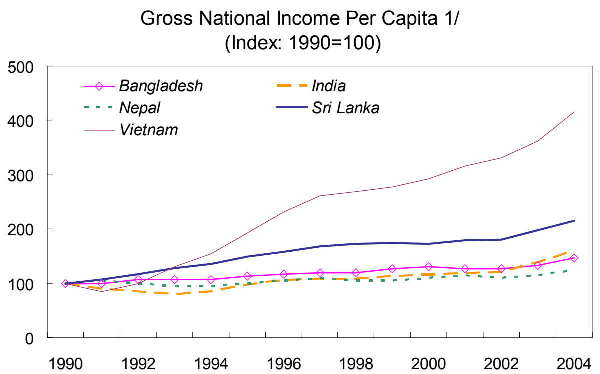
EXECUTIVE SUMMARY

- **Notwithstanding an escalation of hostilities, Sri Lanka's economy has continued to show resilience**. Military confrontations between the government forces and the Liberation Tigers of Tamil Eelam (LTTE) in the North and East have intensified recently, and progress to settle the conflict through multi-party negotiations remains limited. With only minor interruptions in most parts of the country, growth is projected at 7 percent. Financial markets have remained calm, though investor confidence has been somewhat weakened by increased uncertainties.
- **Growth has accelerated since mid-2005, reflecting in part tsunami-related reconstruction efforts**. This was initially accompanied by large capital inflows and lower inflation. More recently, however, while strong growth brightens the near term outlook, inflation has been rising, coupled with a slowdown in capital inflows and a rise in the debt service burden. Continued fast credit growth and a further increase in world oil prices are key risks, which may intensify the underlying imbalances. The high debt level and relatively low international reserves also add to vulnerabilities.
- **Macroeconomic policies in the near term should be geared toward reducing inflation expectations and external vulnerabilities**. Meeting the 2006 budget deficit target is appropriate to limit stimulus, and further interest rate adjustments may also be required to contain inflation. These policies should be supported by greater flexibility in the exchange rate to help safeguard external reserves and maintain competitiveness.
- **Over the medium term, the authorities aim to reduce poverty through raising potential growth**. This will require fundamental reforms to improve the business climate and promote private investment.
    - ***Fiscal consolidation***. The authorities stressed their commitment to bring the fiscal deficit down to 5 percent by 2010, which is essential for debt sustainability. This is best achieved through revenue enhancing policies and rationalization of current spending to protect critical development projects. The recent decision to implement the full pass-through of oil prices has removed a significant component of fiscal vulnerability. Other concrete measures, however, remain to be spelled out in the 2007 budget.
    - ***Banking reform***. Significant progress has been made to improve financial stability, but challenges remain, particularly in the two large state-owned banks. Fast credit growth could also undermine loan quality. An FSAP update will help reflect new challenges and vulnerabilities and prepare the system for the transition toward Basel II in 2008.
    - ***Infrastructure development***. Power bottlenecks, high energy cost, and large quasi-fiscal losses remain key constraints on growth. The authorities are implementing a new energy policy which aims at expanding capacity, employing low-cost alternative sources, and adjusting prices to help remove quasi-fiscal losses. Financing of this policy, however, implies an increase in commercial borrowing over the medium term. To ensure debt sustainability, critical steps will need to be taken to improve debt management, enforce a sound regulatory environment for private investors, and develop capital markets.

I. INTRODUCTION

1. **Notwithstanding decades of civil conflict, Sri Lanka's economy has shown resilience**. Growth performance has improved from an average of 4–5 percent in the 1980−90s to 6–7 percent recently. From a regional perspective, Sri Lanka's growth in income per capita has markedly exceeded the pace of its neighbors since the early 1990s, reaching $1,000 in 2004, and helping to lift thousands out of poverty. The human development index and other non-income social indicators have also improved over time, and they are now far ahead of those in other South Asian economies. However, income inequality has deteriorated in the last few years,[1] rural poverty remains high, and the urban-rural poverty gap and regional growth disparities widened. Meeting some of the Millennium Development Goals (MDGs) continues to be a challenge.



Source: World Bank, *World Development Indicators*.
1/ Atlas method.

Selected Social Indicators in Asia

	Sri Lanka	Nepal	China	India	Bangladesh	Bhutan	Pakistan
Human development index rank 1/	93	136	85	127	139	134	135
Life expectancy at birth 2/	74	62	71	63	63	64	65
Adult literacy rate 2/	91	49	91	61	...	...	50
Reduction in infant mortality 2/ (from 1970; per 1,000 live births) 1/	52	104	55	64	99	86	39
Infant mortality (per 1,000 live births) 2/	12	59	26	62	...	...	80
Poverty headcount ratio at national poverty line (in percent) 3/	25	42	5	29	50	...	33

Source: *Human Development Report 2005*, UNDP; and *World Development Indicators*, World Bank.

1/ 2003 data.
2/ 2004 data.
3/ 1990 to 2002 from the Human Development Report for the most recent year available in each country.

2. **President Rajapaksa's government has placed a strong emphasis on reducing poverty through raising economic growth over the medium term**. This is to be achieved by increasing growth to 8 percent, supported by a sharp increase in investment, especially in infrastructure (power and roads). The strategy also emphasizes the need to reduce regional inequalities, create income-generating activities to assist the poor, and promote small and medium enterprise development, along with a new energy policy to increase power generation while reducing its cost. A Development Forum is being planned for early 2007.

[1] See Chapter VI, *Regional Economic Outlook*, Asia and Pacific Department, September 2006. The Gini index for Sri Lanka increased by about 10 Gini points (the highest among the 18 Asian countries).

II. Recent Developments

3. **Since late 2005, there has been a sharp escalation in hostilities between the government and the LTTE**. The peace talks in June failed in the last minute, bringing the four-year ceasefire close to collapse and raising fears of a return to a full-scale civil war. The authorities have made further efforts to settle the conflict through multi-party negotiations. More recently, both sides communicated their willingness to resume peace talks during October 28−29 through their facilitators. While this has raised cautious optimism, risks remain. The intensity of fighting, in particular, continues to pose a threat to the peace efforts.

4. **The economy has shown strong resilience, with growth reaching 8 percent in the first half of 2006, but inflationary pressures are building** (Table 1, Figure 1). Improved agricultural performance, strong tsunami-reconstruction activities, and robust service sector growth, helped mitigate the impact of rising oil prices and the removal of export quotas for textiles and apparel. GDP growth is projected at 7 percent for 2006, reflecting some easing in the second half of 2006 in an environment of rising interest rates and high oil prices. Inflation declined in 2005, but has risen since early 2006 reflecting pressures from fast credit growth, the impact of the oil price pass-through, and increases in wages and pension payments.[2] Unemployment has declined to 7¾ percent at end-2005 (from 8½ percent in 2004), indicating a possible gradual tightening in the labor market. CPI inflation is projected at 12 percent for 2006.

5. **The external current account deficit has been widening, and reserves are below comfortable levels**. Despite robust growth in exports and remittances, the oil shock and strong non-oil (intermediate and capital goods) imports are expected to widen the current account deficit to 4¾ percent of GDP in 2006 (from 2.8 percent of GDP in 2005) (Table 2, Figure 2).[3] Tsunami-related inflows amounted to about $1 billion (including the debt moratorium and the Fund's Emergency Assistance) in 2005, equivalent to 4 percent of GDP. An additional $450 million tsunami-related inflows is projected in 2006, but the actual disbursements have so far been slow (Appendix I). With the debt service burden rising (due in part to the expiration of the Paris Club moratorium), the government has resorted to foreign currency borrowing from domestic banks (through syndication) and to the issuance of domestic dollar-denominated bonds to buffer the balance of payments. Gross official reserves have been hovering around $2.4 billion, equivalent to 2.4 months of imports and 86 percent of short-term debt. The rupee-dollar exchange rate has weakened somewhat since

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[2]Food-based CPI (70 percent of the total weight) increased by 7 percent during January-July 2006, while nonfood CPI increased by 17 percent, with sub-components in electricity, fuel products, and transportation rising by an average of 25 percent, reflecting mainly the impact of oil price pass-through during April-July.

[3]See Chapter I of the selected issues, "Macroeconomic Challenges of High Oil Prices in the South Asian Region."

the second half of 2005. Reflecting high domestic inflation relative to trading partners, the real effective exchange rate (REER) appreciated by 2 percent during the same period (Box 1).

6. **Despite monetary policy tightening, credit growth remains high**. The central bank raised its policy rate five times (cumulative 2 percentage points) during November 2004-December 2005, and by another 1 percentage point recently. Reserve money growth was brought down to below 15 percent at end-March 2006 (from 20 percent a year ago), but this trend has reversed since April reflecting increased central bank financing of the budget. Credit growth to the private sector (including housing loans) remains strong (about 24 percent in June), contributing to demand pressures (Table 3).

7. **The 2005 fiscal deficit widened to 8.7 percent of GDP, larger than budgeted, mainly because of tsunami-related spending**. Excluding tsunami-related flows, the budget deficit was contained at 7.5 percent of GDP (compared to 8.2 percent of GDP in 2004). Revenue increased, reversing the downward trend of previous years. But there were large overruns in oil subsidies and in the wage bill,[4] which were offset by cuts in other recurrent expenditures and a reduction in interest payments to protect capital spending (Table 4).

8. **The fiscal deficit in the first half of 2006 was contained through adjustment of capital expenditures**. Tax revenue grew at a healthy 23 percent, but still fell short of the budget target of 27 percent growth. There have been sizable overruns on recurrent expenditure, emerging from larger than budgeted oil subsidies and pensions, as well as additional security and humanitarian spending. However, a generous capital budget provided scope for adjustment (in line with project execution) and helped to contain the deficit. Excluding tsunami-related spending (1.7 percent of GDP), the budget deficit target would be 7.4 percent of GDP (similar to the actual in 2005). With slower than expected tsunami-related disbursements, domestic financing of the budget in the first six months reached Rs. 101 billion, compared with the budget estimate of Rs. 123 billion for the year.

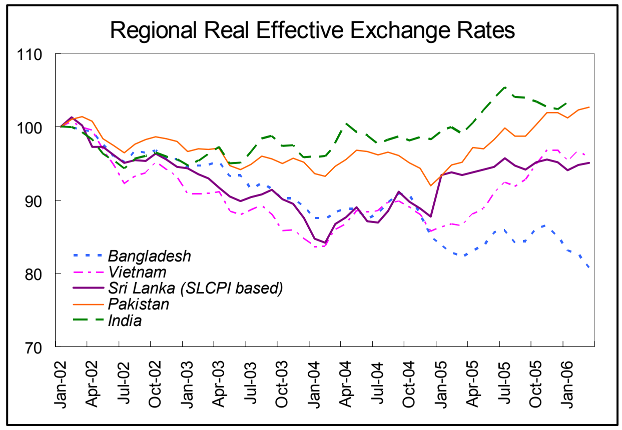
9. **Total public debt declined by 11 percent of GDP, but remains high at 94 percent of GDP in 2005**. Moreover, liquidity pressures are building. Out of the total $935 million foreign currency borrowing from domestic banks and local investors during 2004–05, about $780 million will need to be repaid in 2006 ($300 million of which in the last quarter). Sri Lanka was given its first international credit rating by Fitch (BB-) in December 2005, on par with Vietnam, Indonesia, Brazil, and Turkey. But with renewed security concerns, Fitch

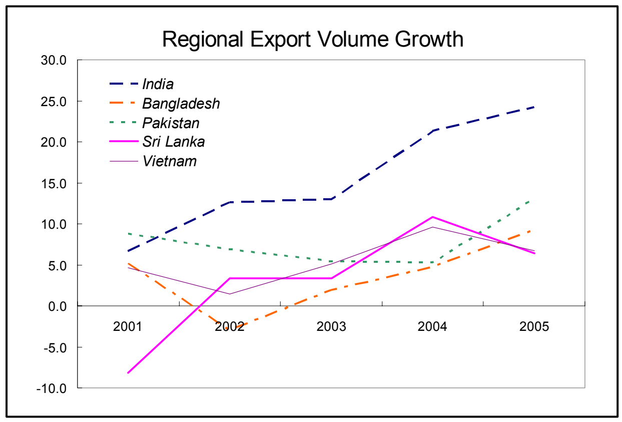
[4]This resulted from a 20 percent wage hike and the hiring of over 42,000 graduates to public services.

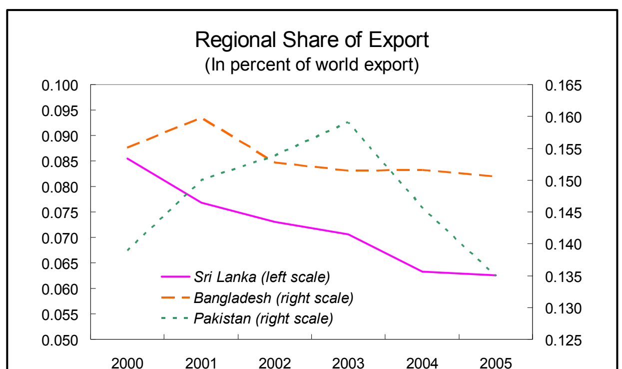
Box 1. Sri Lanka: Exchange Rate Assessment and External Competitiveness

Indicators of Sri Lanka's external competitiveness warrant close monitoring.

- **Sri Lanka's real effective exchange rate (REER) is in the middle range compared with its main regional competitors** (see figure). The REER (CPI based) depreciated by 23 percent during 1998–2004 before appreciating by 8 percent in the first half of 2005, following pledges of tsunami aid from donors (Figure 2). There was a further appreciation of 2 percent in the next 12 months up to June 2006, resulting mainly from higher relative price differentials. Given the extent of the previous depreciation, this recent appreciation is not of immediate concern but bears monitoring.







Source: IMF DOTS.

- **Unit labor costs in industry appear to be increasing and profitability decreasing**. Productivity growth in industry in 2005 declined by 5.6 percent which, together with increases in firm's costs arising from higher domestic interest rates, oil prices, and wages (from public-sector wage spillover effects) point toward declining profitability.

- **Export volume growth appears to be moderating, including in the garments sector**. With the elimination of the textiles quota, Sri Lanka's export growth in garments and textiles (45 percent of total goods exports) slowed to 3 percent in 2005 as compared to that of Bangladesh and Vietnam, which were at 15 percent and 12 percent, respectively. It is not clear to what extent this reflects underlying trends versus short-term fluctuations—garments industry representatives report strong order books, a growing niche market for Sri Lankan apparels, and increased backward linkages which would reduce costs and turnover periods. Furthermore, Sri Lanka has maintained its competitive edge in tea and spice exports, which accounts for about 15 percent of total exports.

- **Sri Lanka's market share in world exports appears to be declining**. Sri Lanka's share in total world exports (0.06 percent) declined by 27 percent during 2000–05, mainly from a loss of market share in the United States and EU. Over the same period, Bangladesh and Pakistan's share in total world exports was broadly maintained at 0.08 percent and 0.13 percent, respectively. This deteriorating trade performance reflects in part structural weaknesses and political vulnerabilities particular to Sri Lanka which have affected FDI and business sentiment, and in part to competition from rapidly growing Chinese and Indian exports.

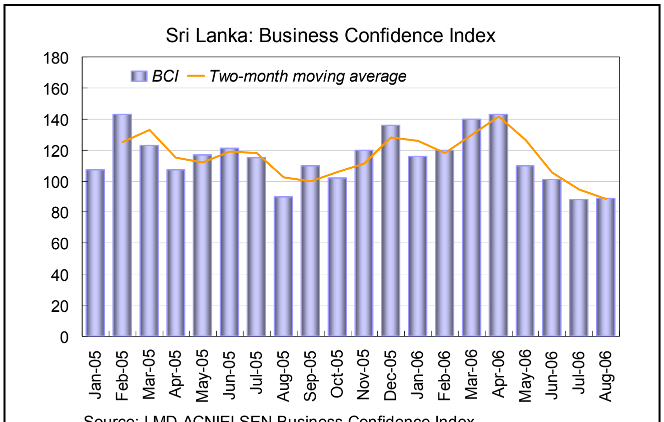
downgraded the country outlook for Sri Lanka to negative (from stable). The government decided to put the planned global bond issuance on hold and instead raised $580 million of dollar-denominated Sri Lanka Development Bonds (SLDB) during April-September 2006. The bonds carried a maturity of 2–3 years and an average interest rate of LIBOR+140 bps.

10. **Sri Lanka's financial markets have been holding up despite increased security concerns and volatility in international financial markets**. The Colombo Stock Exchange (CSE) has become one of the best performers in the region. The All Share Price Index rose by a cumulative 70 percent during 2004–05, and is up by another 25 percent so far in 2006, owing to a large extent to the performance of the telecommunication industry and the financial sector. The average P/E ratio of 12 is similar to those in Bangladesh and Pakistan, but lower than in India. The decline during the emerging market sell-off in May was modest (by only 2.5 percent), reflecting in part investor optimism over the near-term economic outlook, as well as the lack of alternative channels for other high yield investments in Sri Lanka.

III. Policy Discussions

A. Outlook and Risks

11. **While growth remains robust, near-term risks and vulnerabilities have increased since the last Article IV consultation**. Inflationary pressures are building; managing further oil price shocks remains a challenge; and reserves are below comfortable levels. The rising debt service burden, particularly during 2008−09, has intensified external vulnerabilities. Potential increases in military spending also add risks to the fiscal outlook. The setbacks in the peace process, which have caused some weakening in confidence, could further affect investment going forward.



Source: LMD-ACNIELSEN Business Confidence Index.

12. **Sri Lanka's medium-term prospects are favorable, provided that peace resumes, near-term risks are managed, and essential reforms are implemented** (Table 5). The country has significant untapped growth potential, including in the conflict affected areas in the North and East, and could also benefit from productivity gains by an educated labor force and rapid growth in major countries in the region. Staff projects growth to sustain at around 7 percent over the medium term, assuming macroeconomic stability and fiscal consolidation, but noted that growth could reach the authorities' 8 percent target or even higher if the above-mentioned challenges are overcome and fundamental reforms are advanced.

13. **Otherwise, medium-term prospects are subject to significant downside risks**. Fiscal consolidation is key to creating space for critical infrastructure investment and social spending without jeopardizing debt sustainability. Without it, higher fiscal deficits would increase the interest payment burden on the budget, crowd out private sector investment, and undermine financial sector development. Other reforms, addressing entrenched problems in the labor market, trade regime, and energy sector, will also help Sri Lanka to improve its growth potential.

14. **The authorities are aware of the risks to the economic outlook**. They emphasized that maintaining macroeconomic stability and increasing growth to 8 percent are the two pillars underpinning their medium-term strategy. They acknowledged that far-reaching structural policies will be required for improving the business climate for private investment and job creation. They are focusing on fiscal consolidation and debt sustainability, reforms of the banking sector and state-owned enterprises, infrastructure development, and reducing rural-urban income disparities. In addition, they are working on deepening regional integration, including with India and Pakistan. Against this background, the discussions centered on managing short-term risks and vulnerabilities, as well as some key elements of the structural reform agenda.

B. Fiscal Policy

15. **The authorities agreed that adhering to the 2006 fiscal deficit target would help address inflationary risks and strengthen the credibility of fiscal consolidation**. Revenue collections have improved significantly in the first seven months, with income tax and VAT growing at 47 percent and 12 percent, respectively. The ongoing expansion of VAT to the financial sector and services has already helped boost revenue. The authorities also plan to implement some within-year measures to strengthen risk assessment, reduce illegitimate VAT refunds, and modify the depreciation schedule for capital goods (e.g., with a reduction in the depreciation allowance). For the year as a whole, revenue is projected to improve by 1 percent of GDP (compared to a targeted increase of 1.8 percent of GDP in the budget).

16. **The authorities attributed the sizable recurrent spending overruns to date to certain unforeseen factors**. The most important was higher world oil prices, contributing to larger than anticipated oil subsidies. There were also increases in pension payments following the November election, and additional security-related spending more recently.

17. **Nevertheless, the government has taken measures to offset spending overruns**. Revenue collection efforts have been enhanced. Steps were also taken to achieve full price pass-through for major fuel products (see ¶18) and to rationalize fertilizer subsidies. They are confident that with these measures, together with further rationalization of low-priority projects, the fiscal deficit target of 9.1 percent of GDP will be met. They plan to intensify the implementation of tsunami-related projects to fully utilize committed donor resources in 2006.

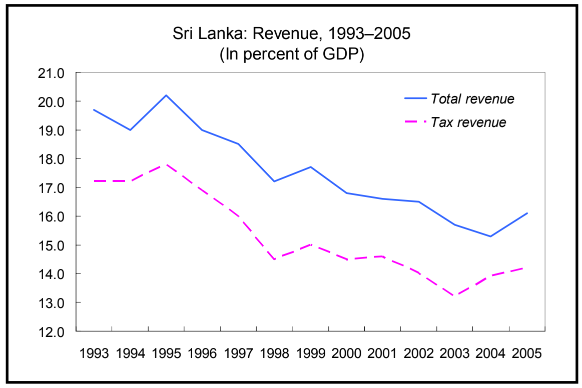
18. **Full price pass-through for major fuel products has virtually eliminated oil subsidies in the budget, starting from September 2006**. Domestic fuel prices were increased by 35 percent (weighted average) during April-September, achieving full pass-through for petrol and diesel, while substantially reducing subsidies for kerosene. To avoid amplifying price shocks, the authorities have removed VAT (15 percent) on diesel. Moreover, the pricing formula was revised to ensure cost recovery plus a profit margin for the two oil companies (one foreign), setting the stage for price liberalization starting from September.

19. **The authorities are committed to fiscal consolidation over the medium term**. They aim to bring the deficit down to 7½ percent of GDP in 2007 and to 5 percent by 2010—essentially the same consolidation path as stipulated under the Fiscal Management Responsibility Act (FMRA), but with a two-year delay. Staff supported this consolidation path, and noted that this is best achieved through two-pronged reforms to broaden the tax base and strengthen tax administration, while rationalizing recurrent expenditure (Box 2). Staff discussed options including reducing exemptions, simplifying VAT rates while broadening the VAT base, and introducing the TIN to enhance administration. The authorities agreed in principle that quality changes are required, but found it difficult to implement some measures, like simplifying VAT rates, as early as 2007 without adequately analyzing the revenue implications of different rate options. They indicated that extending VAT to wholesale and retail stages would not be feasible in the near term as it would require changes in the constitution to modify the power of provincial councils over sales taxes to prevent potential double taxation at both the central and local levels. In addition, a revenue sharing mechanism between the central and local governments will be needed. Noting exemptions were rising, staff also underscored the need to review the exemption criteria in the context of the 2007 budget.

20. **Increased infrastructure and social spending have placed a premium on the need to rationalize recurrent expenditure**. In view of Sri Lanka's public sector hiring, which significantly outpaced growth in population and labor force in the past five years, staff advised to restrain real growth in wages and salaries with limited hiring. In addition, efforts are needed to improve targeting and delivery of subsidies and social programs. Interest costs could also be reduced through strengthened debt management to replace the expensive short-term bank loans in foreign currency with less expensive, longer term, instruments. The authorities responded that efforts have been made in these areas. In particular, they are targeting an overall nominal wage increase of 20 percent over the next three years (2007−09) for the public sector, supported by limited recruitment. Negotiations have started with labor unions of SOEs and public banks. Moreover, improvements in the targeting for fertilizer subsidies are also envisaged in the 2007 budget.

Box 2. Sri Lanka: Challenges with Tax Revenue Mobilization

Tax revenue mobilization remains a challenge in Sri Lanka, posing a constraint to government goals of fiscal consolidation. At 14.2 percent of GDP in 2005, central government tax revenue in Sri Lanka is higher than in India and Bangladesh, but remains much lower than levels observed in the 1990s (averaged 19 percent of GDP), reflecting to a large extent the impact of trade reforms through reductions in tariffs. This declining trend in tax revenue was reversed in 2005 (for the first time since 1999), largely due to better performance in income and excise taxes, as well as in other taxes.



In the first seven months of 2006, tax revenue grew by a healthy 23 percent, but still lower than the ambitious budget target. Tax revenue is projected to improve by 1 percent of GDP to 15.2 percent of GDP in 2006 based on improvements in all tax categories, except VAT which is expected to remain flat as a ratio of GDP.

VAT collection, the largest category in all taxes, accounts for about 41 percent of total tax revenues. The coverage of VAT, however, remains narrow with many exemptions causing cascading effects. In particular, wholesale and retail trade remains outside the VAT net and are taxed on the basis of turnover by the provincial governments. There are many nonstandard exemptions, including in the agricultural sector (including inputs), imported capital goods, pharmaceuticals, lease of residential accommodation, import by persons having an agreement with the Board of Investment, pearls and precious stones, essential food items (e.g., rice, flour, milk, bread, fish, vegetable, tea, potatoes, onions, etc). Moreover, Sri Lanka currently has three VAT rates (5, 15, 20), plus a zero rate for exporters and domestic buyers of capital inputs, complicating VAT administration and increasing the scope for fraud. Despite these weaknesses, the efficiency ratio of Sri Lanka's VAT (defined as the ratio of VAT revenue to GDP divided by the standard rate), at 0.39, is in line with the regional average in Asia and Latin America (both at 0.38) and Eastern and Central Europe (at 0.4).

Fiscal consolidation over the medium term requires a significant strengthening in tax revenue on a sustainable basis. This could be achieved through tax base broadening, further improvements in tax administration, and a more intensive and efficient use of information technology. Options discussed with the authorities include:

* Unifying the VAT rates to simplify administration and improve compliance;
* Broadening the VAT base, including trimming exemptions and extending to wholesale and retail sectors, and introducing a low presumptive tax for companies below the VAT registration threshold;
* Improving VAT audit by adopting a sound risk assessment framework to enforce governance and reduce fraud in the refund system;
* Introducing the Taxpayer Identification Number (TIN) to individual income tax payers; and
* Tightening the eligibility criteria for corporations under the Board of Investment with the aim to curtail further proliferation of tax exemptions.

21. **Fiscal consolidation and strengthened debt management are critical for medium-term debt sustainability**. Staff noted that chronic fiscal deficits have propelled public and publicly guaranteed debt to over 90 percent of GDP, and interest payments have reached one third of tax revenue. With GDP per capita already above $1,000 in 2005, Sri Lanka is likely to move towards middle-income status in the next few years, implying potentially less concessional financing. Therefore, a meaningful fiscal consolidation is essential. The authorities explained that the amount borrowed during 2004–05 was in part to cushion the oil shock. Recently, they have sought to mobilize less expensive resources through issuance of foreign-currency-denominated SLDBs of longer maturity (2–3 years). Staff noted that while this strategy gives a breathing space in 2007 and reduces interest costs as compared to treasury bonds of similar maturity, debt service pressures in foreign exchange are expected to rise sharply from 2008, and likely to exert pressures on the balance of payments. It is important to gradually unwind such borrowing while limiting it for general budget support. The authorities were also encouraged to coordinate closely with donors to establish a framework, aimed at fully utilizing the committed external concessional financing in the pipe line.

22. **The authorities emphasized that implementing the new energy sector policy will require additional financing of about $800 million during 2007–2010**. They are currently exploring various long-term financing options, including sharing mechanisms with investors, tapping international capital markets, and developing the corporate bond market. Staff supported these approaches, and indicated that a well-developed domestic bond market would provide a system for shared risks and improve the allocation of capital to its most productive users, thereby stimulating productivity. Moreover, it would be an important vehicle to support private sector development. Early implementation of this policy will help prepare Sri Lanka for the potential decline in concessional financing as the country moves toward middle-income status. The Fund is ready to provide technical assistance if needed.

23. **The DSA presented to the authorities highlighted the sensitivity of debt dynamics to the fiscal deficit, growth, and exports**. The fiscal consolidation indicated above would yield a declining path for Sri Lanka's total public and public guaranteed debt, falling from 94 percent of GDP in 2005 to 74 percent of GDP in 2010. With a modest level of commercial borrowing from 2007 onwards (including financing for the planned energy sector projects), debt-service-to-exports is projected to remain at around 13 percent over the medium term, below the DSA indicative threshold for debt service distress (at 20 percent) for a medium performer under the 2005 CPIA Index. However, extreme stress tests, including lower GDP growth, lower exports, and exchange rate and deflator shocks, could bring this ratio to around 21 percent (Table II.1, Appendix II), indicating a risk of debt distress.

C. Monetary and Exchange Rate Policies

24. **The authorities agreed that monetary policy should be geared toward reducing inflation expectations**. In light of pressures from the oil price pass-through and fast credit growth, further monetary tightening will be required. Interest rate hikes could also be

justified in an environment of rising global and regional interest rates. The authorities are committed to bring down reserve money growth to around 16 percent by end-2006 (from 18 percent at end-June) and adjust interest rates as needed. They also intend to step up open market operations to reduce excess liquidity in the banking system. Staff noted that loan growth to the housing sector has outpaced the overall credit growth by a significant margin, posing potential risks to uneven economic development among sectors and potential rising of NPLs.

25. **The authorities underscored their commitment to a market-based exchange rate and to limit intervention to reduce volatility**. They concurred that greater flexibility in the nominal exchange rate will help safeguard external reserves and reduce external vulnerability.[5] The authorities explained that the intervention undertaken during May-July was to reduce volatility in response to market pressures arising from lumpy tsunami-related imports. Net sales in August were markedly reduced, although there has been some pick up in September. They also noted that steps are being taken, including increasing official banking services and lowering the cost and time period for transfers, to facilitate a continuation of strong inflows of workers' remittances to help mitigate future shocks.[6] Sri Lanka maintains requirements for the deposit of margin by importers of certain goods. These requirements affect approximately less than 3 percent of total imports. They give rise to an exchange restriction that is subject to Fund approval under Article VIII, Section 2(a) of the Fund's Articles of Agreement.*

26. **Staff shared its analysis on Sri Lanka's real exchange rate and medium-term competitiveness, highlighting the likely intensified competition in global markets**. Staff agreed with the authorities that exchange rate competitiveness is not an immediate concern in view of the small variations in the REER in the last 12 months and the current trend of export performance. However, the decline in labor productivity and the rise in unit labor costs warrant close monitoring. The authorities appeared less worried about the recent drop in the export market share of garments and textiles, noting that order books look promising for the year, and that Sri Lanka still maintains a niche market in apparel. They also expect the Generalized System of Preferences (GSP) to yield positive results. Moreover, Sri Lanka's tea exports to major European and Middle East markets have performed well to date.

[5]Based on developments in the past three years, the exchange rate regime in Sri Lanka has been reclassified under the Fund system as managed float since June 2006 (from the previous free float).

[6]See Chapter III of the selected issues, "Are Workers' Remittances a Hedge Against Shocks? The Case of Sri Lanka."

*On November 9, 2006, the Fund approved the retention of the exchange restriction until November 2, 2007 or the completion of the next Article IV consultation with Sri Lanka, whichever comes earlier.

D. Financial Sector Policies

27. **Banking sector soundness has improved, and progress has been made in strengthening the supervisory framework**. The NPL ratios of the state-owned banks declined from 18 percent in 2003 (15.6 percent including foreign currency banking units) to 8 percent in June 2006, and reached similar levels to those of domestic banks. Capital adequacy ratios have also improved (to 8.3 percent of total assets), and steps have been taken to further enhance the regulatory and supervisory framework, including plans to adopt the Basel II capital accord by 2008 (Box 3). However, risks remain. While credit growth is a welcome sign of financial deepening, credit acceleration in the housing sector is a concern. Supervision will need to be strengthened to mitigate risks of a potential rise in NPLs, including raising loan-specific capital buffers or increasing provisions for fast growing credit categories. Moreover, the banking system continues to be characterized by high spreads which are almost double those in other economies in the region. Fostering consolidation in the banking industry would help rationalize the cost structure and improve competitiveness. Given the current structure of cross holding of assets by the banking groups and conglomerates, it is also important to implement a consolidated supervision framework to monitor financial risks among these entities.

28. **Continued efforts in restructuring the two large public banks remain important for financial sector stability** (Box 3). While their NPL ratios have declined and provisioning and profitability have improved, loan practices and risk management remain weak, and the low capital adequacy ratio in the People's Bank is still a risk. Staff encouraged a stepped up effort toward implementing the restructuring program for the People's Bank, supported by AsDB. The authorities indicated that they are moving toward implementing Basel II in 2008, and that will cover the two public banks with respect to all prudential measures. They also agreed that an FSAP update in 2007 would be useful to verify the improvements and examine new challenges and vulnerabilities in these banks.

29. **Staff sought clarification regarding the new role of SEMA as a holding company of strategic SOEs, including public banks**. The importance of addressing the risk of conflict of interests was emphasized, as this arrangement could potentially open the door for connected lending between the industrial groups and public banks all under the purview of SEMA. In this regard, it is critical to ensure the role of the CBSL as the sole regulatory power to supervise and regulate operations of all public banks under SEMA.

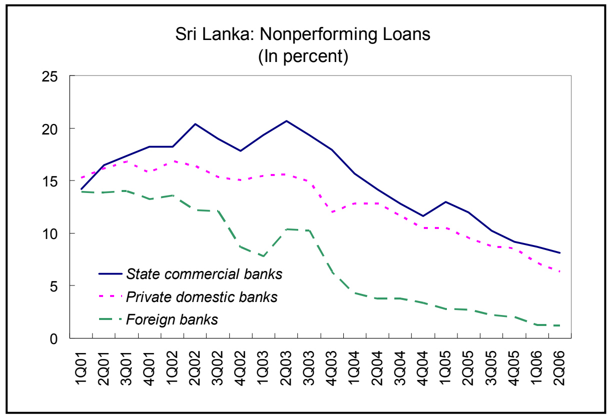
E. Structural Policies

30. **Infrastructure development (power and roads) is a central element of the government's medium-term development strategy**. Their emphasis is on restoring the financial viability of the power sector while expanding generation capacity by using more

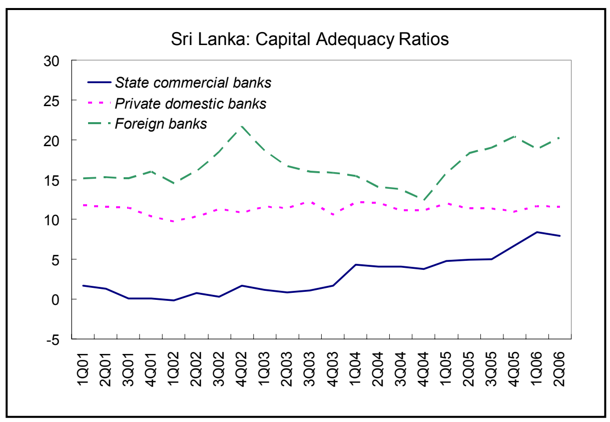
Box 3. Sri Lanka: State-Owned Banks

The financial situation of the Sri Lankan banking sector depends crucially on the performance of the state-owned banks. The banking sector is dominated by two commercial state-owned banks, Bank of Ceylon and the People's Bank, together accounting for about a third of banking system assets. Both banks have had a long history of recapitalization and restructuring. For both banks, recapitalization in the 1990s was not combined with effective restructuring, resulting in underperformance, and negative equity in the case of the People's Bank. The 2002 FSAP identified these banks as the key vulnerability in the banking system.

Progress has been made in the restructuring of the two state-owned banks recently. For People's Bank the restructuring plan calls for recapitalization with a loan from the Asian Development Bank over a period of five years. The first tranche of equity capital investment—of about $20 million—took place in December 2005 upon completion of some of the benchmark targets. The restructuring plan formulated for Bank of Ceylon in 2004 included targets in the areas of asset reconstruction, systems upgrading, human resource development, and capital enhancement, to be achieved within a two-year period. The bank was able to achieve its targets for 2005. There have also been changes in the Board and senior management of both banks that appears to have strengthened these institutions.



Both banks have seen improvements in their financial performance. The NPL ratios of the state banks have improved from 18 percent in 2003 (15.6 percent including foreign currency units) to 8 percent in June 2006 and have reached similar levels to those of domestic private banks. However, they are high compared to the 1 percent NPL ratio of foreign banks operating in the country. At the same time, provisioning has increased from 70 percent of all NPLs to 80 percent. As a result, net NPLs (net of interest in suspense and loan loss provisions) have declined below 2 percent. People's Bank reported a positive net worth of about Rs. 4 billion in 2005, from a negative net worth of Rs. 6 billion in 2001. The capital adequacy ratio of Bank of Ceylon has increased to 12 percent, above the regulatory minimum of 10 percent, and that of People's Bank turned positive following the recapitalization and has since reached 2 percent. Profitability rations have also increased on the back of a stronger economic and robust credit growth.



Notwithstanding these improvements, the state banks face entrenched structural weaknesses and operating challenges. They still suffer from large stocks of bad debt, poor risk management practices, inadequate information technology, and very difficult labor problems that stand in the way of modernization and restructuring. This is compounded by weaknesses in the legal system and framework for dealing with insolvencies and loan recoveries. Furthermore, lending by state-owned banks to state-owned enterprises increases the risks of the banking system.

cost-efficient sources (including coal power). The authorities indicated that, following the initial increase in electricity tariffs in September, further adjustments are envisaged with a view to eliminate future quasi-fiscal losses by 2007–08 (currently estimated at ½ percent of GDP in 2006). Staff encouraged the authorities to also speed up operational restructuring of the power companies to reduce system losses and improve efficiency, and strengthen the regulatory guidelines to promote private investment including FDI. The road projects are progressing well with the support of the World Bank and AsDB. The authorities expect that the forthcoming development forum will help map out the financing requirements of their development strategy with donor support.

31. **Reducing rural-urban income inequality remains a priority of the government**. While recent price increases for energy products bringing fiscal and efficiency gains, they could exert significant impact on the poor by lowering their real income. This is of concern in Sri Lanka as the income gap between the rich and the poor has widened during the last decade. Staff suggested that safety net measures be introduced to cushion the real income impact on the poor.[7] Several scenarios estimating the social impact of energy price adjustment were discussed, with a view to identify ways to address this issue in the 2007 budget. The authorities indicated that some cash payments may be considered in 2007 for targeted low income households, and that they will review more thoroughly other affordable and transparent safety net means in the context of their development plan.

32. **Sri Lanka's performance in the post-MFA environment highlights potential challenges in the period ahead**. Recent data indicate that textile and garment exports grew at only about 4 percent in January-July, and Sri Lanka's market share in apparel to the United States and EU may continue to decline given increased competition and lack of full-utilization of the GSP access due to issues regarding rules of origin.[8] The authorities explained that plans have been developed recently to strengthen the backward linkages of the garments sector with textile factories to help reduce input costs and turnover periods. Also, poor infrastructure, particularly weaknesses in port operations, raises the cost of manufacturing and exporting, and plans are underway to address these issues.

33. **Maintaining a liberal trade system is critical for Sri Lanka to benefit from regional and global trade**. In this regard, the recent ad hoc increases in fees placed on a number of consumer imports (cesses) have complicated the system and sent wrong signals to the private sector. The authorities reiterated their continued commitment to an open trade regime. They were less concerned about the cesses, arguing that these fees cover limited

[7]See Chapter II of the selected issues, "The Fiscal and Distributional Impacts of Fuel Subsidy Reform and Alternative Mitigating Measures."

[8]This refers to the minimum threshold for locally produced materials and value added which cannot always be met by Sri Lanka's garment exporters.

consumer goods and are earmarked for specific use including export promotion and development related activities. The staff encouraged them to review this issue with assistance from the World Bank. A number of bilateral trade negotiations are ongoing, including with India and Pakistan.[9] In this context, staff advised that moving to a low uniform tariff structure will help minimize distortions and inefficiencies.

IV. Staff Appraisal

34. **Sri Lanka's near- and medium-term economic prospects depend critically on progress on the peace front and on implementing essential reforms**. The authorities' medium-term framework rightly places its emphasis on raising growth and reducing vulnerability through fiscal consolidation, infrastructure development, supporting rural and small and medium enterprises, and creating income-generating activities to assist the poor. This strategy, however, is yet to be fully articulated in terms of well-defined measures to create the fiscal space needed for increased investment and social spending. Achieving 7−8 percent growth will also require an improvement in investment efficiency and productivity. In this context, policies will need to be fleshed out to further reform the financial sector, rationalize the trade regime, and improve the business climate to lift the growth potential over the medium term.

35. **Macroeconomic policies in the near term should be geared toward reducing inflationary expectations and external vulnerabilities**. The economy has shown remarkable resilience against adverse shocks. However, with the strong growth momentum, demand pressures are increasing as evidenced by rising inflation and a widening current account deficit. Continuing the current policy stance with fast credit growth would pose upside risks to inflation. In this context, the recent increase in policy rates is appropriate, signaling the commitment of the authorities to price stability. Nevertheless, further interest rates hikes may still be needed to firmly contain credit growth and keep inflation expectations in check.

36. **The current exchange rate regime has served Sri Lanka well and remains appropriate in the period ahead**. The authorities should limit intervention in the foreign exchange market to smoothing excessive volatility, and allow greater flexibility in the exchange rate to help safeguard external reserves and maintain competitiveness, particularly in view of the declining trend in Sri Lanka's export market share and rising unit labor costs. In view of potential external shocks and an expected rise in debt service burden over the medium term, a sustained drop in external reserves below the current level should be avoided. With regard to the exchange restriction arising from the requirments that importers

[9] South Asian Free Trade Agreement (SAFTA) came into effect on January 1, 2006. Under the agreement, India, Pakistan, and Sri Lanka will bring down their customs duties significantly.

of certain goods deposit margin, the authorities have committed to eliminate the measures shortly. Staff is looking into whether the exchange restriction warrants approval in accordance with Fund policies.*

37. **The authorities' commitment to adhere to the 2006 budget deficit target is appropriate, and the 2007 budget should firmly advance to fiscal consolidation**. This will help achieve a more balanced policy mix for growth and stability. Recent steps toward full pass-through for major petroleum products have removed a major element of fiscal vulnerability. For the 2007 budget, the tendency to rely on overly optimistic revenue projections to deliver adjustment should be avoided, as this complicates fiscal management when the envisaged revenue yields do not materialize. The budget will need to focus on adopting revenue measures that simplify the tax system, enhance administration, and improve tax buoyancy through base broadening. Reducing exemptions should be a priority, which could be implemented without delay. Sustainable fiscal adjustment will also require greater spending efficiency, including restraining real wage growth through limited hiring and improving targeting for subsidy programs. This will help free resources for productive investment as well as deficit reduction. Rural development also represents a potentially large expenditure commitment, and should proceed in line with revenue enhancing efforts.

38. **Debt sustainability in Sri Lanka hinges on the strength of fiscal consolidation and policies to improve potential growth over the medium term**. While the authorities' medium-term fiscal consolidation path provides a strong rationale for reform, implementation is key. To date, however, concrete fiscal and structural measures supporting this adjustment path remain to be spelled out. Insufficient fiscal adjustment could lead to adverse debt dynamics, further compromising the ability of the government in meeting its poverty reduction and MDG objectives. Moreover, increased debt service pressures in the next few years could complicate debt management. A well-defined medium-term fiscal policy framework, supported by an improved debt management policy, will be important to help manage this situation. Further recourse to commercial borrowing for budgetary purposes should be limited. Capital market development, in particular the corporate bond market, could help channel private investment envisaged under the medium-term development plan.

39. **Good progress has been made in strengthening financial sector stability and in implementing the 2002 FSAP recommendations**. Enhancing the regulatory and supervisory framework and restructuring the two large public banks have contributed to visible improvements in financial soundness indicators and declined NPL ratios across the banking

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*On November 9, 2006, the Fund approved the retention of the exchange restriction until November 2, 2007 or the completion of the next Article IV consultation with Sri Lanka, whichever comes earlier.

system. Building on this positive momentum, efforts could be made to further strengthen prudential standards to mitigate risks posed by rapidly rising credit and enlarged exposures. Strengthening the framework for the consolidated supervision is also critical for monitoring system risks, including among the banking groups and financial conglomerates. Satisfactory progress in meeting the Basel Core Principles is an essential prior to the planned adoption of Basel II in 2008. Moreover, banking industry consolidation could help rationalize the cost structure and prepare banks for regional competition. Restructuring efforts for the two large public banks will need to focus on credit risk management to ensure that new lending policies will significantly improve the quality of the loan portfolio, and improving the framework for dealing with insolvencies and loan recoveries. In this context, an early FSAP update would be beneficial. It is also important to clarify the role of SEMA as a holding company for both strategic SOEs and public banks, and the CBSL's sole regulatory power should be protected.

40. **The energy sector plays a vital role in economic growth**. In the next few years, the cost of energy will remain high and quasi-fiscal losses could continue if electricity prices remain below cost recovery levels. Further adjustments in tariffs, combined with balance sheet restructuring and enhanced operational efficiency, is key to eliminate these losses and generate internal funds for investment. Remaining quasi-fiscal losses could be brought on budget. Design of the new tariff structure should consider provisions to protect low-income groups. In addition, with the new formula to liberalize domestic fuel prices based on commercial principles, any temptations to interfere should be limited. Strengthening regulatory guidelines for the energy sector could also help promote a broadening of the investor base for needed long-term energy sector financing.

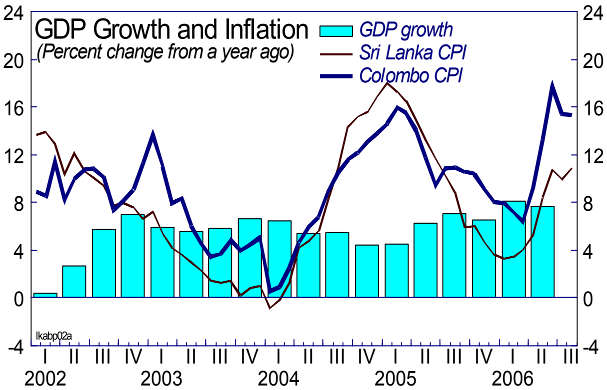
41. **An open trade regime with minimum distortions will best serve Sri Lanka to benefit from regional and global growth**. Consideration could be given to curtail the cess regime with an aim to integrate these fees in the tariff structure. Over the medium term, a single low tariff structure could be considered to help maximize efficiency.

42. **Staff encourages the authorities to further develop their medium-term policy framework into a comprehensive growth and poverty reduction strategy**. Sri Lanka has made significant progress in the last decade to improve its social indicators and revitalize the economy, and the government's emphasis on reducing poverty and narrowing the rural-urban income inequality will go a long way to support a sustainable economic development. Moving forward, the authorities are encouraged to build consensus for needed policies to support their growth and poverty reduction objectives. This strategy will also benefit from more regular and broad-based participatory consultations with relevant parties to spell out policy debates. Provincial and district-level participation is also important for targeting and costing of poverty reduction policies.

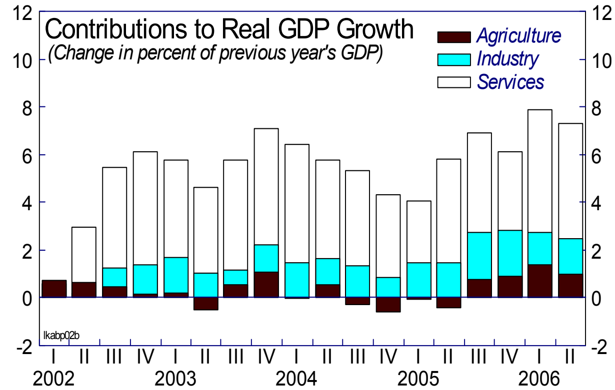
43. It is recommended that the next Article IV consultation with Sri Lanka take place on a standard 12-month cycle.

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

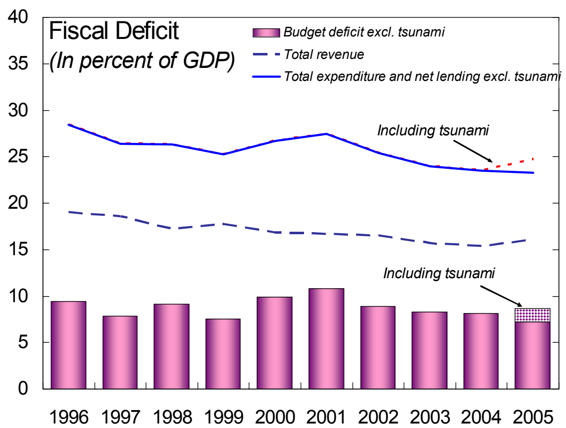
GDP growth continued to be strong and inflation subsided by end-2005. The trend in inflation has, however, reversed in 2006.



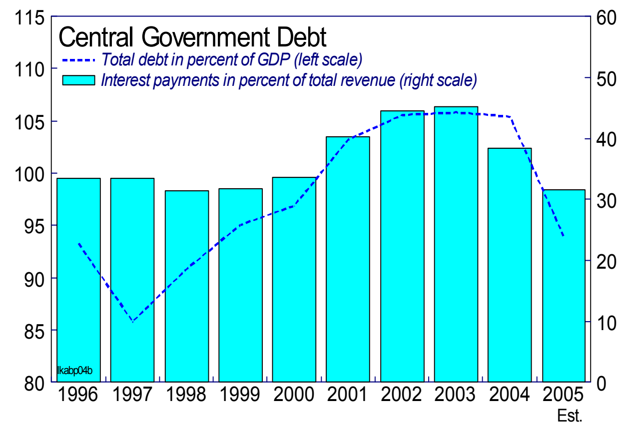
All main sectors performed better than in 2004 and this has continued in the first quarter of 2006.



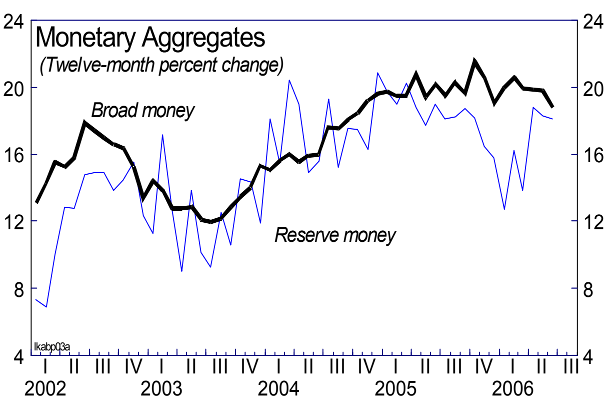
The fiscal deficit, excluding tsunami-related spending, was contained in 2005.



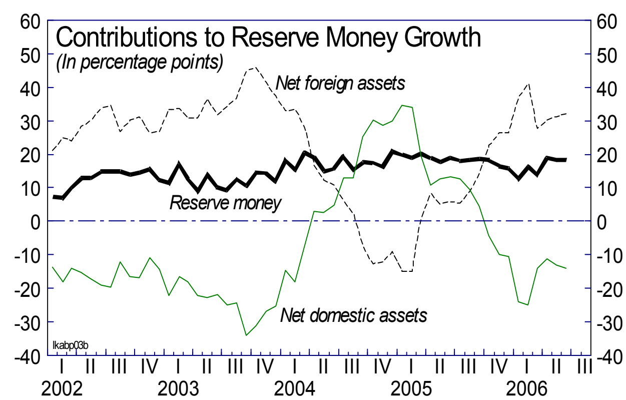
Public debt declined owing to strong growth.



Monetary policy was tightened...



...through active open market operations and policy interest rate.

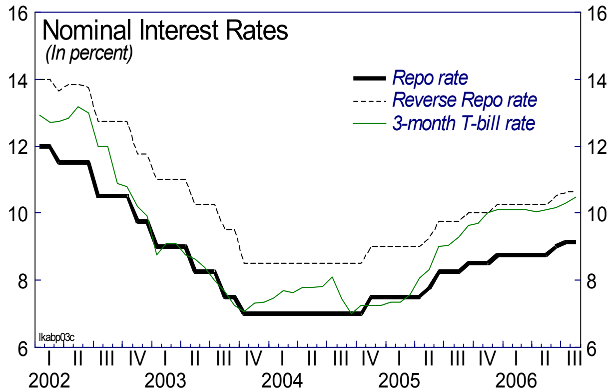


Sources: Data provided by the Sri Lankan authorities; and CEIC Data Company Ltd.

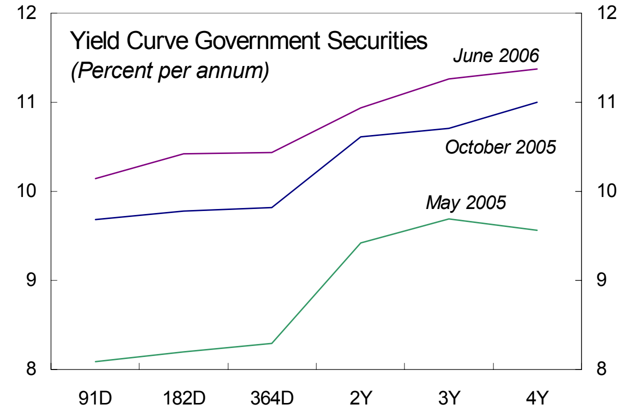
1/ GDP for FY2004 is a staff estimate.

Figure 2. Sri Lanka: Financial and External Sector Developments

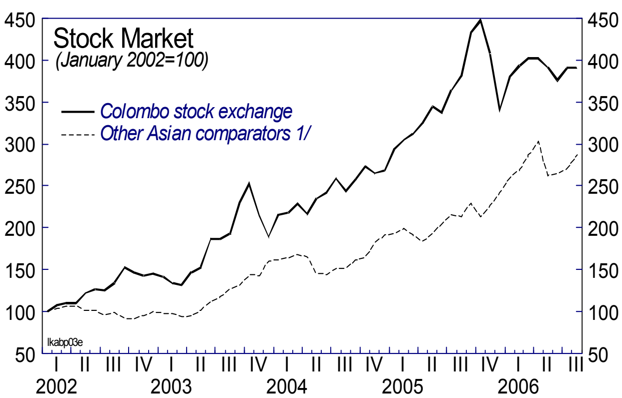
The Central Bank has increased its policy rate by 2½ percentage points since November 2004.



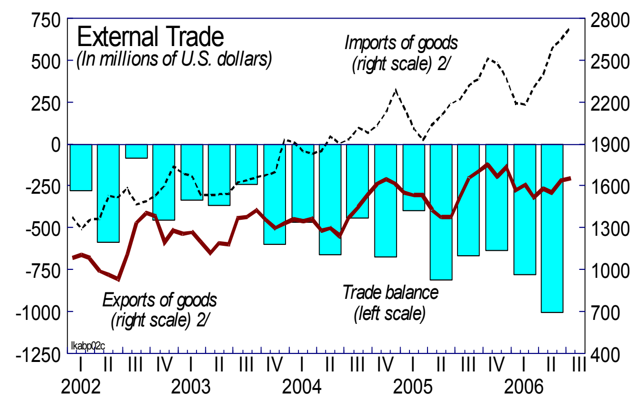
The recent steepening of the yield curve suggests that inflation expectations have increased.



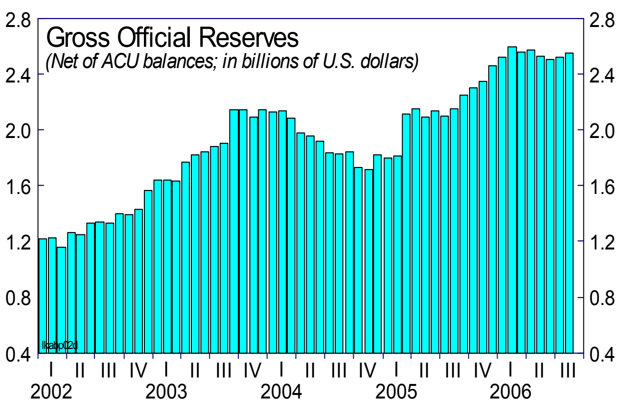
The stock market performed strongly during most of 2005, but declined sharply following upsurge of violence.



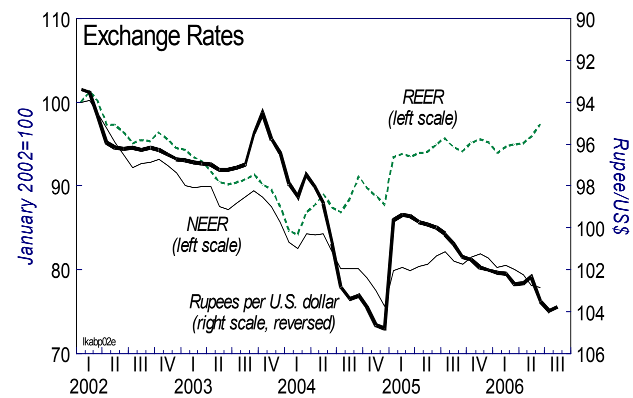
The trade deficit narrowed slightly in 2005 owing to strong export growth and a slowdown in non-oil imports but has begun to widen in 2006.



Large tsunami aid inflows and workers' remittances helped strengthen the balance of payments and build up reserves.



The rupee exchange rate has weakened somewhat since the second half of 2005.



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

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

Table 1. Sri Lanka: Selected Economic Indicators, 2001–2006

Main exports (percent of total, 2005): garment (48), tea (14)
GDP per capita (2004): US$1,029
Unemployment rate (2005): 7.7 percent
Poverty rate (2004, incidence): 22 percent
FDI (2005): $200 million
Public debt (2005): 94 percent of GDP
Foreign public debt (percent of total, 2005): 43

	2001	2002	2003	2004	2005 Est.	2006 Proj.
GDP and inflation (in percent)						
Real GDP growth	-1.5	4.0	6.0	5.4	6.0	7.0
Inflation (Sri Lanka CPI; average)	12.1	10.2	2.6	7.9	10.6	8.0
Inflation (Sri Lanka CPI; end-of-period)	13.4	6.6	1.0	16.8	3.6	12.0
Public finances (in percent of GDP)						
Revenue	16.6	16.5	15.7	15.3	16.1	17.0
Expenditure	27.5	25.4	24.0	23.5	24.7	26.0
Primary balance	-4.1	-1.6	-1.2	-2.2	-3.6	-3.6
Overall balance	-10.8	-8.9	-8.3	-8.2	-8.7	-9.1
Overall balance (excluding tsunami)	-10.8	-8.9	-8.3	-8.2	-7.5	-7.3
Domestic financing	8.8	8.0	4.8	5.8	5.2	4.8
Government debt (domestic and external)	103.2	105.6	105.8	105.4	93.9	89.6
Money and credit (percent change, end of period)						
Reserve money	7.0	12.3	11.9	20.9	15.8	16.0
Broad money	13.6	13.4	15.3	19.6	19.1	16.5
Domestic credit	16.2	6.5	7.6	22.4	15.5	18.9
Private sector credit	8.9	12.0	16.9	22.1	21.5	20.7
Public sector credit	30.6	-2.6	-10.0	23.2	0.7	13.8
91-day T-bill rate (in percent, end of period)	12.9	9.9	7.4	7.3	10.5	10.5
Balance of payments (in millions of U.S. dollars)						
Exports	4,817	4,699	5,133	5,757	6,347	6,950
Imports	5,974	6,105	6,673	7,999	8,863	10,501
Current account balance	-179	-236	-74	-646	-650	-1,281
Current account balance (in percent of GDP)	-1.1	-1.4	-0.4	-3.2	-2.8	-4.7
Export value growth (percent)	-12.8	-2.4	9.2	12.2	10.2	9.5
Import value growth (percent)	-18.4	2.2	9.3	19.9	10.8	18.5
Gross official reserves (end of period)						
In millions of U.S. dollars 1/	1,183	1,560	2,146	1,833	2,458	2,662
In months of imports	2.0	2.4	2.8	2.2	2.5	2.4
As a percent of short-term debt 2/	57	80	109	88	72	86
External debt (public and private)						
In billions of U.S. dollars	9.5	10.3	11.7	12.8	13.0	13.6
As a percent of GDP	60.2	62.6	64.1	63.9	55.4	49.7
Memorandum items:						
Nominal GDP (in billions of rupees)	1,407	1,582	1,761	2,029	2,366	2,759
Nominal GDP (in billions of U.S. dollars)	15.7	16.5	18.2	20.1	23.5	27.4

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

1/ Excluding central bank Asian Clearing Union (ACU) balances.
2/ As reserves exclude ACU balances, they are also excluded from short-term debt to compute this ratio.

Table 2. Sri Lanka: Balance of Payments, 2005–2010

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

	2005 Act.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.
Current account	-650	-1,281	-1,734	-1,501	-1,244	-1,173
Trade balance	-2,516	-3,551	-4,371	-4,600	-4,793	-5,267
Exports	6,347	6,950	7,588	8,213	8,863	9,565
Of which: textiles and garments	2,896	3,012	3,133	3,258	3,388	3,524
Imports	8,863	10,501	11,959	12,813	13,656	14,832
Non-oil imports	7,208	8,354	9,528	10,328	11,143	12,284
Of which: Tsunami adjustment	342	248	350	220	110	0
Oil imports	1,655	2,147	2,430	2,485	2,513	2,548
Services	338	377	499	597	700	855
Receipts	1,539	1,662	1,862	2,048	2,253	2,500
Income	-300	-247	-259	-272	-286	-300
Transfers	1,828	2,140	2,398	2,775	3,135	3,539
Private (net)	1,735	1,995	2,334	2,708	3,073	3,488
Official (net)	93	145	64	67	62	51
Capital and financial account	1,224	1,556	1,776	1,384	1,513	1,405
Capital transfers (net)	250	276	282	290	158	145
Financial account	974	1280	1494	1094	1355	1260
Long-term flows	798	1110	1474	1053	1305	1210
Direct investment	234	324	315	378	416	478
Private sector borrowing 1/	11	-52	150	85	125	40
Official sector borrowing	553	838	1009	590	764	692
Disbursements	747	2,065	1,783	1,788	1,889	1,859
Program	20	55	100	105	110	130
Project	608	759	1102	917	981	756
Commercial loans (gross) 2/	120	1251	581	766	798	973
Of which: SLDB	0	580	290	383	399	487
Amortization	194	1227	774	1198	1125	1167
Of which commercial	0	806	281	566	598	673
Short-term flows	176	170	20	41	50	50
Errors and omissions	-336	0	0	0	0	0
Overall balance	238	275	42	-117	269	232
Financing	-238	-275	-42	117	-269	-232
Debt service moratorium	264	0	0	0	0	0
Of which: moratorium on interest due	77	0	0	0	0	0
NIR (- = increase)	-502	-275	-42	117	-269	-232
Gross reserves	-625	-203	-12	185	-175	-196
Reserve liabilities (- is outflow)	123	-72	-29	-69	-94	-36
Memorandum items:						
Current account (in percent of GDP)	-2.8	-4.7	-5.6	-4.4	-3.3	-2.9
Tsunami Inflows	497	451	610	466	272	0
Export growth (in percent)	10.2	9.5	9.2	8.2	7.9	7.9
Import growth (in percent)	10.8	18.5	13.9	7.1	6.6	8.6
Oil	36.9	29.7	13.2	2.2	1.1	1.4
Gross official reserves 3/ 4/	2,458	2,662	2,674	2,489	2,664	2,860
(In months of imports of goods and nonfactor services)	2.5	2.4	2.2	2.0	1.9	1.9
(In percent of short-term debt)	72	86	73	70	73	89
Net international reserves	2,076	2,351	2,393	2,277	2,546	2,778
GDP (US$ millions)	23,540	27,411	30,739	33,854	37,266	40,859
Real growth rate	6	7	7	7	7	7
Oil price (US$ per barrel)	53.4	67.2	73.5	72.3	70.3	68.5
Short-term debt (US$ million, residual maturity)	3,400	3,091	3,670	3,542	3,664	3,215

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

1/ Includes public corporations.
2/ From 2006 includes dollar denominated Sri Lanka Development Bonds (SLDBs) and Foreign Currency Banking Union (FCBU) borrowing.
3/ Net of ACU debit balances.
4/ Valued at historical cost through 2002, and at market cost since then.

Table 3. Sri Lanka: Monetary Accounts, 2003–2006

	2003 Dec. Act.	2004 Dec. Act.	2005 Dec. Act.	2006 June Act.	2006 Dec. Proj.
Monetary authorities	(In billions of Sri Lankan rupees)				
Net foreign assets	165	152	197	219	231
Net domestic assets	-23	19	1	-6	-1
Of which : net credit to government	42	108	74	78	88
Reserve money	141	171	198	212	230
	(Contribution to reserve money growth, in percent)				
Net foreign assets	37.4	-9.1	26.5	32.1	17.1
Net domestic assets	-25.5	30.0	-10.7	-14.0	-1.0
Reserve money (percent change)	11.9	20.9	15.8	18.1	16.0
Monetary survey	(In billions of Sri Lankan rupees)				
Net foreign assets	167	170	205	197	222
Monetary authorities	165	152	197	219	231
Deposit money banks	2	19	8	-22	-9
Net domestic assets	551	688	817	892	969
Domestic credit	732	896	1,034	1,132	1,230
Public sector (net)	212	262	263	286	300
Government (net)	176	220	247	270	277
Public corporations	36	41	17	16	23
Private sector	519	634	771	846	930
Other items (net)	-181	-208	-217	-240	-261
Broad money	718	859	1,022	1,089	1,191
	(Annual percent change)				
Net foreign assets	51.0	1.9	20.3	6.1	8.3
Monetary authorities	40.2	-7.8	29.8	35.9	17.2
Deposit money banks	-137.1	641.9	-57.3	-188.0	-211.9
Net domestic assets	7.6	25.0	18.7	22.6	18.5
Domestic credit	7.6	22.4	15.5	21.3	18.9
Public sector (net)	-10.0	23.2	0.7	12.8	13.8
Government (net)	-8.7	25.1	11.9	16.2	12.3
Public corporations	-15.9	13.8	-59.5	-23.8	36.0
Private sector	16.9	22.1	21.5	24.5	20.7
Broad money	15.3	19.6	19.1	19.3	16.5
	(Contribution to broad money growth, in percentage points)				
Net foreign assets	9.1	0.4	4.0	1.2	1.7
Net domestic assets	6.3	19.2	15.0	18.0	14.8
Domestic credit	8.3	22.9	16.1	21.8	19.1
Public sector (net)	-3.8	6.9	0.2	3.6	3.6
Government (net)	-2.7	6.2	3.1	4.1	3.0
Public corporations	-1.1	0.7	-2.9	-0.6	0.6
Private sector	12.1	16.0	15.9	18.2	15.6
Memorandum items:					
Broad money multiplier	5.08	5.02	5.16	5.13	5.19
Velocity of broad money	2.65	2.61	2.54	...	2.50
Private sector credit (in percent of GDP)	29.5	31.3	32.6	...	33.7

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

Table 4. Sri Lanka: Summary of Central Government Operations, 2004–2010
(In percent of GDP, unless otherwise indicated)

	2004	2005	2006			2007	2008	2009	2010
	Act.	Est.	Budget	Staff Proj.	Q2	Projections			
Total revenue	15.3	16.1	17.8	17.0	7.5	17.3	17.8	18.3	18.8
Tax revenue	13.9	14.2	16.0	15.2	6.7	15.6	16.1	16.6	17.1
Income taxes	2.0	2.2	2.8	2.5	1.0	...	...	...	...
Value added tax/GST	5.9	5.9	6.4	5.9	2.7	...	...	...	...
Excise taxes	3.2	3.3	3.1	3.3	1.5	...	...	...	...
Taxes on international trade	2.0	1.9	2.4	2.2	1.0	...	...	...	...
Other	0.6	1.0	1.3	1.3	0.5	...	...	...	...
Nontax revenue	1.5	1.8	1.8	1.8	0.8	1.7	1.7	1.7	1.7
Total expenditure and net lending	23.5	24.7	26.9	26.0	11.9	24.8	24.1	23.9	23.8
Current expenditure	19.2	18.7	18.7	19.9	9.3	18.2	17.6	17.3	16.7
Civil service wages and salaries	3.2	3.8	4.1	4.0	1.8	3.9	3.8	3.7	3.6
Other civilian goods and services	1.3	1.0	1.2	2.1	1.6	1.2	1.2	1.2	1.1
Security related expenditure	3.6	3.5	3.6	3.6	1.7	3.5	3.3	3.2	3.0
Subsidies and transfers	5.2	5.4	4.3	4.7	1.6	4.1	4.0	3.9	3.8
Households	4.1	4.3	3.1	3.5	...	...	...	...	...
Of which : Samurdhi	0.4	0.4	0.4	0.4	0.2	...	...	...	...
pensions	1.8	2.0	1.8	1.8	1.0	...	...	...	...
petroleum	0.9	1.1	0.1	0.4	...				
tsunami	0.0	0.4	0.1	0.1	...				
Institutions, corporations, other government agencies	1.1	1.1	1.2	1.2	...	...	...	...	...
Interest payments 1/	5.9	5.1	5.6	5.5	2.6	5.5	5.3	5.3	5.2
Foreign	0.7	0.3	0.7	0.7	0.3	0.7	0.6	0.7	0.7
Domestic	5.2	4.8	4.9	4.8	2.3	4.9	4.6	4.6	4.5
Capital expenditure and net lending	4.3	6.0	8.2	6.1	2.6	6.6	6.5	6.6	7.1
Of which : capital expenditure	...	5.9	7.8	6.3	...	6.7	6.5	6.6	7.1
Of which : tsunami	...	1.0	1.7	1.7	...	0.8	0.4	0.0	0.0
Saving to be identified	…	...	...	...		0.0	0.0	0.0	0.0
Overall balance	-8.2	-8.7	-9.1	-9.1	-4.4	-7.5	-6.3	-5.6	-5.0
Overall balance (without tsunami measures) 1/	-8.2	-7.5	-7.3	-7.3		-6.7	-5.9	-5.6	-5.0
Financing	8.2	8.7	9.1	9.1	4.4	7.5	6.3	5.6	5.0
Net external financing	1.8	2.0	3.0	1.5	...	2.3	1.5	2.0	1.3
Net domestic financing	5.8	5.2	4.5	6.0	...	4.2	4.0	3.0	3.3
Bank	2.2	1.1	0.0	1.1	...	0.0	0.0	0.0	0.0
Nonbank	3.7	4.1	4.5	4.9	...	4.2	4.0	3.0	3.3
Privatization	0.1	0.0	0.0	0.0	...	0.0	0.0	0.0	0.0
Grants	0.4	1.4	1.6	1.5	...	1.0	0.8	0.6	0.4
Of which : tsunami	...	0.4	1.2	1.0	...	0.6	0.4	...	...
Memorandum items:									
Current account balance (excluding grants)	-3.9	-2.7	-0.9	-3.0		-0.9	0.2	1.0	2.1
Primary balance (excluding grants)	-2.2	-3.6	-3.5	-3.6		-1.9	-1.0	-0.4	0.2
Primary balance (including grants)	-1.8	-2.2	-2.0	-2.1		-0.9	-0.2	0.2	0.6
Paris Club debt moratorium	…	1.0	...	...		...	...	...	...
Nominal GDP (in billions of rupees)	2,029	2,366	2,721	2,759	2,759	3,194	3,650	4,132	4,643
Total debt	105.4	93.9	90.8	89.6		84.3	80.4	76.9	73.8
Of which : domestic debt	56.3	53.5	51.0	51.9		48.7	46.6	44.2	42.6

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

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

Table 5. Sri Lanka: Medium-Term Macroeconomic Framework, 2005–2010

	2005 Prov.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.
Real sector (percent change)						
Real GDP	6.0	7.0	7.0	7.0	7.0	7.0
Contribution of domestic demand	5.5	10.5	10.8	8.2	8.1	9.4
Contribution of external demand	0.5	-3.5	-3.8	-1.2	-1.0	-2.3
Inflation (Sri Lanka CPI; average)	10.6	8.0	8.0	6.0	5.0	5.0
Inflation (Sri Lanka CPI; end-of-period)	3.6	12.0	7.0	5.5	5.0	5.0
Savings-investment balance (in percent of GDP)						
Gross national saving	23.7	22.6	23.6	25.1	26.9	28.2
Gross domestic investment	26.5	27.3	29.2	29.6	30.2	31.0
Private	22.3	23.0	24.5	25.0	25.5	26.0
Public	4.2	4.3	4.7	4.5	4.7	5.0
Public finances (in percent of GDP)						
Total revenue	16.1	17.0	17.3	17.8	18.3	18.8
Total expenditure and net lending	24.7	26.0	24.8	24.0	23.9	23.7
Current expenditure	18.7	20.0	18.1	17.5	17.2	16.6
Of which: interest payments	5.1	5.5	5.5	5.2	5.2	5.1
Capital expenditure and net lending	6.0	6.1	6.7	6.5	6.7	7.2
Overall balance	-8.7	-9.1	-7.5	-6.2	-5.6	-5.0
Overall balance (excluding tsunami)	-7.5	-7.3	-6.7	-5.8	-5.6	-5.0
Primary balance	-3.6	-3.6	-2.1	-1.0	-0.4	0.1
Net external financing (including grants)	3.4	4.3	4.2	2.5	2.6	2.1
Net domestic financing	5.2	4.8	3.3	3.7	3.0	2.9
Assets sales	0.0	0.0	0.0	0.0	0.0	0.0
Total government debt	93.9	89.6	84.4	80.3	76.9	73.7
Of which: domestic debt	53.5	50.7	47.8	45.5	43.2	41.4
Balance of payments (in percent of GDP)						
Trade balance	-10.7	-13.0	-14.2	-13.6	-12.9	-12.9
Current account balance	-2.8	-4.7	-5.6	-4.4	-3.3	-2.9
Overall balance	1.0	1.0	0.1	-0.3	0.7	0.6
Gross official reserves (in millions of U.S. dollars) 1/	2,458	2,662	2,674	2,489	2,664	2,860
(in months of imports of goods and services)	2.5	2.4	2.2	2.0	1.9	1.9
Total external debt (public and private)	55.4	49.7	47.2	44.5	42.7	40.3
Money and credit (in percent of GDP)						
Reserve money	8.4	8.3	8.3	8.3	8.3	8.4
Broad money	43.2	43.2	43.1	43.5	43.8	44.5
Domestic credit	43.7	44.6	44.2	45.0	44.6	44.8
Private sector credit	32.6	33.7	34.9	37.0	37.6	38.2
Public sector credit	11.1	10.9	9.2	8.0	7.0	6.5
Memorandum item:						
Oil price (U.S. dollar per barrel)	53.4	67.2	73.5	72.3	70.3	68.5

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

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

Table 6. Sri Lanka: Vulnerability Indicators, 2001–2005

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

	2001	2002	2003	2004	2005
Banking sector indicators 1/					
Nonperforming loans (as percent of total loans)					
State-owned commercial banks	18.2	17.8	17.9	11.6	9.2
Domestic private banks	15.7	15.0	12.0	10.5	8.5
Foreign banks	13.2	8.7	6.3	3.3	2.0
Risk-based capital asset ratio (total capital over risk-weighted assets)					
State-owned commercial banks	0.1	1.7	1.7	3.8	6.7
Domestic private banks	10.4	10.8	10.6	11.1	10.9
Foreign banks	16.0	21.7	15.8	12.4	20.4
Financial indicators					
Broad money (percent change, 12-month basis) 2/	13.6	13.4	15.3	19.6	19.1
Private sector credit (percent change, 12 month basis) 2/	8.9	12.0	16.9	22.1	21.5
Share of deposits in broad money 2/	88.1	87.9	88.1	88.4	88.8
Share of foreign currency deposits in total deposits 2/	21.8	22.1	21.7	23.8	22.8
Stock market index (ASPI; 1985=100)	621	815	1,062	1,507	1,922
External indicators					
Exports (annual percent change)	-12.8	-2.4	9.2	12.2	10.2
Imports (annual percent change)	-18.4	2.2	9.3	19.9	10.8
Current account balance (excluding official transfers)	-1.3	-1.6	-0.6	-3.4	-3.2
Capital and financial account balance	3.4	2.7	4.0	3.2	5.2
Of which: portfolio investment	-0.1	0.2	0.0	0.1	0.3
Medium- and long-term inflows, net	1.0	2.0	4.0	3.4	3.4
Foreign direct investment	0.5	1.1	0.9	1.1	1.0
Exchange rate (Sri Lankan rupee per U.S. dollar, period average)	89.4	95.7	96.5	101.2	100.5
Reserves indicators					
Gross official reserves (millions of US$; excl. ACU balance)	1,183	1,560	2,146	1,833	2,458
As percent of broad money	20.1	24.2	28.9	22.3	24.5
As percent of short-term debt 3/ 4/	57.4	79.6	109.0	87.5	72.3
Debt indicators					
Government debt (domestic and external)	103.2	105.6	105.8	105.4	93.9
Total external debt (public and private)	60.2	62.6	64.1	63.9	55.4
Debt service (as percent of exports goods & services)	14.3	12.3	10.9	10.1	7.4
Short-term debt (in percent of GDP) 3/ 4/	10.5	9.7	9.1	10.4	9.9

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

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

Table 7. Sri Lanka: Projected Payments to the Fund, 2006–2010

(In millions of SDRs, unless otherwise indicated)

	2006	2007	2008	2009	2010
Disbursements	0.0	0.0	0.0	0.0	0.0
Repayments 1/	98.32	7.76	46.04	62.8	24.04
Charges/interest 1/	9.45	9.67	8.87	6.24	3.69
Stock of outstanding use of Fund resources	168.5	160.7	114.7	51.9	27.8
Memorandum items:					
Debt service					
Payments to the Fund/exports GNFS	1.8	0.3	0.8	0.9	0.3
Payments to the Fund/Quota	26.1	4.2	13.3	16.7	6.7
Payments to the Fund/GDP	0.6	0.1	0.2	0.3	0.1
Payments to the Fund/reserves	5.9	1.0	3.3	3.9	1.5
Outstanding use of Fund resources					
Outstanding UFR/exports GNFS	2.9	2.5	1.7	0.7	0.3
Outstanding UFR/quota	40.7	38.9	27.7	12.5	6.7
Outstanding UFR/GDP	0.9	0.8	0.5	0.2	0.1
Outstanding UFR/reserves	9.3	8.9	6.9	2.9	1.5

Source: Fund staff estimates.

1/ On an obligation basis.

Table 8. Sri Lanka: Millennium Development Goals 1/

	1990	1995	1998	2001	2004
Eradicate extreme poverty and hunger 2/	(2015 target = halve 1990 $1 a day poverty and malnutrition rates)				
Income share held by lowest 20 percent	...	...	...	8.0	...
Malnutrition prevalence, weight for age (in percent of children under 5)	...	33.0	...	30.0	...
Poverty gap at $1 a day - PPP (in percent)	...	...	...	1.0	...
Poverty headcount ratio at $1 a day - PPP (in percent of population)	...	...	...	6.0	...
Poverty headcount ratio at national poverty line (in percent of population)	20.0	25.0	...	...	...
Prevalence of undernourishment (in percent of population)	...	...	26.0	...	22.0
Achieve universal primary education 3/	(2015 target = net enrollment to 100)				
Literacy rate, youth total (in percent of people ages 15-24)	95.0	...	...	...	96.0
Persistence to grade 5, total (in percent of cohort)	92.0	...	...	...	...
Primary completion rate, total (in percent of relevant age group)	92.2	...	98.6	...	...
School enrollment, primary (in percent of net)	...	...	...	...	99.0
Promote gender equality 4/	(2005 target = education rate to 100)				
Proportion of seats held by women in national parliament (in percent)	5.0	...	5.0	5.0	4.0
Ratio of girls to boys in primary and secondary education (in percent)	101.7	...	...	102.1	102.3
Ratio of young literate females to males (in percent of ages 15-24)	98.3	...	...	...	101.1
Share of women employed in the nonagricultural sector (in percent of total nonagricultural employment)	39.0	44.0	40.0	45.0	43.0
Reduce child mortality 5/	(2015 target = reduce 1990 under 5 motality by two thirds)				
Immunization, measles (in percent of children ages 12-23 months)	80.0	87.0	94.0	99.0	96.0
Mortality rate, infant (per 1,000 live births)	26.0	21.0	...	16.0	12.0
Mortality rate, under-5 (per 1,000)	32.0	25.0	...	19.0	14.0
Improved maternal health 6/	(2015 target = reduce 1990 maternal mortality by three fourths)				
Births attended by skilled health staff (in percent of total)	...	...	...	96.0	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	92.0	...
Combat HIV/AIDS, malaria, and other diseases 7/	(2015 target = halt, and begin to reverse, AIDS, etc.)				
Children orphaned by HIV/AIDS	...	...	...	...	...
Contraceptive prevalence (in percent of women ages 15-49)	...	...	...	70.0	...
Incidence of tuberculosis (per 100,000 people)	60.5	...	...	...	60.5
Prevalence of HIV, female (in percent of ages 15-24)	...	...	...	0.0	...
Prevalence of HIV, total (in percent of population ages 15-49)	...	...	...	0.0	0.0
Tuberculosis cases detected under DOTS (in percent)	...	59.3	70.7	68.0	70.2
Ensure environmental sustainability 8/	(2015 target = various /1)				
CO2 emissions (metric tons per capita)	0.2	0.3	0.4	0.5	...
Forest area (in percent of land area)	36.0	...	...	32.0	30.0
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	7.0	9.0	8.0	8.0	9.0
Improved sanitation facilities (in percent of population with access)	70.0	...	...	91.0	...
Improved water source (in percent of population with access)	68.0	...	...	78.0	...
Nationally protected areas (in percent of total land area)	...	...	...	...	13.5
Develop a global partnership for development 9/	(2015 target = various /2)				
Aid per capita (current U.S. dollars)	42.9	30.6	22.6	16.7	26.7
Debt service (PPG and IMF only, in percent of exports of Goods and Services, excl. workers' remittances)	15.0	9.0	9.0	10.0	9.0
Fixed line and mobile phone subscribers (per 1,000 people)	7.2	14.2	37.2	79.8	164.9
Internet users (per 1,000 people)	0.0	0.1	2.9	8.0	14.4
Personal computers (per 1,000 people)	0.2	1.1	4.8	9.3	27.3
Total debt service (in percent of exports of goods, services and income)	14.0	8.0	8.0	10.0	9.0
Unemployment, youth female (in percent of female labor force ages 15-24)	46.9	41.3	33.6	30.9	36.1
Unemployment, youth male (in percent of male labor force ages 15-24)	22.8	27.0	24.6	19.9	21.9
Unemployment, youth total (in percent of total labor force ages 15-24)	33.3	32.8	28.2	23.6	27.2
General indicators					
Fertility rate, total (births per woman)	2.5	2.2	2.1	2.0	1.9
GNI per capita, Atlas method - current (in U.S. dollars)	470.0	700.0	810.0	840.0	1,010.0
GNI, Atlas method - current (in billions of U.S. dollars)	7.9	12.7	15.2	15.7	19.5
Gross capital formation (in percent of GDP)	22.6	25.7	25.1	22.0	25.0
Life expectancy at birth, total (years)	71.2	72.5	73.1	73.9	74.4
Literacy rate, adult total (in percent of people ages 15 and above)	88.7	...	...	...	90.7
Population, total (in millions)	17.0	18.1	18.8	18.7	19.4
Trade (exports and imports of goods and services, in percent of GDP)	67.2	81.6	78.5	80.9	81.9

Source: *World Development Indicators* database, April 2006.

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

APPENDIX I: SRI LANKA—TSUNAMI RELIEF AND RECONSTRUCTION UPDATE

The initial relief efforts have been largely successful with the government facilitating the distribution of goods and building interim shelters. As the reconstruction activities gain momentum in 2006, a few issues remain to be resolved including the relocation of previous inhabitants of the newly demarked no-construction buffer zone, and improved coordination between the government and donors on the utilization of tsunami funds. On the economy, tsunami reconstruction activities and relief efforts helped support growth and improved the balance of payments position, while the impact on inflation seems modest to date.

Reconstruction Activity

The tsunami of December 26, 2004 killed over 35,000 people and displaced 1 million, with extensive damage to physical property and infrastructure and loss of livelihoods. The immediate relief efforts were largely successful with the help of the government, the local communities and private sector, and international donors and NGOs. The recovery and reconstruction process is expected to take 3–5 years with an estimated cost of about $2.2 billion. The international community pledged $2.8 billion for recovery and reconstruction activities, of which $2 billion were committed. Sri Lanka received about $260 million in debt moratorium from Paris Club creditors and $157.5 million in emergency assistance from the Fund.

The initial relief efforts were successful. This included facilitating the distribution of in-kind goods, providing 50,000 temporary houses, and extending welfare support to thousands of people. While figures on aid disbursements are difficult to obtain and consolidate, a minimum of $500 million (2.2 percent of GDP) was received in 2005.

Reconstruction activity is gaining momentum in 2006. The government recently revised the total housing requirement from the original 98,525 units to 120,000 units in order to include people without legal ownership of land outside the former buffer zone and extended families. About 13 percent of the total units in the housing program are donor funded. At end-2005, 85,525 families had been assigned new locations in either transitional shelter (53,000) or in private homes (32,525). About 18,154 permanent houses had been completed and about 80,371 remained. The government plans to finish construction of all housing units by the end of 2006. About 55,483 housing units were already completed at end-June 2006, and 40,589 units were under construction.

Some significant issues have affected progress with tsunami reconstruction. Relocation debates unleashed social conflicts over religion and more than half of households are not willing to move to government-identified sites. Lost documentation (loss of identity cards and ownership documents) has been a major hindrance for obtaining grants and loans from banks. Also, there have been some complaints of corruption and an effective mechanism for dispute resolution is absent. There is also a shortage of building materials and manpower, which may result in higher prices as the reconstruction gathers pace.

Economic Impact

Tsunami reconstruction activities supported growth. Real GDP growth accelerated to 6 percent in 2005, compared with 5½ percent in 2004 and with an average of 5 percent in the last decade. The construction sector—mostly related to tsunami relief and reconstruction—grew by 9 percent, which helped offset in part the loss of activities in fishery which contracted by about 40 percent. Hotel and restaurant services recovered to a large extent during the year.

Tsunami inflows contributed to a turn around in the balance of payments. The balance of payments registered a surplus of $238 million in 2005, compared with a deficit of $205 million in 2004. The turnaround was supported by the tsunami inflows, amounting to about $1 billion (including the Fund emergency assistance and debt moratorium from the Paris Club), that helped offset the current account deficit.

The impact of tsunami activities on inflation seems modest to date. Year-on-year inflation slowed down to 3.6 percent at end-2005, compared with 16.8 percent at end-2004. While the prices of building materials surged during the year, there have been no clear signs of this contributing to wage pressure. Tsunami inflows also helped strengthen the rupee exchange rate, helping slow inflation by containing the prices of imported goods.

The tsunami also resulted in changes in the pattern of employment and sources of income. Most livelihoods affected by the tsunami are fishery related and low income households receiving less than $50 per month pre-tsunami. The tsunami victims were mainly women, children and elderly. The latest government report on Needs Assessment Survey for Income Recovery suggests a 15 percent income non-recovery rate among the households with men and a 35 percent non-recovery rate among those with women. It also found that displaced people are more vulnerable to being unemployment and earn less whenever they find employment. The structure of household income also changed slightly after the tsunami, with a significant increase in income that result from sources such as remittances and government welfare and a significant fall in income from the fisheries sector.

Sri Lanka: Main Source of Household Income by Sector
(In percent)

Sector	Before Tsunami	Now
Agriculture and livestock	5	4
Fisheries	43	30
Manual labor and manufacturing	20	24
Private services and small business	23	21
Public sector/government services	5	6
Temporary relief work with non-government organizations	0	2
Income not from work (foreign remittances, government welfare, charity, loans, pensions, selling personal belongings)	2	12
Other	0	1
Not mentioned	0	1
Total	100	100

Source: *Joint Status Report of the United Nations Group and the Sri Lankan Government*.

Appendix II: Sri Lanka—Debt Sustainability Analysis[10]

Assumptions

Sri Lanka's DSA presents an illustrative scenario assuming strong growth, fiscal consolidation, and a gradual increase in foreign currency commercial borrowing to support infrastructure developments over the medium term. Growth over 2007–2010 is projected to be 7 percent based on the current trend and policies outlined in the main report. The fiscal consolidation path assumes a reduction in the fiscal deficit to 5 percent by 2010 and to 4 percent by 2026. Export growth is assumed at 9 percent in the medium term, while reserves are maintained at around 2 months of imports. In addition to the standard DSA, the analysis includes an assessment of the pressures on external debt service arising from the stock of domestic foreign-currency-denominated loans as of September 2006 (of about $1.2 billion). A gradual net increase in such borrowing is assumed from 2007 onwards (at an average of $250 million per year) to illustrate the needed financing to support the authorities' development plan in an environment of diminishing concessional financing. Risks are reflected in the debt service distress indicators through the extreme stress tests in Figure II.2.

Central Government Debt Sustainability

The sustainability of Sri Lanka's public sector debt depends largely on the strength of future fiscal consolidation and structural reforms to increase potential growth. The baseline scenario of sustained fiscal consolidation yields a favorable path for public debt. Under this scenario, central government debt falls linearly from 94 percent of GDP in 2005 to 74 percent in 2010 and 48 percent in 2026 (Table II.1). NPV indicators of debt-to-GDP and debt-to-revenue as well as the debt-service-to-revenue ratio perform similarly. The main driver of the relatively favorable debt dynamics is a continued interest rate/growth differential. The real growth projection of 7 percent over 2006–2010 and 6 percent through 2026 (compared to an average of 4½ percent over the last 10 years) exceeds the projected real interest rates on domestic and foreign debt (5.8 percent for the period 2006–2012).

There are substantial downside risks to this outlook, largely arising from a stall or reverse of reforms. The alternative scenario A2 (Table II.2) assumes continuation of recent policies (2003–2005) throughout the period: primary deficit of 1.6 percent, an average real interest rate of 1.5 percent, and real growth of 5.8 percent. This period coincides with a historical period based on peace but limited fiscal consolidation, which can also be interpreted as a no policy change scenario. Under these assumptions, the NPV of debt-to-GDP would decline marginally from 78 percent in 2006 to 75 percent in 2010 and to

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[10] This DSA was conducted jointly and agreed with the World Bank.

70 percent in 2026. A greater risk exists if growth and primary balances were to continue at the average level of the last 10 years. This scenario could be associated to a reverse of reforms or return to the conflict situation of the last decade. In this case, the NPV of debt-to-GDP would increase to 80 percent of GDP in 2010 as compared to falling to 65 percent in the baseline and would continue to increase to a level of 104 percent in 2026 (Table II.2, alternative scenario A1). Under the two alternative scenarios (A1 and A2), the debt service-to-revenue ratio would remain around the high level of 2005, constraining the government's ability to increase other expenditures.

External Debt Sustainability

Sri Lanka's nominal external debt has been consistently above 50 percent of GDP in the last decade. In 2005, the majority of total external debt was public and publicly guaranteed (PPG) primarily of medium- to long-term maturity. Private external debt comprised mainly of short-term debt, in particular export trade credits. External debt is mainly concessional (about 70 percent), with low effective interest rates of just over 2 percent. External debt ratios are particularly vulnerable to movements in the rupee exchange rate against the SDR, Japanese yen and U.S. dollar given that 90 percent of external debt is held in these denominations.

The baseline scenario suggests that Sri Lanka's medium term external debt ratios are on a sustainable path but debt service pressures are emerging in the near term. Ratios of the NPV of PPG external debt, as a percent of both GDP and exports, are projected to decline smoothly over 2006–2026 (Table II.3 and Figure II.2) and remain well below the indicative thresholds of debt distress for low-income countries with medium policy frameworks (see table).[11] However, the baseline debt-service-to-exports ratio increases rapidly from 5 percent to 15.5 percent over 2005–2006 and averages at the higher level of 10.5 percent over 2007–2011. In part, this reflects the resumption of interest and amortization payments following the Paris Club moratorium in 2005 (2.5 percent of the total increase in debt service

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

	Indicative Thresholds (Medium performer)	Sri Lanka's Medium-Term Baseline		
		2006	2011	2026
NPV of debt/exports	150	94	87	48
NPV of debt/GDP	40	29	25	11
NPV of debt service/exports	20	15	8	9

[11] Based on debt and debt service thresholds approved by Boards of the Fund and Work Bank for use in the assessment of LIC DSA framework. Sri Lanka is classified as a medium performing country based on its 2005 Country Policy and Institutional Assessment Index (CPIA) score of 3.6.

over 2006–2011). The major part, however, reflects the rollover of foreign currency commercial liabilities of the public sector of relatively short (2–3 years) maturity. Including all foreign currency liabilities increases debt service pressures further, particularly over 2008–2009. While the debt service to exports ratio is below the indicative threshold for debt-distress countries, its rapid increase, lumpy payment schedule, and high rollover risk is worrisome as it places significant liquidity pressures on the public sector balance sheet and increases the vulnerability of the debt dynamics to shocks.

Sensitivity analyses show a contained trajectory for PPG external debt stock ratios but indicate potential vulnerabilities in the debt-service ratio. A one standard deviation shock to the historical export growth value will increase the NPV of external debt to GDP by 6 percent over 2006–2008, falling to the 2006 level in 2013. The same shock would increase the NPV of external debt to exports by 45 percentage points over 2006–2008, falling to the 2006 level in 2018. Stress tests on the debt-service-to-exports reflect increased vulnerability to export growth and combination shocks, particularly over 2012–2013 when the most extreme test shows an increase in the ratio to about 16.4 percent of exports. Including all foreign currency liabilities significantly increases the vulnerability of debt-service with shocks to export growth propelling it to just under 21 percent in 2013. In the medium term, given current assumptions on commercial borrowing, the debt-service-to-exports ratio plateaus at approximately 9 percent of exports.

Staff's Assessment

Staff assesses Sri Lanka to have a moderate risk of public and external debt distress. Sri Lanka's debt sustainability could be significantly improved in the medium to longer term if meaningful fiscal consolidation takes place and key structural reforms are implemented to unleash the growth potential. The path of Sri Lanka's public debt is favorable under the baseline scenario of strong and sustainable growth and fiscal consolidation, and the debt service burden appears manageable. However, while the baseline shows that the external debt stock and debt service indicators are well below thresholds, extreme stress tests (assuming slower growth, lower exports, and deflator and exchange rate shocks) could raise the debt service indicators to the debt distress thresholds. Moreover, Sri Lanka could face some lumpy repayments in the next few years on account of domestic foreign currency loans cumulated during 2005–06. A well-defined medium term fiscal framework, supported by an improved debt management policy, would help manage the situation. Steps to develop domestic capital market will also go a long way to prepare Sri Lanka for the potential decline in concessional financing as the country moves toward middle-income status.

Table II.1. Sri Lanka: Public Sector Debt Sustainability Framework, Baseline Scenario, 2003–2026

(In percent of GDP, unless otherwise indicated)

	Actual			Historical	Standard	Projections									
	2003	2004	2005	Average 5/	Deviation 5/	2006	2007	2008	2009	2010	2011	2006–11 Average	2016	2026	2012–26 Average
Public sector debt 1/	105.8	105.4	93.9			89.6	84.3	80.4	76.9	73.8	70.7		60.8	48.3	
Of which : foreign-currency denominated	55.4	56.1	48.7			45.2	42.8	40.4	38.7	37.1	35.6		26.1	16.5	
Change in public sector debt	0.2	-0.4	-11.5			-4.3	-5.3	-4.0	-3.5	-3.2	-3.1		-1.6	-1.1	
Identified debt-creating flows	-3.5	-2.4	-9.7			-4.0	-5.6	-3.7	-3.3	-3.0	-2.0		-1.5	-1.0	
Primary deficit	0.7	1.8	2.2	2.1	1.1	2.1	0.9	0.2	-0.2	-0.6	-0.8	0.3	-0.7	-0.1	-0.3
Revenue and grants	16.2	15.8	17.4			18.5	18.3	18.6	18.9	19.2	19.1		19.5	19.9	
Of which : grants	0.5	0.4	1.4			1.5	1.0	0.8	0.6	0.4	0.4		0.5	0.4	
Primary (noninterest) expenditure	16.9	17.6	19.6			20.6	19.2	18.8	18.6	18.6	18.3		18.8	19.8	
Automatic debt dynamics	-3.6	-4.1	-11.1			-6.4	-6.6	-4.0	-3.1	-2.5	-1.3		-0.8	-0.9	
Contribution from interest rate/growth differential	-2.1	-4.6	-6.3			-5.0	-4.3	-3.5	-2.8	-2.3	-1.1		-0.7	-0.6	
Of which : contribution from average real interest rate	3.9	0.8	-0.3			1.1	1.6	2.1	2.5	2.8	3.1		2.8	2.2	
Of which : contribution from real GDP growth	-6.0	-5.4	-6.0			-6.1	-5.9	-5.5	-5.3	-5.0	-4.2		-3.5	-2.8	
Contribution from real exchange rate depreciation	-1.6	0.5	-4.8			-1.4	-2.4	-0.5	-0.3	-0.2	-0.2		...	...	
Other identified debt-creating flows	-0.6	-0.1	-0.8			0.3	0.1	0.1	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-0.6	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	-1.1			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.3			0.3	0.1	0.1	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	3.8	2.0	-1.8			-0.3	0.3	-0.2	-0.2	-0.1	-1.1		-0.1	-0.1	
NPV of public sector debt	...	...	...			77.8	73.1	70.2	67.9	65.3	62.7		56.3	44.7	
Of which : foreign-currency denominated	...	...	34.2			33.4	31.5	30.3	29.7	28.6	27.6		21.6	12.8	
Of which : external	...	...	30.0			30.9	29.1	28.0	27.6	26.6	25.6		19.8	11.1	
NPV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	32.2	28.5	28.4			28.8	25.0	24.3	22.6	21.5	20.0		17.6	15.0	
NPV of public sector debt-to-revenue ratio (in percent) 3/	...	...	...			420.7	399.4	377.6	359.3	340.1	328.1		289.2	224.5	
Of which : external	…	…	…			166.9	159.2	150.6	145.9	138.4	134.1		101.6	56.0	
Debt service-to-revenue ratio (in percent) 3/ 4/	104.1	91.2	84.9			93.0	81.5	82.8	76.8	73.1	68.2		59.8	49.3	
Primary deficit that stabilizes the debt-to-GDP ratio	0.5	2.2	13.7			6.4	6.2	4.2	3.2	2.6	2.3		0.9	1.0	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	6.0	5.4	6.0	4.5	2.3	7.0	7.0	7.0	7.0	7.0	6.0	6.8	6.0	6.0	6.0
Average nominal interest rate on forex debt (in percent)	1.3	1.4	0.6	1.4	0.3	1.6	1.7	1.7	1.8	1.9	1.9	1.8	2.1	2.6	2.3
Average real interest rate on domestic currency debt (in percent)	8.7	2.3	1.2	5.8	3.0	3.1	4.1	5.6	6.9	7.9	9.1	6.1	8.4	6.1	7.2
Inflation rate (GDP deflator, in percent)	5.0	9.4	10.0	8.7	2.7	9.0	8.2	6.8	5.8	5.0	5.0	6.6	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.1	10.0	18.3	2.5	9.4	12.0	0.1	4.7	6.1	6.8	5.5	5.8	6.4	6.2	6.6
Grant element of new external borrowing (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...

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

1/ Gross central government debt.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues including grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table II.2. Sri Lanka: Sensitivity Analysis for Key Indicators of Public Debt 2006–2026

					Projections							
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2026
NPV of debt-to-GDP ratio						NPV of Debt-to-GDP Ratio						
Baseline	78	73	70	68	65	63	62	61	60	58	56	45
A. Alternative scenarios												
A1. Real GDP growth and primary balance are at historical averages 1/	78	76	77	78	80	80	84	86	89	90	92	104
A2. Key indicators at 2003–2005 averages 4/	78	75	75	75	75	74	76	76	76	75	75	70
A3. Permanently lower GDP growth 2/	78	73	71	69	67	66	67	67	67	67	66	73
B. Bound tests												
B1. Real GDP growth is at historical average minus one standard deviations in 2006–2007	78	77	80	79	77	76	78	79	79	79	79	83
B2. Primary balance is at historical average minus one standard deviations in 2006–2007	78	75	75	73	70	67	67	67	65	64	63	53
B3. Combination of B1-B2 using one half standard deviation shocks	78	77	79	77	74	71	71	70	69	67	66	56
B4. One-time 30 percent real depreciation in 2007	78	86	82	79	76	72	73	72	71	69	67	56
B5. 10 percent of GDP increase in other debt-creating flows in 2007	78	83	80	77	74	71	71	69	68	66	64	51
NPV of Debt-to-Revenue Ratio 2/						NPV of Debt-to-Revenue Ratio 3/						
Baseline	421	399	378	359	340	328	324	317	308	299	289	225
A. Alternative scenarios												
A1. Real GDP growth and primary balance are at historical averages 1/	421	414	411	412	414	420	434	446	455	463	470	518
A2. Key indicators at 2003–2005 averages 4/	421	415	411	408	404	403	409	408	404	399	393	351
A3. Permanently lower GDP growth 2/	421	402	383	367	351	343	345	345	344	342	340	368
B. Bound tests												
B1. Real GDP growth is at historical average minus one standard deviations in 2006–2007	421	422	426	415	403	399	404	407	408	408	407	418
B2. Primary balance is at historical average minus one standard deviations in 2006–2007	421	412	405	386	365	353	350	345	338	330	322	269
B3. Combination of B1-B2 using one half standard deviation shocks	421	422	425	405	384	371	368	362	355	347	338	281
B4. One-time 30 percent real depreciation in 2007	421	468	440	417	394	379	379	373	364	354	344	284
B5. 10 percent of GDP increase in other debt-creating flows in 2007	421	453	429	408	386	373	367	359	350	340	329	256
Debt service-to-revenue ratio 3/						Debt Service-to-Revenue Ratio 3/						
Baseline	93	82	83	77	73	68	66	66	63	61	60	49
A. Alternative scenarios												
A1. Real GDP growth and primary balance are at historical averages 1/	93	83	88	85	85	83	85	88	88	89	90	102
A2. Key indicators at 2003-2005 averages 4/	93	82	85	82	81	78	79	81	80	80	80	80
A3. Permanently lower GDP growth 2/	93	82	84	78	75	71	71	71	70	69	69	73
B. Bound tests												
B1. Real GDP growth is at historical average minus one standard deviations in 2006–2007	93	85	91	86	83	80	80	81	80	80	79	82
B2. Primary balance is at historical average minus one standard deviations in 2006–2007	93	82	85	81	77	73	71	71	69	67	66	57
B3. Combination of B1-B2 using one half standard deviation shocks	93	84	90	85	82	77	75	75	73	71	69	60
B4. One-time 30 percent real depreciation in 2007	93	82	84	79	75	71	70	70	68	66	65	58
B5. 10 percent of GDP increase in other debt-creating flows in 2007	93	82	91	85	81	76	74	74	71	69	68	55

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

1/ The historical sceneario could also be interpreted as a return to conflict scenario
2/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
3/ Revenues are defined inclusive of grants.
4/ Real growth, primary balance, real interest rate and residual. 2003-2005 coincides with a period based on peace, which can also be interpreted as a no policy change scenario

Table II.3. Sri Lanka: External Debt Sustainability Framework, Baseline Scenario, 2006–2026 1/

(In percent of GDP, unless otherwise indicated)

	Actual										Historical	Standard	Projections						2006–11			2012–26
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Average 7/	Deviation 7/	2006	2007	2008	2009	2010	2011	Average	2016	2026	Average
External debt (nominal) 1/	61.0	54.2	55.4	63.7	61.8	60.2	62.6	64.1	63.9	55.4			49.7	47.2	44.5	42.7	40.3	38.4		31.2	20.8	
Of which : public and publicly guaranteed (PPG)	59.1	52.4	53.7	61.9	60.1	58.6	60.8	62.3	61.8	53.7			48.4	45.6	42.8	40.8	38.5	36.4		29.3	18.9	
Change in external debt	-5.7	-6.8	1.2	8.2	-1.9	-1.6	2.4	1.5	-0.2	-8.5			-5.7	-2.5	-2.7	-1.8	-2.3	-2.0		-1.2	-1.0	
Identified net debt-creating flows	0.1	-3.1	-1.9	2.9	2.8	2.9	-2.5	-6.4	-3.6	-7.7			0.2	1.5	0.3	-0.6	-1.0	-0.7		-1.5	-0.8	
Non-interest current account deficit	2.3	0.6	-0.4	1.7	4.5	-0.5	0.1	-0.8	2.0	1.9	1.0	1.7	3.4	4.4	3.3	2.2	1.8	1.7		0.2	0.2	0.3
Deficit in balance of goods and services	8.9	7.1	6.0	7.8	10.8	5.8	6.7	6.3	9.1	9.3			11.6	12.6	11.8	11.0	10.8	10.9		10.0	10.4	
Exports	35.0	36.5	36.2	35.6	39.6	39.3	36.1	35.9	36.3	33.5			31.4	30.7	30.3	29.8	29.5	29.2		27.2	23.2	
Imports	43.9	43.6	42.2	43.4	50.4	45.1	42.8	42.1	45.4	42.8			43.0	43.3	42.1	40.8	40.3	40.1		37.2	33.6	
Net current transfers (negative = inflow)	-5.5	-5.5	-5.7	-5.8	-6.1	-6.4	-6.8	-6.8	-6.9	-7.8	-6.3	0.7	-7.8	-7.8	-8.2	-8.4	-8.7	-8.9		-9.6	-10.2	-9.8
Other current account flows (negative = net inflow)	-1.1	-1.0	-0.7	-0.3	-0.2	0.1	0.2	-0.2	-0.2	0.4			-0.4	-0.4	-0.3	-0.3	-0.3	-0.3		-0.2	-0.1	
Net FDI (negative = inflow)	-0.6	-0.9	-0.9	-1.1	-1.1	-0.5	-1.1	-0.9	-1.1	-1.0	-0.9	0.2	-1.2	-1.0	-1.1	-1.1	-1.2	-1.2		-0.9	-0.5	-0.8
Endogenous debt dynamics 2/	-1.6	-2.8	-0.6	2.4	-0.6	3.9	-1.6	-4.7	-4.5	-8.6			-2.1	-1.9	-1.9	-1.7	-1.7	-1.2		-0.8	-0.5	
Contribution from nominal interest rate	2.5	2.0	1.8	1.9	2.0	1.6	1.3	1.2	1.2	0.9			1.3	1.2	1.1	1.1	1.0	1.0		1.0	0.7	
Contribution from real GDP growth	-2.4	-3.6	-2.4	-2.4	-3.7	1.0	-2.3	-3.4	-3.1	-3.3			-3.3	-3.1	-3.0	-2.8	-2.7	-2.2		-1.8	-1.2	
Contribution from price and exchange rate changes	-1.8	-1.2	0.0	2.9	1.0	1.3	-0.6	-2.5	-2.7	-6.2			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	-5.8	-3.7	3.1	5.3	-4.8	-4.5	4.9	7.9	3.4	-0.8			-5.9	-4.0	-3.0	-1.2	-1.3	-1.3		0.2	-0.2	
Of which : exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	-0.6	
NPV of external debt 4/	...	...	...	...	...	...	...	...	...	31.2			30.6	30.2	29.3	29.0	28.0	27.3		21.7	13.1	
In percent of exports	...	...	...	...	...	...	...	...	...	93.0			97.4	98.1	96.6	97.4	95.0	93.5		79.9	56.3	
NPV of PPG external debt	...	...	...	...	...	...	...	...	...	29.5			29.4	28.6	27.6	27.2	26.2	25.3		19.8	11.1	
In percent of exports	...	...	...	...	...	...	...	...	...	88.1			93.5	93.0	91.1	91.1	88.9	86.8		72.7	48.0	
Debt service-to-exports ratio (in percent)	15.3	12.1	12.7	14.0	13.2	14.3	12.3	10.9	10.1	7.4			16.8	13.3	15.0	12.1	12.8	9.7		11.6	11.0	
PPG debt service-to-exports ratio (in percent)	12.1	10.2	10.1	11.0	9.9	9.4	10.0	8.8	8.0	5.0			15.4	12.1	12.3	10.1	10.4	8.4		8.9	8.7	
PPG debt service-to-exports ratio including SLDB (in percent) 5/	...	...	...	...	...	...	...	...	...	...			18.4	12.3	15.6	14.0	13.4	10.0		11.6	12.6	
Total gross financing need (billions of U.S. dollars)	...	...	...	485.3	1,362.4	1,650.7	1,651.6	1,602.4	1,665.9	2,076.8			2,331.1	2,481.3	2,481.3	2,480.8	2,480.8	2,480.5		3,190.8	5,989.8	
Non-interest current account deficit that stabilizes debt ratio	8.0	7.4	-1.6	-6.6	6.4	1.1	-2.3	-2.3	2.2	10.4			9.1	6.9	5.9	4.1	4.2	3.7		1.5	1.2	
Key macroeconomic assumptions																						
Real GDP growth (in percent)	3.8	6.4	4.7	4.3	6.0	-1.5	4.0	6.0	5.4	6.0	5.3	1.0	7.0	7.0	7.0	7.0	7.0	6.0	6.8	6.0	6.0	6.0
GDP deflator in U.S. dollar terms (change in percent)	2.8	2.1	0.0	-5.0	-1.6	-2.1	1.0	4.1	4.3	10.7	5.0	4.1	8.8	4.8	2.9	2.9	2.5	3.6	4.3	2.4	2.4	2.4
Effective interest rate (percent) 6/	4.0	3.6	3.5	3.4	3.3	2.5	2.3	2.1	2.1	1.6	2.0	0.3	2.7	2.7	2.7	2.7	2.7	2.7	2.7	3.3	3.7	3.4
Growth of exports of goods & services (U.S. dollar terms, in percent)	5.0	13.4	3.6	-2.3	16.1	-4.4	-3.6	9.6	11.3	8.3	6.4	6.8	9.2	9.7	8.6	8.3	8.5	8.5	8.8	6.8	6.9	6.9
Growth of imports of goods & services (U.S. dollar terms, in percent)	2.0	7.9	1.2	2.1	21.1	-13.7	-0.4	8.5	18.5	10.5	9.3	7.7	17.1	13.0	7.1	6.6	8.3	9.1	10.2	7.0	7.5	7.3
Grant element of new public sector borrowing (in percent)						...	...	...	...	...	...	...	9.4	11.8	10.7	10.6	8.6	10.3	10.2	15.3	7.3	12.8
Memorandum item:																						
Nominal GDP (billions of U.S. dollars)	13.9	15.1	15.8	15.7	16.3	15.7	16.5	18.2	20.1	23.5			27.4	30.7	33.9	37.3	40.9	44.9		67.7	154.3	

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Sri Lanka Development Bonds (SLDB) are dollar-denominated government bonds held by domestic banks and investors
6/ Current-year interest payments devided by previous period debt stock.
7/ Historical averages and standard deviations are generally derived over 2002-2005 due to the previous civil conflict, subject to data availability.

Table II.4. Sri Lanka: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006–26

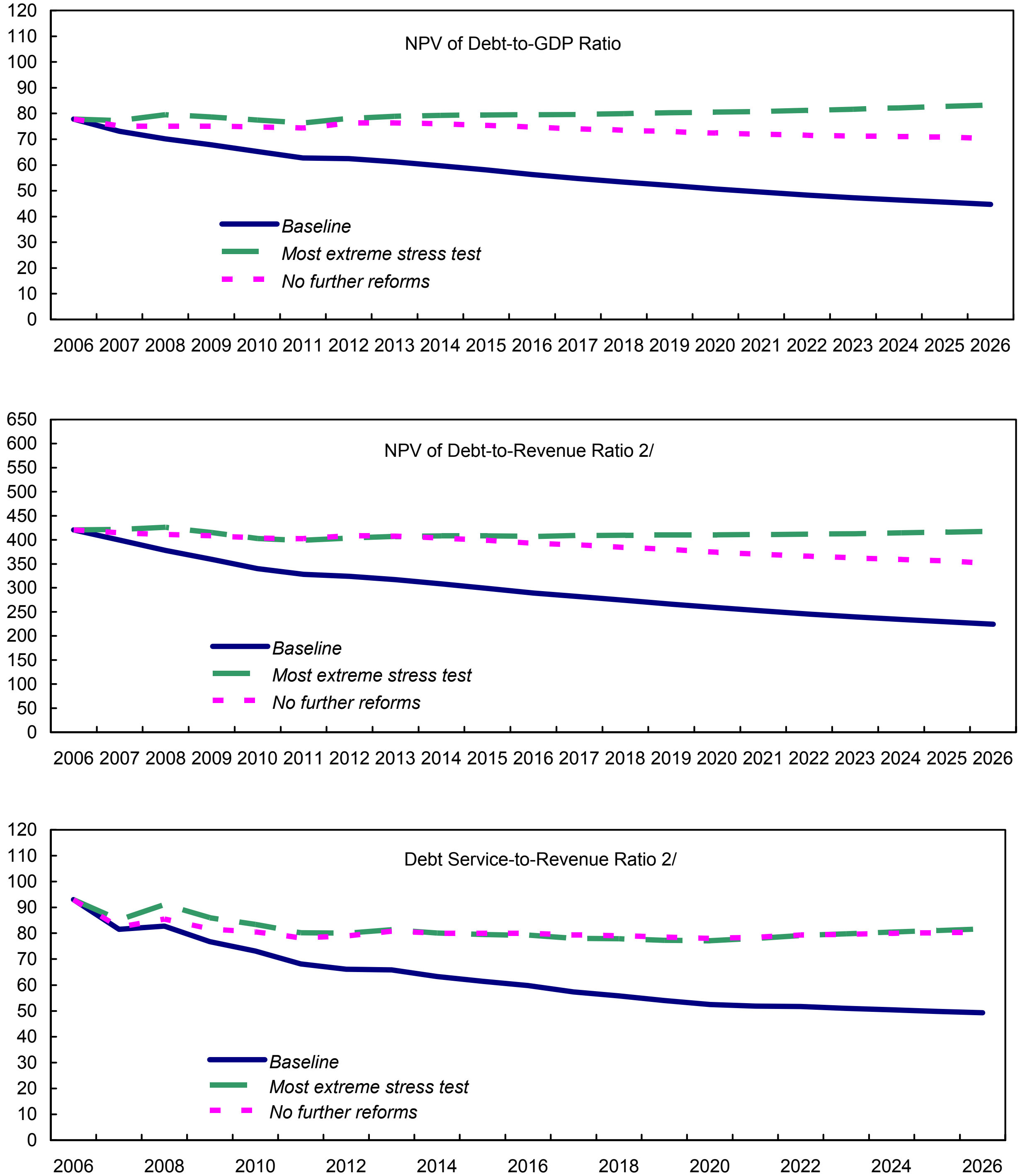
(In percent)

	Projections							
	2006	2007	2008	2009	2010	2011	2016	2026
NPV of Debt-to-GDP Ratio								
Baseline	29	29	28	27	26	25	20	11
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–26 1/	29	25	22	20	19	18	15	11
A2. New public sector loans on less favorable terms in 2007–26 2/	29	30	29	30	29	29	26	20
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	29	29	29	29	28	27	21	12
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	29	31	35	34	33	32	23	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007–08	29	30	29	29	28	27	21	12
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007–08 4/	29	30	31	30	29	28	21	11
B5. Combination of B1-B4 using one-half standard deviation shocks	29	33	38	37	35	34	25	12
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	29	40	39	38	37	35	28	16
NPV of Debt-to-Exports Ratio								
Baseline	94	93	91	91	89	87	73	48
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–26 1/	94	83	73	69	64	60	55	46
A2. New public sector loans on less favorable terms in 2007–26 2/	94	96	97	99	99	98	94	86
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	94	93	91	91	89	87	73	48
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	94	112	139	138	135	131	102	60
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007–08	94	93	91	91	89	87	73	48
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007–08 4/	94	97	101	100	98	95	77	49
B5. Combination of B1-B4 using one-half standard deviation shocks	94	110	131	130	127	123	96	56
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	94	93	91	91	89	87	73	48
Debt Service Ratio								
Baseline	15	12	12	10	10	8	9	9
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007-26 1/	15	12	12	9	9	6	6	8
A2. New public sector loans on less favorable terms in 2007-26 2/	15	12	10	9	8	9	9	11
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	15	12	12	10	10	8	9	9
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	15	13	15	14	14	12	13	11
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007–08	15	12	12	10	10	8	9	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007–08 4/	15	12	13	11	11	9	10	9
B5. Combination of B1–B4 using one-half standard deviation shocks	15	13	14	13	13	11	13	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	15	12	12	10	10	8	9	9
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	2	2	2	2	2	2	2	2

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and nondebt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure II.1. Sri Lanka: Indicators of Public Debt Under Alternative Scenario, 2006–2026 1/



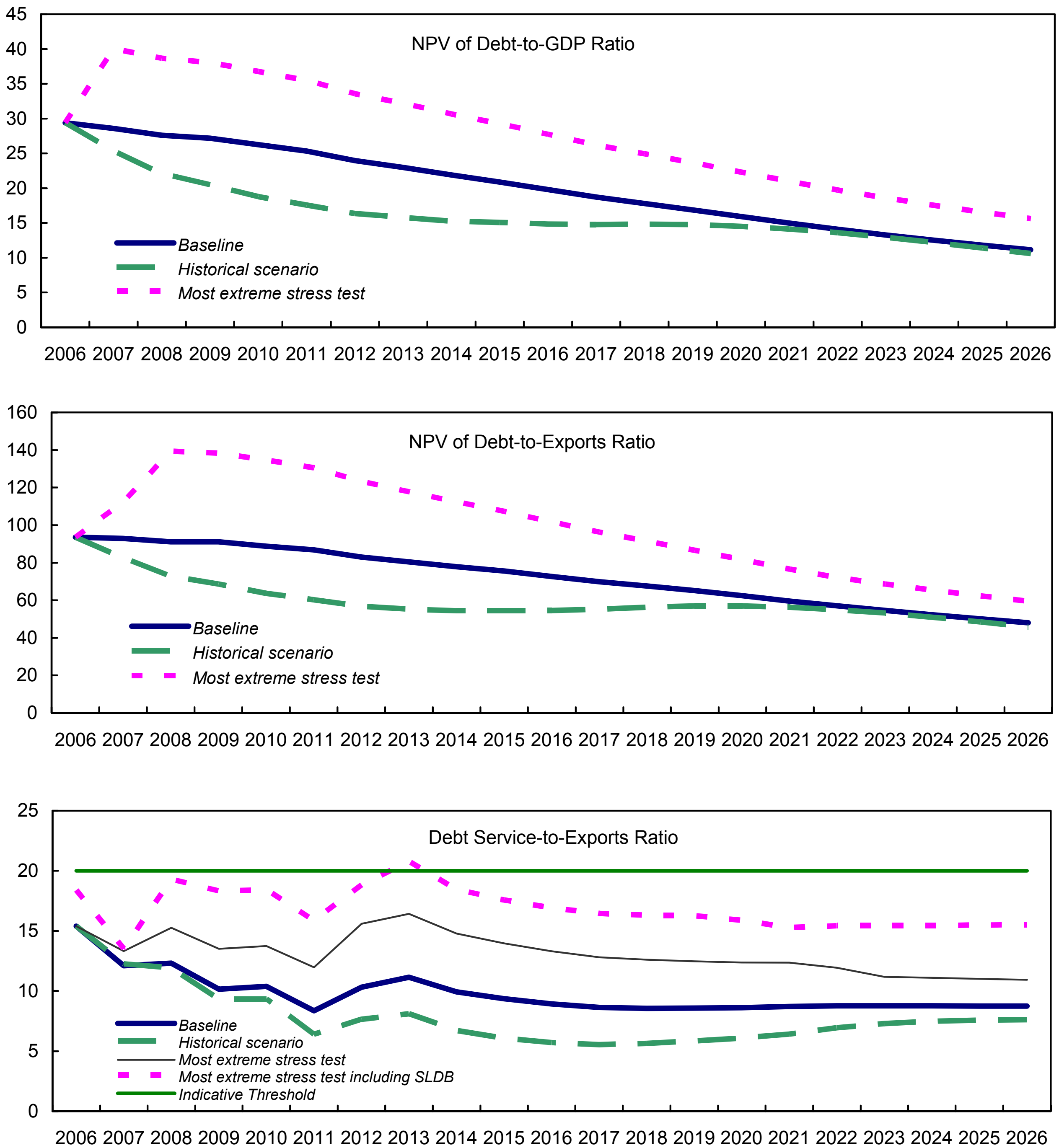
Source: Staff projections and simulations.

1/ Most extreme test is the test that yields the highest ratio in 2009. No further reforms test is the test that assumes continuation of recent (2003–2005) policies.

2/ Revenue including grants.

Figure II.2. Sri Lanka: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006–2026

(In percent)



Source: Staff projections and simulations.

APPENDIX III: SRI LANKA—FUND RELATIONS

(As of August 31, 2006)

I. **Membership Status**: Joined 8/29/50; accepted Article VIII, Sections 2, 3, and 4, March 1994.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	413.40	100.00
Fund holdings of currency	513.74	124.27
Reserve position in Fund	47.86	11.58

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	70.87	100.00
Holdings	2.06	2.91

IV. **Outstanding Purchases and Loans**:	SDR Million	Percent Quota
Emergency Assistance	103.35	25.00
Extended arrangements	20.67	5.00
PRGF arrangements	38.39	9.29
Stand-by arrangements	24.16	5.84

V. **Financial Arrangements**:

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

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

	2006	2007	2008	2009	2010
Principal	18.12	7.76	46.04	62.80	24.04
Charges/interest	2.66	9.67	8.87	6.24	3.69
Total	20.78	17.44	54.91	69.04	27.73

VII. **Exchange Rate Arrangement**:

Managed float. The central bank floated the rupee on January 23, 2001. The CBSL has removed the foreign exchange regulations that were imposed after the float. By Circular No. 35/01/005/0010/01 dated October 22, 2004, Circular No. 35/01/005/0010/05 dated October 18, 2006 and Operating Instructions Ref. 02/04/004/0009/001, the CBSL required importers to deposit with commercial banks margins of 50 percent of the total invoice value with respect to the import of certain goods (and 100% with respect to certain vehicles). In particular, these measures restrict current payments due in connection with letters of credit (which are a "normal short term banking and credit facility" under Article XXX(d)).

VIII. **Safeguards Assessment**:

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

IX. **Article IV Consultation**:

It is expected that the next Article IV consultation with Sri Lanka will be in accordance with the provisions applying to countries on the standard consultation cycle. The Executive Board concluded the 2005 Article IV consultation on July 15, 2005.

X. **FSAP and ROSC Participation**:

- MFD: Both the FSSA and the FSAP reports were completed in 2002.

- STA: A data ROSC was completed and the report published in 2002.

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

XI. **Resident Representative**:

A resident representative has been stationed in Sri Lanka since 1977. Mr. Valdivieso is the current Senior Resident Representative.

APPENDIX IV: SRI LANKA—RELATIONS WITH THE WORLD BANK GROUP[12]

(As of September 5, 2006)

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

A. IMF-World Bank Collaboration in Specific Areas

World Bank Activities

A number of operations support the implementation of reforms in public administration and public expenditure management, including: (i) the ***Economic Reform Technical Assistance*** (ERTA) credit; (ii) the recently closed ***Distance Learning Initiative*** helped to strengthen the environment for policy reform and build capacity in the public and private sectors through the transfer of the latest global knowledge with the establishment and operation of a Distance Learning Center (DLC); and (iii) the ***e-Sri Lanka Development Project*** that aims to enhance growth, employment and equity by promoting affordable access to and wide use of on-line public information and services by citizens and businesses and private sector competitiveness, particularly of knowledge industries and small and medium enterprises. The Bank has also led the dialogue on public expenditure issues, primarily to assist in the efforts to implement a medium term budget framework (MTBF).

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

In the education sector, the Bank was involved in two recently closed projects (***Second General Education*** and ***Teachers Education and Teachers Deployment***) and a major report (*Treasures of the Education System in Sri Lanka: Restoring Performance, Expanding*

[12] Prepared by the World Bank staff.

Opportunities and Enhancing Prospects)—that provided a comprehensive analysis of the education system and assisted the Government in developing the sector strategy. These provided the foundation for the ***Education Sector Development Project***. With regard to reform of the tertiary sector, Bank support is being provided through the ***Improving the Relevance and Quality of Undergraduate Education*** project.

In rural development**,** the Bank completed a major study—*"Sri Lanka: Promoting Agricultural and Rural Non-Farm Sector Growth"*—that identified key constraints, including poor access to critical infrastructure and services, ineffective public sector expenditure programs, poor flow of information on technology transfer and dominance of public sector as a service provider and underutilization of private sector initiatives. Another major study underway focuses on the constraints to and actions needed to sustain the growth of the tea and rubber sectors, and to improve the welfare of the large number of tea and rubber dependent households. The ***Community Development and Livelihood "Gemi Diriya"*** project addresses poverty reduction and reinvigoration of the rural economy.

In the area of peace and reconstruction of the North and East (NE), the ***North East Irrigated Agriculture Project II*** (NEIAP II) helps conflict-affected communities in the NE and adjoining areas in restoring livelihoods, enhancing agricultural and other production and incomes, and building capacity for sustainable, social and economic reintegration. To address housing needs, the ***North East Housing Reconstruction Project*** (NEHRP) is providing the poorest conflict-affected families in the NE (that meet accepted vulnerability criteria) with improved and affordable housing units.

To assess and improve the environment for the private sector, the Bank and ADB jointly conducted a comprehensive **Investment Climate Assessment** (ICA) of the urban formal sector and entrepreneurship in the rural areas. The Bank, through the ***Legal and Judicial Reform Project,*** is also working to make the existing legal and judicial framework more efficient, transparent and responsive to the needs of the public at large and of the private sector in particular.

In infrastructure*,* the ***Economic Reform Technical Assistance*** (ERTA) project was designed to facilitate reforms in priority sub-sectors (transport, telecommunications, petroleum, power, port and airport services, and urban water supply and sanitation services). Through the ***Renewable Energy for Rural Economic Development*** (RERED) project, the Bank is helping to improve the quality of rural life by utilizing off-grid renewable energy technologies to bring electricity to remote communities and promote private sector power generation from renewable energy resources from the main grid. In addition, through the ***Second Community Water Supply and Sanitation*** (CWSSP II) project, the Bank is supporting the implementation of demand-responsive and sustainable rural water and sanitation services. The Bank recently approved a large ***Road Sector Assistance Project*** with the objective of lowering transportation costs through sustainable delivery of an efficient national road system.

Related to the tsunami, the Bank—in collaboration with ADB and Japan Bank for International Cooperation—conducted a preliminary damage and needs assessment and released a joint report in early February 2005. The assessment formed the basis for a ***Tsunami Emergency Recovery Program*** (TERP) covering roads, rail, power, water, housing, health, education and livelihoods.

World Bank and IMF Collaboration

The Bank and the IMF are working closely together on financial sector issues. Through the recently closed ***Central Bank Strengthening*** project, the Bank supported improvements to the Central Bank and the financial sector policy and regulatory framework. The Bank also recently completed a piece of sector work entitled *"Sri Lanka: Improving Access to Financial Services"* that highlights numerous opportunities for promoting higher financial inclusion and points to the need for a multi-pronged approach to address current gaps and serve the diverse needs of households and businesses. The IMF has been providing technical advice to the Central Bank in a number of reform areas, including with regard to drafting/ implementing key new legislation and in conducting active open market operations.

The Bank and the IMF have shared responsibility for discussing social protection programs with the Government—including the various options under the 2002 Welfare Benefit Act—and reforming the welfare system to better target the poor and improve efficiency. Related to this, the Bank recently completed a report that reviews Sri Lanka's social protection programs and proposes options for enhancing their role in promoting growth with equity.

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

B. World Bank Group Strategy and Lending Operations

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

Bank Assistance Program in Sri Lanka. The Bank's active portfolio as of September 5, 2006 comprises 16 IDA credits/grants and one Global Environmental Facility (GEF) grant for a total commitment (net of cancellation) of $806.6 million (Table IV.1). The FY06 lending program includes two new projects approved in December 2005: (i) Education Sector Development Project; and (ii) Road Sector Assistance Project.

Economic and Sector Work. A key economic report is the "*Development Policy Review"* (DPR) (Report No. 29396-LK, December 8, 2004). This was complemented by a major piece on poverty: "*Poverty Assessment for Sri Lanka—Engendering Growth with Equity: Opportunities and Challenges"* (June 2006). A number of important sector reports/policy notes were completed in FY04–FY06: *"Treasures of the Education System in Sri Lanka: Restoring Performance, Expanding Opportunities and Enhancing Prospects,"* "*Sri Lanka: Improving the Rural and Urban Investment Climate,*" "*Post-Tsunami Recovery Program: Preliminary Damage and Needs Assessment," "Attaining the Millennium Development Goals in Sri Lanka," "Sri Lanka: Improving Access to Financial Services," "Decentralization and Service Delivery in Sri Lanka: Assessment and Options."* Other key diagnostic work completed over the last few years includes the Country Procurement Assessment Review (CPAR), Country Financial Accountability Assessment (CFAA), ROSC Accounting and Auditing Assessment, *"Promoting Agricultural and Rural Non-Farm Sector Growth"* (Report No. 25387-CE, February 26, 2003), Health Sector Policy Note and Roads Policy Note. Economic and sector work currently under way includes work on nutrition, ageing, and the tea and rubber sectors. These helped shape the report, "*Sri Lanka Development Forum: The Economy, The Tsunami and Poverty Reduction"* (Report No 32221-LK, April 28, 2005) that aimed to contribute to the national debate on the primary issues.

IFC's Activities in Sri Lanka. As of July 31, 2006, IFC's held portfolio in Sri Lanka consisted of investments in eight companies, with a total committed exposure of US$89.6 million. The portfolio is spread over financial institutions, power, health care, manufacturing, ports and telecommunications. Greater investment involvement is linked to progress on the political/security situation. IFC remains interested in investing in Sri Lanka (especially in infrastructure, manufacturing and financial markets) depending upon progress on reforms. Focus is instead on delivering a technical assistance (TA) program. In FY06, IFC opened a dedicated small and medium enterprise development program for Sri Lanka and the Maldives. IFC will provide $2 million of the $10 million total funding requirement for the five-year program along with other donors. The program's focus will be on financial services, and the business enabling environment, as well as specific sub-sectors, such as, tourism, construction and agribusiness. In light of the tsunami, IFC accelerated the launch of this program to assist the rehabilitation and creation of sustainable private enterprises.

Questions may be referred to Ms. Tinsley (458-4920) and on IFC to Ms. Gekis (458-4865).

Table IV.1. Summary of World Bank Operations

(As of September 5, 2006)

Credit/ Grant #	FY[1/]	Name of Operation	IDA Amount	GEF Amount	Cancel- lation	Undis- bursed[2/]
			(In millions of U.S. dollars)			
2880	1996	Private Sector Infrastructure Development	77.0		15.0	2.9
3384	2000	Legal and Judicial Reforms	18.2			3.1
3496	2001	Land Titling and Related Services (LIL)[3/]	5.0			1.0
3673	2002	Renewable Energy for Rural Economic Development	75.0			20.0
3722	2003	Economic Reform Technical Assistance	15.0			3.6
		Improving Relevance and Quality of Undergraduate				25.2
3781	2003	Education	40.3			
H013	2003	National HIV/AIDS Prevention	12.6			9.0
H035	2003	Second Community Water	39.8			28.1
H078	2004	Community Development and Livelihood	51.0			43.8
H095	2004	Health Sector Development	60.0			50.4
3935	2004	North-East Irrigated Agricultural Project II	64.7			61.6
4014	2005	North East Housing Reconstruction Program	75.0			53.4
3986	2005	E-Sri Lanka Development	53.0			39.8
4039/ H147	2005	Tsunami Emergency Reconstruction Program Phase II	75.0			15.2
H196	2006	Education Sector Development Project	60.0			54.9
4138	2006	Road Sector Assistance	100.0			89.3
GEF Projects[4/]						
51248	2002	Renewal Energy for Rural Economic Development[5/]		8.0		1.8
		Total	821.6	8.0	15.0	503.1

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

APPENDIX V: SRI LANKA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of June 30, 2006)

The Asian Development Bank (ADB) started its operation in Sri Lanka in 1969 and has provided 133 loans totaling about $3.7 billion and 220 technical assistance projects totaling about $91.6 million.

The Asian Development Bank approved five loans for Sri Lanka in 2005, amounting to $253 million. A grant of $150 million from the ADB's Asian Tsunami Fund was also approved. The $150 million grant and a $7 million loan for the Tsunami-affected Areas Rebuilding Project (TAARP) will help to rapidly improve the living conditions of people in tsunami-affected areas by restoring basic social infrastructure, community and public services, and livelihoods. ADB's Asian Tsunami Fund was set up in February with an initial ADB contribution of $600 million to deliver prompt emergency grant funding to tsunami-affected countries. An additional $14 million grant and a $26 million loan for the North East Community Restoration and Development Project II (NECORD II) will continue the government's rehabilitation program in conflict-affected areas of the Northern and Eastern provinces.

Six Technical Assistance (TA) projects were approved, amounting to $2.78 million. Two JFPR projects were also approved, amounting to $4 million, for tsunami related assistance. ADB assistance in 2005 includes road sector development, North East rehabilitation, technical education, and local government infrastructure improvement.

In 2005, the ADB's Board of Directors endorsed the Country Strategy and Program Update (CSPU) for 2006–2008, which envisages assistance of about $840 million over the next three years. The CSPU 2006–2008 supports road and port development, social infrastructure including education, rural finance and SME support, agriculture, and fiscal reforms.

ADB's top priorities in Sri Lanka are supporting broad-based economic growth, advancing social development and supporting improved governance. Emphasis will be placed on poorer regions and those encountering particular hardship. Out of the total, $270 million will come from ADB's Asian Development Fund (ADF), which supports the sustainable social and economic development of poor countries in the Asian and Pacific region, and $570 million will be from ordinary capital resources (OCR). The timing and magnitude of the assistance program will be responsive to the status and implementation of the ceasefire agreement, the prevailing security situation and country performance.

Reflecting ADB's country-wide focus, ADB's support over the three–year duration of the new program cycle will help the country provide quality education, increase access of the poor to social services, develop basic economic infrastructure, rebuild conflict-torn areas and reintegrate them into the national economy, enhance rural livelihoods, remove the barriers to attracting investment, and improve governance.

The lending program will be supported by technical assistance operations of about $8 million. The technical assistance program will support project preparation, institutional development, and economic, thematic and sector work.

As of June 30, 2006, the sectoral distribution of the loan portfolio was agriculture and natural resources, 14.2 percent; water supply, sanitation, waste management, 11.4 percent; energy, 8.0 percent; education, 11.4 percent; finance, 7.8 percent; transport and communications, 24.7 percent; industry and trade 3.9 percent; law, economic management, and public policy 4.0 percent, and multisector, 14.6 percent.

Lending by the Asian Development Bank, 1998–2005

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Commitment	190	184	209	100	157	315	184	n.a.
Net resource transfer	93	72	47	65	125	166	116	123
Disbursement	126	99	76	91	171	225	186	206

Source: Asian Development Bank.

APPENDIX VI: SRI LANKA—STATISTICAL ISSUES

Staff Assessment

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

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

Outstanding Statistical Issues

Real Sector

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

A technical assistance report by STA (October 1998) recommended that authorities should produce a single, high quality official CPI, which should cover all households (rather than just lower-income ones), and include a reliable price indicator for rent and owner-occupied housing. In response, a new nationwide CPI, covering the second to eighth income deciles, is being published. STA expects to publish this new index in IFS, following an assessment of its quality.

A data ROSC mission in June 2001 noted that considerable progress has been made in meeting most requirements for the Special Data Dissemination Standard (SDDS). However, the mission identified a number of deficiencies. The national accounts suffer from a lack of data sources and from undeveloped statistical techniques. Sri Lanka does not have periodic comprehensive benchmarks or a system for conducting regular annual surveys of establishments. A statistical business register, which would serve as the main basis for conducting sample surveys, is not available. As a result, the few surveys that are conducted do not have good sample frames. Most of the data used for regular compilation are obtained on a timely basis. However, detailed data needed to measure both output and intermediate consumption are mostly unavailable or not collected. As a result, the estimates of gross value added are prepared directly relying on outdated fixed ratios established from the base year 1996, often with outdated studies or ad hoc assumptions. Quarterly indicators are used for compiling quarterly value added estimates. The methodology for deriving GDP at constant prices is not satisfactory. Expenditures estimates are available only annually and rely mostly on commodity flow techniques. Whenever possible, estimates are validated and checked with other sources.

Fiscal Sector

A government finance statistics mission from STA in May 2003 followed up on the ROSC recommendation to develop a migration path to compile data in accordance with the *Government Finance Statistics Manual 2001 (GFSM 2001)*. As part of that plan, the authorities agreed to revise from end–2003 the budgetary classifications and the accounting structure to eventually match the *GFSM 2001* classifications of all stocks and flows and to apply that chart of accounts to all general government units. Progress with the implementation of these improvements needs to be assessed.

Data for 2002 were reported for publication in the 2004 *GFS Yearbook, but no updates were received since then.* These data cover only the budgetary accounts of central government. No data on the four extra-budgetary funds or the provincial and local governments are provided. No sub-annual data are provided for publication in IFS.

Monetary Sector

Foreign Currency Banking Units (FCBUs) are now classified as resident institutions in the monetary survey (since 1998). To adjust for the proportion of nonresident foreign currency deposits (NRFC), which are actually held by residents (mainly returning migrant workers), 50 percent of these deposits are reclassified from foreign liabilities to domestic deposits. The authorities started reporting the adjusted monetary data to STA from January 1999.

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

External Sector

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

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

The CBSL provides gross and net official reserves and intervention data in U.S. dollar terms on a weekly basis.