



SRI LANKA

March 2022

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Sri Lanka, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 25, 2022 consideration of the staff report that concluded the Article IV consultation with Sri Lanka.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 25, 2022, following discussions that ended on December 20, 2021, with the officials of Sri Lanka on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 10, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Sri Lanka.

The documents listed below will be separately released.

Selected Issues

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International Monetary Fund
Washington, D.C.



IMF Executive Board Concludes 2021 Article IV Consultation with Sri Lanka

FOR IMMEDIATE RELEASE

Washington, DC – February 25, 2022: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Sri Lanka.

Sri Lanka has been hit hard by COVID-19. On the eve of the pandemic, the country was highly vulnerable to external shocks owing to inadequate external buffers and high risks to public debt sustainability, exacerbated by the Easter Sunday terrorist attacks in 2019 and major policy changes including large tax cuts at late 2019. Real GDP contracted by 3.6 percent in 2020, due to a loss of tourism receipts and necessary lockdown measures. Sri Lanka lost access to international sovereign bond market at the onset of the pandemic.

The authorities deployed a prompt and broad-based set of relief measures to cope with the impact of the pandemic, including macroeconomic policy stimulus, an increase in social safety net spending, and loan repayment moratoria for affected businesses. These measures were complemented by a strong vaccination drive. GDP growth is projected to have recovered to 3.6 percent in 2021, with mobility indicators largely back to their pre-pandemic levels and tourist arrivals starting to recover in late 2021.

Nonetheless, annual fiscal deficits exceeded 10 percent of GDP in 2020 and 2021, due to the pre-pandemic tax cuts, weak revenue performance in the wake of the pandemic, and expenditure measures to combat the pandemic. Limited availability of external financing for the government has resulted in a large amount of central bank direct financing of the budget. Public debt² is projected to have risen from 94 percent of GDP in 2019 to 119 percent of GDP in 2021. Large foreign exchange (FX) debt service payments by the government and a wider current account deficit have led to a significant FX shortage in the economy. The official exchange rate has been effectively pegged to the U.S. dollar since April 2021.

The economic outlook is constrained by Sri Lanka's debt overhang as well as persistently large fiscal and balance-of-payments financing needs. GDP growth is projected to be negatively affected by the impact of the FX shortage and macroeconomic imbalances on economic activities and business confidence. Inflation recently accelerated to 14 percent (y/y) in January 2022³ and is projected to remain double-digit in the coming quarters, exceeding the target band of 4–6 percent, as strong inflationary pressures have built up from both supply and demand sides since mid-2021. Under current policies and the authorities' commitment to preserve the tax cuts, fiscal deficit is projected to remain large over 2022–26, raising public debt further over the medium term. Due to persistent external debt service burden,

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² Comprises central government debt, guaranteed debt, and the CBSL's foreign liabilities.

³ Measured by the Colombo Consumer Price Index.

international reserves would remain inadequate, despite the authorities' ongoing efforts to secure FX financing from external sources.

The outlook is subject to large uncertainties with risks tilted to the downside. Unless the fiscal and balance-of-payments financing needs are met, the country could experience significant contractions in imports and private credit growth, or monetary instability in case of further central bank financing of fiscal deficits. Additional downside risks include a COVID-19 resurgence, rising commodity prices, worse-than-expected agricultural production, a potential deterioration in banks' asset quality, and extreme weather events. Upside risks include a faster-than-expected tourism recovery and stronger-than-projected FDI inflows.

Executive Board Assessment⁴

Executive Directors commended the Sri Lankan authorities for the prompt policy response and successful vaccination drive, which have cushioned the impact of the pandemic. Despite the ongoing economic recovery, Directors noted that the country faces mounting challenges, including public debt that has risen to unsustainable levels, low international reserves, and persistently large financing needs in the coming years. Against this backdrop, they stressed the urgency of implementing a credible and coherent strategy to restore macroeconomic stability and debt sustainability, while protecting vulnerable groups and reducing poverty through strengthened, well-targeted social safety nets.

Directors emphasized the need for an ambitious fiscal consolidation that is based on high-quality revenue measures. Noting Sri Lanka's low tax-to-GDP ratio, they saw scope for raising income tax and VAT rates and minimizing exemptions, complemented with revenue administration reform. Directors encouraged continued improvements to expenditure rationalization, budget formulation and execution, and the fiscal rule. They also encouraged the authorities to reform state-owned enterprises and adopt cost-recovery energy pricing.

Directors agreed that a tighter monetary policy stance is needed to contain rising inflationary pressures, while phasing out the central bank's direct financing of budget deficits. They also recommended a gradual return to a market-determined and flexible exchange rate to facilitate external adjustment and rebuild international reserves. Directors called on the authorities to gradually unwind capital flow management measures as conditions permit.

Directors welcomed the policy actions that helped mitigate the impact of the pandemic on the financial sector. Noting financial stability risks from the public debt overhang and sovereign-bank nexus, they recommended close monitoring of underlying asset quality and identifying vulnerabilities through stress testing. Directors welcomed ongoing legislative reforms to strengthen the regulatory, supervisory, and resolution frameworks.

Directors called for renewed efforts on growth-enhancing structural reforms. They stressed the importance of increasing female labor force participation and reducing youth unemployment. Further efforts are needed to diversify the economy, phase out import restrictions, and improve the business and investment climate in general. Directors also called for a prudent management of the Colombo Port City project, and continued efforts to strengthen governance and fight corruption. They noted the country's vulnerability to climate change and welcomed efforts to increase resilience.

⁴ At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

Table 1. Sri Lanka: Selected Economic Indicators, 2018–22

| | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|-------|-------|-------|-------|-------|
| | | | | Proj. | |
| Output | | | | | |
| Real GDP growth (percent) | 3.3 | 2.3 | -3.6 | 3.6 | 2.6 |
| Prices 1/ | | | | | |
| Inflation (average, percent) | 4.3 | 4.3 | 4.6 | 6.0 | 10.5 |
| Inflation (end of period, percent) | 2.8 | 4.8 | 4.2 | 12.1 | 8.3 |
| Central government finances | | | | | |
| Revenue and grants (percent GDP) | 13.5 | 12.6 | 9.2 | 8.9 | 10.7 |
| Expenditure (percent GDP) | 18.8 | 20.6 | 21.9 | 20.3 | 20.3 |
| Primary balance (percent GDP) | 0.6 | -2.0 | -6.2 | -4.9 | -2.8 |
| Overall balance (percent GDP) | -5.3 | -8.0 | -12.8 | -11.4 | -9.6 |
| Central government debt (percent GDP) | 84.2 | 86.8 | 101.2 | 107.1 | 108.6 |
| Public debt (percent GDP) 2/ | 91.0 | 93.6 | 110.0 | 118.9 | 119.9 |
| Money and credit | | | | | |
| Broad money (percent change) | 13.0 | 7.0 | 23.4 | 15.4 | 13.9 |
| Credit to the private sector (percent change) | 15.9 | 4.2 | 6.5 | 13.8 | 13.0 |
| Balance of payments | | | | | |
| Current account (percent GDP) | -3.2 | -2.2 | -1.3 | -3.8 | -3.8 |
| FDI (percent GDP) | 1.8 | 0.8 | 0.5 | 0.9 | 1.2 |
| Reserves (US\$ millions) | 6,919 | 7,642 | 5,664 | 3,138 | 2,204 |
| Reserves (months imports) | 3.4 | 5.0 | 3.1 | 1.5 | 1.0 |
| External debt (percent GDP) 3/ | 60.2 | 65.1 | 66.4 | 65.6 | 64.2 |

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/ Valued at face value.



SRI LANKA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

February 10, 2022

KEY ISSUES

Context. COVID-19 severely hit the economy, causing a loss of tourism receipts and necessitating several strict lockdowns. Pre-pandemic tax cuts and the impact of COVID-19 led to fiscal deficits larger than 10 percent of GDP in 2020 and 2021 and a rapid increase in public debt to 119 percent of GDP in 2021. Sri Lanka's access to international capital markets was lost in 2020, prompting a decline of international reserves to critically low levels and large-scale direct lending to the government by the Central Bank of Sri Lanka (CBSL). External debt repayments and a widening current account deficit have led to foreign exchange (FX) shortages, while the official exchange rate has been de facto fixed since April 2021. Inflation is on the rise, reaching double digits in December 2021, reflecting imported inflation, supply shocks, and a pickup in domestic demand amid loose monetary policy.

Outlook. Sri Lanka started experiencing a combined balance of payments and sovereign debt crisis. In staff's view, public debt has become unsustainable, and gross reserves are critically low and insufficient to cover near-term debt service needs. While the authorities' efforts to raise new FX financing could provide breathing space in the short term, it remains unclear how the large FX debt service obligations beyond 2022 can be met. A successful vaccination campaign has led to improved prospects for tourism, but the near and medium-term growth outlook is clouded by heightened macroeconomic imbalances, FX shortages, and suspension of non-priority imports. The large public debt burden has subordinated monetary and exchange rate policies to fiscal needs and continues to hinder the CBSL from pursuing its price stability objective.

Recommendations. To restore macroeconomic stability and debt sustainability, implementing a credible and coherent strategy covering both the near and medium term is needed. Staff recommends a comprehensive set of policies with specific measures:

- Substantial revenue-based fiscal consolidation. Reforms should focus on strengthening VAT and income taxes, through rate increases and base broadening measures. Fiscal adjustment should be accompanied by energy pricing reforms to reduce fiscal risks from lossmaking public enterprises. Institution building reforms, such as revamping the fiscal rule, would help ensure the credibility of the strategy.

- Developing a comprehensive strategy to restore debt sustainability.
- Near-term monetary policy tightening to ensure that the recent breach of the inflation target band is only temporary. Recent welcome steps to gradually unwind the CBSL's large treasury bill holdings should continue through close coordination with the Ministry of Finance.
- Gradually restoring a market-determined and flexible exchange rate. To avoid disorderly movements in the exchange rate, the transition should be carefully sequenced and implemented as part of a comprehensive macroeconomic adjustment package.
- Social safety nets should be strengthened, by increasing spending, widening coverage, and improving targeting, to mitigate the adverse impacts of macroeconomic adjustment on vulnerable groups.

The swift and broad-based policy actions by the authorities mitigated the impact of the pandemic on the financial sector. However, the public debt overhang and the persistent fiscal and BoP financing shortfalls pose significant financial stability risks, highlighting the need of the credible and coherent macroeconomic strategy. To preserve financial sector stability, the CBSL should continue to closely monitor loans under moratorium and identify vulnerabilities through stress testing. Adoption of the new Banking Act would help broaden the CBSL's regulatory powers and upgrade its resolution framework.

Renewed efforts are needed on growth-enhancing structural reforms, including increasing female labor force participation, reducing youth unemployment, liberalizing trade, developing a wide-reaching and coherent investment promotion strategy, and reforming price controls and state-owned enterprises (SOEs). Efforts to strengthen governance and reduce corruption vulnerabilities should continue.

Approved By
**Anne-Marie Gulde-
 Wolf (APD) and
 Bikas Joshi (SPR)**

Discussions took place in Colombo during December 7–20, 2021. The mission met with Minister of Finance Rajapaksa, Central Bank of Sri Lanka Governor Cabraal, Secretary to the Treasury Attygalle, other senior officials, and private sector representatives. The mission comprised M. Nozaki (Head), K. Hellwig (HQ), M. Li (HQ), (all APD), F. Vitek (FAD), V. Prokopenko (HQ) (MCM), M. Kryshko (SPR), and T. Feridhanusetyawam and M. Abeyawickrama (Resident Representative office). S. Bhalla (OED) joined the policy and concluding meetings. G. Gamwalla-Khadivi and P. Polec (both APD) supported the mission.

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CONTEXT

- 1. Sri Lanka faced a difficult macroeconomic situation on the eve of the pandemic.** The economy was yet to fully recover from the Easter Sunday terrorist attack in April 2019. It was highly exposed to external shocks, with an inadequate gross reserves position (62 percent of the Fund's Assessing Reserve Adequacy metric at end-2019). Risks to public debt sustainability were elevated, due to a high debt level and one of the highest levels of gross financing needs among emerging market economies, limiting fiscal space to counteract major shocks such as COVID-19.
- 2. In the context of substantial shocks, the program supported by the IMF during 2016-19 could not resolve all of Sri Lanka's vulnerabilities.** The combination of unbalanced macroeconomic policies and a difficult external environment prompted the authorities to embark on the adjustment program in 2016, supported under the Extended Fund Facility (EFF) by the IMF. Important progress was made through prudent monetary policymaking, earlier fiscal consolidation, and landmark reforms including a new income tax law and an automatic fuel pricing mechanism. However, program implementation was challenged by large unforeseen shocks including the 2017 drought, the 2018 political crisis, and the 2019 terrorist attack. Inflation was stable but growth was weaker than initially projected. Reserve accumulation was hampered by renewed exchange rate pressures and capital outflows, reflecting both global and domestic factors. Large depreciation in late 2018, a reversal of fiscal consolidation in 2019, and a real interest rate shock resulted in an increase in the public debt to GDP ratio from 84 percent in 2016 to 94 percent in 2019, a very high level by emerging market standards. The EFF-supported arrangement expired in June 2020 after the 6th review was completed in November 2019 (no further review was completed).
- 3. Major policy changes since late 2019 exacerbated the pre-pandemic vulnerabilities.** The new government following the Presidential and Parliamentary elections (in November 2019 and August 2020, respectively), headed by President Rajapaksa of the Sri Lanka Podujana Peramuna party, pledged to develop a people-centric economy through tax policy changes to promote production and reduce the cost of living. In this context, income tax and VAT were cut in late 2019, with estimated revenue losses exceeding 2 percent of GDP. The automatic fuel pricing mechanism was discontinued, raising fiscal risks from state-owned enterprise losses. The plans to upgrade legislation relating to central bank independence and the fiscal rules were suspended (Annex I). These policy changes, while aimed at promoting growth and employment, further eroded fiscal space, increased Sri Lanka's vulnerability to shocks, and halted institution building reforms.

Text Table. Sri Lanka: Tax Cuts Introduced in Late 2019

Personal income tax (PIT):

- Raise the tax free allowance from 500,000 to 3,000,000 rupees
- Reduce the top marginal tax rate from 24 to 18 percent
- Abolish mandatory withholding for most employees

Corporate income tax (CIT):

- Reduce the standard CIT rate from 28 to 24 percent
- Introduce new sectoral exemptions

Value-added tax (VAT):

- Reduce the standard VAT rate from 15 to 8 percent
- Raise the VAT registration threshold from LKR 12 million to 300 million in annual turnover

Other taxes:

- Eliminate the Nation Building Tax, the Economic Service Charge, and the Debt Repayment Levy

THE PANDEMIC AND POLICY RESPONSE

A. Developments During the Pandemic

4. Multiple COVID-19 waves hit Sri Lanka, while vaccinations have caught up. During the first and second waves (March–September 2020 and October 2020–March 2021), the government introduced strict containment measures, including a ban on air passenger arrivals as well as nationwide and localized lockdowns. The third wave (April–October 2021) caused by the Delta variant resulted in higher caseloads and deaths and prompted new lockdowns. Meanwhile, a strong vaccination campaign starting in 2021Q2 has double vaccinated close to 65 percent of the population. With most containment measures and border restrictions relaxed in October 2021, mobility indicators have largely recovered to their pre-pandemic levels. The spread of the Omicron variant has not led to a notable increase in cases as of January 2022.

5. The pandemic and necessary containment measures triggered a severe economic downturn. A sharp drop in tourist arrivals and a contraction in manufacturing and services activity caused real GDP to contract by 3.6 percent (y-o-y) in 2020, despite the authorities' policy support. While real GDP grew by 4.4 percent in the first 9 months of 2021, the recovery in 2021Q4 is expected to be dragged down by a temporary restriction on the use and importation of chemical fertilizer, with an adverse impact on agricultural production, and by the negative effect of foreign exchange (FX) shortages and the suspension of certain imports (import restrictions) on industrial activity. Annual growth is projected to be 3.6 percent.

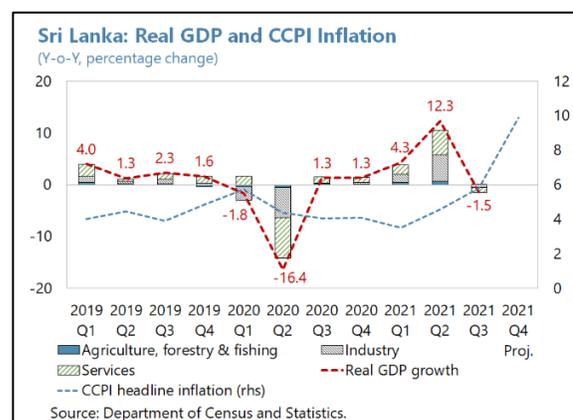
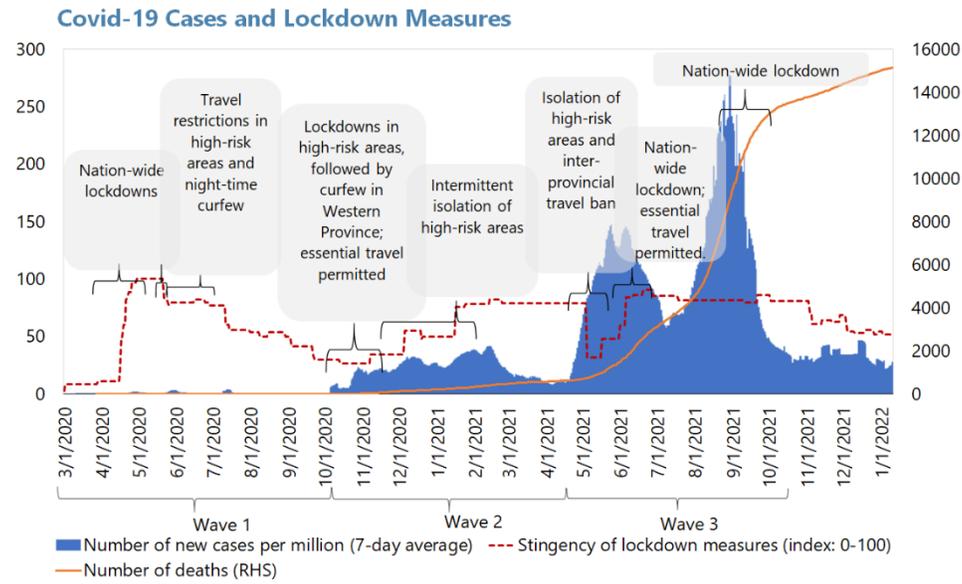
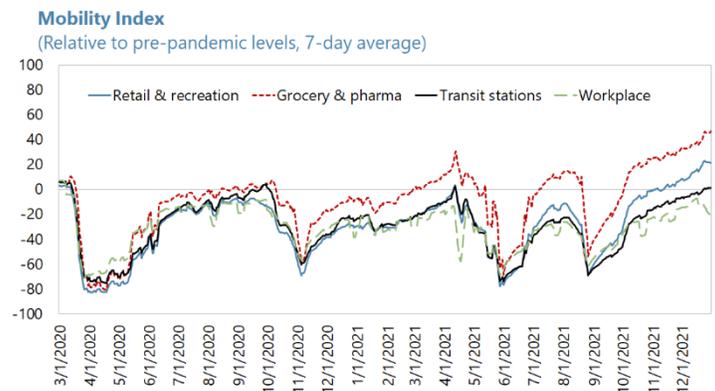


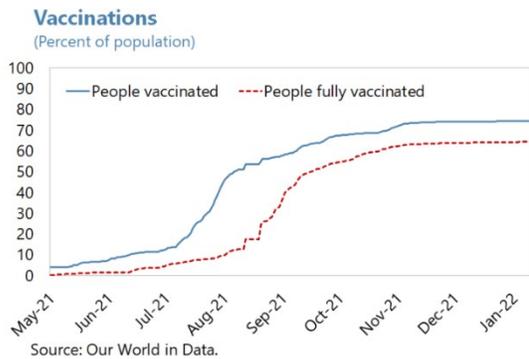
Figure 1: Sri Lanka: COVID-19 Impact, Lockdown Measures, and Vaccinations



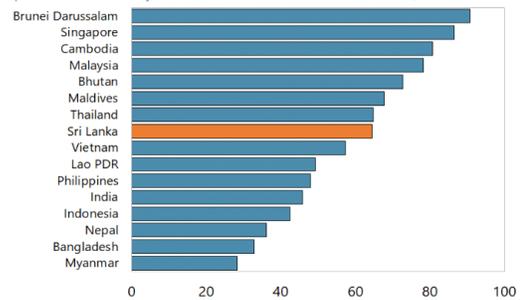
Source: Our World in Data.



Sources: Google; and IMF staff estimates.

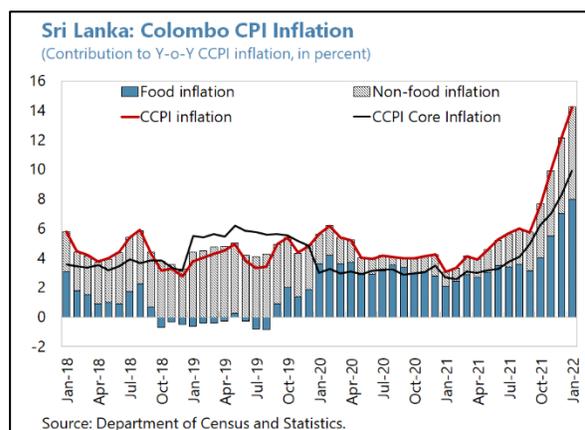


Share of Population Fully Vaccinated Against COVID-19
 (In percent, as of January 11th, 2022 or most recent available data)

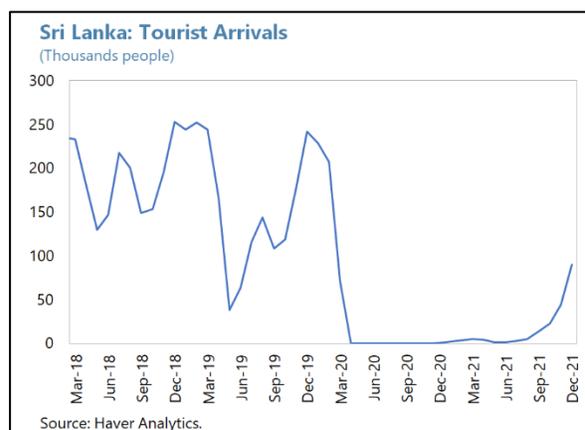


Source: Our World in Data.
 Note: The graph illustrates South Asia and ASEAN Countries.

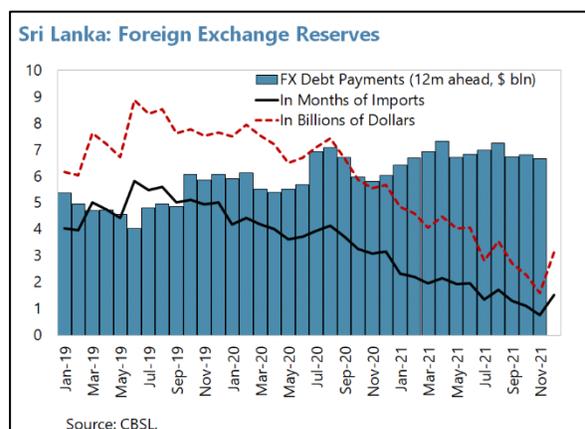
6. Inflation gathered speed in 2021. After being held down in 2020 by a deep recession and the 2019 VAT rate cut, inflation has steadily risen since early 2021, reflecting exchange rate depreciation, supply shortages, increases in administered fuel and food prices (reflecting higher international prices), and a recovery in demand against the backdrop of a large money expansion (¶11, 12). Headline inflation has breached the 4-6 percent target band of the Central Bank of Sri Lanka (CBSL) and rose to 14.2 percent in January 2022. Core inflation rose from 2.7 percent in January 2021 to 9.9 percent a year later. Private sector wages and inflation expectations are also on the rise.



7. The current account (CA) deficit exceeded its pre-pandemic level. It narrowed to 1.3 percent of GDP in 2020 (from 2.2 percent of GDP in 2019), with subdued exports and the collapse in tourism receipts more than offset by a sharp decline in imports due to low oil prices, weak domestic demand, suspension of certain imports (Annex VI on import restrictions), and a strong pickup in remittances. In 2021, the CA deficit is expected to have widened to 3.8 percent of GDP, on account of a rebound in oil prices and a recovery in imports demand. Tourist arrivals recovered in Q4 but tourism receipts were dormant for most part of the year, while remittance flows lost momentum.



8. International reserves have decreased to a critically low level since Sri Lanka lost access to international capital markets. Reflecting the pre-pandemic fiscal slippage, preexisting debt vulnerabilities, and the pandemic impact, Sri Lanka's EMBI spread rose sharply to 1,870 basis points (bps) at the onset of the pandemic and recently exceeded 2,500 bps. Rating agencies have downgraded Sri Lanka to CCC and lower. As a result, Sri Lanka lost access to international capital markets to roll over maturing international sovereign bonds (ISBs). Financial support from Bangladesh (US\$200 million), China (US\$2.8 billion), and India (US\$1.4 billion) during the pandemic provided some breathing space. Sri Lanka also received new SDR allocations in August 2021 (\$780 million), 85 percent of which had been converted and used for debt repayment



and FX intervention as of end-2021. However, the authorities' large FX debt obligations¹ and acute external financing constraints prevented the SDR allocation from having a more long-lasting impact on reserve adequacy. Owing to large external debt service including the maturities of ISBs in October 2020 and July 2021 (\$1 billion each) and January 2022 (\$500 million), unwinding of foreign holdings of rupee-denominated treasury securities, and a widening CA deficit, gross international reserves (GIR) declined from \$7.6 billion at end-2019 to \$3.1 billion (1.5 months of imports, 25 percent of ARA metric) at end-2021² and to \$2.4 billion at end-January 2022. Net international reserves have become negative since November 2021.

B. Policy Response

9. The authorities introduced various COVID-19 relief measures. These include tax and utility bill forbearance, cash transfers to vulnerable families, and loan repayment moratoria for affected businesses. The CBSL relaxed prudential requirements for banks and developed a refinancing facility to provide SMEs with concessional working-capital loans. Many of these measures helped the economy cope with the pandemic impact.

10. The 2019 tax cuts, the COVID-19 impact on revenues, and the expenditure measures widened fiscal deficits to 12.8 percent of GDP in 2020 and 11.4 percent of GDP in 2021, raising public debt well above 100 percent of GDP.

- In 2020, the primary deficit (cash basis) rose to 6.2 percent of GDP, from 2.0 percent of GDP in 2019. Tax revenues declined from 11.6 percent of GDP to 8.1 percent of GDP, due to the tax cuts, cyclical effects, suspension of non-priority imports, and lockdown measures. The increase in the deficit is partly explained by the clearance of arrears (1.6 percent of GDP) which accumulated in 2019. Non-interest current spending (excluding the arrears clearance) increased by 1.2 percent of GDP, reflecting higher wage spending and pandemic-related outlays, while capital spending (excluding the arrears clearance) declined by 2.0 percent of GDP.
- Preliminary end-November outturns suggest a similar performance in 2021, with continued revenue losses from the suspension of vehicle imports and additional COVID-19 spending, leaving the projected annual primary deficit at 4.9 percent of GDP.
- Owing to the fiscal deficits and new guarantees, largely to cover the losses of Ceylon Petroleum Corporation (CPC), public debt (including guaranteed debt and Fund credit outstanding) increased to 114 percent of GDP in 2021Q3, from 94 percent of GDP in 2019.

¹ FX debt service of more than \$3 billion was paid since the SDR allocation.

² The end-2021 GIR amount includes a currency swap with the People's Bank of China (PBOC) equivalent of US\$1.5 billion that was disbursed late December.

Text Table. Sri Lanka: Relief Measures in Response to COVID-19

Revenue Measures:

Tax exemptions on imports of medical and pharmaceutical supplies
 Tax exemptions on imports of protective equipment
 Extensions of tax payment deadlines
 Exemptions from tax penalty payments during lockdowns
 Forbearance for SME tax arrears

Expenditure Measures:

| | <i>Cost in 2020 (Percent of GDP)</i> | <i>Cost in 2021, prel. (Percent of GDP)</i> |
|---------------------------------------|--|---|
| Total COVID-related spending | 0.8 | 1.3 |
| Vaccination program | 0.0 | 0.4 |
| Other health spending | 0.2 | 0.3 |
| Cash transfers to eligible households | 0.5 | 0.1 |
| Other spending | 0.1 | 0.8 |

Financial Sector Measures:

Moratoria on loan repayments for tourism and other COVID-affected sectors
 Working capital loans at concessional rates, backed by a CBSL refinancing facility
 Concessions for NPLs, suspension of recovery actions, and relaxation of loan classification rules
 Reduction in capital conservation buffer, liquidity coverage ratio, and net stable funding ratio
 Postponement of increase in minimum capital amount of banks
 Restrictions on discretionary payments by banks

Other Measures:

Payment of an interest-free advance of LKR 10,000 to welfare recipients
 One-month grace period for the payment of utility bills and credit card bills less than LKR 50,000
 Exemption of penalty payments on payment of taxes during COVID-19 lockdowns
 Six-month moratorium on leasing loans for 1.5 million self-employed persons

Text Table. Sri Lanka: Central Government Operations, 2019-21^{1/}
(In percent of GDP)

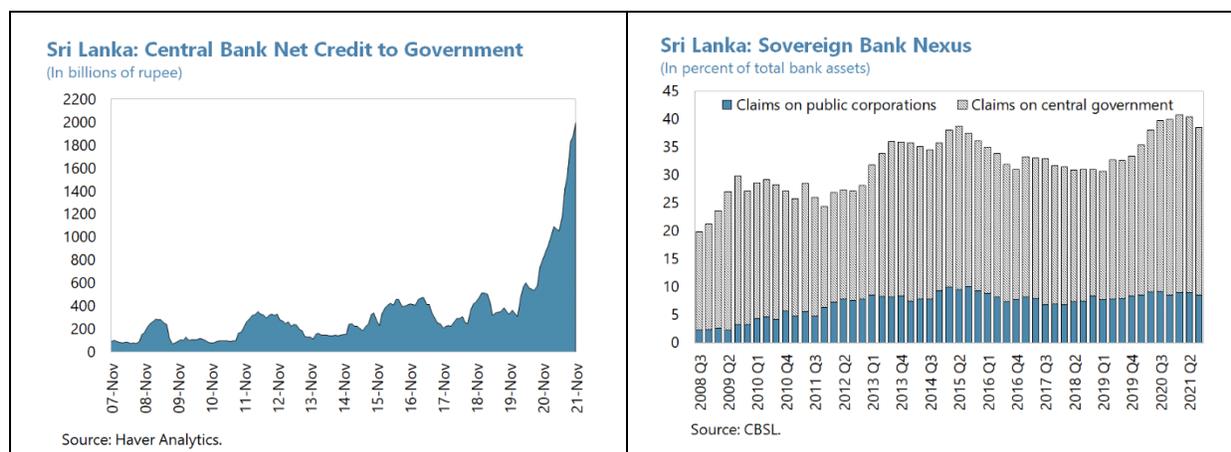
| | 2019 | 2020 | 2021 (proj.) | 2020 (Jan.- Nov.) | 2021 (Jan.- Nov.) |
|--|------|-------|-----------------|-------------------------|-------------------------|
| Revenues and grants | 12.6 | 9.2 | 8.9 | 8.4 | 8.1 |
| Tax revenues | 11.6 | 8.1 | 7.9 | 7.5 | 7.2 |
| Non-tax revenues | 1.0 | 1.0 | 1.0 | 0.9 | 0.8 |
| Grants | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Expenditure | 20.6 | 21.9 | 20.3 | 19.0 | 18.5 |
| Current spending | 15.3 | 17.8 | 16.8 | 15.9 | 15.6 |
| Capital spending and net lending | 5.3 | 4.1 | 3.5 | 3.1 | 2.9 |
| Overall balance | -8.0 | -12.8 | -11.4 | -10.5 | -10.4 |
| Primary balance | -2.0 | -6.2 | -4.9 | -4.4 | -4.4 |
| <i>Memorandum items:</i> | | | | | |
| Net accumulation of arrears | 1.6 | -1.6 | 0.0 | | |
| Primary balance (adjusted for arrears) | -3.6 | -4.6 | -4.9 | | |

Source: Sri Lankan authorities; and IMF staff calculations

1/ cash basis

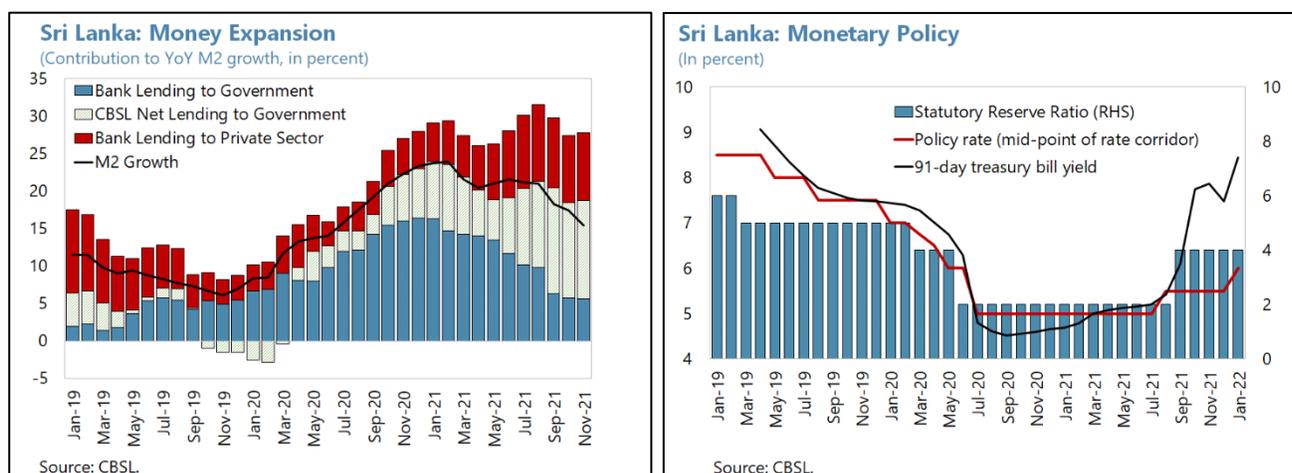
11. Large fiscal deficits have led to an unprecedented amount of central bank budget financing and higher sovereign exposure by domestic banks. The government's net domestic financing (NDF) requirements jumped to 13.3 percent of GDP in 2020 and are expected at 12.3 percent of GDP in 2021 (against an average of 3.4 percent of GDP over 2010-19), while net external financing turned negative. To prevent instability in the treasury security markets, the authorities temporarily introduced explicit interest rate caps for the primary market in mid-2020, with auction shortfalls covered by the CBSL. As a result, the CBSL's net credit to the government increased by 9 percent of GDP between March 2020 and November 2021. Meanwhile, reflecting the large NDF requirements, banks' claims on the government and SOEs (including holdings of ISBs, Sri Lanka Development Bonds, and treasury securities, as well as loans to SOEs) rose to around 40 percent of total bank assets in 2021.³

³ The sovereign exposure of the two largest state banks is even higher.

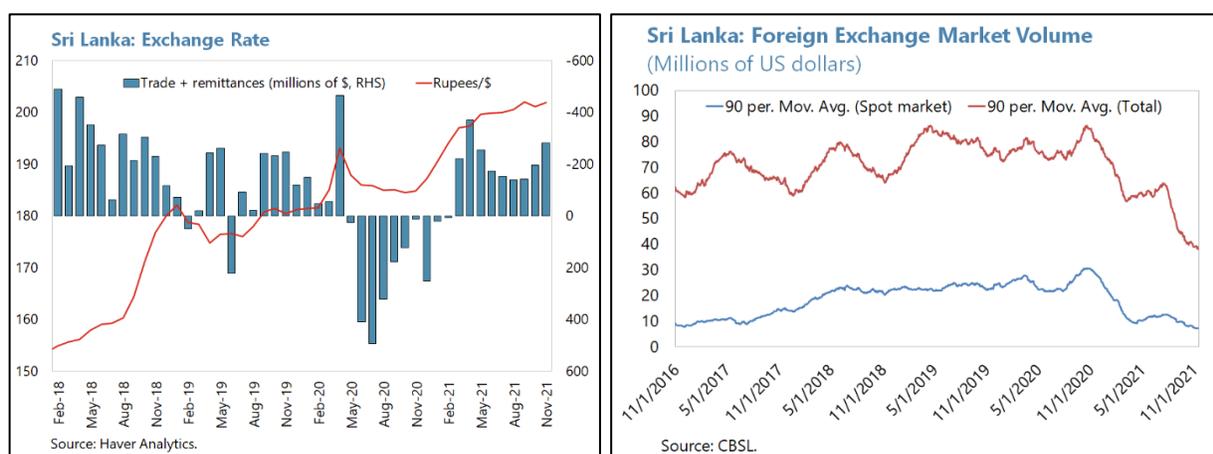


12. Loose monetary policy was maintained from the onset of the pandemic until scaled back in August 2021.

- Policy rates and the statutory reserve ratio (SRR) were reduced by 250 and 300 bps, respectively, over January-July 2020, and kept unchanged through August 2021. The rate cuts and liquidity injection led to lower bank lending rates, overall easier financing conditions, and an eventual private credit growth recovery from 6½ percent (y-o-y) in December 2020 to 13½ percent in November 2021, led by mortgage and consumer loans.
- In August 2021, the policy rates and SRR were raised by 50 and 200 bps, respectively. Since then, the rate caps on treasury securities auctions were also removed, shifting up the yield curve and allowing the CBSL to start scaling back its holdings of treasury bills. The policy rates were further raised by 50 bps in January 2022 to curtail the build-up of demand pressures.
- Along with the large-scale central bank budget financing and a notable increase in credit to public corporations, M2 growth reached 22.9 (y-o-y) at end-2020 and 15.1 percent at end-November 2021.



13. Policies to fix the exchange rate and prices of basic commodities led to dysfunctional FX markets and shortages of FX and of these goods. The CBSL has effectively fixed the official exchange rate at LKR 200–203 per U.S. dollar since April 2021, relying on moral suasion, surrender requirements on the FX received through export proceeds and converted remittances, and direct FX sales to cover essential imports. Staff has identified one of these measures as being inconsistent with Sri Lanka’s Article VIII obligations.⁴ In staff’s view, the authorities’ FX policy has led to sizable imbalances in the spot and forward markets, FX hoarding, and severe dollar shortages for importers. Parallel market quotes were reported at around 20 percent premium, albeit on a limited scale. Price controls for basic food items were introduced in mid-2021 to limit the increase in the cost of living, but were eventually lifted in October 2021. The FX shortage, price controls, and import restrictions have resulted in shortages for several commodities such as sugar, rice, milk powder, and cooking gas.



OUTLOOK, RISKS, AND POLICIES TO REGAIN MACROECONOMIC STABILITY

14. In staff’s view, Sri Lanka’s public debt is unsustainable (Annex IV). Public debt and gross financing needs (GFNs) are projected to have reached 118.9 percent and 30.1 percent of GDP, respectively, in 2021. Based on staff analysis, the fiscal consolidation necessary to bring debt down to safe levels would require excessive adjustment over the coming years, pointing to a clear solvency problem. Debt rollover risk is also very high. Staff projects FX debt service to reach around US\$7 billion in 2022, including the US\$1 billion ISBs maturing in July 2022, against critically low gross

⁴ Through a temporary incentive scheme for inward worker remittances that launched in December 2020 to encourage more workers’ remittances through formal channels, the authorities currently offer an additional incentive over the exchange rates used by banks for such remittances. This measure gives rise to a multiple currency practice inconsistent with Sri Lanka’s Article VIII obligations as the deviation between the more favorable (effective) exchange rate used for qualifying inward workers remittances and the exchange rate used for other inward remittances is more than 2 percent.

reserves and the lack of market access (¶18). The FX debt service is projected to remain around US\$7-8 billion over the medium-term.

15. Sri Lanka’s debt overhang and persistent fiscal and BoP financing shortfalls will constrain growth and jeopardize macroeconomic stability in both the near and medium term.

Sri Lanka has started experiencing a debt and BoP crisis where sizable and persistent FX inflows are urgently needed to avoid depletion of gross reserves. The large uncertainties around how to close fiscal and BoP financing gaps—which would persist for years absent policy changes—render macroeconomic forecasting extremely challenging. The illustrative scenario below aims to describe the authorities’ current policies while making optimistic assumptions that the financing gaps are closed through asset sales and new—currently unidentified and uncertain—external financing from bilateral strategic partners at reasonable costs.

- The primary deficit would decline to 2.8 percent of GDP in 2022 as envisaged in the Budget, despite substantial risks (¶21). Absent permanent revenue measures and market access, increasingly binding financing constraints would force the government to cut capital spending from 3.5 percent of GDP in 2021 to 2.5 percent of GDP during 2022-26. Still, the fiscal deficit would remain elevated above 9 percent of GDP, leaving fiscal financing gaps averaging 5 percent of GDP to be filled every year.
- The current account deficit would narrow gradually over the medium-term, as tourism slowly recovers. However, due to the persistent external debt service burden, even if fresh, still-unidentified, BoP financing of US\$2-3 billion (2-3 percent of GDP) became available each year, gross reserves would stay critically low at around 1 month of imports over 2022-26.
- A severe debt overhang, heightened macro imbalances, prolonged FX shortages, and the cut in government capital spending would erode business and public confidence and deter investment, productivity growth, and confidence in the currency. Accordingly, growth would weaken to 2.6 percent in 2022—amid the lingering impact of the chemical fertilizer ban and supply shortages (¶15)—and stay below potential (estimated in the range of 3.1-4.1 percent absent structural reforms, Annex II) through 2026.⁵ Private credit growth, averaging 9½ percent in 2022-26 under this scenario, is predicated on covering the fiscal financing needs while broadly preserving price stability. Inflation would exceed the CBSL’s target band of 4-6 percent in 2022-24, adding to exchange rate pressures.

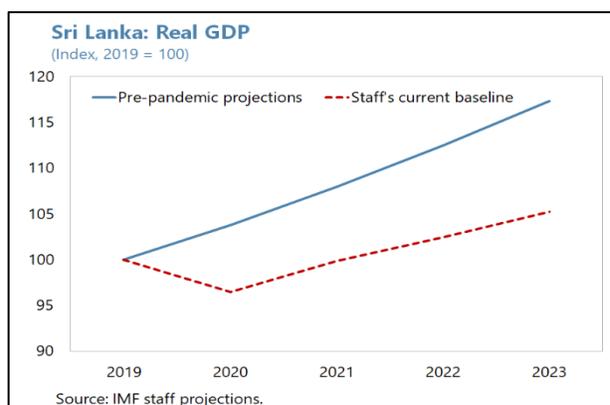
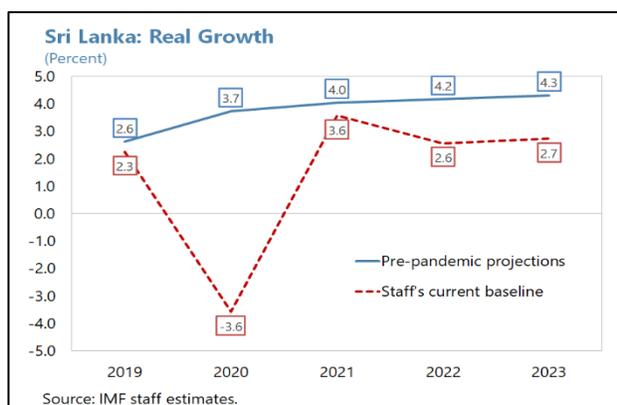
⁵ A rebased GDP series is being finalized, which could lead to a modest upward revision of the nominal GDP level.

Text Table. Sri Lanka: Fiscal and External Financing Gaps, 2021-26

| | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
|--|--------------------------|--------------|--------------|--------------|--------------|--------------|
| | <i>in percent</i> | | | | | |
| Real GDP growth | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 |
| Inflation (average) 1/ | 6.0 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 |
| | <i>in percent of GDP</i> | | | | | |
| Government revenues and grants | 8.9 | 10.7 | 10.8 | 11.0 | 11.1 | 11.3 |
| Government expenditure and net lending | 20.3 | 20.3 | 20.3 | 20.4 | 20.5 | 20.4 |
| of which: capital exp. and net lending | 3.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Overall fiscal balance | -11.4 | -9.6 | -9.6 | -9.4 | -9.4 | -9.1 |
| Identified financing | 11.4 | 6.0 | 4.2 | 4.0 | 3.3 | 4.1 |
| Privatization | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 |
| Net external financing | -0.9 | -1.0 | -0.9 | -1.0 | -1.8 | -0.9 |
| Net domestic financing | 12.3 | 7.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Fiscal financing gap | 0.0 | 3.6 | 5.4 | 5.4 | 6.1 | 5.0 |
| in million USD | 0 | 3,133 | 4,882 | 5,121 | 6,108 | 5,315 |
| | <i>in million USD</i> | | | | | |
| Overall balance of payments | -2,470 | -3,557 | -2,119 | -2,149 | -2,877 | -1,789 |
| Current account balance | -3,153 | -3,331 | -2,504 | -2,482 | -2,605 | -2,711 |
| Capital and financial account balance | 683 | -226 | 385 | 333 | -273 | 922 |
| Identified financing | 2,470 | 784.7 | -369.3 | -261.2 | -279.6 | -283.5 |
| Drawdown of reserves | 2,527 | 934 | -182 | -31 | -49 | -67 |
| Repayments to the IMF | -57 | -149 | -187 | -231 | -232 | -218 |
| External financing gap | 0 | 2,772 | 2,487 | 2,409 | 3,157 | 2,075 |
| | <i>Memorandum items</i> | | | | | |
| Primary fiscal balance (percent of GDP) | -4.9 | -2.8 | -2.5 | -2.2 | -2.0 | -1.8 |
| Gross international reserves (million USD) | 3,138 | 2,204 | 2,386 | 2,416 | 2,465 | 2,532 |
| in months of imports of G&S | 1.5 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |

Source: IMF staff projections.

1/ Colombo CPI.



16. Risks around this scenario are clearly tilted to the downside. Should the unidentified external financing not be forthcoming, the country could experience a disorderly adjustment

through severe import compression and potentially external arrears in the near-term. Relying on domestic sources to fill the fiscal financing gaps, as intended by the authorities, would either suffocate private credit growth or require further monetary financing of the fiscal deficit, which can undermine monetary stability. Confidence in the currency and the financial sector could erode under such a downside scenario, leading to an even worse macroeconomic outcome, severely affecting life and livelihood of many segments of the population, and risking intensifying social discontent. The Risk Assessment Matrix (Annex III) indicates additional downside risks, including a COVID-19 resurgence, rising commodity prices, potential loss of preferential trade access to the EU, a potential deterioration in banks' asset quality, worse-than-anticipated impact of the chemical fertilizer ban on agricultural production, and extreme weather events. Upside risks include a faster-than-expected tourism recovery and stronger-than-projected FDI inflows.

17. The authorities have presented plans to tackle the crisis but these are unlikely to put the economy back on a stable and sustainable path. The authorities are following a 6-month Roadmap announced by the CBSL in October 2021, which aims to address near-term FX shortages by raising new financing from government-to-government loans and currency swaps with foreign central banks, expediting state asset sales, and tightening export surrender requirements. In this regard, new bilateral support by India totaling US\$1.4 billion, comprising a central bank currency swap, a credit line for fuel imports, and deferment of clearing Sri Lanka's balance at the Asian Clearing Union, has recently been secured. However, even if these inflows could provide some breathing space in the short term, it remains unclear how the large FX debt service obligations this year and beyond can be met.

18. To avert a full-fledged BoP and debt crisis, there is an urgent need for implementing a credible and coherent strategy to restore fiscal and debt sustainability and regain macroeconomic stability, covering both the near and medium term. Staff recommends a comprehensive set of policies with specific measures, comprising:

- Implementing revenue-based fiscal consolidation and tightening monetary policy; moving away from an unsustainable de-facto exchange rate peg and restoring a market-determined exchange rate, while containing the risk of disorderly exchange rate movements; and mitigating adverse impacts of the macroeconomic adjustments on vulnerable groups by strengthening social safety nets. Institution building reforms, such as revamping the fiscal rule, would help ensure the credibility of the strategy.
- Developing a comprehensive strategy to restore debt sustainability. The development of such a strategy is the prerogative of the authorities, and the Fund always advises members to stay current on their debt obligations to the extent possible. This said, in staff's view, fiscal consolidation and macroeconomic policy adjustments alone cannot restore Sri Lanka's debt sustainability.

Authorities' Views

19. The authorities acknowledged the magnitude of the challenges caused by the pandemic but considered the outlook presented by staff as overly pessimistic. During the pandemic, the policy responses consisting of fiscal and monetary stimulus as well as loan moratoria for affected businesses supported the economy and livelihoods. The authorities were confident that pursuing the current policy strategy detailed in the CBSL Roadmap and the 2022 Budget would ensure macroeconomic stability and a strong economic recovery. They expect real GDP growth to rebound to 5 percent in 2022 and accelerate to 7 percent of GDP over the medium term and rebasing of GDP to result in an upward revision on nominal GDP levels from 2015 onwards.

20. The authorities viewed the BoP and debt challenges as a temporary problem. The authorities acknowledged the debt service challenge over coming years, but stressed that Sri Lanka has maintained its unblemished record of debt servicing. As the Roadmap envisages, the authorities viewed that the near-term FX shortages would be addressed by expected government-to-government external loans and currency swaps with foreign central banks, expedited FDI and monetization of underutilized government assets, and temporary export surrender requirements. In their view, as maturing ISBs are repaid, reliance on commercial external debt—several ISBs were issued during IMF-supported programs in the past—and debt vulnerabilities are reduced. The government remains committed to honoring all forthcoming obligations and expects that this commitment will help entice investors in the future. Under the authorities' forecast, the current account balance will improve in the near term, owing to a strong recovery in tourism reflecting successful vaccination efforts, a rebound in remittances as more Sri Lankans are leaving for working abroad, export diversification into IT services, and lower oil imports from increasing use of renewable energy. In view of the risks involved in this strategy, the government is seeking new loans from foreign counterparts as well as swap facilities from foreign Central Banks and special facilities to support imports. The authorities argued that the new SDR allocation and disbursement would have been more effective if they had been made at the outset of the pandemic.

POLICY DISCUSSIONS

A. Advancing Revenue-based Fiscal Consolidation

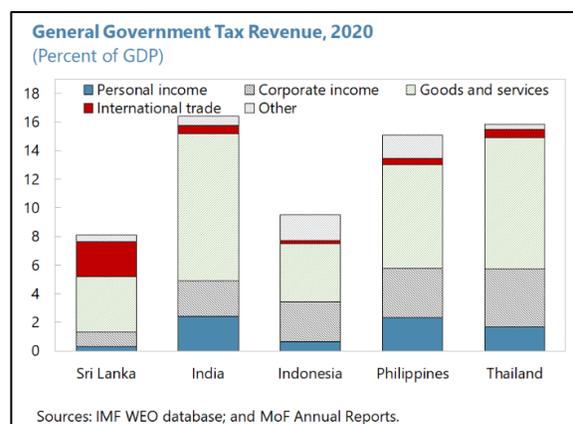
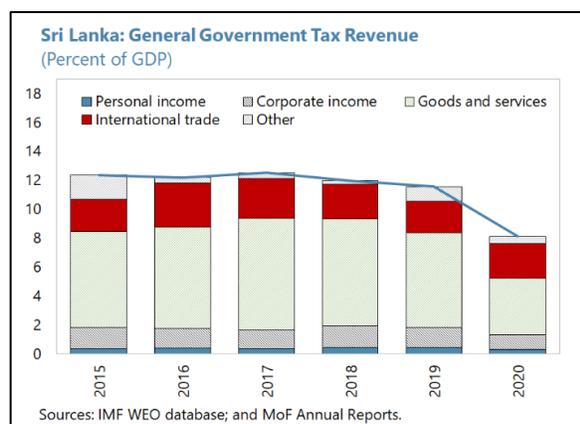
21. Planned fiscal consolidation in 2022 is welcome, but meeting its deficit target is at substantial risk. The 2022 Budget aims to reduce the primary deficit to 2.8 percent of GDP in 2022, a sizable fiscal adjustment of about 2 percent of GDP from 2021. It introduces revenue measures including a one-time income tax surcharge (applied retroactively to 2020/21 income), a turnover tax, a new Special Goods and Services Tax (SGST),⁶ and a higher VAT rate on financial services, which could generate 1.6 percent of GDP. Even so, the budgeted expenditure envelope is predicated on optimistic revenue assumptions—the budget projects tax revenues excluding measures to increase

⁶ The SGST consolidates excises, para-tariffs, and other levies on alcohol, tobacco, vehicles, gambling, and telecommunications into a single tax, with an increase in effective rates.

by 27 percent from 2021. Further, in January 2022, the authorities introduced a 1.2 percent of GDP spending package, consisting of increases in public sector wages, pensions, and social transfers, to address the rising cost of living. The overly optimistic assumptions and new spending increases weaken budget credibility, given that additional revenue measures or drastic cuts to capital spending would likely be needed to meet the primary balance target.

22. Staff and the authorities agreed on the importance of revenue-based fiscal consolidation beyond 2022, but staff sees the need to anchor it in high-quality and permanent revenue measures.⁷ Staff recommends that, at a minimum, fiscal consolidation should achieve a primary balance of zero by 2024. The authorities' objective of reaching a primary surplus by 2025 is close to this minimum path. Staff and the authorities agreed that fiscal consolidation should be primarily revenue based—Sri Lanka's tax-to-GDP ratio is among the lowest in the world, reflecting low tax rates following the 2019 tax cuts and low collection efficiency. But it is unclear how the authorities' revenue goals can be achieved, as they commit to preserving the 2019 tax reforms, which introduced large PIT, CIT and VAT rate cuts and exemption increases. Moreover, the revenue measures in the 2022 budget are overwhelmingly one-off, whereas the January 2022 package is likely to increase wage and pension spending permanently.

23. Staff recommends strengthening income tax and VAT. Generous corporate and personal income tax (CIT and PIT) exemptions eroded the effectiveness of the 2017 Inland Revenue Act (IRA) and the widespread use of project-based tax holidays, the effectiveness of which remains questionable, has led to large revenue losses. The multitude of indirect taxes renders the tax system unpredictable and complex, while high para-tariffs hinder competitiveness and growth. The main tax measures of the 2022 Budget were undesirable: retroactive income taxes on the past taxable income undermine tax certainty, and turnover taxes are less efficient than the VAT due to a cascading of the tax burden along the supply chain. Instead, the needed revenues should be mobilized from CIT, PIT, and VAT, by raising rates, minimizing exemptions, and reinstating mandatory withholding requirements under the IRA. This would ensure efficient revenue mobilization and larger contributions from high-income earners while avoiding overburdening the poor.



⁷ See accompanying Selected Issues Paper "Mobilizing Revenue in Sri Lanka."

- 24. Efforts to strengthen revenue administration should continue.** Staff supports the authorities' shift towards risk-based compliance management, the strengthening of the Large-Taxpayer Unit, and the increased use of digitization in revenue administration. However, the authorities' plan to make the Treasury administer the new SGST would lead to more fragmentation and create operational inefficiencies. Instead, efforts should be stepped up to improve capacity at the Customs and Excise Departments.
- 25. Spending discipline is needed to support consolidation efforts.** Given limited fiscal space and the need for higher social safety net spending (₹147), some scaling-back of non-priority expenditure may be needed, accompanied by greater spending efficiency. An overarching strategy for managing the public wage bill is needed to reverse the recent increasing trend. Expenditure rationalization, however, is no substitute for revenue mobilization, given that Sri Lanka's non-interest recurring expenditures are not out of line with its peers.
- 26. Cost-recovery based energy pricing is needed to mitigate fiscal risks from state-owned enterprises (SOEs).** With retail fuel and electricity prices generally set below cost-recovery levels on a discretionary basis, the CPC and the Ceylon Electricity Board (CEB) have been loss-making for years, and the resulting debt overhang has hindered new investments. Electricity tariffs were slightly below the unit cost of electricity due to an increase in hydro generation in 2021, and the fuel price increase in December 2021 brought retail fuel prices closer to cost-recovery levels. To mitigate the implied fiscal risks, automatic fuel and electricity pricing mechanisms should be adopted, under which retail prices are periodically adjusted in line with cost-recovery levels. This would pass changes in input costs through to consumers and eliminate energy subsidies which disproportionately benefit the rich rather than the poor. If energy subsidies are not eliminated, then they should be transparently remunerated through the budget within targeted fiscal deficits. Finally, an overarching strategy is needed to address high SOE debt and growing currency mismatches on energy SOEs' balance sheets.
- 27. Improvements in budget formulation and execution procedures are needed to support successful fiscal consolidation.** By overestimating revenues and underestimating interest payments, past budgets have provided unrealistic assessments of available resources. Meanwhile, weak internal reporting and commitment control mechanisms have led to frequent expenditure arrears. Staff commends the authorities' reform initiatives in these areas, including the creation of a Macro-Fiscal Unit at the Ministry of Finance (MoF), the rollout of the ITMIS electronic platform to facilitate commitment-based spending controls and fiscal reporting, and the recent move from annual to quarterly commitment ceilings, which should be used proactively to help meet the fiscal deficit target for 2022. Staff also recommends stepping up efforts to strengthen the Macro-Fiscal Unit and adopt the GFSM 2014 fiscal reporting standards. In addition, the current fiscal rule—which has not been satisfied since its inception in 2003—should be revamped in line with international best practice to anchor fiscal sustainability.

Authorities' Views

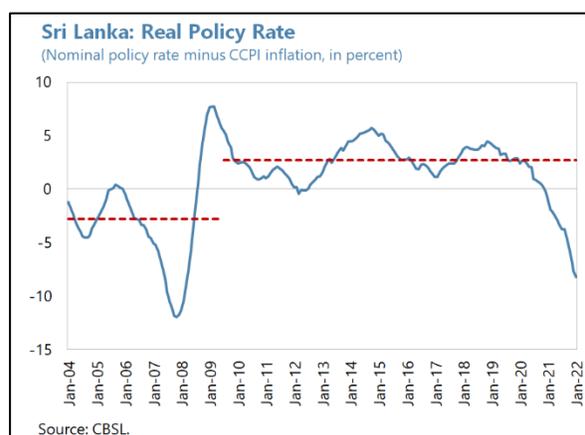
28. The authorities agreed with the need for revenue-based fiscal consolidation. They committed to reduce the primary deficit to 2.8 percent of GDP in 2022 and achieve a primary surplus by 2025. Under their plan, the relief spending introduced in January 2022 will be financed within the budget envelope and the deficit target. Disagreeing with the need for rate increases for income tax and VAT, the authorities reiterated their intention to keep the current low-tax regime unchanged over the medium-term for simplicity and predictability. In the authorities' view, a strong economic recovery and ongoing efforts to increase tax compliance, including measures to strengthen the Large Taxpayer Unit, digitalization of tax administration, and information sharing among government agencies will raise the tax to GDP ratio over the medium term. They noted that the SGST was aimed at ensuring the efficiency in tax administration via avoiding the complexities associated with the application and administration of multiple tax regimes on specified goods and services. The authorities acknowledged the revenue losses from tax incentives but stressed their importance for promoting investment. They also noted that during the 2016 EFF IMF-supported program, the increase in revenue from the tax hikes were offset by higher interest payments by the government, resulting in a marginal net effect on fiscal consolidation.

29. The authorities broadly concurred with staff's recommendations on expenditure management and SOE reforms. They highlighted ongoing efforts on expenditure management, including raising the retirement age for civil servants and rationalizing externally financed capital projects. An IT-based spending commitment control system has been introduced, ensuring that the government can control spending execution and avoid arrears. The authorities concurred with the need to regain the financial viability of loss-making SOEs. In this vein, fuel prices were increased in late December to incorporate rising global oil prices. In the authorities' view, the automatic pricing mechanism for fuel and electricity is an option to regain the financial viability of energy SOEs, but it should allow price smoothing to avoid excess volatility in retail prices.

B. Preserving Hard-Earned Price Stability and Restoring A Market-based Exchange Rate

30. The large public debt burden has subordinated monetary and exchange rate policies to fiscal needs. Due to high public debt and large interest bills, as well as a large share of dollar-denominated public debt, the CBSL has been mindful about fiscal implications of policy rate setting and greater exchange rate flexibility. Staff's recommended policies to restore fiscal and debt sustainability would help resolve Sri Lanka's long-standing fiscal dominance and thereby support the CBSL in conducting policies independently. This would also increase the effectiveness of necessary reforms to enhance the frameworks for flexible inflation targeting and a flexible exchange rate, including legislative reforms to strengthen central bank independence.

31. Further monetary policy tightening is warranted in the near-term, given rising inflationary pressures that can undermine Sri Lanka’s hard-earned price stability. While the policy accommodation in 2020 mitigated the economic downturn, inflationary pressures have been quickly building up since mid-2021. With private sector wages and inflation expectations also on the rise as well as the announced public sector wage increase, price pressures are likely to become more persistent. The policy tightening in August 2021 and the removal of the interest rate caps for T-bill auctions in September 2021 led to a significant upward shift in the yield curve. However, with both headline and core inflation rapidly rising, the real policy rate remains negative and well below its historical average of 2½ percent per annum (over the past decade), suggesting a still highly accommodative stance. Near-term monetary policy tightening is thus warranted to ensure that the recent breach of the 4–6 percent inflation target band is only temporary. In this regard, the 50-bps policy rates increase to 5.5-6.5 percent in January 2022 is a step in the right direction. Staff welcomes the authorities’ plan to launch their first Monetary Policy Report, which would enhance communication and clarify the flexible inflation targeting framework. The CBSL’s macro-forecasting models could play a more prominent role in informing policy decisions.



32. The CBSL should phase out its direct financing of budget deficits. Further monetary financing would aggravate inflation risks—staff’s analysis based on a battery of empirical results suggests that price increases are expected to catch up with money expansion over time in Sri Lanka.⁸ The CBSL’s plan and some initial steps taken to gradually unwind its large T-bill holdings are welcome and critical for fulfilling its price stability mandate. In doing so, the CBSL should coordinate with the MoF on a well-sequenced and time-bound exit strategy and clearly communicate that monetary budget financing should remain an extraordinary last-resort measure.

33. To facilitate the external adjustment, the authorities should gradually return to a market-determined and flexible exchange rate. The current policy to effectively fix the official exchange rate, which has led to dysfunctional FX markets (¶13), is unsustainable. To help rebalance supply and demand in the FX markets, moral suasion used to dissuade exchange rate movements should be phased out to allow the exchange rate to adjust to market conditions, as exercised before April 2021. To avoid disorderly movements in the exchange rate, these measures should be carefully sequenced and implemented as part of a comprehensive macroeconomic adjustment package. FX intervention by the CBSL should be limited to truly disorderly market conditions, especially given the precarious reserves position. When needed, additional monetary policy tightening should be

⁸ See accompanying Selected Issues Paper “Government Financing during COVID-19 and its Implications for Money and Inflation in Sri Lanka.”

considered to counter FX market pressures and mitigate exchange rate pass-through to inflation. Greater exchange rate flexibility is also a prerequisite for flexible inflation targeting.

34. Sri Lanka’s external position in 2021 is assessed as weaker than the level implied by the medium-term fundamentals and desirable policies (Annex V). The current account balance in 2021, projected at a deficit of 3.8 percent of GDP, is weaker than a norm implied by fundamentals and adjustments needed to ensure external sustainability over the medium term. External debt vulnerabilities are high, and the level of reserves remained precariously low compared to an adequate level, posing severe vulnerabilities to external shocks. Improving Sri Lanka’s external position would require, among others, implementing strong growth-friendly fiscal consolidation, restoring debt sustainability, conducting prudent monetary policy accompanied by greater exchange flexibility, and rebuilding international reserves to adequate levels. In addition, structural reforms to boost Sri Lanka’s export capacity and steps to encourage FDI in export-oriented sectors would be key.

35. Import restrictions and capital flow management measures (CFMs) introduced during the pandemic should be temporary. Import of certain non-priority goods was suspended over 2020–21, and this is expected to have reduced the import bill by 2.4 percent of GDP (Annex VI), but such measures are detrimental to economic activity and the authorities should develop a schedule for them to be phased out. While the 2020 import restrictions focused on consumption goods, the majority of the 2021 restrictions fell on intermediate and capital goods, affecting agriculture, transport, and IT sectors. The authorities also introduced new CFMs and tightened existing CFMs during the pandemic.⁹ While these could help mitigate FX shortages in the near term, they should not be a substitute for the comprehensive policy package (¶18) and warranted macroeconomic adjustment. Staff assesses that Sri Lanka maintains a multiple currency practice inconsistent with Sri Lanka’s Article VIII obligations (¶13 and the Informational Annex) and no approval is recommended.

36. Sri Lanka’s capacity to repay the Fund needs to be closely monitored. The credit outstanding to the Fund stood at SDR902 million (US\$1.3 billion) at end-2021, with payments (repurchases and charges) due averaging US\$170 million over 2022–29 (Table 6). While the credit outstanding and the payments due are not large (1.5 percent of GDP at end-2021 and around 1 percent of total exports over 2022–27, respectively) and Sri Lanka has kept a sound track record of repaying debt, its precarious reserves position, debt overhang, as well as persistent fiscal and BoP financing shortfalls pose high risks to Sri Lanka’s capacity to repay the Fund.¹⁰

⁹ Main CFM measures introduced or tightened in 2020–2021 and currently in force include: (i) a repatriation requirement for exports of goods and services; (ii) a surrender requirement for exporters on proceeds from exports of goods and services; (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. Measures (i) and (vii) constitute a tightening of existing CFMs on outflows, while the others are new CFMs on outflows.

¹⁰ Sri Lanka’s credit outstanding to the Fund falls below the thresholds for a Post Financing Assessment.

Authorities' Views

37. The authorities viewed the current monetary policy stance as appropriate. They viewed the rising inflationary pressures as mostly driven by transitory supply-side factors such as upward adjustments to administratively determined prices and a rise in global commodity prices. In the authorities' view, demand-side pressures have been addressed by the policy rates increase in August 2021 and the abolishment of interest rate caps for treasury security auctions that led to a significant upward shift in the yield curve. They expected the resultant increases in market interest rates to encourage savings and discourage excessive consumption (which has fueled imports) and facilitate a gradual unwinding of the CBSL's holding of treasury bills as announced in the CBSL's Roadmap. Against this backdrop, the authorities projected inflation to decline toward the target range starting mid-2022. They emphasized that raising policy rates at this juncture would put an undue burden on businesses under loan moratorium and raise interest costs for the government. Nonetheless, the CBSL stands ready to act against any signs of intensifying inflationary pressures and destabilizing inflation expectations. The authorities acknowledged the inflation risks from central bank financing of the budget deficit and stressed the temporary nature of this measure. They further noted that the policy rates were raised again in January 2022.

38. The authorities disagreed with staff's recommendations on exchange rate policy. They acknowledged imbalances in the FX markets, but noted transactions outside the official market remained limited. The authorities expected FX market pressures to dissipate as recoveries in tourism and remittances improve the current account and FX inflows envisaged under the CBSL's Roadmap materialize. The authorities pointed out that their efforts in securing FX inflows, under the Roadmap, have strengthened the reserves position and helped achieve relative stability in the FX market and the exchange rate. In their view, the current FX market condition does not bode well with a floating of the rupee, with potential risk of disorderly exchange rate movements adversely affecting inflation and public debt dynamics. They further noted that exchange rate depreciation would have limited impact on the current account balance, reflecting low price elasticity of imports. The authorities highlighted that import restrictions, surrender requirements for exports, requirements for banks to sell a portion of the converted remittances to the CBSL, and some other capital flow management measures were intended to be temporary. They may remain in place under the current circumstances, but the authorities expected their adverse impact on growth to be limited. With a view to further supporting external sector stability, the CBSL further strengthened the incentive scheme for workers' remittances.

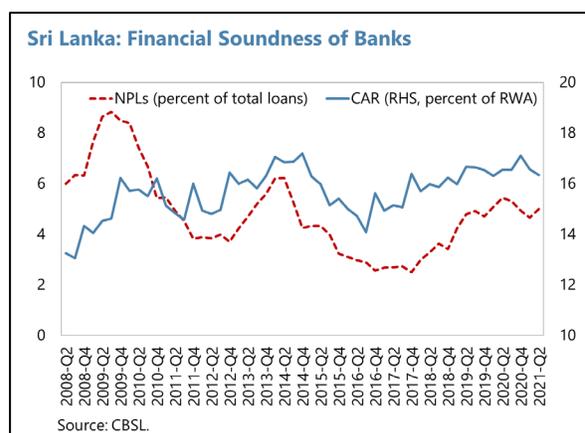
C. Ensuring Financial Sector Stability

39. Reflecting commendable efforts by the CBSL to strengthen the regulatory and supervisory frameworks, the performance of the financial sector was satisfactory before the pandemic. Since the mid-2010s, the CBSL increased and upgraded capital and liquidity requirements based closely on the Basel standards, implemented the International Financial Reporting Standard 9, and enhanced supervisory methods with a new risk-based approach. As a result, financial soundness indicators of banks—accounting for over 60 percent of total financial

sector assets—were broadly satisfactory before the pandemic, except that non-performing loans (NPLs) rose due to the economic slowdown in 2019. Performance of licensed finance companies (LFCs), which account for around 6 percent of total financial sector assets and cater to higher-risk borrowers, has been weaker than that of banks. The regulatory and supervisory frameworks for LFCs were strengthened but remain lighter than those for banks.

40. The COVID-19 pandemic put significant pressures on the financial sector, mitigated by the swift and broad-based policy actions of the authorities. Several lockdowns and the collapse of tourism activity have significantly constrained the ability of borrowers to service their debt. Since March 2020, the CBSL has adopted a range of measures aimed at boosting liquidity of financial institutions, relaxing capital requirements, and reclassifying NPLs, which allowed banks to delay the formation of loan-loss provisioning. In addition, some measures aimed to relieve financial pressures on borrowers, including moratoria on loan repayments and a new refinancing facility.

41. Banks and LFCs appear to have preserved capital, profitability, and liquidity against the backdrop of healthy corporate earnings, with reported NPL ratios relatively stable. Although the loan repayment moratoria and relaxed prudential requirements complicate the assessment of banks' underlying asset quality, the share of loans under repayment moratoria has steadily declined from around 25 percent of total loans in mid-2020 to around 9 percent in August 2021, with banks actively working with their borrowers to restructure loans as needed.



42. However, the debt overhang and the persistent fiscal and BoP financing shortfalls pose significant financial stability risks.

- Banks' large exposure to the government and SOEs (₹11) strengthens the sovereign-bank nexus. Continued large borrowing needs of the public sector would constrain banks' lending to the private sector and thereby weigh on growth.
- Sovereign rating downgrades have constrained banks' access to external financing and import credit, amplifying FX shortages. On the other hand, banks' exposure to exchange rate risks are mitigated by their minimal net open FX positions as required by regulations and their relatively tight FX lending standards (such as the requirement for FX income).

43. A credible and coherent macroeconomic strategy (₹18) is therefore indispensable for preserving confidence in financial sector stability, supported by continued vigilance. The planned unwinding of the COVID-19 relief measures, including scheduled expiration of the repayment moratoria for individuals and businesses affected by COVID-19 and for the tourism sector in March and June 2022, respectively, is welcome. Besides targeted support to distressed-but-

viable borrowers, the CBSL should continue to closely monitor the quality of loans exiting the moratorium. Given the financial sector risks, the CBSL should also proactively identify vulnerabilities through stress testing. During this process, maintaining restrictions on bank profit distributions would help ensure capital adequacy. The capital and other prudential requirements should be restored to pre-pandemic standards under a feasible timeframe.

44. Efforts to strengthen the regulatory, supervisory, and resolution framework should continue, building on the progress made before the pandemic. It would be important to broaden the CBSL's regulatory powers and upgrade the resolution framework by setting up a special resolution regime for financial institutions, expanding resolution tools, improving deposit insurance, and enhancing emergency liquidity assistance. The finalization and adoption of the new Banking Act should help achieve these goals. The regulatory and supervisory requirements for banks and nonbank deposit-taking financial institutions should be harmonized. Although larger and more sophisticated financial institutions should be subject to tighter regulatory and supervisory requirements, it is important to ensure level-playing field for banks and LFCs, which conduct essentially the same banking operations.

Authorities' Views

45. The authorities emphasized that swiftly-enacted and broad-based extraordinary financial sector measures have helped address the challenges raised by the pandemic. They noted that despite significant pressures, both banks and licensed finance companies (LFCs) have remained well capitalized and profitable, and the share of loans under repayment moratorium has been declining. Going forward, the CBSL recognized the importance of closely monitoring the quality of loans under moratorium and conducting stress tests as appropriate. The CBSL agreed with the need to pursue longer-term reform efforts, including the adoption of the new Banking Act. The CBSL acknowledged the importance of consolidating LFCs as needed, but did not see the need to unify the regulatory and supervisory frameworks for banks and LFCs, noting that LFCs provide some financial services that are not provided by the banks including in rural areas.

D. Protecting the Vulnerable, Raising Potential Growth, and Strengthening Institutions

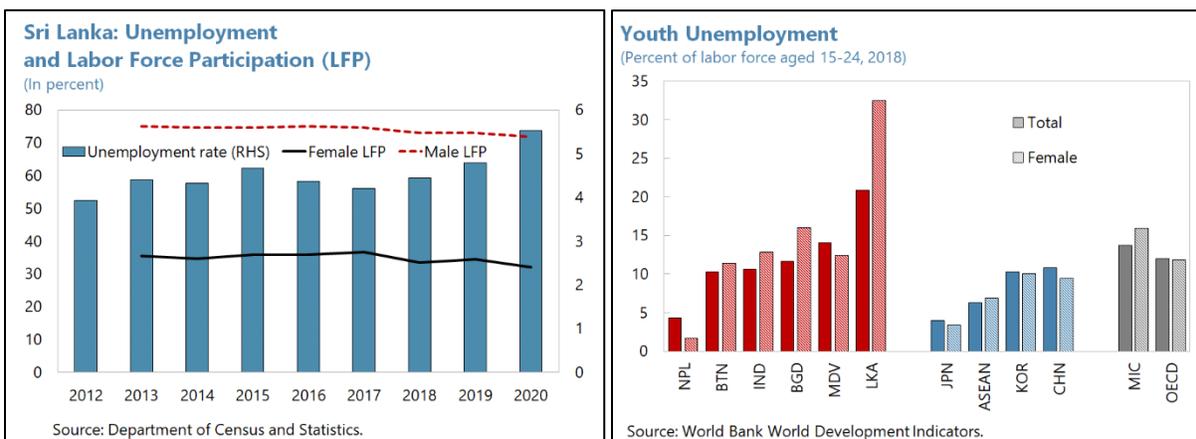
46. The pandemic inflicted severe economic damage on the poor and the informal sector. The World Bank estimates that Sri Lanka's \$3.2/day poverty rate increased from 9.2 percent in 2019 to 11.7 percent in 2020. Moreover, earnings losses were concentrated on the bottom 40 percent of households, exacerbating income inequality. Revenue, employment, and salary expenditures of micro, small, and medium enterprises declined by around 60–80 percent during the first COVID-19 wave, disproportionately hitting Sri Lanka's large informal sector that accounts for two thirds of total

employment.¹¹ Needed macroeconomic adjustments could have further adverse impact on these vulnerable groups.

47. Sri Lanka should thus step up social safety net (SSN) reforms (Annex VII). SSN spending, at around 0.4 percent of GDP (excluding COVID-19 relief), remains low compared with peers. There is a need for improving coverage and targeting as well as raising per-family benefit while preserving its progressivity. Revenue mobilization is critical for creating space for higher SSN spending and ensuring fair burden-sharing of fiscal consolidation.

48. Renewed commitment to growth-enhancing structural reforms is needed. The engines of growth in Sri Lanka have slowed down in recent years and—unless decisive policy changes are initiated—could moderate further over the medium term. Labor force growth is projected to slow, due to population aging, while capital accumulation is likely held back by the debt overhang and macroeconomic uncertainties. Reforms to unlock Sri Lanka’s growth potential should focus on promoting female labor force participation, creating job opportunities for the young, reducing trade barriers, and improving investment climate.

- Labor force participation (LFP) rate has fallen to a decade low, with female LFP disproportionately hit by the pandemic, further widening the gender gap. Sri Lanka’s youth unemployment also stands out among its peers, which weighs on employment growth. Recent reform efforts to increase the minimum retirement age against an aging population are welcome. Further, more targeted reforms aimed at improving female LFP and reducing youth unemployment—by improving access to finance, realigning vocational training needs, and providing job search support—will be important.



- Sri Lanka’s exports have remained concentrated in low complexity/value-added products, reflecting Sri Lanka’s relatively restrictive trade regime, which hinders diversification by incentivizing investments into protected sectors. Trade and economic liberalization is important for facilitating export diversification and boosting productivity growth. In particular, reducing

¹¹ See accompanying Selected Issues Paper “The Informal Sector and the Impact of the COVID-19 Pandemic in Sri Lanka.”

non-tariff barriers could help improve medium-term productivity, especially in sectors reliant on global value chains.¹² The authorities' intention to improve business and investment climate is welcome, but it should be supported by a tangible, wide-reaching, and coherent strategy.

- The Colombo Port City project (Annex VIII) brings about an important opportunity for investment promotion and for testing growth-enhancing structural reforms. To maximize its benefits while minimizing associated risks, there is a need to ring-fence tax concessions, ensure compliance with international tax and AML/CFT standards, and shield the domestic financial sector from offshore banking activities in the Port City.
- The government plays a significant role in the economy. It administers or influences prices of a wide range of basic commodities such as rice, wheat, milk powder, cement, through direct price controls, distorting markets and preventing entry into protected industries. The price controls on these commodities led to supply shortages and rationing and eventually had to be rolled back as price pressures built up in late 2021 (¶13). Moreover, SOEs continue to play a significant role in the economy with more than 400 of them spread across key sectors including ports, energy, water, finance, retail, production of basic food, mining, and construction. Reforms of price controls and the SOE sector are warranted to enable a more efficient allocation of resources, foster competition, and boost productivity.

49. Efforts to strengthen governance and reduce corruption vulnerabilities should

continue. With very limited fiscal space, the need for transparency and accountability in the use of public resources—including COVID-19 spending—is more important than ever. Pandemic-related spending is subject to the normal procurement standards and procedures. The details of COVID-19 spending through social safety net programs and aggregate spending on health infrastructure and quarantine are published and donor-supported expenditure including vaccine support is subject to transparency and accountability standards of the respective donors. Improving SOE governance, leveraging e-government platforms for revenue collection and expenditure management, and ensuring public sector transparency are essential for reducing governance vulnerabilities. Staff commends the authorities' continued efforts in strengthening their AML/CFT regime, including important steps taken to strengthen the legal framework for operationalizing the beneficial ownership registry. Upgrading the anti-corruption legislation should be a priority,¹³ and the recent Cabinet decision to resume this reform process, after a significant delay in 2020-21, is welcome.

50. The IMF's capacity development (CD) assistance will support strengthening

macroeconomic and financial sector management. Technical assistance (TA) on revenue administration is expected to resume, following delays due to logistical constraints during the pandemic. The authorities also appreciated the training provided to the Macro-Fiscal Unit and expect continued engagement with the IMF on public financial management and fiscal statistics. Financial sector TA to follow-up the 2019 Financial Sector Stability Review has covered a broad

¹² IMF, Regional Economic Outlook for Asia and Pacific, October 2021.

¹³ See Country Report No. 19/335 for a detailed description of these reforms.

range of topics, such as macroprudential policy arrangements, stress testing, and regulation and supervision of nonbank financial institutions, including through a resident advisor. SARTTAC has also provided TA on key macro statistics and monetary policy operations.

Authorities' Views

51. The authorities broadly agreed with staff's recommendations. They highlighted that social safety nets have been used to mitigate the impact on the poor and vulnerable during the pandemic; the 2022 Budget made new provisions for social assistance; and the January 2022 relief package raised the transfer amount for recipients of Samurdhi cash transfers. Substantial outlays were made for COVID-19 mitigation actions and the vaccination program. The authorities agreed on the importance of raising female labor force participation and were keen to pursue further research for understanding the driving forces. The authorities agreed that exports should be diversified beyond traditional products and ongoing efforts such as introducing a single window should facilitate private investment and attract FDI. They noted that the Colombo Port City Act is such that AML/CFT legislation already prevailing is applicable to the Port City and that the laws and regulations will be followed and applied within the Port City without exemption. The authorities appreciated capacity development support from the IMF, notably for the Macro Fiscal Unit and financial sector stress testing.

STAFF APPRAISAL

52. The authorities' prompt policy response has cushioned the economic impact of COVID-19. The pandemic has taken a heavy economic toll in Sri Lanka, due to a sharp drop in inbound tourism and lockdown measures. The authorities' policies, including COVID-19 relief spending, monetary policy loosening, and loan moratoria for affected businesses prevented a worse economic downturn. Sri Lanka's successful vaccination drive is also commendable.

53. Nonetheless, the pandemic aggravated Sri Lanka's preexisting debt overhang and inadequate external buffers. Staff assesses that Sri Lanka's public debt is unsustainable. Left unaddressed, persistent fiscal and BoP financing shortfalls will constrain growth and jeopardize macroeconomic stability in both the near and medium term. The country has started experiencing a combined debt and BoP crisis where avoiding depletion of gross reserves requires sizable and persistent FX inflows. Should the external financing needs not be met, heavy reliance on domestic financing to cover fiscal deficits would eventually suffocate private credit growth or undermine monetary stability.

54. To avert a full-fledged BoP and debt crisis and to restore macroeconomic stability and debt sustainability, implementing a credible and coherent strategy covering both the near and medium term is urgently needed. The comprehensive strategy should comprise macroeconomic policy adjustments and measures to mitigate adverse impacts on the vulnerable and the poor. It should also entail development of a comprehensive strategy to restore debt sustainability, given that, in staff's view, fiscal consolidation and macroeconomic policy adjustments alone cannot restore Sri Lanka's debt sustainability.

55. Staff recommends credible medium-term fiscal consolidation based on concrete policy measures. Planned fiscal consolidation in 2022 is welcome, but additional revenue measures or drastic cuts to capital spending would likely be needed to meet the primary balance target. Fiscal consolidation should be primarily revenue-based, given Sri Lanka's very low tax-to-GDP ratio. The needed revenue should be mobilized from CIT, PIT, and VAT, by raising rates, minimizing exemptions, and ensuring greater contributions from high-income earners. Fiscal consolidation should be supported by continued progress in revenue administration reform, expenditure rationalization, and stronger budget formulation and execution procedures. Cost-recovery based energy pricing through automatic fuel and electricity pricing mechanisms should be adopted to mitigate fiscal risks from SOEs. The fiscal rule should be revamped to anchor fiscal consolidation.

56. Tighter monetary policy and a market-based exchange rate are needed as part of the comprehensive strategy. Given rising inflationary pressures and expectations, near-term monetary policy tightening is warranted to ensure that the recent breach of the inflation target band is only temporary. The CBSL's initial steps to unwind its large holdings of Treasury bills are welcome and should continue, in close coordination with the MoF. The current unsustainable policy to fix the official exchange rate should be replaced with a gradual return to a market-determined and flexible exchange rate to facilitate external adjustment. Sri Lanka's external position is assessed as weaker than the level implied by the medium-term fundamentals and desirable policies.

57. Social safety nets should be strengthened to protect the most vulnerable. The pandemic has disproportionately hit the poor and the informal sector whose vulnerability could be further aggravated by macroeconomic adjustment. In addition to creating fiscal space for higher social safety net spending, the coverage, targeting, and per-family benefit needs to be strengthened to provide adequate protection for vulnerable groups.

58. Restoring macroeconomic stability and continued vigilance are needed to ensure financial sector stability. The swift and broad-based policy actions by the authorities mitigated the financial sector impact of the pandemic. However, the public debt overhang and the persistent fiscal and BoP financing shortfalls pose significant financial stability risks, highlighting the need for a credible and coherent macroeconomic strategy. The CBSL should continue to closely monitor loans under moratorium and identify vulnerabilities through stress testing. Finalization and adoption of the new Banking Act will help broaden the CBSL's regulatory powers and upgrade its resolution framework.

59. Staff recommends renewed efforts on growth-enhancing structural reforms. Increasing female labor force participation and reducing youth unemployment are key to countering slowing labor supply growth due to population aging. Trade and economic liberalization are important for facilitating export diversification and boosting productivity growth. The authorities should develop a schedule for the import restrictions to be phased out. A wide-reaching and coherent investment promotion strategy should help avoid excessive reliance on tax incentives. The Port City project should be managed prudently to maximize its growth benefits and minimize its fiscal and financial risks. Reforms of price controls and the SOE sector would allow for a more efficient allocation of

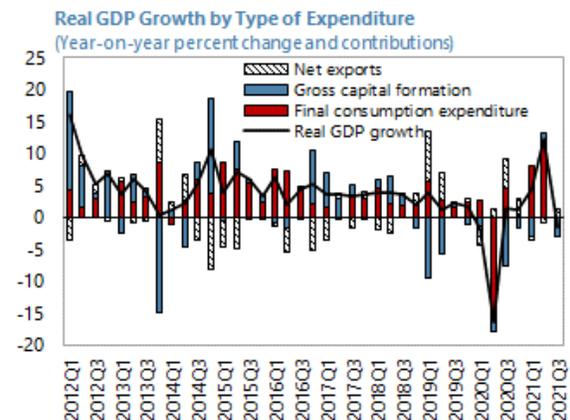
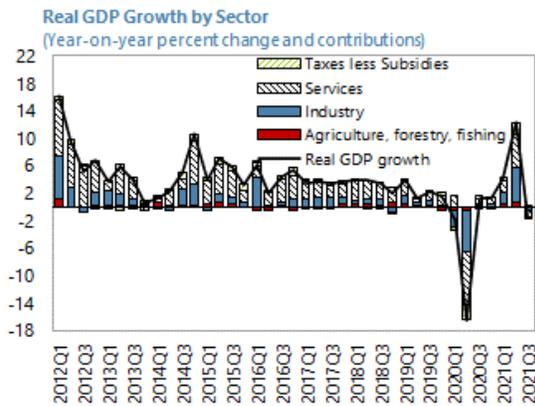
resources and foster competition. Efforts to strengthen governance and reduce corruption vulnerabilities should also continue.

60. Staff recommends that the next Article IV Consultation with Sri Lanka takes place on the standard 12-month cycle.

Figure 2. Sri Lanka: Real Sector

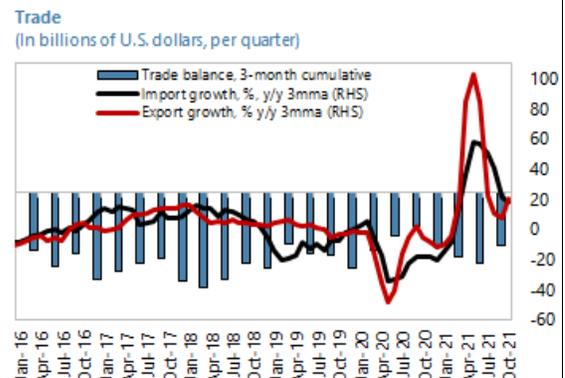
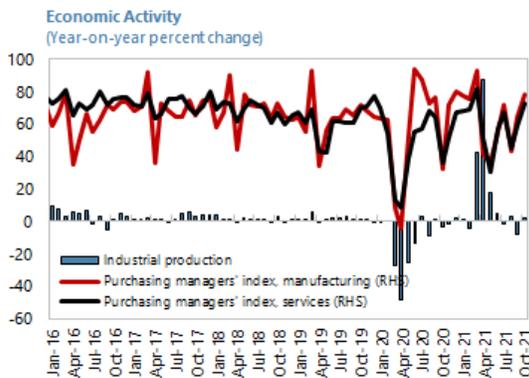
Real GDP recouped part of its COVID loss in the first nine months of 2021, as manufacturing and services rebounded, ...

... supported by a recovery in final consumption expenditure.



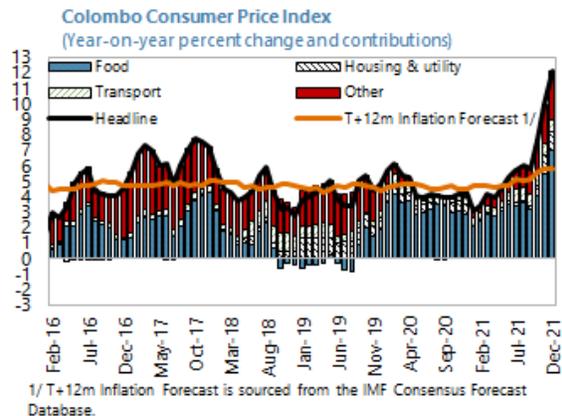
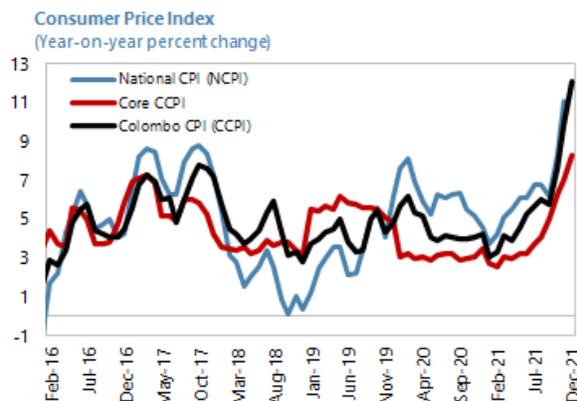
PMIs and industrial production have been modestly expansionary of late, with the exception of a brief contraction during the third wave...

... leading to a normalization of the trade deficit towards pre-pandemic levels.



Both headline and core inflation are on a rising trend, ...

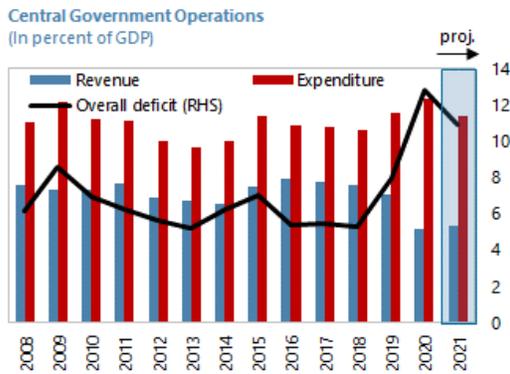
... as food inflation remains elevated and price pressures in non-food categories start to build.



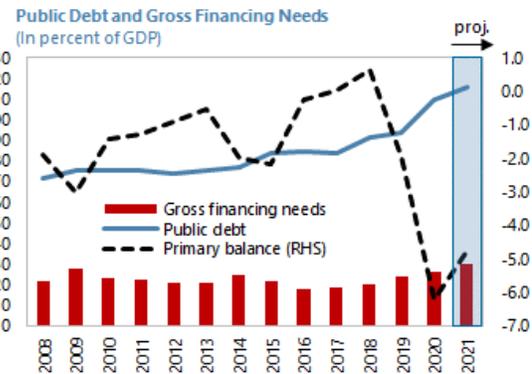
Sources: Department of Census and Statistics; CBSL; IMF Consensus Forecast Database; and IMF staff estimates.

Figure 3. Sri Lanka: Fiscal Sector

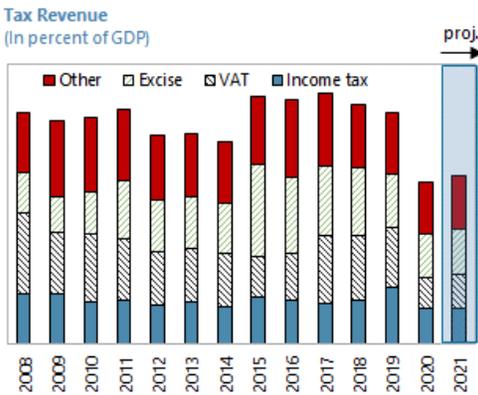
A collapse in revenues, due to both policy changes and pandemic impact, drove up budget deficits in 2020-21, ...



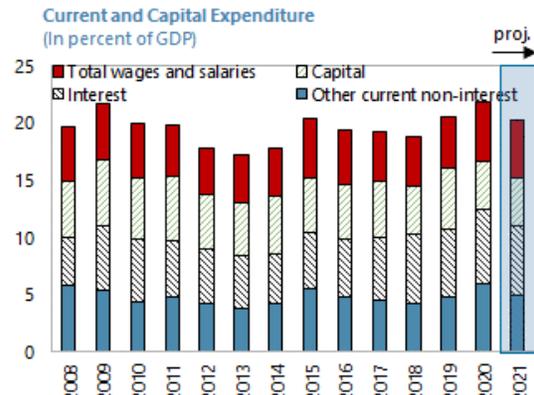
... leading to a sharp rise in public debt and a continued increase in gross financing needs.



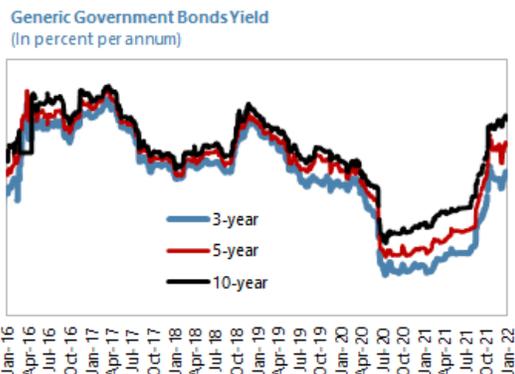
VAT and income tax cuts, import restrictions, and the economic downturn reduced the tax to GDP ratio.



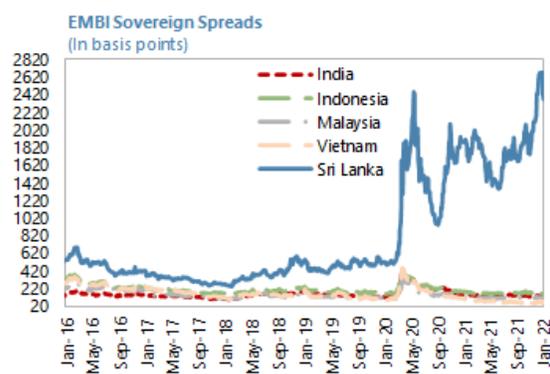
Non-interest current spending increased in 2020, while interest payments reached 6.5 percent of GDP.



Local currency bond yields have been rising since the authorities removed the auction yield caps in September 2021, ...



... while Sri Lanka's EMBI spreads remain at very high levels.

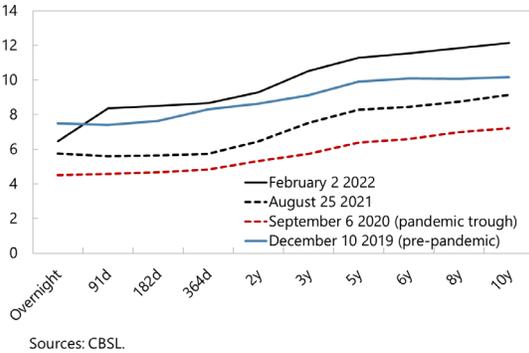


Sources: CBSL; Ministry of Finance; JP Morgan Chase & Co.; and IMF staff estimates.

Figure 4. Sri Lanka: Financial Market

T-bill and T-bond yields rose recently, pushing the yield curve above its pre-pandemic level, ...

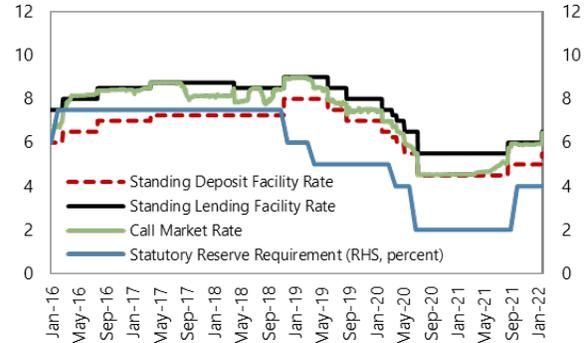
Yield Curve Evolution
(In percent)



Sources: CBSL.

...following the monetary policy rate hikes in August 2021 and January 2022.

Policy and Interbank Rates
(In percent per annum)



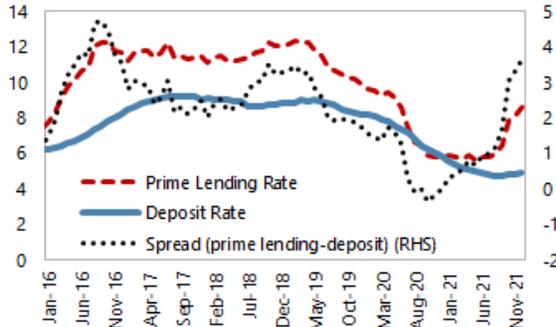
The central bank's purchase of T-bills in primary markets led to loose liquidity conditions until mid-2021...

Overnight Liquidity
(In billions of rupees)



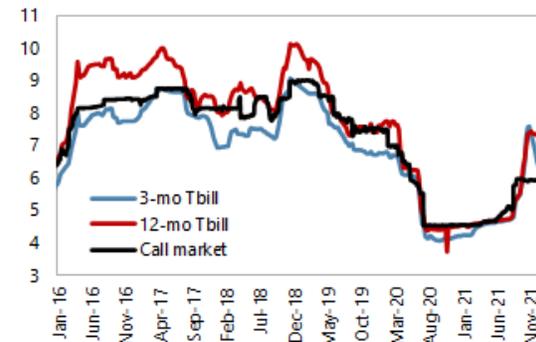
Lower short-term rates have passed through to bank deposit and lending rates, ...

Deposit Rate and Spread
(In percent)



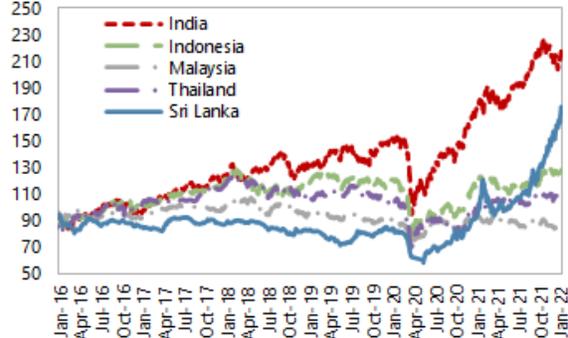
... and kept interest rates at low levels, until the reversal seen in recent periods.

Short-Term Interest Rates
(In percent per annum)



... with the low-rate environment propping up the equities market.

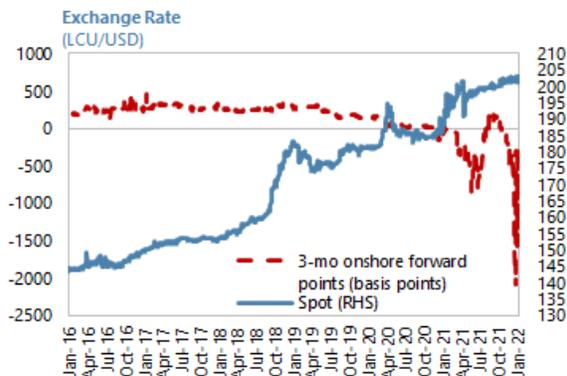
Stock Market Index
(Dec 30, 2014 = 100)



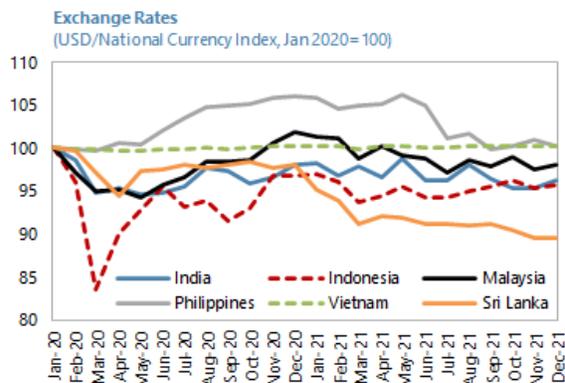
Sources: CBSL; CEIC Daily Database; Bloomberg Data LP; and IMF staff estimates.

Figure 5. Sri Lanka: Foreign Exchange and Reserves

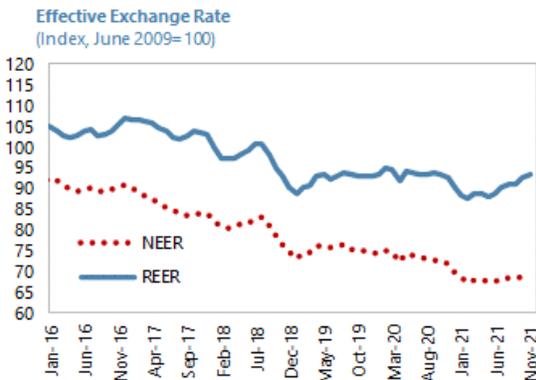
The official exchange rate has been de facto fixed since April 2021, while the forward FX market has been volatile.



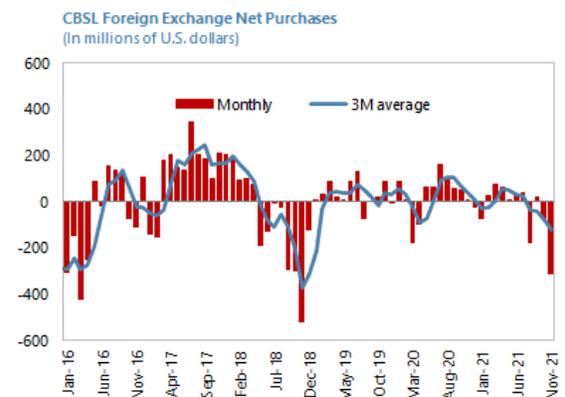
In line with its external sector weaknesses, Sri Lanka's rupee has depreciated more than its peers since 2020.



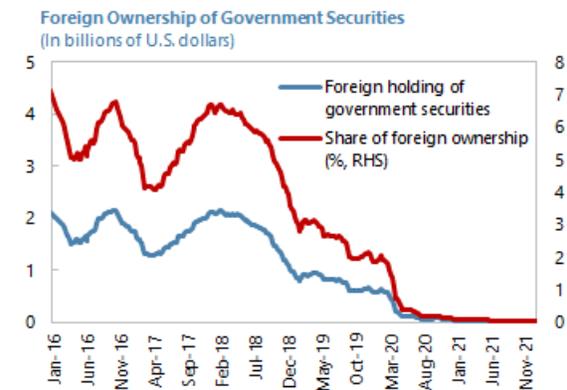
Nominal effective exchange rate has depreciated over the past years, with real effective exchange rate little changed since 2018 ...



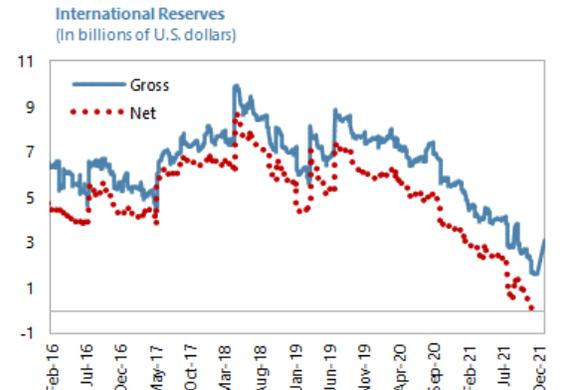
... while efforts to build up reserves through FX purchases have been hampered since the onset of the pandemic.



Most foreign holders of local currency T-bills and T-bonds have exited and stayed out.



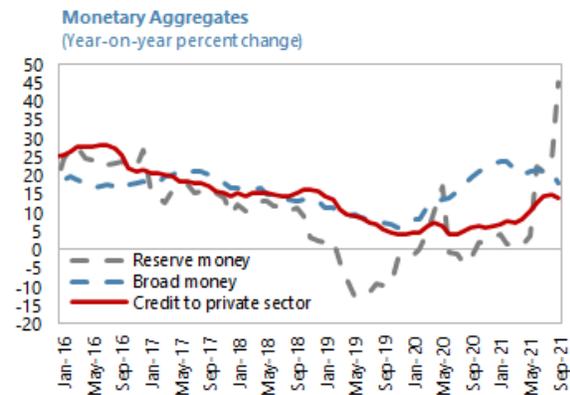
GIR have declined amid Sri Lanka's loss of market access since March 2020, while NIR recently dipped into the negative territory.



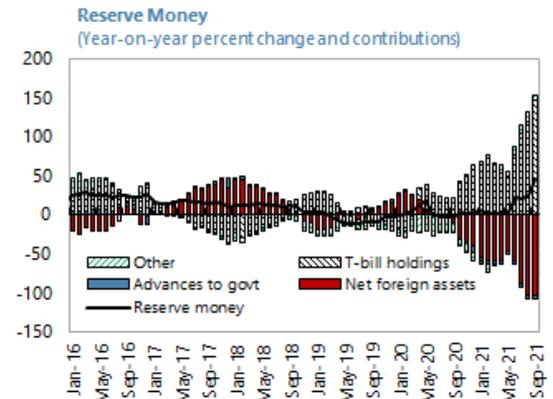
Sources: CBSL; Bloomberg Data LP; CEIC Data Company Limited; INS; and IMF staff estimates.

Figure 6. Sri Lanka: Monetary and Financial Sector

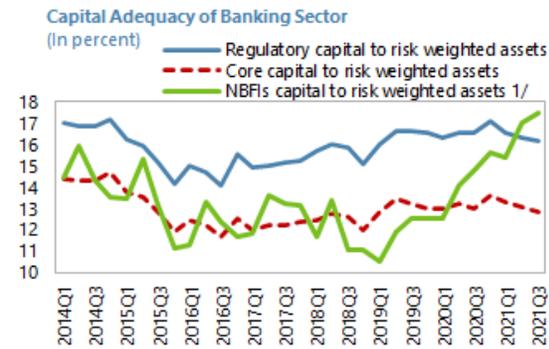
Monetary aggregates expanded rapidly during the pandemic as private credit also started to rebound.



Central bank holdings of government debt made up for falling NFAs and contributed to reserve money growth.

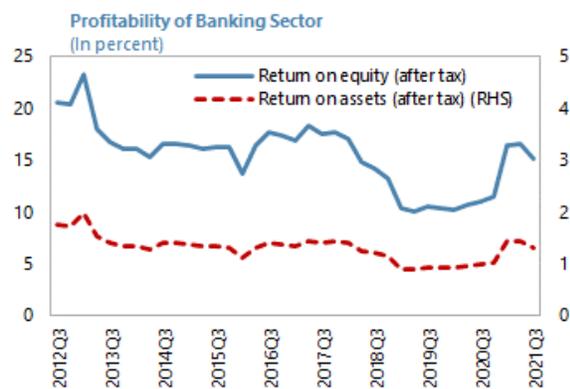


Banks' reported capital adequacy appears largely intact, ...

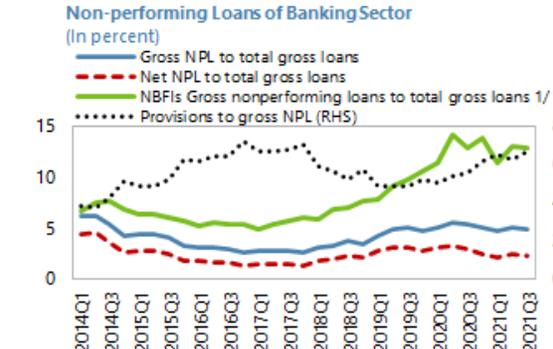


1/ NBFIs stands for Licensed Finance Companies and Specialized Leasing Companies.

The low-rate environment also benefited banks' profitability by widening the net interest margin.

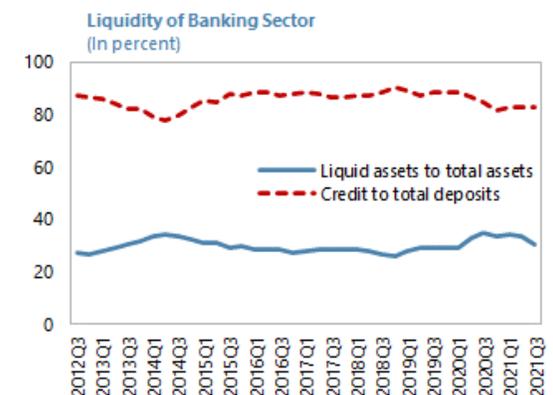


... while NPLs only marginally increased, likely reflecting the loan moratoria introduced during the pandemic.



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

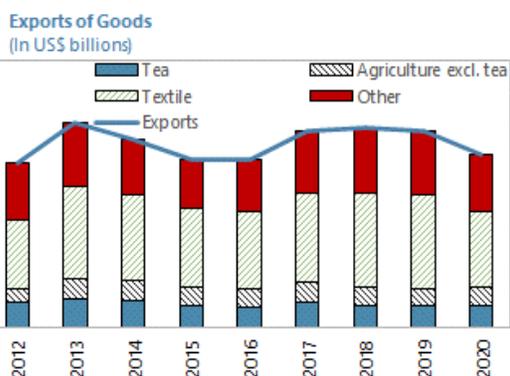
The banking sector on the whole remains liquid.



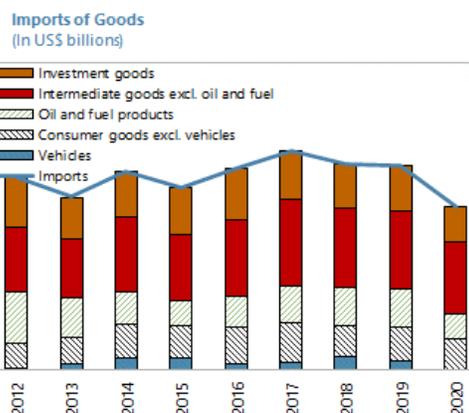
Sources: CBSL; and IMF staff estimates.

Figure 7. Sri Lanka: Balance of Payments

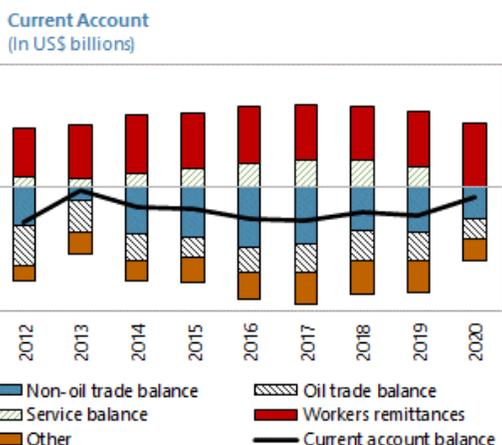
Sri Lanka's goods exports suffered from lower global demand in 2020, ...



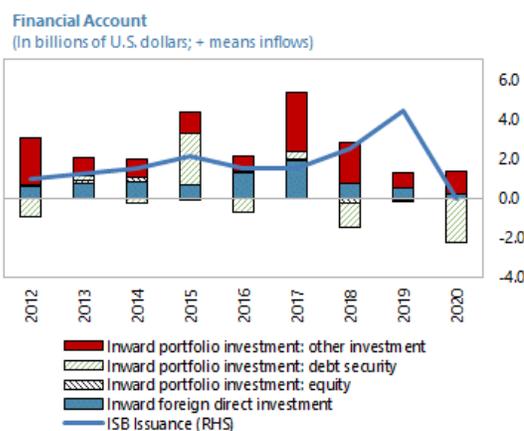
... while its imports also contracted as the country entered lockdowns and imposed import restrictions.



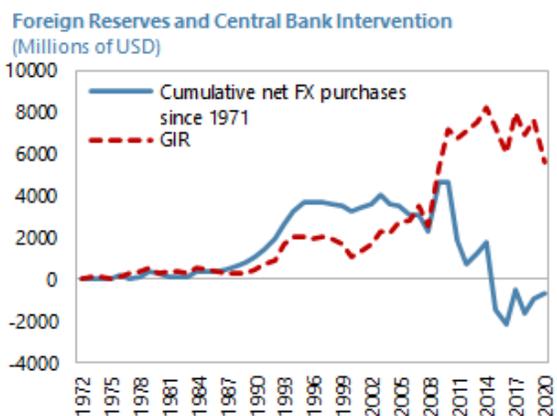
As a result, the current account deficit shrank in 2020, ...



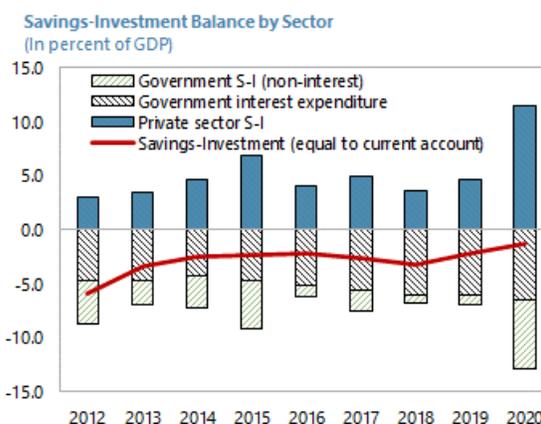
... while external financing conditions tightened substantially in 2020 as market access was lost.



Most of Sri Lanka's reserve accumulation since late 2000s has been financed by external borrowings, ...



... which led to high interest bills for the government, contributing to a persistent current account deficit.



Sources: CBSL; Ministry of Finance; and IMF staff calculations.

Table 1. Sri Lanka: Selected Economic Indicators, 2019–26

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
|--|---------|---------|---------|---------|---------|---------|---------|---------|
| | Act. | Act. | | | Proj. | | | |
| GDP and inflation (in percent) | | | | | | | | |
| Real GDP growth | 2.3 | -3.6 | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 |
| Inflation (average) 1/ | 4.3 | 4.6 | 6.0 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 |
| Inflation (end-of-period) 1/ | 4.8 | 4.2 | 12.1 | 8.3 | 6.7 | 6.0 | 5.5 | 5.0 |
| GDP Deflator growth | 2.7 | 3.4 | 5.7 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 |
| Nominal GDP growth | 5.1 | -0.3 | 9.5 | 13.4 | 9.9 | 9.4 | 8.7 | 8.2 |
| Savings and investment (in percent of GDP) | | | | | | | | |
| National savings | 19.7 | 24.0 | 19.5 | 19.7 | 20.9 | 21.2 | 21.4 | 21.6 |
| Government | -2.7 | -8.7 | -7.9 | -7.1 | -7.1 | -6.9 | -6.9 | -6.6 |
| Private | 22.4 | 32.7 | 27.4 | 26.8 | 28.0 | 28.1 | 28.2 | 28.2 |
| National Investment | 21.9 | 25.4 | 23.4 | 23.5 | 23.7 | 23.8 | 24.0 | 24.1 |
| Government | 4.2 | 4.2 | 3.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| Private | 17.7 | 21.1 | 19.8 | 20.9 | 21.1 | 21.2 | 21.4 | 21.6 |
| Savings-Investment balance | -2.2 | -1.3 | -3.8 | -3.8 | -2.8 | -2.6 | -2.6 | -2.6 |
| Government | -6.9 | -12.9 | -11.5 | -9.7 | -9.7 | -9.5 | -9.4 | -9.2 |
| Private | 4.7 | 11.6 | 7.7 | 5.9 | 6.9 | 6.9 | 6.8 | 6.6 |
| Public finances (in percent of GDP) | | | | | | | | |
| Revenue and grants | 12.6 | 9.2 | 8.9 | 10.7 | 10.8 | 11.0 | 11.1 | 11.3 |
| Expenditure | 20.6 | 21.9 | 20.3 | 20.3 | 20.3 | 20.4 | 20.5 | 20.4 |
| Primary balance | -2.0 | -6.2 | -4.9 | -2.8 | -2.5 | -2.2 | -2.0 | -1.8 |
| Central government balance | -8.0 | -12.8 | -11.4 | -9.6 | -9.6 | -9.4 | -9.4 | -9.1 |
| Central government net domestic financing | 4.4 | 13.3 | 12.3 | 7.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Central government gross financing needs | 20.6 | 26.2 | 30.1 | 32.8 | 36.2 | 36.9 | 38.6 | 40.1 |
| Central government debt | 86.8 | 101.2 | 107.1 | 108.6 | 110.2 | 111.7 | 113.5 | 115.4 |
| Public debt 2/ | 93.6 | 110.0 | 118.9 | 119.9 | 121.1 | 122.3 | 123.7 | 125.3 |
| Money and credit (percent change, end of period) | | | | | | | | |
| Reserve money | -3.0 | 3.4 | 37.2 | 13.9 | 9.9 | 9.4 | 8.7 | 8.2 |
| Broad money | 7.0 | 23.4 | 15.4 | 13.9 | 9.9 | 9.4 | 8.7 | 8.2 |
| Domestic credit | 6.5 | 24.6 | 19.7 | 12.7 | 8.9 | 8.5 | 8.0 | 7.5 |
| Credit to private sector | 4.2 | 6.5 | 13.8 | 13.0 | 10.2 | 9.0 | 7.9 | 6.9 |
| Credit to central government and public corporations | 10.4 | 53.6 | 26.4 | 12.4 | 7.5 | 8.0 | 8.1 | 8.1 |
| Balance of payments (in millions of U.S. dollars) | | | | | | | | |
| Exports | 11,940 | 10,047 | 12,222 | 13,598 | 14,254 | 15,003 | 15,730 | 16,474 |
| Imports | -19,937 | -16,055 | -20,018 | -22,629 | -23,600 | -24,595 | -25,647 | -26,661 |
| Current account balance | -1,848 | -1,083 | -3,153 | -3,331 | -2,504 | -2,482 | -2,605 | -2,711 |
| Current account balance (in percent of GDP) | -2.2 | -1.3 | -3.8 | -3.8 | -2.8 | -2.6 | -2.6 | -2.6 |
| Export value growth (percent) | 0.4 | -15.9 | 21.6 | 11.3 | 4.8 | 5.3 | 4.8 | 4.7 |
| Import value growth (percent) | -10.3 | -19.5 | 24.7 | 13.0 | 4.3 | 4.2 | 4.3 | 4.0 |
| Gross official reserves (end of period) | | | | | | | | |
| In millions of U.S. dollars | 7,642 | 5,664 | 3,138 | 2,204 | 2,386 | 2,416 | 2,465 | 2,532 |
| In months of prospective imports of goods & services | 5.0 | 3.1 | 1.5 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| In percent of ARA composite metric | 61.6 | 45.8 | 24.8 | 16.8 | 17.4 | 17.0 | 16.7 | 16.8 |
| External debt (public and private) | | | | | | | | |
| In billions of U.S. dollars | 54.6 | 53.6 | 54.3 | 56.4 | 58.5 | 60.5 | 62.5 | 64.7 |
| As a percent of GDP | 65.1 | 66.4 | 65.6 | 64.2 | 65.1 | 63.7 | 62.4 | 61.3 |
| Memorandum items: | | | | | | | | |
| Nominal GDP (in billions of rupees) | 15,013 | 14,973 | 16,393 | 18,587 | 20,426 | 22,337 | 24,291 | 26,279 |
| Nominal GDP (in billions of U.S. dollars) | 84.0 | 80.7 | 82.7 | 87.8 | 90.0 | 94.9 | 100.2 | 105.6 |
| Exchange Rate (period average) | 178.8 | 185.5 | 198.3 | ... | ... | ... | ... | ... |
| Exchange Rate (end of period) | 181.6 | 186.4 | 200.4 | ... | ... | ... | ... | ... |

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).

Table 2a. Sri Lanka: Summary of Central Government Operations, 2019-26
(In billions of rupees)

| | 2019 | 2020 | 2021 | 2022 | | 2023 | 2024 | 2025 | 2026 |
|-------------------------------------|----------|----------|----------|----------|------------|--------------|--------------|--------------|--------------|
| | Act. | Est. | Proj. | Budget | Proj. | Proj. | | | |
| Total revenue and grants | 1,899 | 1,373 | 1,461 | 2,223 | 1,998 | 2,197 | 2,460 | 2,704 | 2,968 |
| Total revenue | 1,891 | 1,368 | 1,456 | 2,213 | 1,992 | 2,191 | 2,454 | 2,698 | 2,962 |
| Tax revenue | 1,735 | 1,217 | 1,301 | 1,987 | 1,779 | 1,957 | 2,198 | 2,419 | 2,661 |
| Income taxes | 428 | 268 | 300 | 496 | 441 | 396 | 455 | 496 | 537 |
| VAT | 444 | 234 | 310 | ... | 382 | 411 | 455 | 495 | 537 |
| Excise taxes | 399 | 322 | 298 | ... | 357 | 436 | 495 | 569 | 651 |
| Other trade taxes | 169 | 197 | 124 | ... | 163 | 226 | 258 | 280 | 305 |
| Other | 295 | 196 | 268 | ... | 436 | 489 | 534 | 580 | 631 |
| Nontax revenue | 156 | 151 | 156 | 226 | 213 | 234 | 256 | 278 | 301 |
| Grants | 8 | 5 | 5 | 10 | 6 | 6 | 6 | 6 | 6 |
| Total expenditure and net lending | 3,095 | 3,284 | 3,325 | 3,851 | 3,776 | 4,155 | 4,561 | 4,979 | 5,373 |
| Current expenditure | 2,301 | 2,672 | 2,755 | 2,935 | 3,311 | 3,645 | 4,003 | 4,372 | 4,716 |
| Wages and salaries | 686 | 794 | 840 | 968 | 1,055 | 1,148 | 1,243 | 1,338 | 1,433 |
| Goods and services | 162 | 180 | 184 | 189 | 189 | 225 | 246 | 267 | 289 |
| Subsidies and transfers | 552 | 717 | 677 | 663 | 805 | 817 | 893 | 972 | 1,051 |
| Interest payments 1/ | 901 | 980 | 1,054 | 1,115 | 1,262 | 1,455 | 1,621 | 1,796 | 1,942 |
| Capital expenditure and net lending | 794 | 612 | 570 | 916 | 465 | 511 | 558 | 607 | 657 |
| Overall balance | -1,196 | -1,910 | -1,864 | -1,628 | -1,778 | -1,958 | -2,101 | -2,276 | -2,404 |
| Financing | 1,196 | 1,910 | 1,864 | 1,628 | 1,115 | 850 | 897 | 794 | 1,082 |
| Privatization | 0 | 0 | 0 | 0 | 5 | 11 | 12 | 12 | 12 |
| Net external financing | 575 | -83 | -154 | -179 | -191 | -183 | -232 | -432 | -245 |
| Net domestic financing | 622 | 1,994 | 2,018 | 1,807 | 1,301 | 1,021 | 1,117 | 1,215 | 1,314 |
| Financing gap | 0 | 0 | 0 | 0 | 663 | 1,108 | 1,205 | 1,481 | 1,323 |
| Memorandum items: | | | | | | | | | |
| Central government primary balance | -295 | -930 | -810 | -513 | -516 | -503 | -481 | -480 | -462 |
| Central government debt 1/ | 13,032 | 15,158 | 17,564 | ... | 20,195 | 22,512 | 24,961 | 27,569 | 30,327 |
| Fund credit outstanding | 227 | 240 | 236 | ... | 224 | 196 | 156 | 112 | 69 |
| Nominal GDP (in billion of rupees) | 15,013 | 14,973 | 16,393 | 18,511 | 18,587 | 20,426 | 22,337 | 24,291 | 26,279 |

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

1/ Debt and interest projections assume that fiscal financing gaps are filled from yet unidentified external sources (see DSA Annex)

Table 2b. Sri Lanka: Summary of Central Government Operations, 2019–26
(In percent of GDP)

| | 2019 | 2020 | 2021 | 2022 | | 2023 | 2024 | 2025 | 2026 |
|-------------------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| | Act. | Est. | Proj. | Budget | Proj. | | Proj. | | |
| Total revenue and grants | 12.6 | 9.2 | 8.9 | 12.0 | 10.7 | 10.8 | 11.0 | 11.1 | 11.3 |
| Total revenue | 12.6 | 9.1 | 8.9 | 12.0 | 10.7 | 10.7 | 11.0 | 11.1 | 11.3 |
| Tax revenue | 11.6 | 8.1 | 7.9 | 10.7 | 9.6 | 9.6 | 9.8 | 10.0 | 10.1 |
| Income taxes | 2.8 | 1.8 | 1.8 | 2.7 | 2.4 | 1.9 | 2.0 | 2.0 | 2.0 |
| VAT | 3.0 | 1.6 | 1.9 | ... | 2.1 | 2.0 | 2.0 | 2.0 | 2.0 |
| Excise taxes | 2.7 | 2.2 | 1.8 | ... | 1.9 | 2.1 | 2.2 | 2.3 | 2.5 |
| Other trade taxes | 1.1 | 1.3 | 0.8 | ... | 0.9 | 1.1 | 1.2 | 1.2 | 1.2 |
| Other | 2.0 | 1.3 | 1.6 | ... | 2.3 | 2.4 | 2.4 | 2.4 | 2.4 |
| Nontax revenue | 1.0 | 1.0 | 1.0 | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 |
| Grants | 0.1 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total expenditure and net lending | 20.6 | 21.9 | 20.3 | 20.8 | 20.3 | 20.3 | 20.4 | 20.5 | 20.4 |
| Current expenditure | 15.3 | 17.8 | 16.8 | 15.9 | 17.8 | 17.8 | 17.9 | 18.0 | 17.9 |
| Wages and salaries | 4.6 | 5.3 | 5.1 | 5.2 | 5.7 | 5.6 | 5.6 | 5.5 | 5.5 |
| Goods and services | 1.1 | 1.2 | 1.1 | 1.0 | 1.0 | 1.1 | 1.1 | 1.1 | 1.1 |
| Subsidies and transfers | 3.7 | 4.8 | 4.1 | 3.6 | 4.3 | 4.0 | 4.0 | 4.0 | 4.0 |
| Interest payments 1/ | 6.0 | 6.5 | 6.4 | 6.0 | 6.8 | 7.1 | 7.3 | 7.4 | 7.4 |
| Capital expenditure and net lending | 5.3 | 4.1 | 3.5 | 4.9 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Overall balance | -8.0 | -12.8 | -11.4 | -8.8 | -9.6 | -9.6 | -9.4 | -9.4 | -9.1 |
| Financing | 8.0 | 12.8 | 11.4 | 8.8 | 6.0 | 4.2 | 4.0 | 3.3 | 4.1 |
| Privatization | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 |
| Net external financing | 3.8 | -0.6 | -0.9 | -1.0 | -1.0 | -0.9 | -1.0 | -1.8 | -0.9 |
| Net domestic financing | 4.1 | 13.3 | 12.3 | 9.8 | 7.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Financing gap | 0.0 | 0.0 | 0.0 | 0.0 | 3.6 | 5.4 | 5.4 | 6.1 | 5.0 |
| Memorandum items: | | | | | | | | | |
| Central government primary balance | -2.0 | -6.2 | -4.9 | -2.8 | -2.8 | -2.5 | -2.2 | -2.0 | -1.8 |
| Central government debt 1/ | 86.8 | 101.2 | 107.1 | ... | 108.6 | 110.2 | 111.7 | 113.5 | 115.4 |
| Fund credit outstanding | 1.5 | 1.6 | 1.4 | ... | 1.2 | 1.0 | 0.7 | 0.5 | 0.3 |
| Nominal GDP (in billion of rupees) | 15,013 | 14,973 | 16,393 | 18,511 | 18,587 | 20,426 | 22,337 | 24,291 | 26,279 |

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

1/ Debt and interest projections assume that fiscal financing gaps are filled from yet unidentified external sources (see DSA Annex)

Table 3. Sri Lanka: Monetary Accounts, 2019–22 ^{1/}
(In billions of rupees, unless otherwise indicated, end of period)

| | 2019 | 2020 | 2021 | 2022 |
|--|--------|--------|--------|--------|
| | Act. | | Proj. | |
| Central Bank of Sri Lanka | | | | |
| Net foreign assets | 896 | 527 | -346 | -514 |
| Net domestic assets | 37 | 438 | 1,669 | 2,021 |
| Net claims on central government | 363 | 869 | 1,814 | 2,035 |
| Net claims on banks | 2 | 114 | 114 | 114 |
| Other items, net | -328 | -546 | -259 | -128 |
| Reserve Money | 933 | 964 | 1,324 | 1,508 |
| Monetary survey | | | | |
| Net foreign assets | 101 | -209 | -938 | -1,170 |
| Monetary authorities | 896 | 527 | -346 | -514 |
| Deposit money banks | -795 | -736 | -592 | -657 |
| Net domestic assets | 7,523 | 9,615 | 11,795 | 13,538 |
| Net claims on central government | 2,796 | 4,548 | 5,903 | 6,715 |
| Credit to corporations | 6,615 | 7,173 | 8,132 | 9,102 |
| Public corporations | 818 | 1,002 | 1,112 | 1,169 |
| Private corporations | 5,797 | 6,171 | 7,020 | 7,933 |
| Other items (net) | -1,887 | -2,106 | -2,240 | -2,279 |
| Broad money | 7,624 | 9,406 | 10,857 | 12,367 |
| Memorandum Items | | | | |
| Gross international reserves (in millions of U.S. dollars) | 7,642 | 5,664 | 3,138 | 2,204 |
| Net international reserves (in millions of U.S. dollars) | 5,871 | 3,543 | -334 | -919 |
| Net Foreign Assets (in millions of U.S. dollars) | 4,807 | 2,628 | -1,555 | -2,223 |
| Private credit (in percent of GDP) | 38.6 | 41.2 | 42.8 | 42.7 |
| Money multiplier | 8.2 | 9.8 | 8.2 | 8.2 |
| Broad money velocity | 2.0 | 1.6 | 1.5 | 1.5 |
| Money and credit (percent change, end of period) | | | | |
| Broad money | 7.0 | 23.4 | 15.4 | 13.9 |
| Reserve money | -3.0 | 3.4 | 37.2 | 13.9 |
| Credit to public corporations | 8.3 | 22.5 | 11.0 | 5.1 |
| Credit to private sector | 4.2 | 6.5 | 13.8 | 13.0 |

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

^{1/} Covers the central bank and other depository corporations.

Table 4. Sri Lanka: Balance of Payments, 2019–26
(In millions of U.S. dollars, unless otherwise indicated)

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | Act. | Est. | | | Proj. | | | |
| Current account | -1,843 | -1,083 | -3,153 | -3,331 | -2,504 | -2,482 | -2,605 | -2,711 |
| Balance on goods | -7,997 | -6,008 | -7,796 | -9,031 | -9,346 | -9,592 | -9,918 | -10,187 |
| Credit (exports) | 11,940 | 10,047 | 12,222 | 13,598 | 14,254 | 15,003 | 15,730 | 16,474 |
| Debit (imports) | -19,937 | -16,055 | -20,018 | -22,629 | -23,600 | -24,595 | -25,647 | -26,661 |
| Balance on services | 2,849 | 819 | 1,300 | 2,268 | 3,404 | 3,786 | 4,078 | 4,292 |
| Credit (exports) | 7,474 | 3,035 | 2,862 | 4,621 | 6,747 | 7,440 | 7,865 | 8,211 |
| Debit (imports) | -4,625 | -2,216 | -1,562 | -2,353 | -3,343 | -3,654 | -3,787 | -3,919 |
| Primary income, net | -2,462 | -2,101 | -1,969 | -2,303 | -2,448 | -2,669 | -2,871 | -3,030 |
| Secondary income, net | 5,766 | 6,207 | 5,313 | 5,735 | 5,887 | 5,993 | 6,106 | 6,214 |
| Of which: workers' remittances (net) | 5,757 | 6,194 | 5,302 | 5,725 | 5,877 | 5,983 | 6,097 | 6,205 |
| Capital account (+ surplus / - deficit) | 23 | 28 | 12 | 12 | 12 | 12 | 12 | 12 |
| Balance from current account and capital account | -1,820 | -1,055 | -3,141 | -3,319 | -2,492 | -2,471 | -2,593 | -2,699 |
| Financial account (+ net lending / - net borrowing) 1/ | -2,469 | 1,484 | -671 | 238 | -373 | -322 | 285 | -910 |
| Direct investments | -666 | -419 | -704 | -1,020 | -1,100 | -1,180 | -1,232 | -1,240 |
| Portfolio investments | -2,312 | 2,383 | 1,281 | 1,345 | 1,149 | 1,390 | 2,037 | 880 |
| Equity and investment Fund shares | 5 | 217 | 221 | -145 | -90 | -100 | -100 | -100 |
| Debt instruments | -2,317 | 2,166 | 1,060 | 1,490 | 1,239 | 1,490 | 2,137 | 980 |
| Of which: deposit taking corporations | 250 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Of which: general government | -2,567 | 2,166 | 1,060 | 1,490 | 1,239 | 1,490 | 2,137 | 980 |
| T-bills, T-bonds, and SLDBs | 333 | 531 | 60 | -10 | -11 | -10 | -13 | -20 |
| Sovereign bonds | -2,900 | 1,635 | 1,000 | 1,500 | 1,250 | 1,500 | 2,150 | 1,000 |
| Other investments | 509 | -480 | -1,248 | -87 | -422 | -532 | -520 | -550 |
| Of which: | | | | | | | | |
| Currency and deposits | -259 | 79 | -1,095 | 228 | 79 | 196 | 112 | 111 |
| Central bank | 0 | -400 | -1,300 | 200 | 0 | 0 | 0 | 0 |
| Deposit taking corporations | -259 | 479 | 205 | 28 | 79 | 196 | 112 | 111 |
| Loans | 573 | -289 | 415 | -376 | -576 | -754 | -665 | -719 |
| Deposit taking corporations | 281 | -75 | 650 | -57 | -114 | -246 | -191 | -176 |
| General government | 89 | -116 | -285 | -389 | -332 | -296 | -262 | -331 |
| Other sectors | 203 | -97 | 50 | 70 | -130 | -212 | -212 | -212 |
| SDR allocation | 0 | 0 | -787 | 0 | 0 | 0 | 0 | 0 |
| Errors and omissions | -640 | 795 | 0 | 0 | 0 | 0 | 0 | 0 |
| Overall balance (- = need of inflow) 1/ | 9 | -1,744 | -2,470 | -3,557 | -2,119 | -2,149 | -2,877 | -1,789 |
| Financing (- = inflow) | 336 | -1,690 | -2,470 | -785 | 369 | 261 | 280 | 284 |
| Change in reserve assets | 336 | -1,704 | -2,527 | -934 | 182 | 31 | 49 | 67 |
| Use of Fund credit, net | 0 | 14 | 57 | 149 | 187 | 231 | 231 | 216 |
| Financing gap (- = inflow) | -327 | -53 | 0 | -2,772 | -2,487 | -2,409 | -3,157 | -2,075 |
| IMF | -327 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other IFIs | 0 | -53 | 0 | 0 | 0 | 0 | 0 | 0 |
| unidentified financing | 0 | 0 | 0 | -2,772 | -2,487 | -2,409 | -3,157 | -2,075 |
| Memorandum items: | | | | | | | | |
| Current account (in percent of GDP) | -2.2 | -1.3 | -3.8 | -3.8 | -2.8 | -2.6 | -2.6 | -2.6 |
| Gross official reserves | 7,642 | 5,664 | 3,138 | 2,204 | 2,386 | 2,416 | 2,465 | 2,532 |
| In months of prospective imports of goods and services | 5.0 | 3.1 | 1.5 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| In percent of ARA composite metric | 61.6 | 45.8 | 24.8 | 16.8 | 17.4 | 17.0 | 16.7 | 16.8 |
| Net international reserves | 5,871 | 3,543 | -334 | -919 | -552 | -291 | -11 | 274 |
| In percent of ARA composite metric | 47.4 | 28.6 | ... | ... | ... | ... | ... | 1.8 |
| Nominal GDP | 83,991 | 80,677 | 82,682 | 87,795 | 89,977 | 94,948 | 100,155 | 105,603 |

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

1/ Excluding changes in reserves assets and financing from the IMF and other international financial institutions.

Table 5. Sri Lanka: Financial Soundness Indicators for Commercial Banks, 2018–21

| | 2018 | | | | 2019 | | | | 2020 | | | | 2021 | | |
|--|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 |
| Capital adequacy | | | | | | | | | | | | | | | |
| Regulatory capital to risk weighted assets | 15.7 | 16.0 | 15.9 | 16.2 | 16.0 | 16.7 | 16.7 | 16.5 | 16.3 | 16.5 | 16.6 | 17.1 | 16.6 | 16.3 | 16.2 |
| Tier 1 capital/risk weighted assets | 12.4 | 12.8 | 12.6 | 13.1 | 12.9 | 13.5 | 13.2 | 13.0 | 13.0 | 13.3 | 13.0 | 13.6 | 13.3 | 13.0 | 12.9 |
| Equity capital and reserves to assets ratio | 8.4 | 8.6 | 8.6 | 8.7 | 8.9 | 9.0 | 9.1 | 9.0 | 8.8 | 8.9 | 8.7 | 8.6 | 8.5 | 8.6 | 8.5 |
| Asset quality | | | | | | | | | | | | | | | |
| Gross nonperforming loans to total gross loans (without interest in suspense) | 3.0 | 3.3 | 3.6 | 3.4 | 4.2 | 4.8 | 4.9 | 4.7 | 5.1 | 5.4 | 5.3 | 4.9 | 4.7 | 5.0 | 4.8 |
| Net nonperforming loans to total gross loans | 1.7 | 1.9 | 2.3 | 2.0 | 2.7 | 3.0 | 3.1 | 2.8 | 3.1 | 3.2 | 2.9 | 2.4 | 2.1 | 2.4 | 2.2 |
| Provision coverage ratio (total) | 59.0 | 56.6 | 52.3 | 57.4 | 48.9 | 48.5 | 48.1 | 52.3 | 50.4 | 53.6 | 55.6 | 61.3 | 65.2 | 62.3 | 66.8 |
| Foreign currency denominated loans to total loans & advances | 18.9 | 18.9 | 19.3 | 20.0 | 19.3 | 19.6 | 20.2 | 20.1 | 21.9 | 21.4 | 20.4 | 19.8 | 19.5 | 19.3 | 18.5 |
| Earnings and profitability | | | | | | | | | | | | | | | |
| Return on equity (after tax) | 17.2 | 14.8 | 14.1 | 13.2 | 10.3 | 10.1 | 10.5 | 10.3 | 10.2 | 10.6 | 10.9 | 11.4 | 16.2 | 16.5 | 15.1 |
| Return on assets (after tax) | 1.4 | 1.3 | 1.2 | 1.1 | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 1.4 | 1.4 | 1.3 |
| Net interest income to gross income | 72.4 | 74.4 | 73.7 | 72.9 | 78.7 | 76.6 | 76.5 | 76.5 | 73.3 | 73.6 | 74.5 | 75.1 | 70.9 | 74.1 | 75.9 |
| Staff expenses to noninterest expenses | 44.8 | 45.2 | 45.0 | 44.1 | 43.8 | 44.5 | 44.4 | 44.6 | 40.5 | 46.2 | 46.3 | 46.4 | 46.8 | 46.6 | 45.4 |
| Total cost to total income | 76.0 | 76.7 | 76.8 | 76.8 | 79.3 | 78.3 | 77.9 | 77.8 | 79.0 | 76.6 | 76.8 | 75.7 | 69.2 | 69.4 | 70.1 |
| Net interest margin | 3.7 | 3.7 | 3.6 | 3.6 | 3.7 | 3.7 | 3.6 | 3.6 | 3.4 | 3.2 | 3.1 | 3.1 | 3.5 | 3.5 | 3.4 |
| Liquidity | | | | | | | | | | | | | | | |
| Liquid assets to total assets | 28.5 | 27.9 | 26.6 | 25.7 | 27.3 | 29.0 | 28.9 | 28.9 | 29.2 | 33.1 | 34.8 | 34.1 | 34.0 | 33.3 | 30.2 |
| Assets/funding structure | | | | | | | | | | | | | | | |
| Deposits to total assets | 72.3 | 73.2 | 72.7 | 72.0 | 73.1 | 73.6 | 73.2 | 73.2 | 73.1 | 74.4 | 75.2 | 76.0 | 76.0 | 76.1 | 75.6 |
| Borrowings to total assets | 15.1 | 14.1 | 14.6 | 15.0 | 13.6 | 13.1 | 13.3 | 13.4 | 13.9 | 12.6 | 12.2 | 11.5 | 11.6 | 11.6 | 12.3 |
| Credit to deposits (loans net of interest in suspense to deposits) | 87.2 | 87.5 | 88.7 | 90.6 | 89.4 | 87.4 | 88.2 | 88.7 | 88.7 | 86.5 | 84.8 | 81.6 | 83.8 | 82.9 | 83.1 |
| Foreign currency denominated liabilities to total liabilities | 21.9 | 21.2 | 21.7 | 22.8 | 21.7 | 21.8 | 22.0 | 21.9 | 23.0 | 21.7 | 21.1 | 20.4 | 20.4 | 20.7 | 19.6 |

Source: CBSL.

Table 6. Sri Lanka: Projected Remaining Payments to the Fund, 2022–33^{1/}
(in millions of SDR, unless otherwise indicated)

| | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 | 2033 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Fund repurchases and charges | | | | | | | | | | | | | |
| In millions of SDR | 50.4 | 114.5 | 138.1 | 166.2 | 164.5 | 152.8 | 121.3 | 55.8 | 30.5 | 0.7 | 0.7 | 0.7 | 0.7 |
| In millions of U.S. dollars | 71.8 | 162.8 | 198.4 | 240.7 | 239.9 | 224.1 | 177.9 | 81.8 | 44.8 | 1.0 | 1.0 | 1.0 | 1.0 |
| In percent of exports of goods and services | 0.5 | 0.9 | 0.9 | 1.1 | 1.0 | 0.9 | 0.7 | 0.3 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| In percent of quota | 8.7 | 19.8 | 23.9 | 28.7 | 28.4 | 26.4 | 21.0 | 9.6 | 5.3 | 0.1 | 0.1 | 0.1 | 0.1 |
| In percent of gross official reserves | 2.3 | 7.4 | 8.3 | 10.0 | 9.7 | 8.9 | 5.9 | 2.3 | 1.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Fund credit outstanding^{2/} | | | | | | | | | | | | | |
| In millions of SDR | 902.3 | 797.9 | 668.8 | 510.1 | 351.4 | 202.7 | 83.9 | 29.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| In millions of U.S. dollars | 1,272 | 1,141 | 965 | 741 | 514 | 298 | 123 | 44 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| In percent of exports of goods and services | 8.4 | 6.3 | 4.6 | 3.3 | 2.2 | 1.2 | 0.5 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| In percent of quota | 155.9 | 137.9 | 115.5 | 88.1 | 60.7 | 35.0 | 14.5 | 5.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| In percent of GDP | 1.5 | 1.3 | 1.1 | 0.8 | 0.5 | 0.3 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| In percent of gross official reserves | 40.5 | 51.8 | 40.4 | 30.7 | 20.8 | 11.8 | 4.1 | 1.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Memorandum items: | | | | | | | | | | | | | |
| Exports of goods and services (in millions of U.S. dollars) | 15,084 | 18,219 | 21,000 | 22,443 | 23,595 | 24,685 | 25,795 | 26,956 | 28,169 | 29,437 | 30,762 | 32,146 | 33,592 |
| 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 |
| Quota (in millions of U.S. dollars) ^{2/} | 816 | 827 | 835 | 835 | 835 | 835 | 835 | 835 | 835 | 835 | 835 | 835 | 835 |
| Gross official reserves (in millions of U.S. dollars) ^{2/} | 3,138 | 2,204 | 2,386 | 2,416 | 2,465 | 2,532 | 3,032 | 3,532 | 4,032 | 4,532 | 5,032 | 5,532 | 6,032 |

Source: IMF staff estimates.

^{1/} 2021 is actual. Projections as of January 28, 2022. Capacity to repay indicators are based on a macroframework with large financing gaps (see Table 4 BOP).^{2/} As of the end of the year.

Annex I. Implementation of Past Article IV Recommendations

| Past Article IV Recommendations | Implementation |
|--|--|
| <p>Reduce fiscal deficit by mobilizing revenue, through removing tax exemptions, implementing a new income tax law, and improving tax administration. Upgrade the fiscal rules.</p> | <p>In late 2019, the authorities reduced tax rates for corporate income tax (CIT), personal income tax (PIT), and VAT and abolished mandatory income tax withholding for most employees. The 2021 Budget included several new tax exemptions. Revenue administration efforts are ongoing, with e-filing mandatory for CIT from November 2021. Plans to upgrade the fiscal rules were suspended.</p> |
| <p>Advance SOE reforms, including through energy pricing reforms. Recognize off-budget fuel and electricity subsidies as central government expenditure to prevent buildup of contingent liabilities.</p> | <p>An automatic fuel pricing mechanism was in place in 2018-19 but is no longer in use. Electricity pricing reform was halted. Plans to restructure Sri Lankan Airlines were suspended.</p> |
| <p>Strengthen international reserves by continuing FX purchases and allow for greater exchange rate flexibility.</p> | <p>The CBSL's cumulative net FX purchases in 2019-21 were negative. The exchange rate is heavily managed, through intervention and moral suasion.</p> |
| <p>Adhere to flexible inflation targeting framework. Upgrade the legal underpinnings of the policy framework through upgrading the central bank law.</p> | <p>The CBSL's monetary policy has been largely data driven, consistent with the IT framework. But the pandemic and the public debt overhang have created a more challenging situation for it to conduct monetary and exchange rate policies independently (130). A revised central bank law has not been adopted.</p> |
| <p>Strengthen financial sector regulation and supervision for both banks and non-bank financial institutions (NBFIs).</p> | <p>Prior to the COVID-19, important measures to strengthen financial sector policy framework were the implementation of IRFS 9 for financial institutions, an increase in the capital adequacy requirement and introduction of liquidity requirements based on Basel standards, and adoption of risk-based supervision of banks. The finalization and adoption of the new Banking Act is expected in 2022, which would broaden the regulatory powers of the CBSL and upgrade the resolution framework. The authorities do not see the need to unify the regulatory and supervisory frameworks for banks and NBFIs.</p> |
| <p>Strengthen social safety nets by improving targeting accuracy of social assistance programs and expand coverage. Improve the framework for natural disaster risk financing, including through natural disaster contingency budgeting.</p> | <p>The authorities have been implementing the social safety net reforms, but the progress has been mixed. Natural disaster related spending has been allocated on an ad hoc basis, and not yet based on the developed framework. Emergency and disaster management plans are being developed.</p> |
| <p>Advance structural reforms to improve competitiveness and foster inclusive growth. Liberalize the trade regime, improve the business and investment climate, promote female labor force participation.</p> | <p>Trade barriers remain high as the authorities favor import substitution. The authorities intend to improve the business and investment climate, and encourage female labor force participation, but these have yet to be supported by coherent strategies.</p> |

Annex II. Potential Growth in Sri Lanka

1. The annex updates an earlier growth accounting exercise and uses its findings to re-estimate Sri Lanka’s growth potential.¹ A similar growth accounting approach is followed in which the output Y_t is calculated by the Cobb-Douglas production function:

$$Y_t = A_t K_t^\alpha L_t^{1-\alpha}$$

where the growth rate of output $\frac{\dot{Y}_t}{Y_t}$ can be expressed as follows (after taking logs and differentiating with respect to time):

$$\frac{\dot{Y}_t}{Y_t} = \frac{\dot{A}_t}{A_t} + \alpha \frac{\dot{K}_t}{K_t} + (1 - \alpha) \frac{\dot{L}_t}{L_t}$$

Data on **output**, **labor supply (L)**, and **capital stock (K)** are sourced from the World Bank WDI database, Sri Lanka Labor Force Surveys (total employment), and Penn World Table 10.0, respectively. The capital share of income is assumed to be 0.3, consistent with the earlier exercise and broadly within the range for EMs found in relevant literature.² The **total factor productivity (TFP, or A)** is then computed as the residual of the production function.

2. The growth accounting reveals the underlying drivers behind the recent growth deceleration. Following a post-civil war growth spurt in 2010-12, characterized by faster capital formation and robust productivity growth, the Sri Lankan economy switched to a lower gear as both factor accumulation and TFP decelerated. The contribution from labor supply, in particular, has decreased notably compared to earlier periods, coinciding with the slowing growth in Sri Lanka’s working age population.

| Sri Lanka: Growth Accounting (1971-2019) | | | | |
|--|--------|----------------------------|-------------------|-----|
| Periods ¹ | Output | Weighted by $\alpha = 0.3$ | | TFP |
| | | Labor supply (L) | Capital stock (K) | |
| 1971-77 | 2.9 | 1.1 | 1.7 | 0.1 |
| 1978-87 | 5.2 | 2.0 | 1.9 | 1.2 |
| 1988-02 | 4.4 | 0.8 | 1.2 | 2.5 |
| 2003-09 | 5.9 | 1.8 | 2.1 | 2.1 |
| 2010-12 | 8.5 | -0.3 | 2.5 | 6.3 |
| 2013-19 | 3.9 | 0.9 | 1.9 | 1.0 |

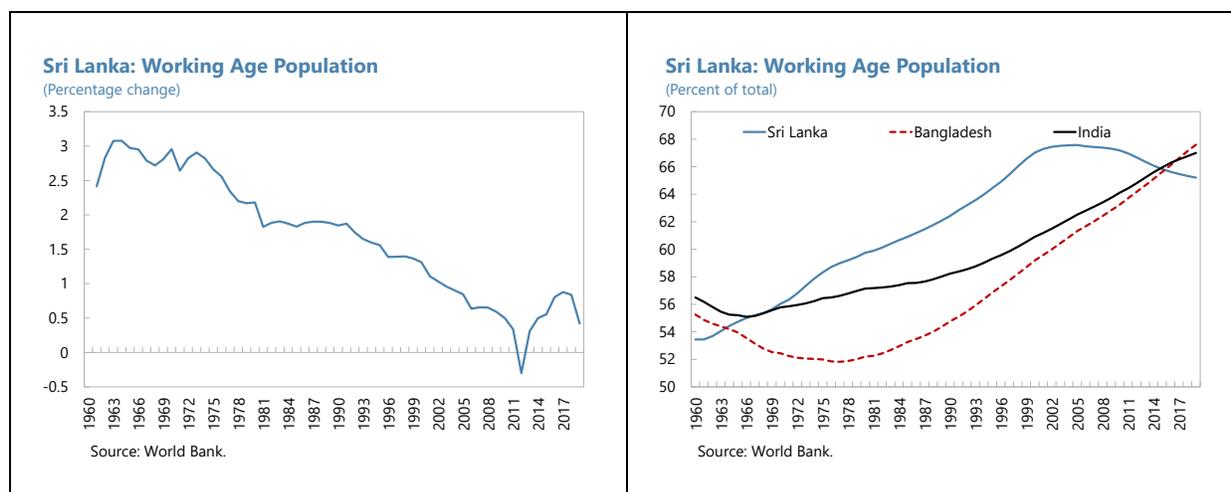
¹ 2010-12 captures the immediate period following the end of the civil war. Please see 2018 SIP for descriptions of earlier periods.

3. The recent downtrend in growth also raises concerns about possibly lower growth potential. Exogenous factors such as natural disasters, the 2018 political crisis, and the 2019 terrorist attack have not only caused large output losses for current periods but also may have left a long-lasting impact on growth potential by impeding factor accumulation and productivity growth. Chronic balance of payment challenges and associated policy uncertainties would further deter much needed investment and entrepreneurship. On top of these, demographic headwinds from an

¹ “Sri Lanka: Structural Transformation—the New Frontier,” 2018, by E. Kvintradze, A. Sundararaj, and M. Takebe, IMF Country Report No. 18/176.

² The assumption on capital share of income only marginally affects the estimate of growth potential.

aging population are expected to deprive Sri Lanka of an important source of growth.³ The more recent COVID-19 shock can potentially have serious “super-hysteresis” effects if its economic repercussions are not handled properly.



4. Taking these all into consideration, Sri Lanka’s medium-term growth potential is estimated to be around 3.1–4.1 percent at this juncture. The capital share of income is assumed to remain at 0.3 absent major economic transformation in the next years. The growth of labor supply (L) is proxied by annualized growth rates (just over 0.1 percent) of working age population in the UN World Population Prospects (medium variant), which implies very little labor contribution to potential growth. The capital contribution to growth has been relatively stable in the past few decades and is projected at around 2 percent over the medium-term.

Sri Lanka: Annual Growth of Potential Output (2021-2026)

| Potential output | Weighted by $\alpha = 0.3$ | | TFP |
|------------------|----------------------------|-------------------|-----|
| | Labor supply (L) | Capital stock (K) | |
| 3.1-4.1 | 0.1 | 2 | 1-2 |

Finally, TFP growth can be expected to fall in the range of 1–2 percent based on the backward-looking growth accounting exercise (depending on the choice of historical reference periods).⁴

5. The growth potential estimate is surrounded by both downside and upside risks. Slower growth of capital stock due to lower public capital spending to support fiscal consolidation could adversely affect growth potential. On the other hand, higher female labor participation could help counter demographic headwinds and larger than expected FDI inflows—with its associated positive externalities—would support the growth of capital stock and TFP. More importantly, macroeconomic stability and policy certainty would largely reduce growth surprises and thereby foster an easier environment to attract investment, create jobs, and improve productivity.

³ Sri Lanka’s median age (33) is higher than in some large emerging market countries (Brazil, Argentina, Turkey, Indonesia) and all other South Asian countries.

⁴ Contribution from capital stock and TFP growth has averaged 1.7 and 1.8 percent, respectively, between 1971–2020. These historical averages, together with a projected contribution from labor supply of 0.1 percent, would imply a growth potential of around 3.6 percent, which falls at the midpoint of the estimated range.

Annex III. Risk Assessment Matrix¹

| Source of Risks | Likelihood | Expected Impact | Policy Response |
|---|------------|--|---|
| Domestic risks | | | |
| More binding (fiscal and BoP) financing constraints than envisaged under the illustrative baseline scenario | High | H: Forces disorderly adjustment either through import compression, larger spending cuts, arrears, monetary financing of fiscal deficit, or a combination of these, disrupting production and investment, eroding confidence, and leading to destabilizing inflation and exchange rate dynamics. | Implement a credible and coherent strategy to restore fiscal and debt sustainability, regain macroeconomic stability, and fundamentally address the FX shortage issue, covering both the near and medium term, as detailed in paragraph 18 of the staff report. |
| Worse-than-anticipated impact of the temporary chemical fertilizer ban on agricultural production | High | H: Weighs on growth, aggravates food supply shortages and overall inflationary pressures; emergency food imports can add to BoP pressures. | |
| Sharper deterioration in banks' asset quality | Medium | M: Can lead to tightening of domestic credit conditions and potential fiscal costs in case capital shortfalls emerge. Weaker balance sheets can hinder banks' access to foreign financing and further tighten domestic FX liquidity. | Proactively identify vulnerabilities and ascertain true conditions of banks through stress testing. Maintain restrictions on bank profit distributions to help ensure capital adequacy. Recognize and address solvency and capital adequacy issues upfront. |
| Loss of GSP+ preferential trade access to the EU | Medium | M: Can adversely affect the exporting industry (with EU being one of Sri Lanka's largest markets), and further complicate BoP challenges. | Continue engagement with the EU in finding a resolution. Liberalize the trade regime and improve the investment climate to diversify exports. |
| External risks | | | |
| Global resurgence of the COVID-19 pandemic. | High | H: New virus outbreaks and lockdowns can further disrupt economic activities, delay tourism recovery, and fuel social discontent. | Continue vaccination drive to achieve herd immunity; manage local outbreaks with targeted containment measures to minimize economic impact. |
| Uncontrolled COVID-19 local outbreaks | Medium | | |
| Rising commodity prices amid bouts of volatility. | Medium | H: Can further widen the current account deficit—aggravating BoP pressures—and add to inflationary pressures. | Implement a credible and coherent strategy to restore fiscal and debt sustainability and regain macroeconomic stability. Rely on exchange rate flexibility as first line of defense; tighten monetary policy to preserve price stability. |
| Higher frequency and severity of natural disasters related to climate change | Medium | H: Can disrupt agriculture production and increase food inflation. Higher imports of food and fuel will worsen current account balance. Disaster-related spending will challenge fiscal consolidation. | Develop a comprehensive disaster financing framework, including contingency budgeting and disaster linked social protections. Implement structural reforms to improve growth potential. |

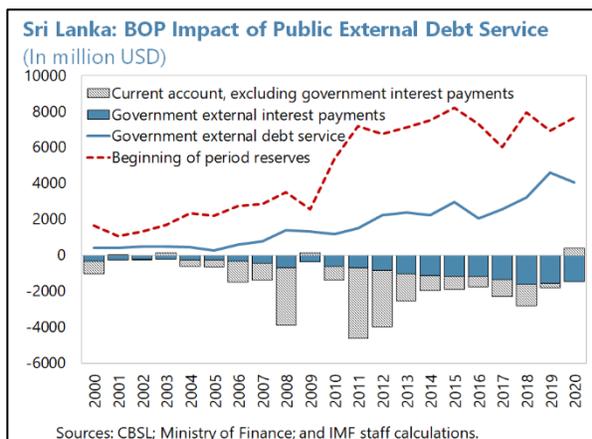
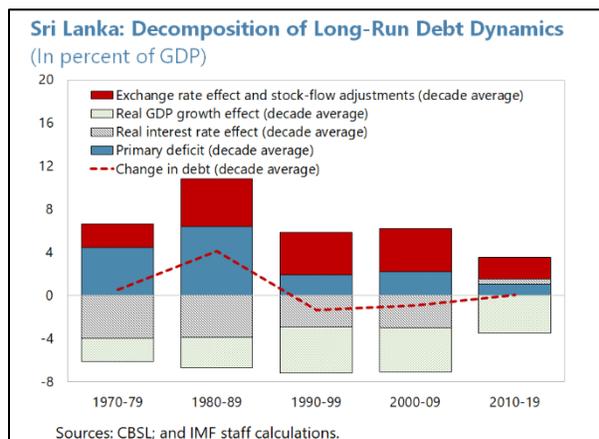
¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, 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.

Annex IV. Debt Sustainability Assessment

In staff's view, debt is unsustainable. Even under benign financing assumptions, debt would continue to increase under the baseline scenario. And downside risks are substantial. Fiscal consolidation efforts necessary to bring down debt over the coming years to safe levels would be too large to be economically and politically feasible. Large fiscal and external financing gaps imply very high rollover risks. The assessment of unsustainable debt is supported by the quantitative tools of the IMF's new Sovereign Risk and Debt Sustainability Framework (SRDSF).

Background and Assumptions

1. Sri Lanka has a longstanding public debt overhang. Primary deficits were reined in after the end of the civil war in 2009 (averaging 1 percent of GDP in 2010-19, on cash basis), but not enough to reduce debt. Access to international capital markets (with International Sovereign Bonds (ISBs) issuances since 2007) brought a shift to commercial borrowing and an increase in external interest rates. Meanwhile, the successful containment of inflation since 2009 meant positive real interest rates on domestic debt. As a result, the government's interest bill (6.5 percent of GDP in 2020) is among the highest in the world. Interest payments also weigh on the current account, and central government external debt service increased from US\$1.3 billion in 2009 to US\$4.1 billion in 2020, giving rise to substantial rollover risk.



2. Many of the downside risks highlighted in the 2019 Debt Sustainability Analysis (DSA) have materialized. Public debt comprises central government debt, guaranteed debt, and the CBSL's foreign liabilities, including Fund credit outstanding and international currency swaps. The last DSA for Sri Lanka was conducted for the 6th EFF Review in late 2019.¹ Since then, the public debt-to-GDP ratio has sharply increased, from 93.6 percent at end-2019 to 113.6 percent at end-September 2021, due to several domestic and external factors: (i) the fiscal deficit widened, due to tax cuts announced in late 2019 and implemented in 2020; (ii) the COVID-19 pandemic led to an

¹ [IMF Country Report No. 19/335](#).

economic contraction in 2020 and to additional fiscal costs through additional health expenditures, social transfers, and lower revenues; (iii) the rupee depreciated by 2.6 percent in 2020 and by 7.5 percent in 2021, leading to an increase in the local currency value of FX-denominated debt; and (iv) the government issued 0.3 percent of GDP in new debt to service Ceylon Electricity Board (CEB)'s debt to Ceylon Petroleum Corporation (CPC) and issued 1.5 percent of GDP in new guarantees. In 2021Q4, public debt increased further and is projected to reach 118.9 percent of GDP at end-2021. This estimate includes the CBSL's liabilities of US\$1.7 billion arising from currency swap arrangements with Bangladesh Bank and People's Bank of China.

3. More than half of central government debt is owed to domestic creditors (Table 1).

Central government debt stood at 101.2 percent of GDP at end-2020, of which three fifths were owed to domestic creditors, including the Central Bank of Sri Lanka (CBSL). Commercial banks held 25 percent of central government debt. At end-September 2021, central government debt stood at 104 percent of GDP, and the domestic share increased further to 62 percent. Since end-2019, external debt declined in nominal term, as foreign investors left the domestic securities market and sold some ISB holdings to residents. Moreover, the ISBs maturing in 2020, 2021, and January of 2022 totaling US\$2.5 billion were not rolled over. The US\$1.9 billion decline in external government debt from end-2019 to September of 2021 was achieved by drawing down reserves which fell by US\$4.9 billion during the same period.

4. Contingent liabilities are substantial.

The stock of state-owned enterprise (SOE) debt reached 15.8 percent of GDP in 2020 (see Text Table). In 2020, CPC benefited from low oil prices, but the higher prices in 2021 have led to new losses, despite a domestic fuel price increase in July 2021. While less than half of SOE debt (6.6 percent of GDP in 2020) is covered by an explicit guarantee, many SOEs are required to fulfil non-commercial obligations such as supplying fuel and electricity at prices below cost recovery levels and operational losses, requiring government support to service their debt.

Text Table. Sri Lanka: SOE debt, 2018–20

| | 2018 | | 2019 | | 2020 | |
|------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Rs. Bn | % GDP | Rs. Bn | % GDP | Rs. Bn | % GDP |
| Ceylon Petroleum Corporation | 615 | 4.3 | 624 | 4.2 | 600 | 4.0 |
| Ceylon Electricity Board | 535 | 3.7 | 657 | 4.4 | 690 | 4.6 |
| Road Development Authority | 232 | 1.6 | 264 | 1.8 | 323 | 2.2 |
| Sri Lankan Airlines 1/ | 255 | 1.8 | 455 | 3.0 | 444 | 3.0 |
| Sri Lanka Ports Authority 2/ | 304 | 2.1 | 132 | 0.9 | 123 | 0.8 |
| Other 3/ | 158 | 1.1 | 163 | 1.1 | 193 | 1.3 |
| Total | 2099 | 14.7 | 2295 | 15.3 | 2373 | 15.8 |

Sources: SOE Financial Statements.
 Note: liabilities reported on unconsolidated basis; includes SLA and CEB liabilities to CPC.
 1/ Reports the total liabilities of Sri Lankan Airlines as of end-March of the following year.
 2/ 2019-20 figures exclude loans related to Hambanethota port (Rs. 157 billion at end-2020)
 3/ Reports total debt outstanding to banks.

5. Sri Lanka currently cannot refinance its debt in an orderly manner.

With the outbreak of the global pandemic in 2020Q1, Sri Lanka lost access to international capital markets. Spreads increased and have since then hovered between 1,000 and 2,700 basis points, and all three international ratings agencies have downgraded Sri Lanka to CCC and lower. The authorities

temporarily imposed strict ceilings on interest rates in treasury security auctions, resulting in substantial auction shortfalls and primary T-bill purchases by the CBSL. To help finance the government, the CBSL provided 3.5 percent of GDP in direct financing in 2020 and around 5 percent of GDP in the first 3 quarters of 2021.

6. The baseline scenario of the DSA reflects staff’s Article IV medium-term macroeconomic projections. Under the illustrative baseline scenario, the projected primary deficit would forcibly adjust, to 2.8 percent of GDP in 2022 and further to 1.8 percent by 2026, reflecting the phasing-out of COVID-related spending, wage bill restraint, cyclical revenue gains, and a sharp cut to capital spending due to lack of financing. Growth would remain below its pre-pandemic trend. Guaranteed debt is assumed to remain constant as a share of GDP.

7. The scenario assumes that financing gaps can be filled at moderate borrowing costs. Under the projected primary balance path, Sri Lanka’s financing needs exceed the absorption capacity of the domestic financial sector—despite substantial spending cuts.² To avoid any financing gaps, the baseline scenario assumes that the necessary financing to close the financing gaps can be mobilized from yet unidentified external sources at an interest rate of 7 percent, more benign than what commercial creditors would likely charge but far less generous than the conditions of bilateral support in 2020–21.

Public Debt Sustainability

8. In staff’s view, current fiscal policies are not sustainable. Under the baseline, public debt would keep increasing throughout the projection horizon, reaching 125.3 percent of GDP in 2026, despite relatively favorable interest rate assumptions (Figure 1). And interest payments will remain above 70 percent of tax revenues throughout the projection horizon. The deficit generates financing needs that exceed the domestic financial system’s capacity. And continued reliance on central bank financing would eventually lead to a de-anchoring of inflation expectations. Despite improvements in commitment control, the size of the fiscal financing challenge suggests that new domestic expenditure arrears could emerge in the years ahead.³

9. Contingent liabilities from the SOE sector could materialize soon. CEB and CPC’s balance sheets remain highly exposed to currency fluctuations. Moreover, unless international fuel prices and energy generation costs are passed through to consumers, CPC and CEB are likely to incur further operational losses. Sri Lankan Airlines, already in distress before the pandemic, was hit hard by the pandemic and is in need of regular transfers from the government. It will most likely also need support to service its Eurobond (US\$175 million) maturing in 2024.

² At end-2020, credit to the government accounted for 31 percent of banking sector assets. The baseline scenario assumes net domestic financing of 5 percent of GDP for 2023–26, a level consistent with limited crowding-out of credit to the private sector and a slowdown in money growth relative to 2020–21.

³ No new budget expenditure arrears have been reported in 2020–21 and all pre-2020 arrears have been cleared.

10. The debt trajectory is subject to large macroeconomic risks. The prospect of the pandemic remains highly uncertain, and the debt trajectory is sensitive to exchange rate shocks. Inflationary pressures from the recent monetary expansion would lead to a lower real interest rate in the short term but could eventually cause the CBSL to raise its policy rates. And while banks appear well capitalized, asset quality in the financial sector remains uncertain. Shock scenarios (Figure 4) indicate the high sensitivity of the outlook to shocks, including the materialization of SOE contingent liabilities (10 percent of outstanding guaranteed debt per year) and the materialization of a one-time financial sector contingent liability shock in 2022. And most vulnerability indicators in the heatmap (Figure 5) signal high risk.

11. In staff's view, Sri Lanka's debt is unsustainable. Based on staff analysis, fiscal consolidation necessary to bring debt down to safe levels would require excessive adjustment over the coming years, pointing to a clear solvency problem. The DSA realism tools (see Figure 3) also indicate that the primary balance adjustment projected under the baseline already falls into the top 10th percentile of historically observed consolidations across countries. A more ambitious adjustment, required to significantly reduce debt, would put Sri Lanka even further into the upper tail. Rollover risk is very high. FX debt service needs of US\$7 billion each year will require access to very large amounts of external financing at concessional rates and long maturities, sustained over many years.

Mechanical Risk Signals

12. To further assess debt risks, several model-based approaches are used (Figure 6).⁴ The new SRDSF tools indicate high near and medium-term risks under the baseline scenario. The near-term stress logit model flags an increase in the stress probability to close to 80 percent, driven by the debt-to-revenue ratio and the annual change in debt to GDP. The medium-term tools also indicate high risk:

- The *GFN tool* indicates high risk, due to (i) elevated GFN in 2021-26, and (ii) an already high level of banking sector credit to the government (as a share of banking sector assets), limiting the ability to provide additional domestic financing in case of a renewed loss of market access.
- The fan chart tool indicates high risk, due to the 2026 central government debt level and the debt stabilization probability of only 23 percent.

Staff has also conducted the model-based risk analysis under an ambitious adjustment scenario with more favorable growth assumptions. The risk ratings would remain unchanged, supporting staff's assessment of unsustainable debt.

⁴ Sri Lanka is a pilot country for the SRDSF rollout.

Table 1. Sri Lanka: Composition of Public Debt

| | end-2019 | | | | end-2020 | | | |
|--|----------------|---------------|----------------|-------------------------------|----------------|---------------|----------------|-------------------------------|
| | billion Rupees | million USD | percent of GDP | percent of central govt. debt | billion Rupees | million USD | percent of GDP | percent of central govt. debt |
| Total public and publicly guaranteed debt and CBSL external liabilities | 14,048 | 77,343 | 93.6 | | 16,472 | 88,364 | 110.0 | |
| Central government debt | 13,032 | 71,746 | 86.8 | 100.0 | 15,158 | 81,318 | 101.2 | 100.0 |
| Domestic currency | 6,005 | 33,061 | 40.0 | 46.1 | 7,948 | 42,639 | 53.1 | 52.4 |
| T-bills | 898 | 4,942 | 6.0 | 6.9 | 1,621 | 8,698 | 10.8 | 10.7 |
| CBSL | 26 | 142 | 0.2 | 0.2 | 655 | 3,512 | 4.4 | 4.3 |
| Banks | 685 | 3,770 | 4.6 | 5.3 | 813 | 4,361 | 5.4 | 5.4 |
| Non-banks | 163 | 900 | 1.1 | 1.3 | 153 | 821 | 1.0 | 1.0 |
| External creditors | 24 | 131 | 0.2 | 0.2 | 1 | 4 | 0.0 | 0.0 |
| T-bonds | 4,687 | 25,802 | 31.2 | 36.0 | 5,720 | 30,683 | 38.2 | 37.7 |
| CBSL | 49 | 269 | 0.3 | 0.4 | 71 | 378 | 0.5 | 0.5 |
| Banks | 822 | 4,525 | 5.5 | 6.3 | 1,513 | 8,118 | 10.1 | 10.0 |
| Non-banks | 3,735 | 20,566 | 24.9 | 28.7 | 4,129 | 22,153 | 27.6 | 27.2 |
| External creditors | 80 | 442 | 0.5 | 0.6 | 6 | 34 | 0.0 | 0.0 |
| Rupee loans (due 2023) | 24 | 133 | 0.2 | 0.2 | 24 | 129 | 0.2 | 0.2 |
| CBSL advances | 236 | 1,300 | 1.6 | 1.8 | 153 | 821 | 1.0 | 1.0 |
| Overdrafts and other 1/ | 160 | 884 | 1.1 | 1.2 | 430 | 2,308 | 2.9 | 2.8 |
| Foreign currency | 7,027 | 38,686 | 46.8 | 53.9 | 7,210 | 38,678 | 48.2 | 47.6 |
| Multilateral | 1,470 | 8,092 | 9.8 | 11.3 | 1,642 | 8,811 | 11.0 | 10.8 |
| Bilateral 2/ | 1,132 | 6,232 | 7.5 | 8.7 | 1,163 | 6,239 | 7.8 | 7.7 |
| Japan | 618 | 3,402 | 4.1 | 4.7 | 659 | 3,537 | 4.4 | 4.3 |
| India | 153 | 843 | 1.0 | 1.2 | 147 | 786 | 1.0 | 1.0 |
| People's Republic of China | 139 | 764 | 0.9 | 1.1 | 125 | 669 | 0.8 | 0.8 |
| Korea | 64 | 131 | 0.4 | 0.5 | 69 | 369 | 0.5 | 0.5 |
| Germany | 43 | 237 | 0.3 | 0.3 | 45 | 242 | 0.3 | 0.3 |
| France | 34 | 188 | 0.2 | 0.3 | 39 | 207 | 0.3 | 0.3 |
| United States | 24 | 134 | 0.2 | 0.2 | 21 | 111 | 0.1 | 0.1 |
| Canada | 5 | 27 | 0.0 | 0.0 | 5 | 24 | 0.0 | 0.0 |
| Others | 92 | 506 | 0.6 | 0.7 | 233 | 295 | 0.4 | 0.4 |
| Commercial 2/ | 4,425 | 24,361 | 29.5 | 34.0 | 4,404 | 23,628 | 29.4 | 29.1 |
| Domestic law | 728 | 4,009 | 4.9 | 5.6 | 720 | 3,862 | 4.8 | 4.7 |
| Sri Lanka Development Bonds | 560 | 3,084 | 3.7 | 4.3 | 492 | 2,639 | 3.3 | 3.2 |
| Domestic creditors | 559 | 3,079 | 3.7 | 4.3 | 487 | 2,612 | 3.3 | 3.2 |
| External creditors | 1 | 5 | 0.0 | 0.0 | 5 | 27 | 0.0 | 0.0 |
| FCBU (domestic bank loans) | 168 | 925 | 1.1 | 1.3 | 228 | 1,224 | 1.5 | 1.5 |
| Foreign law | 3,697 | 20,352 | 24.6 | 28.4 | 3,684 | 19,766 | 24.6 | 24.3 |
| International sovereign bonds | 2,734 | 15,050 | 18.2 | 21.0 | 2,619 | 14,050 | 17.5 | 17.3 |
| Domestic creditors | 202 | 1,113 | 1.3 | 1.6 | 416 | 2,230 | 2.8 | 2.7 |
| External creditors | 2,531 | 13,937 | 16.9 | 19.4 | 2,203 | 11,820 | 14.7 | 14.5 |
| Syndicated loans | 242 | 1,333 | 1.6 | 1.9 | 280 | 1,500 | 1.9 | 1.8 |
| of which (China Dev. Bank) | 182 | 1,000 | 1.2 | 1.4 | 280 | 1,500 | 1.9 | 1.8 |
| China EXIM | 477 | 2,624 | 3.2 | 3.7 | 528 | 2,835 | 3.5 | 3.5 |
| Others | 244 | 1,345 | 1.6 | 1.9 | 257 | 1,381 | 1.7 | 1.7 |
| Guaranteed debt | 778 | 4,285 | 5.2 | | 986 | 5,292 | 6.6 | |
| CBSL external liabilities | 238 | 1,312 | 1.6 | | 327 | 1,755 | 2.2 | |
| Fund credit outstanding | 238 | 1,312 | 1.6 | | 253 | 1,355 | 1.7 | |
| International currency swaps | - | - | - | | 75 | 400 | 0.5 | |
| Domestic central government debt | 6,830 | 37,605 | 45.5 | 52.4 | 9,072 | 48,668 | 60.6 | 59.8 |
| External central government debt | 6,201 | 34,141 | 41.3 | 47.6 | 6,086 | 32,650 | 40.6 | 40.2 |
| <i>multilateral creditors</i> | 1,470 | 8,092 | 9.8 | 11.3 | 1,642 | 8,811 | 11.0 | 10.8 |
| <i>bilat. creditors (excl China)</i> | 993 | 5,468 | 6.6 | 7.6 | 1,038 | 5,570 | 6.9 | 6.8 |
| <i>of which: Paris club</i> | 789 | 4,120 | 5.3 | 6.1 | 837 | 4,489 | 5.6 | 5.5 |
| <i>China (Govt, EXIM, CDB)</i> | 797 | 4,387 | 5.3 | 6.1 | 933 | 5,003 | 6.2 | 6.2 |
| <i>private creditors</i> | 2,941 | 16,193 | 19.6 | 22.6 | 2,473 | 13,265 | 16.5 | 16.3 |

Source: Sri Lankan authorities and IMF staff estimates.

1/ net of deposits

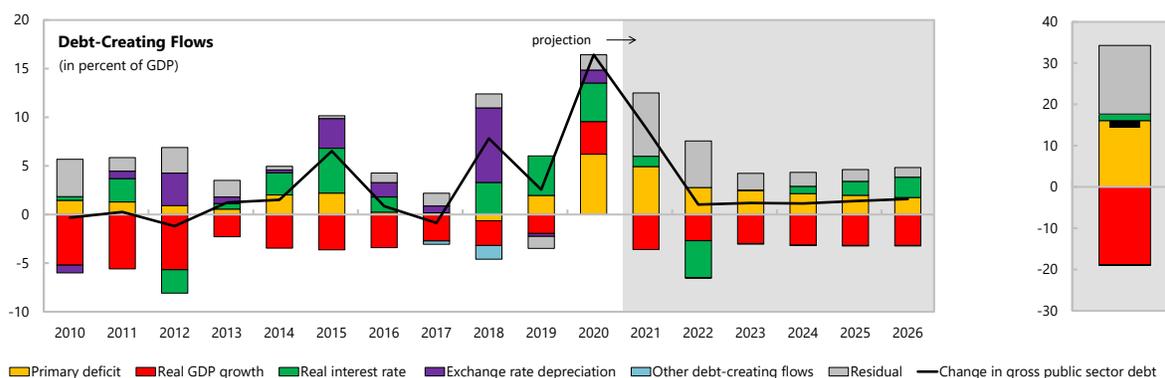
2/ the presentation follows the authorities' classification

Figure 1. Sri Lanka: Public Sector Debt Sustainability Analysis – Baseline Scenario

(In percent of GDP, unless otherwise indicated)

| | Debt, Economic and Market Indicators ^{1/} | | | | | | | | | As of January 14, 2022 | | |
|--|--|------|-------|-------------|-------|-------|-------|-------|-------|--------------------------|---------|-------|
| | Actual | | Prel. | Projections | | | | | | | | |
| | 2010-2018 ^{2/} | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | | | |
| Nominal gross public debt | 79.7 | 93.6 | 110.0 | 118.9 | 119.9 | 121.1 | 122.3 | 123.7 | 125.3 | Sovereign Spreads | | |
| o/w: guarantees & CBSL external liabilities | 4.6 | 6.8 | 8.8 | 11.8 | 11.3 | 10.9 | 10.5 | 10.2 | 9.9 | EMBIG (bp) ^{3/} | 2566 | |
| Public gross financing needs | 21.1 | 20.6 | 26.2 | 30.1 | 32.8 | 36.2 | 36.9 | 38.6 | 40.1 | 5Y CDS (bp) | n.a. | |
| Real GDP growth (in percent) | 5.6 | 2.3 | -3.6 | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 | Ratings | Foreign | Local |
| Inflation (GDP deflator, in percent) | 5.3 | 2.7 | 3.4 | 5.7 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 | Moody's | Caa2 | n.a. |
| Nominal GDP growth (in percent) | 11.2 | 5.1 | -0.3 | 9.5 | 13.4 | 9.9 | 9.4 | 8.7 | 8.2 | S&P's | CCC | n.a. |
| Effective interest rate (in percent) ^{4/} | 7.6 | 7.5 | 7.5 | 7.0 | 7.2 | 7.2 | 7.2 | 7.2 | 7.2 | Fitch | CC | n.a. |

| | Contribution to Changes in Public Debt | | | | | | | | | cumulative | debt-stabilizing primary balance ^{9/} |
|---|--|------|-------|-------------|------|------|------|------|------|------------|--|
| | Actual | | Prel. | Projections | | | | | | | |
| | 2010-2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | | |
| Change in gross public sector debt | 1.8 | 2.6 | 16.4 | 8.9 | 1.0 | 1.2 | 1.1 | 1.4 | 1.6 | 15.3 | |
| Identified debt-creating flows | 0.2 | 3.8 | 14.9 | 2.4 | -3.8 | -0.5 | -0.3 | 0.2 | 0.6 | -1.4 | |
| Primary deficit | 0.9 | 2.0 | 6.2 | 4.9 | 2.78 | 2.5 | 2.2 | 2.0 | 1.8 | 16.1 | |
| Primary (noninterest) revenue and grants | 13.0 | 12.6 | 9.2 | 8.9 | 10.7 | 10.8 | 11.0 | 11.1 | 11.3 | 63.9 | |
| Primary (noninterest) expenditure | 13.9 | 14.6 | 15.4 | 13.9 | 13.5 | 13.2 | 13.2 | 13.1 | 13.1 | 79.9 | |
| Automatic debt dynamics ^{5/} | -0.5 | 1.8 | 8.6 | -2.5 | -6.5 | -2.9 | -2.4 | -1.7 | -1.1 | -17.2 | |
| Interest rate/growth differential ^{6/} | -2.4 | 2.1 | 7.3 | -2.5 | -6.5 | -2.9 | -2.4 | -1.7 | -1.1 | -17.2 | |
| Of which: real interest rate | 1.4 | 4.1 | 4.0 | 1.1 | -3.8 | 0.1 | 0.8 | 1.4 | 2.1 | 1.6 | |
| Of which: real GDP growth | -3.8 | -2.0 | 3.3 | -3.6 | -2.7 | -3.0 | -3.1 | -3.2 | -3.2 | -18.8 | |
| Exchange rate depreciation ^{7/} | 1.9 | -0.3 | 1.3 | ... | ... | ... | ... | ... | ... | ... | |
| Other identified debt-creating flows | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 | 0.0 | 0.0 | -0.2 | |
| Privatization proceeds (negative) | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 | 0.0 | 0.0 | -0.2 | |
| Contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Residual, including asset changes ^{8/} | 1.6 | -1.2 | 1.6 | 6.5 | 4.8 | 1.7 | 1.4 | 1.2 | 1.0 | 16.6 | |



Source: IMF staff.

1/ Public sector is defined as central government and includes public guarantees, defined as outstanding amount of loans guaranteed by the central government and CBSL external liabilities (i.e. Fund credit outstanding and liabilities from international swap arrangements).

2/ Based on available data.

3/ EMBIG.

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

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

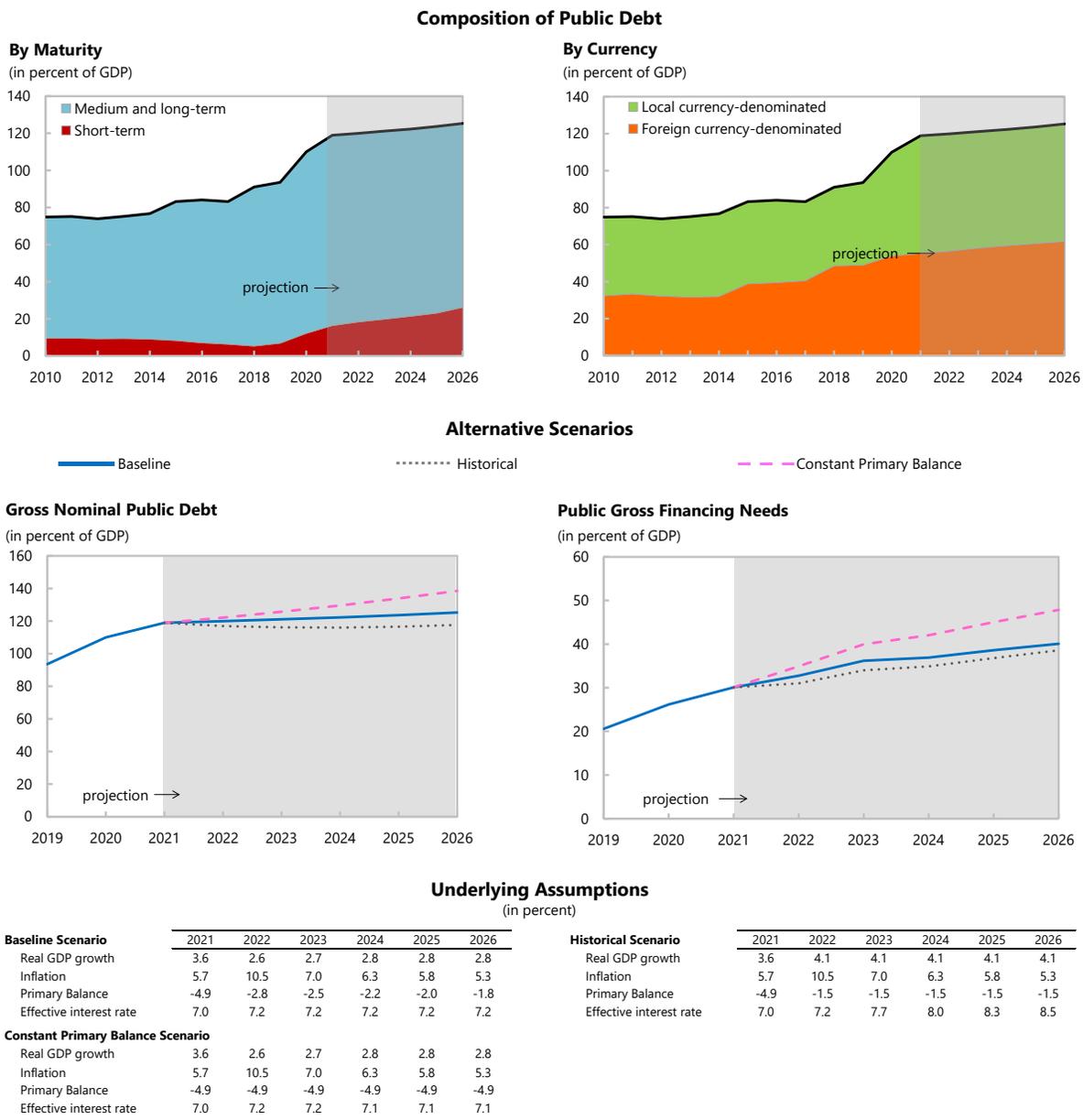
6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

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

8/ Includes changes in the stock of guarantees, asset changes, and interest revenues. For projections, includes exchange rate changes during the projection period.

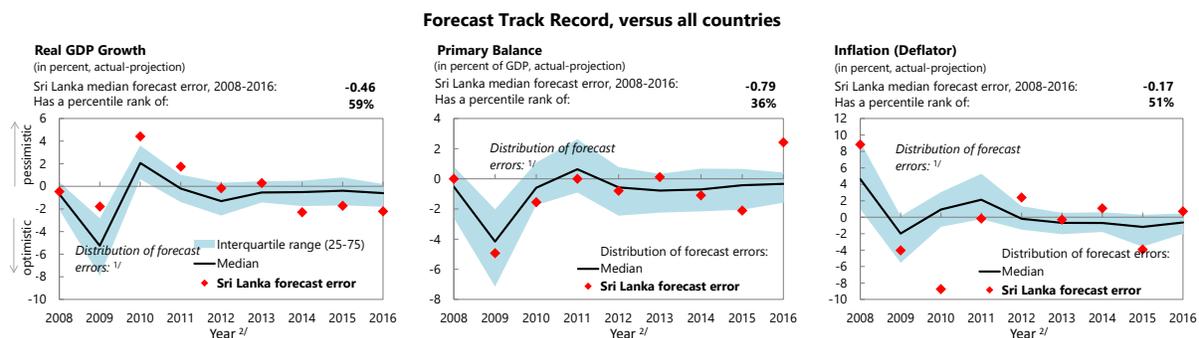
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. Sri Lanka: Public Debt Sustainability Analysis - Composition of Public Debt and Alternative Scenarios



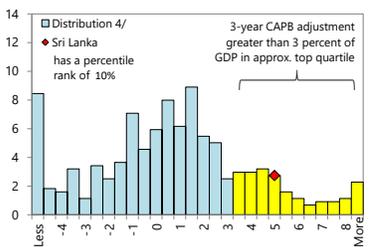
Source: IMF staff.

Figure 3. Sri Lanka: Public Debt Sustainability Analysis – Realism of Baseline Assumptions

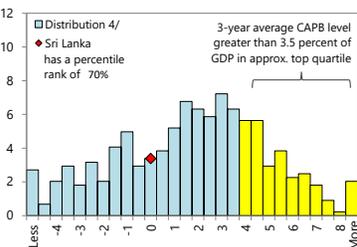


Assessing the Realism of Projected Fiscal Adjustment

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

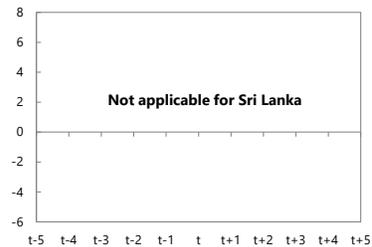


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis^{3/}

Real GDP growth
(in percent)



Source : IMF Staff.

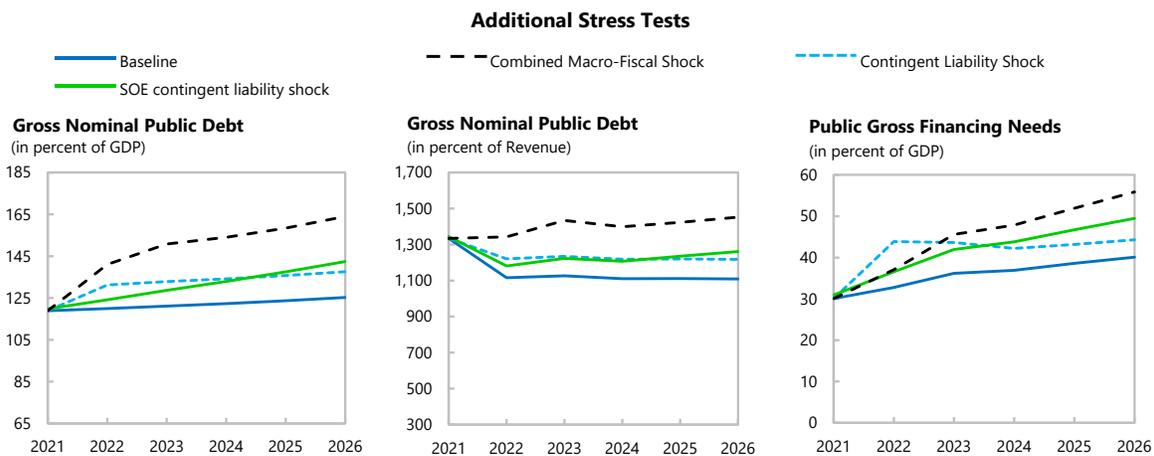
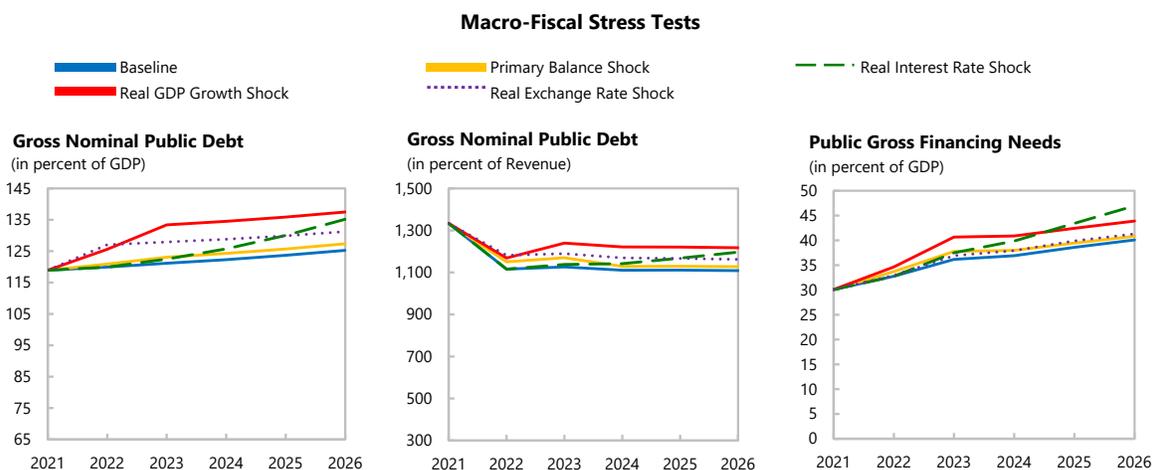
1/ Plotted distribution includes all countries, percentile rank refers to all countries.

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

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

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

Figure 4. Sri Lanka: Public Debt Sustainability Analysis – Stress Tests



Underlying Assumptions (in percent)

| | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
|---------------------------------------|------|------|------|------|------|------|-----------------------------------|------|-------|------|------|------|------|
| Primary Balance Shock | | | | | | | Real GDP Growth Shock | | | | | | |
| Real GDP growth | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 | Real GDP growth | 3.6 | -0.9 | -0.7 | 2.8 | 2.8 | 2.8 |
| Inflation | 5.7 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 | Inflation | 5.7 | 9.7 | 6.1 | 6.3 | 5.8 | 5.3 |
| Primary balance | -4.9 | -3.7 | -3.4 | -2.2 | -2.0 | -1.8 | Primary balance | -4.9 | -3.4 | -3.6 | -2.2 | -2.0 | -1.8 |
| Effective interest rate | 7.0 | 7.2 | 7.2 | 7.3 | 7.2 | 7.2 | Effective interest rate | 7.0 | 7.2 | 7.2 | 7.3 | 7.2 | 7.3 |
| Real Interest Rate Shock | | | | | | | Real Exchange Rate Shock | | | | | | |
| Real GDP growth | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 | Real GDP growth | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 |
| Inflation | 5.7 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 | Inflation | 5.7 | 17.1 | 7.0 | 6.3 | 5.8 | 5.3 |
| Primary balance | -4.9 | -2.8 | -2.5 | -2.2 | -2.0 | -1.8 | Primary balance | -4.9 | -2.8 | -2.5 | -2.2 | -2.0 | -1.8 |
| Effective interest rate | 7.0 | 7.2 | 8.5 | 9.3 | 9.9 | 10.4 | Effective interest rate | 7.0 | 7.6 | 6.9 | 6.9 | 6.9 | 7.0 |
| Combined Shock | | | | | | | Contingent Liability Shock | | | | | | |
| Real GDP growth | 3.6 | -0.9 | -0.7 | 2.8 | 2.8 | 2.8 | Real GDP growth | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 |
| Inflation | 5.7 | 9.7 | 6.1 | 6.3 | 5.8 | 5.3 | Inflation | 5.7 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 |
| Primary balance | -4.9 | -3.7 | -3.9 | -2.2 | -2.0 | -1.8 | Primary balance | -4.9 | -12.7 | -2.5 | -2.2 | -2.0 | -1.8 |
| Effective interest rate | 7.0 | 7.6 | 8.0 | 8.8 | 9.5 | 10.0 | Effective interest rate | 7.0 | 8.4 | 7.7 | 7.4 | 7.4 | 7.4 |
| SOE contingent liability shock | | | | | | | | | | | | | |
| Real GDP growth | 3.6 | 2.6 | 2.7 | 2.8 | 2.8 | 2.8 | | | | | | | |
| Inflation | 5.7 | 10.5 | 7.0 | 6.3 | 5.8 | 5.3 | | | | | | | |
| Primary balance | -4.9 | -5.3 | -3.4 | -2.2 | -2.0 | -1.8 | | | | | | | |
| Effective interest rate | 7.0 | 7.2 | 7.1 | 7.1 | 7.1 | 7.1 | | | | | | | |

Source: IMF staff.

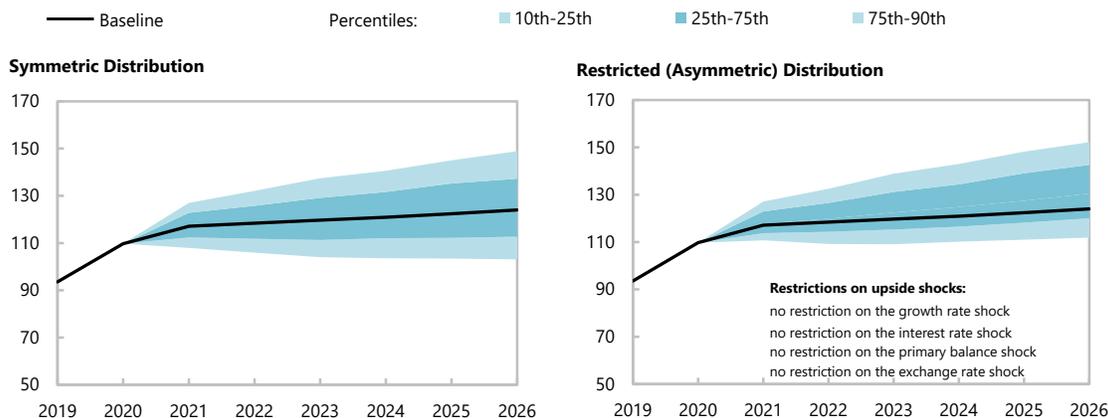
Figure 5. Sri Lanka: Public Debt Sustainability Analysis - Risk Assessment

Heat Map

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

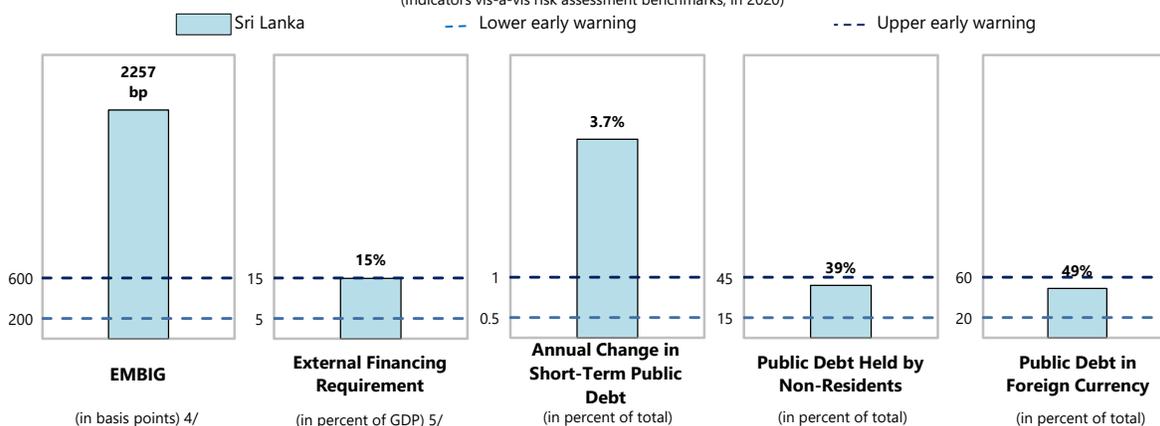
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

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

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

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

Lower and upper risk-assessment benchmarks are:

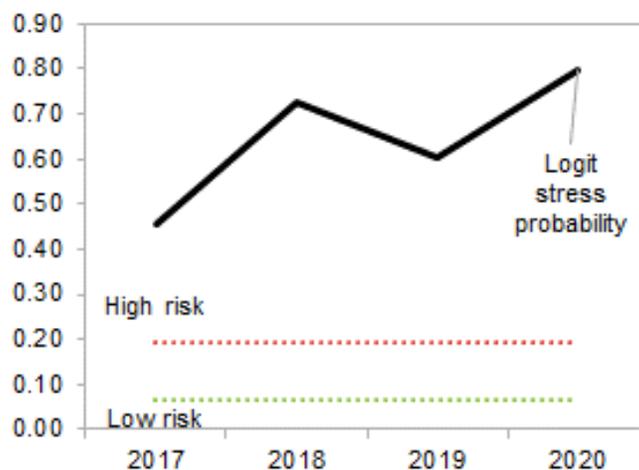
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 16-Oct-21 through 14-Jan-22.

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

Figure 6. Sri Lanka: SRDSF Results

Determination of Mechanical Near-term Signal



Deriving the GFN Financeability Index and Mechanical Signal

| Indicator | Weight | Value |
|--|--------|-------------|
| Average GFN-to-GDP ratio in the baseline | 0.34 | 35.1% |
| Initial bank claims on the govt (pct of assets) | 0.32 | 31.0% |
| Change in bank claims on govt, stress scenario (pct of assets) | 0.33 | 5.2% |
| GFN financeability index | | 23.8 |
| Signal | | High |
| Thresholds: | | |
| Moderate-high | | 17.9 |
| Low-Moderate | | 7.6 |

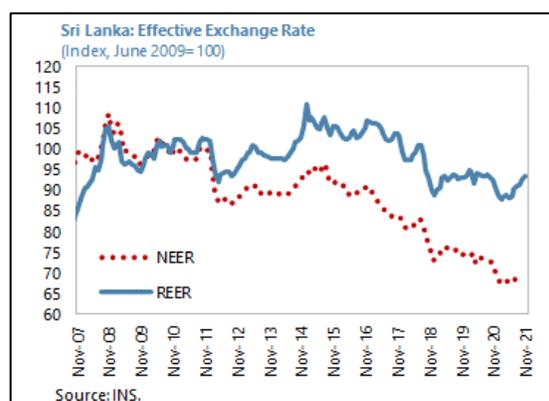
Deriving the Debt Fanchart Index and Mechanical Signal

| Indicator | Raw value | Index |
|--------------------------------|-----------|-------------|
| Fanchart width | 62.7% | 0.53 |
| Prob of debt non-stabilization | 76.9% | 1.12 |
| Debt(t+5) x institutions | 72.2% | 1.57 |
| Debt fanchart index | | 3.21 |
| Signal | | High |
| Thresholds: | | |
| Moderate-high | | 2.08 |
| Low-moderate | | 1.13 |
| Memo: | | |
| Debt(t+5) | | 113.8% |
| Institutional quality index | | 0.63 |

Annex V. External Sector Assessment

Sri Lanka's external position in 2021 is assessed as weaker than the level implied by medium-term fundamentals and desirable policies. This assessment is informed by the current account model, based on staff's estimate for the 2021 current account. External debt vulnerabilities are high, and the level of reserves remained precariously low against an adequate level, posing severe vulnerabilities to external shocks. Improving Sri Lanka's external position would require, among others, implementing revenue-based fiscal consolidation, restoring debt sustainability, conducting prudent monetary policy accompanied by greater exchange flexibility, and rebuilding international reserves to adequate levels. In addition, structural reforms to boost Sri Lanka's export capacity and steps to encourage FDI in export-oriented sectors would be key.

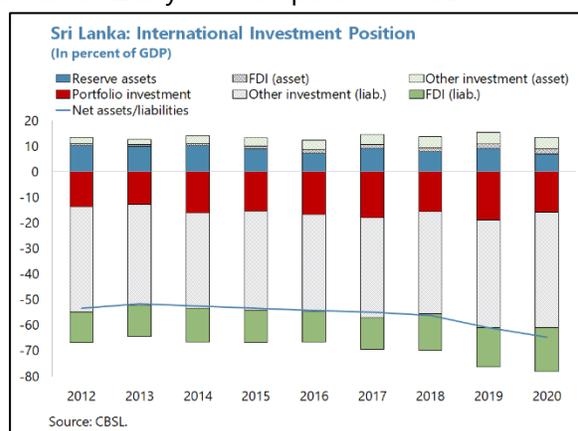
1. Sri Lanka's balance of payments faced negative shocks in 2020 amid the pandemic and loss of market access. As several lockdowns to contain the spread of COVID-19 severely hit growth and trade, the current account deficit narrowed to 1.3 percent of GDP in 2020, from 2.2 percent in 2019. This reflected a combination of subdued exports and a collapse in tourism receipts which were more than compensated by a sharp decline in imports of goods and services (including due to lower global oil prices and restricted travel of Sri Lankans abroad) and higher remittance inflows benefitting from a switch to formal banking channels. A host of import restrictions, introduced when the pandemic began and ranging from suspension of consumption goods imports (most notably personal vehicles) to more stringent minimum credit requirements, also contributed to narrowing the current account deficit. While FDI inflows slowed on the back of lockdowns and the recession, portfolio flows reversed to negative as Sri Lanka lost access to international capital market. As a result, maturing Eurobonds (\$1 billion) in October 2020 were repaid out of gross international reserves (GIR), which decreased from US\$7.6 billion at end-2019 to US\$5.7 billion at end-2020. After an appreciation of 1 percent in 2020, the average real effective exchange rate (REER) depreciated by 6 percent through October 2021, driven by nominal rupee depreciation until April 2021 in response to FX market pressures.



2. The balance of payments is expected to weaken further in 2021 and over the medium term. The current account deficit is projected to widen to 3.8 percent of GDP in 2021 driven by higher imports outpacing exports amid a post-pandemic recovery, a plunge in remittances, and a slowly recovering tourism. This includes expected savings from suspension of certain imports over 2021 (0.9 percent of GDP, Annex VI). GIR further declined to US\$3.1 billion at end-December 2021. The current account deficit is expected to gradually decline to around 2.6 percent of GDP by 2026, as tourism inflows reach pre-pandemic highs. However, the financial account and

GIR will remain under pressure in the medium term, dominated by large government external financing needs.

3. Sri Lanka remains a net debtor country, with large external liabilities and limited external assets. Sri Lanka's net external liabilities increased sizably from 53 percent of GDP on average during 2012-2017 to 65 percent of GDP in 2020, primarily due to a jump in gross external liabilities from 67 to 78 percent of GDP amid high government borrowing and rupee depreciation in 2018-20. Gross external assets remained relatively stable at 13 percent of GDP, with the decline of GIR compensated by the valuation effect. FDI accounted for about a quarter of net external liabilities, and other investment (debt portfolios and/or bank loans) accounted for about 60 percent. Some 85 percent of the total debt liabilities (66 percent of GDP) are long-term, with the government remaining the largest debtor, holding close to two thirds of the total external debt liabilities.



4. In staff's view, Sri Lanka's public debt is unsustainable (Annex IV). Restoring Sri Lanka's debt sustainability to bring external public debt and debt service down to manageable levels will help raise Sri Lanka's NIIP and reduce risks to external sustainability from elevated gross external liabilities and potential adverse valuation effects.

External Position

5. Sri Lanka's external position in 2021 is weaker than the level implied by the medium-term fundamentals and desirable policy settings.

- The External Balance Assessment (EBA) CA model estimates Sri Lanka's current account norm of about -1.6 percent of GDP. However, a small surplus is needed to ensure external sustainability over the medium term, therefore the current account norm is adjusted upwards by about 1.9 percent of GDP.

Sri Lanka: External Balance Assessment: CA Model
(in percent of GDP, unless otherwise noted)

| | | |
|--------------------------------------|-----------------|--------------|
| Projected 2021 CA | [1] | -3.8% |
| Cyclical contributions | [2] | 0.7% |
| Cyclically adjusted actual CA | [3] = [1]-[2] | -4.5% |
| Additional temporary factors | [4] | 1.7% |
| Covid-19 adjustors | | 1.7% |
| Oil | | 0.0% |
| Tourism | | 1.7% |
| Medical | | 0.0% |
| Adjusted CA | [5] = [3]+[4] | -2.7% |
| CA Norm (from model) 1/ | [6] | -1.6% |
| Adjustment to the norm 2/ | [7] | 1.9% |
| Adjusted CA Norm | [8] = [6]+[7] | 0.3% |
| CA Gap | [9] = [5]-[8] | -3.0% |
| <i>of which Relative policy gap</i> | | -2.1% |
| Fiscal balance | | -0.5% |
| Health expenditure | | 0.3% |
| Change in FX reserves | | -1.7% |
| Private credit | | -0.3% |
| Capital controls | | 0.2% |
| Elasticity | [10] | -0.18 |
| REER gap 3/ | [11] = [9]/[10] | 16.8% |

1/ Cyclically adjusted, including multilateral consistency adjustment.
2/ Adjustor to ensure external sustainability over the medium term.
3/ "-" undervalued ER; "+" overvalued ER

- The cyclically adjusted CA balance (estimated at -4.5 percent of GDP in 2021) is subject to additional adjustment due to temporary impact of the COVID-19 pandemic on tourism (1.7 percent of GDP).
- As a result, with adjusted projected CA of -2.7 percent of GDP, based on staff's estimate for the 2021 CA of -3.8 percent, against adjusted CA norm of 0.3 percent of GDP, the EBA-based current account gap for 2021 is -3.0 percent of GDP. Policy gaps (mainly a large fiscal deficit and inadequate FX reserves) explain -2.1 percent of GDP, while -0.9 percent of GDP is a residual. The estimated current account gap points to a REER overvaluation of about 17 percent.
- The EBA-lite REER model yields a similar REER overvaluation of about 14.8 percent, while the EBA External Sustainability (ES) approach—calibrated at stabilizing the NFA/GDP at a benchmark level—points to a REER overvaluation of about 3 percent.
- Placing greater weight on the EBA CA and EBA-lite REER models, which use a rich set of cross-country information, and incorporate estimated adjustments for COVID-19 impacts and external sustainability, staff assesses Sri Lanka's external position to be weaker than the level implied by medium-term macroeconomic fundamentals and desirable policy settings. Sri Lanka has a negative current account gap in 2021, exceeding 2 percent of GDP, and consistent with a REER overvaluation of about 17 percent.

| Sri Lanka: EBA-lite REER Model | | |
|--------------------------------|---------------|-------|
| Ln(REER) AVG 2021 | [1] | 4.48 |
| Ln(REER) Fitted | [2] | 4.31 |
| Ln(REER) Norm | [3] | 4.33 |
| Residual | [1]-[2] | 0.16 |
| REER Gap 1/ | [4] = [1]-[3] | 14.8% |
| of which: Policy gap | | -1% |
| Elasticity | [5] | -0.18 |
| CA gap, % GDP | [6]=[4]*[5] | -2.6% |

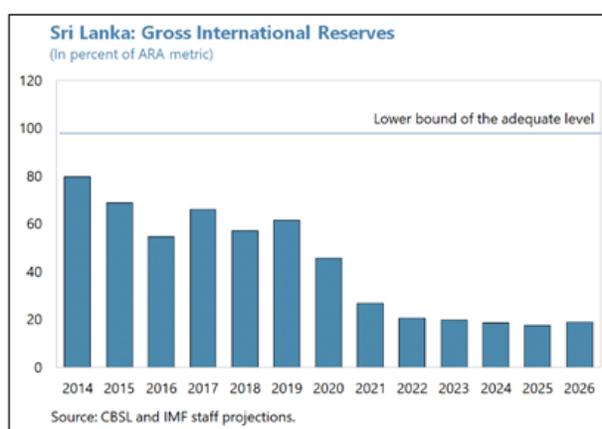
1/ "-" undervalued ER; "+" overvalued ER

| Sri Lanka: EBA External Sustainability Model (in percent of GDP, unless otherwise noted) | | |
|---|---------------|--------|
| Benchmark NFA/GDP 1/ | [1] | -53.7% |
| Projected 2021 CA | [2] | -3.8% |
| Cyclical contributions | [3] | 0.7% |
| Cyclically adjusted actual CA | [4] = [2]-[3] | -4.5% |
| CA stabilizing NFA at benchmark | [5] | -3.9% |
| CA Gap | [6]=[4]-[5] | -0.5% |
| Elasticity | [7] | -0.18 |
| REER gap 2/ | [8]=[6]/[7] | 3.0% |

1/ Average NFA/GDP over 2012-2018, preceding Covid-19 pandemic and 2019 terrorist attack.
2/ "-" undervalued ER; "+" overvalued ER

Reserve Adequacy

6. Sri Lanka's international reserve position remains precariously low against an adequate level. GIR, historically supported by extensive external government borrowing, declined from 62 percent of the Fund's Assessing Reserve Adequacy (ARA) metric at end-2019 to 46 percent at end-2020 and 25 percent at end-December 2021, much below the recommended adequacy range of 100-150 percent. They are also well short of Foreign exchange (FX) debt service for the



coming years—\$7-8 billion per year during 2022–26, including maturing International Sovereign Bonds of \$1–2 billion per year.

7. The CBSL is pursuing an interventionist approach to exchange rate policy. Initially in response to the pandemic and later in 2021 in response to FX market pressures, the authorities suspended certain non-priority imports, and introduced surrender requirements for exports and converted remittances, and other capital controls to stabilize the exchange rate and preserve scarce international reserves. FX interventions were substantial, albeit on balance not deeply negative (between March 2020 and November 2021, the CBSL has cumulatively sold \$4.4 billion and purchased \$4.3 billion in spot and forward FX markets including through swap transactions). While the CBSL allowed the exchange rate to fluctuate from the onset of the pandemic through March 2021, the rupee has been de-facto pegged to the U.S. dollar since April 2021, with the CBSL applying strong moral suasion and reportedly signaling to banks the maximum level of the rupee in the official market. Parallel market quotes were once reported at around 20 percent premium, albeit on a limited scale. In addition, until mid-September private commercial banks offered a more depreciated exchange rate than the official one to some of its clients.

Capital Flow Management

8. To mitigate the adverse impact of the pandemic on the balance of payments, Sri Lankan authorities introduced temporary FX management and capital flow management measures. Following the COVID-19 shock in March 2020, Sri Lanka lost market access and capital outflows led to a drain of reserves. Net capital inflows declined by 4.8 percent of GDP in 2020. While FDI inflows declined by 37 percent, portfolio investment inflows recorded a reversal, primarily in debt securities due to government's inability to borrow from international capital markets and due to an exit of foreign investors from domestic government bonds market.¹ To help alleviate the pressure, the authorities introduced temporary FX management and capital flow management measures (CFMs) in April 2020 and further extended/tightened them in 2021.² The import restrictions were mainly related to suspension of importation of non-essential/non-priority goods, most notably personal vehicles. Between September and October 2021, the CBSL temporarily introduced a 100 percent non-interest-bearing cash margin deposit requirement on Letters of Credit for importing over 600 consumer goods and also prohibited banks from lending to importers to meet these margins. Main CFM measures which are currently in force include: (i) a repatriation requirement for exports of goods and services; (ii) a surrender requirement for exporters on proceeds from exports of goods and services; (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

¹ Foreign holdings of domestic government securities declined from about 0.6 percent of GDP at end-2019 to about 0.1 percent of GDP at end-2020.

² In June 2021, the suspension of non-priority imports was somewhat relaxed, as 104 HS goods codes were removed from the 546 HS codes temporary suspension list. The chemical fertilizer import ban introduced in early May 2021 has been reversed at end-November 2021.

emigrants for emigrants. Measures (i) and (vii) above constitute a tightening of existing CFMs on outflows, while the others are new CFMs on outflows.³

9. While import restrictions hinder trade, growth and distort markets, CFMs may be needed in the near term to mitigate capital outflow risks. That said, the CFMs should not be a substitute for warranted macroeconomic adjustment.

³ To facilitate private inflows, the CBSL also offered free FX cover for non-resident investment into domestic government securities and for private sector FX borrowing and lifted limits on short term FX borrowing by commercial banks.

Annex VI. Import Restrictions in Sri Lanka

In response to balance of payment pressures, the authorities introduced import restrictions that temporarily suspended imports of non-priority goods and placed many goods under a licensing regime. Estimates suggest that gross savings of the import bill in 2020 were about US\$1.2 billion (7½ percent of total imports), falling primarily on consumer goods (most notably personal vehicles). Expected incremental savings in 2021 would amount to US\$0.8 billion (4 percent of total imports), with two thirds of the impact coming from restricting intermediate goods and capital goods imports used as input in domestic production and supporting investment. While these restrictions help relieve balance of payments pressures, they inhibit trade, adversely affect economic growth, distort markets, and the authorities should develop a schedule for them to be phased out.

1. Amid the COVID-19 global pandemic and loss of market access, the authorities introduced a host of temporary import restrictions to alleviate pressure on the balance of payments. From March 2020, a series of import control regulations (ICR) temporarily suspended the imports of non-priority/non-essential goods and placed many goods under licensing regime.¹ These regulations initially focused on restricting the imports of consumer goods, most notably personal vehicles but also household and furniture items, clothing and accessories, home appliances, many non-food consumption goods, beverages (including mineral waters, beer, champagne, whiskey, other alcoholic beverages), rubber products, cosmetics and toiletries. Later in 2021 when BoP pressures intensified many intermediate and investment goods were added such as pneumatic tyres, ceramic products, palm oil, special purpose motor vehicles, and chemical fertilizers. These regulations were changed from time to time, recently allowing for some relaxation of restrictions.² Some exemptions allowing imports of suspended goods included: (i) importation for exports; (ii) importation using funds of foreign buyers, without obtaining funds from local banks; (iii) imports of raw materials not available locally and required for a manufacturing product with at least 35 percent local value added; and (iv) imports required for flagship projects (except those in MOF "Negative List"³).

2. Estimated gross savings of the import bill in 2020 amounted to about US\$1.2 billion (1.5 percent of GDP), falling primarily on consumer goods.⁴ Total goods imports declined from US\$19.9 billion (24 percent of GDP) in 2019 to US\$16.1 billion (20 percent of GDP) in 2020. To

¹ ICRs #1-11 of 2020 and ICRs #1-15 of 2021. All these regulations related to import restrictions imposed by Import and Export Control Department are available at <http://www.imexport.gov.lk/index.php/en/downloads/gazette.html>. Several ICRs also mandated longer minimum credit requirements, but these restrictions are much softer compared to temporary import suspension or licensing and are not considered in this analysis.

² In June 2021, the import restrictions were somewhat relaxed, as 104 HS goods codes were removed from the 546 HS codes temporary suspension list (ICR #10 of 2021). In November 2021, foreign-grown rice imports were allowed and the import ban on chemical fertilizer, introduced in early May 2021, has been reversed.

³ Ministry of Finance's Negative List of imported goods for flagship projects included cement, steel reinforcement, plywood sheets, aluminum cladding material with framework, plywood and PVC doors and other goods—primarily the materials for residential/office buildings construction.

⁴ The savings is an upper bound as it abstracts from falling demand in 2020 compared to 2019 due to the pandemic.

quantify the BoP gains from import restrictions, we have used product-level granular import data and marked all goods with Harmonized System (HS) trade codes in restricted categories (“ban”, “temporary suspension”, and “licensing”) as per ICRs #1-11 of 2020. Gross savings would be estimated as a sum of a 2020-2019 difference in imports for those restricted goods for which 2020 value declined relative to 2019. For some restricted categories, 2020 imports actually increased implying that restrictions were not effective. The sum of a 2020-2019 difference in imports for those restricted goods represents overruns. The top 3 gross savings (table below) came from a ban on importing personal vehicles (\$506 million or 43 percent of the total), restrictions on transport equipment (\$139 million, 12 percent) and building materials (\$90 million, 8 percent). More broadly, consumer goods such as vehicles, household and furniture items, clothing and accessories, home appliances, non-food consumables, and other consumer products accounted for 70 percent of gross savings (\$827 million), while investment and intermediate goods were 7 and 23 percent, respectively. The largest overruns occurred in importing oils and fats, household and furniture items, and machinery and equipment, suggesting that importers were able to manipulate the HS codes and/or the restrictions themselves were short-lived.

3. Incremental savings in 2021 are expected to come largely from intermediate and capital goods imports and are estimated at about US\$0.8 billion (0.9 percent of GDP). In total, import restrictions over 2020–21 are expected to save the imports bill by 2.4 percent of 2021 GDP.

The savings in the 2021 import bill come from two sources:

continuation of 2020 restrictions in 2021 and new import restrictions imposed in 2021. On an incremental basis, both sets of restrictions contribute about 50 percent to the total savings. However, new restrictions are more economically costly because they substantially limit the supply of key intermediate goods used as inputs in producing domestic output or providing services such as tyres, palm oil and chemical fertilizers. They also hurt productivity by restricting imports

of key investment and capital goods such as special purpose motor vehicles, tankers, vessels to transport goods and people. Overall, about \$276 million or 36 percent of incremental savings will fall on consumer goods, while \$487 million or 64 percent of the total will be accounted for by intermediate and investment goods.

| Sri Lanka: Estimated Savings of Import Bill in 2021 from Import Restrictions | | |
|---|---------------------------|------------|
| In thousands of US dollars 1/ | | |
| Category of goods | Incremental Savings 2/,3/ | |
| | amount | share, % |
| Consumer goods | -275,695 | 36 |
| 2020 restrictions | -275,695 | 36 |
| 2021 restrictions | 0 | 0 |
| Intermediate goods | -205,259 | 27 |
| 2020 restrictions | -25,733 | 3 |
| 2021 restrictions | -179,526 | 24 |
| Investment goods | -282,468 | 37 |
| 2020 restrictions | -90,438 | 12 |
| 2021 restrictions | -192,030 | 25 |
| Grand Total | -763,422 | 100 |

Sources: Sri Lanka authorities, ITC Trademap and Fund staff estimates.

Notes:

1/ Table shows the incremental impact on 2021 imports of 2020 restrictions and of import restrictions introduced in 2021 as per Import Control Regulations #1-12 of 2021 where the restriction is either “ban” or “temporary suspension” or “licensing”. Relaxations of restrictions (e.g. ICR #10 of 2021) are not included as their impact is considered small.

2/ Incremental savings from 2020 restrictions in 2021 assume (i) 2020 savings accumulated during Q2-Q4 2020; (ii) no imports in 2021 in restricted groups of goods.

3/ Incremental savings from 2021 restrictions assume no imports in 2021 in restricted groups of goods and account for timing.

Text Table. Sri Lanka: Estimated Savings of Import Bill in 2020 from Import Restrictions

(In thousands of US dollars)

| Category of goods | Amount of Restricted Imports 1/ | | Gross Savings 2/ | | Overruns 3/ |
|---------------------------------------|---------------------------------|------------------|-------------------|-------------|----------------|
| | 2019 | 2020 | amount | share, % | |
| Consumer goods | 1,673,840 | 987,033 | -827,084 | 70.4 | 140,277 |
| Beverages | 65,152 | 16,243 | -48,913 | 4.2 | 4 |
| Cereals and milling industry products | 27,124 | 17,925 | -9,304 | 0.8 | 105 |
| Clothing and accessories | 212,937 | 137,808 | -83,607 | 7.1 | 8,478 |
| Cosmetics and toiletries | 48,377 | 38,406 | -15,025 | 1.3 | 5,054 |
| Fruits | 1,171 | 560 | -611 | 0.1 | 0 |
| Home appliances | 101,538 | 76,363 | -25,175 | 2.1 | 0 |
| Household and furniture items | 259,455 | 227,116 | -66,363 | 5.6 | 34,024 |
| Medical and pharmaceuticals | 27 | 29 | 0 | 0.0 | 2 |
| Oils and fats | 23,102 | 96,755 | -13,190 | 1.1 | 86,843 |
| Other food and beverages | 24,655 | 14,719 | -10,476 | 0.9 | 540 |
| Other non food consumables | 66,734 | 66,182 | -4,980 | 0.4 | 4,428 |
| Printed materials and stationary | 3,519 | 1,423 | -2,096 | 0.2 | 0 |
| Rubber products | 48,589 | 27,679 | -20,976 | 1.8 | 66 |
| Seafood | 2,195 | 685 | -1,510 | 0.1 | 0 |
| Spices | 10,780 | 4,315 | -6,962 | 0.6 | 497 |
| Sugar and confectionery | 2,094 | 921 | -1,220 | 0.1 | 47 |
| Vegetables | 20,930 | 10,036 | -11,072 | 0.9 | 178 |
| Vehicles | 755,461 | 249,868 | -505,604 | 43.0 | 11 |
| Intermediate goods | 562,181 | 514,238 | -77,200 | 6.6 | 29,257 |
| Agricultural Inputs | 529 | 101 | -428 | 0.0 | 0 |
| Base metals | 8,773 | 1,132 | -7,641 | 0.6 | 0 |
| Chemical products | 104,093 | 116,352 | -5,063 | 0.4 | 17,322 |
| Diamonds and precious or semi stones | 3,471 | 2,386 | -1,085 | 0.1 | 0 |
| Food preparations | 100,383 | 96,255 | -7,044 | 0.6 | 2,916 |
| Mineral products | 672 | 273 | -399 | 0.0 | 0 |
| Other intermediate goods | 18,407 | 17,129 | -3,005 | 0.3 | 1,727 |
| Plastic and articles thereof | 133,386 | 110,421 | -22,965 | 2.0 | 0 |
| Textile and textile articles | 27,246 | 15,168 | -12,078 | 1.0 | 0 |
| Vehicle and machinery parts | 164,897 | 154,897 | -17,292 | 1.5 | 7,292 |
| Wheat and Maize | 324 | 124 | -200 | 0.0 | 0 |
| Investment goods | 733,738 | 502,815 | -271,314 | 23.1 | 40,391 |
| Building materials | 260,336 | 174,924 | -89,677 | 7.6 | 4,265 |
| Machinery and equipment | 253,376 | 245,910 | -39,936 | 3.4 | 32,470 |
| Other investment Goods | 3,922 | 1,747 | -2,400 | 0.2 | 225 |
| Transport equipment | 216,104 | 80,234 | -139,301 | 11.8 | 3,431 |
| Grand Total | 2,969,759 | 2,004,086 | -1,175,598 | 100 | 209,925 |

Sources: Sri Lanka authorities, ITC Trademap and Fund staff estimates.

Notes:

1/ Table shows a summary, broken down by standard categories, of imports of goods in restricted HS codes as per Import Control Regulations #1-11 of 2020 where the restriction is either "ban" or "temporary suspension" or "licensing".

2/ Gross savings is a sum of difference in imports for those restricted goods for which 2020 value *declined* relative to 2019.

3/ Gross overruns is a sum of difference in imports for those restricted goods for which 2020 value *increased* relative to 2019.

4. While reducing BoP pressures, import restrictions hamper trade, impede economic growth, distort markets, and the authorities should develop a schedule for them to be phased out. Unlike in 2020 when 70 percent of gross savings from import restrictions came from consumer goods, the 2021 expected incremental savings fall disproportionately on imports of intermediate goods (27 percent of savings) and capital imports (37 percent) used as input in domestic production or services and supporting capital investment. The affected sectors such as agriculture (8 percent share of GDP) and transport (11 percent share of GDP) are macro critical so that these import restrictions have a substantial negative impact on economic activity. For example, a ban on imports of chemical fertilizer, introduced in May and revoked in late November 2021, was hurting tea and rubber production and exports, with potentially substantial output and export losses. It is also expected to weigh on domestic production of rice, necessitating rice imports. The vehicle import ban squeezed the market and consumers at during the pandemic – when the need for personal transportation is much higher than usual – and led to a surge in prices of used vehicles. Apart from

the economic growth impact, import restrictions also distorted markets. For example, the local rice market suffered from high prices reflecting lack of competition in domestic rice collection and milling and a ban on imports of foreign-grown rice. The authorities had to approve the emergency imports of 100,000 metric tons in June 2021 to stabilize rice prices and ultimately removed the rice import ban in November 2021.

Annex VII. The Social Safety Net: Recent Developments and Reform Priorities¹

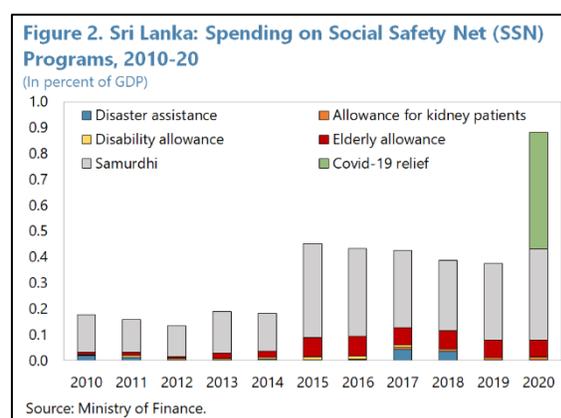
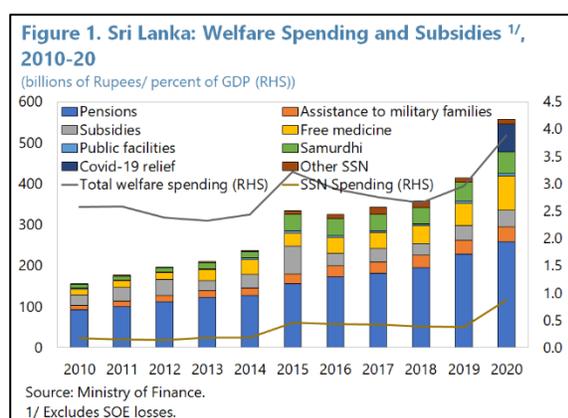
Recent Developments and the COVID-19 Pandemic

1. Sri Lanka's welfare spending increased gradually in terms of GDP over the past decade before surging in 2020 due to the COVID-19 spending (Figure 1, Table 1). The welfare spending includes payments for social safety net (SSN) programs², civil service pensions, assistance to military families, development subsidies including fertilizer and crop subsidies, free medicine, educational scholarships and in-kind transfers, and public facilities such as free transport and street lighting. The total welfare spending increased from 2.5 percent of GDP on average during 2010–2014 to 3 percent of GDP during 2015–19 partly driven by large subsidies during the election year in 2015 and a substantial increase in pensions and SSN spending during 2015–19. In 2020, the overall spending surged to 3.9 percent of GDP driven by spending on the COVID-19 relief at about 0.5 percent of GDP.

| Program | In million Rupees | Percent of GDP |
|---|-------------------|----------------|
| Social Safety Net programs | 131,918 | 0.9 |
| Cash transfer programs | 64,110 | 0.4 |
| Samurdhi (cash transfer and other programs) | 52,434 | 0.4 |
| Assistance to elderly (over 70 years of age) | 9,868 | 0.1 |
| Disability allowance | 32 | 0.0 |
| Allowance for kidney patients | 1,776 | 0.0 |
| Covid-19 relief 1/ | 67,571 | 0.5 |
| Additional cash transfers | 57,652 | 0.4 |
| Livelihood support program | 9,919 | 0.1 |
| Disaster assistance | 237 | 0.0 |
| Other welfare spending | 448,982 | 3.0 |
| Education (scholarships, nutrition programs etc.) | 24,191 | 0.2 |
| Pension | 257,833 | 1.7 |
| Assistance to military families | 37,460 | 0.3 |
| Subsidies (mostly on agriculture) | 39,595 | 0.3 |
| Free medicines (in public hospitals) | 83,685 | 0.6 |
| Public facilities (including free transport) | 6,218 | 0.0 |
| Total | 580,900 | 3.9 |

Source: IMF Staff estimates based on the Ministry of Finance Annual Report 2020
1/ Excluding Rs.11.7 billion cash relief recorded under the Samurdhi program, and Rs. 38.2 billion Covid spending for quarantine, health infrastructure, and others.

2. After a substantial increase in 2015, spending on the SSN programs has remained stagnant at around 0.4 percent of GDP until the large increase in 2020 due to the COVID-19 relief (Figure 2). The SSN programs in Sri Lanka include: poverty targeted cash transfers such as



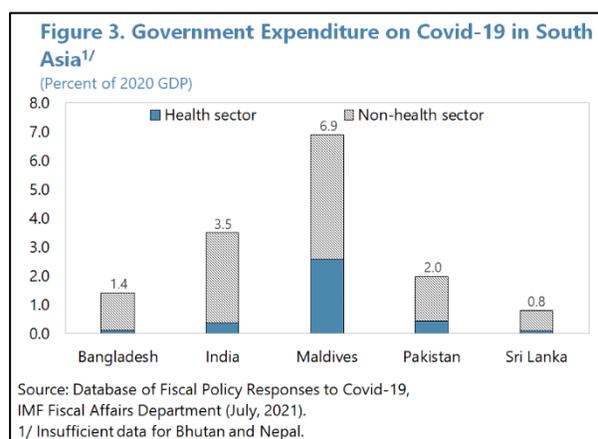
¹ Incorporating discussion and comments from the World Bank staff working on the Social Safety Net Project.

² The Social Safety Net is broadly defined as non-contributory assistance for poor and vulnerable groups and is part of a Social Protection Program that include access to social services, social insurance, and labor market policies.

Samurdhi and illness allowances; social pensions such as the elderly or disability allowances; and emergency cash or in-kind transfers during natural disasters. The Samurdhi program remains the largest SSN program, providing cash transfers and various empowerment programs that include rural infrastructure, livelihood support, social development, housing programs, and microfinance programs through Samurdhi Banks. The programs have benefited nearly 1.8 million households (31 percent of total households) in the form of monthly cash grants ranging Rs 420–3,500 for households earning less than Rs 1,500/month (less than 3 percent of income per capita) and several savings and credit schemes targeted at informal entrepreneurs and own-account farmers. The SSN spending doubled from 0.2 percent of GDP on average during 2010–14 to 0.4 percent of GDP during 2015–20 (excluding the COVID-19 relief) due to the expansion of the Samurdhi and elderly allowance programs.

3. Since the COVID-19 pandemic in 2020, the authorities have used the existing SSN programs to provide additional relief to low-income households and small businesses

(Table 1). In 2020, the authorities allocated additional Rs. 67.6 billion to provide monthly cash grants of Rs. 5,000/family and in-kind transfers to poor and vulnerable families during March-April and October-November, i.e., during the peak of the first and second waves of the pandemic. This is part of total COVID-19 related spending estimated at Rs. 117.5 billion (0.8 percent of GDP) in 2020, including Rs. 49.9 billion (0.3 percent of GDP) for quarantine, health infrastructure, medicines, and others.³ In cross-country comparison, however, the COVID-19 related spending is low compared to South Asian peers largely due to limited fiscal space (Figure 3). A further Rs. 210 billion (1.3 percent of GDP) was allocated in 2021, including Rs. 18.5 billion (0.1 percent of GDP) for cash transfers and an estimated Rs. 191.5 billion (1.2 percent of GDP) for vaccination, quarantine, medical supplies and infrastructure, and other COVID-19 measures. Existing recipients of Samurdhi, disability allowance, elderly allowance, kidney patients, and the farmers' and fishermen's pension schemes received temporary top-ups. The cash transfers were also extended to waitlisted and newly identified families under these programs and to low-income families under quarantine. In addition, the authorities extended various support to individuals and businesses affected by the pandemic, including tax concessions for SMEs, moratoria on loan repayments for tourism and other affected sectors, and concessions on utility bill payments.



4. The COVID-19 pandemic has raised poverty and inequality although early findings suggest that the relief measures have helped mitigate the adverse impact. The World Bank (2021) estimated that the \$3.2/day poverty rate has increased from 9.2 percent in 2019 to

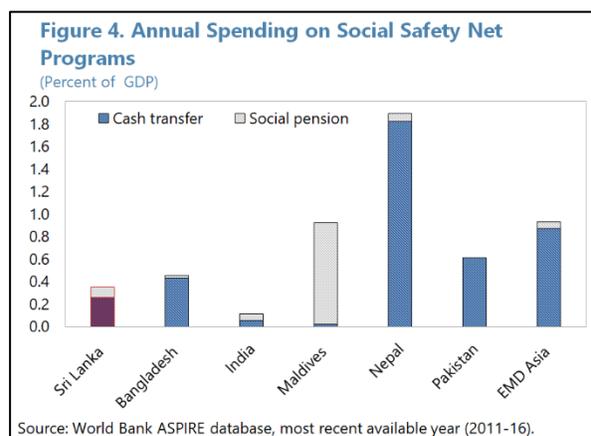
³ This excludes Covid-19 expenses by other ministries (e.g., Ministry of Defense, Ministry of Public Security) and other support granted to farmers and government institutions that were not classified as Covid-19 expenditure in the 2020 Annual Report of Ministry of Finance.

11.7 percent in 2020. Moreover, the \$1.9/day (extreme) poverty rate is expected to have doubled since 2019 and the poverty gap is estimated to increase from 17.9 percent in 2019 to 20 percent in 2020, indicating that 500,000 have fallen into poverty due to Covid-19 and that the poor have fallen deeper into poverty. Moreover, earnings losses have been disproportionately spread across the income distribution, with richer households experiencing minor earnings losses compared to the bottom 40 percent, likely exacerbating income inequalities that could lead to serious implications. Despite these dire outcomes, preliminary evidence based on phone surveys conducted by the UNICEF/UNDP (2020) found that the COVID-19 relief measures reached 66 percent of households. Accordingly, the World Bank estimates that these measures have the potential to buffer the impact on poor households by reducing the share of population living under the \$3.2 poverty line by 1.4 percent from the estimated baseline of 11.7 percent in 2020.

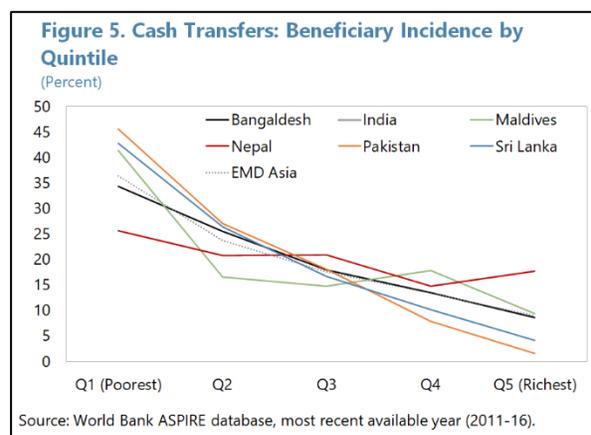
Challenges and Reform Progress

5. Sri Lanka's SSN program has continued to face challenges particularly in terms of low coverage and inadequate targeting.

- Sri Lanka's spending on SSN programs remains low compared to its peers, and the recent COVID-19 relief measures were small compared to household income and expenditure. Spending on SSN (excluding COVID-19 relief) has remained low at 0.4 percent of GDP, lower than regional peers and the Asian emerging market and developing countries, resulting in modest transfers per household (Figure 4). The monthly cash allowance of Rs. 5,000/household was distributed only in some months during the lockdown in 2020-21. In 2020, on average each eligible household received Rs. 22,000, about 7 percent of annual expenditure of the poorest households, or less than 2 percent of annual revenue of micro informal firms (pre-pandemic). Poorer households tend to be larger in size and therefore received lower transfers per person.



- Although Sri Lanka's SSN program is generally progressive (targeted to the poorer households), there is scope for improvement in coverage and targeting.** Sri Lanka's cash transfer programs such as Samurdhi, with 69 percent of beneficiaries coming from the poorest 40 percent of households, are generally as progressive as peers (Figure 4). However, UNICEF (2020) found that 58 percent of households who were meant to receive Samurdhi did not receive the benefits (exclusion error), while 58 percent of households who were not supposed to receive have in fact received the benefits (inclusion error), indicating scope for targeting improvement. This is partly caused by the lack of a centralized and integrated system to determine eligibility with no standard reporting and sharing of household data between programs. The beneficiary selection is partly at the discretion of local-level program officers and therefore less transparent. Without an effective exit mechanism, some beneficiaries have remained in programs even though their income level may no longer meet the criteria, while political interests blocked the removal of existing beneficiaries.



6. The authorities have been implementing the SSN reforms, but the progress has been mixed. The Welfare Benefits Board (WBB) was established in 2016 to provide the necessary legal and institutional framework for welfare relief benefits and set out a transparent process in selecting or excluding recipients. However, the functioning of WBB and implementation of other SSN reform programs supported by the World Bank Social Safety Nets Project (SSNP) have been slower than expected due to limited capacity, fragmented institutions, complex legal constraints, and the COVID-19 pandemic since 2020. In the meantime, the Department of Samurdhi Development has continued to manage and implement the Samurdhi programs.

- New eligibility criteria for the Samurdhi programs have been developed but not implemented.** As part of the reform program supported by the IMF Extended Fund Facility (approved in 2016), new eligibility criteria were established in 2019 based on objective and verifiable characteristics of beneficiaries. However, the new criteria have not been implemented since the implementation requires Parliamentary approval, the supporting regulations, and the completion of the social registry, which has been delayed. In addition, the increase in poverty and vulnerability to the poor due to the pandemic suggests the importance of completing the technical infrastructure before adopting new eligibility criteria.
- Some progress has been made in updating the social registry, developing the Integrated Welfare Management System (IWMS), and developing formula for Samurdhi graduation.** The authorities have continued to update household data in the social registry and develop IWMS, the first e-Government system that integrates information and reaches all levels of

government administration. The system focuses on support for low-income households and aims to digitalize the registry to better facilitate the provision of social assistance. It aims to improve the identification and enrollment process, the delivery of support via intermediaries, and the management of disbursements, queries, appeals, and complaints. The Department of Samurdhi Development has initiated a pilot project for developing a mechanism based on the existing criteria to target the poorest households for cash transfers and gradually transitioning the others who are empowered onto a lighter package of support.

7. The authorities are currently developing the National Social Protection Strategy (NSPS) for social protection programs in Sri Lanka. The NSPS is expected to identify challenges and policies in social protection over the medium-term, including an action plan that can guide coordination among programs, strengthen delivery systems, and commit of resources to this sector. The National Planning Department under the Ministry of Economic Policies and Plan Implementation is leading the NSPS in consultation with the Presidential Task Force for Economic Revival and Poverty Alleviation. The task force was established in April 2020 to revive the economy and eradicate poverty while paying special attention to the COVID-19 challenges. The NSPS process is still at an early stage, with a first draft expected by 2022.

Policy Priorities

8. From a macroeconomic perspective, providing adequate fiscal space to raise SSN spending and broaden the coverage remains the top priority. The COVID-19 relief spending has declined in 2021 as the pandemic situation improved, providing some space for partial reallocation of funds towards other SSN programs. Moving forward, the SSN spending should remain above pre-pandemic levels but with better targeting. The objective is to strike a balance between raising the allocation gradually and broadening the coverage to include the informal sector and poor families that are not covered by the programs, while keeping it affordable and improving the targeting given the limited fiscal space. This could be done, for example, by graduating the high-income Samurdhi beneficiaries onto lighter sub-programs (livelihood and empowerment programs) and targeting cash transfers towards the poorest 40 percent of households along with an increase in the per-household transfer amount. The disability and kidney disease benefits (currently reaching only about half of eligible households) could be raised while the elderly benefit could be expanded along with the aging population.

9. On structural areas, several policy actions could be implemented over the near- and medium-term to improve coverage and targeting of beneficiaries. The upcoming NSPS should guide the reform process over the medium term, and therefore, the first critical step is to ensure that the NSPS sets out sound policy priorities and follows good principles of a social protection strategy. **In the near-term**, while the NSPS is being formulated, the policy priorities could focus on improving the delivery and effectiveness of existing SSN programs, making it more responsive and adaptive to economic shocks and changes in the institutional framework. This could be done by completing the social registry and the IWMS, focusing on digitalization and systems development and making sure that the system will be ready to support broader reforms guided by the NSPS at a later stage. **Over the medium-term**, the focus would be on establishing an institutional framework to coordinate

welfare programs and lead reforms in line with the strategy outlined by the NSPS. Considering the fragmented institutions, developing effective coordination among various institutions that manage social protection programs is critical. This should be complemented by ensuring that the supporting infrastructure, such as digital recording and delivery system, the social registry, and the IWMS, are all well-functioning. An effective institutional framework and infrastructure would pave the way for implementing policies to improve coverage and targeting.

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World Bank (2021). *The COVID-19 Impact on Livelihoods and Poverty in Sri Lanka*. Background Note to Sri Lanka Poverty Assessment.

Annex VIII. Colombo Port City Project

1. The Colombo Port City project involves developing an urban city center on reclaimed land of 269 hectares adjacent to the Colombo Harbor. Once fully operational (expected in 2041), the Port City would accommodate residential, retail, financial, and commercial activities. A project company owned by China Harbor Engineering Company (CHEC) oversaw the land reclamation, with FDI totaling US\$1.4 billion (1.5 percent of GDP). In return, CHEC is granted 116 hectares of the reclaimed land as a 99-year leasehold. The government, on the other hand, is responsible for connecting the Port City with utilities such as electricity, water, and sewerage, up to the boundary of the reclaimed land.

2. In May 2021, Parliament approved a Bill that provides for the establishment of the Colombo Port City Special Economic Zone (SEZ). As per the Bill, all investment applications would have to be made in foreign currency with funds raised abroad. Salaries of workers within the SEZ would be dollarized and exempted from income tax. The Bill also provides for the establishment of a Commission empowered to grant registrations, licenses, authorizations, and other approvals to carry on businesses and other activities in the SEZ. Particularly, the Commission will be entitled to provide tax breaks up to 40 years and a wide range of exemptions (for example from VAT, income tax, excise tax, debit tax, customs duties, ports and airport levy, Sri Lanka Export Development Act levies, Betting and Gaming laws, and labor laws) to qualified businesses. A benchmarking exercise is currently underway with support from international consulting companies, which would inform the design of the regulatory framework.

3. The immediate economic impact of the Port City project depends on project implementation. The Port City is a long-term project with most its benefits expected to be realized at later operational stages, as the City is projected to contribute about \$13 billion (16 percent of 2020 GDP) in direct and indirect value addition to Sri Lanka's economy per annum after it becomes fully operational (expected in 2041).¹ Most value addition and job creation in the near-term are expected to be construction related and on a much smaller scale. While authorized offshore companies would be allowed to engage in business with (including by receiving goods and services from) Sri Lankan residents outside the Port City, spillovers would be limited at early stages of the development. The project could contribute to fiscal revenue through royalty payments by prospective businesses and lease of government-owned marketable land (62 hectares) in the Port City. The project's short run impact on export growth is more uncertain and its contribution to FX earnings will depend on the import content of attracted investment.

4. Ringfencing the tax concessions through a robust administration is important for minimizing foregone revenue. In doing so, tax concessions offered in the Port City should be clearly codified and carefully ringfenced through rigorous regulations, and the Commission should judiciously exercise its discretionary power in granting tax concessions and exemptions given

¹ According to an independent study by PricewaterhouseCoopers in November 2021.

Sri Lanka's already weak revenue mobilization. Effective revenue administration is critical for mitigating risks from tax planning between offshore entities and their onshore affiliates and can be supported by significantly scaling back the list of taxes eligible for exemptions to reduce administrative hurdles.² IRD's capacity and expertise should be leveraged to safeguard transparency and accountability, by requiring all SEZ companies (regardless of their tax-exempt status) to file tax returns. Besides, a tax expenditure review covering the SEZ should be part of the annual budgetary process and subject to periodical evaluation.

5. Compliance with international tax standards is important for avoiding negative perceptions. The creation of a low-tax jurisdiction is likely to draw attention from the international community given a renewed focus on such matters, including in the context of the recently agreed OECD-led Inclusive Framework (which introduces a global minimum tax of 15 percent for large multinational corporations starting 2023).³ It would therefore be important to adhere to international tax and regulatory standards and information exchange agreements established with foreign counterparts, including those guided by the OECD's Common Reporting Standard.

6. Offshore financial services should be regulated and supervised in keeping with global norms to shield the domestic financial sector from offshore activities in the Port City.

Regulations should be carefully drafted to avoid major regulatory gaps between the onshore and offshore financial sectors and by ensuring the CBSL's adequate representation in the offshore financial sector regulatory authority (provided for by the SEZ legislation). Meanwhile, offshore institutions should be prohibited from providing financial services to residents or accessing the central bank's liquidity window and deposit insurance in Sri Lanka. Any direct or indirect financial linkages between the onshore and offshore financial sectors (including through cross-ownership) should be closely monitored to assess and mitigate potential spillover risks. This is particularly important given the scope to improve regulatory and supervisory requirements for non-bank financial institutions.

7. Stronger transparency requirements would help alleviate AML/CFT concerns associated with offshore financial services. Full compliance with international standards on reporting, supervision, bank secrecy, and beneficial ownership, and customer due diligence requirements would help mitigate risks of illicit financial flows through the Port City. The current AML/CFT legal framework in Sri Lanka is expected to be applicable to the new offshore banks/financial institutions. As such, the Financial Intelligence Unit's AML/CFT responsibilities should extend to offshore financial services in the Port City and adequate due diligence checks should be

² The ringfencing needs to be rigorous enough to ensure tax concessions and exemptions are not granted on transactions and/or income that are linked to onshore business activities, in order to mitigate risks of tax evasion by resident companies. However, such ringfencing would be costly to administer and prone for abuse; and could be perceived as "harmful tax competition" by the OECD and the EU. A codified investment tax credit based on stringent qualifying criteria would be more efficient, less prone to abuse, and more effective in preserving the tax base than discretionary tax holidays.

³ As of February 2022, Sri Lanka has not endorsed the agreement. However, a uniform global minimum tax rate, once widely adopted, implies that any concessions offered below such level would just constitute a transfer of taxing power to other countries.

carried out on all prospective offshore financial institutions, especially those that originate from higher risk jurisdictions. A renewed commitment to comply with FATF standard will be welcome to avoid potential adverse impact on capital inflows of any non-compliance.

8. Lastly, Sri Lanka needs a more comprehensive strategy for investment promotion. The Port City project provides a good opportunity for attracting foreign investment and for experimenting with growth enhancing reforms that are otherwise more difficult to undertake in the onshore economy. While the idea of setting up a one-stop shop to facilitate foreign investment is welcome, it would not by itself be sufficient to alleviate the macroeconomic challenges faced by Sri Lanka. This would need to be addressed by more fundamental policy adjustments and structural reforms aimed at restoring macro stability and improving the business and investment climate. In contrast, tax incentives are often not a critical determinant for attracting investment and the revenue forgone could be better spent on human capital and infrastructure, while improving the doing business environment. Besides, an investment promotion regime resting on discretionary incentives is also not conducive for attracting new investors as it lacks transparency and clarity.



SRI LANKA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 10, 2022

Prepared By

Asia and Pacific Department (in collaboration with other departments)

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FUND RELATIONS

(As of December 31, 2021)

Membership Status: Joined: August 29, 1950; Article VIII

| General Resources Account: | SDR Million | Percent Quota |
|-----------------------------------|--------------------|----------------------|
| Quota | 578.80 | 100.00 |
| Fund holdings of currency | 1,433.23 | 247.62 |
| Reserve Tranche Position | 47.86 | 8.27 |

| SDR Department: | SDR Million | Percent Allocation |
|---------------------------|--------------------|---------------------------|
| Net cumulative allocation | 950.21 | 100.00 |
| Holdings | 88.28 | 9.29 |

| Outstanding Purchases and Loans: | SDR Million | Percent Quota |
|---|--------------------|----------------------|
| Extended Arrangements | 902.27 | 155.89 |

Latest Financial Arrangements:

| Type | Date of Arrangement | Expiration Date | Amount Approved (SDR Million) | Amount Drawn (SDR Million) |
|------------------|----------------------------|------------------------|--------------------------------------|-----------------------------------|
| EFF | 06/03/2016 | 06/02/2020 | 1,070.78 | 952.23 |
| Stand-By | 07/24/2009 | 07/23/2012 | 1,653.60 | 1,653.60 |
| ECF ¹ | 04/18/2003 | 04/17/2006 | 269.00 | 38.39 |

Overdue Obligations and Projected Payments to Fund² (SDR Million; based on existing use of resources and present holdings of SDRs):

| | Forthcoming | | | | |
|------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| | <u>2022</u> | <u>2023</u> | <u>2024</u> | <u>2025</u> | <u>2026</u> |
| Principal | 104.39 | 129.08 | 158.70 | 158.70 | 148.71 |
| Charges/interest | 10.08 | 8.98 | 7.50 | 5.78 | 4.08 |
| Total | 114.47 | 138.06 | 166.21 | 164.49 | 152.79 |

¹ Formerly PRGF.

² When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Safeguards Assessment:

The 2016 update safeguards assessment found that the Central Bank of Sri Lanka (CBSL) continued to strengthen its safeguards framework in a number of areas, including in its audit and financial reporting functions. Transparency in financial reporting has been maintained and the external audit mechanism is sound. Progress has been made in modernizing the internal audit function. However, the assessment found that the CBSL Monetary Law Act (MLA) fell short of leading international practices, especially in the areas of the bank's autonomy and aspects of its governance arrangements. While the CBSL implemented all safeguards recommendations, no amendments to the MLA were made.

Exchange Rate Arrangement:

The *de jure* exchange rate arrangement is free floating since its introduction by the Central Bank of Sri Lanka (CBSL) on January 23, 2001. The *de facto* exchange rate arrangement was reclassified from floating to crawl-like effective April 29, 2021. The Sri Lankan rupee depreciated by 10.4 percent in 2020-2021 and was Rs 201.1 per U.S. dollar as of January 20, 2022. While the CBSL allowed the exchange rate to fluctuate from the onset of the COVID-19 global pandemic in March 2020, the rupee has been *de facto* pegged to the U.S. dollar since April 2021. The CBSL maintains restrictions on payments and transfers for current international transactions for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision 144 (52/51).

Sri Lanka also maintains a multiple currency practice subject to Fund jurisdiction under Article VIII, Section 3. It arises from a temporary incentive scheme for inward worker remittances under which the authorities offer an additional incentive over the exchange rates used by banks for such remittances, with the deviation between the more favorable (effective) exchange rate used for qualifying inward workers remittances and the exchange rate used for other inward remittances being more than 2 percent.

Article IV Consultation:

It is proposed that that the next Article IV Consultation with Sri Lanka takes place on the standard 12-month cycle.

ROSC Assessments:

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

FSAP and FSSR Participation:

- MCM: An FSAP took place in 2002; an FSAP update was done in 2008; and an FSAP stability module was conducted in 2012. A Financial System Stability Review was completed in 2019.

Capacity Development:

- FAD. TA has been provided in a wide range of areas. In 2020, TA was provided on implementing the new Inland Revenue Act (IRA), enhancing corporate tax compliance, and assessing tax expenditures. In 2019, TA was provided to review the tax and customs administrations, enhance tax compliance, improve cash and debt management, and (jointly with LEG) update the fiscal rule. In 2018, TA was provided on implementing PPPs and enhancing VAT compliance.
- ICD. TA missions on macroeconomic forecasting, including developing and implementing a Forecasting and Policy Analysis System (FPAS) and a semistructural Quarterly Projection Model (QPM) have continued under Phase II of the project, which focuses primarily be on integrating the FPAS into the decision-making processes of the CBSL.
- LEG. LEG assisted the authorities in drafting amendments to the Monetary Law Act and provided technical assistance to the Financial Intelligence Unit on enhancing the AML/CFT framework and supervisory tools, drafting of amendments to related legislations and regulations, and deploying a new IT system.
- MCM. Following the completion of FSSR in 2019, an FSSR follow up TA project was launched, which included placement of a resident advisor to CBSL on macroprudential policy issues (from August 2020) as well as periodic short-term TA missions on stress testing (April 2021) and technology risk management for nonbank financial institutions (May 2021 and November 2021). During 2018-21, TA missions have also been provided in the areas of monetary and foreign exchange operations (September 2018, November 2020, and June 2021) and institutional framework for public debt management (August 2019).
- STA. STA has been closely engaged with the authorities in various areas, including national accounts, price statistics, government finance statistics, and monetary accounts (see also the section on statistical issues below). From 2019 to 2021, assistance was provided to the CBSL to develop new residential property price indexes.
- SARTTAC: SARTTAC has provided extensive TA and training in a wide range of areas. In the fiscal sector, in 2021 training was provided to strengthen the new Macro-Fiscal Unit at the Ministry of Finance. In 2019, TA was provided on revenue mobilization and the compilation of Government Finance Statistics (GFS). In the real sector, TA was provided in price statistics as well as benchmarking/rebasing national accounts statistics. In the monetary sector, SARTTAC has provided Sri Lanka with TA to enhance the effectiveness of monetary policy implementation and, in coordination with ICD, continued to support the CBSL in incorporating FPAS into the decision making processes. In-country and regional macro training courses (some were delivered virtually

during the pandemic) also included macro-diagnostics, financial programming, and financial sector supervision.

Resident Representative

Since November 2018, Mr. Tubagus Feridhanusetyawan has been the resident representative based in Colombo.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

World Bank: <https://www.worldbank.org/en/country/srilanka>

Asian Development Bank: <https://www.adb.org/countries/sri-lanka/main>

STATISTICAL ISSUES

(As of January 24, 2022)

| I. Assessment of Data Adequacy for Surveillance |
|--|
| <p>General: Macroeconomic statistics are broadly adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series. Fiscal statistical coverage has yet to be expanded beyond the budgetary central government, which hinders a more comprehensive fiscal risk analysis. While monetary aggregates are reported and published regularly and timely, detailed monetary statistics are only available after a long lag.</p> |
| <p>National Accounts: In 2015, the Department of Census and Statistics (DCS) released a comprehensive revision of the national accounts. The revision included a change of base year from 2002 to 2010; an expanded coverage for the service sector; and several improvements in the compilation methods. An STA mission in August 2021 assisted the DCS to prepare an updated set supply and use tables for 2015, which will be used to benchmark a revised set of national accounts (base year 2015) The DCS has scheduled, at the earliest, the release of the new national accounts series for February 2022. The DCS began publishing quarterly national accounts in 2015. However, the data are presented on a basis relative to the same quarter of the previous year. GDP data by expenditure are available on quarterly and annual basis and rely mostly on commodity flow methods.</p> |
| <p>Price Statistics: The DCS released new national Consumer Price Indexes (NCPI) and a Producer Price Index (PPI) in 2015. The NCPI and Colombo Consumer Price Index (CCPI) are currently based on weights from the 2012/13 Household Income and Expenditure Survey (HIES). The weights for both the CCPI and NCPI should be updated to include the results of the 2019 HEIS, which were released in 2021. In 2021, a revised PPI was published, incorporating new samples of producers and transactions, and an update to the production weights from 2010 to 2016. The updated weights reflected a shift in industrial activity from agriculture to manufacturing. The DCS should aim for more timely updates of the weights based on Annual Survey of Industry data, as the 2019 results were released in late 2021.</p> |
| <p>Government Finance Statistics: The Sri Lankan authorities report budgetary central government operations data in <i>GFSM 2014</i> format on an annual basis and debt data to the World Bank's Public-Sector Debt Statistics database on a quarterly basis. Further improvements are needed in the fiscal data, including resolving significant statistical discrepancies in 2013-2017 and 2020, filling the data gaps in the time series, reconciling positions in assets and liabilities, and releasing monthly or quarterly data in a timely manner. The immediate focus is the compilation of the data for the central government while the authorities work towards expanding the institutional coverage. An important challenge that must be addressed before there is an expansion of statistical coverage beyond the central government is a thorough examination of 188 of the 248 existing entities that are owned/controlled by the budgetary central government, so that they can be sectorized properly. Authorities are also working on improving other statistical requirements, including the new Integrated Treasury Management Information system (ITMIS) that has been customized to reflect a</p> |

Chart of Accounts (COA) highly aligned with *GFSM 2014*; and the elaboration of a roadmap for a transaction from a cash to accrual accounting basis of reporting.

Monetary and Financial Statistics: The CBSL compiles and publishes monetary and financial statistics, with concepts, definitions, and classification that are broadly in line with the *Monetary and Financial Statistics Manual (MFSM) 2000*. Beginning in June 2011, data are based on a standardized report form (SRF) for the central bank and other depository corporations. Central bank balance sheet data are frequently delayed due to technical issues stemming from the creation of new accounts. Moving forward, monetary data should be expanded to include the financial accounts of other financial corporations (pension funds, insurance corporations, and collective investment funds, as well as non-deposit taking leasing and finance companies) that account for about 30 percent of total financial sector assets.

CBSL has not reported data to the Financial Access Survey (FAS) since 2016. Until 2016, CBSL reported data for some FAS indicators, including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

Financial sector surveillance: The CBSL regularly reports quarterly FSIs to the IMF for publication. Currently, the CBSL reports 11 core and 8 encouraged FSIs.

External sector statistics (ESS): Since 2014, the CBSL is reporting to STA its International Investment Position (IIP) and balance of payments statistics (BOP) on a quarterly basis following the sixth edition of the *Balance of Payments Manual (BPM6)*. The timeliness of ESS, particularly IIP, could be improved. A technical assistance mission on ESS conducted in May 2015 observed commendable progress in improving the quality of the data, including a better coverage of the balance of payments, IIP, CDIS and external debt.

II. Data Standards and Quality

Sri Lanka subscribed to the IMF's Special Data Dissemination Standard (SDDS) on November 3, 2015. Sri Lanka's latest SDDS [Annual Observance Report](#) and [metadata](#) are available on the Dissemination Standards Bulletin Board.

A data module Report on the Observance of Standards and Codes ([ROSC](#)) for Sri Lanka was published in May 2002.

Table 1. Sri Lanka: Common Indicators Required for Surveillance¹

(As of January 2022)

| | Date of latest observation | Date received | Frequency of Data ⁸ | Frequency of Reporting ⁸ | Frequency of publication ⁸ |
|---|----------------------------|---------------|--------------------------------|-------------------------------------|---------------------------------------|
| Exchange rates | Today | Today | D | D | D |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities ² | 11/2021 | 01/06/2022 | M | M | M |
| Reserve/Base Money | 11/2021 | 01/06/2022 | M | M | M |
| Broad Money | 11/2021 | 01/06/2022 | M | M | M |
| Central Bank Balance Sheet | 11/2021 | 01/06/2022 | M | M | M |
| Consolidated Balance Sheet of the Banking System | 11/2021 | 01/06/2022 | M | M | M |
| Interest Rates ³ | 11/2021 | 01/06/2022 | M | M | M |
| Consumer Price Index (New Colombo CPI) | 1/2022 | 1/2022 | M | M | M |
| Revenue, expenditure, balance, and composition of financing – general government ^{4,5} | N/A | N/A | N/A | N/A | N/A |
| Revenue, expenditure, balance, and composition of financing – central government ^{4,5} | 11/2021 | 1/2022 | M | M | Q |
| Stocks of central government and central government-guaranteed debt ⁶ | 2021Q3 | 11/2021 | Q | Q | Q |
| External Current Account Balance | 2021Q3 | 12/2021 | Q | Q | Q |
| Exports and Imports of goods and services | 2021Q3 | 12/2021 | Q | Q | Q |
| GDP/GNP | 2021Q3 | 12/2021 | Q | Q | Q |
| Gross external debt | 2021Q3 | 12/2021 | Q | Q | Q |
| International Investment Position ⁷ | 2021Q3 | 1/2022 | Q | Q | Q |

¹ TCIRS latest updates based on National Summary Data Page and the authorities' submissions to the IMF country team.

² Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional value of financial derivatives to pay and receive foreign currency, including those linked to a foreign currency but settled by other means.

³ Both market-based and officially-determined, including discount rates, money market rates, and rates on treasury bills, notes, and bonds.

⁴ Foreign, domestic bank, and domestic nonbank financing.

⁵ The general government consists of the central government (Budgetary government, including Special Spending Units, all Ministries, Departments, and District Secretariats), Provincial Councils and Local Governments.

⁶ Including currency and maturity composition.

⁷ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁸ Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annual (A); Irregular (I); Not Available (NA).

**Statement by Surjit Bhalla, Executive Director for Sri Lanka
and Chandranath Amarasekara, Alternate Executive Director
February 25, 2022**

1. We thank the mission team led by Mr. Nozaki for the frank discussions held in Colombo in December 2021 with our Sri Lankan authorities. Our authorities look forward to continuing the engagement with the Fund and appreciate the commitment of the management and staff to maintain this relationship. While the high risks facing the Sri Lankan economy at present are well recognized, our authorities are of the view that some of these risks are exaggerated in the staff assessment and the efforts of the authorities to address these challenges are understated, as documented in this BUFF statement.

Background and the Growth Outlook

2. The Sri Lankan economy was not in a strong position when the COVID-19 pandemic caused further disruptions. The heinous Easter Sunday terrorist attacks in 2019 had a devastating impact on the economy, particularly through its effects on tourism and investor confidence. The improvement in business sentiments following the Presidential elections held in November 2019 and the implementation of the new policy agenda of the government were disturbed by the pandemic and the required containment and remedial measures. The impact of the pandemic resulted in the historically highest contraction of the Sri Lankan economy, with a significant impact on foreign exchange flows in terms of trade, tourism and investment, as well as on all other sectors of the economy. The authorities implemented swift measures to address the socio-economic impact of the pandemic, which required additional financing. Adverse Sovereign rating action since the beginning of the pandemic curtailed Sri Lanka's access to conventional debt markets, necessitating the country to adopt measures to contain foreign exchange outflows in terms of non-priority imports and capital flow management (CFM) measures. While most of the restrictions on imports have now been lifted, limited availability of foreign financing also prompted the government to embark on a reform agenda to strengthen non-debt foreign exchange inflows and absorb a part of such inflows towards rebuilding foreign exchange reserves. Some early results of these measures have been observed which include merchandise exports recording a historic high in 2021, an ongoing rebound in tourism, as well as the Central Bank being able to absorb a portion of export proceeds repatriated and workers' remittances converted. These are detailed later in this BUFF statement.

3. In this context, our authorities are more optimistic about Sri Lanka's growth outlook than the staff assessment. The Sri Lankan economy contracted in 2020 due to the COVID-19 pandemic and associated lockdowns, the second annual contraction in its history (the first being a 1.5 percent contraction in 2001). Nevertheless, reflecting the impact of the timely measures taken by the authorities, the contraction was limited to 3.6 percent, a better outcome than predicted by IMF (4.6 percent) and the World Bank (6.7 percent).

4. The authorities expect economic growth to record around 4 percent in 2021 and improve further to around 5 percent in 2022. Several factors support this expectation. The progress of the vaccination drive (with more than 65 percent of the population being fully vaccinated, more than 78 percent receiving at least one dose, and more than 30 percent receiving the booster dose) which, in addition to direct government financing, is supported by various other governments and multilateral agencies, has been encouraging. A rapid rebound in tourism (with more than 136,000 tourists visiting the country in the first 1 ½ months of this year, compared to an average of 350,000 arrivals during the same period in 2018 and 2019) is observed. Mobility has normalized to a great extent. Measures taken to support domestic production for the local and export markets are beginning to show results with improved business confidence. Providing early signs of this expected rebound, activity in the Colombo stock market has displayed a record performance (with the All Share Price Index increasing 80.5 per cent in 2021). Purchasing Managers' Indices (PMIs) for both manufacturing and services have shown expansionary trends since the third quarter of 2021.

5. Meanwhile, with technical assistance from IMF, Sri Lanka's GDP is expected to be rebased to the year 2015. The finalization of rebasing, which was due in 2020, was disrupted by the pandemic, and is now expected by March 2022. This exercise is expected to have improved coverage of the development of the Colombo Port City and the expansion of the digital economy, resulting in a 5-8 percent higher nominal GDP annually from 2015 than the values recorded at present, as per the available information.

Fiscal Policy, Labor Market, Poverty, and Structural Reforms

6. The effects of the COVID-19 pandemic have impacted revenue collection, expenditure management and also financing, amidst the need for fiscal intervention to protect lives and livelihoods during the pandemic. Nevertheless, the government remains committed to ensuring medium term fiscal consolidation. Efforts are underway to recoup revenue losses observed during the pandemic, particularly through a one-time surcharge tax, and also by introducing a special Goods and Services Tax (GST), a social security contribution and increasing the Value Added Tax (VAT) on financial services. Expenditure management has been strengthened by the introduction of quarterly commitment ceilings in the Budget 2022, amidst the increase in recurrent expenditure, mainly due to pandemic-related direct expenditure, including relief and livelihood support extended to the needy segments of the society and expenditure on measures to contain the spread of the pandemic. Ongoing digitalization of the economy, including public services, is expected to support both revenue enhancement and expenditure management. In particular, measures have been taken to strengthen tax administration in line with the digitalization drive of the government. The government is also committed to achieving more realistic fiscal targets, as displayed by the enactment of the Fiscal Management (Responsibility) (Amendment) Act No. 12 of 2021, which targets debt to GDP ratio at 60 percent by 2030. The government plans the overall fiscal deficit to be brought down from around 11.1 percent of GDP in 2021 to 4.4 percent by

2024, with a primary surplus expected in 2024, which, along with envisaged economic growth, will assist Sri Lanka to improve its debt dynamics.

7. Reforms to State Owned Enterprises (SOEs) are also being carried out, albeit under difficult circumstances caused by rising energy prices and other pandemic related effects on key SOEs, including the Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board, and SriLankan Airlines. Revision of domestic petroleum prices in June and December 2021 helped improve the balance sheet of CPC, and the government stands ready to revise prices to reflect international market trends while minimizing the adverse effect of such revision on the economy. Sri Lanka already meets a sizable portion of its energy requirement through hydro and other renewable sources, and the measures that are being taken to increase the reliance on renewable energy to 70 percent by 2030 would dampen the effect of global energy prices on the Sri Lankan economy going forward, while reducing its vulnerability to climate change.

8. The authorities are gravely concerned about the lingering effects of the pandemic on labor market outcomes and on poverty. As noted in the staff report, the welfare measures taken by the authorities have dampened the adverse consequences of the pandemic on poverty and well-being of the population. Multiple waves of the pandemic and high food inflation have necessitated government intervention, which continues to impact fiscal sector outcomes. Long term measures are being put in place – and our authorities agree with staff that further efforts are required – to resolve issues including low female labor force participation, addressing informality in the labor market, pension reforms, addressing inequality, better targeting of the flow of welfare benefits, and improving resilience to climate change. Increasing of the retirement age of government officials, as implemented in 2022, is expected to have multiple benefits to the economy, including extending the population dividend and productivity gains.

External Sector Developments and Policies

9. As noted by staff, Sri Lanka's external sector has been severely affected by the pandemic. However, the performance and prospects are mixed, with downside as well as upside risks. The dual impact of the Easter Sunday terrorist attacks in 2019 and the COVID-19 pandemic has resulted in Sri Lanka losing over US\$10 billion from tourism earnings alone over a relatively short period of 2 ½ years. This has also affected a large domestic supply chain that services the tourism industry. The recent rebound of tourist arrivals is encouraging, and the authorities expect over one million tourist arrivals in 2022, compared to 2.3 million arrivals in 2018. Meanwhile, workers' remittances declined significantly from US\$7.1 billion in 2020 to US\$5.5 billion in 2021 (a 22.7 percent decline) thereafter. The decline in remittances can be attributed to the return of migrant workers from countries affected by the pandemic, job termination of some workers abroad, and the reduction of new departure observed in 2020 and early 2021. Migration for employment has rebounded with the opening of international borders and proactive measures taken by the authorities. As there was evidence that a part of

remittances flows that were previously being received by the formal financial sector was being routed to parallel markets to finance illegal activity, the authorities took steps to crack down such activity, while introducing several incentives to encourage migrant workers to remit funds through banking channels and facilitating remittances through the implementation of digital solutions. The allowance of an additional incentive of Rupees 8 per US\$ remitted through formal channels is purely aimed at recouping the loss of remittance inflows and curbing illegal, parallel market activity. This incentive is expected to be temporary and will be in place until the end of the traditional festive season in April 2022.

10. Merchandise exports recorded its historically highest value in 2021. With the removal of most restrictions, imports have also reached a high level, widening the trade deficit. In addition to the price impact, volumes of both exports and imports have also risen, signaling the normalization of domestic economic activity. Meanwhile, other services exports, including IT/BPO, are estimated to have recorded a healthy expansion during the year. Overall, the external current account deficit is likely to have expanded to around 3.5 percent of GDP in 2021, following the pandemic-induced contraction of the current account deficit to 1.3 percent of GDP in the previous year.

11. The expansion of the current account deficit and sizable debt service payments, along with the absence of regular financial inflows through commercial borrowing, have added pressure on the foreign exchange market. However, the authorities are of the view that these pressures could be used as an opportunity to address Sri Lanka's external sector vulnerabilities in a sustained manner. In this regard, fresh efforts are being made to strengthen non-debt foreign exchange inflows, including a) diversifying merchandise and services exports working closely with partner economies, b) enhancing remittances, particularly through skilled and semi-skilled migration and introducing more convenient digital methods of money transfers, c) attracting investments, including the planned monetization of non-strategic and under-utilized state assets, and d) a fresh measure to build non-borrowed foreign exchange reserves through absorbing a part of export proceeds and workers' remittances from the market, which has already helped the Central Bank to collect around US\$ 700 million in 2021 and thus far in 2022.

12. Our authorities have also announced a program, in the form of an interim Road Map, to secure bridging financing from a number of countries, including swaps with the People's Bank of China, Reserve Bank of India, and Bangladesh Bank (which staff has shown as a part of public debt in the Report) until the aforementioned non-debt inflows materialize. Until the expected inflows materialize, the exchange rate is currently being closely managed with limited Central Bank intervention and support from the banking sector, in order to prevent adverse speculation, and in view of the impact of any sharp movements of the exchange rate on the country's debt profile, inflation and overall economic activity. A gradual reduction in the government's external debt exposure is already observed, and the exposure to the International Sovereign Debt market is expected to decline from

US\$15.05 billion at end 2019 to US\$11.55 billion by end 2022. The authorities reiterate Sri Lanka's commitment to maintaining its impeccable track record of debt servicing.

13. The authorities appreciate the general allocation of SDRs by IMF in August 2021, under which Sri Lanka received SDR 554.8 million. The authorities are also of the view that an earlier disbursement could have been more useful in preventing undue Sovereign rating downgrades observed across the globe since the onset of the pandemic.

Inflation, Monetary Policy and the Financial Sector

14. Our authorities acknowledge that the recent rise in inflation, driven mainly by food inflation (latest at 25 percent), rising petroleum prices, and supply chain disruptions, remains a major concern. While the progressive reform to liberalize price determination of hitherto administratively determined prices of several essential goods as well as the pickup in economic activity have also contributed to recent inflationary pressures, the government has taken measures to mitigate the impact of rising cost of living on the general public, while the Central Bank has tightened monetary policy since August 2021 to dampen demand driven pressures on inflation.

15. Having assisted the government, the private sector businesses and individuals, and the financial sector to overcome the unprecedented challenges posed by the pandemic, the Central Bank has commenced to unwind monetary accommodation without derailing the process of economic recovery. Policy rates were increased in August 2021, interbank market rates were allowed to increase to the upper bound of the policy interest rate corridor, liquidity in the domestic money market was allowed to move into negative territory, maximum ceilings imposed on auctions for Government securities were removed, and market interest rates were allowed to adjust upwards in response to the tightened monetary policy stance and liquidity conditions. Although inflation is still mostly supply driven, policy rates were again increased in January 2022 to prevent any destabilization of inflation expectations within the flexible inflation targeting monetary policy framework, which envisages inflation in a target range of 4-6 percent over the medium term. Monetary policy measures already adopted will also help ease pressures in the external sector. The Central Bank remains committed to ensuring an early return of inflation to the target range.

16. As observed in the staff report, the financial sector remains resilient in the face of the COVID-19 pandemic. Support to the tourism sector and other related sectors including transportation, which has been in place since the Easter Sunday attacks, as well as moratoria provided to other sectors, are announced to be phased out. Our authorities are committed to strengthening the regulatory, supervisory, and resolution framework, and developing necessary frameworks to ensuring the success of the international financial center planned in the Colombo Port City. Steps are being taken to fast-track the consolidation master plan for non-bank financial institutions, which would strengthen the overall financial sector further. Sri Lanka was removed from the FATF gray list in October 2019, and the AML/CFT related

legal, supervisory and regulatory frameworks are being continually strengthened in line with global standards. The introduction of improved reporting and analysis systems, strengthening of the legal framework for operationalizing the beneficial ownership registry, and the planned amendments to the Financial Transactions Reporting Act, the Prevention of Money Laundering Act, and the Suppression of Terrorist Financing Act, which are expected to be enacted this year, are important steps in this regard.

Technical Assistance and Capacity Building

17. Our authorities wish to thank IMF and development partners for the support extended to Sri Lanka in terms of technical assistance and capacity building, particularly in the areas of macro statistics, macro modelling, fiscal, financial, and monetary policy analyses and operations.

Concluding Remarks

18. The Sri Lankan economy is going through one of the most difficult episodes in its history, and our authorities are confident that Sri Lanka will rebound, as it has done in the past, as the pandemic effects subside, aided by policies that are being put in place to strengthen its resilience and uplift the lives of its people on a sustainable basis.

19. We request the Fund to support the authorities' efforts looking beyond standard prescriptions for emerging market economies, recommendations that may not be in line with the socio-economic traditions and expectations of economies like Sri Lanka.