INTERNATIONAL MONETARY FUND

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SRI LANKA

December 2023

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY, REQUESTS FOR A WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION, MODIFICATION OF PERFORMANCE CRITERIA, REPHASING OF ACCESS, AND FINANCING ASSURANCES REVIEW—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

In the context of the First Review Under the Extended Arrangement Under the Extended Fund Facility, Requests for a Waiver of Nonobservance of Performance Criterion, Modification of Performance Criteria, Rephasing of Access, and Financing Assurances Review, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 12, 2023, following discussions that ended on October 19, 2023, with the officials of Sri Lanka on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on November 28, 2023.
- A **Statement by the Executive Director** for Sri Lanka.

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

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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR23/439

IMF Executive Board Completes the First Review Under the Extended Fund Facility Arrangement with Sri Lanka

FOR IMMEDIATE RELEASE

- The IMF Board completed the first review under the 48-month Extended Fund Facility with Sri Lanka, providing the country with access to SDR 254 million (about US$337 million) to support its economic policies and reforms.
- Sri Lanka's performance under the program was satisfactory. All but one performance criteria and all but one indicative targets were met at end-June. Most structural benchmarks due by end-October 2023 were either met or implemented with delay. Notably, the authorities published the Governance Diagnostic Report, making Sri Lanka the first country in Asia to undergo the IMF Governance Diagnostic exercise.
- The authorities have made commendable progress toward restoring debt sustainability, raising revenue, rebuilding reserves buffers, reducing inflation, and safeguarding financial stability. Strong commitment to improving governance and protecting the poor and vulnerable remains critical.

Washington, DC – **December 12, 2023:** The Executive Board of the International Monetary Fund (IMF) completed today the first review under the 48-month Extended Fund Facility (EFF) Arrangement. The completion of the first review allows for an immediate disbursement of SDR 254 million (about US$337 million), bringing the total IMF financial support disbursed so far to SDR 508 million (about US$670 million).

The total amount of Sri Lanka's EFF Arrangement is SDR 2.286 billion (about US$3 billion) as of the time of program approval on March 20, 2023 (see Press Release). The program supports Sri Lanka's efforts to restore macroeconomic stability and debt sustainability, safeguard financial stability, and enhance growth-oriented structural reforms.

Following the Executive Board discussion on Sri Lanka, Mr. Kenji Okamura, Deputy Managing Director, issued the following statement:

``Macroeconomic policy reforms are starting to bear fruit and the economy is showing tentative signs of stabilization, with rapid disinflation, significant revenue-based fiscal adjustment, and reserves build-up.

``Performance under the EFF-supported program has been satisfactory. All quantitative performance criteria for end-June were met, except the one on expenditure arrears. All indicative targets were met, except the one on tax revenues. Most structural benchmarks were either met or implemented with delay by end-October 2023. The publication of a Governance Diagnostic Report, the first in Asia and a structural benchmark under the program, is a commendable first step towards addressing deep-rooted corruption weaknesses. Continued commitment to improving governance and timely implementation of the report's recommendations can deliver tangible economic gains to all citizens.

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``Sri Lanka's agreements-in-principle with the Official Creditors Committee and Export-Import Bank of China on debt treatments are consistent with the EFF targets. They are an important milestone putting Sri Lanka's debt on the path towards sustainability. A swift completion and signature of the Memoranda of Understanding with the official creditors is important. Timely implementation of the agreements, together with reaching a resolution with external private creditors on comparable terms, should help restore Sri Lanka's debt sustainability over the medium term.

``To ensure a full and swift recovery, sustaining the reform momentum and strong ownership of reforms is of paramount importance. Key priorities include advancing revenue mobilization, aligning energy pricing with costs, strengthening social safety nets, rebuilding external buffers, safeguarding financial stability, eradicating corruption, and enhancing governance.

``Reinforcing the revenue-based fiscal consolidation supported by revenue administration reforms is critical to recover from program slippages and promote a break from past policy shortcomings.

``The Central Bank of Sri Lanka should continue to focus on the multi-pronged disinflation strategy to safeguard the credibility of its inflation targeting regime. Accumulating reserves, supported by exchange rate flexibility, remains an important priority under the EFF.

``Implementing the bank recapitalization plan and strengthening financial supervision and crisis management framework are crucial to safeguard financial sector stability.

``Further strengthening the social safety net and protecting social spending remains critical to safeguarding the poor and vulnerable.''

Sri Lanka: Selected Economic Indicators 2020-2028

	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Est.			Projections		
GDP and inflation (in percent)									
Real GDP	-4.6	3.5	-7.8	-3.6	1.8	2.7	3.0	3.1	3.1
Inflation (average) 1/	4.6	6.0	45.2	17.9	7.9	5.6	5.4	5.3	5.2
Inflation (end-of-period) 1/	4.2	12.1	54.5	4.8	6.6	5.6	5.4	5.3	5.2
GDP Deflator growth	3.3	8.5	48.8	20.4	10.1	6.3	5.4	5.3	5.2
Nominal GDP growth	-1.5	12.3	37.2	16.1	12.1	9.1	8.6	8.5	8.5
Savings and investment (in percent of GDP)									
National savings	31.6	33.0	33.4	31.8	30.8	30.5	30.9	31.4	31.4
Government	-8.3	-7.3	-6.2	-6.0	-3.1	-0.9	-0.3	0.3	0.6
Private	39.9	40.3	39.7	37.8	33.9	31.4	31.3	31.1	30.8
National investment	33.0	36.7	34.4	30.3	31.6	31.6	32.0	32.4	32.3
Government	6.2	7.4	7.0	4.1	5.1	5.1	5.0	5.0	5.0
Private	26.8	29.4	27.4	26.2	26.5	26.5	27.0	27.4	27.2
Savings-Investment balance	-1.4	-3.7	-1.0	1.5	-0.8	-1.1	-1.1	-1.0	-0.8
Government	-14.5	-14.7	-13.3	-10.1	-8.2	-6.0	-5.3	-4.7	-4.4
Private	13.1	11.0	12.3	11.6	7.5	4.9	4.3	3.8	3.6
Public finance (in percent of GDP)									
Revenue and grants	8.8	8.3	8.3	10.2	13.0	15.0	15.0	15.1	15.2
Expenditure	21.0	20.0	18.5	19.0	20.3	20.3	19.7	19.3	19.1
Primary balance	-5.9	-5.7	-3.7	-0.7	0.8	2.3	2.3	2.3	2.3
Central government balance	-12.2	-11.7	-10.2	-8.8	-7.3	-5.3	-4.7	-4.2	-3.9
Central government gross financing needs	26.1	31.0	33.9	27.8	25.3	23.0	19.8	17.1	12.3
Central government debt	96.7	102.7	115.5	107.8	110.3	111.4	110.8	108.0	104.6
Public debt 2/	105.1	114.9	125.8	114.1	115.9	116.3	115.1	111.7	107.9
Money and credit (percent change, end of period)									
Reserve money	3.4	35.4	3.3	9.0	16.9	9.1	8.6	8.5	8.5
Broad money	23.4	13.2	15.5	7.0	18.2	9.1	8.6	8.5	8.5
Domestic credit	24.6	19.5	18.8	5.5	10.6	3.0	2.0	3.7	3.2
Credit to private sector	6.5	13.1	6.4	0.3	7.7	8.7	9.4	9.6	9.5
Credit to private sector (adjusted for inflation)	1.9	7.2	-38.8	-17.6	-0.2	3.2	4.0	4.3	4.3
Credit to central government and public corporations	53.6	26.5	31.1	9.8	12.8	-1.0	-3.7	-1.5	-3.0
Balance of Payments (in millions of U.S. dollars)									
Exports	10,048	12,499	13,106	12,365	13,555	14,377	15,111	15,846	16,651
Imports	-16,055	-20,638	-18,291	-17,887	-20,718	-23,002	-24,322	-25,144	-26,049
Current account balance	-1,187	-3,285	-744	1,232	-634	-908	-879	-846	-764
Current account balance (in percent of GDP)	-1.4	-3.7	-1.0	1.5	-0.8	-1.1	-1.1	-1.0	-0.8
Current account balance net of interest (in percent of GDP)	0.5	-2.1	0.1	2.9	1.2	0.9	0.9	1.1	1.3
Export value growth (percent)	-15.9	24.4	4.9	-5.7	9.6	6.1	5.1	4.9	5.1
Import value growth (percent)	-19.5	28.5	-11.4	-2.2	15.8	11.0	5.7	3.4	3.6
Gross official reserves (end of period)									
In millions of U.S. dollars	5,664	3,139	1,898	3,806	5,346	7,477	9,894	13,525	15,320
In months of prospective imports of goods & services	3.2	2.0	1.2	2.0	2.6	3.4	4.3	5.7	6.2
In percent of ARA composite metric	46.0	24.7	16.4	33.2	44.7	59.9	77.1	99.7	109.6
Usable Gross official reserves (end of period) 3/									
In millions of U.S. dollars	5,664	1,565	462	2,371	3,910	7,477	9,894	13,525	15,320
In months of prospective imports of goods & services	3.2	1.0	0.3	1.3	1.9	3.4	4.3	5.7	6.2
In percent of ARA composite metric	46.0	12.3	4.0	20.7	32.7	59.9	77.1	99.7	109.6
External debt (public and private)									
In billions of U.S. dollars	53.4	58.4	57.4	53.8	55.5	57.7	59.9	63.4	65.1
As a percent of GDP	63.2	65.9	76.7	64.7	68.0	70.4	71.8	72.7	70.3
Memorandum items:									
Nominal GDP (in billions of rupees)	15,672	17,600	24,148	28,033	31,422	34,291	37,226	40,397	43,812
REER appreciation (percent, period average)	0.6	-6.0	-4.8	-5.2	-3.7	-5.8	-4.0	-1.5	0.0
Exchange Rate (period average)	185.6	198.8	322.6	...	...	...	...	...	...
Exchange Rate (end of period)	186.4	200.4	363.1	...	...	...	...	...	...

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

1/ Colombo CPI.

2/ Comprising central government debt, publicly guaranteed debt, and CBSL external liabilities (i.e., Fund credit outstanding and international currency swap arrangements).

3/ Excluding PBOC swap ($1.4bn in 2022) which becomes usable once GIR rise above 3 months of previous year's import cover.

INTERNATIONAL MONETARY FUND

SRI LANKA

November 28, 2023

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY, REQUESTS FOR A WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION, MODIFICATION OF PERFORMANCE CRITERIA, REPHASING OF ACCESS, AND FINANCING ASSURANCES REVIEW

EXECUTIVE SUMMARY

Context. As part of the IMF-supported arrangement Sri Lanka has undertaken significant reforms to pave the way out of a deep economic and debt crisis. The economy is showing tentative signs of stabilization, supported by rapid disinflation and a significant fiscal adjustment. Tax revenues have increased but not as much as initially projected, and reserves accumulation has slowed, including due to slow progress on debt restructuring. Continued ownership of reforms is essential to rebuild fiscal credibility and to improve governance and reduce corruption vulnerabilities. The authorities reached agreements in principle (AIPs) with official creditors on debt treatments consistent with program parameters and are in good faith discussions with their private creditors.

Program Status. In March 2023, the IMF's Executive Board approved a 48-month Extended Arrangement under the Extended Fund Facility (EFF), with access to Fund resources of SDR 2.286 billion (395 percent of quota or about US$3 billion), and a first disbursement of SDR 254 million (about US$333 million). The arrangement supports Sri Lanka's efforts to restore sustainability through an ambitious revenue-based fiscal consolidation and debt restructuring; maintain price stability as well as rebuild reserves under greater exchange flexibility; safeguard financial sector stability; and address corruption vulnerabilities. On completion of the first review, Sri Lanka would have access to an additional SDR 254 million.

Program Performance. Program performance at end-June was satisfactory. All end-June quantitative performance criteria (QPCs) were met, except on expenditure arrears, and all continuous QPCs were also met. All end-June indicative targets (IT) were met, except on tax revenue. Headline inflation led to the nonobservance of the end-June lower outer MPCC band, triggering consultation with the Executive Board. Based on the available data, all end-September ITs were met except for the tax revenue floor. Most structural benchmarks (SBs) due by end-October 2023 were either met or implemented with delay.

Program Risks. Risks to program implementation and financing are high and have increased since program approval. Implementation risks arise from Sri Lanka's track record of reform implementation and the challenging political and social situation. A deeper crisis induced by delays in implementing the debt restructuring, a weakened banking sector, exchange rate pressure, and loss of market confidence could also complicate program implementation. In this regard, contingency plans are crucial, and policies should remain agile to adjust to the evolving circumstances.

Program Modalities. All three prior actions for the first review have been met. Modifications of end-December 2023 program targets are being proposed for the QPCs for Net Credit to Government (NCG), the Monetary Policy consultation Clause (MPCC) and the ITs on central government tax revenue and treasury guarantees. The program also proposes new and modified structural benchmarks. Staff support the authorities' request to rephase access by adjusting the disbursement availability schedule to better align it with data availability for test dates. A waiver is requested for the non-observance of the end-June QPC on arrears given that this nonobservance was temporary. Staff recommends that the Board completes the required MPCC consultation.

Approved By
Anne-Marie Gulde-Wolf (APD) and Martin Cihak (SPR)

Discussions were held in Colombo during September 14-28, in Marrakech during October 9-13 and virtually during October 16-19, 2023. The mission met with President and Finance Minister Wickremesinghe, Central Bank of Sri Lanka Governor Dr. Weerasinghe, State Minister Semasinghe, Secretary to the Treasury Siriwardana, and other senior government and CBSL officials; and representatives of the Parliamentary Opposition, the business community, civil society, and development partners. The staff team comprised P. Breuer (senior mission chief) and K. Svirydzenka (deputy mission chief), M. Li, H. Selim, Y. Zhang (all APD), S. Dhungana (SPR), D. Rozhkov (FAD), M. Adams, H. Miao (both MCM), H. Lan Vu (COM), S. Jahan (resident representative), and M. Abeyawickrama (local economist). C. Amarasekara (OED) joined most discussions. R. Yang and M. Odoño (both APD) assisted in the preparation of this report.

CONTENTS

TABLES

ANNEXES

APPENDIX

Acronyms

AC	Anti-Corruption
AB	Appropriation Bill
ACU	Asian Clearing Union
ADB	Asian Development Bank
AIP	Agreement in Principle
AQR	Asset Quality Review
BA	Banking Act
BoP	Balance of Payment
BSTA	Bulk Supply Transaction Account
CBA	Central Bank Act
CBSL	Central Bank of Sri Lanka
CD	Capacity Development
CDB	China Development Bank
CEB	Ceylon Electricity Board
CIT	Corporate Income Tax
COT	Comparability of Treatment
CPC	Ceylon Petroleum Corporation
CPI	Consumer Price Index
DDO	Domestic Debt Operation
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
EFF	Extended Fund Facility
EMBI	Emerging Markets Bond Index
FAD	Fiscal Affairs Department
FDI	Foreign Direct Investment
FPP	Financial Programming and Policies
FSSR	Financial Sector Stability Reviews
FX	Foreign Exchange
GD	Governance Diagnostic
GDP	Gross Domestic Product
GFN	Gross Financing Needs
GFS	Government Finance Statistics
GIR	Gross International Reserves
HNWI	High Net Worth Individuals
IFC	International Finance Corporation
IRD	Inland Revenue Department
ISB	International Sovereign Bond
IT	Indicative Target
ITMIS	Integrated Treasury Management Information System
LEG	Legal Department
LKR	Sri Lankan Rupee
LTU	Large Taxpayers Unit

MCM	Monetary and Capital Markets Department
MCP	Multiple Currency Practices
MEFP	Memorandum Of Economic and Financial Policies
MPCC	Monetary Policy Consultation Clause
MTFF	Medium-Term Fiscal Framework
NCG	Net Credit to Government
NER	Nominal Exchange Rate
NIR	Net International Reserves
NOP	Net Open Position
NPL	Non-Performing Loan
NPV	Net Present Value
OCC	Official Creditor Committee
OSI	Official Sector Involvement
PAYE	Pay As you Earn
PAL	Port and Airport Levy
PDMA	Public Debt Management Agency
PFM	Public Financial Management
PMI	Purchasing Managers' Index
PSI	Private Sector Involvement
PSSA	Payment Settlement and Systems Act
QPC	Quantitative Performance Criterion
RAMIS	Revenue Administration Management Information System
RBI	Reserve Bank of India
RDA	Road Development Authority
REER	Real Effective Exchange Rate
SARTTAC	South Asia Regional Training and Technical Assistance Center
SB	Structural Benchmark
SDP	Strategic Development Projects
SLA	Sri Lankan Airlines
SLDB	Sri Lankan Development Bond
SOE	State Owned Enterprises
SPR	Strategy, Policy, and Review Department
SRR	Statutory Reserve Ratio
SSN	Social Safety Nets
SVAT	Simplified Value-Added Tax
TA	Technical Assistance
TADAT	Tax Administration Diagnostic Tool
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	World Bank
WBB	Welfare Benefits Board
WBPS	Welfare Benefit Payment Scheme

CONTEXT

1. **The authorities are implementing the four-year EFF program approved in March 2023**. The program prioritizes macroeconomic stabilization, restoration of fiscal and financial sustainability, and growth-enhancing reforms including governance. The Parliament endorsed the policies under the program on April 28 and a resolution on the implementation of domestic debt restructuring on July 1. The initial strong reform momentum has yielded increased tax revenues, a rapid deceleration of inflation, reserves accumulation, and an easing of shortages of essential goods. Social tensions have subsided somewhat.

2. **The authorities concluded the key aspects of their domestic debt operation (DDO), reached agreements in principle (AIPs) with official creditors, and advanced discussions with external private creditors**. The DDO, executed in July-September 2023, includes the restructuring of the Central Bank of Sri Lanka (CBSL)'s holdings of T-bills and provisional advances into Treasury Bonds, the superannuation funds' holdings of T-bonds into longer-term maturities, as well as a conversion of commercial banks' selected local law FX-denominated claims on the government (including Sri Lankan Development Bonds (SLDBs)) into rupee debt instruments. The Ceylon Petroleum Corporation (CPC) FX loan restructuring is yet to be finalized. The CBSL and the Reserve Bank of India (RBI) agreed to settle arrears on the Asian Clearing Union (ACU) balances by turning these liabilities and associated penalty interest (due to late payments) into a special swap (US$2.2 billion) and combining it with the RBI South Asian Association for Regional Cooperation (SAARC) swap (US$400 million). These liabilities (US$2.6 billion) will be paid during 2023-26.[1] Negotiations with external private creditors have also advanced, and agreements in principle (AIPs) with official creditors have been reached (¶16).

RECENT MACROECONOMIC DEVELOPMENTS

3. **The economy is showing tentative signs of stabilization**.

- **Economic activity remains subdued, but inflation has subsided significantly**. GDP contracted by 7.9 percent in H1-2023. High frequency indicators indicate some recovery in services, but a lingering contraction in manufacturing. Headline inflation y-o-y fell significantly from a peak of 70 percent in September 2022 to 1.5 percent in October 2023.[2] Rapid disinflation was driven by responsive monetary policy, strong base effects, weak demand, an appreciating Rupee (between December 2022 and September 2023) and muted second-round effects.[3]

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[1] The full repayment of ACU liabilities, which arose from unsettled trade payments between Sri Lanka and India during 2021-22, were programed into the balance of payments financing gaps at the time of the EFF request.

[2] Inflation is monitored and conditionalities are set based on the Colombo CPI.

[3] Base effects were due to the dissipation of the effects of the March 2022 depreciation and last year's food and energy price surge. The second-round effects are from the electricity price hikes and contained wage increases.

- **Earlier rapid reserve accumulation slowed down by September 2023, in part constrained by banks' requirements for foreign exchange (FX)**. In H1-2023, lower imports (-19 percent y-o-y) and strong remittances (75 percent y-o-y) contributed to a current account (CA) surplus (around US$1 billion). However, the SLDB restructuring led banks to close their resulting net open FX positions (NOP) by placing their foreign exchange assets abroad. Further, the continued foreign currency default rating of the sovereign made it difficult for banks and businesses to renew their letters of credit, causing them to pay down their external liabilities, including trade credits and loans. These financial outflows were estimated at US$950 million at end-June. As their accumulation slowed down from US$1.25 billion in March-May to only U$50 million during June-September, Gross International Reserves (GIR) are projected to reach US$3.8 billion at end-2023 (US$600 million less than at program request). After appreciating by 22.6 percent between March and May the nominal exchange rate depreciated by 10 percent during June-September, despite CBSL intervention through direct sales (US$150 million) and support for a state-owned bank to reduce its FX NOP (US$225 million on a net basis).[4]

- **Total revenue is projected to increase by 2 percentage points of GDP from last year, but not as much as initially projected** (Text Table). Tax revenue for 2023 is expected to increase to 9.2 percent of GDP, as supported by actual data through September. The shortfall of 0.8 ppt of GDP relative to the projection at program request is due to unanticipated economic developments and weaknesses in revenue administration (Annex I). The primary deficit target of 0.7 percent of GDP is expected to be met through an under execution of capital spending, driven in part by the reduction of externally financed projects amid uncertainty resulting from debt restructuring.[5] Despite the

Sri Lanka: Fiscal Outturn, 2022-23

	2022		2023	
	Act.		Proj.	
	Billion Rupees	percent of GDP	Billion Rupees	percent of GDP
Total Revenue and Grants	**2,013**	**8.3**	**2,847**	**10.2**
Total Revenue	**1,979**	**8.2**	**2,835**	**10.1**
Tax Revenue	**1,751**	**7.3**	**2,593**	**9.2**
Income Taxes	534	2.2	861	3.1
Taxes on property	0	0.0	0	0.0
Tax on goods & services	876	3.6	1,374	4.9
VAT	463	1.9	679	2.4
Excise Taxes	343	1.4	450	1.6
Other taxes & levies	70	0.3	245	0.9
Tax on external trade	341	1.4	357	1.3
Non Tax Revenue	**228**	0.9	**243**	0.9
Grants	33	0.1	12	0.0
Total Expenditure and net lending	**4,473**	**18.5**	**5,317**	**19.0**
Current Expenditure	**3,520**	**14.6**	**4,517**	**16.1**
Salaries & wages	956	4.0	975	3.5
Goods & services	183	0.8	254	0.9
Interest payments	1,565	6.5	2,274	8.1
Subsidies & transfers	815	3.4	1,014	3.6
Social Safety Net	142	0.6	187	0.7
Capital Expenditure and Net Lending	**953**	**3.9**	**800**	**2.9**
Capital Expenditure	715	3.0	800	2.9
Net Lending	237	1.0	0	0.0
Overall balance	**-2,460**	**-10.2**	**-2,470**	**-8.8**
Primary balance	**-895**	**-3.7**	**-196**	**-0.7**

Source: Sri Lankan authorities; and IMF staff calculations.

[4] This intervention had an immediate negative US$450 million impact on program NIR because of underlying forward transactions that will be unwound in later years of the program.

[5] While the cumulative primary balance at end-October was in a surplus of 0.8 percent of GDP, seasonal spending patterns during the last quarter, including on capital projects, are expected to leave the 2023 projection of a 0.7 percent of GDP primary deficit unchanged.

disbursement of budgetary support by the Asian Development Bank (ADB) and World Bank (WB) of US$350 million and US$250 million in May and June, budget liquidity has remained tight, due to large interest payments (6.3 percent of GDP at end-October, reflecting elevated T-bills rates (¶18) and external debt service. Budget financing in 2023 is mostly expected to come from domestic sources (6.6 percent of GDP) in light of external financing shortfalls.

- **Despite recently improved liquidity and financial conditions, financial system vulnerabilities remain**. Banks have maintained depositor confidence and FX and rupee liquidity stress has subsided somewhat. Post-DDO, financial conditions in the local currency debt market also eased somewhat from their crisis peak but T-bills yields are still significantly above the policy rate (¶18), reflecting subdued appetite for government securities. The Asset Quality Review (AQR) exercise and the bank recapitalization roadmap developed by the CBSL confirmed that two largest state-owned commercial banks (about 40 percent of bank assets) had a capital shortfall at end-2022, which will be addressed through the authorities' banks recapitalization plan (¶26). Other challenges include worsening credit quality, shrinking profitability and large unhedged FX exposure to the public sector. Private credit continued to contract at -7.6 percent y-o-y in July 2023.

OUTLOOK AND RISKS

4. The outlook is for a moderate recovery in 2024. Growth is projected to pick up from -3.6 percent in 2023 to 1.8 percent in 2024, supported by accommodative monetary conditions and the relaxation of import restrictions. Constrained bank credit and fiscal consolidation will weigh on the outlook. Inflation is expected to edge up to 4.8 percent by end-2023 following the October electricity tariff hike (¶14) and further to 6.6 percent by end-2024 following the introduction of the Value-Added Tax (VAT) measures (¶11). The CA is expected to post a deficit of 0.8 percent of GDP due to strong import growth as restrictions are relaxed, despite higher tourism earnings and remittances inflows. New program and project financing along with Foreign Direct Investment (FDI) would bring GIR up to US$5.35 billion at end-2024. The macroeconomic framework reflects the authorities' indicative debt treatment scenario (¶16 and Annex IV).

5. Risks to the program have increased since program approval.[6]

- **Program Financing**. The program is at risk of being underfinanced due to a number of factors, including: (i) reserves are being accumulated at a slower pace due to uncertainties arising from the debt restructuring and upcoming large outflows; (ii) financing risks have increased with higher gross financing needs projected for 2024-27—due in part to shorter maturities—and less certain financing, including for projects; (iii) recapitalization needs of CBSL and banks could be higher than expected; (iv) potential effects from restructuring of domestic FX debt; and (v) revenue is being raised at a slower pace and revenue administration remains inadequate.

[6] The Risk Assessment Matrix (RAM, Annex VIII) provides more details about domestic and external risks while ¶34 discusses enterprise risks.

- **Domestic risks** stem from incomplete program implementation against the backdrop of a weak track record, delays in addressing banking sector vulnerabilities including from rising dollarization (¶21), some upside inflation risks (¶19) and reform fatigue, particularly ahead of presidential elections in 2024. Social unrest could re-emerge, fueled by falling real incomes, including from tax rate hikes and cost-recovery pricing in the energy sector, insufficient anti-corruption efforts, and delayed local elections. Delays in implementing the debt restructuring could lead to weaker confidence and tighter financing conditions.

- **External risks** arise in part from intensified regional conflicts, including Russia's prolonged war in Ukraine and the conflict in the Middle East, resulting commodity price volatility, and a sharp global slowdown, which could reduce capital flows and reserve accumulation and lead to sharp exchange rate depreciation. Slow progress in debt restructuring would worsen the balance of payments, thus creating wider financing gaps.

6. Program risks are being managed through policy adjustment and contingency measures. Program risks from policy slippages would be corrected by compensating actions where possible. Program overperformance should be locked in to secure the program objectives. Revenue shortfalls would be mitigated by stronger ex-ante conditionality on revenue performance and a stronger focus on revenue administration reforms to enhance collection efforts. The authorities are engaging closely with their creditors to minimize delays in debt restructuring. Should downside risks materialize, contingency plans include the authorities' commitment to undertake immediate remedial action to address unexpected developments (e.g., more frequent electricity tariff revisions and emergency tariff revisions when needed, emergency policy rate hikes if inflation risks appear) and to consult in advance with staff on the adoption of these measures and revisions to the policies contained in the MEFP. The authorities also commit to refrain from policies that would be inconsistent with the program's objectives. Other contingency plans are discussed in ¶34.

PROGRAM PERFORMANCE

7. Performance of quantitative conditionality was satisfactory. All continuous Quantitative Performance Criteria (QPCs) were observed, and end-June quantitative targets were met except for the QPC on arrears, the Indicative Target (IT) on tax revenue, and inflation leading to the nonobservance of the end-June lower outer MPCC band, triggering a consultation with the Executive Board. Based on the available data, all end-September ITs were met except for the tax revenue floor.

- **Fiscal**. The primary balance posted a surplus of Rs. 31 billion at end-June and Rs. 123.7 billion at end-September, surpassing the quantitative targets of a deficit of Rs. 113 billion and 160 billion respectively. Tax revenues fell short of the IT by about 8 percent (and an average of 0.3 percent of GDP) for both June and September. Budget liquidity tensions led to the accumulation of expenditure arrears in the amount of Rs. 34.5 billion, thus missing the June QPC, but authorities cleared them by end-September. Other quantitative targets at end-June were met.

- **Monetary and Reserves**. Inflation fell below the lower outer band of the Monetary Policy Consultation Clause (MPCC) in Q2-2023 by 4.6 percentage points (Annex V) and fell further down to 3.8 percent in Q3-2023, within the MPCC inner band. Large T-bill purchases by foreigners helped the CBSL unwind exposure to government securities with Net Credit to Government (NCG) falling from Rs. 3,020 billion at end-March to Rs. 2,800 billion at end-June, exceeding the performance criterion by Rs. 90 billion. The end-September IT of Rs. 2,840 billion was also met by a small margin (with outturn of Rs. 2,838 billion). Program Net International Reserves (NIR), estimated at US$-1.9 billion at end-June, exceeded the adjusted target of US$-2.9 billion, and the September IT was also met.

8. The majority of structural benchmarks (SBs) due by end-October 2023 were met despite some delays.

- **Fiscal**. Continuous SBs on setting fuel and electricity prices at cost recovery levels were met on an ex-ante basis. However, the Ceylon Electricity Board (CEB) incurred losses in July and August following a 14 percent cut in the average tariff in July based on optimistic assumptions on rainfall and global energy prices. As corrective action, the average electricity tariff was increased by 18 percent in October, ahead of the scheduled January revision (¶14).[7] Cabinet approved in June a comprehensive strategy to restructure the balance sheets of four key SOEs (Annex II). The 2024 Appropriation Bill (AB) submitted to parliament in October was broadly in line with program parameters.[8] Parliament passed the new welfare benefit payment scheme (WBPS) known as *Aswesuma* in May. SBs regarding the cabinet approval of revenue measures to support fiscal consolidation in 2024 (end-July) and the ITMIS rollout (end-September) were not met, the latter on account of an insufficient number of trainers.

- **Monetary Policy**. Parliament approved the Central Bank Act (CBA) on July 20 instead of end-April, thus missing the SB. The CBA strengthens the price stability mandate and removes government representation from the Governing Board and Monetary Policy Board., Further, because the revised CBA allows a long transitory period for monetary financing of 18 months—contrary to one of the key objectives in the March 2023 Memorandum of Economic and Financial Policies (MEFP)—staff assesses the SB as not having been met. Remedial action is discussed in ¶20.

- **Financial**. The SB requiring the completion of the first AQR round, covering the five largest banks, was not met (implemented with delay in May 2023 instead of end-April), and the second round, covering four smaller banks, was completed in August 2023. The end-June SB on cabinet approval of a full revision of the Banking Act (BA) was not met. The authorities opted to change

[7] The electricity cost recovery tariff includes the cost of any new borrowing and interest payments (but not the principal) on old debts.

[8] The AB allocation for social spending of Rs. 200 billion fell slightly short of the program floor set at Rs. 205 billion. The authorities increased the allocation in the Budget Speech on November 13, 2023.

their legislative strategy and introduce amendments to the current Act.[9] While Cabinet approved instructions to draft such amendments in June, it has not yet approved the draft legislation (¶27). The end-July SB for the CBSL to develop the roadmap for banks' recapitalization was not met (implemented with delay in October) as the authorities required more time to complete forward-looking stress tests and analysis of banks' NOPs and confirm public sector restructuring assumptions. The end-October SB on determining the recapitalization strategy of viable banks was met.

- **Anti-Corruption**. The SB to publish the governance diagnostic report in September was met. On July 19 (end-June SB), the Parliament approved the Anti-Corruption (AC) Bill, which strengthens the asset declaration system and the anti-corruption commission's investigative powers. Due to the delay and the lack of an envisaged provision for a transparent and merit-based selection process for the Anti-Corruption Commission members, the SB is assessed as not met. An alternative SB is proposed that reinforces the processes of the appointing body, the Constitutional Council (¶28).[10]

9. Program modalities have been adjusted to account for the recent macroeconomic developments.

- **Waiver of non-observance** for the end-June QPC on arrears (¶32).

- **MPCC Consultation**. Headline inflation led to the nonobservance of the lower outer band of the end-June MPCC, largely due to passthrough of exchange rate appreciation and muted second round effects (Annex V). In response, the authorities lowered the policy rate by 550 bps between June and October. The CBSL is committed to closely monitoring the inflation developments and adjusting monetary policy with the aim to anchor inflation around the target. Hence, staff recommends the Board to complete the consultation.

- **Modifications of End-December 2023 Quantitative Targets**. The QPC for NCG has been revised upward marginally from Rs. 2,740 billion to Rs. 2,800 billion (¶20) to address structural liquidity shortages. The MPCC clause is now set at a lower mid-point of 5 percent relative to 15 percent at program approval to account for faster disinflation (¶3 and 19). Meanwhile, the IT on central government tax revenue has been revised downwards by about 13 percent to Rs. 2,550 billion to account for the slower-than-envisaged revenue mobilization (¶3 and 11) and the IT on the limits on treasury guarantees has been revised upwards to account for the guarantee for the new special swap (¶2).

- **New Proposed Quantitative Targets** (¶33). A new continuous QPC on new CBSL purchases of government securities in the primary market is being proposed as of December 2023 as a

[9] The authorities initially worked on a fully new draft Bill, but concluded in May 2023 that it would be more feasible to meet the SB by introducing extensive amendments to the existing BA.

[10] The Constitutional Council is a constitutional authority tasked with maintaining independent commissions and monitoring their affairs, aimed at limiting political influence.

remedial action to mitigate risks from continued monetary financing due to the 18-months transitory period allowed in the new CBA (¶8 and 20). The existing IT on the tax revenue floor is upgraded to QPC as of June 2024 to further reflect the authorities' commitment to revenue mobilization reforms.

- **Prior Actions** (¶33). The authorities have completed three prior actions on (i) the adoption of a revenue package to secure adequate revenue mobilization measures in the 2024 budget (¶11); (ii) cabinet approval of quarterly instead of semi-annual electricity tariff revisions to ensure that emerging losses from CEB are addressed more quickly (¶8 and 14); and (iii) the formulation of a recapitalization plan for the five largest banks (¶26).

- **Structural Benchmarks** (¶33). Modified SBs include the reformulation of the continuous SB on setting the end-user electricity tariffs with quarterly instead of semi-annual adjustments (¶14), the postponement of the submission to Parliament of the new PFM law from December 2023 to February 2024 (¶15). New SBs are being proposed in different sectors (MEFP Table 2).

- **Rephasing of Access**. Staff support the authorities' request to rephase access by adjusting the disbursement availability schedule to better align it with data availability for test dates (¶33).

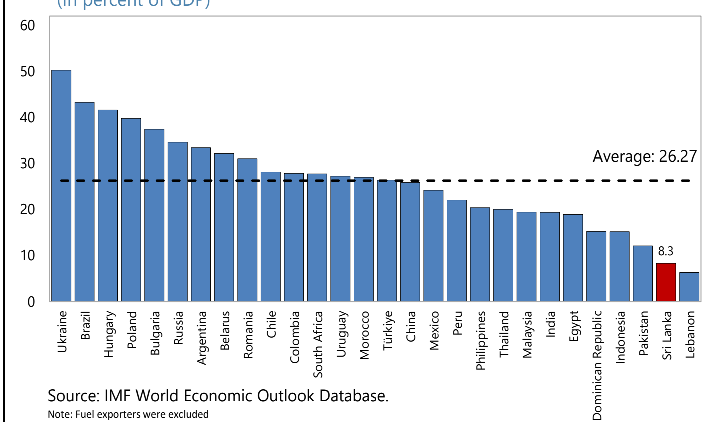
POLICY DISCUSSIONS

A. Preserving the Revenue-Based Consolidation

10. The draft 2024 budget is consistent with program parameters. The AB submitted to Parliament in October targets a primary surplus of 0.8 percent of GDP in 2024 (**quantitative performance criterion**), up from a projected deficit of 0.7 percent of GDP in 2023. Even with revenue measures adopted so far, government revenue remains substantially lower than in other emerging market and middle-income countries (text chart). In 2024, tax revenue is forecasted in the AB to increase to 12.1 percent of GDP, supported by a package of further revenue measures (¶11) **(prior action)**. These measures, together with the indexation of excises to inflation by end-December 2023 and the introduction of a property tax as well as a gift and inheritance tax by 2025, would ensure that the revenue effort

Government Revenue in Emerging Market and Middle-Income Economies, 2022

(In percent of GDP)

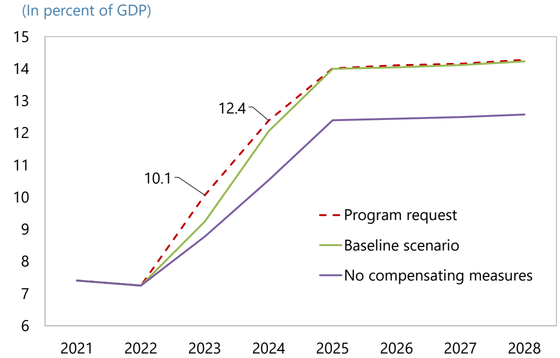


Source: IMF World Economic Outlook Database.

Note: Fuel exporters were excluded

set at the outset of the program is maintained over the medium-term.[11] The draft 2024 budget plans a small increase in the wage bill from 3.5 percent of GDP in 2023 to 3.6 percent to mitigate the impact of high inflation on real income erosion. It also includes an appropriation of Rs. 450 billion (1.4 percent of GDP) for the recapitalization of banks (¶26). Domestic financing for the budget is expected to decline from 2023 (¶3) but still accounts for 5 percent of GDP given that external financing is expected to remain stable. The program continues to target a central government primary surplus of 2.3 percent of GDP starting 2025. The authorities have agreed to refrain throughout the program from any tax policy or administrative measures including new income tax proposals or tax incentives that may erode tax revenue (¶28). The national budgets will be consistent with program parameters and needed revenue measures will be implemented in a timely fashion (**structural benchmarks**). The authorities are also committed to maintaining the stock of budget expenditure arrears at zero throughout the program (**quantitative performance criterion**).

11. The authorities have prepared a package of revenue measures aiming to preserve the revenue-based consolidation in 2024. The expected yield from the agreed tax policy measures is estimated at 2.9 percent of GDP and would raise the tax revenue **(new QPC)** to 12.1 percent of GDP under staff's baseline, which remains slightly lower than program approval projections due to the 2023 revenue shortfall (text figure).



Sources: Sri Lanka Ministry of Finance; and IMF Staff Calculations.

- **Main Tax Policy Measures**. The authorities have adopted several revenue measures (**prior action**, Text Table) to be effective at the latest by January 2024. The expected yield from these measures is estimated at 2.7 percent of GDP and includes further VAT reforms such as (i) abolishing many exemptions including on fuel, Liquefied Petroleum Gas and selected food and agriculture items;[12] (ii) increasing the rate from 15 to 18 percent; (iii) harmonizing the liable registration thresholds for the VAT and Social Security Contribution levy (SSCL) to Rs. 60 million per annum. The package also includes expected gains from relaxing import restrictions among others (Text Table and MEFP¶8).

- **Tax Administration Measures**. The authorities have begun to implement the Fiscal Affairs Department (FAD) recommendations to revamp tax administration. This would support the tax collection effort by an additional 0.2 percent of GDP in compliance gains in 2024. To increase taxpayer compliance, the authorities will, by March 2024, introduce, track, and report on a quarterly basis 7 Key Performance Indicators (KPIs) related to four core tax administration

[11] Introduction of property taxation requires several preparatory steps, including setting up a property registry and accurate up-to-date valuation of assets. The authorities have started work on these measures with the help of IMF CD, and progress will be assessed in the second review.

[12] The VAT exemption on electricity will remain to avoid exacerbating the impact of the new electricity tariff increase on the poor (¶14).

functions of: (1) payment; (2) filing; (3) reporting; and (4) registration (Appendix 2 in MEFP) (**new structural benchmark**). To improve compliance with on-time filing and payment from large taxpayers, the Inland Revenue Department (IRD) will create and implement within the Large Taxpayers Unit (LTU) a new High Net Worth Individuals (HNWI) unit, as well as a design and monitoring unit and a strengthened Risk Management Unit by December 2023 (**new structural benchmark**). Other measures are outlined in the MEFP (¶10-15). The authorities will adopt by end-December 2023 a strategy laying out a gradual multi-step process, with a specific timeline, to build a valid VAT refund system and fully repeal the Simplified Value-Added Tax (SVAT) by April 2025 (**new SB**). They also intend to adopt by January 2024 a medium-term IRD Modernization Strategy and Implementation Plan with FAD CD assistance.

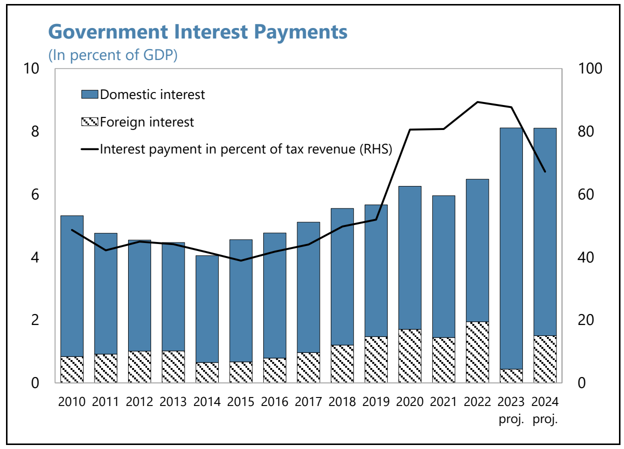
Sri Lanka: Expected Yield from Agreed Tax Policy Measures in 2024, Percent of GDP

	Program request	Baseline
Total revenue measures	**2.3**	**2.9**
1. Fiscal measures agreed at Program Request	**1.4**	**1.4**
Eliminate the majority of VAT exemptions [1/]	1.2	1.2
Compliance gains	0.2	0.2
2. Increasing the VAT rate	0.0	0.4
3. Measures agreed during first review mission	0.0	0.3
Increase in Special Commodity Levy on sugar		0.1
Expansion of the 5% WHT on service fee to payment made to all service providers		0.05
Reducing the registration threshold for SSCL and VAT to Rs. 60 mn and other measures		0.2
4. Other measures	0.9	0.7
Increase in excises in liquor and tobacco	0.1	0.1
Partial lifting of import restrictions	0.8	0.6
Memo items		
Tax revenue	12.4	12.1

Sources: Sri Lankan authorities; and IMF staff estimates.

1/ Relative to program request, the yield does not include the elimination of VAT exemptions on electricity and kerosene and other smaller goods such as infant milk powder, pharmaceutical projects, organic fertilizer, agriculture seeds among others.

12. Expenditure rationalization measures will support the primary balance path. The interest bill will remain large at 8.1 percent of GDP in 2024 (text chart), as domestic rates remain elevated (¶18), before gradually declining over the medium-term. Capital expenditure is expected to increase to 4.1 percent of GDP in 2024 to mitigate the adverse effects on growth from its recent compression. Avoiding revenue shortfalls will help minimize further cuts to capital expenditure (MEFP ¶15). A public expenditure review with assistance from the WB would help find possible savings in current spending. It will be important to ensure that any expenditure measures are not regressive and complement the revenue-based consolidation.



13. To ensure adequate support for the poor and vulnerable, the program will continue to improve targeting, adequacy, and coverage of social safety nets (SSN). The floor on SSN spending has been set at Rs. 205 billion (0.7 percent of GDP) in 2024, which preserves the real value of cash transfers per household (**indicative target**). Payments under the new scheme (*Aswesuma*), using the new Social Registry, developed with the support of the World Bank, started in July 2023. Staff recommended completing the proper grievance procedure related to appeals and objections related to the selection of beneficiaries. The authorities have committed to paying cash transfers to the previous beneficiaries who applied but were not selected under the new criteria until the review of grievances is completed during the transition period.

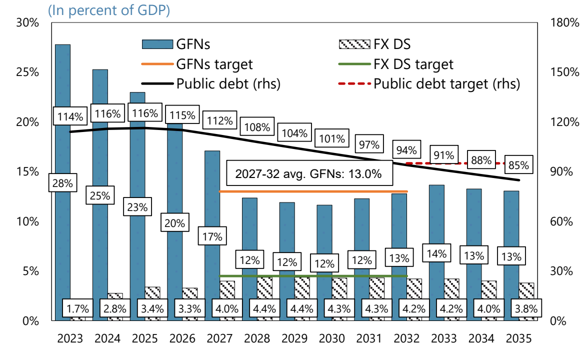
14. The frequency of formula-based adjustment of cost-recovery electricity tariffs has been increased from semi-annual to quarterly to address emerging losses more quickly. To allow CEB to break even in 2023, the average electricity tariff was increased by 18 percent with effect from October 20. The cabinet-approved quarterly tariff revisions are to commence from January 2024 (**prior action**). The **continuous SB** on setting electricity tariffs at cost-recovery levels has been adjusted accordingly. Conservative assumptions need to be applied in setting the tariffs to prevent further losses from arising. The introduction of improvements in the Bulk Supply Transaction Account (BSTA) should lead to more frequent automatic tariff adjustments in-between revisions (**end-December SB**). The authorities will continue to work with the WB and ADB on options for lowering the CEB's administrative, generation and distribution costs. The mechanism for setting fuel prices will remain unchanged but the authorities committed to adjusting the formula if the built-in margin of 4 percent proves insufficient to cover potential losses, including arising from the transfer of supply contracts of about 25 percent of CPC fuel stations to other producers (Annex II).

15. Public Financial Management (PFM) reforms will be strengthened to improve fiscal discipline and contain fiscal risks. The SB on the new PFM law is proposed to be postponed from end-December 2023 to end-February 2024 to allow for further consultations with Technical Assistance (TA) experts. To further strengthen PFM, two new SBs are proposed which involve cabinet approval of: (i) a reduction in the limit on government guarantees from 15 to 7.5 percent of GDP by end-December 2023; and (ii) a fiscal strategy statement including a medium-term fiscal framework (MTFF) by end-June 2024. Relatedly, the authorities are developing guidelines for the issuance and management of loan guarantees and on-lending, with assistance from FAD and the WB. Their SOE strategy (Annex II) is expected to be implemented by end-December 2023. Further SOE reforms focus on restructuring, including divestment, of some SOEs, and enhancing financial transparency, with assistance from the WB and International Finance Corporation (IFC) (MEFP ¶21). Measures to contain PFM corruption risks are discussed in ¶28.

B. Restoring Public Debt Sustainability

16. Significant progress in reaching a debt treatment consistent with achieving the program debt targets has been made. Sri Lanka's debt continues to be unsustainable pending resolution (Annex III). Beyond the DDO (¶12), the authorities focused their external debt restructuring negotiations on the four major groups of creditors (97 percent of the total restructurable external claims) (Text Table). As of November 2023, an AIP was reached with the Official Creditors Committee (OCC) with terms in line with program parameters. Work on codifying the agreement with the OCC in a Memorandum of Understanding is advancing and there are good prospects it will be finalized in the coming months. A preliminary AIP was also reached with China EXIM Bank, in October 2023, on terms comparable to the OCC AIP and consistent with the program debt targets based on the information shared with staff on a confidential basis. Staff has also assessed that the authorities engage in good faith negotiations with the International Sovereign Bond (ISB) bondholders with a view to reaching an AIP no later than the second review of the EFF, and that negotiations with the China Development Bank (CDB) are also at an advanced stage.[13] The authorities met these two groups of creditors in October 2023 in Marrakech and Beijing, respectively, to carry on the negotiations of terms comparable to the OCC and consistent with program parameters. Staff has facilitated the debtor-creditor engagement in line with Fund policies and its duty of neutrality, by ensuring timely sharing of the macroeconomic and financing assumptions underpinning the program, explaining program design and debt sustainability targets, as well as assessing the consistency of debt treatment proposals with program parameters. The debt relief agreed and being negotiated, all taken together, is expected to be consistent with the program debt targets, though with minimal buffers, which highlights implementation risks (Annexes III and IV). An active public debt management strategy is particularly

Debt Targets Compliance
(In percent of GDP)



Sources: IMF staff estimates and projections.

[13] The public offer made by foreign bondholders on October 13 features a state-contingent debt instrument with debt service that steps down automatically as the dollar GDP underperforms the more optimistic (than IMF staff's baseline) macro assumptions that anchor the initially high contractual flows. The authorities have expressed reservations about the offer.

critical for mitigating medium-term refinancing risks and adequately restoring debt sustainability, in light of the elevated Gross Financing Needs (GFNs) in the near-term (¶17).

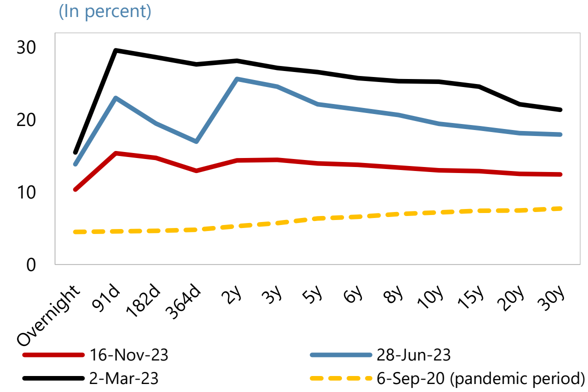
Sri Lanka: Restructurable External Claims (at end-2022, US$ millions)

	Balance	Arrears	Stock	% total
Official Sector Involvement (subject to LIOA)	**9,802**	**777**	**10,578**	**39%**
OCC (Paris Club, India, and Hungary)	5,395	427	5,821	21%
China EXIM	4,172	311	4,483	17%
Other non-OCC bilaterals (incl. smaller Chinese creditors)	235	39	274	1%
Private Sector Involvement (subject to LIA)	**14,295**	**2,229**	**16,524**	**61%**
Sri Lankan ISBs	11,550	1,633	13,183	49%
China Development Bank	2,564	338	2,902	11%
Other private credtiors	182	258	440	2%
Total	**24,097**	**3,006**	**27,102**	**100%**

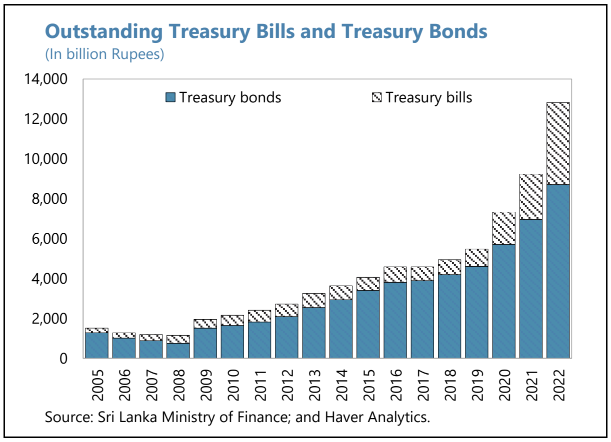
Sources: Sri Lankan authorities and IMF staff calculations.

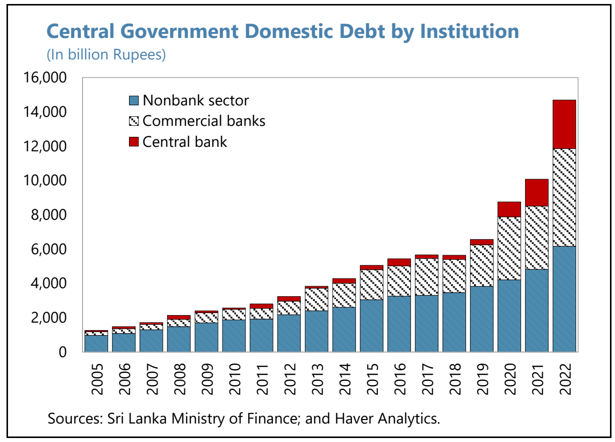
17. A centralized Public Debt Management Agency (PDMA) with significant operational autonomy supported by a new Public Debt Management Act will help improve debt management, and is critical in the near-term. The authorities plan to increase the borrowing limit from 13.9 to 23.4 percent of GDP in 2024 to accommodate the need to issue long-term debt instruments in the context of the expected bank recapitalization schemes and external debt restructuring operation. Meanwhile, IMF and WB Technical Assistance supported the authorities' efforts to set-up the PDMA, with a view to centralize debt management functions and better manage debt portfolio risks (e.g., FX, rollover and interest rate risks). The authorities are committed to completing the legislative requirements to establish the PDMA in line with international best practices by March 2024 and complete the establishment of the PDMA by December 2024. To improve debt transparency, the Ministry of Finance (MoF) has started publishing in February 2023 a quarterly public debt bulletin. The next bulletin will include more granular information on domestic debt, including debt service cost and creditor types. The normalization of the local currency debt markets following the DDO is welcome. However, going forward, more active public debt management focusing on lengthening the maturity of domestic debt and mitigating medium-term refinancing risks is critical, to reduce large GFNs in the near term. Large GFNs are due in part to a large stock of T-bills held by both banks and nonbank financial institutions and maturing in the next 12 months (roughly 13 percent of GDP). These T-bills will need to be refinanced with longer term government securities, in line with the historical patterns of

Yield Curve Evolution
(In percent)



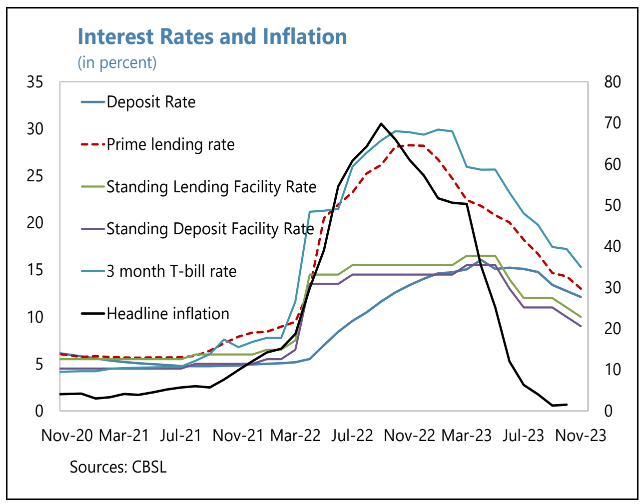
Sri Lanka's domestic debt absorption with large presence of longer-term securities and nonbank investors (text charts), to mitigate rollover risks.





C. Maintaining Price Stability and Rebuilding External Buffers

18. Following a remarkable turnaround in inflation, the CBSL loosened the monetary stance. Between June and October, the policy rate (lending facility) was reduced by 550 bps to 11 percent. In August, interest rate caps on certain lending categories (pawning, overdrafts, and credit card) were also imposed to loosen financial conditions. Based on the latest inflation projections and Taylor rule analysis, CBSL's stance was appropriate, especially accounting for rapid disinflation, re-anchored inflation expectations, credit contraction, and high forward-looking real policy rate (4 percent). An additional policy rate cut of 100 bps in November to 10 percent has raised inflation risks.



19. The authorities should continue to follow a prudent and agile approach in formulating monetary policy because of the underlying risks. Going forward, the monetary policy stance needs to be carefully calibrated to strike the right balance between maintaining a credible inflation path close to the target and supporting economic stabilization, in line with the MPCC clause and a real policy rate path close to neutral. Room for further loosening in the near-term is limited given potential upside inflationary pressures from (i) second-round effects from new tax measures (¶11), (ii) downward pressure on the exchange rate from relaxing import restrictions and banks closing their NOPs arising from the restructuring of CPC-related debts, and (iii) risks of capital outflows from lower interest rates. Excessive loosening may make it difficult to control inflation later and even require a policy reversal which would hurt CBSL's credibility. Meanwhile, MPCC bands have been revised downward relative to the program request and are now set with a mid-point target at 5 percent from December 2023 onwards to ensure a prudent monetary stance going forward. Meanwhile, monetary policy should be implemented through the policy rate, avoiding interest rate caps, which increase pressure on the already weak banking system. The CBSL is committed to eliminating the interest rate caps as soon as possible.

20. The unwinding of net credit to government by the CBSL should continue in line with program targets with the Treasury maintaining a cash buffer to pre-empt the need for monetary financing. Despite a temporary increase in July to accommodate tight liquidity amid DDO-related uncertainties; NCG has declined since August. Taking into account the planned repayment by end-2023 by Treasury of Rs. 4,283 billion of T-bills and T-bonds including those held by the CBSL and other repayments within the DDO, the NCG ceiling is proposed to be set at Rs. 2,800 billion for end-2023 (**QPC**), slightly higher than at program request to alleviate money market structural liquidity shortages. In 2024, the CBSL is expected to continue offloading government securities as domestic borrowing markets normalize and external financing resumes. To compensate for the extended transition period permitting monetary financing under the CBA, the CBSL committed to not making additional primary market purchases of government securities, with deviations permissible to account for external financing shortfalls within six months of the first review (**new continuous PC**). Staff recommend that T-bills auctions aim to raise adequate amounts that include a buffer to allow the Treasury to meet cashflow needs without relying on monetary financing.

21. The government needs to advance without delay the modalities of the CBSL recapitalization. The swap of CBSL T-bills holdings for long-term T-bonds reduces the government's near-term GFNs and refinancing risks at the cost of reducing CBSL capital. In estimating the capital impact, staff cautioned against valuing the T-bonds using a discount rate that is disconnected from the current market yield curve (such as the theoretical risk-free discount rate). To avoid undesirable implications such as weaker demand for CBSL liabilities (e.g., cash in circulation), higher inflation risk premia, and rising dollarization risks, which could ultimately undermine CBSL independence and effectiveness of monetary policy, staff emphasized the urgency of recapitalizing the CBSL. After assessing the impact of the DDO on the CBSL's balance sheets, done in close consultation with external auditors and IMF staff and by applying good accounting standards and valuation frameworks, the government should stand ready to inject capital into the CBSL, as soon as fiscal buffers allow it, so as to reach positive equity from 2025, which would increase to 2 percent of GDP by 2031. A buffer of 0.5 percent GDP has been reserved for the recapitalization of the CBSL in 2024, which staff assesses as sufficient to bring CBSL equity to positive levels based on IMF staff's estimate of CBSL's NPV loss from DDO and its equity position at the time of bond exchange in September 2023. The recapitalization needs of banks (¶26) and CBSL are incorporated in the DSA.

22. Furthermore, the bank liquidity framework needs to be upgraded to improve monetary transmission and protect the prudential liquidity buffer. The Statutory Reserve Ratio (SRR) was cut in August 2023 from 4 to 2 percent to boost liquidity in the banking sector. To better serve its monetary and prudential purposes, the SRR framework could be expanded to cover more deposit-taking institutions (e.g., national savings bank) and FX deposits in the banking sector, this would reduce regulatory arbitrage, discourage dollarization and safeguard the settlement risk. In addition, the liquidity framework should be applied equally to all banks. Current restrictions limiting licensed commercial banks' access the CBSL deposit facilities (e.g., 5 times per month) weaken the transmission of the CBSL policy rate to bank deposit rates and should be removed to facilitate monetary policy transmission.

23. While subject to risks given recent and upcoming outflows, reserve levels are projected to rise in 2024 until adequacy is achieved at the end of the program. Taking into account banks' FX positions, the end-2023 NIR target is kept unchanged, but the adjusted target (**QPC**) is forecasted to be lower given lower-than-expected project financing.[14] Once banks' NOPs rebalance in 2024, the CBSL committed to accumulate more reserves, with GIR forecasted at U$5.35 billion at end-2024, around US$800 million below program approval projections. There are significant expected net drains on gross reserves over the program period, with the largest being repayments on restructured debt, and payments on central bank credit lines including US$2.6 billion for the ACU repayments and the RBI SAARC swap. Notwithstanding these drains, the economic recovery and improved sovereign ratings, reserve adequacy (as measured by IMF's Assessing Reserve Adequacy (ARA) metric) is still expected to be reached by 2027, albeit with a greater degree of uncertainty. To drive a proactive reserve accumulation strategy, the program will include caps on adjustors for project financing and FX payments on restructured CPC loans. Additionally, staff warned against repeated recourse to CBSL interventions through direct sales and urged that foreign exchange interventions be limited to disorderly market conditions and consistent with meeting NIR targets. In response, the authorities committed to restructure the remaining FX local law debt of the government and the SOEs to the state banks in a way that minimizes the adverse impact on banks' capital and FX NOPs (MEFP ¶27). In case FX sales threaten NIR targets, program conditionality such as FX intervention budgets could be considered in future reviews.

24. The exchange rate regime is flexible, but the FX market remains shallow, and the exchange rate has recently displayed relative stability. Beyond the periods in June and August, the central bank has only engaged in FX accumulation to build reserves, with the market settling into a pattern of relative stability without large direct central bank FX sales. Banks have managed their FX positions after the DDO, settling customer inflows and outflows internally without using the interbank FX market in significant amounts. Hence, the market has dried up, leading to a shallow market with low turnover and small movements in the exchange rate.

25. The authorities have relaxed import restrictions apart from vehicles and eliminated some measures inconsistent with their Article VIII obligations. Most import restrictions were relaxed in phases (286 items in June, 325 in July, and 299 in October). Removing remaining restrictions on import of vehicles will be considered after the completion of the debt restructuring

[14] Adjustors for project financing FX cashflows to the central bank will likely undershoot initial projections by over US$1 billion, as donors' disbursements are expected to fall short of commitments partially due to the delay with debt restructuring.

so as not to generate undue current account pressures. Since program approval, the authorities have eliminated three out of the six existing multiple currency practices and three out of eight existing exchange restrictions.[15] They have also relaxed some Capital Flow Management Measures (CFMs) including through increasing limits on certain outflows (Annex VII). The authorities are also working on formulating a plan (initially envisaged to be completed end-June 2023) on the phased removal of import restrictions, exchange restrictions, Multiple Currency Practices (MCPs), and CFMs during the program period.

D. Ensuring Financial Stability

26. A prompt implementation of the banks' recapitalization strategy is crucial to safeguard financial stability. To support compliance with the CBSL roadmap for the recapitalization of the banking sector and to ensure that implementation delays are minimized, the Financial Crisis Management Committee (comprising CBSL and MoF) has developed a recapitalization plan for the five largest banks (**prior action**). The plan assesses the size of capital and FX shortfalls taking into account the restructuring terms for the CPC FX loans and the locally held portion of the ISBs, the impact on banks' NOPs, additional provisions recommended by the AQR, and a forward-looking assessment of NPLs based on stress testing, and sets out the high-level terms, conditions and format for government support. State-owned banks, which are the most affected by the restructuring, are presumed to raise capital from the government. Private banks will submit capital plans for review by the CBSL; public capital support would be available only as a backstop and its design would take account of the state's aim to avoid increasing its role in the governance of private banks. A similar plan will be developed for the remaining four banks covered by the AQR by end-February (**new SB**). The main issues identified by the AQRs related to collateral valuation and underprovisioning for domestic law FX exposures to the public sector. Recapitalization needs are expected to remain within the contingency amounts incorporated in the DSA at program approval (about 6 percent of 2022 GDP[16]) (Annex III).

[15] The following MCPs have been eliminated since the program approval: (i) the authorities stopped using the weekly volume weighted average rate for CBSL's FX sales in bilateral non-Request for Quote outright spot transactions with Authorized Dealers (ADs) thus eliminating the MCP, (ii) MCP arising from unremunerated cash margin deposit requirement on imports of certain items made under LC, DA, and DP payment terms was eliminated by no longer mandating cash margin requirements, and (iii) the authorities no longer offer an incentive on inward worker remittances that result in a more favorable effective exchange rate for such transactions thus eliminating the related MCP. Similarly, the following exchange restrictions have been eliminated: (i) the exchange restriction arising from unremunerated cash margin deposit requirement on imports of certain items made under LC, DA, and DP payment terms was eliminated by no longer mandating cash margin requirements, (ii) prioritization and rationing of FX by CBSL and CBSL's informal guidance to ADs to prioritize access to FX for essential items (which resulted in undue delays and payment arrears for current international transactions) have ceased eliminating the exchange restriction arising from these practices, and (iii) amounts due for longer than 90 days under Sri Lanka's net debtor position to India under the Asian Clearing Union payment arrangement have been transformed to general debt by the special swap agreement with the Reserve Bank of India.

[16] Details of the recapitalization operation are still to be finalized but for purposes of the DSA staff assume it takes place in mid-2024, and provides participating banks with long-term LKR bonds, in exchange for common equity or Additional Tier 1 capital instruments (with no coupon or dividend payments in the first three years).

27. The authorities need to move swiftly with amendment of the BA to help restore investor confidence and improve the governance of the state-owned banks. There is an urgent need to strengthen financial sector supervision and safety nets as well as enhance crisis management capacity. With the change in the legislative strategy related to the BA, cabinet already approved instructions to amend the BA to ensure that the amendments meet the authorities' commitments to strengthen requirements for bank capital, large exposures, related party lending, governance and fit-and-proper standards, and audit standards for state-owned banks. The end-December 2023 SB related to Parliamentary approval of a full revision of the BA is proposed to be replaced with a new one requiring parliamentary approval by end-January 2024 of the amendments of the BA (**new SB**). The implementation of the amendments to the Banking Act is proposed for end-March 2024 (**new SB**). Significant reforms to the resolution regime were passed earlier in the year and will require further work to strengthen the deposit insurance fund, which is expected to take place with WB financial support and TA.

E. Reducing Corruption Vulnerabilities and Strengthening Governance

28. The authorities have committed to ambitious governance reforms based on key recommendations from the Governance Diagnostic (GD) report to help restore and sustain economic, social and political stability. The report highlighted remaining gaps in the anti-corruption legal framework and urged for timely implementation of the Act and priority reforms to tackle corruption vulnerabilities in several areas, including revenue administration, tax policies, public procurement, PFM, and financial oversight. A government action plan (**new SB**) will inform next steps in the implementation of recommendations.

- **Anticorruption Legal Frameworks and Institutions**. Considering the limitation of approved AC legislation (¶8), and in line with the Twenty-First Amendment to the Constitution, the Constitutional Council is developing rules for appointing Commission to Investigate Allegations of Bribery or Corruption (CIABOC) commissioners that will establish an open and transparent process to ensure selected candidates meet the highest levels of professionalism, ethical conduct, and integrity. Rules for the selection process will be published in the Gazette by end-December 2023 (**new SB**). Moreover, a more comprehensive asset recovery law will be enacted by April 2024 in compliance with the Financial Action Task Force (FATF) standards in consultation with the IMF (**new SB**). Staff also recommended appointing commissioners and publishing implementation plans for the AC Bill by December 2023. The operationalized Anti-Corruption commission should publish the asset declarations for senior officials by July 2024 (**new SB**).

- **Tax Policy and Revenue Administration**. In order to reduce corruption risks from tax exemptions granted to some businesses under the Strategic Development Projects (SDP), the authorities will no longer approve new projects under the SDP Act by December 2023 and will amend the law to ensure that it includes explicit and transparent processes for the selection and evaluation of new investment projects. The authorities have also agreed not to extend new tax incentives schemes without prior consultations with the IMF (MEFP ¶16 and 33). The authorities also agreed to mitigate corruption vulnerabilities in tax policy and revenue administration (MEFP¶ 33).

- **PFM**. To address corruption risks in public procurement, the authorities will publish on a semi-annual basis on a designated website by end-December 2023 (**new SB**) (i) all public procurement contracts above LKR 1 billion along with comprehensive information in a searchable format on contract award winners; (ii) a list of all firms receiving tax exemptions through the Board of Investment and the SDP and an estimation of the value of the tax exemption; and (iii) a list of firms receiving tax exemptions on luxury vehicle imports.

- **Financial Sector Oversight**. The cabinet will adopt and publish, in consultation with the IMF and WB/IFC, a framework to strengthen the governance of State-Owned Banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience by end-June 2024 (**new SB**).

- **AML/CFT**. Sri Lanka updated the National ML/FT Risk Assessment (NRA) and published the report on September 14, 2023. The AML/CFT National Policy for 2023-2028 was approved by the Cabinet of Ministers on August 7, 2023. The authorities are committed to continue to strengthen the AML/CFT regime, leveraging the support from development partners, including introducing amendments to the legal framework, conducting AML/CFT risk-based supervision, strengthening the use of financial intelligence and cooperation between FIU, law enforcement, and the CIABOC.

F. Raising Potential Growth

29. Sri Lanka's long-run prosperity hinges on deliberate efforts to implement growth-enhancing reforms. The authorities' reform agenda would be incorporated into the EFF-supported program after economic stabilization efforts have succeeded.

- **Trade and FDI**. The authorities rationalized para-tariffs as commitments under the WB's Development Policy Operation (DPO).[17] More trade reforms are underway including implementing a National Export Strategy, expediting bilateral and regional trade agreements, participating in global value chains, and promoting tourism. The restrictive and cumbersome investment regime needs to be streamlined, for example through fully implementing a national single window for investors.

- **Labor Productivity, Participation, and Gender Gaps**. The authorities are committed to developing a comprehensive and actionable strategy to improve (i) labor market flexibility

[17] Sri Lanka is phasing out (i) over a period of 3 years the Export Development Board Cess and reducing the Cess by 33 percent from April 1, 2023; and (ii) over a period of 5 years the Port and Airport Levy (PAL) and reducing the PAL by 20 percent from April 1, 2023.

through the ongoing reforms to the Labor Act,[18] (ii) labor skills through education reforms, (iii) financial inclusion including through supporting female entrepreneurs' access to credit guarantee schemes, (iv) public transportation infrastructure, and (v) availability, quality and affordability of child and elderly care.

- **Other Reforms**. Efforts to improve public sector efficiency should continue including digitalization of public services, and addressing investment needs in electricity generation and transmission. Reducing the government and SOEs' role in the economy is also important for a more efficient allocation of resources, fostering competition, and boosting productivity, for example through facilitating private sector access to land and digital platforms. To address climate vulnerabilities, Sri Lanka should strengthen efforts to adapt to climate change, including through contingency budgeting and insurance schemes for natural disasters.

PROGRAM MODALITIES

30. The attached Letter of Intent (LOI) and Memorandum of Economic and Financial Policies (MEFP) describes the authorities' progress in implementing the economic reform program and sets out policy commitments going forward. The Technical Memorandum of Understanding clarifies program definitions and quarterly targets.

31. Financing Assurances and Arrears Policies. Sri Lanka's program is fully financed, with firm commitments of financing for the next twelve months and good prospects for adequate financing for the rest of the program period. Program financing gaps in 2023-27 are expected to be filled through debt restructuring and new financing. AIPs with the main official creditors (¶16) and the consent received from Sinosure, Government of China, Saudi Arabia, Kuwait, Iran, and Pakistan, to which Sri Lanka continues to have arrears, are in line with Lending into Official Arrears (LIOA). Consistent with the Lending into Arrears (LIA) policy, the authorities are also making good faith efforts on debt restructuring with private creditors (including the CDB) and are pursuing appropriate policies consistent with the EFF program which is essential for supporting Sri Lanka's adjustment efforts. With these, staff assesses that the progress made in restructuring Sri Lanka's debt is consistent with restoring its medium-term external viability and safeguarding its capacity to repay the Fund. Therefore, completion of the financing assurances review is recommended. Firm assurances from the WB and ADB have been received regarding 2023-2024 financing, with good prospects for IFI financing in the rest of the program period. The total non-IMF IFI program financing envelope amounts to US$3.57 billion over the program period.

[18] The separate pieces of labor laws are being unified into one comprehensive legislation.

Sri Lanka: External Financing Gap and Program Financing, 2022-2027
(In millions of USD)

	2022	2023	2024	2025	2026	2027	Total 2022-27
Financing Gap (A)	-2,834	-5,674	-4,654	-4,708	-3,291	-3,949	-25,110
Program Financing (B)	2,834	5,674	4,654	4,708	3,291	3,949	25,110
IMF EFF	0	682	682	685	689	346	3084
IFI program financing support	0	1,220	780	524	524	524	3,572
World Bank*	0	570	330	0	0	0	900
ADB	0	650	450	300	300	300	2,000
Other Financing**	0	0	0	224	224	224	672
Debt moratorium: external arrears accumulation	2,834	0	0	0	0	0	2,834
Debt relief	0	3,772	3,192	3,499	2,078	1,579	14,120
Sovereign bonds (market access)	0	0	0	0	0	1500	1,500
Shortfall (A+B)	0	0	0	0	0	0	0
Memorandum:							
Gross International Reserves	*1,898*	*3,806*	*5,346*	*7,477*	*9,894*	*13,525*	
Project loans	*1,473*	*680*	*1,200*	*1,556*	*1,603*	*1,651*	

Sources: CBSL; and IMF staff projections.

* An additional US$135 million disbursement from the WB on deposit insurance is not included in program financing, as it will be ringfenced.

** This includes WB financing based on expectations of IDA21 allocation, and historical net disbursement trends from the range of WB instruments.

32. **Staff supports the authorities' requests for the waiver of non-observance of one PC at end-June given that this breach is temporary and that the September IT was met**. The end-June QPC on arrears was missed due to heightened temporary liquidity shortages (¶8) but all outstanding arrears were cleared by end-September 2023.

33. **New program conditionality has been agreed with the authorities to further strengthen the program**. The authorities completed all 3 prior actions. Performance will be monitored through QPCs (Table 1 attached to the MEFP). Staff propose revised targets for end-December 2023—QPC on the NCG, the MPCC bands, and the IT on tax revenue and for the IT on the limit on treasury guarantees due to the new guarantee of the special swap between the CBSL and the RBI (¶2). Staff recommends that the Board completes the required MPCC consultation (Annex V). Staff propose new quantitative targets for end-March (ITs), end-June (QPCs), and end-September 2024 (ITs). Staff propose a new continuous QPC on new CBSL purchases of government securities in the primary market as of December 2023 and to upgrade the IT on tax revenue to a QPC as of June 2024. New structural benchmarks are proposed (MEFP Table 2). Staff proposes

rephasing of access by moving all but the final availability dates for the following reviews by one month to October 1 and April 1 to better align the schedule with data availability for end-June and end-December test dates.

34. The Fund faces a number of enterprise risks. First, financial risks arise from risks to Sri Lanka's capacity to repay and from prolonged debt risks which suggests that credit risks to the Fund extend beyond the program until final repurchase (¶36 and Annex III). Second, business and reputational risks stem from waning public support for reforms, especially after the conclusion of the debt restructuring deal. Third, security risks stemming from socio-political tensions may pose risks to Fund operations. Key mitigation measures include the authorities' firm commitment to the conclusion of public debt restructuring; upfront implementation of reform measures (¶10-14) including on anti-corruption (¶27); adjusting program conditionality to evolving circumstances; and extensive Capacity Development (CD) support to help ensure timely delivery of program reforms (Annex VI). Moreover, a steadfast implementation of structural reforms should help boost confidence and growth and mitigate risks from debt and Sri Lanka's capacity to repay. Safety risks would need addressing through appropriate mitigation measures, in line with Fund policies.

35. Safeguards. The effective implementation of the new CBA will be key to improve the CBSL's institutional framework, including its mandate, aspects of governance arrangements, and autonomy. In view of the domestic debt restructuring operation and weakened financial position, the CBSL received TA on assessing its balance sheet and monetary operations. The CBSL has also initiated steps to implement recommendations of the 2023 safeguards assessment and performed an internal audit verification of the program monetary data submitted to the Fund. Staff will continue to engage with the CBSL on the implementation of the other recommendations.

36. Capacity to repay the Fund (Table 7). Fund outstanding credit would peak at 3.7 percent of GDP in 2027, corresponding to 14.4 percent of exports of goods and services and 24 percent of gross reserves. EFF repurchases and charges would peak in 2031, at 2.5 percent of exports of goods and services and 4.0 percent of gross reserves. Capacity to repay is thus adequate under the program scenario but is subject to risks. It is contingent on the successful implementation of program measures and a debt restructuring that restores debt sustainability.

37. Jurisdictional Issues. Since program approval, Sri Lanka has not (i) introduced additional measures giving rise to new MCPs or exchange restrictions or (ii) modified/intensified existing exchange restrictions and MCPs subject to Fund Approval under Article VIII; or (iii) concluded bilateral payment agreements that are inconsistent with Article VIII of IMF Articles of Agreement; or (iv) imposed or intensified import restrictions for balance of payments purposes.

STAFF APPRAISAL

38. Macroeconomic reforms are starting to bear fruit, but vulnerabilities remain. The authorities' reform efforts are commendable, including rapid disinflation, rebuilding reserves, and significant fiscal adjustment. Steps towards relaxing import restrictions and removing administrative BOP measures should help boost private sector activity and economic growth. The progress in the debt negotiations is a significant step towards restoring debt sustainability. The publication of the governance diagnostic report—the first in Asia—should pave the way for addressing deep-rooted corruption weaknesses and unleashing Sri Lanka's growth potential. However, the growth momentum remains subdued, the banking sector remains vulnerable and reserves accumulation has slowed.

39. Preserving the revenue-based fiscal consolidation supported by revenue administration reforms is critical to promote a break from past policy slippages. Notwithstanding the revenue shortfall relative to program approval, tax revenue is expected to increase considerably in 2023 despite a challenging economic context. As the recovery takes hold, efforts to improve revenue administration including through boosting compliance by large taxpayers and curbing corruption vulnerabilities in the tax system can support revenue collection. Reforms in PFM and energy pricing remain critical. Efforts to protect the vulnerable need to be preserved.

40. A faster-than-warranted monetary policy loosening should be avoided. Given upside inflation risks, monetary policy needs to avoid further loosening that may require a policy reversal if such risks materialize. The authorities' efforts to meet the NCG targets are commendable, given the government's tight liquidity. To preserve central bank independence, the CBSL needs to continue offloading government securities and no longer make purchases in the primary market. Meanwhile, the government needs to expedite efforts to recapitalize the CBSL.

41. Despite the near-term challenges, the authorities should continue accumulating reserves, supported by greater exchange rate flexibility. Rebuilding external buffers and restoring reserve adequacy are critical to meet program targets, including to restore debt sustainability. A slower pace for reserve accumulation during the remainder of 2023 is justified amid FX scarcity given the financial system's need for FX and lower project financing. However, a faster pace of accumulation would be needed in 2024 and beyond to ensure reserve adequacy is achieved by 2027. Selling FX should be limited to disorderly market conditions and not prevent the exchange rate from moving in line with economic fundamentals.

42. Financial stability hinges on a well-recapitalized banking system and strengthened legal framework. Despite recent improvements, financial system vulnerabilities remain and need to be addressed promptly. The prompt implementation for financial sector recapitalization is key to safeguarding financial stability. Efforts to strengthen financial supervision and crisis management framework are crucial to enhance resilience and prepare the financial system for times of stress.

43. Reforms to tackle corruption and strengthen governance are critical to unleash Sri Lanka's growth potential. Enacting the anti-corruption bill is an important milestone in eradicating corruption in Sri Lanka. The next step is to ensure a transparent and merit-based selection process for the Anti-corruption Commission members. A timely implementation of key recommendations from the Governance Diagnostic exercise to tackle corruption vulnerabilities in revenue administration, tax policies, public procurement, and PFM as well as financial oversight will be critical.

44. More visible ownership of program reforms is key for credibility. Going forward, the reform momentum should be strengthened with enhanced ownership, building on the progress made so far. Accelerating implementation of structural reforms especially for fiscal, banking and governance reforms is critical and will increase confidence in Sri Lanka's recovery.

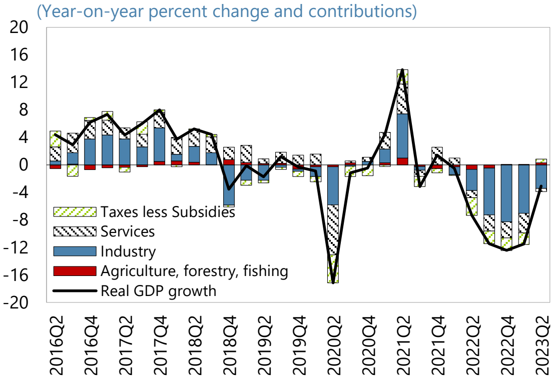
45. Risks to program implementation and financing are high and have increased since program approval. Risks stem from slower-than-envisaged reserve accumulation amid debt restructuring uncertainties, less certain project financing, potential delays in implementing the debt restructuring, a weakened banking sector, exchange rate pressure, and loss of market confidence. Implementation risks also arise from Sri Lanka's weak track record of reform implementation, and the challenging political and social situation. In this regard, contingency plans are crucial and policies should remain agile to adjust to the evolving circumstances.

46. Staff supports the completion of the first review under the EFF arrangement, in light of recent progress, corrective actions and the authorities' commitment to maintaining the reform momentum. Staff also supports the authorities' request for modification of quantitative conditionality, completion of the MPCC consultation with the Executive Board and modification of the MPCC, rephasing of access as well the waiver for the non-observance of the PC on arrears. Staff also supports the completion of the financing assurances review.

Figure 1. Sri Lanka: Real Sector

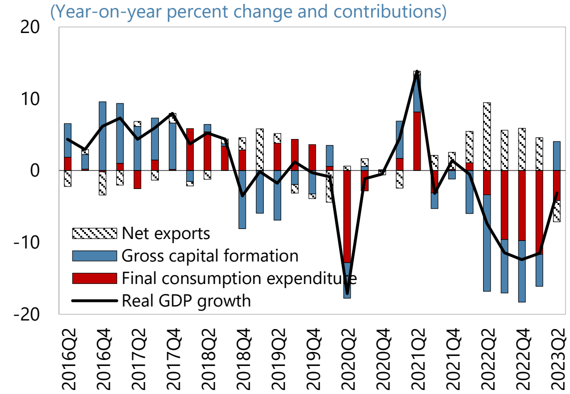
Following a large contraction in 2022, the economy continued to contract in the first half of 2023, reflecting weak industrial activity…

Real GDP Growth by Sector
(Year-on-year percent change and contributions)



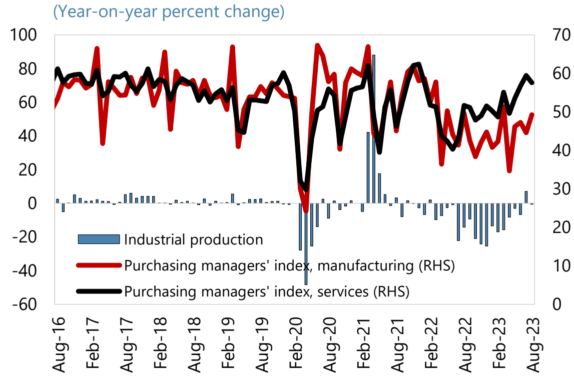
…while consumption remained suppressed by the interest rate environment.

Real GDP Growth by Type of Expenditure
(Year-on-year percent change and contributions)



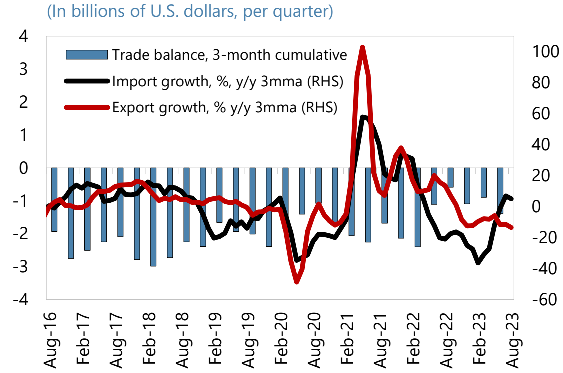
PMIs and industrial production suggest some stabilization, but growth momentum remains weak.

Economic Activity
(Year-on-year percent change)



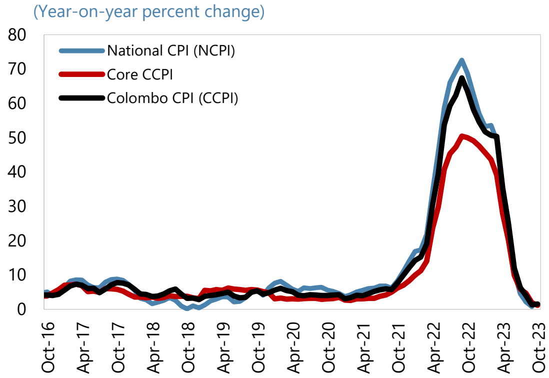
Trade balance improved due to large import compression.

Trade
(In billions of U.S. dollars, per quarter)



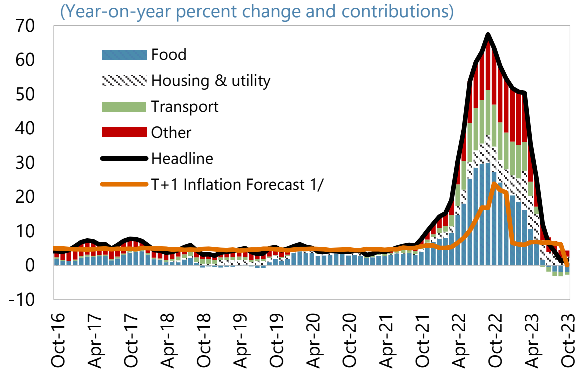
Headline and core inflation have fallen significantly in recent months…

Consumer Price Index
(Year-on-year percent change)



…reflecting the passthrough of tight monetary conditions, easing commodity inflation, weak demand, and a stronger rupee.

Colombo Consumer Price Index
(Year-on-year percent change and contributions)

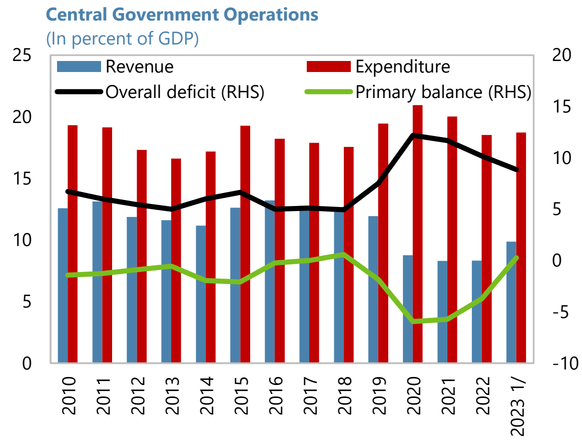


Sources: CBSL; and IMF staff estimates.

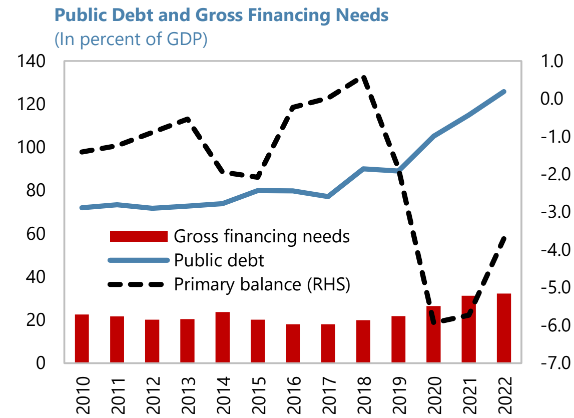
1/ T+1 Inflation Forecast is sourced from the IMF Consensus Forecast Database.

Figure 2. Sri Lanka: Fiscal Sector

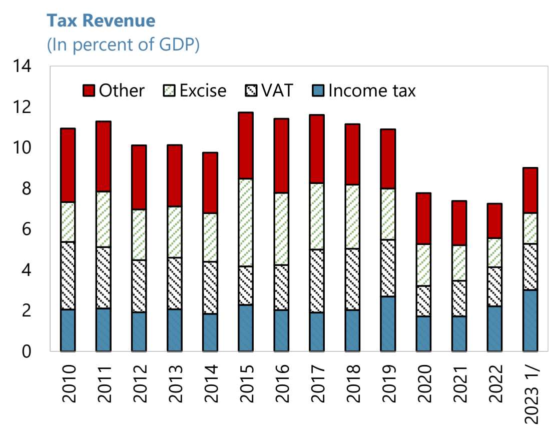
Amid the recession, tax revenue increases and primary spending restraint delivered a primary surplus.



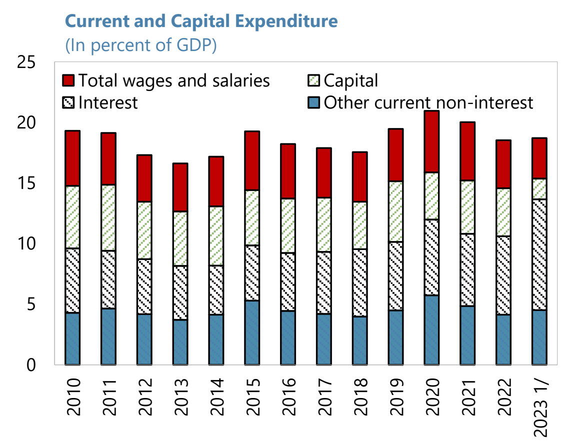
Public debt and gross financing needs remain elevated.



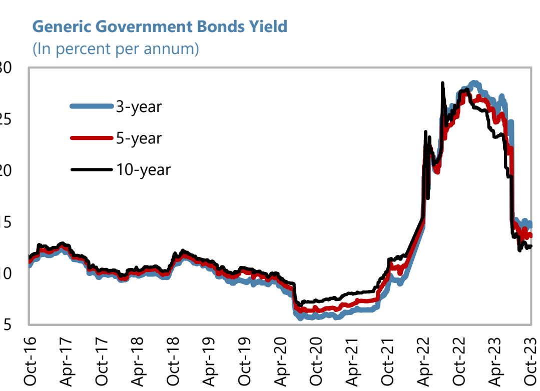
Tax collections were driven by improved income taxes and other indirect domestic taxes…



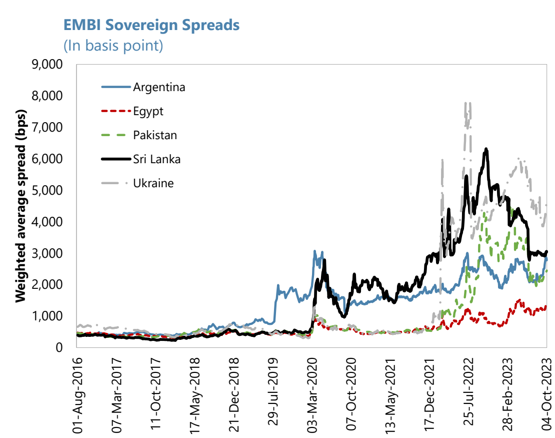
…but interest payments weigh on the budget.



Local currency yields have declined but remain much higher than historic levels…



…and Sri Lanka's Emerging Markets Bond Index (EMBI) spreads have declined but remain at high levels.



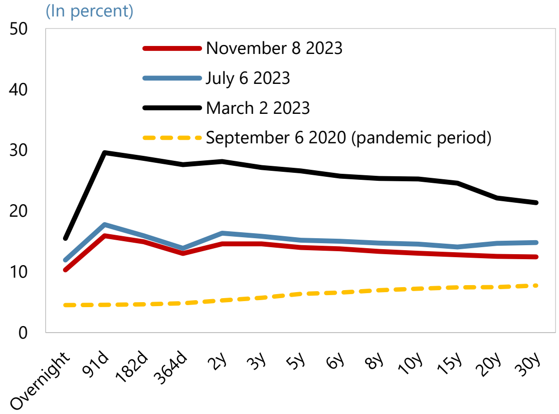
Sources: CBSL; Ministry of Finance; Bloomberg Data L.P.; and IMF staff estimates.

1/ 2023 data is annualized based on the first 9 months data.

Figure 3. Sri Lanka: Financial Market

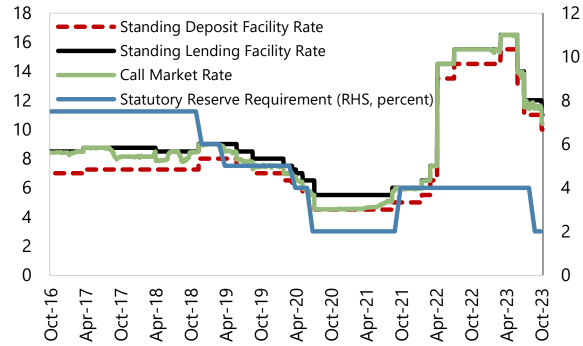
T-bill and T-bond yields have moderated slightly, …

Yield Curve Evolution
(In percent)



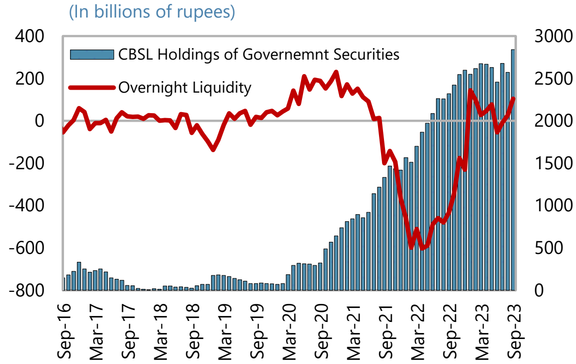
…reflecting a policy rate cut, disinflation, and resolution of uncertainty regarding debt restructuring.

Policy and Interbank Rates
(In percent per annum)



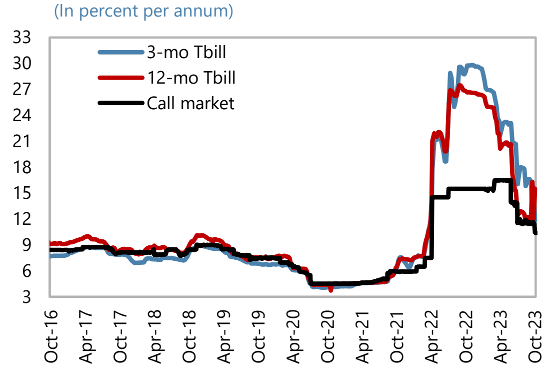
The central bank's net credit to government has peaked…

Overnight Liquidity
(In billions of rupees)



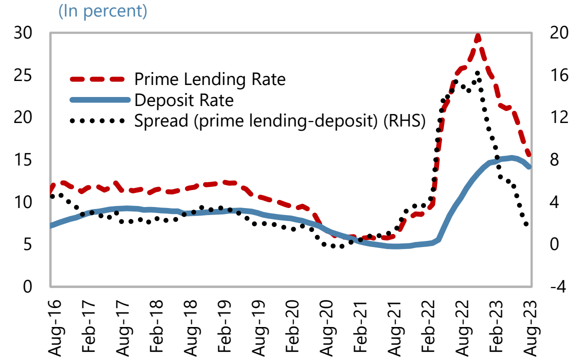
…while the gap narrowed between budget financing costs and the call market rate.

Short-Term Interest Rates
(In percent per annum)



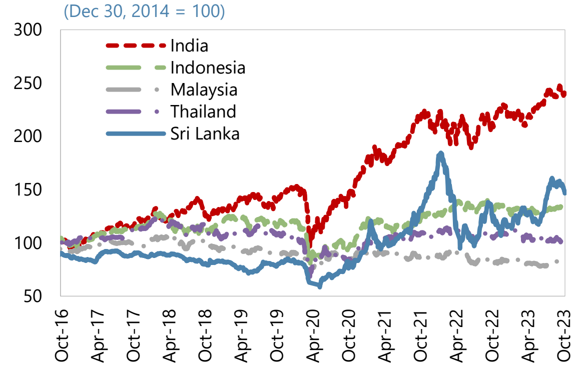
Lending rates moderated while deposit rates remained elevated due to high share of time deposits…

Deposit Rate and Spread
(In percent)



…as the equities market showed first signs of recovery following its collapse in 2022.

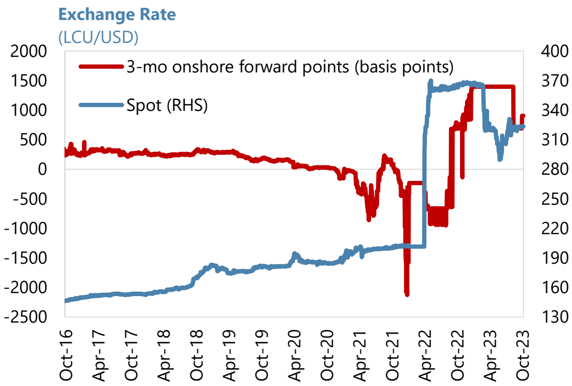
Stock Market Index
(Dec 30, 2014 = 100)



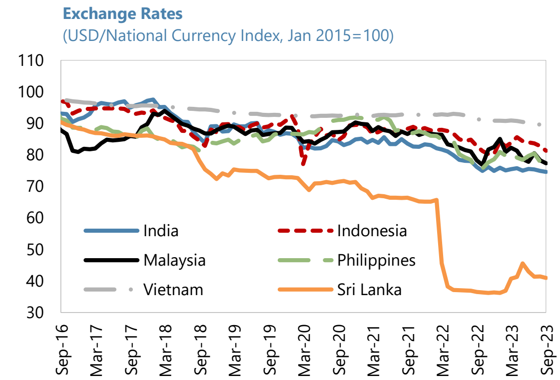
Sources: CBSL; CEIC Daily Database; Bloomberg Data L.P.; and IMF staff calculations.

Figure 4. Sri Lanka: Foreign Exchange and Reserves

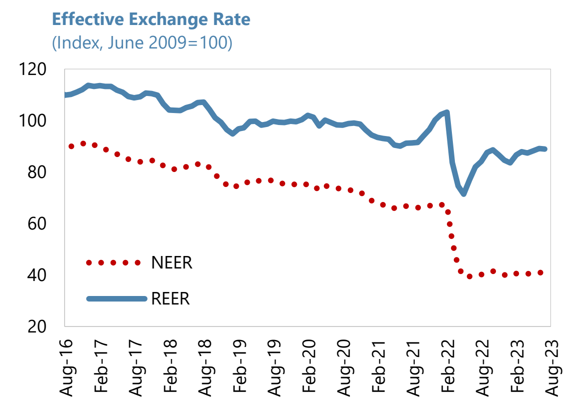
The rupee remains above its post-devaluation level after reversing some of its earlier appreciation…



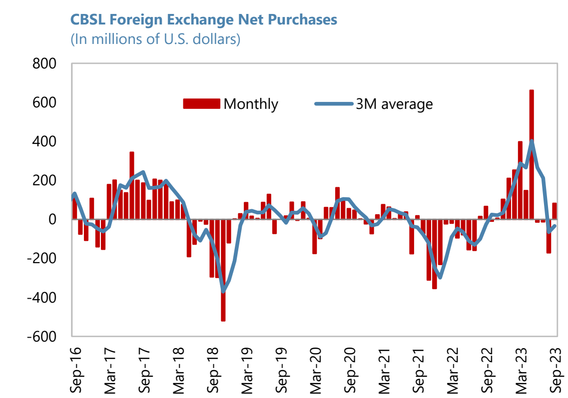
…and clawed back some but not all the gap with regional peers.



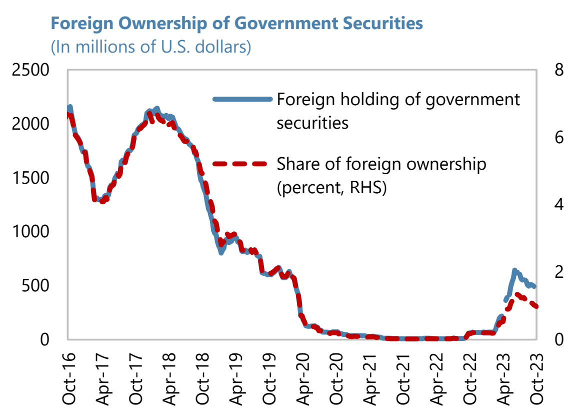
Inflation and the recent nominal appreciation has offset some of the earlier REER depreciation…



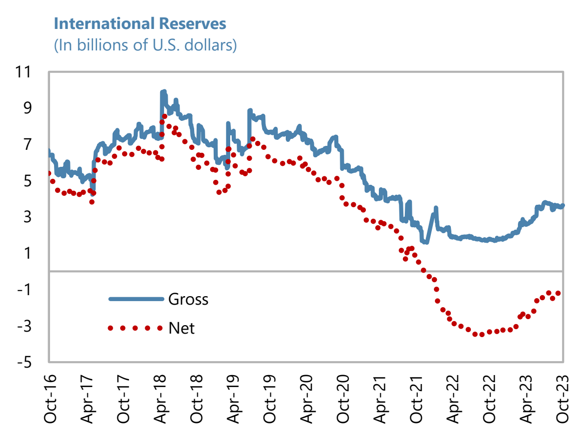
…while the CBSL has purchased significant FX in the market in H1 2023 to build reserves.



There has been some entry of foreign investors into the T-bills market in 2023.



Both GIR and NIR have bounced back by June 2023 from their lows in 2022 but remained flat since June.

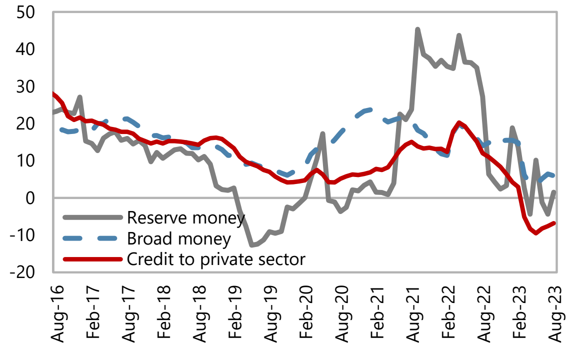


Sources: CBSL; Bloomberg Data L.P.; CEIC Data Company Limited; and IMF staff calculations.

Figure 5. Sri Lanka: Monetary and Financial Sector

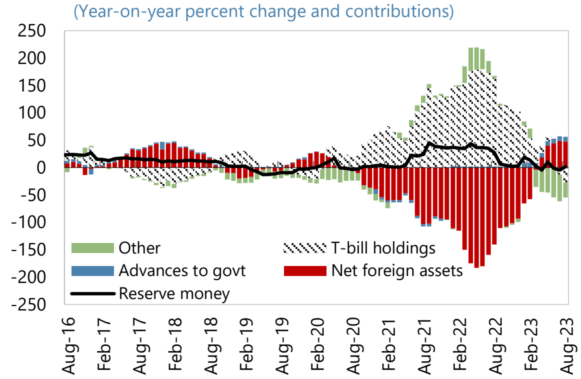
Monetary aggregates fell sharply, and private credit continued to contract.

Monetary Aggregates
(Year-on-year percent change)



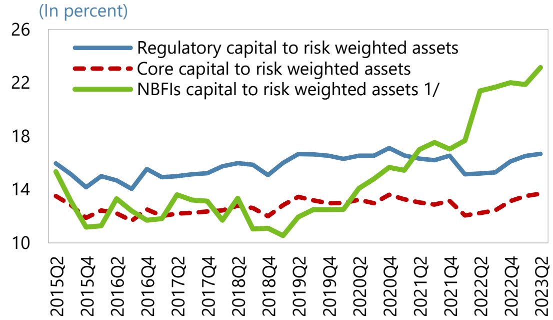
Despite recovery of Net Foreign Assets, declining T-bill holdings contributed to negative reserve money growth.

Reserve Money
(Year-on-year percent change and contributions)



While banks' reported capital adequacy still appeared above regulatory requirements, this does not include adjustments recommended by the AQR...

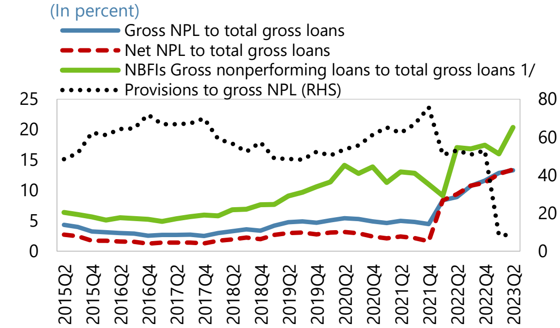
Capital Adequacy of Banking Sector
(In percent)



1/ NBFI stands for Licensed Finance Companies and Specialized Leasing Companies.

...and reported NPLs have continued to rise, likely to reflect the high real interest rates and economic contraction.

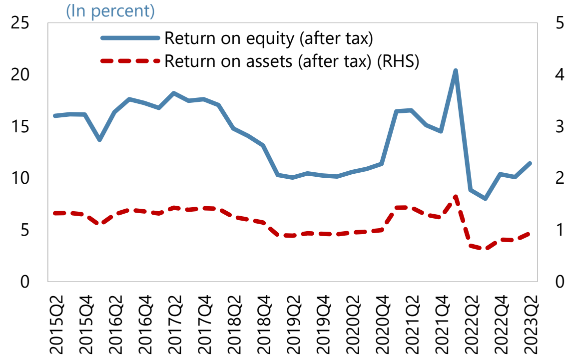
Non-performing Loans of Banking Sector
(In percent)



1/ NBFI stands for Licensed Finance Companies and Specialized Leasing Companies.

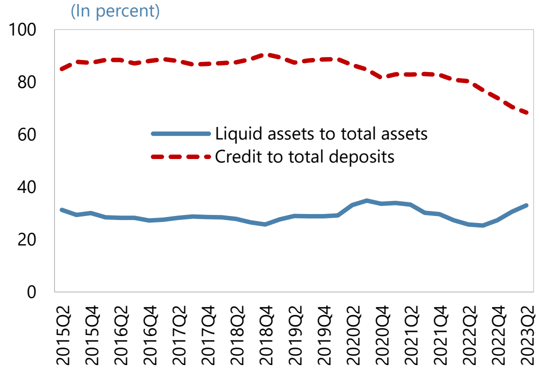
As the net interest rate margin compressed profitability shrank.

Profitability of Banking Sector
(In percent)



The banking sector overall remains liquid.

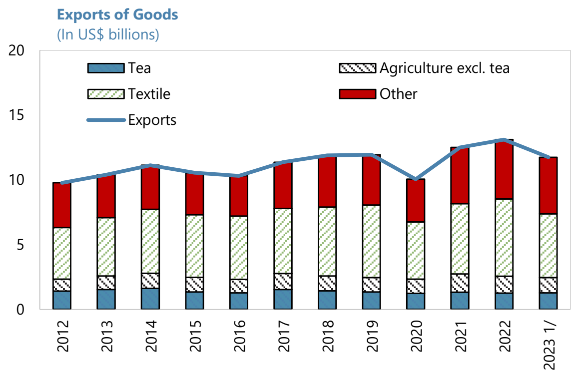
Liquidity of Banking Sector
(In percent)



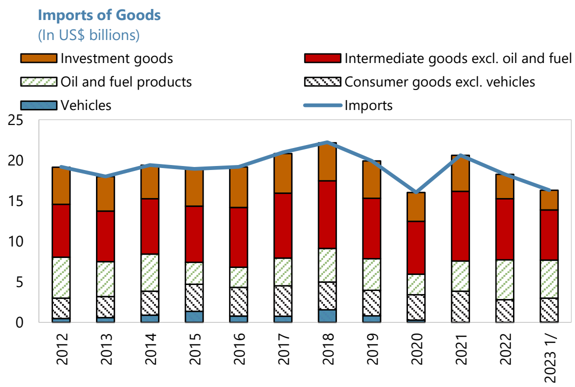
Sources: CBSL; and IMF staff calculations.

Figure 6. Sri Lanka: Balance of Payments

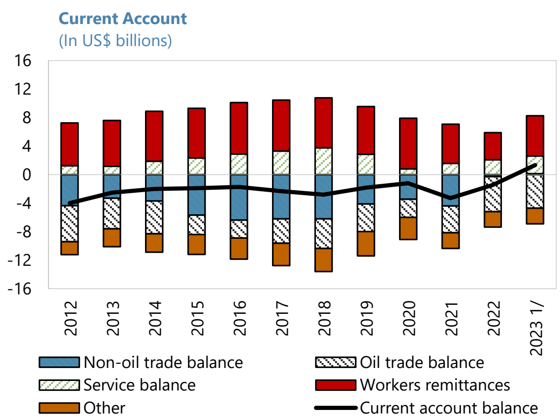
Sri Lanka's goods exports dropped in the first half of 2023,



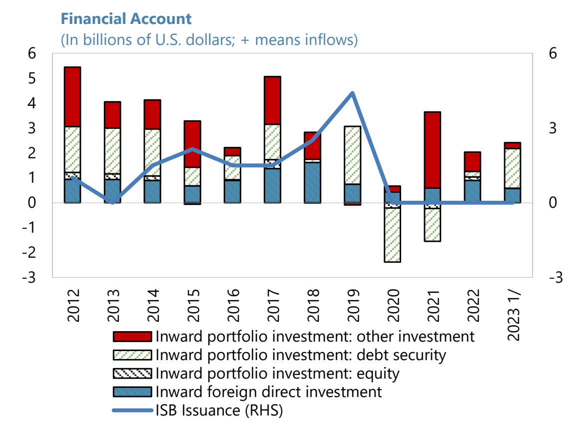
...and import declined due to import compression and restrictions have continued in the first half of 2023.



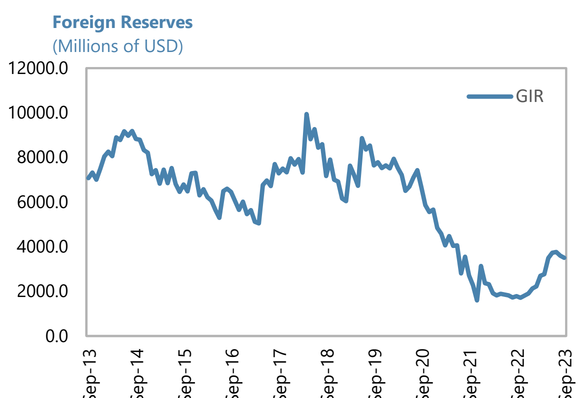
The current account moved to a surplus in H1 2023, ...



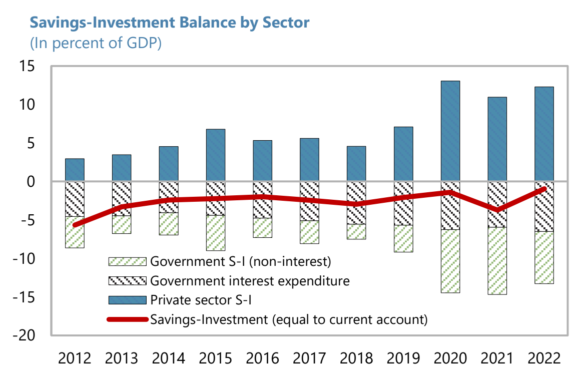
...while external financing was dependent on program partners.



GIR grew significantly in first half of 2023 as net purchases were large...



while the savings investment balance has continued to include net savings by private sector and net investment by the public sector.



Sources: CBSL; and IMF staff estimates.

1/ 2023 data is annualized based on the first half year data.

Table 1. Sri Lanka: Selected Economic Indicators, 2019-28 (Restructuring Scenario)

	2019	2020	2021	2022	2023	2023	2024	2024	2025	2026	2027	2028
		Act.		Prel.	Prog. Req.	Proj.	Prog. Req.	Proj.		Proj.		
GDP and inflation (in percent)												
Real GDP growth	-0.2	-4.6	3.5	-7.8	-3.0	-3.6	1.5	1.8	2.7	3.0	3.1	3.1
Inflation (average) 1/	4.3	4.6	6.0	45.2	28.5	17.9	8.7	7.9	5.6	5.4	5.3	5.2
Inflation (end-of-period) 1/	4.8	4.2	12.1	54.5	15.2	4.8	6.7	6.6	5.6	5.4	5.3	5.2
GDP Deflator growth	3.9	3.3	8.5	48.8	30.0	20.4	10.7	10.1	6.3	5.4	5.3	5.2
Nominal GDP growth	3.6	-1.5	12.3	37.2	26.0	16.1	12.3	12.1	9.1	8.6	8.5	8.5
Savings and investment (in percent of GDP)												
National savings	32.0	31.6	33.0	33.4	26.4	31.8	28.0	30.8	30.5	30.9	31.4	31.4
Government	-2.5	-8.3	-7.3	-6.2	-4.4	-6.0	-2.0	-3.1	-0.9	-0.3	0.3	0.6
Private	34.6	39.9	40.3	39.7	30.9	37.8	30.0	33.9	31.4	31.3	31.1	30.8
National Investment	34.1	33.0	36.7	34.4	28.0	30.3	29.4	31.6	31.6	32.0	32.4	32.3
Government	6.6	6.2	7.4	7.0	4.5	4.1	5.0	5.1	5.1	5.0	5.0	5.0
Private	27.5	26.8	29.4	27.4	23.5	26.2	24.5	26.5	26.5	27.0	27.4	27.2
Savings-Investment balance	-2.1	-1.4	-3.7	-1.0	-1.6	1.5	-1.4	-0.8	-1.1	-1.1	-1.0	-0.8
Government	-9.2	-14.5	-14.7	-13.3	-9.0	-10.1	-7.0	-8.2	-6.0	-5.3	-4.7	-4.4
Private	7.1	13.1	11.0	12.3	7.4	11.6	5.6	7.5	4.9	4.3	3.8	3.6
Public finances (in percent of GDP)												
Revenue and grants	11.9	8.8	8.3	8.3	11.0	10.2	13.3	13.0	15.0	15.0	15.1	15.2
Expenditure	19.5	21.0	20.0	18.5	19.0	19.0	19.7	20.3	20.3	19.7	19.3	19.1
Primary balance	-1.9	-5.9	-5.7	-3.7	-0.7	-0.7	0.8	0.8	2.3	2.3	2.3	2.3
Central government balance	-7.5	-12.2	-11.7	-10.2	-8.0	-8.8	-6.4	-7.3	-5.3	-4.7	-4.2	-3.9
Central government gross financing needs	21.7	26.1	31.0	33.9	26.6	27.8	17.9	25.3	23.0	19.8	17.1	12.3
Central government debt	82.6	96.7	102.7	115.5	100.0	107.8	101.6	110.3	111.4	110.8	108.0	104.6
Public debt 2/	89.0	105.1	114.9	125.8	111.2	114.1	108.5	115.9	116.3	115.1	111.7	107.9
Money and credit (percent change, end of period)												
Reserve money	-3.0	3.4	35.4	3.3	23.5	9.0	11.2	16.9	9.1	8.6	8.5	8.5
Broad money	7.0	23.4	13.2	15.5	22.6	7.0	11.2	18.2	9.1	8.6	8.5	8.5
Domestic credit	6.5	24.6	19.5	18.8	11.4	5.5	3.2	10.6	3.0	2.0	3.7	3.2
Credit to private sector	4.2	6.5	13.1	6.4	11.2	0.3	8.1	7.7	8.7	9.4	9.6	9.5
Credit to private sector (adjusted for inflation)	-0.1	1.9	7.2	-38.8	-17.3	-17.6	-0.6	-0.2	3.2	4.0	4.3	4.3
Credit to central government and public corporations	10.4	53.6	26.5	31.1	11.5	9.8	-0.8	12.8	-1.0	-3.7	-1.5	-3.0
Balance of payments (in millions of U.S. dollars)												
Exports	11,940	10,048	12,499	13,106	13,666	12,365	14,517	13,555	14,377	15,111	15,846	16,651
Imports	-19,937	-16,055	-20,638	-18,291	-20,597	-17,887	-21,479	-20,718	-23,002	-24,322	-25,144	-26,049
Current account balance	-1,844	-1,187	-3,285	-744	-1,184	1,232	-1,092	-634	-908	-879	-846	-764
Current account balance (in percent of GDP)	-2.1	-1.4	-3.7	-1.0	-1.6	1.5	-1.4	-0.8	-1.1	-1.1	-1.0	-0.8
Current account balance net of interest (in percent of GDP)	-0.2	0.5	-2.1	0.1	0.2	2.9	0.9	1.2	0.9	0.9	1.1	1.3
Export value growth (percent)	0.4	-15.9	24.4	4.9	4.3	-5.7	6.2	9.6	6.1	5.1	4.9	5.1
Import value growth (percent)	-10.3	-19.5	28.5	-11.4	12.6	-2.2	4.3	15.8	11.0	5.7	3.4	3.6
Gross official reserves (end of period)												
In millions of U.S. dollars	7,642	5,664	3,139	1,898	4,431	3,806	6,128	5,346	7,477	9,894	13,525	15,320
In months of prospective imports of goods & services	5.0	3.2	2.0	1.2	2.2	2.0	3.0	2.6	3.4	4.3	5.7	6.2
In percent of ARA composite metric	61.6	46.0	24.7	16.4	36.1	33.2	48.7	44.7	59.9	77.1	99.7	109.6
Usable Gross official reserves (end of period) 3/												
In millions of U.S. dollars	7,642	5,664	1,565	462	2,995	2,371	4,692	3,910	7,477	9,894	13,525	15,320
In months of prospective imports of goods & services	5.0	3.2	1.0	0.3	1.5	1.3	2.3	1.9	3.4	4.3	5.7	6.2
In percent of ARA composite metric	61.6	46.0	12.3	4.0	24.4	20.7	37.3	32.7	59.9	77.1	99.7	109.6
External debt (public and private)												
In billions of U.S. dollars	54.6	53.4	58.4	57.4	56.2	53.8	58.3	55.5	57.7	59.9	63.4	65.1
As a percent of GDP	61.4	63.2	65.9	76.7	74.7	64.7	76.7	68.0	70.4	71.8	72.7	70.3
Memorandum items:												
Nominal GDP (in billions of rupees)	15,911	15,672	17,600	24,148	29,852	28,033	33,533	31,422	34,291	37,226	40,397	43,812
REER appreciation (percent, period average)	-5.0	0.6	-6.0	-4.8	-8.5	-5.2	-4.6	-3.7	-5.8	-4.0	-1.5	0.0
Exchange Rate (period average)	178.7	185.6	198.8	322.6	....	...	....	...	...	...	...	...
Exchange Rate (end of period)	181.6	186.4	200.4	363.1		...		...	...	...	...	...

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

1/ Colombo CPI.

2/ Comprising central government debt, publicly guaranteed debt, and CBSL external liabilities (i.e., Fund credit outstanding and international currency swap arrangements).

3/ Excluding PBOC swap ($1.4bn in 2022) which becomes usable once GIR rise above 3 months of previous year's import cover.

Table 2a. Sri Lanka: Summary of Central Government Operations, 2019-28 (Restructuring Scenario)

(In billions of rupees)

	2019	2020	2021	2022	2023		2024			2025	2026	2027	2028
	Act.			Prel.	Program request	Proj.	Budget Speech	Program request	Proj.	Proj.			
Total revenue and grants	1,899	1,373	1,464	2,013	3,280	2,847	4,127	4,463	4,081	5,139	5,587	6,105	6,672
Total revenue	1,891	1,368	1,457	1,979	3,268	2,835	4,107	4,449	4,067	5,124	5,571	6,088	6,653
Tax revenue	1,735	1,217	1,298	1,751	3,005	2,593	3,820	4,154	3,789	4,800	5,229	5,702	6,234
Income taxes	428	268	302	534	895	861	1,080	1,010	1,021	1,109	1,204	1,304	1,411
VAT	444	234	308	463	796	679	1,400	1,456	1,370	1,558	1,694	1,855	2,039
Excise taxes	399	322	307	343	526	450	545	671	545	662	731	797	870
Other taxes on goods and services	132	31	31	70	297	245	290	343	318	351	381	414	449
Taxes on international trade	332	362	350	341	492	357	505	674	536	708	771	848	940
Property taxes	0	0	0	0	0	0	0	0	0	411	447	485	526
Nontax revenue	156	151	159	228	263	243	287	295	278	324	342	386	419
Grants	8	5	7	33	12	12	20	13	13	15	16	17	19
Total expenditure and net lending 1/	3,095	3,284	3,522	4,473	5,681	5,317	6,978	6,594	7,020	6,957	7,342	7,789	8,371
Current expenditure	2,301	2,672	2,748	3,520	4,608	4,517	5,277	5,142	5,063	5,438	5,712	5,999	6,405
Wages and salaries	686	794	846	956	1,012	975	1,098	1,207	1,095	1,234	1,340	1,454	1,577
Goods and services	162	180	169	183	300	254	330	335	317	343	372	404	438
Subsidies and transfers	552	717	685	815	1,104	1,014	1,198	1,199	1,104	1,253	1,387	1,528	1,682
of which: social safety net transfers	…	…	…	142	187	187	205	201	205	220	238	259	281
Interest payments 2/	901	980	1,048	1,565	2,192	2,274	2,651	2,400	2,546	2,607	2,612	2,613	2,707
Capital expenditure and net lending 1/	794	612	774	953	1,073	800	1,701	1,453	1,957	1,519	1,631	1,790	1,966
Capital expenditure	799	615	768	715	1,073	800	1,260	1,453	1,312	1,519	1,631	1,790	1,966
Capital transfers 1/ 3/							450		644				
Net lending	-5	-4	7	237	0	0	-9	0	0	0	0	0	0
Overall balance 1/	-1,196	-1,910	-2,058	-2,460	-2,401	-2,470	-2,851	-2,132	-2,939	-1,819	-1,756	-1,684	-1,699
Financing	1,196	1,910	2,058	2,460	2,401	2,470	0	2,132	2,939	1,819	1,756	1,684	1,699
Privatization	0	0	0	0	0	0	0	0	0	0	0	0	0
Net external financing	575	-83	-14	425	1,052	610		1,112	603	614	720	892	360
Net domestic financing	622	1,994	2,072	2,035	1,349	1,861		1,020	2,337	1,204	1,036	791	1,339
Memorandum items:													
Central government primary balance (program definition) 4/	-295	-930	-1,010	-895	-209	-196	250	268	251	789	856	929	1,008
Central government primary balance	-295	-930	-1,010	-895	-209	-196	-200	268	-393	789	856	929	1,008
Central government debt 1/	13,142	15,158	18,082	27,899	29,856	30,223		34,084	34,674	38,214	41,240	43,621	45,817
Nominal GDP (in billion of rupees)	15,911	15,672	17,600	24,148	29,852	28,033	31,500	33,533	31,422	34,291	37,226	40,397	43,812

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

1/ For 2024, the total spending envelopes include capital transfers appropriations for the planned recapitalization of the five largest banks. Overall and primary balances of fiscal accounts include this amount but they are excluded from program targets. See Note 4.

2/ Based on illustrative restructuring terms.

3/ Staff's baseline is higher than the 2024 appropriation because staff also incorporates potential recapitalization amounts for the CBSL.

4/ As per the EFF TMU and for the purpose of program monitoring, the government's equity injections into banks for recapitalization purposes will not be recorded as central government expenditure.

Table 2b. Sri Lanka: Summary of Central Government Operations, 2019-28 (Restructuring Scenario)

(In percent of GDP)

	2019	2020	2021	2022	2023		2024			2025	2026	2027	2028
	Act.			Prel.	Program request	Proj.	Budget Speech	Program request	Proj.				
Total revenue and grants	11.9	8.8	8.3	8.3	11.0	10.2	13.1	13.3	13.0	15.0	15.0	15.1	15.2
Total revenue	11.9	8.7	8.3	8.2	10.9	10.1	13.0	13.3	12.9	14.9	15.0	15.1	15.2
Tax revenue	10.9	7.8	7.4	7.3	10.1	9.2	12.1	12.4	12.1	14.0	14.0	14.1	14.2
Income taxes	2.7	1.7	1.7	2.2	3.0	3.1	3.4	3.0	3.2	3.2	3.2	3.2	3.2
VAT	2.8	1.5	1.8	1.9	2.7	2.4	4.4	4.3	4.4	4.5	4.6	4.6	4.7
Excise taxes	2.5	2.1	1.7	1.4	1.8	1.6	1.7	2.0	1.7	1.9	2.0	2.0	2.0
Other taxes on goods and services	0.8	0.2	0.2	0.3	1.0	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0
Taxes on international trade	2.1	2.3	2.0	1.4	1.6	1.3	1.6	2.0	1.7	2.1	2.1	2.1	2.1
Property taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.2	1.2	1.2	1.2
Nontax revenue	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0
Grants	0.0	0.0	0.0	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure and net lending 1/	19.5	21.0	20.0	18.5	19.0	19.0	22.2	19.7	22.3	20.3	19.7	19.3	19.1
Current expenditure	14.5	17.0	15.6	14.6	15.4	16.1	16.8	15.3	16.1	15.9	15.3	14.9	14.6
Wages and salaries	4.3	5.1	4.8	4.0	3.4	3.5	3.5	3.6	3.5	3.6	3.6	3.6	3.6
Goods and services	1.0	1.1	1.0	0.8	1.0	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Subsidies and transfers	3.5	4.6	3.9	3.4	3.7	3.6	3.8	3.6	3.5	3.7	3.7	3.8	3.8
of which: social safety net transfers	...	...	...	0.6	0.6	0.7	0.7	0.6	0.7	0.6	0.6	0.6	0.6
Interest payments 2/	5.7	6.3	6.0	6.5	7.3	8.1	8.4	7.2	8.1	7.6	7.0	6.5	6.2
Capital expenditure and net lending 1/	5.0	3.9	4.4	3.9	3.6	2.9	5.4	4.3	6.2	4.4	4.4	4.4	4.5
Capital expenditure	5.0	3.9	4.4	3.0	3.6		4.0	4.3	4.2	4.4	4.4	4.4	4.5
Capital transfers 1/ 3/						2.9	1.4		2.1				
Net lending	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance 1/	-7.5	-12.2	-11.7	-10.2	-8.0	-8.8	-9.1	-6.4	-9.4	-5.3	-4.7	-4.2	-3.9
Financing	7.5	12.2	11.7	10.2	8.0	8.8	0.0	6.4	9.4	5.3	4.7	4.2	3.9
Privatization	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
Net external financing	3.6	-0.5	-0.1	1.8	3.5	2.2	0.0	3.3	1.9	1.8	1.9	2.2	0.8
Net domestic financing	3.9	12.7	11.8	8.4	4.5	6.6	0.0	3.0	7.4	3.5	2.8	2.0	3.1
Memorandum items:													
Central government primary balance (program definition) 4/	-1.9	-5.9	-5.7	-3.7	-0.7	-0.7	0.8	0.8	0.8	2.3	2.3	2.3	2.3
Central government primary balance	-1.9	-5.9	-5.7	-3.7	-0.7	-0.7	-0.6	0.8	-1.3	2.3	2.3	2.3	2.3
Central government debt 1/	82.6	96.7	102.7	115.5	100.0	107.8		101.6	110.3	111.4	110.8	108.0	104.6
Nominal GDP (in billion of rupees)	15,911	15,672	17,600	24,148	29,852	28,033	31,500	33,533	31,422	34,291	37,226	40,397	43,812

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

1/ For 2024, the total spending envelopes include capital transfers appropriations for the planned recapitalization of the five largest banks. Overall and primary balances of fiscal accounts include this amount but they are excluded from program targets. See Note 4.

2/ Based on illustrative restructuring terms.

3/ Staff's baseline is higher than the 2024 appropriation because staff also incorporates potential recapitalization amounts for the CBSL.

4/ As per the EFF TMU and for the purpose of program monitoring, the government's equity injections into banks for recapitalization purposes will not be recorded as central government expenditure.

Table 3. Sri Lanka: Monetary Accounts, 2019-28 1/ (Restructuring Scenario)
(In billions of rupees, unless otherwise indicated, end of period)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
		Act.			Proj					
Central Bank of Sri Lanka										
Net foreign assets	896	527	-387	-1,606	-933	-238	856	2,041	3,553	4,264
Net domestic assets	37	438	1,693	2,956	2,404	1,957	1,020	-4	-1,343	-1,867
Net claims on central government	363	869	2,094	3,432	2,812	2,462	1,742	1,022	452	232
o.w. Holdings of government securities for monetary operations 2/	52	-8	529	698	283	283	263	243	223	203
Other items, net	-328	-546	-544	-465	-398	-494	-711	-1,016	-1,784	-2,088
Reserve Money	933	964	1,306	1,349	1,471	1,719	1,876	2,036	2,210	2,397
Currency in circulation	678	835	1,005	1,027	984	1,110	1,172	1,236	1,309	1,443
Commercial banks' deposits	255	130	301	323	486	609	704	801	901	953
Monetary survey										
Net foreign assets	101	-209	-982	-1,753	-650	88	952	1,929	3,288	3,994
Monetary authorities	896	527	-387	-1,606	-933	-238	856	2,041	3,553	4,264
Deposit money banks	-795	-736	-595	-146	284	326	96	-111	-264	-270
Net domestic assets	7,523	9,615	11,629	14,049	13,811	15,467	16,024	16,499	16,710	17,695
Net claims on central government	2,796	4,548	5,832	7,466	9,040	10,132	10,022	9,599	9,435	9,117
Credit to corporations	6,615	7,173	8,170	9,161	8,507	9,282	9,984	10,804	11,717	12,711
Public corporations	818	1,002	1,188	1,735	1,059	1,262	1,264	1,264	1,264	1,264
Private corporations	5,797	6,171	6,981	7,427	7,448	8,020	8,720	9,540	10,453	11,447
Other items (net)	-1,887	-2,106	-2,373	-2,579	-3,736	-3,947	-3,982	-3,904	-4,442	-4,133
Broad money	7,624	9,406	10,647	12,296	13,161	15,556	16,976	18,429	19,998	21,689
Memorandum Items										
Gross international reserves (in millions of U.S. dollars)	7,642	5,664	3,139	1,898	3,806	5,346	7,477	9,894	13,525	15,320
Net international reserves (in millions of U.S. dollars)	5,871	3,543	-423	-3,196	-1,317	638	3,198	5,682	9,158	11,173
Net Foreign Assets of commercial banks (in millions of U.S. dollars)	-4,379	-3,950	-2,967	-403	773	809	220	-243	-564	-564
Reserve money (in percent of GDP)	5.9	6.2	7.4	5.6	5.2	5.5	5.5	5.5	5.5	5.5
Private credit (in percent of GDP)	36.4	39.4	39.7	30.8	26.6	25.5	25.4	25.6	25.9	26.1
Money multiplier	8.2	9.8	8.2	9.1	8.9	9.1	9.1	9.1	9.1	9.1
Broad money velocity	2.1	1.7	1.7	2.0	2.1	2.0	2.0	2.0	2.0	2.0
					(Annual percentage change)					
Nominal GDP	3.6	-1.5	12.3	37.2	16.1	12.1	9.1	8.6	8.5	8.5
Broad money	7.0	23.4	13.2	15.5	7.0	18.2	9.1	8.6	8.5	8.5
Reserve money	-3.0	3.4	35.4	3.3	9.0	16.9	9.1	8.6	8.5	8.5
Credit to private sector	4.2	6.5	13.1	6.4	0.3	7.7	8.7	9.4	9.6	9.5
Credit to private sector (adjusted for inflation)	-0.1	1.9	7.2	-38.8	-17.6	-0.2	3.2	4.0	4.3	4.3

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

1/ Covers the monetary authorities and commercial banks. Excludes deposit-taking finance companies

2/ Arise from purchases of government securities, for monetary policy purposes, on temporary basis with an agreement to reverse the transaction after an agreed number of days.

Table 4a. Sri Lanka: Balance of Payments, 2019-28 (Restructuring Scenario)

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

	2019	2020	2021	2022	2023	2023	2024	2024	2025	2026	2027	2028
		Act.		Prel.	Prog. Req.	Proj.	Prog. Req.	Proj.		Proj.		
Current account	**-1,844**	**-1,187**	**-3,285**	**-744**	**-1,184**	**1,232**	**-1,092**	**-634**	**-908**	**-879**	**-846**	**-764**
Balance on goods	-7,997	-6,008	-8,139	-5,185	-6,931	-5,523	-6,962	-7,163	-8,625	-9,212	-9,298	-9,398
Credit (exports)	11,940	10,048	12,499	13,106	13,666	12,365	14,517	13,555	14,377	15,111	15,846	16,651
Debit (imports)	-19,937	-16,055	-20,638	-18,291	-20,597	-17,887	-21,479	-20,718	-23,002	-24,322	-25,144	-26,049
Non-oil imports	-16,045	-13,513	-16,895	-13,394	-15,943	-13,341	-17,469	-16,025	-18,377	-19,697	-20,495	-21,350
Oil imports	-3,892	-2,543	-3,743	-4,897	-4,654	-4,546	-4,010	-4,693	-4,625	-4,626	-4,649	-4,698
Balance on services	2,850	819	1,586	2,110	3,507	2,868	4,066	2,821	3,649	4,052	4,208	4,408
Credit (exports)	7,475	3,035	2,475	3,062	5,511	4,438	6,298	4,620	5,680	6,183	6,445	6,758
Debit (imports)	-4,625	-2,216	-889	-953	-2,004	-1,570	-2,232	-1,798	-2,031	-2,131	-2,237	-2,350
Primary income, net	-2,462	-2,205	-1,960	-1,165	-1,993	-1,715	-2,456	-2,119	-2,022	-2,013	-2,149	-2,284
Secondary income, net	5,765	6,207	5,227	3,496	4,233	5,602	4,259	5,827	6,090	6,295	6,393	6,511
Of which: workers' remittances (net)	5,754	6,194	5,221	3,493	4,223	5,602	4,249	5,826	6,091	6,295	6,394	6,511
Capital account (+ surplus / - deficit)	**23**	**28**	**25**	**19**	**12**	**12**	**12**	**12**	**12**	**12**	**12**	**12**
Balance from current account and capital account	**-1,821**	**-1,159**	**-3,260**	**-725**	**-1,172**	**1,244**	**-1,080**	**-622**	**-896**	**-867**	**-834**	**-752**
Financial account (+ net lending / - net borrowing) 1/	**-2,469**	**1,636**	**-1,752**	**-142**	**-3,211**	**-156**	**-2,320**	**-1,693**	**-2,556**	**-2,796**	**-4,310**	**-2,766**
Direct investments	-666	-419	-574	-883	-950	-775	-1,280	-1,200	-1,490	-1,520	-1,635	-1,645
Portfolio investments	-2,312	2,382	1,547	201	-101	-256	-110	-260	-113	-120	-1,620	-609
Equity and investment Fund shares	5	216	232	-137	-90	-30	-100	-100	-100	-100	-100	-100
Debt instruments	-2,317	2,166	1,314	338	-11	-226	-10	-160	-13	-20	-1,520	-509
Of which: deposit taking corporations	250	0	0	0	0	0	0	0	0	0	0	0
Of which: general government	-2,567	2,166	1,314	338	-11	-226	-10	-160	-13	-20	-1,520	-509
T-bills, T-bonds, and SLDBs	333	531	28	-53	-11	-226	-10	-160	-13	-20	-20	-20
Sovereign bonds	-2,900	1,635	1,286	391	0	0	0	0	0	0	-1,500	-489
Other investments 2/	509	-327	-2,725	540	-2,160	875	-930	-233	-953	-1,156	-1,055	-513
Of which:												
Currency and deposits	-259	79	-3,709	245	27	-825	421	1,072	476	255	-200	0
Central bank	0	-400	-1,375	-400	200	-1,675	400	900	900	555	0	0
Deposit taking corporations	-259	479	-2,334	645	-173	851	21	172	-424	-300	-200	0
Loans 2/	573	-136	1,445	103	-2,619	-641	-2,306	-1,283	-1,318	-1,329	-758	-575
Deposit taking corporations	281	-75	2,152	1,645	-416	269	-246	-137	-165	-163	-121	-69
General government	89	-116	-875	-1,545	-2,023	-1,140	-1,848	-1,097	-1,013	-1,016	-517	-506
Disbursements	-448	-1,076	-2,100	-2,316	-3,009	-2,150	-2,392	-1,980	-2,217	-2,264	-2,175	-1,701
Amortizations	1,814	1,855	1,815	1,153	986	1,010	544	883	1,204	1,248	1,658	1,194
Other sectors	203	56	168	3	-180	230	-212	-49	-140	-150	-120	0
SDR allocation	0	0	-787	0	0	0	0	0	0	0	0	0
Other accounts receivable/payable (incl. ACU balance)	-25	114	-180	-1,492	736	1,994	997	0	0	0	0	0
Errors and omissions	-640	765	-1,739	-513	0	0	0	0	0	0	0	0
Overall balance (- = need of inflow) 1/	**8**	**-2,030**	**-3,247**	**-1,095**	**2,039**	**1,400**	**1,240**	**1,071**	**1,660**	**1,929**	**3,476**	**2,015**
Financing (- = inflow)	**336**	**-1,977**	**-3,247**	**-1,095**	**2,702**	**2,082**	**1,905**	**1,752**	**2,344**	**2,616**	**3,819**	**2,009**
Change in reserve assets	336	-1,991	-3,304	-1,235	2,533	1,909	1,697	1,539	2,131	2,417	3,632	1,795
Use of Fund credit, net	0	14	57	140	168	173	208	213	213	200	188	214
Financing gap (- = inflow) 4/	**-328**	**-53**	**0**	**0**	**-663**	**-682**	**-665**	**-682**	**-685**	**-689**	**-346**	**0**
IMF	-328	0	0	0	-663	-682	-665	-682	-685	-689	-346	0
Other IFIs	0	-53	0	0	0	0	0	0	0	0	0	0
Memorandum items:												
Current account (in percent of GDP)	-2.1	-1.4	-3.7	-1.0	-1.6	1.5	-1.4	-0.8	-1.1	-1.1	-1.0	-0.8
Gross official reserves	7,642	5,664	3,139	1,898	4,431	3,806	6,128	5,346	7,477	9,894	13,525	15,320
In months of prospective imports of goods and services	5.0	3.2	2.0	1.2	2.2	2.0	3.0	2.6	3.4	4.3	5.7	6.2
In percent of ARA composite metric	61.6	46.0	24.7	16.4	36.1	33.2	48.7	44.7	59.9	77.1	99.7	109.6
Usable Gross official reserves 3/	7,642	5,664	1,565	462	2,995	2,371	4,692	3,910	7,477	9,894	13,525	15,320
In months of prospective imports of goods and services	5.0	3.2	1.0	0.3	1.5	1.3	2.3	1.9	3.4	4.3	5.7	6.2
In percent of ARA composite metric	61.6	46.0	12.3	4.0	24.4	20.7	37.3	32.7	59.9	77.1	99.7	109.6
Net international reserves	5,871	3,543	-423	-3,196	-221	-1,317	2,416	638	3,198	5,682	9,158	11,173
In percent of ARA composite metric	47.4	28.8	-3.3	…	…	…	19.2	5.3	25.6	44.3	67.5	79.9
Nominal GDP	89,015	84,441	88,548	74,846	75,267	83,190	76,011	81,640	81,879	83,399	87,225	92,628

Sources: Data provided by the CBSL; and IMF staff estimates.

1/ Excluding changes in reserves assets and credit and loans with the IMF.

2/ Excluding credits and loans with the IMF, other than reserves (net purchases and repurchases), and other international institutions' loan disbursement.

3/ Excluding PBOC swap ($1.4bn in 2022) which becomes usable once GIR rise above 3 months of previous year's import cover.

4/ In this table, all program financing in 2022-2027 (IFI budget support, debt relief, external arrears) except the IMF financing is included above the line.

Table 4b. Sri Lanka: Balance of Payments, 2019-28 (Restructuring Scenario)

(In percentage of GDP, unless otherwise indicated)

	2019	2020	2021	2022	2023	2023	2024	2024	2025	2026	2027	2028
		Act.		Prel.	Prog. Req.	Proj.	Prog. Req.	Proj.		Proj.		
Current account	**-2.1**	**-1.4**	**-3.7**	**-1.0**	**-1.6**	**1.5**	**-1.4**	**-0.8**	**-1.1**	**-1.1**	**-1.0**	**-0.8**
Balance on goods	-9.0	-7.1	-9.2	-6.9	-9.2	-6.6	-9.2	-8.8	-10.5	-11.0	-10.7	-10.1
Credit (exports)	13.4	11.9	14.1	17.5	18.2	14.9	19.1	16.6	17.6	18.1	18.2	18.0
Debit (imports)	-22.4	-19.0	-23.3	-24.4	-27.4	-21.5	-28.3	-25.4	-28.1	-29.2	-28.8	-28.1
Non-oil imports	-18.0	-16.0	-19.1	-17.9	-21.2	-16.0	-23.0	-19.6	-22.4	-23.6	-23.5	-23.0
Oil imports	-4.4	-3.0	-4.2	-6.5	-6.2	-5.5	-5.3	-5.7	-5.6	-5.5	-5.3	-5.1
Balance on services	3.2	1.0	1.8	2.8	4.7	3.4	5.3	3.5	4.5	4.9	4.8	4.8
Credit (exports)	8.4	3.6	2.8	4.1	7.3	5.3	8.3	5.7	6.9	7.4	7.4	7.3
Debit (imports)	-5.2	-2.6	-1.0	-1.3	-2.7	-1.9	-2.9	-2.2	-2.5	-2.6	-2.6	-2.5
Primary income, net	-2.8	-2.6	-2.2	-1.6	-2.6	-2.1	-3.2	-2.6	-2.5	-2.4	-2.5	-2.5
Secondary income, net	6.5	7.4	5.9	4.7	5.6	6.7	5.6	7.1	7.4	7.5	7.3	7.0
Of which: workers' remittances (net)	6.5	7.3	5.9	4.7	5.6	6.7	5.6	7.1	7.4	7.5	7.3	7.0
Capital account (+ surplus / - deficit)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance from current account and capital account	**-2.0**	**-1.4**	**-3.7**	**-1.0**	**-1.6**	**1.5**	**-1.4**	**-0.8**	**-1.1**	**-1.0**	**-1.0**	**-0.8**
Financial account (+ net lending / - net borrowing) 1/	**-2.8**	**1.9**	**-2.0**	**-0.2**	**-4.3**	**-0.2**	**-3.1**	**-2.1**	**-3.1**	**-3.4**	**-4.9**	**-3.0**
Direct investments	-0.7	-0.5	-0.6	-1.2	-1.3	-0.9	-1.7	-1.5	-1.8	-1.8	-1.9	-1.8
Portfolio investments	-2.6	2.8	1.7	0.3	-0.1	-0.3	-0.1	-0.3	-0.1	-0.1	-1.9	-0.7
Equity and investment Fund shares	0.0	0.3	0.3	-0.2	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Debt instruments	-2.6	2.6	1.5	0.5	0.0	-0.3	0.0	-0.2	0.0	0.0	-1.7	-0.5
Of which: deposit taking corporations	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which: general government	-2.9	2.6	1.5	0.5	0.0	-0.3	0.0	-0.2	0.0	0.0	-1.7	-0.5
T-bills, T-bonds, and SLDBs	0.4	0.6	0.0	-0.1	0.0	-0.3	0.0	-0.2	0.0	0.0	0.0	0.0
Sovereign bonds	-3.3	1.9	1.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0	-1.7	-0.5
Other investments 2/	0.6	-0.4	-3.1	0.7	-2.9	1.1	-1.2	-0.3	-1.2	-1.4	-1.2	-0.6
Of which:	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	-0.3	0.1	-4.2	0.3	0.0	-1.0	0.6	1.3	0.6	0.3	-0.2	0.0
Central bank	0.0	-0.5	-1.6	-0.5	0.3	-2.0	0.5	1.1	1.1	0.7	0.0	0.0
Deposit taking corporations	-0.3	0.6	-2.6	0.9	-0.2	1.0	0.0	0.2	-0.5	-0.4	-0.2	0.0
Loans 2/	0.6	-0.2	1.6	0.1	-3.5	-0.8	-3.0	-1.6	-1.6	-1.6	-0.9	-0.6
Deposit taking corporations	0.3	-0.1	2.4	2.2	-0.6	0.3	-0.3	-0.2	-0.2	-0.2	-0.1	-0.1
General government	0.1	-0.1	-1.0	-2.1	-2.7	-1.4	-2.4	-1.3	-1.2	-1.2	-0.6	-0.5
Disbursements	-0.5	-1.3	-2.4	-3.1	-4.0	-2.6	-3.1	-2.4	-2.7	-2.7	-2.5	-1.8
Amortizations	2.0	2.2	2.0	1.5	1.3	1.2	0.7	1.1	1.5	1.5	1.9	1.3
Other sectors	0.2	0.1	0.2	0.0	-0.2	0.3	-0.3	-0.1	-0.2	-0.2	-0.1	0.0
SDR allocation	0.0	0.0	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable/payable (incl. ACU balance)	0.0	0.1	-0.2	-2.0	1.0	2.4	1.3	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.7	0.9	-2.0	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (- = need of inflow) 1/	**0.0**	**-2.4**	**-3.7**	**-1.5**	**2.7**	**1.7**	**1.6**	**1.3**	**2.0**	**2.3**	**4.0**	**2.2**
Financing (- = inflow)	**0.4**	**-2.3**	**-3.7**	**-1.5**	**3.6**	**2.5**	**2.5**	**2.1**	**2.9**	**3.1**	**4.4**	**2.2**
Change in reserve assets	0.4	-2.4	-3.7	-1.6	3.4	2.3	2.2	1.9	2.6	2.9	4.2	1.9
Use of Fund credit, net	0.0	0.0	0.1	0.2	0.2	0.2	0.3	0.3	0.3	0.2	0.2	0.2
Financing gap (- = inflow) 4/	**-0.4**	**-0.1**	**0.0**	**0.0**	**-0.9**	**-0.8**	**-0.9**	**-0.8**	**-0.8**	**-0.8**	**-0.4**	**0.0**
IMF	**-0.4**	**0.0**	**0.0**	**0.0**	**-0.9**	**-0.8**	**-0.9**	**-0.8**	**-0.8**	**-0.8**	**-0.4**	**0.0**
Other IFIs	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:												
Current account (in percent of GDP)	-2.1	-1.4	-3.7	-1.0	-1.6	1.5	-1.4	-0.8	-1.1	-1.1	-1.0	-0.8
Gross official reserves	7,642	5,664	3,139	1,898	4,431	3,806	6,128	5,346	7,477	9,894	13,525	15,320
In months of prospective imports of goods and services	5.0	3.2	2.0	1.2	2.2	2.0	3.0	2.6	3.4	4.3	5.7	6.2
In percent of ARA composite metric	61.6	46.0	24.7	16.4	36.1	33.2	48.7	44.7	59.9	77.1	99.7	109.6
Usable Gross official reserves 3/	7,642	5,664	1,565	462	2,995	2,371	4,692	3,910	7,477	9,894	13,525	15,320
In months of prospective imports of goods and services	5.0	3.2	1.0	0.3	1.5	1.3	2.3	1.9	3.4	4.3	5.7	6.2
In percent of ARA composite metric	61.6	46.0	12.3	4.0	24.4	20.7	37.3	32.7	59.9	77.1	99.7	109.6
Net international reserves	5,871	3,543	-423	-3,196	-221	-1,317	2,416	638	3,198	5,682	9,158	11,173
In percent of ARA composite metric	47.4	28.8	-3.3	…	…	…	19.2	5.3	25.6	44.3	67.5	79.9
Nominal GDP	89,015	84,441	88,548	74,846	75,267	83,190	76,011	81,640	81,879	83,399	87,225	92,628

Sources: Data provided by the CBSL; and IMF staff estimates.

1/ Excluding changes in reserves assets and credit and loans with the IMF.

2/ Excluding credits and loans with the IMF, other than reserves (net purchases and repurchases), and other international institutions' loan disbursement.

3/ Excluding PBOC swap ($1.4bn in 2022) which becomes usable once GIR rise above 3 months of previous year's import cover.

4/ In this table, all program financing in 2022-2027 (IFI budget support, debt relief, external arrears) except the IMF financing is included above the line.

Table 5. Sri Lanka: Composition of Public Debt 1/ (Including Arrears)

	Debt Stock (end of period, incl. arrears)			Debt Service on end-2022 debt stock (on contractual terms)					
	2022			2023	2024	2025	2023	2024	2025
	(In US$mn)	*(Percent total debt)*	*(Percent GDP)*	*(In US$mn)*			*(Percent GDP)*		
Total public debt	**83,670**	**100.0**	**125.8**	**27,825**	**10,295**	**10,046**	**33.4**	**12.7**	**12.4**
External (foreign law)	**41,549**	**49.7**	**62.5**	**7,450**	**5,301**	**5,987**	**8.9**	**6.5**	**7.4**
Multilateral creditors[2]	11,519	13.8	17.3	1,085	1,170	1,182	1.3	1.4	1.5
IMF	1,062	1.3	1.6	212	244	236	0.3	0.3	0.3
World Bank	3,839	4.6	5.8	285	294	310	0.3	0.4	0.4
ADB	5,973	7.1	9.0	524	548	553	0.6	0.7	0.7
Other Multilaterals	645	0.8	1.0	65	83	82	0.1	0.1	0.1
Bilateral Creditors	11,471	13.7	17.2	1,818	1,221	1,503	2.2	1.5	1.8
Paris Club	4,784	5.7	7.2	489	436	404	0.6	0.5	0.5
o/w: Japan	2,828	3.4	4.3	200	190	182	0.2	0.2	0.2
Non-Paris Club	6,687	8.0	10.1	1,329	786	1,099	1.6	1.0	1.4
o/w: China	4,483	5.4	6.7	615	593	533	0.7	0.7	0.7
India	1,883	2.3	2.8	680	160	538	0.8	0.2	0.7
Bonds	13,364	16.0	20.1	2,010	2,343	2,741	2.4	2.9	3.4
Commercial creditors	3,159	3.8	4.8	502	567	560	0.6	0.7	0.7
o/w: China Development Bank	2,901	3.5	4.4	500	565	559	0.6	0.7	0.7
Central bank bilateral currency swaps	2,036	2.4	3.1	2,036	-	-	2.4	0.0	0.0
Domestic (local law)	**42,121**	**50.3**	**63.3**	**20,375**	**4,994**	**4,059**	**24.4**	**6.2**	**5.0**
T-Bills	11,364	13.6	17.1	10,404	-	-	12.5	0.0	0.0
Bonds	25,124	30.0	37.8	6,110	4,850	3,922	7.3	6.0	4.8
Loans	5,633	6.7	8.5	3,862	144	138	4.6	0.2	0.2
Memo items:									
Collateralized debt[3]	0	0	0						
o/w: Related	0	0	0						
o/w: Unrelated	0	0	0						
Contingent liabilities									
o/w: Public guarantees	(included in public debt)								
o/w: Other explicit contingent liabilities									
Exchange rate (eop., Rupees/$)	363								
Nominal GDP (billions of Rupees)	24,148								

1/As reported by the Sri Lankan authorities according to their classification of creditors, including by official and commercial. Debt coverage is the same as the DSA.

2/Multilateral creditors" are simply institutions with more than one official shareholder and may not necessarily align with creditor classification under other IMF policies (e.g. Lending Into Official Arrears).

3/Debt is collateralized when the creditor has rights over an asset or revenue stream that would allow it, if the borrower defaults on its payment obligations, to rely on the asset or revenue stream to secure repayment of the debt. Collateralization entails a borrower granting liens over specific existing assets or future receivables to a lender as security against repayment of the loan. Collateral is "unrelated" when it has no relationship to a project financed by the loan. An example would be borrowing to finance the budget deficit, collateralized by oil revenue receipts. See the joint IMF-World Bank note for the G20 "Collateralized Transactions: Key Considerations for Public Lenders and Borrowers" for a discussion of issues raised by collateral.

Table 6. Sri Lanka: Gross External Financing, 2019-28 (Restructuring Scenario)

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

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Proj.					
Current account	-1,844	-1,187	-3,285	-744	1,232	-634	-908	-879	-846	-764
Balance on goods	-7,997	-6,008	-8,139	-5,185	-5,523	-7,163	-8,625	-9,212	-9,298	-9,398
Credit (exports)	11,940	10,048	12,499	13,106	12,365	13,555	14,377	15,111	15,846	16,651
Debit (imports)	-19,937	-16,055	-20,638	-18,291	-17,887	-20,718	-23,002	-24,322	-25,144	-26,049
Balance on services	2,850	819	1,586	2,110	2,868	2,821	3,649	4,052	4,208	4,408
Credit (exports)	7,475	3,035	2,475	3,062	4,438	4,620	5,680	6,183	6,445	6,758
Debit (imports)	-4,625	-2,216	-889	-953	-1,570	-1,798	-2,031	-2,131	-2,237	-2,350
Primary and secondary income, net	3,303	4,002	3,267	2,331	3,887	3,707	4,068	4,281	4,244	4,227
Amortization	-3,999	-3,099	-1851	-1727	-98	-2816	-3198	-2884	-2729	-3381
General government	-3,314	-2,855	-2,815	-1,653	-1,010	-883	-1,204	-1,248	-1,658	-2,281
Sovereign bonds	-1,500	-1,000	-1000	-500	0	0	0	0	0	-1086
Syndicated loans	-474	-335	-92	0	0	0	0	0	0	0
Bilateral and multilateral	-1,341	-1,520	-1,723	-1,153	-1,010	-883	-1,204	-1,248	-1,658	-1,194
Central bank	0	386	1318	260	1502	-1113	-1114	-757	-191	-220
IMF repurchases/repayments	0	-14	-57	-140	-173	-213	-214	-202	-191	-220
Other central bank liabilities, net	0	400	1375	400	1675	-900	-900	-555	0	0
Private sector loans	-685	-630	-354	-335	-590	-820	-880	-880	-880	-880
Debt service on treated CG and guaranteed debt on pre-restructuring terms	...	...	...	-2,834	-3,772	-4,061	-4,366	-2,941	-2,974	-2,513
Principal	...	...	...	-2,107	-2,628	-3,088	-3,524	-2,274	-2,463	-2,126
Interest	...	...	...	-727	-1,144	-973	-842	-667	-511	-387
Debt service on treated CG and guaranteed debt debt post-restructuring	...	...	...	0	0	869	867	863	1,395	1,859
Principal	...	...	...	0	0	346	327	327	862	1,325
Interest	...	...	...	0	0	523	540	536	533	534
Gross external financing needs	-5,843	-4,285	-5,136	-5,305	-2,638	-6,642	-7,605	-5,841	-5,154	-4,798
Sources of financing	5,843	4,285	5,136	5,305	2,638	6,642	7,605	5,841	5,154	4,798
Borrowing	5,851	2,294	1833	1,749	-1,127	3,528	5,028	4,967	6337	5939
General government	4,531	622	2083	2,376	1,156	1,360	1,706	1,760	3171	3296
T-bills, Tbonds, and SLDBs, net	-333	-531	-28	53	226	160	13	20	20	20
Sovereign bonds	4,400	0	0	0	0	0	0	0	1500	1575
Syndicated loans	0	500	800	0	0	0	0	0	0	0
Bilateral and multilateral	448	629	1300	2,316	930	1,200	1,693	1,740	1651	1701
Official capital transfers	16	24	11	7	0	0	0	0	0	0
Other capital inflows, net	1,321	1,672	-250	-627	-2,283	2,168	3,322	3,207	3,166	2,644
Deposit-taking corporations, excl. central bank, net	-460	-437	362	-2,769	-1,120	-47	566	449	307	55
FDI inflows, net	666	419	574	883	775	1,200	1,490	1,520	1,635	1,645
Private sector loans	482	574	186	332	360	869	1,020	1,030	1,000	880
Other capital inflows, net	632	1,116	-1373	927	-2,298	146	246	208	224	64
Change in reserve assets	-336	1,938	3,304	722	-1,909	-1,539	-2,131	-2,417	-3,632	-1,795
External financing gap	328	53	0	2,834	5,674	4,654	4,708	3,291	2,449	654
Exceptional Financing	...	...	...	2,834	5,674	4,654	4,708	3,291	2,449	654
IMF EFF	...	...	...	0	682	682	685	689	346	0
IFI budget support	...	...	...	0	1,220	780	524	524	524	0
Debt moratorium: external arrears accumulation	...	...	...	2,834	0	0	0	0	0	0
Debt relief	...	...	...	0	3,772	3,192	3,499	2,078	1,579	654

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

Table 7. Sri Lanka: Projected Payments to the Fund, 2023-36 1/

(In millions of SDRs, unless otherwise indicated)

	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036
Fund repurchases and charges														
In millions of SDR	208.2	271.2	297.8	313.0	329.2	351.5	400.7	436.2	495.8	486.7	441.7	339.6	242.0	149.0
In millions of U.S. dollars	279.4	364.0	401.7	424.6	448.9	479.4	546.4	594.8	676.1	663.6	602.3	463.1	330.0	203.1
In percent of exports of goods and services	1.7	2.0	2.0	2.0	2.0	2.0	2.2	2.3	2.5	2.4	2.1	1.5	1.0	0.6
In percent of government fiscal revenue	3.3	3.4	3.3	3.4	3.4	3.4	3.6	3.7	3.9	3.6	3.1	2.2	1.5	0.8
In percent of quota	36.0	46.9	51.5	54.1	56.9	60.7	69.2	75.4	85.7	84.1	76.3	58.7	41.8	25.7
In percent of gross official reserves	7.3	6.8	5.4	4.3	3.3	3.1	3.5	3.6	4.0	3.8	3.4	2.5	1.8	1.1
Fund credit outstanding 2/														
In millions of SDR	1,176.8	1,526.1	1,875.4	2,234.7	2,348.8	2,188.6	1,968.5	1,693.3	1,333.5	952.5	592.7	317.5	127.0	21.2
In millions of U.S. dollars	1,579	2,052	2,538	3,037	3,214	2,995	2,693.9	2,317.3	1,824.9	1,303.5	811.1	434.5	173.8	29.0
In percent of exports of goods and services	9.4	11.3	12.7	14.3	14.4	12.8	11.0	9.1	6.8	4.7	2.8	1.4	0.5	0.1
In percent of government fiscal revenue	18.8	19.4	20.7	24.3	24.5	21.3	17.9	14.4	10.6	7.1	4.1	2.1	0.8	0.1
In percent of quota	203.3	263.7	324.0	386.1	405.8	378.1	340.1	292.6	230.4	164.6	102.4	54.9	21.9	3.7
In percent of GDP	1.9	2.5	3.1	3.6	3.7	3.2	2.8	2.3	1.7	1.1	0.7	0.3	0.1	0.0
In percent of gross official reserves	41.5	38.4	33.9	30.7	23.8	19.6	17.0	14.2	10.8	7.5	4.6	2.4	0.9	0.1
Memorandum items:														
Exports of goods and services (in millions of U.S. dollars)	16,803	18,174	20,058	21,294	22,291	23,409	24,462	25,563	26,713	27,915	29,171	30,484	31,856	33,289
Central government fiscal revenue (billion of Rupees)	2,835	4,067	5,124	5,571	6,088	6,653	7,270	7,945	8,683	9,489	10,369	11,332	12,384	13,533
Quota 2/	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8
Quota (in millions of U.S. dollars) 2/	777	778	783	787	792	792	792	792	792	792	792	792	792	792
Gross official reserves (in millions of U.S. dollars) 2/	3,806	5,346	7,477	9,894	13,525	15,320	15,820	16,320	16,820	17,320	17,820	18,320	18,820	19,320

Source: IMF staff estimates.
1/ Projections as of Nov 2, 2023.
2/ As of the end of the year.

Table 8. Sri Lanka: Proposed Reviews and Disbursements Under the Four-Year Extended Arrangement

Availability Date	Amount (millions of SDR)	Percent of Quota (%)	Conditions
At arrangement approval	254	43.9	Board Approval of the Extended Arrangement
September 1, 2023	254	43.9	Completion of the 1st review based on end-June 2023 and continuous perfomance criteria
April 1, 2024	254	43.9	Completion of the 2nd review based on end-December 2023 and continuous perfomance criteria
October 1, 2024	254	43.9	Completion of the 3rd review based on end-June 2024 and continuous perfomance criteria
April 1, 2025	254	43.9	Completion of the 4th review based on end-December 2024 and continuous perfomance criteria
October 1, 2025	254	43.9	Completion of the 5th review based on end-June 2025 and continuous perfomance criteria
April 1, 2026	254	43.9	Completion of the 6th review based on end-December 2025 and continuous perfomance criteria
October 1, 2026	254	43.9	Completion of the 7th review based on end-June 2026 and continuous perfomance criteria
March 1, 2027	254	43.9	Completion of the 8th review based on end-December 2026 and continuous perfomance criteria
Total	2,286.0	395.0	

Source: IMF staff.

Table 9. Sri Lanka: Reviews and Disbursements Under the Four-Year Extended Arrangement (Original)

Availability Date	Amount (millions of SDR)	Percent of Quota (%)	Conditions
At arrangement approval	254	43.9	Board Approval of the Extended Arrangement
September 1, 2023	254	43.9	Completion of the 1st review based on end-June 2023 and continuous perfomance criteria
March 1, 2024	254	43.9	Completion of the 2nd review based on end-December 2023 and continuous perfomance criteria
September 1, 2024	254	43.9	Completion of the 3rd review based on end-June 2024 and continuous perfomance criteria
March 1, 2025	254	43.9	Completion of the 4th review based on end-December 2024 and continuous perfomance criteria
September 1, 2025	254	43.9	Completion of the 5th review based on end-June 2025 and continuous perfomance criteria
March 1, 2026	254	43.9	Completion of the 6th review based on end-December 2025 and continuous perfomance criteria
September 1, 2026	254	43.9	Completion of the 7th review based on end-June 2026 and continuous perfomance criteria
March 1, 2027	254	43.9	Completion of the 8th review based on end-December 2026 and continuous perfomance criteria
Total	2,286.0	395.0	

Source: IMF staff.

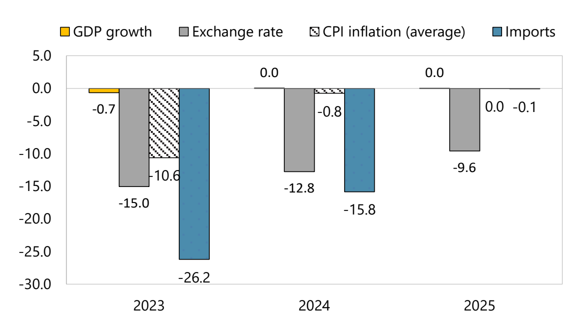
Annex I. Drivers of the Tax Revenue Shortfall in 2023

1. Tax revenue in 2023 is expected to improve relative to last year. Tax revenue is projected at about 9.2 percent of GDP in 2023, about 2 percentage points above 2022, driven mainly by improvements in income tax collections and other indirect domestic taxes, following significant tax policy measures adopted since September 2022.

2. Revenue is nevertheless projected to fall short relative to program request projections. The shortfall is estimated at 0.8 percentage points of GDP. This underperformance is expected to carry over to 2024 with a revenue gap of about 0.3 percentage points of GDP. Signs of the revenue shortfall became apparent starting Q1-2023 but compensating measures were not sufficient in 2023. Staff estimates that without new compensating measures, the revenue gap would be much larger, about 1.5 ppt of GDP on average between 2023 and 2024.

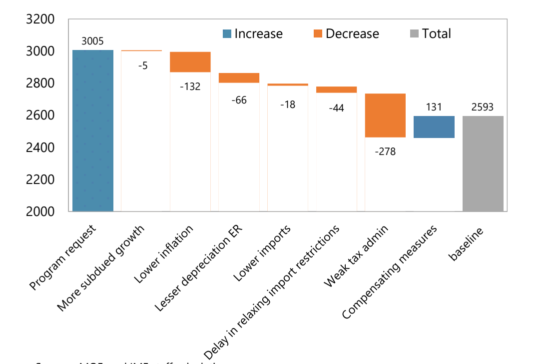
3. Staff analysis shows that economic factors and shortcomings in revenue administration explain most of the underperformance. In the absence of new measures tax revenue is projected to be almost 20 percent lower on average in 2023 and 2024 than at the program request. A number of factors could be attributed to this underperformance. First, *economic factors* (a larger economic contraction, less depreciated exchange rate, lower inflation, and lower imports) are estimated to contribute almost 40 percent to the tax revenue shortfall in 2023 and about 30 percent in 2024 (see text charts). The exchange rate is more appreciated relative to the program request, which in combination with lower commodity prices are expected to reduce the value of imports. Imports account for about one third of tax revenue and are projected to be lower by more than 25 percent in local currency terms in 2023 relative to the program request. This economic underperformance would result in tax revenue that is about 7 percent lower in 2023 than projected at the time of the program request.[1] Second, *a delay in the lifting of import restrictions on motor vehicles* accounts for about 8 percent of the shortfall. Finally, *weak revenue administration* is assumed to account for the balance in the shortfall, which is about 50 percent of the shortfall.

Unanticipated Shocks, Difference with SR
(change in percent)



Sources: CBSL; and IMF Staff Calculations.

Estimated Drivers of Revenue Shortfalls in 2023
(in million Rs)

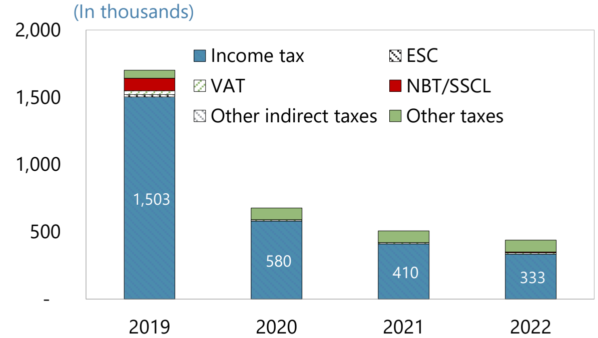


Sources: MOF; and IMF staff calculations.

[1] To estimate the contribution of economic factors to the revenue shortfall, staff has gradually updated the macroframework of the program request Staff Report with the updated macroeconomic assumptions.

4. **Efforts to increase taxpayer compliance have not yet translated into increased revenue**. The January Tax Administration Diagnostic Tool (TADAT) assessment and follow-up discussions with the tax authority have also highlighted weaknesses in tax administration, including low filing compliance and inadequate tools to detect and deter inaccurate reporting among others. As a result, and despite the tax policy reforms, especially those related to lowering the registration thresholds for both income taxes and VAT, the number of registered taxpayers has not materially increased. In fact, the total number of registered taxpayers at end-2022 was only about 438,000 compared to about 1.7 million before the 2019 tax measures. Without any compensating measures, staff assess that revenue administration shortcomings could contribute to an additional revenue loss of 10 percent in 2023 relative to program request projections.

Number of Taxpayers
(In thousands)



Source: IMF staff based on IRD data.

Annex II. SOE Restructuring Strategy

1. The SOE sector in Sri Lanka has been a source of inefficiencies, fiscal risks, and governance vulnerabilities for many years. Many SOEs have a monopoly or dominant market positions, crowding out the private sector. SOEs in strategic sectors were typically pricing their products below cost recovery, and the difference was often not covered by the central government budget, leading to growing indebtedness, including to state-owned banks. Furthermore, the lack of oversight and transparency around the operation of SOEs increased exposure to corruption vulnerabilities, especially regarding procurement and other forms of contracting, and capital investments.

2. The four keys SOEs (CPC, CEB, Sri Lanka Airlines (SLA) and Road Development Authority (RDA)) have significant legacy debt in their balance sheets. A large part of this debt was incurred when prices and tariffs were set below cost recovery, but the central government did not provide subsidies to cover the difference.

3. The authorities started to take action to improve the balance sheets of these SOEs in 2022. About US$3 billion of foreign currency debts (US$2.4 billion for CPC and US$0.6 billion for CEB) were transferred to government accounts. The strategy to restructure the CPC foreign currency domestic loans taken over by the government is being finalized (Annex IV). Furthermore, debts amounting to Rs. 146.5 billion (about US$0.5 billion) recorded as sub-loans in the CEB financial statements were converted into equity investment by the government in the CEB. Nevertheless, some key SOE remained with a negative equity position as of end-2022 (Text Table 1).

Text Table 1. Financial Position of Four SOEs, End-2022 (Rs. million)

	Assets	Liabilities	Equity
CPC	492,449	578,161	-85,712
CEB	1,062,344	707,917	354,427
SLA	182,263	608,687	-426,424
RDA (end-2021 data)	1,179,077	401,514	777,563

Sources: Sri Lankan authorities; and IMF staff calculations.

4. Another key step to restore financial viability was the adoption of cost-recovery pricing mechanisms for fuel and electricity. The mechanisms allowed CPC and CEB to stop making operating losses for the first time in many years. The pricing formula for the CPC includes a 4 percent profit margin, intended to be used to start repaying the legacy debts. For CEB, the pricing formula is designed to stop losses and provides for debt servicing, but not for principal repayment of old debts. The strategy for those CEB debts is still to be fully elaborated and will rely on a combination of future profits and equity injections from investors (as the company is unbundled and partially divested) and possibly the government.

5. The authorities have also taken the first steps to break the monopolies of SOEs and start divesting some of them. In May 2023, contracts to supply about 25 percent of fuel stations were transferred from CPC to independent providers (mostly foreign), significantly reducing the CPC's market share. The other providers will be subject to the same pricing mechanism as the CPC. Furthermore, the divestment of an initial set of eight SOEs was approved by Cabinet in March 2023, along with an authorization to engage IFC as a transaction advisor for three of these, including SLA.

6. The balance sheet restructuring strategy adopted in June 2023 meets the structural benchmark under the program. It aims to further reduce the debt overhang and the associated fiscal risks. The strategy includes a settlement of cross-debts between CPC, CEB, SLA and the government. A budget-neutral equity injection by the government into CEB and SLA totaling about Rs 230 billion will allow them to repay their debts to the CPC, which will in turn repay the debt to the Treasury for supplies made through the Indian Line of Credit of almost identical amount, making the whole operation budget-neutral. Additional legacy debts of CPC to the National Iranian Oil Company will be repaid from the profits generated by the cost-recovery fuel pricing mechanism, while most of the external debt obligations of the SLA will be subject to debt restructuring (Text Table 2).

Text Table 2. Restructuring of Balance Sheets of Selected SOEs

	Amount	Action to be taken
CPC		
Debt to Treasury for supplies made through the Indian Line of Credit (ILC)	US$ 697 mln	To be repaid with receivables from CEB and SLA (about US$765 mln) by December 15, 2023. Financed by a temporary loan from the BoC.
Debt to the National Iranian Oil Company (NIOC)	US$ 251 mln	Monthly repayments of US$ 5 mln out of CPC profits (generated by the fuel pricing mechanism)
CEB		
Debt to CPC for fuel supplies	Rs 129 bn	To be repaid using equity investment from the Treasury
SLA		
Debt to CPC for fuel supplies	Rs 102.5 bn	To be repaid using equity investment from the Treasury
Foreign currency loans with state banks and international bonds	US$ 171 mln	Subject to debt restructuring as part of the overall debt restructuring perimeter.
RDA		
Debt guaranteed by the Treasury	Rs 352 bn	Commercial activities (expressways) to be separated and assigned to Sahasya Investments Ltd (SIL). The treasury will provide gap financing to the SIL to pay the loans obtained to construct expressways. The remainder of the RDA will continue to be financed through budgetary allocations.

Source: Sri Lankan Authorities.

7. In parallel, an ambitious program of SOE reforms is being implemented with assistance from the WB, ADB, United States Agency for International Development (USAID) and other development partners. The WB's DPO involves drafting the new SOE legislation and implementing regulations, as well as the transfer of operational control of select SOEs from the line ministries to the ministry of finance. In addition, assistance is provided to the government in drafting a new comprehensive Electricity Act to reform the energy sector and provide the legal basis for unbundling of CEB and incorporating several successor companies. The Bank's support complements the programs of ADB and USAID to support the restructuring of the CEB and CPC.

Annex III. Debt Sustainability Analysis—An Update

This DSA update focuses on important changes in assumptions relative to the March 2023 program request vintage and provides an assessment of the authorities' execution of the domestic debt operation and their indicative debt treatment scenario for foreign debt (as negotiations carry on). Discussions on the restructuring processes can be found in the main text of the Staff Report (¶16) and Annex (IV).

DSA Assumptions

1. **The macroeconomic framework, and in particular near-term projections, has been updated to reflect recent developments since March 2023**. This update features (i) a downside surprise to 2023H1 growth, (ii) faster than expected disinflation, and, in tandem, (iii) less than expected depreciation. The medium-term projections of these macro variables remain anchored at (i) Sri Lanka's medium-term growth potential, (ii) the central bank's inflation target, and (iii) the External Balance Assessment (EBA)-based misalignment and external adjustment needs, respectively. These changes together contribute to a lower projected nominal GDP path.

Text Table 1. DSA Macroeconomic Assumptions, Differences with Program Request

	2023	2024	2025	2026	2027	2028
Real growth (%)						
Program request	-3.0	1.5	2.6	3.0	3.1	3.1
Current	-3.6	1.8	2.7	3.0	3.1	3.1
GDP deflator inflation (yoy, %)						
Program request	30.0	10.7	5.6	5.2	5.1	5.0
Current	20.4	10.1	6.3	5.4	5.3	5.2
Primary balance (% of GDP)						
Program request	-0.7	0.8	2.3	2.3	2.3	2.3
Current			unchanged			
Nominal GDP (Rs bln)						
Program request	29,852	33,533	36,326	39,362	42,634	46,154
Current	28,033	31,422	34,291	37,226	40,397	43,812

Sources: IMF staff estimates and projections.

2. **Financing assumptions in the near and medium terms are also updated to reflect recent developments but overall remain broadly similar to those at program approval**. Notably, project financing is lowered in 2023-24 reflecting smaller than expected inflows due to delays in concluding debt restructuring. At the same time, as a large share of new project disbursements (including from multilateral development banks) have floating rates linked to global benchmarks, they are adding to near-to-medium term debt service. On the domestic front, earlier uncertainties related to the authorities' DDO plans had led to a maturity shortening which has

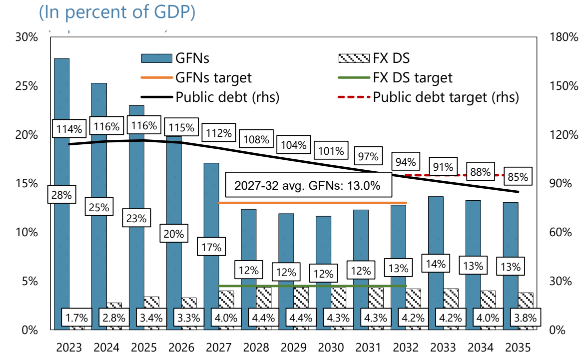
increased the near-term gross financing needs and associated refinancing risks. Interest rates have started to normalize following the execution of the DDO and the reductions in monetary policy rates. These have been reflected in this DSA update, which also endogenizes the authorities' plans for restructuring SOE local law FX-denominated debt to state banks that lowers the estimated banking sector recapitalization costs (from US$3.7 billion in the program request DSA to US$3.35 billion) through higher coupons to mitigate day one fair value losses.[1] The DSA further assumes that banks receiving public money for recapitalization would start compensating the capital injection from 2028 onwards (¶26), through dividends and coupons (on AT1 capital instruments) to the government that will go toward reducing the interest costs of the recapitalization bonds.[2] A majority of gross domestic issuances in 2023-24 are absorbed by banks and pension funds, within their respective absorptive capacity following the recent DDO.

3. **Debt restructuring assumptions now reflect the authorities' indicative debt treatment scenario and their preliminary agreements already reached with creditors, as of November 2023**. These terms feature a principal haircut in the proposed ISB treatment, maturity extension with lower interest rate in the proposed bilateral debt treatment. The proposed debt treatments for foreign creditors imply a meaningful Net Present Value (NPV) reduction and are still under negotiation on a confidential basis—so they cannot be further described in the DSA. On the yet to be finalized restructuring of the CPC loans (transferred to the government) to state banks, the DSA assumes the authorities' latest proposal.

Compliance with Debt Targets

4. **All four debt targets are respected in the authorities' abovementioned restructuring strategy (text chart)**. This DSA update assumes a full execution of the authorities' indicative and agreed debt treatments. The four debt targets (on program period external debt service relief, post-program GFNs and FX debt service, and debt stock) are met, though with little to no buffer—highlighting substantial implementation risks. In particular, the authorities should explore ways to reduce the elevated GFNs in 2027 which are in part attributed to the maturity of certain T-bonds that were not restructured in the authorities' DDO.

Debt Target Compliance
(In percent of GDP)



Sources: IMF staff estimates and projections.

[1] The updated recapitalization costs assume 50 percent of the estimated capital shortfalls in private banks are raised privately instead of resorting to public money and leave space for a potential recapitalization of the central bank once the fair value loss of its recent T-bills holdings' conversion (to longer term T-bonds) is crystalized (see ¶21 of the staff report).

[2] For DSA analytical purposes, dividend and coupon payments are all treated as interest income.

Table 1. Sri Lanka: Risk of Sovereign Stress (Restructuring Scenario)

Horizon	Mechanical signal	Final assessment	Comments
Overall	…	High	Sri Lanka is in debt distress. The fiscal adjustment, combined with debt restructuring will eventually restore debt sustainability. However, downside risks remain high under a restructuring scenario.
Near term 1/	n.a.	n.a.	Not applicable
Medium term	High	High	Risks remain high under a restructuring scenario due to relatively high levels of debt and GFNs, a strong sovereign-bank nexus, and the economy's vulnerability to large shocks.
Fanchart	High	…	
GFN	High	…	
Stress test	...	…	
Long term	…	High	Long-term risks include slowing growth due to a declining labor force and climate vulnerabilities.
Sustainability assessment 2/		Sustainable	The debt operation will put Sri Lanka on a firm downward path. But the reduction of debt vulnerabilities to safe levels will take time. Meanwhile, external shocks or domestic policy reversals could lead to renewed debt increase.
Debt stabilization in the baseline			Yes

DSA summary assessment

Sri Lanka is in a deep crisis, as debt is unsustainable. Deep fiscal reforms are necessary but not sufficient to address the situation in a durable manner. Contributions from creditors are therefore needed, along with new concessional financing, to restore debt sustainability. Even after a successful program and debt restructuring, debt risks will remain high for many years.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Table 2. Sri Lanka: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					Yes	
2. Subsectors included in the chosen coverage in (1) above:						

	Subsectors captured in the baseline	Inclusion	Comments
1	Budgetary central government	Yes	
2	Extra budgetary funds (EBFs)	No	
3	Social security funds (SSFs)	No	
4	State governments	No	
5	Local governments	No	
6	Public nonfinancial corporations	Yes	Guaranteed debt
7	Central bank	Yes	Fund credit and bilateral swaps
8	Other public financial corporations	Yes	Guaranteed debt

(Rows 1–3: CG; rows 1–5: GG: expected; rows 1–6: NFPS; rows 1–8: CPS)

3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/
4. Accounting principles:	Basis of recording		Valuation of debt stock		
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/
5. Debt consolidation across sectors:		Consolidated		Non-consolidated	

Color code: chosen coverage (green); Missing from recommended coverage (red); Not applicable (grey)

Chosen (green): CG; Yes; Loans; Debt securities; Cash basis; Face value 6/; Non-consolidated. Missing (red): Currency & deposits; Oth acct. payable 2/; IPSGSs 3/.

Reporting on intra-government debt holdings

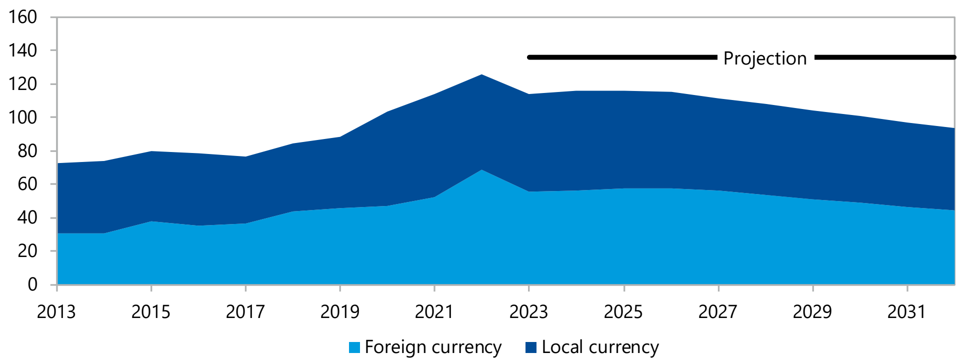
	Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
1	Budget. central govt							2834	4228	7062
2	Extra-budget. funds									0
3	Social security funds									0
4	State govt.									0
5	Local govt.									0
6	Nonfin pub. corp.								702	702
7	Central bank									0
8	Oth. pub. fin. corp									0
	Total	0	0	0	0	0	0	2834	4930	7764

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: The DSA perimeter includes (i) central government debt; (ii) SOE debt guaranteed by the central government; and (iii) liabilities of the central bank arising from the 2016-20 EFF and bilateral swap arrangements. Note: Oth. pub. fin. corp. holdings of CG debt includes holdings by state-owned banks (estimated based on end-September information) but excludes retirement funds. Provincial and local governments do not carry debt as they are not authorized to borrow.

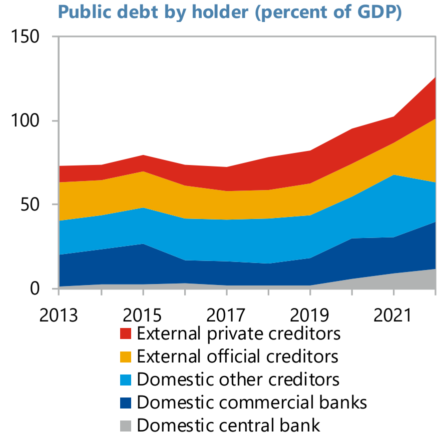
Table 3. Sri Lanka: Public Debt Structure Indicators

Debt by currency (percent of GDP)



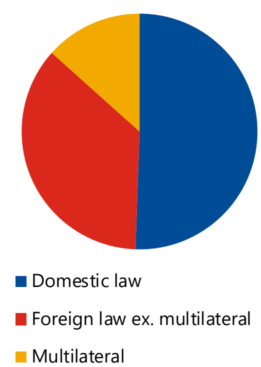
Note: The perimeter shown is central government.

Public debt by holder (percent of GDP)



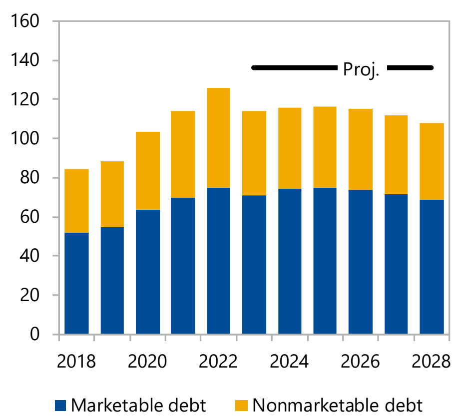
Note: The perimeter shown is central government.

Public debt by governing law, 2022 (percent)



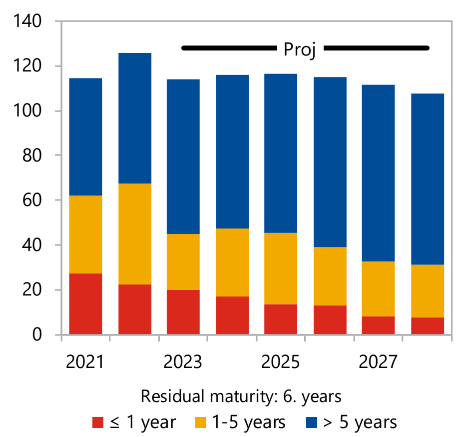
Note: The perimeter shown is central government.

Debt by instruments (percent of GDP)



Note: The perimeter shown is central government.

Public debt by maturity (percent of GDP)



Note: The perimeter shown is central government.

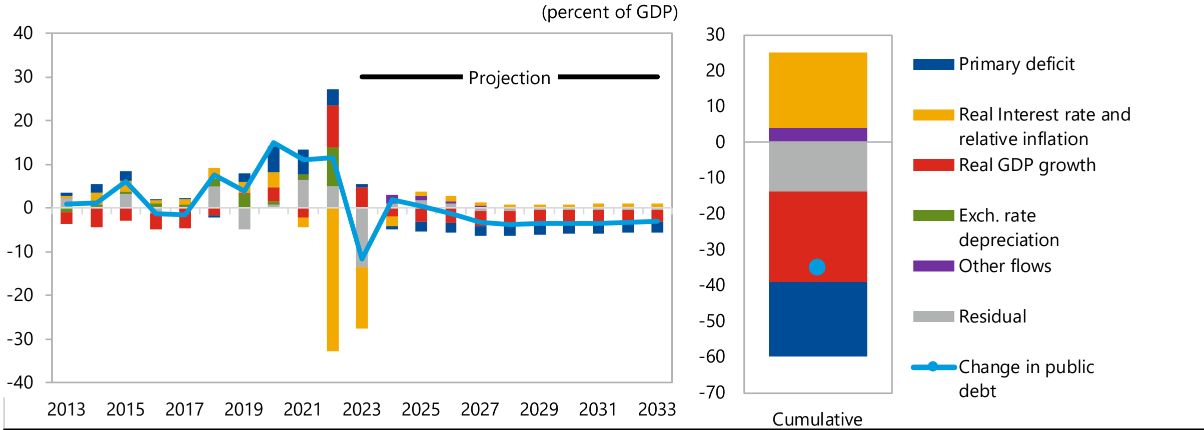
Commentary: Accelerating inflation has reduced the real value of domestic debt in 2022, while exchange rate depreciation has led to a large increase in external and foreign-currency debt. Foreign-law debt accounts for more than half of Sri Lanka's debt. The debt operation is assumed to rebalance the maturity profile.

Table 4. Sri Lanka: Baseline Scenario
(Percent of GDP unless indicated otherwise)

	Prel.	Medium-term projection						Extended projection				
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Public debt	125.8	114.1	115.9	116.3	115.1	111.7	107.9	104.2	100.7	97.3	94.0	90.8
Change in public debt	11.5	-11.7	1.8	0.5	-1.3	-3.4	-3.8	-3.6	-3.5	-3.4	-3.3	-3.1
Contribution of identified flows	6.6	1.8	0.9	-1.3	-2.2	-2.7	-3.2	-3.0	-3.0	-2.9	-2.9	-2.7
Primary deficit	3.7	0.7	-0.8	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Noninterest revenues	8.2	10.1	12.9	14.9	15.0	15.1	15.1	15.1	15.1	15.1	15.1	15.1
Noninterest expenditures	11.9	10.8	12.1	12.6	12.7	12.8	12.8	12.8	12.8	12.8	12.8	12.8
Automatic debt dynamics	2.9	1.1	-0.4	0.0	-0.4	-0.8	-0.9	-0.7	-0.7	-0.6	-0.6	-0.4
Real interest rate and relative inflatio	-15.7	-3.6	1.6	3.0	2.9	2.6	2.4	2.5	2.4	2.4	2.3	2.4
Real interest rate	-32.9	-14.0	-2.2	1.0	1.2	0.8	0.8	0.9	0.9	0.9	0.9	1.1
Relative inflation	17.2	10.4	3.8	2.1	1.7	1.7	1.6	1.6	1.5	1.4	1.4	1.3
Real growth rate	9.7	4.7	-2.0	-3.1	-3.4	-3.4	-3.3 .	-3.2	-3.1	-3.0	-2.9	-2.8
Real exchange rate	8.8	...	...	...	...	...	... .	...	...	...	...	...
Other identified flows	0.0	0.0	2.1	1.0	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	0.0	0.0	2.1	1.0	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Contribution of residual	4.9	-13.5	0.9	1.8	1.0	-0.7	-0.6	-0.6	-0.5	-0.5	-0.5	-0.4
Gross financing needs	33.9	27.8	25.3	23.0	19.8	17.1	12.3	11.9	11.6	12.3	12.8	13.7
of which: debt service	30.2	27.1	26.1	25.3	22.1	19.4	14.6	14.2	13.9	14.6	15.1	16.0
Local currency	21.1	25.3	23.3	21.9	18.8	15.4	10.3	9.8	9.6	10.3	10.9	11.7
Foreign currency	9.1	1.7	2.8	3.4	3.3	4.0	4.4	4.4	4.3	4.3	4.2	4.2
Memo:												
Real GDP growth (percent)	-7.8	-3.6	1.8	2.7	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Inflation (GDP deflator; percent)	48.8	20.4	10.1	6.3	5.4	5.3	5.2	5.2	5.2	5.2	5.2	5.2
Nominal GDP growth (percent)	36.5	16.1	12.1	9.1	8.6	8.5	8.5	8.5	8.5	8.5	8.5	8.5
Effective interest rate (percent)	9.4	7.5	8.0	7.2	6.5	6.1	6.0	6.1	6.2	6.2	6.3	6.5

Contribution to change in public debt

(percent of GDP)



Staff commentary: Public debt increased drastically in 2020-22, due to exchange rate depreciation, large fiscal deficits, SOE borrowing, and external borrowing by the Central Bank. In the near term, inflation and contribution from creditors (assumed in 2023, and shown in the residuals) will lead to a sizable drop in public debt. The debt reduction over the longer term rests on continued fiscal discipline.

Table 5. Sri Lanka: Realism of Baseline Assumptions

Forecast Track Record 1/	t+1	t+3	t+5
Public debt to GDP			
Primary deficit			
r - g			
Exchange rate depreciaton			
SFA			
	real-time	t+3	t+5
Historical output gap revisions 2/			

Comparator group:

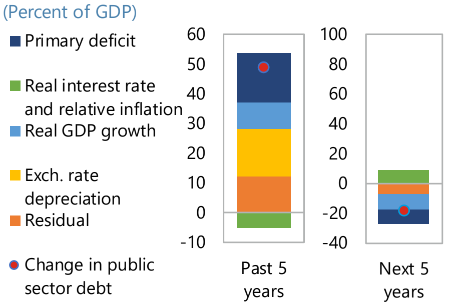
Emerging Markets, Non-Com. Exporter, Program

Color code:

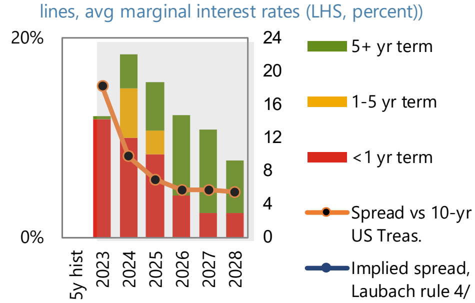
Optimistic	> 75th percentile
	50-75th percentile
Pessimistic	25-50th percentile
	< 25th percentile

Public Debt Creating Flows

(Percent of GDP)

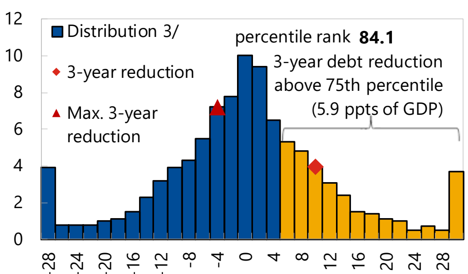


Bond Issuances (bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))

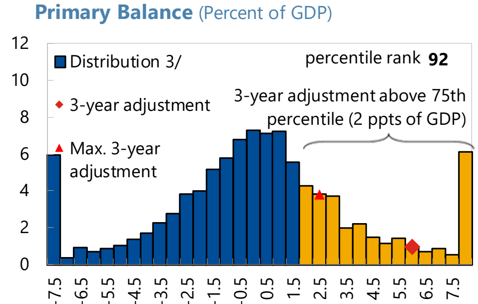


3-Year Debt Reduction

(Percent of GDP)

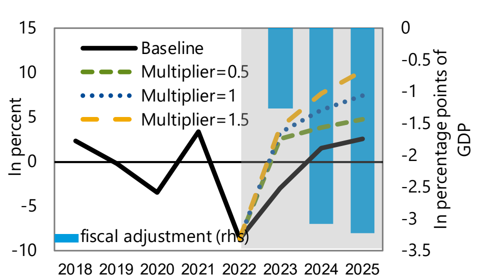


3-Year Adjustment in Cyclically-Adjusted Primary Balance (Percent of GDP)



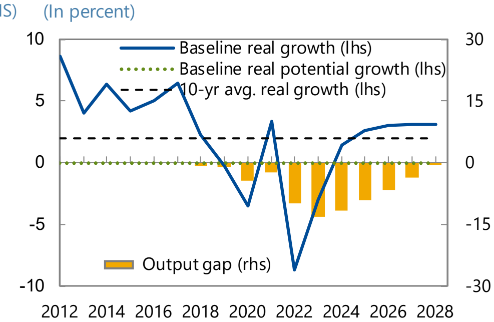
Fiscal Adjustment and Possible Growth Paths

(Lines, real growth using multiplier (LHS); bars, fiscal adj. (RHS)



Real GDP Growth

(In percent)



Commentary: Domestic yields are presently high but expected to normalize under the program. The fiscal adjustment efforts are ambitious but backed by identified measures that are needed to restore fiscal sustainability. Growth recovery will be slow due to sovereign default and economic crisis, as well as the associated balance sheet impact.

1/ Projections made in the October and April WEO vintage.

2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates and final estimates in the latest October WEO) in the total distribution of revisions across the data sample.

3/ Data cover annual obervations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

Table 6. Sri Lanka: Medium-Term Risk Analysis

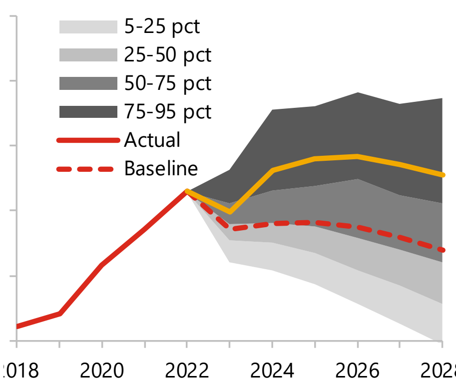
Fanchart and GFN Financeability Indexes

(percent of GDP unless otherwise indicated)

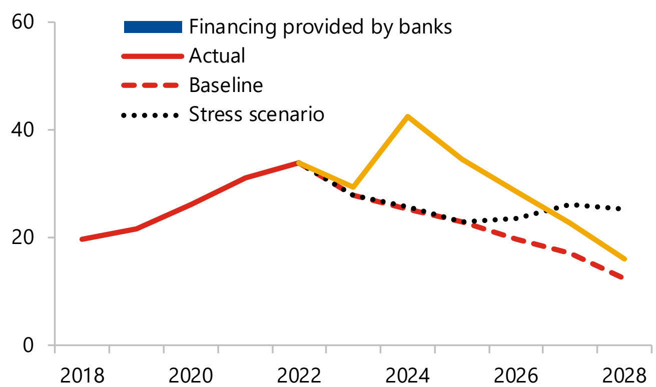
Module	Indicator	Value	Risk index	Risk signal	Emerging Markets, Non-Com. Exporter, (0 – 25 – 50 – 75 – 100)
Debt fanchart module	Fanchart width	76.0	1.1	...	
	Probability of debt not stabilizing (pct)	8.9	0.1	...	
	Terminal debt level x institutions index	68.2	1.5	...	
	Debt fanchart index	**...**	**2.7**	**High**	
GFN finance-ability module	Average GFN in baseline	18.2	6.2	...	
	Bank claims on government (pct bank assets)	36.2	11.7	...	
	Chg. in claims on govt. in stress (pct bank assets)	4.7	1.6	...	
	GFN financeability index	**...**	**19.5**	**High**	

Legend: Interquartile range; Sri Lanka

Final fanchart (pct of GDP)



Gross Financing Needs (pct of GDP)

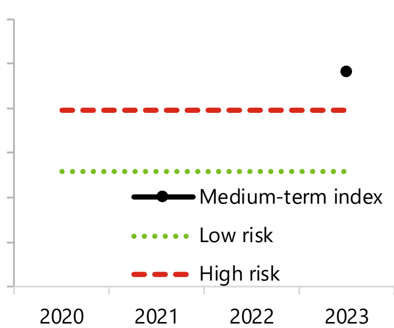


Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-term index

(index number)



Medium-term risk analysis

	Low risk threshold	High risk threhsold	Weight in MTI	Normalized level
Debt fanchart index	1.1	2.1	0.5	0.6
GFN finaceability index	7.6	17.9	0.5	0.4
Medium-term index (MTI)	0.3	0.4	...	0.5, High

Prob. of missed crisis, 2023-2028 (if stress not predicted): 54.5 pct.

Prob. of false alarm, 2023-2028 (if stress predicted): 3.4 pct.

Commentary: Both MT tools point to high level of risks, associated with relatively high levels of debt and GFNs, a strong sovereign-bank nexus, and the economy's vulnerability to large shocks. Sri Lanka is prone to natural disasters such as typhoons and such natural disasters could take both debt and gross financing needs to very high levels, threatening sustainability further.

Table 7. Sri Lanka: Long Term Modules: Large Amortizations Trigger

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Medium-term extrapolation with debt stabilizing	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Historical average assumptions	GFN-to-GDP ratio	
	Amortization-to-GDP ratio	
	Amortization	
Overall Risk Indication		

Annex IV. Developments in Debt Restructuring Negotiations

1. **Official sector involvement (OSI) is spearheaded by the Official Creditors Committee (OCC) co-chaired by France, India and Japan**. Four OCC meetings have been held-on May 9, June 8, July 24, and September 22, to discuss the coordination process, the OSI perimeter and burden-sharing, and the OCC Secretariat's debt treatment proposal. On process, the committee welcomed the Sri Lankan President's commitment to transparency and comparability of treatment (COT) and signaled its openness to the authorities' simultaneous engagement with commercial creditors. On perimeter and burden-sharing, committee members provisionally agreed on a cutoff date of March 18, 2022, tied to the authorities' formal IMF program request. At the September 22 meeting, the Secretariat presented a working paper that lays out its proposed debt treatment, which is being finalized among OCC members. In November 2023, an agreement in principle was agreed between the authorities and the OCC to restructure its claims on Sri Lanka. The authorities' engagement with Chinese creditors have also advanced. China ExIm has participated in the OCC meetings as observer, held technical discussions with the advisors, and in October announced a tentative agreement with the Sri Lankan authorities.

2. **Private Sector Involvement (PSI) of holders of International Sovereign Bonds has kept its momentum**. The authorities received an initial restructuring proposal from the foreign bondholders' advisors (Rothschild and White & Case) on April 11, prompting them to prepare the indicative debt treatment scenario which now underpins their engagement with all foreign creditors. On October 13, the foreign bondholders group presented (publicly) a revised proposal to the Sri Lanka authorities, which features a macro-linked bond with state-contingent debt service that step-downs from its initial high levels anchored by optimistic macro assumptions should the dollar GDP underperform its benchmarks. They have engaged further with the authorities' advisors on this proposal on the sidelines of the October 2023 IMF/WB Annual Meetings. Discussions are still ongoing, and the authorities have not accepted this proposal. The authorities have also engaged with the local holders of ISBs (mainly private banks) through their advisors. The litigation brought by Hamilton Reserve Bank is still ongoing, and the US court has recently granted Sri Lanka's motion for a stay until February 29, 2024. The authorities have also had technical exchanges with the CDB, including in person in Colombo in May 2023 and in Beijing in October 2023, to reconcile their DSA modeling and advance technical discussions.

3. **The authorities' DDO was launched in July 2023 and its key aspects were concluded in September 2023**. Following a series of consultations with domestic creditors and stakeholders, the authorities have decided on the DDO perimeter in line with the indicative scenario, which covers (i) the CBSL's holdings of Treasury Bills from outright primary market purchases and its provisional advances to the government; a voluntary exchange of Treasury Bonds, with a minimum participation requirement for superannuation funds to avoid an increase in their investment income tax rate from 14 percent to 30 percent (in line with other corporates), and (ii) the Sri Lankan Development Bonds (SLDBs) and domestic banks' FX loans extended to the central government. The CBSL's Treasury Bills exchange was undertaken under the new Central Bank Act (which enables CBSL's primary market purchase of Treasury Bonds through debt exchange under transitional provisions). The exchange

restructured CBSL's current short-term claims on the government into a new 15-year debt instrument with a gliding interest rate path that matches the projected disinflation trajectory. The Treasury Bonds exchange attracted a very high participation by superannuation funds and lengthened the average maturity of their holdings at a 12 percent initial coupon rate (roughly equal to the current yield to maturity) before stepping down to 9 percent in 2026 in line with a declining inflation trajectory. Finally, the holders of SLDBs and FX-denominated bank loans to the central government opted to receive local currency payments in the form of a floating rate indexed to the monetary policy rate (Standing Lending Facility Rate plus 1 percent) 10-year amortizing T-bond with no haircut to minimize the initial fair value loss from restructuring. These debt exchanges were geared toward providing significant liquidity relief to the government, which would also contribute to reducing future GFNs. The authorities are finalizing their strategy to restructure the FX local law recently taken over by the government from the CPC. Since these claims are held by state banks (whose capital positions are precarious), the restructuring terms are being contemplated in the context of a holistic bank recapitalization plan.

4. Staff facilitated the debtor-creditor engagement in line with Fund policies and its duty of neutrality. Since the program approval in March 2023, staff's role in supporting the authorities' restructuring efforts has focused on ensuring timely sharing of the macro and financing assumptions underpinning the program; explaining program designs and debt sustainability targets; providing DSA modeling support to creditors on an as requested basis; and assessing debt treatment proposals' consistency with program parameters. In particular, staff has participated in all the OCC meetings and liaised very closely with the Secretariat on its debt treatment Working Papers; responded comprehensively to Chinese creditors' questions about program designs and the debt relief envelope, both in writing and through meetings; and assisted the authorities in assessing the foreign bondholders group's proposal of macro-linked bond, focusing on its consistency with debt targets and the prospects of restoring debt sustainability. Staff will continue supporting the authorities' engagement with their creditors in line with Fund policies.

Annex V. Consultation with the IMF Executive Board on Missed Inflation Target Under the MPCC

Consultation on Nonobservance of MPCC Target in Quarter 2, 2023
Central Bank of Sri Lanka
November 27, 2023

Inflation decelerated much more rapidly than expected – headline inflation declined to 23.4 percent in the second quarter of 2023, 4.6 percentage points lower than the outer MPCC band as agreed under the EFF. This letter explains: (1) the reasons why inflation fell below the lower outer limit of the MPCC band in Q2 2023; and discusses: (2) the policy response and (3) inflation outlook.

1. Inflation deviation from the consultation band.

Aside from the global food and energy deflation, strong base effects,[1] the faster-than-expected disinflation in Sri Lanka has been primarily driven by the following factors:

- **Limited Exchange Rate Passthrough**: The expected Rupee depreciation – in line with the external sector rebalancing needs and the authorities' commitment to build up reserves – did not materialize. Instead, Rupee appreciated by 18 percent between February and May 2023, partly driven by confidence boost following the EFF program approval.

- **Muted Second Round Effects**: The inflation surges last year, and the electricity tariff hikes this year (66 percent) did not generate expected second round effects. Instead, nominal wage growth remained moderate compared to the increases in headline inflation as elevated interest rates and tight fiscal consolidation continued to weigh on domestic demand (private credit and real GDP growth contracted by 4.5 and 7.9 percent in the first half of 2023, respectively).

2. Policy Response.

The CBSL lowered the policy rate (lending facility) by 550 basis points between June and October. Broader monetary conditions also eased significantly – 3-month T-bills rate and prime lending rate declined from the peak of 30-33 percent to 16.6 and 14 percent respectively in October 2023, thanks to narrowing risk premia with the finalization of domestic debt restructuring. The monetary stance is justifiable especially given anchored inflation expectations and high real rates – contemporary (9.6 percent) and forward-looking (4 percent) real policy rates (lending facility) are still above the neutral rate (2.5 percent).

[1] From the depreciation and high commodity prices in 2022.

3. Inflation Outlook.

Inflation is expected to increase to 4.8 precent in Q4 2023 due to the 18 percent increase in the electricity tariff in October. Further increases are projected in 2024 due to tax policy measures (e.g., VAT rate increases and removal of several exemptions) before gradual convergence to inflation target 5 percent in the outer years.

Annex VI. IMF Capacity Development Missions

January 2021 - September 2023		
TA/Training Missions	**Provider**	**Date**
Tax Policy		
Tax Policy Reform	FAD	June 6 - 17, 2022
VAT and Excise Tax	FAD/LEG	January 12 - 25, 2023
Property and Wealth Tax	FAD	June 30 - July 13, 2023
Revenue Administration		
Strengthening the Large Taxpayer Office	FAD/SARTTAC/STX/LTX	February 15 - March 8, 2022
Implement Large Taxpayer Office	FAD/STX	April 4 - 18, 2022
Tax Administration Diagnostic Tool (TADAT) training	FAD	December 5 - 9, 2022
TADAT Assessment	SARTTAC (with ADB and WB)	January 9 - 26, 2023
RAMIS	SARTTAC	March 7 - 20, 2023
Guiding the Development of Tax Administration Reform	FAD (with WB)	July 3 - 11, 2023
Medium-term revenue administration reform plan	FAD	August 28 - September 1, 2023
Public Financial Management		
Strengthening macro-fiscal unit: Fiscal Analysis and Forecasting	SARTTAC	March 15 - 26, 2021
TA Mission on Strengthening the Macro-Fiscal Unit	FAD/SARTTAC/STX/LTX	January 20 - February 9, 2022
Macro-Fiscal Unit and MTFF	FAD/SARTTAC/LTX	September 19 - 23, 2022
Fiscal Risks Management	FAD/SARTTAC/LTX	October 3 - 7, 2022
PFM Diagnostic Scoping Mission/ PFM Reform Agenda	FAD/SARTTAC/STX/LTX	December 8 - 10, 2022
Public Debt Management Reform Plan	FAD/LEG/MCM (with WB)	February 20 - March 3, 2023
Public Debt Management Office	MCM	October 16-24, 2023
PFM Law (fiscal rules)	FAD/LEG	March 13 - 23, 2023

January 2021 - September 2023 (continued)		
TA/Training Missions	**Provider**	**Date**
Developing a Fiscal Strategy Statement	FAD	June 12 - 16, 2023
Debt Management Law	LEG/MCM/WB	June 26 - July 7, 2023
PFM Law (budget preparation, budget execution, and reporting)	FAD/LEG	August 10 - 21, 2023
Monetary and Foreign Exchange Operations		
Monetary Policy Operations	MCM/SARTTAC	June 1 - July 2, 2021
Monetary Policy Frameworks and Implementation	MCM/SARTTAC	June 6 - 17, 2022
Forecasting and Policy Analysis System	ICD/SARTTAC	November 28 - December 9, 2022; February 5 – February 16, 2024 (planned)
Liquidity Monitoring	MCM/SARTTAC	September 1 - 9, 2022
Central Bank Balance Sheet	MCM	December 1 - 12, 2022
Central Bank Liquidity Monitoring and Monetary Operations	MCM/SARTTAC	July 4 - 17, 2023
Financial Sector Supervision and Regulation		
Strengthening Technology Risk Management of NBFIs & Building Supervisory Capacity	MCM	May 11 - November 12, 2021
Financial Sector Stability Reviews (FSSR) Follow-up and Stress Testing	MCM	May 1 - 12, 2021
FSSR Macroprudential TA/ Resident Advisor	MCM	February 2023
Policy discussion on revision of Payment Settlement and Systems Act (PSSA) (first phase)	MCM	October 24 - November 4, 2022
Macroprudential Policy Tools	MCM	May, July, October 2023
Operationalizing Macroprudential Policy Framework	MCM	June 13 - 20, 2023
Policy discussion on revision of PSSA (second phase)	MCM	August 2 - 8, 2023
Governance and Anti-corruption		
GD Scoping Mission	LEG	March 9 - 14, 2023
GD Mission	LEG/FAD/MCM/FIN	March 20 - 31, 2023

January 2021 - September 2023 (concluded)		
TA/Training Missions	**Provider**	**Date**
Government Finance Statistics (GFS)		
Implementing a Strategy for Broadening the Coverage and Scope of GFS to General Government	SARTTAC	January 24 - February 3, 2022
Expanding Compilation for Consolidated Central Government	SARTTAC	January 23 - 27, 2023
Real Sector Statistics		
National Accounts: GDP Rebasing	SARTTAC	March 29 - April 23, 2021
National Accounts: GDP Rebasing	SARTTAC	August 16 - 20, 2021
Price Statistics: Updating the Index of Industrial Production and PPI	SARTTAC	November 1 - 26, 2021
National Accounts: GDP Rebasing	SARTTAC	February 7 - 8, 2022
Institutional Sector Accounts - Sequence of Accounts	SARTTAC	November 21 - 25, 2022
Rebasing and Updating the consumer price index (CPI) Weights	SARTTAC	December 19 - 23, 2022
Expand Coverage of the Producer Price Index	STA	April 17 - 28, 2023
Others		
Scoping Mission: Model-Based Financial Programming and Policies (FPP)	ICD	January 30 - February 3, 2023
Developing a Model-based FPP Macroframework	ICD	June 5 - 9, 2023
Financial Programming and Policies: National Training	SARTTAC	March/April 2024 (planned)

Source: IMF Staff

Annex VII. Capital Flow Management (CFM) Measures

(Note: Measures highlighted below in italics are those introduced/ changed after the last Article IV consultations (2021 Article IV) was completed.)

1. Repatriation requirement for exports of goods and services.

Action	Type of Change to CFM
On **October 28, 2021**, in addition to repatriation of goods, exporters must repatriate proceeds from services provided outside Sri Lanka, within 180 days from the date of provisioning of services.	tightening

2. Surrender requirement for exporters on proceeds from exports of goods and services.

On **February 18, 2021**, the CBSL issued a rule that all exporters of goods shall, immediately upon the receipt of such export proceeds into Sri Lanka, convert 25 percent of such export proceeds to Sri Lankan rupees.	introduced
On **March 9, 2021**, exporters were given a period of 14 days to convert aforesaid 25 percent of export proceeds received into Sri Lanka Rupees, provided that such date of conversion shall not be a date later than 180 days from the date of shipment.	easing
On **April 9, 2021**, the CBSL reduced the surrender requirement for exporters to 10 percent of the export proceeds (from previous 25 percent) as well as increased the period up to 30 days (from previous 14 days) within which such conversion should be done by exporters upon receipt of such proceeds, provided that such date of conversion shall not be a date later than 180 days from the date of shipment.	easing
On **May 28, 2021**, the CBSL increased the surrender of exports proceeds to 25 percent. However, discretion was given to the Monetary Board of CBSL to determine a lesser percentage up to 10 percent, for conversion of received export proceeds, for the specific export sectors or industries or individual exporters.	tightening
On **October 28, 2021**, exporters of goods and, in addition exporters of services are required to convert, the remaining balance of such export proceeds into Sri Lankan rupees, on or before the seventh day of the succeeding month, upon meeting certain authorized payments. Such date of conversion shall not be a date later than 180 days from the date of shipment or provision of services.	general easing
*On **March 11, 2022**, in addition to direct exporters, every local supplier, who receives payments in foreign currency out of the export proceeds of direct exporters, were required to mandatorily convert the residual of such receipts into Sri Lankan rupees, upon utilizing the same only in respect of*	tightening

the authorized payments, on or before the seventh day of the following month.	
*On **August 12, 2022**, the surrender requirement for exporters of services was eliminated.*	easing

3. Surrender requirement for banks on purchases of export proceeds (eliminated from March 7, 2023).

On **February 18, 2021**, the CBSL issued a rule that all exporters of goods shall convert a certain portion of such export proceeds to Sri Lankan rupees, of which 50 percent is to be sold by licensed commercial banks (LCBs) to the CBSL.	introduced
On **March 17, 2021**, the CBSL temporarily suspended, until further notice, the requirement of licensed banks to sell 50 percent of the conversions of received export proceeds to the CBSL.	easing
On **May 28, 2021**, the CBSL imposed the requirement for LCBs to sell 10 percent of converted exports proceeds to the CBSL.	tightening
On **December 27, 2021**, the CBSL increased the percentage of mandatory sales by banks on the account of mandatorily converted export proceeds from 10 percent to 25 percent to the CBSL.	tightening
*On **March 21, 2022**, the CBSL increased the percentage of mandatory sales by banks on the account of mandatorily converted export proceeds from 25 percent to 50 percent to the CBSL.*	tightening
*On **April 11, 2022**, the CBSL reduced the percentage of mandatory sales by banks on the account of mandatorily converted export proceeds from 50 percent to 25 percent to the CBSL.*	easing
*On **February 27, 2023**, the CBSL further decreased the percentage of mandatory sales by banks on account of mandatorily converted export proceeds from 25 percent to 15 percent to the CBSL.*	easing
*On **March 7, 2023**, the CBSL abolished the requirement for banks to surrender, to the CBSL, a fraction of their purchases of FX from export proceeds.*	removed

4. Surrender requirement for banks on purchases of inward worker remittances *(eliminated from March 7, 2023).*

On **January 27, 2021**, the CBSL imposed a new requirement, instructed all LCBs to sell 10 percent of such remittances converted to Sri Lankan rupees, to the CBSL.	introduced
On **March 17, 2021**, the above requirement is suspended until further notice.	easing

On **May 28, 2021**, the CBSL reimposed the requirement for LCBs to sell 10 percent of converted inward worker_remittances to Sri Lankan rupees to the CBSL.	tightening
On **December 27, 2021**, the CBSL increased the percentage of mandatory sales by banks on the account converted inward workers' remittances from 10 percent to 25 percent to the CBSL.	tightening
*On **March 21, 2022**, the CBSL increased the percentage of mandatory sales by banks on the account converted inward workers' remittances from 25 percent to 50 percent to the CBSL.*	tightening
*On **April 11, 2022**, the CBSL decreased the percentage of mandatory sales by banks on the account converted inward workers' remittances from 50 percent to 25 percent to the CBSL.*	easing
*On **February 27, 2023**, the CBSL further decreased the percentage of mandatory sales by banks on account of converted inward workers' remittances from 25 percent to 15 percent to the CBSL.*	easing
*On **March 7, 2023**, the CBSL abolished the requirement for banks to surrender, to the CBSL, a fraction of their purchases of FX from inward worker remittances.*	removed

5. Suspension of outward remittances on capital transactions.

On **April 2, 2020**, the following outward remittances were suspended, for a period of 3 month: 1. Any outward remittances other than the remittances on current transactions through Business Foreign Currency Accounts (BFCAs) or Personal Foreign Currency Accounts (PFCAs) held by persons resident in Sri Lanka. 2. Outward remittances through the Outward Investment Accounts (OIAs) for the purpose of making investments in overseas by persons resident in Sri Lanka excluding the following: a) investments to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka under the provisions of the Foreign Exchange Act (FEA), or b) investments to be made to fulfill the regulatory requirement in that country, provided that, the Head of Department of Foreign Exchange is satisfied with the fulfilment of such requirement. The Monetary Board of the CBSL has the authority to grant permission in terms of the Section 7(10) of the FEA for investments on a case by case basis, when they exceed the specified limits provided that the proposed investment is to be financed out of a FX loan obtained by the investor from a person resident outside Sri Lanka under the provisions of the FEA, or the proposed investment is to be made to fulfill the regulatory requirement in that country.	tightening

On **July 2, 2020**, the following outward remittances were suspended, for a period of 6 months: 1. Any outward remittances through BFCAs or PFCAs held by persons resident in Sri Lanka, other than outward remittances on permitted current transactions up to any amount or outward remittances on capital transactions up to a maximum of US$20,000. 2. Outward remittances through the OIA for the purpose of making investments in overseas by persons resident in Sri Lanka excluding the following: a) investments to be financed out of a FX loan obtained by the investor from a person resident outside Sri Lanka, or b) an additional investment to be made to fulfill the regulatory requirements in the investee's country applicable on the investment already made in a company or a branch office in that country, or c) an additional investment/infusion of funds (as applicable) to be made by eligible resident companies in already established subsidiaries or branch offices in overseas, up to a maximum of US$20,000, for the purpose of working capital requirements of the investee or d) the remittances up to a maximum of US$20,000 for the purpose of maintenance of liaison, marketing, agency, project, representative or any other similar offices already established in overseas provided that, the Head of Department of Foreign Exchange is satisfied with the fulfillment of such requirement. The Monetary Board of the CBSL continues to have the authority to grant permission for investments on a case-by-case basis, which exceed the specified limits, provided that, a) the proposed investment is to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka, or b) the proposed investment is to be made to fulfil the regulatory requirement in the investee's country applicable on the investment already made in a company or branch office in that country.	easing
On **December 18, 2020**, the validity of the above measures was extended for further 6 months from January 2, 2021.	time extension
On **July 02, 2021**, the following measures on outward remittances were implemented, for a period of 6 months: 1. Limiting the outward remittances on capital transactions through BFCAs or/and PFCAs held by a person resident in Sri Lanka, up to a maximum of US$20,000. 2. Suspending payments through OIAs for the purpose of making investments in overseas by persons resident in Sri Lanka, excluding:	general easing

(a) investments to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka, or (b) an additional investment to be made to fulfill the regulatory requirements in the investee's country applicable on the investment already made, in a company or a branch office in that country, or (c) an additional investment/infusion of funds (as applicable) to be made by eligible resident companies in already established subsidiaries or branch offices in overseas, up to a maximum of US$15,000, for the purpose of working capital requirements of the investee, or (d) the remittances for the purpose of maintenance of liaison, marketing, agency, project, representative or any other similar offices already established in overseas, by eligible resident companies, up to a maximum of US$30,000; provided that, the Head of Department of Foreign Exchange is satisfied with the fulfillment of such requirement. The Monetary Board of the CBSL continues to have the authority to grant permission for investments on a case-by-case basis, which exceed the specified limits, provided that, a) the proposed investment is to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka, or b) the proposed investment is to be made to fulfil the regulatory requirement in the investee's country applicable on the investment already made in a company or branch office in that country.	
On **December 15, 2021**, the period of validity of the above measures were extended for further 6 months from January 2, 2022.	time extension
*On **June 30, 2022**, the suspension/limitations above were extended for further 6 months. In addition, for, the same period, it was suspended making outward remittances by a subsidiary or branch office of a company incorporated overseas, on behalf of its employees for the purpose of contributing to an Employee Share Ownership Plan or Employee Share Option Scheme.*	tightening
*On **December 22, 2022**, the period of validity of the above measures introduced on July 1, 2021 and June 30, 2022, were extended for further 6 months from December 30, 2022.*	time extension
*On **June 28, 2023**, the following measures were implemented by a new Order, for a period of 6 months:* *1. Limiting the outward remittances on capital transactions through PFCAs held by a person resident in Sri Lanka, up to a maximum of US$20,000.*	easing

2. *Limiting the outward remittances on capital transactions through BFCAs held by a person resident in Sri Lanka, for the purpose of expanding their core business overseas, up to a maximum of US$100,000;* 3. *Suspending payments through Outward Investment Accounts for the purpose of making investments overseas by persons resident in Sri Lanka, excluding:* *(a) investments to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka, or* *(b) an additional investment to be made to fulfill the regulatory requirements in the investee's country applicable on the investment already made, in a company or a branch office in that country, or* *(c) an additional investment/infusion of funds (as applicable) to be made by eligible resident companies in already established subsidiaries or branch offices overseas, up to a maximum of US$30,000, for the purpose of working capital requirements of the investee, or* *(d) remittances for the purpose of maintenance of liaison, marketing, agency, project, representative or any other similar offices already established overseas, by eligible resident companies, up to a maximum of US$30,000, or* *(e) investments by following eligible resident investors in the ordinary shares of a company outside Sri Lanka, for the purpose of expanding their core business overseas:* *i. Companies listed in the Colombo Stock Exchange (CSE) - up to a limit of US$200,000,* *ii. Companies that are not listed in CSE - up to a limit of US$100,000.* *(f) investments by companies incorporated in Sri Lanka to set up overseas offices, up to a limit of US$100,000.* *provided that the Head of the Department of Foreign Exchange of CBSL is satisfied with the fulfillment of such requirement.* *The Monetary Board of the CBSL continues to have the authority to grant permission on case-by-case basis for the investments which exceed the specified limits, provided that:* *(a) the proposed investment is to be financed out of a foreign currency loan obtained by the investor from a person resident outside Sri Lanka, or* *(b) the proposed investment is to be made to fulfill the regulatory requirement in the investee's country applicable on the investment already made in a company or branch office in that country.*	

6. Restrictions on purchases of Sri Lankan International Sovereign Bonds by local banks.

Effective **March 19, 2020**, the CBSL suspended, for a period of 3 months, the purchase of Sri Lanka International Sovereign Bonds (ISBs) by LCBs and National Savings Bank (NSB).	suspension
On **June 19, 2020**, the CBSL extended the suspension of above transactions for a further period of 3 months, except for such purchase of ISBs is funded by using new foreign currency inflows to the banks.	easing
On **December 11, 2020**, the CBSL required the LCBs and NSB to suspend the purchase of ISBs for a further period of 6 months unless such purchase of ISBsis funded by new FX inflows to such licensed banks sourced from abroad.	tightening
On **December 23, 2020**, LCBs and NSB were required to suspend the purchase of Sri Lanka ISBs with immediate effect for a period of 3 months.	tightening
On **March 18, 2021**, LCBs and NSB were informed to suspend the purchase of Sri Lanka ISBs with effect from March 23, 2021 until April 9, 2021.	Time extension
On **April 9, 2021**, the LCBs and NSB were required to suspend the purchase of ISBs until April 23, 2021.	Time extension
On **April 23, 2021**, the LCBs and NSB were required to suspend the purchase of ISBs until further notice.	Time extension
On **June 16, 2021**, the CBSL canceled the above measure. The LCBs and NSB may purchase ISBs in the secondary market subject to the following conditions. o Source of funds to be limited to fresh borrowings from overseas and it should be established to the satisfaction of the CBSL. o Investment of funds sourced as above in Sri Lanka's development bonds (SLDB) and ISBs in the proportion of 50% each. o LCBs and NSB to adopt appropriate risk mitigation measures to prevent maturity mismatches between the borrowings and the ISB/SLDB investments, in addition to other risk mitigation measures already prescribed/followed.	easing

7. Restricting outward transfer of funds for emigrants etc.

On **April 2, 2020**, the following measures were introduced for a period of 3 months: a) the eligible migration allowance for the emigrants who are claiming the migration allowance for the first time has been limited up to a maximum of US$30,000. b) the repatriation of funds under the migration allowance through Capital Transactions Rupee Accounts (CTRAs) by the emigrants who	tightening

have already claimed migration allowance under the general permission was suspended.	
On **July 2, 2020**, the following measures were introduced for a period of 6 months: a) the eligible migration allowance for the emigrants who are claiming the migration allowance for the first time continue to be limited up to a maximum of US$30,000, b) the repatriation of funds under the migration allowance through CTRAs by the emigrants who have already claimed migration allowance, was limited up to a maximum of US$20,000.	easing
On **December 18, 2020**, the period of validity of the above measures were extended for further 6 months from January 2, 2021.	time extension
On **July 02, 2021**, the following measures were implemented for a period of 6 months: a) Suspended the repatriation of funds under the migration allowance out of funds received as monetary gifts by an emigrant from an immediate family member, being funds realized from any asset in Sri Lanka (including movable, immovable, tangible and intangible assets); b) Limited the repatriation of funds under the migration allowance through CTRAs by the emigrants who have already claimed migration allowance, up to a maximum of US$10,000. c) Continued to limit the eligible migration allowance for the emigrants who are claiming the migration allowance for the first time, up to a maximum of US$30,000. d) Limited the outward remittances or issuance of FX for any Sri Lankan individual who resides in or outside Sri Lanka and has obtained Temporary Residence Visa of another country, up to a maximum of US$20,000 per person. e) Limited the issuance of FX for any person resident in Sri Lanka who intends to leave Sri Lanka under the Temporary Residence Visa of another country up to a maximum of US$10,000 per person.	tightening
On **December 15, 2021**, the period of validity of the above measures were extended for further 6 months from January 2, 2022.	time extension
*On **June 30, 2022**, the suspension/limitations above were extended for further 6 months.*	time extension
*On **December 22, 2022**, the above suspension/limitations were extended for further 6 months from December 30, 2022.*	time extension
*On **June 28, 2023**, the following measures were implemented for a period of 6 months:*	easing

a) *Limit the eligible migration allowance for the emigrants who are claiming the migration allowance for the first time, up to a maximum of US$50,000.* b) *Limit the repatriation of funds under the migration allowance through CTRAs by the emigrants who have already claimed migration allowance, by the date of this Order, up to a maximum of US$20,000;* c) *Limit the outward remittances or issuance of FX for any Sri Lankan individual who resides in or outside Sri Lanka and has obtained Temporary Residence Visa of another country, up to a maximum of US$20,000 per person.* d) *Limit the issuance of FX for any person resident in Sri Lanka who intends to leave Sri Lanka under the Temporary Residence Visa of another country up to a maximum of US$10,000 per person.*	

8. Limit on the nonresident participation on local bond market (please see CFM taxonomy of the IMF).

2006: A limit of 5 percent was imposed on the amount of rupee - denominated government securities (T - Bonds) that nonresident investors can hold as a share of the total outstanding stock.	introduced
2007: the limit was raised to 10 percent	easing
2008: the limit was extended to T - Bills (also at 10 percent)	easing
2011: the limit was increased to 12.5 percent	easing
2015: the limit was reduced to 10 percent	tightening
2019: the limit was reduced further to 5 percent	tightening

Annex VIII. Risk Assessment Matrix[1]

Source of Risks	Likelihood	Expected Impact	Policy Response
Domestic Risks			
Program financing risks arising from lower reserve accumulation, financing shortfall from external partners, high domestic interest burden, higher-than-expected bank and CBSL recapitalization needs and lower tax revenue collection	High	**H**: Program becomes underfinanced	Depending on the triggers, a combination of actions including (i) higher program financing access to IMF and other development partners, (ii) deeper debt restructuring, (iii) broader and more frontloaded revenue mobilization measures can be considered.
Incomplete program implementation and reform fatigue	High	**H**: Can weaken confidence and delay access to external financing and easing of domestic financing condition, slowing economic stabilization.	Enforce program performance through corrective actions. Streamline and prioritize reform agenda in line with the program objectives. Monitor program performance closely in collaboration with authorities' Implementation Unit.
Delays in addressing banking sector vulnerability	High	**H**: Weak balance sheets can hinder credit growth and weigh on economic recovery.	Expedite the implementation of banks' recapitalization strategy and legislative changes to strengthen the governance of state-owned banks.
Social unrest, fueled by falling real incomes including from tax hikes and cost recovery pricing in the energy sector, insufficient anti-corruption efforts, and delayed local election	High	**M**: Can delay or reverse progress of important reforms	Proactively implement inclusive reforms including social security and anti-corruption reforms. Strengthen communication to increase public understanding of the program design and objectives.
Upside inflation risks from stronger economic rebound and second round effect from new tax measures	Medium	**M**: can de-anchor inflation expectations and reduce real income	Monitor inflation development closely and tighten monetary policy if needed to keep inflation anchored around the target level.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Source of Risks	Likelihood	Expected Impact (concluded)	Policy Response
Slow progress in debt restructuring	High	**H**: Worsen government financing and balance of payments, thus creating financing gaps	Improve government financing through revenue mobilization efforts. Address the bop pressure by allowing the exchange rate to adjust and seeking for higher access to external financing support.
		External Risks	
Intensification of regional conflict(s). Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, FDI and financial flows, and payment systems, and lead to refugee flows.	High	**H**: Disrupt trade, remittances, and capital inflows, worsening balance of payments. Can also slow growth recovery.	Support the economy with easing monetary policy and targeted fiscal support. Address the bop pressure by allowing the exchange rate to adjust and seeking for higher access to external financing support.
Commodity price volatility. A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability.	High	**H**: Increase volatility to inflation dynamics and uncertainties to economic activity	Closely monitor implications to inflation and maintain agility of monetary policies.
Abrupt global slowdown or recession. Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs.	Medium	**H**: Slow trade and capital inflows, with negative spillovers to growth.	Support the economy with easing monetary policy and targeted fiscal support. Address the bop pressure by allowing the exchange rate to adjust and seeking for higher access to external financing support.

Appendix I. Letter of Intent

November 27, 2023
Colombo

Ms. Kristalina Georgieva
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Georgieva:

As part of the IMF-supported arrangement, we have undertaken significant reforms to pave our way out of a deep economic and debt crisis. Our economy is showing tentative signs of stabilization, supported by rapid disinflation and a significant fiscal adjustment. Tax revenues have increased but not as much as initially projected, and reserves accumulation has slowed, including due to slow progress on debt restructuring. We reached agreements in principle (AIP) with official creditors on a debt restructuring consistent with program parameters and are in good faith discussions with our external private creditors.

As of end-June 2023, all quantitative performance criteria (QPCs) for the first review were met, except on expenditure arrears, and all indicative targets (IT) were met, except on tax revenue. Most structural benchmarks (SBs) due by end-October 2023 were either met or met with delay. Notably, at the end of September, we published the Governance Diagnostic Report, making Sri Lanka the first country in Asia to do so.

In the policy area, we remain committed to the implementation of the action plan we have presented when requesting the 48-month arrangement under the EFF. Our objectives remain: (i) an ambitious revenue-based fiscal consolidation, accompanied by stronger social safety nets, fiscal institutional reforms, and cost-recovery based energy pricing; (ii) restoration of public debt sustainability; (iii) restoring price stability and rebuilding reserves under greater exchange rate flexibility; (iv) safeguarding financial sector stability; and (v) structural reforms to address corruption vulnerabilities and enhance growth.

The policies we will be implementing over the coming months are presented in the attached Memorandum of Economic and Financial Policies (MEFP), which updates the MEFP of March 2023. We believe that the economic and financial policies set forth in the MEFP are sufficient to ensure that the objectives of the program will be met. We stand ready to take any further measures that may prove necessary to meet our objectives. We will consult in advance with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. We will refrain from policies that would be inconsistent with the program's objectives. We will supply the Fund with timely and accurate data that are needed for program monitoring.

With regards to program conditionality, we have completed all 3 prior actions. We are requesting that the IMF Executive Board: (i) grants a waiver of nonobservance of the end-June 2023 QPC on arrears, which was temporary; (ii) approves the modification for end-December 2023 QPC on NCG and ITs on central government tax revenue and the limit on treasury guarantees; (iii) completes the Board consultation triggered by the end-June 2023 MPCC breach and approves the resetting of the MPCC clause; (iv) approves the new proposed quantitative targets for the next 12 months, including introducing starting December 2023 a new continuous QPC on new CBSL purchases of government securities in the primary market and starting from June 2024 changing the existing IT on the tax revenue floor to a QPC; (vi) approves the modification of SBs, including for the continuous SB on setting the end-user electricity with quarterly adjustments and the postponement of the submission to Parliament of the new PFM law from December 2023 to February 2024, (vii) approves the new SBs in different areas, and (viii) approves the rephasing of access.

The program will continue to be monitored through semi-annual reviews, quantitative performance criteria, indicative targets, and structural benchmarks as described in the attached MEFP and Technical Memorandum of Understanding (TMU).

With this, we are requesting the IMF Executive Board approve the completion of the first review under the EFF approved in March 2023 and the disbursement of SDR 254 million (43.9 percent of quota) upon approval.

In keeping with its policy of transparency, we consent to the IMF's publication of this letter and its attachments, as well as the associated staff report.

Sincerely yours,

/s/

Ranil Wickremesinghe
Minister of Finance, Economic Stabilization,
and National Policies

/s/

Nandalal Weerasinghe
Governor
Central Bank of Sri Lanka

Attachments: - Memorandum of Economic and Financial Policies

- Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

I. Context and Macroeconomic Developments

1. **We remain fully committed to the economic reform program supported by the extended arrangement under the EFF**. The IMF Executive Board approved Sri Lanka's four-year EFF program on March 20, 2023 to address one of the worst economic crises in our history. The Parliament endorsed the policies under the program on April 28. The program continues to prioritize restoring macroeconomic stability and debt sustainability, mitigating the economic impact on the poor and vulnerable, safeguarding financial sector stability, and strengthening governance and medium-term growth potential.

2. **Despite tentative signs of economic stabilization, vulnerabilities remain**. The current account improved on the back of large import compression and strong remittances in the first half of 2023. However, the financial account showed lower net inflows, with low project financing and continued private sector deleveraging. Additionally, banks built up their FX positions to meet net open position (NOP) requirements, affecting the liquidity in the FX market and creating significant obstacles to the accumulation goals of Gross Official Reserves. Following our decisive monetary policy actions, inflation declined rapidly. Nonetheless, growth momentum remains subdued, especially in industrial activities, though the services sector is showing some recovery. Tax revenue increased significantly but gains are lower than expected, the financial system remains vulnerable, and external debt restructuring negotiations need to be finalized soon to ensure a path to sustainability. Economic vulnerabilities were compounded by deep-rooted governance issues and structural impediments, which need to be addressed with a comprehensive anti-corruption and growth-enhancing reform agenda. Our commitments under this economic program will help restore confidence and improve liquidity in foreign exchange. This should help stabilize the economy and restore economic growth.

- Following an annual contraction of 7.8 percent last year, real Gross Domestic Product (GDP) contracted further by 7.9 percent in H1 2023 and is projected to contract by 3.6 percent in 2023, before a moderate expansion by 1.8 percent in 2024 and gradual convergence towards the growth potential of around 3 percent over the medium term.

- Inflation decelerated rapidly from the peak of nearly 70 percent in September 2022 down to 1.5 percent in October 2023. Rapid disinflation has been driven by the lagged effect of significantly tight monetary policy stance, a strong base effect, weak demand, an appreciated Rupee, and muted second round effects.

- The current account is projected to record a surplus of 1.5 percent of GDP in 2023 driven by large import compression and strong remittances growth, partially offset by weak textiles exports and gradual recovery in tourism earnings. During the first half of the year, the CBSL built significant amounts of reserves, through net purchases of US$1.7 billion in January-June. However, the financial account is projected to show lower net inflows, driven by banks investing their FX assets in accounts abroad and redemptions of external liabilities. Driven by these developments and banks' actions to close NOPs, FX market liquidity tightened since June, prompting the CBSL to provide additional FX liquidity on some occasions. With these shocks materializing in the second half of the year, reserve accumulation will be lower than expected, and Gross International Reserves (GIR) are projected to reach US$3.8 billion at end-2023. Going forward, economic stabilization and fiscal and debt sustainability are expected to restore investor confidence and attract financial inflows. In the meantime, fiscal adjustment, recovery in tourism, and competitiveness gains through a flexible exchange rate will support a small non-interest current account deficit (compared to the historical average) after import restrictions are unwound, facilitating rebuilding reserves.

II. Economic Program

3. To restore macroeconomic stability and public debt sustainability in Sri Lanka, we have embarked on a comprehensive economic reform program that rests on the following key pillars: (i) an ambitious primarily revenue-based fiscal consolidation, accompanied by fiscal institutional reforms and cost-recovery based energy pricing, aimed at restoring fiscal sustainability and strengthening fiscal discipline; (ii) a stronger social safety net to protect the most vulnerable; (iii) a sovereign debt restructuring strategy aimed at restoring public debt sustainability, (iv) a multipronged strategy to restore price stability and rebuild international reserves under continued exchange rate flexibility; (v) policies to safeguard financial stability; (vi) focused reforms to address governance and corruption vulnerabilities; and (vii) broader structural reforms to unlock Sri Lanka's growth potential.

4. We see the ambitious reform agenda under the EFF as critical for exiting the crisis. We have already implemented upfront policies including on tax reforms, cost recovery energy pricing, and improving the social safety net. All continuous quantitative performance criteria (QPCs) were observed and QPCs for end-June on primary balance (PB), net international reserves (NIR), and net credit to government (NCG) target were met but not the one on expenditure arrears and not the indicative target (IT) on tax revenues. The revenue underperformance, combined with a large interest bill and high domestic borrowing costs during the first half of the year contributed to very tight liquidity and thus resulted in the accumulation of arrears by end-June, but which were subsequently cleared by September 2023. Structural benchmarks (SB) due for end-October 2023 were either met or implemented with delay, except for the amendments of the Banking Act (¶31), the Central Bank Act (¶28), the Cabinet approval of 2024 revenue measures, the completion of the Integrated Treasury Management Information System (ITMIS) rollout (¶19) and the anti-corruption Act (AC act) (¶33). The AC act was enacted with delay and without providing for a transparent and merit-based selection process for commissioners. We are committed to addressing these remaining gaps (¶8, 19, 28, 31, 33).

III. Advancing Revenue-Based Fiscal Consolidation and Reforms to Social Safety Nets, Fiscal Institutions, and SOEs

5. Tax revenue underperformance will require capital spending cuts in the short-term to preserve the fiscal consolidation path. Tax revenues fell short of the June IT by about 8 percent, and is projected at about 9.2 percent of GDP in 2023, about 0.8 percentage point of GDP lower than projected at the time of the program request, despite the adoption of some tax reform measures. This underperformance is primarily driven by weaker-than-expected collections in import-related indirect taxes, which were affected by the decline in global commodity prices. Tax revenue is still expected to increase significantly but not as much as initially envisaged. The shortfall was due to a combination of factors including: (i) unanticipated economic developments (a larger decline in growth, a less depreciated exchange rate, declining inflation, and lower imports), (ii) implementation delays in the lifting of import restrictions which was supposed to partly come into effect in 2023, and (iii) existing shortcomings in revenue administration—in particular to broaden the taxbase and to enhance enforcement. Given that there is neither time nor scope to compensate for the revenue shortfall by year end, we request a downward adjustment of the tax revenue floor for end-2023 (**indicative target**). As restoring debt sustainability and regaining creditor confidence are overriding objectives, we intend to meet our primary balance target (end-December 2023 **QPC**) by reducing the execution of both current and capital expenditure relative to approved allocations in the budget.

6. We are committed to bringing back on track and preserving the revenue-based fiscal adjustment. We will continue to target a central government primary surplus of 2.3 percent of GDP by 2025 and in subsequent years. To reach this target, the primary balance will improve from -3.7 percent of GDP in 2022 to -0.7 percent of GDP in 2023, and 0.8 percent of GDP in 2024 (**quantitative performance criterion**). We have approved measures that will partly compensate for revenue underperformance in 2024 (¶8) relative to the program request and would ensure that the revenue effort set at the outset of the program is maintained over the medium-term. Throughout the program, we will refrain from any tax policy and administrative measures that may erode tax revenue notwithstanding our commitments under the World Bank Development Policy Operations (DPO) to phase out para tariffs in a budget neutral manner and consult with the IMF on any new tax proposals including on providing new tax incentives (¶34). We will also ensure that the annual budgets approved by Parliament are consistent with program parameters including the targets on the primary balance, revenues, and non-interest expenditure and that needed revenue measures requiring legislative amendments are approved by Cabinet by end-September of the preceding year (**structural benchmarks**). Additional quantitative targets will continue to ensure our commitment to (i) increase tax revenue collection (converting the existing **IT** to a **QPC**), (ii) reduce the stock of budget expenditure arrears to zero (**quantitative performance criterion**), and (iii) a ceiling on the issuance of treasury guarantees (**indicative target**). We have requested an increase in the limit of the latter to accommodate the issuance of a new guarantee (US$2.6 billion) for the Special Swap Agreement signed between the CBSL and the Reserve Bank of India (RBI) combining the settlement of deferred Asian Clearing Union (ACU) liabilities and the outstanding Bilateral SAARC Swap Agreement with the RBI, with applicable interest.

7. We have prepared a 2024 draft Budget that is consistent with program parameters. We will adopt a package of revenue measures to raise the tax to GDP ratio to 12.1 percent of GDP in 2024 (¶8) (**Prior Action)**. We already submitted to Parliament for the first reading the 2024 Appropriation Bill (AB), which sets spending limits for line ministries, and it is broadly consistent with program parameters in October 2023 **(structural benchmark)**. On the spending side, the draft budget based on the November 13th Budget Speech includes: (i) a planned increase in the wage bill from 3.5 percent of GDP in 2023 to 3.6 percent to mitigate the impact of high inflation on real income erosion, (ii) an allocation for Social Safety Nets cash transfers of Rs. 205 billion, which was increased from Rs. 200 in the Appropriation Bill to be consistent with the program **Indicative Target** (¶17), (iii) an allocation of Rs. 1,260 billion for capital expenditure (4 percent of GDP), (iv) an allocation of Rs. 450 billion (1.4 percent of GDP) for the recapitalization of banks. The draft budget targets a primary surplus of Rs. 250 billion (0.8 percent of GDP). We plan to obtain parliamentary approval for the 2024 Appropriation Act consistent with program targets in December 2023 (**structural benchmark**).

8. We have continued to implement revenue measures to underpin the revenue effort in 2024. The tax policy measures adopted since 2022 are expected to raise tax revenue from 7.3 percent of GDP in 2022 to 9.2 percent in 2023. We remain committed to raising this ratio to at least 14 percent by 2026, by implementing a sequenced package of tax measures (Appendix 1). We have increased excise taxes on alcohol and tobacco products by an additional 20 percent in July 2023 as planned, introduced a second increase in fuel taxes in June 2023 and lifted import restrictions as of October 10 on items other than motor vehicles for personal use to help increase import-related taxes and support economic activity. We have adopted the following revenue measures with expected gains for 2024 which are expected to come into effect at the latest by January 2024 **(Prior Action)**:

- We are planning further reforms to our VAT system. We have already submitted to Parliament an amendment to the VAT legislation to remove exemptions on 87 main items, a decision that will come into effect in December 2023. We are also planning to submit to Parliament another amendment to remove additional exemptions on petroleum, diesel, LPG, motor vehicles as well as other identified items and we will increase the VAT tax rate from 15 to 18 percent. We also plan to reduce the VAT Registration threshold from Rs. 80 million per annum to Rs. 60 million per annum.

- We will reduce the liable registration threshold of the Social Security Contribution Levy from Rs. 120 million per annum to Rs. 60 million per annum, thus harmonizing the threshold with the VAT and improving incentives to report VAT revenues.

- We have issued a gazette notification to increase in the Special Commodity Levy on sugar from 25cts/Kg to Rs. 50/Kg in November 2023.

- We will also expand the 5 percent withholding tax on service fee payments made to all service providers and we expect some gains in import-related taxation from relaxing import restrictions on several items.

9. Furthermore, the following additional measures will complement the existing revenue effort. To prevent the erosion of excise taxes in real terms, we will introduce automatic indexation of all excises to inflation by January 1, 2024, with technical assistance from the IMF. In addition, we have begun work to fix the VAT refund system (¶14). We have begun preparatory work supported by IMF technical assistance in June 2023 to revamp the property tax system and introduce a wealth transfer tax. In particular, by 2025, we will introduce a nationwide real property tax, and consider adjusting the system of transfers between the central and provincial governments. We will also introduce a gift and inheritance tax with a tax-free allowance and minimal exemptions. In the medium term, we will ensure that our tax system does not overly rely on the use of fees and inefficient (turnover-based) taxes to compensate for weak administrative capacity. In the long-term, we will ensure that adequate VAT taxation replaces the Special Commodity Levy on sugar and the SSCL. We will also consider removing CIT exemptions on exports of IT services by April 2025.

10. We will prioritize revenue administration reforms that strengthen tax compliance. Existing weaknesses in our revenue administration have impeded our tax collection efforts despite the adoption of several tax policy measures. We have initiated efforts to broaden the tax base (which narrowed significantly since the 2019 tax measures as shown by the much smaller number of registered taxpayers), improving enforcement as well as simplifying the tax. To bring taxpayers back into the net, we have mandated that several groups of potential taxpayers such as professionals must register with Inland Revenue Department (IRD). We also expanded tax registration to the entire adult population, to be implemented as of January 2024. To boost compliance and ensure adequate levels of revenue collection, we will by March 2024 introduce, track and report 7 Key Performance Indicators related to the four core tax administration functions of: (1) payment; (2) filing; (3) reporting; and (4) registration (Appendix 2) (**new Structural Benchmark**). Quarterly targets for each of these KPIs have been agreed between IMF staff, the IRD and the Ministry of Finance.

11. We will also improve enforcement with a focus on large taxpayers to optimize revenue collection by (i) prioritizing assessment of VAT and CIT returns for the current tax period subject to higher taxation over older returns, (ii) creating and implementing by December 2023 within the Large Taxpayers Unit (LTU) of IRD a new High Net Worth Individuals (HNWI) unit, as well as a design and monitoring unit along with a strengthened Risk Management Unit to ensure on-time filing and payment **(new structural benchmark)**; and (iii) introducing modern risk-based audits for large taxpayers.

12. We have initiated efforts to modernize the IRD. We commit to the following measures: (i) streamline the online portal for simplified individual income tax filing by June 2024; (ii) accelerate outreach to re-register VAT taxpayers who dropped out; and (iii) enhance the electronic Revenue Administration Management Information System (RAMIS) to support the assessment of 2022/23 income tax returns and to administer and assess the Social Security Contribution Levy (SSCL) by end March 2024, with a view to reducing interactions between taxpayers and tax officials. We will more broadly ensure that processing tax collections is only carried out through RAMIS as of June 2024.

We will also adopt by January 2024 a medium-term IRD Modernization Strategy and Implementation Plan with IMF FAD CD assistance.

13. **We have initiated work to fix the VAT refund system to ensure the full repeal of the SVAT system by April 2025**. The VAT refund system is currently slow and backlogged and needs to work more efficiently based on risk management principles before the SVAT is abolished. By December 2023, we will adopt a Cabinet-approved strategy that would lay out a gradual multi-step process to fully repeal the SVAT by April 2025 **(new Structural Benchmark)** so as not to overburden the tax administration and create delays in VAT refunds to exporters which would result in VAT refund arrears. In the meantime, we will also promptly take measures to tighten controls of the SVAT system including by verifying that all registered identified purchasers (RIPs) meet the eligibility criteria and deregister those who do not or who are noncompliant. In parallel, we will also work with the CBSL to ensure that the current foreign exchange repatriation requirements do not create unnecessary delays in the refund process, and we will ensure that sufficient funds will be available to pay approved refunds.

14. **We are considering the creation of a semi-autonomous Revenue Authority**, incorporating initially the Inland Revenue Department, and later the Customs and Excises departments. We believe the authority will strengthen revenue collection in the long-term and increase revenue administration professionalism and effectiveness. However, we recognize that creation of such new institution will take time and will require significant resources, and we will make every effort to ensure that this does not undermine our effort to increase revenues, which remains our highest priority. We will consult with IMF experts before taking further steps in establishing the Revenue Authority.

15. **Going forward, we will ensure that needed expenditure rationalization measures will not overly rely on capital expenditure cuts so as not to harm long-term growth**. We under-executed capital expenditure by more than 1 percent of GDP relative to approved allocations in the 2023 budget due to shortfalls in foreign project financing and more stringent approval criteria to ensure better quality expenditure. Whilst this helped meet the primary balance target in 2023, going forward, we will avoid the full adjustment falling on capital spending. Further capital spending cuts, if still needed, will rely on transparent criteria to guide project cancellation decisions in order to mitigate adverse effects on growth and not discourage revenue mobilization efforts. We will take measures to raise public investment efficiency as recommended by the 2018 IMF Public Investment Management Assessment, strengthen the process to prioritize capital projects and undertake a public expenditure review with assistance from the World Bank to find possible savings in current spending.

16. **We will continue to enhance Social Safety Nets (SSN) to help cushion the poor and vulnerable from the impact of the economic crisis and policy adjustments**. We raised the spending on SSN programs and incorporated measures to improve the coverage and targeting to reduce inclusion and exclusion errors.

- We have strengthened our institutional framework to improve the effectiveness and efficiency of the SSN programs. We obtained Parliamentary approval of the welfare benefit payment scheme (WBPS) and the application of the new eligibility criteria to identify low-income families for receiving welfare benefit payments in May 2023 (Structural Benchmark). Effective from July 2023, we have started making payments under the new WBPS (also known as Aswesuma) to beneficiaries that were selected using the new eligibility criteria, leading to better targeting. We are also committed to addressing the grievances (both appeals and objections) that were filed after the beneficiaries list was published in June 2023. The Welfare Benefits Board (WBB), the key coordination agency for all welfare benefits including SSN programs and reforms, will complete the review of grievances and will ensure that the transition to Aswesuma is complete by end-December 2023. Towards this goal, we are committed to ensure that starting from January 2024, cash transfers under Samurdhi will cease and no ineligible beneficiaries will receive Aswesuma cash transfers. We will continue to periodically assess the Aswesuma scheme and its design. For this purpose, we will use survey data to assess the targeting and adequacy of Aswesuma.

- Under the program, a spending floor on SSN spending of Rs. 187 billion in 2023 (**Indicative Target**) was set which comprises cash transfers under the Samurdhi/ Aswesuma and the three categorical programs (benefits for elderly, disabled, and chronic kidney disease). We have met the program IT on the SSN spending floor up to June 2023. In H1-2023, all Samurdhi beneficiaries received cash transfers as the Aswesuma program was not in place. A slow transition to the new Aswesuma scheme has delayed the disbursement of the cash transfers, starting July 2023. We have committed to pay the previous Samurdhi beneficiaries who applied but were not selected under Aswesuma until their grievances are resolved. Additionally, remedial measures are underway (including addressing the grievances) to ensure all cash transfers are made retroactively by end-December 2023. Going forward, we will raise the budget allocation of SSN spending to these groups to Rs. 205 billion (or 0.7 percent of GDP) in 2024 (**Indicative Target**) to maintain the real value of cash transfers per household. Additionally, we will raise and protect social spending related to nutrition and education (i.e., school nutrition program and nutrition for expectant mothers) over the medium-term.

- We will also seek Cabinet approval of an updated graduation strategy for the four household categories that are receiving benefits under Aswesuma by end-March 2024. In terms of institutional arrangements, the Ministry of Finance will continue to lead discussions on external financing for SSN programs.

17. To mitigate fiscal risks arising from the energy SOEs, we will continue to implement automatic fuel and electricity pricing mechanisms, while making adjustments to prevent forecasting errors from causing unnecessary slippages. In November 2022, we obtained Cabinet approval to (i) automate monthly retail fuel price adjustment as prescribed by the 2018 fuel pricing formula to achieve cost recovery; and (ii) automate quarterly cost-recovery based electricity price adjustment. Following this approval, retail fuel prices have been adjusted monthly in line with cost-recovery, and retail electricity prices were increased to cost-recovery level in February 2023. As a result, CPC has been consistently profitable in 2023, and CEB has become profitable in the second quarter of 2023. However, following a decrease of the average electricity tariff by 14 percent as of July 1, a more severe than expected drought and fluctuations in coal and oil prices resulted in the CEB making losses again in August and September. Going forward:

- We will continue to set retail fuel prices to their cost-recovery levels on a monthly basis using the formula and will compensate the CPC for providing any residual fuel subsidies with on-budget transfers (**continuous structural benchmark**).

- We have already revised the average end-user electricity tariff by 18 percent effective from October 20, 2023 to recoup the losses incurred by the CEB earlier in the year by end-December 2023 and ensure that the CEB breaks even for 2023. We estimate that this early tariff revision (instead of the regular one in January) will set the tariff at the cost-recovery level for the first quarter of 2024 as well. This early revision shows the need for more frequent electricity tariff adjustments, given the inherent uncertainty in the forecasts of rainfall and global energy prices. We have adopted a Cabinet memo changing the frequency of electricity tariff revisions to quarterly starting in January 2024 (**prior action**). Going forward, we will maintain the electricity tariff at its cost-recovery level (overall across different types of final consumers) with quarterly formula-based adjustments on a forward-looking basis in January, April, July and October each year (effective from January 1, April 1, July 1, and October 1, respectively); the CEB will submit tariff revision requests to the Public Utilities Commission of Sri Lanka by end-October (for January tariff revisions), by end-January (for April tariff revisions), by end-April (for July tariff revisions) and by end-July (for October tariff revisions; we will compensate the electricity sector for providing any residual electricity subsidies with on-budget transfers; and we will use tariff surcharges in the periods between revisions to restore cost recovery in case CEB is making losses (**revised continuous structural benchmark**). We will improve the Bulk Supply Transaction Account (BSTA) to accurately measure the electricity subsidy and will start using it to determine the cost-recovery based electricity tariff and government transfer requirement by December 2023 (**structural benchmark**).

- To ensure that the CPC and CEB are fully compensated for the residual fuel and electricity subsidies with on-budget transfers, a zero ceiling on the cost of non-commercial obligations for fuel and electricity (net of government transfers) is set under the program (**indicative target**; see the Technical Memorandum of Understanding for details).

- We will explore the possible mechanisms to make more frequent automatic adjustments to the tariff between the semi-annual revisions. Once fully operational, the BSTA will be a key element of this mechanism, triggering an automatic surcharge or discount once the BSTA exceeds a specified threshold for two consecutive weeks. Furthermore, by June 2024, we will introduce legislative reforms making the Minister of Power and Energy responsible for implementing cost-recovery based fuel and electricity price adjustments.

18. We will further improve the timeliness, accuracy, and coverage of fiscal data. After completing the rollout of the ITMIS by March 2024, the MOF's Department of State Accounts will begin to report monthly cash flows from revenues, expenditures, and financing by the third business day of the subsequent month. We have also taken preliminary steps to eventually update our fiscal reporting framework to the GFSM 2014 standard by end-2024. Finally, we will form a committee that will hold bi-weekly meetings to address any issues regarding the timeliness, accuracy, and coverage of fiscal data.

19. We will continue efforts to enhance the core public financial management (PFM) functions of macro-fiscal analysis and forecasting, fiscal data collection and reporting, fiscal management, budget formulation and execution, and public debt management through sequenced reforms. Under the current PFM framework and practice, government budgets have systematically overestimated revenues and underestimated interest payments, which combined with weak expenditure management has often led to budget overruns and spending arrears. To tackle these problems:

- Efforts to enact the new PFM law have progressed with support from IMF TA. We plan to submit the new legislation to Parliament by end-February 2024, to allow sufficient time to finalize the draft (**revised structural benchmark**).

- We will continue to integrate the MOF's recently established Macro-Fiscal Unit into fiscal policy decision making by clearly defining its roles and responsibilities, and strengthening its macro-fiscal analytical, forecasting, and reporting capacity.

- Despite delays caused by the lack of sufficient qualified training staff, we will continue to strengthen commitment-based spending controls by completing the rollout of the ITMIS, a full-fledged IT-based PFM platform, and by introducing a more rigorous IT-based commitment control framework such as an e-procurement system for public investment. While the end-September 2023 structural benchmark on completing the rollout of ITMIS and expanding its coverage to all heads (national budget execution agencies) was missed, we expect the ITMIS to cover 168 budget heads (98 percent of the total) by end-December 2023, and the remaining 3 budget heads by end-March 2024. This will enable us to improve the analytical content of in-year budget execution reports.

- To provide binding multi-year guidance for the budget and public investment, we will accelerate progress towards developing a medium-term fiscal framework (MTFF). In 2023, we have begun developing multi-year baseline fiscal projections, and work towards producing a Fiscal Strategy Statement early in the budget preparation cycle, to provide binding multi-year guidance for the budget and public investment. By end-June 2024, we will obtain Cabinet approval of the fiscal strategy statement (FSS) that would include the medium-term fiscal framework (MTFF) **(new structural benchmark)**. This report will enhance the transparency and accountability of our new fiscal rules framework.

- To improve budget discipline and further strengthen the PFM framework, we will obtain Cabinet approval of a reduction in the limit on government guarantees to 7.5 percent of GDP by end-December 2023 (**new structural benchmark**). This will complement the ceiling on government guarantees set under the program and ensure that budget discipline is maintained in the long term.

20. We will press ahead with structural reforms to strengthen the governance of SOEs and make them more efficient and financially viable.

- To make the CPC more efficient, we are implementing the Cabinet decision of June 2022 to allow the entry of additional private sector firms into the downstream petroleum sector. Contracts with about 25 percent of fuel stations have been transferred from CPC to other companies, allowing for a more dynamic and competitive environment. In addition, the fuel pricing formula includes a small margin, that allowed CPC to start repaying some of the old financial obligations in August 2023.

- We have obtained Cabinet approval of a comprehensive strategy to restructure the balance sheets of the CEB, CPC, SriLankan Airlines (SLA), and the Road Development Authority, in consultation with IMF staff in June 2023. We plan to settle mutual debts in a budget-neutral way (with additional equity injections into CEB and SLA almost exactly cancelling the CPC debt to the Treasury already reported in the fiscal accounts) by end-December 2023. We will, by February 2024, also develop and adopt a credible strategy, with assistance from the International Finance Corporation (IFC), for the divestment of SLA. We will continue SOE reforms aimed at improving their commercial performance, financial transparency, and increasing private sector participation, with World Bank assistance.

- With assistance from the World Bank, we will, by end-February 2024, develop a road map for restructuring CEB, including restructuring of its remaining legacy debts (incurred prior to 2023). We will ensure that the restructuring of old CEB debts does not create additional burden for the central government budget.

- We will implement the draft strategy by the SOE restructuring unit to reform the business model of SLA to make it financially viable, through a divestment strategy (approved by the Cabinet in November 2022). Following the envisaged restructuring of the SLA's balance sheet with IFC assistance, any residual government-guaranteed FX loans will be transferred to the government's balance sheet. At that point, there will be no more government guarantees for the SLA's FX loans.

- To strengthen the governance of SOEs and enhance their financial transparency, we will: (i) clarify the mandates of key SOEs through Statements of Corporate Intent and hold their management accountable for delivering satisfactory results informed by key performance indicators; (ii) review the framework for selecting SOE board members to ensure that they are qualified and independent; and (iii) ensure that all 52 major SOEs publish their audited financial statements. This year, we succeeded in making financial statements of all 52 major SOEs available on the dedicated website by end-June. However, auditing all the statements is taking longer than anticipated. We anticipate that audited statements of all but five small SOEs would be available by end-December 2023. The remaining five SOEs require auditing their statements going back to 2018, and we expect to complete that process during 2024.

21. We will continue to strengthen the framework for SOE borrowing. Throughout the program, we will ensure that new SOE borrowing is limited to the financing of commercially viable activities (e.g., investment projects), whereas subsidies and other quasi-fiscal activities will be remunerated through government transfers. We will also ensure that, with the exception of project loans on-lent by the Treasury and short-term trade financing, there will be no new borrowing in foreign currency for non-financial SOEs with less than 20 percent of revenues denominated in foreign currency. Our new PDM law (¶23) will: (i) prohibit new Treasury guarantees to SOEs with negative equity; and (ii) prohibit new Treasury guarantees on SOE liabilities in foreign currency. We will also strengthen the governance and oversight of state-owned banks to ensure that their lending to SOEs is guided solely by commercial considerations (¶34).

IV. Restoring Public Debt Sustainability

22. We remain committed to putting public debt onto a sustainable path.

- Since the EFF program approval in March 2023, significant progress has been made in our restructuring negotiations with creditors. These negotiations are anchored by the debt sustainability targets established under the EFF program, which include (i) reducing the ratio of public debt to GDP to below 95 percent by 2032, (ii) reducing the central government's annual gross financing needs below 13 percent of GDP, on average, in 2027-32, (iii) reducing the central government's annual debt service in foreign currency below 4.5 percent of GDP in every year in 2027-32, and (iv) closing the balance of payments financing gaps of $17 billion over the EFF program period.

- Following the adaptation of the resolution on the implementation of the domestic debt optimization (DDO) strategy by the Parliament in June, we have now concluded a major part of DDO, with debt treatments executed for the outstanding Provisional Advances from the CBSL to the Government and the outstanding Treasury bills purchased by the CBSL in the primary market, superannuation funds' holdings of T-bonds, and holdings of Sri Lanka Development Bonds by resident and non-resident investors). As envisaged, these operations are geared toward providing substantial liquidity relief to the government while minimizing the balance sheet and cash flows implications for domestic creditors to preserve financial stability and social cohesion. We are finalizing our strategies to restructure the remaining FX local law debt of the government and the SOEs to the state banks, with an aim to minimize the adverse impact on banks' capital and FX net open positions within the program debt targets.

- In May 2023, we shared with all of our external creditors an indicative debt treatment scenario that is consistent with achieving the aforementioned debt sustainability targets. Our proposed restructuring perimeter includes all FX foreign law debt except for debt to international financing institutions, bilateral currency swaps, and emergency financing credit lines extended in 2022. Since then, the restructuring discussions have intensified, through the official creditors committee (OCC), direct discussions with Chinese creditors, and close contacts with the two ISB bondholder committees (representing foreign and local holders, respectively).

- We remain committed to making sufficient progress in these restructuring negotiations, in line with the general expectation of concluding these negotiations by the first review. In this respect, we have reached a preliminary agreement with the EXIM Bank of China and an agreement in principle with the OCC). We welcome the ISB bondholders' proactive engagement with us and our advisors and the significant progress made in our negotiations with the China Development Bank. We are hopeful these negotiations will lead to eventual debt treatment agreements in the coming weeks and months and help us ensure a clear path to restoring debt sustainability. We appreciate our creditors' understanding of the importance of reaching debt agreements consistent with the program parameters and in an equitable manner. We reiterate our commitment (as communicated in our President's open letter to official bilateral creditors on March 14) to refrain from resuming debt service payments to any external commercial or bilateral creditor unless it agrees to a comprehensive debt treatment in line with the IMF program parameters, debt sustainability targets, and the comparability of treatment principle. We are also committed to communicating transparently with all our creditors on debt treatments agreed with any creditor or group of creditors and to report regularly our indebtedness to ensure full transparency.

- It is our utmost priority to resolve our arrears to external creditors as soon as possible. Consistent with the IMF's arrears policies, we have continued our engagement with external commercial creditors in good faith through early dialogues, timely information sharing, and opportunities for them to provide input on the design of restructuring strategies. We also appreciate our bilateral official creditors' strong commitment to continue working with us towards a debt treatment that is consistent with restoring debt sustainability, including through specific and credible assurances by all major bilateral creditors and consent to Fund financing notwithstanding arrears to them by other bilateral creditors. We will keep IMF staff informed of any tentative debt treatment agreements, with the consent of parties involved, to facilitate their timely analysis with respect to consistency with the debt targets.

23. We are committed to improving debt management and debt transparency.

- Currently, public debt is managed by the CBSL's Public Debt Department, the MOF's External Resources Department and Treasury Operation Department. To improve debt management, we will complete necessary legislative requirements by passing the public debt management law to establish a public debt management agency (PDMA) in line with international best practices by February 2024 and complete the establishment of the agency by December 2024. The PDMA (i) will report to and be accountable to the Ministry of Finance but have significant operational autonomy; (ii) assume overall policy responsibility for debt management by formulating medium-term debt strategies and annual borrowing plans; and (iii) direct the implementation of annual borrowing plans, including taking decisions on auction cut-offs. The PDMA will oversee all domestic and international market-based financing decisions and participate in the evaluation of all debt, derivatives, and guarantees.

- We are committed to improving debt transparency. The MOF commenced publishing a quarterly bulletin of public debt and debt service in February 2023 covering the debt profile as of end-September 2022. The latest one has been published in August 2023 reflecting outstanding debt as of June 2023. We are committed to gradually broadening the quarterly bulletin's coverage to stock and debt service flows of all liabilities and contingent liabilities of the budgetary central government and of extrabudgetary central government units. In line with international best practice, we will issue guidelines regarding the statistical treatment of guaranteed debt of distressed corporations, and the transfer of government liabilities to SOEs, to be approved by Cabinet.

V. Restoring Price Stability and Rebuilding External Buffers

24. We are committed to stabilizing inflation around its target level by taking a prudent and agile approach in formulating monetary policy.

- With rapid disinflation in recent months, a key objective of the CBSL is to maintain an inflation around its target level of 5 percent (YoY), which will be monitored through the Monetary Policy Consultation Clause (MPCC) with a mid-point at 5 percent (reset at a lower level compared to program request) and inner and outer bands of ±1.5 and 3 percentage points on December 2023 and onwards (**Quantitative Performance Criterion**). A policy consultation will be held with the IMF staff ahead of each Monetary Policy Board meeting. A nonobservance of the inner and outer bands would require completion of a policy consultation with the IMF staff and the IMF Board, respectively (see Technical Memorandum of Understanding).

- Headline and core inflation fell significantly from their peaks of 70 and 50 percent in September 2022 to 12 and 10 percent in June 2023 respectively—outside of the MPCC band—and further down to less than 2 percent since September 2023. Inflation expectations are also re-anchored to single digit levels.

- In response, the monetary tightening cycle that raised the policy rate by 11 percent from August 2021 (5.5 percent) to March 2023 (16.5 percent) came to an end. The CBSL reduced the policy rates by 650 bps since June 2023, which currently stand at 9-10 percent. The treasury yields (3 months) and the prime lending rate have also fallen significantly from the peak of 30-33 percent to 15.3 and 13.0 percent, respectively. We also reduced Statutory Reserve Requirement (SRR) from 4 percent to 2 percent in August 2023 to ease domestic liquidity conditions. Broadly speaking, monetary conditions loosened significantly.

- In order to reduce the lending rate and encourage the passthrough of the policy rate to the lending rate, the CBSL imposed caps on interest rates i.e., on pawning facilities at 18 percent, on pre-arranged temporary overdrafts at 23 percent, and on credit cards at 28 percent, per annum, while capping penal interest rate at 2 percent over and above the regular interest rates for all licensed banks. The CBSL also directed banks to reduce lending rates in line with monetary policy. While these regulations aim to expedite the monetary policy transmission in the near term, considering the distortionary impact on credit provisions, we will eliminate them as soon as possible.

- In the period ahead, inflation is expected to edge up due to the electricity price hike in October 2023 (¶17) and new tax measures in 2024 (¶8). We will closely monitor inflation risks and carefully calibrate the future monetary policy stance to take account of the implications of (i) the second-round effect of newly proposed tax measures, (ii) the potential exchange rate passthrough in reaction to financial outflows, (iii) banks' NOP as result of debt restructuring, and (iv) relaxing import restrictions.

- Under a flexible inflation targeting framework, enshrined in the new Central Bank Act (CBA) No. 16 of 2023, enacted on September 15, 2023, the CBSL will remain prudent and carefully assess and calibrate its policy stance, consistent with its price stability mandate, to maintain inflation around the target. We are committed to sustain the forward-looking real policy rates close to the neutral rate level. During the program period, we stand ready to adjust the policy stance as guided by the inflation forecasts and inflation performance against the MPCC.

25. To support our disinflation strategy, we will continue to refrain from monetary financing. The fiscal adjustment, debt relief, and new external financing envisaged under the program will allow budget deficits to be financed in a more sustainable way going forward, without relying on inflationary monetary financing (i.e., direct credit to government to finance budget deficits) that has jeopardized price stability. The reduction in net domestic financing needs of the government and the improvement in the net international reserves position will also enable the CBSL to gradually unwind its remaining large holdings of Treasury securities. The pace of the reduction is informed by the market's estimated capacity to absorb the CBSL's divestment and a need to prevent excessive expansion of the CBSL's balance sheet from rebuilding reserves. The reduction in the CBSL's holdings of Treasury securities and the discontinuation of monetary financing will be monitored by (1) a **quantitative performance criterion** on the ceiling of the CBSL's net credit to the government (NCG) (excluding the CBSL's temporary holdings of treasury securities for short-term monetary operations; see TMU) and (2) a **new continuous performance criterion** to ensure no more purchases of Treasury securities from the primary market. The ceiling for the NCG target is set at Rs. 2,800 billion for end-December 2023, and is programmed to decline to Rs. 2,720 billion by end-June 2024, and to Rs. 2,560 billion by end-September 2024. The ceiling for the continuous PC on the new primary purchases of Treasury securities is set at zero. Both targets are subject to an adjustor in the amount of program financing shortfall in the first six months after the first review. We will also raise domestic borrowing amounts aiming to maintain an adequate cash balance – including a buffer – in order to meet our cashflow needs while reducing reliance on monetary financing.

26. The CBSL remains committed to objectively assess the negative impact of the DDO on its balance sheet by January 2024, in close consultation with IMF staff and external auditors. MOF is committed to boost the equity of the CBSL through a capital injection to reach a positive level by 2025, as soon as the fiscal buffer is available. The CBSL will follow good accounting standard to evaluate and confirm the discount rates applicable for the DDO and the resultant accounting entries in consultation with External Auditors. The authorities will consult with IMF staff on the design and implementation of these steps.

27. We are firmly committed to allowing continued exchange rate flexibility and rebuilding international reserves.

- We are committed to maintaining a market-determined and flexible exchange rate to serve as a buffer against external shocks. In March 2023, we eliminated market guidance to confine daily exchange rate movements within a pre-defined band around the weighted average spot interbank rate of the previous trading day. Since then, we have allowed the rupee to move in line with fundamentals.

- We will gradually rebuild gross international reserves including through outright FX purchases in the market, supported by a non-interest current account surplus, new external financing and other non-debt creating inflows, and sovereign debt relief. We commit to meet the program targets on Net Official International Reserves (NIR) (**quantitative performance criterion**), which for 2024, are predicated on the CBSL's outright FX purchases on a net basis of $2 billion in 2024. Going forward, we will strive to save any overperformance in accumulating the NIR. As a signal of our proactive approach to accumulating reserves in cases of shortfall in project financing, we will also include a cap on this adjustor for NIR target going forward throughout the EFF program. We will also include a cap on the adjustor for FX payments (amortization and interest) on restructured CPC loans. Finally, we will encourage banks to close any potential net open position issues in a planned and orderly fashion in order to avoid disorderly market conditions in the FX market.

- To avoid an "on and off" approach to exchange rate flexibility and allow the rupee to adjust to changing fundamentals, we will limit FX interventions to truly disorderly market conditions that could lead to destabilizing inflation and/or balance sheet effects and transparently disclose our intervention transactions in order to guide market expectations. In this regard, we will rationalize our intervention decision based on objective criteria and subordinate it to the CBSL's price stability mandate, while ensuring that our FX intervention budget is consistent with meeting the NIR targets.

28. We will strengthen the institutional frameworks supporting flexible inflation targeting and greater exchange rate flexibility.

- The new CBA has strengthened the CBSL's independence and modernize its policy framework to enable credible inflation targeting. In particular, provisions are made under the new Act to (i) establish price stability as the CBSL's primary objective and financial stability as the other objective, (ii) buttress the CBSL's operational autonomy by removing government representation from the Governing Board and Monetary Policy Board. To address potential fiscal liquidity shortfall, the new CBA included an 18-month transitory period to allow monetary financing as a last resort, which is not fully in line with the program objective of prohibiting monetary financing. However, our commitment to discontinue monetary financing, despite the long transitory period, is governed by program conditionality (¶26).

- To further enable and support exchange rate flexibility, we are committed to fostering a deeper and more liquid foreign exchange market and developing adequate systems for managing exchange rate risks, including with the technical assistance of the IMF.

29. We have started phasing out the administrative measures imposed to support the balance of payments, including those introduced on an emergency basis, and will continue this phase-out as conditions allow. These measures include import restrictions, exchange restrictions, multiple currency practices (MCPs), and capital flow management (CFM) measures.

- Over 2020-22 we suspended the import of many non-priority non-critical goods, which helped contain the import bill and relieved BOP pressures but also hurt economic activity. However, the removal of temporary suspension of imports begun in September 2022 with the removal of 707 items and continued with the relaxation of import restrictions on 286 goods in June 2023, followed by relaxation on 325 further goods in July 2023, and 299 goods in October 2023. With the October relaxation, we have removed import restrictions on all items apart from motor vehicles. In addition, we will provide a time-bound plan for relaxing restrictions on motor vehicles, after the completion of the debt restructuring process. This plan will be tied to removing tax exemptions on imports of motor vehicles granted to specific groups including civil servants to curb any revenue leakages from the lifting of the restrictions.

- At the time of the approval of the IMF EFF program in March 2023, we had in place the following exchange restrictions: (i) the prioritization and rationing of FX by CBSL and CBSL's informal guidance to Authorized Dealers (ADs) to prioritize access to FX for essential items, which results in undue delays and payment arrears for current international transactions; (ii) prohibitions on converting Sri Lanka Rupees into FX for certain current international transactions (e.g. servicing certain external loans, payment of any income on certain nonresident investments); (iii) unremunerated cash margin deposit requirements on imports of certain items under letters of credit (LC), documents on payment (DP) and documents on acceptance (DA) payment terms; (iv) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (v) the levy of a 14 percent remittance tax on nonresidents' profits; (vi) limits on repatriation by nonresidents of proceeds derived from current transactions; (vii) the requirement to provide a tax clearance certificate prior to permitting transfers for certain current transactions; and (viii) Sri Lanka's net debtor position under the Asian Clearing Union payment arrangement that is pending settlement for longer than 90 days. Out of these exchange restrictions, we have eliminated (i), (iii), and (viii) and plan to eliminate the others when conditions allow.

- As of the approval of the IMF EFF program in March 2023, we also had in place the following measures giving rise to MCPs: (i) unremunerated cash margin deposit requirement on imports of certain items made under LC, DA and DP payment terms; (ii) official exchange rate calculated based on the previous day's transactions in the interbank FX market and used for CBSL's FX transactions with the government; (iii) the use of the weekly volume weighted average rate for

CBSL's FX sales in bilateral non-Request for Quote outright spot transactions with ADs; (iv) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (v) the levy of a 14 percent remittance tax on nonresidents' profits, and (vi) MCP arising from an incentive on inward worker remittances that result in a more favorable effective exchange rate for such transactions. Out of these MCPs, we have now eliminated (i), (iii), and (vi) and plan to eliminate others when conditions allow.

- Alongside, since 2020, we had introduced new CFMs and tightened existing CFMs, including on payments outside of Sri Lanka from foreign currency deposit accounts during the pandemic and recent crisis.[1] Out of these, we have removed the surrender requirement for banks on purchases of export proceeds and inward worker remittances and since program approval, relaxed the CFMs related to outward remittances on capital transactions and outward transfers of funds for emigrants.

- While the mentioned import restrictions, exchange restrictions, MCPs and CFMs could help mitigate FX shortages in the near term, we believe they should not be a substitute for the comprehensive policy package and ongoing macroeconomic adjustment. We are committed to phasing these measures out as macroeconomic situation stabilizes. To this end, we have already revoked some of these restrictions, and are working on a plan for the phased removal of these measures during the program period, in line with our commitment at program approval, as we make progress with achieving macroeconomic stability, particularly with respect to the exchange rate, debt sustainability, and financial stability, improved market access prospects, and accumulation of reserves above critical levels.

- During the program period, we will not: (i) introduce or intensify exchange restrictions or multiple currency practices (MCPs); (ii) impose or intensify import restrictions for balance of payments purposes, or (iii) conclude any bilateral payment agreements inconsistent with Article VIII (**continuous performance criteria**).

VI. Ensuring Financial Stability

30. We are committed to ensuring a healthy and adequately capitalized banking system and addressing the significant vulnerabilities in the banking system. Banks face increasing credit risk in their private sector loan books, large exposures to the public sector, and the impact of the debt restructuring (including on their foreign exchange /Net Open Positions). Against this background:

- The CBSL hired two internationally reputable independent specialist firms without conflicts of interest to perform asset quality reviews (AQRs) based on a Terms of Reference agreed with IMF

[1] CFMs introduced or tightened since 2020 include: (i) a repatriation requirement for exports of goods and services; (ii) a surrender requirement for exporters on proceeds from exports of goods; (iii) a surrender requirement for banks on purchases of export proceeds; (iv) a surrender requirement for banks on purchases of inward worker remittances; (v) suspension of outward remittances on capital transactions; (vi) restrictions on purchases of Sri Lankan ISBs by local banks; (vii) restrictions on outward transfers of funds for emigrants.

staff. The diagnostic exercise by these two firms assessed the impact on banks' capital from asset quality deterioration, FX exposure and the sovereign default. The first round of AQRs was completed for five banks accounting for more than 70 percent of domestically-owned bank assets in May 2023, comprising the two largest state-owned banks and the three largest private sector banks. The second round of AQR covering the four smaller domestically-owned banks accounting for 20 percent of domestically-owned bank assets was completed in August 2023. To support the diagnostic exercise, the CBSL provided the assessors with guidance on the expected impact of debt restructuring on impairment. CBSL also stepped up its efforts to supervise banks' valuation, classification, and impairment practices for exposures to the sovereign and the broader public sector, and monitoring the liquidity position of banks and the regulatory compliance of loans which have benefited from moratoria and forbearance measures. The successful completion of AQRs has laid the foundation for designing a plan to recapitalize the banking sector.

- The CBSL will take appropriate action regarding banks unable to ensure their viability, beginning with intensifying supervision and imposing prompt corrective actions. In October 2023, the CBSL developed a roadmap for restructuring and recapitalization of the five large banks to address capital and FX liquidity shortfalls identified through the diagnostic exercise, forward-looking stress testing based on macro-financial scenarios, and domestic debt restructuring and intervene in banks assessed to be non-viable. To support compliance with the roadmap, the MOF will complete the restructuring related to SOE FX debt mainly comprising former CPC debt. The authorities have also developed a banks' recapitalization plan that include the size, timing, instruments, and terms and conditions for government recapitalization of viable banks which are unable to close capital shortfalls from private sources (**Prior Action)**. The five banks will submit time-bound plans for capital restoration and closure of their FX net open positions; the CBSL will define the content of these, review them to determine their credibility, and oversee their implementation. A similar process for recapitalization planning will be completed for the remaining four banks by end-February 2024 **(new SB)**. The CBSL will develop a roadmap by December 2023 and the authorities will develop the detailed recapitalization plan by February 2024.

- To effectively manage and minimize the impact of financial crises which are systemic in nature, we have established a Financial Sector Crisis Management Committee. The committee is chaired by the Governor and the Secretary to the Treasury will function as the Deputy Chairperson. The committee includes senior representatives from the MoF and the CBSL and has responsibility for crisis preparedness and management, in-crisis coordination, information-sharing and communication among the authorities.

31. The frameworks for financial sector supervision and crisis management will be strengthened. Parliament approved the Banking (Special Provisions) Act in July 2023 to strengthen key elements of the CBSL's crisis management powers, which are currently set out in the Banking Act. Amendments to the Banking Act that are consistent with IMF recommendations were approved in principle by Cabinet in June 2023 and the final approval by Cabinet is expected in

November 2023. The amendments to the Banking Act are expected to be approved by Parliament by January 2024 (**new SB**), with a view to implementing them by March 2024 **(new SB).** The Banking (Special Provisions) Act and amendments to the Banking Act will strengthen: (i) the resolution authority mandate of the CBSL, as well as powers, tools, and appropriate funding mechanisms for resolution of distressed financial institutions; (ii) the deposit insurance framework – including appropriate backstop funding arrangements from the government – and the regime for liquidation of banks; (iii) regulatory standards in areas including bank licensing, bank ownership, consolidated supervision, the capital and liquidity framework, large exposures and related party transactions, governance requirements, and recovery planning and early intervention powers; and (iv) regulation and supervision of state-owned banks (¶33). For non-bank deposit-takers the CBSL has already reduced regulatory arbitrage on non-performing loan classification and capital requirements. The review of the Banking Act and the Finance Business Act will take further steps to minimize regulatory arbitrage. In parallel, staffing of the Bank Supervision Department and the structure, staffing, and funding of the Resolution and Enforcement Directorate in the CBSL will be strengthened to ensure it is able to effectively carry out its expanded responsibilities. The CBSL updated its framework for provision of Emergency Loans and Advances (ELA) for banks in November 2022 and the new CBSL Act effected on September 15, 2023 enables a similar framework to be extended to other financial institutions regulated and supervised by CBSL; Liquidity provision to these Non-Bank Finance companies by the deposit insurance fund will be ended. These initiatives will closely follow international best practices and be developed in consultation with IMF staff.

32. We will strengthen the resilience and governance of state-owned banks. The government will include in the amendments of the Banking Act described in the previous paragraph provisions ensuring state-owned banks meet the same regulatory requirements as private banks, including on large exposures, related party lending, appointment of directors and key management personnel and governance, and binding time-bound transition periods for the reduction of existing large exposures. The cabinet will by end-June 2024 adopt and publish a framework prepared in consultation with IMF and WB staff to strengthen the governance of public banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience **(new structural benchmark)**. Clear mandates will be defined to ensure that state-owned banks are run at arm's length from the government, lend to SOEs on a commercial basis and within standard prudential limits on concentration risk and foreign currency lending, with supervision by the CBSL equivalent to its supervision of private banks.

VII. Reducing Corruption Vulnerabilities

33. We are committed to advance governance and anti-corruption reforms as a central pillar of our program. Based on the recommendations in the Governance Diagnostic report, published on September 30 we will develop and publish a Government Action Plan by February 2024 **(new structural benchmark)** to implement all priority recommendations, with special attention to the following areas to set the stage for broader reform agenda.

- **Anticorruption Legal Frameworks and Institutions**. The new AC Act significantly strengthens the asset declaration system and anti-corruption commission's investigative power but is still lacking adequate provision for the transparent and merit-based selection of the Commission members. To address the remaining gap, in line with the 21st Amendment to the Constitution, the Constitutional Council will develop rules for appointing Commission to Investigate Allegation of Bribery or Corruption (CIABOC) Commissioners that will establish an open and transparent process to ensure selected candidates meet the highest levels of professionalism, ethical conduct, and integrity. These rules for the selection process will be published in the Gazette by end-December **(new Structural Benchmark)**. The anti-corruption legal framework needs to be further strengthened with a more comprehensive asset recovery law by April 2024 in compliance with FATF standards and in consultation with the IMF **(new structural benchmark)**. Rapid operationalization of the AC Act will be critical to address current corruption vulnerabilities associated with the lack of mechanism to review and publish asset declarations by public officials, and to investigate and prosecute corruption cases. In this regard, we are committed to appointing commissioners to the CIABOC and publishing implementation plans for the AC Act by December 2023. The CIABOC will publish asset declarations for senior officials in line with AC Act by July 2024 **(new structural benchmark)**.

- **Tax Policy**. The Strategic Development Projects (SDP), Board of Investments (BoI), and Port City Acts currently grant a wide range of tax exemptions to some businesses with no specific or transparent criteria or process for the selection of projects benefiting from such exemptions. In order to minimize revenue losses and curb corruption risks under this set-up. We will also no longer provide tax exemptions or incentives and we will evaluate all tax incentives including weighing their benefits against their costs. We will also no longer approve new projects under the SDP Act as of December 2023 and the law will be amended only to accept new investment proposals upon the promulgation of explicit and transparent processes for evaluation of all proposals. We will also evaluate all existing SDP contracts and publish a report detailing the exemptions that have been provided and the value of all tax, regulatory, and other exemptions. We will also publish a list of all tax exemptions and tax benefits granted by the BoI or other government agencies, along with an estimation of the cost to the state of the favorable tax treatment. Should we consider new tax proposals to attract investments, we will consult with IMF prior to their implementation. We also commit to amend the tax legislation (in particular, the Special Commodity Levy) to impose further discipline on the ministerial authority to introduce tax policy changes without prior parliamentary approval by end-June 2024 and ensure that modifications that are permitted do not result in tax revenue losses.

- **Revenue Administration**. We plan to reduce corruption vulnerabilities in revenue collection from taxes, excises and customs that could arise from: (i) decentralized and discretionary tax policies favoring certain prioritized sectors and commodities, and (ii) lack of effective system for information sharing and performance monitoring to detect and sanction corrupt behaviors in revenue administration. The limited progress that has been made in digitizing processes in tax and customs requires high levels of direct interaction with officials and reduces the ability to identify integrity issues through data analytics. To address these issues, each revenue department will develop and launch a program of anti-corruption measures to strengthen internal oversight and sanctioning processes. Additionally, the IRD will fully implement a staff Code of Conduct by December 2023, followed by a public report on steps taken and results obtained by December 2024 and will strengthen information sharing between IRD and CIABOC. It will also develop and implement a simplified PIT return that can be filed via mobile phone technology by end-June 2024.

- **PFM**. We intend to tackle corruption associated with (i) political engagement in the public procurement selection, and (ii) limited oversight and transparency around the management of SOE operations. To reduce corruption vulnerabilities in procurement, we are committed to publishing on a semi-annual basis on a designated website by December 2023 **(new SB)** (i) all public procurement contracts above Rs. 1 billion, along with comprehensive information in a searchable format on contract award winners; (ii) a list of all beneficiaries receiving tax exemptions through the Board of Investment and the SDP, and an estimation of the value of the tax exemption; and (iii) a list of firms receiving tax exemptions on luxury vehicle import. We will also enact a Public Procurement Law by December 2024 that reflects international good practice and will coordinate with the WB to provide needed technical support. To address governance weaknesses in the management of state-owned enterprises, we will implement the State-Owned Enterprise Policy, including an explicit policy on the management of state financial assets, and ensure that all officers and directors of the State Holding Company and of individual SOEs are appointed in a rigorous, transparent, and merit-based process. We further commit to strengthening accountability and oversight by vesting with the Auditor General the authority to levy surcharges on officers, including Chief Accounting Officers, for failure to properly discharge responsibility for oversight and accountability of public resources.

- **Financial Sector Oversight**. With the amendments to the Banking Act (¶32), we will enhance the regulation and supervision of financial institutions' corporate governance, especially the assessment of board and senior management fitness, propriety, and effectiveness in line with international standards and best practices. In the meantime, the cabinet will adopt and publish a framework prepared in consultation with IMF and WB staff to strengthen the governance of public banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience by end-June 2024 **(new SB)**.

- **AML/CFT**. We will continue to strengthen our AML/CFT regime. With technical assistance from the World Bank, Sri Lanka updated the National ML/FT Risk Assessment (NRA), and the final report of the NRA was published on September 14, 2023. The AML/CFT National Policy for 2023-2028 developed based on the threats, vulnerabilities and risks identified in the NRA was approved by the Cabinet of Ministers on August 7, 2023, and has also been published. Further, we are strengthening the AML/CFT legal framework by introducing amendments to align with AML/CFT international standards. The Companies Act will be amended to strengthen the beneficial ownership provisions relating to legal persons, the only remaining non-compliant aspect of the FATF 40 Recommendations. Amendments are also being finalized for the Prevention of Money Laundering Act, the Convention on Suppression of Terrorist Financing Act, the Financial Transactions Reporting Act, and the Voluntary Social Service (Registration and Supervision) Act. Besides, risk-based AML/CFT supervision is being strengthened through regular supervision of financial institutions and designated non-finance businesses and professions and joint supervisory activities via other regulatory bodies (BSD, SNBFI, SEC & IRCSL). We will conduct AML/CFT risk-based supervision focusing on compliance by reporting entities with beneficial ownership requirements and enhanced due diligence measures for politically exposed persons. We will also strengthen the use of financial intelligence to identify potential corruption activities and the cooperation between FIU, law enforcement, and Commission to Investigate Allegations of Bribery or Corruption (CIABOC) to facilitate parallel investigations and prosecutions. We will leverage the support from our development partners in these key reform areas. We will strengthen the institutional framework of the FIU by providing adequate resources.

VIII. Advancing Growth-Enhancing Structural Reforms

34. Our growth-enhancing reform agenda will focus on key areas critical for unlocking Sri Lanka's growth potential. Our commitments in the near-term focus on stabilizing the macro economy and restoring debt sustainability. Later in the program we will develop an agenda of structural reforms designed to allow Sri Lanka to reach its full potential.

- We are fully committed to trade liberalization, which is critical for attracting investment and boosting productivity growth. We have adopted regulations to rationalize the para-tariffs and will carefully implement the plan with due consideration given to its revenue implications and be complemented with measures to support local businesses in enhancing their competitiveness. We will pursue further trade reforms with technical assistance from development partners.

- To improve the resilience of the external sector, we will implement a National Export Strategy while expediting negotiations of Free Trade Agreements and entry into regional trade blocs. Initiatives are also planned to improve the competitiveness of Sri Lanka's exports while enabling the positioning in Global Value Chains. Initiatives to develop the industry sector to cater to both domestic and global markets are in train. We will also implement comprehensive strategies to transform the IT/BPO and Tourism sectors to key service exports.

- As part of initiatives to improve productivity across the economy, reforms to the public sector are also to be undertaken. We will expedite measures in relation to the digitalization of government services; upskilling and reskilling of public sector workers; auditing of government institutions; commitment to create a public sector that is free of corruption, fraud and malpractices.

- In light of low labor productivity, stemming from poor relevance of existing human capital base, labor market rigidities and a large gender gap in employment, labor market reforms under the program will be geared towards improving the quality and quantity of labor, including promoting female labor force participation. This will also serve as an effective counterforce to the negative impact of population aging on labor supply. In this regard, we will develop a comprehensive and actionable strategy, which can include reforms to: (i) labor laws to improve labor market flexibility (ii) the education sector to improve labor productivity and to close gender gaps (iii) promote financial inclusion including through credit guarantee schemes supporting female entrepreneurs, (iv) upgrade public transport infrastructure, and (v) increase quantity, quality and affordability of child and elderly care facilities. We are also committed to steadfast implementation of these committed reforms. Sri Lanka is committed to urgently addressing climate-related vulnerabilities considering its far-reaching implications on the agriculture sector, especially the direct impacts on the livelihoods and overall food security. Recently, the severity and frequency of climate-related disasters has intensified, underscoring the pressing need to find immediate solutions. Efforts are underway to enhance electricity generation from renewable energy, led by annual additions of solar and wind capacity. Private sector financing and multilateral financing are expected to help meet the envisaged annual investment in this regard. Sri Lanka will also proactively engage with multilateral partners to build the technical capacity to catalyze the rapid implementation of climate mitigation and adaptation efforts.

- With the support of development partners, we will embark on broader reforms to address growth impediments, including impediments to private investment; the large role of the public sector in the economy; an inefficient electricity sector; and climate change. Reforms could be targeted to facilitate investment by reducing red tape and modernizing the regulatory and doing business environment; reducing electricity cost by improving the generation mix and electricity distribution efficiency; reducing the government's and SOEs' role in the economy to enable a more efficient allocation of resources, foster competition, and boost productivity; and strengthening climate change adaptation, including through contingency budget and insurance scheme for natural disasters.

IX. Program Risks and Contingency Planning

35. We stand ready to deploy contingency measures should downside risks materialize. Risks to program implementation are high, given adverse initial conditions, a complex debt restructuring with a potential for delays, and large downside risks to the program baseline scenario:

- A delay in concluding debt restructuring negotiations with creditors could suspend Sri Lanka's much needed access to the financial support from IFIs, causing a deeper and prolonged BOP crisis. We will intensify our engagement with creditors to accelerate the debt restructuring negotiations and minimize this risk. We also commit to stay current on our payments to the IMF and Multilateral Development Banks.

- In the near term, the lack of macroeconomic policy space severely hampers our ability to address the downside risks vis-à-vis the baseline. Signs of sustained increases in inflation and de-anchored inflation expectations would need to be addressed by a tighter monetary policy stance than envisaged under the baseline. We will ensure that monetary policy remains prudent and tuned to inflation risks stemming from economic uncertainties.

- The stresses due to banks' net open positions may affect bank solvency and also create significant FX market pressure. In order to avoid a situation where banks crowd the FX market to close net open positions all together, we will work on a plan in the banking sector roadmap for an orderly resolution to bank capital and NOP issues after the debt restructuring is executed.

- Any program underperformance will be corrected by remedial measures. We will ensure that possible further revenue shortfalls are mitigated by enhanced revenue administration and enforcement, and through targeted spending cuts as a last line of defense instead of depending solely on capital expenditure reductions. Slippages in the reserves buildup relative to targets would require the introduction of explicit FX intervention rules to avoid hindering needed exchange rate adjustment. Delays in key structural reforms should be avoided to allow program reviews to conclude as scheduled. Finally, program overperformance resulting from better-than-expected outturns should be locked in to the extent possible, to assure achieving the program objectives.

X. Program Monitoring and Safeguards

36. Our program will be subject to semiannual reviews with performance criteria, the MPCC bands, and indicative targets set out in Table 1 attached to this MEFP and Technical Memorandum of Understanding (TMU). Completion of the second and third reviews will require observance of the quantitative performance criteria for end-December 2023 and end-June 2024, respectively, as well as continuous performance criteria, as specified in Table 1 attached to this MEFP. The reviews will also assess progress toward observance of the structural benchmarks specified in Table 2 attached to this MEFP. The second and third reviews of the program will take place on or after April 1 and October 1, 2024, respectively. We continue to request the use of IMF financing for budget support, and, in this respect, we finalized a Memorandum of Understanding between the CBSL and the Ministry of Finance on responsibilities for servicing financial obligations to the IMF. We also recognize the importance of the safeguards assessment of the Central Bank which was finalized in February 2023. The recently passed CBA would serve to address some of the identified safeguards issues, and the CBSL has initiated steps to implement other safeguards recommendations.

37. With regards to program conditionality, we also request that the Executive Board grants:

- **Waiver of nonobservance of the PC on arrears**, which was temporary. This QPC was missed due to heightened liquidity shortages which have eased somewhat with external financing disbursements, improvements in tax collection and better domestic financing conditions. We have been able to clear all outstanding arrears by end-September 2023.

- **MPCC Consultation**. Inflation breached the end-June lower outer MPCC band. We request that the Board completes the required consultation.

- **Modification of End-2023 Quantitative Targets**. We request the following for end-2023 targets: (i) an upward revision in the QPC for NCG from Rs. 2,740 bn to Rs. 2,800 billion (¶25) to address structural liquidity shortages, (ii) a resetting of the MPCC clause at a lower mid-point of 5 percent relative to 15 percent at program approval to account for faster disinflation (¶24), (iii) a downward revision of the IT on central government tax revenue from Rs. 2,940 billion to Rs. 2,550 billion to account for the slower-than-envisaged revenue mobilization (¶5) and (iv) an increase in the IT on the limits on treasury guarantees from Rs. 1,700 billion to Rs. 2,100 billion to account for the guarantee of the Special Swap Agreement of about US$2.6 billion between the CBSL and the Reserve Bank of India to restructure the outstanding liabilities under the Asian Clearing Union (ACU) agreement (including past due interest) and Bilateral SAARC Swap Agreement, which will be repaid through monthly installments over the next 3 years. (¶6).

- **New Proposed Quantitative Targets**. To reinforce our commitment to refrain from monetary financing, we agree to the new continuous QPC on new CBSL purchases of government securities in the primary market as of December 2023. To underline our commitment to revenue mobilization, we agree to upgrade the existing IT on the tax revenue floor to QPC as of June 2024.

- **Rephasing of Access**. Finally, we request revising the availability dates by one month to October 1 and April 1 to better align the schedule with data availability for end-June and end--December test dates.

- We also request completion of the financing assurances review.

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

(Cumulative from the beginning of the year to the end of the period, unless otherwise noted)

	2022	2023														2024		
	end-Dec.	end-Mar				end-June				end-Sep				end-Dec.		end-Mar	end-June	end-Sep
	Actual	IT	Adj. IT	Act/Prel.		QPC	Adj. PC/IT	Act/Prel.		IT	Adj. IT	Act/Prel.		PC/IT (Orig.)	PC/IT (Prop.)	IT	Proposed PC/IT	Proposed IT
Quantitative performance criteria																		
Central government primary balance (floor, in billion rupees)	-895	-56	-56	48	Met	-113	-113	31	Met	-160	-160	124	Met	-209	-209	70	140	220
Program net official international reserves (Program NIR, floor, end of period stock, in million US$) 1/ 2/	-3,540	-3,188	-3,424	-2,956	Met	-2,830	-2,901	-1,918	Met	-2,068	-2,772	-2,492	Met	-1,592	-1,592	-2,035	-1,810	-1,524
Net credit to the government of the CBSL (ceiling, end of period stock, in billion rupees) 3/	2,834	2,890	2,890	3,020	Not Met	2,890	2,890	2,800	Met	2,840	2,840	2,838	Met	2,740	2,800	2,800	2,720	2,560
Stock of expenditure arrears of the central government (ceiling, in billion rupees)	60	30	30	0	Met	0	0	34.5	Not met	0	0	0	Met	0	0	0	0	0
Proposed central government tax revenue (floor, in billion rupees)																750	1,500	2,400
Continuous performance criteria (cumulative from beginning of the program)																		
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	0	0		0	0	0	Met	0	0	0	Met	0	0	0	0	0
Proposed CBSL purchases of government securities in the primary market	...	...	...	...		...	...	...		...					0	0	0	0
Monetary policy consultation clause																		
Year-on-year inflation in Colombo Consumers Price Index (in percent) 4/																		
Outer band (upper limit)	...	55.0	55.0	...		34.0	34.0	...		20.0	8.0	...		18.0	8.0	8.0	8.0	8.0
Inner band (upper limit)	...	53.5	53.5	...		32.5	32.5	...		18.5	6.5	...		16.5	6.5	6.5	6.5	6.5
Actual / Center point	58.6	52.0	52.0	50.9	Met	31.0	31.0	23.4	Not met	17.0	5.0	3.8	Met	15.0	5.0	5.0	5.0	5.0
Inner band (lower limit)	...	50.5	50.5	...		29.5	29.5	...		15.5	3.5	...		13.5	3.5	3.5	3.5	3.5
Outer band (lower limit)	...	49.0	49.0	...		28.0	28.0	...		14.0	2.0	...		12.0	2.0	2.0	2.0	2.0
Indicative targets																		
Central government tax revenue (floor, in billion rupees)	1,751	650	650	578	Not met	1,300	1,300	1,199	Not met	2,100	2,100	1,934	Not met	2,940	2,550			
Social spending by the central government (floor, in billion rupees)	142	35	35	48	Met	70	70	96	Met	120	120	126.5	Met	187	187	50	100	150
Cost of non-commercial obligations (NCOs) for fuel and electricity (net of government transfers) (ceiling, in billion rupees) 5/	...	0	0	0	Met	0	0	0	Met	0	0	0	Met	0	0	0	0	0
Treasury guarantees (ceiling, in billion rupees)	1,181	1,700	1,700	1,074	Met	1,700	1,700	1,024	Met	1,700	1,700	1,050	Met	1,700	2,100	2,100	2,100	2,100

1/ The CBSL's conventional definition of net official international reserves (NIR) includes outstanding liabilities in foreign exchange swaps with domestic commercial banks. The Program NIR excludes the outstanding liabilities in foreign exchange swaps with domestic commercial banks from the CBSL's conventional NIR definition. See TMU for details.

2/ Program NIR will be adjusted upward/downward by the cumulative amounts of (i) foreign program financing by the central government, (ii) net borrowings from SLDBs and FCBUs by the central government in FX terms, (iii) external commercial loans (including Eurobonds and syndicated loans) by the central government, (iv) the amount of project loans and grants' FX cash flows, and (v) proceeds from commercialization of public assets to non-residents, that are higher/lower than assumed under the program; and by the cumulative amounts of (vi) amortization of total external debt of the central government (excl.IMF), (vii) interest payments on total external debt of the central government, plus 2024 onward, interest payments on total external debt of CBSL (excl. IMF), (viii) interest payments on SLDBs and FCBUs by the central government in US dollar terms, and (ix) amortization and interest payments in FX for restructured CPC loans, that are lower/higher than assumed under the program. See TMU for details.

3/ Excludes holdings of treasury securities for monetary policy purposes and Rupee-denoimated government deposits. See TMU for details on the calculation for the test date.

4/ See the TMU for how to measure year-on-year inflation.

5/ NCOs refer to the obligation of CPC and CEB to supply fuel and electricity at administered prices. See TMU for how to measure the cost of NCOs.

Sources: Authorities; and IMF Staff.

Table 2. Sri Lanka: Structural Benchmarks		
	Date	**Status**
Fiscal, SOE, and Social Safety Net Reforms		
Set retail fuel prices to their cost-recovery levels with monthly formula-based adjustments, and compensate the CPC for providing any fuel subsidies with on-budget transfers	Continuous	Met
Adjust the end-user electricity tariff schedule to its cost-recovery level (overall across different types of final consumers) with semi-annual formula-based adjustments on a forward-looking basis in January and July each year (effective from January 1 and July 1, respectively); the CEB submits tariff revision requests to the Public Utility Commission of Sri Lanka by end-October (for January tariff revisions) and by end-April (for July tariff revisions); and compensate the electricity sector for providing any residual subsidies with on-budget transfers.	Continuous	Met
Parliamentary approval of the welfare benefit payment scheme and the application of the new eligibility criteria to identify low-income families for receiving welfare benefit payments.	End-May 2023	Met (Parliament approved on May 12)
Cabinet approval of a comprehensive strategy to restructure the balance sheets of the CEB, CPC, Sri Lankan Airlines, and the Road Development Authority, in consultation with IMF staff	End-June 2023	Met
Cabinet approval of revenue measures to support fiscal consolidation during 2024, in line with program parameters	End-July 2023	Not met To be adopted as a prior action
Completion of the rollout of the ITMIS, expanding its coverage to all 220 heads (national budget execution agencies)	End-September 2023	Not met Expected to be met by end-March 2024
Submission to Parliament for the first reading of the 2024 Appropriation Bill that is in line with program parameters	End-October 2023	Met
Submission to Parliament of a new PFM law, in consultation with IMF staff, that will authorize the budget formulation process, roles and responsibilities of relevant agencies, and information and accountability requirements	End-December 2023	Postponed
Parliamentary approval of the 2024 Appropriation Act and the spending allocations in line with program parameters	End-December 2023	

Table 2. Sri Lanka: Structural Benchmarks (continued)		
	Date	**Status**
Improve the BSTA to accurately measure the electricity subsidy and start using it to determine the cost-recovery based electricity tariff and government transfer requirement.	End-December 2023	
Newly Proposed and Reformulated		
Prior Actions		
Cabinet approval of quarterly revisions of electricity tariffs, starting in 2024		Met
Cabinet approval of the package of revenue measures (paragraph 8)		Met
SBs		
Maintain cost-recovery level of the end-user electricity tariff schedule (overall across different types of final consumers) with quarterly formula-based adjustments, on a forward-looking basis in January, April, July and October each year (effective from January 1, April 1, July 1, and October 1 respectively); the CEB submits tariff revision requests to the Public Utility Commission of Sri Lanka by end-October (for January tariff revisions), end-January (for April tariff revisions), end-April (for July tariff revisions) and end-July (for October tariff revisions); compensate the electricity sector for providing any residual subsidies with on-budget transfers; and use tariff surcharges in the interim, in case CEB is making losses	Continuous	
Create and implement within the LTU a HNWI unit and a design and monitoring unit that includes a strengthened Risk Management Unit	End-December 2023	
Obtain Cabinet approval of a reduction in the limit on government guarantees to 7.5 percent of GDP	End-December 2023	
Submission to Parliament of a new PFM law, based on IMF TA, that will authorize the budget formulation process, roles and responsibilities of relevant agencies, and information and accountability requirements	End February 2024	
Obtain Cabinet approval of the fiscal strategy statement (FSS) containing a medium-term fiscal framework (MTFF).	End-June 2024	
Cabinet approval of revenue measures requiring legislative amendments to support fiscal consolidation during 2025, in line with program parameters	End-September 2024	

Table 2. Sri Lanka: Structural Benchmarks (continued)		
	Date	**Status**
Obtain Cabinet approval of a strategy to build a VAT refund system and achieve a full repeal of SVAT, with timeline and intermediate steps	End-December 2023	
Introduction, tracking and reporting quarterly KPIs of tax compliance	End-March 2024	
Monetary, exchange rate and external sector policies		
SBs		
Parliamentary approval of the new CBA prepared in consultation with IMF staff	End-April 2023	Not met (Implemented with delay on July 21, 2023, long transitory arrangement is remedied with a new continuous PC)
Financial sector		
Completion of the AQR component of bank diagnostic exercise for the two largest state-owned banks and the three largest private sector banks	End-April 2023	Not met (Implemented with delay in mid-May)
Cabinet approval of a full revision of the Banking Act in consultation with IMF staff	End-June 2023	Not met (In progress, reformulated and merged with SB on parliamentary approval by end-January 2024)
Development by the CBSL of a roadmap for addressing banking system capital and FX liquidity shortfalls and intervening in banks assessed to be non-viable.	End-July 2023	Not met (Met with delay on October 10)
Determination by the government of the size, instruments, and terms and conditions for potential government recapitalization of viable banks are unable to close capital shortfalls from private sources.	End-October 2023	Met on October 31, 2023
Parliament approval of a full revision of the Banking Act in consultation with IMF Staff	End-December 2023	Reformulated into SB on amendments by end-January 2024

Table 2. Sri Lanka: Structural Benchmarks (continued)		
	Date	**Status**
Newly Proposed and Reformulated		
Prior Actions		
Determination by the authorities of the size, instruments, and terms and conditions for potential government recapitalization of viable banks among the five large banks which are unable to close capital shortfalls from private sources.		Met on October 31, 2023
SBs		
Parliamentary approval for the amendments to the Banking Act consistent with IMF recommendations in MEFP in March 2023.	End-January 2024	
Government and CBSL to develop a detailed recapitalization plan for the remaining four banks	End-February 2024	
Implementation of the amendments to the Banking Act.	End-March 2024	
Governance		
Enact new anti-corruption legislation to harmonize it with the United Nations Convention Against Corruption, in consultation with IMF staff consistent with MEFP.	End-June 2023	Not met. (Implemented with delay on July 19, lacks transparent and merit-based selection process, remedied by new SB in ¶33)
Publication of the Governance Diagnostic report.	End-September 2023	Met
Newly Proposed		
SBs		
In line with requirements under the 21st Amendment to the Constitution, the Constitutional Council will develop rules for appointing CIABOC Commissioners that will establish an open and transparent process to ensure selected candidates meet the highest levels of professionalism, ethical conduct, and integrity. These rules will be published in the Gazette by end-December.	End-December 2023	
Publish on a semi-annual basis on a designated website (i) all public procurement contracts above Rs. 1 billion, along with comprehensive information in a searchable format on contract award winners; (ii) a list of all firms receiving tax exemptions through the Board of Investment and the SDP, and an estimation of the value of the tax exemption; and (iii) a list of firms receiving tax exemptions on luxury vehicle import.	End-December 2023	

Table 2. Sri Lanka: Structural Benchmarks (concluded)		
	Date	**Status**
Publication of a government action plan for implementing recommendations in the Governance Diagnostic report.	End-February 2024	
Enact a comprehensive Asset Recovery Law to harmonize it with the United Nations Convention Against Corruption, in consultation with IMF staff.	End-April 2024	
Cabinet approval and publication of a framework prepared in consultation with IMF [and WB] staff to strengthen the governance of public banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience.	End-June 2024	
The operationalized Anticorruption commission shall publish asset declarations for senior officials in line with Anticorruption Act.	End-July 2024	
Sources: IMF Staff		

Appendix I. Tax Reforms to be Implemented for 2023-25[1]

	To take effect on or before:
Income Tax	
Remove CIT exemptions on exports of IT services	April 1, 2025
Start estimating and publishing the direct costs imposed by tax incentives granted under the Strategic Development Projects and Board of Investment Acts.	January 1, 2024
Excise Duties	
Introduce automatic indexation of all excises to inflation.	January 1, 2024
Property, Wealth, and Wealth Transfer Taxes	
Introduce a nationwide real property tax including a review of related fiscal transfers, requesting technical assistance as needed.	January 1, 2025
Introduce a gift and inheritance tax with a tax-free allowance and minimal exemptions.	January 1, 2025

[1] See the IMF's 2022 TA report "Sri Lanka: Revenue-Raising Tax Policy Reform Options" for detailed discussions of the tax reforms.

Appendix II. KPIs for Inland Revenue – Quarterly Targets Under EFF

KPI	Baseline	March 2024 Target	June 2024 Target	September 2024 Target	December 2024 Target
KPI-1.1: Risk Based Audit Shift to data-driven, risk-based audit case selection and assignment, away from discretion-based selection by auditor and/or supervisor.	No cases are currently selected on a systematic, data-driven, risk basis.	10 LTU cases selected in Q1	20 new LTU cases selected in Q2	30 new LTU cases selected in Q3, & 2 percent of new non-LTU cases selected during Q3	40 new LTU cases selected in Q3, & 5 percent of new non-LTU cases in Q4
KPI-1.2: Audit Effectiveness. The strike rate is the percent of completed audit cases that resulted in an adjustment that increased the tax liability by [XX] percent or more than the taxpayer's self-declared.	Baselines currently unknown and must be determined using historic data for different taxpayer segments: large, upper corporate, medium corporate.	No Target	No Target	TBD after EFF Second Review	TBD after EFF Second Review
KPI-2.1: Tax Return Filing Compliance of Large Taxpayers This is the percentage of expected tax	From 2023 TADAT Assessment (P4.12): On-Time CIT Filing: 93.4 percent On-Time VAT Filing: 82.6 percent	85 percent of VAT returns on-time	87 percent of VAT returns on-time & 90 percent of PAYE returns on-time	89 percent of VAT returns on-time	91 percent of VAT returns on-time & 95 percent of CIT returns on-time

KPI	Baseline	March 2024 Target	June 2024 Target	September 2024 Target	December 2024 Target
returns from large taxpayers by the due date: (1) VAT – one-month after monthly or quarterly deadline; (2) PAYE by April 30; (3) CIT by November 30	Only baseline for PAYE is 23.6 percent but covers all employers not just under LTU control.				
KPI-2.2: Tax Return Filing Compliance of Non-Large Taxpayers This is the percentage of expected tax returns from non- large taxpayers by the due date.	From 2023 TADAT Assessment (P4.12): On-Time CIT Filing: 32 percent On-Time VAT Filing: 45.5 percent PAYE Filing: 23.6 percent.	48 percent of VAT returns on-time	52 percent of VAT returns on-time & 60 % of PAYE returns on-time	56 percent of VAT returns on-time	60 percent of VAT returns on-time & 50 percent of CIT returns on-time
KPI-2.3: Electronic Filing of Individual Income Tax (IIT) Returns First three quarters will reflect 2022/23 IIT returns, Q4 will reflect 2023/24 IIT return.	From 2023 TADAT assessment (P4.14): 23 percent of IIT returns filed electronically in 2021	30 percent filed electronically	35 percent filed electronically	40 percent filed electronically	50 percent filed electronically

KPI	Baseline	March 2024 Target	June 2024 Target	September 2024 Target	December 2024 Target
KPI-3.1: Management of Collectible debt Collectible debt is that portion of arrears owed to IRD that is not subject to dispute and where there is no legal impediment to collection action.	From 2023 TADAT assessment (P5.18): At end of 2021, ratio of collectible debt to annual collections was 13.75 percent, but deteriorated to 15.4 percent by end-2022.	Collectible debt is not above 15 percent of 2024 revenue target	Collectible debt is not above 14 percent of 2024 revenue target	Collectible debt is not above 13 percent of 2024 revenue target	Collectible debt is not above 12 percent of 2024 revenue target
KPI-4.1: VAT Registration	The registered VAT population was nearly 29,000 before the 2019 changes and has fallen to 12,000. IRD seeks to rebuild VAT and SSCL taxpayer base to 20,000 by end-2024	14,000 active VAT and SSCL registered taxpayers	16,000 active VAT and SSCL registered taxpayers	18,000 active VAT and SSCL registered taxpayers	20,000 active VAT and SSCL registered taxpayers

Attachment II. Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out a framework for monitoring the performance of Sri Lanka under the program supported by the Extended Arrangement under the Extended Fund Facility (EFF). It specifies the performance criteria and indicative targets (including adjustors) under which Sri Lanka's performance will be assessed through semiannual reviews. Monitoring procedures and reporting requirements are also specified.

2. The quantitative performance criteria and indicative targets specified in Table 1 attached to the Memorandum of Economic and Financial Policies (MEFP) are listed as follows.

a) a quantitative performance criterion on central government primary balance (floor);

b) a quantitative performance criterion on central government tax revenue (floor);

c) a quantitative performance criterion on the stock of expenditure arrears of the central government (ceiling);

d) a quantitative performance criterion on net official international reserves (floor);

e) a quantitative performance criterion on the CBSL's net credit to the government (ceiling);

f) a continuous quantitative performance criterion on new external payment arrears of the nonfinancial public sector and the CBSL (ceiling);

g) performance criterion on new CBSL's purchases of government securities in the primary market;

h) a monetary policy consultation clause;

i) an indicative target on social safety net spending (floor);

j) an indicative target on cost of non-commercial obligations for fuel and electricity (net of government transfers) (ceiling); and

k) an indicative target on treasury guarantees (ceiling).

3. Throughout this TMU, the central government is defined to include line ministries, departments, and other public institutions. The Central Bank of Sri Lanka (CBSL), state-owned enterprises, parastatals and other agencies that do not receive subventions from the central government are excluded from the definition of central government. Debt is defined in accordance with paragraph 8 of the Guidelines on Public Debt Conditionality in Fund Arrangements attached to Executive Board Decision No. 16919-(20/103), adopted October 28, 2020.

I. PERFORMANCE CRITERIA

A. Performance Criterion on Central Government Primary Balance

4. Unless otherwise specified, all definitions follow the GFSM1986. The primary balance of the central government on cash basis is defined as central government revenues and grants minus expenditures and net lending, plus interest payments. The proceeds from privatization or commercialization of public assets to residents or non-residents (as defined in paragraph 10) will not be recorded as part of central government revenues. Spending will be recorded in the period during which cash disbursements are made.

5. For the purpose of program monitoring, the primary balance of the central government on cash basis will be measured as the overall balance of the central government plus the interest payment of the central government. The overall balance of the central government is measured from the financing side, as the negative of the sum of the items listed below. Here, net borrowings refer to gross disbursements minus principal repayments. For 2022, the primary balance of the central government on cash basis measured in this manner was minus Rs 895 billion (the overall balance was minus Rs. 2,460 billion and the interest payment was Rs 1,565 billion).

a) Net borrowings from issuances of Treasury Bills, Treasury Bonds, and loans in local currency. In 2022, the total amount of such net borrowings was Rs. 3,610 billion.

b) Net decreases in the balances (deposits minus overdrafts) of the central government in the banking system. In 2022, the total amount was Rs. minus 814.5 billion (an increase in bank balances).

c) Net increases in CBSL advances, net of changes in central government deposits at the CBSL. In 2022, the total amount was Rs. minus 85 billion.

d) Net borrowings from Sri Lankan Development Bonds (SLDBs) and domestic loans in foreign currency. In 2022, the total amount was Rs minus 461 billion.

e) Commercial borrowings issued under foreign law, including international sovereign bonds and syndicated loans. In 2022, the total amount was Rs 0 billion.

f) Net borrowings from official project and program loans and trade credit lines. In 2021, the total amount was Rs 535 billion.

g) Net borrowings from all other bonds, loans, and advances contracted by the central government. In 2022, the total amount was Rs minus 2.9 billion.

h) Proceeds from privatization or commercialization of public asset to residents and nonresidents. In 2022, the total amount was Rs 0 billion.

6. For the purpose of program monitoring, the government's equity injections into banks for recapitalization purposes will not be recorded as central government expenditure. Accordingly, the primary balance as defined in paragraph 5 will be reduced by the amounts transferred to banks. By contrast, the government's equity injections into other corporations (both private and state-owned) will be recorded as central government expenditure, consistent with GFSM 1986. Accordingly, the primary balance as defined in paragraph 5 will not be reduced by the amounts transferred to other corporations. Net lending by the government is recorded as a government expenditure, in line with GFSM1986. For example, funds lent by the government to CPC in 2022 related to fuel credit lines from India are recorded above the line (increasing the deficit). A repayment in 2023 and 2024 will similarly be recorded above the line (reducing the deficit).

B. Performance Criterion on the Stock of Expenditure Arrears of the Central Government

7. Expenditure arrears of the central government are defined as: (i) any invoice that has been received by a spending agency of the central government from a supplier of goods, services, and capital goods delivered and verified, and for which payment has not been made within the contractually agreed period (taking into account any applicable contractual grace period), or in the absence of a grace period, within 3 months after the due date; and (ii) wages, pensions, or transfers expensed by the central government, for which payment has been pending for longer than 3 months to domestic or foreign residents.

C. Performance Criterion on Central Government Tax Revenue

8. Central government tax revenue refers to revenues from taxes collected by the central government. It excludes all revenues from asset sales, grants, and non-tax revenues. The revenue target is calculated as the cumulative flow from the beginning of the year. For 2022, central government tax revenue defined in this manner was Rs 1,751 billion.

D. Performance Criterion on Net Official International Reserves

9. For the purpose of program monitoring, the stock of net official international reserves (NIR) will be measured as the difference between (a) and (b) below, and will be called the "Program NIR." On January 3, 2023, the Program NIR, evaluated at market exchange rates, stood at minus US$3,524 million. The Program NIR at the test dates will be evaluated at the program exchange rates and gold price specified in paragraph 9. On January 3, 2023, the Program NIR, evaluated at the program exchange rates, stood at minus US$3,520 million.

a) The CBSL's conventional definition of the NIR, which is the sum of (i) the difference between the gross foreign assets and liabilities of the CBSL and (ii) the balance of State Treasury's (DSTs) Special Dollar, Japanese Yen, and Chinese Yuan Revolving accounts, both expressed in terms of market values. Gross foreign assets of the CBSL consists of monetary gold; foreign exchange balances held outside Sri Lanka; foreign securities (valued in market prices); foreign bills purchased and discounted; the reserve position at the IMF and SDR holdings; and the Crown Agent's credit balance. Foreign exchange balances, securities, and bills denominated in Chinese Yuan, including the assets held under the People's Bank of China (PBOC) swap arrangement, are part of the gross foreign assets of the CBSL. Excluded from gross foreign assets will be participation in international financial institutions; holdings of nonconvertible currencies;[1] holdings of precious metals other than monetary gold; claims on residents (e.g., statutory reserves on foreign currency deposits of commercial banks and central bank foreign currency deposits with resident commercial banks); pledged, non-liquid, collateralized or otherwise encumbered foreign assets (such as the government's war risk insurance deposit with Lloyds during 2001/02; except for assets held under the PBOC swap arrangement); claims on overseas subsidiaries of domestic commercial banks and claims in foreign exchange arising from derivative transactions (such as futures, forwards, swaps and options). Gross foreign liabilities are all foreign currency denominated liabilities of the CBSL to non-residents (including currency swap arrangements with foreign central banks); the use of Fund credit (including for budget support purposes); and Asian Clearing Union debit balance. Commitments to sell foreign exchange to residents arising from derivatives such as futures, forwards, swaps, and options, such as commitments arising from currency swaps with domestic commercial banks, are not included in the gross foreign liabilities. DST accounts are foreign currency accounts held by the Treasury and managed by the CBSL as an agent of the government. On January 3, 2023, the NIR as per the CBSL's conventional definition, evaluated at market exchange rates, stood at minus US$3,222 million.

b) The CBSL's outstanding liabilities (i.e., net short positions) in foreign exchange swaps with domestic commercial banks, which stood at US$302.4 million on January 3, 2023.

10. For the purpose of measuring the Program NIR, all foreign-currency related assets and liabilities will be converted into U.S. dollar terms at the exchange rates prevailing on January 3, 2023, as specified in Table 1. Monetary gold will be valued at US$1,831.615 per troy ounce, which was the price prevailing on January 3, 2023 as per CBSL.

[1] Convertible currencies include the currencies of the SDR basket (U.S dollar, U.K pound, Japanese yen, Chinese yuan, Euro) as well as Canadian dollar, Australian dollar, and Swiss franc.

Table 1. Sri Lanka: Program Exchange Rates
(Rates as of January 3, 2023)

Currency	Units of Currency per 1 US dollar
Sri Lanka rupee	363.11
British pound	0.838012
Japanese yen	132.650000
Canadian dollar	1.365800
Euro	0.948317
Chinese yuan	6.892800
Australian dollar	1.497006
Swiss franc	0.939650
SDR	0.752014
Memorandum:	
Gold price, US$/oz	1831.62

Source: IMF, CBSL
Note: JPY and AUD rates as of December 23, 2022

The Following Adjustment Will Apply:

11. If (i) the amount of foreign program financing (exclusive of EFF disbursements) by the central government, (ii) the amount of net borrowings from SLDBs and FCBUs by the central government in FX terms, (iii) the amount of external commercial loans (including international sovereign bonds and syndicated loans) borrowed by the central government, (iv) the amount of project loans and grants disbursed as FX cash flows to the central government, and (v) proceeds from commercialization of public assets to non-residents—as set out in Table 2a. or 2b.—are higher/lower in U.S. dollar terms than assumed under the program, the floor on the program NIR will be adjusted upward/downward by the maximum of the cumulative differences on the test date and the caps on the adjustors as specified. The proceeds from commercialization of public assets are defined as cash receipts from the sale or lease of publicly held assets. Such assets will include, but not be limited to, publicly held land, public holdings of infrastructure or commercial real estate, and public or quasi-public enterprises. These adjustors will apply to the NIR floor for end-December 2022 and thereafter.

12. If the sum of amortization of total external debt and interest payments on total external debt owed by the central government (excluding IMF) in U.S. dollar terms (starting 2024 the interest payments adjustor will also include external interest payments by the CBSL excl. IMF), as well as the sum of interest payments on SLDBs and FCBUs by the central government in U.S. dollar terms—as set out in Table 2a. or 2b.—is higher/lower than assumed under the program, the floor on the Program NIR will be adjusted downward/upward by the cumulative differences on the test date. Total external debt refers to external debt owed by the central government to all foreign creditors (excluding IMF), as defined in the *2013 External Debt Statistics: Guide for Compilers and Users*. These adjustors will apply to the NIR floor for end-December 2022 and thereafter.

Table 2a. Sri Lanka: Program Assumptions (2023)

(Cumulative from the beginning of each calendar year, in million US$)

	Mar. 2023	Jun. 2023	Sep. 2023	Dec. 2023
Foreign program financing of the central government	0	330	750	900
Net borrowings from SLDBs and FCBUs by the central government in FX terms	0	0	0	0
External commercial loans (including Eurobonds and syndicated loans) by the central government	0	0	0	0
Proceeds from commercialization of public assets to non-residents	0	0	0	0
Amortization of total external debt owed by the central government (excl. IMF)	239	778	877	989
Interest payments on total external debt owed by the central government (excl. IMF)	47	107	337	568
Interest payments on SLDBs and FCBUs by the central government in US dollar terms	0	0	0	0
Project loans and grant FX cash amounts disbursed to the central government	219	548	876	1,204

13. The adjustor on the amount of project loans and grants disbursed as FX cash flows to the central government will be capped at US$1.15 billion in 2023, and at US$250 million in 2024. The 2024 adjustor on amortization and interest payments in FX for restructured CPC loans will be capped at US$100 million. The other adjustors will be uncapped.

Table 2b. Sri Lanka: Program Assumptions (2024)

(Cumulative from the beginning of each calendar year, in million US$)

	Mar. 2024	Jun. 2024	Sep. 2024	Dec. 2024
Foreign program financing of the central government	425	650	800	800
Net borrowings from SLDBs and FCBUs by the central government in FX terms	0	0	0	0
External commercial loans (including Eurobonds and syndicated loans) by the central government	0	0	0	0
Proceeds from commercialization of public assets to non-residents	0	0	0	0
Amortization of total external debt owed by the central government (excl. IMF)	187	374	561	748
Interest and Amortization payments on FX restructured CPC loans by central government	25	50	75	100
Interest payments on total external debt owed by the central government and central bank (excl. IMF)	308	615	919	1,226
Interest payments on SLDBs and FCBUs by the central government in US dollar terms	0	0	0	0
Project loans and grant FX cash amounts disbursed to the central government	105	210	315	420

14. In the event NIR outcome outperforms its program target(s), the CBSL will consult with IMF staff on raising the targets for subsequent test dates accordingly to safeguard such overperformance.

E. Performance Criterion on the CBSL's Net Credit to the Government (NCG)

15. **The CBSL's net credit to the Government (NCG)** will be measured as the difference between a) and b) below.

(a) The CBSL's claims on the central government, which include provisional advances, government securities acquired by the CBSL through primary market purchases, the central government's special direct issuances to the CBSL, and long-term or outright open market operations. For the program monitoring purpose, government securities acquired through purchases of government securities, solely for monetary policy purposes (e.g., standing lending facility and short-term open market operations) and emergency liquidity assistance (ELA) operations, on a temporary basis with an agreement to reverse the transaction in less than 90 days, will be excluded from the CBSL's claims on the central government. For the program monitoring purpose, the stock of government securities held by the CBSL will be measured in the face value.

(b) The central government's Rupee-denominated deposits at the CBSL. The deposits related to foreign program financing (including IMF disbursements) placed at the government's account at the CBSL are not part of the central government's Rupee-denominated deposits at the CBSL.

The Following Adjustment Will Apply:

16. The ceiling on the CBSL's NCG will be adjusted upward by the amount of shortfalls in foreign program financing of the central government (measured against programmed amounts as set out in Table 2). This adjustor will only apply to the NCG ceiling during six months after the Board date of the First review. The foreign currency amounts will be converted to Sri Lankan rupees using the program exchange rates defined in paragraph 9.

II. CONTINUOUS PERFORMANCE CRITERIA

F. Performance Criterion on New External Payment Arrears of the Nonfinancial Public Sector and the CBSL

17. A continuous performance criterion applies to the non-accumulation of new external payments arrears on external debt contracted or guaranteed by the nonfinancial public sector and the CBSL. The nonfinancial public sector is defined following the 2001 Government Finance Statistics Manual and the 1993 System of National Accounts. It includes (but is not limited to) the central government as defined in paragraph 3 and nonfinancial public enterprises, i.e., boards, enterprises, and agencies in which the government holds a controlling stake. External payments arrears consist of debt-service obligations (principal and interest) to nonresidents that have not been paid at the time they are due, as specified in the contractual agreements, subject to any applicable grace period. However, overdue debt and debt service obligations that are in dispute

will not be considered as external payments arrears for the purposes of program monitoring. Arrears resulting from the nonpayment of debt service, for which a rescheduling or restructuring agreement is being sought, are excluded from this definition. This continuous performance criterion will be monitored continuously by the authorities and any non-observance will be immediately report to the Fund.

G. Performance Criterion on New CBSL's Purchases of Government Securities in the Primary Market

18. A continuous performance criterion applies a ceiling of zero on new purchases of government securities by the CBSL in the primary market on the continuous basis.

The Following Adjustment Will Apply:

19. The ceiling (¶17) will be adjusted upward by the amount of shortfalls in foreign program financing of the central government (measured against programmed amounts as set out in Table 2). This adjustor will only apply to the ceiling ((¶17) during six months after the Board date of the First review. The foreign currency amounts will be converted to Sri Lankan rupees using the program exchange rates defined in paragraph 9.

H. Other Continuous Performance Criteria

20. During the program period, Sri Lanka will not:

a) impose or intensify **restrictions on the making of payments and transfers** for current international transactions;

b) introduce or modify **multiple currency practices** (MCPs);

c) conclude **bilateral payment agreements** that are inconsistent with Article VIII of IMF Articles of Agreement; and

d) impose or intensify **import restrictions** for balance of payments purposes.

III. MONETARY POLICY CONSULTATION CLAUSE

21. The inflation target bands around the projected 12-month rate of inflation in consumer prices, as measured by the headline Colombo Consumers Price Index (CCPI) published by the Department of Census and Statistics of Sri Lanka, are specified in Table 1 attached to the MEFP. The CCPI index (2021=100) will be used to measure actual inflation. For this purpose, the year-on-year inflation for each test date is measured as follows:

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

where

t = the month within which the test date is included

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

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

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

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

If the observed year-on-year inflation for the test date of end-December 2023 and end-June 2024 falls outside the outer bands specified in Table 1 attached to the MEFP, the authorities will complete a consultation with the IMF Executive Board which would focus on: (i) the stance of monetary policy and whether the Fund-supported program remains on track; (ii) the reasons for the deviation; and (iii) on proposed policy response. When the consultation with the IMF Executive Board is triggered, access to Fund resources would be interrupted until the consultation takes place and the relevant program review is completed. In addition, if the observed year-on-year inflation falls outside the inner bands specified in Table 1 attached to the MEFP for the test date of end-December 2023, end-March 2024, end-June 2024, and end-September 2024, the authorities will complete a consultation with IMF staff on the reasons for the deviation and the proposed policy response.

IV. INDICATIVE TARGETS

I. Indicative Target on Social Safety Net Spending

22. The Social Safety Net (SSN) spending is the central government's spending on SSN programs[2] comprising of: (1) Aswesuma cash transfers (the authorities are currently transitioning from the Samurdhi program to the new Aswesuma program; this transition is expected to be completed by end-December 2023) (2) Samurdhi cash transfers (until end-December 2023), ; (3) assistance to the elderly (over 70 years of age); (4) allowance for disabled people; and (5) financial support for kidney patients. These classifications are in line with the reporting in the Ministry of Finance Annual Report as in Table 9).

J. Indicative Target on Cost of Non-Commercial Obligations for Fuel and Electricity (Net of Government Transfers)

23. The non-commercial obligations (NCOs) for fuel and electricity refer to the obligations of Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) to supply fuel and electricity at prices below cost-recovery levels. The indicative target is set on the cost of fuel and

[2] Including additional relief, defined as relief to those who are affected by difficult economic circumstances and allocated to the four programs defined here.

electricity NCOs net of government transfers, which corresponds to the cost of the NCOs that are not compensated by the central government budget.

24. The cost of NCOs for fuel during each quarter is measured as the cost of sales (including fuel cost, terminal charges, transport charges, personnel cost, other operational expenses, exchange rate variation, and finance cost; excluding sales taxes) minus revenues (net of sales taxes) with regard to fuel supplies by CPC for transport, power generation, aviation, industries, kerosene and LPG, and agrochemicals. If the revenues (net of taxes) exceed the cost of sales, the cost of NCOs for fuel is zero. The government transfers to cover the cost of fuel NCOs are measured as central government current transfers disbursed to CPC.

25. Starting on January 1, 2024, the cost of NCOs for electricity during each quarter will be measured as total expenditures (including energy purchases and allowed revenue for transmission) minus total sales revenues from 5 distribution licensees under CEB, as shown in the statement of the Bulk Supply Transaction Account managed by CEB. Until January 1, 2024, the cost of NCOs for electricity during each quarter will be measured by total losses as reported on the CEB's financial statement. If the total sales revenues exceed the total expenditures, the cost of NCOs for electricity is zero. The government transfers to cover the cost of electricity NCOs are measured as central government transfers disbursed (including capital injection as specified in paragraph 6) to CEB.

26. For the purpose of program monitoring, the cost of fuel and electricity NCOs net of government transfers is calculated as follows. This takes account of a time lag in estimating the cost of fuel and electricity NCOs.

For the test date of end-December 2023:

{ NCO(2022Q4) + NCO(2023Q1) + NCO(2023Q2) + NCO(2023Q3) } – { G(2023Q1) + G(2023Q2) + G(2023Q3) + G(2023Q4) }

For the test date of end-March 2024:

NCO(2023Q4) – G(2024Q1)

For the test date of end-June 2024:

{ NCO(2023Q4) + NCO(2024Q1) } – { G(2024Q1) + G(2024Q2) }

For the test date of end-September 2024:

{ NCO(2023Q4) + NCO(2024Q1) + NCO(2024Q2) }

– { G(2024Q1) + G(2024Q2) + G(2024Q3) }

where

NCO(q) = cost of NCOs for fuel and electricity during quarter "q"

NCO_fuel(q) = cost of NCOs for fuel during quarter "q"

NCO_electricity(q) = cost of NCOs for electricity during quarter "q"

NCO(q) = NCO_fuel(q) + NCO_electricity(q)

G(q) = central government transfers to CPC and CEB disbursed during quarter "q"

G_fuel(q) = central government transfers to CPC disbursed during quarter "q"

G_electricity(q) = central government transfers to CEB disbursed during quarter "q"

G(q) = G_fuel(q) + G_electricity(q).

K. Indicative Target on Treasury Guarantees

27. Treasury guarantees are defined as outstanding debt guarantees issued by the central government. A guarantee of a debt refers to any explicit legal obligation of the central government to service such a debt in the event of nonpayment by the recipient. Treasury guarantees exclude letters of comfort. Outstanding guarantees are defined as the drawn amounts of guaranteed debts. They differ from issued guarantees, which are defined as the total amount of guaranteed debts (including for debts that are not disbursed yet). Treasury guarantees include outstanding treasury guarantees published in the Statement of Contingent Liabilities contained in the Annual Report of the Ministry of Finance. Rupee values for guarantees issued in other currencies will be calculated using the exchange rate for the last day of the calendar year as it appears in the Statement of Contingent Liabilities in the Annual Report of the Ministry of Finance. As of end-2022, the outstanding treasury guarantees were valued at Rs 1,180.7 billion.

V. DATA REPORTING REQUIREMENTS

28. Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the Memorandum of Economic and Financial Policies and Letters of Intent. All the program monitoring data will be provided by the Ministry of Finance and the CBSL. For the purpose of monitoring the fiscal performance and expenditure arrears under the program, data will be provided in the format as shown in Tables 3, 4, and 5. For the purpose of monitoring the NCG targets under the program, data will be provided in the format shown in Table 6. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 7 and 8. For the purpose of monitoring the performance against the indicative target on social safety net spending, data will be provided in the format shown in Table 9 on a quarterly basis. For the purpose of monitoring the financial performance of three state-owned enterprises—CEB, CPC, and SriLankan Airlines—data will be provided in the format shown in Tables 10, 11, and 12, respectively, on a quarterly basis. For the purpose of monitoring the performance against the indicative target on the cost of

fuel NCO (net of government transfers), data will be provided in the format shown in Table 13 on a quarterly basis. For the purpose of monitoring the performance against the indicative target on treasury guarantees, data will be provided in the format shown in Table 14 on a quarterly basis.

29. Data relating to the fiscal targets (Table 3, Table 4, and Table 5) will be furnished within no more than five weeks after the end of each month, except for the data on salaries and wages, goods and services, subsidies and transfers (and its subcomponents) that will be furnished within no more than seven weeks after the end of each month (the data on total recurrent expenditure and interest payments will be furnished within no more than five weeks after the end of each month). Data relating to the monetary targets (Table 6) will be furnished within no more than four weeks after the end of each month. Data relating to the external targets (Table 7 and Table 8) will be furnished within no more than 25 days after the end of each month. Data relating to the indicative target on social safety net spending (Table 9) will be furnished within no more than two months after the end of each quarter. Data relating to the three state-owned enterprises (Tables 10-12) will be furnished within no more than 2 months after the end of each quarter. Data relating to the indicative target on the cost of fuel NCO (net of government transfers) (Table 13) will be furnished within no more than 5 weeks after the end of each quarter. Data relating to the indicative target on treasury guarantees (Table 14) will be furnished within no more than two months after the end of each quarter.

30. For the purpose of monitoring the financial sector, the authorities will provide a quarterly written update and the following information on a bank-by-bank basis:

- Liquidity monitoring template, with breakdown by currency (daily)
- LCR template, with breakdown by currency (monthly)
- Net open foreign currency positions (weekly)
- Exposures to the central government and large SOEs (CEB, CPC, SLA, RDA), with breakdown by entity, currency, and instrument (monthly)
- Maturities of exposures to the central government and large SOEs (CEB, CPC, SLA, RDA), (monthly)
- Arrears of state-owned banks (monthly)
- Impairment schedule including breakdown of impairments on public sector exposures (monthly)
- Monthly supervisory returns to CBSL including statements of financial position and comprehensive income (monthly)
- Top 10 largest depositors (quarterly)
- Large exposures exceeding 15 percent of capital (quarterly)

- Capital adequacy template (quarterly)

- Financial soundness indicators (quarterly)

Daily financial sector data will be provided within one week of the end of the reporting period; weekly data within two weeks; monthly data within four weeks; quarterly data within six weeks.

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

Total Revenue and Grants
Total Revenue
Tax Revenue
Income Taxes
Personal & corporate
Corporate & non-corporate
Personal
Corporate
Personal Income Tax (PAYE)
Economic Service Charge
Interest Income tax
Tax on goods & services
VAT
Domestic
Imports
Excise Taxes
Liquor
Cigarettes
Motor vehicles
Petroleum
Other
Other taxes & levies incl. SSCL
Social Security Contribution L
Domestic
Imports
Other Taxes and Levies
Tax on external trade
Import Duties
Cess Levy
Special Commodity Levy
Ports & Airporst Development Levy
Non Tax Revenue
Property Income
Fines, Fees and Charges
Other
Grants
Total Expenditure
Current Expenditure
Salaries & wages
Goods & services
Interest payments
Subsidies & transfers
Public Corporations
Public Institutions
Households
Capital Expenditure
Net Lending
Primary balance
Overall balance
Total Financing
Total Foreign Financing (Net)
Total Domestic Financing (Net)
Privatization

Table 4. Sri Lanka: Central Government Financing

(In millions of rupees)

	(i) Borrowing/ Cash inflow	(ii) Repayment/ Cash outflow	(iii) Net
1. Domestic financing in local currency			
T-bills 1/			
T-bonds 1/			
Loans			
Deposits and overdrafts at banks			
CBSL advances and deposits			
Other (specify)			
2. Domestic financing in foreign currency			
Sri Lanka Development Bond (SLDB) 1/			
Loans			
Other (specify)			
3. Net foreign financing			
International Sovereign Bonds 2/			
Official project loans			
Official program loans			
Official trade credit			
Syndicated loans			
Other (specify)			
3. Privatization receipts			
Total financing (1+2+3+4)			

1/ including net purchases by non-residents
2/ including net purchases by residents

Table 5. Sri Lanka: Unpaid Bills and Arrears 1/

(In millions of rupees)

Recurrent	
Capital	
Total	
o.w. more than 3 months:	
Recurrent	
Capital	
Total	

1/ as agreed for the purpose of monitoring the program

Table 6. Sri Lanka: CBSL's Balance Sheet 1/

(In millions of rupees)

Net foreign assets
Foreign assets
Foreign liabilities
o.w. Reserve liabilities
Net dometic assets
Net credit to government
Claims on government
Provisional advances
Treasury bills, o.w.,
Acquired through primary market purchases 1/
Acquired through standing lending facility operations
Acquired through ST OMOs
Acquired through LT OMOs
Acquired through outright OMOs
Acquired through emergency liquidity assistance
Treasury bonds, o.w.,
Acquired through standing lending facility operations
Acquired through ST OMOs
Acquired through LT OMOs
Acquired through outright OMOs
Government deposits 2/
Claims on commercial banks
Other items (net)
Reserve money
Currency in circulation
Commercial bank deposits
Memo: Net worth of the CBSL

1/ includes direct issuances of treasury securities by the government to the CBSL.

2/ Rupee-denominated deposits, excluding those converted from foreign program financing.

Table 7. Sri Lanka: Foreign Exchange Cashflows of the Central Bank and the Government 1/

(In millions of U.S. dollars)

1. Total inflows, without swaps
Loans (public sector)
Program loans (budget support)
Project loans and grants
SLDBs
FCBUs
Commerical loans
Syndicated loans
Sovereign bonds
Other inflows
Interest receipts, forex trading profits, capital gains
Change in balances in DST account
o/w proceeds from public assets
2. Total outflows, without swaps
Public sector debt service
Public sector amortization (excl. to IMF)
Official loans
multilateral creditors
India credit lines
other loans
SLDBs
FCBU loans
Syndicated loans
Settlement of ISBs
Public sector interest payment (incl. to IMF)
Interest to IMF
Interest to external creditors
Interest on domestic FX debt (SLDB, FCBU, etc)
3. Net FX purchases from market
Outright purchases of FX from commercial banks
Outright sales of FX to commercial banks
4. Swaps with domestic commercial banks
OMO FX swap transactions-inflows
OMO FX swap transactions-outflows
Net inflows (incl. swaps = 1-2+3+4) at current rates
Net inflows (excl. swaps = 1-2+3) at current rates
Net International Reserves (at market rates)
Net International Reserves (at program rates)
Gross International Reserves (at market rates)
Changes in Reserve Related Liabilities
Change in ACU liabilities
Change in liabilities to IMF
existing debt service (amortization)
new purchases
International swaps with foreign CBs
inflows
outflows
Valuation changes
Changes in CBSL other liabilities

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

Table 8. Sri Lanka: Gross Official Reserve Position 1/

(In millions of U.S. dollars)

Date	Central Bank				Government				Gross Official Reserves				Liabilities					Net International Reserves	IMF-EFF liability of the Government	Outstanding domestic swaps liabilities	IMF-EFF Programme NIR at market exchange rate
	Reserves managed by IOD		Reserves Position at IMF & SDR holdings	Total	Crown Agent's Credit Balance	DST's Special Dollar Revolving Credit Balance	DST's Yen Accounts	Total	(without ACU & DA & with swap)	(with ACU & swap & without DA)	Outstanding assets of BOC London branch deposit, NZD assets and SEK assets*	(with ACU & swap & without DA & excluding outstanding assets of BOC London branch deposit, NZD assets and SEK assets)	Other Deposits	Asian Clearing Union	Drawings from the IMF	International currency swap	Total				
	Foreign Assets (FA) (with ACU & without DA)	Domestic Assets (DA) (BOC & PB)																			
				(1+2)				(4+5+6)	(8-10)	(3+7)		(9-8)						(10-11)			(12-13-14)
	1		2	3	4	5	6	7		8	9	10					11	12	13	14	15

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

Table 9. Sri Lanka: Social Safety Net Spending (by Month) 1/

(In millions of rupees)

Budget Code		Total	Of which, externally financed
	Total Social Safety Net Spending [2/] = (1)+(2)+(3)+(4)+(5)		
	Cash transfers to empower the poor and vulnerable		
110-1-2-40-1510	(1) Aswesuma cash transfers		
331-2-2-1-1501	(2) Samurdhi cash transfers		
171-2-77-11-1501 and 171-2-77-12-1501	(3) Assistance to elderly (over 70 years and over 100 years)		
171-2-7-1-1501	(4) Allowance for disabled people		
171-2-7-4-1501	(5) Financial support for kidney patients		

1/ In line with the reporting of the Ministry of Finance Annual Report

2/Recipients include current, waitlisted, and new beneficiaries of the four main SSN programs i.e., (1), (2), (3), (4), (5) above. Starting January 2024, cash transfers under (2) will cease.

Table 10. Sri Lanka: Financial Outturn of Ceylon Electricity Board 1/
(In millions of rupees)

Total revenue	
Sale of electricity	
Other income	
Total expenditure	
Direct generation cost	
Generation, transmission, and distribution O&M cost	
Corporate expenses	
Interest on borrowings and delayed payments	
Depreciation	
Other cost	
Operating profit/loss	
Liquidity position	
Borrowings from banks	
Payments to banks	
Outstanding debt to banks	
Purchases from CPC and IPP	
Payments to CPC and IPP	
Outstanding to CPC and IPP	

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

Table 11. Sri Lanka: Financial Outturn of Ceylon Petroleum Corporation 1/
(In millions of rupees)

Total revenue	
Octane 90	
Diesel	
Other products	
Other income	
Total expenditure	
Cost of sales	
Sales and distribution	
Administration	
Finance cost	
Depreciation	
Other cost	
Operating profit/loss	
Outstanding dues to state banks	

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

Table 12. Sri Lanka: Financial Outturn of Sri Lankan Airlines 1/
(In millions of rupees)

Total revenue	
Passenger	
Cargo	
Other income	
Total expenditure	
Aircraft fuel cost	
Employee cost	
Other operating expenses	
Financial cost	
Operating profit/loss	
Capital contribution	

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

Table 13. Sri Lanka: Cost of Non-Commercial Obligations for Fuel 1/

(In millions of rupees, unless otherwise noted)

Product	**a=e-b** **Cost of NCOs** Rs millions	**b=c-d** **revenue (net of sales** Rs millions	c Sales revenue Rs millions	d Sales taxes Rs millions	**e=f+g+h+i +j+k+l** **(net of sales taxes)** Rs millions	f Cost of sales Rs millions	g Terminal charge Rs millions	h Transport charge Rs millions	i Personnel cost Rs millions	j Other expenses Rs millions	k Exchange rate variation Rs millions	l Finance cost Rs millions	m Sales quantity Million liters
A.TRANSPORT													
Super petrol (92 octane)													
Unladed petrol (95 octane)													
Auto diesel													
Super diesel													
B.POWER GENERATION													
Auto diesel													
Fuel oil 800'													
Fuel oil 1500'													
Fuel oil 1500' low sulphur													
Fuel oil 200'													
Naphtha													
C.AVIATION													
Jet A-1 (Foreign)													
Jet A-1 (Sri Lankan Airline)													
Jet A-1 (Local)													
Avgas													
D.INDUSTRIES													
Ind Kero													
Fuel oil 800'													
S.B.P.													
Bitumen													
Lubricant													
E.DOMESTIC													
Kerosene													
LPG													
F.AGRO													
Agro chemicals													
Total (A-F)													
Memorandum item:													
Central government current transfers to CP [x]													

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

Table 14. Sri Lanka: Treasury Guarantees 1/
(In millions of rupees)

	Treasury Guarantees Issued	Treasury Guarantees Outstanding
Total Treasury Guarantees		
Ceylon Electricty Board		
Ceylon Petroleum Corporation		
National Water Supply and Drainage Board		
Road Development Authority		
SriLankan Airlines		
Other		

1/ As agreed for the purpose of monitoring the indicative target under the program.

Statement by Krishnamurthy Subramanian, Executive Director for Sri Lanka and Chandranath Amarasekara, Alternate Executive Director
December 12, 2023

Introduction

Our Sri Lankan authorities thank the management and staff of the Fund for the continued productive and cordial engagement. The authorities wish to thank the Official Creditor Committee (OCC) co-chaired by India, Japan and France, the ExIm Bank of China and other creditor nations for the timely agreements-in-principle and financing assurances, which paved the way for the Executive Board discussion on the First Review under the Extended Arrangement under the Extended Fund Facility (EFF).

Our authorities are vigorously pursuing the EFF-supported reform agenda as evidenced by the strong program performance, including exceeding program targets on the fronts of inflation, net international reserves, the primary balance, and net credit to the government. Following the unprecedented socio-economic and political crisis that Sri Lanka experienced in 2022, the authorities have taken several difficult, yet macroeconomically desirable corrective actions, to reset the country's economic trajectory. The Sri Lankan economy, which was on the verge of collapse with the day-to-day lives of its citizenry being severely disrupted by the shortage of essential goods and services, was rescued with emergency funding from neighboring India as well as support from other nations and multilateral agencies. The engagement with the Fund bolstered the nation's hopes, and the authorities' efforts to correct the course of the economy led to the approval of the IMF-EFF arrangement in March 2023.

Our authorities have implemented a series of significant reforms over the past several months. These include tax policy reforms that were also backed by amendments to the relevant Acts and the issuance of Gazettes. Cost reflective pricing for retail petroleum products and electricity was introduced to prevent a further accumulation of losses to key State-Owned Enterprises (SOEs). Disinflation was a key priority for the authorities. Effective September 2023, the Central Bank Act (CBA), defined price stability as the prime objective of the Central Bank of Sri Lanka (CBSL) with financial system stability as the other objective. The CBA also established flexible inflation targeting as the monetary policy framework, recognized the flexible exchange rate regime, removed government representation from the CBSL Boards, and established the CBSL as the country's macroprudential authority. Most importantly, the CBA prevents future monetary financing of fiscal deficits. The Banking (Special Provisions) Act was effected from September 2023 to provide the CBSL the resolution authority in respect of licensed banks. The Parliament also approved a resolution on the domestic debt optimization strategy in July 2023, with due regard to preserving financial system stability. The introduction of the Anti-Corruption Act in August 2023 was aimed at the establishment of an independent Commission to detect and investigate allegations of bribery, corruption and offences related to the declaration of assets and liabilities and associated offences. *Aswesuma*, the government's social safety net program, was rolled out to strengthen and streamline the country's social welfare system, by minimizing inclusion and exclusion errors as well as leakages. Our authorities also presented the IMF-EFF backed reform packages to the Parliament and obtained its endorsement in April 2023, in order to ensure the smooth implementation of the program with wider support from the legislative branch of the government.

As a result of these efforts, the year-on-year contraction of the real economy has reduced from 12.4 percent in Q4 2022 to 3.1 percent in Q2 2023; this performance also reflects the resilience of the Sri Lankan economy and its people. Though official statistics on national accounts are awaited, ground-level reports and high frequency data indicate that the economy has moved to a positive growth territory from Q3 2023. **Inflation (Colombo Consumer Price Index (CCPI) based, headline), which was on an upward spiral and peaked at 69.8 percent in September 2022, started decelerating faster than expected and reached 1.3 percent by September 2023.** The external current account is likely to record a surplus in 2023, and the CBSL made net purchases from the domestic forex market exceeding US$ 1.8 billion (trade date basis) thus far during the year. **The Sri Lanka rupee, which depreciated by 44.8 percent against the US dollar in 2022, appreciated by 11.0 percent thus far during the year.** Gross official reserves (GOR) improved from US$ 1.8 billion in April 2022 to US$ 3.6 billion by end November 2023. **In the fiscal sector, tax revenue collection increased by 55.8 percent during January-November 2023 compared to the same period of the previous year, and a primary surplus was maintained by end June and end September 2023.** The stability of the financial system was preserved.

The authorities are aware that economic and social dividends of most reform measures and macroeconomic adjustments would only be observed in the medium- to long-term. Some reforms and adjustments do cause pain and difficulty to the general public and businesses in the near-term. Therefore, until the economic stabilization objective is fully realized, occasional social unrest and agitation cannot be avoided, particularly in a multi-party democratic polity in which populism has been taken for granted for decades. The authorities are taking every possible step to minimize such pain, while reemphasizing to the public and the business community that the ongoing radical restructuring of the economy is crucial if Sri Lanka is to avert an even deeper socio-economic and political crisis in future.

Fiscal Policy

In order to restore fiscal sustainability, our authorities are in the process of implementing significant corrections to fiscal policy covering both revenue and expenditure, with increased focus on revenue administration and public financial management. The authorities presented the National Budget 2024 in November 2023 in line with program parameters.[1] The Parliament is expected to vote on the Budget

[1] https://treasury.gov.lk/api/file/ed037ac8-9727-4292-ae9b-edac08c7a314

on December 13, 2023. In addition to the revenue measures implemented in 2022 and 2023, the government proposed to increase the Value Added Tax (VAT) rate from 15 percent to 18 percent and remove most VAT exemptions, while introducing several measures to further improve tax compliance and administration. Tax revenue to GDP ratio, which was at 7.3 percent in 2022, is expected to improve to 9.2 percent of GDP in 2023 and 12.1 percent in 2024. Sluggish economic activity and import restrictions that were in place during most of 2023 impacted revenue collection during the year. However, the pickup in economic activity, the absence of import restrictions (except motor vehicles), and the ongoing and proposed improvements to revenue administration will support revenue improvement in 2024 and beyond.

The Budget also proposed to adjust public sector wages and pensions to partially compensate for the increased cost of living. Allocations to social safety nets have been set at 0.7 percent of GDP in line with program discussions. With high borrowing costs faced by the government since 2022, interest expenditure is expected to remain high in 2023 as well as in 2024. The Budget 2024 includes provisions for bank recapitalization, and the fiscal deficit for 2024 is projected at 7.6 percent (without bank recapitalization). This represents an improvement in fiscal health compared to the expected deficit of 8.5 percent in 2023 and the double-digit deficits recorded during 2020-2022. During this year, the authorities were able to maintain a primary surplus by end-June and end-September, and a deficit of 0.7 percent of GDP is expected by end 2023 with a surplus of 0.8 percent (without bank recapitalization) in 2024. This is a significant improvement from the primary deficits of 5.7 percent in 2021, and 3.7 percent in 2022. With bank recapitalization, the fiscal deficit and the primary deficit for 2024 are envisaged at 9.1 percent and 0.6 percent of GDP, respectively. The expected revenue improvement will provide adequate space for the government to gradually increase capital expenditure on development projects in the period ahead. Going forward, the proposed Public Financial Management Act will aid the authorities' efforts to strengthen fiscal sustainability.

Strictly limited foreign financing and the absence of deficit financing from the Central Bank resulted in considerable challenges to the General Treasury in terms of cashflow management. However, the authorities have been able to manage such stresses without giving rise to speculative increases of yields on government securities, as evidenced in recent auctions. The authorities have managed to build sufficient cash buffers to thwart adverse speculation and smooth out Treasury operations.

The authorities are also in the process of reforming SOEs. Cost-reflective, formula-based, monthly pricing has been introduced in the petroleum sector, while electricity tariffs have been adjusted to reflect the true cost of generation. Considering the unpredictability of hydro-power generation and the resultant energy mix, the authorities will implement quarterly adjustments to electricity prices from 2024 in place of the semi-annual adjustments introduced in 2023. The participation of the private sector is expected to improve the performance of energy utilities. Several other key SOEs are also being restructured, and the government has established special unit for this purpose. Such restructuring is expected to reduce the over-exposure of the fiscal and financial sectors to SOEs.

Inflation and Monetary Policy

Decisive monetary policy action by the CBSL enabled rapid disinflation. CCPI-based headline and core inflation (year-on-year), which peaked at 69.8 percent and 50.2 percent, respectively, in September 2022, decelerated to single digits by mid-2023, with further deceleration thereafter. Headline and core inflation in November 2023 were recorded at 3.4 percent and 0.8 percent, respectively. Some upward movement of inflation is expected in 2024 due to the scheduled increases in taxes and the one-off effect of recent electricity tariff adjustments. Nevertheless, inflation expectations remain anchored and demand pressures on inflation remain muted. Beyond 2024, inflation is projected around the targeted level of 5 percent, supported by appropriate policy measures. The authorities wish to note that staff projected double-digit inflation throughout 2023, requiring the CBSL to effect a prior action of a 100 basis point tightening of monetary policy in March 2023.[2] The faster-than-expected disinflation, which was more in line with the CBSL projections, prompted the CBSL to ease the monetary policy stance by 650 basis points since June 2023. This disinflation also caused a breach of the lower outer band of inflation under the monetary policy consultation clause (MPCC) and required a significant downward adjustment to the MPCC from September 2023 onwards. The CBSL policy rates currently form a band of 9-10 percent, compared to current inflation of 3.4 percent and the targeted level of 5 percent.[3]

Recent monetary policy easing, supported by sufficient market liquidity and interest rate caps on selected lending products, are expected to ease market interest rates to a level more affordable to businesses and households. The prime lending rate, which was at around 29.7 percent at the peak recorded in November 2022, is currently at 13.03 percent, while the 364-day primary market Treasury bill rate, which peaked at 30.5 percent in August/September 2022, is currently at 12.88 percent. Credit to the private sector by commercial banks, which recorded a month-on-month decline from June 2022 to May 2023, has rebounded somewhat thereafter. However, credit flows remain weak, and the year-on-year contraction of private sector credit in October 2023 was 4.3 percent. Following the domestic debt operation that converted the CBSL's short term credit to the government into longer term instruments, the CBSL has commenced the process of gradual unwinding of its government securities portfolio.

Financial Sector

The authorities remain committed to ensuring a sound financial system and addressing vulnerabilities. The banking sector assets are on a gradual upward trend, and the deteriorating trend in credit quality has also shown some moderation. Liquidity ratios were maintained above the minimum requirements. Net interest margin (NIM) of the banking industry was recorded at around 3.5 percent in recent months, while return on equity (ROE) has remained above 10 percent during this period. Total capital

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[2] https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20230303_Monetary_Policy_Review_No_2_2023_e_Bg5y8.pdf

[3] https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/pr/press_20231124_Monetary_Policy_Review_No_8_2023_e_Jw52vr.pdf

adequacy ratio (CAR) has been maintained above 16 percent thus far in 2023. The Asset Quality Review (AQR) carried out recently will guide the process of recapitalization of the banking sector. The amendments to the Banking Act, expected by end-January 2024, will further strengthen financial sector regulation and supervision. Measures are being taken to strengthen the state-owned banks and improve their governance frameworks, particularly in relation to the process of appointing directors and management and requiring their boards to have a majority of independent members. Meanwhile, the authorities continued to strengthen the country's AML/CFT regime, and several legislative amendments are also envisaged in this regard.

External Sector

Sri Lanka is likely to record an external current account surplus in 2023. Import contraction, supported by import restrictions and subdued demand conditions, contributed to a decline in the trade deficit. The removal of import restrictions (except motor vehicles) is unlikely to exert considerable pressure on the balance of payments. The growth slowdown in export markets and domestic disruptions resulted in a decline in export earnings. Nevertheless, a significant improvement in worker remittances and earnings from tourism, along with the reduced trade deficit, supported the current account. Worker remittances increased to US$ 4.9 billion during the period from January to October 2023 from US$ 2.9 billion recorded during the same period in the previous year. Cumulative tourist arrivals up to end November have doubled at 1,276,951 in 2023, compared to 628,017 arrivals during the corresponding period in 2022. The current account deficit is expected to remain around 1.5 percent to 2.0 percent in the medium term. As cashflows gradually improved, banks settled their external liabilities and invested in liquid assets abroad, resulting in some financial outflows. In the meantime, some increase in foreign portfolio and direct investments was observed during the year. The CBSL continued to accumulate foreign exchange from the domestic market to rebuild Gross Official Reserves and intervened in the market when necessary to prevent excessive volatility. The Sri Lanka rupee appreciated against the US dollar by 11.0 percent thus far during the year.

Anti-Corruption Efforts and Growth-supporting Reforms

Our authorities welcome the Governance Diagnostic Assessment (GDA) carried out by the Fund at the invitation of the authorities. Sri Lanka is the first Asian country for which a GDA has been conducted, and the authorities published the report as scheduled, considering the importance that domestic and international stakeholders attribute to this diagnostic.[4] The government is committed to implementing the recommendations made in the GDA. The landmark Anti-Corruption Act was unanimously approved by the Parliament in July 2023, and the process of selection of anti-corruption commissioners by the Constitutional Council (chaired by the Speaker of the Parliament and comprising Members of the Parliament representing the government and the opposition, and civil society members) is underway.

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[4] https://treasury.gov.lk/api/file/d0bbb4a3-3b7f-4b2e-98ae-fdecc0181788

With economic stabilization firming up, our authorities are gradually increasing the focus on enhancing medium- to long-term growth. Measures are being taken to increase merchandise and services exports. Open trade policies are expected to be bolstered by Sri Lanka's planned phasing out of para-tariffs and entry into bilateral and multilateral trade agreements. The stable macroeconomic environment is also expected to provide a sound basis to spur domestic and foreign investments. Meanwhile, planned reforms to labor, land and capital markets would improve the productivity and efficiency of the economy. Our authorities are redoubling efforts to address Sri Lanka's extreme and rising vulnerability to climate change, while working with the global community to mobilize collective support for urgent climate action.

Debt Negotiations

The Sri Lankan authorities have engaged with official and commercial creditors transparently and in good faith. These engagements have resulted in agreements-in-principle with official bilateral creditors, including the OCC and the ExIm Bank of China, in line with program parameters. The authorities look forward to finalizing the debt agreements in a transparent manner with all creditors early. In addition to acknowledging the support extended by all creditor nations, the authorities wish to recognize the role played by the management and staff of the Fund throughout the process of debt negotiations. The authorities have also engaged closely with commercial creditors and expect to continue negotiations to reach an early agreement.

Conclusion

The authorities, while being aware of Sri Lanka's patchy record of implementation in the past, are consciously endeavoring to break away from this past. This is evidenced in the cumulative portfolio of path-breaking reform measures that have been implemented despite stiff opposition and periodic protests. Given the enormity of the transformation that the authorities have embarked upon, there is no illusion that the sincere commitment displayed so far must be diligently continued to minimize the implementation risks, which remain non-trivial. In this context, the authorities have established a high-level implementation monitoring committee with the participation of officials from Presidential Secretariat, the Ministry of Finance, and the Central Bank of Sri Lanka. Meetings between the IMF staff and the committee are being held on a weekly basis. The authorities also gratefully acknowledge technical assistance and capacity development support from the Fund, which would enable meeting the targets and benchmarks set under the program.

Our Sri Lankan authorities wish to assure their commitment to the close engagement with the Fund and the timely implementation of the EFF-supported economic program. In consideration of this commitment as well as Sri Lanka's strong performance against the quantitative performance criteria, indicative targets and structural benchmarks, our authorities appreciate the Executive Directors' support for the favorable conclusion of the First Review of the EFF-arrangement.