8.6	2.7	11.5	9.0	9.0	9.0	9.0	9.0	9.4	9.0	9.0	9.0
Growth of real primary spending (deflated by GDP deflator, in percent)	10.1	18.3	9.8	4.2	9.0	8.2	0.5	5.2	5.5	6.0	6.9	5.4	6.1	4.9	5.7

Sources: Country authorities; and Fund staff estimates and projections.

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Sri Lanka: Sensitivity Analysis for Key Indicators of Public Debt 2007–2027

	Projections							
	2007	2008	2009	2010	2011	2012	2017	2027
	NPV of Debt-to-GDP Ratio							
Baseline	82	78	74	70	66	62	47	24
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	82	80	79	78	77	76	76	83
A2. Primary balance is unchanged from 2007	82	79	77	75	72	70	67	68
A3. Permanently lower GDP growth 1/	82	78	75	71	67	64	54	50
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2008-2009	82	81	81	78	74	71	62	52
B2. Primary balance is at historical average minus one standard deviations in 2008-2009	82	81	80	75	70	66	51	30
B3. Combination of B1-B2 using one half standard deviation shocks	82	82	82	78	72	68	52	31
B4. One-time 30 percent real depreciation in 2008	82	96	91	86	80	75	59	37
B5. 10 percent of GDP increase in other debt-creating flows in 2008	82	88	83	79	74	69	54	32
	NPV of Debt-to-Revenue Ratio 2/							
Baseline	434	409	382	354	325	303	228	114
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	433	420	408	395	381	374	367	389
A2. Primary balance is unchanged from 2007	433	414	395	377	358	347	324	319
A3. Permanently lower GDP growth 1/	433	410	385	360	333	314	262	234
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2008-2009	433	425	417	393	366	349	298	240
B2. Primary balance is at historical average minus one standard deviations in 2008-2009	433	422	411	381	349	325	247	140
B3. Combination of B1-B2 using one half standard deviation shocks	433	428	423	391	358	334	254	144
B4. One-time 30 percent real depreciation in 2008	433	500	467	432	396	370	287	174
B5. 10 percent of GDP increase in other debt-creating flows in 2008	433	459	429	398	365	341	261	152
	Debt Service-to-Revenue Ratio 2/							
Baseline	76	73	68	61	56	59	45	31
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	76	74	70	65	62	67	65	75
A2. Primary balance is unchanged from 2007	76	73	68	63	59	63	58	62
A3. Permanently lower GDP growth 1/	76	73	68	62	57	60	50	50
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2008-2009	76	76	72	66	61	65	56	51
B2. Primary balance is at historical average minus one standard deviations in 2008-2009	76	73	69	65	60	62	49	36
B3. Combination of B1-B2 using one half standard deviation shocks	76	75	72	67	61	64	50	37
B4. One-time 30 percent real depreciation in 2008	76	74	70	64	58	61	49	39
B5. 10 percent of GDP increase in other debt-creating flows in 2008	76	73	74	68	62	64	51	37

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

SRI LANKA

Staff Report for the 2007 Article IV Consultation

Supplementary Information

Prepared by the Asian and Pacific Department
(In consultation with PDR)

Approved by Masahiko Takeda and Mark Plant

November 19, 2007

I. INTRODUCTION

1. This supplement provides information on recent economic developments that have become available since the issuance of the staff report, including staff's preliminary assessment of Sri Lanka's 2008 budget proposal unveiled on November 7. The new information dose not change the analysis and policy recommendations contained in the staff report. Paragraphs 9–12 below should be considered part of the staff appraisal.

II. RECENT DEVELOPMENTS AND OUTLOOK

2. The CBSL has recently revised down its real GDP growth projection to 6.7 percent for 2007, from the original projection of 7.5 percent and closer to the staff projection of 6 percent. While overall economic activity has remained broadly strong, tea and rice production has been adversely affected by labor disputes and adverse weather conditions, while tourism continued to suffer from the unsettled security situation. Inflation sustained at around 22 percent in September, reflecting a combination of demand pressures, rising oil prices, and possibly an emerging wage effect following the minimum wage adjustment in May/June.

3. Market sentiment has been boosted by the recent issuance of Sri Lanka's first medium-term sovereign bond of $500 million. This bond issue helped a buildup in external reserves to $3.2 billion by mid-November (from $2.6 billion at end-September), covering 2.7 months of imports. The improved prospects for the funding of the government also helped to ease pressures on the rupee, which has appreciated by about 2 percent since late October.

4. The government has used the full amount of Rs. 56 billion from the bond issue to retire high interest rupee treasury bills held by the CBSL, thereby reducing the CBSL's direct financing of the budget. The lowering of the government's domestic borrowing

requirement seems to have helped to drive treasury security rates down to 15¾ percent in mid November, from a peak of 18¼ percent in early October, while call money rates fell to 13–15 percent.

5. Continuing increases in international oil prices have heightened balance of payments risks. Based on the latest WEO projections, the current account deficit is expected to widen to 5 percent of GDP in 2007 and 6½ percent of GDP in 2008.

III. The 2008 Budget

6. The 2008 budget proposal targets a marginal reduction in the fiscal deficit to 7.7 percent of GDP (from an estimated 7.8 percent of GDP in 2007). This falls considerably short of the authorities' earlier plan to lower the deficit to 6.3 percent of GDP in 2008 (under the 2008 Budget Call announced in July), which was supported by staff. The budget also entails major risks on both revenue and expenditure sides, raising questions on the feasibility of the authorities' medium-term plan to reduce the budget deficit to 5 percent of GDP by 2010 (Table 1).

7. Achieving the proposed tax revenue target of 17.7 percent of GDP in 2008 (from an estimated 16.3 percent in 2007) will be a challenge, in view of new measures estimated to yield only about 0.6 percent of GDP.

- The budget introduced some base-broadening measures, including limiting tax holidays (i.e., by allowing the existing 5-year tax holidays to lapse, while restricting future tax holidays to 3 years for major investment only), further broadening the income tax base, and improving the collection of tax arrears. In addition, significant increases are proposed in excises on motor vehicles and other consumer durables, telecommunication, and liquor and cigarettes, as well as fees and levies on services. Measures on trade, including a broadening of the cess regime and an increase in surcharges on custom duties, could contribute to tax revenue, but they may also potentially distort the trade system.

- At the same time, the budget granted numerous new tax concessions (including for the fishery, gem and jewelry, shipping, and textile industries), waived VAT on all key development projects, and substantially reduced VAT on petrol to partly offset the impact of price adjustments required under the automatic formula.

8. Recurrent expenditure is budgeted to be contained in real terms, but its potential overrun is sizable (estimated at around 2 percent of GDP).

- The overall subsidies appear to be substantially underestimated in the budget. The authorities decided to deviate from the automatic pricing formula for diesel and kerosene, starting from January 1, 2008. The likely cost of this decision is estimated at about 1 percent of GDP, while the budget seems to have omitted this cost (by applying the oil price at $70 per barrel). Other subsidies, which are budgeted to decline by 0.4 percent of GDP from the level in 2007, also seem to be low.

- Provisions for wages and salaries, as well as living and pension allowances, also seem to be low, particularly as a number of new measures is expected to boost recurrent spending. This includes the planned new recruitment of an additional 15,000 college graduates into public service, as well as additional funds to help resolve distressed debt of government employees. Preliminary estimates indicate that the costing of these policies could be around ½ percent of GDP.

- Nevertheless, the ambitious capital budget, up by 2¾ percent of GDP (compared to the historical trend) or by 1¾ percent of GDP (compared to the projected level in 2007), could provide a buffer (as in the past).

9. Staff assessment indicates that the 2008 budget deficit target, at 7.7 percent of GDP, is only a marginal consolidation (from 2007) and subject to significant risks of deficit overrun, with heightened risks for debt sustainability and that could adversely affect debt distress. Even if tax revenue targets are fully met, there could still be a potential overrun in the recurrent spending, amounting to about 2 percent of GDP, mainly due to oil subsidies and wages and allowances.[1] In addition, to ensure the credibility of the authorities' medium-term fiscal consolidation plan, there is a need to overperform the 2008 budget deficit target by about 1¼ percent of GDP in order to deliver the fiscal consolidation path planned earlier.

10. Staff calls for a total fiscal adjustment of about 1¼ percent of GDP (after adjusting the buffer of 2 percent of GDP in the capital budget) to deliver the fiscal deficit of 6½ percent of GDP in 2008 as indicated in the Staff Report. To this end, implementing concrete revenue measures under the budget to deliver their intended targets will be crucial. Additional measures to further streamline tax exemptions and broaden the VAT base may also be needed to ensure that the impact of new tax incentives in the budget will be fully compensated.

11. On the expenditure side, staff urge the authorities to conduct an early review of oil subsidies in light of the recent developments in world oil prices. The decision to deviate from the automatic pricing formula for diesel and kerosene in 2008 could expose the budget to large fiscal and quasi-fiscal risks, as recent increases in international oil prices seem unlikely to be reversed any time soon. The authorities are encouraged to consider full, or at a minimum, substantial partial pass-through to contain these risks, and also to help promote energy conservation. This should be supported by a stronger social safety net to protect the poor.

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[1]Military expenditure is budged at 3.9 percent of GDP in 2008, compared to the projected 4.2 percent of GDP in 2007.

12. The new public hiring is expected to have a lasting impact on the budget. While near term corrective measures may be required, the authorities should also seek assistance from the World Bank to review the need for civil service reform, aimed at containing the overall wage bill in real terms as stipulated under the authorities' medium-term consolidation plan.

Table 1. Sri Lanka: Summary of Central Government Operations, 2006–2011

(In percent of GDP, unless otherwise indicated)

	2006	2007		2008	2008	2009	2010	2011
		Budget	Projection	Budget	Staff Report Projections			
Total revenue	17.1	18.4	18.3	19.6	18.6	19.0	19.4	19.8
Tax revenue	15.3	16.6	16.3	17.7	16.8	17.2	17.6	18.0
Income taxes	2.9	3.1	3.4	3.7	...	...	...	...
Value added tax/GST	5.9	6.2	6.1	6.5	...	...	...	...
Excise taxes	3.3	3.3	3.3	3.5	...	...	...	...
Taxes on international trade	1.9	2.2	1.8	1.9	...	...	...	...
Other	1.4	1.8	1.7	2.1	...	...	...	...
Nontax revenue	1.7	1.8	1.9	1.9	1.8	1.8	1.8	1.8
Total expenditure and net lending	25.5	27.7	26.0	27.3	24.9	24.5	24.3	24.0
Current expenditure	19.6	18.4	19.0	18.6	18.4	18.0	17.8	17.5
Civil service wages and salaries	4.1	3.8	4.1	3.8	3.9	3.9	3.9	3.9
Other civilian goods and services	1.1	1.4	1.3	1.4	1.3	1.3	1.3	1.3
Security related expenditure	3.8	4.1	4.2	3.8	3.9	3.9	3.8	3.8
Subsidies and transfers	5.1	3.9	4.2	4.2	3.8	3.7	3.7	3.7
Households	3.7	3.1	3.3	3.2	...	...	...	...
Of which : Samurdhi	...	0.0	0.3	0.3	...	...	...	...
pensions	...	1.9	2.1	1.9	2.0	2.0	2.0	2.0
petroleum	...	0.0	0.0	0.0	…	…	…	…
tsunami	...	...	...	…	…	…	…	…
Institutions, corporations, other government agencies	1.4	...	0.9	1.0	...	...	...	...
Interest payments 1/	5.4	5.2	5.2	5.5	5.5	5.2	5.1	4.8
Foreign	0.6	...	0.7	0.8	0.7	0.7	0.7	0.7
Commercial			0.4	...	0.4	0.4	0.4	0.4
Domestic	4.8	...	4.1	4.7	4.4	4.1	4.1	3.8
Capital expenditure and net lending	5.9	9.3	7.0	8.7	6.5	6.5	6.5	6.5
Of which : tsunami	0.8	0.7	0.4	0.0	0.1	0.0	0.0	0.0
mega projects		3.6	1.6	3.7	1.5	1.5	1.5	1.5
Overall balance	-8.4	-9.2	-7.8	-7.7	-6.3	-5.5	-4.9	-4.2
Overall balance (without tsunami measures) 1/	-7.6	-8.6	-7.4	...	...	...	...	...
Financing	8.4	9.2	7.8	7.7	6.3	5.5	4.9	4.2
Net external financing	1.5	3.7	3.7	2.9	1.9	1.9	1.7	1.5
Net commercial borrowing	1.9	...	0.0	…	1.0	0.9	0.8	0.7
Net other domestic financing	3.9	4.8	3.3	4.0	3.0	2.3	2.0	1.6
Privatization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	1.1	0.7	0.8	0.8	0.5	0.4	0.4	0.4
Memorandum items:								
Current account balance (excluding grants)	-2.5	0.1	-0.8	1.0	0.2	1.0	1.6	2.3
Primary balance (excluding grants)	-3.0	-4.0	-2.6	-2.2	-0.8	-0.3	0.2	0.6
Primary balance (including grants)	-2.0	-3.3	-1.8	0.1	-0.3	0.1	0.6	1.0
Paris Club debt moratorium	...				...	...	...	...
Nominal GDP (in billions of rupees)	2,802	3,242	3,311	3,825	3,825	4,420	5,106	5,900
Total debt	94.7	93.3	90.1	91.8	86.2	85.7	80.9	75.7
Of which : domestic debt	54.3	51.7	49.2	50.7	46.5	47.1	43.6	40.1

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

1/ Measures include tsunami expenditure and in 2005 interest savings from Paris Club debt moratorium.

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

IMF Executive Board Concludes 2007 Article IV Consultation with Sri Lanka

On November 21, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sri Lanka.[1]

Background

Sri Lanka's strong economic growth in the past four years has lifted per capita income to about $1,300, well exceeding regional peers. Reflecting the economy's resilience, in 2006, real growth accelerated to 7½ percent despite the oil price shock and heightened security conditions. There are, however, indications that the economy may be operating at full capacity given rising inflation, a low unemployment rate, and a high current account deficit. High oil prices, slow fiscal consolidation, and security concerns are key risks to the near term growth-inflation outlook.

Monetary policy tightening in 2006 was insufficient to contain inflation, but additional measures were taken in early 2007. In January 2007, the Central Bank of Sri Lanka (CBSL) announced its "Road Map" aiming at reducing inflation to single digit levels by the end of the year through a tighter monetary stance. To this end, the CBSL limited banks' access to the reverse repo window and strengthened prudential measures to contain excessive exposure to sectoral risks. Also, the CBSL stepped up open market operations and allowed treasury rates to increase to 17½ percent during January-June (from 12½ percent at end-2006). These measures, together with a dissipation of pass-through effects from administered price adjustments, contributed to a deceleration in inflation to (annualized) single digits in the first four months of 2007, and real interest rates started to turn positive. This favorable inflation trend has, however, reversed since

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

May and inflation increased to 21¾ percent (yoy) in August due to the combined effect of the elimination of remaining fuel subsidies, increases in food prices, and a pause in further monetary tightening during that period.

The fiscal deficit target for 2007, at 7.8 percent of GDP, indicates a modest fiscal consolidation from a deficit of 8.4 percent of GDP in 2006. This target envisages a substantial increase in tax revenue, a full elimination of fuel subsidies, and a containment of the wage bill. Together, they are expected to more than offset increases in military expenditure, spending on goods and services, and capital spending. Revenue grew by 25 percent in the first half of 2007, but it was still at about 40 percent of the ambitious annual target. Wages and military spending have been contained as of June, but they could continue to be key fiscal risks in the period ahead. The 2008 budget proposal targets a marginal reduction in the fiscal deficit to 7.7 percent of GDP. This falls considerably short of the authorities' earlier plans to lower the deficit to 6.3 percent of GDP in 2008 (under the 2008 Budget Call announced in July).

The external current account deficit is projected to sustain at around 5 percent of GDP in 2007 while reserves are expected to remain at around 2½ months of imports. In the first half of 2007, exports and remittances continued to grow strongly, while import growth decelerated mainly owing to limited increases in world oil prices during that period. For the year as a whole, healthy exports and remittances are expected to be largely offset by the implementation of mega infrastructure projects and high oil prices since July.

In light of favorable local and global liquidity conditions in the last two years, the government has continued to resort to dollar-denominated borrowing to finance the budget while supporting reserves. By end-2006, the public domestic dollar commercial debt reached $1.6 billion (or 6 percent of GDP) at an average maturity of 1½ years. Over 90 percent of this debt was financed from domestic sources, including remittances. This has resulted in a bunching of foreign exchange debt service over the next few years, but so far favorable market conditions have allowed the government to refinance this debt at low cost. In October the government successfully issued its first $500 million international sovereign bond at a yield of 8¼ percent and maturity of 5 years.

Significant progress has been made in improving financial sector stability. Salient features include a sharp decline in the NPL ratios across banks, a marked strengthening in the capital base of the banking industry, and a sustained improvement in banks' operating profits. Moreover, implementation of the Basel Core Principles has advanced to facilitate a planned adoption of Basel II in 2008. Nevertheless, underlying structural and operational weaknesses remain. Further efforts should focus on improving banking sector resilience to shocks through improving asset quality and strengthening credit and liquidity risk management; strengthening risk-based supervision; and advancing structural and operational restructuring in public banks and limiting state interference.

Financial viability of the energy sector is central to fiscal consolidation and debt sustainability over the medium term. Ceylon Electricity Board (CEB) is likely to incur financial losses of about 20 billion rupees (¾ percent of GDP) in 2007, due primarily to the lack of adjustment in electricity tariffs, which have fallen well below cost recovery levels. A large part of these losses was financed by loans from public banks, posing risks to the financial sector. The authorities' medium-term strategy is to use alternative and cheaper energy sources to reduce Sri Lanka's heavy reliance on oil-based thermal power generation. The construction of three coal power plants (total 900 MW) is expected to be completed during 2008–10. This will not only address the acute energy shortage in Sri Lanka but also significantly lower the cost of energy production (by about one-third from the current level) and bring the CEB to cost recovery levels.

Executive Board Assessment

Executive Directors welcomed Sri Lanka's impressive recent growth performance, which has led to a sharp reduction in unemployment and rising per capita income. At the same time, Directors noted that growth has been underpinned in part by expansionary fiscal and monetary policies, leading to an increase in macroeconomic and external sector vulnerabilities. In particular, inflation has accelerated, the external current account deficit remains large, and gross official reserves are relatively low. Directors urged the authorities to tighten macroeconomic policies, while acknowledging that a return to political stability will also be crucial in underpinning sustained economic progress going forward.

Against this background, Directors called for a determined effort to reduce the fiscal deficit to 5 percent of GDP by 2010–11 as planned. This will be essential to ensure public debt sustainability and to create space for productive and social investment. Revenue mobilization and current expenditure rationalization should be key elements of the adjustment effort. In particular, Directors underscored the importance of streamlining tax exemptions, broadening the income and value added tax base, simplifying the value added tax, and strengthening tax administration. In this regard, Directors welcomed the downward revision of the fiscal deficit target for 2007 stemming from an increase in tax revenue, elimination of fuel subsidies, and containment of the wage bill. They called for a sharper fiscal adjustment than envisaged in the 2008 budget proposal, to ensure that the 2008 budget deficit target is consistent with the medium-term fiscal consolidation plan.

Directors noted the significant risk of public debt distress in Sri Lanka, arising from heavy reliance on dollar-denominated, short-term commercial debt. They stressed the need to lengthen and smoothen the maturity profile of the debt to reduce rollover and liquidity risks, including through capital market refinancing, and to improve debt management in general.

Directors were concerned that the decision to deviate from the automatic pricing formula for diesel and kerosene in 2008 could expose the budget to large fiscal and quasi-fiscal risks, if international oil prices remain high or continue to rise. They called for full or significant pass-through of international oil price movements to contain these risks and to promote energy conservation.

Directors considered that further monetary tightening in the near term is warranted in view of the current fiscal risks, strong growth of credit, and inflationary pressures. They advised that open market operations be stepped up and that treasury security rates be allowed to adjust to levels that would help bring down inflation to single digit levels. Policy rates should also be adjusted gradually to align them with market interest rates, thereby restoring their signaling role in the conduct of monetary policy. Directors also encouraged the authorities to improve the coordination of fiscal and monetary policies.

Most Directors agreed that the real effective exchange rate remains broadly in line with economic fundamentals, given the recent trade performance. Directors underscored that greater flexibility of the exchange rate will be needed to reduce external vulnerabilities and safeguard official reserves. In this regard, they welcomed the authorities' commitment to let the exchange rate be market determined, and called for continued attention to the exchange rate in light of potential external pressures arising from high oil prices and the emerging debt refinancing burden. They recommended that intervention in the foreign exchange market be limited to smoothing excessive volatility of the exchange rate, while allowing for a build-up of foreign reserves to more comfortable levels. The authorities were urged to eliminate the exchange restriction arising from the remaining import margin requirement on motor vehicles expeditiously.

Directors commended the progress in strengthening prudential regulations, enhancing banking and insurance supervision and central bank operations, and improving financial market infrastructure. They encouraged continued financial sector reform, guided by the Financial Sector Assessment Program (FSAP) update, with particular emphasis on further improving banking sector resilience, strengthening risk-based supervision, advancing the preparatory work for Basel II adoption in 2008, and accelerating the operational restructuring of state-owned banks. Directors also urged the authorities to limit state interference in the operations of state-owned banks, and some Directors renewed the call for privatization of these banks.

Directors welcomed the launch of the authorities' broad-based Ten-Year Horizon Development Plan (2006–2016), which includes a comprehensive growth and poverty reduction strategy. They underlined the importance of building consensus on the targeted mix of policies and reforms. Regarding the energy sector restructuring plan, Directors welcomed the emphasis on reducing energy costs. However, they called for timely measures to address the current financial imbalances in the Ceylon Electricity Board, including adjustment of electricity tariffs to cost-recovery levels accompanied by adoption of an appropriate safety net to protect the poor.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Sri Lanka: Selected Economic Indicators, 2004–2008

	2004	2005	2006	2007	2008
				Projection	
GDP and inflation (in percent)					
Real GDP growth	5.4	6.0	7.4	6.0	6.0
Inflation (Sri Lanka CPI; average)	7.9	10.6	9.5	17.7	11.5
Inflation (Sri Lanka CPI; end-of-period)	16.8	3.6	17.9	13.0	11.0
Public finances (in percent of GDP)					
Revenue	15.3	16.1	17.1	18.3	18.6
Expenditure	23.5	24.7	25.5	26.0	24.9
Primary balance	-2.2	-3.6	-3.0	-2.6	-0.8
Overall balance	-8.2	-8.7	-8.4	-7.8	-6.3
Overall balance (excluding tsunami)	-8.2	-7.3	-7.6	-7.4	-6.3
Domestic financing	5.8	5.2	5.8	3.3	3.9
Government debt (domestic and external)	107.5	95.3	94.7	90.1	86.2
Money and credit (percent change, end of period)					
Reserve money	20.9	15.8	21.2	11.5	12.7
Broad money	19.6	19.1	17.8	16.3	14.0
Domestic credit	22.4	19.1	29.5	17.0	17.9
Private sector credit	22.1	26.3	24.0	21.9	21.0
Public sector credit	23.2	1.8	46.1	4.4	8.7
91-day T-bill rate (in percent, end of period)	7.3	10.1	12.8	19.0	14.5
Balance of payments (in millions of U.S. dollars)					
Exports	5,757	6,347	6,883	7,646	8,412
Imports	7,999	8,863	10,260	11,307	12,532
Current account balance	-646	-650	-1,339	-1,337	-1,528
Current account balance (in percent of GDP)	-3.2	-2.8	-5.0	-4.6	-4.8
Export value growth (percent)	12.2	10.2	8.4	11.1	10.0
Import value growth (percent)	19.9	10.8	15.8	10.2	10.8
Gross official reserves (end of period)					
In millions of U.S. dollars 1/	1,833	2,458	2,515	2,912	2,854
In months of imports	2.2	2.5	2.4	2.5	2.2
As a percent of short-term debt 2/	88	92	82	91	82
External debt (public and private)					
In billions of U.S. dollars	12.8	13.0	14.2	15.4	16.3
As a percent of GDP	63.9	55.4	52.8	52.6	51.6
Total stock of public dollar commercial debt 3/					
In millions of U.S. dollars	550	1,065	1,609	2,396	2,209
As a percent of GDP	2.7	4.5	6.0	8.2	7.0
As percent of gross official reserves	30	43	64	82	77
Memorandum items:					
Nominal GDP (in billions of rupees)	2,029	2,366	2,802	3,311	3,825
Nominal GDP (in billions of U.S. dollars)	20.1	23.5	26.9	29.3	31.5

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

1/ Excluding central bank Asian Clearing Union (ACU) balances.
2/ As reserves exclude ACU balances, they are also excluded from short-term debt to compute this ratio.
3/ Staff estimates based on total stock outstanding of foreign exchange commercial debt plus nonresident purchase of rupee-denominated treasury bonds.

Statement by K.G.D.D. Dheerasinghe, Alternate Executive Director for Sri Lanka
November 21, 2007

1. The Executive Director's office and the Sri Lankan authorities wish to express their appreciation to the staff for a well focused set of papers. They also wish to thank the Executive Board and the Management of the Fund for useful advise and assistance to Sri Lanka.

2. The GDP data used in our statement are estimates compiled by the Department of Census and Statistics (DCS) of Sri Lanka. As was planned in early 2007 our authorities have decided to use the GDP estimates compiled by the DCS as they are now in a position for timely release of data. For purpose of comparison too GDP data issued by DCS for 2006 have been used. As a result, numbers used in this report may differ marginally from those in the Staff Reports.

Recent Economic Developments and Outlook

3. Despite numerous challenges faced during the year, Sri Lanka has been able to maintain its growth momentum at a historically high level. Following the high growth of 7.7 percent in 2006, Sri Lankan economy grew by 6.2 per cent in the first six months of 2007. The growth is broad based with manufacturing and services sectors growing faster and agriculture sector too contributing positively. The economy is projected to grow by 6.7 per cent in 2007. The unemployment rate which dropped to a record low of 6.2 per cent in the first quarter 2007, has risen marginally to 6.5 per cent during the second quarter largely due to a decline in employment in the agriculture sector. However, unemployment will remain low due to creation of new employment opportunities in the manufacturing and services sectors.

4. Our authorities are well aware of the need to contain high inflation that is prevalent at present. The inflation which decelerated till June 2007 reversed its trend since July 2007 attributable to upward adjustments in certain administered prices and removal of fairly high subsidies on diesel and kerosene prices. Removal of subsidies, however, is expected to contribute positively in lowering inflation in the future as it would reduce inflationary financing of the Government budget. With a view to addressing the issue of high inflation Sri Lankan authorities have also announced a "Road Map for Monetary and Financial Sector Policies for 2007 and Beyond" indicating their commitment to contain growth in money supply and to bring down inflation to a single digit level by end 2007. To contain money growth at targeted levels, a tight monetary policy stance has been adopted by the Central Bank. Policy interest rates were raised by 50 basis points during the year whilst resorting to aggressive open market operations to maintain market liquidity at a desired level. The tight monetary policy measures have enabled the Central Bank to achieve reserve money targets during the first three quarters of the year. To ensure greater transparency, our authorities have taken steps to strengthen the communication policy of the Central Bank by issuing regular and occasional press releases for information of the public.

5. As stated in our Buff statement last year, Sri Lankan authorities were well aware of the need to contain fiscal deficit to avoid adverse ramifications associated with it. They also understand that

fiscal prudence is a necessary condition in successful economic management. While confirming the line, our authorities have given priority to further strengthening fiscal consolidation process through enhancing government revenue and rationalizing expenditure whilst maintaining adequate public investment to provide impetus to growth. The authorities have taken measures to strengthen tax administration, streamline tax incentives and exemptions whilst enhancing tax compliance and enforcement. As a result of this concerted effort tax revenue has increased by 20.9 per cent in the first nine months of 2007. The recurrent expenditure is expected to decline to 17.8 per cent in 2007 compared to 18.7 per cent in 2006 as a percentage of GDP. The overall fiscal deficit has been declining steadily from 10.8 per cent in 2001. The revised Government Budget 2007 projects to reduce the overall deficit to 7.2 per cent of the GDP as compared to 8.1 per cent in 2006. The Budget 2008 proposes a further reduction of the deficit, although marginally, to 7.0 per cent of GDP.

6. Sri Lankan authorities are committed to maintaining a market determined exchange rate with limited intervention in the domestic foreign exchange market only for smoothening any excessive volatility. As noted by the staff in their paper on "Selected Issues" Sri Lanka's external competitiveness estimates of the equilibrium Real Effective Exchange Rate (REER) under various approaches indicate that the current level of REER is broadly in line with economic fundamentals. Import margin requirement (50 per cent) which was introduced in October 2006 on selected goods was removed in May 2007. However, Sri Lankan authorities are compelled to maintain the 100 per cent margin requirement imposed on selected vehicle imports purely as a prudential measure to ensure broader macro economic stability.

7. As an oil importing country, Sri Lanka is experiencing difficulties due to high and rising oil prices. Oil import bill accounted for 20 per cent of imports in 2006. The rising oil bill continues to exert pressure on the exchange rate and drain on reserves. The authorities have already removed the subsidy on domestic prices and allowed petroleum companies to revise domestic prices of their products in line with international market prices since July 2006. Further, the authorities have encouraged the state owned oil company to enter into hedging arrangements as a risk management measure. In spite of rising oil and food import prices, the external sector has shown a significant improvement in the first 8 months of 2007. Export growth has been 11.7 per cent and this together with slower growth of imports at 3.5 per cent, has resulted in a reduced trade deficit. Terms of Trade too have shown a marginal improvement. The remittances by Sri Lankans employed abroad have shown a growth of 17 per cent and this has helped finance over 80 per cent of the trade deficit whilst containing the current account deficit at a low level. The foreign direct investments have reached a record level of US$ 604 million in 2006 and the authorities are confident that this trend is continuing further in 2007. With increased capital inflows, the overall Balance of Payments (BOP) showed a surplus of US$ 192 million during the first half of 2007 and is projected to record a surplus of US$ 450 million by end 2007. As a result, the gross official reserves are expected to increase from US dollars 2,526 million at end 2006 to US dollars 2,971 million by end 2007. Our authorities are committed to maintain this trend in the medium-term, as well.

8. The high level of public debt has drawn the attention of the authorities. The debt to GDP ratio has continuously declined in response to the prudent measures adopted since 2004 when public debt outstanding stood at 102.5 per cent of GDP. According to latest estimates, the outstanding Government debt would decline further to 85.5 per cent of GDP in 2007. The authorities are mindful of the issues discussed in the staff paper on Debt Sustainability Analysis.

Financial Sector Developments and Stability

9. Financial sector in Sri Lanka expanded further assisted by increased competition, innovations and growth in economic activities. Profitability, capital and asset quality indicators of banks improved thereby witnessing the financial sector stability. However, some degree of volatility in the money, exchange and capital markets was observed due to market uncertainty and high inflation expectations. The authorities have adopted measures to improve risk management, enhance access to finance, strengthen payments and settlement systems and improve supervision and regulation of financial institutions. The Inter Regulatory Institutions Council was set up in early 2007 to ensure effective regulation of financial conglomerates. The outlook for financial system stability remains favourable as the capacity of the financial system to withstand and manage risks at the institutional and infrastructure level has improved significantly. The Real Time Gross Settlement System has operated with almost 100 per cent system availability. The cheque imaging and truncation system became operational since early 2007.

10. As stated in our Buff statement last year, our authorities do not consider privatization as a panacea. Instead of privatization option, the two state owned banks have been given commercial autonomy and they have performed extremely well manifesting this right decision. The financial performance of the two state banks in 2006 outclassed many private and foreign banks in a highly competitive environment of the banking industry in Sri Lanka. As a further step towards gradual liberalization of the financial sector, foreign investors have been permitted to invest in Sri Lanka Rupee denominated Government Securities subject to a limit. A new Companies Act incorporating international best practices was enacted in 2007. The implementation of Basel II from January 2008, adoption of a mandatory Code of Corporate Governance for banks and moving towards International Accounting Standards for financial reporting would undoubtedly contribute to further improvement of stability in the financial sector.

11. Our authorities are pleased with the success of the debut international bound issue of US$ 500 million which was launched last month. It is encouraging to note that in the back drop of adverse market conditions such as the subprime crisis, affecting investor sentiments around the world, Sri Lanka's inaugural bond issue received an overwhelming response from investors across the globe. The authorities believe, that this is a clear manifestation of investor confidence in the Sri Lankan economy. The authorities are of the view that the debut bond issue has enabled Sri Lanka to establish its presence in the international capital markets and broaden the country's investor base. Further, the bench mark established by the Government with this bond issue would assist the large private corporates of Sri Lanka to access international capital markets in the future. The authorities intend to invest the proceeds of the bond issue in a number of large infrastructure projects including

a sea port, two power plants, two highway projects and several irrigation projects construction of which have been approved in the Budget 2007.

12. Recognising the value of the FSAP, our authorities engaged with the Fund and the Bank to have an assessment early, in 2002. The recent update of the FSAP was requested for as many improvements have been instituted in the financial system since the initial assessment. The authorities have engaged in major reforms that have further enhanced the financial system as acknowledged in the FSAP report. The resilience of the banking sector has grown with strong improvements in the key performance indicators, in a challenging macro economic environment. Legislative changes and other reforms have strengthened the regulatory and supervisory capacity of the Central Bank and other regulatory bodies. With the implementation of Basel II from the beginning of 2008, the risk management of banks and supervision of the banking system would be strengthened further. The infrastructure for financial sector activity has been greatly improved. A real time gross settlement system, a scripless security settlement system and a central depository system for government securities have been put in place, as has a cheque imaging and truncation system. Thus, a modern, efficient and reliable payment and settlement system is in operation.

13. The authorities broadly agree with the observations by staff in the FSAP update. The specific comment of the authorities on the two ROSCs are noted in Appendix I and Appendix II to the FSAP. We would like to highlight a few comments in this Buff.

(a) Our authorities are strongly of the view that privatization is not the only way to improve the performance of state-owned enterprises. It can be achieved by providing greater autonomy and operational independence. In fact, the vast improvement in the performance of the two state-owned commercial banks in recent years is clear testimony to this.

(b) There is no evidence that the presence of the Secretary to the Treasury, in the governing board of the Central Bank carries the risk of conflict of interest and lack of independence. In fact, his presence on the Board has helped to ensure consistency in policy and close co-operation between the Central Bank and the Ministry of Finance.

14. Our authorities are deeply conscious of the fact that continuous improvements are required in any financial system to ensure its continued strength and resilience. As such, they will continue to implement policies and changes to strengthen the stability of the financial system.

Structural Issues and Reforms

15. Our authorities are well aware of the need for structural changes, reforms and market development in order to sustain the growth momentum and alleviate poverty. Progress has been made in introducing reforms in the existing public enterprises through the Strategic Enterprise Management Agency which was set up a few years ago. Reforms in public administration includes the introduction of IT systems in the registration of births, marriages and deaths and its data base

management. A legal reform project is underway at present and several regional Appeal Courts were set up, this year, to accelerate legal proceedings relating to appeal cases which were hitherto confined to one Appeal Court in Colombo.

Future Directions

16. Our authorities have emphasized that the future direction of the economy will fall within the framework of "Mahinda Chintana", vision for a new Sri Lanka, a Ten Year Horizon Development Framework 2006-2016" The strategies of this policy framework has been built on the basis of free market concepts with domestic aspirations to provide necessary support to domestic enterprises including small and medium enterprises and to encourage foreign investment. With the adoption of this strategy our authorities are confident in maintaining a high economic growth ensuring a regionally balanced growth whilst providing better livelihood for people including those who are in abject poverty. The Sri Lankan authorities have embarked on several key infrastructure projects in the areas of power generation, irrigation, high ways, ports and airports as part of the growth strategy.

17. Pursuant of efforts to widen the ambit of Indo-Sri Lanka Free Trade Agreement (ISLFTA) to go beyond the horizon of trade in goods and include trade in services to facilitate greater investment flows between the two countries as well as to explore new areas of economic corporation, the Sri Lankan authorities have held several rounds of negotiations with the Indian authorities under the Comprehensive Economic Partnership Agreement signed between India and Sri Lanka a few years ago. The relaxation of rules of origin, reduction of the existing negative list, resolving the issues relating to implementation under ISLFTA, Customs co-operation and trade facilitation, dispute resolution and preferential safeguard measures will facilitate further trade expansion between the two countries. Sri Lanka which depends heavily on trade has a great potential for trade expansion particularly with countries in the region.