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Sri Lanka: Seventh Review under the Stand-By Arrangement and Requests for Waivers of Nonobservance of Performance Criteria, Extension of the Arrangement Period, Rephasing of Purchases, and Establishment of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Sri Lanka.

In the context of the seventh review under the stand-by arrangement and requests for waivers of nonobservance of performance criteria, extension of the arrangement period, rephasing of purchases, and establishment of performance criteria, the following documents have been released and are included in this package:

- The staff report for the Seventh Review under the Stand-By Arrangement and Requests for Waivers of Nonobservance of Performance Criteria, Extension of the Arrangement Period, Rephasing of Purchases, and Establishment of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on February 3, 2012, with the officials of Sri Lanka on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 16, 2012. 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 April 2, 2012 discussion of the staff report that completed the review.

- A statement by the Executive Director for Sri Lanka.

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

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

*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

Seventh Review Under the Stand-By Arrangement and Requests for Waivers of Nonobservance of Performance Criteria, Extension of the Arrangement Period, Rephasing of Purchases, and Establishment of Performance Criteria

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

Approved by Hoe Ee Khor and Taline Koranchelian

March 16, 2012

Summary

- **Economic performance.** Output growth was strong in 2011, at 8¼ percent, and inflation subdued. However, strong growth in credit and domestic demand caused the external current account deficit to widen sharply during the year. With the authorities defending a rigidly managed exchange rate, external reserves have fallen sharply since mid-2011.
- **Program performance.** All end-June 2011 targets were met, and most outstanding structural benchmarks have been implemented. The end-December target on budget net domestic financing was also met, while that on reserve money was missed for technical reasons. However, the floor on net international reserves was missed by a large margin, and the state energy enterprises continued to run significant losses.
- **Policies.** In February 2012, the authorities introduced a comprehensive package of measures to rein in the current account deficit, stem the reserve loss, and bolster fiscal performance. Monetary and credit policy was tightened, petroleum and electricity prices increased, petroleum taxes raised, and the rupee trading band abolished to allow the exchange rate to adjust and contribute to the needed adjustment.
- **Outlook.** The policy package should improve Sri Lanka's reserve position and place the external current account deficit on a sustainable trajectory. However, the next several months are critical, as the authorities will need to stabilize reserves and consolidate a shift to a more flexible monetary and exchange rate policy regime. The remainder of the SBA, if extended through July, would provide critical support through the initial phase of this adjustment.
- **Missions.** Two missions to Colombo—in September 2011 and February 2012—discussed the 7th Review. The team consisted of Messrs. Aitken (Head), Anand, and Ding (APD), Dwight (SPR), and Mathai (Resident Representative). Mr. Bingham (APD), who is taking over as next mission chief, joined the February mission. Mr. Weerasinghe (OED) participated in both discussions.

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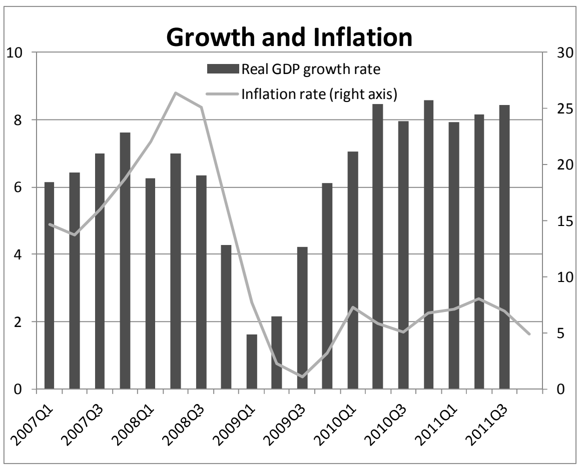
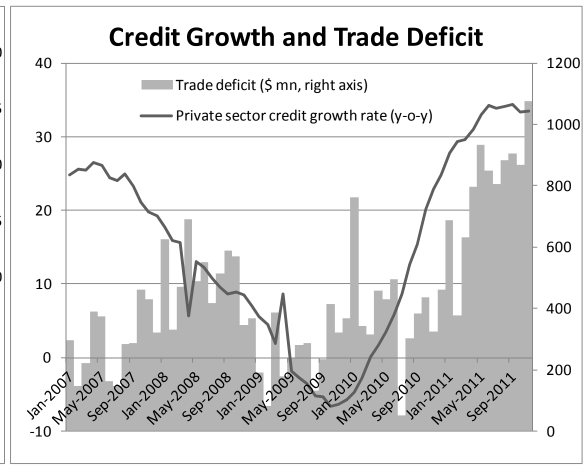
I. Developments in 2011

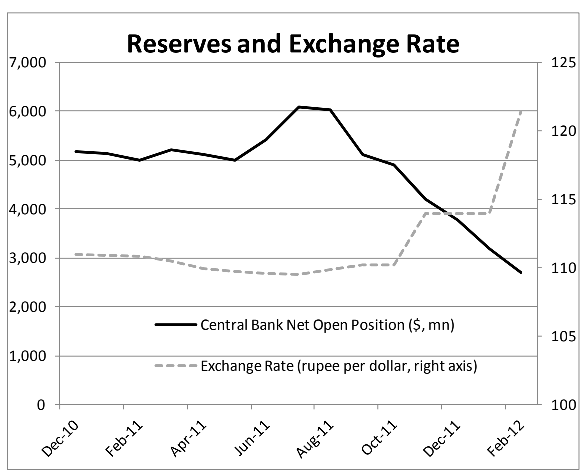
1. **Growth and inflation**. The strong economic recovery continued in 2011, with growth estimated at 8¼ percent. Activity was robust across all sectors, supported by healthy exports and strong growth in domestic demand. Agriculture recovered from flooding early in the year, and is expected to grow at 6 percent. Industrial production grew at 10 percent through September, and growth in services maintained a strong momentum, with tourism, though still a small sector, growing by more than 30 percent. Inflation, which had picked up in the first half of 2011, due to the flood related price increase, eased back below 5 percent by end year, as food price pressures moderated.





2. **Credit growth.** Bank credit shrank for many months in 2009 and early 2010 but then began growing rapidly, as the economic recovery took hold and interest rates declined. Fueled by ample liquidity, banks increased their lending sharply and private sector credit grew by close to 35 percent (y/y) in 2011. The rapid expansion in credit, which was spread across all sectors, in turn fueled a strong surge in domestic demand.

3. **External developments.** The strong domestic demand, combined with higher oil prices, caused a sharp increase in imports in 2011. As a result, despite healthy growth in exports, especially in the first half of the year, and robust remittances, the current account deficit widened from 2¼ percent of GDP in 2010 to 7½ percent of GDP in 2011. Although capital inflows, including foreign direct investment, continued to pick up, the rupee came under increasing downward pressure in the second half of 2011, especially after the size of the trade deficit became apparent and started to weigh on sentiment. With the central bank defending a tightly managed exchange



rate, foreign reserves declined sharply. Gross reserves fell from a peak of almost $8 billion in mid-2011, and continued to fall to under $5½ billion, or 2¼ months of import cover, by early 2012, despite a 3 percent depreciation in November, and an increase in swaps which raised the central bank's forward liabilities to about $¾ billion.

4. **Market sentiment**. Market sentiment was initially very positive in 2011. In July, Sri Lanka received a rating upgrade from Fitch and outlook upgrades from Moody's and Standard & Poor's. A $1 billion Eurobond was issued in July at a favorable spread of 332 basis points over US Treasuries and was oversubscribed 7.5 times. However, as the year progressed, sentiment became more cautious. Onshore participants started to cover short-dollar positions, or, in the case of exporters, extend long dollar positions. More recently, spreads on Sri Lanka's Eurobond have widened and offshore investors have started to focus more closely on the deterioration in Sri Lanka's balance of payments.

5. **Program targets.** All end-June 2011 quantitative targets were met (LOI, Table 1). The end-December 2011 target on budget net domestic financing was also met, and the target for reserve money was missed by a small margin for technical reasons.[1] However, the end-December target for net international reserves was missed by nearly $2½ billion, and the indicative target on the combined losses of the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) was also missed by a large margin (discussed below).

6. **Structural benchmarks.** The authorities have met most of the structural benchmarks under the program (LOI, Table 2). Only two benchmarks remain outstanding. As discussed in the authorities' letter of intent, cabinet approval of the amendments to the Petroleum Act is expected in the second quarter. However, the reform of the regulatory framework for private sector super annuation funds has been delayed. While the authorities still support this reform, it has become entangled with the initiative to create a mandatory private pension scheme that sparked wide-spread social unrest last year.

II. Policy Discussions

7. The policy discussions for the 7th Review focused mainly on the strategy to address the pressures on the balance of payments and tackle the losses of the state-owned energy corporations. The discussions aimed to delineate principles for the package of measures that the authorities later announced in February, namely that (a) the package contains credible upfront measures, spread across a number of instruments; (b) policies be managed

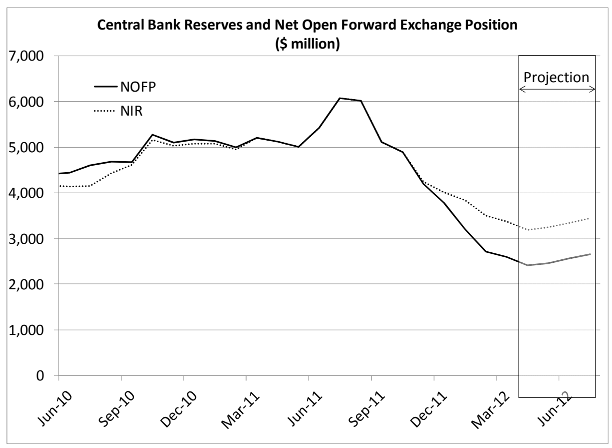
[1] The authorities raised their statutory reserve requirement by 1 percentage point in April 2011. Under the program, the adjustment to reserve money was based on the monetary base that prevailed in April, rather than that projected for end-December 2011. The authorities argued, and staff agreed, that the design of the adjuster only partially compensated for the increase in statutory reserve requirement.

flexibly and proactively thereafter to restore a sustainable balance of payments position; and (c) the package avoids disruptive administrative measures.

A. The Policy Package

The authorities' policy package contains the three main elements described below.

8. **Exchange rate flexibility.** Staff has long argued that a flexible exchange rate regime would help the authorities manage the economic recovery more effectively. The case for exchange rate flexibility increased as the year progressed, and the need to stem the loss of reserves and place the external current account deficit on a sustainable footing became more pressing. In November 2011, the authorities depreciated the exchange rate by 3 percent, but continued to defend the new rate, and it was not until early February, when the trading band on the exchange rate was abolished, that the authorities moved more decisively to establish a more flexible exchange rate regime. Since then, the authorities have steadily scaled back their intervention in the foreign exchange market, allowing the rupee to depreciate by around 6 percent over 4 weeks to a present level of around Rs 121/$. The central bank has signaled that it intends to phase out its intervention early in the second quarter, with a view to fully establishing exchange rate flexibility before the current program expires.



9. **Reining in credit growth**. In order to bring the external current account deficit back down to sustainable levels, the authorities agreed that credit growth needed to be reined in. With banks having already drained their excess liquidity over the previous six months, raising reserve requirements was not a practical option. Instead, the central bank adjusted its policy rates and instructed banks' to rein in their lending in order to reduce credit growth below 20 percent in 2012. The 50 basis point increase, combined with the tighter liquidity, has raised market rates by close to 150 basis points since late November.

10. **Increase energy prices.** To reduce losses at the state energy enterprises and boost central government revenues, the authorities raised the retail price of petroleum products by an average of over 30 percent in early February. The price of fuel oil supplied to the CEB was increased by 50 percent, although it remains subsidized. To absorb the increased cost of fuel oil and reduce CEB losses, electricity prices were increased by an average of around 20 percent. Staff estimates that the price increases will reduce the enterprises' losses by about 1 percent of GDP and boost government revenues by around ¼ percent of GDP. The

authorities took steps to mitigate the impact of these price increases on the most vulnerable by providing temporary subsidies for the poorest households, who use kerosene.

11. **Staff Assessment.** Staff has welcomed the package of measures taken by the authorities. The measures, combined with a shift to a flexible exchange rate regime, constitute a robust response to the widening external imbalances that has put tremendous pressure on foreign reserves in the second half of 2011. Just as important, the package has avoided falling back on disruptive administrative and trade related measures that might have side-tracked the government's broader economic reform efforts.

12. **Challenges.** Nevertheless significant challenges remain in the implementation of this package in the coming months. These relate mainly to the conduct of monetary and exchange rate policy. With regards to exchange rate policy, it is vital that the authorities consolidate the transition to a genuinely flexible exchange rate system. The challenge for monetary policy is two-fold: (a) the authorities will need to develop an operational framework to implement its instruction to banks to reduce overall credit growth in 2012; and (b) with a more flexible exchange rate regime, monetary policy will need to be transformed so that interest rates play a bigger role in macroeconomic management. Some time is needed to assess the initial impact of the authorities' policy package, but a further increase in policy rate will likely soon be needed to rein in credit growth, respond to potential inflationary pressures, and support the exchange rate while the central bank is phasing out its intervention in the foreign exchange market. The authorities will also need to monitor potential vulnerabilities in the banking and corporate sector during this transition. However, the preliminary indications are that the vulnerabilities to interest rate and exchange rate shocks are relatively contained. These issues will be explored further in the forthcoming FSAP update mission planned for July.

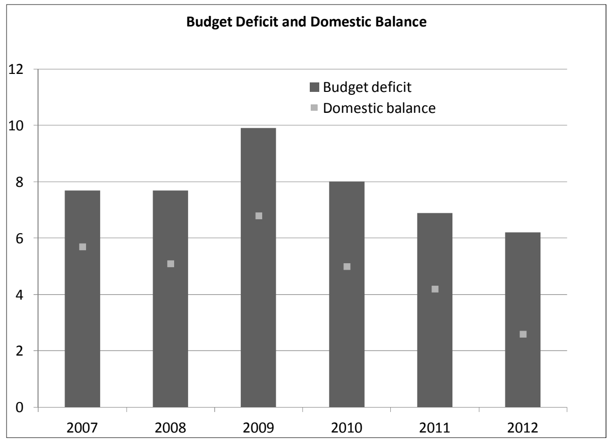
B. Fiscal Policy and State Enterprise Reform

13. The discussions also covered the broader issues of fiscal reform that have long been central to this program. This aspect of the discussions covered performance against the authorities' fiscal consolidation path, progress on revenue reforms, and the state of state-owned enterprise reform.

14. **Fiscal performance in 2011.** Preliminary information suggests that the budget deficit declined to 6.8 percent of GDP from 8.0 percent in 2010, in line with the program's objectives. Revenues declined just under ½ point to 14.4 percent of GDP, in part because the government's decision to cushion the impact of increasing higher oil prices resulted in a decline in revenues from petroleum taxation. The base broadening and compliance enhancing components of the tax reforms introduced in the 2011 budget also took somewhat longer than expected to yield results. However, the shortfall in revenues was more than offset by lower expenditure. Current expenditure declined by 1¼ percent of

GDP, on account of lower wage and interest payments, and cuts in defense spending and transfers and subsidies. Capital expenditure declined by ¼ percent of GDP.

15. **The 2012 budget deficit.** The budget targets a deficit of 6¼ percent of GDP. While this is higher than projected at the last review (5¼ percent of GDP), much of the larger deficit is due to higher spending on externally financed capital projects, which are projected to rise by 1 percent of GDP in 2012, although a downward revision in revenue due to the lower outturn in 2011 also contributed. However, the slower consolidation of the budget deficit has only a modest impact on the debt outlook (see below) and the projected decline in the domestic budget deficit,[2] by over 1½ percent of GDP, makes a contribution to the needed adjustment in the balance of payments. Consequently, staff agreed that a further reduction in the budget deficit for 2012 was not warranted at this time.



16. **Revenue in 2012.** Staff welcomed the ambitious revenue target set in the 2012 Budget—an increase of ¾ percent of GDP relative to the 2011 outturn—but noted additional measures might be needed to achieve that target. Given that much of the decline in revenues in the past couple of years was due to lower oil revenues, the authorities expressed their intention to increase taxes on petroleum. Staff supported the proposal, and, accordingly, taxes on petroleum products were raised in February, and a number of additional items (e.g. palm oil, fish) were brought into the tax net for the Special Commodity Levy. The authorities were confident that these measures, combined with the depreciation of the rupee, would be sufficient to achieve the 2012 budget deficit target of 6¼ percent of GDP. Nevertheless, while the primary emphasis is on continuing reforms to enhance compliance and broaden the tax base, they are prepared to take additional measures, as needed, to secure the deficit target. Staff suggested that potential candidates for additional measures might include increasing excise tax rates in line with inflation, and if need be, raising the Nation Building Tax.

17. **State Enterprise performance in 2011.** The combined losses of the state oil and electricity companies, which are funded by credit from the state banks, increased to 1½ percent of GDP in 2011 from just under ½ percent of GDP in 2010. The losses of the CEB rose to ¼ percent of GDP, despite an increase in electricity prices of 8 percent, due to higher oil prices and a shift in power generation from hydro to costlier thermal power. The increase in international oil prices also caused losses at the CPC to increase to 1¼ percent

[2] i.e., excluding externally funded capital projects.

of GDP, from just under ½ percent of GDP in 2010. Though retail petroleum prices were raised twice, higher diesel and kerosene costs were not fully passed on to the consumers, and the CPC continued to supply fuel oils at subsidized rates to the CEB.

18. **Enterprise losses in 2012.** The medium-term strategy to place the state-owned electricity board and petroleum corporation on a financially sound footing requires a combination of restructuring to reduce costs and a more flexible pricing structure. However, prompt steps were needed to contain the losses of these two enterprises as they could have risen to 2 percent of GDP in 2012 in the absence of price increases. The energy price increases in February should reduce those losses to under 1 percent of GDP.[3] The challenge going forward will be to improve the cost structure of the electricity industry by reforming the generation mix through maximizing existing hydropower capacity and further developing coal power generation. Nevertheless if oil prices increase further and losses rise again, further electricity and petroleum price increases may be needed.

C. Other issues

19. **Financial sector reforms.** The financial sector reform agenda remains on track. The Amendment to the Banking Act aimed at improving the banking resolution framework was approved by cabinet in April (structural benchmark). The Finance Business Act was passed in September to enhance the examination and supervisory powers to regulate licensed finance companies. An FSAP stability module update is scheduled for 2012 to assess reform progress to date and help identify future measures to strengthen the regulatory and supervisory system and to foster financial stability going forward.

20. **Program issues.** The authorities request extension of the arrangement until July 23, 2012 and rephrasing of remaining purchases under the current arrangement to provide additional time to stabilize net international reserves and fully establish the new flexible exchange rate regime. The completion of the current seventh review is based on the end-December 2011 performance criteria, and continuous performance criteria, under the program. The authorities have requested a waiver of nonobservance of the end-December 2011 performance criteria for net international reserves and reserve money. Going forward, the authorities request for the completion of the eighth review, the establishment of an end-June 2012 performance criterion on net international reserves, and indicative targets on net domestic financing of the budget and reserve money of the central bank, as described in the Technical Memorandum of Understanding and the attached Table 1. The indicative targets have been set on variables which will not be fully monitorable before the program expires and for which performance criteria are not critical for the success of program.

[3] The potential losses depend on the level of international oil prices and the hydro/oil power generation mix. At current oil prices, the structural losses would range from 0-1 percent of GDP depending on the generation mix.

	Test Date		Proposed Board Date	Amount of Purchase
	Original	Proposed		(million SDR)
7th Review	end-June 2011	end-December 2011	April 2, 2012	276
8th Review	end-December 2011	end-June 2012	July 16, 2012	276

D. Outlook and Risks

21. **Growth.** Growth is expected to moderate to around 7–7½ percent in 2012, as activity slows in response to the tightening of monetary and fiscal policy. Nevertheless, growth is expected to remain reasonably healthy, supported by the continued expansion of agriculture in the northern and eastern provinces, a boost to construction from major infrastructure projects, and the continued expansion of tourism. The depreciation of the rupee should also, over time, help boost exports.

22. **Inflation.** The rupee depreciation and the sizeable increases in petroleum and electricity prices will lead to an increase in consumer prices. Staff estimates the first-round effects to be of the order of 4–5 percent, however, the annual average inflation rate should still remain in single digits given that it has recently come down sharply (to 3½ percent in January), and food price inflation is expected to remain benign. Limited public sector wage increases so far should also help. Nevertheless, the central bank will need to stand ready to respond to rising inflation risks especially if higher international oil prices persist.

23. **Balance of payments.** Staff expect that recent steps taken by the authorities will reduce the external current account deficit to a more sustainable level. A continued pick up in long term capital flows, including foreign direct investment, and a turnaround in short term capital flows should help bring the balance of payments for the year into broad balance. However, this outlook is subject to a number of risks. Higher oil prices and any weakening of external demand for Sri Lanka's exports would put pressures on the balance of payments, as would any slippages in the authorities' efforts to rein in credit growth and maintain two-way flexibility of the exchange rate.

24. **Reserves.** Recent developments suggest that the pace of intervention, and associated loss of reserves, has moderated significantly, and that the authorities are on track to stabilize net international reserves by the end of the second quarter. Nevertheless, given that the current account will only respond with a lag, in the short-term, much will depend on how investor sentiment responds to the package of measures announced by the authorities in February. The authorities will need to continue to manage the exchange rate flexibly and maintain a tight monetary stance over the coming months to achieve the program's external reserve objectives. Even then, Sri Lanka's reserve buffers will remain relatively low at around 2.7 months of imports and 75 percent of short term debt.

25. **Iran embargo.** Sri Lanka has a revolving line of credit with Iran for oil imports, the outstanding balance of which currently stands at around $0.5 billion. It is possible that the embargo may disrupt Sri Lanka's ability to continue to import oil from Iran (which

currently covers over 90 percent of crude oil imports of Sri Lanka) causing the line of credit to wind down over a four month period. If Sri Lanka is unable to secure alternative funding, some adjustment of the reserve path through end June may be needed. The magnitude of such adjustment, if any, will be determined in the context of discussions for the Eighth review.

26. **Debt Sustainability.** Despite a higher deficit path and the depreciation of rupee, Sri Lanka's medium-term debt outlook remains broadly unchanged from that presented in the last Debt Sustainability Analysis. Public debt is still projected to fall to around 65 percent of GDP by 2015 and external debt to just over 40 percent of GDP. Nevertheless, there has been an increase in roll-over risk over the past year. The ratio of reserves to short-term debt (by remaining maturity) has fallen to 70 percent, as a result of the decline in gross reserves in the second half of 2011, and the increase in the current account deficit has inevitably also increased the risk premium on Sri Lanka's local and foreign currency debt. This increase in rollover risk underscored the need for a credible package of measures to stem the loss of reserves and place the current account on a more sustainable path.

III. Staff Assessment

27. **Overview.** Impressive progress has been made since the current program was launched in 2009: the economy has recovered strongly, inflation has fallen, and government finances have steadily improved. Nevertheless, there was an undue delay in adjusting monetary and exchange rate policy in 2011 to curb surging import demand arising from the strength of the economic recovery. As a result, a once comfortable external reserve position has been significantly eroded. However, policies were adjusted decisively in early 2012, and the package of adjustment measures implemented, including a shift towards a more flexible exchange rate regime, have placed the economy on a more sustainable trajectory. However, it will take time for the economy to transit fully to the new policy environment. In the meantime, the authorities will need to be vigilant and stand ready to adjust policies further to stabilize the external position. The remainder of the program, if extended through July, would provide critical support through the initial phase of this adjustment.

28. **Balance of payments prospects.** The combination of monetary and fiscal policy tightening, and the depreciation of the rupee, is expected to move the balance of payments gradually into surplus over the course of the year. While the long term strengthening of the balance of payments rests on the current account deficit being brought back in line with sustainable long term capital inflows, in the short run, much will hinge on current policies reversing the adverse shift in investor sentiment towards Sri Lanka over the past two quarters. This will require steadfast implementation of a flexible exchange rate regime supported by firm monetary and fiscal policies.

29. **Monetary and exchange rate policy.** There has been an important shift in monetary and exchange rate policy. Policy rates have been raised for the first time in five years and the central bank has significantly tightened the credit targets for banks in 2012. Just as important, the central bank has shifted from a de facto exchange rate peg to a flexible exchange rate regime over the last six weeks. It will be important that the shift in the monetary and exchange rate policy regimes be sustained and consolidated. Although more time is needed to assess the impact of recent policy measures, a further increase in monetary policy rates will likely be needed to contain credit and inflation and provide support for the exchange rate as the central bank phases out its intervention in the market.

30. **Fiscal policy.** The program's budget deficit target for 2011 of 6¾ percent of GDP was achieved, and the budget deficit target of 6¼ percent of GDP for 2012 is appropriate, especially as the domestic deficit is projected to contract by over 1½ percentage points of GDP in 2012. Staff welcomes the measures taken to reverse the recent decline of petroleum tax revenues and bolster the overall revenue effort in 2012. With these measures, staff agrees with the authorities that the 2012 budget deficit target is within reach.

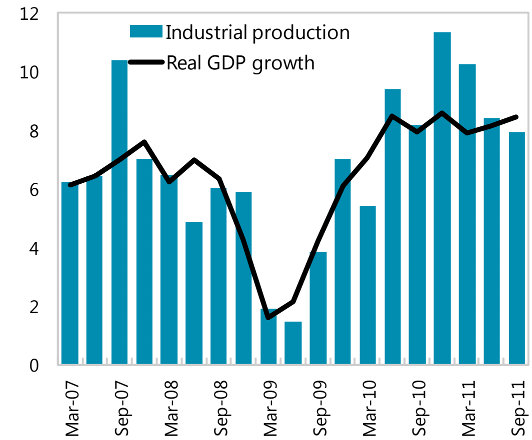
31. **State enterprise policy.** Securing a durable turnaround in the financial performance of the two state energy enterprises has been a longstanding program objective, as it is essential to put public finances on a sustainable footing. Ultimately, this will require restructuring to place the operations of these two enterprises on a more commercial basis. The substantial increases in electricity and petroleum prices are an important step forward, as were the steps taken last year to eliminate inter-enterprise arrears. These adjustments have inevitably had an adverse social impact in the short run, and the staff welcomes the steps taken by the authorities to mitigate their impact on the most vulnerable.

32. **Completion of Review.** Staff supports the authorities' request for waivers of the end-December 2011 performance criteria on net international reserves and reserve money, which are now the controlling performance criteria for the Seventh Review. Staff considers the non-observance of reserve money target to be minor and temporary due to technical reasons. For the non-observance of the NIR target for end-December 2011, the authorities have taken corrective actions as discussed in section A. Given these actions, staff recommends completion of the Seventh Review. Staff also support the authorities request for a two month extension of the arrangement and the rephasing of purchases.

Figure 1. Economic and Program Performance

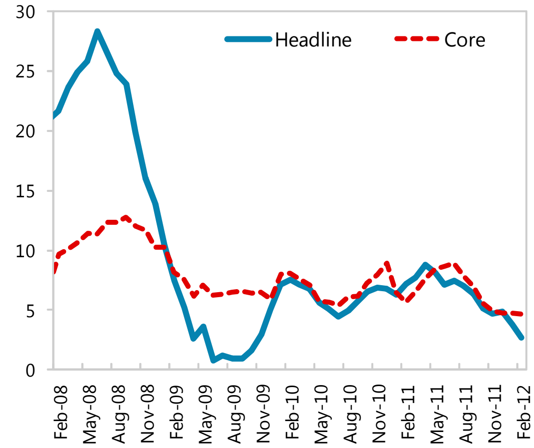
Growth remiained strong ...

Growth
(in percent yoy)



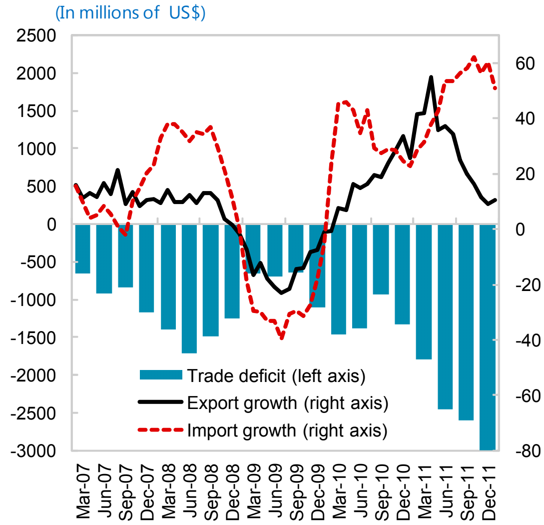
... and inflation subdued.

Inflation
(In percent yoy)



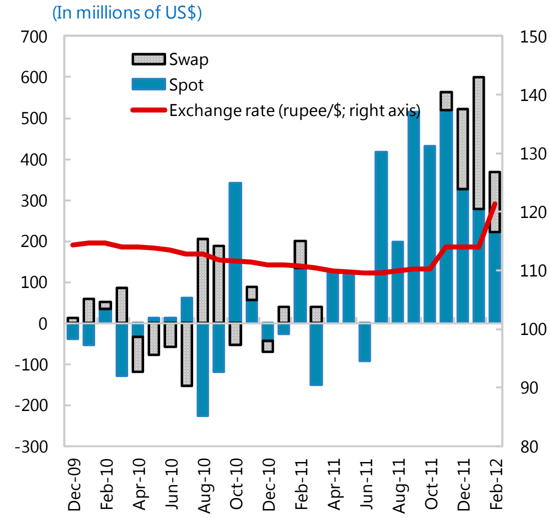
Strong growth in domestic demand contributed to an increase in the trade deficit.

Trade Deficit
(In millions of US$)



The central bank intervened heavily to absorb the presure on the exchange rate.

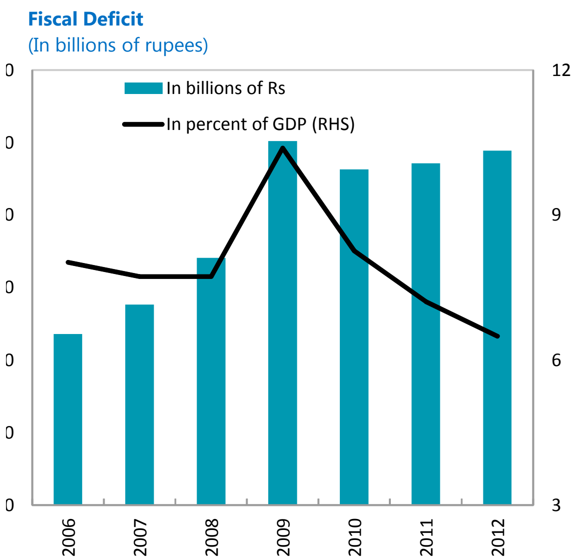
Intervention
(In miillions of US$)



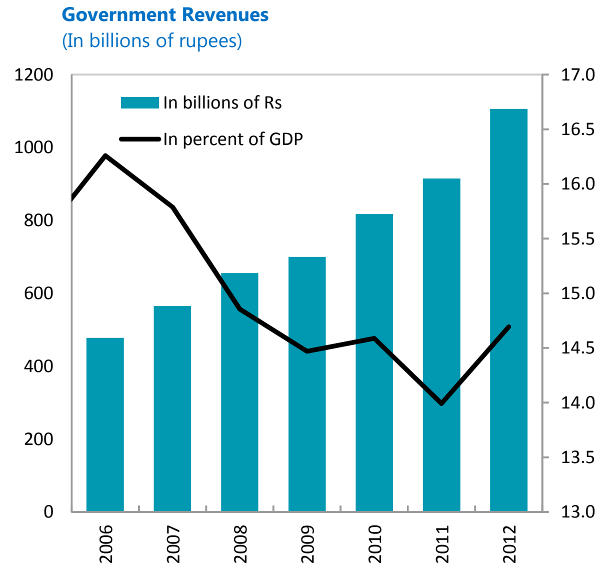
Sources: CEIC Data Company Ltd.; IMF, Information Notice System; and IMF staff estimates.

Figure 2. Fiscal Developments

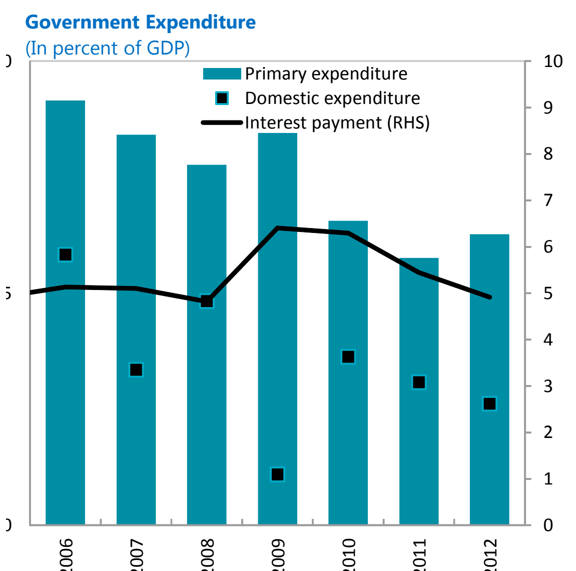
The fiscal deficit has fallen...



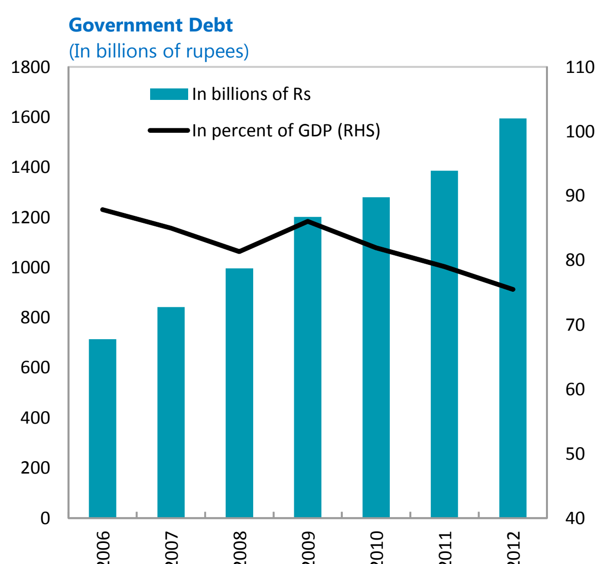
... despite declining revenues.



Because of tight control over primary expenditures...



... government debt is on a declining trend.

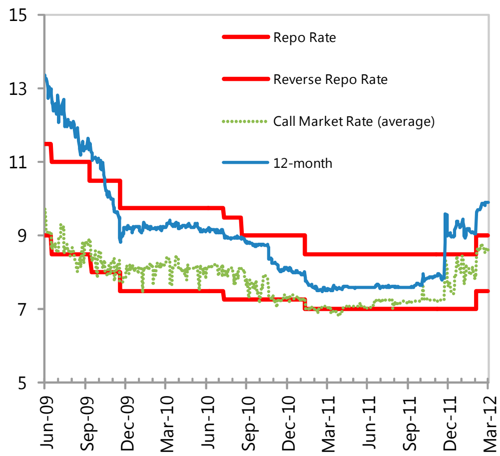


Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; Bloomberg LP; and IMFstaff estimates.

Figure 3. Monetary and External Developments

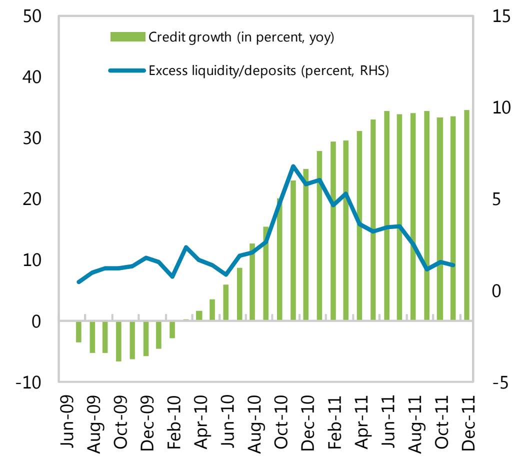
The central bank kept the policy rates unchanged until recently.

Interest Rates
(In percent)



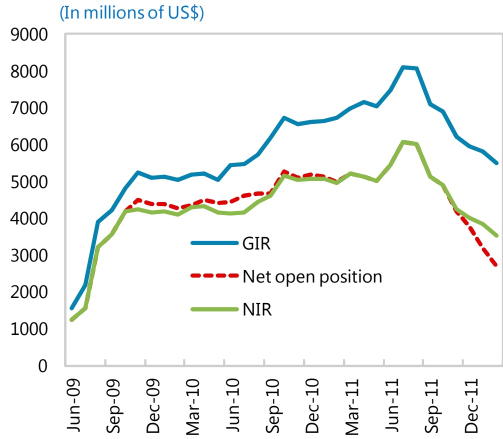
Private sector credit growth picked up rapidly, bringing down the excess liquidity in the banking system.

Credit Growth and Excess Liquidity
(In percent)



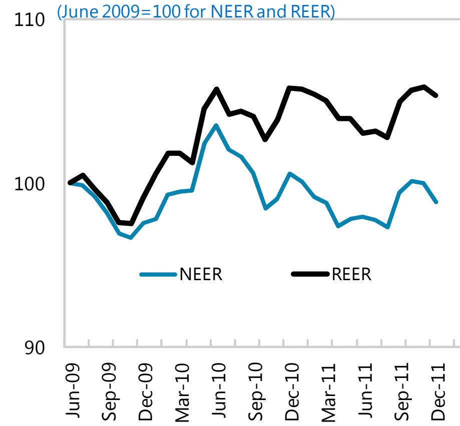
External reserves declined sharply in 2011.

External Reserves
(In millions of US$)



Real exchange rate has appreciated since the beginning of the program.

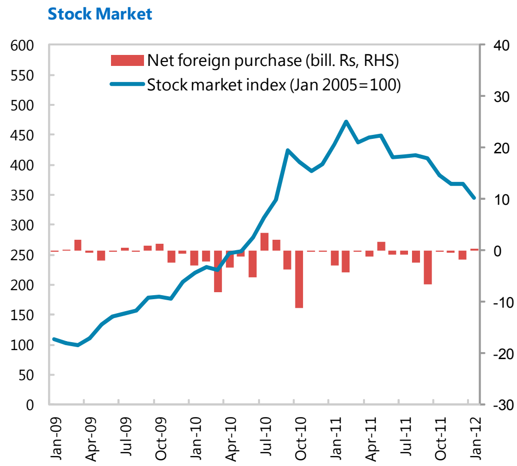
Real Exchange Rate
(June 2009=100 for NEER and REER)



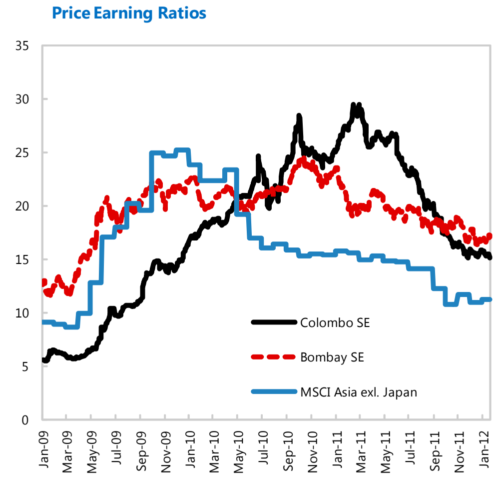
Sources: Central Bank of Sri Lanka; CEIC Data Company Ltd.; Bloomberg LP; and IMFstaff estimates.

Figure 4. Financial Sector Developments

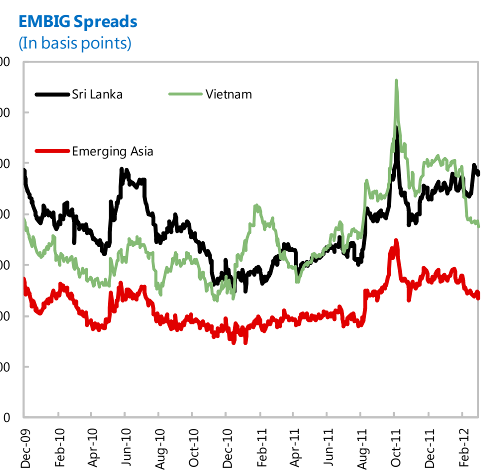
In 2011 the stock market registered a decline and foreign interest remained modest...



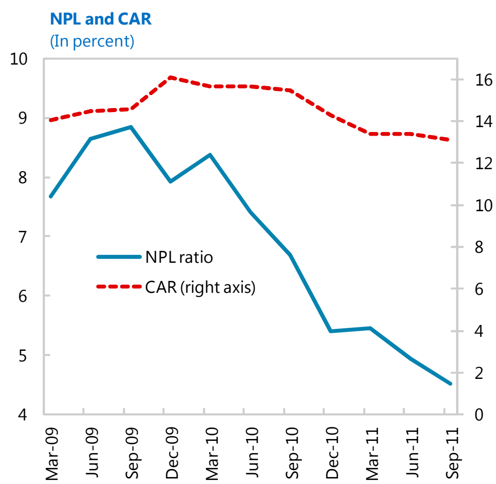
Although the Price Earning Ratio has declined, it remains above the average for the region.



Sri Lanka's sovereign risk spreads are above the regional average.



The NPLs of the banking system continue to decline.



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

Table 1. Sri Lanka: Selected Economic Indicators, 2008–2012

	2008	2009	2010	2011	2012
				Prel.	Proj.
GDP and inflation (in percent)					
Real GDP growth	6.0	3.5	8.0	8.2	7.5
Inflation (average)	22.4	3.5	6.2	6.7	7.5
Inflation (end-of-period)	24.3	5.0	6.8	4.9	9.1
Core Inflation (end-of-period)	10.3	5.9	8.9	5.3	7.6
Public finances (in percent of GDP)					
Revenue 1/	14.9	14.5	14.6	14.0	14.7
Grants 1/	…	…	0.3	0.3	0.3
Expenditure	22.6	24.9	22.9	21.2	21.2
Central government balance 1/	-7.7	-9.9	-8.0	-6.8	-6.2
Consolidated government balance 1/	-8.1	-10.3	-8.5	-8.4	-7.2
Central government domestic financing	7.1	5.1	4.5	4.0	3.9
Government debt (domestic and external)	81.4	86.1	81.9	79.0	75.5
Money and credit (percent change, end of period)					
Reserve money	1.5	13.1	18.8	21.9	16.0
Broad money	8.5	18.6	14.9	18.0	16.0
Domestic credit	18.0	3.4	15.4	31.3	13.5
Private sector credit	7.9	-6.5	24.9	34.7	16.9
Public sector credit	46.2	23.7	0.4	24.8	6.6
Balance of payments (in millions of U.S. dollars)					
Exports	8,110	7,085	8,570	10,486	11,863
Imports	-14,091	-10,206	-13,451	-20,327	-23,287
Current account balance	-3,886	-214	-1,088	-4,437	-4,734
Current account balance (in percent of GDP)	-9.5	-0.5	-2.2	-7.5	-7.3
Export value growth (percent)	6.2	-12.6	21.0	22.4	13.1
Import value growth (percent)	24.8	-27.6	31.8	51.1	14.6
Gross official reserves (end of period) 2/					
In millions of U.S. dollars	1,580	4,897	6,410	5,734	6,572
In months of imports	1.6	3.9	3.4	2.7	2.7
External debt (public and private)					
In billions of U.S. dollars	17.8	20.9	24.8	28.4	30.2
As a percent of GDP	43.7	49.7	50.1	48.1	46.5
Memorandum items:					
Nominal GDP (in billions of rupees)	4,411	4,835	5,602	6,536	7,528

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.

Table 2. Sri Lanka: Summary of Central Government Operations, 2008-2012
(In percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012
			Prov.	Prel.	Budget
Total revenue (including grants)	15.6	15.0	14.9	14.4	15.0
Total revenue	14.9	14.5	14.6	14.0	14.7
Tax revenue	13.3	12.8	12.9	12.3	13.3
Income taxes	2.9	2.9	2.4	2.5	2.5
Turnover taxes/GST	4.6	3.5	3.9	3.3	3.5
Excise taxes	2.3	2.0	2.3	2.8	3.0
Taxes on international trade	1.8	2.0	1.3	1.4	1.6
Other	1.7	2.3	2.9	2.4	2.7
Nontax revenue	1.6	1.7	1.7	1.7	1.4
Grants 1/	…	0.5	0.3	0.3	0.3
Total expenditure and net lending	22.6	24.9	22.9	21.2	21.2
Current expenditure	16.9	18.2	16.7	15.4	14.7
Civil service wages and salaries	3.2	3.0	2.8	2.7	2.6
Other civilian goods and services	1.1	1.0	0.7	1.0	1.2
Security expenditure (incl. contingency)	3.9	3.9	3.4	3.1	2.9
Subsidies and transfers	3.9	3.9	3.5	3.3	3.1
Interest payments	4.8	6.4	6.3	5.4	4.9
Capital expenditure and net lending	5.7	6.7	6.1	5.8	6.5
Overall balance of the central government	-7.7	-9.9	-8.0	-6.8	-6.2
Financing	7.7	9.9	8.0	6.9	6.2
Net external financing 2/	0.6	4.8	3.5	2.9	2.3
Net domestic financing	7.1	5.1	4.5	4.0	3.9
Privatization	0.0	0.0	0.0	0.0	0.0
Memorendum Items:					
Primary balacne (excluding grants)	-2.9	-4.0	-2.0	-1.7	-1.6
Total public debt	81.1	86.1	81.9	79.0	75.5
Domestic debt	48.3	49.7	45.8	43.2	42.1
Foreign debt	32.8	36.4	36.1	35.8	33.4
Nominal GDP (In billions of Rupees)	4,411	4,835	5,602	6,536	7,528

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, 2008–2012

	2008	2009	2010	2011	2012
				Est.	Proj.
Monetary authorities	(Stocks, in billions of Sri Lankan rupees)				
Net foreign assets	148	412	505	359	371
Net domestic assets	120	-109	-145	81	139
Of which : net credit to government	217	109	77	243	308
Reserve money	268	304	361	440	510
	(Contribution to reserve money growth, in percent)				
Net foreign assets	-54.7	98.4	30.7	-40.7	2.9
Net domestic assets	56.3	-85.3	-12.0	62.7	13.1
Reserve money (percent change)	1.5	13.1	18.8	21.9	16.0
Monetary survey	(Stocks, in billions of Sri Lankan rupees)				
Net foreign assets	78	402	377	158	163
Monetary authorities	148	412	505	359	371
Deposit money banks	-70	-10	-128	-201	-208
Net domestic assets	1,445	1,404	1,714	2,290	2,677
Domestic credit	1,897	1,961	2,263	2,972	3,374
Public sector (net)	619	766	769	959	1,022
Private sector	1,278	1,196	1,494	2,012	2,352
Other items (net)	-452	-557	-549	-681	-696
Broad money	1,523	1,806	2,074	2,448	2,841
	(Annual percent change)				
Net foreign assets	-65.9	417.2	-6.1	-58.2	3.6
Monetary authorities	-49.4	178.2	22.6	-29.1	3.6
Deposit money banks	8.5	-85.3	-1140.2	-56.9	-3.6
Net domestic assets	22.9	-2.8	22.1	33.6	16.9
Domestic credit	18.0	3.4	15.4	31.3	13.5
Public sector (net)	46.2	23.7	0.4	24.8	6.6
Private sector	7.9	-6.5	24.9	34.7	16.9
Broad money	8.5	18.6	14.9	18.0	16.0
	(Contribution to broad money growth, in percent)				
Net foreign assets	-10.7	21.3	-1.4	-10.6	0.2
Net domestic assets	19.2	-2.7	17.1	27.8	15.8
Domestic credit	20.6	4.2	16.7	34.2	16.4
Public sector (net)	13.9	9.6	0.2	9.2	2.6
Private sector	6.7	-5.4	16.5	25.0	13.9
Memorandum items:					
Broad money multiplier	5.7	6.0	5.8	5.6	5.6
Velocity of broad money	2.9	2.7	2.7	2.7	2.7
Private sector credit (in percent of GDP)	29.0	24.7	26.7	30.8	31.2

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

Table 4. Sri Lanka: Balance of Payments, 2008–2012
(In millions of U.S. dollars, unless otherwise indicated)

	2008	2009	2010	2011	2012
				Est.	Proj
Current account	**-3,886**	**-214**	**-1,088**	**-4,437**	**-4,739**
Trade balance	**-5,981**	**-3,122**	**-4,881**	**-9,841**	**-11,439**
Exports	**8,110**	**7,085**	**8,570**	**10,486**	**11,833**
Textiles and garments	3,469	3,274	3,372	4,201	4,690
Tea	1,271	1,185	1,439	1,476	1,532
Other	3,370	2,625	3,759	4,809	5,612
Imports	**14,091**	**10,206**	**13,451**	**20,327**	**23,272**
Non-oil imports	10,723	8,040	10,432	15,679	18,131
Oil imports	3,368	2,167	3,019	4,648	5,141
Services	**401**	**391**	**705**	**1,014**	**1,437**
Receipts	2,004	1,889	2,473	3,108	3,738
Payments	1,603	1,498	1,768	2,094	2,301
Income	**-972**	**-488**	**-572**	**-259**	**-378**
Transfers	**2,666**	**3,005**	**3,660**	**4,649**	**5,641**
Private (net)	2,565	2,927	3,608	4,605	5,580
Remittances	2,918	3,330	4,116	5,145	6,174
Official (net)	101	77	52	44	61
Capital and financial account	**1,773**	**3,102**	**2,877**	**3,798**	**4,739**
Capital transfers (net)	291	233	164	167	194
Financial account	1,483	2,361	2,713	3,631	4,545
Long-term flows	1,016	1,303	2,379	2,814	3,501
Direct investment	**691**	**384**	**435**	**900**	**1,440**
Foreign direct investment	691	384	435	900	1,440
Private sector borrowing 1/	**74**	**79**	**149**	**52**	**644**
Disbursements	265	390	580	398	991
Amortization	191	311	431	346	347
Official sector borrowing	**252**	**840**	**1,795**	**1,862**	**1,417**
Disbursements	1,059	1,780	2,460	2,700	2,800
Program loans	23	0	40	0	0
Project loans	886	1,280	1,420	1,700	2,300
Commercial loans	150	500	1,000	1,000	500
Amortization	807	940	665	838	1,383
Short-term flows	**466**	**1,058**	**334**	**817**	**1,044**
Government short-term net	-213	1,369	531	233	500
Nonbank private sector	594	228	-1,032	157	-206
Banking sector	26	-533	1,064	599	600
Portfolio investment	60	-6	-230	-172	150
SDR allocation	0	508	0	0	0
Errors and omissions	728	-162	-868	-422	0
Overall balance	-1,385	2,725	921	-1,061	0
Financing	1,385	-2,725	-921	1,061	0
NIR (- = increase)	1,385	-2,725	-921	1,061	0
Gross reserves	1,482	-3,316	-1,514	676	-787
Reserve liabilities (- is outflow)	-97	591	592	385	787
Memorandum items:					
Current account (in percent of GDP)	-9.5	-0.5	-2.2	-7.5	-7.3
Gross official reserves (net of ACU debit balances)	1,580	4,897	6,410	5,734	6,521
(In months of imports of goods and nonfactor services)	1.6	3.9	3.4	2.7	2.7
(In percent of short-term debt)	35	79	97	70	79
Net international reserves	1,425	4,150	5,072	4,011	4,011
GDP (US$ millions)	40,720	42,040	49,536	59,095	64,618
Short-term debt and amortizaton (US$ million, residual	4,572	6,183	6,605	8,140	8,249

Sources: Data provided by the Central Bank of Sri Lanka; and Fund staff estimates and projections.
1/ Includes public corporations.

Table 5. Sri Lanka: Preliminary External Financing Requirements, 2008–2012

(In millions of U.S. dollars)

	2008	2009	2010	2011	2012
				Est.	Proj.
Current account, including official transfers	**-3,886**	**-214**	**-1,088**	**-4,437**	**-4,739**
(in percent of GDP)	-9.5	-0.5	-2.2	-7.5	-7.3
Trade Balance	-5,981	-3,122	-4,881	-9,841	-11,439
Exports	8,110	7,085	8,570	10,486	11,833
Imports	14,091	10,206	13,451	20,327	23,272
Private transfers	2,565	2,927	3,608	4,605	5,580
Other	-470	-20	185	799	1,120
Amortization	-1,095	-1,353	-1,124	-1,193	-1,787
Public sector	-807	-940	-665	-838	-1,383
Multilateral	-232	-232	-232	-232	-232
Bilateral	-373	-373	-373	-373	-373
IMF	-97	-102	-28	-9	-57
Private sector	-191	-311	-431	-346	-347
Change in NFA of commercial banks (- = an incre	26	-533	1064	599	600
Change in official reserves (- = an increase)	1,482	-3,316	-1,514	676	-787
Gross external financing requirement	**-3,473**	**-5,416**	**-2,662**	**-4,355**	**-6,713**
(in percent of GDP)	-9	-13	-5	-7	-10.4
Sources of financing	**3,473**	**4,723**	**2,041**	**3,961**	**5,869**
Borrowing	**1,324**	**2,170**	**3,040**	**3,098**	**3,791**
Official Sector Financing Commitments	1,059	1,780	2,460	2,700	2,800
Official Sector Borrowing	1,059	1,780	2,460	2,700	2,800
Multilateral	358	316	545	509	0
Bilateral	551	964	915	1,191	2,300
Syndicated loans	150	500	1,000	1,000	500
Private Sector Borrowing	265	390	580	398	991
New Official Borrowing	0	0	0	0	0
Other Capital Account	**2,150**	**2,045**	**-999**	**863**	**2,078**
Capital transfers	291	233	164	167	194
FDI inflows	691	384	435	900	1440
Other (including errors and omissions)	1,168	1,428	-1,598	-204	444
Rupee denominated T-bonds	-213	1,369	531	233	500
Nonbank private sector (trade credits)	594	228	-1,032	157	-206
Portfolio investment	60	-6	-230	-172	150
Errors and omission	728	-162	-868	-422	0
Other	0	0	0	0	0
SDR allocation	0	508	0	0	0
External financing gap=IMF financing	**0**	**-693**	**-621**	**-394**	**-844**
Gross official reserves of the Central Bank of Sri L	1,580	4,897	6,410	5,734	6,521
(In months of imports of goods and nonfactor se	1.6	3.9	3.4	2.7	2.7

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

Table 6. Sri Lanka : Financial Soundness Indicators of the Banking Sector, 2007-2011

Ratio(%)	2007	2008	2009	2010	2011*
Capital Adequacy					
Regulatory Capital to Risk Weighted Assets(RWCAR)	14.1	14.5	16.1	16.1	14.3 **
Tier 1 Capital/Risk Weighted Assets(Tier 1 RWCAR)	12.6	12.5	14.1	14.3	12.7 **
Net Non - Performing Loans to Total Capital Funds	14.0	18.5	26.2	15.2	11.5
Debt to Capital Funds	220.0	209.4	160.1	170.9	168.7
Capital to Assets Ratio	8.0	8.1	8.1	8.3	8.7
Asset Quality					
Gross Non - Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	5.2	6.3	8.5	5.4	3.8
Gross Non - Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	6.8	8.1	10.7	7.3	6.1
Net Non-Performing Loans to Total Gross Loans	1.9	2.6	4.2	2.3	1.7
Provision Coverage Ratio (Total)	64.5	60.9	53.0	58.2	56.7
Earnings & Profitability					
Return on Equity(ROE)-After Tax	14.0	13.4	11.8	22.4	19.7
Return on Assets(ROA)- After Tax	1.1	1.1	1.0	1.8	1.7
Interest Income to Gross Income	87.4	86.3	86.0	83.1	85.7
Staff Expenses to Non Interest Expenses	44.2	44.5	46.5	45.4	43.8
Personnel Expenses to Total Income	10.5	9.9	10.6	12.0	12.1
Total Cost to Total Income	79.2	79.8	78.1	71.9	73.9
Interest Margin	4.4	4.4	4.6	4.6	4.2
Liquidity					
Liquid Assets to Total Assets	28.3	28.3	35.3	31.3	26.9
Statutory Liquid Assets Ratio - DBU	30.4	31.3	39.2	36.6	32.4
Assets/Funding Structure					
Deposits	69.5	69.6	74.1	72.9	72.3
Borrowings	17.5	17.0	12.9	14.2	14.7
Capital to External Funds	9.2	9.4	9.3	9.5	10.0
Credit to Deposits	88.1	87.0	71.5	76.4	84.9

* Provisional.

** Excluding the audited profits for the year.

Source: Data provided by the authorities.

Table 7: Sri Lanka Projected Payments to the Fund
(In millions of SDRs, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017
Fund repurchases and charges							
In millions of SDRs	8.1	55.5	322.9	488.8	371.0	331.9	173.7
In millions of U.S. dollars	12.4	85.6	498.0	753.8	572.1	511.8	267.8
In percent of exports of goods and NFS	0.1	0.5	2.9	3.9	2.7	2.1	1.0
In percent of quota	2.0	13.4	78.1	118.2	89.7	80.3	42.0
In percent of gross official reserves	0.2	1.3	9.2	13.9	8.7	5.8	2.1
Fund credit outstanding							
In millions of SDRs	1119.5	1644.9	1352.0	878.3	516.6	189.3	17.1
In millions of U.S. dollars	1710.9	2536.7	2085.1	1354.6	796.7	292.0	26.3
In percent of quota	270.8	397.9	327.1	212.5	125.0	45.8	4.1
In percent of GDP	2.9	3.9	2.9	1.8	0.9	0.3	0.03
In percent of gross official reserves	29.8	38.9	38.7	24.9	12.1	3.3	0.2
Memorandum items:							
Exports of goods and services (millions of US$)	13594	15571	17403	19237	21484	23964	26738
Quota (millions of SDRs)	413	413	413	413	413	413	413
Quota (millions of US$)	632	638	638	638	638	638	638
Gross official reserves (millions of US$)	5734	6521	5392	5434	6582	8814	12560
GDP (millions of US$)	59095	64618	70990	77132	84546	92634	101327
U.S. dollars per SDR (March 9,2012)	1.53	1.54	1.54	1.54	1.54	1.54	1.54

Source: IMF Staff estimates

ATTACHMENT I
SRI LANKA: LETTER OF INTENT

Colombo, March 15, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde

This letter supplements the Memorandum of Economic and Financial Policies of July 16, 2009 and the Letters of Intent dated October 30, 2009; June 19, 2010; September 14, 2010; January 17, 2011; and March 15, 2011.

1. The economy performed well in many respects in 2011. Output growth stayed strong, at 8¼ percent, and inflation remained subdued. Program performance under the Seventh Review was also on track in the first half of 2011, with all of the end-June 2011 quantitative targets and most of the outstanding structural benchmarks met.

2. Though economic fundamentals were healthy, there were emerging signs in the third quarter that the balance of payments was coming under pressure. A stronger-than-expected rebound in the growth of credit and domestic demand, as well as higher-than-expected oil prices, led to a significant increase in imports, and despite healthy growth in exports and remittances, the current account deficit widened sharply to 7½ percent of GDP. As a result, although the end-December target for net domestic financing of the budget was met, the floor on net international reserves was missed by a large margin. Moreover, higher international petroleum prices and lower hydroelectricity production due to low rainfall resulted in the Ceylon Petroleum Corporation and the Ceylon Electricity Board continuing to incur significant losses.

3. Recognizing the downside risks of these emerging trends against the backdrop of global uncertainties, the Sri Lankan authorities introduced several corrective measures:

- Following a 3-percent depreciation of the rupee in November 2011, the trading band on the exchange rate was discontinued in early February 2012 to allow greater exchange rate flexibility and reduce intervention in the foreign exchange market.

- Policy rates were raised and directions were given to banks to limit their credit growth, which will result in limiting the expansion of credit to below 20 percent and significantly decelerating monetary expansion in 2012.

- In keeping with global price developments, domestic petroleum and electricity prices were increased by an average of 32 percent and 20 percent, respectively. This revision offset increased costs and reduced the losses of the state energy corporations. An increase in petroleum taxes also served to fund measures to cushion the impact of the price increases on the most vulnerable, non-electrified household consumers, the fisheries sector and small service operators, and ensure the achievement of the fiscal deficit target of 6¼ percent of GDP for 2012.

4. As a result of these policy changes, the rupee depreciated by around 5 percent to Rs 120/$ immediately after the trading band was removed and is now trading freely at around Rs. 124/$. Since early February, we have limited Central Bank sales of foreign exchange to supporting the oil bill on a declining scale. This has sharply reduced the level of intervention in recent weeks and the corresponding decline in reserves. More immediately, we expect to start rebuilding our net international reserves and aim, at least, to reverse the recent decline in net international reserves completely by end-2012. We are confident that the package of measures taken will reduce the external current account deficit towards a sustainable level by the end of 2012.We are firmly committed to a flexible monetary and exchange rate policy under which we will take whatever necessary steps that are needed to achieve these objectives.

5. Beyond these changes, our policy agenda remains in line with the *Sri Lanka - Emerging Wonder of Asia: Mahinda Chintana – Vision for the Future: The Development Policy Framework of the Government of Sri Lanka*, which has been described in the program's Memorandum of Economic and Financial Policies and subsequent Letters of Intent. We will continue the restructuring of the state-owned Electricity Board and Petroleum Corporation to place them on a financially sound footing. We have already restructured overdue obligations between these two enterprises. Cabinet approval for the amendments to the Petroleum Act to strengthen the regulatory framework is on track and is expected to be received in the second quarter. The Cabinet has also approved amendments to the Banking Act to reform the banking regulatory and supervisory framework, and we look forward to the forthcoming FSAP update, which will help strengthening our banking supervision framework further.

6. We request completion of the Seventh Review of the Stand-By Arrangement (SBA), following which we intend to draw one tranche amounting to SDR 275.6 million. We request waivers of non-observance for the end-December 2011 performance criteria on net international reserves given the corrective actions discussed in paragraph 3, as well as the performance criteria on reserve money, which was missed for technical reasons, though the central bank's target was met by a comfortable margin.

7. We request an extension of the SBA to July 23, 2012 and that the remaining purchase be rephased to provide more time for our new flexible exchange rate regime to become established while we stabilize and then start rebuilding net international reserves before the program expires. At that time we could review the way forward to continue the above reforms and policy measures and ensure that the economy is placed firmly on a sustainable growth path. We request the establishment of end-June 2012 performance criteria and indicative targets with respect to the completion of the Eighth and final review under the arrangement to be scheduled for July 16 as discussed in the Technical Memorandum of Understanding and the attached table.

8. We believe that the policies set forth in this and previous Letters of Intent are adequate to achieve the objectives of our economic program, but the authorities stand ready to take additional measures as appropriate to ensure achievement of the objectives. We will continue to liaise with the IMF when modifying measures contained in this letter, or adopting measures that would deviate from program goals, and provide the IMF with the information necessary for program monitoring.

9. In keeping with its policy of transparency, the Government has authorized the publication of this letter and the attached Technical Memorandum of Understanding.

Yours sincerely,

/s/

Gitanjana Gunawardena
Deputy Minister of Finance and Planning

/s/

Ajith Nivard Cabraal
Governor, Central Bank of Sri Lanka

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

	2009	2010	2011						2012	
			End-Jun. Performance Criteria			End-Dec. Performance Criteria			End-Mar. Indicative Targets	End-Jun. Performance Criteria on NIR and Indicative Targets on Reserve Money and NDF
			EBS/11/46	Adj.	Prel.	EBS/11/46	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$) 1/ 2/ 3/ 4/ 5/	2,725	-115	35	164	357	129	1,359	-1,061	-684	-670
Reserve money of the CBSL (ceiling, eop stock, in million rupees)	303,500	360,000	402,199	420,356	405,310	416,167	434,324	442,436	468,500	474,165
Net domestic financing (NDF) of the central government from the banking system and the non-bank sector (ceiling, cumulative from the beginning of the year, in million rupees) 6/ 7/ 8/ 9/ 10/	392,476	349,149	188,602	195,026	191,346	358,650	277,311	259,245	230,814	300,478
Continous performance criteria										
Accumulation of new external payment arrears (ceiling, eop, in million US$)	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)	-19,400	-35,685	…			0		-99,000		
Memorandum items:										
External debt service assumed under the program (cumulative from the beginning of the year, in million rupees) 7/	141,914	96,555	57,915		64,339	116,466		132,411		
Privatization proceeds to the central government in connection with the sale of central government assets (in million rupees) 8/	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) 9/	6,038	6,038	1,575		1,575	1,575		1,575		
Foreign program financing assumed under the program (cumulative from the beginning of the year, in million US$)	0	50	…		…	…		…	…	…
External commercial loans (including Eurobonds and syndicated loans) assumed under the program (cumulative from the beginning of the year, in million US$) 2/	500	0	0		0	0		1,000	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$) 1/	1,345	0	0		100	0		232	…	…
Official external debt service assumed under the program (cumulative from the beginning of the year, in million US$) 3/	878	824	531		502	1,070		1,072	…	…
Settlement of syndicated loans assumed under the program (cumulative from the beginning of the year, in million US$) 4/	225	25	0		0	0		0	0	0
Outstanding value (i.e., receivables) on swaps and forwards by CBSL (eop stock, in million US$) 5/	245	200	0		0	0		0	782	782

1/ If 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 (discontinued after Dec 2011).

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 (discountinued after Dec 2011).

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/ If the outstanding value on swaps and forwards is higher/lower than assumed under the program, the floor on NIR will be adjusted upward/downward by the difference on the test date. This adjustor is introduced from end-March 2012. The outstanding value as of February 29, 2012 was $782 million. The downward adjustment in the NIR target will be up to a maximum of $ 600 million.

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 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.

8/ 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.

9/ 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.

10/ The 2012 indicative targets on NDF include restructuring bonds amounting to Rs. 60,000 million issued to settle outstanding dues from state owned institutions to the Ceylon Petroleum Corporation.

Table 2. Sri Lanka: Structural Benchmarks (SB)

Structural Benchmarks	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	Implemented with delays
Approval by Parliament of an interim budget for the first four months of 2010 consistent with program targets.	12/15/2009	Implemented
Develop a plan to address outstanding debts between the CEB, CPC and state-owned banks.	12/31/2009	Implemented
Issuance of prudential regulations and guidelines to credit card companies and payment service providers.	12/31/2009	Implemented
Submission to parliament of the 2010 budget consistent with program targets.	4/30/2010	Implemented with delays
Submission to the parliament of a revised Finance Business Act which includes clarifying the legal authority of the CBSL in enforcing its regulations on all deposit taking finance companies.	5/31/2010	Implemented with delays
Submission by the Presidential Tax Commission of a final report, including specific tax reform measures.	8/31/2010	Implemented with delays
Parliamentary approval of full-year 2010 budget consistent with program targets	8/31/2010	Implemented
Issuance of regulations to establish a deposit insurance scheme.	9/30/2010	Implemented
Submission to parliament of the 2011 budget consistent with program targets, including income tax and VAT reform measures.	11/30/2010	Implemented
Cabinet approval of a regulatory framework for private-sector superannuation funds.	12/31/2010	Not met
Restructure the overdue obligations accumulated up to end-2009 by Ceylon Electricity Board to Ceylon Petroleum Corporation.	12/31/2010	Implemented with delays
Amend BOI regulations	3/31/2011	Implemented
Amend the Strategic Investment Law and issue supporting regulations on defining and contracting strategic projects	3/31/2011	Implemented
Cabinet approval of amendments to the Banking Act	3/31/2011	Implemented with delays
Cabinet approval of amendments to the Petroleum Act	9/30/2011	Not met
Submission to parliament of the 2012 budget	11/30/2011	Implemented

ATTACHMENT II
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 for the eighth and final review contemplated for completion by July 16, 2012.

I. FISCAL TARGETS

A. Indicative Target 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 2009, NDF of the central government defined in this manner amounted to Rs. 392.5 billion. Of this amount, Rs. 49.0 billion was net borrowing from the domestic banking system, Rs. 185.2 billion was net borrowing from the domestic non-bank sector, Rs. 146.9 billion was net foreign inflows into the Treasury Bill and Treasury Bond markets and Rs. 11.3 billion was net borrowing from other sources.

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

3. 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 2009, the sum of that overall position of the CEB and CPC defined in this manner stood at Rs. -19.4 billion.

II. Monetary Targets

A. Indicative Target on Reserve Money of the CBSL

4. **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 2009, reserve money defined in this manner stood at Rs. 303.5 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).

III. External Sector Targets

A. Performance Criterion on Net Official International Reserves

5. **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 2009, NIR defined in this manner stood at U.S. dollars 4,150 million.

The following adjustment will apply:

6. 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.

7. An adjustor to the NIR target of the CBSL will be implemented to reflect changes in the CBSL's net position under foreign exchange forwards and swaps. Specifically, if the outstanding value on forwards and swaps is higher/lower than assumed under the program (Table 4), the NIR target of the CBSL will be adjusted upward/downward by the change in the outstanding value of forwards and swaps relative to the programmed level. The CBSL's outstanding value on swaps and forwards was $782 million at February 29, 2012. The downward adjustment in the NIR target will be up to a maximum of $600 million.

8. 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 External Payment Arrears

9. **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 ¶9 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

10. 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.[1] With regards to the fiscal targets, the data in table 5 will be furnished within no more than five weeks after the end of each month and the data in table 6 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.

11. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 5 and 6.

12. For the purpose of monitoring the monetary targets under the program, data will be provided in the format shown in Table 7.

13. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 8 and 9.

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[1] The deadline for submitting monetary and external data for end-December 2010 and 2011 will be five weeks due to the added time needed to close the books at the end of the year.

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

	2010	2011			2012	
	Dec	Mar	Jun	Dec	Mar	Jun
External Program Loans	5,699	…	…	…	…	…
External Commercial Loans	0	0	0	0	…	…
External Debt Service	96,555	31,221	57,915	116,466	…	…

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

	2010	2011			2012	
	Dec	Mar	Jun	Dec	Mar	Jun
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)

	2010	2011			2012	
	Dec	Mar	Jun	Dec	Mar	Jun
Foreign Bills Inward	6,038	1,575	1,575	1,575	…	…

Table 4. Sri Lanka: External Financing for NIR Purposes

(cumulative from the beginning of the year unless otherwise stated, in millions of U.S. dollars)

	2010	2011			2012	
	Dec	Mar	Jun	Dec	Mar	Jun
Program Loans	50	…	…	…	…	…
External Commercial Loans	0	0	0	0	0	0
Treasury Bills/Bonds	0	0	0	0	…	…
Official External debt service	824	250	531	1,070	…	…
Settlement of Syndicated Loans	25	0	0	0	…	…
Outstanding value on swaps and forwards by CBSL 1/	200	0	0	0	782	782

1/ End of period stock.

Table 5. Sri Lanka: Summary of Central Government Operations 1/

(In millions of rupees)

Total revenue
Tax revenue
Income taxes
Value added tax
Domestic
Imports
Excise taxes
Tax on liquor
Tax on cigarettes/tobacco
Petroleum
Motor vehicle
Other
Stamp duties
Port and airport development duty
Debit tax
Import duties
Cess levy
Special commodity levy
Nation Building Tax
Telephone subscriber levy
Licence taxes and other
Nontax revenue
Grants
Total expenditure and net lending
of which: Interest payments
Foreign
Commercial
Domestic
Overall balance of central Government
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 6. 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 7. 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 8. 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 9. Sri Lanka: Estimated Gross Official Reserve Position (in US$ million) 1/

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

1/ As agreed for the purpose of monitoring the program

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 12/117
FOR IMMEDIATE RELEASE
April 2, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Seventh Review Under the Stand-By Arrangement for Sri Lanka and Approves US$ 426.8 Million Disbursement Sri Lanka

The Executive Board of the International Monetary Fund (IMF) today completed the seventh review of Sri Lanka's economic performance under a program supported by a Stand-By Arrangement (SBA). The completion of the review enables the immediate disbursement of an amount equivalent to SDR 275.6 million (about US$ 426.8 million), bringing total disbursements under the arrangement to an amount equivalent to SDR 1.378 billion (about US$ 2.13 billion). In addition, the Executive Board approved an extension of the arrangement period to July 23, 2012, to allow time for the completion of the eighth and final review.

The Executive Board also approved waivers of nonobservance for end-December performance criteria on net international reserves and reserve money. A rephasing of the remaining disbursements was also approved by the Board.

The SBA was approved on July 24, 2009 (see Press Release No. 09/266) for an amount equivalent to SDR 1.65 billion (about US$ 2.56 billion), or 400 percent of Sri Lanka's quota.

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

“While the strong economic recovery continued in 2011, and inflation remained subdued, a combination of rapid credit growth and a tightly managed exchange rate caused the external current account deficit to widen and external reserves to fall sharply. As a result of higher oil prices, the state energy enterprises also continued to run significant losses.

“The authorities have recently introduced a broad package of measures to rein in the current account deficit, stem the reserve loss, and bolster fiscal performance. Monetary and credit policy have been tightened, petroleum and electricity prices increased, petroleum taxes raised, and the rupee trading band abolished to allow the exchange rate to adjust more flexibly. The authorities are taking steps to mitigate the adverse impact on the most vulnerable. Fiscal policy will also continue on a consolidation path, with the 2012 Budget targeting a reduction in the deficit to 6.2 percent of GDP.

“The authorities intend to use the forthcoming FSAP update to strengthen the financial system further. Continued structural reforms to place the state owned energy enterprises on a financially sound footing will reduce demands on the budget.

“The adjustment measures implemented by the authorities have placed the economy on a more sustainable trajectory. However, it will take time for the new monetary and exchange rate regime to become fully established, and the authorities will need to stand ready to adjust policies further to stabilize external reserves, especially if the global environment becomes less favorable,” Mr. Zhu said.

Statement by Nandalal P. Weerasinghe, Alternate Executive Director for Sri Lanka
April 2, 2012

Since completion of the sixth review in April 2011, program performance under the SBA was on track during the first half of the year. During the second half of 2011, some unexpected developments in the balance of payments led to a significant gap between the actual and targeted NIR and delayed the completion of the seventh review. My authorities implemented a decisive reform package in February 2012 aimed at addressing the emerging imbalances. They are thankful to staff and management for their continuous engagement and support to bring the program back on track and appreciate the support extended by the Executive Directors in coping with challenges faced by the Sri Lankan economy. They broadly concur with staff's assessment.

I wish to make a few remarks on some salient aspects of the staff report, drawing on the constructive and open-minded discussion between staff and my authorities.

Program Performance

All performance criteria for end June and end December 2011 were met except for the NIR target and reserve money target due to technical reasons for end-December 2011, which was to be the final test date under the SBA. Imports grew continuously both in 2010 and 2011 by 32 percent and 51 percent, respectively, compared to staff's projection for 2011 of 17 percent, the basis on which the NIR target was set at the beginning of 2011. Major reasons for the persistently high import growth were: 1) private sector domestic investments fueled by post-conflict business optimism: 2) major reconstruction activities in the conflict-affected North and Eastern provinces and 3) rising international petroleum prices. A large part of the rising current account deficit was financed through issuances of two 10-year sovereign bonds of US dollars one billion each issued in 2010 and 2011, and sale of local currency denominated government securities to foreign investors, as other capital inflows were not forthcoming in a significant way. Since such commercial borrowings are excluded from the NIR target, this was reflected as a shortfall in meeting the NIR target. The recent policy package is expected to adjust trade and current account deficits to a sustainable level and build up external reserves gradually to a more comfortable level.

All structural reforms under the SBA have been completed except for the amendment to the Petroleum Act and the establishment of the regulatory framework for private-sector superannuation funds. Amendment to the Petroleum Act has already been drafted and approval from the Cabinet of Ministers is expected by the completion of the final review. Due to public protests about the proposed private sector pension scheme, introduction of the regulatory framework for private pension funds has been postponed for the time being.

On the basis of the successful implementation of the strong policy package introduced in February 2012, my authorities request approval of the completion of the seventh review and waivers of nonobservance of performance criteria, extension of the arrangement period, rephasing of purchases, and establishment of new performance criteria.

Recent Economic Developments and Outlook

The Sri Lankan economy continued to grow at a rate above 8 percent for the second consecutive year since 2009. Economic growth during the last two years was mainly driven by higher domestic demand, both investment and consumption, generated by rising business optimism and consumer confidence. Rapid reconstruction in the conflict affected areas and higher integration of these two provinces with other parts of the country due to infrastructure developments and de-mining operations have provided ample opportunities for new investments in these areas. In addition, the government continued to implement on a rapid infrastructure development drive covering all parts of the country, which include road development, ports and airports developments and expansion of power generation capacity. At the same time, the private sector continued to expand investments in areas of tourism, agriculture, industries, telecommunications and transport services. The buildup of demand has not caused any inflationary pressures so far as excess capacity is still available, particularly in the Northern and Eastern provinces. Rising aggregate domestic demand was financed mainly through rapid expansion in private sector credit, particularly through higher access to credit in lagging regions which generated higher demand for import of investment and intermediate goods. The sharp rise in petroleum prices during the latter part of 2011 raised import expenditure, further widening the trade deficit. Although, exports also grew by a record 22 percent during 2011 and tourism receipts and remittances accelerated, they were outpaced by the growth in imports resulting in a sharp widening of trade and current account deficits towards the latter part of 2011. My authorities used a part of external reserves, which had peaked at above US dollars 8 billion (4.4 months of imports of goods and services) in August 2011, to finance the widening trade deficit, particularly in payment of oil bills. In response to growing imbalances in the current account, the exchange rate depreciated by 3 percent in November 2011, followed by greater flexibility in its movements from February 2012, and further tightening of monetary policy. In addition, domestic petroleum and electricity prices were also increased in line with international prices.

My authorities are confident that the polices implemented so far strike a right balance between curtailing the current account deficit and maintaining growth of around 7 percent in 2012, with improved prospects of more accelerated growth momentum in the medium term on a sustainable basis.

Monetary and Exchange Rate Policy

Inflation remained at a single digit level for the third consecutive year in 2011 and below the Central Bank’s target of 4-6 percent announced at the beginning of 2011. In view of persistently high excess liquidity in the domestic money market and rapid growth in private sector credit, the Central Bank commenced the tightening cycle by raising the Statutory Reserve Ratio (SRR) by 100 basis points in April 2011. During the second half, with Central Bank interventions in the foreign exchange market in order to reduce the pressure in the market, rupee liquidity was further tightened and short-term interest rates were allowed to rise gradually. Despite gradual tightening of monetary policy, credit growth continued to remain high. Therefore, in February 2012, the Central Bank raised its policy rates by 50 basis points while issuing directions in March 2012 to licensed banks to restrict credit expansion to more sustainable levels. Since February 2012, the short-term interest rate structure has shifted further upwards. Inflation, on year-on-year basis, was 2.7 percent, at end-February 2012, the lowest since January 2010. The second round impact of the sharp exchange rate depreciation and higher petroleum prices is expected to be low given the hawkish monetary policy stance and the credible track record of stable inflation in the past 3 years. The favorable impact of enhanced agricultural production in the Northern and Eastern provinces on food prices is expected to contain inflation within single digits in 2012 as well.

Since September 2011, the foreign exchange market experienced heightened liquidity shortage due to the sharp rise in cost of petroleum imports. Accordingly, my authorities had to supply around US dollars 550 million per month on average to alleviate short term supply demand imbalances. With the exchange rate moving more flexibly from February 2012, and in fact, depreciating by 12 percent so far since February 9, 2012, average intervention has been limited only to provide financing for a small portion of oil bills to the CPC. This policy has helped minimize the reduction in the NIR and the indicative target for NIR for end-March, 2012 is expected to be met with a comfortable margin. My authorities have committed to turn around the NIR path by end June 2012, i.e., before the test date for the final review.

However, significant challenges still remain in meeting the NIR target for end June. First, since the current account deficit has been running at around 8 percent of GDP before the correction, the adjustment to a more sustainable level will take time before enabling my authorities to start building up reserves. Second, empirical evidence for Sri Lanka suggests that exports take a longer time to respond to exchange rate adjustments than imports, indicating that the current account deficit during the transition period could still remain high. Third, the performance of exports depends more on external market conditions rather than depreciation. Fourth, emerging restrictions on crude oil imports from Iran could make the NIR path vulnerable as Sri Lanka has a credit line to import crude oil from Iran. Any suspension of imports from Iran would prevent rolling over the credit facility for oil imports unless a similar line of credit is provided by new suppliers. If the above conditions come into play adversely, meeting the NIR target for end June could be challenging as the current NIR target requires the Central Bank to purchase foreign exchange from the market which could lead to short-term disruptive movements in foreign exchange liquidity with undesirable shocks to the exchange rate. While my authorities are fully committed to maintain exchange rate flexibility and will make every effort to turn around the NIR path, under such extreme circumstances, some adjustments of the reserve path through end June may be needed.

Fiscal Policy and State Enterprise Reforms

One of the key objectives of the SBA was to implement necessary fiscal reforms aimed at bringing down the fiscal deficit and public debt on a sustainable basis by implementing necessary tax reforms and prudent public expenditure management. The fiscal deficit as a percentage of GDP is on a steady declining path from as high as 9.9 percent of GDP in 2009 to 6.9 percent of GDP in 2011. The 2012 Budget targets a further reduction of the deficit to 6.2 percent of GDP. According to staff's assessment, the medium-term outlook remains on track with public debt set to fall below 65 percent of GDP by 2015 from 78.5 percent of GDP at end 2011. My authorities have gained credibility by meeting all fiscal targets set under the SBA for 2011. The tax reforms recommended by the Presidential Tax Commission were introduced in the Budget 2011 and implementation was completed during 2011. Somewhat lower than projected revenue outcome for 2011 was mainly due to the reduction of petroleum taxes in order to cushion rising petroleum prices in international markets. With the adjustment of taxes on petroleum products and the full impact of tax reforms implemented in 2011, tax revenue is expected to improve in 2012. My authorities will continue to maintain tight control over current expenditure. They will, however, accommodate externally funded capital expenditure at a level higher than expected earlier, which is the main reason for the somewhat higher fiscal deficit for 2012 than envisaged at the time of the previous review.

Despite increases in domestic petroleum and energy prices from time to time, the financial positions of two major SOEs, namely, CPC and CEB worsened during 2011 in consonance with the rise in oil prices in global markets and the lagged adjustment of domestic prices. In addition, demand for oil and energy in the rapidly growing economy has been much higher than anticipated, requiring a shift in power generation towards costlier thermal power as the capacity of hydro power generation is limited. The recent adjustment in petroleum and energy prices, together with the completion of restructuring overdue obligations accumulated by the CEB up to end 2009 owed to CPC (structural benchmark), would place both SOEs on a better financial footing.

Financial Sector Developments

The financial sector remains healthy with prudential indicators pointing to adequate capital and liquidity buffers and healthy profit levels. Asset quality of the banking sector has improved, as reflected by the positive developments in nonperforming loans (NPLs), lowering credit risk. The banking, finance and leasing and insurance sectors expanded their branch network, including in the Northern and Eastern provinces, thereby increasing access to financial services.

My authorities took measures to further strengthen the regulatory and prudential framework governing the financial system. The major reform was the enactment of the new Finance Business Act aimed at further strengthening the regulation of finance companies and enhancing powers to combat unauthorized deposit-taking and finance business activities. The minimum capital requirements for finance companies were enhanced and corporate governance provisions relating to fitness and propriety of directors and senior management were also strengthened. New prudential requirements for capital adequacy and liquidity for leasing companies were introduced. Amendments to the Banking Act with provisions to enable the consolidated supervision of banking groups and measures to facilitate mergers and acquisitions for consolidation and resolution were submitted to the Cabinet of Ministers for approval. Directions on integrated risk management and customer protection were also issued. Comprehensive amendments to the Regulation of the Insurance Industry Act also came into effect during 2011. My authorities look forward to the scheduled update of the FSAP for 2012 to assess progress in financial sector reforms and help identify future measures to further strengthen the regulatory and supervisory system.

Conclusion

My authorities highly value the contribution made by the Fund in achieving an impressive progress in the Sri Lankan economy since 2009 under the current SBA. They would like to reiterate their commitment to implement whatever reforms necessary to maintain macroeconomic stability and look forward to continued engagement with the Fund.