

**International Monetary Fund**

[Sri Lanka](#) and the  
IMF

**Sri Lanka:** Letter of Intent, Memorandum of Economic and Financial  
Policies, and Technical Memorandum of Understanding

**Press Release:**  
[IMF Completes  
Second Review of the  
Extended  
Arrangement Under  
the EFF with Sri  
Lanka and Approves  
US\\$ 167.2 Million  
Disbursement](#)  
July 17, 2017

June 23, 2017

The following item is a Letter of Intent of the government of Sri Lanka, which describes the policies that Sri Lanka intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Sri Lanka, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

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## Letter of Intent

Colombo, June 23, 2017

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

Dear Ms. Lagarde:

This letter serves as a supplement to our Letters of Intent dated May 12, 2016, and November 3, 2016, and the associated Memorandum of Economic and Financial Policies (MEFP) dated May 12, 2016. The attached MEFP updates the MEFP dated May 12, 2016, by describing reform progress so far and setting out the plans and policies of the authorities of Sri Lanka for 2017–2019. Table 1 and Technical Memorandum of Understanding (TMU) attached to the MEFP set out quantitative targets that are to be observed under the Extended Arrangement. Table 2 attached to the MEFP sets out a proposed prior action for approval of the second review as well as new and modified structural benchmarks.

We believe that the policies set forth in the attached MEFP, together with the previously issued MEFP and Letters of Intent, are adequate to achieve the objectives of our economic program, but the Government stands ready to take additional measures as appropriate to ensure achievement of its objectives. We will continue to consult in advance with Fund staff on adoptions of measures or revisions of the policies contained in the MEFP and in this letter, in accordance with the Fund's policies on such consultations. We will provide the Fund with the information it requests for monitoring program implementation.

Against the background of our performance to date and our strong commitment going forward, we request completion of the Second Review of the Extended Arrangement under the EFF, after which we intend to draw one tranche amounting to SDR 119.894 million. We are also requesting waivers on the nonobservance of non-accumulation of external arrears as steps have been taken to clear the arrears, and a waiver of applicability of the end-June 2017 QPCs. We are also seeking the modification of the performance criterion on the net official international reserves and ITs for June 2017 as well as structural benchmarks, as specified in the tables 1 and 2 of the MEFP and TMU.

In keeping with its policy of transparency, the Government has authorized the publication of this letter and its attachments as well as the associated staff report.

Sincerely yours,

/s/

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Mangala Samaraweera  
Minister of Finance

/s/

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Indrajit Coomaraswamy  
Governor  
Central Bank of Sri Lanka

## Attachment I. Memorandum of Economic and Financial Policies

### I. MACROECONOMIC OUTLOOK

**1. The economic outlook is broadly stable despite headwinds from severe weather events.** Growth is projected to recover gradually from 4.4 percent in 2016 to around 5 percent in 2017, as growth in manufacturing, construction, and services will somewhat offset the impact of the drought in 2017 Q1 and the floods in 2017 Q2 on agriculture. Credit growth will likely slow in coming months, in a lagged response to monetary tightening in 2016 and the recent tightening in 2017. The current account deficit is expected to improve in 2017. However, the current account could be adversely affected by severe weather events which will increase oil and food imports. Mainly driven by higher food prices, headline inflation is projected to temporarily rise above the midpoint of the program's inflation consultation band, but is expected to stay within the inner band.

### II. PROGRAM PERFORMANCE

**2. Since July 2016, fiscal policy has been largely on track under our program, but reserve accumulation and some structural measures have been delayed.** While the end-December quantitative targets were met for the primary balance and tax revenues, the NIR target was missed by \$411 million and the reserve money target was breached by Rs 46 billion. Inflation stayed within the consultation band. We have made progress on structural measures, albeit with further delays in some areas than originally intended.

### III. FISCAL POLICY

#### Fiscal stance

**3. The main priority for fiscal policy remains a durable reduction of the fiscal deficit and public debt through domestic revenue mobilization.** The government reduced the overall fiscal deficit to 5.4 percent of GDP in 2016, from a deficit of 7 percent in 2015. This deficit reduction was achieved through a bolstering of tax revenues—rather than one off measures—while containing recurrent, discretionary, and capital spending. For 2017, the budget targets a primary surplus of Rs 55 billion (0.4 percent of GDP), supported by revenue measures equivalent to Rs 140 billion (1 percent of GDP), thereby aiming to exceed the program targets for 2017 in both primary surplus and tax revenues. We mitigate the risk of revenue underperformance by committing to align expenditures with revenue outturns on a quarterly basis, as specified in the budget. We also aim to improve transparency and accountability of the budget execution process by submitting quarterly reports to Parliament since Q2.

**4. In light of the high public debt, expenditures in 2017 will be benchmarked to the level consistent with the program targets.** Should revenues exceed the program targets, the surplus will be saved as a buffer to cover the cost of unexpected natural disasters or be used to bring down debt. In the event of revenue shortfall, we will rationalize discretionary spending on goods and

services and capital projects. Such precautions will help create space for addressing the impact of natural disasters including the drought, if needed, and strengthen international reserves accumulation. The drought in late 2016 has increased thermal power generation and is expected to result in financial losses of the CEB for 2017. These losses will be compensated by necessary adjustments in the tariff and central government on-budget transfers to the CEB as necessary, and not permanently increase contingent fiscal liabilities in the form of higher borrowing by the CEB. The 2017 budget contained a tax expenditure statement (structural benchmark) and a plan to rationalize selected tax incentives in 2017.

**5. It is critical that fiscal consolidation continue over the medium-term.** We are committed to a steady path of lowering fiscal deficits to ensure a medium-term reduction in the public debt to GDP ratio. As first indicated in the Prime Minister's November 2015 speech to parliament, we aim to bring the overall central government deficit down to at least 3.5 percent of GDP by 2020, which should lower the central government debt to about 70 percent of GDP. Specifically, we target to overperform the program target of primary balance in 2017 and a primary surplus of adequate size in 2018, anchored by an increase in the tax to GDP ratio by about 1 percentage point of GDP annually in 2017–18. Annual budget proposals for 2018–19 will be in line with the program targets as described in Table 2 (modified structural benchmark). We will ensure fiscal consolidation beyond 2019 by revising the Fiscal Management (Responsibility) Act to include binding targets for the government deficit and level of overall public debt.

**6. Fiscal consolidation will rely mainly on measures to broaden the tax base and improve the efficiency of collection and spending rather than expenditure cuts.** Sri Lanka's fiscal deficits stem not from exceptionally high expenditures, but from a steady erosion of the tax base over the last two decades. Sri Lanka's tax-to-GDP ratio fell to one of the lowest in the world, and the nation's tax efficiency ratio is also below that of comparator countries—particularly for the VAT. Our strategy to re-set tax policies and bolster tax administration focuses on: (i) broadening the tax base; (ii) rationalizing the tax system and removing the many exemptions, holidays, and special rates that have undermined fair and effective tax administration; (iii) strengthening capacity for risk-based revenue administration to improve tax compliance; and (iv) bolstering public financial management, in particular on commitment control, and financial planning and discipline.

**7. We have been developing the medium-term debt management framework and strengthening technical capacity with multilateral and bilateral TA support.** Legislative reforms toward active liability management are underway, with a view to smoothing out the government's amortization requirements over time. Proceeds from commercializing public assets, if any, will be earmarked for debt services over the medium term, including for maturing international sovereign bonds starting in 2019.

## Revenue mobilization

**8. A number of measures were implemented in 2016 to improve revenue performance.** As an initial step towards rationalizing tax incentives, the Cabinet suspended the Board of Investment Act in May 2016, annulling its capacity to grant tax exemptions and other forms of

preferential treatment and instead concentrating these powers in the Ministry of Finance, which has ultimate oversight of tax policy. The VAT amendment enacted in November 2016 raised the VAT rate from 11 percent to 15 percent and broadened the VAT net by eliminating exemptions for telecommunication and private healthcare, excluding diagnostic tests, dialysis and services provided by the Outpatient Department (OPD), while the VAT continues to apply to wholesale and retail trade.

### **9. Further measures to broaden the tax base are envisaged for 2017 and the medium**

**term.** The 2017 budget includes measures to broaden the tax base, including transforming corporate tax exemptions to investment-based ones and eliminating exemptions for financial income tax. Thresholds for personal income tax will be maintained at levels that capture a sufficient portion of the tax base.

- We have been revamping the income tax law by redrafting the Inland Revenue Act (IRA) over the course of 2016 and 2017. The new IRA aims to establish a predictable, stable, transparent and even-handed framework, and widens the tax net through the elimination of tax exemptions so that over time, tax rates may be reduced.
- We will submit to Parliament the new IRA consistent with the IMF staff recommendations to:
  - increase tax revenue by broadening the base through removing exemptions;
  - modernize the legal framework for taxation by adopting principle-based drafting, streamlining the law's structure, and simplifying its language;
  - promote the business climate by enhancing taxpayers' protections and providing greater certainty on their tax affairs;
  - improve compliance by strengthening administrative powers of the Inland Revenue Department (IRD).
- We will complete a diagnostic review of the VAT system by June 2017 (structural benchmark), and implement amendments to simplify and strengthen the VAT system. This review will provide a foundation for further revenue mobilization in 2018.
- Starting with the 2017 budget presented last November, annual budgets began to include a catalogue of tax expenditures (tax exemptions, holidays, and other incentives), along with an estimate of their cost so that their merits can be debated openly. Cabinet did not yet adopt a time bound strategy to reduce or eliminate these tax expenditures, as agreed with IMF staff (structural benchmark). The government will include a plan to rationalize tax expenditures and a tax expenditure statement in the annual budgets for 2018 and 2019, as described in Table 2 (modified structural benchmark).

**10. Improvements to tax administration complement tax policy reforms.** Changes to tax policy will be ineffective in raising revenue unless accompanied by a concerted effort to strengthen capacity on revenue administration. Laudable efforts have been underway at the IRD for some

time—including essential steps toward automation and the use of information technologies that are standard in many middle-income economies. Our reform agenda include structural benchmarks to bolster these efforts and raise our tax administration to the highest standard.

- End-December structural benchmarks for tax administration were met. With respect to VAT administration, IRD adopted a VAT compliance strategy that includes a time-bound plan to implement risk-based audits and KPIs to measure their effectiveness. IRD also fully rolled out the RAMIS IT system.
- With respect to income tax administration, a concrete plan is critical to ensure that the new IRA is implemented in a timely and effective manner, including the training of tax officers. We have initiated the implementation plan by establishing a steering committee and its terms of reference, creating project teams at the IRD, and initiating the stakeholder consultation and communication process through the publication of detailed tax manuals. Public outreach campaign is also planned, to educate and sensitize taxpayers to the new framework. IRD will adopt compliance strategies for corporate and personal income taxes (structural benchmark), following a successful implementation of the new IRA.
- More broadly, organizational and business procedure reform has begun at the IRD including restructuring along functional lines, creating a design and monitoring unit, making management structure more efficient to speed up interaction with taxpayers, strengthening the Large Taxpayer Unit, introducing mandatory e-filing, and enhancing the use of taxpayer identification numbers. The IT system for customs administration (ASYCUDA) has been improved, with case selection for risk-based cargo audit now automated.

**11. A disciplined approach to government spending and prioritization of public investment (both in physical and human capital) complements revenue-based fiscal consolidation.** We intend to keep the overall spending envelope under control, while reallocating spending within this envelope to areas that will bolster our medium-term prospects for robust and inclusive economic growth. To ensure a more effective, targeted and expanded social welfare scheme, we established the Welfare Benefits Board that will rationalize the various social assistance schemes through a consolidated national database for social assistance beneficiaries. To ameliorate the impact of the drought, the government will provide cash support to affected families within the overall budget envelope. With the assistance of the World Bank and other development partners, we will also upgrade our procurement processes, produce a national policy statement for public investment management, and strengthen our capacity in the area of debt management.

## IV. PUBLIC FINANCIAL MANAGEMENT

**12. Further improvements in fiscal management and transparency are planned to address past irregularities and prevent future occurrences.** For both credibility and to fully meet our financial commitments, we see careful monitoring of government spending commitments as essential.

- A commitment recording system has been established. Through modification of the existing IT system (CIGAS) and manual reporting from line ministries, the MOF is now capable of tracking spending commitment for each line ministry on a monthly basis. As discussed earlier, we are reporting to parliament on the status of commitments in each quarter and then adjust spending through careful commitment and cash management. We plan to put in place an IT-based commitment control system by mid-2017 with commitment ceilings for line ministries for the rest of the year. The commitment control system will be implemented from the beginning of 2018 using the ITMIS system as described in Table 2 (new structural benchmark).
- The rollout of the new Integrated Treasury Management Information System (ITMIS) should significantly expand PFM capabilities, including commitment control, budget preparation, treasury, accounting, and procurement, among others.
  - Phase I of the ITMIS system – the budget planning module – was rolled out to all ministries in December 2016, including Ministries of Finance and Health (structural benchmark). This module includes a system of commitment controls that can be used to implement a formal commitment record system and quarterly expenditure ceilings. While the system has been fully rolled out, it is being operated in parallel to existing system to ensure it is functioning properly, with plans to operationalize it beginning in 2018.
  - Phases II and III of ITMIS have been rolled out to the Ministries of Finance and Health with full rollout of these modules expected next year as internal capacity to run the system is being developed.
- To boost transparency, the MOF will begin publishing quarterly financial bulletins summarizing government fiscal operations, ensure that annual budgets explicitly cost out tax expenditures, and adhere to Government Finance Statistics Manual (GFSM) standards. Budgets will also include an analysis of fiscal risks, including those related to SOEs and public-private partnerships (PPPs).

## V. STATE ENTERPRISES

**13. The financial condition of some of our state enterprises and ultimate responsibility for their existing obligations are a challenge we seek to address and resolve as part of the program.** Sri Lanka currently has about 200 public enterprises representing a substantial share of the nation's economic activity. With technical assistance from the IMF, we identified outstanding obligations of the central government and SOEs totaling Rs 1.36 trillion in end-2015. These included (i) outstanding obligations of the central government, totaling Rs 58 billion, which were settled during 2016; and (ii) those of 4 SOEs (CPC, CEB, Sri Lankan Airlines, and the Sri Lanka Port Authority), totaling Rs 1.2 trillion. Although some SOEs are profitable and performing well, collectively they represent a risk to public finances (either directly or through the state banks which fund the largest SOEs). A comprehensive strategy for SOE reform and a more rules-based approach to financial



management is being developed. In the near-term, however, our strategy encompasses the following elements:

- To enhance oversight and financial discipline, Statements of Corporate Intent (SCIs) were signed in March 2017 and published in April 2017 for the five largest SOEs (CPC, CEB, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authority). The SCIs encompass the SOE's mission, high level objectives, and multiyear corporate plan; capital expenditure and financing plans; and explicit financial and non-financial targets. They also include description and cost of non-commercial obligations (NCOs) such as utility subsidies to strengthen the transparency and fiscal accountability. We plan to publish NCOs in the annual budget for 2018 and 2019, as described in Table 2 (modified structural benchmark). We will also look at strengthening the legal framework for the governance and oversight of SOEs, including through establishment of coherent financial regulations for SOEs on governance, accountability, and funds management.
- We have been implementing a resolution strategy for Sri Lankan Airlines, originally approved by Cabinet in 2015. The airline has already undertaken route and fleet optimization, reducing operational losses. The next step is to secure a strategic partner and resolve the need for capital injection and debt consolidation, thereby effectively removing this company from the government's accounts. To monitor progress, we will report the company's financial performance on a quarterly basis (see the Technical Memorandum of Understanding). In light of ongoing restructuring efforts, Sri Lankan Airlines did not participate in the publication of SCI. We aim to put the airline on a commercial footing and resolve fiscal contributions, if any, to the airline's liabilities. This milestone can be set as a structural benchmark for future program reviews.
- The structural benchmark for establishing automatic fuel and electricity pricing mechanisms has not been met. We are pursuing a sequence of steps to put the reform process back on track. First we will complete a report outlining the cost of non-commercial obligations for fuel and electricity by September 2017 (new structural benchmark), supported by IMF TA. To correctly estimate the cost of non-commercial obligations for electricity, the CEB and the Public Utility Commission will establish a Bulk Supply Transactions Account and start using it to settle transactions between generators, the transmission operator, and distributors as specified in the November 2015 tariff methodology by March 2018 (new structural benchmark). Second, once the extent of the non-commercial obligations for fuel and electricity is known, we will explicitly account for them in our program targets beginning in the third review. Finally, to reduce the possibility of future financial losses by the CPC and the CEB and avoid large ad hoc adjustments in retail prices, while allowing time for public consultation and education, we will obtain cabinet approval of the automatic pricing mechanism for fuel by March 2018 and for electricity by September 2018 as described in Table 2 (modified structural benchmarks). To monitor progress, we will report the financial performance of the CPC and the CEB on a quarterly basis (see the Technical Memorandum

of Understanding). We intend to introduce cost-reflective water tariff settings when the PUC starts regulating the water sector.

## VI. MONETARY AND EXCHANGE RATE POLICY

### 14. **The focus of monetary policy will remain on keeping inflation in the mid-single digits.**

Throughout 2016, the CBSL tightened monetary policy by raising the statutory reserve ratio in January 2016 and raising the policy rates by 50 bps each in February 2016 and again in July 2016. While credit growth slowed due to these policy changes, it remained robust at 20.4 percent y-o-y in March 2017 and inflation picked up in early 2017 due to the implementation of VAT amendments in November and the impact of drought. To rein in inflationary pressure and curtail the buildup of adverse inflation expectations as well as to control credit growth, the CBSL raised policy rates by 25 bps in March 2017 and stands ready to further tighten monetary policy in 2017 as warranted. This tightening will also help preempt potential capital outflows. Monetary policy will continue to be monitored through a monetary policy consultation clause (see the Technical Memorandum of Understanding), supported by monitoring of reserve money developments.

**15. A roadmap for flexible inflation targeting will be completed by October 2017 to establish inflation as the nominal anchor moving away from using the exchange rate as the de-facto anchor.** While continuing to develop a macro forecasting model with IMF TA, the CBSL will take next steps, including establishing price stability as the primary objective of monetary policy and publicly communicating the inflation targets. While the CBSL intends to retain a role for smoothing excessive exchange rate volatility, it will guard against a real or perceived conflict of objectives and adopt FX intervention policies consistent with a flexible exchange rate regime. Foreign exchange market functionality can be improved, including by further liberalizing financial account transactions and deepening the FX market. The CBSL will develop a road map and identify time-bound reform measures as described in Table 2 (new structural benchmark), guided by IMF TA in May 2017. These time-bound measures will be incorporated into future program reviews. Through this process, we will establish among other things: (i) the legal framework, including central bank independence from fiscal or political pressures that would conflict with an inflation objective; (ii) a sound financial system that would reduce the risk of conflict between monetary and financial system stability objectives; (iii) well developed technical infrastructure, including improved forecasting and modeling capabilities, and (iv) a policy decision making process governed by the guidelines on the choice of targets and how unanticipated shocks would be addressed.

**16. In tandem with moving toward flexible IT, the CBSL will continue a market-oriented approach to exchange rate policy.** It is the CBSL's intention to durably transition to a more flexible exchange rate regime. In this context, the CBSL will aim to develop (i) a deeper and more liquid foreign exchange market; (ii) adequate systems to review and manage exchange rate risks; and (iii) a transparent intervention policy, consistent with an inflation targeting regime. Accordingly, since late February, the CBSL has intervened in the FX market only to build up reserves or to stem excessive movements in the exchange rate and will continue to do so.

**17. A strengthening of reserve coverage (guided by the IMF's ARA reserve metric) has been programmed, supported by regular FX purchases.** With gross official reserves (GIR) close to 3 months of imports by end-April 2017, we are acutely aware of the importance of building up external buffers. Towards this goal, we renewed our commitment to greater exchange rate flexibility and undertook corrective actions that facilitated the steady build-up of reserves. In particular, as a corrective action for missing the NIR target for end-2016, we made a net outright FX purchase of \$442 million in March and April, with significantly limited FX sales during that period and monetary tightening. Supported by FX purchase and financial inflows, the level of program NIR (per the TMU definition) recovered from a low level at end-2016 to \$2.3 billion by end-April. Between January to end-May 2017, the exchange rate has depreciated by around 1.8 percent against the US\$. We will continue to take appropriate corrective actions to enable the steady buildup of reserves with a view to fully offsetting the end-December NIR shortfall within 2017, while allowing for greater exchange rate flexibility. Further, we are committed to having monthly consultation with the IMF in making necessary corrective actions in foreign exchange intervention if there are significant deviations from an agreed upon benchmark. However, in the event that the gap between supply and demand of foreign exchange results in a highly disruptive movement of the exchange rate, we will consult with the Fund staff on the appropriate policy response. We also plan to gradually wind down FX swaps with domestic commercial banks to around US dollars 2.0 billion by end December 2017, and further reduce swap liabilities gradually during 2018.

**18. During the program, we will not impose or intensify restrictions on the making of payments and transfers for current international transactions; introduce or modify multiple currency practices; conclude bilateral payments agreements that are inconsistent with Article VIII; or impose or intensify import restrictions for balance of payments reasons.** The CBSL and the government will also abstain from providing exchange guarantees for foreign currency borrowing.

## VII. FINANCIAL SECTOR POLICIES

**19. To strengthen our financial system, we intend to undertake several measures:** (i) deploy, as needed, macro-prudential tools such as a sector-specific limit on the loan-to-value ratio including in the construction and real estate sectors; (ii) implement the Basel III capital standard and assess its impact on capital positions of state owned banks; (iii) improve the financial sector risk management of greater exchange rate flexibility; and (iv) develop a resolution mechanism for distressed non-bank financial companies (in coordination with IMF TA in April 2017). While financial soundness indicators remain adequate for the banking system as a whole, the capital adequacy ratio (CAR) has been declining as the broad-based and still robust credit growth has increased risk-weighted assets.

**20. We stand ready to further strengthen CBSL's autonomy and governance arrangement.** The IMF safeguards assessment, completed in August 2016, identified issues in the areas of the CBSL's autonomy and governance arrangement (e.g., the government's voting representation in the Monetary Board, absence of recapitalization provisions, and inadequate limits on credit to

government). These issues will be addressed as we amend the legal framework for the central bank. A step was taken with IMF Legal department's participation in the IMF TA on inflation targeting in May, and we will take next steps with a dedicated TA later in 2017.

## VIII. POLICIES TO STRENGTHEN TRADE AND INVESTMENT

**21. Achieving medium-term macroeconomic objectives will require a renewed effort toward greater integration into regional and global supply chains, higher levels of FDI, and enhancing prospects for private sector investment.** In addition to better infrastructure, this will entail improvements in the trade regime and investment climate. Immediate steps toward this end have been the establishment of an Agency for Development (which will seek to prioritize infrastructure development), as well as an Agency for International Trade (responsible for trade promotion and negotiation of trade and investment agreements). The lifting of EU ban on fishery imports was a welcome change, and the GSP plus trade status with EU was reinstated in May 2017.

**22. To boost trade and private sector development, we will seek to reduce costs and bolster competitiveness.** A key element in this work would be a review of Sri Lanka's trade regime including an evaluation of para-tariffs and other nontariff barriers that have led to a high level of effective protection and hampered exports. We are working with the World Bank to strengthen our structural competitiveness. We aim to increase the efficiency of trade facilitation, remove barriers to foreign investment entry and establishment (including access to land), enhance access to finance, and strengthen financial market infrastructure. These steps should help attract FDI and complement public investment.

## IX. RISKS AND CONTINGENCIES

**23. The high degree of uncertainty in the global economic environment has elevated economic and financial risks to the program.** The main risks include (i) acceleration of capital outflows, reflecting further strengthening of the US dollar and higher rates which could lead to a further decline in the already low reserves; (ii) weaker than projected revenues; (iii) weaker than expected capital inflows, which would widen the projected financing gap given already substantial gross fiscal financing needs of about 19 percent of GDP in 2017; (iv) lower than expected growth or new pressures on the trade account; and (v) weaker than expected performance of state owned enterprises. These risks could further challenge public debt and external sustainability. Should such risks materialize, the government stands ready to adjust promptly its policies, in close consultation with the IMF staff, to ensure the achievement of a sustainable external position at the end of the program.

## X. PROGRAM MONITORING

**24. Our program will be subject to semiannual reviews** with performance criteria and indicative targets set out in Table 1 attached to this MEFP and Technical Memorandum of Understanding (TMU). Completion of the third and fourth reviews will require observance of the

quantitative performance criteria for end-June 2017 and end-December 2017, respectively, as well as continuous performance criteria, as specified in Table 1 attached to this MEFP. The reviews will also assess progress toward observance of the structural benchmarks specified in Table 2 attached to this MEFP. The third and fourth reviews of the program will take place on or after November 20, 2017 and April 20, 2018, respectively.

**Table 1. Sri Lanka: Quantitative Performance Criteria (PC) and Indicative Targets (IT)**  
(Cumulative from the beginning of the year, unless otherwise noted)

	2016						2017					
	Sep. 1/		Act.	Dec.		Mar. 1/		Jun.	Sep. 1/		Dec.	
	Prog.	Adj. Prog.		Prog.	Adj. Prog.	Prog.	Adj. Prog.		Prog.	Adj. Prog.		
<b>Quantitative performance criteria</b>												
Central government primary balance (floor, in billion rupees)	-85	-85	-35	-97	-97	-29	-5	-5	9	-8	-4	-3
Net official international reserves (CBSL's conventional definition, floor, in million US\$) 2/ 3/ 4/ 5/	330	675	243	...	...	...	...	...	...	...	...	...
Program net official international reserves (Program NIR, floor, in million US\$) 2/ 3/ 4/ 5/	...	...	...	262	-267	-678	1,161	56	-113	2,027	1,976	2,236
<b>Continuous performance criteria (cumulative from beginning of the program)</b>												
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US\$) 6/	0	0	7	0	0	7	0	0	13	0	0	0
<b>Monetary policy consultation clause</b>												
Year-on-year inflation in Colombo Consumers Price Index (in percent) 7/												
Outer band (upper limit)	7.5	7.5	...	7.9	7.9	...	8.2	8.2	...	7.9	8.8	8.5
Inner band (upper limit)	6.0	6.0	...	6.4	6.4	...	6.7	6.7	...	6.4	7.3	7.0
Actual / Center point	4.5	4.5	4.5	4.9	4.9	4.2	5.2	5.2	6.5	4.9	5.8	5.5
Inner band (lower limit)	3.0	3.0	...	3.4	3.4	...	3.7	3.7	...	3.4	4.3	4.0
Outer band (lower limit)	1.5	1.5	...	1.9	1.9	...	2.2	2.2	...	1.9	2.8	2.5
<b>Indicative targets</b>												
Central government tax revenue (floor, in billion rupees)	1,021	1,021	1,067	1,428	1,428	1,464	383	383	415	803	1,232	1,718
Reserve money of the CBSL (ceiling, end of period stock, in billion rupees)	794	794	794	810	810	856	851	851	892	905	935	967
<b>Memorandum items:</b>												
Foreign program financing by the central government (in million US\$) 3/	200	...	0	325	...	185	0	...	0	125	125	225
External commercial loans by the central government (in million US\$) 3/	2,000	...	2,186	2,186	...	2,186	1,500	...	0	1,950	1,950	2,200
Proceeds from commercialization of public assets (in million US\$) 3/	...	...	...	...	...	...	...	...	...	0	200	200
The cumulative net change in the amount of SLDBs and foreign holdings of Treasury Bills, Treasury Bonds assumed under the program (in million US\$) 4/	-1,124	...	-621	...	...	...	...	...	...	...	...	...
Net borrowings from SLDBs (in million US\$) 4/	...	...	...	-669	...	-1,056	0	...	408	...	...	...
Net borrowings from SLDBs and FCUBs (in million US\$) 4/	...	...	...	...	...	...	...	...	...	627	627	627
Amortization of official external debt by the central government (in million US\$) 5/	713	...	858	1,015	...	1,017	352	...	365	529	889	1,065
CBSL's outstanding liabilities in FX swaps with domestic commercial banks (in million US\$)	...	...	2,466	...	...	2,497	...	...	2,339	...	...	...
Net official international reserves (CBSL's conventional definition, end of period stock, in million US\$, market exchange rate) 2/	5,359	...	5,272	5,490	...	4,529	6,446	...	4,353	6,168	6,023	6,161

1/ Indicative target.

2/ Under the CBSL's conventional definition of net official international reserves (NIR), outstanding liabilities in foreign exchange swaps with domestic commercial banks are not part of the CBSL's foreign liabilities. The Program NIR is measured as the difference between the CBSL's conventional definition of NIR and outstanding liabilities in foreign exchange swaps with domestic commercial banks. See the TMU on details.

3/ If (i) the amount of foreign program financing by the central government, (ii) the amount of external commercial loans (including Eurobonds and syndicated loans) by the central government, and (iii) proceeds from commercialization of public assets is higher/lower in U.S. dollar terms than assumed under the program, the floor on the Program NIR will be adjusted upward/downward by the cumulative differences on the test date.

4/ For end-September 2016, if the cumulative net change in the amount of SLDBs and foreign holdings of Treasury Bills and Treasury Bonds are higher/lower in U.S. dollar terms than assumed under the program, the floor on net official international reserves will be adjusted upward/downward by the cumulative differences on the test date. For end-December 2016 and end-March 2017, if the cumulative net borrowings of the government from SLDBs are higher/lower in U.S. dollar terms than assumed under the program, the floor on the Program NIR will be adjusted upward/downward by the cumulative differences on the test date. For end-June 2017 and thereafter, if the cumulative net borrowings of the government from SLDBs and FCUBs are higher/lower in U.S. dollar terms than assumed under the program, the floor on the Program NIR will be adjusted upward/downward by the cumulative differences on the test date.

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

6/ Arrears arising due to Iranian payment issue.

7/ See the TMU for how to measure year-on-year inflation. Note June 2017 onwards the MPCC and inflation is based on the new index (2013=100).

**Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program**

<b>Proposed Prior Action</b>			
Submit to Parliament a new Inland Revenue Act, complete with schedules for investment incentives and exemptions, with a view to simplifying and broadening the income tax in line with staff recommendations.			
<b>Structural Benchmark</b>	<b>Target Completion Date</b>	<b>Status</b>	<b>Comment</b>
<b>New structural benchmarks</b>			
MOF to implement an IT-based commitment control system with commitment ceilings for line ministries for the 2018 budget.	January 2018		The ITMIS modules for budget planning and commitment control will be operational for the 2018 budget. This enables MOF to transition from cash-based expenditure management to commitment-based control.
MOF to complete a report outlining the cost of non-commercial obligations for fuel and electricity.	September 2017		A step in a sequence of reforms to put the automatic fuel and electricity pricing reform back on track.
CEB and the Public Utilities Commission (PUC) to establish a Bulk Supply Transactions Account and start using it to settle transactions between generators, the transmission operator, and distributors as specified in the November 2015 tariff methodology.	March 2018		A step in a sequence of reforms to put the automatic electricity pricing reform back on track.
Develop a roadmap for flexible inflation targeting and flexible exchange rate regime that identifies timebound reform measures to be taken during the program period.	October 2017		An IMF TA mission for designing the roadmap took place in May 2017.
<b>Modified structural benchmarks</b>			
Submit to Parliament the 2018 budget that is in line with the program targets and includes: (i) a tax expenditure statement, (ii) a plan to rationalize tax expenditures in 2018 as agreed with IMF staff, and (iii) the estimated fiscal cost of non-commercial obligations (including subsidies) for SOEs.	November 2017		The structural benchmark for the 2018 budget is updated to incorporate the unmet structural benchmarks for a tax expenditure rationalization plan and publication of the noncommercial obligations for SOEs.

<b>Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)</b>			
Submit to Parliament the 2019 budget that is in line with the program targets and includes: (i) a tax expenditure statement, (ii) a plan to rationalize tax expenditures in 2019 as agreed with IMF staff, and (iii) the estimated fiscal cost of non-commercial obligations (including subsidies) for SOEs.	November 2018		The structural benchmark for the 2019 budget is updated to incorporate the unmet structural benchmarks for a tax expenditure rationalization plan and publication of the noncommercial obligations for SOEs.
Cabinet to approve automatic fuel pricing mechanism (agreed with IMF staff) that ensures retail prices above cost-recovery levels and a financial position of Ceylon Petroleum Corporation capable of covering debt service.	March 2018		The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms.
Cabinet to approve automatic electricity pricing mechanism (agreed with IMF staff) that ensures retail prices above cost-recovery levels and a financial position of Ceylon Electricity Board capable of covering debt service.	September 2018		The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms.
<b>Existing structural benchmarks</b>			
<b>Fiscal Policy Management</b>			
Submit to Parliament the 2017 budget in line with the program targets.	November 2016	Met	The 2017 budget was submitted to Parliament on November 10, 2016.
Submit to Parliament the 2018 budget in line with the program targets.	November 2017		To be replaced with the new structural benchmark for the 2018 budget (see above).
Submit to Parliament the 2019 budget in line with the program targets.	November 2018		To be replaced with the new structural benchmark for the 2019 budget (see above).
<b>Tax Policy Reform</b>			
Publish a tax expenditure statement as part of the official government budget.	December 2016	Met	Published as part of the 2017 budget.



<b>Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)</b>			
Approve by cabinet a time-bound strategy (agreed with IMF staff) to reduce or eliminate tax expenditures.	December 2016	Not met	In the context of the 2017 budget, Cabinet approved a plan to rationalize profit-based corporate tax incentives and tax exemptions for financial income in 2017. However, a comprehensive multi-year plan for reducing or eliminating tax expenditures has not been adopted. This remaining step is built into the benchmarks for the 2018 and 2019 budgets.
Submit to Parliament a new Inland Revenue Act with a view to simplifying and broadening the income tax.	March 2017	Not met (implemented as a prior action)	A complete draft of the new Inland Revenue Act that incorporates all 2017 budget measures and comments from IRD and the private sector has been prepared, supported by IMF TA. The submission of the Act, complete with schedules for investment incentives and exemptions in line with staff recommendations, is a prior action for the second review.
Complete by Ministry of Finance (MOF) a diagnostic review of the VAT system.	June 2017	In progress	IMF TA missions for VAT diagnostics took place during April–May 2017.
<b>Tax Administration Reform</b>			
Adopt by MOF Inland Revenue Department Key Performance Indicators on the number of risk-based VAT audit.	December 2016	Met	The Key Performance Indicators for risk-based VAT audit were included in the VAT compliance strategy for large taxpayers.
Adopt by MOF Inland Revenue Department a VAT compliance strategy that includes a time-bound plan to implement risk-based audit.	December 2016	Met	Draft VAT compliance strategies for large, medium and small taxpayers were developed with support from IMF TA in October 2016. Considering the IRD's capacity, a decision has been made to first implement the VAT compliance strategy to large businesses and then extend to small- and medium-sized businesses.

**Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)**

Fully roll out by MOF Inland Revenue Department new IT systems (RAMIS) for major domestic taxes (including income tax and VAT), including web-based tax filings for income tax and VAT.	December 2016	Met	
Adopt by MOF Inland Revenue Department compliance strategies for corporate and personal income taxes.	June 2017	In progress	A FAD TA mission visited Colombo in January to provide guidance on implementation of new Inland Revenue Act. The new Act contains increased powers for the Inland Revenue Department (e.g., interest and penalties on late filings) which should improve compliance in general. The compliance strategies for income taxes will be prepared as part of the implementation plan.
<b>Public Financial Management</b>			
Establish by MOF a commitment record system (with quarterly reports produced no later than one month after the end of each quarter) and quarterly expenditure commitment ceilings for the 2016 budget and the 2017 budget.	December 2016	Not met (implemented partially)	Through modification of the existing IT system (CIGAS) and manual reporting from line ministries, the MOF is now capable of tracking spending commitment for each line ministry on a monthly basis. The authorities plan to report to parliament on the status of commitments in each quarter beginning in 2017Q2 and put in place a system of commitment ceilings for line ministries for the rest of the year.
MOF to roll out ITMIS with an automated commitment control module for Ministry of Finance.	January 2017	Met	The system has been fully rolled out to all ministries including Ministries of Finance and Health. It is being operated in parallel to the existing IT system to ensure it is functioning properly, with plans to operationalize it beginning in 2018.
MOF to roll out ITMIS with an automated commitment control module for Ministry of Health.	January 2017	Met	The system has been fully rolled out to all ministries including Ministries of Finance and Health. It is being operated in parallel to the existing IT system to ensure it is functioning properly, with plans to operationalize it beginning in 2018.

**Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (continued)**

<b>State Enterprise Reform</b>			
Cabinet to approve a resolution strategy for Sri Lankan Airlines.	December 2016	Met	Substantial reforms have been undertaken under a strategy approved by the Cabinet in June 2015. The airline has taken restructuring measures (e.g., route and fleet optimization) and reduced operational losses under the oversight of the Ministry of Public Enterprise Development and a Cabinet Committee. The authorities will report the airline's financial performance to IMF staff on a quarterly basis.
Record the fiscal cost of non-commercial obligations (including subsidies) for SOEs in the central government budget, starting in 2017.	November 2016	Not met (implemented in effect for major SOEs)	The 2017 budget did not report the cost of the non-commercial obligations. Nonetheless, the Statement of Corporate Intent includes information on non-commercial obligations of the respective SOE. Therefore, the benchmark has been effectively fulfilled since the SCIs for the 5 large SOEs were published in April 2017. Publication of the non-commercial obligations is built into the benchmarks for the 2018 and 2019 budgets.
MOF, line ministries, and SOEs to sign and publish Statements of Corporate Intent for the six largest SOEs (Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lankan Airlines, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authorities).	December 2016	Met with delay	Draft Statement of Corporate Intents (SCIs) were finalized in December 2016 for each of the 6 SOEs except for Sri Lankan Airlines. Following Cabinet approval, the SCIs were signed in March 2017 and published in April 2017.
MOF to introduce automatic fuel pricing mechanism that ensures retail prices above cost-recovery levels and a financial position of Ceylon Petroleum Corporation capable of covering debt service.	December 2016	Not met	While the authorities have capacity to design an automatic fuel pricing mechanism, they have not decided on its implementation given political sensitivity. The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms to put the reform process back on track.

**Table 2. Sri Lanka: Existing Structural Benchmarks and Proposed Prior Action under the EFF-Supported Program (concluded)**

MOF to introduce automatic electricity pricing mechanism that ensures retail prices above cost-recovery levels and a financial position of Ceylon Electricity Board capable of covering debt service.	December 2016	Not met	While the authorities have capacity to design an automatic electricity pricing mechanism, they have not decided on its implementation given political sensitivity. The target date has been reset to allow time for public consultation and education, followed by a sequence of reforms to put the reform process back on track.
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## Attachment II. Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out a framework for monitoring the performance of Sri Lanka under the program supported by the Extended Arrangement under the Extended Fund Facility (EFF). It specifies the performance criteria and indicative targets (including adjustors) under which Sri Lanka's performance will be assessed through semiannual reviews. Monitoring procedures and reporting requirements are also specified.
2. The quantitative performance criteria and indicative targets specified in Table 1 attached to the Memorandum of Economic and Financial Policies (MEFP) are listed as follows.
  - a) a quantitative performance criterion on central government primary balance (floor);
  - b) a quantitative performance criterion on net official international reserves (floor);
  - c) a continuous quantitative performance criterion on new external payment arrears by the nonfinancial public sector and the CBSL (ceiling);
  - d) a monetary policy consultation clause;
  - e) an indicative target on central government tax revenue (floor); and
  - f) an indicative target on reserve money of the CBSL (ceiling).
3. Throughout this TMU, the central government is defined to include line ministries, departments, and other public institutions. The Central Bank of Sri Lanka (CBSL), state-owned enterprises, parastatals and other agencies that do not receive subventions from the central government are excluded from the definition of central government. Debt is defined in accordance with paragraph 8 of the Guidelines on Public Debt Conditionality in Fund Arrangements attached to Executive Board Decision No. 15688-(14/107), adopted December 5, 2014.

### I. PERFORMANCE CRITERIA

#### A. Performance Criterion on Central Government Primary Balance

4. The primary balance of the central government on cash basis is defined as central government revenues and grants minus expenditures and net lending, plus interest payments. Spending will be recorded in the period during which cash disbursements are made.
5. For the purpose of program monitoring, the primary balance of the central government on cash basis will be measured as the overall balance of the central government plus the interest payment of the central government. The overall balance of the central government is measured

from the financing side, as the negative of the sum of the items listed below. Here, net borrowings refer to gross disbursements minus principal repayments. For 2015, the primary balance of the central government on cash basis measured in this manner was Rs –241 billion (the overall balance was Rs –768 billion and the interest payment was Rs 527 billion).

- a) Net borrowings from issuances of Treasury Bills, Treasury Bonds, and Rupee Loans.<sup>1</sup> In 2015, the total amount of such net borrowings was Rs 257.6 billion.
- b) Net borrowings from Sri Lankan Development Bonds (SLDBs) and commercial borrowings including international sovereign bonds and syndicated loans. In 2015, the total amount was Rs 455.7 billion.
- c) Net borrowings from project and program loans. In 2015, the total amount was Rs 69.7 billion, after adjustment for program loans that were contracted and disbursed during 2014 but were recorded in the 2015 fiscal account (Rs 61.6 billion).
- d) Net increases in non-market borrowings, CBSL advances, government import bills, government overdraft from the banking system, cash items in process of collection, and borrowings from offshore banking units of domestic commercial banks. In 2015, the total amount was Rs –10.1 billion.
- e) Net decreases in the deposit of the central government in the banking system. In 2015, the total amount was Rs –4.4 billion (an increase in deposit).
- f) Net borrowings from all other bonds, loans, and advances contracted by the central government. In 2015, the total amount was Rs –0.5 billion (net repayment).

**The following adjustment will apply:**

6. If the actual amount of gross cash disbursement of project loans in 2017 is higher than Rs 230 billion, the floor on the primary balance of the central government for end-December 2017 will be adjusted downward by the difference between the actual amount and Rs 230 billion. The downward adjustment of the primary balance target will be capped at Rs 20 billion. If the actual amount of gross cash disbursement of project loans in 2017 is lower than Rs 230 billion, the floor on the primary balance of the central government for end-December 2017 will not be adjusted.

## **B. Performance Criterion on Net Official International Reserves**

7. For the purpose of program monitoring, net official international reserves (NIR) will be measured as the difference between (a) and (b) below, and will be called the “Program NIR.” At

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<sup>1</sup> Rupee Loans are a medium to long-term debt instrument issued with maturities more than two years on tap basis or as private placements by the CBSL on behalf of the government under the Registered Stock and Securities Ordinance.

end-2015, the Program NIR, evaluated at market exchange rates, stood at US\$ 2,893.1 million. At end-2016, the Program NIR, evaluated at market exchange rates, stood at US\$ 2,032.1 million. Targets for the Program NIR are set for cumulative flows from the end of the previous year. To calculate the cumulative flows, the Program NIR at the test dates and the end of the previous year are evaluated at the program exchange rates and gold price specified in paragraph 9.

a) The CBSL's conventional definition of the NIR, that is, (i) the difference between the gross foreign assets and liabilities of the CBSL and (ii) the balance of State Treasury's (DSTs) Special Dollar, Japanese Yen, and Chinese Yuan Revolving accounts, both expressed in terms of market values. Gross foreign assets of the CBSL consists of monetary gold; foreign exchange balances held outside Sri Lanka; foreign securities (valued in market prices); foreign bills purchased and discounted; the reserve position at the IMF and SDR holdings; and the Crown Agent's credit balance. Foreign exchange balances, securities, and bills denominated in Chinese Yuan are part of the gross foreign assets of the CBSL. Excluded from gross foreign assets will be participation in international financial institutions; holdings of nonconvertible currencies; holdings of precious metals other than monetary gold; claims on residents (e.g., statutory reserves on foreign currency deposits of commercial banks and central bank foreign currency deposits with resident commercial banks); pledged, non-liquid, collateralized or otherwise encumbered foreign assets (such as the government's war risk insurance deposit with Lloyds during 2001/02); and claims in foreign exchange arising from derivative transactions (such as futures, forwards, swaps and options). Gross foreign liabilities are all foreign currency denominated liabilities of the CBSL to non-residents (including currency swap arrangements with foreign central banks); the use of Fund credit; and Asian Clearing Union debit balance. Commitments to sell foreign exchange to residents arising from derivatives such as futures, forwards, swaps, and options, such as commitments arising from currency swaps with domestic commercial banks, are not included in the gross foreign liabilities. DST accounts are foreign currency accounts held by the Treasury and managed by the CBSL as an agent of the government. At end-December 2015, the NIR as per the CBSL's conventional definition, evaluated at market exchange rates, stood at US\$ 5,028.8 million. At end-December 2016, this amount was US\$4,529.0 million (evaluated at market exchange rates).

b) The CBSL's outstanding liabilities (i.e., net short positions) in foreign exchange swaps with domestic commercial banks, which stood at US\$ 2,135.7 million at end-December 2015 and \$2,496.9 million at end-December 2016.

**8.** The framework to wind down outstanding liabilities in foreign exchange swaps with domestic commercial banks will include discontinuing the provision of FX swaps on concessional terms and gradually reducing outstanding net short positions of FX swaps with commercial banks as described in the MEFP.

**9.** For the purpose of the program, all foreign-currency related assets and liabilities will be converted into U.S. dollar terms at the exchange rates prevailed on January 2, 2017 (January 3, 2017 for SDR), as specified in Table 1. Monetary gold will be valued at US\$1,151.84 per troy ounce, which was the price prevailed on January 2, 2017.

<b>Table 1. Sri Lanka: Exchange Rates</b> (Rates as of January 2, 2017)	
Currency	Sri Lankan Rupee per currency unit
U.S. dollar	149.9747
British pound	185.2338
Japanese yen	1.2835
Canadian dollar	111.7047
Euro	157.7659
Chinese yuan	21.5095
SDR 1/	200.49

Source: CBSL and IMF.  
1/ As of January 3, 2017

**The following adjustment will apply:**

**10.** If (i) the amount of foreign program financing by the central government, (ii) the amount of net borrowings from SLDBs and FCBUs by the central government, (iii) the amount of external commercial loans (including international sovereign bonds and syndicated loans) by the central government, and (iv) proceeds from commercialization of public assets—as set out in Table 2—are higher/lower in U.S. dollar terms than assumed under the program, the floor on the program NIR will be adjusted upward/downward by the cumulative differences on the test date. The proceeds from commercialization of public assets are defined as cash receipts from the sale or lease of publicly held assets to non-residents. Such assets will include, but not be limited to, publicly held land, public holdings of infrastructure or commercial real estate, and public or quasi-public enterprises. These adjustors will apply to the NIR floor for end-June 2017 and thereafter.

**11.** If the amount of amortization of official external debt by the central government in U.S. dollar terms—as set out in Table 2—is higher/lower than assumed under the program, the floor on the program NIR will be adjusted downward/upward by the cumulative differences on the test date. Official external debt refers to external debt owed to multilateral and official bilateral creditors, as defined in the *2013 External Debt Statistics: Guide for Compilers and Users*. These adjustors will apply to the NIR floor for end-June 2017 and thereafter.



<b>Table 2. Program Assumptions</b> (cumulative from the beginning of the year, in million US\$)			
	Jun. 2017	Sep. 2017	Dec. 2017
Foreign program financing by the central government	125	125	225
Net borrowings from SLDBs and FCBUs by the central government	627	627	627
External commercial loans (including Eurobonds and syndicated loans) by the central government	1,950	1,950	2,200
Proceeds from commercialization of public assets	0	200	200
Amortization of official external debt by the central government	529	889	1,065

## II. CONTINUOUS PERFORMANCE CRITERIA

### A. Performance Criterion on New External Payment Arrears by the Nonfinancial Public Sector and the CBSL

**12.** A continuous performance criterion applies to the non accumulation of new external payments arrears on external debt contracted or guaranteed by the nonfinancial public sector and the CBSL. The nonfinancial public sector is defined following the 2001 Government Finance Statistics Manual and the 1993 System of National Accounts. It includes (but is not limited to) the central government as defined in ¶13 and nonfinancial public enterprises, i.e., boards, enterprises, and agencies in which the government holds a controlling stake. External payments arrears consist of debt-service obligations (principal and interest) to nonresidents that have not been paid at the time they are due, as specified in the contractual agreements, subject to any applicable grace period. However, overdue debt and debt service obligations that are in dispute will not be considered as external payments arrears for the purposes of program monitoring.

## III. MONETARY POLICY CONSULTATION CLAUSE

**13.** The inflation target bands around the projected 12-month rate of inflation in consumer prices, as measured by the headline Colombo Consumers Price Index (CCPI) published by the Department of Census and Statistics of Sri Lanka, are specified in Table 1 attached to the MEFP. The new CCPI index (2013=100) will be used to measure actual inflation. For this purpose, the year-on-year inflation for each test date is measured as follows:

$$\{ \text{CCPI}^*(t) - \text{CCPI}^*(t-12) \} / \text{CCPI}^*(t-12)$$

where

t = the month within which the test date is included

CCPI(t) = CCPI index (all items) for month t

CCPI(t-k) = CCPI index (all items) as of k months before t

CCPI\*(t) = { CCPI(t-2) + CCPI(t-1) + CCPI(t) } / 3

CCPI\*(t-12) = { CCPI(t-14) + CCPI(t-13) + CCPI(t-12) } / 3

If the observed year-on-year inflation for the test date of end-June 2017 or end-December 2017 falls outside the outer bands specified in Table 1 attached to the MEFP, the authorities will complete a consultation with the IMF Executive Board which would focus on: (i) the stance of monetary policy and whether the Fund-supported program remains on track; (ii) the reasons for the deviation; and (iii) on proposed policy response. When the consultation with the IMF Executive Board is triggered, access to Fund resources would be interrupted until the consultation takes place and the relevant program review is completed. In addition, if the observed year-on-year inflation falls outside the inner bands specified in Table 1 attached to the MEFP for the test date of end-June 2017, end-September 2017, or end-December 2017, the authorities will complete a consultation with IMF staff on the reasons for the deviation and the proposed policy response.

## IV. INDICATIVE TARGETS

### A. Indicative Target on Central Government Tax Revenue

**14.** Central government tax revenue refers to revenues from taxes collected by the central government. It excludes all revenues from asset sales, grants, and non tax revenues. The revenue target is calculated as the cumulative flow from the beginning of the year. For 2015, central government tax revenue defined in this manner was Rs. 1,356 billion.

### B. Indicative Target on Reserve Money of the CBSL

**15.** Reserve money of the CBSL consists of currency in circulation (with banks and with the rest of the public), financial institutions' domestic currency deposits at the CBSL, and the deposits of following government agencies: the National Defence Fund (General Ledger Acc. No. 4278), the Buddha Sasana Fund A/C (General Ledger Acc. No. 4279); and the Road Maintenance Trust Fund (General Ledger Acc. No. 4281). At end-December 2015, reserve money defined in this manner stood at Rs. 673.4 billion.

**The following adjustment will apply:**

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

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

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

where  $\Delta M$  denotes the change in reserve money,  $r_0$  denotes the reserve requirement ratio prior to any change;  $B_0$  denotes the reservable base in the period prior to any change;  $\Delta r$  is the change in the reserve requirement ratio; and  $\Delta B$  denotes the immediate change in the reservable base as a result of changes to its definition.

## V. DATA REPORTING REQUIREMENTS

**18.** Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the Memorandum of Economic and Financial Policies and Letters of Intent. All the program monitoring data will be provided by the Ministry of Finance and the CBSL. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 3 and 4. For the purpose of monitoring the monetary targets under the program, data will be provided in the format shown in Table 5. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 6 and 7. For the purpose of monitoring the financial performance of three state-owned enterprises—the Ceylon Electricity Board, the Ceylon Petroleum Corporation, and the SriLankan Airlines—data will be provided in the format shown in Tables 8, 9, and 10, respectively.

**19.** Data relating to the fiscal targets (Table 3 and Table 4) will be furnished within no more than five weeks after the end of each month, except for the data on salaries and wages, goods and services, subsidies and transfers (and its subcomponents) that will be furnished within no more than seven weeks after the end of each month (the data on total recurrent expenditure and interest payments will be furnished within no more than five weeks after the end of each month). Data relating to the external and monetary targets (Tables 5, Table 6, and Table 7) will be furnished within no more than three weeks after the end of each month. Data relating to the three state-owned enterprises (Tables 8–10) will be furnished within no more than 2 months after the end of each quarter.

**Table 3. Sri Lanka: Central Government Operations 1/**  
(In millions of rupees)

<b>Total Revenue &amp; Grants</b>
Total Revenue
Tax revenue
Income Tax
Personal & Corporate
Corporate & non-corporate
PAYE
Economic Service Charge
Tax on interest income
Taxes on goods & services
VAT
Excise Taxation
Liquor
Cigarettes
Motor vehicles
Petroleum
Other
Other Taxes & Levies
NBT
Stamp duties
Telecommunication Levy
Motor vehicles Taxes & Other
Sales tax
Debit tax
Telephone Subscriber Levy
National Security Levy
Tax on treasury bills
Taxes on External Trade
Imports
Cess
Special Commodity Levy
PAL
Non-Tax Revenue
Property income
Fines, Fees & Charges
Other
Grants
<b>Total Expenditure</b>
Recurrent Expenditure
Salaries & wages
Goods & Services
Interest Payments
Subsidies & Transfers
Public Corporations
Public Institutions
Households
Capital Expenditure
Net lending
<b>Primary Balance</b>
<b>Overall balance</b>
<b>Total Financing</b>
Total Foreign Financing (Net)
Total Domestic Financing (Net)
Privatization

1/ As agreed for the purpose of monitoring the program.

**Table 4. Sri Lanka: Central Government Financing 1/**  
(In millions of rupees)

**1. Domestic instrument borrowings**

T-Bills (net)  
T-Bonds  
Rupee Loans  
Other

**2. Domestic non-instrumental borrowings**

Sri Lankan Development Bonds (SLDB)  
Non market borrowings  
CBSL advances  
Government deposit at CBSL  
Government import bills  
Cash items in process of collection (CIPC)  
Overdraft to government  
Short term loans  
Deposit with commercial banks  
Oversee Banking Units  
Other

**3. Net foreign financing**

Net T-Bill purchase by nonresidents  
Net T-Bond purchase by nonresidents  
International sovereign bonds  
Project loans  
Other

**Total financing (1+2+3)**

Memorandum items:

T-Bonds  
Gross borrowings  
Repayments  
Net borrowings  
SLDBs  
Gross borrowings  
Repayments  
Net borrowings  
ISBs  
Gross borrowings  
Repayments  
Net borrowings  
Project loans  
Gross borrowings  
Repayments  
Net borrowings

1/ As agreed for the purpose of monitoring the program.

**Table 5. Sri Lanka: Balance Sheet of the Central Bank of Sri Lanka 1/**  
(In millions of rupees)

**Net foreign assets****Foreign assets**

Cash and balances abroad  
 Foreign securities  
 Claims on ACU  
 IMF Related Assets  
 SDRs  
 RR on FCDs of banks  
 Receivables (Accrued Interest)  
 Derivative Financial Instruments

**Foreign liabilities**

IMF & nonresident a/c  
 SDRs  
 Liabilities to ACU  
 Payables  
 Derivative Financial Instruments

**Net domestic assets****Claims on Government**

Advances  
 Treasury bills & Treasury Bonds  
 Treasury Bonds  
 Cash items in collection

**Government deposits****Claims on commercial banks**

Medium and long-term  
 Short-term

**Other assets (net)****Reserve money**

Currency in circulation  
 Commercial bank deposits  
 Government agencies deposits

1/ As agreed for the purpose of monitoring the program.

**Table 6. Sri Lanka: Foreign Exchange Cashflows of the Central Bank and the Government 1/**  
(In millions of U.S. dollars)

**1. Total inflows**

Loans  
  Program  
  IMF  
  Project (cash component only)  
  Commercial borrowing (incl. new and rolled over SLDBs)  
Interest earnings, forex trading profits, cap gains  
Purchases of foreign exchange  
Change in balances in DST's A/Cs  
  Of which: Proceeds from commercialization of public assets  
Other inflows  
  Borrowing from SLDBs  
  Loans from FCBUs  
  Syndicated Loans  
  International Swaps/Commercial Loans/Sovereign Bonds  
  OMO FX swap transactions

**2. Total outflows**

Public Debt Service Payments  
  Amortization  
    Principal (foreign loans)  
    Settlement SLDBs  
    Settlement FCBU  
    Settlement of syndicated loans  
  
  Interest  
    Foreign loans  
    Domestic foreign currency loans  
      SWAP/Loan interest  
      ISB interest  
  Payments to the IMF/ change in valuation of liabilities  
  Foreign exchange sales to commercial banks  
  OMO FX swap transactions

**3. SWAP**

Inflow  
Outflow Including Interest

**3. Net flow at current rates (1-2)**

**Net International Reserves (at market exchange rates)**

**Net International Reserves (at program exchange rates)**

**Gross International Reserves (at market exchange rates)**

1/ As agreed for the purpose of monitoring the program.

Table 7. Sri Lanka: Gross Official Reserve Position 1/  
(In millions of U.S. dollars)

Date	Central Bank			Government				Gross Official Reserves		Liabilities				Net International Reserves	Overall balance	Memorandum Items -				
	Reserves managed by IOD		Reserve Position at I.M.F. & SDR hol.	Total	Crown Agent's Credit Balance	D S T's Special Dollar Revolving Cr.balance	DST's Yen Accounts	Total	(without ACU & DA & with Swap)	(with ACU & SWAP & without DA)	Other Deposits	Asian Clearing Union	Drawings from the IMF			International Currency Swap	Total	Swaps with Commercial Banks		
	Foreign Assets (FA) (with ACU & Without DA)	Domestic Assets (DA) (BOC & PB)																1st Leg (New)	2nd Leg (Maturity)	Outstanding stock (Short position)
	1	2	3	4	5	6	7	8	9	10	11	12	13			14	15			
			(1)+(2)				(4)+(5)+(6)	(8) - (10)	(3)+(7)											

1/ As agreed for the purpose of monitoring the program.



**Table 8. Financial Outturn of Ceylon Electricity Board 1/  
(In millions of rupees)**

**Total revenue**

Sale of electricity  
Other income

**Total expenditure**

Direct generation cost  
Generation, transmission, and distribution O&M cost  
Corporate expenses  
Interest on borrowings and delayed payments  
Depreciation  
Other cost

**Operating profit/loss**

**Liquidity position**

Borrowings from banks  
Payments to banks  
Outstanding debt to banks  
Purchases from CPC and IPP  
Payments to CPC and IPP  
Outstanding to CPC and IPP

1/ As agreed for the purpose of monitoring the program.

<b>Table 9. Financial Outturn of Ceylon Petroleum Corporation 1/ (In millions of rupees)</b>	
<b>Total revenue</b>	
	Octane 90
	Diesel
	Other products
	Other income
<b>Total expenditure</b>	
	Cost of sales
	Sales and distribution
	Administration
	Finance cost
	Depreciation
	Other cost
<b>Operating profit/loss</b>	
	Outstanding dues to state banks
1/ As agreed for the purpose of monitoring the program.	

**Table 10. Financial Outturn of Sri Lankan Airlines 1/  
(In millions of rupees)**

**Total revenue**

Passenger  
Cargo  
Other income

**Total expenditure**

Aircraft fuel cost  
Employee cost  
Other operating expenses  
Financial cost

**Operating profit/loss**

Capital contribution

1/ As agreed for the purpose of monitoring the program.