INTERNATIONAL MONETARY FUND

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SRI LANKA

June 2016

FOURTH POST-PROGRAM MONITORING DISCUSSION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

In the context of the third Post-Program Monitoring discussions, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 13, 2015 consideration of the staff report that concluded third Post-Program Monitoring Discussion with Sri Lanka.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 13, 2015, following discussions that ended on September 18, 2015, with the officials of Sri Lanka on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 27.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Supplement to the Staff Report** updating information on recent developments.
- A **Statement by the Executive Director** for Sri Lanka.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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IMF Executive Board Concludes Fourth Post-Program Monitoring with Sri Lanka

On November 13, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Fourth Post-Program Monitoring with Sri Lanka.[1]

Recent economic developments reflect a more challenging external environment as well as a sharpening of macro-financial imbalances that began to emerge late in 2014. During the first half of 2015, growth picked up to 5.6 percent versus 4.5 percent in 2014. Headline inflation fell to -0.3 percent in September before rising to 1.7 percent in October, while core inflation (excluding fresh food, transport, and energy prices) has risen since the beginning of 2015, reaching 4.4 percent in October.

Preliminary data indicate that the government fiscal deficit in the first half of 2015 was 3.7 percent of GDP. Tax revenue collection picked up, but not to the extent assumed in the 2015 budget. The external accounts benefitted from the lower oil price, but higher imports of consumer and investment goods more than offset this effect. Following the reduction of policy rates in April 2015, the Central Bank of Sri Lanka (CBSL) has kept monetary policy unchanged. Successful issuance of a US$ 1.5 billion sovereign bond in October helped boost foreign reserves and partially compensate for earlier declines.

The economic outlook remains uncertain, and will depend to a large extent on the course set for economic policies in the coming months. The risks are tilted to the downside. Underlying growth momentum appears relatively firm and the outlook for headline inflation looks contained. However, the large increase in wages and salaries in the revised 2015 budget and lower administered prices have boosted incomes. Together with a reduction in import taxes on vehicles, this has fed through to a sharp rise in imports, a deterioration in the nonoil current account balance, rising core inflation, and continued weakness in the structure of public finances. Further, external risks have risen. Global growth prospects have weakened. Global financial conditions have tightened and may rebalance further when the U.S. Federal Reserve moves to raise interest rates.

[1] The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

Executive Board Assessment

In concluding the Fourth Post-Program Monitoring Discussions with Sri Lanka, Executive Directors endorsed the staff's appraisal, as follows:

Economic growth continued to be fairly strong in 2015, while headline inflation has remained low. The external current account deficit is projected to narrow moderately in 2015, due largely to lower oil prices. Private sector credit growth has picked up sharply in 2015. At the same time, deterioration in the overall balance of payments, the loss of central bank foreign exchange reserves, the weak state of public finances, and growing public debt are reasons for concern.

Despite continued access to international debt markets, these trends suggest that financial risks for Sri Lanka have increased. To mitigate these risks, the authorities should take appropriate corrective actions to safeguard macroeconomic stability and lay the foundation for durable and inclusive growth. Improvements in the business climate, reform of state owned enterprises, and a more open trade regime are key to boosting competitiveness and growth.

In view of high public debt, fiscal developments this year pose a risk to the economy and call for ambitious measures in the 2016 budget to put Sri Lanka's fiscal position on a more sustainable footing. Sri Lanka has a very low tax-to-GDP ratio, and high levels of current expenditure constrain needed development spending, limit policy space, and threaten debt sustainability. Therefore, a comprehensive reform of tax policy and administration, and a prompt resumption of fiscal consolidation supported by increased revenues should be a key policy priority.

With the recent acceleration in private sector credit growth and rising core inflation, there is now little scope for further monetary easing. Most factors—including the deterioration in the balance of payments and pressures on the rupee—suggest that the CBSL should be prepared to tighten monetary policy in the coming months, albeit at a gradual pace.

Another policy challenge is to reduce external vulnerabilities and address the deterioration in the balance of payments. Tighter fiscal and monetary policies could help restrict aggregate demand, contain the recent sharp rise in imports, and strengthen the external balance. However, to be more effective, these policies should be supported by greater exchange rate flexibility, reduced foreign exchange intervention, and efforts to deepen the foreign exchange market, as well as structural reforms to enhance competitiveness.

The financial sector remains relatively stable, and the authorities are taking measures to tackle remaining vulnerabilities in the nonbank financial sector. However, there is the need for continued progress in consolidated bank supervision and in developing a more robust stress testing framework.

Sri Lanka: Selected Economic Indicators, 2013–20

	2013	2014	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
GDP and inflation (in percent)								
Real GDP growth	3.4	4.5	5.2	5.5	5.5	5.5	5.5	5.5
Inflation (average)	6.9	3.3	1.1	3.4	4.3	5.0	5.0	5.0
Inflation (end-of-period)	4.7	2.1	3.2	3.6	5.0	5.0	5.0	5.0
Core inflation (end-of-period)	2.1	1.2	5.0	5.4	4.1	4.1	4.1	4.1
Savings and investment (in percent of GDP)								
National savings	23.6	24.5	25.3	26.7	26.3	25.6	25.0	24.7
Government	-0.7	-1.1	-1.7	-2.2	-1.7	-1.2	-0.9	-0.6
Private	24.3	25.6	27.0	28.9	28.0	26.8	25.8	25.4
National Investment	27.0	27.1	27.7	28.2	28.6	28.8	28.7	28.6
Government	6.2	6.2	5.8	6.4	6.7	7.0	6.9	6.8
Private	20.8	20.8	21.8	21.8	21.8	21.8	21.8	21.8
Savings-Investment balance	-3.4	-2.6	-2.4	-1.5	-2.3	-3.3	-3.7	-3.9
Government	-6.9	-7.3	-7.5	-8.5	-8.3	-8.2	-7.7	-7.4
Private	3.5	4.8	5.2	7.1	6.1	4.9	4.0	3.6
Public finances (in percent of GDP)								
Revenue	11.0	11.0	12.5	12.1	12.3	12.6	12.9	13.0
Grants	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Expenditure	16.5	16.8	18.4	18.7	18.7	18.7	18.7	18.7
Central government balance	-5.3	-5.7	-5.7	-6.5	-6.3	-6.1	-5.8	-5.7
Central government domestic financing	4.2	4.9	7.0	5.9	5.6	5.4	6.4	5.8
Government debt (domestic and external)	70.8	71.8	75.0	75.6	75.5	74.9	74.0	73.4
Money and credit (percent change, end of period)								
Reserve money	0.9	18.3	19.5	15.8	14.8	14.8	15.2	14.8
Broad money	16.7	13.4	17.6	15.8	14.8	14.8	15.2	14.8
Domestic credit	13.5	10.6	18.8	15.1	13.2	13.6	14.1	13.6
Credit to private sector	7.5	8.8	9.5	10.1	8.8	11.0	10.0	11.5
Credit to government	24.6	12.9	32.6	21.1	18.1	16.3	18.1	15.4
Balance of payments (in millions of U.S. dollars)								
Exports	10,394	11,130	10,971	11,799	12,588	13,108	13,955	14,638
Imports	-18,003	-19,417	-19,698	-20,431	-22,620	-24,980	-27,421	-29,241
Current account balance	-2,541	-2,018	-1,927	-1,266	-2,089	-3,267	-4,062	-4,543
Current account balance (in percent of GDP)	-3.4	-2.6	-2.4	-1.5	-2.3	-3.3	-3.7	-3.9
Export value growth (percent)	6.4	7.1	-1.4	7.5	6.7	4.1	6.5	4.9
Gross official reserves (end of period) 1/								
In millions of U.S. dollars	7,495	8,208	7,750	7,384	7,900	7,918	7,891	8,193
In months of imports	3.9	4.1	3.7	3.2	3.1	2.9	2.7	2.5
External debt (public and private)								
In billions of U.S. dollars	39.9	43.0	44.3	44.4	46.2	48.5	53.0	57.6
As a percent of GDP	53.6	54.6	54.7	52.1	49.9	48.3	48.9	49.1
Memorandum items:								
Nominal GDP (in billions of rupees)	9,592	10,292	10,981	11,979	13,179	14,599	16,173	17,915

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

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

INTERNATIONAL MONETARY FUND

SRI LANKA

FOURTH POST-PROGRAM MONITORING DISCUSSION

October 27, 2015

KEY ISSUES

Context: Recent economic developments reflect a more challenging external environment as well as a sharpening of macro-financial imbalances that began emerging late in 2014. While relatively strong economic growth continues in the context of low overall inflation, the heavy focus on political transition since the beginning of the year has delayed needed adjustments to macroeconomic policies. Quick action is needed to reestablish credible policies and restore confidence.

Fiscal policy: Fiscal consolidation has stalled and public debt is set to rise in 2015. A targeted budget deficit of 4.4 percent of GDP is likely to be missed as envisioned increases in government revenue and cuts to investment expenditure appear insufficient to offset increases to recurrent spending (wages, salaries, and pensions). Public debt as a share of GDP is set to rise in 2015 and beyond under current policies.

Monetary policy: Monetary policy has been on hold since the last rate cut in April 2015 and there appears little room for additional easing. Private sector credit growth has accelerated rapidly, core inflation has steadily increased since the beginning of the year, and excess liquidity visible in 2014 has been absorbed through new lending and purchases of government securities.

External sustainability: The windfall from lower oil prices has been more than offset by an increase in imports of consumer and investment goods (partially spurred by higher government recurrent spending), lower remittance growth and a decline in foreign investment. The overall balance of payments has deteriorated sharply, putting downward pressure on the rupee and leading to a substantial decline in central bank foreign exchange reserves.

Financial sector: Financial sector indicators for the first half of 2015 are broadly consistent with other indicators of macroeconomic activity. Profitability has generally increased in the bank and nonbank sectors, and capital adequacy and other prudential indicators do not indicate stress. There are remaining pockets of vulnerability in individual institutions—particularly in the nonbank sector.

Approved By
Kalpana Kochhar and Dhaneshwar Ghura

Discussions were held in Colombo, September 8-18, 2015. The mission met with Prime Minister Wickremesinghe, Finance Minister Karunanayake, Central Bank of Sri Lanka Governor Mahendran, Secretary to the Treasury Samarathunga, other senior officials and private sector and civil society representatives. The staff team comprised Mr. Schneider (head), Mr. Jonas, Mr. Ghazanchyan (all APD), Ms. Diouf (SPR), Ms. Kvintradze (resident representative), and Mr. Wijeweera (local economist). Ms. Gunaratne (OED) participated in some of the policy discussions. S. George, M. Inoue, and Q. Zhang also assisted in the preparation of this report.

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RECENT DEVELOPMENTS AND OUTLOOK

A. Political Transition

1. Following the defeat of 10-year incumbent Mahinda Rajapaksa, an interim government under Maithripala Sirisena initiated significant political and constitutional reforms—trimming the powers of the presidency and beginning the process of moving Sri Lanka to a Westminster style of government. Fresh elections on August 17th gave the ruling United National Party (UNP) 106 seats in the 225-member parliament, while the opposition United People Freedom Alliance took 95 seats. The UNP has formed a national government with members of the opposition under a two-year agreement.

2. The new government has 48 cabinet posts and 45 state and deputy ministers. A number of new agencies and ministries have been created in the process. Notably, a number of functions belonging to the Ministry of Finance (MOF) have been shifted to other organizations: (i) oversight of the state banks and the Sri Lanka Insurance Corporation has been transferred to the newly created Ministry of Public Enterprises Development (MPED); (ii) the Department of Import and Export has been placed under the Ministry of Development Strategy and International Trade (MDSIT); and (iii) the Central Bank of Sri Lanka (CBSL) moved from the MOF umbrella to the new Ministry of National Planning and Economic Development—headed by the prime minister. A new Ministry of Megapolis and Western Province Development has also been established.

B. Recent Economic Developments

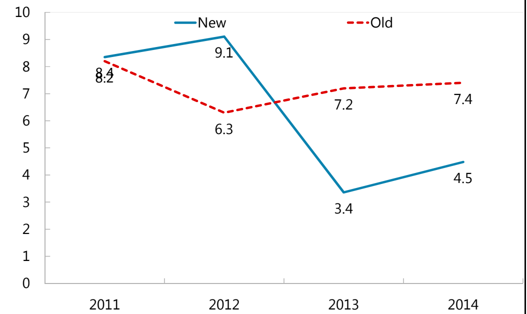
3. GDP data for the first half of 2015 (based on a rebased/revised national accounts series (Box 1))—indicate a pickup in growth to 5.6 percent versus 1.3 percent for the first half of 2014. Agriculture reflected a recovery from poor conditions in the first half of 2014, but industry was comparatively weak. Services (predominantly personal, financial, and real estate services) were stronger. On the demand side, the pickup in growth likely reflects higher consumption (boosted by sharp increases in public wages and lower energy prices). This offset sharply lower public investment—which fell by 14 percent in the first part of the year as the new government undertook a review of infrastructure projects.[1] Headline inflation fell to -0.3 percent in September—reflecting base effects, while core inflation (excluding fresh food, transport, and energy prices) has risen since the beginning of 2015—reaching 4.2 percent in September, consistent with a gradual reduction in economic slack.

[1] An ongoing research project in cooperation with the IMF's Research Department seeks to specify the impulse response functions to quantify the impact of increased/decreased public capital spending on growth, and will be presented as part of the 2016 Article IV Consultation.

Box 1. Sri Lanka: New National Accounts Series

The Department of Census and Statistics released in June a new national accounts series—rebasing GDP from 2002 to 2010 and incorporating a number of statistical improvements. Nominal GDP increased—reflecting broader coverage of economic activity—while growth rates for 2011–14 declined on average by about 1 percentage point. There has also been a shift from the share (contribution to growth) of industry towards services. The newly rebased GDP series together with methodological changes are currently under review by STA.

Real GDP Growth, 2011–2014
(Percent)



Sources: Department of Census and Statistics

The revision of GDP also impacts selected macroeconomic indicators. Public debt, fiscal, and current account deficits (as a share of GDP) are broadly lower—but not to a degree that substantively affects staff's assessment of vulnerabilities or recommended policies.

	2011		2012		2013		2014		Average 2010-14	
	Old	New	Old	New	Old	New	Old	New	Old	New
GDP	**8.2**	**8.4**	**6.3**	**9.1**	**7.2**	**3.4**	**7.4**	**4.5**	**7.3**	**6.4**
Agriculture	1.4	4.6	5.2	3.9	4.7	3.2	0.3	-2.2	2.9	2.4
Industry	10.3	9.3	10.3	9.0	9.9	4.1	11.4	1.2	10.5	5.9
Services	8.6	8.9	4.6	11.2	6.4	3.8	6.5	6.5	6.5	7.6

The change in the series necessitates a revised estimate of potential growth, which staff now estimate at about 5.5 percent (down from 6.5 percent under the old GDP series). This is lower than 2004–12 average growth but the historic and new series are not directly comparable and these estimates should be treated with caution given (i) high volatility in the new series; and (ii) historical (pre-2010) growth rates have not changed.

Sri Lanka: Selected indicators (percent of GDP)

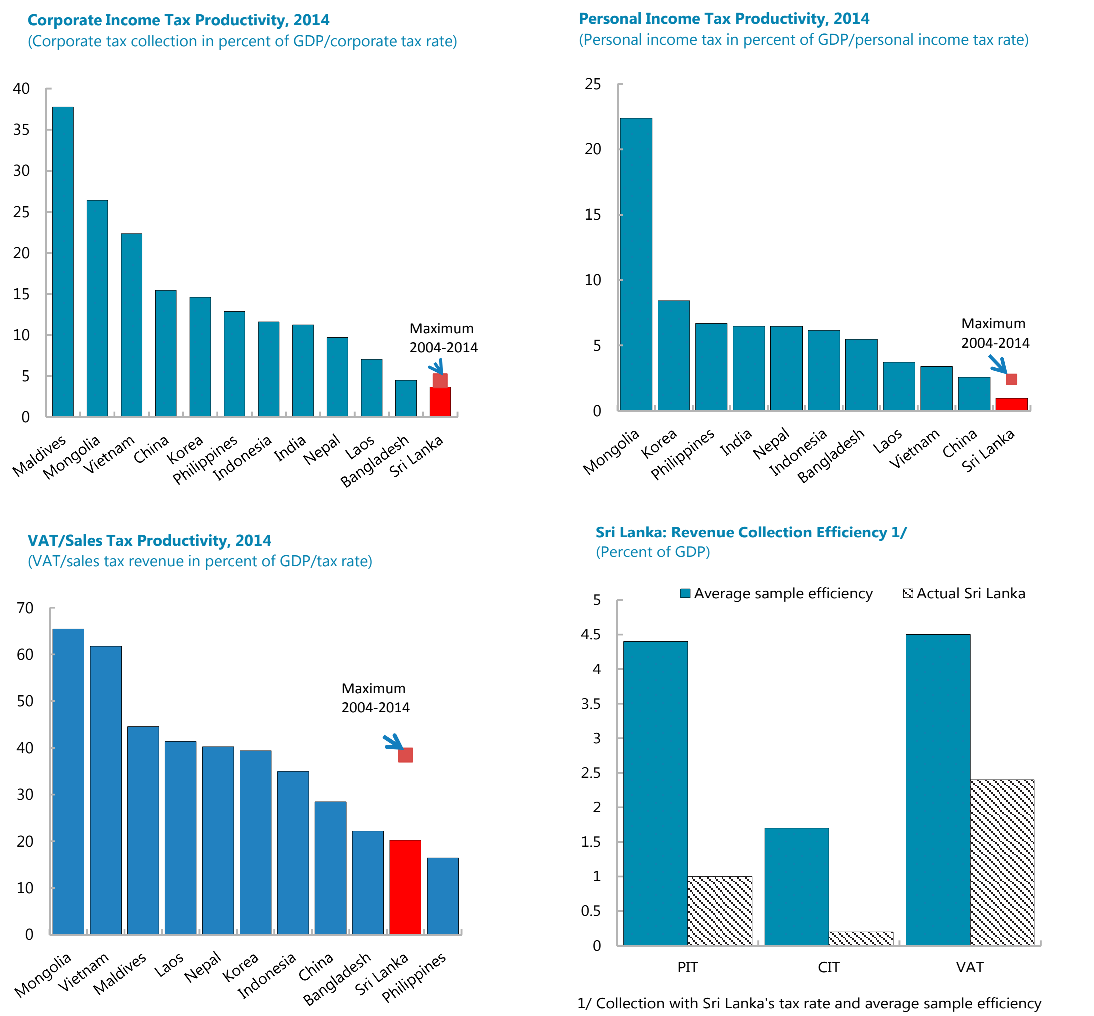
Year	**Base Year: 2002**			**Base year: 2010**		
	Fiscal Balance	Current Account	Public Debt	Fiscal Balance	Current Account	Public Debt
2010	-8.0	-2.2	81.9	-7.0	-1.9	71.6
2011	-6.9	-7.8	78.5	-6.2	-7.1	71.1
2012	-6.5	-6.7	79.2	-5.6	-5.8	68.7
2013	-5.9	-3.8	78.3	-5.3	-3.4	70.8
2014	-6.1	-2.7	75.9	-5.7	-2.6	71.8

Source: IMF data and staff calculations.

4. **Preliminary data indicate the fiscal deficit for the first half of 2015 was 3.7 percent of GDP**. The January–June fiscal deficit was slightly higher in rupee terms compared with the first half of 2014. Tax revenues rose by 18.6 percent over the same period in 2014—a significant increase compared with 7 percent in 2014. However, this is substantially less than the 35 percent growth for 2015 assumed in the budget. Further, most of the growth in tax revenue is due to a sharp rise in

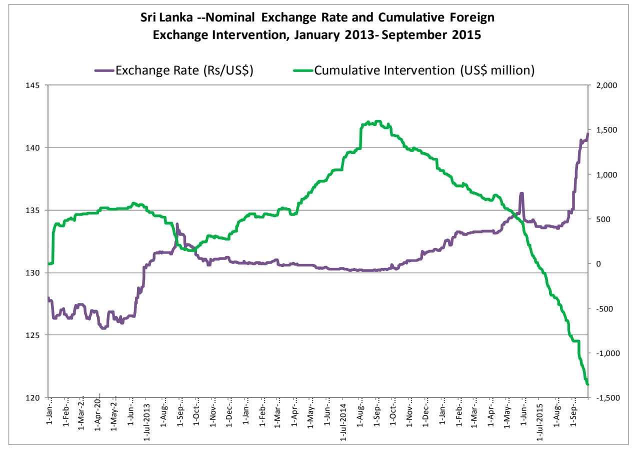
motor vehicle imports. Tax revenues excluding motor vehicles grew by only 1 percent and nontax revenues fell by 8 percent. VAT and income taxes underperformed significantly—reflecting continued low productivity (including by international comparison). As in previous years, expenditure cuts have offset revenue shortfalls. Capital spending has borne the brunt of the cuts—declining by 14 percent. At the same time, reflecting large increases to public wages, salaries, and pension payments, recurrent spending rose by 20 percent—more than double the growth seen in 2014. With net external financing turning negative, issuance of domestic government debt (including foreign-exchange denominated Sri Lankan Development Bonds--SLDBs) to finance the deficit increased sharply. [2]

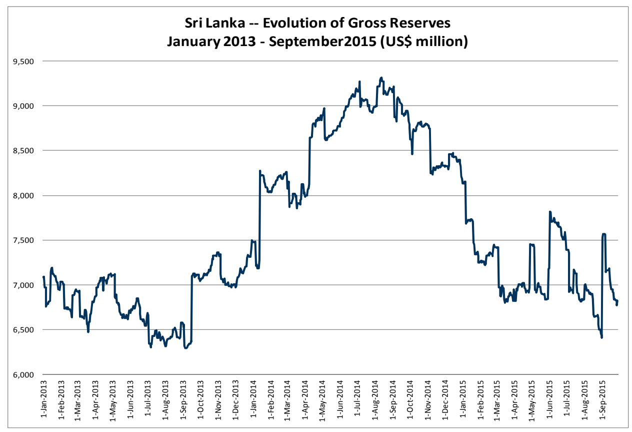
Figure 1. Sri Lanka: Comparative Tax Productivity



[2] As a result, banks' holding of T-bills, T-bills and SLDBs increased from 20 percent of total assets at end 2014 to 21 percent of total assets at end-June 2015.

5. **The external accounts have come under pressure as a surge in consumer and investment imports combined with declining exports and capital inflows more than offset a windfall from lower oil prices**. Boosted by the sharp rise in household income from higher public wages and salaries and lower fuel and electricity prices, consumer goods imports rose by over 38.8 percent in January-July 2015, led by vehicles. Combined with a 21 percent rise in investment goods, this more than offset a $1.3 billion reduction in oil shipments. With a steady exit of foreign investors from government T-bills, lower external borrowing, and a drop in foreign direct investment, the overall balance of payments deteriorated sharply during the first half of the year. Daily interventions to maintain a relatively stable rupee/US dollar exchange rate placed a drain on central bank foreign exchange reserves. Net interventions by the CBSL in the foreign exchange market during January-September amounted to about $2.4 billion, with gross reserves falling by $1.4 billion (gross reserves benefited from a $650 million sovereign bond issue in May[3], and two swaps totaling $1.5 billion with the Reserve Bank of India).





6. **Exchange rate developments have reflected domestic policies and volatility in major market currencies**. The rupee moved relatively little during January-August—depreciating by only about 2 percent in nominal terms vis-à-vis the U.S. dollar. However, in real effective terms the rupee appreciated by 5 percent during January-August reflecting low inflation and sharp drops in the Euro and Yen relative to the U.S. dollar. Further nominal depreciation (about 4.4 percent) of the rupee took place during September following a decision by the CBSL at the beginning of the month to cease giving a daily reference rate, exit from daily intervention and allow the market a greater role in determining the value of the rupee. The nominal drop in the rupee during September is likely to have erased some of the real effective appreciation noted above. The CBSL's absence from the market was short lived, however, and daily intervention resumed after only one week.

7. **Monetary policy has remained unchanged in the last five months**. Policy rates were reduced by 50 bps in April 2015 to a new historical low—reflecting what appears to be the last move in a cycle that began with the first easing of policy rates in December 2012. Despite the substantial easing of monetary policy over the past two years, near-zero inflation means that real interest rates have actually increased over the past year. Financial markets appear to have accepted that policy

[3] The CBSL, on behalf of the government, successfully launched and priced a US$650 million 10-year International Sovereign Bond on in late May, at a yield of 6.125 per cent per annum.

rates have bottomed out—as reflected in the acceleration of private sector credit growth (over 20 percent through August)—and credit to state enterprises rose to over 30 percent. The overhang of excess liquidity visible during the second half of 2014 has been eliminated, and call market rates have begun to move upwards in recent months as government borrowing from the domestic market surged.

8. **Financial sector indicators for the first half of the year are broadly consistent with other indicators of macroeconomic activity**. The banking sector recorded a net profit growth of over 20 percent in the first half 2015 on the back of wider net interest margins. Loan portfolios expanded with the perception that policy rates have bottomed out while demand for vehicle loans also increased following the reduction in taxes for small cars. However, exposure to gold-backed pawning witnessed a marked decline. Banks' investment portfolios have also risen—mainly through corporate debentures and government securities, reflecting the large expansion of domestic debt.[4] On the negative side, non-performing loans (NPLs) have increased. Further declines in the price of gold and delinquencies related to credit with select trading partners (mainly Russia) were the main causes. Nonbank financial institution performance also improved in first half 2015. Net profits more than doubled (YoY) on a healthy growth in net interest income. However, liquidity levels in NBFIs remain relatively weak.

OUTLOOK

9. **Sri Lanka's economic outlook is uncertain and medium-term prospects rest heavily on the course set for macroeconomic policies over the next few months, with risks tilted to the downside**. On the one hand, underlying growth momentum remains relatively firm and the outlook for headline inflation looks contained given downward pressure from falling commodity prices. Real GDP growth for 2015 is projected to reach 5.2 percent, while headline inflation is expected to remain contained to 3.2 percent by year-end. On the other hand, the recent policy mix has increased the downside risks: it engendered a substantial increase in demand, which has fed through to a sharp deterioration in the nonoil current account balance, a steady rise in core inflation, and continued weakness in the structure of public finances. Further, external risks have risen. Global growth prospects have weakened (as reflected in the most recent WEO forecast), and growth projections for emerging markets have generally declined.[5] Global financial conditions have tightened and may rebalance further when the U.S. Federal Reserve moves to raise interest rates.

[4] The rise in domestic debt to finance the budget deficit was a policy decision based on a desire to mitigate foreign exchange risk from externally borrowed resources, and facilitated by a large overhang of domestic liquidity in the financial system. While this strategy may have reached its limit, staff sees sovereign-financial risk as low, given that (i) T-bonds, T-bills and SLDBs were 21 percent of total assets of commercial banks as of June 2015; (ii) these are often held to maturity so market risk is low; and (iii) credit risk is also low because default is unlikely.

[5] Direct spillovers from economic malaise in emerging markets are thought to be limited. Exports to Russia and China, for example, are less than 3 percent and 2 percent of total exports, respectively. China has become an important source of investment in recent years, but other players (including India and the U.S.) remain important. The key risk appears to be of China and EM downturns creating a negative feedback loop to Sri Lanka's critical advanced country markets (the U.S. and Euro area).

10. The medium-term outlook under a status-quo set of policies suggests potentially heightened vulnerability on the fiscal and external accounts, and limited maneuvering room to adjust to shocks. Staff sees three key risks to the outlook: (i) continued low revenue performance, related stress on the fiscal accounts and public debt, leading to further cuts to investment spending; (ii) external imbalances, continued downward pressure on the rupee, tighter external financing, and draining of international reserves; and (iii) lower GDP growth as a result of weak investment, declining net exports, and stagnation in key sectors.

POLICY DISCUSSIONS

A. Fiscal Policy—Road to Revenue

11. Higher recurrent spending in the revised 2015 budget together with other measures that effectively boosted household income is feeding into macroeconomic imbalances. The combination of higher wages, salaries, and pension payments, together with reductions in fuel and electricity prices and some import taxes has led to a surge in consumption and imports. The February 2015 post-program monitoring mission estimated that roughly a third of the nominal increase in household income would leak out through imports, and that the windfall from lower oil prices would be sufficient cushion for the balance of payments. In the event, household consumption and the leakage through imports have been higher than expected—putting downward pressure on the exchange rate and draining central bank foreign exchange reserves (given the implicit commitment to a stable nominal exchange rate). Rising core inflation is also likely linked to the boost in household income through higher demand for non-tradables.

12. The staff argued that the absence of measures to bring durable increases in revenue has brought fiscal consolidation to a halt and raised debt sustainability risks.[6] The super-gains tax, the mansion tax, and other one-off measures[7] (if approved and implemented during the budget cycle) together with lower investment spending, may contain the 2015 fiscal deficit to about the same level as seen in 2014. However, the debt-to-GDP ratio is expected to climb in 2015 and in subsequent years without a concerted effort toward fiscal consolidation—which would in turn be very difficult to achieve without a fundamental re-set of revenue policies.

13. The 2016 budget represents the first major statement on macroeconomic policies for the new government and should set a course for 2016 and beyond. In the absence of a medium-term economic strategy, the budget will likely be taken as the defining statement of the new government's policy commitments. It is essential that credible steps are outlined toward reestablishing fiscal consolidation. Absent measures to fill the gap left by the expiration of one-off tax measures from 2015, a baseline projection suggests that the overall deficit could rise to an

[6] An updated Debt Sustainability Analysis (attached) highlights increased risks to sustainability from recent developments and the current policy stance.

[7] Several retroactive tax measures were proposed on a one-off basis in the 2015 revised budget (see EBS/15/38), but were not approved by parliament. The measures are being resubmitted to parliament in the fourth quarter, and their estimated value is 0.6 percent of GDP.

estimated 6.5 percent of GDP, implying a further increase in the public debt-to-GDP ratio. The staff recommended targeting a fiscal deficit of no more than 5 ½ percent of GDP for 2016, consistent with a reduction in the net domestic financing requirement and a modest reduction in the debt-to-GDP ratio. This will require renewed tight control of public expenditures in the coming year, together with additional revenue measures equivalent to over 1 percent of GDP.

14. Short-term fiscal targets reestablishing fiscal consolidation should be accompanied by policy commitments to establish milestones for putting public finances on a sustainable (and growth-friendly) medium-term path. Bearing in mind the very low level of productivity of Sri Lanka's tax framework, basic principles underlying a credible shift in policy are (i) a transparent budget process that costs and presents tax expenditures (tax holidays, exemptions, and special rates) as an explicit spending item in each budget; and (ii) a multi-year process of policy reform toward a tax system that is simple, efficient, and fair. In broad terms, this encompasses the following:

- Halting the provision of new tax holidays, exemptions, and special rates.
- Eliminating existing tax holidays and exemptions across different types of tax; and using other incentives (such as tax credits or accelerated depreciation) with respect to investment projects.
- Simplifying the complex tax system (including unification of rates) to create a more equitable tax framework that would also facilitate more effective tax administration and improve tax compliance.
- Continuing with current efforts to improve tax administration—particularly through automation and removal of opportunities for discretionary tax treatment.

15. The authorities emphasized their strong commitment to reducing the fiscal deficit. For 2015, they stated that there are still many unknown elements (budgetary commitments) being discovered. They estimated that unsettled expenditures from 2011–14 are in the range of Rs 200 billion and could push the 2015 deficit as high as 7 percent of GDP. They agreed that revenue performance needs to improve and contribute to deficit reduction, and that increasing revenues by 1 percentage point of GDP in 2016 (as suggested in the adjustment scenario) will be difficult, but achievable. Rather than focusing on exemptions, however, the authorities argued that the first step should be to reduce corruption in tax administration (with corruption in excises being worst), followed by increased collection efficiency. They were optimistic that the current strong growth of excise collection will continue, and saw room for further strengthening excise revenue growth by addressing the shortcomings in vehicle valuations (undervaluation of the actual value of imported vehicles) and stronger implementation of checks and scans at container terminals. Tax reforms are considered to be implemented over a longer-term horizon (5 years). The authorities also signaled that they are actively exploring programmatic budget support with the World Bank and other international financial institutions as well as closer engagement with traditional bilateral partners as a means of reducing the cost of external financing.

B. Monetary Policy—Time to Tighten?

16. The current stance of monetary policy is appropriate, but several factors suggest the need for a tightening bias going forward. Historically low rates of inflation and anemic private credit growth left room for successive rounds of monetary easing over the past two years. Staff estimates of the neutral policy rate (Taylor rule) indicate near alignment with existing policy rates. However, and despite staff estimates suggesting the existence of some slack (of roughly 0.5 percent of GDP based on staff estimates of potential output at 5.5 percent), several indicators suggest that further rate cuts should be avoided and that policy should focus on consolidating low levels of inflation—particularly given the long lags (4–5 quarters) in monetary transmission and the disproportionate impact of inflation on the poor (Box 3). While headline inflation remains contained, the increase in core inflation signals upward pressure on prices that is likely to accelerate given the strong boost to household incomes from recent wage and salary increases. Private credit growth has accelerated rapidly and may now be near a level considered "excessive" by historical standards. External pressures also argue against any further easing of monetary policy. Any exit from the current policy rate would ideally be gradual—in the range of 25–50 basis points—subject to market conditions.

17. The authorities agreed on the need for caution, and also highlighted the increase in private credit growth and core inflation as potential concerns. The credit cycle in their view is approaching the peak, and is expected to slow to 15-16 percent (YOY) by end 2015. However, they agreed that a tightening might be needed should private credit show signs of accelerating past this benchmark. The authorities believe that currently the economy is not yet operating at full potential and that domestic demand (consumption) will continue to drive growth. In this context, they suggested that staff's analysis might be underplaying the positive side of low rates and higher consumption. While higher consumption can create imbalances, it can also be useful if contained in the medium term. Further, they suggested that with a number of countries in the region moving to devalue their currencies and the U.S. Federal Reserve delaying its decision to adjust rates, moving to tighten might make Sri Lanka an outlier with respect to monetary policies—particularly with headline inflation still at very low levels.

C. External Sector Policies—Market Forces

18. Staff welcomed the decision by the CBSL to cease setting daily spot rates and allow the market to play a greater role in determining the value of the rupee. Econometric analysis suggests the rupee is not fundamentally misaligned, but there are pressures evident on the balance of payments linked to macro-fiscal policies (the expansion of wages and salaries noted above), external shocks (particularly falling demand from trading partners in the Middle East and Russia), and investor confidence (Box 4). Elimination of the policy-based misalignment implicit in the current fiscal stance and a clear and steady commitment to a flexible exchange rate will be essential to restoring equilibrium on the foreign exchange market and providing sufficient room to start rebuilding international reserves. The approach taken in September—with the CBSL effectively stepping out of the foreign exchange market and communicating this move to market participants—should be reestablished to allow sufficient movement of the rupee to affect relative prices and help restore a market-based equilibrium level.[8] The reestablishment of policy credibility will also be critical to restoring external financing and other inflows to levels more in line with previous years.

19. The authorities reiterated their desire for the rupee to be determined by market forces. While intervening to service large transactions (such as large one-off trade operations, or sale or non-rollover of maturing government securities) or to mitigate unwarranted volatility, the intention is to manage the float and allow the rupee to adjust gradually based on the flow of foreign exchange. They emphasized the expectation that, with uncertainty surrounding the timing of depreciation now reduced, inflows from export earnings and remittances should help to boost the volume of foreign exchange in the market—obviating the need for daily sales by the central bank. An increase in external financing flows—preferably at low rates—should also help to bring equilibrium to the market and reduce current pressures on the rupee. They indicated that the acceleration in interventions since mid-September has been driven in large part by the need to provide foreign exchange in response to foreign exit from the government securities market.

D. Financial Sector—Pockets of Vulnerability

20. The financial system appears generally well capitalized and stable. The combined increase in lending and investment portfolios at banks have led to a decrease in liquidity ratios, although they remain well above prudential levels as well as peer-country averages. Notably, non-bank financial institutions (NBFIs-including the state pension system) have also absorbed a considerable amount of new government debt. Pockets of potential risk also remain—particularly within the NBFI sector.

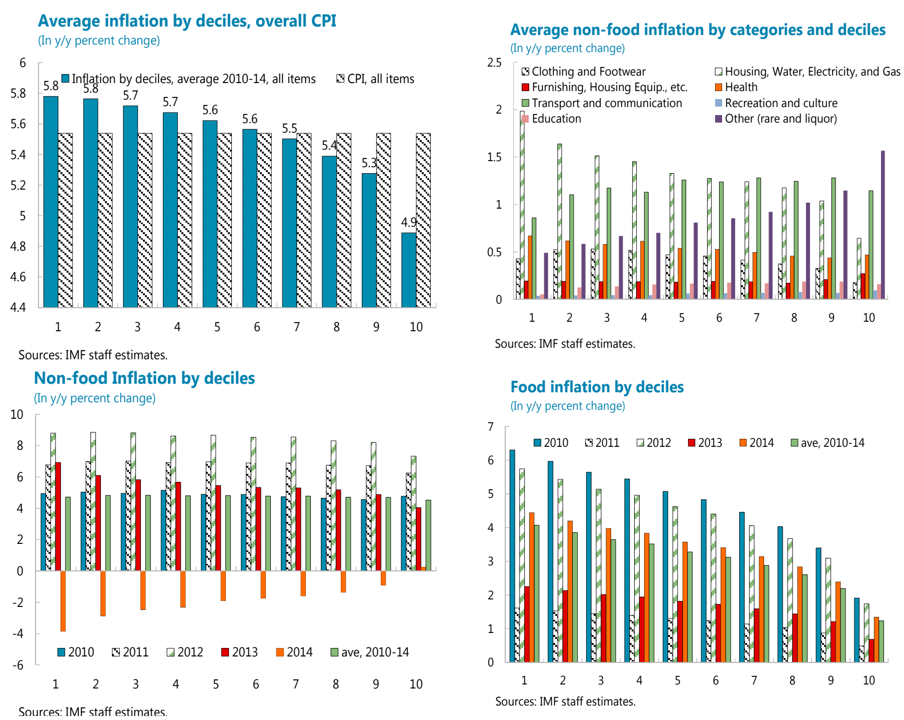
21. Staff recommended follow up on recent TA recommendations pertaining to financial sector stability. Of key importance is the development and implementation of an effective framework for consolidated supervision, which should include (i) bringing the single borrower limit (SBL) and related party lending definitions in line with international best practices; (ii) introducing fit and proper assessments for owners of non-bank financial institutions; and (iii) training supervisory staff to evaluate banks' individual capital adequacy assessments and establish a robust framework to set appropriate minimum capital adequacy requirements for individual banks that reflect their risk profiles. Further, financial sector stress testing—while improving—needs to assess risks in a forward looking way, looking beyond capital adequacy to the impact on solvency, liquidity, and potential contagion. Further work is also needed to amend the legal framework to allow for a more comprehensive and efficient resolution regime.

[8] Increased exchange rate flexibility would also be appropriate in the context of an eventual move to a inflation targeting regime as currently being considered by the authorities.

Box 2. Sri Lanka: Impact of Inflation on Households by Income Level

Inflation has recently been low in Sri Lanka (2.1 percent at end 2014—owing mainly to lower oil prices) but was on average about 9 percent during the last decade. However, analysis of inflation across income groups suggests that poor households in Sri Lanka face disproportionally higher inflation than higher-income households. In particular: (i) poor households face higher inflation overall than higher income households; (ii) for poor households inflation is higher for housing (including utilities), clothing, and health; (iii) richer households pay more for furnishings, transport, education, and rare/luxury items (including liquor and tobacco); and (iv) poor households face higher food inflation than their richer counterparts. Changes in oil prices change the welfare of households symmetrically during both episodes of higher and also lower oil prices. With rising oil prices in 2007, utilities and electricity inflation with full pass-through was 8 percent for poor households—three times as high as the highest income household. The same ratio applies with recent oil price decline. The same is observed with food. Food inflation in 2007 exceeded 16 percent for the lowest income and 4 percent for the highest income strata, and the divergence ratio is also about three in 2014.

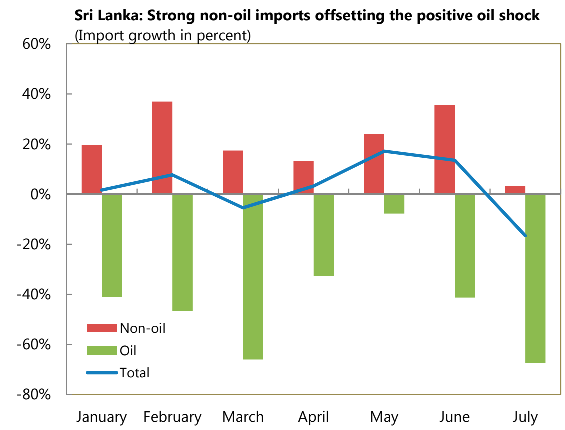
Sri Lanka: Inflation-poverty Nexus

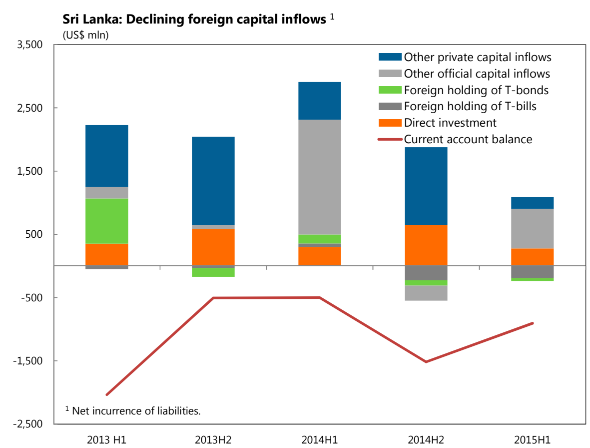


The authorities pointed to administered prices—mostly on staple food items (dhal, dried fish, sprats, coriander, canned fish, milk powder) with higher consumption share by the poor, and also cross subsidies on energy, which should have affected positively the poor segments of the population during the period analyzed.

Box 3. Sri Lanka: External Pressures

Sri Lanka's balance of payments is under evident pressure owing to strong imports, foreign investors deleveraging from government securities, and slowing foreign inflows. The CA deficit almost doubled during the first half of 2015, mainly due to a 24 percent increase in non-oil imports fueled by fiscal stimulus which offset the windfall from lower oil prices. In addition, exports decreased, caused by a ban on fish exports to the EU, lower commodity prices, and the Russian crisis, and remittances growth slowed to 2 percent from 11 percent in 2014. Financial account inflows are essentially supported by official borrowing, notably government sovereign bond and SLDB issuances and swap arrangements with the Reserve Bank of India. Other capital inflows decreased sharply compared to 2014, with foreign investors deleveraging from government securities (T-bills and bonds) and a drop in foreign direct investment and project loans partly caused by the government review of investment projects. All these factors put strain on the balance of payments, resulting to reserve losses. In an effort to curb outflows, the authorities strengthened capital controls on Sri Lankan investment abroad during January-March.[9]





The rupee has depreciated 7.2 percent since January despite heavy intervention by the CBSL (US$2.4 billion as of Sept 28, 2015) reflecting balance of payment pressures and low investor confidence. Further depreciation is yet predicted by the forward market. This depreciation reflects low investor sentiment, with a decrease in foreign holding of government papers and anemic foreign capital inflow (Figure 1). It also reflects domestic speculative behaviors as there are anecdotal evidence that 25 percent of export receipts are being kept abroad and importers placed early their orders because of expectations of future depreciation once CBSL heavy intervention ceases. Econometric analysis however suggests that the rupee is not fundamentally misaligned. External Balance Analysis (EBA) estimations show that the cyclically-adjusted CA is close to its norm as predicted by fundamentals. However, policy gaps are relatively high, at more than 1.5 percent.

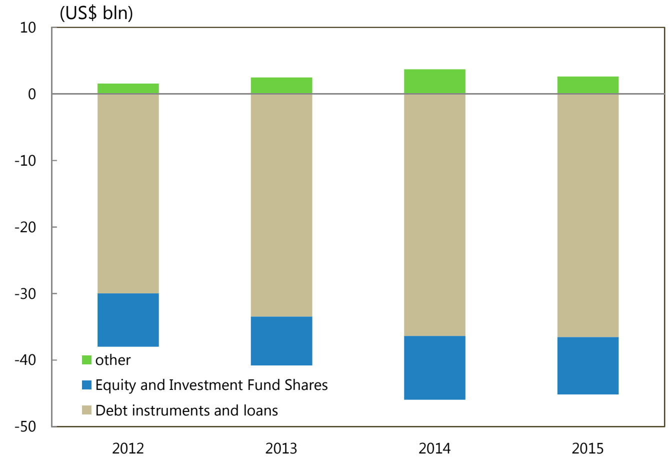
[9] The authorities temporarily put on hold authorization requests for investments abroad higher than US$100,000. During the mission, the authorities indicated that this measure was no longer in place.

Box 3. Sri Lanka: External Pressures (concluded)

The rupee has appreciated in real terms reflecting low inflation and sharp drops in the Euro and Yen relative to the U.S. dollar. The recent nominal depreciation has helped moderate a year-long trend of real effective appreciation. However, further gain of competitiveness would hinge upon deep structural reforms, which would be beneficial to reverse the current dip in exports. Improving investor sentiment is heavily reliant on government commitment to more prudent policy and ER flexibility. In the meantime, CBSL macroprudential measures (including a ceiling of 70 percent for vehicle loan-to-value ratios) should help curb imports, thus reducing reserve outflows and the need for intervention.

External debt sustainability is not an immediate concern, but vulnerabilities pose a risk. External debt is sizeable, estimated at 54.6 percent of GDP at end-2014, and predominantly owned by the public sector (61 percent of total) although private debt owned by commercial banks is rising fast. The ratio of debt to exports is also high, at 257 percent in 2014. Recent nominal exchange rate depreciation could pose a significant risk, if sustained; as stress tests show that a 30 percent real depreciation would raise the debt to GDP ratio to about 70 percent (see 2015 DSA). Rollover risks are however low as 83 percent of total debt is long term and the next sovereign bond repayment is due in 2019 (US$ 1.5 billion). Lower than expected GDP or export rebound from their current dip would deteriorate debt dynamics. Although the net international investment position is appropriately negative given high investment needs, it is increasing skewed towards debt and loans owing to foreign investment shift away from equity investments. Moreover, public external financing at non concessional terms substitute gradually for concessional financing to which Sri Lanka does not have access anymore.

Sri Lanka: NIIP skewed towards debts and loans
(US$ bln)



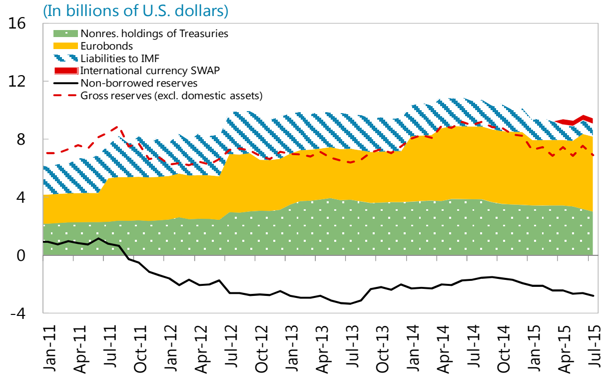
Source: Sri Lankan authorities

22. The authorities also saw the financial system as broadly stable—well capitalized and with most financial soundness indicators well above established prudential levels. They highlighted that under current stress tests, the banking system appears resilient to a broad range of shocks, but they agreed on the need for a more holistic approach that assesses the impact of shocks on more than just capital adequacy. They highlighted that existing weaknesses in the financial system more broadly are mostly in the nonbank financial sector—highlighted by the recent settlement of one long-standing troubled institution and liquidity injection into a second finance company through the Central Bank Deposit Insurance and Liquidity Support Fund (DILS).[10] The government is investigating the possibility of a more formalized mechanism for dealing with problem assets in a range of NBFIs—potentially in the form of a special purpose vehicle (SPV) that would take on problem assets.

POST PROGRAM MONITORING

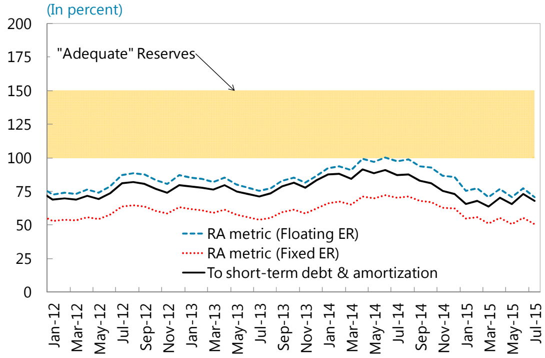
23. Sri Lanka's access to IMF resources currently stands at 120.8 percent of quota. Capacity to repay the IMF remains adequate (Table 5). Relative to the first PPM staff discussion in November 2013, both the Payments to the Fund and Fund Credit Outstanding as share of gross official reserves have declined substantially throughout the projection period. However, as highlighted in the above discussion of macroeconomic outturns and balance of payments pressures, important risks are clearly present and vulnerabilities have increased since the third PPM discussion in April. Chief among these repayment risks are low and declining foreign exchange reserve coverage (in nominal terms and by the Fund's reserve adequacy metrics), a reliance on debt and portfolio flows to finance current account deficits, and exchange rate risks as highlighted in the DSA.

Evolution of Gross Reserves
(In billions of U.S. dollars)



Source: IMF staff estimates.

Sri Lanka: Reserve Metrics Dynamics
(In percent)



Source: IMF staff estimates.

[10] The government moved in July to begin payment to the deposit holders of the defunct Golden Key Credit Card Company. The Supreme Court had earlier given a ruling to pay 41 percent of account balances to depositors. Rs.6 billion was provided to The Finance Company in December 2014 from the DILS.

STAFF APPRAISAL

24. Sri Lanka's political transition and the singular focus on elections and constitutional reforms have come at some economic cost. The revised 2015 budget—with its strong emphasis on increasing household incomes—has engendered higher consumption and imports. Fiscal consolidation has stagnated, and public debt is once again on the rise. The desire to maintain a relatively stable exchange rate through the electoral period also placed a heavy burden on the central bank to intervene in the foreign exchange market on an almost daily basis. Structural reforms—while much discussed—have also effectively been on hold pending the establishment of the new government. In general, macroeconomic imbalances have grown since the last PPM discussion, and the lack of clarity regarding near and medium-term policies is a cause for a concern, particularly given what is likely to be a more difficult regional and global environment going forward. Corrective policy actions are needed to mitigate near-term risks, and ensure a medium-term macroeconomic framework capable of supporting high levels of inclusive growth.

25. Fiscal policy remains Sri Lanka's Achilles Heel. The staff strongly urges the authorities to put Sri Lanka back on a path to fiscal consolidation, using the 2016 budget as a platform to signal the stance of reform policies for the medium term. The staff is of the view that a deficit of 5.5 percent of GDP or less could be achieved in 2016 with a combination of revenue reforms and expenditure constraint. For 2017 and beyond, staff urges the authorities to set in place a medium-term fiscal framework targeting a steady reduction of the fiscal deficit and a fall in the public-debt-to-GDP ratio to 50 percent.[11]

26. In context of fiscal reform, the steady decline in tax revenue as a share of GDP has been repeatedly highlighted in IMF staff reports as a critical weakness—driving sub-optimal choices with respect to expenditure cuts, narrowing fiscal space to address shocks, and maintaining upward pressure on an already heavy public debt burden. Sri Lanka's tax-to-GDP ratio is now one of the lowest in the world, illustrating the very low level of tax productivity. It is critical in staff's view to use the current window of opportunity to undertake overdue second-generation tax reforms—as much for equity, a transparent investment environment as fiscal consolidation. A fundamental re-set of policies toward taxation are needed. The 2009 report of the Presidential Tax Commission remains a valid starting point for reform, supplemented by more recent (and ongoing) assessments by Fund technical assistance. Essential in this context is to transparently address the issue of tax expenditures—tax holidays, exemptions, and special rates—which pervade Sri Lanka's tax system and are at the heart of low collections. Absent such an effort, changes to administration or even tax rates are unlikely to provide a durable solution to Sri Lanka's perennial revenue decline.

27. Monetary policy has achieved a revival of private credit in the midst of low inflation, but tightening may be necessary in the months ahead. Staff's estimates suggest that with policy rates now near the neutral rate there appears little room for further easing. Further, core inflation

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[11] For elaboration on staff's suggested medium-term fiscal strategy, see IMF Country Report 14/286: *Public Debt in Sri Lanka—Too High?*

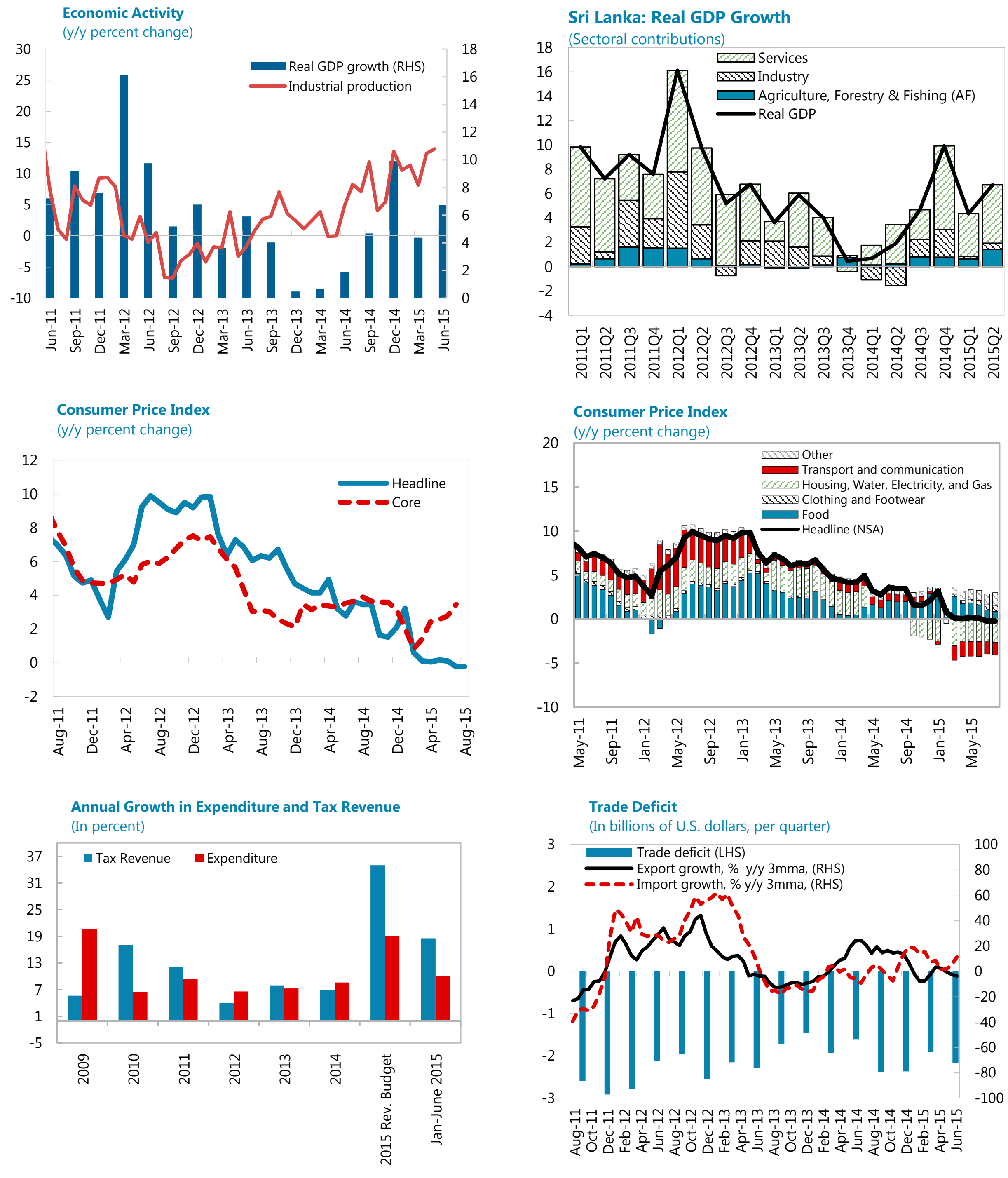
running above 4 percent through September, private credit growth in excess of 20 percent and unemployment declining in the second quarter of 2015 also suggest declining slack in the economy and the need for a tightening bias in coming months. External factors also suggest that an increase in policy rates might be warranted. The CBSL's hiatus from the foreign exchange market and subsequent depreciation of the rupee has not been fully effective in achieving a new equilibrium given continued weakening of exports, slow remittance growth, and continuing foreign exit from government securities. The staff agrees with the authorities that the sensitivity of external flows to changes in policy rates is limited, but given the current combination of domestic and external pressures, the signaling effect of monetary tightening is nonetheless important.

28. Financial soundness indicators do not suggest macro-financial risk. However, the recent increase in non-performing loans in the banking sector is a concern while the non-bank finance sector remains vulnerable despite recent healthy performance. Staff recommends close follow up of financial sector stability TA findings in particular its key recommendations relating to consolidated supervision, stress testing and legal framework.

29. The move toward exchange rate flexibility was welcome but unfortunately short-lived. Staff remains of the view that the exchange rate is not fundamentally misaligned. Rather, external factors (slower growth in Europe, declining demand for rubber, tea, and other commodities in key markets in Russia and the Middle East), low remittance growth and tighter external financing, together with a fiscal-induced surge in imports are the more important factors in explaining the sharp deterioration in the balance of payments. In that context, exchange rate flexibility alone cannot provide a solution to the current imbalance in the foreign exchange market. Rather, a flexible rupee must be accompanied by fiscal constraint, support from monetary policies, clear messaging to the markets regarding macroeconomic policies, and structural reforms to create greater competitive advantage—not just in goods markets but also for foreign investment. As these measures come together (and the "policy gap" addressed going forward), the staff urges the central bank to protect the limited cushion of reserves and refrain from intervention aside from addressing unwarranted volatility.

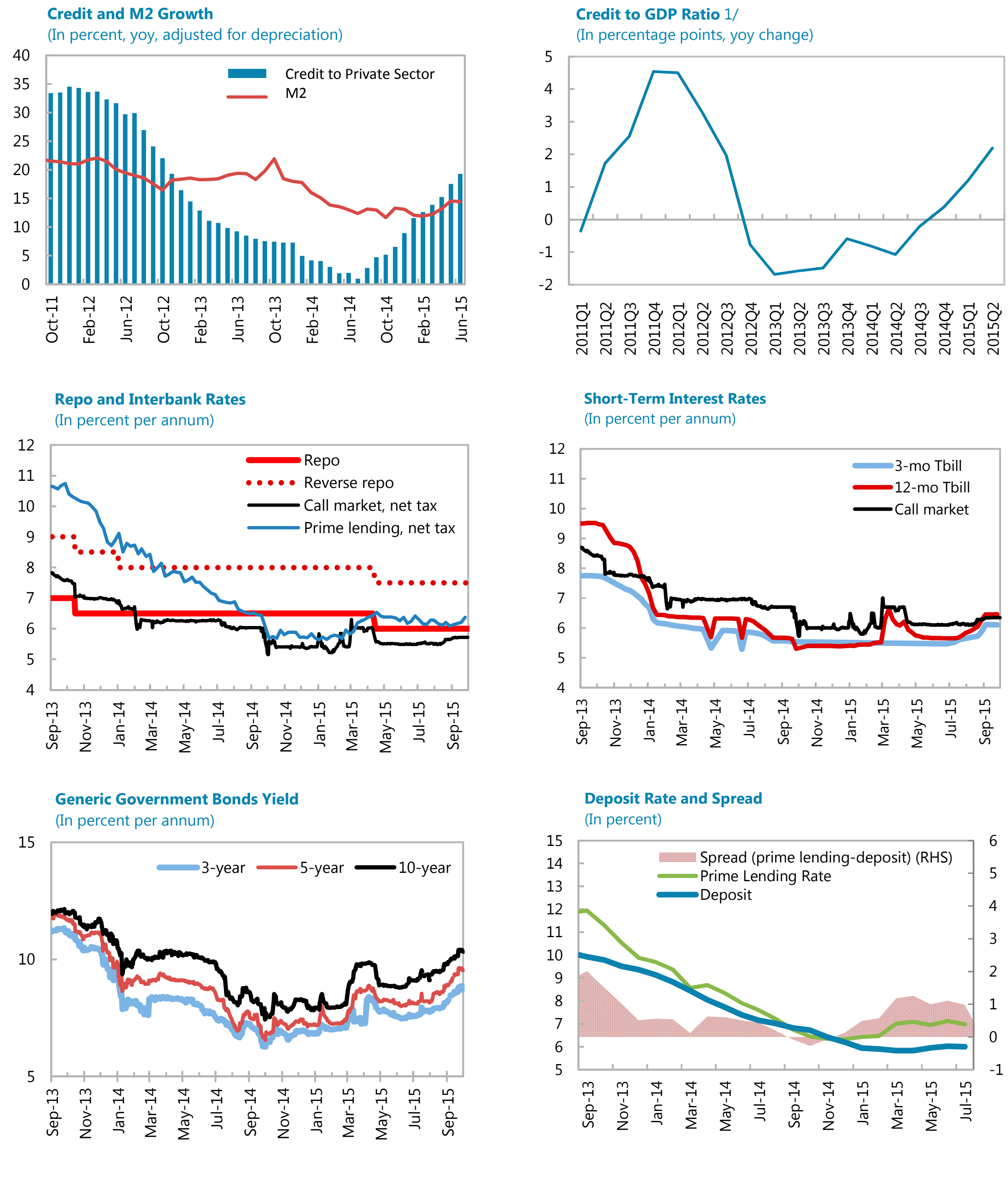
30. Structural reforms need to focus on giving market forces a greater role in economic activity and increasing competitiveness. On the latter, the staff welcomes the authorities' intention to revive discussions on GSP plus, and efforts to address issues related to the EU ban on import of fishery products. The business climate would also benefit from further strengthening anti-corruption efforts, which could include the implementation of international standards regarding domestic politically exposed persons, and enhanced cooperation between the financial intelligence unit and the anti-corruption commission. From a longer-term perspective, more will need to be done with respect to promoting an open trade regime and outward orientation. This should ideally include a clear government commitment to avoid selective trade protection and para-tariffs and nontariff barriers. With respect to market forces, reform of state enterprises—putting them on a commercial footing and allowing key tariffs (mainly fuel and electricity) to reflect market developments will be key.

Figure 2. Sri Lanka: Macroeconomic Developments



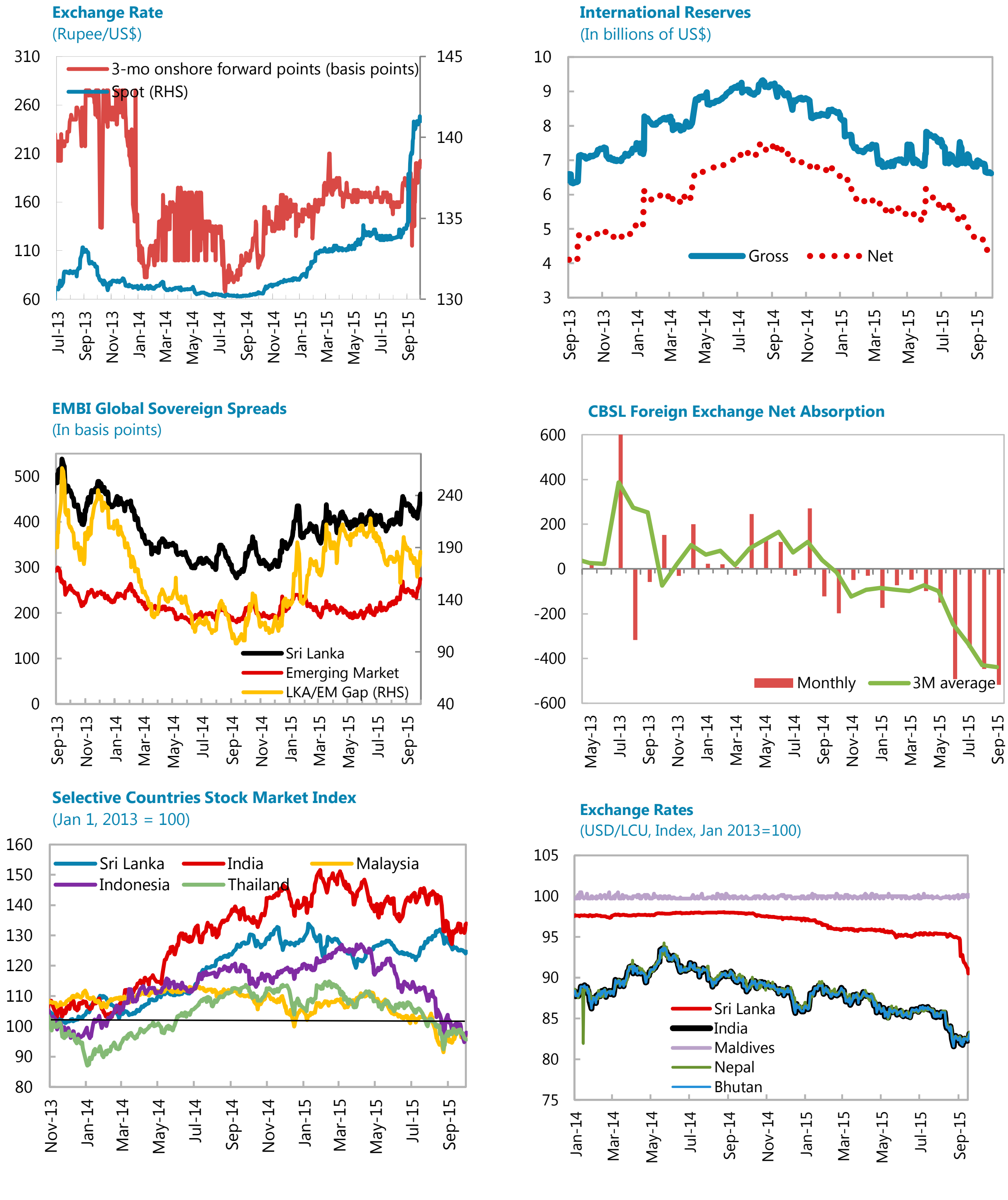
Sources: Central Bank of Sri Lanka; Ministry of Finance; IMF staff calculations.

Figure 3. Sri Lanka: Interest Rates



Sources: Central Bank of Sri Lanka; CEIC Daily Database; Bloomberg Data LP; and IMF staff calculations.

Figure 4. Sri Lanka: Foreign Exchange and Reserves



Sources: Central Bank of Sri Lanka; APDCORE Database; Bloomberg Data LP; and IMF staff calculations.

Table 1. Sri Lanka: Selected Economic Indicators, 2013–20

	2013	2014	2015	2016	2017	2018	2019	2020
					Proj.			
GDP and inflation (in percent)								
Real GDP growth	3.4	4.5	5.2	5.5	5.5	5.5	5.5	5.5
Inflation (average)	6.9	3.3	1.1	3.4	4.3	5.0	5.0	5.0
Inflation (end-of-period)	4.7	2.1	3.2	3.6	5.0	5.0	5.0	5.0
Core inflation (end-of-period)	2.1	1.2	5.0	5.4	4.1	4.1	4.1	4.1
Savings and investment (in percent of GDP)								
National savings	23.6	24.5	25.3	26.7	26.3	25.6	25.0	24.7
Government	-0.7	-1.1	-1.7	-2.2	-1.7	-1.2	-0.9	-0.6
Private	24.3	25.6	27.0	28.9	28.0	26.8	25.8	25.4
National Investment	27.0	27.1	27.7	28.2	28.6	28.8	28.7	28.6
Government	6.2	6.2	5.8	6.4	6.7	7.0	6.9	6.8
Private	20.8	20.8	21.8	21.8	21.8	21.8	21.8	21.8
Savings-Investment balance	-3.4	-2.6	-2.4	-1.5	-2.3	-3.3	-3.7	-3.9
Government	-6.9	-7.3	-7.5	-8.5	-8.3	-8.2	-7.7	-7.4
Private	3.5	4.8	5.2	7.1	6.1	4.9	4.0	3.6
Public finances (in percent of GDP)								
Revenue	11.0	11.0	12.5	12.1	12.3	12.6	12.9	13.0
Grants	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Expenditure	16.5	16.8	18.4	18.7	18.7	18.7	18.7	18.7
Central government balance	-5.3	-5.7	-5.7	-6.5	-6.3	-6.1	-5.8	-5.7
Central government domestic financing	4.2	4.9	7.0	5.9	5.6	5.4	6.4	5.8
Government debt (domestic and external)	70.8	71.8	75.0	75.6	75.5	74.9	74.0	73.4
Money and credit (percent change, end of period)								
Reserve money	0.9	18.3	19.5	15.8	14.8	14.8	15.2	14.8
Broad money	16.7	13.4	17.6	15.8	14.8	14.8	15.2	14.8
Domestic credit	13.5	10.6	18.8	15.1	13.2	13.6	14.1	13.6
Credit to private sector	7.5	8.8	9.5	10.1	8.8	11.0	10.0	11.5
Credit to government	24.6	12.9	32.6	21.1	18.1	16.3	18.1	15.4
Balance of payments (in millions of U.S. dollars)								
Exports	10,394	11,130	10,971	11,799	12,588	13,108	13,955	14,638
Imports	-18,003	-19,417	-19,698	-20,431	-22,620	-24,980	-27,421	-29,241
Current account balance	-2,541	-2,018	-1,927	-1,266	-2,089	-3,267	-4,062	-4,543
Current account balance (in percent of GDP)	-3.4	-2.6	-2.4	-1.5	-2.3	-3.3	-3.7	-3.9
Export value growth (percent)	6.4	7.1	-1.4	7.5	6.7	4.1	6.5	4.9
Import value growth (percent)	-6.2	7.9	1.4	3.7	10.7	10.4	9.8	6.6
Gross official reserves (end of period) 1/								
In millions of U.S. dollars	7,495	8,208	7,750	7,384	7,900	7,918	7,891	8,193
In months of imports	3.9	4.1	3.7	3.2	3.1	2.9	2.7	2.5
External debt (public and private)								
In billions of U.S. dollars	39.9	43.0	44.3	44.4	46.2	48.5	53.0	57.6
As a percent of GDP	53.6	54.6	54.7	52.1	49.9	48.3	48.9	49.1
Memorandum items:								
Nominal GDP (in billions of rupees)	9,592	10,292	10,981	11,979	13,179	14,599	16,173	17,915
Nominal GDP (in billions of U.S. dollars)	74.5	78.8	81.0	85.2	92.5	100.4	108.5	117.4

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

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

Table 2. Sri Lanka: Summary of Central Government Operations, 2013–20 1/

(in percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020
			Proj.					
Total revenue (including grants) 2/	11.2	11.1	12.6	12.2	12.4	12.7	12.9	13.0
Total revenue	11.0	11.0	12.5	12.1	12.3	12.6	12.9	13.0
Tax revenue	9.6	9.6	11.2	10.7	10.9	11.2	11.4	11.5
Income taxes	2.1	1.9	2.3	1.9	2.0	2.1	2.1	2.2
VAT	2.3	2.3	2.0	2.1	2.2	2.3	2.4	2.5
Excise taxes	2.2	2.3	3.8	3.5	3.6	3.7	3.7	3.8
Other trade taxes	1.3	1.3	1.2	1.3	1.3	1.3	1.3	1.3
Other	1.8	1.8	1.8	1.8	1.8	1.9	1.9	1.8
Nontax revenue	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Grants	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Total expenditure and net lending 1/	16.5	16.8	18.4	18.7	18.7	18.8	18.7	18.7
Current expenditure	12.0	12.2	14.3	14.4	14.1	13.9	13.8	13.7
Civil service wages and salaries	2.0	2.2	3.0	3.0	3.0	3.0	3.0	3.0
Other civilian goods and services	0.6	0.5	1.0	1.0	1.0	1.0	1.0	1.0
Security expenditure (including contingency)	2.1	2.5	2.8	2.7	2.7	2.6	2.6	2.6
Subsidies and transfers	2.5	2.7	3.3	3.1	3.0	2.8	2.7	2.7
Interest payments	4.6	4.2	4.3	4.6	4.4	4.5	4.5	4.4
Capital expenditure and net lending	4.6	4.6	4.0	4.3	4.6	4.8	4.9	5.0
Overall balance of the central government	-5.3	-5.7	-5.7	-6.5	-6.3	-6.1	-5.8	-5.7
Financing	5.3	5.7	5.7	6.5	6.3	6.1	5.8	5.7
Net external financing	1.1	0.8	-1.3	0.6	0.7	0.7	-0.6	-0.1
Net domestic financing	4.2	4.9	7.0	5.9	5.6	5.4	6.4	5.8
Memorandum items:								
Primary balance (excluding grants)	-0.9	-1.6	-1.5	-2.0	-1.9	-1.6	-1.4	-1.3
Total public debt	70.8	71.8	75.0	75.6	75.5	74.9	74.0	73.4
Domestic currency	40.0	41.6	45.0	46.7	48.0	50.4	51.2	51.5
Foreign currency	30.9	30.2	30.0	28.9	27.6	24.5	22.8	22.0
Nominal GDP (in billion of rupees)	9,592	10,292	10,981	11,974	13,174	14,593	16,165	17,907

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

1/ Fiscal projection is based on the assumptions of current policies, and does not reflect any new policy measures that could be adopted after the election.

2/ Revenue and expenditure from 2011 may be different from numbers published by Sri Lankan authorities since it excludes the tax exemptions granted for specific projects and the amounts of tax concessions granted on importatiton of motor vehicles by public servants from revenue and corresponding expenditures.

Table 3. Sri Lanka: Monetary Accounts, 2013–16
(in millions of rupee, unless otherwise indicated, end of period)

	2013	2014	2015	2016
			Proj.	
	(Stocks, in billions of Sri Lankan rupees)			
Central Bank of Sri Lanka				
Net foreign assets	529	690	659	633
Net domestic assets	-41	-112	32	166
Net claims on central government	114	148	323	473
Other items, net	-170	-277	-308	-323
Reserve Money	489	578	690	799
Monetary survey				
Net foreign assets	-76	17	-78	-110
Monetary authorities	529	690	659	633
Deposit money banks	-605	-673	-737	-744
Net domestic assets	3,494	3,859	4,634	5,385
Net claims on central government	1,301	1,436	1,963	2,446
Credit to corporations	2,899	3,204	3,553	3,901
Public corporations	365	446	531	575
Private corporations	2,534	2,758	3,022	3,325
Other items (net)	-707	-783	-882	-962
Broad money	3,418	3,876	4,556	5,275
Memorandum Items				
Gross international reserves (US $millions)	7,495	8,208	7,750	7,386
Net international reserves (US $millions)	5,149	6,517	6,566	6,666
Private credit/GDP	26.4	26.8	27.5	27.8
Money multiplier	7.0	6.7	6.6	6.6
Broad money velocity 1/	2.8	2.7	2.4	2.3
	(Annual percentage change)			
Broad money	16.7	13.4	17.6	15.8
Reserve money	0.9	18.3	19.5	15.8
Credit to public corporations	24.8	22.2	19.1	8.3
Credit to private sector	7.5	8.8	9.5	10.1

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

1/ Calculated using end-period quarterly GDP, annualized.

Table 4. Sri Lanka: Balance of Payments, 2013–20, BPM6
(in millions of U.S. dollars, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020
					Proj.			
Current account	-2,541	-2,018	-1,927	-1,266	-2,089	-3,267	-4,062	-4,543
Balance on goods	-7,609	-8,287	-8,727	-8,632	-10,032	-11,872	-13,466	-14,603
Goods credit (exports)	10,394	11,130	10,971	11,799	12,588	13,108	13,955	14,638
Goods debit (imports)	-18,003	-19,417	-19,698	-20,431	-22,620	-24,980	-27,421	-29,241
Non-oil imports	-13,695	-14,819	-17,024	-17,756	-19,386	-21,233	-23,133	-24,366
Consumer goods	-3,182	-3,853	-4,759	-4,958	-5,455	-6,015	-6,503	-7,111
Intermediate goods	-6,259	-6,815	-7,297	-7,638	-8,307	-9,019	-9,825	-10,173
Investment goods	-4,253	-4,152	-4,968	-5,160	-5,623	-6,199	-6,805	-7,082
Oil imports	-4,308	-4,597	-2,674	-2,674	-3,234	-3,747	-4,288	-4,875
Services	1,180	1,880	2,187	2,719	3,247	3,869	4,640	5,280
Credit (exports)	4,685	5,605	6,379	7,285	8,170	9,177	10,326	11,369
Debit (imports)	-3,505	-3,725	-4,192	-4,565	-4,922	-5,309	-5,685	-6,090
Primary income, net 1/	-1,751	-1,839	-1,906	-2,040	-2,186	-2,346	-2,520	-2,711
Secondary income, net 2/	5,639	6,227	6,518	6,686	6,882	7,082	7,284	7,490
General government (net)	21	28	29	31	32	34	35	35
Workers' remittances (net)	5,619	6,199	6,489	6,655	6,850	7,048	7,249	7,455
Capital account (+ surplus / - deficit)	71	58	53	40	28	16	13	11
Balance from current account and capital account	-2,470	-1,960	-1,874	-1,226	-2,061	-3,252	-4,048	-4,533
Financial account (+ net lending / - net borrowing)	-3,064	-1,935	-1,874	-1,226	-2,061	-3,252	-4,048	-4,533
Direct investments	-867	-877	-763	-814	-910	-1,061	-1,315	-1,568
Portfolio investments	-2,068	-1,996	705	-524	-657	-742	619	-125
Other investments	-1,240	-610	-207	478	-1,010	-1,467	-1,825	-2,141
Of which : Loans	-1,118	-1,847	31	-542	-930	-1,387	-1,745	-2,061
Central bank 3/	453	719	508	463	245	0	0	0
Deposit taking corporations	-124	-1,358	-656	-250	-300	-350	-450	-550
General government 4/	-841	-646	531	-491	-611	-698	-816	-912
Other sectors	-605	-563	-352	-264	-265	-339	-480	-599
Change in reserve assets	1,112	1,548	-1,609	-366	516	18	-1,526	-699
Errors and omissions	-594	24	0	0	0	0	0	0
Memorandum items:								
Current account (in percent of GDP)	-3.4	-2.6	-2.4	-1.5	-2.3	-3.3	-3.7	-3.9
Gross official reserves 4/	7,495	8,208	6,600	6,234	6,750	6,768	5,241	4,543
In months of prospective imports of goods and nonfactor services	3.9	4.1	3.2	2.7	2.7	2.5	1.8	1.4
In percent of ARA composite metric	87	86	68	62	63	59	42	34
Net international reserves	5,149	6,517	5,416	5,513	6,274	6,292	4,766	4,067
GDP	74,464	78,805	80,978	85,189	92,508	100,376	108,544	117,376

Sources: Data provided by the Central Bank of Sri Lanka; and IMF staff estimates and projections.
1/ Under BPM5 known as Income.
2/ Under BPM5 known as Transfers.
3/ Credits and loans with the IMF (other than reserves).
4/Sri Lanka entered a $1.5 billion swap line with the Reserve Bank of India. Projections in 2015 include net drawing of $1.1 billion to be repaid in 2016 ($400 million was initially drawn in April 2015 and will be repaid this year).

Table 5. Sri Lanka: Projected Payments to the Fund, 2015–20 1/
(in millions of SDR, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020
Fund repurchases and charges						
In millions of SDR	53.3	331.1	173.2	0.2	0.2	0.2
In millions of U.S. dollars	75.0	466.0	243.7	0.3	0.3	0.3
In percent of exports of goods and NFS	0.4	2.4	1.2	0.0	0.0	0.0
In percent of quota	12.9	80.1	41.9	0.0	0.0	0.0
In percent of gross official reserves	1.0	6.3	3.1	0.0	0.0	0.0
Fund credit outstanding						
In millions of SDR	551	172	0.0	0.0	0.0	0.0
In millions of U.S. dollars	776	242	0.0	0.0	0.0	0.0
In percent of quota	133	42	0.0	0.0	0.0	0.0
In percent of GDP	1.0	0.3	0.0	0.0	0.0	0.0
In percent of gross official reserves	10.0	3.3	0.0	0.0	0.0	0.0
Memorandum items:						
Exports of goods and services (in millions of U.S. dollars)	17,350	19,083	20,757	22,285	24,281	26,008
Quota	413	413	413	413	413	413
Quota (in millions of U.S. dollars)	582	584	589	591	596	601
Gross official reserves (in millions of U.S. dollars)	7,750	7,384	7,900	7,918	7,891	8,193
GDP (in millions of U.S. dollars)	80,978	85,189	92,508	100,376	108,544	117,376

Source: IMF staff estimates.

1/ As of October 9, 2015.

Table 6. Sri Lanka: Financial Soundness Indicators—All Banks, 2010–15
(in percent)

	2010	2011	2012	2013	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2
Capital adequacy										
Regulatory capital to risk weighted assets	16.2	16.0	16.4	16.3	17.0	16.9	16.9	15.6	16.3	16.0
Tier 1 capital/risk weighted assets	14.3	14.4	14.7	13.7	14.4	14.4	14.3	13.1	13.8	13.5
Capital to assets ratio	8.3	8.7	8.6	8.2	8.3	8.3	8.4	8.2	8.2	8.2
Asset quality										
Gross nonperforming loans to total gross loans (without interest in suspense)	5.4	3.8	3.7	5.6	6.2	6.2	5.3	4.2	4.3	4.3
Net nonperforming loans to total gross loans	3.0	2.1	2.2	3.8	4.4	4.5	3.6	2.6	2.7	2.7
Provision coverage ratio (total) 1/	58.1	57.1	53.4	40.4	37.7	36.8	41.9	50.7	48.1	48.3
Earnings and profitability										
Return on equity (after tax)	22.0	19.8	20.3	16.0	16.1	15.3	16.5	16.6	16.7	16.7
Return on assets (after tax)	1.8	1.7	1.7	1.3	1.3	1.3	1.4	1.4	1.4	1.4
Interest income to gross income	83.1	85.5	86.3	69.7	66.6	67.9	68.2	69.3	74.6	74.6
Staff expenses to noninterest expenses	45.2	44.2	45.8	44.9	45.1	44.6	44.2	43.5	46.0	46.0
Personnel expenses to total income	12.0	12.2	10.7	25.0	10.4	10.8	10.6	10.6	12.0	12.1
Total cost to total income	72.0	74.1	75.2	79.3	80.4	80.4	77.7	75.8	73.7	73.7
Net interest margin	4.6	4.2	4.1	3.5	3.2	3.2	3.3	3.5	3.9	3.9
Liquidity										
Liquid assets to total assets	31.1	26.8	26.6	31.9	33.8	34.1	33.4	32.2	31.0	31.1
Assets/funding structure										
Deposits	72.4	71.5	70.3	70.7	71.2	70.2	68.9	67.6	66.6	67.4
Borrowings	15.1	15.8	16.7	16.4	15.9	16.9	18.3	20.2	21.4	20.6
Capital to external funds	9.5	10.0	9.9	8.2	9.5	9.5	9.6	9.3	9.3	9.3
Credit to deposits	76.4	84.7	87.4	82.2	79.0	77.9	79.6	83.1	85.5	85.0

Source: Central Bank of Sri Lanka.

SRI LANKA

STAFF REPORT FOR THE FOURTH POST-PROGRAM MONITORING DISCUSSION—DEBT SUSTAINABILITY ANALYSIS

October 27, 2015

Approved By
Kalpana Kochhar and Dhaneshwar Ghura

Prepared by the Staff Representatives for the Fourth Post-Program Monitoring Discussion with Sri Lanka

Sri Lanka's public debt sustainability has weakened relative to the assessment in the 2014 Article IV Report. Public and external debts remain elevated, reflecting lower growth and higher deficits, and in the absence of revenue-based fiscal adjustment, would remain high.

Macroeconomic assumptions:

- **Growth** in the medium-term is projected at 5.5 percent, in line with the downward-revised estimates of potential output following the release of rebased GDP numbers.

- **Inflation** is projected to gradually pick up to around 5 percent, following a sharp deceleration in 2015 as a result of decline in commodity prices and reduction in some administered prices.

- In the absence of formulated medium-term policies, baseline **fiscal projection** is based on the continuation of current policies, with only a moderate improvement in revenue collection reflecting ongoing improvements in tax administration. Low revenues are assumed to necessitate a continued compression of capital spending. However, to the extent that the 2016 budget will contain policies to raise revenue while restoring spending discipline, there are upside risks to the baseline.

- Following a decline in 2015 and 2016 thanks to low oil prices, **the current account** is projected to widen gradually during the projected period. In the absence of policy adjustments to boost investment sentiment, FDI and other private capital inflows are assumed to remain subdued.

PUBLIC DEBT SUSTAINABILITY

Background: Since the publication of the last DSA in June 2014, the public debt outlook has weakened and risks to public debt sustainability have increased. The 2014 DSA projected a decline in the public debt-to-GDP ratio from 77 percent in 2014 to below 64 percent by 2019, driven by rapid growth and a gradually improving fiscal balance. In contrast, the updated DSA under the baseline scenario now projects only a marginal decline in debt-to-GDP ratio during 2015–20. The main reasons behind the weakening debt outlook are downward revision of real GDP growth and higher projected fiscal deficits. The combination of stable but high levels of debt and higher shock ranges suggest the possibility that debt is no longer on a sustainable trajectory—but this assumes a full status quo with respect to macroeconomic policies, which is unlikely given pre-election discussions of reform.

Baseline. Under the baseline scenario, the ratio of public debt to GDP is projected to decline only moderately, from 75.0 percent in 2015 to 73.4 percent in 2020, while gross financing needs remain around 20 percent of GDP. The primary balance is projected to improve gradually, but remains in deficit during the projected period – though stronger than the debt-stabilizing balance of -2.4 percent of GDP. Following the rebasing and revision of national accounts, staff reduced projected medium-term growth from 6.5 percent to 5.5 percent in line with estimated potential output. More important for debt dynamics is the assumption of continued current policies—implying only a small decline in the fiscal deficit, from 6.5 percent of GDP in 2016 to 5.7 percent of GDP by 2020. As a result, the primary deficit now contributes (cumulatively) a 10 percentage point increase in the debt ratio, compared to a near zero contribution in the previous DSA.

Heat map analysis indicates a high risk to debt sustainability. The debt burden benchmark of 70 percent of GDP and gross financing need benchmark of 15 percent of GDP are exceeded in all shock scenarios. However, market perception of risks thus far remains moderate, with bond spreads in the middle of the 200–600 point range of lower and upper risk benchmarks. However, as in other emerging market and frontier economies, spreads have been widening recently. On the positive side, terms structure of the public debt continued to improve, with average time to maturity now exceeding 6 years.

Risks. There are both upside and downside risks to the baseline scenario. As the stress tests show, public debt path remains particularly vulnerable to negative growth shock, which could push the debt ratio over 80 percent of GDP. Moreover, the absence of effective measures to raise revenues and reduce the deficit could weaken market confidence, increase governments' borrowing costs and worsen the debt dynamics further. On the upside, fiscal adjustment could materially reduce risks to public debt outlook. The baseline scenario assumes no new revenue measures, though it assumes a 1 percentage point increase in the tax revenue-to-GDP ratio in 2015–20 due to administrative improvements already underway. However, introduction of new revenue measures along the lines recommended by staff could significantly improve fiscal outlook. Lower deficits (and thus lower risk to fiscal sustainability) should also have a positive impact on investors' confidence and the costs of financing. At the same time, higher revenues would protect public investments from repeated cuts, supporting faster growth.

The fiscal adjustment/faster growth alternative scenario illustrates the potential beneficial impact on public debt dynamics. This scenario assumes a faster growth in budget revenues, reaching 15 percent of GDP by 2015, with primary balance moving to a small surplus. Growth is assumed to be gradually picking up to 5.9 percent, compared to the flat path of 5.5 percent in the baseline – reflecting less crowding out and somewhat higher public investment. In this scenario, public debt to GDP ratio is on a clearly declining path, falling to 65 percent of GDP by 2020. However, gross financing needs remain rather elevated during the projected period, around 15 percent of GDP. This underscores the magnitude of the task to bring the public finance on a solid footing.

EXTERNAL DEBT SUSTAINABILITY

Overview and structure. Total external debt was estimated at 54.6 percent of GDP at end-2014. It remains sizeable, although lower than in the 2014 DSA—because of GDP rebasing effects. The composition of external debt has not fundamentally changed. A large part of the external debt is public (56 percent held by the general government and 5 percent by the central bank). However private external debt has mounted fast over the last years. Deposit-taking corporations debt, the bulk of it, represented 19 percent of total debt in 2014 up from 13 percent in 2011. The ratio of debt to exports is high, at 257 percent in 2014. However, rollover risks are low as 83 percent of total debt is long term and the next sovereign bond repayment is due in 2019 (US$ 1.5 billion).

Baseline. Total external debt is projected to remain broadly constant as GDP growth offsets exchange rate depreciation effects and increases in official borrowing—notably a swap with Reserve Bank of India of US$1.1 billion[1] and issuances of a sovereign bond of US$650 million and new government securities called Sri Lankan Development Bonds. Under the baseline scenario, external debt is expected to decrease only slightly over the medium term, stabilizing just under 50 percent of GDP, driven by strong GDP growth and subdued FDI and other debt-creating private capital inflows in the absence of policy adjustment to boost investment sentiment. However, compared to the 2014 DSA, the external debt outlook improved because of the higher rebased nominal GDP and relatively assumed lower private borrowing.

Alternative scenarios. Sri Lanka's external debt dynamics are particularly sensitive to exchange rate shocks. A 30 percent real depreciation would inflate the ratio of debt to GDP by almost 50 percent. Other standard alternative shocks would not fundamentally derail debt consolidation.

Risks. Risks to this assessment are broadly balanced. The baseline and alternative scenarios assume that in the absence of policy adjustment, investment sentiment would remain low. External debt could grow stronger if private investment strengthens, project loans contracted by the government increase, the central bank enters new swap arrangements, or the government negotiates new bilateral or multilateral financing arrangements. The debt outlook could also worsen if growth does not strengthen or if exports do not recover fast from current downward dynamics. On the opposite,

[1] The total amount of the swap arrangement is US$ 1.5 billion, of which US$400 million is due by end-2015.

a reversal of FDI inflows from the current predominantly debt-creating financing to equity-type of investments would improve debt dynamics. Overall, the future external debt levels and vulnerabilities will also depend on the authorities' policies in terms of opening up the capital account further. The authorities' plan to reduce public debt is welcome and would improve public external debt sustainability, but if it comes with an equivalent increase in private sector external borrowing to fill the financing of the current account deficit, external vulnerabilities for the economy as a whole will not be reduced.

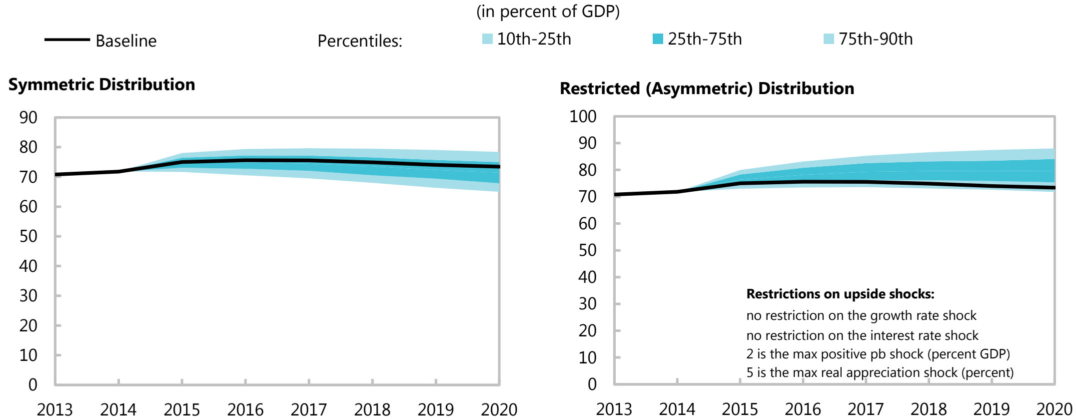
Sri Lanka Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

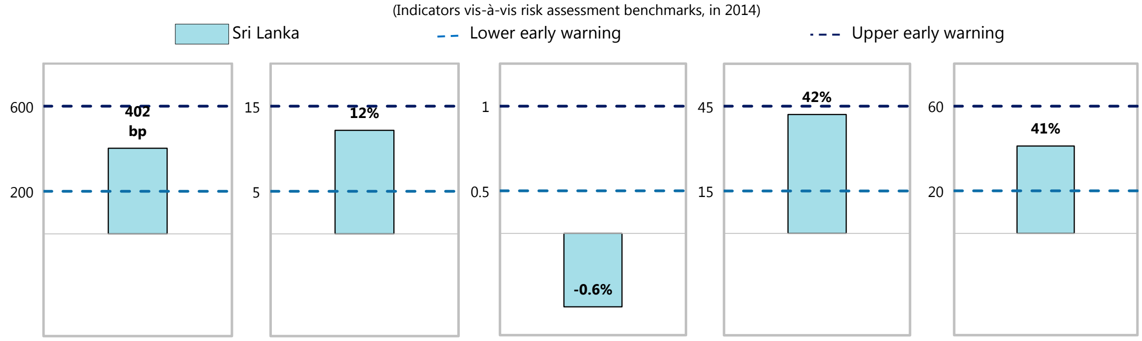
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

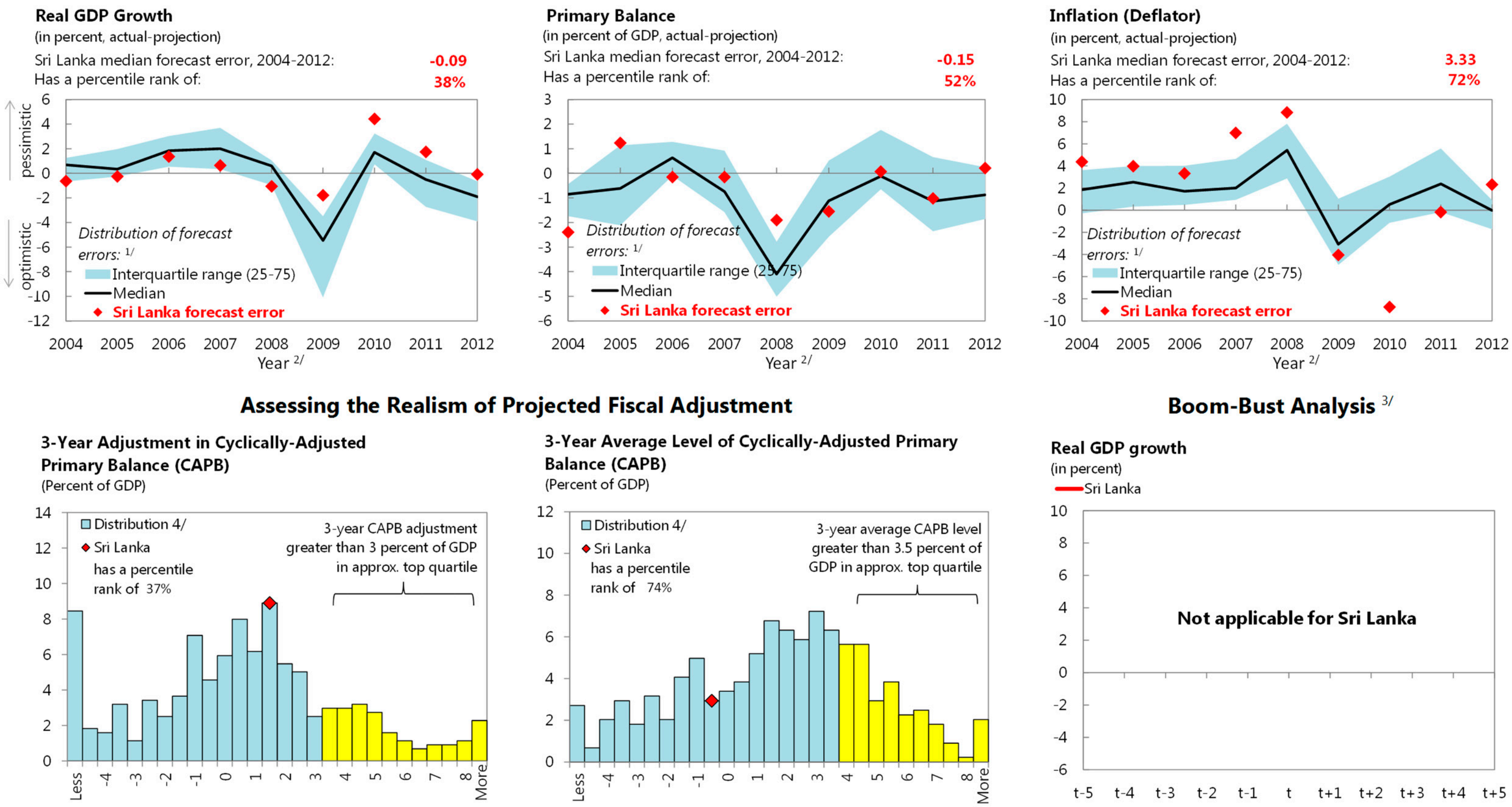
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 12-May-15 through 10-Aug-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Sri Lanka Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus program countries



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Sri Lanka, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Sri Lanka Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

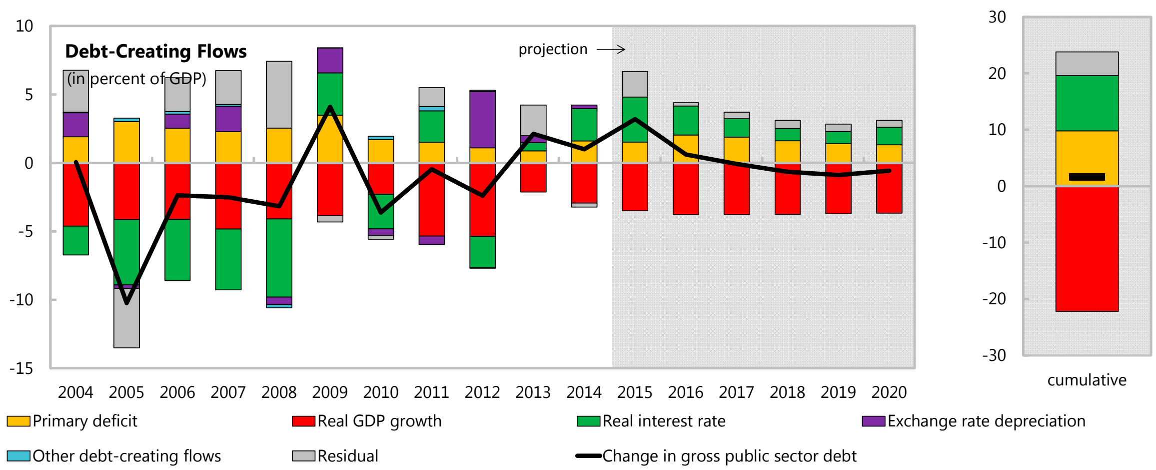
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of August 10, 2015		
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	75.3	70.8	71.8	75.0	75.6	75.5	74.9	74.0	73.4	EMBIG (bp) 3/		399
Public gross financing needs	23.5	21.3	14.7	21.7	20.9	19.0	18.1	17.8	19.0	5Y CDS (bp)		n.a.
Real GDP growth (in percent)	6.6	3.4	4.5	5.2	5.5	5.5	5.5	5.5	5.5	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	10.1	6.2	2.7	1.4	3.4	4.3	5.0	5.0	5.0	Moody's	B1	B1
Nominal GDP growth (in percent)	17.3	9.8	7.3	6.7	9.0	10.0	10.8	10.8	10.8	S&Ps	B+	B+
Effective interest rate (in percent) [4/]	7.3	7.4	6.4	6.4	6.6	6.5	6.6	6.6	7.2	Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.3	2.1	1.0	3.2	0.6	-0.1	-0.6	-0.9	-0.6	1.6	
Identified debt-creating flows	-3.3	-0.1	1.3	1.3	0.4	-0.5	-1.2	-1.4	-1.1	-2.6	
Primary deficit	2.2	0.9	1.6	1.5	2.0	1.9	1.6	1.4	1.3	9.8	-2.4
Primary (noninterest) revenue and grants	13.0	11.0	11.0	12.5	12.1	12.3	12.6	12.9	13.0	75.4	
Primary (noninterest) expenditure	15.3	11.9	12.6	14.1	14.1	14.2	14.3	14.3	14.3	85.2	
Automatic debt dynamics [5/]	-5.7	-1.0	-0.3	-0.2	-1.7	-2.4	-2.9	-2.8	-2.4	-12.4	
Interest rate/growth differential [6/]	-6.6	-1.5	-0.6	-0.2	-1.7	-2.4	-2.9	-2.8	-2.4	-12.4	
Of which: real interest rate	-2.3	0.6	2.4	3.3	2.1	1.3	0.9	0.9	1.3	9.8	
Of which: real GDP growth	-4.3	-2.1	-2.9	-3.5	-3.8	-3.8	-3.8	-3.7	-3.7	-22.2	
Exchange rate depreciation [7/]	1.0	0.5	0.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of Deposits (ne	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroare	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.0	2.2	-0.3	1.9	0.2	0.5	0.6	0.5	0.5	4.2	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

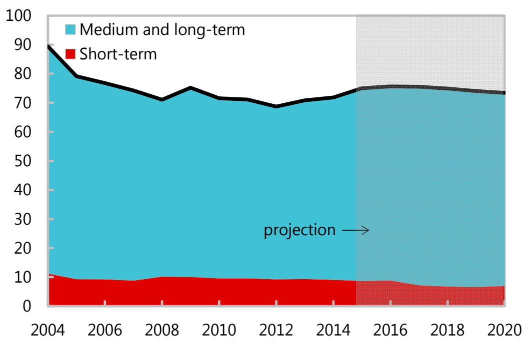
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

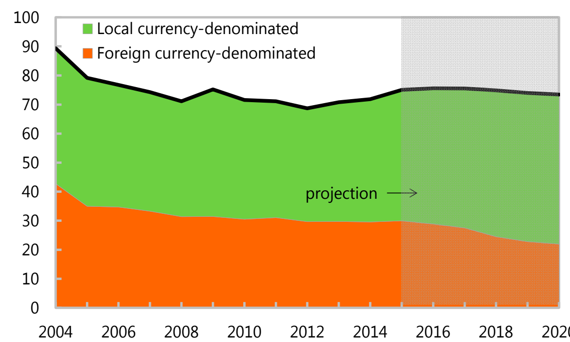
Sri Lanka Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



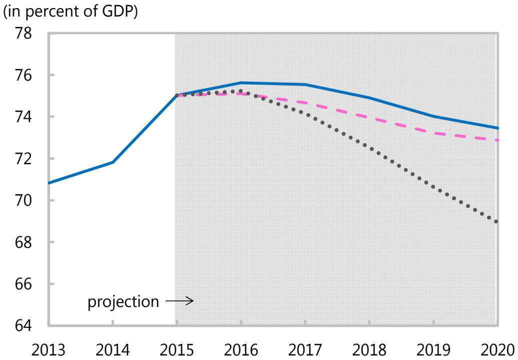
By Currency
(in percent of GDP)



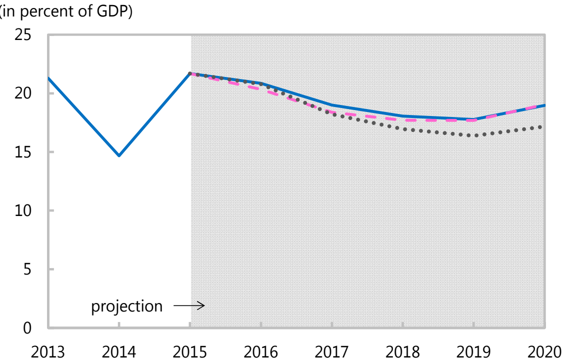
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

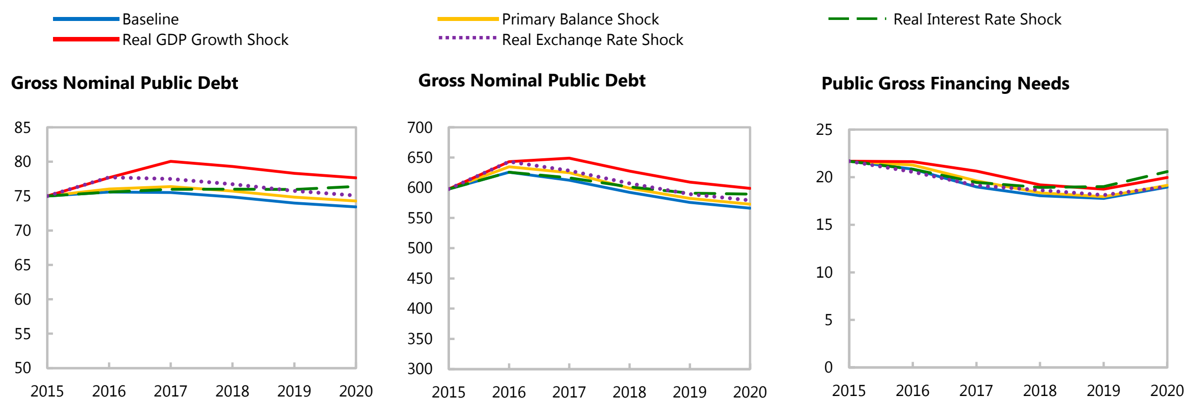
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	5.2	5.5	5.5	5.5	5.5	5.5
Inflation	1.4	3.4	4.3	5.0	5.0	5.0
Primary Balance	-1.5	-2.0	-1.9	-1.6	-1.4	-1.3
Effective interest rate	6.4	6.6	6.5	6.6	6.6	7.2
Constant Primary Balance Scenario						
Real GDP growth	5.2	5.5	5.5	5.5	5.5	5.5
Inflation	1.4	3.4	4.3	5.0	5.0	5.0
Primary Balance	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	6.4	6.6	6.5	6.6	6.6	7.2

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	5.2	6.1	6.1	6.1	6.1	6.1
Inflation	1.4	3.4	4.3	5.0	5.0	5.0
Primary Balance	-1.5	-2.1	-2.1	-2.1	-2.1	-2.1
Effective interest rate	6.4	6.6	5.3	5.0	4.5	4.7

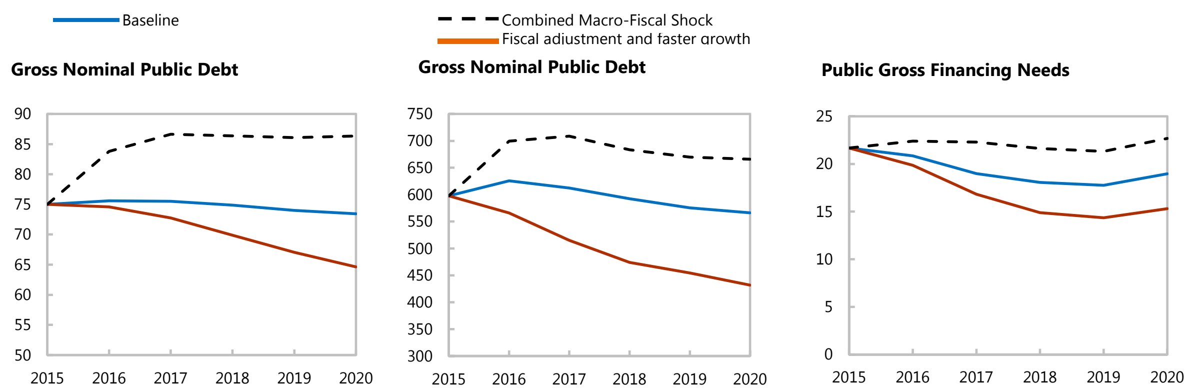
Source: IMF staff.

Sri Lanka Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

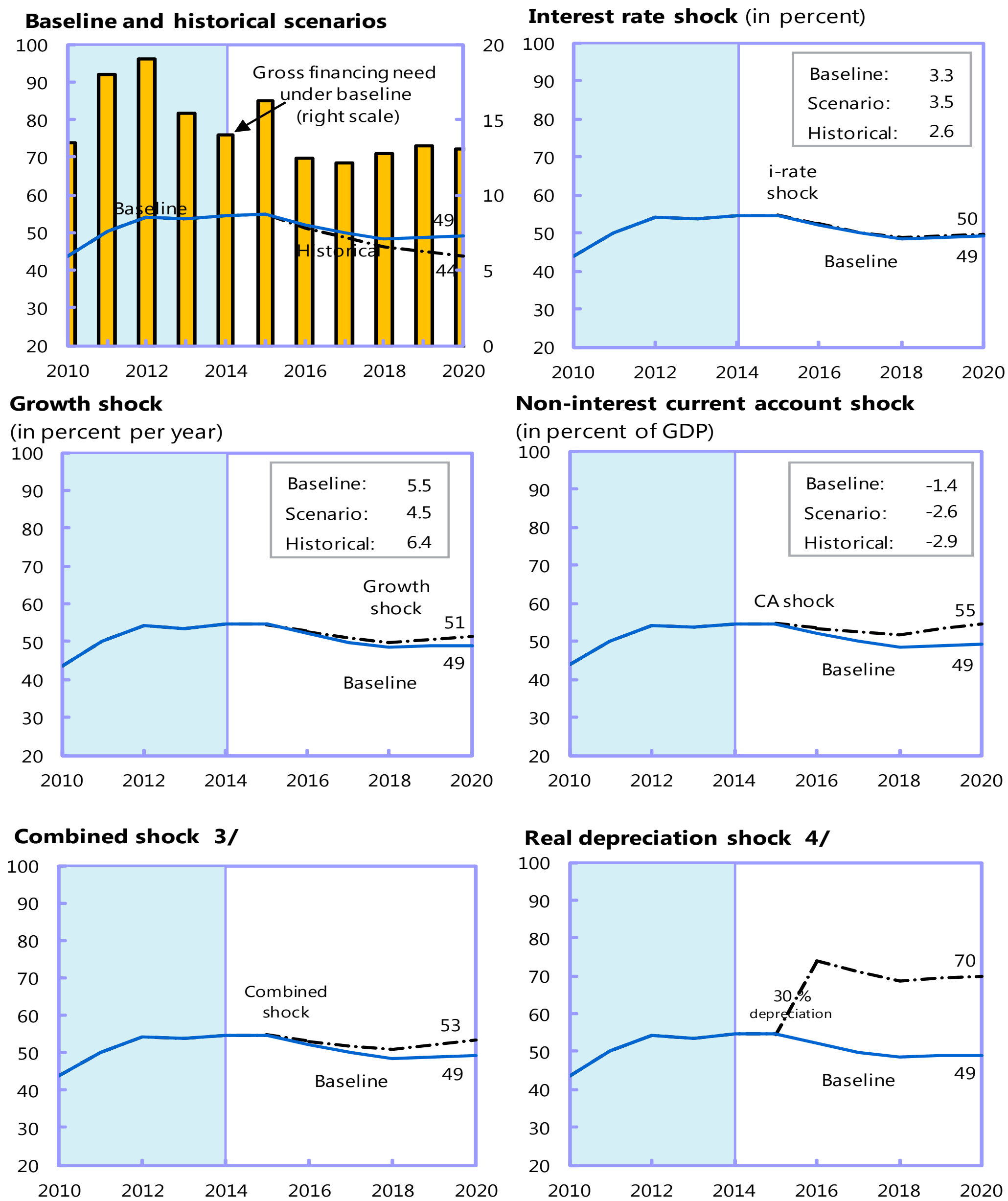
	2015	2016	2017	2018	2019	2020
Primary Balance Shock						
Real GDP growth	5.2	5.5	5.5	5.5	5.5	5.5
Inflation	1.4	3.4	4.3	5.0	5.0	5.0
Primary balance	-1.5	-2.5	-2.3	-1.6	-1.4	-1.3
Effective interest rate	6.4	6.6	6.5	6.6	6.6	7.2
Real Interest Rate Shock						
Real GDP growth	5.2	5.5	5.5	5.5	5.5	5.5
Inflation	1.4	3.4	4.3	5.0	5.0	5.0
Primary balance	-1.5	-2.0	-1.9	-1.6	-1.4	-1.3
Effective interest rate	6.4	6.6	7.1	7.6	7.9	8.7
Combined Shock						
Real GDP growth	5.2	3.5	3.5	5.5	5.5	5.5
Inflation	1.4	2.9	3.8	5.0	5.0	5.0
Primary balance	-1.5	-2.5	-2.7	-1.6	-1.4	-1.3
Effective interest rate	6.4	6.9	6.9	7.4	7.8	8.6

	2015	2016	2017	2018	2019	2020
Real GDP Growth Shock						
Real GDP growth	5.2	3.5	3.5	5.5	5.5	5.5
Inflation	1.4	2.9	3.8	5.0	5.0	5.0
Primary balance	-1.5	-2.4	-2.6	-1.6	-1.4	-1.3
Effective interest rate	6.4	6.6	6.5	6.6	6.6	7.2
Real Exchange Rate Shock						
Real GDP growth	5.2	5.5	5.5	5.5	5.5	5.5
Inflation	1.4	8.5	4.3	5.0	5.0	5.0
Primary balance	-1.5	-2.0	-1.9	-1.6	-1.4	-1.3
Effective interest rate	6.4	6.9	6.3	6.4	6.5	7.0
Fiscal adjustment and faster growth						
Real GDP growth	5.2	5.5	5.6	5.7	5.8	5.9
Inflation	1.4	3.4	4.3	5.0	5.0	5.0
Primary balance	-1.5	-1.0	-0.2	0.6	0.5	0.5
Effective interest rate	6.4	6.6	6.5	6.6	6.6	7.2

Source: IMF staff.

Figure 1. Sri Lanka: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2010.

Table 1. Sri Lanka: External Debt Sustainability Framework, 2012-2020
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2012	2013	2014	10-Year Historical Average	10-Year Standard Deviation	2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	54.2	53.6	54.6			**54.7**	**52.1**	**49.9**	**48.3**	**48.9**	**49.1**	**-3.9**
2	Change in external debt	4.0	-0.6	1.0			0.0	-2.5	-2.2	-1.6	0.5	0.3	
3	Identified external debt-creating flows (4+8+9)	2.3	-2.7	-2.9			-1.7	-2.7	-1.8	-0.7	-0.3	-0.4	
4	Current account deficit, excluding interest payments	4.5	2.0	1.2			0.9	0.0	0.7	1.7	2.2	2.2	
5	Deficit in balance of goods and services	11.9	8.6	8.1			8.1	6.9	7.3	8.0	8.1	7.9	
6	Exports	19.8	20.3	21.2			21.4	22.4	22.4	22.2	22.4	22.2	
7	Imports	31.8	28.9	29.4			29.5	29.3	29.8	30.2	30.5	30.1	
8	Net non-debt creating capital inflows (negative)	-1.7	-1.5	-1.3			-1.3	-1.3	-1.4	-1.4	-1.6	-1.7	
9	Automatic debt dynamics 1/	-0.6	-3.2	-2.7			-1.3	-1.4	-1.1	-1.0	-0.9	-0.9	
10	Contribution from nominal interest rate	1.3	1.4	1.4			1.5	1.5	1.5	1.5	1.6	1.6	
11	Contribution from real GDP growth	-4.5	-1.7	-2.2			-2.8	-2.9	-2.6	-2.5	-2.5	-2.5	
12	Contribution from price and exchange rate changes 2/	2.6	-3.0	-1.9			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	1.8	2.1	4.0			1.7	0.2	-0.5	-0.8	0.8	0.6	
	External debt-to-exports ratio (in percent)	273.3	264.6	257.2			255.1	232.6	222.4	217.8	218.4	221.6	
	Gross external financing need (in billions of US dollars) 4	13.0	11.4	11.0			13.1	10.6	11.3	12.8	14.4	15.3	
	in percent of GDP	19.0	15.4	14.0			16.2	12.5	12.2	12.7	13.3	13.1	
	Scenario with key variables at their historical averages 5/						**54.7**	**51.1**	**48.8**	**46.2**	**45.1**	**43.8**	**-5.5**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	9.1	3.4	4.5	6.4	2.0	5.2	5.5	5.5	5.5	5.5	5.5	
	GDP deflator in US dollars (change in percent)	-5.6	5.7	3.6	6.7	6.6	-2.3	-0.3	3.0	2.8	2.5	2.5	
	Nominal external interest rate (in percent)	2.7	2.9	2.8	2.6	0.5	2.8	2.9	3.1	3.3	3.5	3.6	
	Growth of exports (US dollar terms, in percent)	-0.5	11.1	11.0	9.1	10.2	3.7	10.0	8.8	7.4	9.0	7.1	
	Growth of imports (US dollar terms, in percent)	-2.4	-1.0	7.6	11.4	19.5	3.2	4.6	10.2	10.0	9.3	6.7	
	Current account balance, excluding interest payments	-4.5	-2.0	-1.2	-2.9	2.4	-0.9	0.0	-0.7	-1.7	-2.2	-2.2	
	Net non-debt creating capital inflows	1.7	1.5	1.3	1.2	0.5	1.3	1.3	1.4	1.4	1.6	1.7	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

SRI LANKA

November 10, 2015

FOURTH POST-PROGRAM MONITORING DISCUSSION—SUPPLEMENTARY INFORMATION

Prepared by Asia and Pacific Department

1. This supplement to the staff report summarizes the main developments since the staff report was issued. Staff projections and the thrust of the staff appraisal remain unchanged.

2. Following several months of negative headline inflation, year-on-year headline inflation rose to 1.7 percent in October. This reflects the fact that the effect of reduced administrative prices in September 2014 has dropped out of the base. Core inflation in October reached 4.4 percent.

3. On October 20, Parliament passed several revenue measures that were originally contained in the revised 2015 Budget. This includes the super gain tax, mansion tax, special levy on the casino industry and several other measures. These measures are expected to yield additional revenues of 0.6 percent of GDP in 2015, and are already included in staff's revenue projection.

4. On October 27, the authorities issued a $1.5 billion 10-year bond at a yield of 6.85 percent—the highest rate since 2009. As of November 5, Central Bank of Sri Lanka's (CBSL) gross foreign exchange reserves amounted to $7.4 billion, equivalent to 3.6 months of import cover.

5. The external situation continues to show signs of pressure. Exports fell by about 20 percent in August compared to 2014, while imports declined by 12 percent, leaving the trade August trade deficit broadly unchanged from last year. Net intervention in the foreign exchange market by the CBSL amounted to $278 million in October and $72 million so far in November. The rupee was broadly stable against the US dollar during that period. In real effective terms, the rupee has depreciated by about 4 percent during January–September 2015.

6. To curtail vehicles imports, the Central Bank of Sri Lanka imposed on October 30 a minimum cash margin of 100 percent on Letters of Credit open by commercial banks for imports of vehicles. This measure is to remain in effect until December 1, 2015. Staff has

assessed the measure to be an exchange restriction inconsistent with Sri Lanka's obligations under Article VIII, Section 2(a). However, as this assessment was reached only recently, the mission team has not had a chance to discuss this finding with the authorities in detail or assess whether the criteria set by the Board under Decision No. 1034-(60/27), dated June 1, 1960 for approval of an exchange restriction are met. Therefore, at this time, the authorities have not requested and staff does not recommend approval of the measure.

Statement by Mrs. Swarna Gunaratne, Alternate Executive Director on Sri Lanka
Executive Board Meeting
November 13, 2015

1. On behalf of the Sri Lankan authorities, I would like to thank the staff for the candid discussions and the comprehensive and balanced assessment of the macroeconomic developments of the Sri Lankan economy under the fourth Post-Program Monitoring (PPM) mission.

2. The discussions were held in Sri Lanka just a month after the general election held in August 2015, following the Presidential election held in January 2015. At the election, the United National Party (UNP) won 106 of 225 seats of the Parliament, while United People's Freedom Alliance (UPFA) secured 95 seats. Accordingly, the two main political parties in the country i.e., the UNP and the SLFP (Sri Lanka Freedom Party, the largest party in UPFA) formed a National Government of Consensus.

3. The first budget of the new government will be presented in the Parliament on the 20th of November 2015, which would include clear policy measures to address the current economic issues and reforms to sustain economic growth. Therefore, our authorities are of the view that a detailed medium term policy agenda of the new government will be available only after the budget, and hence they consider that the medium term analysis presented in the staff report is more in line with a baseline scenario.

4. The Honorable Prime Minister of Sri Lanka presented an Economic Policy Statement in the Parliament on the 5th of November 2015, which included a broad overview of the medium term vision and economic strategy of the new government with the intention of announcing specific policy measures in the forthcoming budget. The thrust of the policy statement is to address the current economic issues and to highlight the reforms required for sustainable economic growth and high employment generation. Reducing the budget deficit to 3.5 per cent of GDP by 2020, introducing tax reforms, strengthening tax administration, removing tax holidays and concessions, establishing a State Holding Corporation to manage state owned enterprises, creating a SPV for infrastructure initiatives, promoting thrust areas for development, including agriculture and tourism, taking measures to promote external trade & foreign investment, creating a Public Wealth Trust by amalgamating Employees' Provident Fund and Employees' Trust Fund to be managed by a Board answerable to the Parliament, enhancing allocations made for education and health and improving competitiveness are among the major policy priorities highlighted in the policy statement.

5. The SBA supported program, which was successfully completed in 2012, helped Sri Lanka to strengthen its macroeconomic stability and build policy spaces amidst a challenging external environment. Sri Lanka's outstanding borrowings under the SBA had fallen below the threshold level that generally calls for PPM even by the time of the 3rd PPM. However, my authorities wished to continue the engagement with the Fund and invited a 4th PPM. My authorities broadly agree with the thrust of the staff assessment and stand ready to continue the close engagement with the Fund.

Economic Growth and Outlook

6. Sri Lankan economy sustained its growth momentum with continued low inflation. The economy achieved a healthy growth of 5.6 per cent during the first half of 2015, compared to 1.3 per cent growth in the first half of 2014, largely supported by the expansion in agriculture and services activities. Increased paddy production, marine fishing and marine aquaculture activities and other food crops largely contributed to the agriculture growth while the expansion in financial services, wholesale and retail trade and other personal services activities contributed to the growth in services. Industrial growth decelerated mainly due to weak performance in construction and manufacturing activities. On the demand side, pick-up in domestic demand, largely supported by increased wages and lower oil prices, contributed to the growth.

7. My authorities have projected a 5.7 per cent of growth for 2015 compared to the growth of 4.5 per cent in 2014. The slowdown in public sector construction activity and conservative sentiment of private investors, particularly in the first half of the year due to uncertain period prior to the General Election, slowed down the growth to some extent. The political stability, proposed reforms by the new government and the expected recovery in the global economy would help Sri Lanka to return to the high growth trajectory.

8. Sri Lanka subscribed to the IMF's Special Data Dissemination Standards (SDDS) on the 3rd of November 2015 bringing the number of subscribing jurisdictions to 66. Sri Lanka is the 12th jurisdiction in the Asia and Pacific region to subscribe to the SDDS.

Monetary Policy

9. Year on year headline inflation, which was 2.1 per cent at the end of 2014, gradually declined to below zero levels during July to September, largely attributable to downward revision of administered prices, mainly domestic energy prices. However, inflation rebounded again to 1.7 per cent in October, with the dissipation of these administered price revisions. Inflation is expected to be in the range of 2 - 3 per cent by end 2015. Reflecting the firming up of aggregate demand, core inflation has shown some upward movement since March 2015 and stood at 4.4 per cent in October.

10. In March 2015, along with the revival of growth in credit to the private sector, the Central Bank of Sri Lanka (CBSL) removed the restriction that was in place since September 2014 on access to its Standing Deposit Facility (SDF) by commercial banks. The removal of this restriction resulted in an increase and excessive volatility in short term money market rates. In order to minimize volatility and to signal the market of the continuation of the relaxed monetary policy stance, the CBSL reduced its policy rates by 50 basis points in April 2015. The net impact of these two measures has been an increase in short term market interest rates from the levels observed until February 2015.

11. In spite of these adjustments, the CBSL continued to maintain a relaxed monetary policy stance so far during the year in the backdrop of persistent low inflation and inflation expectations. Market interest rates remained at relatively low levels supporting the sustained

increase in credit growth. Credit to the private sector grew steadily to reach 21.3 per cent on a year on year basis by end August 2015, albeit on a low base, contributing to the increase in monetary expansion which has increased from 13.4 per cent at the end of 2014 to 16.8 per cent by August 2015 on year-on-year basis. My authorities note the staff's concerns on the accelerating credit growth and core inflation and have already taken several measures, including enforcing a Loan to Value Ratio (LTV) and a margin deposit requirement on letters of credit, to contain credit growth. Going forward, my authorities will undertake preemptive monetary policy measures in a timely manner considering both domestic monetary conditions as well as external developments.

Financial Sector

12. The financial sector stability and soundness improved as reflected by high capital and liquidity levels and increased profitability. The Capital Adequacy Ratios (CAR) in the banking sector have been maintained well above the regulatory minimum ratio of 10 per cent. At end June, the total CAR and core CAR remained at 16 per cent and 13.5 per cent, respectively. Reflecting overall business expansion, higher margins and increased lending and investment activity, the profitability of the banking sector expanded. Nevertheless, NPL increased slightly from 4.2 per cent at end 2014 to 4.3 per cent at end June 2015. However, the commercial banks are maintaining sufficient buffers. My authorities have taken proactive measures to strengthen regulatory and supervisory frameworks while taking measures to adhere to BASEL III international standards.

External Sector

13. Sri Lanka's external sector recorded a modest performance during the first eight months of the year. Decline in external demand for major export commodities due to the slow recovery of the global economy and the withdrawal of foreign investments from the government securities market anticipating the normalization of monetary policies in advanced economies were major reasons for the lower performance in the external sector. Foreign investor presence for International Sovereign Bonds remained intact during this period. Despite the growth in trade in services, the current account deficit widened with the increased trade deficit. Inflows to the financial account of the balance of payments (BOP) moderated reflecting the decline in foreign investment inflows and unwinding of foreign investments in government securities.

14. An increased pressure in the foreign exchange market was witnessed since late 2014. This was largely due to the increased trade deficit, slowdown in net capital inflows, increased debt service payments of the government due to depreciation of the Sri Lankan Rupee against the US Dollar, repayment of matured International Sovereign Bond of USD 500 million in January 2015 and unwinding of foreign investments in government securities market. The CBSL intervened in the foreign exchange market to reduce undue pressure on the exchange rate by supplying about USD 1.9 billion, on a net basis, during the first 8 months of the year. However, since 4th September, the CBSL decided to limit its intervention in the foreign exchange market.

15. My authorities took a number of measures to contain the pressure on external sector and to maintain country's reserves at a comfortable level.

- The CBSL entered in to a currency SWAP agreement with the Reserve Bank of India (RBI) in April 2015 and received USD 400 million under the arrangement for South Asian Association for Regional Cooperation (SAARC) member country

  Central Banks. Another currency SWAP agreement was signed with the RBI and received USD 1.1 billion in September 2015.

- An International Sovereign Bond of USD 650 million with a 10-year maturity was issued in June 2015. The second International Sovereign Bond issue during the year of USD 1,500 million with a 10-year maturity was issued in October 2015.

- Considering the adverse implications of sharp increase in motor vehicle imports on the BOP, a 100 per cent margin deposit requirement against the letters of credit opened with the commercial banks on motor vehicle imports was imposed with effect from 30 October 2015. However, this is a temporary measure and will be effective only till 1st December 2015.

- LTV of 70 per cent in respect of loans and advances granted for the purpose of purchase or utilization of motor vehicles by banks and financial institutions was imposed with effect from the 15th of September 2015. However, implementation of this measure was deferred till the 1st of December 2015.

- More flexibility in the determination of the exchange rate was allowed with effect from the first week of September 2015, and the intervention of the CBSL has been limited only to avoid excessive volatility in the exchange rate.

16. Sri Lanka's Rupee which depreciated moderately till August 2015, showed a faster depreciation since early September when the CBSL allowed more flexibility in the determination of the exchange rate. Accordingly, the rupee depreciated by 7.0 per cent during 2015 up to end October 2015. My authorities note the Staff's view that there is no fundamental misalignment of the exchange rate.

Fiscal Policy

17. The focus of the fiscal policy in 2015 has been on strengthening the fiscal consolidation process to reduce the budget deficit and the government debt. The original budget for 2015 passed in the Parliament in November 2014 targeted a budget deficit of 4.6 per cent of GDP. The interim budget presented by the new government in January 2015 has targeted an even lower budget deficit of 4.4 per cent of GDP, with the anticipation of enhancing revenue collection with several new tax measures. However, the budget deficit in 2015 is likely to exceed the target due to the delays in targeted revenue collection and the increase in recurrent expenditure. The budget deficit in 2015 is more likely to be around 6.0-6.5 per cent while the debt to GDP ratio would be around 75.0 per cent.

18. My authorities stand committed for strengthening the fiscal consolidation. It is expected that firm measures to enhance revenue mobilization would be introduced in the budget for 2016 which will be presented on the 20th of November 2015. Also, under the new government's development agenda, it is expected to introduce policies related to public investment and strict monitoring of project implementation. In the Honorable Prime Minister's policy statement, special attention has been given on reforming public enterprises. To successfully manage state enterprises, it has been proposed to establish a State Holding Corporation Limited, an organization that will provide state entrepreneurship. All the state owned enterprises would come under this institution that will have the capacity to make decisions on sound market based financial principles.

19. My authorities have recognized the continued weak revenue mobilization as the key challenge of the fiscal consolidation. Several reforms have been implemented from time to time to simplify the tax system, broaden the tax base and improve tax compliance. However, these efforts have not been adequate to reach the desired revenue targets. It is expected that specific measures in this direction will be introduced in the upcoming budget. Several Fund missions visited Sri Lanka in the recent past to provide TA on the fiscal sector issues and my authorities will take a serious note of their recommendations. The Revenue Administration Management Information System (RAMIS) which is being introduced at the Inland Revenue Department (IRD) is expected to address some of these concerns. An IMF TA is being arranged to identify the weaknesses in tax laws as well as their complexities with a view to introducing necessary improvements to the legal frameworks of the country's tax system and redrafting tax laws.

Conclusion

20. Sri Lanka's economic growth continued to remain strong with benign inflation outlook. Financial sector stability remains healthy. Sri Lanka has had two elections in 2015 where a new President and a new government were elected in January and August, respectively. Hence, it was an economically and politically uncertain period. There were some policy slippages mainly in the fiscal and external sectors, partly attributable to the global developments. In the absence of a firm medium term macroeconomic program, the staff report reflects only a baseline analysis. The government's medium term vision and the economic strategies were presented by the Honorable Prime Minister to the Parliament on the 5th of November 2015. More precise reforms and policies will be presented in the forthcoming 2016 budget which is to be presented to the Parliament on the 20th of November 2015. These measures would help to maintain macroeconomic stability of the economy addressing current issues while supporting to achieve a sustainable high economic growth.