August 2010
IMF Country Report No. 10/260

Sri Lanka: First Review Under the Stand-By Arrangement—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Sri Lanka.

In the context of the first review under the stand-by arrangement, the following documents have been released and are included in this package:

- The staff report for the First Review Under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on September 22, 2009, 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 October 26, 2009. 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 Press Release summarizing the views of the Executive Board as expressed during its November 6, 2009 discussion of the staff report that completed the request and/or review.

- A statement by the Executive Director for Sri Lanka.

The documents listed below have been separately released.

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

*Also included in Staff Report

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

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SRI LANKA

First Review under the Stand-By Arrangement

Prepared by the Asia and Pacific Department in Consultation with Other Departments

Approved by Kalpana Kochhar and Dominique Desruelle

October 26, 2009

Stand-By Arrangement: A 20-month Stand-By Arrangement in the amount of SDR 1.65 billion (400 percent of quota) was approved by the Executive Board (IMF Country Report No. 09/310) on July 24, 2009, and a first purchase of SDR 206.7 million was made following the Board meeting. With the exception of the performance criteria on net domestic financing (NDF) of the central government, all end-July performance criteria were met. The net international reserves (NIR) and reserve money targets for end-September have also been met. Unadjusted NDF was held below the end-September ceiling, and available data suggest that the target is within reach. Given these considerations, staff supports the authorities' request for a waiver of applicability for the end-September NDF target.

Summary: Economic developments have been somewhat stronger than expected. The decline in output growth is showing some early signs of bottoming out. Exports have recently shown signs of a recovery. Import growth has thus far remained subdued, but higher-than-expected remittances since May and the pickup in economic activity are likely to deliver a rebound in the second half of this year. A sharp increase in investor interest has led to significant capital inflows, and gross reserves currently stand at \$4¾ billion. Private sector credit growth has been sluggish but there are signs that credit demand is now picking up. As anticipated, banks' nonperforming loans have increased, but the banking sector remains well-capitalized. Budget revenues have grown somewhat partly reflecting the impact of the tax measures put in place in May, and the budget deficit is still on track to reach the target of 7 percent of GDP in 2009. This will, however, require further growth in revenue and significant expenditure restraint.

Discussions: A staff team consisting of B. Aitken (Head), D. Nyberg, M. Saxegaard (APD), E. Kvintradze (SPR), S. Peiris (MCM), and K. Mathai (Resident Representative) visited Colombo on September 9-22, 2009. Mr. Dheerasinghe (OED) joined the discussions. The team held discussions with the Senior Advisor the President, the Deputy Minister of Finance, the Governor of the Central Bank of Sri Lanka, Secretary to the Treasury, representatives of the private sector and civil society, donors, and other officials.

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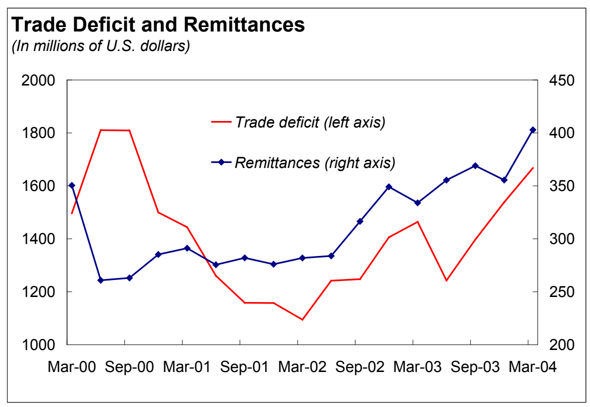
I. Background

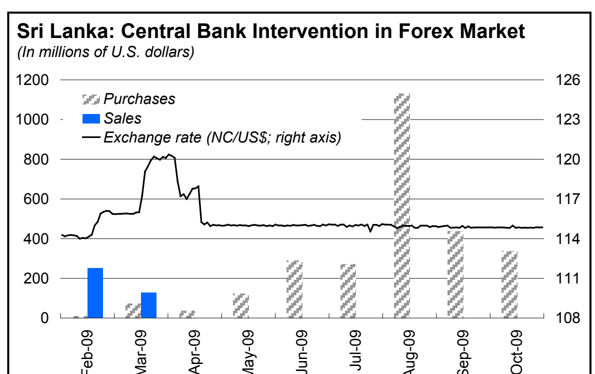
1. **Context.** Following the end-July Board approval of the program, economic developments have been somewhat stronger than expected. The growth outlook has improved as a result of higher confidence following the end of the war with the LTTE. The economy is now projected to grow at 3½ percent in 2009 relative to a projected 3 percent at the time of program approval, mainly on account of a faster than expected recovery in the retail sector and construction and improved prospects for tourism (Table 1). Inflation remains subdued at below 1 percent and is expected to remain in the single digits for 2009.

2. **Political developments.** In the first post-war local elections on August 8 the governing coalition won the majority of seats in the northern town of Jaffna, but suffered a defeat to a regional Tamil party in the town of Vavuniya, an area where a significant number of the internally displaced persons are being held in government camps. In elections in the Southern Province on October 10, the ruling party won an unprecedented two-thirds majority of the vote, reflecting the current popularity of the government among the wider population following the victory over the LTTE. Parliamentary elections will be held by end-April, 2010, and it is expected that early presidential elections will be called for in early 2010.

3. **External sector.** Growth projections for both exports and imports have been revised upward since July. Exports have showed signs of recovery in recent months and are expected to pick up further during the remainder of the year, in particular for garments where exporters are now experiencing strong demand from European and U.S. purchasers needing to rebuild their depleted inventories. Tea exports, which suffered earlier this year from inclement weather, are also expected to increase. Import growth has thus far remained subdued, but higher-than-expected inflows of remittances since May and the pick up in economic activity are likely to deliver a rebound in imports during the second half of this year, as was the case in the period following the 2002 ceasefire agreement.



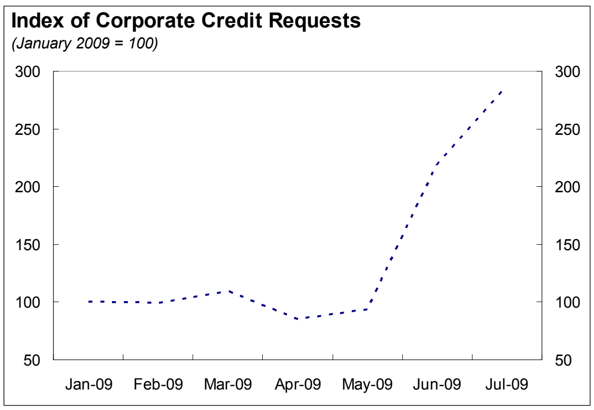
4. **Foreign exchange reserves.** A sharp increase in foreign investor interest has led to significant capital inflows into the government securities and stock markets. Over $1 billion flowed into the domestic bond market since end-July, with nearly $900 million alone in purchases of four- and six-year bonds by a U.S.-based hedge fund over three days in mid-August. As a result, the average maturity of domestic debt has increased. The central bank continues to implement its policy—put in place in mid-

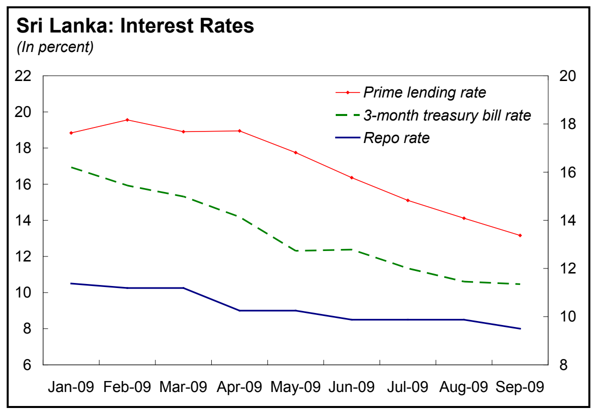


Sources: Bloomberg LP.; and Central Bank of Sri Lanka.

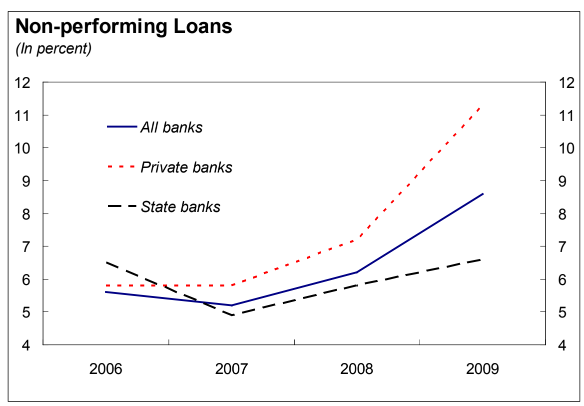
March—of intervening in the foreign exchange market to prevent the rupee from appreciating. Gross reserves have increased rapidly and currently stand at a record $4¾ billion—equivalent to around five months of imports—compared with $2½ billion projected for end-2009 at the time of program approval.[1]

5. **Monetary developments.** Monetary conditions have eased further since July. Reserve money continues to increase in line with expectations, supported by a reduction in policy rates in mid-September. Treasury bill yields have also declined but remain high in real terms, as the central bank has sterilized the bulk of the recent increase in reserves. Credit growth has been sluggish reflecting a lack of lending opportunities. Lending rates, despite their recent decline, remain high. There are signs however that credit demand is now picking up sharply with an increase in optimism about the economic outlook.





6. **Financial sector.** Immediate stresses in the financial sector have eased significantly since early 2009. The Sri Lankan stock market has rallied by more than 40 percent since the end of the war, reaching an all time high in recent weeks. As anticipated, however, the drop in output growth in the first half of 2009 has been reflected in an increase in banks' non-performing loans, although the banking sector remains well-capitalized. The recapitalization of Seylan Bank—a systemically important bank, where the management was handed over to Bank of Ceylon in early 2009 while the central bank functioned as the facilitator —was completed on September 22 through a public share offering and private placement to pre-qualified investors (meeting the program's structural benchmark).

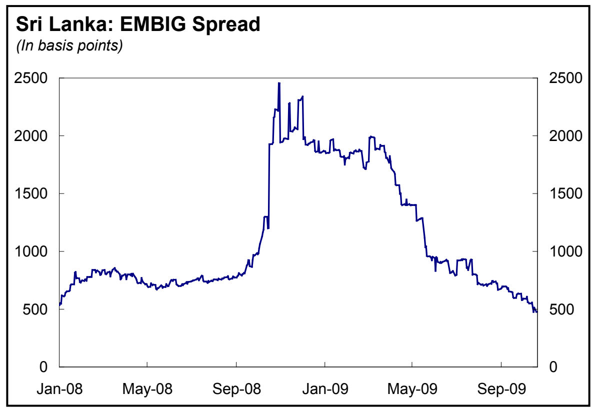


[1] This includes $508 million from the additional SDR allocation in August.

7. **Fiscal policy.** Fiscal performance has been broadly in line with program projections. Revenue is showing signs of recovering as tax measures adopted earlier this year yield results and economic activity picks up.[2] Expenditure growth through August was somewhat higher than expected on account of faster than anticipated execution of donor-financed projects and other current expenditures.

8. **Donor financing.** The ADB and the World Bank are increasingly shifting focus toward financing the war-affected Northern and Eastern provinces. The World Bank recently approved a $75 million project which targets vulnerable communities in the south, and is considering $75 million for the resettlement of internally displaced persons and a $105 million project for provincial roads. The ADB recently approved a $70 million provincial roads project and a $100 million wastewater project, and is expected to provide an emergency assistance loan to help support resettlement of the internally displaced persons. India has increased its support, pledging some $100 million in grants targeting reconstruction-related projects.

9. **Regaining market access.** The authorities issued a five-year $500 million Eurobond in October at a coupon of 7.4 percent. The issue was oversubscribed due to strong foreign investor interest as reflected by the recent decline in the EMBIG spread on the Eurobond issued in October 2007. The proceeds are being used to retire more expensive domestic debt, improve debt sustainability, and lengthen the maturity structure of the debt portfolio.



10. **Program performance.** With the exception of the end-July performance criterion on net domestic financing (NDF), all targets for end-July—as well as the performance criteria on net international reserves (NIR) and reserve money for end-September—have been met (Letter of Intent, Table 1). End-July NDF exceeded the ceiling by about Rs. 2 billion, or less than 1 percent of the program target, because of somewhat faster than anticipated execution of donor-financed projects. These expenditures are difficult to monitor in real time owing to reporting lags[3] and for this reason the staff views the non-observance of the end-July NDF target as reflecting a lack of data available to the authorities as they formulate their borrowing plans, rather than a lack of commitment to the program's targets. Unadjusted NDF for end-September was held below the program ceiling, and available data suggest that the

[2] Revenue jumped sharply in September, in part reflecting a one-off payment by state enterprises of tax arrears which had accumulated over the first nine months of the year.

[3] In the current program design the ceiling on NDF is automatically reduced if external loans to the government are higher than initially assumed under the program. Data on externally financed project implementation are only available with a five week lag.

target is within reach. Given these considerations, staff supports the authorities' request for a waiver of applicability for the end-September NDF target.

11. **Changes to program design.** [4] For the NDF target to fully reflect the authorities' active efforts at fiscal management, the Technical Memorandum of Understanding (Attachment II) has been revised to exclude the automatic adjustor on project financing in assessing future targets, beginning with end-December. However, it is important to preserve the spirit of this adjustor, which is to ensure that the overall budget spending—project and non-project—is undertaken in line with the budget deficit targets. Going forward staff will continue to monitor project financing closely, and if actual financing exceeds program projections because of disbursements from new loan commitments, future NDF targets would be lowered to ensure overall borrowing is in line with the program deficit targets.

II. Policies and Discussion

A. Monetary and Exchange Rate Policy

12. **Monetary policy.** The central bank's policy of gradually loosening monetary conditions has been successful at reversing the liquidity shortages observed earlier this year and bringing down market interest rates. Authorities and staff agreed that because of the continued low inflation and below-potential output growth, there remains scope to loosen monetary policy further, and the program targets for reserve money have been increased accordingly. The authorities noted however that the decline in lending rates is likely to lag policy rates, and that it could be some time before a rebound in credit growth is fully underway.

13. **Reserve accumulation.** The authorities' policy of accumulating in reserves the full amount of capital inflows as a buffer in the event of capital flow reversals continues to be appropriate. To account for the better-than-programmed performance since July and to smooth the reserve buildup over the program period, the end-December NIR target has been revised upward. In keeping with the program's principle that external solvency requires a buildup in net reserves through current account adjustment rather than through external borrowing, the authorities and staff agreed to include an adjustor to the program's NIR target for any external commercial borrowing, including the Eurobond issue.

14. **Exchange rate assessment.** Recent developments have not fundamentally changed the assessment that Sri Lanka's competitiveness remains a concern. Remittances have exceeded expectations, but Sri Lanka's experience following the 2002 ceasefire agreement suggests that these flows will likely be followed by higher consumer imports and a deterioration in the trade balance.

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[4] To accommodate the later-than-envisaged Board date for this review, the purchase dates projected for the second and third reviews have been postponed by one month. The test dates for the quantitative performance criteria and indicative targets for these reviews remain unchanged.

15. **Exchange rate policy.** With Sri Lanka's economy currently in a state of flux, the net supply of foreign exchange to the market could remain strong for some time. But declining remittance inflows, increasing imports, or slower export growth could reduce this supply. The authorities recognize this, reiterating their commitment to allow the exchange rate to adjust as needed to meet the program's reserve targets, and agreed that smoothing the path of intervention to avoid any disruptive movement in the exchange rate would be the right approach if foreign exchange shortfalls are anticipated. Staff also emphasized that markets are increasingly acting on the expectation that the de-facto peg will continue indefinitely, and advised the central bank to begin introducing a limited amount of two-way exchange rate flexibility now to signal to markets that exchange rate policy will not be anchored on a specific peg going forward. The authorities are considering the merits of this approach.

B. Fiscal Policy

16. **Fiscal balances in 2009.** The authorities remain committed to meeting the deficit target of 7 percent of GDP in 2009. They appreciate that achieving this target will be challenging, requiring further revenue improvements and significant expenditure restraint for the remainder of the year. Assuming underlying revenue growth in line with program assumptions—not beyond reach given the trend to date and the full-year effect of the increase in the nation building tax—monthly expenditure in the fourth quarter would need to be held to about 85 percent of the average for the first nine months. While recognizing the need to preserve expenditures on social sectors, the authorities have indicated that there is scope for further savings in non-personnel military spending, low-priority capital projects, and spending on civilian goods and services in order to achieve the target if revenue turns out lower than anticipated.

17. **Interim budget for 2010.** In view of the upcoming parliamentary elections, the cabinet has approved an interim, pre-election ("vote-on-account") budget. This interim budget limits expenditure in the first four months of 2010 to one-third of the budgeted rupee expenditure for 2009, thus helping to deflect pre-election spending pressures. In particular, the interim budget implies ambitious cuts in non-interest recurrent expenditure of 1¾ percent of GDP (on an annualized basis) relative to the first four months of 2009. Depending on revenue and capital spending developments, staff estimates that the interim budget deficit could fall in the range of 6¼ to 6¾ percent of GDP on an annualized basis, broadly consistent with the program's path of fiscal adjustment within the year. [5]

18. **Fiscal adjustment in 2010 and program modifications.** The decision to put in place an interim budget requires some program modifications to maintain the momentum of the good performance so far through the election period while ensuring that fundamental budget reforms are undertaken as soon as the new parliament is in place in April. First, the rules of the interim budget would prevent the government from announcing any new pre-election expenditure initiatives or legislative tax measures, delaying the authorities' ability to

[5] Parliamentary approval of the interim budget by end-December is a new structural benchmark.

implement structural fiscal reforms as previously scheduled. Second, while this budget limits pre-election spending, it does not allow the government to commit formally to budget targets for the year as a whole. Nevertheless, the authorities remain committed to the underlying deficit target for 2010—excluding reconstruction spending—of 6 percent of GDP, and to undertaking tax reform. They will now present to parliament a full year budget for 2010 consistent with the program's deficit target in April, rather than originally envisaged by end-December.[6] They reiterated their intention to keep in this budget security-related expenditure in 2010 constant in nominal terms, implying a cut of ½ percent to ¾ percent of GDP relative to 2009. They maintain their commitment to undertaking tax reform, including base-broadening policy measures, and will draw on the work of the Tax Commission in formulating the 2010 budget proposal. These commitments, together with the revised structural benchmarks, are spelled out in the Letter of Intent for this review.

19. **Tax policy.** The work of the Tax Commission is moving ahead. The commission is considering a wide range of measures with the specific aims of broadening the tax base, simplifying the tax regime, and raising revenue. They are soliciting views from interested parties, including the banking and private sectors, and have benefited from preliminary inputs from a recent FAD technical assistance mission. The commission is on target to compete its interim review by end-October.

20. **Reconstruction.** The authorities have developed a plan for post-war reconstruction of the North (Box 1). The estimated cost for all projects in the three-year reconstruction program is placed at around $2½ billion. A more realistic list of the authorities' priority projects (mainly for the reconstruction of roads, railways, and social infrastructure projects) will cost significantly less and is likely to be closely tied to the availability of foreign financing. While the authorities are still in the early stages of identifying the necessary financing, they hope to be able to obtain loans from donors including the World Bank, the ADB, China, and India sufficient to spend up to ¾ percent of GDP (about $350 million) on reconstruction in 2010.

21. **Accommodating reconstruction spending in the program.** The program aims to ensure underlying fiscal adjustment while allowing for needed reconstruction spending, taking into account its impact on debt sustainability (IMF Country Report No. 09/310, ¶21). To this end the staff and authorities have agreed on an approach in which reconstruction spending will be treated separately from the underlying fiscal adjustment, beginning with the full-year 2010 budget. The underlying budget deficit target under the program will still be set at 6 percent of GDP, with adjustments to that target based on a limited amount of specific and monitorable post-war reconstruction spending. This limit will be based on an analysis of the debt sustainability implications of the government's overall three-year reconstruction program to be carried out as part of the second program review once the total cost of the priority reconstruction projects becomes clearer.

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[6] The structural benchmark on submission to parliament of a full-year 2010 budget consistent with program targets has been moved from end-December, 2009 to end-April, 2010.

Box 1: Reconstruction plans for the Northern Province, 2010-2012

Following the conclusion of the war in May 2009, the authorities are now assessing the reconstruction needs of the Northern province, the poorest in the country and accounting for about 3 percent of the nation's output. Around 6 percent (1 million) of Sri Lanka's population lives in the province, of which 97 percent are of Tamil origin.

The government's overall reconstruction strategy builds on the experience gained following the Tsunami in 2004 and the rebuilding of the Eastern Province, which started in 2007. A Presidential Task Force for Resettlement, Development and Security in the Northern province is leading the reconstruction effort. In addition to the resettlement of internally displaced persons, the task force is also in charge of planning and monitoring reconstruction of the social and economic infrastructure.

Reconstruction expenditure in Northern Province, 2010-2012
(In Rs. Billions)

1. Social protection and livelihood development	8.5
(Main areas: resettlement of IDPs and public service delivery)	
2. Improving economic infrastructure	159.4
(Electricity, roads, public transport, water supply)	
3. Strengthening social infrastructure	29.3
(Education, health, cultural affairs)	
4. Revitalization of productive sectors	28.5
(Agricultural and industrial development)	
5. Human settlements development	69.2
(Housing)	
Total	294.9

The authorities have allocated nearly ¼ percent of GDP in the 2009 budget toward reconstruction spending in the North. In addition, the preliminary needs assessment identifies reconstruction projects of about $2½ billion during 2010-2012, equivalent to about 1¼ percent of annual GDP. Within that envelope, the authorities have identified a list of "priority projects" which will be the first to be undertaken based on available financing. Projects address reconstruction needs in the five main areas of social protection and livelihood development, economic infrastructure, social infrastructure, revitalization of productive sectors, and human settlements. Each project proposal contains a discussion of the rationale, detailed costing and time frame for completion.

The authorities have now begun approaching donors bilaterally for assistance in financing priority reconstruction projects. For some of the larger projects such as road construction and electricity generation, donors can finance part of, rather than the whole project. Most projects assume around 75 percent foreign financing, with the remainder accounted for by domestically-financed counterpart funding.

22. **Fiscal risks.** The fiscal adjustment required for 2009 and 2010 entails substantial risks.

- Meeting the NDF target for end-December, while still possible, will require both further growth in revenue and the ability of the authorities to exercise expenditure restraint. If revenue falls short, the authorities' ability to tighten expenditure to meet the target will become increasingly difficult.

- Achievement of the underlying deficit target of 6 percent of GDP (excluding reconstruction spending) in 2010 will require fundamental tax reform measures or further expenditure measures to be introduced in the full-year 2010 budget. Absent such measures, it is not clear how the program deficit target will be met. The staff would need to evaluate during the fourth review whether the measures proposed by the tax commission and included in the 2010 budget would be revenue enhancing in their first year of implementation, or whether deeper cuts in planned spending would be needed.

23. **State-owned enterprises.** The financial performance of the Ceylon Petroleum Company (CPC) and the Ceylon Electricity Board (CEB) during the first half of 2009 was mixed. The CPC recorded a profit as international market prices for petroleum products remained below domestic retail prices. However, the CEB's losses widened owing to lower than anticipated rainfall which required a shift from relatively cheap hydro power to more expensive thermal electricity generation. The projection for the combined losses of CPC and CEB in 2009 remains unchanged at around ¾ percent of GDP. Nevertheless, the authorities plan to reduce losses at the CEB, both through shifts in the near term toward hydro generation and longer-term measures to reduce generation costs, drawing on assistance from the ADB, remains on track.

C. Financial Sector

24. **Financial sector reform under the program.** Steady progress has been made on the financial sector reform agenda: the recapitalization of Seylan Bank is complete; a contingency plan for the workout of problem banks and financial institutions has been completed by the central bank; and a revised Banking Act aimed at improving the bank resolution framework—which incorporates comments made by all stakeholders including the IMF—has been approved by the central bank.

25. **Banking system.** The rise in NPLs is a concern, but staff agreed with the authorities that the healthy capital position of most banks meant that this did not pose a major risk to the system, although it could constrain credit growth in the months ahead. The central bank supervision department will be closely monitoring the situation to ensure that banks maintain adequate provisioning levels. Spillovers from troubled non-bank finance companies to the rest of the banking system have abated following the transfer of management of Seylan Bank to Bank of Ceylon, although a number of small, distressed finance companies remain to be restructured. The authorities noted that the future Finance Company Act, which is scheduled

to be submitted to Parliament by mid-2010, will clarify the resolution framework for these companies.

III. Other Issues

26. **Safeguards.** The central bank has made a good progress toward implementing the recommendations of the safeguards mission that visited Colombo earlier this year. In particular, the Auditor General has signed a memorandum of understanding formalizing the modalities for the external audit of the CBSL and clarifying the roles of the Auditor General and the audit firm so as to ensure continuity of high-quality external audits. Moreover, as recommended by the safeguards mission, the Management Audit Department has verified the compilation methodology for NIR and reserve money for April, June, and July and will continue to do so for forthcoming test dates.

IV. Staff Assessment

27. **Overview.** With the approval of the program and the end of the conflict, Sri Lanka's immediate external vulnerabilities have subsided, and gross reserves are now at a comfortable level. Nevertheless, the fundamental policy weaknesses which left the country vulnerable in the first place—persistently high budget deficits and external imbalances—still need to be addressed. The authorities have made commendable early progress to this end, and the program remains on track, but continued fiscal deficit reduction and a buildup of reserves through a strengthening of the current account are still needed.

28. **Monetary policy.** The central bank's policy of gradually loosening monetary conditions has been successful in reversing liquidity shortages from earlier this year. But low inflation, weak credit growth, and below-potential output call for a further loosening of monetary policy to support the economic recovery.

29. **Exchange rate and reserve policy.** The central bank's policy of accumulating in reserves the full amount of capital inflows as a buffer in the event of capital flow reversals remains appropriate. At the same time, reserve buildup through foreign borrowing rather than through the current account does not address the economy's external vulnerabilities.

30. **Fiscal policy.** In keeping broadly in line with the program's ambitious fiscal targets the government has demonstrated its commitment to deficit reduction, but this commitment will be increasingly tested going forward. The government remains committed to its deficit reduction targets, but a reprioritization of spending and a sustainable increase in revenues are needed to achieve these. Savings on defense spending should help preserve social spending while containing overall expenditures. A sustainable increase in revenue will require fundamental tax reform focused on raising revenue not by raising rates, but by broadening the base and simplifying the tax system.

31. **Interim budget.** This budget will help deflect pre-election spending pressures in the run-up to parliamentary elections. At the same time, it would delay the authorities' ability to implement planned structural fiscal reforms as previously scheduled, including base-

broadening tax policy measures. The staff believes that changes to the program can be made to carry the momentum of the authorities' good performance to date through the upcoming election period, while respecting the political process and allowing the authorities' to carry out their commitment to implement structural fiscal reform measures once the new parliament is in place.

32. **Reconstruction.** The post-war reconstruction needs required to rehabilitate the North will be considerable over the next three years, but the effort must balance these needs against safeguarding Sri Lanka's debt sustainability. This underscores the importance of fundamental tax reform and further cuts in recurrent spending. In this regard it is encouraging that the government remains committed to its target of reducing the underlying, non-reconstruction related 2010 budget deficit to 6 percent of GDP, while limiting reconstruction spending to only the most important, high priority projects.

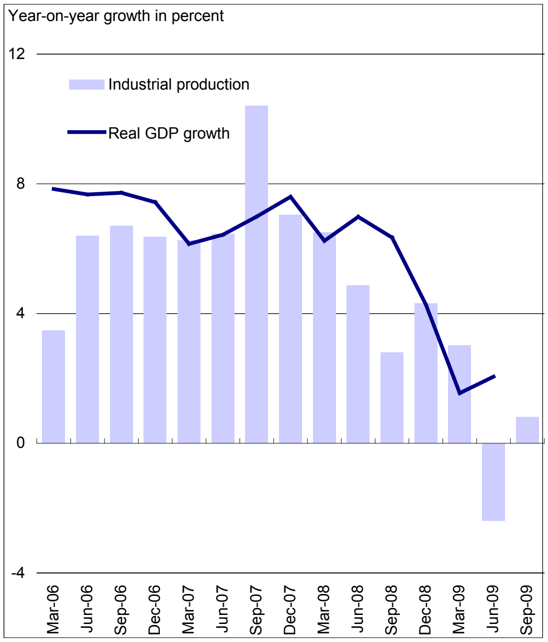
33. **Financial sector.** The rise in non-performing loans, while expected, is a concern. However, the central bank's actions in ensuring that banks retain relatively healthy capital positions have reduced the risk that this poses to the financial sector as a whole. The government's commitment to maintaining the steady progress made so far on financial sector reform, including revising the Banking Act to improve the bank resolution framework, is encouraging.

34. **Risks.** Since program approval, the balance of risks has shifted away from acute short-term external financing problems toward achieving the budget deficit reduction targets. Meeting the domestic borrowing target for end-December, while still possible, will require both further revenue growth and the ability of the authorities to exercise significant expenditure restraint. The authorities' commitment to the deficit target for 2010 is welcome, and the tight non-interest recurrent expenditure restraint implied by the vote-on-account budget is a step in that direction. But with the delay in presenting to parliament the full year budget, the government's plan to achieve this target will only be clear at the time of the program's fourth review. Going forward it will not be sufficient for the authorities merely to exercise spending restraint. They will increasingly need to implement politically difficult but sustainable tax and expenditure reforms to meet the program's deficit reduction targets.

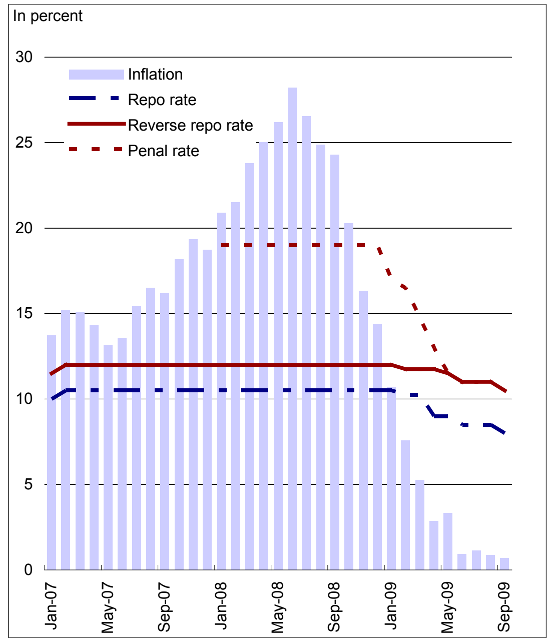
35. The Sri Lankan authorities' performance so far under the program is encouraging and, while the program remains ambitious, its objectives are within reach. Staff believes that although the government's decision to pursue an interim pre-election budget delays by four months the authorities' ability to demonstrate their full-year program commitments for fiscal reform, it does not reflect a weakening of these commitments. On this basis, staff recommends the approval of the First Review.

Figure 1. Recent Economic Developments

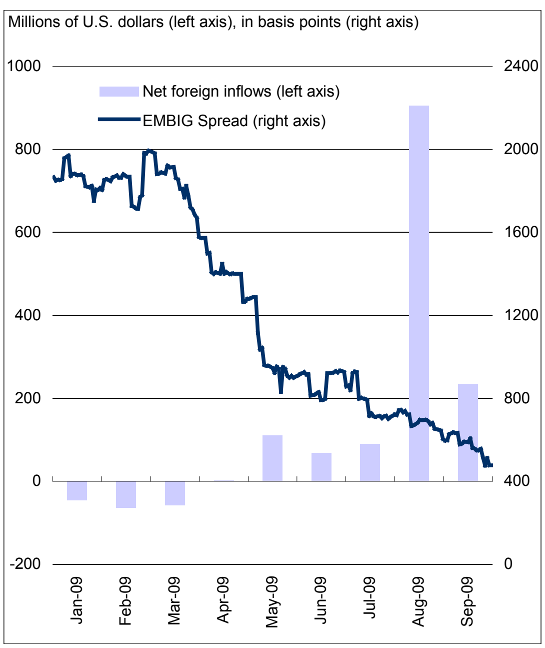
Economic growth remains weak, but there are signs of a recovery.



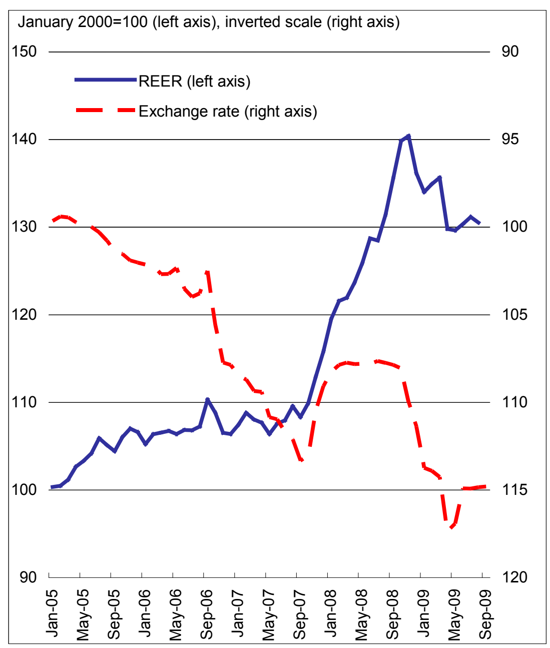
Sharply lower inflation has allowed the central bank to lower key policy rates.



Foreign investor enthusiam has led to higher capital inflows and a decline in spreads...



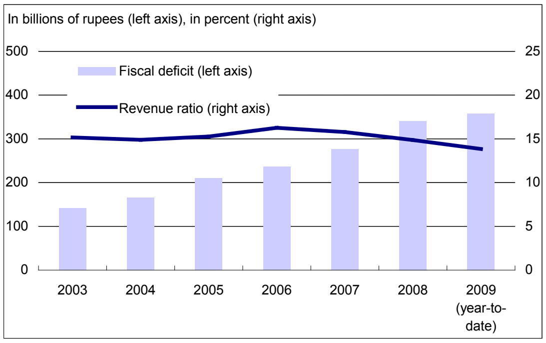
…and put some upward pressure on the exchange rate despite central bank.



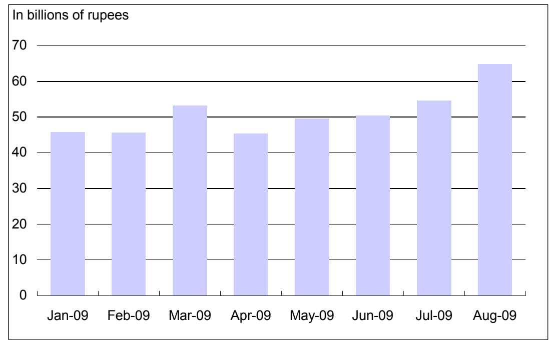
Sources: CEIC Data Company Ltd.; Bloomberg LP; and Fund staff estimates.

Figure 2. Fiscal and Monetary Developments

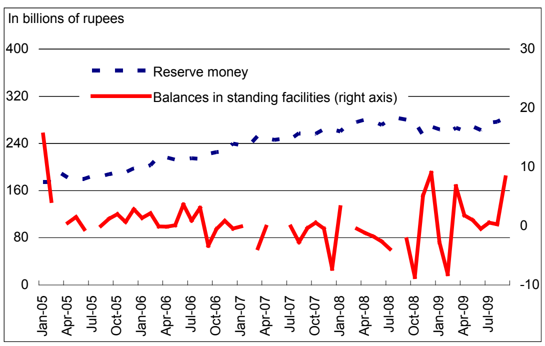
The fiscal deficit increased in the first half of the year on the back of declining revenue...



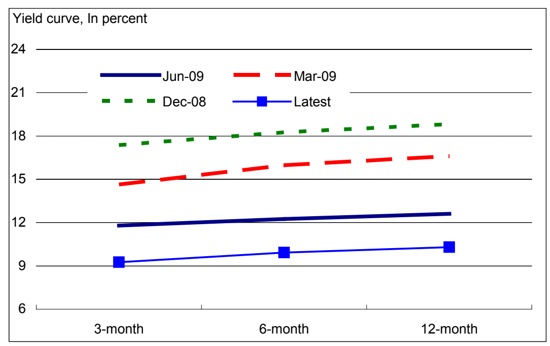
...although there are signs that revenue is improving as the economy recovers.



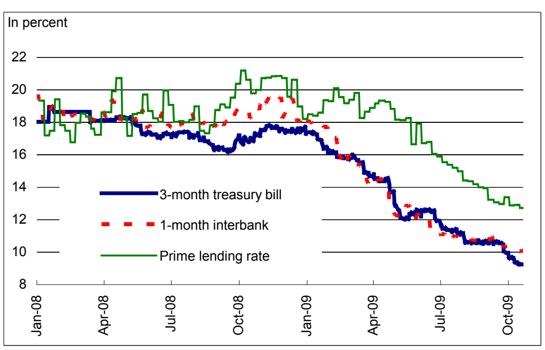
Domestic liquidity conditions have loosened since the beginning of the year.



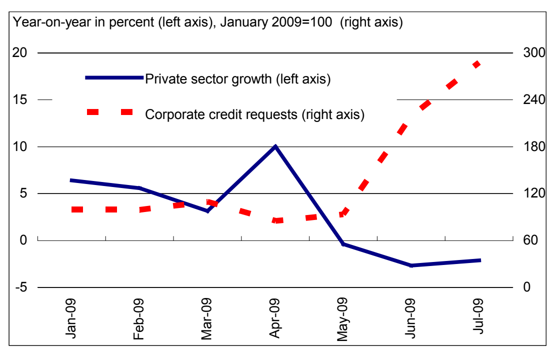
The interest rate structure has come down as a result of the decline in inflationary expecations and capital inflows



...and market rates have declined although lending rates remain high.



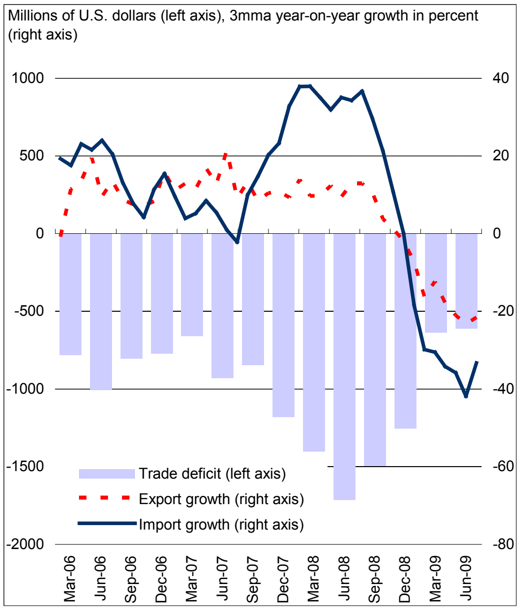
As a result, private sector growth remains low alothough there are signs that credit demand is picking up.



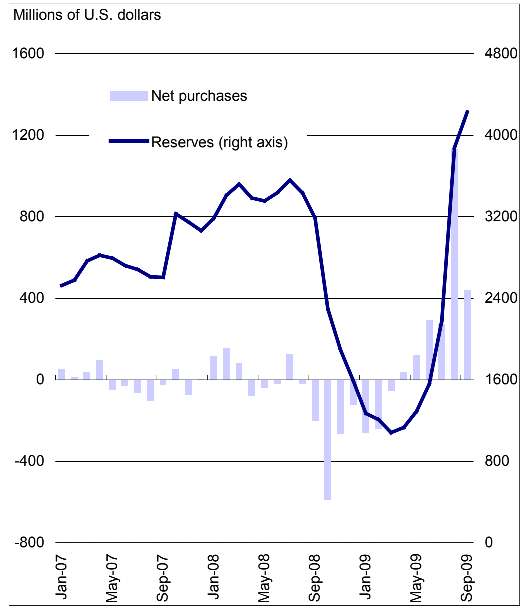
Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; Bloomberg LP; and Fund staff estimates.

Figure 3. External and Financial Developments

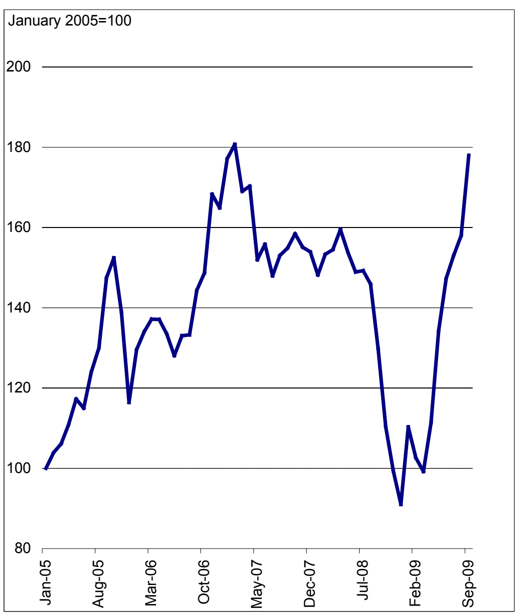
A reduction in demand has led to a contraction in imports and reduced the trade deficit...



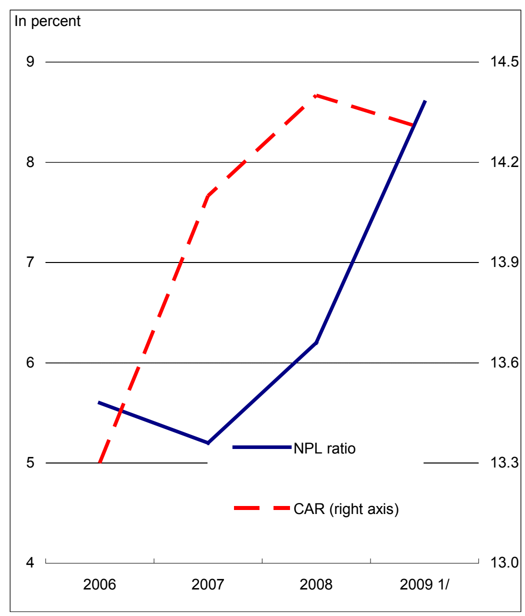
…while an increase in capital flows has allowed the central bank to start rebuilding reserves.



The stock market has reached 30 months highs on the back of rising confidence following the end of the war..



…but there are signs that NPLs are increasing as a result of the slowing economy although the banking system remains well capitalized.



Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; and Fund staff estimates.
1/ As of June 2009.

Table 1. Sri Lanka: Selected Economic Indicators, 2007–2011

Main exports (percent of total, 2008): garment (43), tea (16)
GDP per capita (2008, est.): US$1,972
Unemployment rate (2008): 5.4 percent
Poverty rate (2007, incidence): 15.2 percent
FDI (2008, est.): $691 million
Public debt (2008): 81.1 percent of GDP

	2007	2008	2009		2010		2011
		Est.	Prog.		Prog.		Proj.
			Jul 09	Rev.	Jul 09	Rev.	
GDP and inflation (in percent)							
Real GDP growth	6.8	6.0	3.0	3.5	5.0	5.5	6.5
Inflation (average)	15.8	22.6	4.6	4.0	13.0	11.2	8.6
Inflation (end-of-period)	18.7	14.4	8.0	6.9	10.7	9.5	7.6
Public finances (in percent of GDP)							
Revenue 1/	15.8	14.9	14.8	15.2	15.4	15.4	…
Expenditure	23.5	22.6	21.9	22.3	21.5	21.5	…
Central government balance 1/	-7.7	-7.7	-7.0	-7.0	-6.0	-6.0	-5.0
Consolidated government balance 1/	-8.0	-8.8	-7.7	-7.7	-6.4	-6.6	-4.9
Central government domestic financing	4.1	7.1	6.8	3.8	4.5	4.2	3.9
Government debt (domestic and external)	85.8	81.1	83.7	81.4	84.4	84.1	81.4
Money and credit (percent change, end of period)							
Reserve money	10.2	1.5	12.0	15.5	13.8	14.6	14.5
Broad money	16.6	8.5	14.9	17.5	20.2	16.7	16.7
Domestic credit	16.3	18.0	13.0	4.4	15.2	14.7	14.3
Private sector credit	19.3	7.9	10.5	3.2	17.4	17.4	17.5
Public sector credit	8.9	46.2	18.2	7.1	10.9	9.2	7.7
Balance of payments (in millions of U.S. dollars)							
Exports	7,640	8,137	7098.3	7,237	7,559	7,800	8,541
Imports	11,296	14,009	10,015	10,209	10,552	11,633	12,335
Current account balance	-1,401	-3,719	-478.2	-130	-504	-987	-940
Current account balance (in percent of GDP)	-4.3	-9.4	-1.2	-0.3	-1.3	-2.3	-2.1
Export value growth (percent)	11.0	6.5	-12.8	-11.1	6.5	7.8	9.5
Import value growth (percent)	10.2	24.0	-28.5	-27.1	5.4	13.9	6.0
Gross official reserves (end of period) 2/							
In millions of U.S. dollars	3,063	1,580	2492.4	4,849	4,110	6,244	6,735
In months of imports	2.4	1.6	2.4	4.4	3.7	5.4	5.5
As a percent of short-term debt	60	29	45.5	87	71	107	107
External debt (public and private)							
In billions of U.S. dollars	16.7	17.6	18.0	18.8	19.1	20.5	21.3
As a percent of GDP	51.5	44.4	43.5	44.5	49.8	48.9	48.5
Total stock of public dollar commercial debt 3/							
In millions of U.S. dollars	2,758	2,658	2596.3	3,979	2,307	3,690	3,658
As a percent of GDP	8.5	6.7	6.3	9.4	6.0	8.8	8.3
As percent of gross official reserves	90	168	104.2	82	56	59	54
Memorandum items:							
Nominal GDP (in billions of rupees)	3,578	4,411	4,913	4,913	5,905	5,676	6,567

Sources: Data provided by the Sri Lankan authorities; CEIC Data Company Ltd.; Bloomberg LP.; and Fund staff estimates and projections.
1/ The budget presentation now places grants above the line according to standard practice. Previously grants were classified below the line as a budget deficit financing item.
The consolidated government balance includes the Ceylon Electricity Board and the Ceylon Petroleum Corporation.
2/ Excluding central bank Asian Clearing Union (ACU) balances.
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: Summary of Central Government Operations, 2007–2010

(In percent of GDP, unless otherwise indicated)

	2007	2008	2009		2010	
		Prel.	Jul 09	Rev.	Jul 09	Interim Budget
Total revenue	15.8	14.9	14.8	15.2	15.4	15.4
Tax revenue	14.2	13.3	13.4	13.3	14.0	…
Income taxes	3.0	2.9	3.0	3.2	3.1	…
Value added tax/GST	5.2	4.6	3.8	3.7	4.0	…
Excise taxes	2.7	2.3	2.3	2.2	2.5	…
National security levy			0.0	0.0	0.0	…
Taxes on international trade	1.6	1.8	1.7	1.9	2.1	…
Other	1.7	1.7	2.5	2.5	2.3	…
Nontax revenue	1.6	1.6	1.4	1.4	1.4	…
Grants 1/	…	…	…	0.5	…	0.5
Total expenditure and net lending	23.5	22.6	21.9	22.3	21.5	21.5
Current expenditure	17.4	16.9	16.5	17.2	15.8	16.0
Civil service wages and salaries	3.7	3.2	3.0	3.0	3.0	…
Other civilian goods and services	0.8	1.1	0.8	0.8	0.8	…
Security related expenditure	3.8	3.9	3.7	3.8	3.1	…
Subsidies and transfers	4.1	3.9	3.6	3.5	3.3	…
Interest payments	5.1	4.8	5.5	6.1	5.6	…
Capital expenditure and net lending	6.1	5.7	5.3	5.1	5.7	5.5
Overall balance of central Government 1/	-6.9	-7.7	-7.0	-7.0	-6.0	-6.0
Financing	7.7	7.7	7.0	7.0	6.0	6.0
Net external financing 2/	3.7	0.6	0.3	3.3	1.5	1.8
Net domestic financing	4.1	7.1	6.8	3.8	4.5	4.2
Privatization	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Primary balance (excluding grants)	-2.6	-2.9	-1.6	-1.4	-0.4	…
Total public debt	85.8	81.1	83.7	81.4	84.4	84.1
Domestic debt	47.9	48.3	49.0	45.8	46.0	44.4
Foreign debt	37.9	32.8	34.8	35.6	38.4	39.7

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

1/ The budget presentation now places grants above the line according to standard practice. Previously grants were classified below the line as a budget deficit financing item.

2/ Includes foreign purchases of treasury bills and bonds.

Table 3. Sri Lanka: Monetary Accounts, 2007–2011

	2007	2008	2009		2010		2011
			Prog.				Proj.
			Jul 09	Rev.	Jul 09	Rev.	
Monetary authorities	(Stocks, in billions of Sri Lankan rupees)						
Net foreign assets	293	148	200	421	313	531	595
Net domestic assets	-29	120	100	-111	29	-175	-188
Of which: net credit to government	101	217	263	92	227	90	90
Reserve money	264	268	301	310	342	355	407
	(Contribution to reserve money growth, in percent)						
Net foreign assets	26.3	-54.7	19.3	101.8	37.5	35.3	18.1
Net domestic assets	-16.1	56.3	-7.4	-86.3	-23.7	-20.7	-3.6
Reserve money (percent change)	10.2	1.5	12.0	15.5	13.8	14.6	14.5
Monetary survey	(Stocks, in billions of Sri Lankan rupees)						
Net foreign assets	228	78	153	366	254	464	524
Monetary authorities	293	148	200	421	313	531	595
Deposit money banks	-65	-70	-47	-56	-59	-67	-71
Net domestic assets	1,176	1,445	1597	1,423	1,849	1,623	1,913
Domestic credit	1,608	1,897	2144	1,982	2,470	2,273	2,599
Public sector (net)	423	619	732	663	812	724	780
Private sector	1,185	1,278	1413	1,319	1,658	1,549	1,819
Other items (net)	-432	-452	-547	-559	-621	-650	-686
Broad money	1,404	1,523	1750	1,789	2,103	2,087	2,436
	(Annual percent change)						
Net foreign assets	33.2	-65.9	96.6	370.4	66.3	26.9	12.9
Monetary authorities	27.4	-49.4	35.0	184.4	56.4	26.0	12.1
Deposit money banks	10.7	8.5	-32.9	-20.8	24.2	19.8	6.6
Net domestic assets	13.8	22.9	10.5	-1.5	15.8	14.1	17.9
Domestic credit	16.3	18.0	13.0	4.4	15.2	14.7	14.3
Public sector (net)	8.9	46.2	18.2	7.1	10.9	9.2	7.7
Private sector	19.3	7.9	10.5	3.2	17.4	17.4	17.5
Broad money	16.6	8.5	14.9	17.5	20.2	16.7	16.7
	(Contribution to broad money growth, in percent)						
Net foreign assets	4.7	-10.7	4.9	18.9	5.8	5.5	2.9
Net domestic assets	11.8	19.2	10.0	-1.5	14.4	11.2	13.9
Domestic credit	18.7	20.6	16.2	5.5	18.6	16.3	15.6
Public sector (net)	2.9	13.9	7.4	2.9	4.6	3.4	2.7
Private sector	15.9	6.7	8.8	2.6	14.0	12.9	13.0
Memorandum items:							
Broad money multiplier	5.3	5.7	5.8	5.8	6.2	5.9	6.0
Velocity of broad money	2.5	2.9	2.8	2.7	2.8	2.7	2.7
Private sector credit (in percent of GDP)	33.1	29.0	28.8	26.8	28.1	27.3	27.7

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

Table 4. Sri Lanka: Balance of Payments, 2007–2012

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

	2007	2008	2009		2010		2011	2012
		Est.	Jul 09	Rev.	Jul 09	Rev.	Proj.	
Current account	-1,401	-3,719	-478	-130	-504	-987	-940	-997
Trade balance	-3,656	-5,872	-2,917	-2,972	-2,993	-3,833	-3,794	-3,867
Exports	7,640	8,137	7,098	7,237	7,559	7,800	8,541	9,128
Imports	11,296	14,009	10,015	10,209	10,552	11,633	12,335	12,995
Services	303	402	450	452	499	498	556	619
Income	-358	-916	-676	-567	-677	-618	-669	-712
Transfers	2,310	2,667	2,664	2,958	2,667	2,966	2,967	2,963
Private (net)	2,214	2,566	2,583	2,866	2,592	2,891	2,897	2,903
Official (net)	96	101	81	92	75	75	70	60
Capital and financial account	2,096	1,996	500	2,508	905	1,165	1,131	1,153
Capital transfers (net)	268	291	167	108	125	125	100	80
Financial account	1828	1705	333	1892	780	1040	1031	1073
Long-term flows	1251	1017	379	988	710	970	881	849
Direct investment	548	691	560	560	450	450	518	569
Private sector borrowing 1/	31	74	-306	-123	-194	-194	-93	130
Official sector borrowing	672	251	125	551	454	714	456	150
Disbursements	1,290	1,059	1,000	1,500	1,125	1,385	1,318	1,385
Program loans	20	23	40	40	50	50	50	50
Project loans	729	886	960	960	1075	1335	1118	835
Commercial loans	541	150	0	500	0	0	150	500
Amortization	618	808	875	949	671	671	862	1235
Short-term flows	577	688	-96	904	70	70	150	224
SDR allocation	0	0	0	508	0	0	0	0
Errors and omissions	-166	339	0	0	0	0	0	0
Overall balance	530	-1385	22	2378	401	179	190	156
Financing	-530	1385	-22	-2378	-401	-179	-190	-156
NIR (- = increase)	-530	1385	-22	-2378	-401	-179	-190	-156
Gross reserves	-547	1482	-912	-3268	-1618	-1395	-492	-61
Reserve liabilities (- is outflow)	18	-97	890	890	1216	1216	302	-95
Memorandum items:								
Current account (in percent of GDP)	-4.3	-9.4	-1.2	-0.3	-1.3	-2.3	-2.1	-2.1
Gross official reserves (net of ACU debit balances)	3,063	1,580	2,492	4,849	4,110	6,244	6,735	6,797
(In months of imports of goods and nonfactor services)	2.4	1.6	2.4	4.4	3.7	5.4	5.5	5.2
(In percent of short-term debt)	60	29	45	87	71	107	107	113
Net international reserves	2,810	1,425	1,447	3,803	1,848	3,982	4,172	4,328
Total stock of public commercial dollar debt 2/	2,758	2,658	2,596	3,979	2,307	3,690	3,658	3,378
GDP (US$ millions)	32,347	39,604	41,323	42,150	50,661	48,696	56,340	63,436
Oil price (US$ per barrel)	71.1	97.0	60.5	60.5	74.5	74.5	78.0	80.0
Short-term debt (US$ million, residual maturity)	5,086	5,545	5,480	5,566	5,770	5,821	6,271	6,005

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

1/ Includes public corporations.

2/ Comprises SLDBs, FCBUs, and other commercial loans.

Table 5. Sri Lanka: Preliminary External Financing Requirements, 2008–2011

(In millions of U.S. dollars)

	2008	2009		2010		2011
	Est.	Jul 09	Rev.	Jul 09	Rev.	Proj.
Current account, including official transfers	-3,719	-478	-130	-504	-987	-940
(in percent of GDP)	-9.4	-1.2	-0.3	-1.3	-2.3	-2.1
Trade Balance	-5,872	-2,917	-2,972	-2,993	-3,833	-3,794
Exports	8,137	7,098	7,237	7,559	7,800	8,541
Imports	14,009	10,015	10,209	10,552	11,633	12,335
Private transfers	2,566	2,583	2,866	2,592	2,891	2,897
Other	-413	-144	-24	-103	-45	-43
Amortization	-1,096	-1,278	-1,320	-954	-954	-1,117
Public sector	-808	-875	-949	-671	-671	-862
Multilateral	-144	-164	-164	-185	-185	-211
Bilateral	-381	-392	-392	-322	-322	-356
Syndicated loans	-283	-319	-394	-164	-164	-295
IMF	-97	-47	-47	-34	-34	-12
Private sector	-191	-356	-323	-250	-250	-243
Change in NFA of commercial banks (- = an increase)	91	-250	-250	0	0	0
Change in official reserves (- = an increase)	1,482	-912	-3,268	-1,618	-1,395	-492
Gross external financing requirement	-3,242	-2,919	-4,968	-3,076	-3,336	-2,549
Sources of financing	3,242	1,931	4,030	1,826	2,086	2,236
Borrowing	1,324	1,050	1,700	1,181	1,441	1,468
Official Sector Borrowing	1,059	1,000	1,500	1,125	1,385	1,318
Multilateral	358	395	390	415	430	450
Bilateral	551	605	610	710	955	718
Syndicated loans	150	0	500	0	0	150
Private Sector Borrowing	265	50	200	56	56	150
Other Capital Account	1,918	881	1,822	645	645	768
Capital transfers	291	167	108	125	125	100
FDI inflows	691	560	560	450	450	518
Other (including errors and omissions)	936	154	1,154	70	70	150
SDR allocation	0	0	508	0	0	0
External financing gap=IMF financing	0	-988	-938	-1,251	-1,251	-313
Gross official reserves of the Central Bank of Sri Lanka	1,580	2,492	4,849	4,110	6,244	6,735
(In months of imports of goods and nonfactor services)	1.6	2.4	4.4	3.7	5.4	5.5

Sources: Sri Lankan authorities; and Fund staff estimates and projections.

Table 6. Sri Lanka: Reviews and Disbursements under the Proposed 20-month Stand-By Arrangement

Date	Amount of Purchase with equal disbursements			Condition
	In percent of quota	In SDRs	in USD	
July 24, 2009	50	206.7	312.5	Approved SBA
November 6, 2009	50	206.7	312.5	Completion of the first review and observance of relevant performance criteria
December 15, 2009	50	206.7	312.5	Completion of the second review and observance of relevant performance criteria
February 28, 2010	50	206.7	312.5	Completion of the third review and observance of relevant performance criteria
May 31, 2010	50	206.7	312.5	Completion of the fourth review and observance of relevant performance criteria
August 31, 2010	50	206.7	312.5	Completion of the fifth review and observance of relevant performance criteria
November 30, 2010	50	206.7	312.5	Completion of the sixth review and observance of relevant performance criteria
March 15, 2011	50	206.7	312.5	Completion of the seventh review and observance of relevant performance criteria
Total	400	1653.6	2500	

Colombo, October 30, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

This letter serves as a supplement to our letter of July 16, 2009 and the associated Memorandum of Economic and Financial Policies.

The macroeconomic environment in Sri Lanka has improved significantly since the end of the war with the LTTE and the approval of the Stand-By Arrangement with the International Monetary Fund. Rising investor confidence and an increase in remittances have allowed us to rebuild international reserves, budget revenues are rising, and there are signs that an economic recovery is underway. We maintain our goals of restoring health to the country's public finances, strengthening external viability, addressing weaknesses in the financial system, and protecting the most vulnerable from the burden of the needed adjustment.

Our performance to-date indicates that we remain on track to meet our target of reducing the budget deficit for 2009 and increasing net reserves in line with our commitments under the program. We have met the end-September targets for net international reserves and reserve money. Based on available data, we have also met the end-September target for net domestic financing (NDF). However, a final assessment will be made once data on all the adjustors become available.

In order to ensure this strong fiscal performance continues in the run-up to Parliamentary elections due by April, we have opted to pursue a vote-on-account budget covering the first four months of 2010, limiting our spending during this period to about one-third of 2009 approved budgetary expenditures. We understand that this decision, while important for maintaining fiscal discipline, will delay our ability to implement planned structural fiscal reforms as previously scheduled under the program, including introducing base-broadening tax policy measures.

Nevertheless, we remain committed to achieving our original target of reducing the underlying budget deficit—excluding reconstruction spending—to 6 percent of GDP in 2010, and we believe that changes to the program can be made to maintain our good performance to date while at the same time allowing for structural fiscal reform measures once the new parliament is in place in April 2010. To this end, the cabinet has approved a vote-on-account budget consistent with achieving the 2010 budget deficit target. Parliamentary approval of this budget will be a new structural benchmark for mid-December, 2009. We will present a full year budget for 2010 to Parliament in line with our commitments in paragraph 6 of the

July 16, 2009 Memorandum of Economic and Financial Policies, and this will be a new structural benchmark for end-April, 2010. The presidential tax reform commission will submit its interim report by end-October, 2009, and we still intend the results of this commission's work—including suggestions for base-broadening tax policy measures—to provide an input into the full year 2010 budget.

It is central to our program that we protect the most vulnerable in society and address the urgent humanitarian needs of those adversely affected by the conflict. Our immediate priority is providing humanitarian assistance to remaining internally displaced persons (IDPs). We have proceeded vigorously to resettle the IDPs, and have already reduced the number from 288,000 to 196,000. We are on track to meeting our goal of resettling 70-80 percent of the IDPs by the end of the year, and aim to complete the resettlement by the first quarter of 2010. This has required a major effort, much of which has been carried out by military personnel, toward demining, restoring basic services such as water, health services, and education, and rebuilding basic infrastructure. We have already devoted significant budget resources to this effort by drawing on savings from existing budget provisions.

The broader reconstruction effort over the next three years will be considerable. Drawing on our experience gained following the Tsunami and the reconstruction of the Eastern Province since 2007, our Presidential task force has developed a comprehensive reconstruction plan for the Northern Province. The broad strategy includes rebuilding basic infrastructure, restoration of law and order, revitalization of the productive sectors, human settlement development, and conducting local and provincial council elections—the first of which took place in August. We are approaching our development partners for assistance in financing the plan's priority reconstruction projects, and have already received important commitments for grants, loans, hardware, and expertise.

The end of the conflict will allow us to divert resources previously used for military activities toward the significant resource needs of our reconstruction effort. Currently nearly 75 percent of the demining activities and most of the rebuilding of northern roads are being carried out by military personnel. These efforts will need to continue, and we intend to increasingly redeploy military resources to this purpose. We also aim to free up budget resources for reconstruction and resettlement by keeping 2010 defense-related spending at current rupee levels.

Beyond these changes, our policy agenda remains as described in the July Memorandum of Economic and Financial Policies. We have set the program performance criteria for end-December 2009 and end-March 2010, increasing the NIR target to reflect the faster than anticipated accumulation of international reserves. We have also made changes to the Technical Memorandum of Understanding (TMU) to clarify the measurement of NDF and reserve money for program monitoring purposes.

Given our demonstrated strong commitment to the program to date, we request completion of the first review of the Stand-By Arrangement, and a waiver of applicability for the end-September target on NDF.

In keeping with its policy of transparency, the Government has authorized the publication of this letter and the attached TMU.

Sincerely yours,

/s/	/s/
Ranjith Siyambalapitya Actg. Minister of Finance and Planning	Ajith Nivard Cabraal Governor, Central Bank of Sri Lanka

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

	2008	2009							2010		
	End-December	End-July Performance Critieria			End-Sept. Performance Critieria			End-Dec Performance Criteria	End-March Performance Critieria	End-June Indicative Target	End-Sept. Indicative Target
	Actual	Jul 09	Adj.	Prel.	Jul 09	Adj.	Prel.				
Quantitative performance criteria											
Net international Reserves (NIR) of the Central Bank of Sri Lanka (CBSL) (floor, cumulative change from the beginning of the year, in million US$) 1/ 2/ 3/ 4/ 5/	-1,385	-109	4	111	-13	1,681	2,131	360	35	85	135
Reserve money of the CBSL (ceiling, eop stock, in million rupees)	268,425	274,130	274,116	273,783	280,370	280,370	279,413	315,032	331,308	333,134	342,297
Net domestic financing (NDF) of the central government from the banking system and the non-bank sector (ceiling, cumulative from the beginning of the year, in million rupees) 6/ 7/ 8/ 9/ 10/	296,710	282,004	279,187	281,332	305,001	…	…	342,210	102,500	153,636	192,626
Continous performance criteria											
Contracting and guaranteeing of medium and long-term non-concessional external debt by the government (ceiling, cumulative from end-April 2009, in million US$)	…	1,750	1,750	70	1,750	1,750	383	1,750	1,750	1,750	1,750
Accumulation of new external payment arrears (ceiling, eop, in million US$)	0	0	…	0	0	0	0	0	0	0	0
Indicative targets											
Overall balance of the Ceylon Petroleum Corporation and the Ceylon Electricity Board (floor, cumulative from the beginning of the year, in million rupees)	-49,847	…	…	-6,940	…	…	…	-35,387	…	…	…
Memorandum items:											
External loans assumed under the program (cumulative from the beginning of the year, in million rupees) 6/	80,415	55,928		62,963	75,238		…	…	…	…	…
External grants assumed under the program (cumulative from the beginning of the year, in million rupees) 7/	31,222	5,644		15,036	7,825		…	…	…	…	…
External debt service assumed under the program (cumulative from the beginning of the year, in million rupees) 8/	109,268	72,994		77,212	89,735		…	139,010	24,040	53,988	82,992
Privatization proceeds to the central government in connection with the sale of central government assets (in million rupees) 9/	0	0		0	0		…	0	0	0	0
Outstanding claims by the Bank of Ceylon on the central government (item VIII (e, 1) on the balance sheet of the Bank of Ceylon, in million rupees) 10/	10,897	…		…	…		…	17,120	17,120	17,120	17,120
Foreign program financing assumed under the program (cumulative from the beginning of the year, in million US$) 1/	23	0		0	20		0	40	0	0	0
External commercial loans (including Eurobonds and syndicated loans) assumed under the program (cumulative from the beginning of the year, in million US$) 2/	150	…		…	…		…	0	0	0	0
Cumulative net inflows into the Treasury Bill and Treasury Bond market assumed under the program (cumulative from the beginning of the year, in million US$) 1/	-213	15		105	15		1,245	15	0	0	0
Official external debt service assumed under the program (cumulative from the beginning of the year, in million US$) 3/	802	446		444	588		612	827	191	392	601
Settlement of syndicated loans assumed under the program (cumulative from the beginning of the year, in million US$) 4/	104	…		…	…		…	225	0	25	25
Repayment of foreign currrency loan from the CBSL by the Bank of Ceylon and the People's Bank (cumulative from the beginning of the year, in million US$) 5/	40	261		283	283		283	283	…	…	…

1/ If the amount of program financing and the cumulative net inflows into the Treasury Bill market and Treasury Bond market is higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative differences on the test date.

2/ If the amount of commercial borrowing (including Eurobonds and syndicated loans) is higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative difference on the test date.

3/ If the amount of official external debt service by the central government in U.S. dollars is higher/lower than assumed under the program, the floor on NIR will be adjusted downward/upward by the cumulative differences on the test date.

4/ If the amount of debt service on syndicated loans by the central government in U.S. dollars is higher/lower than assumed under the program, the floor on NIR will be adjusted downward/upward by the cumulative differences on the test date. The adjustor is introduced from end-December 2009.

5/ The floor on NIR will be adjusted upwards by any repayments for the foreign currency loan from the CBSL by the Bank of Ceylon and the People's Bank in excess of the repayment schedule.

6/ If the amount of external loans is higher/lower in rupee terms than assumed under the program, the cumulative ceiling on net domestic financing of the central government will be adjusted downward/upward by the cumulative difference in external loans on the test date. From end-December, external loans will be defined as external program loans and external commercial loans (including Eurobonds and syndicated loans)

7/ If the amount of external grants is lower in rupee terms than assumed under the program, the cumulative ceiling on net domestic financing of the central government will be adjusted upward by the cumulative difference in external grants on the test date.

8/ If the amount of external debt service by the central government in rupee terms is higher/lower than assumed under the program, the ceiling on net domestic financing of the central government will be adjusted upward/downward by the cumulative difference in external debt service payments measured in rupees.

9/ If the amount of privatization proceeds to the central government in connection with the sale of central government assets is higher/lower than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted downward/upward by the cumulative receipt/reimbursement of any privatization proceeds.

10/ If the amount of outstanding claims by the Bank of Ceylon on the central government (item VIII (e, 1) on the balance sheet of the Bank of Ceylon) is lower in rupee terms than assumed under the program, the NDF of the central government will be adjusted upward by the difference on the test date.

Table 2. Sri Lanka: Structural Benchmarks (SB)

Actions	Date	Status
Recapitalization of Seylan Bank through a public share issuance.	9/30/2009	Implemented
A contingency plan for orderly workouts of problem banks and financial institutions will be developed by the CBSL.	9/30/2009	Implemented
Approval by the Monetary Board of a revised Banking Act and other pertinent laws and legislations that: (i) improve the bank resolution framework that more clearly defines the provisions for acquisition, and roles of the conservator and liquidator; and (ii) strengthens the definition of large exposures and related parties to better capture all material risks.	9/30/2009	Implemented
Submission by the tax review commission of an interim report, including on base broadening measures to be incorporated into the 2010 budget.	10/15/2009	Delayed
Approval by Parliament of an interim budget for the first four months of 2010 consistent with program targets.	12/15/2009	
Develop a plan to address outstanding debts between the CEB, CPC and state-owned banks.	12/31/2009	
Issuance of prudential regulations and guidelines to credit card companies and payment service providers.	12/31/2009	
Submission to parliament of the 2010 budget consistent with program targets.	4/30/2010	
Submission to the parliament of a revised Finance Company Act which includes clarifying the legal authority of the CBSL in enforcing its regulations on all deposit taking finance companies.	5/31/2010	

Technical Memorandum of Understanding

1. **This Technical Memorandum of Understanding sets out a framework for monitoring the performance of Sri Lanka under the program supported by the Stand-By Arrangement (SBA).** It specifies the performance criteria and indicative targets (including adjustors) under which Sri Lanka's performance will be assessed through quarterly reviews, starting with the performance criteria for end-December 2009. Monitoring procedures and reporting requirements are also specified. The third review will take place on or after December 31, 2009, the fourth review on or after March 31, 2010, and the fifth review on or after June 30, 2010.

I. FISCAL TARGETS

A. Performance Criterion on Net Domestic Financing of the Central Government

2. **Net domestic financing (NDF) is defined as the change in net credit to the central government by the domestic banking system and the net change in holdings of treasury bills and other government securities by the domestic non-bank sector.** For the purpose of program monitoring, the central government is defined to include line ministries, departments, and other public institutions. The Central Bank of Sri Lanka (CBSL), state-owned enterprise, parastatals and other agencies that do not receive subventions from the central government are excluded from the definition of central government. NDF of the central government is defined as the sum of (i) net borrowing from the CBSL (ways and means advances, loans, holdings of treasury bills, treasury bonds, and other central government bonds minus deposits); (ii) net borrowing from domestic commercial banks and the domestic non-bank sector (loans, advances, holdings of restructuring bonds, and holdings of treasury bills and other central government securities minus deposits); and foreign holdings of Treasury Bills and Treasury Bonds. In 2008, NDF of the central government defined in this manner amounted to Rs. 296.7 billion. Of this amount, Rs. 195.2 billion was net borrowing from the domestic banking system, Rs. 114.8 billion was net borrowing from the domestic non-bank sector, Rs. -17.6 billion was net foreign inflows into the Treasury Bill and Treasury Bond markets and Rs. 4.2 billion was net borrowing from other sources.

The following adjustment will apply:

3. If the amount of external program loans and external commercial loans (including Eurobonds and syndicated loans) to the central government—as set out in Table 1—is higher/lower in rupee terms than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted downward/upward by the cumulative difference on the test date.

4. If the amount of external debt service by the central government in rupee terms—as set out in Table 1—is higher/lower than assumed under the program, the cumulative ceiling

on NDF of the central government will be adjusted upward/downward by the cumulative difference in external debt service payments measured in rupees.

5. If the amount of privatization proceeds to the central government in connection with the sale of central government assets—as set out in Table 2—is higher/lower than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted downward/upward by the cumulative receipt/reimbursement of any privatization proceeds.

6. If the amount of outstanding claims by the Bank of Ceylon on the central government (item VIII (e, 1) on the balance sheet of the Bank of Ceylon)—as set out in Table 3—is lower in rupee terms than assumed under the program, the NDF of the central government will be adjusted upward by the difference on the test date.

B. Indicative Target on the Sum of the Overall Balance of the Ceylon Electricity Board and the Ceylon Petroleum Corporation.

7. The balance of the overall profit or loss position of the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) from their operating income statements is measured from above the line on an accrual basis. At end-December 2008, the sum of that overall position of the CEB and CPC defined in this manner stood at Rs. -50 billion.

II. Monetary Targets

A. Performance Criterion on Reserve Money of the CBSL

Reserve money of the CBSL consists of currency in circulation (with banks and with the rest of the public), financial institutions' domestic currency deposits at the CBSL, and the deposits of following government agencies: the National Defense Fund (General Ledger Acc. No. 4278), the Buddha Sasana Fund A/C (General Ledger Acc. No. 4279); and the Road Maintenance Trust Fund (General Ledger Acc. No. 4281). At end-December 2008, reserve money defined in this manner stood at Rs. 268.4 billion. For the purpose of program monitoring, reserve money on the test date shall be measured as average reserve money during the prevailing reserve week (Friday to Thursday).

The following adjustment will apply:

8. If any bank fails to meet its legal reserve requirement, the ceiling on reserve money will be adjusted downward to the extent of any shortfall in compliance with the requirement.

9. Changes in required reserve regulations will modify the reserve money ceiling according to the formula:

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

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

III. External Sector Targets

A. Performance Criterion on Net Official International Reserves

10. **Net official international reserves (NIR) is defined as (i) the difference between the gross foreign assets and liabilities of the CBSL and (ii) the balance of State Treasury's (DSTs) Special Dollar and Yen Revolving accounts, both expressed in terms of market values.** Gross foreign assets of the CBSL consists of monetary gold; foreign exchange balances held outside Sri Lanka; foreign securities (valued in market prices); foreign bills purchased and discounted; the reserve position at the IMF and SDR holdings; and the Crown Agent's credit balance. Excluded from gross foreign assets will be participation in international financial institutions; holdings of nonconvertible currencies; holdings of precious metals other than monetary gold; claims on residents (e.g., statutory reserves on foreign currency deposits of commercial banks and central bank foreign currency deposits with resident commercial banks) pledged, non-liquid, collateralized or otherwise encumbered foreign assets (such as the government's war risk insurance deposit with Lloyds during 2001/02); and claims in foreign exchange arising from derivative transactions (such as futures, forwards, swaps and options). Gross foreign liabilities are all foreign currency denominated liabilities of the CBSL to non-residents; the use of Fund credit; Asian Clearing Union debit balance and commitments to sell foreign exchange arising from derivatives such as futures, forwards, swaps, and options. In addition, NIR will include the balance of the DSTs' Special Dollar and Yen Revolving accounts. DST accounts are foreign currency accounts held by the Treasury and managed by the CBSL as an agent of the government. At end-December 2008, NIR defined in this manner stood at U.S. dollars 1,424.9 million.

The following adjustment will apply:

11. If the amount of foreign program financing and the cumulative net foreign inflows into the Treasury Bill or Treasury Bond market—as set out in Table 4—is higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative differences on the test date.

12. If the amount of commercial borrowing (including Eurobonds and syndicated loans)—as set out in Table 4—is higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative difference on the test date.

13. If the amount of official external debt service by the central government in U.S. dollar terms (including debt service on syndicated loans)—as defined in Table 4—is higher/lower than assumed under the program, the floor on the NIR will be adjusted downward/upward by the cumulative difference in official external debt service payments.

14. The floor on NIR will be adjusted upwards by any repayments for the foreign currency loan from the CBSL by the Bank of Ceylon's and the People's Bank in excess of the repayment schedule in Table 5.

15. The floor on NIR will be adjusted upward for any increase in Sri Lanka's allocation of Special Drawing Rights (SDR) from the IMF. Sri Lanka's SDR allocation at the time of approval of this arrangement amounted to SDR 70.868 million.

B. Performance Criterion on Contracting and Guaranteeing of Medium and Long-Term Non-Concessional External Debt by the Government

16. **A continuous performance criterion applies to contracting and guaranteeing of medium and long-term non-concessional external debt by the Government.** For the purpose of this performance criterion, the Government is defined as the central government (as defined in ¶2) and the CBSL. The term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

- **a.** Loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future;

- **b.** Suppliers credit, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

- **c.** Leases, i.e., arrangements under which property is provided which the lessee has the right to use for one of more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of this agreement, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.

Under the definition of debt set forth above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt will not give rise to debt. Medium and long-term debt is debt with a maturity of one year or longer. Excluded from this performance criteria are purchases under the stand-by arrangement of the IMF.

17. **Non-concessional borrowing** is defined as borrowing with a grant element of less than 35 percent, following the methodology set out in SM/96/86. The discount rates used to calculate the grant element will be the six-month and ten-year Commercial Interest Reference Rates (CIRRs) averages, as computed by the Strategy and Policy Review Department of the IMF. Six-month CIRRs are updated mid-February and mid-August (covering the six-month period preceding the date of update) and the ten-year CIRRs averages are updated mid-December (covering a period of ten years preceding the date of the update). Six-month CIRRs averages are to be used for loans whose maturity is less than 15 years while 10-years CIRRs averages are to be used for loans whose maturity is equal or more than 15 years.

C. Performance Criterion on External Payment Arrears

18. **A continuous performance criterion applies to the nonaccumulation of external payments arrears on external debt contracted or guaranteed by the central government (as defined in ¶2) or the CBSL.** External payments arrears consist of external debt-service obligations (principal and interest) on debt as defined in ¶16 that have not been paid at the time they are due, as specified in the contractual agreements. However, overdue debt and debt service obligations that are in dispute will not be considered as external payments arrears for the purposes of program monitoring.

IV. Data Reporting Requirements

19. Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the Memorandum of Economic and Financial Policies. All the program monitoring data will be provided by the Ministry of Finance and the Central Bank of Sri Lanka (CBSL). Data relating to the external and monetary targets will be furnished within no more than three weeks after the end of each month.[7] With regards to the fiscal targets, the data in table 6 will be furnished within no more

[7] The deadline for submitting monetary and external data for end-December 2009 will be five weeks due to the added time needed to close the books at the end of the year.

than five weeks after the end of each month and the data in table 7 within no more than nine weeks after the end of each month. For the overall balance of the CEB and the CPC, estimates will be available within four weeks.

20. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 6 and 7.

21. For the purpose of monitoring the monetary targets under the program, data will be provided in the format shown in Table 8.

22. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 9 and 10.

Table 1. Sri Lanka: External Financing Assumptions
(cumulative from the beginning of the year, in millions of rupees)

	2009	2010		
	December	March	June	Sept
External Loans	0	0	0	0
External Commercial Loans	0	0	0	0
External Debt Service	139,010	24,040	53,988	82,992

Table 2. Sri Lanka: Assumptions on Privatization Proceeds
(cumulative from the beginning of the year, in millions of rupees)

	2009	2010		
	December	March	June	Sept
Privatization Proceeds	0	0	0	0

Table 3. Sri Lanka: Outstanding Claims by the Bank of Ceylon on the Central Government
(item VIII (e, 1) on the balance sheet of the Bank of Ceylon, in millions of rupees)

	2009	2010		
	December	March	June	Sept
Foreign Bills Inward	17,120	17,120	17,120	17,120

Table 4. Sri Lanka: External Financing for NIR Purposes
(cumulative from the beginning of the year, in millions of U.S. dollars)

	2009	2010		
	December	March	June	Sept
Program Loans	40	0	0	0
External Commercial Loans	0	0	0	0
Treasury Bills/Bonds	15	0	0	0
Official External debt service	827	191	392	601
Settlement of Syndicated Loans	225	0	25	25

Table 5. Repayment Schedule for the Foreign Currency Loan from the CBSL by the Bank of Ceylon and the People's Bank
(cumulative from the beginning of the year, in millions of U.S. dollars)

	2009	2010		
	December	March	June	Sept
Repayments	283	…	…	…

Table 6. Sri Lanka: Summary of Central Government Operations 1/
(In millions of rupees)
Total revenue
Tax revenue
Income taxes
Value added tax
Excise taxes
Nation Building Tax
Taxes on international trade
Other
Nontax revenue
Grants
Total expenditure and net lending
of which: Interest payments
Foreign
Commercial
Domestic
Overall balance of central Government (Excluding grants)
Financing
Net domestic financing
Net external financing
of which: Program loans
of which: Project loans
of which: Commercial borrowing
of which: Amortization
Privatization

1/ As agreed for the purpose of monitoring the program

Table 7 Sri Lanka: Central Government Expenditure 1/
(In millions of rupees)
Total expenditure and net lending
Current expenditure
Civil service wages and salaries
Other civilian goods and services
Security related expenditure
Subsidies and transfers
Households
Of which : Samurdhi
Pensions
Fertilizer
Institutions, corporations, other government agencies
Interest payments
Foreign
Commercial
Domestic
Capital expenditure and net lending

1/ As agreed for the purpose of monitoring the program

Table 8. Sri Lanka: Balance Sheet of the Central Bank 1/

(In millions of rupees)

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

1/ As agreed for the purpose of monitoring the program

Table 9. Sri Lanka: Summary of Central Bank Foreign Exchange Operations 1/

(In millions of USD)

1. Total inflows
Loans
Program
IMF
Project (cash component only)
Interest earnings, forex trading profits, cap gains
Purchases of foreign exchange
Change in balances in DST's A/Cs
Other inflows
Borrowing from SLDBs
Loans from FCBUs
Syndicated Loans
Commercial loans
Repayments of BOC and PB claims
2. Total outflows
Public Debt Service Payments
Amortization
Principal (foreign loans)
Settlement SLDBs
Settlement FCBU
Settlement of syndicated loans
Interest
Foreign loans
Domestic foreign currency loans
Payments to the IMF/ change in valuation of liabilities
Foreign exchange sales to commercial banks
Foreign exchange deposits at BOC and PB
3. Net flow at current rates (1-2)
Net International Reserves
Gross International Reserves
Cumulative net inflows into the Treasury Bill/Bond market

1/ As agreed for the purpose of monitoring the program

Table 10. Sri Lanka: Estimated Gross Official Reserve Position (in US$ million) 1/

	Central Bank				Government				Total Gross Official Reserves		Liabilities						
Date	Reserves managed by IOD (without ACU) 1	Reserves managed by IOD (with ACU) 2	Reserve Position at I.M.F. & SDR hol. 3	Total {2}+{3} 4	Crown Agent's Credit Balance 5	D S T's Special Dollar Revolving Cr.balance 6	DST's Yen Accounts 7	Total (5)+(6) +(7) 8	(without ACU) {1}+{3}+{8} 9	(with ACU) (4)+(8) 10	Other Deposits	Asian Clearing Union	Drawings from the IMF	Currency Swap	Total	Net International Reserves	Overall balance

1/ As agreed for the purpose of monitoring the program

Press Release No. 09/395
FOR IMMEDIATE RELEASE
November 6, 2009

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under Stand-By Arrangement with Sri Lanka and Approves US$329.4 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Sri Lanka's economic performance under a program supported by a 20-month Stand-By Arrangement (SBA). The completion of the review enables the immediate disbursement of an amount equivalent to SDR 206.7 million (about US$329.4 million), bringing total disbursements under the arrangement to an amount equivalent to SDR 413.4 million (about US$658.8 million).

The SBA was approved on July 24, 2009 (see Press Release No. 09/266) for an amount equivalent to SDR 1,653.6 million (about US$2,577.2 million) or 400 percent of Sri Lanka's quota.

The Executive Board also approved Sri Lanka's request for a waiver of applicability for the end-September 2009 performance criteria on net domestic financing (NDF) of the central government from the banking system and the non-bank sector.

Following the Executive Board's discussion on Sri Lanka, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Sri Lanka' performance under the Stand-by Arrangement is encouraging. Recent economic developments have been stronger than expected, and the near-term outlook has improved. While the Fund-supported program had helped Sri Lanka avoid a balance of payments crisis, fundamental vulnerabilities remain to be addressed. Strict adherence to the program targets and steadfast implementation of the reform agenda will be essential.

"The policy of gradually loosening monetary conditions was successful in reversing earlier liquidity shortages. There is scope for a further cautious easing of monetary policy in view of low inflation, weak credit growth, and below-potential output. The approach to accumulating reserves remains appropriate, and reserves are currently at more comfortable levels. Fundamental external adjustment is still necessary, including through greater exchange rate flexibility.

“The authorities remain committed to a deficit reduction and planned fiscal reforms, particularly through expenditure restraint and tax reform aimed at broadening the tax base and simplifying the system. The interim budget aims to deflect spending pressures in the run-up to parliamentary elections. The authorities intend to submit to the new parliament a full-year budget for 2010 that is consistent with the program’s deficit targets and includes tax reform measures.

“The authorities have made good progress on financial sector reform, notably the amendment to the Banking Act to improve the bank resolution framework. While the rise in non-performing loans is a concern, banks maintain relatively healthy capital positions, mitigating the risk that this poses to the financial sector as a whole.

“Protecting the most vulnerable in society and addressing the urgent humanitarian needs of those adversely affected by the conflict remain key priorities. The authorities have recently stepped up the resettlement of internally displaced persons and expect to complete this process in early 2010. The post-war reconstruction needs will be met by diverting budget resources from military activities, as well as donor financing,” Mr. Kato said.

Statement by K.G.D.D. Dheerasinghe, Executive Director for Sri Lanka
November 6, 2009

1. My Sri Lankan authorities wish to place on record their appreciation of the Fund staff for the useful discussions held in Colombo during September, 09 – 22, 2009 and for the well written paper on the first review of the on going, Stand-by Arrangement (SBA) of Sri Lanka with the Fund. My authorities, also wish to thank the management and Executive Board of the Fund for the assistance provided in the past, particularly the approval of the current SBA and look forward to continued support and cooperation in their efforts in the future.

Developments since approval of SBA

2. The approval of the SBA came about at a time when Sri Lanka was just beginning to reap the peace dividends of a nearly two and a half decade long war that ended in May 2009. Supported by the combined effect of these two positive developments, despite adverse global economic conditions, performance of the Sri Lankan economy improved immensely and growth prospects of the economy for 2009 and beyond appeared to be optimistic. The external current account recorded a surplus in the first half of 2009, compared to a substantially high deficit of 9.4 percent of GDP in 2008, and remained in surplus by end September. The external reserves of the country more than quadrupled in a matter of 5 months by October 2009. Investor confidence has improved significantly as evident from the phenomenal growth in foreign capital inflows and the heavy oversubscription of the Sovereign Euro bond in October 2009.

Inflation Trends, Monetary and Exchange Rate Policy

3. Inflation continued to decline rapidly during the first nine months of 2009, reaching a five year low of 0.7 per cent (yoy) by September. Year-on-year inflation increased marginally to 1.4 per cent in October and, is expected to trend somewhat upward during the remainder of the year with the gradual dissipation of the base effect due to high inflation during 2008, a gradual pick up in domestic demand and the increase in import prices, particularly that of petroleum products.

4. Low and the favourable outlook for inflation provided space for a gradual easing of the monetary policy stance of the Central Bank. Accordingly, the Repurchase and the Reverse Repurchase rates of the Central Bank were reduced gradually by 250 and 150 basis points respectively from the levels prevailed by end 2008. The policy rate reductions have resulted in a gradual decrease in short term market interest rates. Lending rates of banks have gradually declined following the policy rate reductions, and are expected to decline further. Consequently, the sluggish credit demand at present is expected to pick up over time.

5. Gross external reserves have increased from US$ 2,189.3 in July 2009 to US$ 4,790.0 by 29 October 2009, a level sufficient to cover 5.6 months of imports. My authorities are mindful of the risk associated with short term capital inflows and are maintaining a buffer to meet any sudden short term capital outflow.

6. The Sri Lankan rupee has been under appreciation pressure since end April 2009 and the Central Bank has intervened in the market to prevent any excessive appreciation of the currency. The REER, which appreciated during the latter part of 2008 and early 2009 reversed its trend, mainly as a result of relatively low domestic inflation and depreciation of the rupee in nominal terms against major currencies and currencies of trading partners. Therefore, the authorities are of the view that any vulnerability associated with overvaluation of the currency has now reduced substantially.

7. There are signs of improvements of Sri Lanka's external trade that severely suffered from sluggish demand and low global commodity export prices. Earnings from exports showed an increasing trend since April 2009, led by apparel and tea exports. Migrant worker remittances have shown a significant growth of 9.9 per cent in the first eight months of 2009. Tourism has picked up since the dawn of peace and tourist arrivals have increased well over 30 percent each month on average since July 2009.

Fiscal Policy

8. The authorities are committed to meeting the fiscal deficit target of 7.0 per cent of GDP for 2009. The government introduced several measures to rationalize current expenditure and streamline capital expenditure, while making every effort to increase revenue in order to achieve the deficit target and improve overall fiscal performance. However, being impacted by the global economic slowdown and below normal domestic economic activity, revenue performance trailed behind the target during early months of 2009, but improved towards the latter half of the year.

9. The six year tenure of the current Parliament will end by April 2010 and in view of the upcoming parliamentary elections, the Cabinet has approved a vote-on-account (an interim budget) for the first four months of 2010. Under this arrangement, government expenditure for the first four months of 2010 will be limited to around one third of the approved budgetary expenditure for 2009 and this would help deflect any pre-election expenditure pressures. My authorities are confident that the fiscal reforms envisaged for 2010 and beyond can be undertaken as soon as the new Parliament is in place in April 2010. My authorities also remain committed to the underlying budget deficit of 6.0 per cent of GDP for 2010, and undertaking substantial tax reforms. At present, the Presidential Commission on Taxation is considering a wide range of measures with the objective of broadening the tax base, simplifying the tax system and improving revenue performance.

10. Besides the immediate priority of re-settlement of the internally displaced persons (IDPs), my authorities have developed a program for the reconstruction of the country's Northern and Eastern Provinces which were adversely affected by the recently ended conflict. The authorities are still at the early stages of identifying the financing requirement , while the World Bank, ADB, China and India have already committed a sizeable financing requirement for some of the key infrastructure projects.

Financial Sector

11. As noted by the staff, steady progress has been made on the financial sector reform agenda. The main activities since July 2009 include, the completion of re-capitalization of Seylan Bank, finalization of a contingency plan for problem financial institutions and amendments to the Banking Act aimed at improving the bank resolution framework.

12. Sri Lanka's banking system remains strong and resilient. The capital adequacy and profitability ratios have shown further improvement, whilst there was a marginal deterioration in NPL ratios. The Central Bank has taken steps to further strengthen the regulatory framework of both the banks and other licensed financial institutions. The revised Finance Companies Act, which will be submitted to Parliament shortly for approval includes a resolution framework for finance companies.

Post Conflict Resettlement, Reconstruction and Development

13. In my Buff statement issued to the Board in July, I included a brief account of the steps taken by my government with regard to the IDPs from the conflict. At this stage I wish to update the Board on the progress made so far in this regard. My authorities recognize the need to protect the most vulnerable in society and to address the urgent humanitarian needs of those affected by the conflict. My government has proceeded vigorously to settle the IDPs and have already reduced the number of IDPs by 92,000 from a total of about 288,000. My authorities are confident and they are very much on track to re-settle 70 – 80 percent of the IDPs by end of 2009 and to complete the task by early 2010. This process has required a substantial effort, including demining, restoring basic services such as roads, housing, water, education, health, electricity and putting in place the basic administrative infrastructure, despite severe resource constraints, particularly, with regard to financing.

14. The end of the war has provided the opportunity to divert resources previously used for military purposes towards the significant resource requirements of re-construction and development activities. At present nearly 75 percent of the personnel engaged in rehabilitation and reconstruction work constitute military personnel. Hence, a sizeable part of the expenditure classified as military expenditure is currently spent on resettlement and reconstruction work.

Conclusion

15 My authorities are fully committed to the program and its implementation is well on course. The performance of the program to date and meeting of performance targets and structural benchmarks for July and September 2009 as evident from the staff review indicate the commitment of my authorities to the successful implementation of the program.